

Formuepleje's 2020 Performance Turnaround



Stockholm (HedgeNordic) - Formuepleje's Fokus fund is up by 7.11% for the year to November 11th, after a drawdown in the first quarter. In contrast, its benchmark had a larger drawdown and a shallower recovery - it is only up 0.23% for the year to the same date.

The benchmark is the Nordea mortgages index applying the leverage of around four times. The Formuepleje Fokus strategy has not varied its leverage over 2020. Active management explains the outperformance.

Dynamic Duration Management

"In early 2020, spreads on Danish mortgages had tightened, partly due to foreign inflows, which now make up 30% of the market. We therefore decided to go underweight of duration and we underperformed the benchmark in January and February. The benchmark has duration of around 2.5 years, and we went to 2 years. After applying leverage, the figures are 10 years for the benchmark and 10 years for Formuepleje Fokus", says portfolio manager, René Rømer (*pictured*). This substantially explains why Formuepleje Fokus had a smaller performance drawdown than the index in March.

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“When the Corona crisis hit, it was a liquidity event that blew out all kinds of bond spreads. There were fears about liquidity, but in fact liquidity did not drop as much as in 2008. We wrote to investors that we expected a mortgage market normalization based on market liquidity normalizing. We then decided to increase our duration to 3.5 years, which works out at 17.5 years including the leverage. Central banks took decisive action on liquidity, which helped the market to recover”, he adds.

Callables and Carry

The other important shift was in the mix between bullet bonds, which have a predetermined maturity, and callable bonds, which could be repaid before maturity at the option of the borrower. The callables offer a higher cash yield, because the lender has effectively sold a prepayment option to the borrower. But even after factoring in the option value, Rømer judged that, “in March, the option-adjusted spread on callables was attractive and callables seemed cheap on a relative basis”.

The Danish market is split roughly 50/50 between the two types, and Formuepleje shifted from slightly underweight to significantly overweight of callables. “In March we went from 40% to 70% callable bonds to pick up more carry, which has been the main driver of our outperformance since May. Performance has been nearly linear”.

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The arithmetic of the carry is based on subtracting borrowing costs from the income on the bonds. “Income of around 50 basis points less a borrowing cost of minus 30 generates net income of 80 basis points per turn of leverage. The leverage of four times multiples this up to annualized income of around 4%”, explains Rømer.

Borrowing costs have somewhat increased for two reasons: “In March, the Danish

central bank unusually increased its interest rates, from minus 75 to minus 60, while the ECB stayed on hold. This initially increased our repo rate from around minus 55 to around minus 30 basis points. It has since slipped back to somewhere near minus 35". The repo rate increased a little bit more than the 15 basis point increase in the Danish central bank rate, because liquidity has tightened in the Danish money markets. "Excess reserves on the government account at the Danish central bank have gone from 200 billion to about 166 billion. This reduction raises rates at the short end of the curve. In contrast the ECB has 3,000 billion Euros of excess liquidity", points out Rømer.

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The Fokus strategy is almost entirely in Danish mortgage bonds. It can invest up to 50% in Swedish covered bonds, but has never gone over 5%. It had a little bit of exposure earlier in 2020, but now has none. "Sveriges Riksbank (Sweden's central bank) buying has tightened spreads to the extent that the market is not attractive for our level of leverage", says Rømer.

Outlook for Rates

It is worth noting that although Formuepleje has quite substantial exposure to callables relative to its own history, other managers using more leverage have more exposure to prepayment risk, whereas Formuepleje has more exposure to interest rate risk and forms a macro view on it.

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Formuepleje is confident in emphasizing carry partly because they expect interest rates to remain rangebound. "Our major wager is that rates will stay in a range, as central banks want to keep funding costs down and Europe cannot afford much higher interest rates. Equally, much lower rates could create problems for the banking sector so we cannot see the German Bunds going much below minus 60", says Rømer. Formuepleje's stress tests suggest that the strategy performance would still be positive after a 50 basis point rise or fall in interest rates, but that a 100 basis point move in either direction could cause losses. Rømer reckons that

moves of such a size are very unlikely. “Given the output gap we do not expect an inflation pickup that could require the ECB to raise rates”, he points out.

Choice of Banks’ Mortgage Pools

A marginal driver of returns this year has been Formuepleje’s long standing preference for mortgages from certain banks where there is a pattern of lower prepayments. “Prepayments have been higher on Danske Bank and Jyske Bank bonds, because it is easier to make digital payments, amongst other things. They have been lower on Nykredit, which is a consortium of smaller banks”, says Rømer.

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Søren Astrup

While it is worth researching differences between banks, Formuepleje does not carry out ‘postal code’ analysis of individual mortgages (in the way that some US mortgage managers do) because the bonds are pooled from multiple borrowers. Individual loan to value ratios are not a worry but aggregate loan to value ratios, across a whole pool of mortgages, are monitored, and these have gone down in 2020. “There had been fears that the Covid crisis might reduce real estate prices, but in fact they have increased, partly due to the generous fiscal support Denmark’s government has been providing. Though it may be some while before Denmark’s GDP recovers to pre-Covid levels, we are quite comfortable about credit risk in Danish mortgages after 230 years without a default”, says Managing

Director, Søren Astrup.

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