Finding Relative Value in Rates

Stockholm (HedgeNordic) – The Nordic hedge fund industry has long been known for housing a solid group of fixed-income hedge funds. Seven of the nine nominees in the “Fixed Income” category at the 2020 EuroHedge Awards, which recognizes the best players in the European hedge fund sector, were Nordic hedge funds. Two young relative-value hedge funds – **Nordic Rates Opportunity Fund II** and **European Rates Opportunity Fund** – run by Nordea Asset Management’s Copenhagen-based Fixed Income and Covered Bonds team were two of the nominees.

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“In 2017, we launched our Nordic Rates Opportunity Fund simply because there was significant demand among our clients for non-directional products driven by the low-yield environment,” Martin Hagelskjær Nielsen *(pictured left)*, the Head of Danish Fixed Income and Euro Covered Bonds at Nordea Asset Management, tells HedgeNordic. “Investors preferred to invest in products that were not directly exposed to what happened to interest rates, as you typically see in a long-only product,” he elaborates. “They were looking for attractive alpha opportunities in fixed-income alternatives.”

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Nordic Rates Opportunity Fund was first launched in 2017 as a closed fund for pension fund clients, with its open-ended version open for a broader investor audience – Nordic Rates Opportunity Fund II – launching in late 2019. “In June 2019, we also launched the European Rates Opportunity Fund, which focuses on the European market,” says Nielsen, who heads a team of five portfolio managers and five analysts out of Copenhagen. “We have these two fixed-income hedge funds being active in the whole investment universe we cover as an investment boutique.”

Another Relative-Value Player

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“What characterizes our investment approach is that we focus on the rates space,” Nielsen starts explaining the strategy employed by the two Nordea funds. “We seek to avoid credit risk, so we predominantly invest in government bonds, covered bonds, SSAs [sovereign, supranational and agency (SSA) papers],” he elaborates. “We try very much to avoid directional exposure as much as possible. We focus on finding the best possible relative-value exposures,” says Nielsen. “In order to enhance expected, return we use leverage and extensive use of derivatives. This allows us to focus our investment exposures and allocate risk targeting the most attractive fixed income segments.”

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“We believe we have a superior access to information on what is happening in the whole European fixed-income space given that we are one of the largest asset managers in this area,” says Nielsen, who heads the Danish Fixed Income & Euro Covered Bond Team that oversees more than €45 billion across various products. “This means we have a clear understanding of how to price risk premiums in all these different countries and currencies," he adds. "We have in-house tools allowing us to compare the risk premium we get in a German Pfandbrief compared to a French covered bond, for instance, and down to the smallest Spanish and Italian covered bond issuers. At the same time, we factorize all risk exposures and measure in our risk tool how the different exposures interact when creating the final portfolio."

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"We are one of the few players covering the whole European market, from the large issues of government-guaranteed and government bonds down to the smallest covered bond issuers," considers Nielsen. The focus on the entire European rates market provides an ample pool of relative-value opportunities for Nordea's fixed-income hedge funds. "A quick screen of the whole European market and the local Nordic markets provides a great number of opportunities to find pricing differences," says Nielsen.

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Whereas some sets of opportunities may be dwindling due to central bank action, other opportunities are popping up instead. "It is fair to say that the opportunities in the Swedish market are not the same as they used to be, as the Swedish central bank has been active buying covered bonds in their own QE program. That limits some of the opportunities," says Nielsen. "But then we see other opportunities coming up. In Europe, we have significant Government supply, while the issuance of new EUR covered bond debt is rather limited. We have seen more opportunities in the Norwegian market and we are also seeing that the Danish callable market is suffering a little, which could also be an opportunity," he continues. "As a relative-value investor, we continue to see opportunities popping up."

Comparison

Both Nordic Rates Opportunity Fund II and European Rates Opportunity Fund focus on relative-value opportunities. The Nordic-focused fund has had a higher "covered bonds" exposure compared to the European fund. "Nordic covered bonds are among the largest and most liquid covered bond markets in Europe and will typically be an important building block in the Nordic Rates Opportunity Fund," says Nielsen. "At the same time, Nordic covered bonds are supported by a well-functioning repo market creating an important source of funding for hedge funds."

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"In the Danish callable market, for instance, you have 2,000 different ISIN codes and a lot of complexity, as well as embedded options in callable bonds. The callable market in itself is a fantastic source of complexity for hedge funds, for those players who really understand the market," argues Nielsen. Nordea's European Rates Fund, meanwhile, "is typically more balanced between Government and SSA risk relative to covered bond risk," according to Nielsen. "We see it as an investment in the best possible relative-value opportunities we can find in the European investment universe."

“We see it [Nordea European Rates Opportunity Fund] as an investment in the best possible relative-value opportunities we can find in the European investment universe.”

And European Rates Opportunity Fund has managed to capitalize on many such opportunities since launching in mid-2019, with the fund delivering a cumulative return of 19.6 percent since inception, corresponding to an annualized return of 9.8 percent. “The European Rates Opportunity Fund has really shined since it was launched, being among the best Nordic fixed-income funds and exceeding its target return of five percent above the risk-free rate,” Nielsen tells HedgeNordic. “But we must acknowledge that the fund has a much shorter track record than the Nordic-focused fund.”

The other fund, Nordic Rates Opportunity Fund II, “has delivered according to its expected return target,” says Nielsen. The younger version of the fund has gained a cumulative 7.2 percent since launching in December 2019 after gaining 7.5 percent last year following a 2.7 percent-loss in March. “I am quite happy with the performance of the Nordic Rates Opportunity Fund, we are lagging behind some of the best performing peers, but we are also significantly ahead of the underperformers,” highlights Nielsen. “We are in the upper quartile. We are glad to have been able to minimize the drawdown last year.”