Adapting to Low Risk Premiums

Stockholm (HedgeNordic) – The hunger for yield is growing, as yields and risk premiums are going down across the board. We are reaching what were once conceived as unthinkable levels while dealing with a pandemic from which the dire economic consequences are still to be fully seen. “This is also evident within our investment universe, in the mortgage bond market, where risk premiums – observable in the form of the yield pick-up compared to government bonds – are either close to or below their historic lows,” says Carsten Bach *(pictured left)*, CIO at Copenhagen-based CABA Capital.

During the summer of 2017, Carsten Bach, Niels-Ulrik Mousten, and Mette Østerbye Vejen launched the fixed-income hedge fund **CABA Hedge** to harvest structural risk premiums from AAA-rated Scandinavian mortgage bonds. As the intensifying hunger for yield and the resulting increase in demand for positive-yielding AAA-rated mortgage bonds have made the passive harvesting of risk premia in this space less rewarding, the team opted for narrowing their long-term return objective and becoming more active to spot and capitalize on more alpha-generating opportunities.

“Since the great financial crisis, most asset classes have performed extraordinary well, both due to the positive development in the global economy and the extremely easy monetary policies, including interest rates around the lower bound and years of quantitative easing,” says Bach. “With the current starting point of high asset valuations in combination with low interest rates, it is hard to see a repeat of this outstanding performance during the coming decade,” he continues. “Therefore, in our view, investors must adapt their investment strategies to take this into account, either by choosing between lowering their return expectations, scaling up their risk levels, or adapting into more active investment strategies.”

> *“Investors must adapt their investment strategies to take this into account, either by choosing between lowering their return expectations, scaling up their risk levels, or adapting into more active investment strategies.”*

“We have chosen a combination for CABA Hedge, as we have both reduced our return target from 8 percent to 5-6 percent per annum over a five-year horizon and adapted into a more active investment strategy,” points out Bach. The lowering of the return target band enables the CABA team to continue to run the fund with the same level of risk, limit the magnitude and frequency of drawdowns and keep delivering similarly-low correlations to other asset classes.

The active investment approach, on the other hand, enables CABA to “mitigate the return impact from the low risk premiums,” according to Bach “We believe this adaptation to the low risk premiums will allow us to continue delivering attractive returns, both risk-adjusted and in absolute terms, to our investors,” he emphasizes. Despite lowering the long-term return objective, the investment team comprised of Carsten Bach and Chris Nygaard Sørensen *(pictured right)* has been able to deliver 12 percent year-to-date through the end of November.

Being More Active Has Become Less Costly

Chief Product Manager Kristian Myrup Pedersen describes CABA Hedge as “a fixed-income hedge fund specializing in AAA-rated Scandinavian mortgage bonds with a dual strategy of harvesting structural risk premiums and utilizing alpha-opportunities from deep local knowledge about the

Scandinavian bond markets."

Chief Product Manager Kristian Myrup Pedersen

The more flexible and active approach to investing has allowed the CABA team to "add significant value to investors by scaling the risk level up and down over time, depending on the market opportunity set," points out Pedersen. "While the bond risk premiums correlate with other asset classes, the dynamic risk-taking in the fund, including short positions, has demonstrated our team's ability to generate low correlations to other asset classes."

According to Pedersen, the lower risk premiums represent a challenge for both long-only investors seeking beta within the Scandinavian mortgage bond market and hedge fund managers alike. "As risk premiums have declined, the expected return from our beta strategy, which involves being long mortgage bonds and short government bonds, has declined too," asserts Pedersen. CABA Hedge, after all, is designed to capture risk premiums in the mortgage bond market, primarily stemming from spread risk and prepayment risk, on a duration-neutral basis.

"While the bond risk premiums correlate with other asset classes, the dynamic risk-taking in the fund, including short positions, has demonstrated our team's ability to generate low correlations to other asset classes."

Whereas bond risk premiums appear low on an absolute basis and in comparison with other asset classes, they are attractive on a risk-adjusted basis, according to Pedersen. The Danish mortgage market, at the end of the day, is considered one of the safest in the world, which enables investors to employ some leverage to enhance returns without adding too much risk. "By applying leverage, the bond risk premiums across Nordic mortgage markets become attractive on an absolute basis as well," points out Pedersen. Nonetheless, the lower risk premiums driven by the understandable hunt for yield in recent years represents "a challenge for us, as the performance tailwind consequently has been reduced."

"As risk premiums have come down, other opportunities arise," says Pedersen. More importantly, "it has become somewhat easier to benefit from dynamic risk-taking through both long and short positions," he emphasizes. "The reason is that the price in terms of lost carry from being out of the market and the price in terms of negative carry from being short mortgage bonds have come down too," he continues. Therefore, it has become less costly for CABA Hedge to employ the dynamic and active approach to investing. "While we would have preferred to have high risk premiums, the low risk premiums are actually allowing us to be more active in our dynamic risk taking, and by doing so, we have been able to mitigate the negative effect on the beta strategy."

"While we would have preferred to have high risk premiums, the low risk premiums are actually allowing us to be more active in our dynamic risk taking, and by doing so, we have been able to mitigate the negative effect on the beta strategy."

The active approach has enabled CABA Hedge to perform well and limit drawdowns. Pedersen provides an example of an active move by the CABA team. "In the summer of 2019, just before interest rates collapsed and prepayments skyrocketed, we reduced our callable mortgage bond exposure to zero, by doing so, we avoided getting hit by prepayments, and we had dry powder to benefit from the subsequent market opportunities." A more recent move was undertaken during the coronavirus-triggered market volatility and turmoil. "During the Corona crisis in the spring of 2020, we went short callable mortgage bonds, profiting from the broad-based market sell-off. In this case, too, we subsequently benefitted from our dry powder," concludes Pedersen.

This article featured in HedgeNordic's report Alternative Fixed Income Strategies.