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HEDGENORDIC

SPECIAL REPORT
ALTERNATIVE FIXED INCOME

SPECIAL REPORT: ALTERNATIVE FIXED INCOME

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INTRODUCTION

HedgeNordic is the leading media covering the Nordic alternative investment and hedge fund universe. The website brings daily news, research, analysis and background that is relevant to Nordic hedge fund professionals from the sell and buy side from all tiers.

HedgeNordic publishes monthly, quarterly and annual reports on recent developments in her core market as well as special, indepth reports on "hot topics".

HedgeNordic also calculates and publishes the Nordic Hedge Index (NHX) and is host to the Nordic Hedge Award and organizes round tables and seminars.

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Editor´s Note ...

The Strong Run Continues ...

The term alternative fixed income can carry a variety of meanings, with interpretations differing among market participants. The definition often depends on an individual's or firm's perspective and experience. For some, it includes hedge fund strategies that employ dynamic, non-traditional approaches to fixed-income markets. Others associate it with private credit, which involves lending directly to businesses and projects outside traditional banking channels, as well as structured credit products or esoteric debt instruments. Still, others may include various strategies or instruments that are not rooted in fixed income but exhibit similar risk-return characteristics, complementing or even superseding traditional fixed-income investments.

Unlike traditional fixed income – dominated by government and corporate bonds – alternative fixed income spans a spectrum of opportunities offering unique return and risk profiles. Many investors view this space as a way to go beyond traditional investments in public markets, tapping into private lending, structured opportunities, or specialized strategies designed to deliver alpha.

As markets evolve, the importance of alternative fixed income is only expected to grow. Investors are recognizing that this space is not a replacement for traditional fixed income but a complement, offering solutions tailored to today's challenges. The growing demand for uncorrelated returns, inflation protection, and enhanced yield will undoubtedly shape the future of this dynamic and diverse sector.

The breadth of the alternative fixed-income universe is both its strength and its complexity. It spans investments with varying liquidity profiles, risk levels, and return drivers. This diversity means that different investors adopt different definitions depending on their objectives and constraints. HedgeNordic's publication on "Alternative Fixed Income" aims to explore this diverse and dynamic space, featuring insights from allocators and asset managers alike. Whether you're an allocator, a fund manager, or an industry professional, we hope this edition provides a comprehensive understanding of the opportunities and complexities of alternative fixed income.

Highlighting some of the content, the Nordic team at Aegon Asset Management share their definition of alternative fixed income and their wide range of strategies in "Harnessing (Solvency II) Expertise and Scale in Alternative Fixed Income." Anders Persson, CIO and Head of Global Fixed Income at Nuveen, explores alternative credit sub-asset classes in "Investing for Resiliency with Alternative Credit." Marie Lindskog, Head of Alternative Investments at Afa Försäkring, highlights that Private Credit is "A Natural Part of Our Portfolio," discussing the role of private credit in a portfolio and the importance of manager selection.

In the high-yield segment of the fixed-income universe, Christoffer Malmström and Måns Levin, co-founders of Swedish fund boutique Ridge Capital, assert that "Active and Opportunistic Beats the Monkey in High-Yield." Meanwhile, in "High Yield: Resilience Amid a Shifting Backdrop," Scott Roth and Chris Sawyer from Barings highlight that high yield remains well-positioned within a macroeconomic environment that presents both opportunities and challenges. Additionally, the team at Norwegian asset manager Sissener AS is "Breaking Free from UCITS Constraints" with the launch of a new credit fund designed to capitalize on the flexibility offered by the RAIF structure.

Thor Abrahamsen, Senior Investment Executive at Norwegian maritime insurer Gard, presents "Gard's Playbook for Short-Duration Fixed-Income Investing," offering insights into corporate credit, high-yield bonds, and private credit. Eric Larsson, Managing Director, Co-Head, and Portfolio Manager at Alcentra – a Franklin Templeton manager – delves deeper into private credit markets by discussing "Opportunities Amid Complexity in European Special Situations."

In "Unlocking Opportunities in the Central Bank Cutting Cycle," Kristian Myrup Pedersen, Quant Director at Danish fund boutique CABA Capital, introduces CABA's Flex strategy which invests in Scandinavian AAA-rated covered bonds by isolating the spread premium and enhancing expected returns through the strategic use of leverage. Expanding the Nordic perspective, Halldór Grétarsson and Hjörleifur Waagfjörð from Arion Bank discuss alternative fixed income as "A Growing Asset Class for Icelandic Investors," highlighting the increasing relevance of this asset class in Iceland.

We hope this publication sparks insightful discussions and provides readers with the tools and knowledge to capitalize on the opportunities within the evolving alternative fixed-income universe.

Kamran Ghalitschi

PUBLISHER, HEDGENORDIC

Harnessing (Solvency II) Expertise and Scale in Alternative Fixed Income

By Eugeniu Guzun – HedgeNordic

"Alternative fixed income represents a segment of the fixed-income market that investors cannot access directly – an area where managers like us originate, secure, or guarantee loans that are packaged into various solutions."

Frank van den Berk

The finance industry is filled with terms that lack universally agreed definitions, and "alternative fixed income" is one such term. What does this term actually mean, and what falls under its scope? For Aegon Asset Management, which oversees an €80 billion alternative fixed-income platform that includes a lot, but also strategies tailored to Solvency II regulations, the definition is just one part of the conversation.

"Alternative fixed income represents a segment of the fixed-income market that investors cannot access directly – an area where managers like us to originate, secure, or guarantee loans that are packaged into various solutions," explains Frank van den Berk, Head of Marketing Continental Europe at Aegon Asset Management. "Dogmatically, what exactly falls under this term?" asks Frank Drukker, Executive Director of Institutional Business Development at Aegon Asset Management. "Our perspective on the alternative fixed income universe is more comprehensive, encompassing both liquid

Frank van den Berk, Peter Slob, Richa Bazgain, Frank Drukker, Jeroen van Wilgenburg – Nordic team at Aegon Asset Management

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> "Being part of a global insurance group like Aegon, which operates under the Solvency II framework, means many of the strategies we manage are designed with this angle, with what we call a Solvency II tweak."
>
> Peter Slob

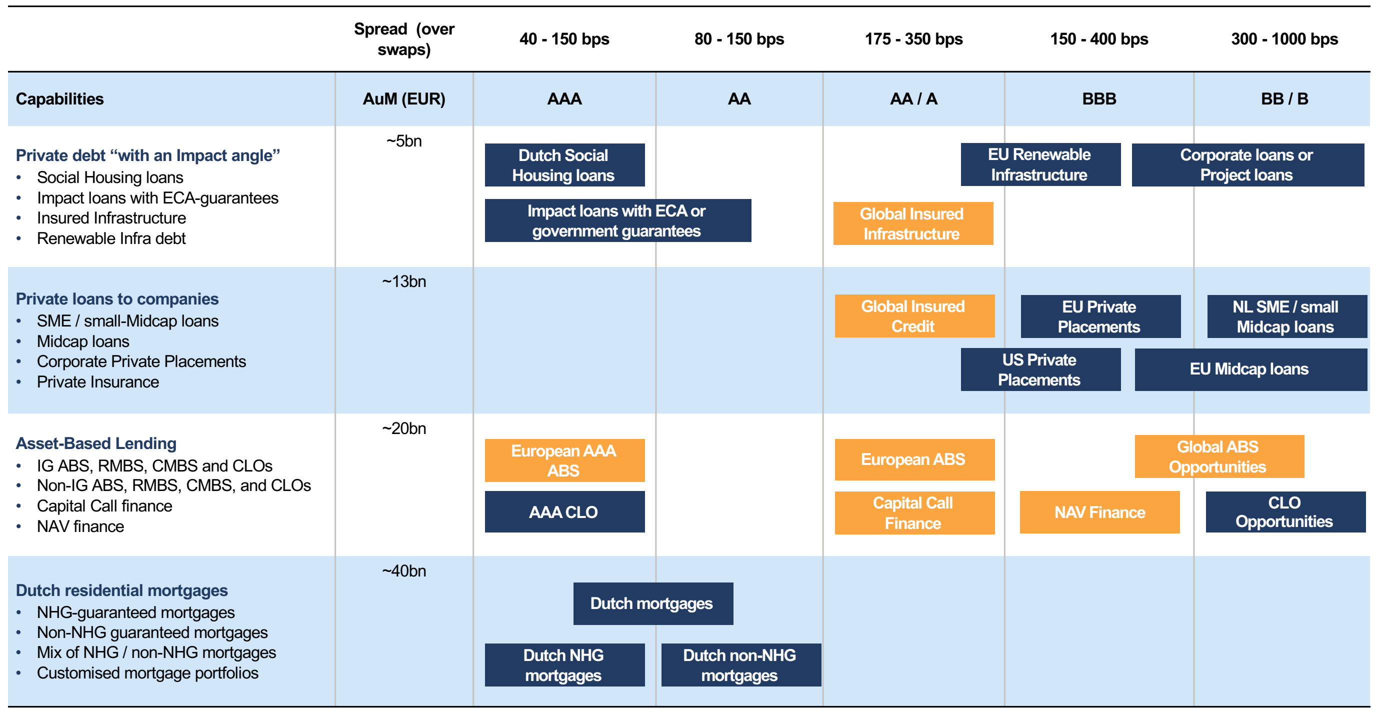
and illiquid components, rated and unrated securities, spread-generating products, yield-generating products, IG and sub-investment grade instruments, and more," Drukker elaborates. "There are so many different dimensions to alternative fixed income."

As the asset management arm of originally Dutch insurer Aegon, Aegon Asset Management offers a wide range of alternative fixed-income strategies tailored to comply with the Solvency II regime, which is particularly relevant for insurance and reinsurance companies operating in Europe. "Being part of a global insurance group like Aegon, which operates under the Solvency II framework, means many of the strategies we manage are designed with this angle, with what we call a Solvency II tweak," explains Peter Slob, who also focuses on Institutional Business Development in the Nordics at Aegon Asset Management. "Both external investors and our insurance group rely on the majority of our alternative fixed-income strategies, always ensuring an alignment of interests with our investors, this since "we" invest in every each of the strategies before bringing it to the market, ourselves."

DIFFERENT FLAVORS OF ALTERNATIVE FIXED INCOME

Aegon Asset Management's alternative fixed-income platform manages over €80 billion across a wide range of strategies led by approximately 60 portfolio managers worldwide. The platform is structured into four broad categories: private debt, private loans, asset-based lending, and Dutch residential mortgages. Within these categories, the team offers a variety of sub-strategies, each with distinct objectives and risk-return profiles. Examples include Collateralized Loan Obligations (CLOs) or Capital Call financing within asset-based lending, Insured Credit under the "private loans" category, or Insured Infrastructure investments with an impact focus under "private debt."

Drukker highlights that the "risk-return" perspective differs significantly for firms operating under Solvency II regulations compared to other players such as a family office. "A company subject to Solvency II or a bank evaluates the risk-return profile very differently than a family office, particularly after



factoring in cost of capital calculations using the Solvency Capital Requirement (SCR)," he explains. Insurers prioritize fixed-income investments that offer the best risk-adjusted returns relative to their SCR impact. For example, an insured credit strategy offering a spread of 250 basis points may appeal less to a family office compared to a global ABS (Asset-Backed Securities) opportunities strategy, which could deliver an absolute return yield in the low teens. "The high capital charges under Solvency II make ABS strategies less attractive, as the potential returns are outweighed by the regulatory costs," Drukker notes.

"ABS is heavily penalized for insurance companies under the Solvency II framework due to the high capital charges, which can reach up to 38 percent under the standard formula," explains Drukker. "This makes it nearly impossible for insurers to generate a return on capital within their regulatory constraints," he adds. In contrast, an insured credit product structured around providing a loan to a sub-investment grade issuer – such as a B or BB-rated loan – can be transformed into an AA or A-rated loan using a 100 percent unconditional insurance guarantee. This enhanced credit profile, combined with a spread of 250 basis points and full insurance coverage, makes such products far more attractive to insurance companies seeking capital-efficient investments.

Another compelling and timely segment within the alternative fixed-income space is fund finance, encompassing both Capital Call Financing and NAV Financing. These tailored financing solutions are designed for investment funds, such as private equity and private debt funds, among others, to help manage cash flows, optimize returns, and address liquidity needs. Drukker and Slob note a growing interest in these strategies: "We are observing increasing momentum in this area of the market, and as a result, we are having numerous discussions with large institutional investors. Part of the appeal lies in the potential spread pickup, which is driven by what we term a 'novelty premium.'"

Frank van den Berk highlights that Aegon's team is actively working to introduce innovative alternative fixed-income strategies into the Nordic region, drawing on solutions already established in the portfolios of Continental European investors. "By examining market trends and developments, we are bringing strategies to the Nordics that have proven successful elsewhere in Europe but have yet to gain traction here," says van den Berk. "Nordic investors are eager to understand why their counterparts across Europe are incorporating these strategies into their portfolios."

LEVERAGING SCALE AND EXPERTISE

In the alternative fixed-income space, size plays a critical role in how managers source, structure, and manage investments. Whether dealing with private credit, asset-backed securities (ABS), infrastructure debt, or other non-traditional fixed-income assets, the scale of an organization can significantly impact its ability to access deals, negotiate favorable terms, and realize efficiencies. As Peter Slob explains, "Being consistently active in the market is key." Taking ABS solutions as an example, Slob says that "all brokers and ABS houses know how to reach us and understand that we are always present and engaged."

As an €80 billion alternative fixed-income platform, Aegon's fixed-income team enjoys two key advantages over its peers in this space. "A crucial advantage is alignment of interest. All of the strategies we develop, we do so not only for third-party investors but also for ourselves, for our insurance group Aegon," explains Frank Drukker. A prime example is the Dutch subordinated SME structure. The first vintage was exclusively funded by capital from Aegon's own general accounts. Vintages 2 and 3, however, are open to third-party investors. "We test these strategies first, ensuring they work and making adjustments, if necessary, before introducing them to the market," says Drukker. "This is a true alignment of interest. When the product performs well, it benefits both us and our clients. That's the way we operate, and we feel very comfortable with this approach."

> "The other key advantage is that we are a powerhouse in the alternative fixed-income space."
>
> Frank Drukker

"The other key advantage is that we are a powerhouse in the alternative fixed-income space," Drukker continues. "We possess deep expertise in the Solvency II treatment, and we know exactly how it works." This strength extends beyond the fixed-income sector, as Aegon's alternative fixed-income platform is just one part of the broader organization. "Ultimately, this platform is integrated into a much larger institution," he emphasizes. "We have 21 people in our global ESG team, who are also available to support our fixed-income platform. Additionally, there's a much larger team working behind the scenes – on the research, structuring, and legal sides – along with other key partners who are essential in developing new, client-focused products."

Aegon Asset Management's Nordic team has focused on the Nordics for a long time now and will continue to actively engage with partners to identify and deliver alternative fixed-income solutions that fit their portfolios.

Investing for Resiliency with Alternative Credit

By Anders Persson - Nuveen

> "Investors should fortify portfolios via broader diversification; alternative credit asset classes in particular can provide much-needed ballast to a traditional portfolio."

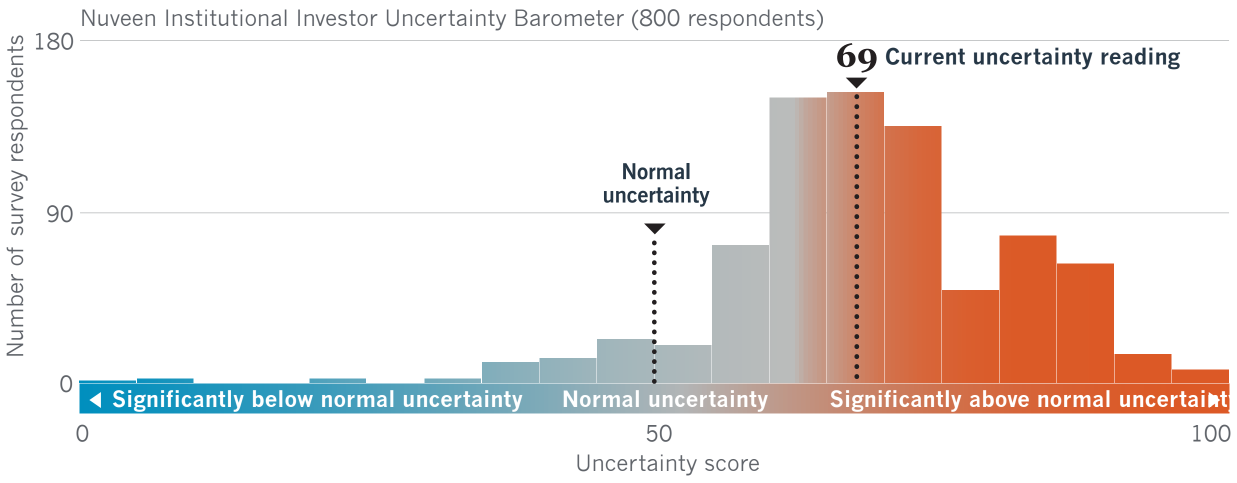
Investors have become increasingly uncertain of the investment landscape given the various economic and geopolitical factors which remain in flux. According to the Nuveen Institutional Investor Uncertainty Barometer, investors feel we are in a period of elevated macroeconomic and geopolitical uncertainty with 93% receiving an Uncertainty Score above the normal level of 50 (Figure 1).

Economic and geopolitical certainty seems a long way off in the current environment, and uncertainty is rarely good for investors. In such volatile conditions, it is important to diversify portfolios for the long term, identifying asset classes which offer resilience in strained market conditions. In the following sections, we explore how different alternative credit asset classes can provide this resilience for investors.

A GREATER EMPHASIS ON QUALITY

Concerns of a full-blown recession have subsided somewhat, though the higher rate environment will mean that any economic slowdown will be more painful for investors, placing a greater emphasis on quality. The current environment continues to put a

Figure 1: Higher-than-normal uncertainty weighs on investors



Source: 2024 Nuveen EQuilibrium Survey. Uncertainty Barometer calculated by taking the mean of all 800 survey participants' Uncertainty Scores. Uncertainty Scores are an average of the answers to four survey questions weighted according to a Principal Components Factor Analysis. To learn more, visit nuveen.com/equilibrium

strain on duration positioning, with this acceptance of higher interest rates making it challenging to generate returns simply by lengthening duration.

This is where investors may find more success in entering the credit market, though selectivity is crucial. Complicating matters further is the continued geopolitical instability in different regions. The Middle East has been at the forefront of this in the first half of 2024, as Israel's conflict with Palestine and Iran has threatened to unravel further. Elsewhere, Russia's invasion of Ukraine continues to weigh heavily on Europe.

ADVANTAGES OF ALTERNATIVE CREDIT

Given these higher levels of interest rate and geopolitical uncertainty, traditional portfolios of equities and (mostly government related) fixed income may be too exposed external risks. Indeed, we have seen this trend materialise in the form of the erratic movements in fixed income and equity indexes so far this year. Instead, we think investors should fortify portfolios via broader diversification; alternative credit asset classes in particular can provide much-needed ballast to a traditional portfolio. In a high-rate environment, asset classes such as direct lending and private fixed income can actually benefit from heightened rates.

Meanwhile, uncertainty created by geopolitical events can be capitalised on through asset classes such as energy infrastructure debt and Commercial Property Assessed Clean Energy (C-PACE) loans, which unlock opportunities that tap into the increasing importance of the energy transition and environmentally friendly construction as long-term trends.

ALTERNATIVE CREDIT STRATEGIES IN FOCUS

- **DIRECT LENDING:** Loans of all types have benefited from the rising rate environment, and with interest rates remaining higher for longer, the asset class remains an attractive one for investors. Moderate and periodical cuts from central banks will likely help boost borrower activity, and alternative lenders should continue to benefit from opportunities as regulations for traditional lenders continue to tighten, creating a supply and demand imbalance.

- **ENERGY INFRASTRUCTURE CREDIT (EIC):** EIC is successfully tapping into long-term drivers, setting the asset class up as a well-positioned allocation capable of weathering multiple market conditions. Significant need for power, driven by increasing computing and data processing and power intense manufacturing, coupled with the push to decarbonise many industries, means demand for infrastructure to meet these needs is set to increase substantially over the long term.

- **REAL ESTATE DEBT:** The market correction following spikes in interest rates seems to be past its peak. While rates will remain higher for longer – which is good news from a debt perspective, the fundamentals of real estate remain strong. We believe the asset class is entering a new vintage, with real estate debt investors benefitting from higher interest rates and better spreads.

The following sector insights do not showcase all of Nuveen's capabilities in alternative credit, nor all our expectations for the asset class. To learn more about the alternative credit services available, reach out to your Nuveen representative.

DIRECT LENDING

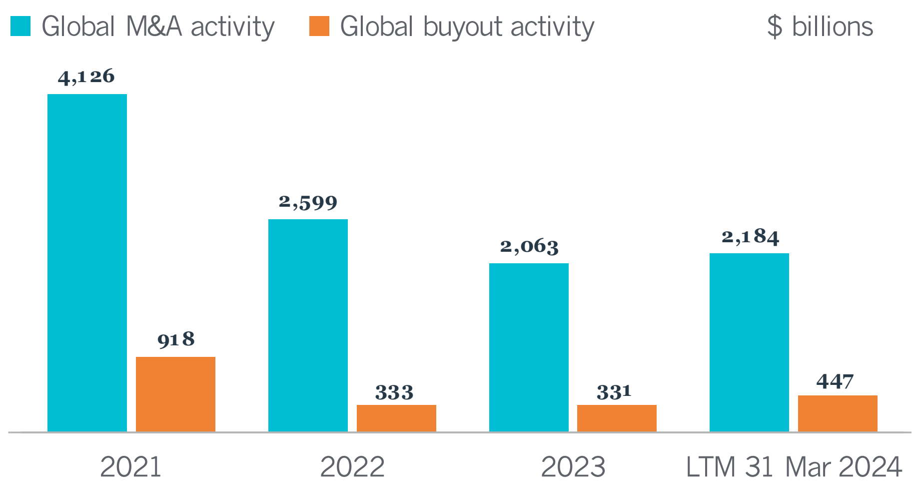
United States: Despite some shocks to inflation data in May, there is an air of greater economic clarity, interest rates appear to have stabilised, and we continue to see an increase in deal flow as buyers and sellers engage in price discovery unlocking additional opportunities (figure 2).

A returning appetite for dealmaking will see increased investment opportunities and more risk. Direct lending managers who have experience in navigating deals effectively and identifying non-cyclical market segments will be better positioned to provide investors with opportunities that take advantage of the high-rate environment, offering shelter from volatile conditions.

Europe: Throughout the first quarter of 2024, the direct lending investment environment has continued to exhibit attractive characteristics, with strong pricing deal volumes, prudent protections, and borrowers, with robust credit characteristics. With the recent rate hiking cycle now appearing to have concluded, we see a more certain macroeconomic environment emerging across Europe, with greater confidence being exhibited by both businesses and investors alike.

The supply/demand imbalance in European direct lending is expected to become further embedded, providing further opportunities for the asset class to grow. Pricing compression in deals has been noted, though all-in yields of direct lending remain attractive, helped by the higher interest rate environment.

Figure 2: Global M&A activity volumes uptick after historic lows and improving buyout volumes



Includes corporates and buyouts. Data sources: M&A activity: S&P Global market intelligence articles "Gloal M&A by the numbers: 2020 Recap" and "Global M&A by the numbers: Q1 2024; Buyout activity: Calcualted as the aggregate value of European and US-focused LBO deal volumes. European volumes converted from EUR into USD as the average FX rate for the relevant annual period. Source: LCD Data accessed on May 26th, 2024

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ENERGY INFRASTRUCTURE CREDIT

Energy infrastructure investment should be propelled by several long-term trends ratcheting demand for capital, with the biggest being a step change increase in electricity demand. There are several catalysts predicted to spur demand growth, led by increased need for data centres to support cloud services and artificial intelligence (AI), which account for approximately 40% of the growth rate.

Onshoring of power-intensive manufacturing, such as semiconductors and electric vehicles, and electrification of transportation are two other emerging power demand sources, as western governments look to ease the reliance on foreign supply chains via tax incentives and other schemes. This protectionist shift offers the asset class an additional layer of defence.

The movement to onshore the manufacturing of clean energy components in the U.S. was initially driven by the supply chain challenges observed during the COVID-19 global pandemic, but even more so has been accelerated by legislation which provides various incentives for domestic supply chains. Subsequently, U.S. construction spending has skyrocketed from less than $80 billion in 2020 to nearly $200 billion in 2023, which is its largest percentage contribution to real GDP growth in more than 40 years. Canada and the European Union have created similar programs which are catalysing a robust global investment opportunity set.

REAL ESTATE DEBT

Commercial real estate (CRE) loans originated during the recovery from a market downturn tend to be the best performing vintage of their period, and we believe 2024 will see the start of a new vintage of strongly performing loans as the CRE investment market enters a new cycle. We believe that higher interest rates and better spreads will deliver stronger returns for CRE debt investors than we have seen over the last 10 years, while stabilising capital values are reducing lending risk.

Capital values are now stabilising after a downward correction that was caused by the shift to a higher interest rate environment. The adjustment happened at different speeds in different markets but impacted most CRE formats across most major investment markets. The fall in collateral values has caused particular problems for existing loans in the most vulnerable CRE formats, and for loans at higher LTVs. But that adjustment is now largely over and new lending takes place against a capital value outlook of stabilisation and upcoming growth outside the most vulnerable CRE formats.

We believe that alternative CRE lenders are set to see higher returns at lower risk levels than were possible in the previous market cycle. In addition, for lenders who are able to successfully navigate the CRE landscape to operate across core plus and value-add risk levels in the upcoming environment of stable and rising collateral values, returns should be even more attractive as changes to banking sector regulation reduce competition among lenders.

COMMERCIAL PROPERTY ASSESSED CLEAN ENERGY (C-PACE)

The universe of investible C-PACE opportunities continues to expand, driven by tailwinds in decarbonisation and resiliency needs in the U.S., offering investors attractive risk/reward returns, duration and diversification.

Continued growth is expected from geographic expansion, with new C-PACE policy and program launches expanding the addressable market of eligible commercial buildings in the U.S., as well as continued institutionalisation of the market.

COLLATERALISED LOAN OBLIGATIONS (CLOS)

The CLO market is celebrating its 30-year anniversary in 2024, with the asset class growing into an important portfolio diversification tool in that time and becoming increasingly popular among investors. Between the start of the year to July 1, 470 U.S. CLOs (broadly syndicated, private credit and middle market) have priced totalling $207.4 billion. This compares to 133 U.S. CLOs totalling $57.1 billion for the same time period last year. Year to-date, 53 private credit and middle market U.S. CLOs have priced totalling $26.1 billion and private credit and middle market CLO issuance is 19% of new issuance for the first half of 2024 (source: JP Morgan as of 1 July 2024).

The higher-for-longer environment continues to suit the CLO market, with the asset class demonstrating strong scalability as the loan structure is able to capitalise on market liquidity.

The CLO market is demonstrating its role as an important portfolio diversifier in the current market environment. With market growth being driven by the continued rise of alternative financing, the asset class's liquidity offers huge scalability potential.

PARTNERING FOR RESILIENCE

Uncertainty is rarely welcomed by investors, and in such times, investing for resiliency has proven to help provide some shelter for portfolios. The current market volatility, driven by continued hawkishness from central banks on interest rates and a troubling geopolitical stage, mean portfolio diversification based around long term, low volatility investment opportunities become increasingly important. Across asset classes in alternative credit, we see how economic uncertainty continues to work in its favour, giving investors an effective tool for diversification.

Read the full article on Nuveen's website. (https://www.nuveen.com/global/insights/alternatives/investing-for-resiliency)

Important information on risk

Investors should be aware that alternative investments including private equity and private debt are speculative, subject to substantial risks including the risks associated with limited liquidity, the potential use of leverage, potential short sales and concentrated investments and may involve complex tax structures and investment strategies. Alternative investments may be illiquid, there may be no liquid secondary market or ready purchasers for such securities, they may not be required to provide periodic pricing or valuation information to investors, there may be delays in distributing tax information to investors, they are not subject to the same regulatory requirements as other types of pooled investment vehicles, and they may be subject to high fees and expenses, which will reduce profits. Real estate investments are subject to various risks associated with ownership of real estate-related assets, including fluctuations in property values, higher expenses or lower income than expected, potential environmental problems and liability, and risks related to leasing of properties. Responsible investing incorporates Environmental Social Governance (ESG) factors that may affect exposure to issuers, sectors, industries, limiting the type and number of investment opportunities available, which could result in excluding investments that perform well. Investments in middle market loans are subject to certain risks such as: credit, limited liquidity, interest rate, currency, prepayment and extension, inflation, and risk of capital loss. Private equity and private debt investments, like alternative investments are not suitable for all investors given they are speculative, subject to substantial risks including the risks associated with limited liquidity, the potential use of leverage, potential short sales, concentrated investments and may involve complex tax structures and investment strategies. Nuveen, LLC provides investment solutions through its investment specialists. This information does not constitute investment research as defined under MiFID.

Anders Persson
CIO, Head of Global Fixed Income – Nuveen

> "Across asset classes in alternative credit, we see how economic uncertainty continues to work in its favour, giving investors an effective tool for diversification."

Marie Lindskog, Head of Alternative Investments – Afa Försäkring

Private Credit:
“A Natural Part of Our Portfolio”

By Eugeniu Guzun – HedgeNordic

Alternative investments such as private equity and private credit have become core components of institutional portfolios, offering a significant source of diversification and the potential for enhanced returns. Swedish insurance company Afa Försäkring, which oversees more than $20 billion in assets, allocates approximately 20 percent of its total portfolio to alternatives, with about 20 percent of this allocation dedicated to private credit. “The objective of our private credit program is to add diversification across our overall portfolio, but more specifically to complement traditional corporate credit, in addition to achieving higher returns compared to liquid fixed income and credit markets,” explains Marie Lindskog, Head of Alternative Investments at Afa Försäkring.

Afa Försäkring allocates 20 percent of its $20 billion under management to alternatives, including private equity, private credit and a smaller allocation to infrastructure investments. The allocation is separate from the direct real estate investments, which are managed by a different team and fall outside of Lindskog’s purview. “Afa Försäkring has a long track record of investing in private equity, which is where the alternatives exposure began back in 1998,” says Lindskog, who has served as Head of Alternatives for over a year after joining Afa Försäkring in 2019.

> “Much like private equity, the diversification benefit to the overall portfolio of private credit comes from accessing a substantial portion of the economy and pool of borrowers that are not part of the listed space.”

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"Private equity remains the largest component of our alternatives portfolio, currently focused on mid- to large-cap buyout funds and co-investments in North America and Europe, with a smaller portion dedicated to growth and secondary funds."

PRIVATE CREDIT: A KEY DIVERSIFIER

In addition to a small allocation in core-plus and value-add infrastructure, the remaining 20 percent of Afa Försäkring's alternatives portfolio is invested in private credit, primarily through senior secured direct lending funds. This private credit allocation is designed to provide diversification within the overall portfolio and to traditional credit exposure, while also generating higher returns from the illiquidity premium. "Much like private equity, the diversification benefit to the overall portfolio of private credit comes from accessing a substantial portion of the economy and pool of borrowers that are not part of the listed space," explains Lindskog. "This allocation is largely about diversification, but also about seizing a market opportunity that expanded after the financial crisis due to increasing regulations on banks," she elaborates. "Today, it has become a very natural part of our portfolio."

Since the early days of its private credit program, Afa Försäkring has aimed to develop a program with a lower risk-return profile, targeting net returns of six to seven percent. In today's higher base rate environment, she believes "the target is clearly achievable" without straying too far along the risk spectrum. "We operate in the lower risk-return segment of the corporate lending market, and so far, we haven't felt the need to venture into more opportunistic areas," Lindskog explains. "Our investment strategy is highly focused on minimizing downside risk, with a strong emphasis on diversification."

Private credit has garnered increasing attention from institutional investors in recent years, driven by its "attractive returns, floating rate structure, and appealing spread levels," among other factors, according to Lindskog. 2023 proved to be a particularly strong year for private credit, with

> "Today, it has become a very natural part of our portfolio."

both high base rates and wide spreads creating a favorable environment. "This combination has been very attractive and has further strengthened the fundraising climate for managers," she adds. While the surge in interest and massive fundraising may present risks for investors, Lindskog remains optimistic and believes "there is still an opportunity for direct lenders to perform well, even as banks and liquid markets have reopened for business again and there is more capital chasing opportunities."

"Increased competition as a result of stronger traditional lending markets and increased dry powder in direct lending funds has already led to lower spread levels in some parts of the market, but it may also result in less emphasis on protection and weaker documentation and covenants as lenders compete for market share," emphasizes Lindskog. Turning to the borrower side of the market, she notes that the current environment of high inflation and interest rates presents challenges for businesses, "especially for companies that were already struggling during the COVID pandemic and had yet not recovered when inflation and interest rate increases hit." According to Lindskog, "Lending costs are high, and with the ongoing discussion around a 'higher for longer' interest rate environment, some businesses are already under significant pressure, even though default levels remain low by historical standards."

MANAGER SELECTION AND RISK MITIGATION IN PRIVATE CREDIT

This combination underscores the critical importance of manager selection when investing in the private credit space, according to Lindskog. "Our focus on downside protection has led us to favor larger managers," she explains. "We seek the advantages of scale, which is why we prioritize managers with proven track records, low loss ratios, a strong emphasis on credit quality and underwriting, and experience in managing challenging situations," Lindskog outlines.

While the selection of underlying managers results from extensive quantitative analysis and qualitative assessments, "the relationship is key, as we expect managers to be part of our portfolio for many years," emphasizes Lindskog. "It's crucial that every step of the process works well for all parties involved, so we dedicate significant time to getting to know them, understanding their strategies, and ensuring alignment of interests. Additionally, we focus on their approach to ESG, which is increasingly becoming a natural part of mitigating downside risk."

Direct lending and private credit differ from private equity in that "you need to identify risks early in the process, as the lender's ability to influence outcomes once the money has been lent is limited," explains Lindskog. "We are fully aware of this, and so are the managers. Therefore, we must be rigorous during the underwriting process to ensure we cover those risks," she emphasizes. Lindskog's team at Afa Försäkring closely monitors "the growing trend of payment-in-kind and similar arrangements borrowers use to defer payments, which could serve as an early indicator of stress in the market." This is also an area where the Afa team has observed differences between managers' approaches.

As the private credit space matures, divergence among managers has become more pronounced. "While it's still a relatively young asset class with limited long-term data across cycles, we've recently observed a greater dispersion than one might expect between different strategies and managers," observes Lindskog. "Even though we focus predominantly on direct lending, there are still notable differences."

Although Afa Försäkring has already built a mature and robust portfolio of well-performing private credit managers, Lindskog and her team "remain highly active in meeting with managers in the market to maintain a strong bench of potential replacements and additions to the program." Similar to their approach with private equity and infrastructure, the portfolio "is the result of many years of relationship building." In conclusion, Lindskog adds, "We consider private credit to be a valuable component of our portfolio. As long-term investors in this asset class, we see many interesting opportunities across various segments of the market, not just in corporate lending, but also in asset backed strategies such as real estate debt."

Active and Opportunistic Beats the Monkey in High-Yield


Christoffer Malmström and Måns Levin, co-founders – Ridge Capital

By Eugeniu Guzun – HedgeNordic

Private credit has grown rapidly as an asset class in recent years, attracting significant interest and scrutiny from investors of all sizes. While the scale of this expansion reflects a strong appetite among investors, the lower liquidity and inherent opacity of private credit can make public credit alternatives such as high-yield bonds equally appealing. Ultimately, the choice between private credit and listed high yield depends on investor goals, investment horizon, and risk tolerance. However, listed high-yield investments provide two key advantages for asset managers like Stockholm-based Ridge Capital: the flexibility to be active and opportunistic in pursuit of high returns and substantially greater liquidity.

Beyond the clear advantage of higher liquidity compared to private markets, "the appeal of high-yield credit or the broader public bond market over private credit lies in the ability to be far more active," explains Ridge Capital co-founder Christoffer Malmström, who previously worked at Park Square Capital – one of Europe's leading private debt firms. "Private debt is purely buy-and-hold; you lend money and wait for seven years to get repaid. That is a significant drawback for the asset class overall," he adds. "In our space, we can be much more opportunistic, seizing opportunities amid market volatility when other funds see outflows or macro events arise."

The flexibility to be active and opportunistic in the Nordic high-yield bond market has allowed Ridge Capital's Northern Yield Fund to outperform its underlying yield-to-maturity since its inception two years ago. The fund posted a 12.8 percent return in its first year of operations in 2023 and 21.9 percent

> "Our performance has exceeded the underlying yield as a result of our focus on the secondary market, where we can adopt a more opportunistic approach and engage in event-driven trades."
>
> Christoffer Malmström

> "Our structure is tailor-made for this market... This structure gives us a clear advantage, like starting 200 meters ahead in a 400-meter sprint – it's virtually impossible for them to catch up."
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year-to-date through the end of October. Over the last 12 months, the average yield-to-maturity has ranged from 15 to 17 percent on a leveraged basis, while the fund's net performance reached around 27.3 percent. "Our performance has exceeded the underlying yield as a result of our focus on the secondary market, where we can adopt a more opportunistic approach and engage in event-driven trades," explains Malmström, the fund's Lead Portfolio Manager.

In these trades, the Ridge Capital team looks for catalysts that can trigger an accelerated price recovery, allowing the internal rate of return to surpass the bond's initial yield at entry. "Our philosophy from the start has been that if you are purely buy-and-hold – like most funds – you leave alpha on the table and will not outperform," Malmström remarks. As the saying goes, any monkey can buy high-yielding bonds. "Go on Bloomberg, sort by highest yield, and pick the highest-yielding bonds. It will work until it doesn't," jokes Malmström. Avoiding default situations has also been key to performance – or rather, has prevented any detractors. "Defaults can significantly impact returns, given an average market default rate of 3-to-5 percent," Malmström explains. "Avoiding these is crucial for any high-yield bond manager."

ADVANTAGE OVER MORE TRADITIONAL PEERS

Christoffer Malmström's experience in security selection and analysis at Park Square Capital provided valuable insights that helps him and the team avoid default situations in the listed high-yield bond market. "The analysis in both the private credit and listed bond markets is quite similar. Whether you're evaluating a stock or a bond, the fundamental approach remains the same," explains Malmström. "While the risks differ and you're examining various parts of the capital structure, the analysis follows a similar bottom-up philosophy," he emphasizes. "We assess operational and market risks, analyze fundamental financials, create cash flow projections, conduct stress tests, and prioritize downside risk over upside potential."

While variations in portfolio management and security selection can lead to disparities among different managers, the Ridge Capital team has designed its fund to gain a competitive edge in what Malmström and other asset managers view as an "inefficient and imperfect Nordic high-yield bond market." The founders of Ridge Capital opted for a Luxembourg-domiciled Reserved Alternative Investment Fund (RAIF) structure, which offers monthly liquidity and the flexibility to use leverage – hence, the ability for more opportunistic investing in the Nordic high-yield bond market.

"Our structure is tailor-made for this market, unlike the daily-traded liquid structures that other managers use," explains Malmström. As history has shown on multiple occasions, daily traded UCITS funds occasionally face significant challenges due to the liquidity mismatch between their underlying investments and the liquidity of their funds. "This structure gives us a clear advantage, like starting 200 meters ahead in a 400-meter sprint – it's virtually impossible for them to catch up," notes Malmström. With its alternative investment fund structure offering monthly liquidity, the Ridge Capital team can act as opportunistic players, avoiding the pressure to sell in challenging market conditions.

This structure also enables Ridge Capital to enhance its return potential through leverage, typically ranging from 1.25 to 1.75 times net asset value (NAV). "Applying leverage to higher-quality bonds enables us to target high returns without going too far out on the risk scale or venturing into distressed debt," Malmström explains. Additionally, the firm utilizes instruments like iTraxx Crossover Index Options to mitigate downside risk, providing the flexibility to generate returns across various market conditions. Ultimately, Malmström believes, "this flexibility, combined with our team's expertise, gives us substantial maneuverability in an imperfect, illiquid, and inefficient market. This is what makes it an attractive space for those willing to roll up their sleeves and get their hands dirty."

UNDERPROMISE AND OVERDELIVER

Ridge Capital launched its Northern Yield Fund at the beginning of 2023, seizing an opportune moment following a challenging year for most investors in 2022. This timing has allowed the fund to achieve an annualized return of 19.0 percent to date. "We have succeeded with our opportunistic trades in the secondary market, but we also acknowledge the significant market tailwinds we've experienced over the past 12 months," Malmström notes. "Most fund managers would echo this sentiment – the market has indeed seen a recovery."

Despite the strong alpha generation and overall performance, Måns Levin, co-founder of Ridge Capital, stresses that the fund's return target "has always been and will continue to be the same: risk-free plus seven percent over the cycle," which translates to low double-digit net returns in the current environment. "Christoffer and I invested a significant amount into the fund from the start and are of course very pleased to have delivered a 19 percent annualized return on that. We continue to have strong conviction going forward and have reinvested the major part of what've earned as managers since launch into the fund," Levin notes.

"The seven percent above the risk-free rate is our target. But our aim is to beat that," reiterates Malmström. "Currently, the underlying yield in our portfolio has a gross yield-to-maturity in the low teens. This serves as a benchmark, and if we continue to excel in our secondary trades, we have the potential to deliver returns that exceed this benchmark," he elaborates. Malmström notes that many investors are keenly focused on the fund's impressive performance. "Some are asking, 'Has the ship sailed, or can you replicate this success?' or 'What can we expect next time?'" He responds with a clear message: "It's been fantastic, and we're going to strive to do it again. That will always be our goal."

High Yield: Resilience Amid a Shifting Backdrop

By Scott Roth and Chris Sawyer – Barings


Scott Roth, Head of Global High Yield – Barings

"High yield issuers remain in good financial health overall, with earnings growth taking place at a slow and steady rate that is in line with expectations."

High yield remains well-positioned against a macro backdrop that gives us both reasons for confidence and concern. On the confidence side, market worries about a near-term U.S. recession may have been premature. Following the U.S. Federal Reserve's (Fed) interest rate cut in September, the market anticipated a fast and steep trajectory of rate cuts for the remainder of 2024 and 2025. With the recent strong jobs number in the U.S., and ongoing strength in housing demand and retail sales, the economy appears stronger than expected, potentially reducing the need for aggressive Fed action. This robust economic backdrop is a net positive for high yield issuers overall.

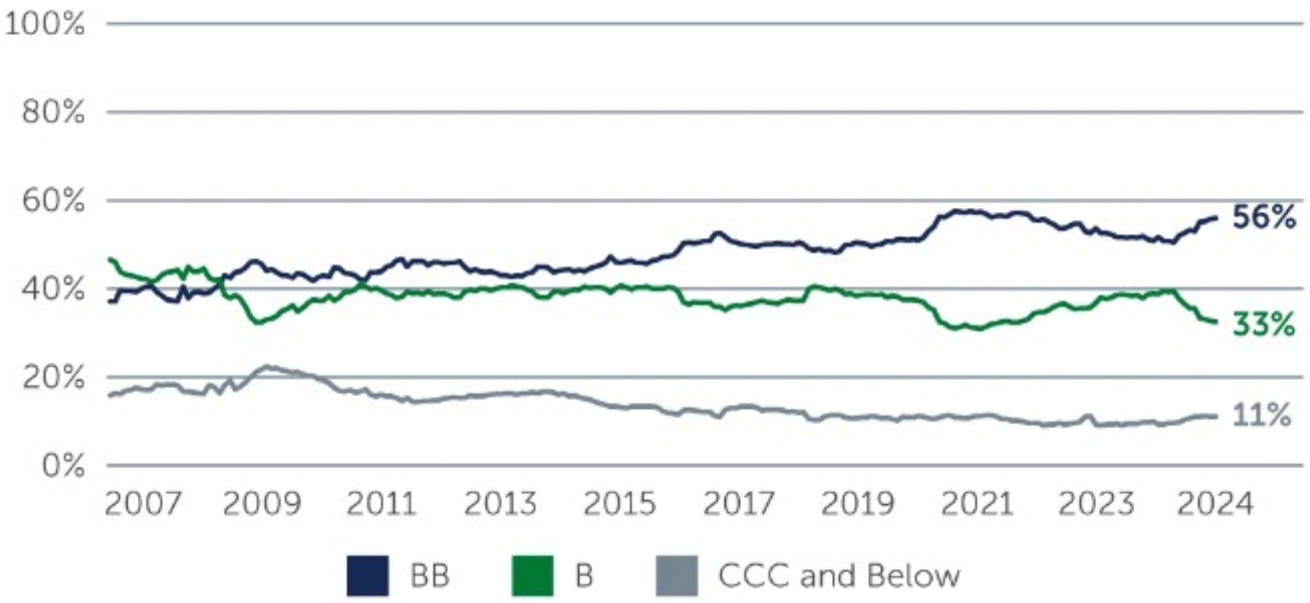
However, geopolitical risks continue to rise with the escalation of conflicts in the Middle East and the ongoing war in Ukraine. The macro backdrop in Europe also looks less rosy than the U.S. We anticipate further central bank easing to combat slowing growth, but expect that even low to modestly negative economic growth would not materially impede the return prospects for most European high yield issuers. Additionally, the high yield market's strong fundamentals and positive technical forces serve as a stable counterweight.

STRENGTH IN FUNDAMENTALS AND TECHNICALS

High yield issuers remain in good financial health overall, with earnings growth taking place at a slow and steady rate that is in line with expectations. While there is some divergence across sectors, the changing interest rate landscape—even if slower than some had expected—should offer some relief to issuers, particularly those in more cyclical sectors. Adding to this strong credit story is the robust ratings profile of the market. For example, the percentage of BB issuers in the global high yield bond index remains near all-time highs, at 56% (Figure 1).

The strong technical forces that have prevailed in the high yield market throughout 2024 have grown even stronger in recent months. Simply put, demand for high yield bonds and loans has been considerably greater than supply. The low supply in the market is largely due to the continued dearth of M&A activity—and while lower rates should ultimately encourage M&A activity tick up, this could take some time and should keep the technical backdrop supportive in the coming months. On the bond side, given the improving credit quality of the high yield market overall, many issuers have been upgraded to investment grade status, contributing to a shrinking market and further pressuring supply. The attractiveness of potential returns in the face of this limited supply will likely remain a forceful market tailwind.

FIGURE 1: A HIGHER-QUALITY MARKET



Source: ICE BofA. As of September 30, 2024.

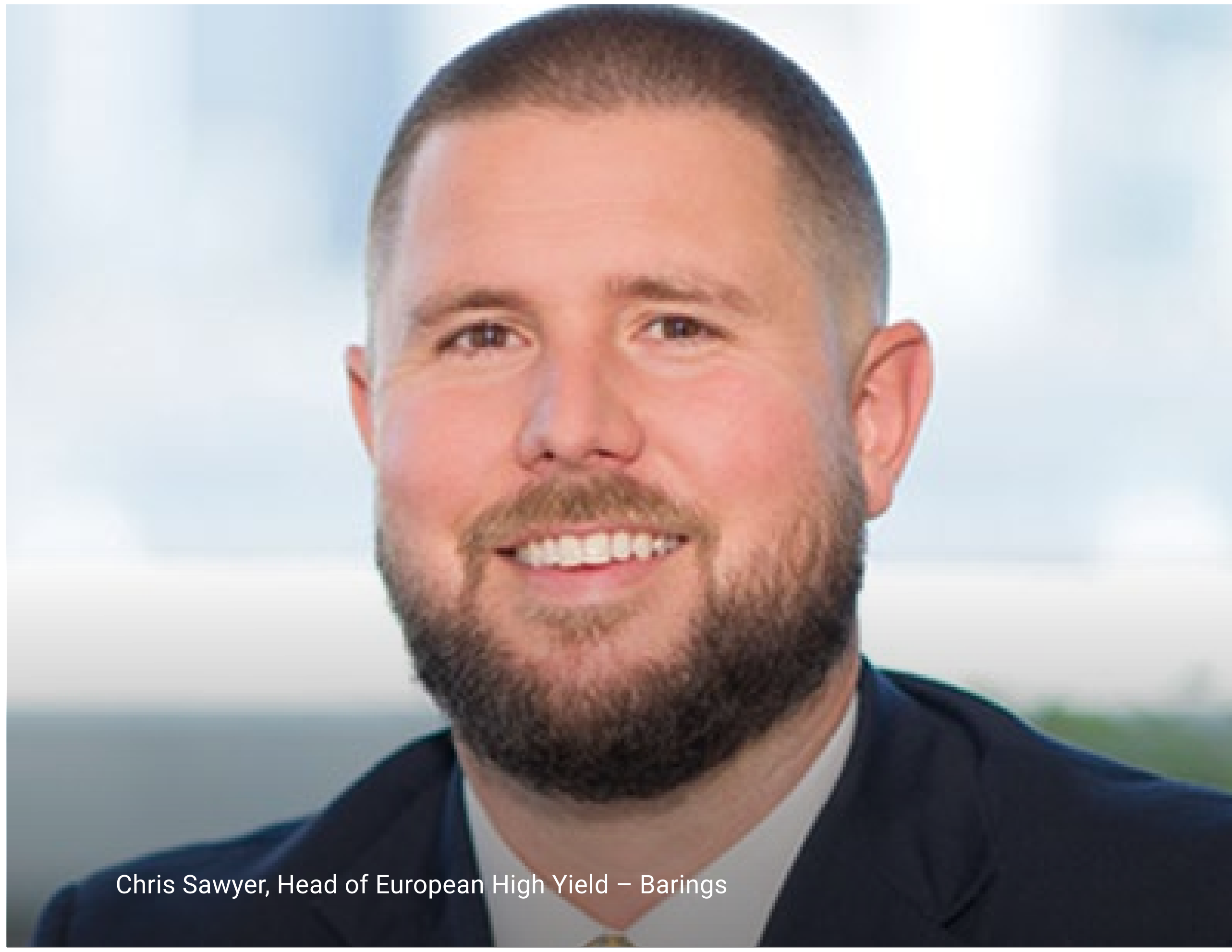
COMPELLING OPPORTUNITY SET IN LOANS & BONDS

Given the fundamental strength of the asset class, we continue to see benefits to a strategic allocation to both high yield bonds and loans. In particular, while some investors may try to opportunistically time their entry into the market, we believe this approach may miss the attractive income and risk-reward profile presented by long-term core allocations to the asset class.

We continue to see value in loans and this confidence has been further bolstered by the recent strong economic data in the U.S. In this still-elevated interest rate environment, loans continue to offer the potential for compelling returns. Specifically, the average coupon for global loans today remains above the long-term average at 8.6%.[1] Another benefit of loans is that unlike other fixed income assets, the majority of the return is coming from contractual income that is paid today rather than awaiting price recovery, resulting in a steadier return profile over time.

Within loans, there are also select discounted opportunities such as liability management exercise (LME) transactions. These have become more prevalent in financially stressed situations, essentially offering issuers ways to recast or restructure their existing debt arrangements. While these transactions must be navigated carefully, they can offer compelling value for managers that have the resources to rigorously analyze the attendant risks.

The bond market is also supported by tailwinds in the medium term. In particular, the total return story continues to be compelling today, with yields on BB and single-B bonds around 5.5% and 6.9%, respectively.[2] Against a backdrop of overall fundamental strength, we also see select opportunities in issuers in more challenged sectors that have already been through an earnings recession, such as chemicals, health care and technology. The companies in these sectors tend to have higher leverage, discounted prices and wider spreads. While it can be difficult to forecast the timing of individual credit turnarounds, many have good liquidity and are able to service their debt—and should ultimately benefit from central bank rate-cutting. That said, uncertainties remain, which means a cautious approach is required to identifying the potential winners and losers in this dynamic market.



Chris Sawyer, Head of European High Yield – Barings

LOOKING AHEAD

We see material tailwinds supporting high yield for the remainder of 2024 and into 2025. But within the broader asset class, we expect that the best relative value at any given time will continue to move around—requiring managers to be nimble and able to move between geographies and asset classes.

While a number of risks remain on the horizon, which could trigger volatility, the market's fundamental strength and diverse opportunities highlight the value investors can uncover—especially when partnering with experienced managers with deep resources and credit research capabilities.

> "Given the fundamental strength of the asset class, we continue to see benefits to a strategic allocation to both high yield bonds and loans."

Source: Credit Suisse. As of September 30, 2024.

Source: Credit Suisse. As of September 30, 2024.


Mikael Gjerding, portfolio manager – Sissener AS

Breaking Free from UCITS: Sissener's New Credit Fund Embraces Flexibility

By Eugeniu Guzun – HedgeNordic

Philippe Sissener and his team at Sissener AS have successfully managed a high-yield UCITS fund for over five years. Seeing the additional potential for enhanced returns, the team has launched a strategy within a more flexible Luxembourg Reserved Alternative Investment Fund (RAIF) structure, offering greater freedom to maneuver. With a monthly subscription and quarterly redemption cycle instead of daily, no restrictions on exposure to individual issuers, and a wider range of allowed credit investments, Sissener Credit Opportunities – guided by Lead Portfolio Manager Mikael Gjerding – aims to provide a higher-return alternative to the already successful Sissener Corporate Bond Fund.

BREAKING FREE OF THE "5/10/40" RULE

"With the rapid growth of our UCITS fund, we are finding that our flexibility to maneuver is increasingly constrained by UCITS regulations," says Philippe Sissener, lead Portfolio Manager of Sissener Corporate Bond Fund. "These rules prevent us from doing everything we can to achieve the highest possible returns," he emphasizes. The "5/10/40" rule under the UCITS structure mandates that no single asset can account for more than 10 percent of a fund's assets and holdings of more than 5 percent cannot collectively exceed 40 percent of the total assets. "We see clear advantages for both our investors and our strategy in having the ability to exceed the 5/10/40 rule."

Concentration is integral to the Sissener Corporate Bond Fund's strategy, and the newly launched RAIF-structured fund amplifies this focus even further. "While many of our UCITS peers hold 100 to 200 positions, we already have a more concentrated portfolio of 30 to 40 core positions," explains Sissener. "With Sissener Credit Opportunities, we maintain an even more concentrated portfolio of 10 to 20 core positions," he adds. By maintaining a focused portfolio, the team can allocate more heavily to their highest-conviction ideas and devote greater time to in-depth research and continuous monitoring of each investment.

"In our UCITS fund, there are some names we would like to own more as a percentage of the fund, but we are capped at 10 percent of the issuer's outstanding debt and legally constrained from adding more under UCITS rules," says Sissener. "In some situations, it is great to have the opportunity to exceed this threshold of 10 percent in order to obtain negative or even positive control."

EXPANDING THE INVESTMENT UNIVERSE

The RAIF structure of Sissener Credit Opportunities also unlocks access to a much wider range of

> "It's the same team, the same underlying philosophy. The difference lies in the legal structure of the new fund, which offers us much more flexibility in our investments."
>
> Mikael Gjerding

investment opportunities. "While the UCITS fund is restricted to publicly listed bonds, the new fund can explore all types of credit, including secondary bank loans and direct lending alongside publicly listed bonds. We have the freedom to pursue any type of credit," says Philippe Sissener. Although the fund may not always be invested in direct loans or distressed loans, Mikael Gjerding highlights, "it's not guaranteed that we'll utilize every option, but having the flexibility to invest across the entire credit spectrum is very important. This flexibility is key and the multitude of opportunities that come with the flexibility."

This structure allows the Sissener team "to take a more significant portion in smaller loans, enabling us to structure deals favorably in a market where standard bonds often have weak covenants and low spreads," Gjerding explains. "For example, when we're providing 25 percent of an issuer's credit, we gain a stronger negotiating position to shape terms that better suit us than the issuer – an obvious advantage," he elaborates. "Currently, UCITS funds are at the mercy of issuers dictating terms, a symptom of the excess capital in the market." This flexible setup grants Sissener Credit Opportunities the agility to adjust as needed.

MARKET-ALIGNED SUBSCRIPTION AND REDEMPTION

Unlike the daily-traded UCITS Sissener Corporate Bond Fund and most of its peers, Sissener Credit Opportunities operates with a monthly subscription cycle and a three-month redemption notice, better aligning with the inherent illiquidity of the Nordic high-yield market. "Managing a large fund with daily liquidity requires us to stick to the most liquid part of the universe," Sissener explains. "Daily liquidity also means we must maintain a cash reserve, typically around five percent, which slightly reduces the fund's return potential," he elaborates. "Additionally, we hold a substantial portion of our fund in shorter-dated, lower-yielding bonds to act as a liquidity buffer if and when needed."

Transitioning from daily to monthly liquidity and a three-month notice requirement is "a major advantage, first and foremost for our investors, as it allows us to adopt a different approach and concentrate risk without the pressure of daily liquidity requirements," emphasizes Sissener. The three-month redemption notice also gives the team a significant lead time, offering ample opportunity to prepare the necessary liquidity in the event of redemptions.

Freed from the constraints of the "5/10/40" rule and with greater flexibility in managing investment liquidity, Gjerding sees these structural advantages as "creating the potential for 200 to 250 basis points in excess returns in today's market with compressed spreads." He adds, "Naturally, if spreads were to widen in the broader market, this differential would also expand." This added return is partly attributed to "the illiquidity premium we believe we can provide to investors comfortable with a three-month capital commitment rather than daily liquidity."

SAME PHILOSOPHY, DIFFERENT STRUCTURE

In managing the Sissener Corporate Bond Fund, Philippe Sissener follows a conservative and cautious investment approach, drawing on the philosophy of Howard Marks at Oaktree, who famously said, "If we avoid the losers, the winners take care of themselves." The new fund's investment strategy, according to lead portfolio manager Mikael Gjerding, "is not very different from what we have in the Corporate Bond Fund." He explains, "All investments in both funds focus on situations with strong debt-servicing ability – that focus is central to our investment process and DNA." Gjerding notes, "It's the same team, the same underlying philosophy. The difference lies in the legal structure of the new fund, which offers us much more flexibility in our investments."

The team's security selection and analysis process "involves actively engaging with companies, meeting their management teams, and dedicating substantial time to understanding them," explains Sissener. "We focus on investing in companies we have followed for a long time. This approach is only feasible when you maintain a limited number of core positions – 30 to 40 in our daily UCITS fund," he adds. "It becomes even more effective with a concentrated portfolio of 10 to 20 core positions in our Credit Opportunities Fund."


Philippe Sissener, portfolio manager – Sissener AS

> "With the rapid growth of our UCITS fund, we are finding that our flexibility to maneuver is increasingly constrained by UCITS regulations."
>
> Philippe Sissener

Sissener Credit Opportunities currently exhibits a yield-to-maturity of 10.3 percent, compared to 8.2 percent in the daily-traded Sissener Corporate Bond Fund. "This structure is well-suited for today's tight spread environment, as it allows us to concentrate more heavily on our highest-conviction ideas," Gjerding explains. "However, the structure can be even more advantageous in a market with wider spreads and more distressed opportunities," he emphasizes. "This is a permanent, evergreen structure, offering benefits in any market environment. The flexibility to explore virtually any area of the credit space is a key advantage."


Thor Abrahamsen, Senior Investment Executive – Gard

“Investors are still somewhat compensated for the risk, as historical default rates remain relatively low. Should the market take a downturn, there is significant potential for volatility in these spreads, which could negatively impact fixed-income portfolios.”

Gard’s Playbook for Short-Duration Fixed-Income Investing

By Eugeniu Guzun – HedgeNordic

Different asset allocators often have varying objectives that shape their investment allocation decisions. For instance, institutional investors such as protection and indemnity (P&I) insurance providers may prioritize shorter-term fixed-income investments to match the shorter-duration nature of their liabilities. Norwegian maritime insurer Gard, the largest P&I player in marine shipping, exemplifies this approach by maintaining a significant allocation to fixed-income assets across the spectrum, including government bonds, high-yield bonds, and private credit, among others, whilst maintaining a relatively low duration.

“Similar to many insurance companies, we hold significant fixed-income allocations due to the nature of our liabilities,” says Thor Abrahamsen, Senior Investment Executive at Gard. Between 65 to 75 percent of Gard’s $2.6 billion investment portfolio is allocated to fixed-income investments, spanning investment-grade, government bonds, global high-yield loans and bonds, emerging markets bonds, and private credit. However, Abrahamsen observes limited attractive opportunities within the fixed-income space in the current environment.

“Spreads on both investment-grade and high-yield bonds are approaching all-time lows,” observes Abrahamsen. “Investors are still somewhat compensated for the risk, as historical default rates remain relatively low.” He goes on to emphasize that since we have not yet experienced a credit cycle, "Once you get to high yield, everything is about credit selection. The objective of careful manager selection is to minimize any additional risk you take."

"should the market take a downturn, there is significant potential for volatility in these spreads, which could negatively impact fixed-income portfolios." Abrahamsen further asserts that government debt is particularly unattractive in the current environment. "For instance, a 10-year Treasury yield of 4.2 percent appears too low, particularly if inflation proves to be more resilient than the market expects, or if current fiscal policies continue."

CORPORATE CREDIT AND HIGH YIELD

Shifting the focus to corporate bonds, Abrahamsen notes that "high-quality corporate credit remains attractive on a fundamental basis compared to government debt." While he does not deem this segment particularly appealing due to low spreads, "it is still preferable to hold high-quality corporate credit over government debt." Examining the high-yield market specifically, Abrahamsen notes that "historically, high-yield bonds have been attractive because their spreads generally compensate for the higher default risk. In net terms, investors are still coming better off as current spreads in the high-yield space are around 300 basis points."

In a diversified portfolio, the current level of spreads is sufficient to protect investors from a typical default cycle, according to Abrahamsen. However, he points out that spreads are highly sensitive to changes in the broader market, which makes this segment "less attractive," particularly given the ongoing interest rate-cutting cycle. Abrahamsen explains that "the high-yield market generally features floating rates and tends to have a shorter duration than investment-grade bonds, which means that the lower duration is less advantageous as shorter-term rates decline." This interest rate environment is one reason why spreads in high yield have started to increase, according to Abrahamsen. "Historically, high yield has offered a good yield pickup versus higher quality bonds. But I am less certain that's the case now."

The investment team at Gard invests in the high-yield market through external managers, focusing on those with a strong track record in credit selection. "Once you get to high yield, everything is about credit selection," emphasizes Abrahamsen. Given that high-yield investments inherently carry a higher risk profile, "the objective of careful manager selection is to minimize any additional risk you take."

PRIVATE CREDIT: ILLIQUID HIGH-YIELDING ALTERNATIVE

Despite having a short duration of liabilities, Gard also maintains a five percent allocation to private credit. "Private credit, which we classify under the alternatives bucket, represents the smallest portion of our fixed-income allocation," notes Abrahamsen. As an insurer with shorter-duration liabilities, Gard "cannot allocate a significant portion of our fixed-income portfolio to private credit," explains Abrahamsen. "However, including it as a side pocket to our traditional credit portfolio makes sense. While the underlying fundamentals of both are correlated and influenced by similar economic factors, private credit provides diversification by featuring a distinct set of borrowers."

He explains that private credit typically falls just below investment grade in the standard credit rating scale, often rated around B or BB, positioning it close to higher-quality high-yield investments. He points out that private credit provides both diversification and a potential yield premium due to its illiquid nature. "Part of the appeal of private assets lies in their perceived lower volatility," Abrahamsen explains. This is largely because their valuations tend to be less volatile, as they are assessed quarterly. However, he cautions that this does not mean the risk is diminished. "The risk is still present; it's just located in a different universe. Private credit is a different credit universe compared to the public market."

Abrahamsen believes there will always be demand for longer-duration assets such as private credit. This asset class has both advantages and disadvantages, with one notable advantage being that the information flow in private markets tends to be superior to that in public markets. "There is no inside information in private markets, so, on average, managers have access to better information than those in public markets, which theoretically reduces risk," Abrahamsen explains. However, he points out that many borrowers in the private space are backed by private equity firms, creating an incentive for these managers to keep borrowers afloat for as long as possible by restructuring deals, even when default may be the best option. "There are various aspects to private credit; some are good, and others are bad."

OUTLOOK

While central banks have successfully navigated the challenging task of taming inflation with a soft landing, Abrahamsen raises an important question about what comes next. "We've moved beyond the discussion of a soft landing. I don't think central bankers truly know how to control an economy; they're doing their best with flawed data. This time, we got lucky," he reflects. However, he believes it is still premature to declare the death of inflation.

"If that's the case, then interest rates are likely to rise again, at least in the long run," Abrahamsen asserts. But he questions how far interest rates can rise before the system starts to strain, noting that "approximately five percent seems to be a limit of some sort."

He further emphasizes his belief that long-term interest rates will continue to rise and remain elevated for an extended period, making government debt particularly unattractive compared to a portfolio of high-grade corporate credit. In the long term, the challenge for central banks lies in "finding an interest rate that balances inflationary pressures within the economy while also enabling governments to finance themselves at reasonable rates. Given debt levels, that seems an impossible task."

Eric Larsson, Managing Director and co-Head and Portfolio Manager – Alcentra, a Franklin Templeton manager

Opportunities Amid Complexity in European Special Situations

By Eugeniu Guzun – HedgeNordic

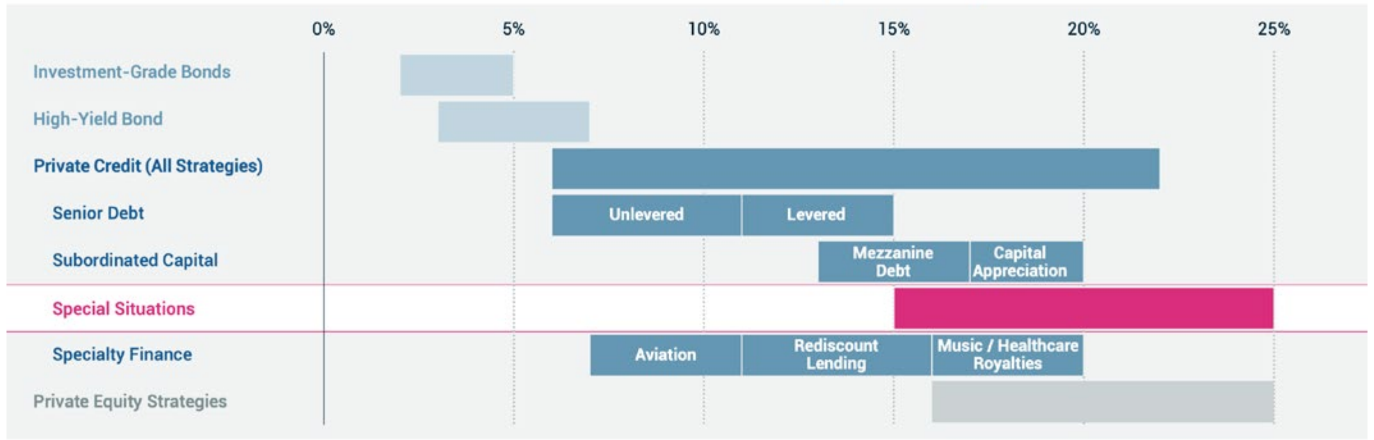
Most managers in both the public and private credit markets share a common goal: to steer clear of difficult and distressed lending situations. However, some managers such as Alcentra – a Franklin Templeton manager and one of the world's largest alternative credit managers –in its Special Situations strategy actively pursue these distressed or special situations in private credit markets. This strategy can provide investors with equity-like returns while maintaining the risk profile of secured debt, along with diversification and, notably, a hedge against challenging market environments. Consequently, exposure to special situations in private credit can serve as a valuable complement to a traditional private credit portfolio.

"European special situations can deliver equity returns with the risk profile akin to a secured debt portfolio," says Eric Larsson, Managing Director and co-Head and Portfolio Manager at Alcentra. "It's the

> "Adding a special situations manager can enhance portfolio diversification. Our sector-agnostic approach ensures that investors gain exposure to a wide range of opportunities in various sectors, leading to a more diversified portfolio overall."

best of both worlds, where we buy debt at a discount, often with low loan-to-value ratios and secured debt," he elaborates. In a downside scenario, investors benefit from access to collateral and a running yield of around seven percent, with the upside optionality of capital appreciation as the situation improves. "It's a way to enhance returns while maintaining low risk and volatility in your strategy."

INVESTMENT-LEVEL UNDERWRITING TARGETS (GROSS IRR %)[1]



Source: Cambridge Associates LLC. 1. Returns are illustrative of each strategy and do not guarantee said returns but are based on historical averages. Illustration does not take into account relative value across credit, or relative value between credit and other asset classes. Specialty finance strategies will have different experiences during the credit cycle depending on the type of asset in which they are invested.

It's not just the equity-like yields that make a special situations portfolio attractive; it also offers both diversification and hedge benefits, according to Larsson. "A traditional private credit or direct lending portfolio typically focuses on four or five core sectors, such as IT services, healthcare, and others," Larsson explains, highlighting the sector diversification of special situations. Since special situations can arise across various sectors, "adding a special situations manager can enhance portfolio diversification. Our sector-agnostic approach ensures that investors gain exposure to a wide range of opportunities in various sectors, leading to a more diversified portfolio overall."

The hedge aspect is especially important for investors with exposure to traditional credit, which can struggle in challenging economic conditions. When businesses face challenges in a weaker economy, "how can we turn that into an opportunity instead?" asks Larsson. The Alcentra team "actively scans the market for such opportunities and seeks to turn them into strong investments." This approach, he adds, introduces a valuable hedge to a private credit portfolio.

UNDERSTANDING SPECIAL SITUATIONS

In private credit markets, special situations refer to unique, non-standard investment opportunities that arise from a company's specific financial or operational challenges or transitions. These situations often require tailored financing solutions and involve higher complexity compared to traditional credit investments. Eric Larsson, who has nearly 20 years of experience in the European stressed and distressed credit markets, categorizes the whole universe into corporate special situations, non-performing loans, asset-backed lending, and other sub-categories. Within the corporate special situations space – the largest and the one Alcentra focuses on – Larsson breaks the space down into three main sub-categories: stressed credit, recapitalizations, and capital solutions.

"Stressed investments involve purchasing a bond with the expectation that things will improve, either through the company's recovery or an injection of capital by the sponsor, with the goal of selling at a higher value once that event occurs," Larsson explains stressed credit investments. "Next, we

Past performance does not predict future returns. **Returns may increase or decrease as a result of currency fluctuations.**

Stressed Credit (15-25% Gross IRR)[1]

- Senior secured leveraged loans and high yield bonds trading at a steep discounts to par
- Companies that are perceived to be distressed but which can grow back into their capital structures
- Opportunity to capture mark to market gains as well as attractive current yield

Recapitalisations (20-30% Gross IRR)[1]

- Good companies with overleveraged balance sheets in need of recapitalisation
- Reconstitution of capital structure which may allow for equity-like return through debt claim
- Operational turnaround through new management team, better governance and execution of business plan

Capital Solutions (15-25% Gross IRR)[1]

- Public or privately sourced super senior new money and rescue financing opportunities
- Often provided on a standalone basis or in connection with balance sheet restructurings
- Exceptional risk-adjusted return given typical first ranking on company assets and attractive economics

	Original Capital Structure	New Capital Structure
New Money	→	200
Senior Debt	500	300
Junior Debt	300	0
Equity	700	0

Other Strategies (15-30% Gross IRR)[1]

- Liquidations – investment post filing for administration based on liquidation recovery analysis
- Administration and litigation financing – fund administration or litigation processes
- Non-Performing Loans (NPLs) – acquisition of portfolios or corporate / retail portfolios of non-performing loans

> "The market may be obscure and difficult to penetrate, but that can work in our favor. Understanding these differences and how to leverage them is crucial for success in the European special situations space."

have recapitalizations, where creditors step in as shareholders after the company undergoes restructuring," he continues. Finally, there are capital solutions, which have become a buzzword lately in the industry, according to Larsson.

"Capital solutions, as we define it, involve providing new capital to corporates facing some form of stress or in need of assistance to navigate a difficult situation," explains Larsson. "This may include companies that need to sell a division but lack access to traditional sources of financing, and therefore require more flexible capital to help them through this period," he elaborates. Alcentra categorizes the broader special situations market into these three areas, with the firm actively participating in all of them and constructing its portfolio based on where the team identifies the most attractive opportunities at a given time.

KEY INGREDIENTS FOR SUCCESS IN EUROPEAN SPECIAL SITUATIONS

Success in special situations investing, particularly within private credit, hinges on several key elements coming together. These include proactive deal sourcing through extensive networks and market intelligence, specialized expertise in industry and restructuring, and the ability to offer tailored financing solutions. As one of the largest alternative credit managers globally, Alcentra has built a robust sourcing channel for its investments, including those in special situations.

Alcentra Special Situations was founded in 2007 with the idea of leveraging Alcentra's position as a leading platform in the CLO market. "At the time, we had a massive library of information on target investment opportunities, covering both syndicated and private transactions," recalls Larsson. "We source between 50 and 60 percent of our investments internally, which means that we are often dealing with companies we've already lent to or have been involved with for an extended time, and we possess comprehensive information and data on them." This gives Alcentra a significant advantage in the space of special situations. "Sourcing in this space, in particular, is extremely key."

As one of Europe's longest-standing special situations platforms, having deployed over €3 billion in capital since its inception in 2007, Alcentra is well-positioned to navigate the nuances and complexities of the European special situations market. This market is characterized by private market dominance and jurisdictional intricacies, which require deep expertise and strategic sourcing. With 40 years of combined industry experience, Laurence Raven and Eric Larsson, Co-Heads of Special Situations at Alcentra, play a crucial role in guiding the firm through the European landscape, which differs significantly from the more mature and established market in the United States.

"The European market is much younger and smaller than the US market," explains Larsson. "Issuers are generally much smaller, and the market is more complex, given the many jurisdictions within Europe, each with its own legal and regulatory framework," he continues. "You need to understand the specific dynamics of each country you operate in, and information is typically harder to access." Unlike the U.S. space, which has a more broadly syndicated and high-yield market, Europe is largely a private market.

Larsson also points out that cultural and language differences further add to the complexity, contributing to pricing inefficiencies. "These inefficiencies can be an advantage if you know how to navigate them," he adds. "The market may be obscure and difficult to penetrate, but that can work in our favor. Understanding these differences and how to leverage them is crucial for success in the European special situations space."

GROWING OPPORTUNITIES POST-PANDEMIC

The opportunity set in special situations investing has expanded significantly in the wake of the COVID-19 era when many businesses took advantage of low interest rates to borrow extensively. Now, as those loans mature in a higher-rate environment and economic conditions tighten, a wave of restructuring and refinancing challenges is emerging, creating fertile ground for special situations investors. "Given the current macroeconomic environment, we believe we will continue to see a strong supply of opportunities in the market," concludes Larsson.

"We expect European economies to remain largely stagnant, with limited room for fiscal support, although there will be some monetary easing as central bank rates come down," he elaborates. "However, we are also dealing with a significant number of overleveraged capital structures that were created during the bull market pre-Covid, when debt was cheap," notes Larsson. These structures have just been carried forward, and there haven't been many defaults so far. "Yet, they are still out there, trying to survive in increasingly challenging macroeconomic conditions."

Views expressed are those of Alcentra as of the date of this article and are subject to change.

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Unlocking Opportunities in the Central Bank Cutting Cycle

By Kristian Myrup Pedersen – CABA Capital

"Given the credit weakness of both the US and most European countries, we believe Scandinavian bonds, where both government and covered bonds are truly AAA-rated, is the right place to be."

BEING ONE STEP AHEAD OF THE CUTTING CYCLE

The late summer of 2024 marked a turning point for financial markets with global central banks starting their first cutting cycle since the early days of the corona crisis in 2020. Although lower rates tend to be positive for risky assets, it is worth noticing that the background for this cutting cycle is a combination of declining economic activity, less heated labor markets and falling inflation, which in itself might not be particularly positive for risky assets. Therefore, now could be a good time to allocate capital towards strategies within asset classes that are likely to directly benefit from this cutting cycle.

Since the financial crisis in 2008, cutting cycles have often been accompanied by quantitative easing programs focusing on government and covered bonds. Should the general economic activity continue to decline, leading to negative risk sentiment, exposure towards bonds qualifying for quantitative easing programs could turn out to be a good protection. First and foremost, this will be government and covered bonds. Given the credit weakness of both the US and most European countries, we believe Scandinavian bonds, where both government and covered bonds are truly AAA-rated, is the right place to be.


Kristian Myrup Pedersen, Quant Director – CABA Capital

TRADITIONAL STRATEGIES TO CAPTURE THE OPPORTUNITIES

With a market size of more than EUR 825 billion, the Scandinavian AAA-rated covered bond market offers attractive opportunities that can be utilized through a variety of different investment strategies.

Firstly, long only investors who do not use derivatives can obtain exposure towards interest rates, spread premium, and in the case of callable bonds, also volatility premium through covered bonds. Therefore, Danish banks, investment funds, and pensions funds are large buyers of covered bonds and use them as the foundation of their fixed income portfolios. A key feature of this investment strategy is that – in the absent of trading – the risk will naturally decline over time as the bonds approach maturity.

Secondly, the above-mentioned investors often also optimize part of their covered bond portfolios through the use of derivatives, where they for example reduce their interest rate risk – but keep their exposure to spread premiums and volatility premiums – by selling interest rate swaps. This strategy comes with

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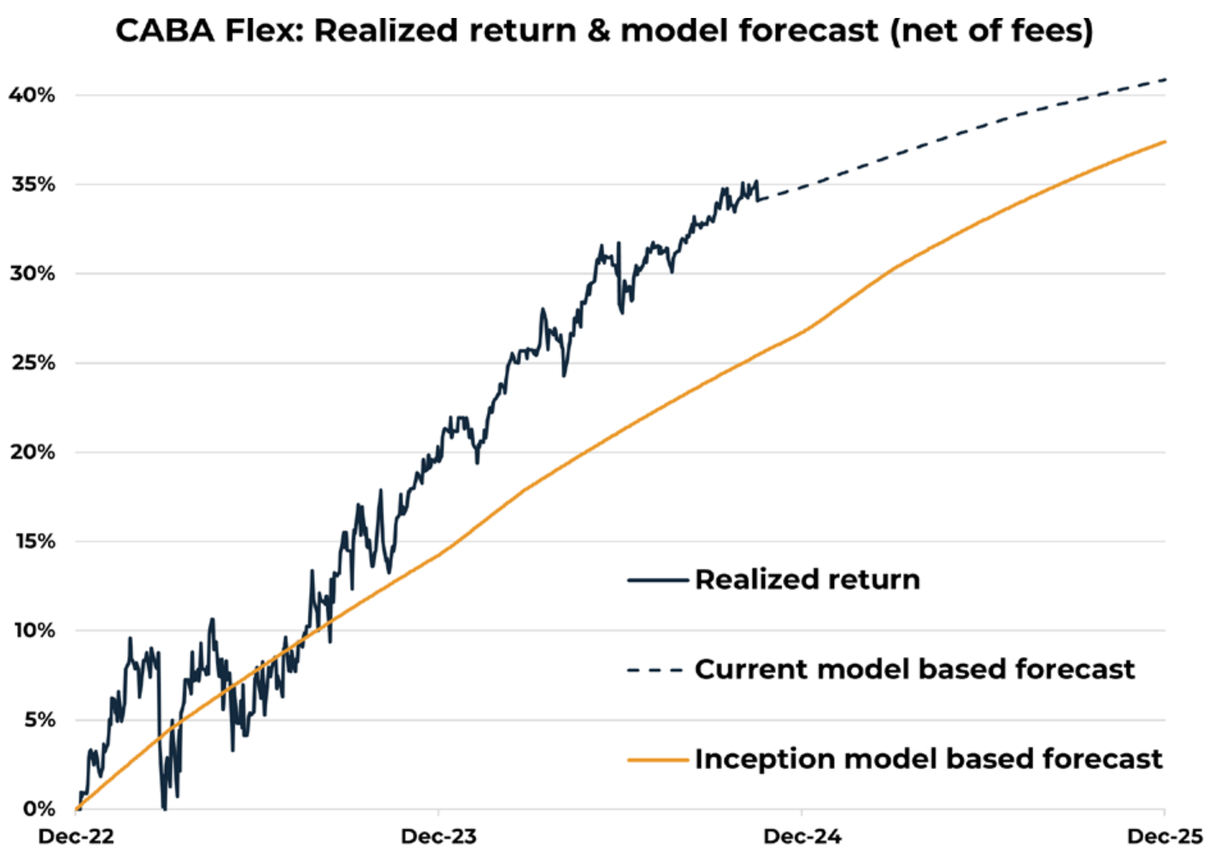
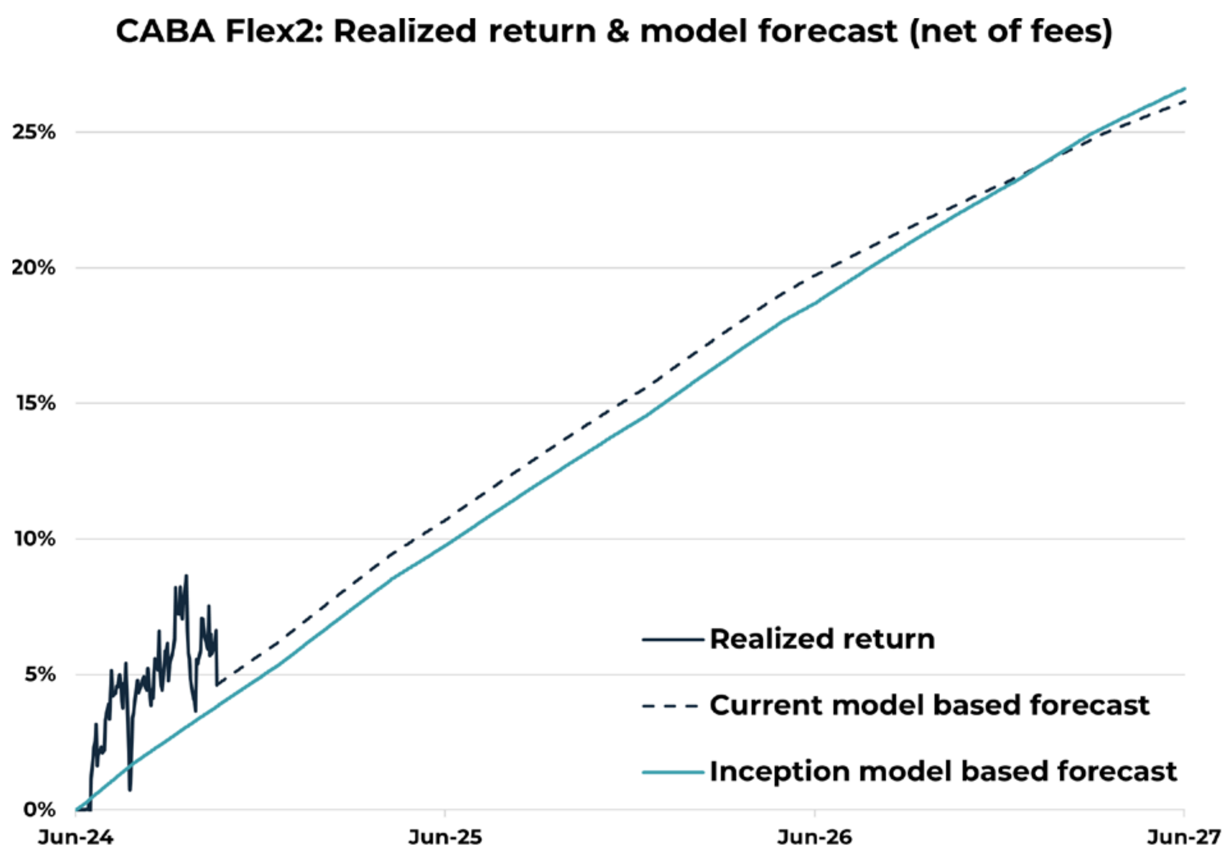




a higher expected return than the reduced interest rate risk would otherwise allow. A key feature here is the separation of spread premiums and volatility premiums from interest rate risk.

Thirdly, fixed income hedge funds often invest in covered bonds, reducing the interest rate to zero by selling swaps, and thereby leaving nothing but the spread premiums and volatility premiums. This is in itself a low-risk strategy, and therefore hedge funds increases the expected return by leveraging the exposure by borrowing money using the covered bonds as collateral. A key feature of this strategy is to increase the attractive risk-adjusted return of spread premiums and volatility premiums to match the expected returns of equities, just with a different risk-return profile adding to portfolio diversification.

The three investment strategies above come with their own pros and cons, and as the typically serve different purposes from a broader portfolio perspective, they all have their justification for existence.

“Diversification is known to be the only “free lunch” in financial markets, and with the CABA Flex funds, investors can have a higher share of risky assets without higher portfolio risk.”

THE NEW CABA FLEX STRATEGY

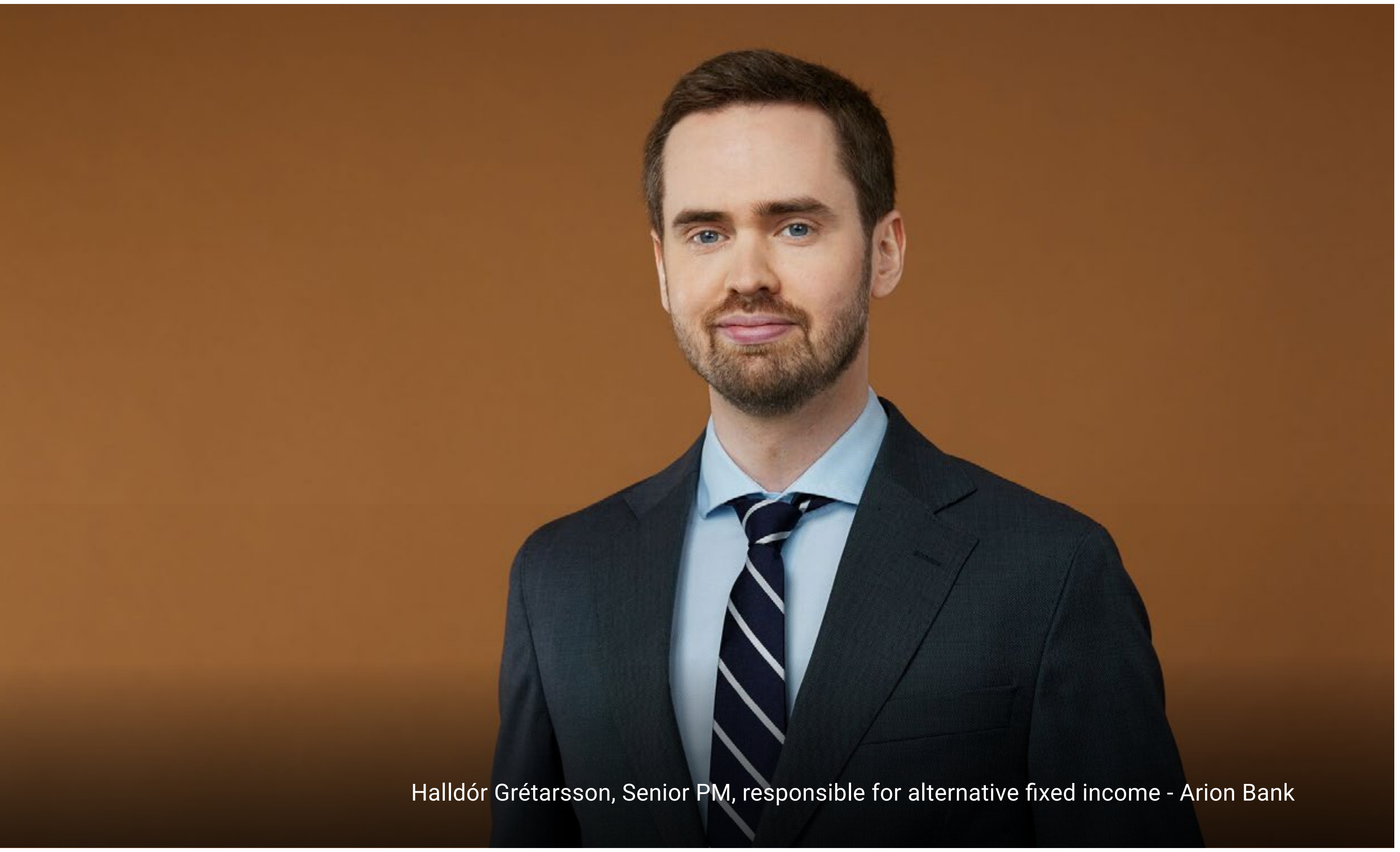
At CABA Capital, we have designed a new investment structure to combine the best of all three AAA-rated covered bond investment strategies above. In the two funds, CABA Flex and CABA Flex2, we invest in covered bonds that are likely to directly benefit from the coming cutting cycle, and we do it in such a way that we are able to obtain “equity-like returns with bond-like risk-profiles.”

In short, we invest in Scandinavian AAA-rated covered bonds, where we isolate the spread premium and increase the expected return by appropriate leverage. The funds are wrapped in 3-year maturity structures with declining risk profiles from start to end, leading to both a profound transparency throughout their lifespans and a high accuracy in return forecasting.

In the two performance charts, we have illustrated the expected return path at inception, the realized return up until now, and the expected return path until maturity for the two funds (all returns are after fees). As the charts show, both funds are performing well with realized returns in the high end of the return expectations at inception. Moreover, as especially the CABA Flex chart show, the volatility of the funds tends to decline over time, which is a feature that is built into the very structure of the funds.

MORE RISKY ASSETS WITHOUT MORE RISK

Diversification is known to be the only “free lunch” in financial markets, and with the CABA Flex funds, investors can have a higher share of risky assets without higher portfolio risk. Over the past 20 years, the underlying CABA Flex strategy would have delivered yearly returns of almost 10 percent, matching the global equity market, with a standard deviation of only half the size of equities. Looking ahead, in an all-else equal scenario, the CABA Flex funds will perform according to their expected return paths, and should we end up in a negative scenario with a severe economic downturn, they have potential to benefit directly from a deep cutting cycle with revitalized quantitative easing program. Therefore, now could be a very good time to allocate from traditional risky assets to our newest fund, CABA Flex2.


Halldór Grétarsson, Senior PM, responsible for alternative fixed income - Arion Bank

Alternative Fixed Income a Growing Asset Class for Icelandic Investors

By Pirkko Juntunen – HedgeNordic

The size of the Icelandic pension funds, relative to GDP, is now larger than the combained market value of the country's banks and insurers, with enough capital to buy all the listed equities and bonds of ISK6 trillion (Euro40.7billion) market. According to data from the Central Bank of Iceland, at the end of 2023 Icelandic pension fund assets totalled ISK7.71 trillion or 184% of GDP. This alone necessitates diversification internationally and also to alternatives there including alternative fixed income both home and abroad.

Frjalsi Pension Fund, the fifth largest in Iceland with assets of ISK500 billion (Euro3.4 billion) and about70,000 members is the largest independent pension fund and has been focusing on investing in alternatives locally since after the economic crisis in 2008 and in foreign alternatives, including foreign fixed income, since 2019, a few years after the currency constraints were removed in 2017. Icelandic pension funds are currently allowed to have 20% in unlisted assets.

The investment case for our investing in alternative fixed income is both diversification and returns, according to Halldór Grétarsson, senior portfolio manager responsible for alternative fixed income at Arion Bank's institutional asset management arm which manages Frjalsi's portfolio. Frjalsi 1, the largest investment path, is currently investted around 11% in unlisted assets (not including undrawn commitments), with about 2% in international alternative fixed income and 2,5% in the domestic market.

Currently there is a 51.5% limit for Icelandic pension funds of investing internationally but this will rise to 53% in 2025 and at the same yearly pace to 65% by 2036. At the end of June about 39% of pension assets were invested internationally, according to the central bank.

"There are plenty of opportunities in Iceland but there are even more possibilities abroad," Grétarsson noted.

„As Icelandic pension funds can only invest 20% in unlisted securities, we prefer and mainly focus on high-octane investments.“

Halldór Grétarsson

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"The Icelandic alternative fixed income market started in full force after the 2008 Global Financial Crisis when the listed market shrunk severly. This spurred the fund management arms of local banks to start private equity funds, such as the Stefnir SIA series (Arion bank) and Landsbréf Hornseries (Landsbankinn)," he said, adding that there are also some smaller non-bank alternatives funds operators today such as Summa. "Over the past five years, the venture capital market has also grown Most of the larger fund management houses are also offering private debt funds," he added.

Grétarsson continued: "We have been investing in foreign private markets since 2019. As Icelandic pension funds can only invest 20% in unlisted securities, we prefer and mainly focus on high-octane investments. When it comes to private credit, our focus has been on levered, direct-lending funds both in the US and in Europe, all of which are mid-cap market focused, with underlying companies between US$25-75 million EBITDA. We consider mid-caps a sweet-spot for us. It has to do with the accessibility to the lending markets by the underlying companies. If you go for the large-cap market then the companies can usually access the broader syndicated market and get better terms or access the high-yield market. If you go for small-caps then the companies are much smaller and usually with greater default risk. "

He further noted that the investments are majority floating-rate senior secured loans. "Because of our preference of high-octane investment we have, in most case, invested in leveraged funds. This is not what European investors typically prefer; it is more of a US-investor focus. But for us, if it is not leveraged the return target is often too low and then we'd rather do more private equity, because of the 20% limit we have on unlisted investments," he explained, adding that the aim in alternatives is to scale up the portfolio returns over the long horizon. The portfolio is currently invested with two US managers and two European managers.

In other fixed income segments Arion Bank invests in a high-yield fund focusing on Scandinavia. "We have seen that premiums in Scandinavia are, in some areas, higher than in Europe and differ to the US in that it is predominantly floating rate, giving us exposure to the credit risk without the interest rate risk," Grétarsson said. "We are noticing that in the US managers have been increasing their allocation to payment-in-kind (PIK) debt. PIK is a type of loan where the borrower pays interest with additional debt rather than cash. " he notes, adding that the portfolio is also invested in distressed debt funds which could benefit if signs of trouble materialise but also provides diversification. Apart from Frjalsi, Arion Bank also manages the assets of five other pension funds. The average asset allocation to fixed income across Arion Bank's portfolio is 54% out of which alternative fixed income constitutes approxinmately an aggregated 3%, and is increasing.

Hjörleifur Waagfjörð, head of institutional asset management at Arion Bank, said: "In the portfolios we manage the average allocation to international alternatives is often on the range 5-10% and up to 7% is currently invested in domestic alternatives. In the domestic market we mostly use local funds or similar investment vehicles to access the alternative fixed income market. These funds, such as the Stefnir SÍL Series, are a relatively new phenomenon, having been introduced in the last 10 years, focusing on secured loans."

Fixed-income related hedge funds are at this point in time not on the radar Waagfjörð said. "Our main foreign alternative focus in the last months has been on the secondary market and private debt. Since the interest rates are giving such a good expected return with some gearing on top, we have not seen the need to look at the hedge fund spectrum" he added.

Unlisted assets of portfolio mandates are currently well under legal restrictions giving room to expand its unlisted investments further, up to the 20%. Waagfjörð said the majority of unlisted illiquid assets are invested private equity, estimating that some 20-40% of flows to unlisted assets go to alternative fixed income.

In June 2024 a law-change relating to pension fund investment limits was introduced which now enables them to invest up to 5% of total assets in equities issued by companies active in the long-term residential rental market regardless of them being listed or unlisted. This led to the establishment of, so far, the largest special residential rental fund Stefnir SRE III (by Stefnir, Arion Bank) with assets of ISK 40 billion. The fund is solely owned by only local pension funds.


Hjörleifur Waagfjörð, Head of Institutional Asset Management - Arion Bank

"Our main foreign alternative focus in the last months has been on the secondary market and private debt.“

Hjörleifur Waagfjörð

Other areas of the alternative fixed income market where Icelandic pension funds have been active for many years include consumer exposure through mortgage loans, both to fund members and through other channels. As part of the country's sustainable financing framework, introduced in 2021 and updated in 2023, green, blue and social bonds can be issued. This year the government issued a Green Bond to boost its sustainability credentials as well as a Gender Bond, designed to boost the financial health and welfare of women. Some of these bond issues have been invested in current portfolio of Frjálsi.

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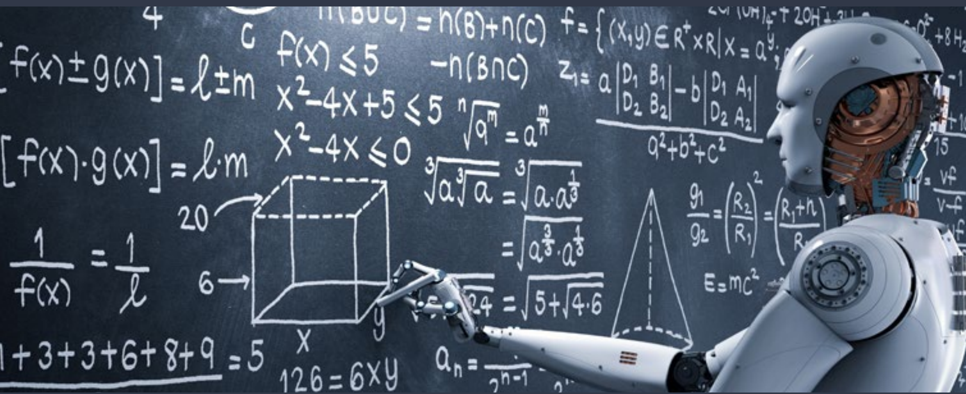

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