

Inflation, Return Target and Drivers



Stockholm (HedgeNordic) - **Catella Hedgefond** was developed 17 years ago to serve as an alternative to fixed-income investments, targeting an average annual return in the range of 3-5 percent. Catella Fonder's flagship hedge fund, which mainly invests in Nordic equities and bonds to deliver stable returns at low risk, has generated an annualized return of 4.0 percent since launching in early 2004 despite a lower annualized return of about 1.0 percent over the past five years. But can the return target be maintained going forward in a low-return environment?

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"The return can be maintained, but then you are forced to take a completely different risk," says Stefan Wigstrand, Catella Hedgefond's fixed-income portfolio manager. "It would have been convenient if you could achieve that return in the risk-free alternative," he continues. Catella Hedgefond has invested heavily in high-yield bonds to compensate for the lower-yielding bond portfolio. "If you have such a broad portfolio as we have, you can take that type of risk," says Wigstrand. "The total portfolio may give a return of around 4 percent, which is high."

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has been historically.”

With stock valuations at record highs, the expected return potential from public equity investments does not look great either. “From a long-term perspective, it is a relatively bad point to enter,” says Anders Wennberg, the fund’s equity-focused portfolio manager. “The expected return on the stock market will be lower in the future than it has been historically.” The team running Catella Hedgefond has opted to build a more concentrated stock portfolio to improve its return potential. The hedge fund, which manages SEK 2.6 billion in assets, has reduced the number of holdings in the equity portfolio from more than 100 positions to less than 50.

Inflation Talk

With actual inflation and inflation expectations on the rise, high-yield bonds are seen as more insulated from rising inflation than other fixed-income securities. Assuming higher inflation is driven by strengthening economic conditions, Wennberg believes that “better finances help cash flows for companies that have borrowed in the credit market.” According to the manager, “even if the long-term interest rates continue to rise, it does not necessarily mean that the spreads will widen as long as the companies’ finances improve.”

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Wennberg argues that the recent rise in inflation will continue for longer, whereas Wigstrand believes the rise is temporary. “There are good arguments that inflation is on the rise, something that central banks have wanted to see for a long time,” says Wigstrand. “The question is how lasting it will be,” he ponders. “I am more skeptical” that inflation will continue to rise. “If you look at other disasters, such as 1918 with the Spanish flu, it did not give any long-lasting inflation but only temporary price increases.”

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Wennberg, on the other hand, argues that the recent rise in actual inflation will

be more lasting. "We have a huge amount of newly printed money from central banks globally that has gone out to consumers via budget deficits and via checks, and there is a pent-up consumption need among consumers," argues Wennberg. "Since then, we have seen wage increases begin to pick up in the U.S.," he adds. "I think the jury is out whether it is sustainable or not."