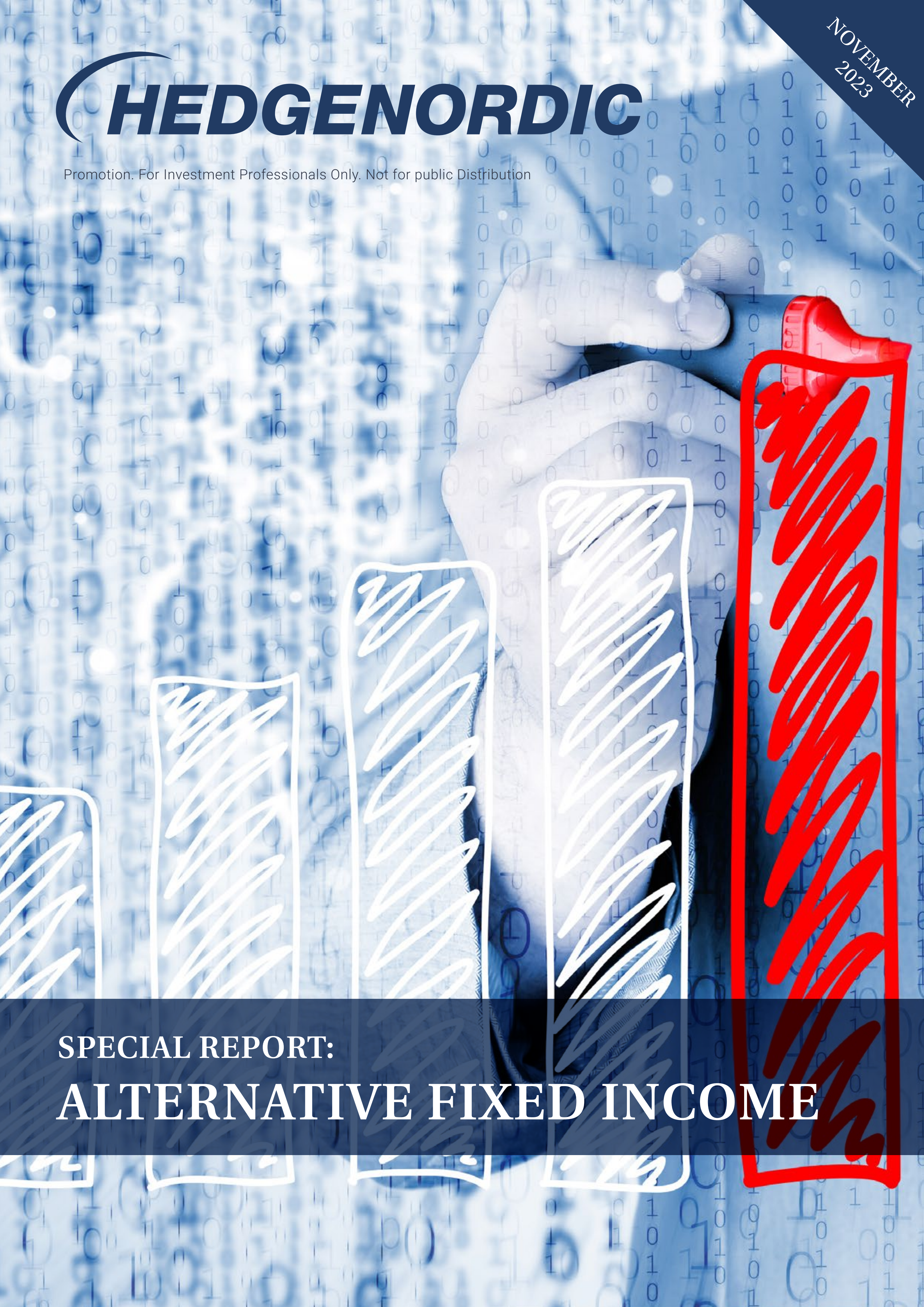

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HEDGENORDIC

Promotion. For Investment Professionals Only. Not for public Distribution

SPECIAL REPORT:

ALTERNATIVE FIXED INCOME

Contents

PROMOTION. FOR INVESTMENT PROFESSIONALS ONLY. NOT FOR PUBLIC DISTRIBUTION

HEDGENORDIC

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…

With the Pain Comes the Gain

Although fixed income markets suffered a meltdown in 2022, the rise in yields has captured the attention and interest of investors seeking to make a 'real' return on investments. After a decade of low interest rates that has suppressed the bond market's ability to generate attractive and reliable returns, fixed-income investing is entering an exciting new era.

Bonds are now highly popular in investing circles, with their popularity increasing in recent months alongside rising interest rates. Admittedly, the journey to higher yields has been painful for bond investors, as various bond market sectors experienced distress. However, with the pain comes the gain. Higher rates can now offer the potential for higher total returns and greater stability in returns going forward.

Amid economic uncertainty, it is imperative to acknowledge the multifaceted forces at play. Geopolitical risks loom large, casting a shadow of unpredictability across the global financial stage. The ebb and flow of international relations can send shockwaves through markets, altering the trajectory of returns and reshaping risk profiles. In this context, it is paramount for investors to be vigilant, attuned to the currents that may sway their portfolios.

Against this backdrop of uncertainty, the need for diversified, resilient investment strategies has possibly never been more pronounced. Alternative fixed income strategies emerge as a beacon of opportunity, offering a spectrum of approaches beyond conventional bonds. From relative value strategies to credit arbitrage, public or private assets, these innovative techniques empower investors to uncover hidden value and mitigate risk.

For institutional investors tasked with stewarding vast pools of capital, the imperative to embrace alternative fixed income strategies is paramount. In this edition we elucidate how Ericsson Pensionsstiftelse, the Nobel Foundation and AP4 may leverage alternative strategies to fortify their portfolios against the headwinds of geopolitical uncertainty and inflationary pressures. By diversifying across a spectrum of strategies and asset classes, institutions can forge a resilient path forward, one that navigates the complexities of today's financial markets with agility and foresight.

This year's edition of HedgeNordic's report on "Alternative Fixed Income" starts off with David van Bragt and Daniel Torres from Aegon Asset Management outlining the "Opportunities in Alternative Fixed Income". Magnus Dahlgren and Fredrik Carlsson from Carlsson Norén Asset Management discuss the opportunity set in hybrid securities, "The Road Less Traveled: The Space Between Bonds and Equities." Ulrika Bergman, Chief Investment Officer at the Nobel Foundation, talks about hedge funds serving as the "Nobel Foundation's Alternative to Fixed Income" in recent years. With fixed-income markets more attractive amid higher interest rates, she is weighing the pros and cons of shifting some of the hedge fund allocation to fixed income. Sissener Corporate Bond Fund has navigated a series of sell-offs in the Nordic high-yield corporate bond market since launching in the first quarter of 2019. Portfolio manager Philippe Sissener says the key has been to "Stay Active and Handpick Your Credits."

"Private Credit is Core Component for Ericsson Pensionsstiftelse," says Michael Levén, portfolio manager at the pension fund covering the employees of Swedish telecoms company Ericsson. After celebrating its 20-year anniversary this summer, Asgard Fixed Income Fund, one of the most decorated Nordic hedge funds, "Eyes Promising Risk Premia Opportunities." Patrik Jonsson, who was entrusted with the responsibility of building AP2's private debt allocation, "Sees Private Debt as Compelling Alternative to Equities."

In "Ridge Capital's Flexibility in the Nordic High-Yield Market," Christoffer Malmström and Måns Levin introduce their freshly-launched strategy within to seize opportunities in the Nordic high-yield corporate bond market. Josephine Richardson from Anthropocene Fixed Income Institute talks about Sustainability Linked Bonds, which can be thought of as "A New Financial Derivative."

Søren Mørch from Danske Bank Asset Management then describes the process of "Making a Sucessful EMD Strategy Even Stronger With Artificial Intelligence." Sriram Reddy from Man GLG concludes by sharing the fourth-quarter credit outlook in "Price Is What You Pay, Value Is What You Get."

In the pages that follow, you will find a compendium of insights, analyses, and case studies, each offering a unique vantage point on the dynamic world of alternative fixed income strategies and the hedge funds that traverse it. We invite you to embark on this journey with us, as we illuminate the pathways to stability and prosperity in an era defined by change.

Enjoy the read!

Kamran Ghalitschi
PUBLISHER, HEDGENORDIC

Opportunities in Alternative Fixed Income

By David van Bragt and Daniel Torres – Aegon Asset Management

David van Bragt, Investment Solutions Consultant – Aegon Asset Management

Alternative fixed income assets have become increasingly important for institutional investors. They provide opportunities to increase the overall portfolio yield when the (often lower) liquidity of these assets is less of a constraint. This is typically the case for long-term investors, such as pension funds or life insurance companies.

SUMMARY

- The alternative fixed income asset class is highly diverse, embracing many asset classes such as private debt, consumer loans, mortgage investments, insured loans, loans to small and medium-sized enterprises (SMEs), infrastructure debt and asset-backed securitizations. These assets can offer enhanced yields compared to government and corporate bonds, along with relatively low correlations to traditional assets.

- An alternative fixed income allocation can offer investors exposure to a wide variety of return drivers, many of which also have an environmental, social and governance (ESG) focus.

- Alternative fixed income is particularly attractive for long-term investors, including pension funds and life insurance companies.

- An interesting feature of many alternative fixed income assets are the additional safety measures compared to traditional corporate loans, such as covenants and guarantees.

- Alternative fixed income strategies exhibit great variety in terms of spread, risk, capital charge, liquidity, duration matching and ESG opportunities. This enables investors to choose those assets which best fit their particular investment needs, by taking the different characteristics of these assets into account.

INTRODUCTION

The alternative fixed income universe is rapidly expanding and has now branched into different directions. Some examples are given below.

Consumer exposure
Many investors have a large exposure to sovereign and corporate risk. Alternative fixed income assets can offer exposure to consumer risk, for example through investments in residential mortgage loans or securitizations backed by credit card loans, auto loans or student loans. This helps diversify their portfolios.

Sustainable financing
A huge capital flow is required to transform the current society into a more sustainable one. Impact investing in infrastructure is already a major trend. Opportunities in water, water treatment, communications and mobility are also available.

Real estate & infrastructure debt
Property and infrastructure investments are a long-term, stable asset class, with the potential for an ESG and/or impact investment focus. Investors who need their private debt investments to contribute to long-term liability hedges can also find real estate debt or infrastructure markets very attractive.

Insured credit
Further diversification can be found in insured credit. These are loans with additional credit protection by a highly-rated insurance company. This strategy can be especially appealing for insurers due to its attractive return on capital under Solvency II.

An alternative fixed income allocation can provide strong diversification benefits, with exposure to a variety of return drivers, often with a focus on ESG factors. Given the illiquid nature of most alternative fixed income categories, the practical allocation between sectors will not be particularly dynamic. However, the high income produced by many of these categories means there is a potential to reallocate income streams to new opportunities or increase allocations to favoured sectors. Regional diversification is also important, although there may be a preference for certain regions in some sectors, given the relative size of the markets and the expertise required for investing successfully in different parts of the market.

Daniel Torres, Investment Solutions Consultant – Aegon Asset Management

A high demand for impact investing - but still a limited supply of deals that conform to the strictest ESG definitions - makes building a diversified portfolio less easy, or at least a more time-consuming process. We believe, however, that the various existing opportunities and ongoing development of the alternative fixed income market make it a good choice for supporting long-term sustainable investing objectives.

In the table on the right side we compare different categories within the alternative fixed income spectrum. It is important to note, however, that the scores on the different dimensions can (and will) shift over time and that the assessment is sometimes based on qualitive instead of quantitative measures (the ESG assessment being an example). Capital charges are determined with the standard formula of the Solvency II regulations.

ESG CONSIDERATIONS

Alternative fixed income strategies are well-suited for sustainable investing. They often finance projects that do not have easy access to capital markets and would otherwise receive less financing. Furthermore, many ESG solutions are driven by smaller, innovative, privately-owned companies, which are commonly involved in direct lending transactions.

Investors can be selective and specific when it comes to ESG. Investors, individually or in small groups, can negotiate terms to stipulate adequate reporting on ESG, or set interest rates contingent on general ESG performance or specific ESG factors. They can also have more direct controls and ways to engage with borrowers. Integrating ESG is part of our investment process for each category of alternative fixed income. This is different for each strategy and opportunities for responsible, sustainable and impact investing can be found.

	Swap spread	Risk	Capital charge	Liquidity	Matching	ESG factors
Dutch mortgages	1.5%-2.0%	Low (AAA-AA)	Low	Low	Moderate	✓
Export credit agency loans	0.5%-1.5%	Low (AAA-AA)	Low	Low	High	✓
Investment grade asset-backed securitizations	~ 2.75%	Low (AAA-BBB)	High	High	Low	✓
Simple, transparent and standardised (STS) securitizations	~ 0.7%	Low (AAA)	Low	High	Low	✓
Insured credit loans	2.0%-2.5%	Low (AA-A)	Low	Low	Moderate	✓
Infrastructure debt (senior)	2.0%	Low (BBB)	Moderate	Low	High	✓
Small and medium-sized enterprise loans	7.0%-8.0%	Moderate (BB)	Moderate	Low	Low	✓

Table 1: Characteristics of a variety of fixed income asset classes (for illustrative purposes only). Indicative spreads in EUR. Actual spreads are reported for strategies which are available via a well-diversified fund format. For more bespoke strategies a spread range is given. Rating indications in this table are either external ratings (when available) or internal ratings (for unrated instruments). We here consider the matching properties for an investor with long-term liabilities. For details on how the strategies can have an ESG angle, get in touch with us. Sources: Bloomberg, Aegon Asset Management, La Banque Postale Asset Management, as at June 30, 2023 or latest available.

CONCLUSIONS

In recent years alternative fixed income assets such as mortgage loans, infrastructure financing and private debt have become much more important categories for institutional investors. They can provide opportunities to increase portfolio yield when the (often lower) liquidity of these assets is not a constraint. This is typically the case for long-term investors, such as pension funds and life insurance companies.

Many insurance investors will already be aware of the benefits of Dutch mortgages, which can provide an attractive return on capital. Other types of alternative fixed income can add diversification alongside mortgages, but also alongside public market investments. Higher yields are possible (even with well-collateralized senior loans), particularly in private corporate debt markets. An interesting feature of these categories is that greater safety measures can exist compared to traditional corporate loans, for example in the form of additional covenants or guarantees.

Alternative fixed income strategies demonstrate great variety, both in terms of spread, risk, capital charge, liquidity, duration matching and ESG factors. Investors have an opportunity to select those assets which best fit their particular investment needs, by taking the different characteristics of these assets into account.

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The Road Less Traveled: The Space Between Bonds and Equities

By Eugeniu Guzun – HedgeNordic

"Hybrids are considered part equity by credit rating agencies and can be valuable for companies in strengthening their rating."

Magnus Dahlgren

Fixed-income boutique Carlsson Norén Asset Management runs a distinctive fund that focuses on the spectrum between senior bonds and equities. This particular space encompasses a variety of financial instruments, spanning from senior bonds at the lower-risk, higher-priority end of the spectrum to equity-like instruments such as preference shares or D shares, which carry greater risk and lower priority.

The current portfolio of Carlsson Norén Yield Opportunity boasts a yield-to-call of between 14 and 15 percent, all without venturing too deeply into high-risk territory. "This is an opportunistic fund that can invest in the entire space between senior bonds and equity, starting from the higher-priority senior bonds, then hybrid bonds and extending to the lower-priority instruments such as preference shares and D shares," explains portfolio manager Magnus Dahlgren. The majority of the fund's exposure is in corporate hybrids and bank hybrids, with a growing exposure to senior bonds at the expense of riskier investments such as preference shares.

"Senior bonds are not necessarily the main focus of the fund, but we have seen very attractive opportunities in this space, especially when comparing to D shares and preference shares in the real estate sector," highlights Dahlgren. Some issuers of preference shares from the Swedish real estate sector are likely to cut their dividends to strengthen their financial position in an environment of higher interest rates. "This universe is not investible for us at the moment because of the low expected rate of return over the long term," explains Dahlgren.

Conversely, real estate companies unlikely to cut their dividends on preference shares are currently trading at yields ranging from seven to nine percent, placing them in the same range as their senior bonds. "For that reason, we prefer the senior bonds because they have a much higher priority and lower risk with a similar expected return," argues Dahlgren. "This will probably change back and we are looking for opportunities to switch back into more equity-like instruments in a couple of years."

BACK TO THE BASICS

While subject to diverse terms and characteristics, hybrid securities fundamentally encompass both debt and equity elements. Dahlgren describes these instruments as having bond-like traits, featuring

“As a general rule, hybrids are not very sensitive to interest rates, but they are more sensitive to the risk sentiment in the market.”

Magnus Dahlgren

pre-determined coupon payments independent of operational performance, along with equity-like attributes such as the absence of a maturity date. Although hybrids are perpetual, they become callable several years after issuance, often at the five-year mark. “Most hybrid securities are perpetual, but in reality, the duration is much shorter because the instruments are callable,” says Dahlgren.

Companies issue hybrids for various reasons, whether driven by regulatory requirements or the desire to improve their credit ratings, given that hybrids carry a partial equity component. “Hybrids are considered part equity by credit rating agencies and can be valuable for companies in strengthening their rating,” explains Dahlgren. “Despite higher interest rates, hybrids can lower the total cost of a company’s debt by enabling a reduction in the interest rate on senior debt.” These securities usually represent the most expensive form of debt for an issuer.

EMERGING FROM TURBULENT TIMES

The financial and real estate sectors naturally witness higher issuance of hybrid securities, which explains the elevated volatility in the Nordic universe of hybrid securities throughout 2022. With real estate companies grappling with increased inflation and higher interest rates, the more junior hybrid securities bore the brunt of heightened uncertainty. The banking sector also experienced turbulence, stemming from the takeover of Credit Suisse by UBS. The Swiss financial regulator mandated the credit-stricken bank to write down additional tier-1 (AT1) bonds, while equity shareholders received payouts from the takeover, leading to a disruption of the traditional pecking order hierarchy.

“As a general rule, hybrids are not very sensitive to interest rates, but they are more sensitive to the risk sentiment in the market,” explains Dahlgren. The unique situation in the Swedish market stemmed from the substantial presence of corporate hybrids within the real estate sector. For issuers of hybrids in other business sectors, “hybrids are not very sensitive to interest rates,” according to Dahlgren. Most hybrids, at least in the Swedish market, take the form of floating-rate notes and are not significantly affected by interest levels at all, except for increased coupon payments.

Despite significant turbulence and uncertainty, Carlsson Norén Yield Opportunity emerged from the turmoil with a loss of 13.6 percent in 2022. The fund has already gained close to seven percent in the first three quarters of 2023, all while still enjoying a yield-to-call in the range of 14 to 15 percent. “Although there’s been turbulence, the fund has managed to navigate this environment very well and the future now looks promising,” Carlsson summarizes last year’s turmoil. “We have weathered these storms tremendously well, avoided troubled companies, and prevented permanent capital loss.”

The switch from equity-like instruments to senior bonds saved a lot of money for Carlsson Norén Yield Opportunity, but its portfolio was still affected by the volatility in the market. “There were no credit events, it was simply price volatility,” says Dahlgren. “We navigated through this turbulence effectively, and with interest rates significantly higher now than a few years ago, along with much higher risk premiums, this creates really good opportunities for long-term investors,” adds the fund’s responsible portfolio manager. “Hybrid securities were yielding around five or six percent a couple of years ago. But now, you can get 15 percent.”

THE OPPORTUNITY AHEAD

As fixed-income macro managers, the team at Carlsson Norén Asset Management holds a well-documented view of where interest rates are headed. They anticipate that rates will decline in the future, particularly benefiting hybrid instruments in the property sector, which “have been hammered during the rise of the interest rates,” according to Carlsson. “Having investments in hybrids tied to the property market is advantageous if interest rates come down because lower rates will be good for the bonds, good for risk premiums, and also good for the property sector.”

Return expectations for Carlsson Norén Yield Opportunity largely hinge on risk sentiment, which, in turn, depends on the development of inflation and interest rates. Dahlgren suggests that expecting at least ten percent annually over the next couple of years is a reasonable projection. Although Carlsson Norén Yield Opportunity seeks to represent an alternative to funds in the fixed-income space,

Fredrik Carlsson also observes that hybrid securities offer much higher potential compared to equity investments of the same issuer.

“I have never seen such a big advantage for hybrids compared to equity investments in the same businesses.” Carlsson points out that the expected return on the stock market typically involves a risk premium of around four percent, translating into an expected return in the range of seven to ten percent. “In the hybrid market, you get a much higher expected return than the equity market at the moment.”

“I have never seen such a big advantage for hybrids compared to equity investments in the same businesses.”

Fredrik Carlsson

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Hedge Funds – Nobel Foundation's Alternative to Fixed Income

By Eugeniu Guzun – HedgeNordic

"We have maintained both a low allocation to fixed income and very low duration in this portfolio, which made sense given the low rates."

In the world of remarkable legacies, few names stand out like Alfred Nobel, the Swedish inventor, scientist, and philanthropist who left much of his fortune to establish the Nobel Prizes. More than a hundred years have passed since the first Nobel Prizes were awarded, and yet, their prestige has only increased with time. Behind this enduring tradition stands the Nobel Foundation, a private institution entrusted with the responsibility of safeguarding Alfred Nobel's vision and ensuring that his prizes continue to honor those who have made profound contributions to humanity.

Since 2017, in her role as Chief Investment Officer, Ulrika Bergman has been charged with overseeing the Nobel Foundation's financial stewardship and asset allocation. As Bergman reveals, the Foundation's approach to asset allocation involves building a well-diversified portfolio with a long-term perspective. The investment strategy is not just about preserving wealth but also growing it in a way that supports the Nobel Prizes' mission. "We have a pretty basic strategic asset allocation framework, where the starting point is Alfred Nobel's will," Bergman tells HedgeNordic.

Ulrika Bergman, Chief Investment Officer – Nobel Foundation

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"The will states that the Nobel Prizes should be funded by the returns from investments in what he refers to as safe securities," says Bergman. As per the will, the Nobel Foundation is entrusted with safeguarding the foundation's asset base, ensuring the long-term financial stability of the prizes. "His will has been translated into our statutes and, over the years, the interpretation of what constitutes safe securities has evolved because he did not explicitly define that in his will," elaborates the Nobel Foundation's CIO. The current goal for the Nobel Foundation is to generate three percent real returns annually, allowing for a margin to cover the costs of giving out the prizes, research for the prizes, and the overall administration.

"To reduce the hedge fund allocation is not something we have decided or see as necessary at this stage. generate good returns and diversification benefits."

ASSET ALLOCATION FRAMEWORK

"Our main goals are to achieve a real return above three percent and to safeguard the assets, with eternity as the horizon," notes Bergman. Given that starting point, the Nobel Foundation's portfolio management relies on a basic strategic asset allocation framework, encompassing investments in various asset classes such as equities, hedge funds, fixed income, and real assets. Bergman and the investment committee use a number of external sources for forecasting of expected returns, risk, and correlations for each asset class to build the basis for their strategic allocation.

Tasked to safeguard the Nobel Foundation's assets and achieve a relatively modest return target, Bergman emphasizes that getting their return projections right in each asset class is of secondary importance. "Being right on the diversification and correlation characteristics of our asset allocation is more important." Even so, the Nobel Foundation's investment capital rose by 7.5 percent annually over the past five years, comfortably achieving its return target.

HEDGE FUNDS AS REPLACEMENT FOR FIXED INCOME

At the close of 2022, the Nobel Foundation had 53 percent of its SEK 5.5 billion investment portfolio allocated to equities, 22 percent to hedge funds, 17 percent to fixed-income assets and cash, and 9 percent to property and infrastructure. Between one-third or one-half of the fixed-income allocation sits in cash and cash equivalents, leaving about 10 percent for fixed-income instruments, such as foreign corporate credits, Swedish fixed income, and unlisted bond funds.

"For a long time, fixed income has only accounted for ten percent of our strategic asset allocation, which made sense given the low-rate environment," Ulrika Bergman tells HedgeNordic. Bergman has spent most of her tenure as CIO of the Nobel Foundation in a low-interest-rate environment since joining in 2017. "We have maintained both a low allocation to fixed income and very low duration in this portfolio, which made sense given the low rates."

As an alternative to the low-yielding fixed-income assets, the Nobel Foundation has maintained an industry-unusual strategic allocation of 25 percent to hedge funds. "Our 25 percent allocation to alternatives essentially comprises hedge funds, serving as replacements for fixed income with a risk-return profile between fixed income and equity risk."

The Nobel Foundation had SEK 1.2 billion allocated to hedge funds at the end of 2022, with this hedge fund portfolio returning 26.1 percent during 2022 in terms of Swedish kronor. With the hedge funds based out of the United States and maintaining U.S. dollar exposure, part of that return stemmed from the weakening of the Swedish krona. The return was still impressive at 11.0 percent in U.S. dollar terms. This follows a return of 12.0 percent in 2021 in terms of Swedish kronor.

With the fixed-income opportunity set arguably more attractive than at any point in the past decade or more, the Nobel Foundation may contemplate moving a portion of its hedge fund portfolio to fixed income. "Given the fact that we thought about our hedge fund portfolio as a partial substitute for fixed income, we might reduce this allocation, but at the same time, we have generated strong returns from our hedge fund portfolio," argues Bergman. "We still need to weigh the pros and cons of each asset class."

"The swift move into higher rates all over the world makes fixed income more attractive," elaborates Bergman. At the same time, it also makes sense to extend the duration of the fixed-income portfolio, as a longer duration may offer diversification benefits. "To reduce the hedge fund allocation is not something we have decided or see as necessary at this stage. Our portfolio has been able to generate good returns and diversification benefits," emphasizes Bergman. "I still believe that hedge funds could provide good diversification in the face of swift changes in trends and quick market turns. They are the quickest ones to react and that helps."

HEDGE FUND MANAGER SELECTION

The Nobel Foundation relies on external managers for exposure to all asset classes. Its hedge fund portfolio of SEK 1.2 billion comprises four different managers, who primarily employ a multi-strategy approach. "We are a small organization, well-known but small in terms of resources," says Ulrika Bergman. "So we try to be very selective in all asset classes and choose managers with a long track record, strong reputation, responsible investing policies – those who tick all the boxes for a high-quality manager."

Given its relatively constrained capital and human resources, the Nobel Foundation mostly tends to invest in the multi-manager, multi-asset space, favoring "big hedge fund shops with thousands of employees who are more likely to have a comparative advantage in terms of both resources, information, data, systems, tools." The focus on the multi-strategy, multi-manager approach also obviates the need to switch between different hedge fund strategies, which may be performing differently in varying market conditions. "Given our focus on the multi-strat approach, we don't need to shift between different strategies. We prefer to leave that decision to our managers."

The market environment of the decade before the Covid pandemic had not been particularly fertile for many hedge fund strategies due to low-interest rates, limited dispersion, and muted volatility resulting from central bank stimulus. Bergman sees a more favorable environment for hedge funds amid higher volatility. "Skilled hedge fund managers are good at finding shorter-term trends or mispricings in the market, which happen more frequently in volatile markets," concludes Bergman.

Philippe Sissener, Portfolio Manager – Sissener AS

Stay Active and Handpick Your Credits

By Eugeniu Guzun – HedgeNordic

> "Our conservative approach to the high-yield market has been very helpful in uncertain and volatile times as we experienced during March 2020 or several times last year…"

Launched in the first quarter of 2019, Sissener Corporate Bond Fund has navigated a series of sell-offs in the Nordic high-yield corporate bond market. The first test came in the roller-coaster year of 2020 when the COVID-19 pandemic triggered significant intra-year swings in credit spreads and returns. 2022 was a challenging year too, with multiple sell-offs driven by war in Ukraine, a European-wide energy crisis, and rapidly rising inflation and interest rates globally.

"It has only been four and a half years since we launched, but we have been through a stress test in terms of COVID, which was the craziest time we've seen since the global financial crisis, or even worse than the financial crisis during those two weeks of March," says portfolio manager Philippe Sissener. "We have been through a pandemic, war, rising interest rates, recession fears, and also a banking crisis that is probably not over," he elaborates. "We are very happy with how the fund has performed."

Sissener Corporate Bond Fund, which employs a more conservative approach to investing in the Nordic high-yield bond market, has fared well in its first four and a half years since its inception. The fund managed by Philippe Sissener as lead portfolio manager gained 6.3 percent in its first year, 8.0 percent in 2020, 7.8 percent in 2021, a relatively solid 2.9 percent during the challenging year of 2022, and 7.9 percent in the first three quarters of 2023. Despite solid performance, its portfolio still sports a yield-to-maturity of 9.2 percent.

"Our conservative approach to the high-yield market has been very helpful in uncertain and volatile times as we experienced during March 2020 or several times last year with the war breaking out, recession fears emerging, interest rates rising, and also the bank crisis in March this year," says Sissener. One advantage of this conservative approach is that Sissener Corporate Bond Fund experiences smaller declines than the broader market during bouts of volatility and, more importantly, recovers much faster from drawdowns.

"The rebound is much faster because investors will always chase quality in times of uncertainty," explains Sissener. A portfolio of more conservative and higher-quality high-yield bonds will decrease less in value and recover more rapidly. "These characteristics of our bond portfolio explain why the fund has been behaving as it has," he elaborates. The preponderance of floating-rate notes in the Nordic high-yield market is another reason for the solid performance of Sissener Corporate Bond Fund in the rising interest rate environment of 2022 and 2023.

"We are not as vulnerable in a rising interest rate environment because we do not experience a significant present value impact on the bond prices, but we do benefit directly from higher interest rates through our coupons instead," says Sissener. In late 2021, for instance, Sissener Corporate Bond Fund had a concentrated bond portfolio with a duration of only 0.4 years and a short time to maturity. "Low duration and shorter time-to-maturity helped us avoid a price beating last year and this year. This has made our returns much less volatile when spreads tighten or expand," says Sissener. "With the high-yield markets down between 10 to 15 percent last year, we were actually up three, which is great results from both a relative and an absolute perspective."

In a higher interest rate environment and with the – still distant – prospect of lower interest rates, the team running the fund has started to add some duration to the portfolio. "We began including some fixed-rate notes to the portfolio to extend the duration," says Philippe Sissener. "Although we will never have a very long duration, as it would be hard to get duration to exceed two years." The current duration of 1.1 is a "very comfortable place to be," according to Sissener. "Even if rates fall, our portfolio will appreciate in terms of price. However, we will receive lower coupons, so the effect balances out."

THE EVOLUTION OF THE MARKET AND THE FOCUS ON PUBLIC ISSUERS

In recent years, the Nordic high-yield market has transformed from a predominantly Norwegian marketplace dominated by industries such as oil services and shipping to a well-diversified pan-Nordic market. "Back in 2005, a high portion of the market was dominated by project-risk companies, with more than 50 percent of the market related to the energy sector," says Sissener. "The market has transformed quite a lot through the global financial crisis," he continues. "Since 2015, we have seen a shift in the market towards a more diversified issuer base, offering a wider range of sectors to choose from, enabling us as investors to build a broad and diversified portfolio."

> "We are seeing a lower default rate among the publicly-listed issuers compared to private companies. We are also observing higher recovery rates... It's a much better risk-reward to focus on this segment."

Despite managing a much larger asset base than before, Sissener prefers to maintain a more concentrated portfolio in higher-quality issues. Sissener Corporate Bond Fund manages NOK 3.6 billion in assets as of the end of October, compared to NOK 2 billion in late 2021. The team also finds most of these high-quality issues among publicly-listed issuers. Sissener Corporate Bond Fund differentiates itself from traditional high-yield funds in the Nordics by focusing entirely on publicly listed issuers.

"First of all, we are seeing a lower default rate among the publicly-listed issuers compared to private companies," Sissener explains. "We are also observing higher recovery rates from publicly-listed issuers in case of default due to their access to equity capital," he elaborates. "Equity is much more available, and if worst comes to worst, we are always able to convert our bonds into a listed equity."

Bonds issued by publicly listed companies also offer higher liquidity in the secondary market. "If you hold a bond issued by a publicly-listed company, you have a much larger pool of potential buyers of your bonds in the secondary market compared to private companies," says Sissener. Typically, only the primary buyers follow the private companies in the secondary market, whereas publicly listed companies attract a broader audience. In addition, publicly listed issuers provide more transparency, better reporting, and easier access to management.

"The publicly listed companies report four times a year, with the media, external analysts, and equity analysts all being on top of these companies," explains Sissener. In contrast, private companies often receive much less attention. Publicly-listed issuers exhibit lower default rates, higher recovery rates, better and more available information, and higher liquidity in the secondary market if and when one wants to buy or sell bonds. "It's a much better risk-reward to focus on this segment."

SOFT OR HARD LANDING, IT DOESN'T MATTER

Predicting the future of the economy has always been a challenging endeavor, with the ongoing debate surrounding whether the economy will experience a 'hard' or 'soft' landing continuing to dominate market attention. "We are always approaching bond investing from a conservative angle," says Sissener, irrespective of the prevailing market conditions. "We believe that it's very hard to say whether we will have a soft or a hard landing, but we definitely believe that the market will continue to be turbulent," he emphasizes.

In such an environment, "it is very important to stay active and handpick your credits and equities and without speculating about the nature of the landing." Their bond portfolio is designed to withstand turbulence, remaining robust in either scenario. "We are prepared for the worst, and then we are happy to get a further upside if indeed there is a soft landing."

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Private Credit is Core Component for Ericsson Pensionsstiftelse

By Eugeniu Guzun – HedgeNordic

Investing in private credit has grown increasingly appealing to many institutional investors seeking alternative avenues beyond traditional fixed-income assets. The potential for higher yields, especially in the once-dominant low-interest-rate environment, along with its diversification benefits, has driven interest in this asset class. Ericsson Pensionsstiftelse, the pension fund covering the employees of Swedish telecoms company Ericsson, has recognized private credit as a core component of its asset allocation.

"We have been investing in private credit since 2011 and see it as a core component in our asset allocation, representing roughly 12 percent of our total assets under management," says portfolio manager Michael Levén. Private credit provides investors with opportunities to access a wide range of credit strategies, spanning from senior direct lending to

> "We have been investing in private credit since 2011 and see it as a core component in our asset allocation."

Michael Levén, Portfolio Manager – Ericsson Pensionsstiftelse mezzanine and non-performing credit. This diversity offers flexibility and the potential for attractive risk-adjusted returns. Ericsson Pensionsstiftelse's private credit portfolio, which accounts for more than one-tenth of its SEK 30 billion portfolio, includes a blend of direct lending, junior debt, and stressed credits.

BENEFITS BEYOND THE YIELDS

Beyond the allure of higher yields, private credit offers several advantages over public debt, including more flexibility, greater downside protection, and protection against inflation. "We expect to get improved risk-adjusted return compared to public debt through yield pickup and downside protection," explains Levén. "The low duration risk and inflation protection due to its floating rate nature are also positives as long as the underlying portfolio companies are able to tackle higher interest costs."

Private credit, typically comprised of floating interest rates that adjust in tandem with benchmark rates, has become even more attractive in a higher interest rate environment. "We believe private credit generally is very attractive in today's market and that the relative attractiveness compared to private equity, for example, has increased given the rapid increase in base rates in addition to slightly increased margins and fees, coupled with lower levels of leverage," says Levén. The portfolio management team at Ericsson Pensionsstiftelse usually targets net internal rates of returns (IRRs) in low to mid-teens for junior debt and stressed credits, compared with a net IRR of 6-9 percent in local currency (USD or EUR) in direct lending. "Given the rapid increase in base rates seen over the last year and a half, our expectations are currently somewhat higher than those figures," argues Levén.

THE PROTECTIVE ARMOR OF PRIVATE CREDIT

Private credit can prove to be an appealing option for investors in a rising rate environment, provided that issuers can withstand higher financing costs. "While higher interest rates are advantageous for private debt as long as the companies can service the interest, we believe it will pose problems for many companies going forward," warns Levén. With Ericsson Pensionsstiftelse accessing this asset class through external fund managers, Levén underscores the importance of investing with "managers that have solid skills in fundamental company analysis and credit underwriting in order to be able to minimize downside by investing in less cyclical sectors and companies."

> "It is also critical for us that the managers we invest with have the resources and expertise to handle difficult situations such as workouts and restructurings when they arise."

Private credit deals are often structured to include security features such as collateral, covenants, and priority repayment rights, offering added protection for investors. Compared to the syndicated loan market, private debt enjoys the advantage of often being a bilateral negotiation between the lender and the company owner, providing more flexibility and protection for investors. Levén argues that "it is also critical for us that the managers we invest with have the resources and expertise to handle difficult situations such as workouts and restructurings when they arise." While Levén does not adhere to strict criteria on the length regarding the length of a manager's track record, if possible, his team prefers to see how managers have performed in more demanding market environments.

ESG: AN INVESTOR'S COMPASS

Many allocators, including Ericsson Pensionsstiftelse, often favor private credit with an ESG (Environmental, Social, Governance) approach that aligns with responsible investment principles. While private credit investments can promote ESG principles, private equity often has a more significant impact in driving ESG initiatives due to its active ownership and ability to influence portfolio companies directly. "Private debt funds generally have less influence than private equity managers on a company's ESG agenda," says Levén. "Since they do not control the companies, the requirements we have on our private debt managers differ a bit from private equity."

Nevertheless, Ericsson Pensionsstiftelse has developed its own ESG due diligence process and an ESG ranking system, where the team rates managers on a scale from 1 to 5, requiring a minimum score of 3 to invest. "There is both an overall ESG score from 1 to 5 and scores from 1 to 5 for each underlying subsection," explains Levén. "Managers generally need to have a minimum overall ESG score of 3 for us to invest in them. If they fall short, we sometimes suggest the manager to make improvements after which we will make a new evaluation," he elaborates.

In certain cases, Ericsson Pensionsstiftelse has declined to invest in managers who did not meet their ESG standards. "Even though these are numerical scores, the assessment is rather qualitative," Levén points out. "Rather than imposing hard requirements, managers need to have ESG policies and frameworks in place, along with organizational resources to support them and report on ESG."

LIMITS TO ALLOCATION DESPITE ATTRACTIVENESS

Ericsson Pensionsstiftelse has been investing in private credit since 2011 and intends to continue doing so in the future. "We have been investing in private credit for more than ten years and it has been a large part and a core component of our portfolio for many years and will likely continue to be so going forward," concludes Levén. "But given that private credit constitutes 12 percent of our total assets under management, we will probably not grow that proportion significantly, even though we see private credit as a very attractive asset class in today's environment."

20-Year Celebration:

Asgard Eyes Promising Risk Premia Opportunities

By Eugeniu Guzun – HedgeNordic

“2022 was very challenging in this respect with almost unprecedented correlation between risk premia strategies, that usually have moved much less in tandem through other recent crises.”

Friis Gade

One of the most decorated Nordic hedge funds celebrated its 20-year anniversary during the summer. Asgard Fixed Income Fund has enjoyed an annualized return of 11.4 percent over the past two decades, with an impressive return of close to 14 percent since Morten Mathiesen took over as CIO in 2008.

Fixed-income boutique Asgard Asset Management specializes in identifying and capturing risk premiums in interest rate markets to achieve high risk-adjusted and mostly uncorrelated returns. Kenny Friis Gade, Deputy CIO at Asgard Asset Management, explains that the foundation for their investment management is a strong belief in the existence of risk premiums in interest rate markets. “These can be identified and isolated, hereby creating attractive investment opportunities on a leveraged basis,” he explains. Investing in risk premia has proven to be an attractive marketplace for fulfilling their investment goals.

Throughout its journey, Asgard Fixed Income Fund has consistently ranked among the best Nordic fixed-income hedge funds, finishing on the podium of the “Best Nordic Fixed-Income Hedge Fund” category nine times in the eleven editions of the Nordic Hedge Award. The fund has delivered an annualized return of 11.4 percent since its inception in July 2003. “The annualized return is of course attractive over such a long time horizon, but it should always be considered in relation to the level of risk embedded in achieving the return,” argues Kasper Ullegaard, the CEO of Asgard Asset Management. Asgard Fixed Income Fund exhibited an annualized volatility in returns of 7.2 percent to reach a Sharpe ratio of 1.5, which “serves as a blue stamp of our strategy,” says Ullegaard.

“The high risk-adjusted return obtained by the Asgard team since the launch of the fund is something we are very proud of!,” expresses Ullegaard. “It truly underscores the viability and longevity of the strategy, which has been followed meticulously throughout the years,” he continues. “Hopefully we can continue to leverage on this strong history to develop the strategy even further as markets undergo continuous change. The agility to exploit market opportunities as they arise throughout time has been a core credential of the Asgard team, which will be equally important going forward.”

EARLY DAYS

In its early days, Asgard Fixed Income Fund was run by a team of three people with a Bloomberg terminal, growing into an organization of now 11 people with different roles across portfolio management, risk management and quantitative tasks. “Key people dependencies have been significantly diminished and proprietary quantitative developments over the years have vastly improved investment decision-making and risk management while reducing the operational risks embedded in running investment risks of this magnitude,” says Ullegaard. “On top of this, Asgard Asset Management has long-lasting and efficient relationships regarding administration and prime brokerage – an aspect not to be underestimated.”

Asgard Fixed Income Fund trades and invests long and short in government, mortgage, covered, and index-linked bonds to capture relative-value opportunities in European, mostly Scandinavian,

Kenny Friis Gade, Deputy CIO
Asgard Asset Management

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Kasper Ullegaard, CEO
Asgard Asset Management

fixed-income markets. Similar to its peers in the Danish universe of fixed-income hedge funds, the fund employs leverage to multiply expected returns from spreads. Friis Gade, who joined Asgard Asset Management earlier this year as Deputy CIO alongside CIO Morten Mathiesen, stresses the need for a strong emphasis on investment discipline and a continuous and consistent process to execute this strategy effectively.

JOURNEY SO FAR

2022 was a challenging year for fixed-income investors and those focusing on capturing risk premia in fixed-income markets. Asgard Fixed Income Fund managed to navigate similarly challenging environments in 2008 with a 4.0 percent decline. 2022, however, proved to be a much more challenging year for the fixed-income fund. "The Global Financial Crisis in 2008 obviously pinpointed some risks embedded in the markets that weren't really recognized earlier," says Ullegaard. "The aftermath of this crisis served as a catapult for the Asgard Fixed Income Fund."

After delivering an annualized return of 18.4 percent in the 12 years since early 2009, the fund paused its winning streak after edging down less than one percent in 2021 before booking a more painful loss of 10.9 percent in 2022. The fund did manage a 16 percent recovery in the final quarter of the year to mitigate some of the downturn. "2022 was very challenging in this respect with almost unprecedented correlation between risk premia strategies, that usually have moved much less in tandem through other recent crises," explains Gade. This initiated a drive internally at Asgard to search for attractive diversifiers to safeguard the risk premia strategies to a larger extent. "We are essentially trying to make the strategy even more robust to different market scenarios."

"The recent period ending autumn 2022 with compressed risk premia due to massive QE from central banks across the globe in the aftermath of the Covid pandemic was certainly also challenging," according to Friis Gade. "We witnessed markets that correlated to a much higher extent than usual, which challenged our positioning to a large degree," he further elaborates. "But we regrouped on risks and focused more on core strategies as the expected return versus risk in this space improved tremendously."

Asgard Fixed Income Fund made a notable recovery, achieving a 16.8 percent gain in the first three quarters of 2023 and 35.8 percent in the trailing 12 months. "The recent, solid performance of the strategy since the end of September of 2022 is predominantly due to ongoing income rather than favourable market movements such as spread compression," emphasizes Friis Gade. "Hence, the expected return of the strategy is still at very lucrative levels from a historical perspective."

JOURNEY GOING FORWARD

One advantage of the low-interest rate environment post the 2008 financial crisis had been the ability to achieve high leverage through cheap repo funding. Friis Gade acknowledges that sub-Libor funding levels prevailing for an extended period after the GFC are highly unlikely, but he remains confident that the proven strategy will continue to serve their investors well in the foreseeable future.

"Opportunities are ample currently and relative value strategies look far more appealing than in the QE period since 2018 and onwards, hence we have a very constructive view on the strategy going forward," concludes Friis Gade. "A broader team has been brought together and risk premia look ripe for picking across our core strategy space, so the future looks very rosy indeed," adds Ullegaard. "But we are humble and know that it will take dedication, focus, and agility to fully exploit these attractive investment opportunities."

"A broader team has been brought together and risk premia look ripe for picking across our core strategy space, so the future looks very rosy indeed."

Kasper Ullegaard

AP2 Sees Private Debt as Compelling Alternative to Equities

By Eugeniu Guzun – HedgeNordic

Patrik Jonsson, Head of Private Debt – AP2

> "We were operating in a zero-interest-rate environment when we started allocating to private debt, so we thought this asset class might offer a good pick-up compared to listed credit."

Following a change in legislation, the four Swedish national pension buffer funds, AP1-AP4, were granted the opportunity to invest in private debt starting in 2021 to capitalize on the illiquidity premium in this asset class and generate returns amid a low-interest-rate environment for traditional fixed income. In late 2020, AP2's board decided to make a strategic allocation of two percent of its then SEK 386 billion portfolio to private debt.

Patrik Jonsson, who had been with AP2 since 2015 as Head of Manager Selection for Public Assets, was entrusted with the responsibility of building AP2's private debt allocation. "At the time we had the legislative change allowing for investments in illiquid private debt, we were in a near-zero percent interest rate environment, and we thought this might be an interesting addition to our portfolio," recalls Jonsson. He faced the challenge of initiating this allocation during the Covid pandemic when travel restrictions were in place and in-person meetings were impossible. "Was I supposed to do a huge allocation with managers I had never met?" Jonsson recalls asking himself at the time.

Jonsson started the process by engaging with existing managers in AP2's portfolio who were involved in listed alternative credit, including high-yield bonds, leveraged bonds, CLOs, and structured credit. "That alternative credit allocation was managed by five external managers, which provided a starting point for building the private debt allocation during the pandemic," says Jonsson. "It was easier to start the allocation process by working with managers with whom we had prior relationships," he claims. The resumption of travel to the United States towards the end of 2021 made the allocation and selection process much more feasible.

Despite the relatively modest allocation target of two percent, AP2's large portfolio size required deploying about SEK 8 billion into private debt. Jonsson emphasizes that building an allocation in the private debt space is a time-consuming process, unlike more liquid asset classes where changes can be made swiftly. "One thing that we have learned over the past years is that it takes time to build an allocation like this," acknowledges Jonsson. "In the private

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debt space, even if I wanted to deploy that money tomorrow, that just cannot be done for practical purposes," he says. "Allocation changes to this asset class take years and years to execute regardless of how much time you spend on this internally. We are working on finding ways to accelerate the ramp-up of our current portfolio."

ILLIQUIDITY PREMIUM – THE PERFECT MATCH

Liquidity is typically perceived as valuable and highly desirable for most investors. However, liquidity often comes at a cost. For long-term investors such as AP2, this lack of liquidity translates into an additional compensation known as the illiquidity premium. "In theory, there should be a premium for investing in illiquid instruments compared to liquid investments and there is definitely an illiquidity premium in private credit," says Patrik Jonsson.

"As an AP fund, this illiquidity premium is a really good match for us." In comparison to many other asset owners, AP2 has the luxury of being able to foresee its inflows and outflows for years, if not decades. "That is a competitive advantage," considers Jonsson. "The ability to accept illiquidity for the premium is something that we should try to exploit."

PRIVATE CREDIT AS AN ALTERNATIVE TO EQUITIES?

Private credit has served as a powerful complement to traditional fixed income, particularly in a low-interest-rate environment. "We were operating in a zero-interest-rate environment when we started allocating to private debt, so we thought this asset class might offer a good pick-up compared to listed credit," recalls Jonsson. Yields on these private debt investments – which are largely based on floating-rate loans – have gone into double digits. "We find ourselves in a different situation all of a sudden," says Jonsson.

"With the base rate in the U.S. above five percent and adding the spread on top of that, we are looking at expected returns that can compete with the expected returns from the equity market," he elaborates.

> "My opinion is that private debt currently could be viewed as a very good alternative to equities."

"Private debt as an asset class has undergone significant changes over the last three years since we started allocating and much of that has occurred in the last twelve months," explains Jonsson. "My opinion is that private debt currently could be viewed as a very good alternative to equities."

DIVERSIFICATION

AP2 started out building the allocation to private debt with plain-vanilla investments, such as senior direct lending in the United States and Europe. Jonsson has also left some room for an allocation to private debt in other regions of the world, but that is not particularly appealing in an environment with attractive opportunities in the U.S. and Europe. "There is no real need to go to other markets at this stage, as that would add more complexity to the portfolio."

Private debt includes a wide range of strategies from senior direct lending and mezzanine strategies to higher risk-return non-performing credit strategies. Having so far mostly invested in senior direct lending, AP2 has considered diversifying the portfolio across more types of credits. "In the current interest rate environment, I don't see the point of pursuing junior, mezzanine, or second-lien investments when the senior part is providing us with such great returns," emphasizes Jonsson. "A senior loan in the U.S. right now yields about 12 percent, why would we be stretching out to try to get 15 or 20 percent."

Jonsson does not see any reason to climb the risk spectrum in pursuit of higher returns. With a contracted return of 12 percent from senior debt investments, he notes that it is important to question how much return is actually needed to fulfill obligations. "If you cannot really fulfill your needs by achieving 12 percent, you have an asset-liability mismatch." For Jonsson, "there is no need to stretch further. This environment is as good as it gets."

DEFAULT EXPECTATIONS

With higher interest rates and a slowing economy, there is a greater likelihood that the companies behind these securities may default on their loans. While the possibility of defaults is a valid concern for investors venturing into the private debt space, it shouldn't dominate their perspective. "Could there be defaults? That's a valid question to ask," says Jonsson. "And yes, there will be defaults."

According to Jonsson, the primary factor that could unsettle this market is substantial credit losses. However, scrutinizing historical loss rates is insufficient for meaningful insights, as they have essentially been at zero since the inception of this asset class. "But it's unlikely they will remain at zero going forward. Yet, if you are generating a 12 percent income, you can afford some haircuts on that and still perform well."

Should credit losses become the catalyst that tips this market over, "that would imply that private equity had been losing money hand over fist," explains Jonsson. Given that private equity continues to support a considerable number of these companies, and the loan-to-value rations are typically well below 50 percent, "seriously contemplating the prospect of substantial credit losses within private credit should give one pause before committing another dollar to private equity."

Ridge Capital's Flexibility in the Nordic High-Yield Market

By Eugeniu Guzun – HedgeNordic

"Northern Yield invests in Nordic high-yield corporate bonds using what we call an unconventional approach with a focus on capital preservation."

Måns Levin

The Nordic high-yield market, characterized by lower liquidity, limited transparency, a higher prevalence of smaller issuers, and a predominantly floating-rate structure in contrast to its European and American counterparts, has consistently commanded a credit premium of approximately 200 basis points. Recognizing these particular characteristics – which also present challenges – Christoffer Malmström and Måns Levin designed a specific strategy within a more alternative and flexible structure to seize opportunities in the Nordic high-yield corporate bond market.

The two friends, who first crossed paths during their Master's studies at the Stockholm School of Economics almost two decades ago, embarked on separate career paths in different financial hubs

Måns Levin, Founder and CEO (left) and Christoffer Malmström, Founder and Lead Portfolio Manager (right) – Ridge Capital

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before reuniting to establish Ridge Capital. Their shared dream of launching their own venture led them to launch Ridge Capital's high-yield bond strategy. With over 13 years of credit investing experience in London, New York and Stockholm, Malmström acts as the lead portfolio manager of the high-yield-focused strategy within a Luxembourg-domiciled structure reserved for professional investors, called Northern Yield.

FLEXIBLE AND ALTERNATIVE STRUCTURE

"Northern Yield invests in Nordic high-yield corporate bonds using what we call an unconventional approach with a focus on capital preservation," explains Levin, who serves as CEO of the firm. Most players active in the Nordic high-yield bond market structure their investment vehicles as UCITS funds, offering daily liquidity to their investors. However, this structure creates a liquidity mismatch between a fund's liquidity profile and the liquidity of its holdings. This mismatch became evident during the market turmoil in March 2020 when several corporate bond funds had to be gated due to substantial investor outflows.

To address this liquidity mismatch, the duo behind Ridge Capital opted to target longer-oriented professional and institutional investors with a more unconventional strategy. By structuring the Northern Yield within an alternative investment structure, they can better manage this liquidity challenge by offering monthly liquidity to investors and requiring a 30 bank days notice for redemptions. Anchor investors have committed to lock up their capital for two years. "This structure gives us much more flexibility to manage the portfolio, allowing us to focus more on bond and credit analysis as well as due diligence instead of constantly monitoring investor flows," elaborates Malmström. "We thrive in inefficient markets."

Ridge Capital's structure also enables the team to maintain a more concentrated portfolio, with Northern Yield currently holding about 40 different bonds across around 30 issuers. "We have a more focused portfolio compared to many of our peers, which allows us to do in-depth analysis on each company," explains Malmström. "Our key focus is on credit analysis and default avoidance," he elaborates, emphasizing that a focused portfolio allows more time and attention to each holding. This concentration underscores the team's commitment to true active management, as the team eschews employing a "buy & hold" or "buy everything" approach.

USE OF LEVERAGE

By design, Northern Yield has the ability to employ leverage, which on average will be around 150 percent of invested capital (i.e., two-thirds of the portfolio is financed with investor's capital and one-third with debt). The strategic use of leverage functions as a tool in the team's arsenal for managing occasional patches of dry liquidity and reaching their goal of attaining equity-like returns at lower volatility. "The leverage we can employ is a source of liquidity for us," according to Levin.

"Leverage also helps us in our objective to generate equity-like returns without going too far out of the risk spectrum," elaborates Malmström. "With leverage, we can buy bonds that are yielding a bit less but are not as risky, and yet achieve our return objectives." The usage of leverage to meet its return objectives allows the team to run a more defensive exposure. "For example, we do not invest in the volatile fossil fuel sector, which has five times more defaults than other sectors," explains Malmström.

Northern Yield targets a long-term annual return of base rate plus seven percent per annum with an annual volatility of less than five percent, which in today's interest rate environment equates to more than 10 percent per annum. Ridge Capital Northern Yield has performed well since its launch in early 2023, delivering a cumulative return of 8.1 percent over its initial ten months of operation. Since it became fully invested in April, it has produced an average return of 1.1 percent per month, with a yield-to-maturity of almost 14 without leverage and slightly over 19 percent with the structural 150 percent leverage.

"Leverage also helps us in our objective to generate equity-like returns without going too far out of the risk spectrum."

Christoffer Malmström

OUTLOOK

"The Nordic high-yield market will continue to offer great opportunities and strong returns in the coming months and years," predicts Levin. "Higher interest rates and risk-premiums all play to our advantage, as we get paid more by borrowers, and we don't expect a decrease in either of those two in the near future," he continues. The flip side, of course, is that given that the Nordic high-yield market predominantly features floating-rate bonds, the inability of some indebted companies to manage debt can add to default situations in the near future.

This floating rate structure, therefore, can be both advantageous and challenging for investors. "We can't emphasize enough that credit selection is key in this market," emphasizes Malmström. "Passive, or over-diversified, strategies, with little to no credit analysis before investment, will be severely hurt by increased default levels," he elaborates. "Even though credit defaults will continue rising, we are very well prepared to face this market phase thanks to our deep systematic rigorous credit analysis, in combination with a focused and active portfolio," says Levin. "This is the right setup in this asset class to avoid credit events."

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Josephine Richardson, Head of Research – Anthropocene Fixed Income Institute

Sustainability-Linked Bonds – A New Financial Derivative

By Josephine Richardson – Anthropocene Fixed Income Institute

> "An SLB can be thought of as a financial derivative on its KPIs."

Capital investment to transition to a net-zero economy is currently falling well short of the $2.7 trillion required annually to deliver on the 2050 target. For the $120 trillion fixed income market to play its part, there is a need to maximise volumes of all available sustainable debt products to achieve the necessary scale.

Sustainability-Linked Bonds (SLB) are a relatively new entrant to the capital markets and becoming a useful tool for companies and governments that need to finance the transition of their operations and economies. Unlike green bonds, which designate investment into discrete projects, SLBs focus on results. The credit product links investor returns to the issuer's performance against sustainability key performance indicators (KPI), which can range from carbon or deforestation reduction to diversity improvements.

There has been a fair amount of negative comment on SLBs in the past year or so, with observers questioning the ambition of issuers' targets, and whether the financial incentives at play are sufficient to influence material behavioural change. Given the potential environmental impact of a well-functioning SLB market, the Anthropocene Fixed Income Institute has looked hard at how the market is functioning and what tools investors can use to maximise the impact of their investments.

In reviewing the market to date, we have found that SLBs are already reaching a broader range of sectors, companies and regions than other types of sustainable debt.

This includes hard-to-transition industries that find it difficult to attract more traditional 'green' capital but must be able to finance operational change if they are to meet climate objectives. Issuers with lower credit ratings, including high-yield, tend to use SLBs more than others, which suggests that the market is demanding that these companies deliver sustainability commitments to access the capital markets. SLBs are gaining popularity in emerging markets, increasingly for sovereigns, where there are challenges in having sufficient eligible projects for green issuance.

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FINANCIAL VALUE DERIVED FROM SUSTAINABLE KPIS

So, there is already much more to be positive about than the debate around SLBs may suggest, but there is one feature in particular that is often overlooked, which should be of interest to those running active strategies.

An SLB can be thought of as a financial derivative on its KPIs. Its value relates directly to its performance in delivering on those commitments, as it is structured to pay a step-up coupon (or step-down) if they are not (or are) met. The ESG reporting of an issuer is therefore financially material, and investors have a direct financial claim on this disclosure.

This is a unique quality of SLBs. It gives bond investors the right to demand a standard of transparency and reporting on sustainability performance more equivalent to what is expected under general financial reporting obligations, which is unfortunately not yet the norm.

COULD DO BETTER

We have spotted several cases where the lack of reporting has had implications for bondholders, and where they have the power to demand more.

The first is a case of shifting emissions from visible operational accounting to more opaque financed emissions, while claiming to have achieved a reduced carbon footprint. This is a key theme in global sustainable finance and poses important questions around investors' role as providers of capital.

Singaporean infrastructure/energy owner and SLB issuer Sembcorp sold its subsidiary Sembcorp Energy India Limited (SEIL) to a private equity consortium, arguing that the transaction would allow it to immediately de-consolidate its thermal coal assets' carbon footprint and reduce its overall carbon intensity.

However, Sembcorp lent the consortium the money to do the deal, using a loss-absorbing structure, so it is still financing those same emissions. This approach was chosen rather than a true decarbonising strategy, replacing coal with renewable energy.

> "It is true that SLB issuers should set robust sustainability targets and AFII's research has shown that by doing so, companies and governments can benefit from an attractive cost-of-capital."

Sembcorp was explicit in its communication that a key benefit of the transaction was the avoidance of coupon step-ups on its SLBs. In this instance, bondholders could have argued that the sustainability performance targets in Sembcorp's SLB should have included both operational and financed emissions. If it had, this would have made it more likely that investors would have received a coupon step-up for emissions reduction targets not being reached.

Meat producer JBS has issued three SLBs, with a step-up linked to emissions intensity commitments. JBS has gone on to restate the parameters of its emissions accounting each time they have reported. The company acknowledges the changes but gives no details or justification.

SLB investors have an opportunity here to challenge JBS to justify its restatements and improve transparency on its environmental impact. Without reliable reporting, investors cannot make informed decisions, and issuers cannot be held accountable for their environmental impact.

Chemical company Nobian's 2022 sustainability report showed a significant drop in emissions and as such, the company avoided paying a coupon step up to its SLB bondholders. However, it is unclear how this emissions reduction has been achieved.

The SLB includes two KPIs with targets at the end of 2022: Scope 1 + 2 absolute emissions, and a percentage of energy from renewable sources. Emissions reportedly reduced by 25% year-on-year, far in excess of the targeted fall of 4% in two years. Detailed analysis of the sustainability report suggests this was delivered partly by generating power from an alternative energy source, Municipal Waste Incineration (MWI). Yet Nobian counts no emissions from this source. It is difficult to imagine that burning rubbish is an emission-free exercise.

Given the SLB structure, Nobian's bondholders have a right to raise questions regarding this irregularity, using the SLB as a tool to provide greater transparency. Removing rather than accounting for these emissions represents a kind of footprint arbitrage that undermines the realisation of true carbon neutrality, with a direct impact on the coupon received by investors. This is a notable example of where the SLB instrument is throwing light into corners that may otherwise have remained hidden from investors.

It is true that SLB issuers should set robust sustainability targets and AFII's research has shown that by doing so, companies and governments can benefit from an attractive cost-of-capital. It is just as true that investors have been given an opportunity here to transform the status of ESG accountability, and we encourage them to use it.

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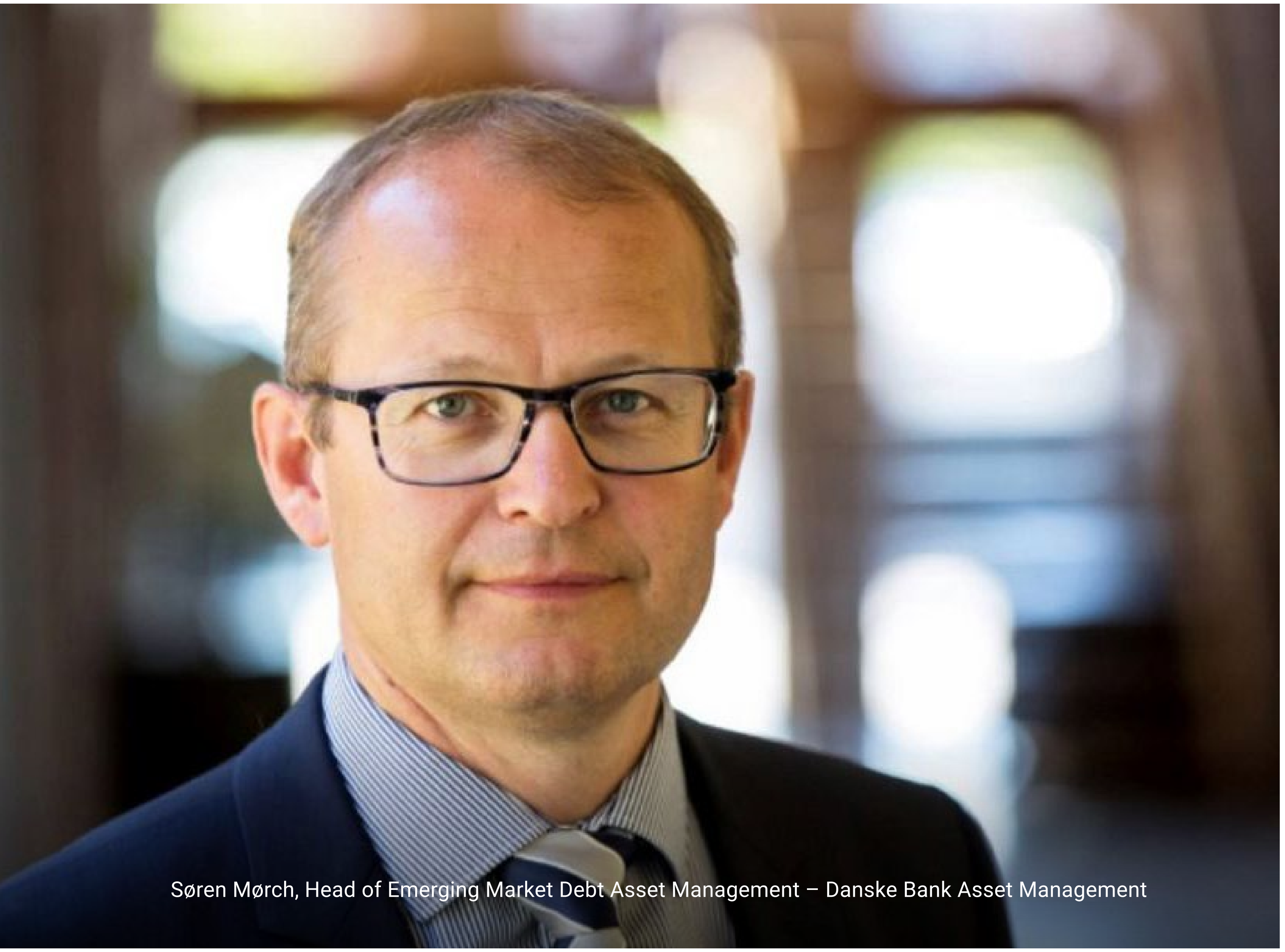
Søren Mørch, Head of Emerging Market Debt Asset Management – Danske Bank Asset Management

Making a Successful EMD Strategy Even Stronger With Artificial Intelligence

"We have added a more sophisticated credit rating model, which in our view enables us to make even better decisions in terms of country allocation. Machine learning has been key to this development."

When Søren Mørch assumed the role of Chief Portfolio Manager for Danske Bank Asset Management's emerging markets debt hard currency strategy last year, his task was simple – but challenging: to continue to employ and further improve an already well-performing strategy.

So far, Søren Mørch and his team have done a commendable job. Since the beginning of November 2022, when Mørch joined Danske Bank Asset Management, the strategy has outperformed its benchmark by 3.85 percent (as of 31.11.2023). According to the most recent data from eVestment, the strategy is among the best-performing EMD HC strategies worldwide in 2023.

A new and sophisticated credit rating model has contributed to the very strong performance of our emerging markets debt hard currency strategy in 2023. So, what have Søren Mørch and his team changed?

"The strategy already had a solid foundation with a proven track record, and this foundation remains intact," says Søren Mørch. "However, we have added a more sophisticated credit rating model, which in our view enables us to make even better decisions in terms of country allocation. Machine learning has been key to this development."

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AN APPLICATION OF ARTIFICIAL INTELLIGENCE

Machine learning is widely considered an application of artificial intelligence. The aim of the machine learning model employed by Danske Bank Asset Management's EMD team is to model credit risk better, thereby improving their ability to identify attractively priced emerging markets. The model uses large amounts of data to sort countries into credit rating categories from AAA to D based on macroeconomic fundamentals, such as government debt, government interest payments, institutional strength, and more.

"The advantage of our new model is that it requires very little structure and very few assumptions compared to more traditional econometric models," explains Senior Portfolio Manager Joshua Loud. "Unique to the model is the algorithm that is free to explore a multitude of different relationships between variables – including some that we as humans would never think to consider – to tap into potentially better ways of making predictions," he continues. "This could include higher-order correlations between multiple variables, which can be almost impossible for a human to think through."

TRAINING THE MODEL WITH HISTORICAL DATA

Investing in hard currency emerging markets debt is all about credit risk. How does the Danske team predict credit rating developments for various emerging markets within the next 1-2 years, and to what extent are these reflected in market pricing? These are key questions.

As former Head of Country Risk at the European Bank for Reconstruction and Development (EBRD), Joshua Loud has played a leading role in the implementation of the new credit rating model.

"Basically, there are thousands of different relationships we could consider, and the model explores all of them and presents us with the ones that work best," says Loud. "We train the model using historical data, then we input macroeconomic forecasts that enable the model to make predictions about credit risk."

> "The advantage of our new model is that it requires very little structure and very few assumptions compared to more traditional econometric models."

The portfolio management team then applies a qualitative adjustment process. "For other, more cyclical events, such as upcoming political elections, we can adjust the model output to reflect additional information that the model cannot see," adds Joshua Loud.

THE VALUE OF TWO DIFFERENT PERSPECTIVES

The portfolio team still uses an additional traditional econometric model that has been the backbone of Danske Bank Asset Management's EMD HC strategy for years. Like most traditional models, it is based on a lot more assumptions. For example, most traditional models assume that variables are related to one another linearly – e.g. if debt goes up by 10 percent of GDP, your credit risk score increases by 1 notch.

In contrast, the machine learning model requires no assumptions about linearity or any other forms of relationship. It might find that the impact of increasing debt on credit risk is different for countries with low debt burdens compared to those with high debt burdens, or that impact depends on the level of development.

"We now use both models in tandem, as we see value in having two different perspectives," says Chief Portfolio Manager Søren Mørch. "When the signals from both models align, we can be more confident about the result, whereas if they send conflicting signals, we tend to be a bit more cautious or do some more exploring."

EL SALVADOR AND EGYPT PRIME EXAMPLES

Søren Mørch highlights El Salvador and Egypt as specific examples of the value of their new machine learning model. "Both our models suggested El Salvador is a better credit risk than its current official rating, with our machine learning model being a tad more optimistic. This confirmed our positive view on El Salvador, and so far this year our overweight in El Salvador has made a positive contribution to our performance," says Mørch.

"In contrast, the models were more divided on Egypt, with the machine learning model more cautious than the econometric model," he emphasizes. "We have been more cautious on Egypt because of the divergence – and given that credit spreads are up in Egypt year-to-date, that caution seems to have been warranted."

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Price Is What You Pay, Value Is What You Get

By Sriram Reddy – Man GLG

Sriram Reddy, Managing Director – Credit at Man GLG

With dispersion in credit markets across geographies and sectors, the opportunity set for bottom-up investors looks attractive.

INTRODUCTION

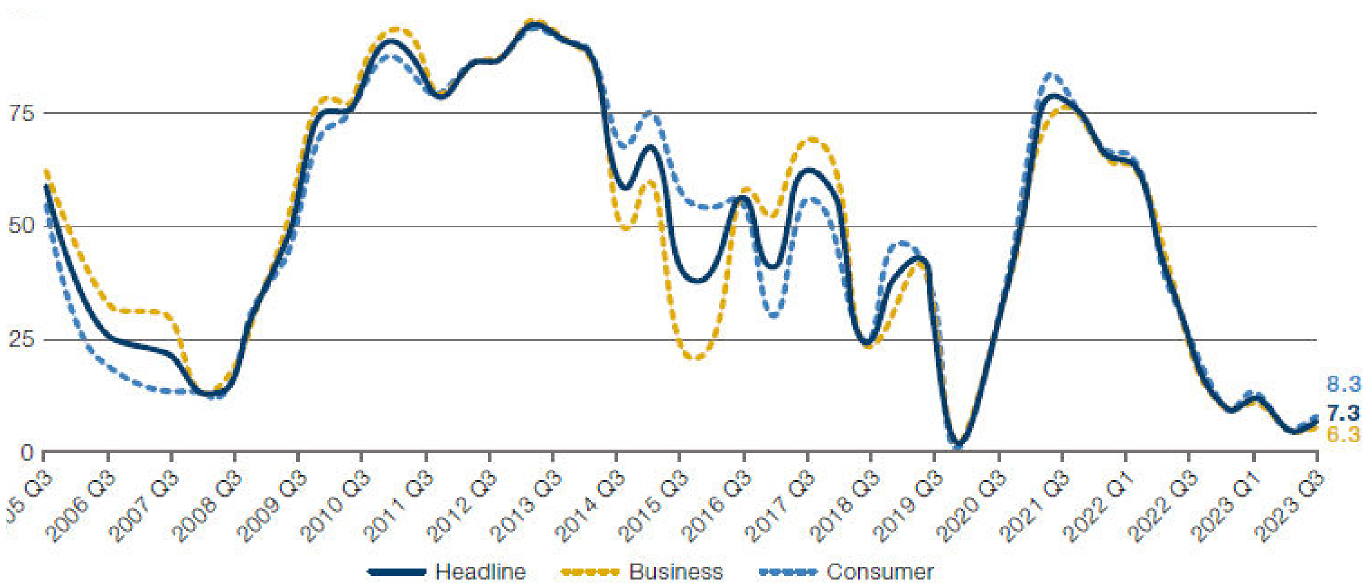
In an earlier article, we wrote about our expectations that the monetary policy path would continue to be restrictive and that rates would remain higher for longer, which is now playing out and we are seeing the market grappling with this new reality. This is likely to create pressure points, particularly in the more cyclical parts of the credit market, such as those issuers with low margins or less pricing power, as well as debt that comes with floating rates. An important factor that has generally been missed, but highlighted in surveys such as the US SLO, is the likely potential for tightening of credit availability which should put pressure on cyclical spreads at the very minimum and increase dispersion more broadly.

ASSESSING VALUE ON AN ABSOLUTE BASIS

Looking at the credit market in aggregate masks the dispersion we are seeing across geographies and sectors. Focusing on the high yield (HY) index, 64% of its constituents trade at spreads at first quartile levels (394 bps) while 13.7% of the market trades at spreads at fourth quartile levels (645 bps). A similar dynamic is visible in the emerging market HY corporate market. In global investment grade (IG), we are seeing more opportunities in credits offering elevated spreads and reflecting potential recessionary conditions. Opportunity exists for the more discerning investor, but it is almost certainly not a beta or passive opportunity, particularly in the HY or EM markets.

The phenomenon is notable given the deteriorating fundamental backdrop. A rise in interest costs and weakening earnings has led to a drop in interest

Figure 1. Credit conditions index: Historical series[1]



Source: American Bankers Association, as of 26 September 2023. Available here: credit-conditions-index-q3-2023.pdf (aba.com).

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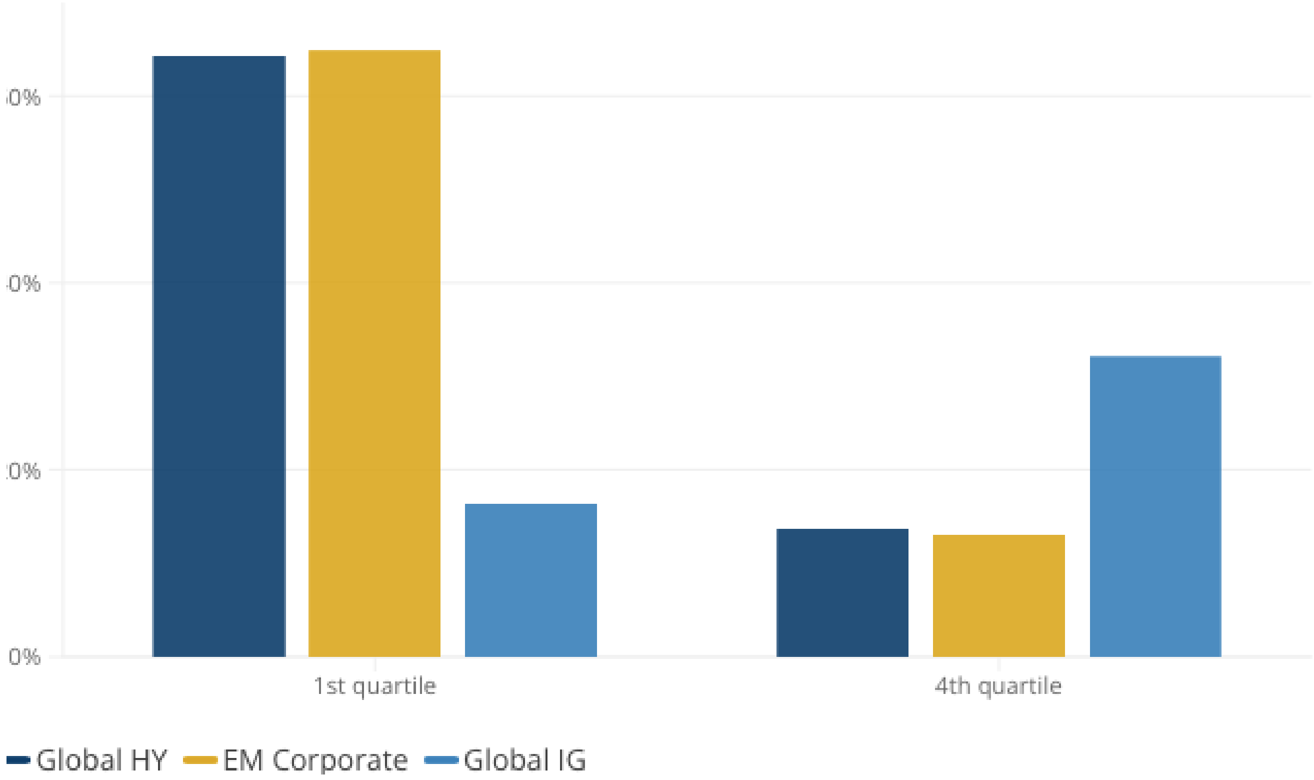
coverage and higher leverage ratios. It may take a few more quarters, but we do think that aggregate spreads will need to reflect this fundamental deterioration as well as the rise in overall bankruptcies which has been trending up over the past few quarters.

On a yield basis, investors continue to be handsomely rewarded relative to history with percentiles still at the upper end of the spectrum.

Additionally, investors can enjoy a substantial margin of safety with break-even levels remaining elevated across many markets providing significant protection against a widening spreads or higher yield environment.

In terms of opportunities elsewhere, there has been an uptick in convertible bond issuance, while issuance also remains healthy in HY and loans – offering opportunities for buyers. However, the competition for banks to fight back against the growth in private lending may lead to further deterioration in fundamentals, so a healthy dose of caution is warranted.

Figure 2. Time to be selective, not to own the entire market



Source: Bloomberg, ICE BofA, as of 29 September 2023.

Figure 3. Q2 2023 credit fundamental summary

	Qtr EBITDA Growth (y/y)	Gross Leverage		Interest Coverage		Cash-to-Debt	
Sector	2Q23	2Q23	vs 3Q22 Δ	2Q23	vs 3Q22 Δ	2Q23	vs 3Q22 Δ
IG (ex Fins)	2.9%	2.3x	0.0x	11.9x	-1.4x	17.8%	-2.0%
HY	-2.8%	3.8x	0.3x	5.0x	-1.2x	9.4%	-1.6%
Loans	4.1%	4.1x	0.0x	4.3x	-1.0x	10.1%	-1.7%

Source: Bloomberg, S&P Capital IQ, Morgan Stanley Research, as of 30 June 2023.

In addition, there is a growing opportunity set in shorter duration credit which is trading at dislocated prices, where there is some uncertainty from the market regarding the ability to refinance. This can lead to attractive opportunities, particularly in asset-heavy companies, but requires extensive due diligence, particularly in relation to the sponsors. This can also be a fertile hunting ground for issuers likely moving into distressed territory in the next few years and which could benefit from a right sizing of their capital structure and/or other flexible capital solutions.

Q4 2023 OUTLOOK

At Man, we have one overriding principle: we have no house view. As such, portfolio managers are free to execute their strategies as they see fit within pre-agreed risk limits. Keeping that in mind, the outlooks below are from the different credit teams at Man.

GLOBAL INVESTMENT GRADE:

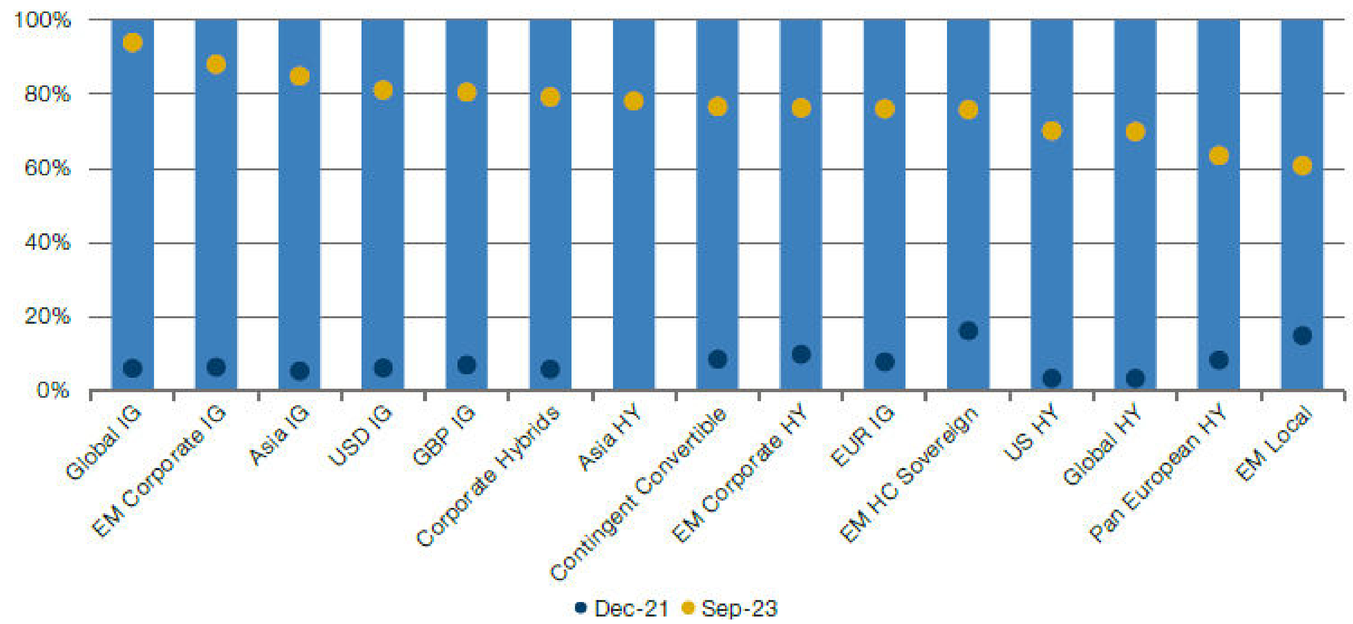
With all in yields remaining high, we think investors can continue to benefit from an allocation to IG credit. Inflation is trending lower, which will remove a significant amount of pressure from central banks and ultimately should make owning duration a key component of an investor's asset allocation. We continue to keep a wary eye on the US as bank fragilities are likely to increase the chances of a hard landing. At the same time, valuations in the US remain more expensive than in Europe.

Whilst we are constructive on the broader market, we believe dispersion between sectors, geographies and single names has created deep value opportunities for bottom-up investors to generate strong excess returns over the medium term. We continue to see value in Europe, with a focus on financial companies, which are in a robust position compared to their US counterparts. Although value has started to emerge, we continue to take a more cautious view on non-financial cyclicals. As growth slows, we believe a higher risk premium will need to be attached to these sectors as demand slows and profitability weakens. All in all, we see dispersion increasing as growth slows and believe the backdrop creates an attractive opportunity set for high conviction and active fund managers.

GLOBAL HIGH YIELD:

In many ways our outlook has not changed from prior quarters. The consequence of tighter monetary policy will be slower growth and we have yet to

Figure 4. Yields: Investors continue to be handsomely rewarded relative to history



Source: Bloomberg, ICE BofA, JP Morgan, as of 29 September 2023.

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Figure 5. Global HY market – Over $500 billion matures in less than three years

	% exposure	Average option-adjusted spread	Average yield-to-worst
Banking	11%	337	7.8
Energy	10%	430	9.3
Automotive	7%	269	6.9
Financial Services	7%	506	9.8
Leisure	7%	317	8.0
Basic Industry	6%	706	11.5
Capital Goods	6%	427	8.5
Utility	6%	581	10.5
Retail	5%	947	14.0
Real Estate	5%	2,500	29.0
Transportation	5%	749	10.7
Services	5%	942	13.5
Telecommunications	5%	729	11.5
Healthcare	4%	852	13.0
Technology & Electronics	4%	391	8.6
Media	3%	716	11.7
Consumer Goods	3%	1,036	14.8

Source: Bloomberg, ICE BofA, as of 29 September 2023.

see a recessionary premium in cyclical parts of the market. Looking forward, we expect dispersion to accelerate and create more opportunities for investors. We maintain a strong preference for first lien and secured exposures and will be guided by bottom-up fundamentals in terms of where value resides. This is pointing us towards senior financials, gaming, consumer staples and special situations in real estate and business services.

Specifically, we believe the senior unsecured credit of European financials offers attractive value. Our focus is on mortgage lenders rather than banks that are more exposed to SME lending or investment banking. We also believe Europe provides a much more promising backdrop relative to the US given the latter's less stringent regulations for regional banks. In Europe, capital ratios must be kept at elevated levels across large and smaller banks which has resulted in less vulnerability across Europe. In the US, deposit outflows and significant lending into the commercial real estate (CRE) market implies a stretched capital position.

The current backdrop remains promising for both global dislocation and special situations investments with monetisation timelines of between one and three years as bonds approach maturity dates. 29% of the global HY market has a maturity date within the next three years, totalling more than $590 billion. This segment of the market has an average option-adjusted spread of 752 bps, yield-to-worst of 12.0% and an average price of $90.[2] We are focussing primarily on performing dislocations where bonds offer a material discount to par with the aim of capturing par by the end of the reinvestment period in 2026.

EMERGING MARKET DEBT:

The outlook for EM is challenging due to declining global liquidity and higher core yields, which may not be absorbed by low-risk premia in hard currency (HC) and local currency (LC) markets. Additionally, market positioning is still extended.

In HC, both the J.P. Morgan Emerging Market Bond Index (EMBIG) Investment Grade and EMBIG (excluding CCC credits) are trading at levels lower than their 10-year average by more than one standard deviation. Therefore, there may be limited room for further tightening, while spreads could significantly widen due to continued monetary tightening. Distressed names may offer case-by-case opportunities, but selectivity is crucial, especially after a strong rally this year.

In LC markets, interest carry and price return have driven performance year to date, but there are hurdles for future gains, including higher core yields, and the easing cycles that have started for some EM central banks. Additionally, the EM inflation outlook is becoming less certain, in contrast to the broad-based disinflation trend of the past four to five months. The underwhelming growth outlook in China is likely to add vulnerability to commodity-exporting currencies. Lastly, market positioning remains extended.

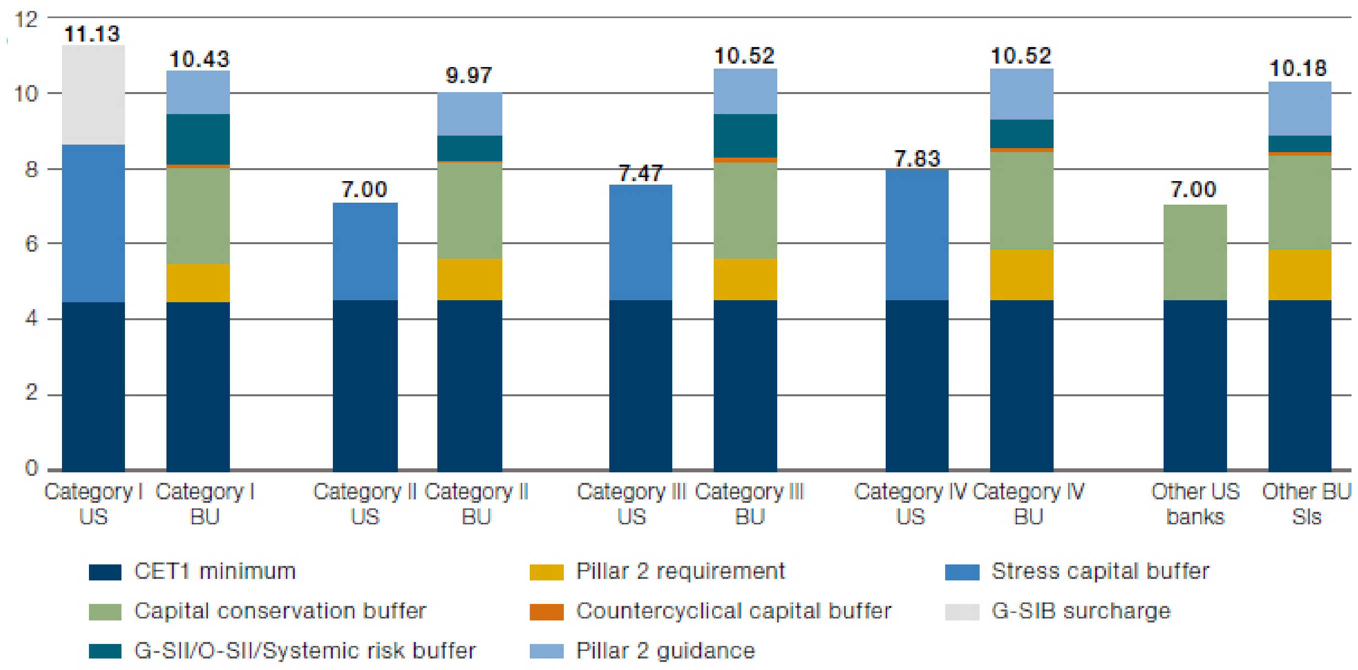
EMERGING MARKET CORPORATE BONDS:

We believe that valuations in the EM corporate bond space remain fair - and in fact tight in a few pockets at an index level once China HY is stripped out. With that said, we are positive about the opportunity set going forward, with dispersion likely to remain high due to uncertainty over the future pathway of growth.

We remain sceptical that China's fiscal policy will come to the rescue of growth and believe there is still some downside risk to real estate in this market. The market remains fixated on what the next China fiscal policy measure might be and while this might support growth, homeowners and certain real estate projects, we are doubtful that this will be a bailout of offshore creditors. We prefer to play China's recovery selectively via some industrials and Macau's gaming sector.

Outside of China, we see opportunities in India, mainly geared towards short-dated paper of high-quality credits in a variety of sectors, as well as special situations in Indonesian HY. In Turkey, we see opportunities in companies that are net cash and retain strong fundamentals with limited downside risks related to currency devaluation and in Latin America, we are becoming emboldened by opportunities in Mexican banks, Brazilian oil field services and within Brazilian special situations.

Figure 6. Required CET1 risk-based capital ratios for banking union Significant Institutions and US banks, compared by US bank category size, as of Q4 2022



Source: ECB, as of 31 December 2022. Available here: Banking supervision beyond capital (europa.eu).

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We expect the primary market to become more active in the coming months after a long period of hibernation and we aim to selectively capitalise on opportunities in this space, though we retain a degree of caution given the difficult macro conditions still percolating in both developed and emerging markets.

CONVERTIBLE BONDS:

We have recently seen signs that rates will remain higher for longer than expected, with some investors now of the belief that rate hikes have further to run. Such a move would be negative for traditional fixed income assets with their higher duration (5.8 for IG, 3.5 for HY and 7.2 for government bonds). Conversely, global convertibles have a duration of just 2.1. Higher rates also lower the probability that economies can avoid a hard landing.

The current set-up for convertibles remains favourable for those required to be invested in equity markets. As has been well documented, equity market strength has been driven by a small handful of mega-cap tech names that are not represented in the convertibles space. Conversely, many convertible bond issuers remain oversold and provide attractive opportunities on the upside. While deltas (equity sensitivity) remain low versus historical levels, this also provides strong downside protection in the event that markets move lower. The positive convexity feature of convertibles means deltas will expand on a move higher in markets, however. The higher for longer rates environment, as well as an upcoming maturity wall, bode well for new issue volumes in the convertible bond space as firms seek to reduce their financing costs and capitalise on strength in equity prices.

CONVERTIBLE BOND ARBITRAGE:

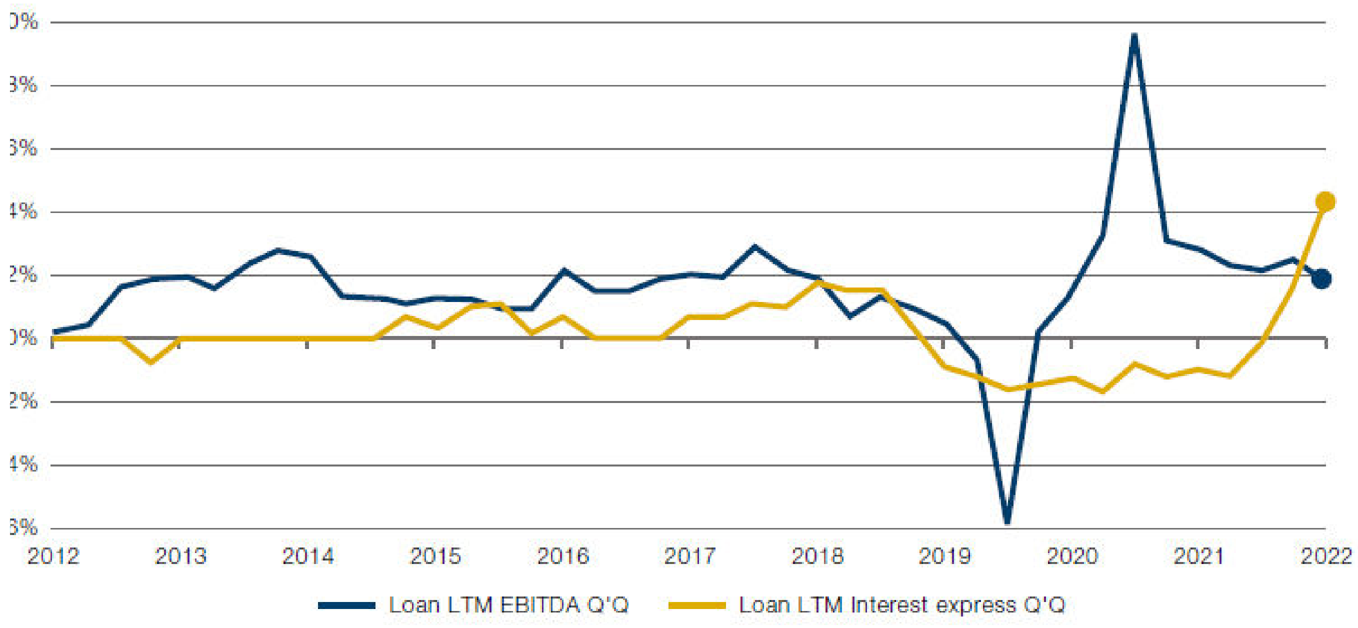
We believe Europe offers better value than the US and Asia in this space. European realised volatility continues to remain near recent lows and implied volatilities have continued to grind lower as a result. This overall cheapening has been exacerbated by a combination of increased primary in Asia and the US, prompting a rebalancing from the EU to the US and Asia, as well as continued redemptions from long only participants. This cheapening has been most pronounced in balance and lower delta, in particular, in longer duration convertibles. The cheapness should also be taken in the context of the more normalised rate environment which makes the equivalent cheapness look even more attractive compared to recent points like March 2020 and July 2022. These valuation lows would however rely on the European Central Bank (ECB) cutting rates or intervening in a broader risk off move. If rates continue to remain elevated and there is no wider market shock that prompts the ECB to cut rates, a 2% cheap universe still presents an attractive entry point to opportunistically scale in, in our view. We anticipate significant opportunities in the event driven space for idiosyncratic selection, driven by factors such as buybacks, M&A and other market prospects. We also believe the rise in stress and dislocation will create more credit specific opportunities.

RESIDENTIAL MORTGAGE-BACKED SECURITIES (RMBS):

US housing has been characterised by some interesting market dynamics as we have moved through 2023. Nationally, home prices have rebounded above the 2022 peak despite previous forecasts of impending doom. Most analysts now project that national home prices will be flat to slightly up in the coming years, range-bound due to competing push-pull forces of supply/demand and unaffordability pressures. Near-record low inventory and homeowners incentivised to stay in place to protect their historically low 30-year fixed rate mortgages, have combined with high demand driven by household formations to protect against a price correction despite a run up in mortgage rates to north of 7%. This stabilised and relatively healthy market contrasts with many CRE sectors, where negative leverage and refinance risk (borrowing costs in excess of investment yields) and underlying fundamental deterioration has led to falling asset values. Adding to this differential in price/valuation is the fact that residential houses are valued by the homeowner bid for a primary residence, whereas CRE properties are valued by 'cap rates'.

Against this backdrop, we are seeing compelling opportunities in residential credit. Investor loans continue to offer attractive risk-adjusted returns, with relative value available in RMBS as spreads on more liquid investments have widened faster than the underlying loans. We are also seeing growing opportunities to invest in home equity loans (HELs), which can deliver structurally levered and diversified exposure with significant equity buffer. This opportunity follows the long-term home price appreciation experienced in the US, where homeowner equity is near historical highs ($30+ trillion[3]) and HELs allow homeowners to release equity from their homes without refinancing their existing first lien mortgage (from <3% to >7%). Specialist investors can aggregate and finance HELs and acquire and finance IG HEL bonds from banks and non-bank lenders, and volume is expected to grow significantly in the coming years.

Figure 7. Interest expenses rose more than 2% faster than EBITDA for the median loan borrower in 4Q22



Source: Morgan Stanley Research, as at 31 December 2023.

LEVERAGED LOANS:

Loans have had a very good year, up close to double digits and outpacing the returns of HY and IG markets. Although the floating rate aspect of loans is the main driver of outperformance, loans have also outperformed HY on an excess return basis. Additionally, lower quality corners of the market have delivered the best returns as the market largely pays no heed to fears over incoming recessionary conditions. The moves year to date are seeming to shrug off the recent deterioration in fundamentals that we highlighted in Figure 3. We expect this to continue as higher interest costs and slowing growth start to impact the market (see Figure 7).

CREDIT RISK SHARING (CRS):

One of the priorities of the EU Capital Markets Union is to revive the EU securitisation market. If we were to use notional significant risk transfer (SRT) issued as a proxy for revitalisation, then 2022 was a very healthy year indeed. With over 30 banks issuing 118 SRT securitisations worth over EUR 170 billion in notional value (up from approximately EUR 130 billion in 2019), issuances are expected to creep past EUR 200 billion by year-end. The diffusion of credit exposures continues to garner broad support from macroprudential supervisors as a means of promoting financial stability. The expansion in funding potential brought about by SRT is another acknowledged benefit, and one of particular pertinence as governments attempt to rouse decelerating economies. These factors play into the observed robustness of the SRT market, having weathered more than 20 turbulent years, delivering investors stable and predictable cash flows throughout. As SRT spreads sit at their widest for over a decade, the opportunity for investors to gain exposure to a diversified pool of high-quality loans is as compelling as ever, in our view.

1. The EAC credit market outlook was conducted twice a year (Q1 and Q3) until 2020, at which point the frequency was increased to quarterly. 2. Source: ICE BofA, as of 29 September 2023. 3. Source: Man GPM, Board of Governors of the Federal Reserve System, data through to April 2023.

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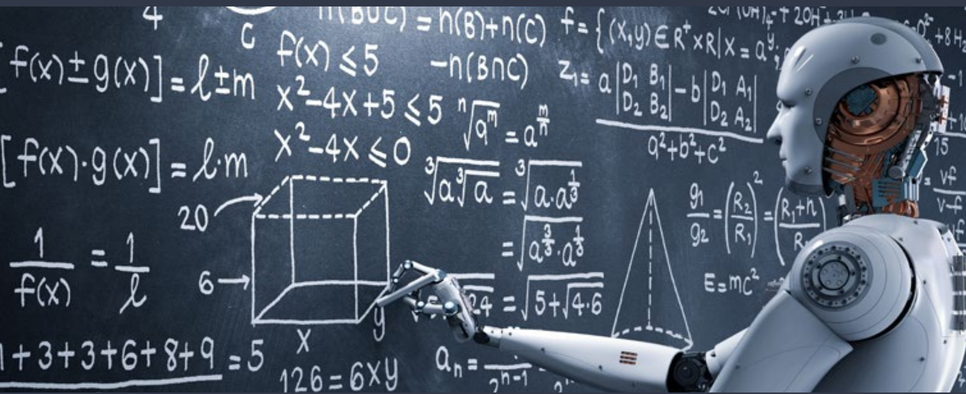

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