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RT

November 2017

PARTICIPANTS:

Pension Denmark, Capital Four, Spektrum, Oddo BHF, Nykredit, Franklin Templeton Investments, Jensen Capital Partners, Kirstein

Make the Call

TIME TO SHORT CREDIT? TIME FOR DISTRESSED DEBT?

Choices Choices

A WIDE RANGE OF CREDIT SUB-ASSET CLASSES

Alternative Fixed Income & Credit Strategies

Topics Discussed:

Stressed and Distressed Debt

Liquidity in Credit Markets

Choice of Instruments

Emerging vs Developed Markets

"Investors are not being compensated for taking interest risk based on expected paths for growth and inflation."

Editor´s Note:

It is highly unusual for real interest to remain negative for multi-year periods in peacetime, in developed economies. Fixed income investors need to take on some credit risk (and/or possibly prepayment risk), to keep pace with inflation. Given low defaults, and continuing economic growth, even today's credit spreads can still be viewed as a relatively attractive risk premium. but yields in the most liquid areas - shorter duration, investment grade, corporate debt - may still fall short of inflation.

Therefore, investors need to research a wide range of credit sub-asset classes. Within the liquid universe, US and emerging market debt offers a marginal yield pickup for those investors hedging back to European currencies- but can be of more interest to those with a constructive view on other currencies, who want to run a carry trade. Senior secured loans can offer some yield premium over high yield bonds, albeit with somewhat less liquidity. Asset-backed securities, including mortgage-backed securities, can also provide higher yields. For investors who are worried about interest rate duration risk, the floating rate nature of loans, ABS and MBS is appealing. Structured credit, mainly derived from corporate loans, ABS and MBS, offers a similar yield pickup and floating interest rate profile. Structured credit also lets investors dial up or down a menu of risk/reward levels to meet their own preferences.

The consensus is that the potentially related opportunities for going short of credit, or buying distressed debt, are few and far between. But markets can change very fast and the consensus can be very wrong, as anyone who lived through 2008 will remember. Consequently, credit investors want to retain the flexibility to opportunistically go short, and pick up distressed bargains, when Mr Market next moves into manic depressive mode.

Liquidity risk in credit markets needs to be managed carefully, but illiquidity risk (from direct lending, for instance) is also a source of additional risk premiums that some investors are keen to exploit. On top of illiquidity premiums, some investors are also seeking out complexity premiums, in areas such as trade finance.

On October 4th, 2017, our roundtable of credit managers, and allocators including pension funds, family offices, insurance companies, and multi-manager fund of funds, discussed their preferred habitats in today's credit markets – and where they expect to shift exposure towards as market conditions change and evolve. The ability to dynamically rebalance portfolios is highly prized in credit investing, which is one reason why active management remains predominant. Passive investing is not viewed as a threat to fees in credit investment management, not least because most active credit managers have outperformed passive indices and ETFs.

Enjoy reading our unique insights from leading hedge fund industry experts.

Kamran Ghalitschi
Publisher HedgeNordic
kamran@hedgenordic.com

Participants:

Contact Details and Short Bio

The Round Table Discussion took place in
Copenhagen, Denmark
October 4th 2017

Allan Lorentzen

Jensen Capital Management

www.jensencapitalconsulting.dk
allo@jensencapitalconsulting.dk

Allan is managing partner at Jensen Capital Consulting and holds more than 20 years of experience within investment advisory, product development and advisory tools. Allan went through the training as banker and investment advisor and holds a business diploma in Finance. He has attended several executive educations internally in the Danske Bank Group as well as at IMD. He was granted the Chartered Alternative Investment Analyst (CAIA) charter in 2008.

Philipp Riise

Spektrum Asset Management

www.spektrum.as
p.riise@spektrum.as

Philip Riise has been with Spektrum A/S since the beginning of 2013. He is employed as a Principal with a focus on advising institutional clients regarding investment strategy, tactical asset allocation, and asset manager selection. Before joining Spektrum A/S, Philip worked at Alm. Brand.
Philip holds a M.Sc. and a B.Sc. in Economics (Finance) from the University of Copenhagen.

Martin Dreier

Oddo BHF

www.am.oddo-bhf.com
mdreier@oddomeriten.eu

Martin Dreier has 9 years of portfolio management experience, first managing investment-grade portfolios at Provinzial Nordwest AM and most recently total-return/high- yield/quantitative products at Oddo Meriten AM. Prior to that, he worked as an economist at WestLB AG. He holds a degree in economics from the university of Dortmund.

Kim Nielsen

Pension Denmark

www.pension.dk
kni@pension.dk

Kim joined PensionDanmark Alternative Investments in 2011 initially working on direct equity transactions but since 2014 focusing on direct lending. Kim has a background from the Treasury Department within DONG Energy Prior to that Kim worked for a Nordic real estate asset manager Proark/Ejendomsinvest.

Kim holds a master's degree in Finance and Accounting from Copenhagen Business School.

Lene Boserup

Nykredit Asset Management

www.nykredit.dk
lebo@nykredit.dk

In 2013, Lene joined Nykredit Asset Management as senior portfolio manager.

Previously, she has worked with Nordea Markets, ABN Amro and Danske Markets, with trading, consulting and analysis of bonds and derivatives vis-à-vis international institutional clients. Lene holds an HD in finance from Copenhagen Business School and is CFA Charterholder.

Simon Sparre

Kirstein

www.kirstein.as
s.sparre@kirstein.as

Simon Sparre is an investment consultant at Kirstein A/S and has worked at the company since 2012.

In his current role, Simon conducts market and manager research and advises clients on business development. He earned his M.Sc. degree in Economics and Finance at University of Copenhagen.

Rene Kallestrup

Capital Four

www.capital-four.com
rene.kallestrup@capital-four.com

René joined Capital Four Management in 2012 after finishing a PhD at the Central Bank of Denmark. In 2011 he did a PhD internship at PIMCO, focusing on tail risk hedging of client portfolios.

His previous experience includes tenure with the Central Bank of Iceland, and as a currency strategist with Danske Bank, Capital Markets. René holds a PhD in sovereign and bank credit risk from the Copenhagen Business School and a Master's degree from Aarhus University.

Peter Vincent

Franklin Templeton Investment Management

www.franklintempleton.com
wpeter.vincent@franklintempleton.co.uk

Peter is Head of Alternative Sales at Franklin Templeton Investments, responsible for developing the firms alternative investment businesses in Europe and the Middle East. He has over 20 years experience in financial services, spanning risk management, asset and liability management, securitization and hedge funds. Peter holds an MA (1st Class) in mathematics and philosophy from the University of Edinburgh and an MSc in management from the London Business School.

Hamlin Lowell

HedgeNordic

www.hedgenordic.com
hamlin@hedgenordic.com

Hamlin has been Contributing Editor to The Hedge Fund Journal since 2010, researching and authoring profiles of hedge fund manager and service providers and been a contributing to HedgeNordic since 2015.

Hamlin is a CFA charterholder and CAIA charterholder. He graduated in Economics from the University of Leicester.

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ROUND TABLE DISCUSSION

ALTERNATIVE FIXED INCOME AND CREDIT STRATEGIES

MODERATED BY: HAMLIN LOWELL, CONTRIBUTING EDITOR AND HEDGEFUND ANALYST AT HEDGENORDIC – COPENHAGEN, OCTOBER 4TH 2017

Hamlin Lovell: Does it make sense for pension funds to follow a liability-matching and immunization methodology? It seems to imply very large exposures to bonds and interest rate derivatives, which sometimes have zero, or even negative, yields.

A SHIFT FROM LIABILITY-DRIVEN INVESTING TO CASH-FLOW DRIVEN STRATEGIES?

Peter Vincent: For pension funds, whether it makes sense or not depends on their circumstances. For a lot of corporate schemes, the imperative for the sponsor is to de-risk. If interest rates go up, then the value of their liabilities goes down, so you might think they wouldn't want to be fully matched if they expect rates to rise. But, for a fully-funded pension scheme, the priority is simply to take risk off the table. The sponsor is totally allergic to downside risk, because if the pension fund becomes unfunded the sponsor must put more money in. However, if it becomes overfunded, the company can't take any money out. So, there's an asymmetrical risk relationship for sponsors. Even though bonds would seem to offer very low and unattractive rates from an absolute return investor perspective, it can still make a lot of sense for immunisation type and LDI (Liability-Driven Investment) driven strategies.

In future, particularly as these pension schemes become more mature, and become cash-flow negative, we are likely to see liability-driven strategies becoming more cash-flow driven. Pension funds will emphasize investments where there's much more predictability about the cash flows.

HOW MUCH INTEREST RATE DURATION IS APPROPRIATE?

Hamlin Lovell: Where are we in the interest rate and monetary policy cycles for the U.S., Europe and perhaps in the Nordic countries that still run their own interest rate policy, such as Sweden and Norway? Or is that best left to an economist?

How much interest rate duration risk should investors be taking at this point in the cycle? How much risk do allocators and managers have in their strategies and how do they hedge or mitigate the interest rate risk?

Martin Dreier: I'm referring to both questions. The Eurozone CPI shows some data pointing to higher inflation. Germany is already heading towards the ECB's 2% target. With the output gap now closing and capacity usage more than 80% in the Eurozone on average, we can expect some uptick in future prices. That said, we're not necessarily ex-

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pecting strong interest rate increases, but of course the unwinding of balance sheets, of the Federal Reserve and the ECB, means I wouldn't be surprised to see yields being higher on a 12 to 24-month horizon.

Therefore, I feel that very prudent duration strategies are appropriate. I wouldn't be very long duration.

Rene Kallestrup: Investors are not being compensated for taking interest risk based on expected paths for growth and inflation, in our view. With long term rates so low, investors should hedge interest rate risk or invest in floating rate assets.

Peter Vincent: Franklin Templeton runs a huge variety of fixed income strategies, I can't comment on all of them. From the alternatives perspective, we are essentially running long/short credit strategies. But we are not positioned with zero duration. Our multi-manager alternative fund is currently around about two and half years' duration.

But that's an average across a globally diversified range of bonds. It's not just what the average duration is, but where you are taking the duration risk that matters.

Hamlin Lowell, HedgeNordic

EUROPEAN VERSUS US AND EM CREDIT

Hamlin Lovell: Apart from Japan, most negative interest rates are in European countries: the Eurozone, Switzerland, and Scandinavia. To what extent do investors need to look outside Europe for yield pickup? Will they still get any extra yield after hedging it back to European currencies?

Rene Kallestrup: Average corporate spreads are higher in the U.S., but that's primarily because the high yield market has more triple 'C's and double 'C's rated credits. Comparing credit spread across the capital structure, from triple 'A's down to 'C's, spreads are more or less the same, both on bonds and loans, in the U.S and Europe. After the cost of hedging dollars back into euros, we don't think it's necessary for go outside Europe for yield. In general, we can find interesting opportunities in Europe, which is less efficiently priced than the U.S. market.

Kim Nielsen: We see the U.S. as a deeper market, much more efficient. Hence, it also has somewhat less volatility, or at least is quicker to go back to normal circumstances.

Martin Dreier: The European market started in the late 1990's, 1998, I think. In its infancy, credit quality was quite weak: back in 2007, just before the financial crisis, up to 2/3 of the market was composed with a majority of single 'B's and triple 'C's. This has completely reversed and now the European high yield market is rather, a double 'B' market with 2/3 of companies rated double 'B', while the U.S. has a higher share of lower rated bonds. 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.

But in terms of market size European high yield markets face challenges. Many rising stars, have migrated to investment grade credits. Companies take advantage of the current low yield environment, and re-financing at early call dates and from time to time migrate into the loan market. Even though there was record supply this year, net supply was only flat. If issuers seek deep and large markets to grow in, the US is probably better than Europe.

Peter Vincent: Generally, the managers in our long/short credit fund currently have more exposure in the U.S. and emerging markets. They also have a short European high yield versus long U.S. high yield trade at the moment. 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. The spread seems to be tighter in Europe.

Rene Kallestrup: We find more dislocations in Europe, but at this point in the cycle, where credit spreads are very low, we are much more cautious and stand ready to capitalize on a potential sell-off. We benefitted from opportunities in bank capital instruments last year, which were trading down some 15 or 20 points. Now we have a very liquid portfolio focused on senior secured paper and we can easily rotate into new opportunities as they arise.

Hamlin Lovell: In emerging markets, should investors buy hard currency bonds or buy local currency bonds and hedge them back?

Peter Vincent, Franklin Templeton

Peter Vincent: I think there's value. Again, managers need to pick where they want to take the risk because EM currencies are not all equal. In local currency terms, EM spreads are at ten year highs whereas hard currency EM bonds have seen quite a lot of flow. Even on a relative value basis, investors might see some value in an EM carry trade.

LONGS VERSUS SHORTS

Hamlin Lovell: More broadly, at this point in the cycle, how much long and short credit risks should investors take?

Martin Dreier: Our credit opportunities strategy has a long bias (but can short credit). Right now, we are full-blown long, European and overseas credit. The economic environment is good. The expected default rate is really low, and default risk compensation is still adequate. This is arguably one of the most controversial times. Raw spreads, either investment grade or high yield are rich by historical standards, but when adjusting for this 'new normal' of long term financed, stable credit metrics, and companies with low default risk, probably we see spreads as rather fair. Hence our bias to a long credit spread duration portfolio. Having said that, we have to keep in mind the yield is really low.

In our view, markets are so compressed that similar spreads do not really compensate for different risks behind the idiosyncratic names. So, good credit selection is absolutely necessary. We don't know yet what will trigger the next sell-off, but once that happens, of course some will hold up better than others.

Peter Vincent: A lot of the risks that we and our managers are taking in our long/short credit fund are idiosyncratic, company-specific risks. I also agree that investors probably want to be more long than short right now. Hence, we still have a positive duration. A lot of our managers however are itching to go short, but now is not the time to be outright short. Clearly, dispersion favours the stock picker and the active manager. Generally, compared to equity markets, credit markets display more dispersion. There is more idiosyncratic risk, partly due to technical reasons, for active managers to capitalize on. As we move into a rate-rising environment, particularly in the U.S., (where, right now, a lot of our exposures are focused), then, there should be an increase in dispersion. That should play really nicely into active management, generally.

SHORT OPPORTUNITIES

Hamlin Lovell: On the short side, can anyone identify particular industries or even companies that could be vulnerable to an economic slowdown, or worse credit conditions, or whatever the catalyst might be?

Rene Kallestrup: The best sectors to short would be those exposed to a cyclical downturn or face secular headwinds. Companies exposed to these two factors are not suited for a very leveraged capital structure. The compression in credit spreads means it's getting cheaper and cheaper to short those credits.

Peter Vincent: Sectors and industries that are vulnerable to rising rates are clearly a good theme at the appropriate time. Right now, shorts are more idiosyncratic. For example, one of our managers has been short a drug manufacturer, predicated on the US election rhetoric around "price gouging". Essentially, our manager shorted the bonds of a pharma firm that produces a medicine for quite a rare disease among young children, and the price of that drug has increased by a huge multiple.

So, if President Trump were to take any action against predatory pricing in the healthcare sector, this company could be vulnerable as around 50% of its revenues come

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from sales of that drug. Other short areas our managers are looking at include auto suppliers, and certain agricultural commodity producers. One manager has a position in an equipment hire type business. It's more about the individual company than sector themes right now.

SENIOR SECURED LOANS

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

Martin Dreier, Oddo BHF

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. We focus on loans where you are paid around 400 to 450 basis points in spread, which is still much higher than before the Great Financial Crisis, and compensates sufficiently for the underlying credit risk. Then, we short the high yield market and single names against it to have limited market risk in the portfolio.

Hamlin Lovell: Are there any disadvantages of senior secured loans as an asset class that anybody would like to point out?

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: There's definitely a trade-off between liquidity and spread. That's also why we think there's a spread differential between the high yield market and the loan market for the same underlying credit quality.

Martin Dreier: We've observed a huge rotation from bonds into loans. Given the positive spread differential between the senior loans, and the high yield market, why are so many issuers looking at the loan market?

Rene Kallestrup: We are looking at more of less all deals coming to the market in the loan space and high yield space and we just weigh up the risk/reward and have the flexibility to switch between loans and bonds. Now we prefer the loans.

INVESTMENT GRADE CORPORATE DEBT

Hamlin Lovell: The most liquid area of the market is investment grade corporate debt. Is the yield high enough to make it worthwhile buying? Some paper in Switzerland, actually has a negative yield. Elsewhere it pays less than one percent. Are you going to do better than break even, after your own fund fees?

Rene Kallestrup: We are not that focused on investment grade but in triple 'B' rated insurance capital we see some value from time to time. In general, we think there's limited default risk in investment grade but the problem is there is much more interest rate sensitivity than in non-investment grade.

Martin Dreier: I generally agree that interest rate sensitivity is an issue in investment grade. Nevertheless, we are running more than 40% in investment grade, and with especially long credit spread duration. We've seen a lot of new issues this year, and some of the companies financing really large takeovers or mergers and acquisitions have offered significant premiums with a secondary issue. For instance, a 20 basis-point premium to the secondary curve on a ten-year bond, at say 8 years' duration, is a nice and very short term gain.

I don't know if those opportunities are going to continue in 2018, but long spread duration has been a major source of performance this year even on the secondary curve.

STRUCTURED CREDIT

Hamlin Lovell: Does structured credit offer a useful yield pickup?

Phillip 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? We see the pick-up and we see the fit in a well-diversified portfolio.

Rene Kallestrup: We think it's good to have flexibility over the credit cycle to rotate into structured credit, in particular non-investment grade rated CLO tranches. Last year after the sell-off we thought there were very good opportunities in that space. Now, we think we are better compensated from buying the loans outright, instead of having ten times exposure to loans via CLO equity for instance. For most junior mezzanine CLO tranches, we believe the spread over the volatility, does not generate a high enough potential Sharpe ratio to justify the exposure.

Peter Vincent: Our managers exposed to structured credit have been performing pretty well so far this year. It's a mixture of trading strategies and buying or shorting the right bond. We've seen some good results from the mortgage-backed space, particularly in the non-agency residential mortgage space. Going forward, that's where we would expect to participate. We think as the Fed starts to unwind QE then there's an awful lot of agency bonds to offload from their balance sheet. So, agency bonds seem a bit more vulnerable than non-agency debt, which currently has strong fundamentals in terms of the underlying housing market, in the U.S..

Then, on the short side, we have certain commercial mortgage-backed securities targeting specific sectors, for example going short retail type assets such as shopping malls.

Hamlin Lovell: Does anyone look at other asset classes and collateral that can lie behind structured credit, such as student loans, auto loans, credit card receivables, or consumer loans?

Rene Kallestrup: We look at these structures, but in general don't think we are being compensated for the underlying risk in primary ABS deals. But, essentially, it's very good to be ready for the day where they have some kind of weakness in the market and there could be some good opportunities to get involved. If you look at pre-crisis, off-the-run ABS deals, there's still some deals where the spread compensates for the underlying credit risk.

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. So, we are very focused on finding partners that can do so and would be able to ensure that it's the right kind of complexity and offers a sufficient yield premium.

Phillip Riise: It is interesting that you can use these struc-

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tures across the whole portfolio. Looking at a CLO, depending on where you are on the structure, it can substitute different parts of your portfolio. The very upper tranches of the CLO could act as a substitute for short dated bonds, reducing interest rate duration in the portfolio. That's a substitution we did to a minor part in our portfolios.

STRESSED AND DISTRESSED

Hamlin Lovell: Some types of structured credit and ABS, such as certain commercial backed securities, student loans and auto loans have become distressed and defaulted already. Is now the right time in the cycle to start looking for stressed and distressed opportunities, or is it just too early?

Rene Kallestrup: There are a few special cases where we can find some good opportunities. A year ago, we found a senior secured bond that was heavily beaten down to below fifty cents on the dollar and now it's going to get refinanced at par. So, it's good to have the flexibility to invest in distressed, but we don't think it's generally the time to reach out for distressed opportunities.

Kim Nielsen: We agree. Allocators need to be prepared for the different opportunities when they appear. If allocators wait until they're starting to think, "distressed is the right thing to do", they then need to find the right kind of partner. This search can mean they are half way through before they actually get to invest in the interesting opportunities. So, we are thinking how we can set up some kind of "rainy day" mandate without a lot of cost. Managers might not be invested for some time, but can quickly take advantage of any distress and volatility.

Peter Vincent: I was educated that it's better to be late than early for distressed. We agree. We need to be ready, because when the opportunities come, we don't then want to start due diligence on managers. Right now, however, it's more about being opportunistic on distressed.

CHOICE OF INSTRUMENTS

Kim Nielsen: We agree. Allocators need to be prepared for the different opportunities when they appear. If allocators wait until they're starting to think, "distressed is the right thing to do", they then need to find the right kind of partner. This search can mean they are half way through before they actually get to invest in the interesting opportunities. So, we are thinking how we can set up some kind of "rainy day" mandate without a lot of cost. Managers might not be invested for some time, but can quickly take advantage of any distress and volatility.

Peter Vincent: Our strategy is a daily liquid, long/short credit fund and it's UCITS compliant. That tends to put some constraints on how managers generate exposure. On the short side, they are essentially limited to using derivatives - credit default swaps and total return swaps - to get that exposure. But, on the long side, obviously, they can use cash bonds.

Simon Sparre, Kirstein

Martin Dreier: We don't want to hedge as our credit scores are fine now. We do not try to earn the basis, or just hedge it and then hope that it's going to work out. The beauty of total the return concept is: if we do not need the credit, we can sell it and don't have any benchmark risk.

On more market-based hedging, the liquid and cost-efficient according to our analysis iTraxx credit default swap indices are more for technical departments. We can play very smart, short term market movements and momentum. But of course, as a hedge instrument, it has large basis risk: very different market dynamics within the synthetic and the cash bond market.

For strategic hedges, we use total return swaps, which are more costly than the iTraxx CDS indices but allow to hedge the market without basis risk. We can hedge 100% of the credit and play a little bit with the underlying. We have those TRS for standardized, quite liquid indices with market makers, and brokers providing liquidity. We can even over-hedge the spread risk.

Rene Kallestrup: Our favourite spot is senior secured loans but we still have selected exposure to high yield bonds. Otherwise, we prefer shorting indices, using credit default swaps or the iBoxx indices (via ETF or TRS). We always seek the most efficient way to short the market. Of course, there's basis risk, but when the markets are very weak, the indices tend to sell off a lot which benefits us. At this point in the cycle we have a limited market risk.

LIQUIDITY IN CREDIT MARKETS

Hamlin Lovell: Is liquidity in the credit markets is getting better or worse? How much does it vary between different type parts of the credit markets?

Peter Vincent: Liquidity, at the moment, is pretty decent. But it does vary, depending on credit quality, so investment grade is obviously much more liquid than high yield. We manage liquidity risk through diversification; through having good counterparties and through monitoring market flows. Being part of Franklin Templeton, we have the benefit of a global trading operation.

Allan Lorentzen: We don't really look that much at liquidity. We advise clients more on a strategic level. Obviously, liquidity is important depending on, say, the investment policy for the client, but at this level of detail it is not really something that we dig into.

Martin Dreier: It has become quite important for us as we are providing daily liquidity. There are several layers. We have a centralized trading desk, which is really monitoring liquidity and special situations in different names. We are monitoring the repo side as well, which is valuable information. Our risk department is evaluating liquidity as a third layer. On a portfolio management basis, we also look at the capital structure, such as how much of a certain bond we own. If a huge fund invests a percent of its one billion in a bond, it's already at five percent of a 200 million bond. That, I think, is still feasible, and probably ten percent of larger bonds with a broad coverage is okay, but at some point, a big fund becomes the market. Then, market impact when trying to exit a position is quite huge. Therefore, liquidity risk for us is of major importance.

Rene Kallestrup: I agree. It's very important to have good trading relationships with the London and U.S. banks. At this point in the credit cycle, markets are rather liquid but when credit markets are weak and less liquid it is very important to have good relationships to move around in the markets. Last year, when we had weakness in bank capital space, we did a lot of good deals by being shown blocks of cheap bonds. We are prepared for the day, if the market gets a bit wobblier, where we can do good deals again.

Kim Nielsen: We are focused on being aware of liquidity. We don't want to be forced to sell below the current level. That may not be the best option if we could wait a month and sell at much better prices.

Hamlin Lovell: Peter, which credit assets fit well into a UCITS liquid alternative structure and which are not liquid enough?

Allan Lorentzen, Jensen Capital

Peter Vincent: All of our funds cover three broad areas. Corporate long short, which is essentially corporate investment grade and high yield; structured credit, and emerging market debt. We are generally trading the senior, liquid end of the market and it's a daily liquid fund so, that does preclude some things. We could potentially have some CAT bonds in there, but probably wouldn't want to get into some of the more exotic/private insurance-linked securities from a liquidity perspective.

To Kim's point, there is a premium from illiquidity, albeit a cyclical one, and so if you're investing in a liquid strategy, you should be realistic in what you're going to get exposure to and what you expect from that. And, one of the interesting aspects of the industry right now is that there is more choice in liquidity and fee structures.

Traditionally, credit managers, particularly in the hedge fund space, would have their offshore Cayman fund charging 2 and 20, with, say, quarterly liquidity and a 25% in-

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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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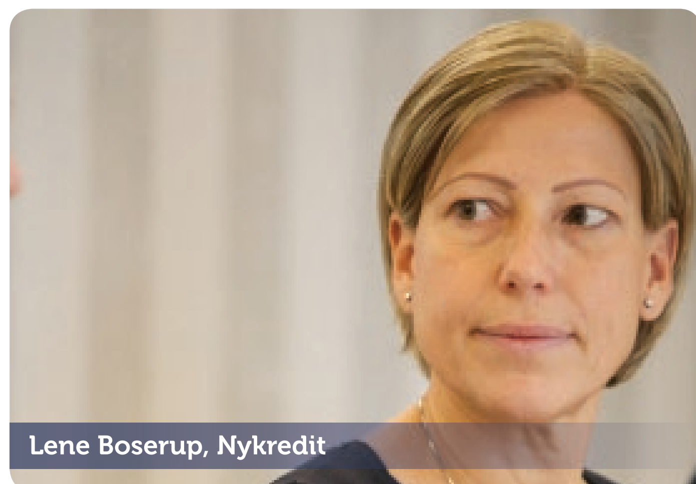
vestor-level gate. They would choose how much of their portfolio is liquid, how much isn't liquid and what the sort of liquidity mismatch they were prepared to run.


Lene Boserup, Nykredit

Now more and more liquid funds are available that allow investors to capture just the liquid bit of these strategies. Conversely, there are more and more pure, dedicated, illiquid credit funds, either in distressed or other strategies such as direct lending. That's pulling the old hedge fund model apart, which is good for investors, because they actually have a choice over their liquidity profile and hopefully, can optimize fee structures.

FEES FOR CREDIT STRATEGIES

Hamlin Lovell: In the long only world, it seems that fees on credit funds are nearly always quite a lot lower than then are on equity funds, at least for retail investors. Institutional investors pay much less anyway. Is it also true that alternative credit funds actually charge less than alternative equity funds - or maybe not? And how are fee structures evolving and developing in the space?

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. So, fee negotiations are not as strong in the alternative space.
Peter Vincent: On the illiquid side, typically we see private debt funds don't charge as much as private equity funds. They may still have the same performance fee and carried interest over an 8% hurdle, but their management fee tends to be lower. In the liquid space, certainly - and I can really only talk about the managers we interact with - we have reduced fees considerably. We don't pay performance fees for liquid strategies. We've a flat management fee and no performance fee. I think that will become more and more common.

Hamlin Lovell: Even though Fidelity yesterday said they're introducing performance fees?

Rene Kallestrup: Many ETFs are charging 50 basis point just to buy high yield bonds, which is strange compared to many actively managed, better performing, long only credit funds charging below 50 basis points. In our view, it makes sense to buy an ETF in equities, but not an ETF in credit. If you are running 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.

Hamlin Lovell: What are pension funds looking for in fee structures?

Kim Nielsen: We have focused on whether managers have a more benchmarked approach. Then, we're also expecting that it's a management fee on a competitive level with less of a performance fee, because there's less room for beating the market. Whereas, if the market has inefficiencies, complexity, et cetera, and the manager is able to add value, then it makes sense to have the performance fee.

Kim Nielsen, Pension Denmark

MANAGED ACCOUNTS

Hamlin Lovell: How often would you use managed accounts in negotiate or tailor fee structures?

Kim Nielsen: We do that from time to time. It may be about fees, but it could also just be because we have some other special requirements. There can be a number of different reasons for choosing a managed account solution, it's not necessarily fee driven.

Rene Kallestrup: We like running managed accounts where clients can choose which kind of credit risk, interest rate risk and restrictions they prefer. Of course, you need to have a certain fund size because of the cost of running the account.
Hamlin Lovell: What do you think is the minimum ticket size that's viable for a managed account?

Kim Nielsen: Most of the managers would like to see 100 million Euros or it could go up to 200 million Euros, depending on the individual case. You need to have scale for it to be more cost-efficient than being in the fund in terms of fees and all the other costs associated with having such an SMA arrangement.

Peter Vincent: We use managed accounts extensively with all of the hedge fund managers in our liquid funds and we offer segregated accounts to people who want to invest that way. Obviously, there is operational complexity. From our perspective, that is massively outweighed by the benefits in terms of transparency and the ability to control the assets. And for multi-manager portfolios, the ability to look through at all of the positions, aggregate all of the risks, control those risks, and manage those risks actively, makes a phenomenal difference. To us, that's very valuable and it's, hopefully, a source of value added to our investors. Also, it takes away all of the operational risk or rather, puts all the operational risk in our control.

Now that we are part of Franklin Templeton, we have access to a fantastic infrastructure that we use for our managed accounts. We might not have this as an independent hedge fund specialist. I think managed accounts are increasingly the way to interact, especially with hedge funds.

Hamlin Lovell: Would you tend to use a platform or a white label infrastructure provider?

Peter Vincent: We have our own platform. There are platforms and platforms. We have gone down a route of "open architecture". From the manager's perspective, we try to make it as easy as possible so they don't have to change their prime broker, and they don't have to enter into new legal or operational commitments. They essentially just execute another trade. That trade then settles through the process onto our account.

This setup makes it more attractive and easier for the manager to open up the account in the first place, which, I think is why managers are more willing to work with us. The reason why there's often a 100 million minimum for managed accounts is because it generally means the managers have to hire additional operations staff, get their lawyers to do all their new agreements, et cetera, et cetera.

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Whereas, the way that we've structured it, using some of the bargaining power that we now have, has made it more efficient to create those accounts.

ILLIQUIDITY AND COMPLEXITY PREMIA

Hamlin Lovell: There are lots of potential places where investors could seek illiquidity and complexity premia. One is direct lending. How comfortable do investors feel with three year, five year, seven year lock ups in direct lending vehicles, often making just bi-lateral loans where there's obviously no liquid, secondary market in the loans, but potentially a yield pickup. For example, how about trade finance? Such as buying invoices at a discount or export credit.

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. There's probably not a lot of room for having a lot of managers doing it as it's not as easily investible, in general, if they don't have the operational set-up of banks, which are focused on this. So, we find it interesting, but not really accessible for pension funds, in general.

Hamlin Lovell: Denmark is quite famous for Vestas windmills, which are all over Europe. Does wind-generated electricity create opportunities for earning a regular income?

Kim Nielsen: We do have an allocation to infrastructure equity, including renewables, and we believe that it creates a good pickup of yield compared to fixed income, but we also realize it is very intensive to invest in it. Hence, most of what we do today is through a local fund manager that in four years has grown from being zero to being fifty employees. It's much more labour-intensive than sitting and investing in financial instruments!

Hamlin Lovell: After the hurricanes that we've seen in the Caribbean, is now a good time to look at catastrophe bonds?

Peter Vincent: We do have an insurance-linked securities capability, and we are looking closely at the opportunity in that space in the near term, because of the damage that the recent devastating hurricanes have done in the US. Essentially, the re-insurance market is notoriously cyclical.

There has been an absence of big hurricane losses for several years, now. U.S. wind is the biggest risk in the insurance linked securities world. So, when the strong winds hit places like Florida, or Texas, it has a significant impact on the capital available to the insurance market and that tends to kick off an upward movement in the pricing cycle. Insurance rates had been being driven increasingly lower and lower. A few years ago, a double-'B' CAT bond could pay 100 basis points more than a high yield bond equivalent, but up until recently was yielding less.

I think the expectation is that prices in the re-insurance markets are going to harden as people come to renew their insurance premiums in January next year. So, you could argue that this might be a buying opportunity for insurance linked securities. A counterargument could be that, actually, there's been so much capital sitting on the sidelines waiting for an event to occur that maybe it won't be quite such a hard market going forward, but, certainly, I would say that insurance premiums look much more attractive now than they have done for quite a while.

Allan Lorentzen: Generally speaking, 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. Some of the losses we've seen so far are mainly in the uninsured space, so it's probably not as attractive as it looks at first site.

Hamlin Lovell: Few lives were actually lost, fortunately, during recent hurricanes, but, life related risk is another one that some pension funds do look at. Has anyone looked at life settlements, which can be called viatical settlements. Investors buy life insurance policies and basically wait for people to die to get the payout.

Simon Sparre: We have seen curiosity towards Life ILS, but some investors get a bit itchy from an ESG point of view, which mostly relates to misconceptions of the purpose of the investment. In essence, life ILS has the same ethical characteristics as other ILS bonds, and may be just as interesting as catastrophe bonds.

Peter Vincent: We don't invest in them. I think, clearly there is a return to be made and there is, as with any insurance related investment, a reason why life settlement exists. 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. I think one of the reasons they are not more popular is that a lot of institutions feel uncomfortable with the perception of moral hazard around owning other people's life policies.

Publisher:

Nordic Business Media AB
BOX 7285
SE-103 89 Stockholm, Sweden
Corporate Number: 556838-6170
VAT Number: SE-556838617001

Direct: +46 (0) 8 5333 8688
Mobile: +46 (0) 706566688

email: kamran@hedgenordic.com

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