

# Thriving Amid Liquidity Crunches

Stockholm (HedgeNordic) – In today's unique environment of ultra-low bond yields, fixed income is mostly used by institutional investors in a defensive capacity, for the diversification of risk, for the protection of capital and as a source of liquidity. Sweden's immature, illiquid and occasionally dysfunctional corporate bond market may have proven that fixed income does not always exhibit these defensive properties. During the month of March alone, 35 funds related to the corporate bond market in Sweden closed doors for redemptions amid a liquidity crunch in the country's fixed-income market.

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"The corporate bond market is characterized by extensive periods of low volatility throughout which investors can harvest the underlying carry premium in corporate bonds," says Fredrik Tauson, a founding partner and portfolio manager at Swedish asset manager Nordic Cross Asset Management. "But then you have these periods of interruption with harsh liquidity challenges, as we experienced during the spring and as we saw from time to time a couple of times before," emphasizes Tauson. Aware and wary of these short – but painful – patches of illiquidity, Nordic Cross Asset Management designed an investment strategy that not only limits the impact of liquidity squeezes but also uses them as a source of extra returns.

## Operating in a Dysfunctional Market

"From time to time, the corporate bond market is dysfunctional with large liquidity challenges," Fredrik Tauson tells HedgeNordic. This structural dysfunctionality was obvious during March when intensifying investor worries about the coronavirus pandemic triggered a broad sell-off in corporate bonds. "The most obvious way to go around this liquidity problem is for traditional corporate bond funds to take on less liquidity risk by holding more cash and liquid assets, which may hamper their future returns," asserts Tauson.

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**Nordic Cross Total Return Bond Fund** rests on three main pillars to provide investors exposure to BB and BBB corporate credit while maintaining ample cash on hand for turbulent periods.

"Instead of investing every last penny in holdings hampered by scarce liquidity, we invest only about 60 percent of the fund in direct corporate bond holdings during normal markets," says Tauson. "The rest is cash and liquid holdings," he continues. "To compensate for the low- or non-yielding part of the portfolio, we use derivatives to boost our credit exposure during periods of low volatility."

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“When we enter environments characterized by harsh illiquidity, we activate our opportunistic strategy and use our big cash position to buy attractively-valued bonds,” highlights Tauson. “We combine our portfolio of long-term core holdings that generate the carry with an opportunistic strategy of investing during turbulent periods when we see obvious liquidity premiums in the market,” explains Tauson, who manages Nordic Cross Total Return Bond Fund alongside Emil Nordström and Magnus Nilsson.

## **The Core**

“In the bottom of the fund, we have the core portfolio with solid names, with satisfactory credit quality corresponding to BB to BBB credit ratings,” Tauson tells HedgeNordic. “These are normally cross-over bonds between the high-yield and investment-grade bond segments,” he continues. Cross-over bonds tend to be more liquid than bonds with ratings below the bottom rung of investment grade, Tauson also points out. About half of the core holdings in Nordic Cross Total Return Bond Fund’s portfolio represent investment-grade bonds and the other half consists of high-yield bonds.

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The portfolio of core holdings is designed to serve as the main contributor to the fund’s return over time due to the carry of corporate bonds and the pull-to-par tendency of bond prices to approach par values as the maturity dates approach. This “core” pillar of the fund’s portfolio generates the “hold and earn” carry, the additional yield of corporate bonds on top of the risk-free treasury bond yield. “A portfolio of BB and BBB bonds approximately generates a carry of STIBOR plus 300 basis points,” highlights Tauson. “Looking back at the fund’s history since inception, about three-fourths of the performance comes from the core holdings.”

## **The Derivatives and Opportunistic Leg**

Nordic Cross Total Bond Return Fund also allocates a pre-determined risk budget to call options that provide additional exposure to the BB to BBB credit risk spectrum during calm market environments. In this sub-strategy, the fund’s credit exposure automatically accelerates or slows down depending on underlying volatility. “We get more boost during low volatility, with the exposure being automatically reduced as volatility rises,” says Tauson. “This is totally, fully quantitative and automatically risk budgeted, so it is no decision of ours when to reduce or increase exposure.”

The automatically-adjusting credit exposure through derivatives has low capital utilization, which leaves the team with ample cash to deploy opportunistically in times of turmoil and liquidity crunches. “This toolbox enables us to hold more cash and liquid positions that we can use for opportunistic investment decisions,” explains Tauson. Nordic fixed-income markets occasionally encounter periods of interruption with limited liquidity, similar to the environment experienced in March earlier this year. “We activate our opportunistic strategy in turbulent markets like the one we just had,” says Tauson.

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In times of distress, the team running Nordic Cross Total Bond Return Fund opportunistically buys high-quality corporate bonds trading significantly below par. “We go for corporate bonds with large liquidity premiums,” says Tauson. “The perfect targets are names with strong credit quality, but for

liquidity reasons, trade well below par,” he elaborates. “Relying on three different strategy pillars, we combine a fundamental bottom-up approach with a quantitative approach to maximize risk-adjusted returns and mitigate the most obvious risks in fixed income such as liquidity risk, duration risk and credit risk.”

### **Leverage for Calm Markets**

Nordic Cross Total Bond Return Fund also relies on a limited use of leverage to run its investment strategy, which is quite uncharacteristic for most fixed-income funds. “This is a traditional UCITS IV fund, so we are restricted to those restrictions and regulations just as everybody else in the UCITS territory,” says Tauson. “The strategy helps us to create some additional exposure during periods characterized by low volatility, periods that normally result in rising net asset values thanks to the underlying carry.”

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“But since the exposure automatically decreases as volatility rises, we are actually less exposed to the market compared with traditional corporate bond funds during turbulent periods,” Tauson emphasizes. This became evident during the spring, when Nordic Cross Total Bond Return Fund fell less than its peers. “The purpose of the strategy is to create market exposure during benign periods and to enable a prudent liquidity which we can use opportunistically during market stress.”

### **ESG Integration**

Environmental, social and governance (ESG) has long been a hot topic for equity investors, with the fixed-income arena also observing a rapid expansion in ESG integration practice among fixed-income money managers. “We integrated ESG from the start of the fund more than three years ago,” says Tauson. “We were actually one of the first credit funds that integrated ESG factors in the investment process,” he asserts.

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The Nordic Cross team’s approach to ESG integration involves excluding bonds issued by entities generating revenues from fossil fuels, controversial products such as tobacco, alcohol, military equipment, among others. “We also aim for promoting bonds that are issued by companies that are at the forefront of ESG integration,” says Tauson. “ESG is an evolving theme, so we are constantly looking over our ESG process to find ways we can enhance it.”

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