

Capitalising on Nordic Market Inefficiencies and Volatility

Stockholm (HedgeNordic) – The SEB Eureka strategy launched in January 2018 has delivered a double digit return in 2020, including a positive month in March 2020, with low single digit volatility, and has averaged high single digit returns since inception. This matches the expectations of Copenhagen-based Senior Portfolio Manager and CIO, Bo Michael Andersen, who began preparing the launch in late 2016: “I came from a position in SEB Markets where I saw from first-hand experience how tougher bank regulations were increasing volatility and mis-pricings, particularly in Scandinavian markets, which were already less efficient. We find the opportunities are better in our local markets than in global fixed income markets.”

The investment universe is mainly ‘AAA’ rated government and covered bonds in the Nordic countries of Denmark, Sweden and Norway, but also includes interest rate swaps and cross currency basis. The fact that these countries still have their own currencies adds to the opportunities.

Though Scandinavia does boast some of the largest covered bonds markets in Europe, the strategy is about alpha rather than asset gathering. It was seeded with around DKK 1.1 billion by tier one institutions in Scandinavia, such as pension funds, insurers and foundations. Assets are currently DKK 2.5 billion and nearly half of capacity has been taken, given the soft capacity limit of DKK 5-6 billion.

“We do not automatically trade every two standard deviation outlier. We need to observe why the market has moved. The “why” is as important as the “what”. Then comes the “how” – how we implement it to get exposure, and how it fits into our existing portfolio.”

Eureka needs to stay nimble to rapidly shift exposures as relative valuations and pricings move around. The investment process starts with quantitative screens, but it is a discretionary process that includes qualitative judgement. “We do not automatically trade every two standard deviation outlier. We need to observe why the market has moved. The “why” is as important as the “what”. Then comes the “how” – how we implement it to get exposure, and how it fits into our existing portfolio. We are trying to construct a well-diversified portfolio,” says Andersen. For instance in covered bonds, the Eureka team will form a view on variables such as mortgage bond issuance, curvature, hedging instruments, investor demand, money market fixings and derivative flows, based on their market intelligence and proprietary analytics.

“We avoid directional exposure and correlation to interest rates, credit and equity.”

Eureka has delivered on its target to generate not only absolute returns but also lowly correlated returns. “Our institutional investor base are focused on the diversification benefit and want strong risk adjusted returns. We avoid directional exposure and correlation to interest rates, credit and equity,” says Portfolio manager, Tore Davidsen. In volatile markets, there is no magic formula that will lead a portfolio to deliver these returns, so diversification, active management and rebalancing are required.

Opportunistic Sub-Strategy Allocations

There are three core return drivers: “on average, one third of returns should come from carry and

roll down on covered bonds, one third from active covered bond trading driven by valuation or shifting between Swedish, Danish and Norwegian paper, and one third from the other strategies, including callable Danish mortgage bonds, interest rate swaps and cross currency swaps,” says Andersen.

“On average, one third of returns should come from carry and roll down on covered bonds, one third from active covered bond trading driven by valuation or shifting between Swedish, Danish and Norwegian paper, and one third from the other strategies.”

Eureka is highly opportunistic however, so the strategy and performance attribution mix will vary from year to year – and in fact less than half of the 23.11% returns from inception to January 2021 have come from covered bonds, both active management and passive harvesting risk premia. This reflects the opportunity set and also the investment philosophy.

Some fixed income arbitrage hedge funds make the majority of their returns from leveraged carry trades, that often demonstrate a “short volatility” return profile because they are either explicitly selling options such as mortgage prepayment options, or perhaps implicitly selling options on liquidity or volatility or both. Eureka is sometimes earning a reward for liquidity provision, and can have a meaningful sensitivity towards spread widening, which has so far peaked at 33 basis points of fund NAV per spread basis point. But viewing the overall strategy in big picture terms, Eureka has found that market volatility creates better trading opportunities. For instance, the return in 2020 was more than that in 2018 and 2019 taken together and a positive return was recorded in March 2020.

“We need tail risk hedges mainly when we have more covered bond exposure. We entered 2020 with very low exposure to covered bonds, because they were expensive, and so did not need to spend money on tail risk hedges.”

Yet very little of the performance has come from explicitly owning long volatility portfolio insurance, such as tail risk hedges. One possibly surprising aspect of the performance attribution is that the tail risk hedges overlay contributed positively in 2019 – but registered a zero return in 2020. This is actually quite easy to explain in the context of opportunistic allocations amongst the sub-strategies: “we need tail risk hedges mainly when we have more covered bond exposure. We entered 2020 with very low exposure to covered bonds, because they were expensive, and so did not need to spend money on tail risk hedges,” says Andersen.

Diversification and active trading delivered a positive return in March 2020. Though the covered bond sleeve unsurprisingly lost ground in March 2020, the overall return for the month was a positive 1.2% because the losses on covered bonds were outweighed by profits on the other strategies, including relative value strategies in interest rate derivatives and government bonds.

This illustrates one important feature of portfolio construction: the sub-strategies are themselves lowly correlated. That partly explains why the strategy has undershot its volatility target of 4-8%, which the manager admits might be a bit too high.

The strategy has also been less volatile because it used moderate leverage, which also meant that the manager had dry powder to take advantage of the March 2020 selloff and rebuild covered bond exposures at very attractive levels.

Leverage and Liquidity

In common with strategy and trade selection, leverage is used very opportunistically and varies a lot. Leverage adjusted to ten year bond equivalent has ranged between two times and seven or eight times in gross terms, and net leverage has been much smaller, often near zero.

Leverage is obtained from multiple banks through repos of between two weeks and three months' maturity. "They are not guaranteed but we want to be an attractive client to banks so they are reluctant to pull repos," says Andersen.

"We do not want to be forced to unwind positions in stressed markets."

Leverage is only one angle of multi-layered risk management, which also includes real time monitoring of risks, limits and stress tests. "We do not want to be forced to unwind positions in stressed markets," says portfolio manager, Rasmus Dall-Hansen. Independent risk management and internal audit, both conducted by the SEB Group, add to the controls.

Leverage also influences the dealing costs of the fund, which has a variable bid/offer spread, based on the costs of building or liquidating the portfolio – essentially the bid/offer spreads on the underlying assets. This protects investors from transaction costs of inflows and outflows, and clearly does not generate any profit for the manager. "The bid/offer spread on underlying instruments is typically 1 or 2 basis points, which multiplies up to 50 or 80 basis points at the fund level after applying leverage".

"We are confident about the liquidity of the markets traded – even under Lehman, the Danish market stayed open, and spreads didn't widen that much in March 2020."

Some areas of the Nordic fixed income markets have occasionally experienced liquidity and valuation issues, most recently in March 2020 when some funds had to briefly suspend dealing. Andersen does not expect this is likely to happen in his markets: "we are confident about the liquidity of the markets traded – even under Lehman, the Danish market stayed open, and spreads didn't widen that much in March 2020," says Andersen. The Luxembourg RAIF structure fund offers monthly liquidity and publishes daily NAVs.

This article featured in HedgeNordic's 2021 "Nordic Hedge Fund Industry Report."