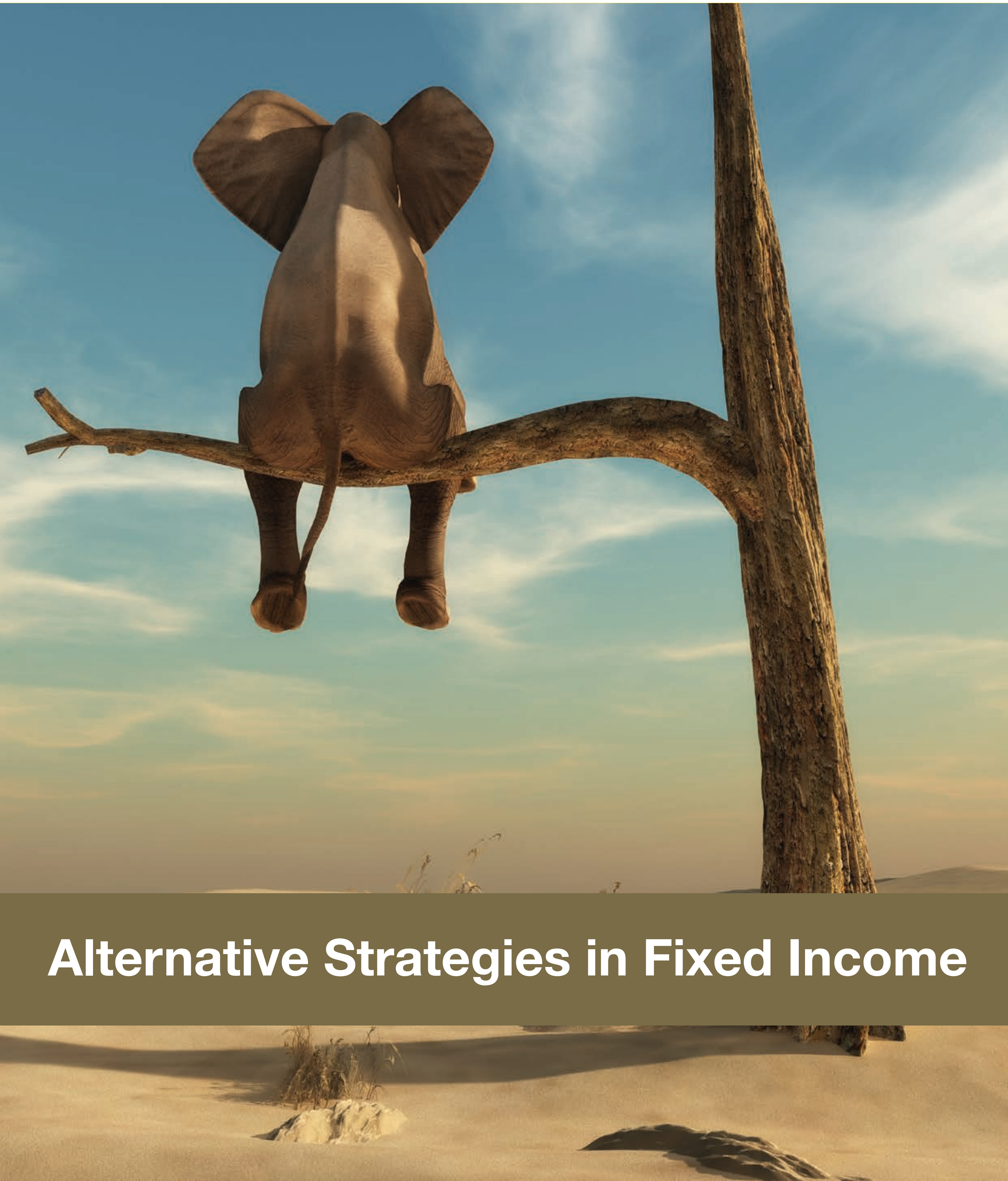
November 2017

HEDGENORDIC



Alternative Strategies in Fixed Income

Contents

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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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Facts & Figures on NHX FIXED INCOME SUB INDEX

23.8% / (-20.8%)
Best (Worst) 12 Month per for NHX FIXED INCOME

15.8%
Best performing NHX FIXED INCOME FUND YTD (NYKREDIT MIRA HEDGE FUND)

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CONSTITUENTS TO NHX FIXED INCOME SUB-INDEX

The Editor...

The elephant is not in the room

Having an "Elephant in the room" is an English-language idiom for an obvious problem or risk no one wants to discuss, or a condition of groupthink no one wants to challenge. It is based on the conviction that something as conspicuous as an elephant can appear to be overlooked or simply ignored by silencing it out of any discussion.

The metaphoric elephant within todays financial markets however is in the open. In fact, it is sitting there, elevated for all to see, big and fat on a bristle branch. Most people in financial markets are in agreement that fixed income markets (as well as equity markets) are priced pretty rich and the hangover will likely come from a cocktail that is heavily shaken, rather than gently stirred.

> "When elephants fight, it is the grass that suffers."

The years of near zero interest rates on pensions and savings are leaving investors struggling for safe havens to park their money, risk free as in the good old days, and make a reasonable return that surpasses inflation rates. Often, these can only be found in alternatives to fixed income instruments; or on what his publication will be focusing on: alternatives within fixed income strategies. And the segment does come in many shapes and colours, as we will try to highlight.

HedgeNordics´ reports are a balanced mix of our own editorial teams research, interviews and opinion pieces and also allows to bring views and voices of industry experts in their own words. The volume of the reports permits to investigate a distinct topic from various angles and viewpoints. The extensive content allows to span the entire range from drawing the big picture of the subject, point out specifics and also look into some niches within the niche, which I hope we have managed to achieve.

To tease you into the paper, here some of the highlights: We were able to scrutinize the claim that there is always value in global bond markets while critically asking if fixed income markets are actually overvalued, Helsinki based AIM Capital tells us how to dissect value in credit. We are reminded that structured credits across all asset classes have delivered strong performance in recent years, look at the merits of convertible bonds and dig up the hidden treasures of short duration high yield.

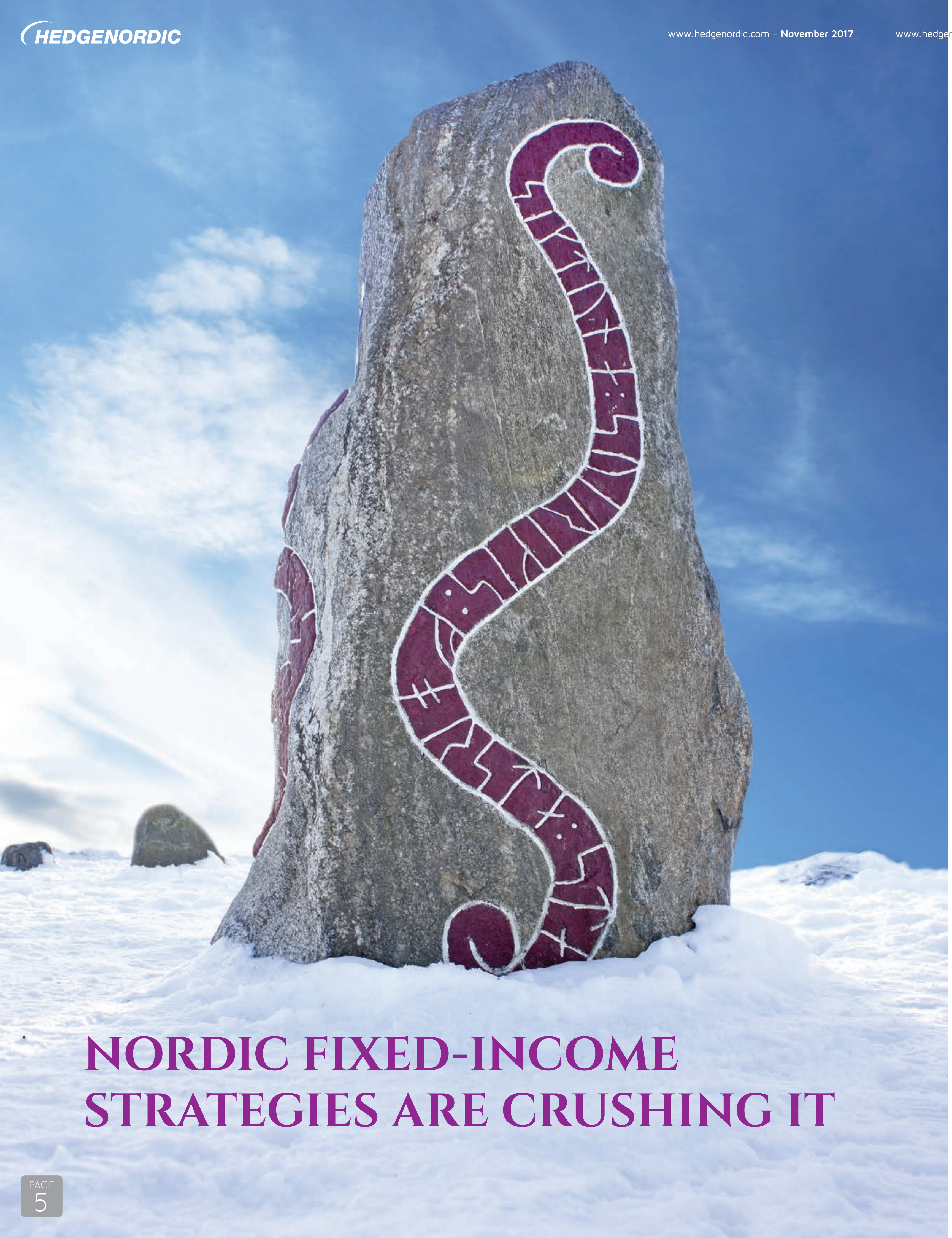
The report gives a crash course on the rise of Green Bonds and their role in financial markets. We were fortunate to be able to interview Helena Lindahl managing the biggest Green Bond fund in the world in terms of AuM.

The hurricane season in the Caribean and Southern part of the united states meant a major and catastrophic event, non the least for ILS / Cat Bonds. HedgeNordic had the opportunity to talk to Nordic asset managers active in the field.

Nordkinn Asset Management, one of the most successful fund launches of recent years in the Nordics investigates if hedge funds can be a part of the solution for a sustainable financial system as regulation sweeps away and shifts long grown roles on financial markets.

We hope you find an interesting angle or two within these pages and plenty of food for thought and leave you with Abraham Lincoln´s saying: "When you have got an elephant by the hind legs and he is trying to run away, it's best to let him run."

Kamran G. Ghalitschi
CEO / Publisher HedgeNordic



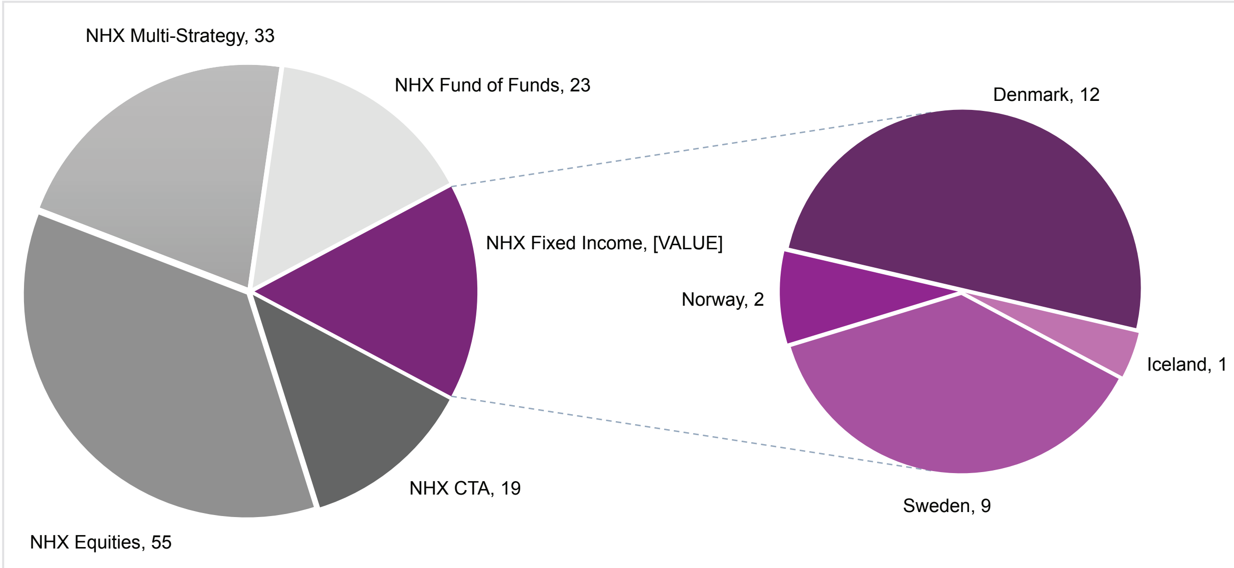
NORDIC FIXED-INCOME STRATEGIES ARE CRUSHING IT

by Eugeniu Guzun – HedgeNordic

The NHX Fixed Income Index is an equally-weighted sub-index of the Nordic Hedge Index (NHX) universe tracking the performance of Nordic fixed income hedge fund managers. The sub-index comprises 24 fixed income funds, accounting for roughly 16% of the total number of NHX constituents.

Danish funds account for exactly half of the fixed income category, with the popularity of fixed income funds in Denmark stemming from the unique structure of the country's mortgage bond market. In Denmark, mortgage banks supply mortgages to home owners, with the funds required being obtained through the simultaneous issuance

COUNTRY BREAKDOWN OF NHX FIXED INCOME INDEX



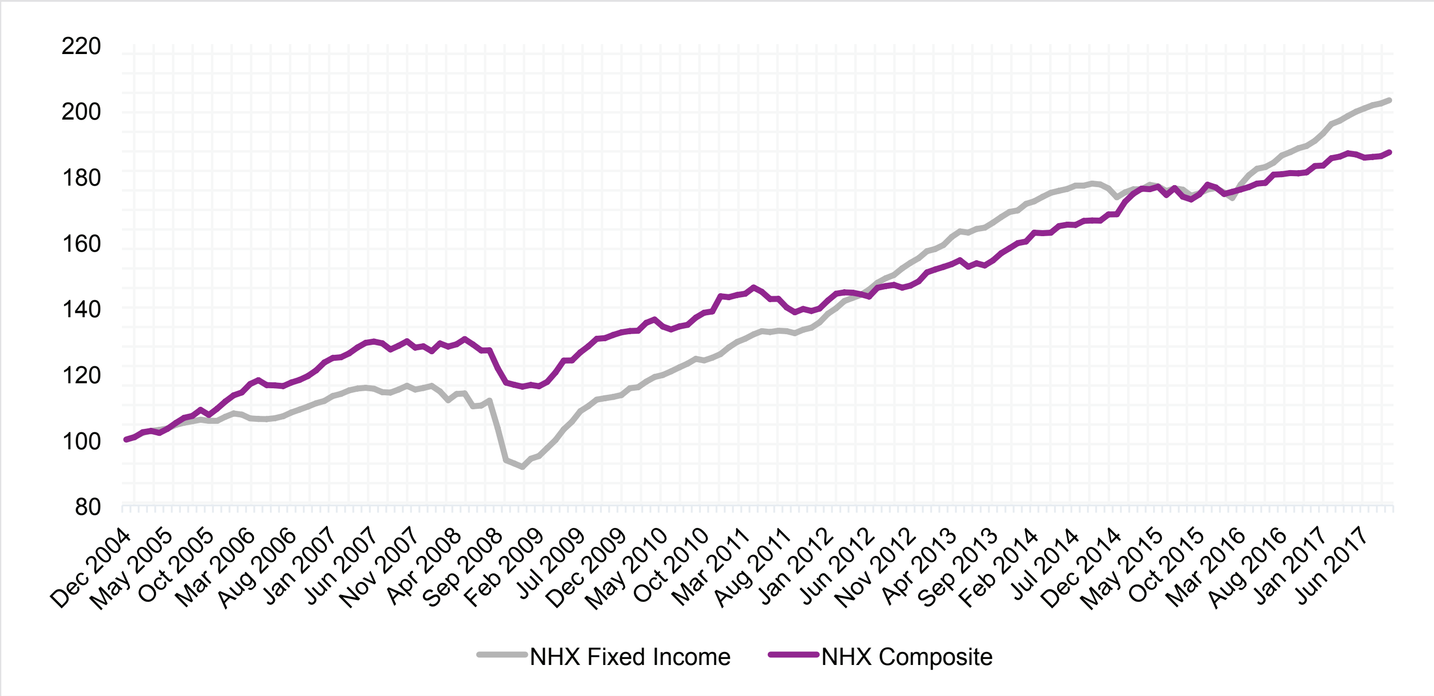
Source: HedgeNordic

of bonds. The so-called mortgage covered bond market serves as an important source of alpha for most Danish funds included in the NHX Index. Danish fixed-income funds account for more than half of the 22 Danish hedge funds that are part of the NHX family.

Meanwhile, the NHX universe includes nine Swedish fixed-income funds, two Norwegian funds, and one Icelandic fund. There are no Finnish fixed-income funds in the NHX family.

The group of Nordic fixed-income hedge funds outperformed each of the remaining four categories tracked by HedgeNordic both in 2016 and thus far in 2017. The fixed-income category was the biggest loser during the turmoil caused by the financial crisis of 2008, but these vehicles have achieved a commendable recovery in the post-crisis era. In fact, Nordic fixed-income strategies have delivered 19 consecutive months of positive returns, with the NHX Fixed Income Index reaching an all-time high in September of this year.

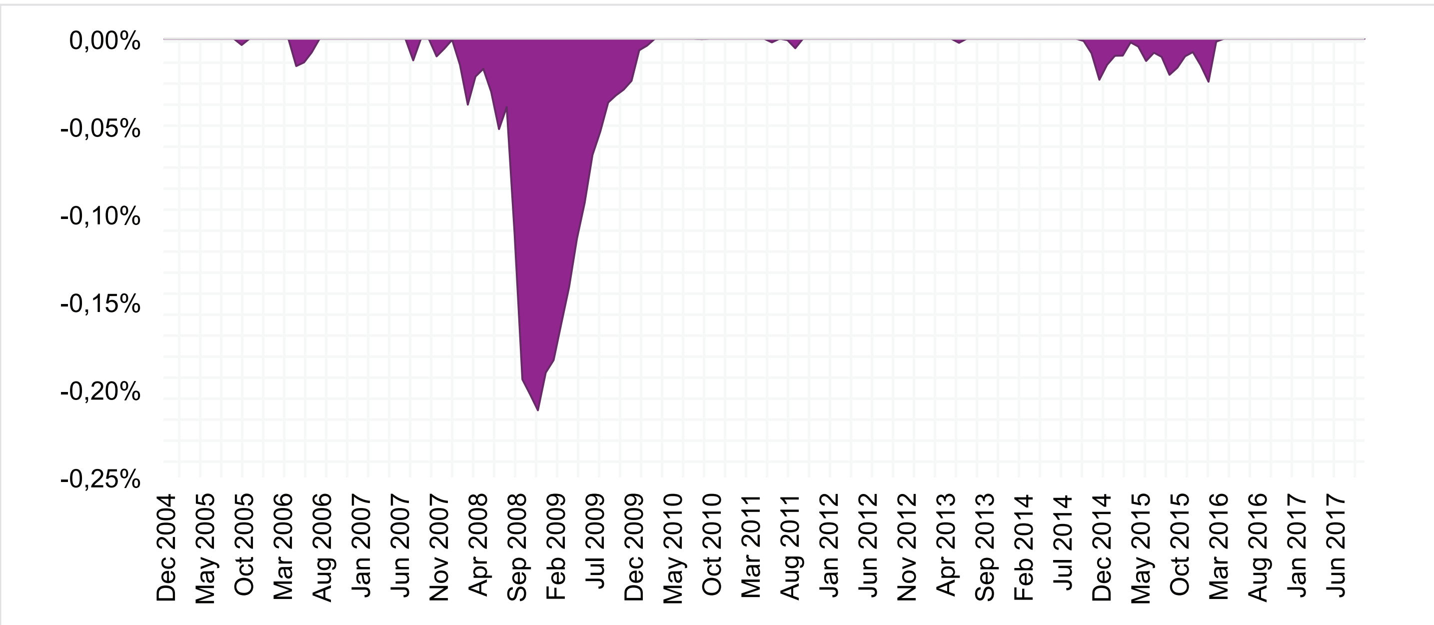
PERFORMANCE COMPARISON OF NHX FIXED INCOME VERSUS NHX COMPOSITE



Source: HedgeNordic

The maximum drawdown for the NHX Fixed Income Index was 21.2%, with the drawdown beginning in late 2007 and extending 14 months right to the end of 2008. The recovery from the valley value of the index hit in December 2008 to a fresh high lasted a total of 15 months. The largest drawdown in the post-crisis era was a mere 2.5%, a relatively long drawdown that started in October 2014 and lasted 17 months. It took only two months to recover the losses. Interestingly enough, the valley value of the index reached in February 2016 marked the start of the 19-month-streak of positive performance.

DRAWDOWN OF NHX FIXED INCOME INDEX

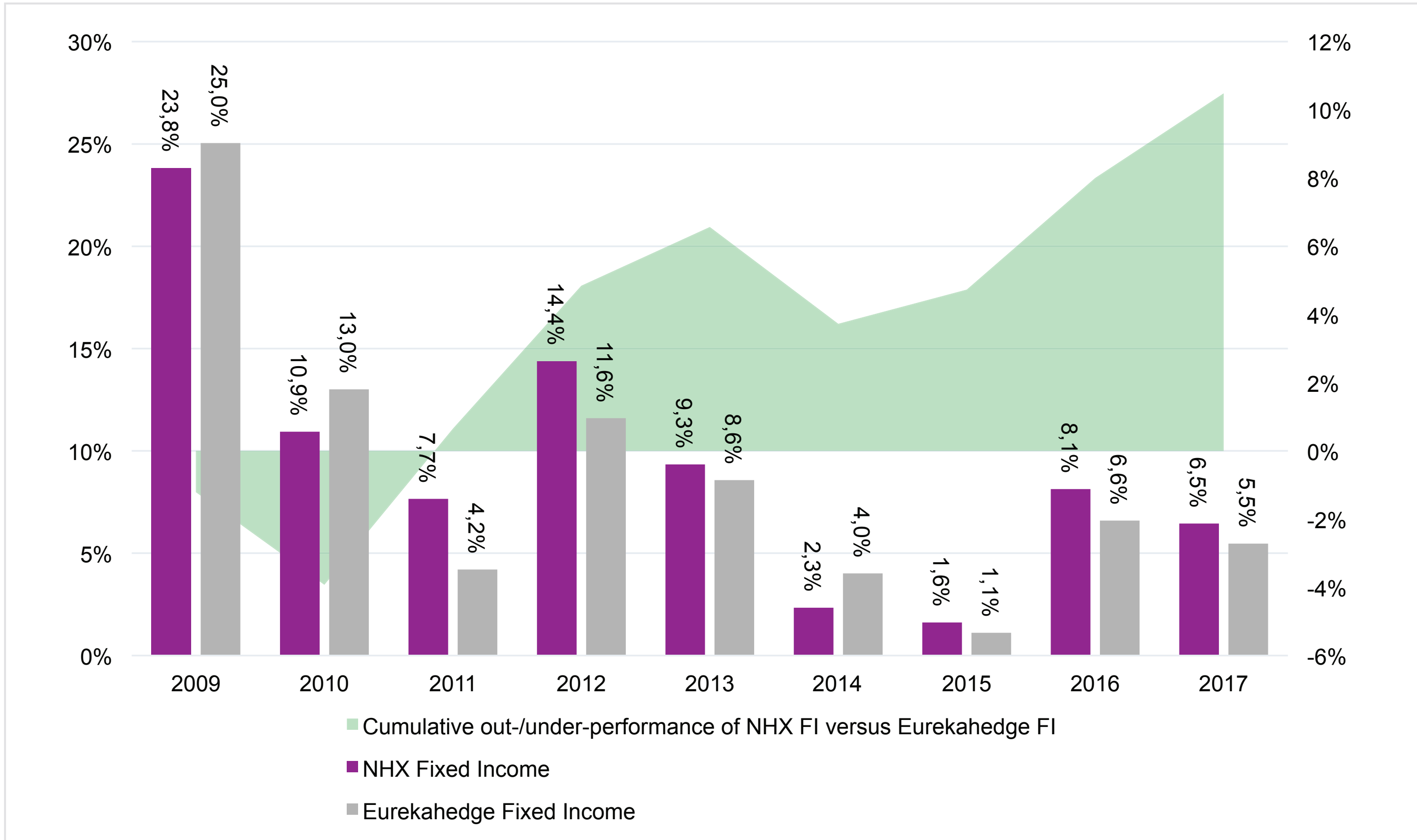


Source: HedgeNordic

Our statistics show that the NHX Fixed Income Index has generated an annualized return of 5.7% since the beginning of 2005, with both the 8.1% return of 2016 and the 6.5% return delivered year-to-date through the end of September being above this historical figure. In comparison, the entire NHX family of funds has returned an annualized 5.1% over the same time span.

Looking back on the historical performance of both Nordic and international fixed-income hedge funds since the beginning of 2005, one can quickly jump to the erroneous conclusion that Nordic fixed-income specialists significantly underperformed international peers. After all, the NHX Fixed Income Index generated a cumulative return of 103% since December 2004, whereas the Eurekahedge Fixed Income Hedge Fund Index - an equally weighted index of 348 constituent funds - returned a cumulative 127% over the same time span.

COMPARISON OF NHX FIXED INCOME VERSUS EUREKAHEDGE FIXED INCOME



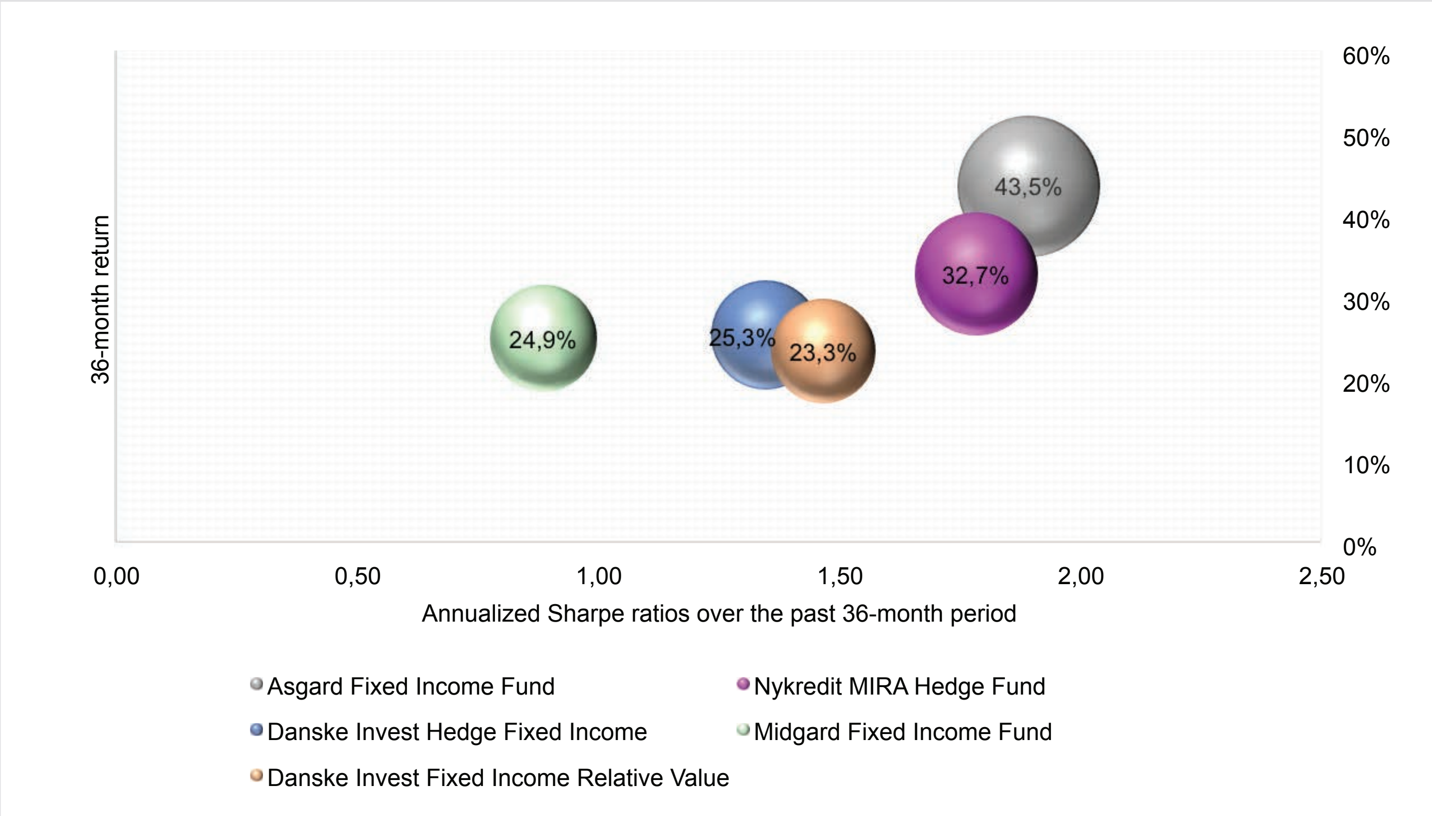
Source: HedgeNordic and Eurekahedge

A different picture emerges in the post-crisis era. Nordic fixed-income hedge funds amassed a cumulative return of 121% since December 2008 through September of this year, whereas international peers generated a cumulative 111% over the same period. The NHX Fixed Income Index outperformed the Eurekahedge Fixed Income Hedge Fund Index in five out of the six previous years, with Nordic fixed-income specialists being on course to beat international peers for a third consecutive year. If one had the ability to invest in the NHX Fixed Income Index at no cost at the end of 2008, the cumulative return from this investment would have lagged the performance of the Eurekahedge index in 2009 and 2010. Nonetheless, the cumulative return of such investment would have outpaced the Eurekahedge index by 10.5% at the end of September 2017.

To summarize, the NHX Fixed Income Index has generated an annualized return of 9.5% since December 2008 through September 2017, with annualized volatility of 2.8%. This compares with the annualized return of 8.9% for the Eurekahedge Fixed Income Hedge Fund Index, which sported annualized volatility of 3.3%. This implies Nordic fixed-income specialists fared better than their international peers while experiencing less volatility in returns.

A quick review of the performance of the fixed-income specialists included in the NHX confirms the statement that the Danish bond market is a strong source of alpha in the Nordic fixed-income universe. Danish funds top the list of the best-performing Nordic fixed-income hedge funds. Asgard Fixed Income Fund, a relative value fixed-income hedge fund that generated a cumulative return of 43.5% in the last 36 months, has won the "Best Nordic Fixed Income Focused Hedge Fund" award for three consecutive years. The Copenhagen-based fund also reached the ultimate Best Nordic Hedge Fund spot at the 2015 Nordic Hedge Award ceremony.

BEST PERFORMING NORDIC FIXED INCOME FUNDS – 36-MONTH RETURN



Source: HedgeNordic

ALTERNATIVE fixed income

The search for true diversification

By **Brad Godfrey**, *Director of Alternative and Asset Allocation Strategies at Eaton Vance*

Many institutional investors today are increasingly seeking liquid, independent return streams that, at a reasonable cost, can deliver true diversification, mitigate downside risk at the portfolio level and potentially also serve as a buffer to the lower forward-looking returns likely to be delivered by traditional risk assets.

The backdrop to this heightened focus includes:

- The failure of a number of institutional investors to achieve their targeted returns.
- Disenchantment with the promised diversification benefits or performance of many hedge funds and the fees paid for that performance.[1]
- Growing consensus about the relatively unattractive forward-looking risk-return trade-off of holding a portfolio dominated by traditional betas.[2]
- Market surprises such as China's 2015 currency devaluation and unexpected changes in central bank accommodation, which have highlighted the changeability of pair-wise correlations and the real challenge faced by investors of creating truly diversified, resilient portfolios.
- The possibility of further political fragmentation globally coupled with increased uncertainty around monetary policy and inflation expectations as the global economy starts to reflate.
- Awareness of the potential for high-quality active, specialist managers to add value by capitalising on opportunities relating to macro uncertainty, structural change and less well-researched opportunity sets.

Not surprisingly, the search for improved risk-adjusted returns in a low-return, elevated-downside-risk environment has seen continued interest in less familiar asset classes and flexible, unconstrained strategies. Current examples include the spike in interest in macro hedge funds

and absolute return fixed-income funds – both of which can potentially navigate a global environment increasingly impacted by geopolitical themes and avoid systematic exposure to rising interest rates.[3]

Key themes in terms of investor trends also include a much sharper focus on cost (the desire for lower cost solutions to that of hedge funds or fund-of-funds in the alternative space), transparency and overall risk management.

In our view, in product terms, liquid alternative bond strategies harnessing the skills of the very best alternative managers potentially have a lot to offer at this point.

That said, investors searching for "true diversification" also want to understand how the addition of an alternative bond strategy will result in a more diversified overall portfolio over time.

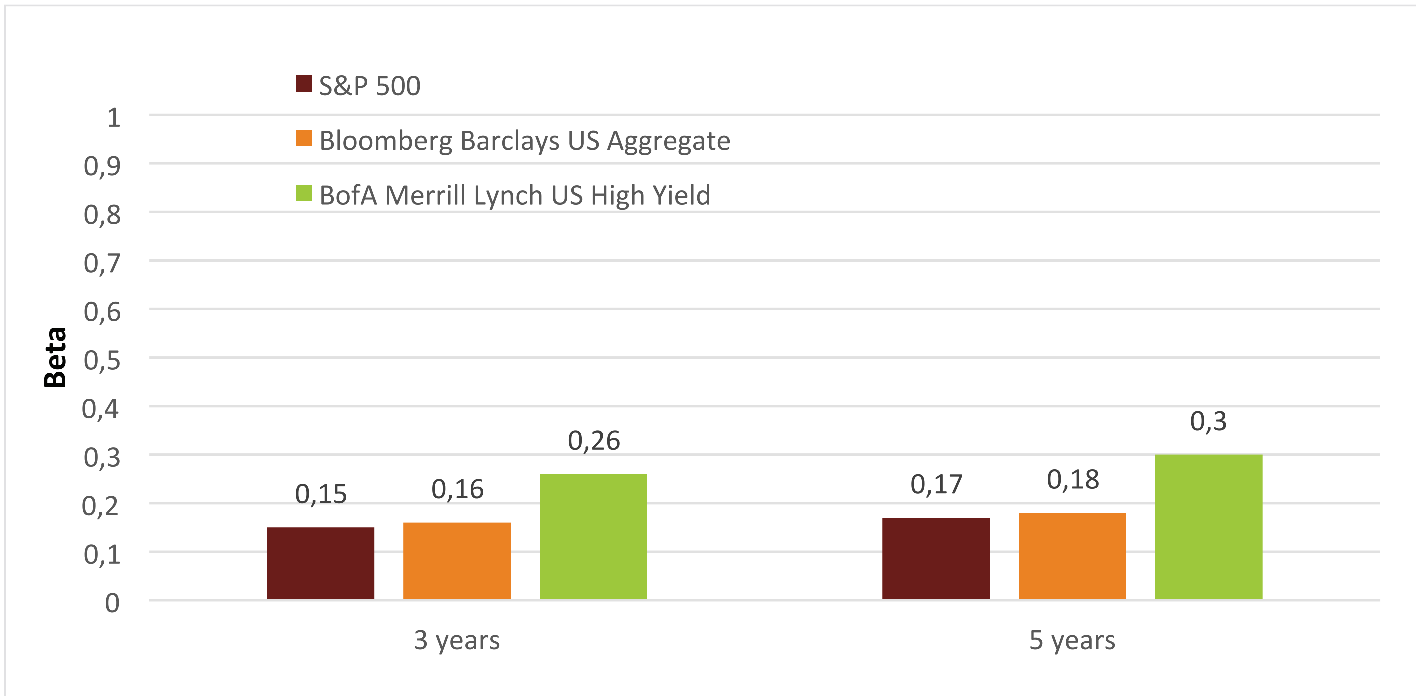
THE PORTFOLIO CHALLENGE OF CORRELATION CREEP

An assumption that investors sometimes make in seeking low-correlated assets to build diversified portfolios is that low correlations will persist. Unfortunately, this is not always the case. One needs look no further than the classic 60/40 stock/bond portfolio to illustrate this point. According to Ibbotson, 20-year rolling periods since 1945 (capturing data starting in 1926), on average, show that stocks and bonds have been uncorrelated – or -0.01, to be precise.[4]

However, this average masks a wide historical range over multi-decade cycles, including lengthy stretches of relatively high correlation, with that relationship varying from a high of just under 0.6 to a low of -0.4. The point here is that for long-term portfolio construction, it is unwise to assume that correlations will stay constant. Portfolio volatility may be higher than anticipated if correlations increase.

For investors seeking a strategic weighting for lowering portfolio volatility, a helpful starting point may be strategies with a strong track record that have a low correlation to both stocks and bonds, and that seek steady risk-adjusted returns. In this context, we believe the Eaton Vance Global Macro Absolute Return Advantage Strategy (GMARA) warrants consideration as a strategic alternative weighting. Exhibit A highlights that GMARA has a low beta to traditional sources of systematic investment risk – including equities.

Exhibit A GMARA has a low correlation to both stocks and bonds.



Sources: Eaton Vance, S&P and Barclays as at 30 June 2017.

The GMARA team, in our view, is able to generate low correlations by:

- Thinking differently and investing differently from many other managers.
- Focusing on a very broad investment universe (126 countries with investable markets) and assets less well-covered by most analysts. The team's search for high Sharpe ratio opportunities globally is not limited by market-based benchmarks.
- A risk factor-focused approach (i.e., isolating the risk factors that drive the prices of instruments: sovereign credit spreads, rates, FX, equity risk premium and corporate credit spreads). This allows for risk to be allocated to a precise area where it is being most well-compensated (which is often more idiosyncratic rather than systematic).
- Shorting, which increases the number of investment options available to a manager and is a useful tool for managing liquidity and risk.
- Actively seeking to keep portfolio betas low.
- In depth, country-level, fundamental research combined with an extensive operational infrastructure and trading capability that allows the team to target opportunities even in countries that, from an operational standpoint, are challenging to invest in.

Designed around transparent, repeatable processes to be a unique source of alpha – not a repackaging of traditional betas – GMARA's track record is not just about low correlation. It has the proven ability to deliver returns

Brad Godfrey,
Director of Alternative and Asset Allocation Strategies at Eaton Vance

consistent with the long-term equity risk premium with bond-like volatility.

As shown in Exhibit B, for the three years to 30 June 2017, GMARA's annual average return of 7.7% represented 80% of the return of the S&P 500 Index, while its standard deviation, at nearly 4.0%, was slightly higher than that of the Bloomberg Barclays US Aggregate Index Bond (2.9%) and considerably lower than that of the S&P 500 Index (10.4%).

Volatility is higher than the median strategy in the Macro Discretionary over the aforementioned three-year period, but its return was higher by an order of magnitude. Risk and return are in line with the strategy's expected 4%-8% volatility range and gross return aim of delivering 6%-8% in excess of the risk-free rate.

[1] According to Preqin Investor Outlook: Alternative Assets H2 2017, over 50% of hedge fund investors are seeking fee changes because they do not seem justified in light of actual returns generated. Around 55% of investors interviewed by Preqin in June 2017 reported that hedge funds had failed to meet expectations in the past 12 months, and 70% said hedge fund portfolio performance had fallen short of their expectations over the past three years.

[2] In the view of Eaton Vance, US Core Fixed Income is, as of 30 June 2017, unlikely to provide in excess of cash plus 2.4% going forward, while passive large-cap US equities are unlikely to generate in excess of cash plus 6.6% from here.

[3] Source: eVestment Hedge Fund Industry Asset Flow Report, April 2017. Year-to date, macro hedge funds have attracted the strongest investor flows (US$11.6 billion) relative to other hedge fund categories.

[4] Ibbotson data is based on 20-year rolling correlations of annual returns of large-company stocks and long-term government bonds. Data is from 1926-1945 through 1994-2013.

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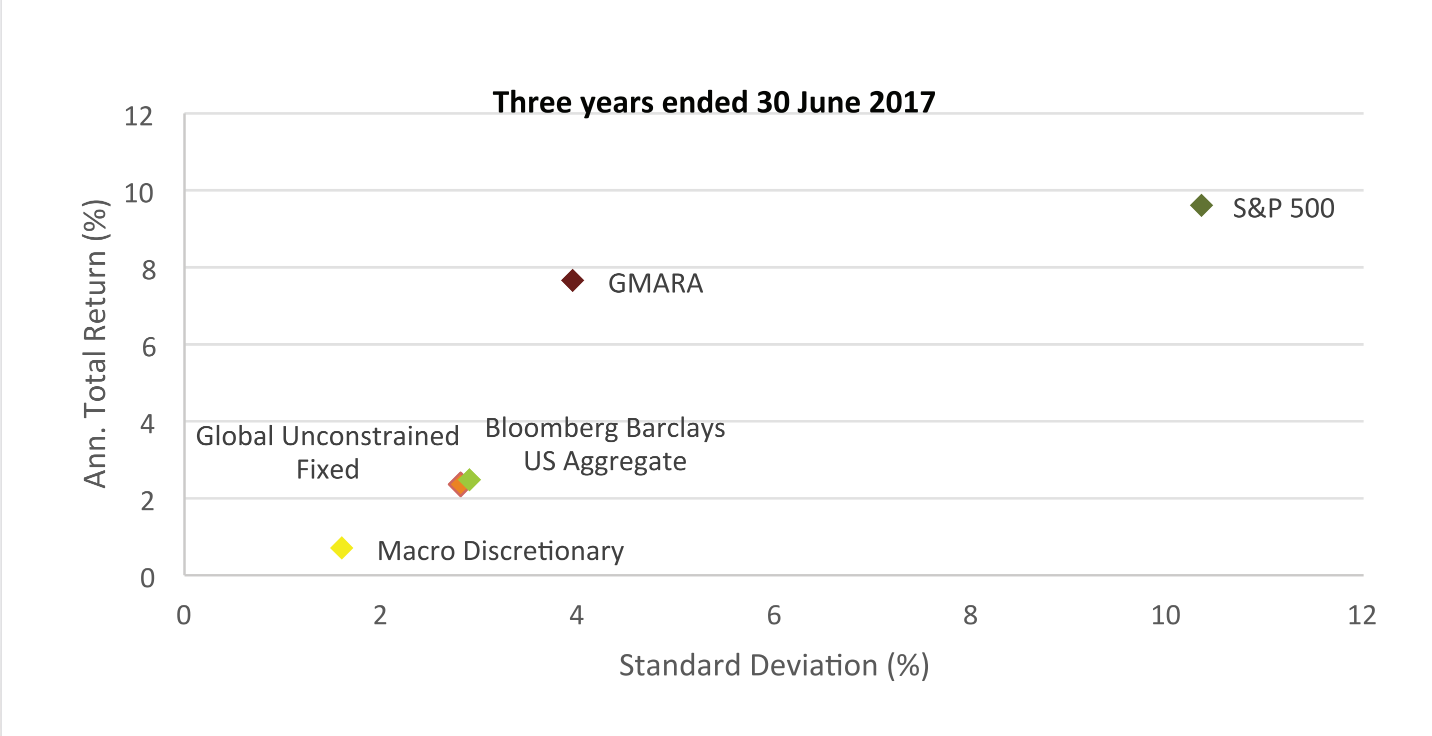
TOMORROW'S TOUGHER PERFORMANCE PICTURE

In our view, absolute volatility levels of a particular strategy should be viewed in conjunction with their contribution to overall portfolio diversification – indicated by low correlation with other asset classes – along with the ability of the strategy to deliver steady, attractive risk-adjusted returns.

At this juncture, stocks and bonds are widely viewed as fully valued, and not likely to replicate their strong performance of recent years. Against this backdrop, we believe there is potential value in adding to a portfolio a strategic weighting in an alternative liquid alternative strategy having a low correlation to both stocks and bonds, and that is underpinned by a transparent, repeatable process designed as a unique source of alpha.

Exhibit B GMARA's attractive risk-adjusted returns.



Sources: Eaton Vance, S&P, Barclays and eVestment as at 30 June 2017. Note: Within the eVestment Alliance universe, GMARA sits with the "Macro Discretionary" category (broadly including strategies with long/short positions), one of two principal alternative categories in the eVestment Alliance universe (the other being Global Unconstrained Fixed Income – generally long-only).

Source of data: eVestment Alliance, Preqin, Ibbotson, Eaton Vance, Morningstar and Bloomberg. Data as at 30 June 2017 unless otherwise stated.

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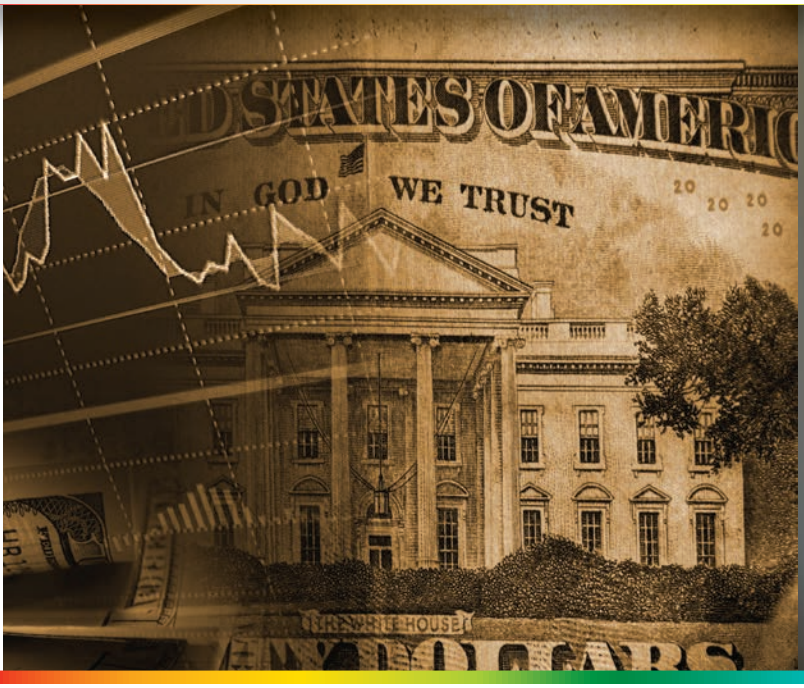
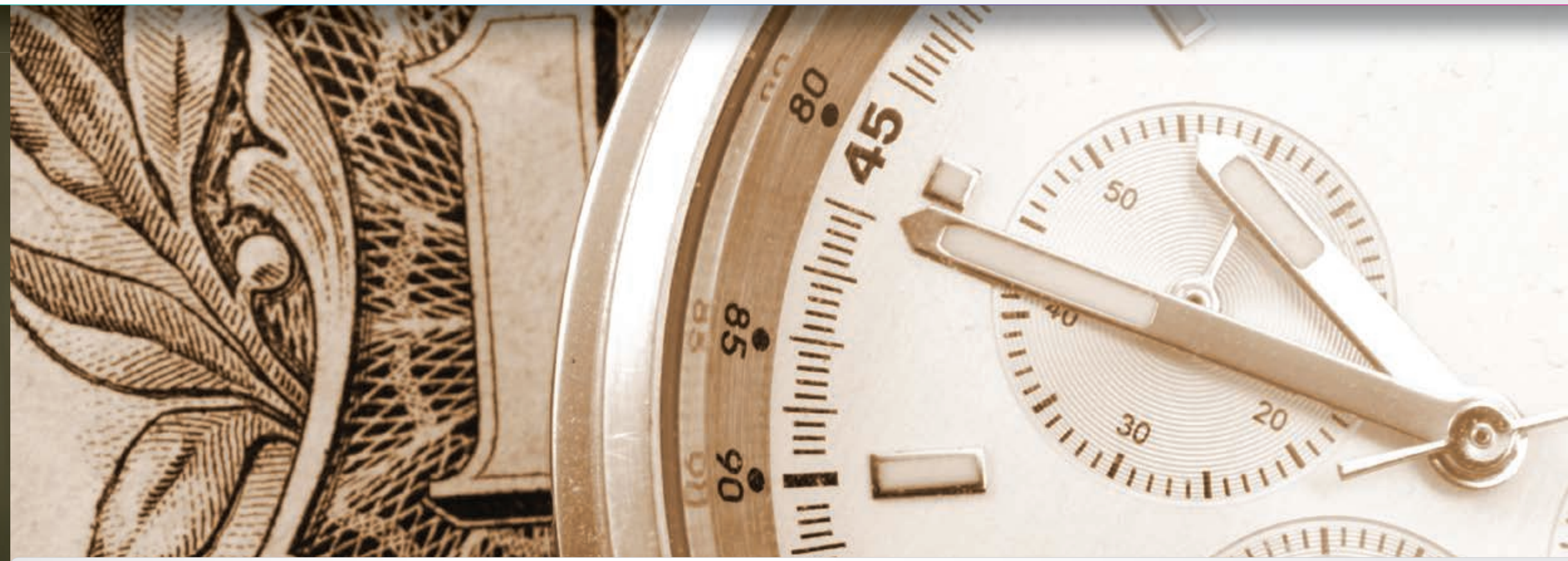
There is always value...





...in global bond markets

by Colin Finlayson, support manager of the Kames Strategic Global Bond Fund

At the beginning of 2011, when markets were slowly recovering from the worst of the financial crisis, we wrote the following:

> "With yields in major government bond markets still close to historic lows and economic recovery seemingly well established, being short bonds seems a sensible strategy. In addition to being the "consensus" view, that is of course also a little bit simplistic."

The Kames Strategic Global Bond Fund finished 2011 in positive territory despite warnings about the imminent demise of the bond market. It proceeded to register an even stronger return in 2012. We would not belittle the challenges the market faced in 2011, nor the challenges we face today. In fact, we agree with many commentators that the current absolute level of rates and spreads are far from appealing.

But there is one message from our 2011 view that we continue to espouse, and have done since we launched the Fund 10 years ago. That is: **to dismiss 'the bond market' as one amorphous mass is clearly wrong. There will always be value in global bond markets.**

The modern fixed income universe is simply too big and diverse to be painted with the same brush. It is partly the reason why, over time, the Kames fixed income team has grown not only in numbers but also in terms of the nationalities and languages represented on our desk. Like the bond market, our team is very much a global affair.

Having a large, diverse and well-respected team is important, but it is the global remit and flexibility of the Kames Strategic Global Bond Fund that allows us to put our investment ideas to work. Given where we are in bond markets, there are two approaches worth exploring, and they are not necessarily mutually exclusive.

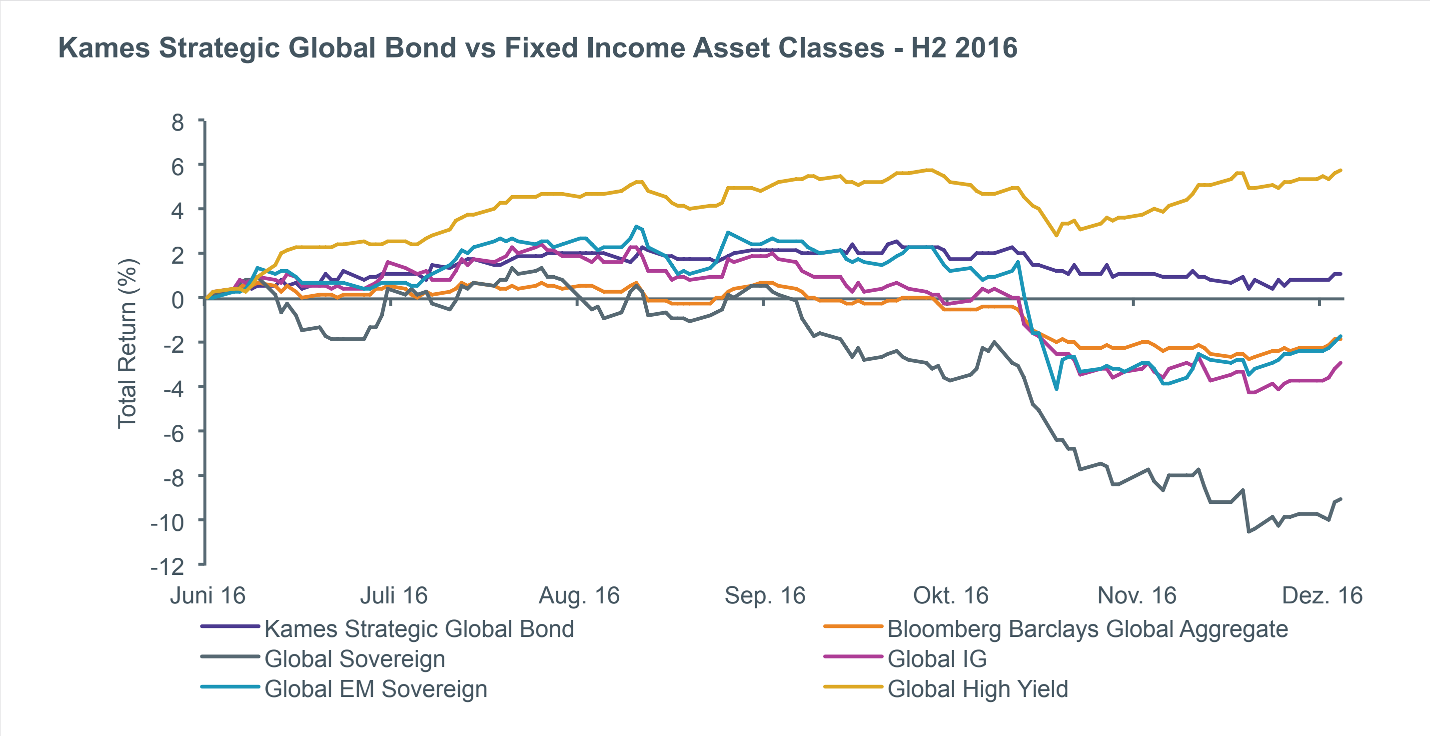
These are preserving value and actively looking for it.

Value preservation

We recognise that valuations in both government and corporate bonds markets are stretched using most measures. As such, we have retained a relatively cautious approach and have avoided assets where we believe the risk/reward ratio is simply unappealing.

This view is manifested in our Fund through our underweight in core government bond markets, and through our unwillingness to invest in the riskier areas of the corporate bond market; we typically avoid CCC-rated and distressed assets for example. These assets have tended to perform strongly in the risk-on environment of 2017 but we have chosen to avoid joining in with the irrational exuberance displayed in these segments of the market. And, despite our lack of exposure to these areas of the market, we have delivered outperformance.

That is not to say we are unwilling to increase the level of risk in the Fund when appropriate but it does highlight our flexibility to avoid what we don't like. The second half of 2016 demonstrates our value preservation approach nicely. As bond yields spiked as investors became excited



Source: Bloomberg, Lipper, Kames Capital - as at 31 December 2016. Source: Lipper. NAV to NAV, noon prices, income reinvested, net of ongoing charges, excluding entry or exit charges. Past performance is not a guide to future performance. The value of investments and the income from them may go down as well as up and it is not guaranteed.

about the 'Reflation trade', the Kames Strategic Global Bond Fund navigated the volatile conditions successfully, as the graph above shows. This is again an example of delivering risk-adjusted returns.

Unlocking the hidden value in bond markets

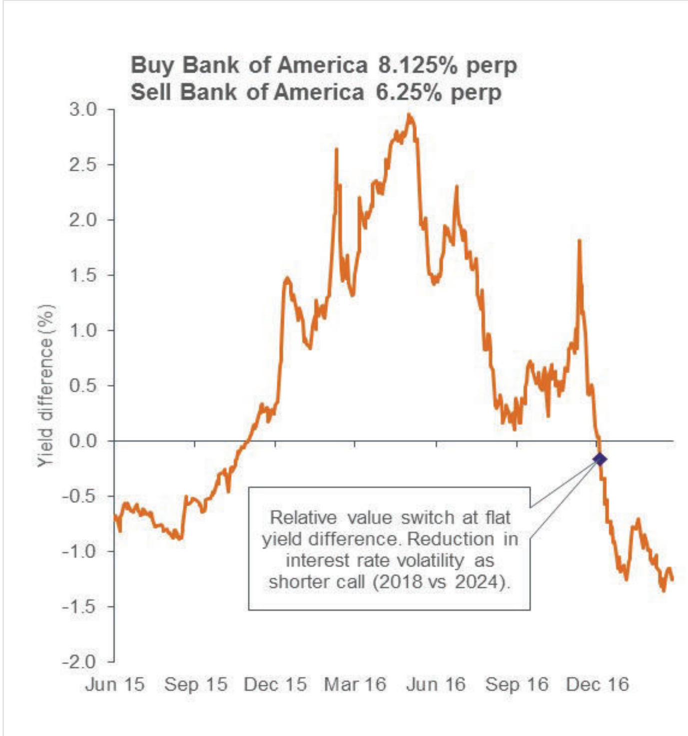
While we know what we don't like in bond markets, identifying where the hidden value lies is not always as straightforward. This often involves understanding relative value and capturing the hidden value involves identifying the best opportunities not only within the various areas of the market but also between them. While we may like a single issuer, the real value comes from choosing the right bond from the various currencies the company has issued, and knowing when to move from one denomination to another.

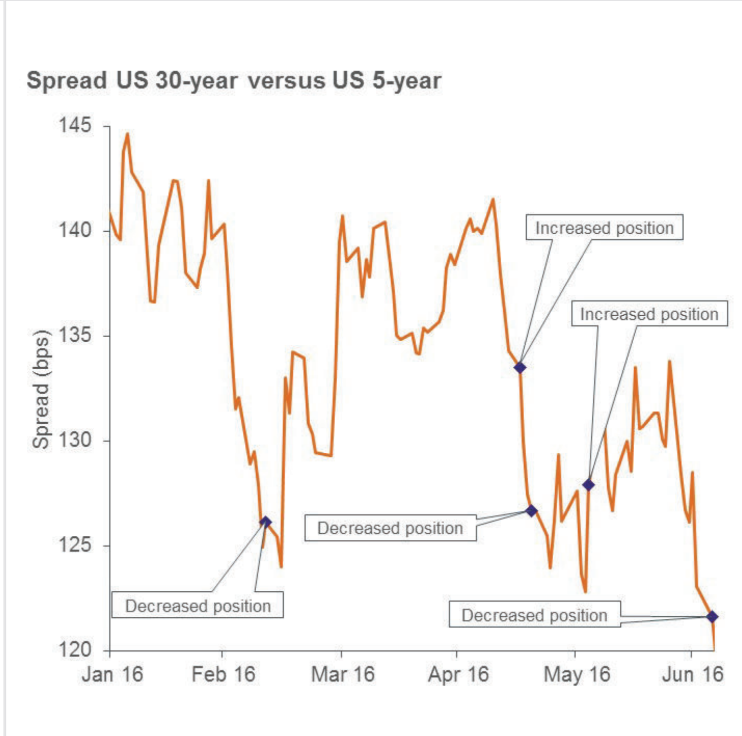
Which of HSBC's over 2,000 bonds are right for our portfolio? It's likely one of them will have value, and if they're overvalued maybe we should trade them against one of Goldman Sach's bonds that we like better.

Similarly, we can identify the sectors we like and look to profit from the relative value between and within those sectors, across and within regions. Our approach to managing interest risk also offers a range of interconnected opportunities to play one market off against another or simply to reduce duration in order to minimise the impact that a rising rate environment can have on the Fund.

Global bond markets are labyrinthine in nature and sourcing the hidden value they contain demands a large and diverse team with a suitably flexible, global mandate to unlock the opportunities.

Two examples on the top right demonstrate our approach.





Source: Bloomberg. Trade examples include onshore and offshore funds.

We can add performance, or reduce volatility, or both – all through relative value trades.

In the chart on the left, we show the yield difference between two Bank of America bonds. We took advantage of both bonds trading at the same yield to switch into an issue which offered less interest rate volatility. In the example on the right, we exploit the spread differential between the 30 and 5-year US treasury yield. Our long-term strategic view is that 5-year yields are too low relative to 30-year yields and as such we have expressed a strategic curve flattening trade. In addition, we have taken relative value opportunities to tactically adjust position sizes in response to market moves – adding value both tactically and strategically, even as central bankers tinker with monetary policy. This flexibility allows us to add value even in a rising interest rate environment.

The current environment for bond markets is challenging and we retain our cautious stance as a result. As we look further out, to what many believe will be a rate rising environment through 2018, we recognise that investors will question where bond markets are headed. We believe that is a legitimate question to ask, and it is one we consider in the strategic positioning of our fund.

But from a global perspective we may equally ask, which bond market are you referring to?

Important information

"We can add performance, or reduce volatility, or both – all through relative value trades."

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HEDGE FUNDS AS PART OF THE SOLUTION FOR A SUSTAINABLE FINANCIAL SYSTEM

by Erik Eidolf / Björn Roger Wilhelmsen, Nordkinn Asset Management AB

Any prospects to implement the "2030 Agenda for Sustainable Development" requires a sustainable financial system. Liquidity is the lubricant for the pricing mechanisms of a sustainable financial system to function properly. Therefore, hedge funds as liquidity providers can be a critical part of the sustainable solution. But, the clock is ticking.

Inspired by the famous Ban Ki-moon quote "we don't have a plan B because there is no planet B" the global community, spearheaded by the United Nations, committed in 2015 to adopt a set of Sustainable Development Goals (SDG's). With 193 nations having signed up for this 2030 Agenda for Sustainable Development, its reach is global. The SDG's seeks to overcome the key global challenges related to poverty, protecting the planet and prosperity. Two years down the road, the positive is that the SDG's has become "a given" in being an integral part of the fiduciary responsibility of asset owners. The negative is that we only have 13 years left. All stakeholders of the financials system must work together if the SDG's will stand a chance, and time is running.

The SDG's and their relevance for hedge funds

As signatory of the PRI, Nordkinn has made its commitment in doing our part in moving the SDG's forward. As a hedge fund manager acting within the financial system, we not only rely on, but also have a vested interest to ensure, that the system remains sustainable and robust. Therefore, we believe that Nordkinn, in our fiduciary responsibility towards our investors, most effectively contributes to the SDG's by specifically advocating for a sustainable financial system.

Liquidity, i.e. the ease with which one asset can be traded for another, is the lubricant for the pricing mechanisms of the financial system to function. The correct pricing of risk is required to allow the global financial system to distribute risks across investors, which is fundamental in how world economic activity is financed efficiently. This is critical because efficient capital markets both maximises and optimises the use of the limited resources at hand globally. By generally deploying a wider range of financial instruments and trading more actively than traditional long only funds, hedge funds foster the provision of liquidity.

Academia has highlighted the importance of the liquidity-role of hedge funds. To name a few, Franzoni & Plazzi (2012) finds that a decrease in hedge fund trading intensity in a given instruments anticipates a future deterioration of instrument-level liquidity, concluding that hedge funds are providers of liquidity. Aragon & Strahan (2012) shows that ownership by institutional investors, including hedge funds, mitigates decline in liquidity during periods of market stress.

Role of liquidity in a sustainable financial system

If anything, the financial crisis demonstrated the importance of robust market-based financing as the costs associated with excessive reliance on the banking system became painfully clear. Europe suffered a long and severe contraction in credit supply due to the impaired banking system. Consequently, market-based finance has become increasingly important to ensure efficient risk sharing.

As an integral part of a sustainable financial system, market liquidity is crucial for market-based finance to function. Liquidity enables the efficient allocation of capital and cost-effectively mitigates commercial and financial risk. In a liquid market, it is easy to execute a trade promptly. Higher liquidity lowers transaction costs (bid/ask spread + commissions) and, therefore, decreases risk premium. The presence of a diverse range of market participants, high quality research and analysis, support market liquidity.

Financial markets are infamous for inherent risks of herd mentality. Lack of individual decision-making cause participants to think and act in the same way as the majority of those around them. The fear of missing

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out on a good investment is often a driving force. This exuberant market behavior adds to the risks of investment bubbles. Herd mentality combined with low liquidity is a dangerous cocktail and by design, hedge funds' benchmark agnostic approach can combat both of these ingredients.

Regulation both friend and foe of liquidity

On one hand, regulatory reforms in the aftermath of the financial crisis have made the financial system safer, thereby reducing the systemic risk associated with market-based financing. But, on the other, regulation also has had undesired side effects on liquidity. Prior to the financial crisis, investment banks were key providers of liquidity through their proprietary trading operations. Since then proprietary trading has largely disappeared. The decline in proprietary trading reduces the depth of capital markets, which makes periods of higher volatility more likely and markets become vulnerable to sharp corrections. Facilitated by regulated exchanges and securities clearing, as investment banks have stepped down from trading activities, hedge funds and other active institutions have stepped in to take their place as important providers of market liquidity.

Importance of market conduct

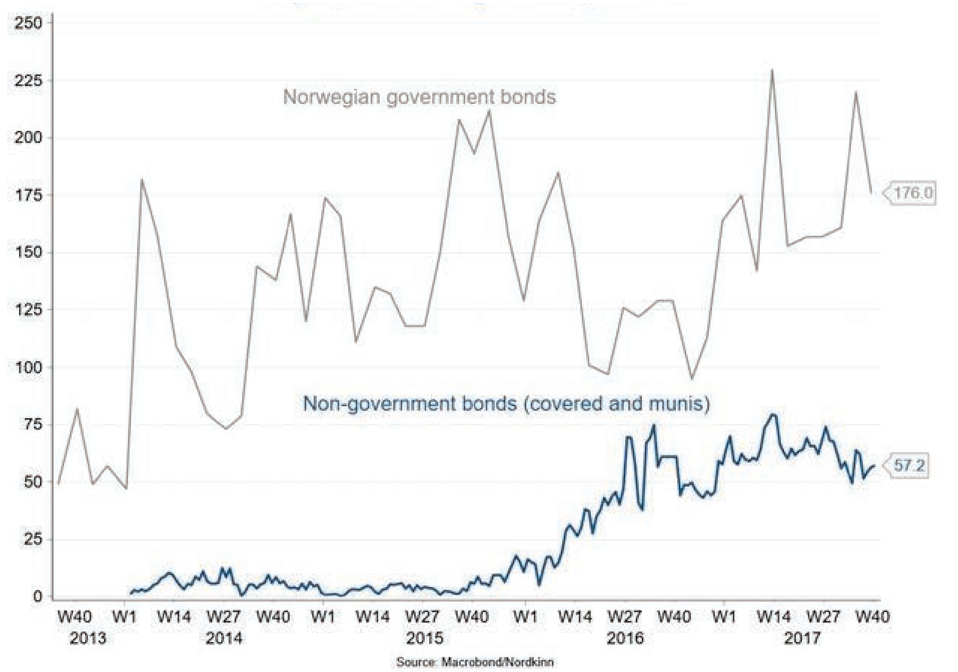
A sustainable financial system requires proper conduct of its market participants. It is in the interest of all that each counterparty keeps a constant focus on business ethics and good conduct including the attention for best execution and prevention of market abuse. Here, regulators play a critical role in finding the optimal regulation that does not prohibit the efficiency of the market mechanisms.

Case study: Norwegian repo market

As a Nordic specialist, Nordkinn Asset Management has meaningful exposures to the Norwegian fixed income market. By looking at the current developments of the Norwegian "repo" market as an empirical example, we believe that Nordkinn's contributions towards a sustainable financial system in the context of liquidity provision can be concretized.

Nordkinn has an incentive and self-interest to secure an efficient repo market in Norway as a liquid repo market is a critical component for the capital markets to function properly. Repos is one of the most widely traded securities within secured financing, i.e. where collateral is used to mitigate risks for both the lender and the borrower.

Repos, outstanding volume, bln NOK



Since Nordkinn launched its Fixed Income Macro Fund in July 2013, with strong support from our trading counterparties in Norway, we have experienced a substantial growth in the covered and municipal bond repo market in particular. The gross outstanding volume of repos and reverse repos in non-government Norwegian bonds has grown to around NOK 60 bln from about NOK 5 bln. The dramatic increase in trading volume and activity in the non-government bond repo market has also supported the government bond repo market in Norway to linger at elevated levels over these years.

The growth of the Norwegian repo market has stimulated the local bond market, as markets for securities used as collateral in repo transactions today is much more liquid. By extension, these developments are contributing to a more sustainable financial system in Norway.

Moving the needle, a day at a time

At Nordkinn, we are committed to advocate for a sustainable global financial system and to do our part. We actively seek to move the SDG's forward by engaging with investors, peers, regulators, and the industry alike. One key success factor for us relies on swift implementation of our investment ideas, which in turn requires an effective and liquid market.

Therefore, it is critical for our investors, for Nordkinn itself and for the markets on which we operate, that Nordkinn keeps a constant focus on our conduct when trading and in taking on our role as liquidity provider. Most importantly, a sustainable financial system being able to rely on robust liquidity provision is essential for reaching the SDG's. So we all better get moving, as we only have 13 years left before we are supposed to get there.

Navigating Private Debt Beware of Calm Waters and Avoid the Corners

by ***Aline Reichenberg Gustafsson,*** CFA – HedgeNordic

For most funds, the first few years are the toughest, especially when it comes to asset gathering. Not so for Scandinavian Credit Fund. This Stockholm-based private debt fund launched in 2016 and winner of the 2016 "Rookie of the year" Nordic Hedge Award, has already beaten its most optimistic forecasts for this year-end's assets under management. So much so that its board of directors decided to cap the amount of new money the fund will be able to accept in December and in February. The Scandinavian Credit Fund's strategy consists primarily in extending direct loans to small and mid-sized companies when they cannot obtain bank financing or when they do not have access to capital markets to issue bonds for example. The fund's portfolio contains mainly Nordic private loans, but its mandate allows for investments in different assets, such as liquid credits and units in other funds, with similar strategies. Anyone with SEK 100,000 can invest, and the fund is open for investments and redemptions on a monthly basis. We spoke to Fredrik Sjöstrand, Portfolio Manager and Founder, about what lies behind this success, and what it means for his portfolio's investments.

One of Sjöstrand's biggest surprises when looking back at the expectations he had with his partner, Peter Norman, CEO, is the enthusiasm investors have shown for their strategy. "We had a bearish target of half a billion Swedish Kronor and an optimistic scenario at 1 billion for the end of 2017. We are not in December yet, and we have already surpassed that target. We are happy and humbled by the trust investors are putting in us," he says. One of the features Sjöstrand is particularly happy about is the fact that the fund has so far delivered exactly the return it

> **"In this yield-starved environment, it is understandable that a strategy that is usually not available for individual investors has attracted followers."**

was set out to produce – 6 to 8 percent return after fees. "We are delivering what we promised, no more, no less." In this yield-starved environment, it is understandable that a strategy that is usually not available for individual investors has attracted followers. Due to investors' keen interest, the fund will temporarily have to limit new inflows, as it needs time to deploy the investments. However, the initial long-term target to close subscriptions at SEK 3 billion is still actual, which leaves room for a trebling of assets, albeit at a somewhat moderate pace.

As a result of the fund's increase in assets, the team needs to adjust the size of its investments. There are two major limiting factors: on one side, the time required to analyse the credits and on the other, the requirement for diversification. "It takes essentially the same time to look at a 5 million investment than to look at a 100 million one," explains Sjöstrand. Practically, this means that the loan sizes need to increase proportionally with the fund assets unless new team members come on board. Currently, the team is expanding its origination capacity with one new hire starting in December, and if the trend continues, it will recruit another member in the second quarter next year.

> **"Banks would not be able to provide the type of financing we do because we are more flexible regarding the collateral we can accept."**

"Our competitors are mainly closed-end private debt funds, which means that they are not subject to a monthly NAV reporting requirement. For us, this increases the need for diversification. We must be very careful with the risks we take," Sjöstrand adds. The diversification as well as the risk management process through careful collateralisation was illustrated last August, as the fund encountered its first credit loss. One of the borrowers entered a difficult situation, and the fund had to take a 75 percent haircut on one of its loans. "Unfortunately, we were not able to avoid it due to a problem with the borrower's mother company. That said, it only represented 25 percent of the entire exposure to the borrower, which shows that overall the collateralisation process protected us well." All in all, the loss amounted to SEK 1 million, which adds to only 10 basis points for the fund's performance, illustrating the importance of sizing opportunities correctly.

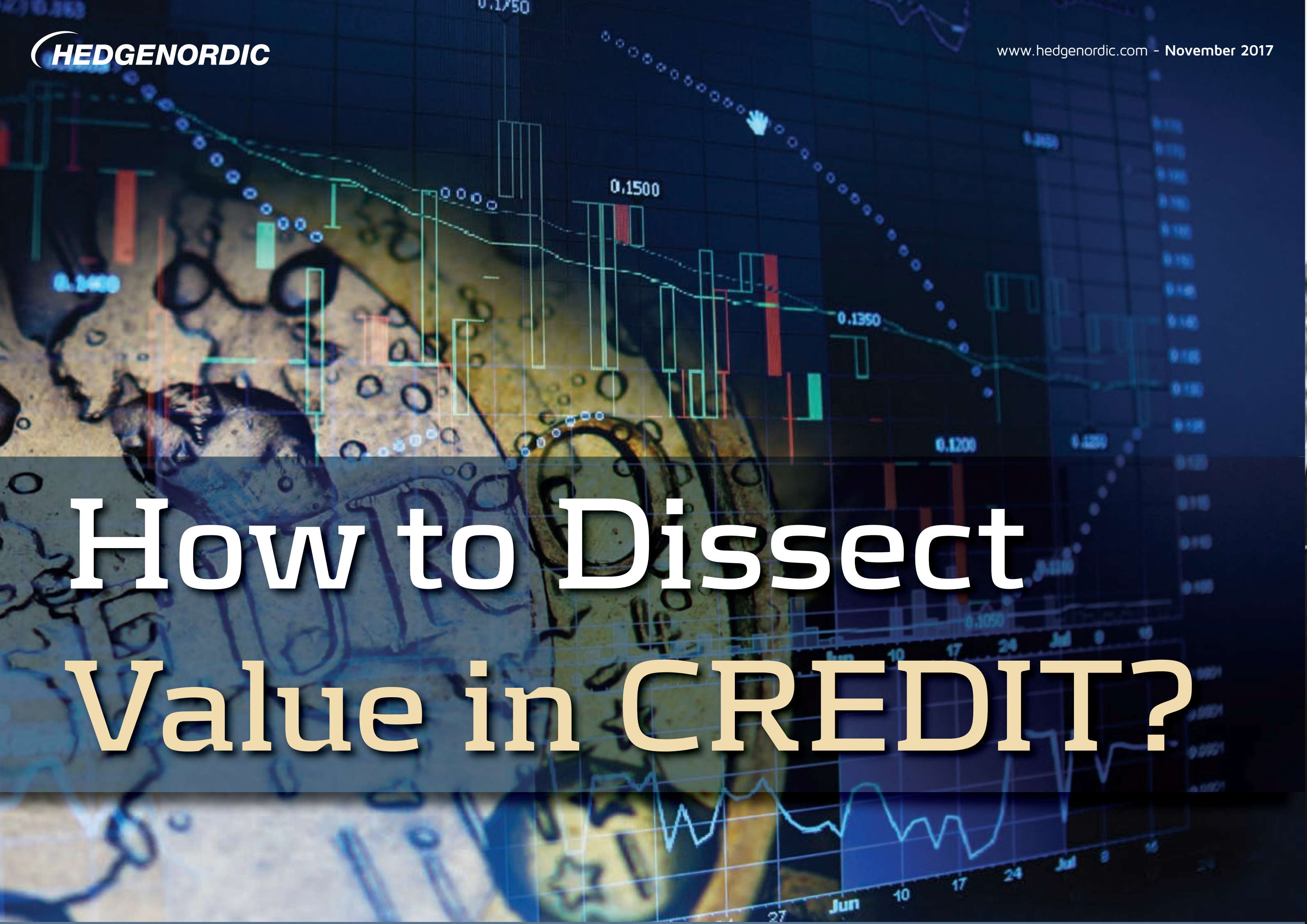
The balance between the resources and the diversification still allows the fund to target loans just below the SEK100 million threshold. According to Sjöstrand, this is important because most of the larger funds are looking at investments above that line. As a result, with almost no competition, not only is it easier to find good quality targets, but the returns are also more attractive. "At that size," Sjöstrand says, "we can also cooperate with the bigger players on larger deals, and we have no risk of cannibalising each other." Currently, about 20-25 percent of the fund's private debt portfolio consists in "club deals", made alongside other lenders. All the other loans are financed entirely by the fund on a stand-alone basis.

There is not much to fear from bank lending on the other side. "If borrowers come to us, they are not choosing between a bank and us. Banks would not be able to provide the type of financing we do because we are more flexible regarding the collateral we can accept. All our loans are secured, but sometimes not directly by the borrower's entity, and banks can't take that."

As of the end of October, private loans composed almost 74 percent of the fund's assets. As a complement and to ensure the liquidity to meet possible redemptions, the fund is allowed to invest in other similar funds or liquid fixed income securities. "We use this opportunity to invest liquidities that we have not yet deployed, as well as to increase diversification," explains Sjöstrand. For example, the fund invested last year in a US private debt fund focused on small- and mid-sized companies. "This is also a good way for us to keep an eye on what is happening on the other side of the Atlantic. What we see is that their yields have come down now to levels similar to those we have here. They were higher before, but competition and interest in this asset class have increased." The assets of the fund Sjöstrand invested in, for instance, more than trebled from $300 million last year to approximately $1 billion.

It does not seem like we can pinpoint anything Sjöstrand is currently worried or unhappy about, but that is not reason enough to relax. "We are moving forward cautiously," he says. "Thirty years in the financial industry have taught me that something is always lurking around the corner. You should always try to make sure the corner is very far away."

Fredrik Sjöstrand of Scandinavian Credit Fund being awarded "Rookie of the Year" at the Nordic Hedge Award in April 2017.



How to Dissect Value in CREDIT?

by ***Laura Wickström,*** CAIA, *and* ***Mikko Niskanen,*** CFA – AIM Capital

Should you invest in equities, credit, or both? In some respect, the question is similar to what is an optimal capital structure for a company. According to the Modigliani-Miller theorem there is no optimal capital structure in a frictionless world. Why should the question of optimal portfolio choice be any different?

In fact, following the reasoning of Black-Scholes-Merton, corporate debt in a frictionless world is essentially a combination of risk-free debt and a short option position on the firm's assets. This too leads to ask what purpose is there for credit after considering that options do not constitute real wealth as arbitrage conditions make them a zero-sum game.

It all comes down to the various frictions that complicate real life. These frictions justify credit's role in investment portfolios and they give rise to valuable investment opportunities. Understanding the presence of frictions is essential for understanding how opportunities arise and how sustainable they can be.

FRICTIONS CREATE INVESTMENT OPPORTUNITIES

Most often, asymmetric information is the underlying reason why frictions arise. While the richness of different terms and conditions in debt agreements are designed to address such frictions, they simultaneously cause credit market segmentation. Thus, as capital finds its way only slowly to various pockets of credit markets, market segmentation creates supply and demand imbalances which may persist for long periods of time.

At the same time, market segmentation is enhanced by market participants who act for reasons other than profit maximization. For example, in recent years central banks have become a large investor. One unintended consequence of that activity may have been further segmentation. Simultaneously, tighter regulations have forced many participants to retreat from pockets of credit markets, also adding to segmentation.

Laura Wickström, *CEO* and
Mikko Niskanen, *CIO* at AIM Capital

HOW TO TAKE ADVANTAGE OF THESE OPPORTUNITIES?

Because of the various frictions and the segmented nature of credit markets, a passive investment approach to credit is not as straightforward as to equity. In fact, even the question of what constitutes an appropriate credit benchmark is much more complicated than the question whether a market cap index is suitable for equities. In other words, the selection of a credit benchmark, in itself, is an active investment decision.

> "Most often, asymmetric information is the underlying reason why frictions arise."

Indeed, market capitalization based approach in credit over-weights companies with the largest amounts of debt. On the other hand, rating restrictions lead to sub-optimal decision-making as bonds are mechanistically forced to be sold after downgrades.

Market segmentation also creates liquidity differences between different credit assets. Investors tend to have a higher required rate of return for less liquid assets. Because of low liquidity some assets and markets tend to be less covered creating information inefficiencies and lags for information absorbed into pricing.

WHERE DO WE SEE OPPORTUNITIES IN CREDIT?

Periods of distress are the best time to invest in credit opportunities. For example, opportunities were abundant in the aftermath of the financial crisis when many credit assets were trading extremely cheap relative to fair value. We started our credit fund in May 2009, to take advantage of these opportunities. Most of those have by

> "Because of the various frictions and the segmented nature of credit markets, a passive investment approach to credit is not as straightforward as to equity."

now corrected, but many other opportunities still exist and new distressed situations will certainly arise. Currently at AIM Capital, we see distressed opportunities in sovereign emerging market credit and invested in Argentina after it came out of default. Further favorable developments there continue to provide more credit investment opportunities.

Another example is our entry into catastrophe reinsurance markets in April 2011. At that time we identified a supply and demand imbalance in reinsurance capital post Japanese earthquake that increased the risk adjusted expected return in Insurance Linked Securities significantly. The hurricane season this autumn could provide similar opportunities.

In addition, several credit investment opportunities have emerged due to increased financial regulation such as trade finance and other type of specialty finance. Banks have withdrawn capital from financing certain activities and as replacement capital is moving in slowly it provides good high-yielding opportunities. Allocating capital to trade, legal and other structured financing has been able to generate high risk-adjusted returns. The same applies to leveraged loans, other private debt and structured credit to some extent.

However, we currently consider credit spreads as relatively tight and compensation for credit risk below historical average. Thus, we have increased our allocation to liquid, trading oriented credit strategies and are more selectively exposed to the general direction of credit markets than before. In our view, this provides the best expected returns in current market conditions.

WHAT DO WE DO AS ACTIVE ASSET ALLOCATORS IN CREDIT?

Segmented nature of credit markets is favorable for specialized investment skill. Our multi-manager approach targets to identify and allocate to skillful managers in select credit investments.

As majority of active trading does not create value after fees, manager selection becomes of utmost importance. The purpose of our due diligence process is to formulate an objective opinion of managers.

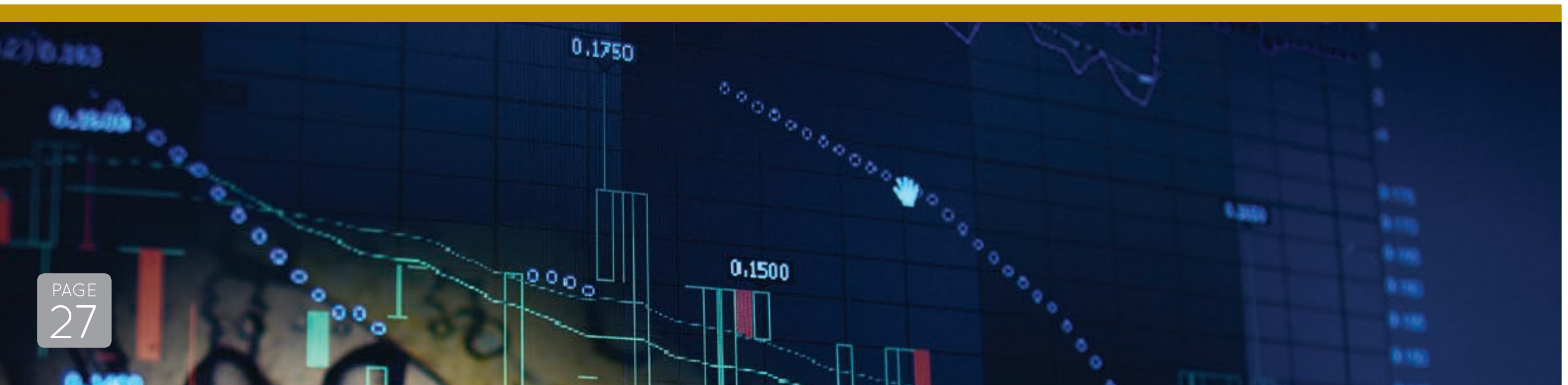
One must avoid several behavioral biases such as chasing historical performance. To identify sustainable investment performance, important aspects in addition to investment skill, are capacity, markets traded - especially in credit we prefer inefficient, niche markets - operational infrastructure and corporate governance.

With this in mind, we see ample possibilities in credit, as real world frictions continue to create investment opportunities for unrestricted, active credit investors.

ABOUT AIM CAPITAL

AIM Capital is an alternative investment fund manager (AIFM) based in Helsinki, Finland that manages portfolios of alternative investments. Clients are typically well-established Nordic institutional investors – including pension funds, foundations, endowments and insurance companies.

Following our objective, our manager selection has provided stable and high risk-adjusted returns for our investors. The goal of our investment research is to identify unique investment opportunities which are less commonly utilized and offer diversification benefits.



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ARE FIXED INCOME MARKETS OVERVALUED?

by Kamran Ghalitschi – HedgeNordic

Back to basics: many investors are currently saying that "bonds are expensive". Is that really so? And if they are, relative to what? HedgeNordic asked John Pattullo, Co-Head of Strategic Fixed Income and Nicholas Ware, Director of Strategic Fixed Income at Janus Henderson Investors, who actually disagree with this common belief. "The reality is that in today's world there are no 'cheap assets'; and those that are, are cheap for good reasons," they say.

"In our view, it is no longer possible to argue that bonds are cheap. Instead, we believe they are probably at or around fair value and reflect the current market environment in which we have low volatility, low defaults, low inflation and a reasonable level of global growth," starts Pattullo.

Owners of bonds get their returns from two places: income and price movements. "In light of current valuations, where spreads have tightened significantly post the Global Financial Crisis," he continues, "we think that future bond returns will mostly come from the 'income' element. This is an environment in which a carry strategy (ie, collecting the coupon) still works, because there are many bonds with reasonable levels of coupon to ensure a good income stream."

The chart 1 shows the typical returns from various fixed income assets and equities over selected periods.

ENOUGH BONDS IN INVESTORS' PORTFOLIOS?

Another question the Strategic Fixed Income team commonly receives is whether they believe bonds are 'under-owned'. "It is clear that equities have attracted significant inflows and investors are feeling quite euphoric; typical late cycle characteristics," explains Ware. "Equally, fixed income asset classes have performed well on a 10-year view."

"We would not argue that either asset class is cheap, but we do believe that investors should seek diversification by holding an appropriate level of bonds. Bonds, and particularly higher quality ones, tend to do well if equities sell off and so provide investors with that diversification. To illustrate this, while the S&P 500 index was down 38% in 2008 at the height of the crisis, the US investment grade (high quality) corporate bond index returned -7.9% and US 10-year Treasury 17%."

"We think a lot of investors are currently focusing on where things can go wrong for bonds. The asset class has enjoyed a particularly strong run, with yields on US Treasuries reaching a July 2016 low of 1.36% (lower yields mean higher prices), although they have since climbed by over 1% from this low point*."

RATE RISES – WHAT WILL THE IMPACT BE?

Investors also question whether the fact that the US economy is doing well, and Federal Reserve officials are suggesting more rate hikes are likely in the near future, mean that bonds are no longer a worthwhile investment? Pattullo and Ware suggest that they still are, and mainly because rate rises are likely to be measured.

"The economy, while growing, is expanding far less quickly than historical norms, and inflation is also well anchored," adds Ware. "We have long thought that Japan provided interesting parallels for other developed markets, given its ageing population and recovery from a debt fuelled crisis."

Chart 1: historical total returns for fixed income and equities

	Total return	Annualised returns			
	YTD	2Y	3Y	5Y	10Y
US corporate IG	4.8	4.6	3.5	3.3	5.7
Euro IG	3.6	4.7	3.5	4.5	5.2
Sterling IG	3.6	8.2	6.5	6.3	6.5
US HY	6.4	8.9	5.1	6.0	7.4
Euro HY	7.9	8.0	6.6	8.0	8.4
Sterling HY	7.9	9.5	8.3	9.4	13.5
US leveraged loans	7.5	7.6	5.4	5.4	5.3
European leveraged loans	3.9	5.5	5.0	5.6	4.6
S&P 500	8.9	22.6	17.9	19.7	12.4

Source: Bank of America Merrill Lynch, Credit Suisse, Janus Henderson Investors, as at 31 October 2017. Note: IG: investment grade; HY: high yield. Loans: Credit Suisse Western European Leveraged Loan Index and US Leveraged Loan Index. Total return year to date; annualised returns for 2, 3, 5 and 10Y. Corporate bond and loan returns hedged back to sterling; S&P 500 index returns in sterling.

"Based on the experience of Japan, we think that while we will see interest rates increasing, the rises are likely be measured and provide only a small headwind, which coupons should be able to more than offset. Also, within our portfolios, if bond yields rise, we will be able to reinvest our maturing bonds into more attractive ones with higher yields, which in time should boost fund returns."

OUTLOOK AND VALUATIONS

Chart 2 below is a comparison of the yields on various fixed income asset classes. Based on this, reasonable value can still be found, particularly within BBB-rated bonds in the US, while within high yield there may still be room for further compression in yields in the US.

The theme the team expects to play out in 2018 is that the global economy will continue to do well. Defaults will likely continue to be low. Higher yielding credit are therefore favoured on a relative basis. The key will be to continue to be selective and remain disciplined with late-cycle conditions evident in the level of dispersion between sectors. This is magnified by significant technological and industry changes impacting certain industries and reflected in our approach of avoiding certain sectors altogether. "It also drives our belief that being index agnostic ultimately helps our investors," Pattullo says.

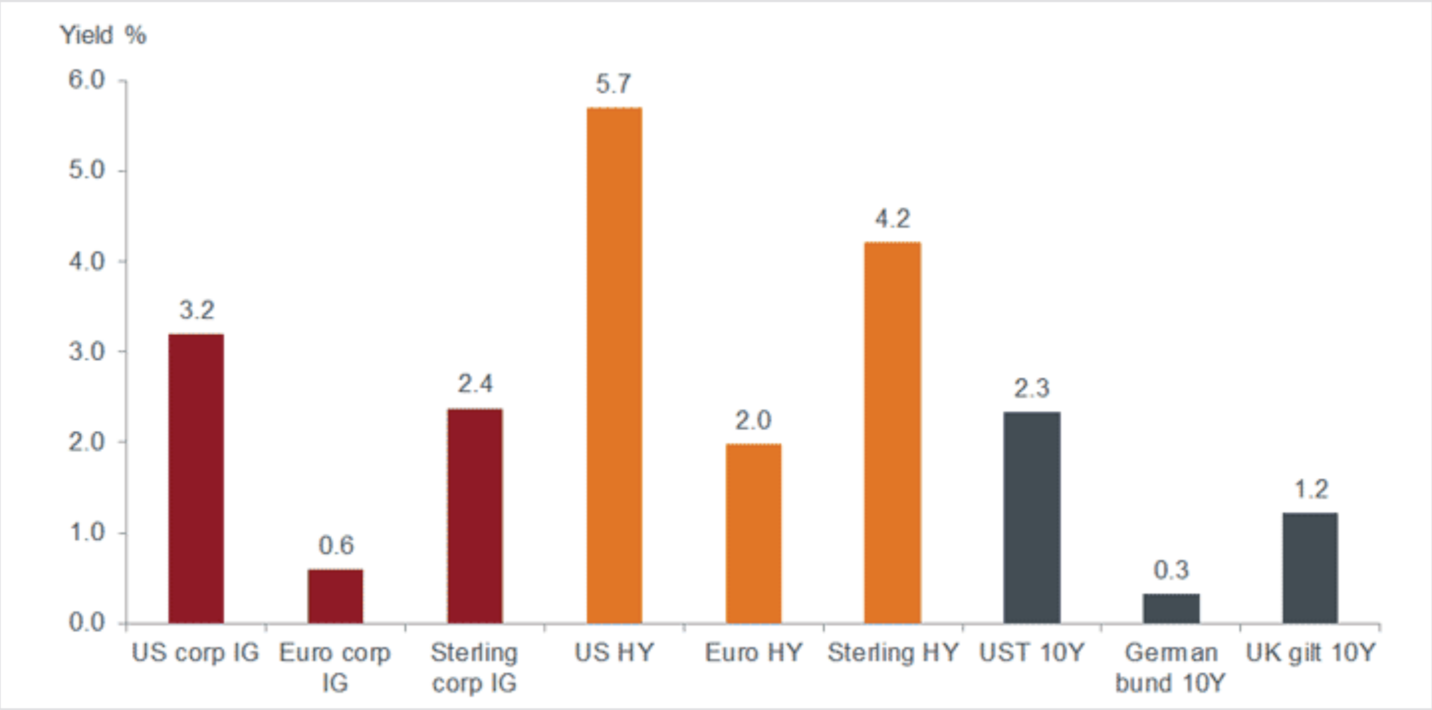
The extent of current levels of dispersion in valuations within high yield and investment grade are shown in charts 3 and 4 on the right. The charts reveal a much higher level of dispersion within high yield but less so for investment grade given its higher quality (e.g., lower levels of leverage).

To illustrate, high-yield corporate bond spreads in sectors with percentile ranking of 50 and above, are now wider than their historical average spread (here the period from 2000 to now), which is indicative of sector issues, but 13 of the 20 sectors are trading in the bottom quartile (tighter spreads than their historical average).

"We expect high-yield dispersion to remain elevated and this should benefit us as opportunities present themselves for credit picking," says Ware.

"An additional point to note is that we have seen money flowing into alternatives, with investors chasing returns. These alternatives are often complex investment structures promising higher returns to compensate for the lower liquidity available versus traditional fixed income instruments. A lot of these strategies are unproven and the depth of liquidity in these markets is quite shallow. We still think investing in the relatively liquid developed world fixed income markets is a better way to seek to deliver superior risk-adjusted returns to our investors."

Chart 2: current yields across global fixed income market

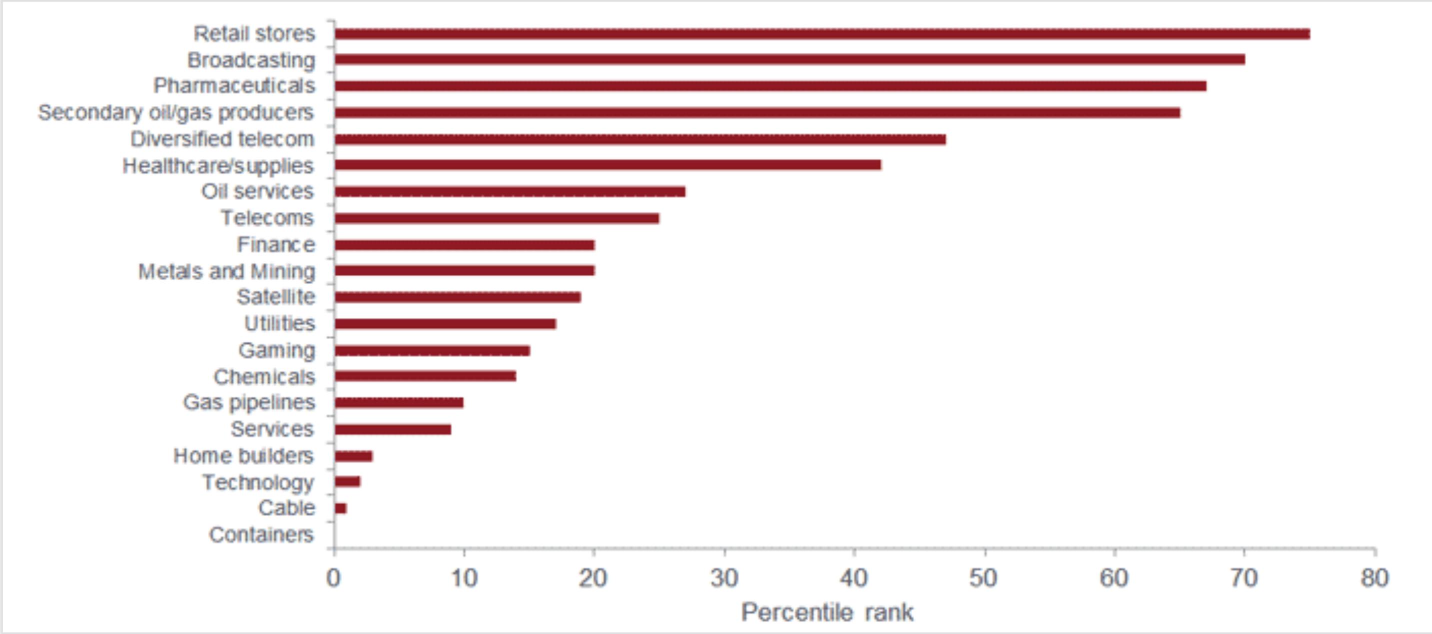


Source: Bank of America Merrill Lynch, Bloomberg, Janus Henderson Investors, as at 8 November 2017. Note: Yield to worst for corporate bonds; generic 10-year yields for US Treasuries, German bunds and UK gilts.

The questions currently being asked by investors are very valid. At a valuation level, while many high-quality credits are trading at fairly expensive levels, they are justifiable taking into account a positive macroeconomic outlook and the quality of the issuers. Further, given the need for income, there may still be a case for remaining overweight high yield and the lower end investment grade corporate bonds. So far at least, for Janus Henderson Investors' Strategic Fixed Income team, the value proposition for investing in fixed income assets remains intact.

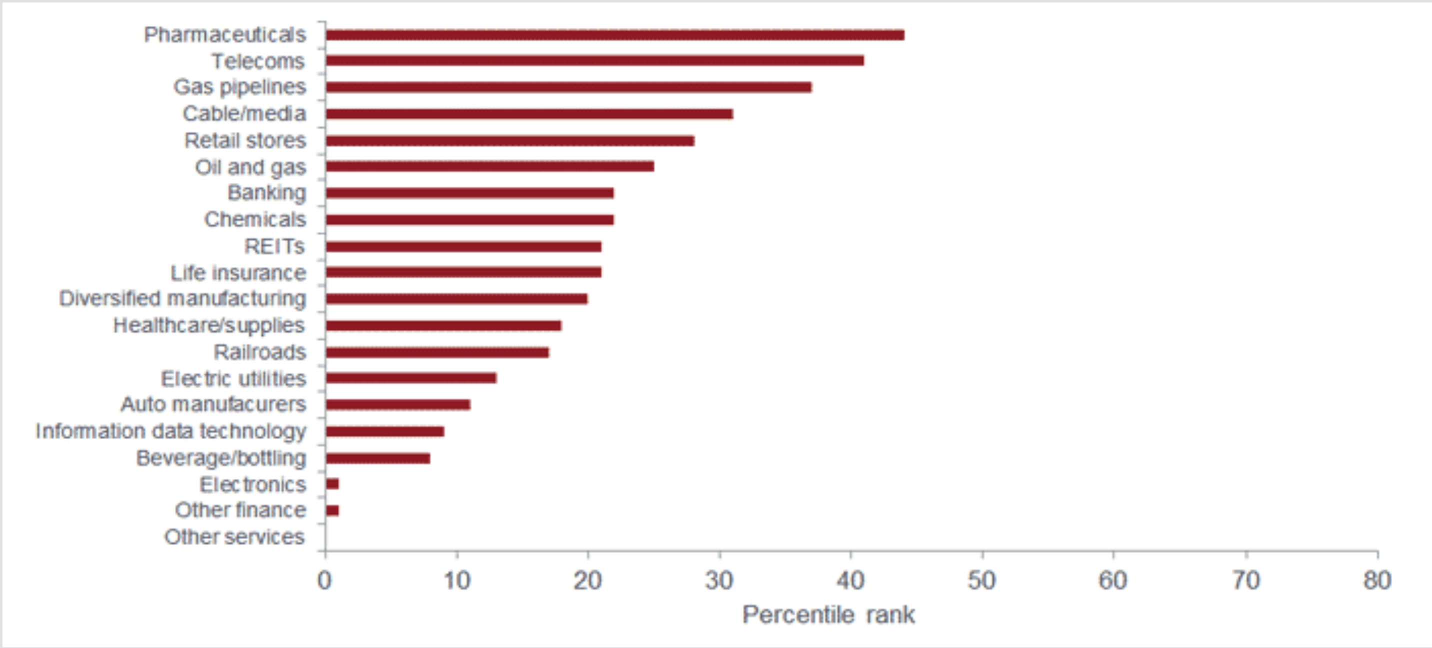
*10-year US Treasuries yield around 2.3%, as at 6 November 2017.

Chart 3: high yield bond valuations — ranking by sectors



Source: The Yield Book Inc, FTSE Index, Goldman Sachs Global Investment Research, Janus Henderson Investors, as at October 2017. Note: Percentile ranks for high yield sector level spread averages. Data spans the period from 2000 to now.

Chart 4: investment grade bond valuations — ranking by sectors



Source: The Yield Book Inc, FTSE Index, Goldman Sachs Global Investment Research, Janus Henderson Investors, as at October 2017. Note: Percentile ranks for investment grade sector level spread averages. Data spans the period from 2000 to now.

Normalisation demands active and flexible management

by ***Hamlin Lovell,*** *– HedgeNordic*

The "absolute return" fund label includes a broad spectrum of strategies, with some almost indistinguishable from traditional long-only products. Whether this is a short-term tactical stance or a hard-wired bias is difficult to discern as the bull market in bonds is older than most funds in this peer group.

Since launch in 2004, the GAM Absolute Return Bond strategy has generally profited from weakness in the government bond market and has shown an average correlation of virtually zero to major government bond indices. The strategy can at times run negative interest rate duration. GAM portfolio manager, Tim Haywood, holds the conviction that an unconstrained approach, with the ability to take both long and short positions, while actively allocating across government, corporate (including convertible debt) and foreign exchange markets in both the developed and emerging world, is needed to navigate the potential normalisation of financial markets that lies ahead.

After a near 40-year bull market in government bonds, the risk/reward profile is asymmetric. For instance, a stress-testing exercise shows that if 10-year UK Gilts reverted to their historical average yield of 5.2%, investors would see mark-to-market losses of around 30%. Even if UK yields merely converge with US yields, investors could see a hit of 7% or so. Haywood's base case is that the Fed hikes its short-term interest rate in December, followed by two or three 25 basis point moves in 2018, and (despite some faltering economic data over the summer) Fed tapering will continue as expected and ultimately drive long-term rates higher. There are a number of ways to position for such an environment, including relative value trades, yield curve steepeners and outright shorts.

> **"Emerging markets have been a key driver of recent strong performance and while some risk has been taken off the table, this market remains a high conviction "buy"."**

At present, the strategy has an outright short exposure to UK and European (German) government debt. Even before the Bank of England signalled a likely rate hike, Haywood was paying attention to a clutch of concerns: an inflation overshoot; Brexit-related growth fears; potentially ballooning government borrowing; credit ratings downgrades, and foreign buyers shying away from Gilts. In Europe, Haywood's short bonds thesis is inspired by far more benign factors: reflationary forces are being manifested in a virtuous circle of credit creation, inflation normalisation, lower unemployment, and economic recovery. All of this seems set to ensure that the ECB's tapering programme will proceed with stereotypical German punctuality.

GAM has also owned US Treasuries - viewed as a safe haven - against European government debt and this trade has performed well.

> **"Spreads within the corporate bond market have continued to grind lower on the back of central bank buying and persistent investor demand."**

Emerging markets have been a key driver of recent strong performance and while some risk has been taken off the table, this market remains a high conviction "buy" for the fixed income team at GAM, which includes Daniel Sheard and Jack Flaherty. This is a somewhat non-consensus view as institutional investors, in aggregate, remain underweight the asset class. The team's hypothesis is that emerging market sovereigns and currencies offer much better value based on real and nominal rates, implied credit risk premia, and currency valuations. The catalysts for markets recognising this value include the fact emerging markets are now growing faster than developed markets – with a widening growth differential – and emerging markets' trade balances are improving.

Specifically, the managers find value in Mexico and Brazil, where slowing inflation lets central banks ease rates, or at least cease raising rates. South Africa is attractive from a yield perspective, but concerns regarding the Zuma administration and central bank autonomy provoke a degree of caution.

Inflows into emerging market debt have helped to make local currency emerging sovereigns among the best performing credit sub-asset classes in 2017 and GAM believes these could accelerate - with scope for quarterly net inflows into EM currencies to reach USD 30-40 billion.

The Brazilian real has also been a successful long currency exposure. Elsewhere in currencies, GAM Absolute Return has been trading the USD from the short side as rate rise expectations in 2017 were pushed back, while looming ECB tapering supports a long euro stance. Other long currency positions include the oversold British pound, Norwegian krone and Turkish lira. As always, Haywood is tactically aware that the USD downdraft could reverse course and can easily trade around the position.

Spreads within the corporate bond market have continued to grind lower on the back of central bank buying and persistent investor demand. In some instances this has taken spreads to multi-year lows, offering little protection against any rise in government bond yields or interest rates. This is also evident in the CDS market, where the cost of protecting against a default in either Europe or the US has fallen to a 10-year low.

However, the outlook for this segment of the market is far from negative and GAM's fixed income team believe the marriage of traditional credit research with more modern investment techniques, including relative value strategies and outright shorts has the potential to deliver a good level of performance. Bank and financial names should benefit from a steepening of yield curves in the developed world and we continue to see value in the energy and resource sectors.

Alternative forms of credit, such as short-dated trade finance securities, offer an alternative to negative yielding government debt in Europe and when combined with a third party insurance or government guarantee, provide excellent risk-adjusted returns. GAM has a number of products in this space.

> **"Alternative forms of credit, such as short-dated trade finance securities, offer an alternative to negative yielding government debt in Europe."**

The GAM Absolute Bond strategy has access to the resources of a team of 30 investment professionals, spread across London, New York, and Zurich, and led by co-managers, Tim Haywood and Daniel Sheard, who each have an average of 30 years' experience. The process is predominantly discretionary, but some systematic inputs come in the form of proprietary quantitative models applied to interest rate and currency markets. (GAM also has an investment platform, GAM Systematic, created when Cantab was acquired in 2016).

The strategy, which runs around USD 12 billion, is available as a UCITS vehicle offering daily liquidity. It can be accessed at various levels of target volatility with target returns ranging from cash (defined as money markets) plus 1-2%, to cash plus 3-5%. A more focused version of the discretionary Rates and FX strategy, equally weighted with systematic investments, targets a return of cash plus 8-10%.

The GAM investment process includes ESG criteria. GAM has been a signatory to the UN PRI since December 2014, and uses Sustainalytics for rankings and indicators.

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ATTRACTIVE INVESTMENT OPPORTUNITIES IN A WELL-SUPPORTED MARKET

by Bengt Rösener, Portfolio Manager, UniInstitutional Structured Credit & Karsten Holetzek, International Institutional Sales, Union Investment

SUMMARY

- Structured credits offer attractive yield premiums over conventional credit asset by earning complexity and liquidity premiums
- Main pillars underpinning the structured credit market are strong collateralisation, broad diversification and transparency, resulting in low default rates – especially in Europe
- Variable-yield securities can help investors to mitigate duration risk and benefit from interest-rate rises
- Growing investor demand thanks to less stringent regulatory requirements and broad-based support from other financial market players
- Technical shortage is likely to continue, thereby supporting the structured credit market

Institutions have been investing directly in loans for the past two decades or so, initially in corporate loans and then, increasingly, commercial mortgage loans. At present, it is generally not possible to invest directly in other types of loans because trading in such loans is often difficult or even impossible. Structured credits are the key to this market segment as they enable flexible and liquid investments in a pool of loans or credits.

The performance of these securities during the financial crisis varied widely depending on the type of receivables underlying the structured credit and their position within the capital structure.

All credit-spread segments suffered heavier price losses during the collapse of Lehman Brothers and the subsequent liquidity crisis. This was also the case in the structured credit market, which has nonetheless managed to stage a recovery in virtually all segments, aside from a little interim volatility, and deliver a highly impressive price performance in recent years.

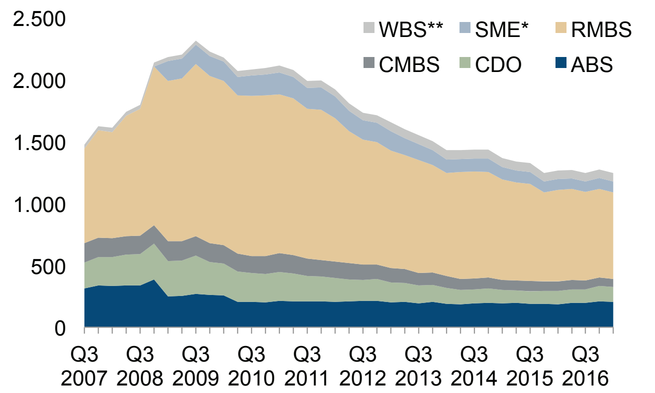
Most asset classes in the structured credit segment demonstrated their stability during the most recent credit cycle, as they had done during the first stress phase of this millennium following the end of the New Economy boom. The best examples of this trend were residential mortgage-backed securities (RMBSs) in Europe, asset-backed securities (ABSs) and collateralised loan obligations (CLOs).

The performance of most structured credit asset classes has recovered significantly, and the number of investors in these products has been on the rise for the past few years owing to their fundamental strength, their transparency and, increasingly, the support offered by public institutions such as the ECB.

STRUCTURED CREDIT PORTFOLIOS: FUNDAMENTALLY HEALTHY

Although the European primary ABS market virtually ground to a halt in the wake of the sub-prime mortgage

European securitisation market volume (in billion euros)



As at 29 September 2017
* SME: small and medium enterprises.
Source: J.P. Morgan

crisis, the situation has improved markedly since 2010. The volume of new issues has been around €80 billion per year since 2014, with a slight upward trend.

The European primary market still lags some way behind the US, where, in recent years, the volume of new CLOs issued has greatly exceeded the total volume of all ABSs in Europe. Although these volumes appear very high, we are still a long way from seeing any market bubble or oversupply: the levels of structured credits currently being issued are not even sufficient to offset the outstanding amounts being redeemed. This is causing the total stock of structured credits to contract constantly, which, from a technical perspective, is very positive for the structured credit market.

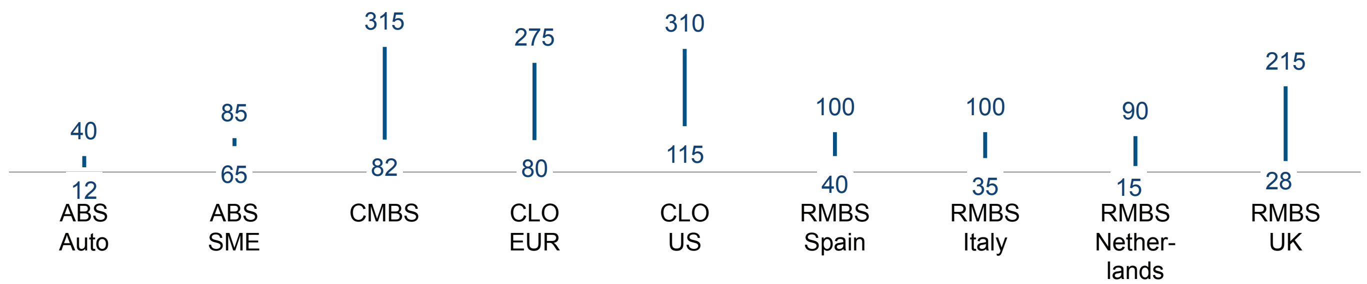
If we analyse the liquidity of structured credits, we can see that many areas of this market reveal bid-ask spreads that are similar to those on corporate bonds and covered bonds. However, structured credits have not remained unscathed by the general market situation. Fundamental events, such as the commodity crisis in early 2016, impact on individual structured credit types. At the start of 2016, for example, US CLOs were affected by a widening of spreads that was more than recouped later on. In certain market phases, some structured credits backed by a pool of loans have turned out to be the more liquid instrument. During the euro crisis, when it was possible to sell only small quantities of peripheral eurozone corporate bonds, for example, there was hardly any difficulty in selling Portuguese and Spanish RMBSs. Bid-ask spreads on RMBSs from the UK or the Netherlands are often less than 5 basis points. As is the case with subordinated bank bonds, the liquidity of less senior structured credit tranches is, of course, lower.

FUNDAMENTAL STABILITY

Contrary to widely held opinion, the historical performance of most types of structured credit has been excellent. The fundamental problems in this segment have largely been limited to certain aspects of US sub-prime mortgage loans.

A totally different picture is revealed by the loss rates on CLOs (which are based on corporate loans) and on European ABSs. Companies in the US and Europe saw their default rates rise sharply during the early part of the financial crisis.

Investment-grade-rated securitisations – Spreads over 3-month EURIBOR (in basis points)



As of September 2017
ABS = Asset Backed Securities; SME = Small & Medium Enterprises; CMBS = Commercial Mortgage Backed Securities; CLO = Collateralised Loan Obligations; RMBS = Residential Mortgage Backed Securities.
Source: Bloomberg, Barclays

Bengt Rösener, Portfolio Manager

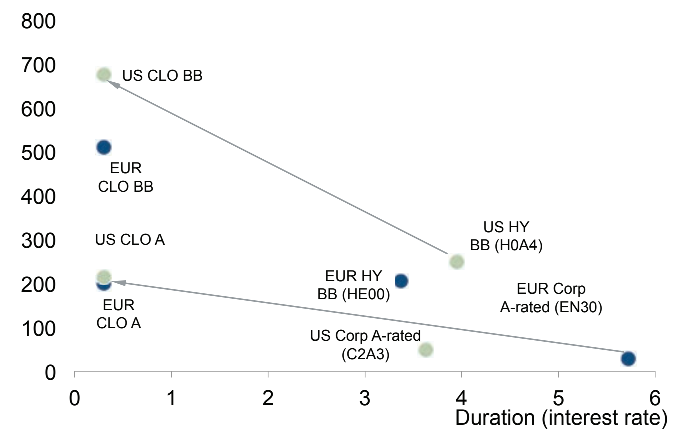
Karsten Holetzek, International Institutional Sales

Because their corporate loans were securely collateralised and, consequently, the resultant recovery proceeds were much higher than those from corporate bonds, the associated products (CLOs and SME ABSs) incurred only minor losses.

European ABSs from other sectors also remained immune to substantial losses. Even though the performance of Europe's property markets varied significantly from one country to another (with prices rising in Germany but falling sharply in the overheated Spanish market), default rates in the European structured credit market were extremely low because it differed from the US market in terms of its loan-to-mortgage values, lending standards, recovery regime and rights of recourse.

Despite the recessionary environment prevailing in some areas, even consumer-dependent credit (such as auto loans and credit card borrowing) remained stable thanks to structural hedges and the high level of net interest income protecting investors against losses.

Corporate credit risk
Spreads (in bps)



As at 29 September 2017
Rating information refers to original ratings.
Source: BofA Merrill Lynch indices

A LUCRATIVE ALTERNATIVE

Taken together, structured credits across all asset classes have delivered a strong performance in recent years. The narrowing of credit spreads in almost all market segments has been caused by steadily increasing investor interest in a further shrinking market but has also been driven by the ECB's asset purchase programme, which began in the second half of 2014. The biggest impact of the asset purchase programme was evident in structured credits from the peripheral countries of the eurozone, although the spreads of securities not eligible for the programme also narrowed because of their relative appeal. At present, the influence of the ABS purchase programme on the spreads is seen as negligible. The market does not anticipate any negative effects arising if the central bank ends the programme.

Depending on the loan type invested in to collateralise the structured credit and depending on its term to maturity, even senior tranches can yield very attractive spreads over the benchmark interest rate (usually three-month Euribor/Libor).

As far as the structured credit market as a whole is concerned, the benign technical scenario outlined above is likely to continue for the time being owing to the shortage of supply resulting from the falling volume of issues outstanding in the market. Given the growing demand from investors coupled with stagnation or further contraction of the market, we expect credit spreads to continue narrowing over the next twelve months.

by Aline Reichenberg Gustafsson – HedgeNordic

When flaws generate opportunities

The hidden treasures of short duration high yield

In today's environment, investors are worried about future interest rate hikes, and any bond investment seems ominous. The Federal Reserve has increased interest rates for the fourth time in a row, but interest rates are still low compared to longer-term history. Could there be an area left worth exploring to diversify away from traditional fixed income and obtain a relatively low-risk yield?

HedgeNordic investigated such an opportunity with Allianz GI's James Dudnick and Steven Gish and their team, who manage together $4.2 billion in short duration high-yielding assets. With short duration, the exposure to changes in interest rates is limited. But why does such an opportunity in the market persist, when everyone seems to be chasing the best possible return in the lower end of the risk spectrum? And do returns over time sufficiently compensate for the risks borne by sub-investment grade credits?

The performance issue is easily verifiable at the onset. Except for a short break during the last financial crisis due to a client-driven interruption in the strategy, the Allianz GI US short duration high-income strategy has a long track record that dates back to more than 20 years. "On a gross basis, the composite has never delivered a negative calendar year return," says Corey Kilcourse, one of the team's product specialists. The return of the strategy has been at around 5.7 percent a year, with an annualised volatility ranging from 1.8 to 2.5 percent depending on the period under consideration, which is less than the comparable volatility of current high yield indices.

For Allianz GI's team, there is definitely "an opportunity to capitalise on a structural inefficiency at the front-end of the non-investment grade credit market," as the pitch book states. But how so? "Most market participants overlook the short-duration high yield segment," explains Kilcourse, "creating an opportunity for benchmark-indifferent investors. There are many structural reasons investors don't own shorter maturity, non-investment grade bonds: essentially that high yield and hedge fund managers need greater absolute return potential; and benchmark-oriented managers don't want to bear the tracking error risk the segment creates. Hence there is a persistent supply/demand imbalance for these securities."

> **"Of course, high yield investing remains an experts game, and even if maturity is within sight, the idiosyncratic risk is still high."**

The team also has enough reasons to believe that this opportunity will persist, and other factors reinforce the market inefficiency. In addition to the stated return requirements and benchmark constraints, mutual funds also have limits to the concentration they can have in any single issuer, which requires them to sell the shortest-dated bonds when the same issuer announces a new bond offering. Those investors that typically target short duration bonds are often unable to buy any credits below investment grade. Money market funds, for example, are subject to formal restrictions regarding the ratings their investments need to bear and for insurance companies, holding non-investment grade bonds may generate significant regulatory capital penalties.

Interestingly, this market opportunity also relies on a major flaw in the rating agencies' methodology. "There is no evidence that any rating agency will correct the two important flaws in their ratings methodology. They rarely or never update the ratings of bonds as they approach maturity, since they are not paid to do so. They also rate bonds of the same seniority identically without regard to the different terms to maturity, even when the shortest-term debt may be pre-funded with excess cash on the balance sheet," explains Kilcourse.

Of course, high yield investing remains an experts game, and even if maturity is within sight, the idiosyncratic risk is still high. Default is one aspect that needs to be taken into consideration, but only looking at instances of default may not tell the whole story. While Allianz GI's strategy has just experienced one default over its long track record, it is essential to consider the overall exposure to distressed credits. "Investment managers can simply avoid defaults with a distressed sale," says Kilcourse. "Tracking defaults can be misleading in this regard, for example, there could be three names on the verge of filing, but these names are already trading at 20 or 30 percent of their par value, or even lower. Typical recovery is 40 cents. So, the manager sells the paper to avoid the default but has already incurred a massive loss, and maybe even more than if they continued to hold through the process."

For the team, owning distressed credits is not part of the strategy and managers are held accountable for their downside participation and distressed positions. "The investment team focuses on minimising risk and capital preservation, rather than achieving the highest possible returns," Kilcourse reminds us. "Therefore, we invest primarily in large, liquid issues of a credit quality that are at the higher end of the below-investment-grade spectrum since this increases the probability of receiving an uninterrupted flow of income. Less than 10 percent of its net assets in securities rated CCC or below. Since its inception, the strategy's average credit quality has been low BB."

"Another way to view defaults," Kilcourse continues, "is if the strategy had encountered defaults, it would not have delivered the track record and risk-return profile it has achieved in the past, especially considering the targeted volatility level of 3 percent or less. When considering defaults and owning distressed names, volatility would be much greater if the strategy had more exposure to distressed names."

A concentrated portfolio allows the team to focus on what they do best: assess credit risk and purchase only securities where their conviction that it will not distress or default during our ownership of that security is high. Kilcourse further illustrates the advantage of concentration: "Diversifying the portfolio simply to own more securities and not just the best credits, would likely introduce more volatility over a full market cycle. The obvious tradeoff is that a sector or security with a higher likelihood of default, like oil exploration and production, for example, can offer higher yields when it doesn't default but it can suffer significantly more negative price declines if it does distress or default."

"Diversifying the portfolio simply to own more securities and not just the best credits, would likely introduce more volatility over a full market cycle. "

Reassuringly, the general credit quality the current high yield market is not showing any signs of weakness. According to Kilcourse, "it has been 21 months since the US high yield market was down more than 50 basis points in a single month. This is the longest such run since March 1997. The team has been surprised that underwriting has not been more frivolous. We have not yet seen a rise in lower-quality new issuance (with PIK/toggle or CCC rating), which are troubling signs that we are at the end of a credit cycle."

Green Bonds 101

Green Bonds are becoming an inexorable investment tool and have experienced a surge of interest in the past decade. Still, doubt remains as to what they actually are, and too many investors still consider Green Bonds to be an 'exotic' investment, as opposed to a tool that generates as good, if not better, returns as traditional bonds. The following outlines the constitution and trajectory of the Green Bond.

By Glenn W. Leaper, PhD, NordSIP

Back to the beginning

The Green Bond market kicked off in 2007 with AAA investment grade issuance from the World Bank and the European Investment Bank (EIB). The first corporate Green Bonds were issued in November 2013, pushing the overall market size to USD11bn. The following year marked a turning point as new issues trebled to reach USD36.6bn, Swedish Real Estate Developer Vasakronan being among the main instigators. Issuance soared to a record high in 2016, accounting for USD93.4bn of investment worldwide, according to rating agency Moody's and the Climate Bond Initiative. Both estimated a surge to over USD200bn in Green Bond issuance for 2017.

Along with national or regional institutions, the World Bank is a major issuer of Green Bonds, being particularly active in the U.S. and India. China is the largest green bond market in the world, while the European Union and the U.S. are among the largest investors. Amid the growing and encouraging trends are issuances from municipal and local governments. The Swedish city of Gothenburg, for example, issued its first Green City Bond in 2013. Massachusetts, California, New York State and the city of Johannesburg launched Green municipal bonds shortly thereafter.

Green Bonds, Green Projects

Green Bonds are created to raise capital and investment for projects with environmental benefits. A Green Bond include any type of debt instrument where proceeds are earmarked to finance **Green Projects**, which must be detailed in the security's legal documentation. Green bonds, which can carry tax advantages for the holder, can make for more attractive investments than taxable bonds, while providing a monetary incentive to tackle climate change and promote renewable sources of energy. Designated Green Bonds must provide clear, assessable environmental benefits, which must be quantified by the issuer where feasible. There are currently four types of Green Bonds as described below.

Green Projects are classified as having 'complementary social benefits' by the Green Bond Principles. The classification is determined by the issuer, based on its primary objectives for underlying projects. Green Projects are covered by several broad categories for eligibility with the objective of addressing key areas of environmental concern, such as: climate change, the depletion of natural resources, loss of biodiversity, as well as air, water and soil pollution. Green Projects can be aimed at initiatives as varied as: energy efficiency, pollution prevention, sustainable agriculture, fishery and forestry, the protection of aquatic and terrestrial ecosystems, clean transportation, sustainable water management, the cultivation of environmentally friendly technologies, green buildings - and to encourage sustainability in general.

4 TYPES OF GREEN BONDS

The four types of Green Bonds, according to the ICMA, are:

1) **'Standard Green Use of Proceeds Bond'**: a standard recourse-to-the-issuer debt obligation aligned with the GBPs,

2) **'Green Revenue Bond'**: a non-recourse-to-the-issuer debt obligation aligned with the GBPs, in which the credit exposure in the bond is to the pledged cash flows of revenue streams, fees, taxes, etc. and whose use of proceeds go to Green Projects,

3) **'Green Project Bond'**, a project bond for a single or multiple Green Projects in which the investor has direct exposure to the risk of project(s) with or without recourse to the issuer, and which is aligned with the GBPs, and

4) **'Green Securitised Bond'**, a bond collateralised by one or more specific Green Projects, and aligned with the GBPs, where the first source of payment is generally the cash flow of the assets. This type of bond covers e.g. asset-backed securitisations of energy-efficient assets.

Bonds intentionally mixing green and social projects are referred to as 'Sustainability Bonds', which have their own separate guidelines.

Prospects and Futures

The CBI has found in its Q2 2017 analysis that the pool of Green Bond issuers continues to grow, extending investor choice, and that the issuers themselves find they can continually access a broader investor base compared to 'vanilla bonds'. Among oversubscription and tight pricing as current market features, 54 percent of Green Bonds were allocated to dedicated green investors, with these and ESG-based mandates supporting market growth overall. 62 percent of these were for bonds originating for Developed Markets, versus 25 percent for bonds originating from Emerging Markets.

The subject of Green Bonds is complex, CBI underlines, with limitations on sample data and data regarding the ongoing development of the market. CBI does, however, pick up on positive trends such as an expanding Green Bond market offering investors a broader choice of instruments, despite a lag in large corporate-issued bonds globally. There are signs, CBI's research suggests, that both issuers and buyers are benefiting from Green Bonds, relative to vanilla bonds.

GREEN BOND PRINCIPLES

Green Bonds must be aligned with the four core components of the Green Bond Principles (GBPs), the voluntary process guidelines set by the International Capital Market Association (ICMA) recommending transparency, disclosure and promoting integrity in the development of the Green Bond market by clarifying the approach for issuance of a Green Bond.

The core components are:

1) Use of proceeds,

2) Process for project evaluation and selection,

3) Management of proceeds,

4) Reporting.

These principles are designed with broad market use in mind, providing issuers guidance on key components involved in launching a credible Green Bond. They also help investors as they require information necessary to evaluate the environmental impact of Green Bond investments. Finally, they assist underwriters by moving the market towards standard disclosures that facilitate transactions. Green bonds should not, under any circumstances, be considered fungible with bonds not aligned with the four core principles of the GBP.

"The Elephant in the Room"

SPP, the Swedish Insurance and Pensions Company, manages SPP's Green Bond fund, the biggest Green Bond fund in the world in terms of AUM. This fund, however, amounts to a mere USD350mn – pointing towards the discrepancies between figures, talk and action. Helena Lindahl, Senior Portfolio Manager of the fund, is unimpressed with the speed of development – Green Bonds have only really taken off since the Paris Climate Agreement, she suggests, with the market proliferating in part due to Chinese investment and now being worth close to a quarter of a trillion dollars, but the concept of Green Bonds still hasn't fully struck home.

Meanwhile, there appears to be (at least) a public relations drive towards Green Bonds in Scandinavia in particular – for example, **Folksam**, the Swedish insurance company, presented a Green Bond acquisition of USD350mn to the United Nations two months ago, **Nordea Asset Management** has launched an enhanced Swedish-Fixed Income fund, and, **Danske Bank** was recently hired to design a new framework for the emission of Green Bonds in the context of **Swedish Sveaskog's** issuance of its second green bond totalling SEK 1bn, among numerous others in the Nordics.

Whither Green Bonds?

The concept of Green Bonds may be on the upswing, with the facts so far to support it - but ingrained attitudes remain, leaving it still somewhat of a niche enthusiasm. Despite numerous studies showing that Green Bonds enhance returns, while being crucial instruments to contribute to meeting the Paris Climate Accord's objectives of reducing CO2 emissions, too many institutions and investors still consider it an exotic topic they can pay lip service to without seriously considering or investing in them. Still, the Green Bond universe has, by any quantifiable measure, exploded over the past decade - with good reason: returns for the environment can actually be returns for the individual. In terms of Green Bonds, issuers can speak to the needs of investors in holistic terms that also amount to the needs of humanity in general.

THE TIME IS RIGHT FOR CONVERTIBLE BONDS

by Scarlett CLAVERIE BULTE,
Investment Specialist Convertible Bonds at UBP

Traditionally known as an "all-weather" asset class due to its dual nature – a debt instrument with an embedded call option – certain market environments are furthermore beneficial to convertible investors.

In today's macro-economic context, we believe conditions are ripe for convertible bonds to stand out. With the Fed setting the stage for a new normalized monetary regime, and given the solid performance achieved by equity markets so far this year, both investors and issuers are looking at convertible bonds with fresh eyes.

From an investor's standpoint, the lower sensitivity to interest rate moves offered by convertible bonds relative to straight bonds, at similar duration, constitute a key asset in such an environment. This attractive feature comes from convertibles' embedded call option. Being positively correlated to interest rate moves, it acts as a safety cushion in rising interest rate environments, partly offsetting the negative impact of an interest rate hike on the bond component of the convertible instrument.

History has shown that periods of rising interest rates were usually paired with positive equity momentum and thus, turned particularly supportive for convertible bonds. Looking back at periods when the yield of the 10 year-Bund (in Europe) or of the 10 year-US Treasury soared by more than 120bps over the past 20 years, clear patterns emerge. During each of these periods, not only convertible bonds outperformed systematically straight bonds, but they were also systematically positive, whereas straight bonds were systematically negative (in absolute terms - see following chart).

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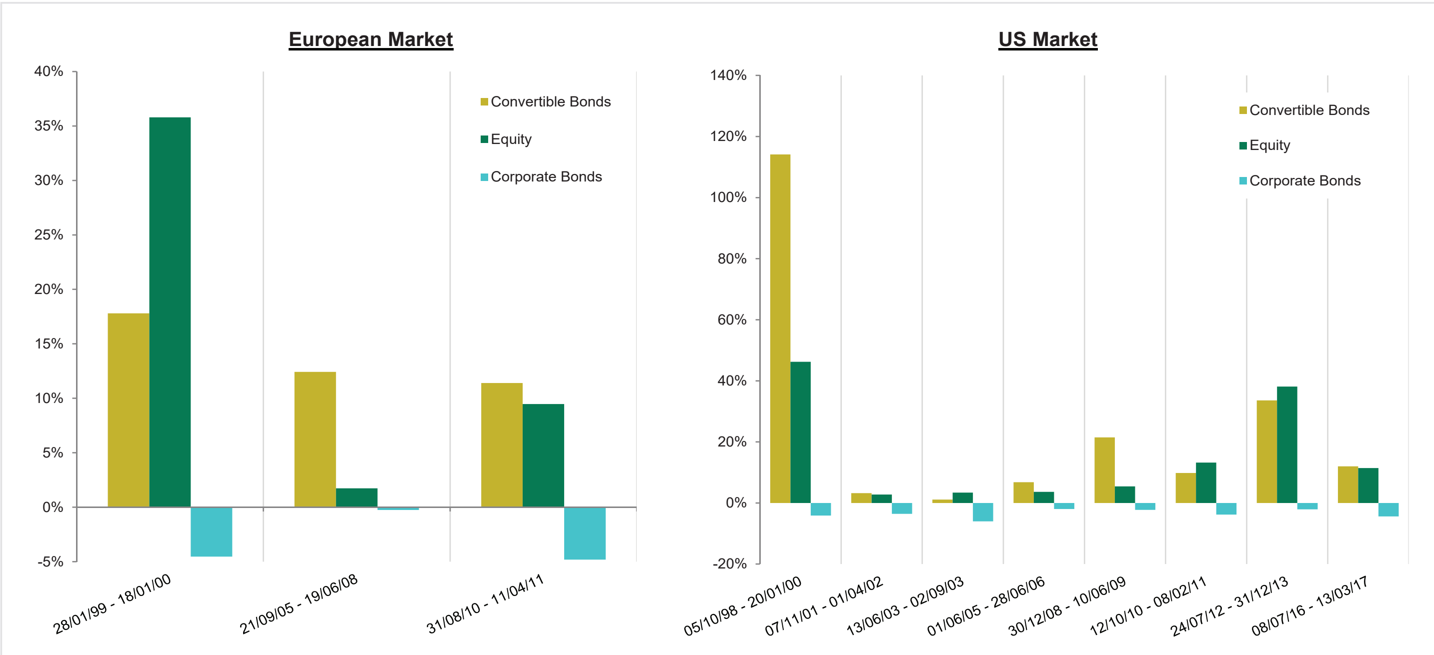
CONVERTIBLE BONDS' BEHAVIOR IN PERIODS OF RISING INTEREST RATES



Source: UBP, Bloomberg Finance LP. 1) US market - Corporate bond index: Barclays US Gov/Credit TR USD; Convertible bond index: Thomson Reuters US Vanilla CB Index; Equity index: S&P 500. 2) European market - Corporate bond index: Citi EuroBig Index; Convertible bond index: Thomson Reuters Europe CB Index; Equity index: Stoxx Europe 50 NR. Past performance is not a guide for current of future results.

"Such benefits can even be observed in the shorter term. Today, in the US, we are seeing negative short-term correlations between convertible bonds, govies and investment grade corporate bonds" notes Jean-Edouard Reymond, head of UBP convertible bond team. **"In a rising rate environment, this should enable convertible bonds to stand out".**

Another competitive edge of convertible bonds over straight bonds today lies in current spread levels. With its extensive asset purchase program, the ECB has biased prices in credit markets. From sovereign to corporate bonds and from investment grade to high yield bonds, the ECB's QE has induced a strong distortion in the traditional bond market, draining opportunities in terms of spreads and maintaining downward pressure on yields.

Comparatively, not being part of the ECB's Corporate Sector Purchase Program's ("CSPP") eligible assets, convertible bonds have remained relatively preserved from this distortion effect. At current spread levels, they exhibit much higher value potential than comparable (duration, currency, credit quality) straight bonds. In this context – and at a time where equity markets benefit from a supportive momentum overall –, convertible bond's optional feature appears as a key asset to embed in one's portfolio, as an alternative to ultra-low yields.

Relative to equities too, convertible bonds have strong value to offer: in particular, a proven ability to mitigate equity downside risk and to provide, to a certain extent, hedging for escalating volatility.

"Not only convertible bonds outperformed systematically straight bonds, but they were also systematically positive, whereas straight bonds were systematically negative."

In fact, while we believe that robust and synchronized global growth remains in place and should continue to support corporate earnings in the months to come, political uncertainties exist: new government coalition in Germany, UK Brexit negotiations with the EU, lingering pressures from anti-EU parties, situation between the US and North Korea etc. As such, the scenario of a correction should not be completely set aside, and could translate in a reversal from current ultra-low volatility regime.

In such a market environment, the benefits of convertible bonds are threefold. Historically, their convex nature has enabled them to capture equities' upside potential and at the same time, to provide effective cushion on the downside, thanks to their bond-floor component. Besides, a rise in volatility usually triggers a positive revaluation of options. As such, investors could expect convertible bonds' embedded call option to benefit from such a trend reversal in volatility levels – were it to materialize –, hence partly making up for the induced detracting impact on their underlying equity component. Also, convertible bonds give investors access to a rare asset: long-term volatility, through their embedded long-term call option on the company's underlying stock.

"This is all the more attractive as such long-term optionality is very rare – even non-existent in the US or in Asia – through traditional listed call options on single stock" adds Xavier Linsenmaier, head of UBP global convertible bond strategies.

Current markets also support convertible issuance dynamics, as revealed by the volume of primary deals we have seen since the beginning of the year (USD 64.6bn, at October-end).

"In current environment of rising interest rates, corporates are increasingly considering convertible bonds in their funding strategy" says Jean-Edouard. **"The financing of new infrastructure projects in the United States should further support this trend".**

Beyond the figures are attractive dynamics. Thus, in the past few months, we have seen existing issuers managing actively their debt: issuing new convertible bonds and, sometimes, using the proceeds to repurchase outstanding papers. In addition to creating attractive valuation opportunities in the secondary market, this allows portfolio managers to tilt their exposure to conviction names in favor of the most balanced, and hence convex, convertible papers.

Recent years have also witnessed an overall improvement in the credit quality of the investment pool – an evolution which has been notably fostered by players such as LVMH, Bayer, Carrefour, Orange etc. For companies, the lower coupons traditionally offered in the convertible bond space (in exchange for the conversion right) constitutes a powerful argument in favor of the asset class, which additionally allows them to diversify their investor basis.

"Another competitive edge of convertible bonds over straight bonds today lies in current spread levels."

Back in 2016, the convex benefits of convertible bonds had been overshadowed by the sharp fall in their implied volatility – the result of an exacerbated risk aversion sentiment among investors on the back of challenging market conditions, which adversely affected the asset class. Today, flows have started to revert from their 2016 lows, supporting convertible bonds' valuation. Fortunately, at current implied volatility levels, there is room for further rally. Aside from the US, convertible bonds' option valuation remains attractively priced relative to its mid-term average level, hence providing a compelling case for selective convex investment opportunities in the universe.

Jean Edouard Reymond started the Convertible Bond Franchsie at UBP in 1999 out of Paris, focusing on European market. In 2012 UBP enlarged their offering with global strategies by hiring regional portfolio managers to support the global coverage. Today the team accounts for 11 persons, of which 6 are investment professionals, with EUR 2.8 bn in AuM of which 2/3 is in four UCITS strategies and 1/3 in mandates.

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BIGGEST NOT GOOD ENOUGH FOR SPP'S LINDAHL

by Aline Reichenberg Gustaffson – NordSIP

Helena Lindahl, SPP

"I see a great parallel with the start of the corporate bond market. It took time for corporate bonds to become an asset class of its own in allocations."

Stockholm (NordSIP) – Helena Lindahl is Senior Portfolio Manager, in charge of managing the Swedish asset manager SPP's green bond fund, the biggest such fund in the world in terms of assets under management. NordSIP sat down for an interview with Lindahl to understand why this position does not seem to satisfy her fully.

"This is the 10th anniversary of green bonds," starts Lindahl, "this concept was invented close to here with Swedish investors, including the AP pension funds and few others. There was a pause during the financial crisis, and then the market caught up in 2011 and 2012 with the UN's Principles for Responsible Investing (PRI). Eventually, Green bonds took off after the Paris climate agreement. The market has proliferated ever since. Including China, the market is now worth a quarter of a trillion US Dollars."

Green bonds have a positive momentum, but the concept is far from having reached its full potential. Lindahl continues: "The hope with green bonds was to create a turnkey financial solution to environmental issues. It is a cost-effective way to invest in a sustainable manner." Large institutions have understood this and have a good appetite for green bonds. However, the appeal is not yet universal. "I see a great parallel with the start of the corporate bond market. It took time for corporate bonds to become an asset class of its own in allocations. Before the market took off, people talked about fixed income portfolios, not corporate bond funds. When funds became available, it enabled a much larger community to invest in this category."

Lindahl underscores that the change is taking place, just not fast enough. It is not clear to her, why more people aren't integrating this new category of bonds faster into their portfolios. "All the large Swedish institutions invest in green bonds, but the trusts and foundations have not caught on. When people begin to allocate to a new sector, they want to see history, track records, statistics, they don't want to invest just because it's green." In this case, however, the history of the existing corporate bonds market should suffice. Green bonds have the same legal framework and mechanisms as similar bonds that are not green. The market is the same and liquidity is equivalent. The only difference is that these bonds' proceeds have been earmarked to finance projects with a positive impact on the environment. "The risk/return of these bonds is the same, if not better than other bonds on the risk side. Purely from a fiduciary duty perspective, institutions should allocate more to green bonds."

Lindahl's dissatisfaction with her fund size becomes clear: "If green bonds are to save the world, being the largest fund with $350 million is not going to do it." SPP faces competition from green bond funds at the largest asset management houses such as Blackrock and Pimco, and yet it is still the largest. "If they had set up their mind to push this kind of product really," says Lindahl, "we would be by far the smallest. The elephant is in the room, but the elephants aren't here."

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STRETCH OF NATURAL DISASTERS HITS INSURANCE LINKED SECURITIES:

WILL RE-PRICING OF RISK CREATE LONG-TERM OPPORTUNITIES?

by Jonathan Furelid – HedgeNordic

The alternative market for so-called insurance-linked securities (ILS) and most notably catastrophe bonds (Cat Bonds) has ballooned in recent years. In the aftermath of the global financial crisis, institutional investors have ploughed money into the sector attracted by its relatively high yields and uncorrelated returns. A recent stretch of severe hurricanes in the U.S. is however putting the market to a test and will lead to repricing of risk in the market, industry experts claim.

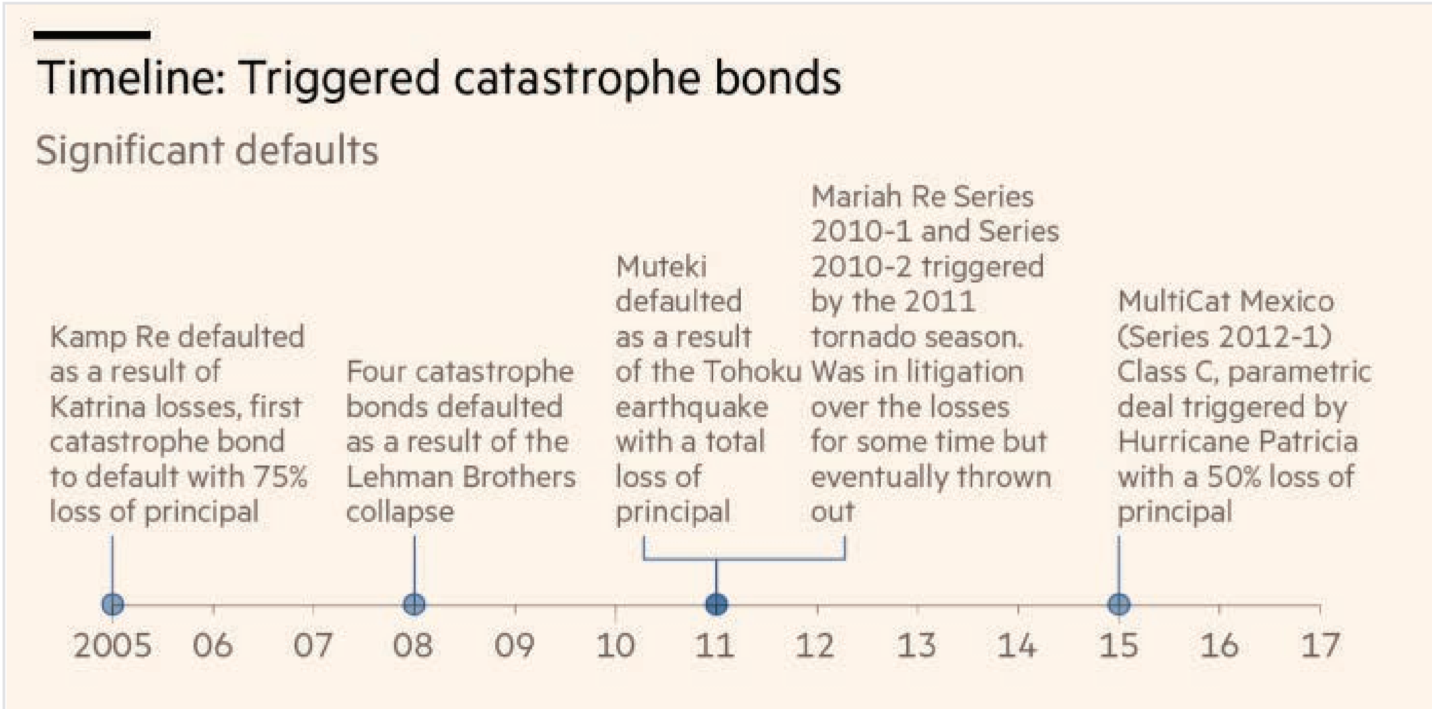
Insurance Linked Securities are financial instruments that are issued to transfer insurance risk to capital markets, allowing investors to trade the risks of large natural disasters. The asset class has attracted portfolio managers eager to diversify their holdings with assets that are uncorrelated to broader markets.

Prior to hurricane Katrina in 2005, the risk from natural disasters in the developed world was almost entirely borne by insurers and governments. Today, fifteen per cent of total reinsurance capital comes from pension funds, endowment funds and sovereign wealth funds. The alternative market for insurance has increased from just \$17bn in 2006 to \$89bn in the first half of this year, according to insurance broker Aon Benfield.

> "Year 2017 is set to be one of the costliest years ever for the re/insurance industry and for the cat bond market".

The alternative capital that has entered the sector has, up until recently, seen few major events causing cat bonds to trigger incurring losses for its holders. Since hurricane Katrina, which saw the first catastrophe bond to default, there has only been a handful defaults as depicted below.

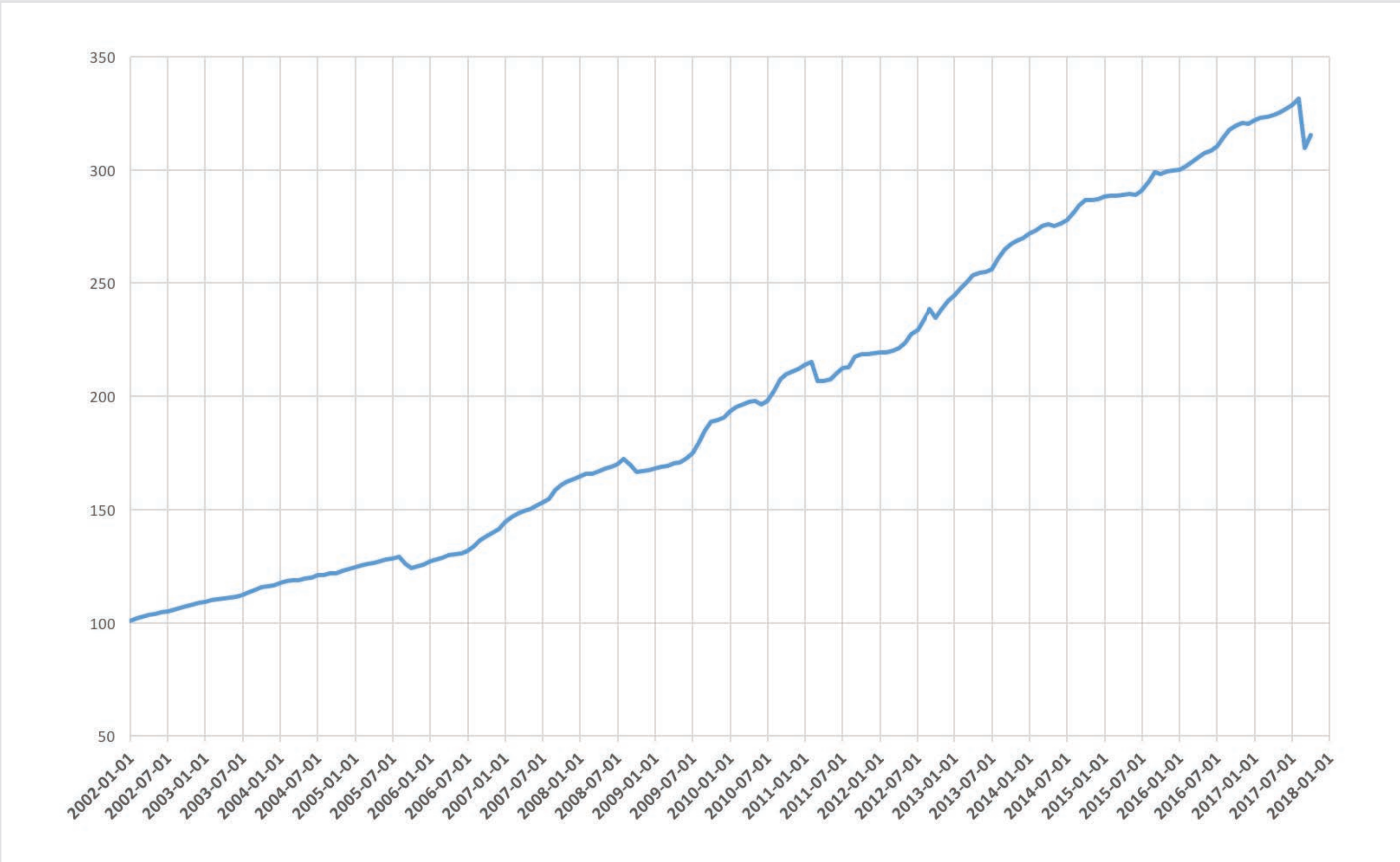
Timeline



Source: RMS research. © FT

Timeline of triggered Cat Bonds. Worth noticing is that the cat bonds triggered in 2008 was a result of the Lehman crash where the investment bank acted as counterpart for the security of four bonds which all became worthless between 2008-2011. As a result of the Lehman crash the way security for cat bonds was arranged was re-designed.

Swiss Re Cat Bond Total Return Index USD



Source: Bloomberg

Today basically all security for cat bonds is placed in government bonds with high credit ratings September 2017 however marked a turning point as three large natural catastrophes, two land falling major hurricanes in the US and the Caribbean and an earthquake in Mexico, were likely to have triggered cat bonds. This was reflected in secondary market valuations where some bonds were priced significantly lower.

The Atlantic hurricane season has been hyperactive this year featuring 17 named storms, tying it with 1936 as the fifth most active season since records began in 1851. In addition, it is the costliest season on record, with a preliminary total of over $316.51 billion (USD) in damages, nearly all of which was due to three of the season's major hurricanes — Harvey, Irma, and Maria.

"Year 2017 is set to be one of the costliest years ever for the re/insurance industry and for the cat bond market", Swedish cat bond fund manager Entropics wrote in a note to investors in their September market commentary.

The difficult market conditions were reflected in the Swiss Re Cat Bond Total Return index, a widely recognised industry benchmark, which fell 6.5 percent during the month, the worst month on record since launching in 2002. The index is on track for its first losing year since inception being down 1.6 percent year-to-date as of end October.

Since the pull-back in September, markets have recovered reflecting less uncertainty about the losses linked to hurricanes Irma and Maria but there is still a lot of uncertainty in the market according to Mikko Niskanen of Finnish alternative asset manager AIM Capital who primarily invest into ILS funds and other sidecar vehicles which provide reinsurance directly.

"It will be seen only gradually how much insurance losses these events will ultimately generate. But on the basis of preliminary estimates, it looks like this year would not be an outlier but instead just a bad drawing from a distribution of returns one should be prepared to see occasionally."

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Re-pricing of market - a long-term opportunity?

The question is whether recent events mark a "perfect storm" that is unlikely to repeat itself or if there are climate change issues that will cause hurricane seasons to become more intense even in the future marking a "new normal".

"In our view, this year's losses were neither a perfect storm nor an indication of a new normal, but instead just a bad outcome within the range of what can be reasonably expected", Niskanen says.

"ILS is a wonderful exposure to have in a portfolio. It is attractively priced, but insurance losses also follow a totally different cycle than other credit losses. Right now the market probably offers a good entry point, but in our view the long-term benefits are just as attractive both before and after these events."

While difficult to assess the future impacts of hurricanes, earthquakes and similar events, risk premiums in the secondary market for ILS have come up putting upward pressure on ILS yields.

"Increasing yields is primarily a result of the fact that insurance capital is leaving the industry following an extreme event as money need to be paid out to the victims. The re/insurance industry then gets a lower overall capitalisation and can therefore issue fewer insurances despite the fact that demand is not decreasing, this leads to increased premiums until the supply and demand picture reaches a new equilibrium", says Robert Lindblom, CEO of Entropics in a comment.

Niskanen adds that the fact that yields rise in the secondary market around loss events is more a symptom of forced selling than risk re-pricing.

"One should focus more on the primary market than the secondary market. The fact that yields rise in the secondary market around loss events is more a symptom of forced selling than risk re-pricing. But of course yields may also increase in anticipation of risk re-pricing in coming renewals".

Lindblom sees the longer-term effects of recent disasters as positive both with regards to diversification effects and return potential for investors in the sector.

"In the longer term, an increased use of alternative capital is expected in the insurance industry via cat bonds and similar instruments for risk transfer. There has been a diversification of the perils on the market in the past years and this development could be accelerated by a hardening of the re/insurance market. For investors, this would not only entail increasing returns, but also improve and further extend the diversification opportunities within the cat bond sphere."

Mikko Niskanen agrees on the long-term potential of the ILS market:

"ILS is a wonderful exposure to have in a portfolio. It is attractively priced, but insurance losses also follow a totally different cycle than other credit losses. Right now the market probably offers a good entry point, but in our view the long-term benefits are just as attractive both before and after these events."

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ROUND TABLE DISCUSSION

ALTERNATIVE FIXED INCOME AND CREDIT STRATEGIES

BY HAMLIN LOVELL – HEDGENORDIC

HedgeNordic invited fund managers and allocators to Copenhagen for a round table discussion on alternative fixed income strategies. The next pages summarize the highlights and key findings of this discusion

LIABILITY-DRIVEN INVESTING AND CASH-FLOW-DRIVEN STRATEGIES

Franklin Templeton's Peter Vincent explained that while some pension fund sponsors face an imperative to de-risk through immunisation and liability-driven investment (LDI) strategies, such strategies are likely to become more cash-flow driven as pension funds mature, and become cash-flow negative.

HOW MUCH INTEREST RATE DURATION IS APPROPRIATE?

Though some pension funds may have little or no latitude to vary their interest rate duration, less constrained, or unconstrained investors can choose to run varying degrees of positive, or negative, duration.

Oddo's Martin Dreier was of the opinion that, given nascent inflation in Germany near the ECB 2% target, and QE tapering with unwinding of Fed and ECB balance sheets, "very prudent duration strategies are appropriate. I wouldn't be very long duration". Capital Four's Rene Kallestrup agreed that "investors are not being compensated for taking interest risk based on expected paths for growth and inflation, and should hedge interest rate risk or invest in floating rate assets". Vincent calculated his multi-manager fund's average duration as being quite low, at 2.5 years, but pointed out that the geographic location of duration may matter more than the global average.

EUROPEAN VERSUS US AND EM CREDIT

Though headline absolute yields on corporate credit appear higher in the US, this is a function of higher risk-free interest rates and lower credit ratings. Dreier and Kallestrup explained that higher credit spreads in the US are mainly due to the US high yield market today having a higher proportion of C-rated credits. Holding credit ratings constant – and hedging USD back to European currencies – Kallestrup saw only a marginal yield pickup from US credit.

Dreier went further and argued that the US market is in fact richer than the European market. Conversely, Vincent still viewed spreads as tighter in Europe, and his managers are running a short Europe/long US spread trade in high yield. Vincent's managers also see value in a selective, emerging markets carry trade - not hedging the currency risk - particularly in EM local currency debt, where spreads are at ten year highs.

Dreier, Kallestrup and Pension Danmark's Kim Nielsen view the US credit market as being a larger, deeper and more efficient market whereas the much younger European credit markets (where high yield began life in 1998) are seen as less efficient. For example, Kallestrup is alert to market dis-locations and, in 2016, opportunistically bought bank capital that sold off by 15 to 20 points.

LONGS VERSUS SHORTS

Dreier can go short, but has a long bias and is currently "full-blown long European and overseas credit" because although "yields are really low, expected default rates are also really low". Dreier reckons converged credit markets are not adequately discriminating between names, and is carefully selecting those credits expected to hold up better in the next sell-off.

Vincent's managers are also running positive credit spread duration. They find that market dispersion is greater in credit than in equity markets, which provides opportunities for active managers to pick off anomalies. Vincent expects higher interest rates will increase dispersion and improve the opportunity set for active managers.

Vincent's managers do not have an outright short stance, but do find sectors vulnerable to rising rates are one short theme; company-specific threats from regulation are another. Kallestrup is identifying structural short candidates in sectors facing secular challenges, and/or sectors seeing cyclical downturns. He finds ever "tighter credit spreads make it cheaper to short such credits".

SENIOR SECURED LOANS

Kallestrup sees primary senior secured loans associated with leveraged buyouts as offering attractive credit spreads of 400-450 basis points. This is still above pre-crisis levels, and risk is mitigated by an equity cushion. These longs are balanced against shorts in high yield indices and single names, to limit market risk.

Kallestrup rotates between loans and bonds according to their relative value. He accepts that loans' current yield premium over high yield is partly an illiquidity premium. Nykredit's Lene Bostrup would only contemplate senior secured loans as a longer term, strategic, holding, as they are not liquid enough for Nykredit's tactical asset allocation team to rebalance exposures.

INVESTMENT GRADE CORPORATE DEBT

Kallestrup recognised that investment grade credit has limited default risk, but pointed out that it has greater interest rate sensitivity than non-investment grade. (Within investment grade, Capital Four sometimes finds value in 'BBB' rated insurance capital rather than corporate credit). Dreier is cognisant of the interest rate risk, and has allocated more than 40% to investment grade, emphasising longer credit spread duration. Secondary issues associated with M&A offering premiums have contributed significant performance to the fund.

STRUCTURED CREDIT

Structured credit – which can be composed of senior secured loans, ABS or other collateral – also offers a yield pick-up, which Spektrum's Phillip Riise finds appealing within a well-diversified portfolio. The long menu of risk/reward profiles makes structured credit very versatile. For instance, recently, Riise has used senior tranches of CLOs as a substitute for short-dated fixed income exposure, thereby reducing interest rate risk. Kallestrup has opportunistically rotated into structured credit, for instance after the sell-off in 2016. Currently, Capital Four prefers to own loans directly rather than leveraged CLO tranches, which do not offer enough extra yield to compensate for the extra volatility, in Kallestrup's opinion.

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Vincent's managers have been trading structured credit from both the long and the short sides, with short themes having included US shopping malls. Going forward, Vincent views non-agency mortgages as well supported by US housing market fundamentals. He also expects non-agencies will be less vulnerable to QE tapering than the agency mortgages that populate the Fed's balance sheet.

Kallestrup keeps an eye out for buying opportunities in non-mortgage ABS, such as student, auto, credit card and consumer loans, but does not generally find that spreads today compensate for credit risk (with the exception of certain pre-crisis, off-the-run, ABS).

Nielsen agrees that "structured credit can offer a complexity premium and less efficiently priced exposure… but we are keen to find partners who can ensure that it's the right kind of complexity and offers a sufficient yield premium".

STRESSED AND DISTRESSED

Kallestrup is not emphasising distressed, but is flexible enough to capitalise on stressed and distressed opportunities in a few special cases. For instance, Capital Four found a senior secured bond sold down to below fifty cents a year ago, which will now be refinanced at par (one hundred).

Nielsen agrees that allocators need to make sure they ready to quickly take advantage of distressed opportunities when they appear, as the due diligence manager search for finding the right partner can take too long.
Vincent agrees that contingency plans with the right managers should be in place before the opportunities come. Right now, Vincent reckons "it is more about being opportunistic on distressed, because it's better to be late than early".

CHOICE OF INSTRUMENTS

Vincent's managers align their portfolio liquidity and choice of instruments with the product's daily dealing, and UCITS-compliant, structure. This means derivatives such as credit default swaps and total return swaps (TRS) are used on the short side, though cash bonds can be used on the long side.

Oddo can use derivatives to exploit technical market moves, but is not seeking to earn basis between cash bond and synthetic/ derivative credit instruments, being wary of this basis risk. For strategic hedges, Dreier uses TRS to hedge without basis risk – and can also use TRS to over-hedge and take a short position.

Kallestrup uses credit default swaps, or iBoxx indices (via ETF or TRS) for hedges, and finds that the basis risk can even be beneficial when indices sell off hard in response to a market rout.

LIQUIDITY IN CREDIT MARKETS

Vincent finds that liquidity risk is greater for high yield than investment grade, and can be managed through diversification, counterparties and monitoring market flows.

Dreier seeks to manage liquidity risk for his daily dealing product in multiple ways: a centralized trading desk; close monitoring of repo markets; risk management department liquidity evaluations; and limits on the percentage of any bond issue owned.

Kallestrup keeps "good trading relationships with the London and U.S. banks" and is well aware that today's liquidity could dry up in a weaker credit market. When weaker hands become forced sellers, Capital Four aims to stay liquid enough to pick up cheap blocks of bonds. Nielsen does not want to become a forced seller.

Vincent's managers generally trade the senior, liquid ends of four credit sub-asset classes: corporate investment grade and high yield, structured credit, and emerging market debt. In the insurance linked space, liquid CAT bonds could be traded but private ILS are off limits. Vincent acknowledges that the UCITS fund structure means his managers cannot expect to collect illiquidity premia.





FEES FOR CREDIT STRATEGIES

If return expectations for liquid strategies are lower, so too are fees in some cases. Vincent's vehicle is not paying any performance fees for liquid credit strategies.

Kallestrup thinks that high yield ETF fees are often higher than actively managed, long only credit funds, that have outperformed passive approaches. "It makes sense to buy an ETF in equities, but not an ETF in credit" he points out.

Kirstein's Simon Sparre finds there is less fee pressure in alternative credit. Kallestrup agrees, saying "for an absolute return focused fund it still makes sense to have a management fee and a performance fee to make sure the manager is on top of finding the best ideas across asset classes". Nielsen is also prepared to pay performance fees, where complexity and inefficiency allow managers to add value. Vincent sees lower management fees, but not lower performance fees, on the illiquid side.

MANAGED ACCOUNTS

Nielsen finds that fees are only one reason for managed account solutions, which can also be driven by other special requirements. Kallestrup is happy to set up managed accounts (above a certain size) to cater for clients' preferences for credit risk, interest rate risk, and other restrictions. Nielsen estimates that at least EUR 100 or 200 million is needed to make managed account fees and costs competitive with those on a fund.

Franklin Templeton uses its own "open architecture" infrastructure platform for managed accounts, which lets managers keep their counterparty, legal and operational relationships and arrangements, reducing costs and minimum feasible ticket sizes. "This setup makes it more attractive, efficient, and easier for the manager to open up the account in the first place" Vincent explains. Vincent invests extensively through managed accounts and finds the operational complexity is worthwhile in return for transparency and control in terms of risk aggregation and risk management.

ILLIQUIDITY AND COMPLEXITY PREMIA

Nielsen judges "export credit agency finance on longer-term transactions makes good sense for investors who have the operational set up of banks to handle it internally". But he doubts whether many pension funds do have such wherewithal. Nielsen also views infrastructure equity, including renewables, as a source of yield pickup versus fixed income – but again, it is much more labour intensive than investing in financial instruments, with one local manager having fifty staff.

Vincent can make use of Franklin Templeton's insurance-linked securities capability and is closely looking at US wind – the biggest ILS risk, where double 'B' rated CAT bonds that once paid higher yields than comparable corporate credit have, until recently, offered smaller spreads. He thinks that the devastating hurricane losses "may have a significant impact on the capital available to the insurance market that tends to kick off an upward movement in the pricing cycle, where premiums are renewed annually in January". Vincent is also cognisant that the sheer weight of capital may mean this turns out to be a false dawn, but he is monitoring it closely.

Jensen Capital Consulting's Allan Lorentzen also reckons "it should be interesting to look at picking up those premiums right now after this disaster. In our view, it's still a bit early though, because the losses haven't really been accounted for, yet, and some of the losses so far are mainly in the uninsured space".

Round table participants were somewhat more cautious on life insurance related investments, due to some perceptions around ESG issues and potential moral hazard. However, these concerns are probably in fact misconceptions. Vincent points out "For any number of reasons, people may need or want to sell their life policies early in order to get the benefit of getting their money up front".

SENIOR SECURED LOANS

Lene Boserup

"If the liquidity is not enough, for our tactical asset allocation team, it's difficult for them to make the switches. So, if we should invest, it should be as a strategic position, not tactical".

Rene Kallestrup

"We find the best value in primary senior secured loans undertaken as part of a leveraged buyout. Senior LBO loans are levered around five times EBITDA and you have a "fresh" equity coming in on top of this of around five times EBITDA; thereby acting as a good cushion in case of deterioration in the credit quality".

STRUCTURED CREDIT

Kim Nielsen

"There is definitely some complexity premium and some less efficiently priced exposure in structured credit. But we are well aware that managers need to work hard to find it. They need to be able to look through the structure to be sure that they are getting the intended exposure."

Philip Riise

"We see a yield pick-up in the private debt markets. The exercise is splitting the pick-up apart and finding out where it stems from. Is it from illiquidity or is it from additional risk factors, which might be difficult to catch?"

ILLIQUIDITY AND COMPLEXITY PREMIA

Allan Lorentzen

"Generally speaking, it should be interesting to look at picking up those [catastrophe bond] premiums right now after this disaster. In our view, it's still a bit early though, because the losses haven't really been accounted for, yet".

Kim Nielsen

"We've looked into export credit agency finance on longer-term transactions, and it makes good sense for investors who can handle it internally"

EUROPEAN VERSUS US CREDIT

Peter Vincent

"Arguably, all credit markets are somewhat artificial at the moment thanks to the central banks' QE programs, and maybe that has greater impact on credit markets in Europe than in the U.S".

Martin Dreier

"Comparing on an aggregated level of spreads, the U.S. is rather rich compared to Europe, (after taking out the credit quality bias) and hedging costs".

FEES

Simon Sparre

"In the institutional space, with a lot of assets going passive, many investors will accept that they must pay for some of the alternative structures to get more bang for the buck. Fee negotiations are not as strong in the alternative space."

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