NOVEMBER 2018

# HEDGENORDIC

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## What Fuels Fixed Income Strategies in a low Interest Rate Environment?

Preparing Fixed Income Porfolios for a Market Shift Ahead

Finding your Niche in the World´s Largest Financial Markets

In Focus: (Nordic) High Yield

# ALTERNATIVE FIXED INCOME

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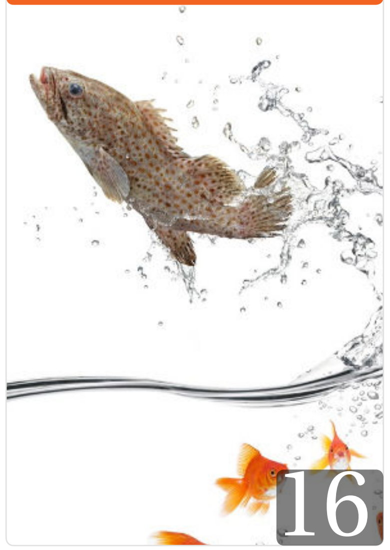

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## INTRODUCTION

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

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

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

**Publication Plan 2019:**

| | |
|---|---|
| February: | Multi Asset |
| March: | Nordic HF Industry Report |
| June: | Private Investors |
| September: | Equity Strategies |
| October: | Norway |
| November: | Alternative Fixed Income |

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# Editor´s Note...

## It is getting cold around us...

**Winter is starting to take a firm grip on us, days are short, grey and cold. This sentiment is seemingly spilling over to the Nordic hedge fund industry, too. Going into the final quarter of the year, October welcomed most Nordic hedge funds with a firm and painful punch, right where it hurts.**

In October, the Nordic Hedge Index (NHX) suffered its worst monthly performance in ten years, recording its third-worst monthly decline on record. Equity-focused hedge funds and trend-following CTAs were hurt the most, as global equity markets experienced a sharp reversal in October and volatility soared.

More than two-thirds of the members of the NHX which had reported performance figures for October ended the month in the red. Five members of the index incurred losses of more than ten percent, and performance dispersion was quite significant between the best and worst performers. The top 30 percent of hedge funds in the NHX gained 0.8 percent on average, whereas the bottom 30 percent declined 5.9 percent.

Returns on the year to date are mostly below zero, too. Only one of the sub-indices to the Nordic Hedge Index (NHX), for fixed income strategies, managed to keep the head above the waterline.

In HedgeNordic´s last Special Report for 2018, we therefore have all eyes on fixed income markets, and the various strategies and instruments portfolio managers utilize in this low interest environment attempting to generate returns for their investors.

Peter Hansson, recently retired CEO of Sparinstitutens Pensionskassa (SPK), looks back at 25 years investing in hedge funds, and shares his views with us on how the industry has changed during his career.

The Head of Alternative Investments at AFA Insurance, Mikael Huldt in a Q&A styled interview with HedgeNordic gives insights on his experience with direct lending. A cut out taken from an "in depth" series we ran on HedgeNordic.com in October.

The paper concludes various articles written by our own editorial staff, or by expert guest writers touching subjects such as how to position fixed income assets for a market shift ahead, the unique structure of the Danish mortgage bond market or how it is crucial to think beyond the beyond the benchmark, especially in emerging market debt.

Dynamically different in an unconstrained bond fund strategy, and the case is made why the credit cycle is maturing, but not rolling over yet. While ESG is an evergrowing topic within asset management, it is still, too often, viewed in an equity context, only. In an article we learn why a much more tailored approach is needed when discussing ESG in a fixed income context.

The publication has a special focus on high yield, corporate debt with an emphasize on the Nordic markets. The paper looks at the segment from various angles, such as the benefits of being a big fish in a small pond, the dilemma of unrated debt and default rates.

In a letter from London, the impacts and fallouts from Brexit are discussed in a series of interviews, just as the negotiations between the EU and the British Prime Minister concluded.

The paper concludes with an interview series inviting Nordic hedge fund managers engage in Nordic corporate debt the revisit some of the defaults in the space and ask if Nordic high yield has put its difficulties behind.

Hopefully, this publication can address, and answer the most pressing questions and make a good read in these cold and grey winter evenings.

**KAMRAN GHALITSCHI**
CEO & PUBLISHER HEDGENORDIC

# NORDIC FIXED-INCOME HFS PASSING THE BATON TO EQUITY MANAGERS

By Eugeniu Guzun – HedgeNordic




Nordic fixed-income hedge funds embarked on a solid run of performance starting with the first quarter of 2016, outperforming each of the remaining four strategy categories tracked by HedgeNordic both in 2017 and 2016. The run ended in February of this year, as volatility returned abruptly to financial markets. Turbulent market conditions during February ended the group's longest streak of consecutive monthly gains. But as the saying goes, nothing lasts forever. With three months left till the end of the year, the crowd of fixed-income vehicles within the Nordic Hedge Index (NHX) will likely not match the performance enjoyed in the previous two years. The group, however, is still the second-best performing category within the NHX year-to-date through September, trailing only equity-focused vehicles.

## Where do fixed-income vehicles in the NHX come from?

There are 29 fixed-income hedge funds in the Nordics as of the end of October, five more vehicles than at the same point last year. Of the 13 Nordic hedge funds launched thus far in 2018, four are investing in the fixed-income space. As shown in the timetable below, SEB Eureka Fixed Income Relative Value was launched during the first quarter of the year, Hamiltonian Global Credit Opportunity and Danske Invest Fixed Income Macro Hedge took off during the second quarter, whereas Nordic Cross Credit Edge was started during the previous quarter.

One in every six members of the Nordic Hedge Index (NHX) run investments strategies that focus on fixed-income markets. A little more than half of all fixed-income hedge funds included in the NHX are based in Denmark, which is not surprising given the sheer size of the Danish mortgage market. Denmark's mortgage bond market is one of the largest and most liquid bond markets in the world. The complexity of this market, characterized by an extensive variety of issuances with very different characteristics, has allowed many local managers to develop a competitive edge in the pursuit of exploiting market inefficiencies. Of the 34 Danish hedge funds included in the NHX, 16 are employing fixed-income strategies. The NHX universe also includes 11 Swedish fixed-income funds and two Norwegian funds. There are no Finnish-based fixed-income vehicles in the NHX family.

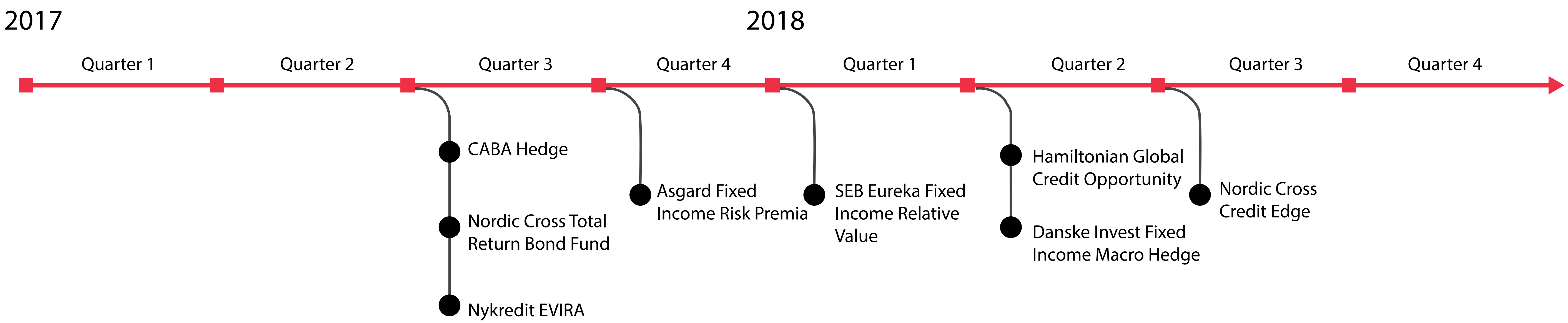

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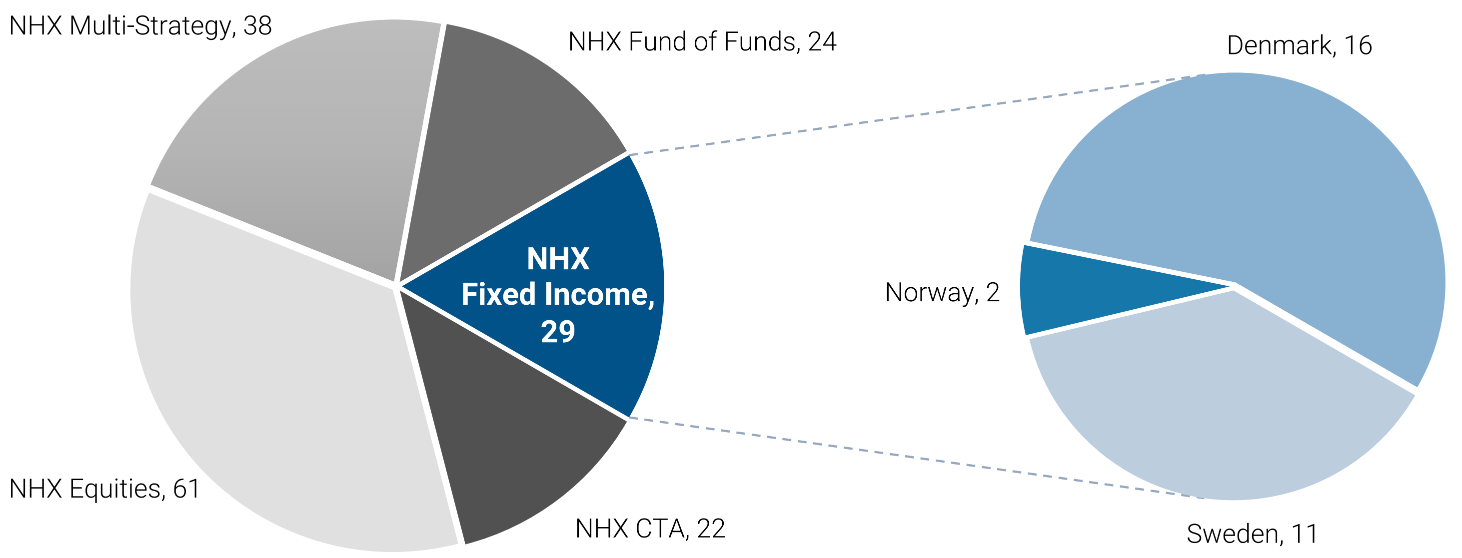
FIGURE 1: COUNTRY BREAKDOWN OF THE NHX FIXED INCOME.




Source: HedgeNordic.

## How did Nordic fixed-income hedge funds perform in the post-crisis era?

The group of fixed-income hedge funds outperformed each of the remaining four NHX categories in the past two years, partly thanks to the group's longest streak of positive performance since HedgeNordic started tracking the universe in 2005. Nordic fixed-income vehicles put together a streak of 23 consecutive monthly gains, which ended during the turbulent month of February. The previous record for the NHX Fixed Income category was a 21-month rally that started in January 2009, with the group also having enjoyed a 20-month rally which started in October of 2011.

Official statistics, commentaries and sentiment suggest the financial crisis of 2008 is behind us, so there is not much value-added from talking about the performance of fixed-income hedge funds going back more than ten years in time. Nordic fixed-income hedge funds did not fare well during 2008 to say the least, with the group ending the year as the biggest loser among the five categories within the Nordic Hedge Index (NHX). Despite the 2008 setback, Nordic fixed-income hedge funds, as measured by the NHX Fixed Income, generated an annualized return of 5.5 percent since the beginning of 2005 through September of this year. The group beat the annualized return of 4.8 percent generated by the entire family of NHX funds, but trailed their international counterparts, who earned 6.2 percent on average over the same time span.

A different picture emerges in the post-crisis era. Fixed-income strategies run by Nordic managers have delivered solid gains post-crisis, partly reflected by three separate nearly two-year streaks of consecutive monthly gains. The NHX Fixed Income outperformed both the universe of Nordic hedge funds and the broader arena of international fixed-income hedge funds since the beginning of 2010 while experiencing less volatility in monthly returns. There are 29 Nordic fixed-income hedge funds, so one would typically anticipate the group to exhibit higher volatility in monthly returns. Not only has the NHX Fixed Income outperformed the NHX Composite and the Eurekahedge Fixed Income Hedge Fund Index since 2010, but the group also achieved that with lower volatility in returns. The NHX currently includes 174 members, whereas the Eurekahedge index contains a much higher number of 332 fixed-income hedge funds.

| Portfolio | Total return (%) | Annualized return (%) | Minimum annual return (%) | Maximum annual return (%) | Annualized volatility in monthly returns (%) |
|---|---|---|---|---|---|
| **Statistics since January 2005 through September 2018** | | | | | |
| NHX Fixed Income | 207.8 | 5.5 | -20.8 | 23.8 | 4.59 |
| NHX Composite | 191.7 | 4.8 | -9.5 | 14.2 | 3.72 |
| Eurekahedge Fixed Income Hedge Fund Index | 227.5 | 6.2 | -11.0 | 25.0 | 3.62 |
| **Statistics since January 2010 through September 2018** | | | | | |
| NHX Fixed Income | 183.1 | 7.2 | 1.6 | 14.4 | 2.28 |
| NHX Composite | 144.6 | 4.3 | -2.5 | 8.3 | 3.05 |
| Eurekahedge Fixed Income Hedge Fund Index | 168.7 | 6.2 | 0.9 | 13.0 | 2.66 |
| **Statistics since January 2015 through September 2018** | | | | | |
| NHX Fixed Income | 119.6 | 4.9 | 1.6 | 7.9 | 2.27 |
| NHX Composite | 113.5 | 3.4 | 1.0 | 4.8 | 2.75 |
| Eurekahedge Fixed Income Hedge Fund Index | 116.3 | 4.1 | 0.9 | 6.7 | 2.09 |

## How big are Nordic fixed-income hedge funds?

The universe of Nordic fixed-income hedge funds oversees €6.91 billion in assets under management as of the end of September based on data for 27 of the 29 members of the NHX Fixed Income. Danish-based vehicles account for around two-thirds of this figure, whereas Swedish funds represent 29 percent of all assets. The two Norwegian fixed-income funds account for six percent of the nearly €7 billion-figure.

Eight out of the nine fixed-income hedge funds that were operating at the end of 2009 collectively managed €611 million at the end of that year, with these eight vehicles managing €2.63 billion in assets as of the end of September of this year. The 12 members of the NHX Fixed Income which were up and running at the end of 2012, meanwhile, had €2.37 billion in assets under management at the end of that year. These 12 vehicles oversee €3.70 billion in capital as of the end of September. All Nordic fixed-income hedge funds launched in 2016 and onwards managed €1.35 billion in assets at the end of September of this year.

FIGURE 2: ASSETS MANAGED BY NORDIC FIXED-INCOME HEDGE FUNDS IN EUROS

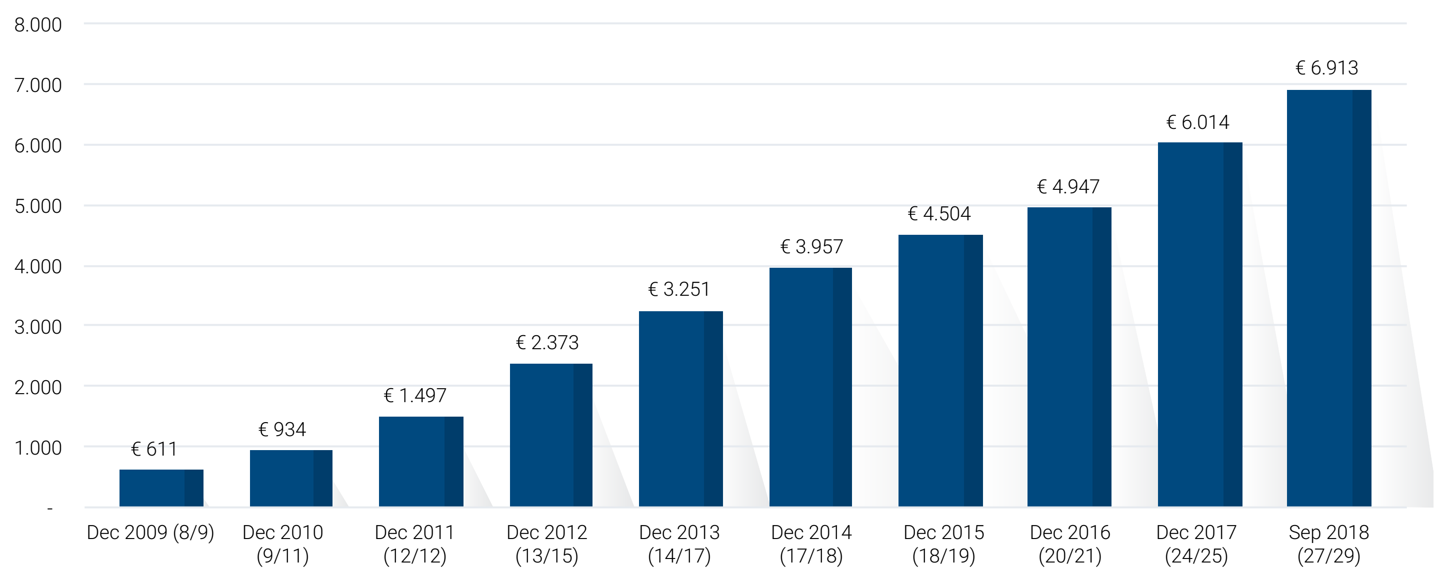
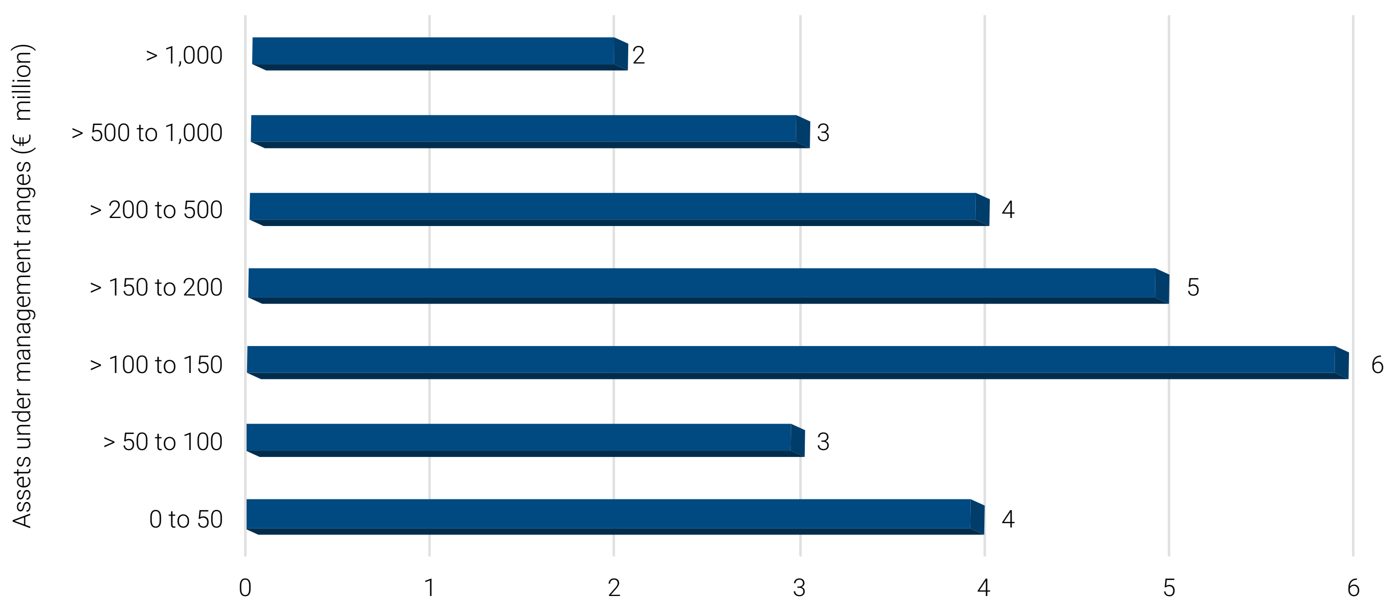



Figure 2. Assets managed by the current members of the NHX Fixed Income. All figures were converted in Euros using year-end exchange rates. x/y shows the proportion of funds with reported AuM data, where y is the number of fixed-income hedge funds operating at each specific point in time and x is the number of funds with reported AuM data. Source: HedgeNordic.

There are eight fixed-income hedge funds in the NHX with an operating life of less than two years, with this young group managing assets of €143.1 million on average. The Nordic hedge fund space also includes ten mid-age fixed-income hedge funds with an operating life between two and eight years, and an additional 11 vehicles with an operating life that exceeds eight years. Mid-age fixed-income hedge funds manage €279.8 million in capital on average, whereas the more veteran fixed-income vehicles in the NHX oversee €311.7 million in assets on average.

FIGURE 3: NUMBER OF NORDIC FIXED-INCOME HEDGE FUNDS BY SIZE, AS OF SEPTEMBER 30, 2018.

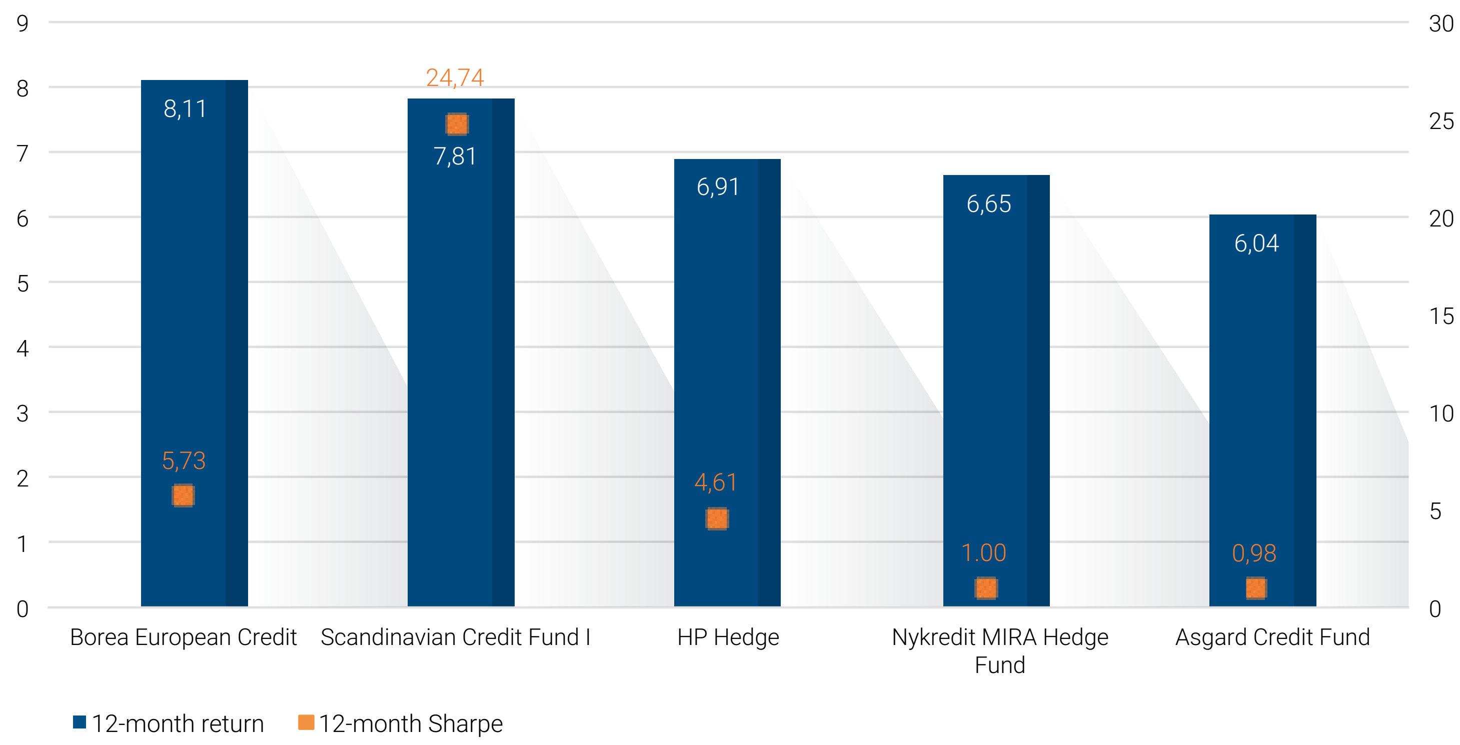



Source: HedgeNordic.





FIGURE 4: BEST PERFORMING NORDIC FIXED-INCOME HEDGE FUNDS BASED ON 12-MONTH RETURNS.




Source: HedgeNordic.

The majority of the Nordic hedge funds employing fixed-income strategies oversee less than €200 million in capital (18 out of the 27 vehicles that reported assets under management figures). Eleven of these hedge funds manage less than €100 million. Four of the 27 vehicles oversee between €200 million and €500 million in capital, whereas five of them manage assets in excess of €500 million. Nordkinn Fixed Income Macro Fund and Danske Invest Hedge Fixed Income Strategies are the largest fixed-income hedge funds in the Nordics, both managing in excess of €1 billion.

## Who tops the fixed-income corner of the Nordic hedge fund industry?

Danish-based fixed-income hedge funds dominate the list of best performers within the NHX Fixed Income. Borea European Credit returned 8.1 percent in the past 12 months through September, clinching the title of the best performing Nordic fixed-income hedge fund of the past year. Swedish fund Scandianvian Credit and Danish vehicle HP Hedge closely follow suit with 12-month returns of 7.8 percent and 6.9 percent, respectively. One-year periods are often too short to judge a hedge fund's performance, and longer time horizons may be warranted. The table below, therefore, displays the best performers in the past three years.

Nykredit MIRA generated an annualized return of 13.9 percent over the past three years, outpacing runners-up Borea European Credit and Asgard Fixed Income Fund, which earned annualized returns of 11.1 percent and 10.9 percent, correspondingly. Nykredit MIRA, a relative-value fund that focuses on Danish mortgage bonds, took the third spot in the "Best Nordic Fixed Income Hedge Fund" at last year's Nordic Hedge Award ceremony. Asgard Fixed Income, meanwhile, was runner-up in the category won by Danske Invest Fixed Income Relative Value. A total of five vehicles earned annualized returns in excess of ten percent in the past three years.

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Federal Reserve building in Washington, DC.

# POSITIONING FIXED INCOME ASSETS FOR THE MARKET SHIFT AHEAD

by Steven Oh, CFA - PineBridge Investments

**Over the past decade, investors in U.S. debt securities have had a good run, boosted in recent years by the Federal Reserve's gradual interest rate tightening. While the global economic climate should remain favorable for fixed income securities over the foreseeable future, we see the seeds of significant macro shifts over the longer term.**

Specifically, we are watching four trends:

- **Global rate normalization.** Rate normalization in the U.S. has been a major theme across fixed income markets during the past several years. Higher rates now may be ahead globally, as the European Central Bank (ECB) as well as the Bank of Japan (BOJ) appear poised to begin tightening sometime in 2019 or 2020.

- **A trail off in U.S. monetary tightening:** The interest rate decoupling that has dominated global markets since the Federal Reserve began raising rates may now go in the opposite direction, as the U.S. is likely to end its tightening cycle both in terms of rate increases and balance sheet contraction, and potentially transition to a loosening cycle.

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- **Less favorable U.S. technicals:** With its rapidly expanding budget deficit set to surpass $1 trillion by 2020, the U.S. will need to increase debt issuance substantially, even as Treasury yields become less competitive. The potential oversupply could meaningfully pressure valuations.

- **Lower returns, greater volatility, wider dispersions**: Today's generally pricier credit valuations and continued signs of a late-stage global economic expansion are setting the stage for lower long-term return expectations and potentially elevated volatility. As the greater dispersions now seen in emerging markets move into developed markets, opportunities are growing for security selection.

Given the possibility of these trends coming to pass, we believe that investors should review their portfolio and consider the following steps to position assets for this emerging transition period in fixed income.

## Paring back riskier credits

Despite an investment climate that has remained favorable for so long, we must not forget that credit cycles have not died. Instead, they have become elongated, with the European sovereign debt crisis and the recent commodity collapse as two recent examples of relatively short-lived selloffs from which the market bounced back reasonably quickly. But long-term corrective declines are inevitable, and when pre-decline excesses are too great, there is a thinner valuation cushion to absorb a downturn. Today, the probability appears to be rising for a credit downturn that will last beyond a quick "buying opportunity" market dip. This implies that investors may be rewarded for paring back the riskier credits that generally have outperformed over the past few years, and focus on fundamentals to determine the strongest risk-adjusted return potential.

## Rethinking U.S. Treasury allocations

Over the past few years, the U.S. bond market has offered a global yield advantage on a foreign-exchange-adjusted basis that has continued to attract investors and support prices despite the Fed's monetary policy tightening cycle. But as the ECB and BOJ begin to increase rates and normalize monetary policy, European and Japanese yields will likely become more appealing to local investors relative to US debt. This should lower global demand at the same time that the supply of U.S. Treasuries is likely to increase

**STEVEN OH, CFA**

GLOBAL HEAD OF CREDIT AND FIXED INCOME

PINEBRIDGE INVESTMENTS

> "As the ECB and BOJ begin to increase rates and normalize monetary policy, European and Japanese yields will likely become more appealing to local investors relative to US debt."

as government debt rises to its highest levels ever.

This technical pressure could have major implications for U.S. Treasuries' traditional role as a safe haven, causing foreign holders of Treasuries to shift back to domestic assets. For example, we believe a yield of 0.5% on 10-year Japanese government bonds will be a level at which a significant portion of bond demand may be enticed to move back home. The same scenarios could play out across other foreign investor segments as well.

While US Treasuries should continue to serve as insurance against extreme market shocks, the supply-demand imbalance is apt to result in greater volatility than in the recent past. As a result, we suggest caution. We continue to prefer U.S .Treasuries over other developed-market sovereign bonds in cases where a move to monetary policy normalization would disadvantage a nation relative to the U.S., but we do advocate for increasing US Treasury allocations at this time.

## Taking a closer look at emerging markets

With greater capacity for expansion, fairly tame inflation, and relatively attractive valuations after a recent selloff, emerging market debt appears to be headed for a long positive run despite growing dispersions across regions and segments. For example, overall volatility has increased for the broad J.P. Morgan Emerging Market Bond Index year to date, but yields for sovereign debt in Argentina and Turkey, for example, have spiked even more. Since spillover from elevated U.S. dollar volatility and tariff uncertainties also are causes for concern, investors should be selective in individual security exposures despite general bullishness.

## Selective de-risking

While we believe markets will remain largely favorable through 2020, negative forces can emerge quickly and unexpectedly. As a result, being slightly more defensive in portfolio positioning makes sense. That translates into a modest dialing back of risk in each segment, reducing high beta exposures and incrementally lowering duration risk profiles, particularly in developed markets outside the U.S., as well as focusing on higher quality credits within segments.

- In **investment grade** credits this can involve trimming BBB allocations and more cyclical sectors, as well as moderately increasing collateralized loan obligation (CLO) holdings. Historically, CLO tranches rated A or higher have suffered no loss of principal when held to maturity.

- In **leveraged finance** we favor higher quality defensive secured loans over high yield bonds, where investors should consider decreasing CCC-rated allocations. In Europe, floating-rate loans may be better than assets prone to interest rate risk, and additional caution is urged for Southern European credit exposures.

- Within **emerging markets**, investment-grade securities may make more sense than high yield debt — although tactical opportunities exist among strong businesses caught in the downdraft of sovereign volatility in countries such as Turkey, Argentina, and Brazil. On the sovereign side, volatility also may present opportunities to invest at attractive valuations during selloffs. Using dynamically managed multisector strategies that have the agility and flexibility to seize opportunities and control volatility may be a good choice for some investors at this time.

## Takeaways

Given what the future is likely to hold, we believe it does not pay to dive into the riskiest parts of the market at this time. In fact, it now appears prudent to begin marginally dialing down risk across and within asset classes. This slightly defensive tilt should help investors lock in past credit gains and better navigate anticipated cycle changes of expected lower returns, greater volatility, and a return to global rate normalization.

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# A big Fish in a Small Pond as the Nordic Corporate Bond Market Matures

By Hamlin Lovell – HedgeNordic

"As we are a big fish in a small pond, the majority of pre-sale processes in the Nordics involve us. We find it is important to meet companies face to face, read the materials, assess security packages and subordination, give feedback, and provide indicative pricing through a syndicate of banks and brokers."

**The Nordic corporate bond market is coming of age. More issuers are getting credit ratings, including from a relatively new agency, ESMA-registered Nordic Credit Rating ASA, though plenty remain unrated. The great majority of large-cap global companies based in the Nordics have a credit rating, usually from S&P or Moodys, but it can be too onerous and costly for mid-cap companies to pay for a rating.**

Though Pareto Asset Management do their own credit analysis and do not actually pay much attention to credit ratings, which have been too lax in some cases, in broad brush terms Pareto Asset Management Portfolio Manager, Stefan Ericson, estimates that: "the Nordic high yield market would have a rating of BB minus now. This might drop to B Plus in a severe downturn, mainly because the market still has a relatively high weighting in energy and shipping. As such, the sectoral composition of Nordic high yield is closer to the US high yield market – where I have worked – than the continental European market".

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Credit spreads are also nearer US than European levels – at around 500 measured in Pareto's base currency of Norwegian Krona (average yields of 630 versus interbank interest rates - NIBOR - of 130). Of course, after hedging into SEK, DKK or EUR the total yield is about 200 lower, but the spread is similar. This extra spread partly reflects the premium that investors demand for the cyclical, "boom and bust", nature of the energy and shipping industries.

## Default cycles

Indeed, there have been bankruptcies and restructurings in Nordic high yield, with one wave around the global financial crisis in 2008, and the next around the oil price crash and oil service market crisis in 2014-2015, which has been described as a deeper crisis than the 2008 one for that particular industry. These cycles of corporate failure - and usually rebirth - highlight one way in which the Nordic market is rather different from US: events and disputes are handled and resolved by out-of-court voluntary negotiations facilitated by the trustees, as opposed to courts. "Nordic Trustee ASA is by far the largest trustee, and the trustee function has been enacted into the legal framework of each of the four Nordic nations" says Ericson.

Defaults are healthy for the market, because investors can now see examples of what happens when a company defaults and restructures. "Some bonds simply swapped into equity while others adjusted maturities, changed amortisation schedules and introduced step-up coupons. The process was more complicated and took longer for firms with bonds issued both under local law and under New York law, such as Seadrill. The Nordic process is not better or worse than the US process - it is just different" argues Ericson.

Overall, the 2014-2015 bond market rout was less severe than in 2008, partly because the energy and shipping percentage of the market was down from 70-80% when Norway accounted for most of the high yield market. "Since 2010, Sweden has started to develop its own corporate bond market, as has Denmark to a smaller degree. Finland in fact has a long established corporate debt market that has been a good source of opportunities for us" Ericson illustrates. The Nordic growth is continuing, enabling a more diversified market resulting in energy and shipping continuously constituting a smaller part of the overall market, currently estimated to around 30%. During the 2014-2015 correction, some of Pareto's strategies saw peak to trough drawdowns of around 18%, pretty close to the 15% swoon in US high yield. Since early 2016, their performance has been steadily climbing.

## Floating rate coupons

Ericson, who also runs a global high yield strategy, points out another difference between Nordic, and US or European high yield markets: lower interest rate sensitivity. Most bonds in the Nordics are FRNs (floating rate notes) and the average duration of Pareto Nordic Corporate Bond fund is about 1.3 years, compared with a typical estimate of around 4 years for US high yield. (Of course, these estimates are subject to some margin of error due to different assumptions around call and refinancing dates). For investors who anticipate interest rates will eventually rise and even normalise, the yield on most Nordic high yield bonds should follow suit.

In the early years of the Nordic markets, Ericson recalls how "investing in high yield was more or less a buy and hold game akin to investing in syndicated loans in bond format. That has now changed, as there are more opportunities for subscribing to primary issues, reinvesting redemption proceeds, and switching between bonds" he points out. One technique used to enhance running yields is capturing capital appreciation from credit "roll down", and Ericson finds the sweet spot here involves holding a five-year bond for three years, until it has two years remaining to maturity.

## Growing new issuance

Primary issuance gives Pareto the chance to help shape the pricing and terms of new deals. "As we are a big fish in a small pond, the majority of pre-sale processes in the Nordics involve us. We find it is important to meet companies face to face, read the materials, assess security packages and subordination, give feedback, and provide indicative pricing through a syndicate of banks and brokers. Our seasoned and senior teams based in Oslo and Stockholm have done this for over 800 companies – a large portion of the market the past 10 plus years. There are some differences between Norway and Sweden, in particular some bonds in Sweden have a much broader investment base. At any one time, we are likely to own 70-80 bonds, diversified by sector" he explains.

**STEFAN ERICSON**
**CFA PARTNER / HEAD OF FIXED INCOME**
**PARETO ASSET MANAGEMENT**

Overall portfolio turnover is around 25-30% per year, implying average holding periods of 3-4 years. The fund does not use leverage, but sometimes has some cash because it takes time to deploy. Active trading decisions recently have included selling out of some bonds issued by property builders, for fear of a property downturn.

The Nordic high yield market is now worth about EUR 50 billion, and as such ranks as the sixth biggest in Europe. With assets in Nordic high yield of close to 5.8 billion NOK (EUR 600 million), Pareto makes up just over 1% of the market. Ericson is confident that the strategy could manage at least EUR 1 billion (at Carnegie, Ericson ran peak assets of around EUR 2 billion in 2014, including some investment grade, when the market was about 40% smaller).

This indication of capacity should rise as the market grows. Ericson expects that "the market will continue to grow because regulators, policymakers and central bankers are keen to foster the growth of capital markets and reduce dependence on bank finance. We may not reach US levels, but could see capital market funding of companies rise from 25% to 35%".

Ericson is "not sure when the next distressed cycle will occur, but does not anticipate owning many distressed bonds, because the fund is not a specialist distressed fund, and getting involved in workouts and restructurings can be too time consuming relative to the upside. Staggered maturities are intended to reduce exposure to companies that hit a wall when trying to refinance during a credit bear market".

When the next credit market downturn comes, Ericson hopes that "the fund's good relationships with 17 counterparties will be helpful in sourcing liquidity – to sell out of distressed names, ideally before they become distressed. Currently, the strategy owns tiny scraps of two C-rated bonds, one being distressed claim and the other a remnant of a restructuring that has deferred coupons".

For the time being, Ericson finds that Nordic corporate bonds offer relatively attractive yields and spreads versus the default risk, and the continued market growth is constantly expanding the potential to enhance portfolio diversification by country, industry and company risk.

By Jens Nystedt, Senior Portfolio Manager, Emso Asset Management

# BEYOND THE BENCHMARK

While being exposed to the major emerging markets ensures holding the market beta, it provides very few diversification benefits.

Fixed income investments in Emerging Markets have traditionally been made through funds that closely track the main fundamental benchmarks. However, limiting EM fixed income investments solely through benchmark driven funds can pose significant downside. Problems with this approach include the risk of missing new opportunities, having excess exposure to frequent issuers rather than to those with positive risk-return characteristics over the medium-term, and the loss of potential diversification benefits that emerging market fixed income investments provide in a global portfolio. We would instead advocate that an investor should consider an alternative investment vehicle: a benchmark agnostic approach that identifies opportunities irrespective of the country's or instruments' inclusion in a benchmark.

**Investing in EM fixed income through fundamental benchmark driven funds limits diversification opportunities.** Popular benchmarks utilized historically by traditional asset managers typically cover only a



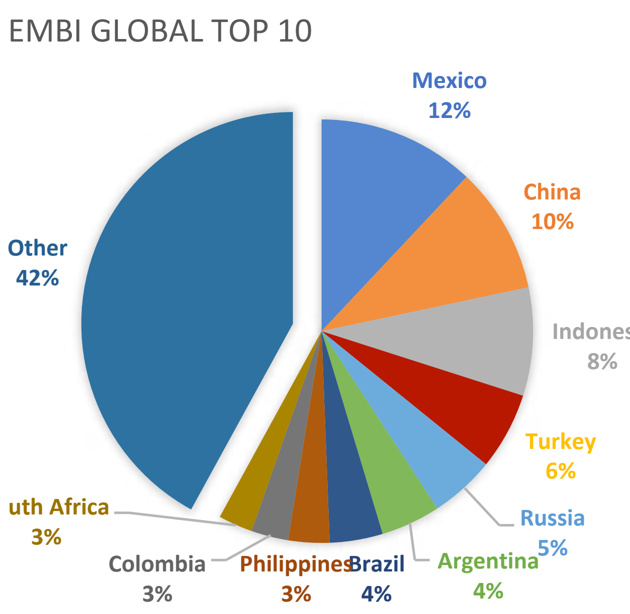


subset of markets deemed to have sufficient liquidity and easier access for foreign investors. In the case of the JP Morgan GBI-EM Index (GBI-EM), which tracks local currency fixed income, only 19 out of 32-35 reasonably accessible EM countries are included. Moreover, given tighter regulation and capital controls, two of the largest local EMs, China and India, are not included. With regard to hard currency assets, benchmark coverage through the JP Morgan EMBI Global Diversified Index (EMBIG) is more comprehensive with more than 67 countries in the benchmark.

But this Index is also heavily concentrated – with the top 20 countries accounting for 63% of the Index's total market capitalization (see Charts 1 and 2). On the corporate side, the main EM fixed income index, JP Morgan CEMBI Broad Diversified (CEMBI), covers 50 countries, but is also heavily concentrated with four sectors accounting for 67% of the index. (Financials comprise 30% of the index, with Oil & Gas at 14%, TMT at 12% and Utilities at 10%.) Along with industry concentration, this Index also has heavy country diversification. The top 20 countries in this index account for 82% of the total market capitalization. Another longer standing issue with the main EM corporate benchmark from JP Morgan is that, in our view, it treats many quasi-sovereigns as EM corporates, unless they're 100% sovereign owned. We believe that even these "nearly" 100% sovereign owned quasi-sovereigns are more akin to pure sovereign risk and trade directly linked to the sovereign rather than their own fundamentals.

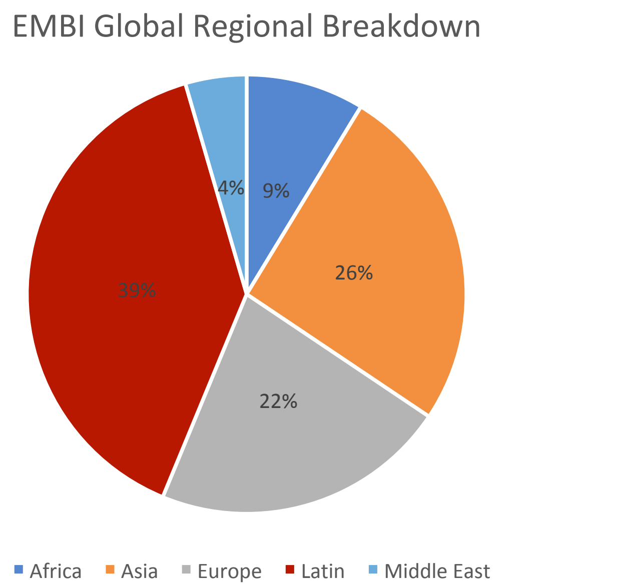
**Does it affect performance and risk characteristics to be concentrated in the major EM fixed income markets?**
While being exposed to the major emerging markets ensures holding the market beta, it provides very few diversification benefits. The market beta can still be attractive during favorable global financial conditions, decent global growth, and supportive commodity prices. However, the beta works against the investor because of the large monthly drawdowns during risk-off periods, e.g. the 2013 Taper Tantrum. Moreover, the GBI-EM shows a very high correlation with the US dollar (denoted as the DXY) as illustrated in Figure 1.

**CHART 1: DIVERSIFICATION OF THE EMBIG INDEX**



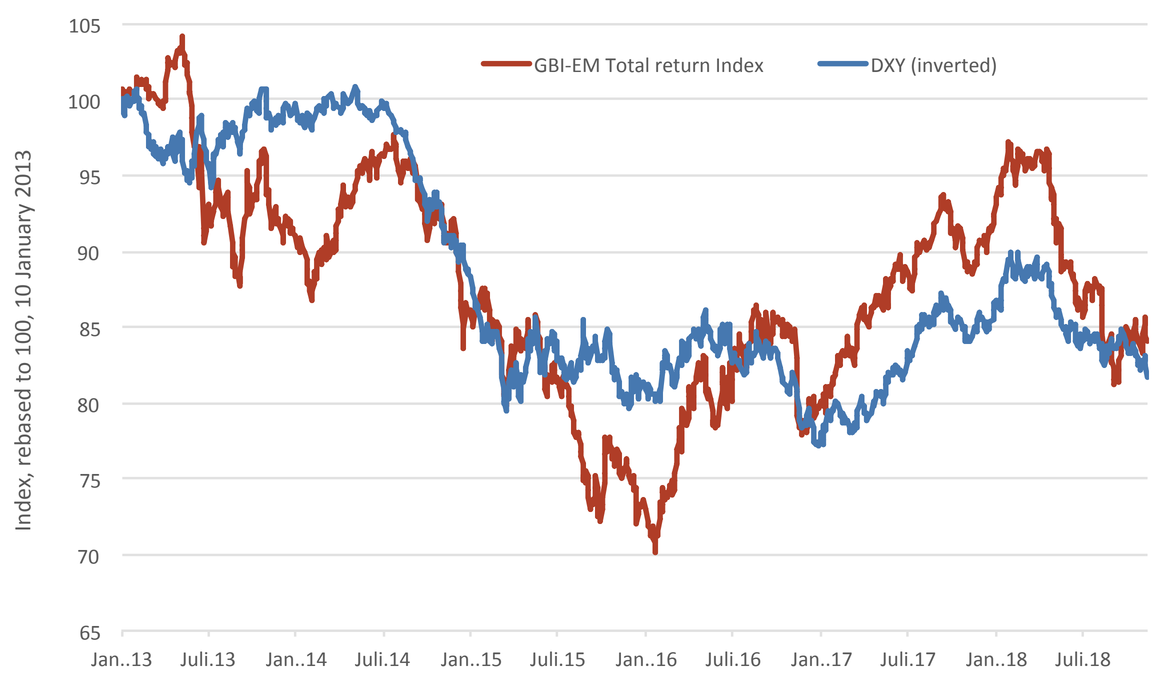

Source: JP Morgan.

**CHART 2 – REGIONAL BREAKDOWN OF THE EMBIG**




Source: JP Morgan.

**FIGURE 1. GBI-EM A HIGHER BETA/CARRY VERSION OF AN ANTI-US DOLLAR**




Source: JP Morgan, Bloomberg

In the case of hard currency sovereign assets, the investment grade component has a high correlation with US Treasuries (UST) given low credit spreads. Idiosyncratic opportunities are found among the high yield EM countries, particularly the frontier markets, such as those countries compromising the JP Morgan Next Generation Market Index (NEXGEM).

Frontier markets by their very nature of being smaller in outstanding issuance size do not command the same research coverage as the larger benchmark names. Hence, it is in these countries that an independent, bottom-up research process which identifies the macro and political drivers has the greatest potential to generate the most favorable investment returns. These returns are often idiosyncratic to the top-down macro drivers, such as the broad US dollar view or actions of the US Federal Reserve, such that positions in frontier EMs can often help to diversify a portfolio. The drawback of frontier exposure is often in the form of the liquidity of the positions and therefore, investment in frontier EMs requires active consideration of position sizing.

Since the global financial crisis, NEXGEM has offered a more appealing risk-reward calculation than either the EMBI Global or its investment grade sub-component. From a Sharpe ratio perspective, we find allocations to EM corporates, proxied by the CEMBI, have performed better, but at the cost of lower overall total return as shown in Table 1. Moreover, EM corporate benchmark volatility is biased significantly downwards given the much lower duration of the index. EM corporate bond issues are generally of a much shorter maturity than those of comparable sovereigns.

In addition, EM corporate bonds are generally subject to lower liquidity, which means that the actual price levels in the corporate bond space often do not accurately reflect transactable prices at comparable volumes to sovereign bonds and that they also move less.

From a correlation perspective, NEXGEM has had a near zero correlation to UST and would tend to outperform in a higher global yield environment where the higher yields are driven by higher global growth and supportive commodity prices. Since the global financial crisis, NEXGEM's correlation with oil prices has been slightly higher at 0.30 than the EMBI Global at 0.24, due to a higher weighting of commodity producing constituents.



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**Table 1. Frontier Markets, proxied below by the JP Morgan NEXGEM Index, have performed well since the Global Financial Crisis**

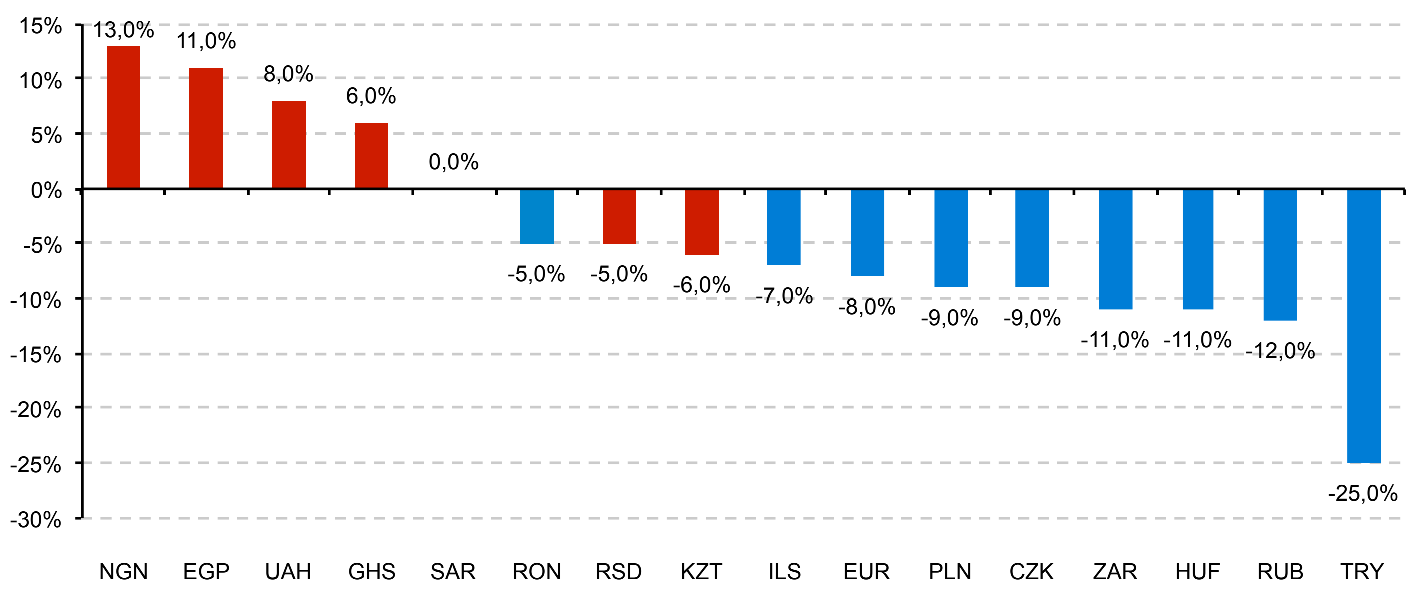
| | Annualized Return | Annualized Volatility | Sharpe |
|---|---|---|---|
| CEMBI BD | 4.8% | 4.8% | 1.0 |
| NEXGEM | 7.4% | 7.9% | 0.9 |
| EMBIGD | 5.2% | 6.3% | 0.8 |
| S&P 500 | 9.1% | 11.8% | 0.8 |
| EMBIGD IG | 4.4% | 6.0% | 0.7 |
| US Treasuries | 2.3% | 3.4% | 0.7 |
| DXY | 2.1% | 7.8% | 0.3 |
| GBI-EM GD | 1.7% | 11.7% | 0.1 |
| MSCI EM Equities | 1.1% | 17.3% | 0.1 |

Using data since Dec 31, 2009 to July 31, 2018, source Bloomberg

**Where do we stand now?** Given the renewed weakness in October, following the partial recovery in EM fixed income in September from the underperformance this summer, we like select sovereign hard currency high yield assets, particularly among the frontier countries, such as Angola.

In EM local fixed income, for unconstrained long only strategies, we see potential opportunities in Egyptian T-bills and the Nigerian Naira, both of which outperformed year-to-date (see Figure 2), as well as in select Argentine peso-denominated debt instruments. Although each of these opportunities offers exposure

**FIGURE 2. FRONTIER MARKETS HAVE OUTPERFORMED EMEA YEAR TO DATE**




Total FX return vs. USD including carry or T-bill/govt bond return if more representative, since 01/01/18. Specifically, 12m Tbill used for NGN, and EGP, 3y govt bond for GHS, 12m NDF for KZT and UAH; 12m FX forward for remaining currencies. Source: JP Morgan, Bloomberg. Data as of 31 November 2018 to on-the-ground local drivers at high domestic interest rates, these instruments are currently not part of the benchmark indices. This exposure to higher yielding credits is matched by a select exposure to lower yielding sovereign credits in the Middle East, where we believe that fundamentals are still likely to improve against a backdrop of supportive oil prices as well as the likelihood of index-inclusion to the major hard currency sovereign benchmarks to start by year-end.

This is not to say that we don't see any idiosyncratic opportunities in the main benchmark countries. The number of elections in emerging markets in 2018 offered several potential idiosyncratic opportunities for countries that are included in the benchmarks.

The market reaction to Andrés Manuel Lopez Obrador's clear win in the Mexican Presidential election on July 1 was very positive, particularly for the Mexican peso, which had seen significant hedges being built ahead of the elections. Subsequently, as the President-elect is ready to soon take the helm, some recent less investor-friendly signals, including the likely cancellation of the new Mexico City Airport project, have hurt market confidence and Mexican financial assets.

Turkish assets, initially struggled significantly, losing more than 20% of their value year-to-date, on the back of a clear win by President Recep Erdogan and the subsequent cabinet appointments and worsening of relations with the United States. However, a convincing monetary policy response by the Turkish Central Bank as well as the release of the US pastor have stabilized market sentiment for now with the Turkish lira still showing signs of being undervalued.

And finally, the election of the right-wing candidate Jair Bolsonaro helped lead a recovery in Brazilian asset prices, and the market is now hopeful for more aggressive fiscal and structural reforms that would put the debt to GDP path back on a sustainable track.

**Conclusion:** A bottom-up, benchmark agnostic investment approach allows, in our view, sufficient flexibility to not only invest in appealing EM fixed income opportunities, identified by a rigorous bottom-up research process, but also to implement top-down macro hedges. This approach would also allow for navigation during periods of risk-off sentiment while generating diversification benefits to a global fixed income portfolio.

**JENS NYSTEDT**

**SENIOR PORTFOLIO MANAGER**
**EMSO ASSET MANAGEMENT**

# The Credit Cycle: Maturing, but not Rolling Over yet


by Hamlin Lovell – HedgeNordic

## SECTOR AND NAME SELECTION KEY

Asgard Credit Fund manager, Daniel Vesterbaek Pedersen, expects that the credit cycle could have at least another year or two to run, but he is quite cautiously positioned ahead of the eventual tipping point - choosing sectors and names carefully, and completely avoiding long exposure in certain areas, including US technology and European financials.

Pedersen disputes the consensus view that the US economy is at full employment and that the credit cycle is at a very late stage. "Headline US unemployment rates of 3.7% - which have historically preceded recession - appear to be at a 50 year low, but ignore those who have dropped out of the labour force. Employment rates of 79.7% for those of prime age (25-54) are actually 2% below the previous peak of 81.7% seen in 2000" he says. Therefore, Pedersen believes that there is spare capacity in the US economy. The growth rate of the economy might not peak until 2019 or 2020. This also explains why average wages are only growing at around 3%, which in turn helps to keep inflation under control; Pedersen reckons, "wage growth in the area of 4% would be needed to push inflation permanently over the Fed's 2% target". This also means the market consensus is factoring in too many hikes in the US Fed Funds Rate, which may not hit 3% by the end of 2019.

For now, many US economic statistics, such as capex up 7% annualized in 2017-2018, retail sales up 5% annually also in the last two years, and industrial production has been accelerating for three years now and is up 5.1% YoY as of September 2018. The acceleration in growth is partly due to deregulation and tax reform. The market has sold off during the last couple of month. Consequently, Pedersen views selected US corporate bonds as offering the best spread versus risk, hence they are the largest weighting. Pedersen is avoiding several sectors, including technology, due to rising regulation; autos, owing to downgrades and auto loan sensitivity; and basic materials, as spreads are too tight.

## MEDIUM TERM RISKS

Pedersen expects average annual default rates to remain pretty low for at least the next year, at around 2.5% in the US and 2% in Europe. This is partly because it takes 12-24 months for Fed rate rises to feed through to corporate balance sheets, and Pedersen does not expect the ECB will begin raising rates until 3Q 2019.

But he does see potential for an explosion of default rates at some stage. Pedersen reminds us that "the past 30 years have seen two multi-year episodes when the cumulative default rate exceeded 30% in high yield: 1988-1992 and 1999-2003 (and also during the depression, 1931-1935). And it was about 25% from 2008-2012. When the economy does break, you will see default rates spike and spreads massively widening".

What's more, "corporate leverage at 45.5% of US GDP is close to its three prior peaks of 43% in 1990; 44.5% in 2002, and 45% in 2009 - and it has reached these levels without a recession. When a recession comes, corporate leverage will further increase, as will debt to EBITDA ratios. Meanwhile, recovery rates tend to fall in a recession" he recalls. Corporate leverage is already guiding sector selection: "the increase in leverage is more than priced in in terms of credit spreads within IT services whereas this is less clear within energy and health care" says Pedersen.

As Europe is at a later stage of monetary policy normalisation than the US, Pedersen believes that European credits will eventually be most vulnerable, for several reasons. The absolute level of yield is so low that some companies may struggle to service debt when rates move towards more normal levels. Whereas the Fed only bought Treasuries and mortgages, ECB asset purchases encompassed a much wider range of assets, including asset-backed securities, covered bonds, and corporate bonds – and will cease net buying in December 2018.

Investors are already starting to price that in: "European investment grade corporates have widened by almost 50 basis points and names that are close to getting downgraded have seen their spreads blow out by 100 basis points in a week, which translates into a mark to market loss of 5% on a five-year bond" says Pedersen.

## VALUE EMERGING IN EUROPE

His strategy, which is currently net long, has not been immune from market volatility. It lost 3.5% in October, and it is down 1.1% year to date as of November 13th - and more value is starting to emerge, and Pedersen is constructive on the economy. He judges the European economy to be well below potential growth rates, and argues that women going back to work, especially in Italy, can enhance growth. For instance, female participation in Spain has risen by about 10%-points, following similar moves seen in Germany and the Nordics. This has not yet happened in Italy.

Pedersen is selectively buying some liquid and cash-rich European BB credits, which can yield around 3%, and is switching into longer dated bonds to take advantage of the steeper curve. In the local Danish market, only three names meet Pedersen's liquidity criteria, and he judges one of them - Maersk - to be attractive at a spread of 200. Similarly, some Finnish corporates are interesting but there are not that many liquid ones. Swedish corporates trade too tight for Pedersen's liking however. Elsewhere, "investment grade credit in Europe now offers a spread of 132 basis points that is slightly higher than the US" he says.

Pedersen has the freedom to select from both the high yield and the investment grade corporate universes, in contrast to some silo managers who may be forced to sell paper that gets downgraded. Pedersen pays more attention to fundamental analysis of balance sheet strength, debt burdens and interest rate costs than he does to credit ratings. Pedersen views the lower end of the BBB corporate segment in Europe as too risky, paying just 1.5% against 4.25% before 2008.

Pedersen's general focus is on corporates but in one Southern European market, Pedersen prefers the sovereign. Having spent more than a year short of Italian bank debt in a trade started at a spread of1.50%, he now finds it is worth owning Italian government bonds at a spread of 3% - but sizes this position in the same way as a corporate name, at a few percent of NAV. By way of contrast, Pedersen does not find Italian (and Spanish) industrials attractive at the same spread as comparable US companies. He believes they should offer a yield premium for taking on European peripheral risk.

The long Italian sovereign is paired against shorts in some Italian bank paper. In other financials, Pedersen is simply standing aside rather than being short. Certain categories of European financial debt have sold off, arguably in sympathy with European bank equities down around 15-40% in 2018, and some managers are drawn to the yield pickup.

Pedersen disagrees: "I am very sceptical on AT1 and Cocos. The prospectus of AT1 bonds warns you that the coupon is at the full discretion of the management. Cocos were specifically designed to absorb losses in the next crisis. They behave okay when the economy and the capital market is okay, but are the worst bonds to own when the market breaks. The yield premium is a jump risk premium, which is the worst kind of premium to be exposed to".

"I want to create a portfolio with as much yield and carry as possible, and as little tail risk as possible" he adds.

Asset backed securities and aircraft leasing certificates are also avoided for now. They are the types of more exotic instruments that he might look to buy when and if a recession leads to substantial spread widening.

## BASIS TRADES

Pedersen has the flexibility to choose between cash bonds and CDS – and sometimes uses both to create a negative basis trade, with positive carry, on the same name. As cash yields have increased by more than have CDS, it can be worthwhile to buy the cash bond and hedge it with CDS, but the yield gap is nowhere near as wide as it was in 2008 – and Pedersen certainly expects that this basis could go more negative in a crisis.

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# Danish Covered Mortgage Bonds: A Unique Asset Class

*by Hamlin Lovell – HedgeNordic*

Denmark's covered bond market dates back to 1787, and is about four times larger than the country's government bond market. Nearly every building in the country - residential and commercial - has a mortgage, that passes through its interest and principal repayments into a bond.

> "Our macro view is that Eurozone interest rates should stay lower for longer than consensus forecasts suggest, and that longer-term interest rates will spike as the ECB ends QE."

Mortgages are securitised, but not split into derivatives such as interest only and principal only loans as they are in the US. Unlike "Fannie" and "Freddie" agency bonds in the US, very few Danish covered bonds have a government guarantee in terms of credit risk - and individual borrowers have defaulted – but covered bonds have never defaulted in 231 years. Denmark has no "sub-prime" market; loan to value ratios are conservative (generally below 80%); and lenders have full recourse to borrowers' other assets and income, for life! (in contrast, US mortgages are non-recourse and most countries have statutes of limitation barring creditors from chasing debtors, beyond a certain number of years after they declare bankruptcy or insolvency). All issuing entities have an S&P AAA rating.

In Europe, Denmark's covered bond market is ranked second only to that of a much larger economy, Germany. Ratios of mortgage debt to GDP appear to be relatively high in Denmark, but the other side of the balance sheet should also be considered. Thanks to decades of compulsory pension saving, covering the whole workforce, Denmark has very high levels of pension fund assets, which invest in mortgage bonds.

## LEVERAGE AND SPREADS

Given that credit risk has historically been a theoretical phenomenon, investing in Danish mortgage bonds is mainly about earning a spread, and expressing views on interest rate risk, or prepayment risk, or both - and sometimes assessing structural changes around regulation or foreign flows. Spreads have come down to around 0.42% over Danish governments, for five-year bullet fixed rate mortgage bonds, with no prepayment risk. 30-year callable fixed rate mortgage bonds, which have prepayment risk, offer higher spreads: around 0.77% over governments.

Spreads and yields that look low in absolute terms can still be attractive, particularly for investors in other countries with negative interest rates, such as Japan, a key source of foreign investors in the Danish market.

Additionally, spreads can be magnified up to a larger return, by obtaining leverage at negative interest rates, using repos. "We are able to get leverage at a cost of -0.4% after all expenses" says Formulepleje Director, Søren Astrup.

Some hedge funds use as much as 10 or 15 times leverage to multiply spreads, and attempt to hedge out interest risk as much as possible. These funds can be mainly a play on spreads and prepayment risk, and can show correlations of near zero to Danish government and covered bond markets.

Formulepleje in contrast uses around four times leverage, and - while employing some interest rate hedges - also expresses views on both interest rate, and prepayment risks, and has exhibited an average correlation of nearer 0.7 to Danish government bonds. The firm recently celebrated its 30th anniversary, and its senior portfolio

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managers, Erik Alfred Bech and Rene Rømer, have been managing covered bond strategies for 12-13 years. The company has DKK 37 billion (EUR 5 billion) invested in Danish mortgages, making up roughly 1.4% of the total market size of DKK 2,800 billion (EUR 380 billion).

## INTEREST RATE RISK

"We avoid floating rate securities, and have 60% invested in "bullets" with 40% invested in callables, where borrowers have a call option on early repayment" says Bech.

The strategy with the bullets is to optimise maturities by taking views on the yield curve. Currently, "we find the best value is in bonds with three to four year maturities. Our macro view is that Eurozone interest rates should stay lower for longer than consensus forecasts suggest, and that longer-term interest rates will spike as the ECB ends QE" explains Bech. Presently, the strategy has an unleveraged modified duration of 2.2 years, which grosses up to around 11 years, given 4 times leverage.

Of course, Formuepleje does not always accurately forecast interest rates. In early 2011, they were taken by surprise when the ECB, under Trichet, raised rates – but still outperformed the benchmark in that year. Conversely, 2014 was the only year since 2009 when they underperformed the benchmark, partly due to overestimating the extent of interest rate rises.

Danish interest rates are currently 0.25% below Eurozone rates, and repo rates follow government bond yields closely. "Negative rates are a bonus but not essential for the strategy, which does crucially need an upward sloping yield curve. This is because the "roll down" is a key source of returns. For example, over one year, as a four-year bond becomes a three-year bond, a lower yield leads to capital gains" explains Rømer.

## CALLABLE BONDS AND PREPAYMENT RISK

"In contrast, carry generates a higher proportion of returns in the callable bucket of the strategy. We use models from Nordea and other banks to assess prepayment risk, and borrowers, who are not investment professionals, may behave irrationally. The borrower's call option is a kind of Bermudan call option, as it is path dependent" says Bech.

**SØREN ASTRUP**
DIRECTOR & PARTNER
FORMUEPLEJE A/S

**RENE RØMER & ERIK ALFRED BECH**
PORTFOLIO MANAGERS, FORMUEPLEJE A/S

"We also take a bottom-up approach to selecting individual bonds that have the least redemption risk, such as longer-dated, ten to fifteen year bonds, that are less sensitive to call risk" continues Bech.

"The strategy aims to maximise Sharpe ratios and need not pay any attention to the benchmark composition" he adds.

The strategy's banner year, 2013, when it outperformed the local market by 10%, was partly due to a shrewd and non-consensus prediction of prepayments. "Banks, which earn fees from prepayments, ran advertising campaigns encouraging borrowers to refinance and shift to floating rate mortgages, based on a 1 year bullet bond, but this came to an abrupt end after the credit ratings agencies threatened to downgrade the entire sector. Prepayments then settled down to much more normal levels" recalls Rømer.

The managers also made a smart move by reducing leverage in the spring of 2015, before the new Basel II Liquidity Coverage Ratio (LCR) rules forced local banks to sell mortgage bonds. (Danish Government bonds are classified as category 1a under LCR, whereas Danish covered mortgage bonds are classified as 1b). After the selloff, the managers rebuilt their exposure later in the year.

"The exception to the two core Danish covered bond strategies is a 5% allocation to Swedish covered bonds, which has eliminated both interest rate and currency risk, in order to focus only on the spread risk" says Bech. The firm does not follow Norwegian covered bonds.

In the current climate, the managers are somewhat cautious about some parts of the Danish market. "We are not inclined to try and pick up illiquidity premia from investing in less liquid bonds. These premia are quite low at the moment, and the most important thing is to maintain a liquid portfolio so that we can sell when we need to" says Rømer.

"The Danish mortgage market still had good liquidity even in the worst days of the financial crisis in 2008" says Astrup. Those who needed to sell bonds, could do so. Investors who were able to hang onto the bonds did not lose money. Though property prices in major Danish cities dropped by up to 25%, and some homeowners facing negative equity were forced to sell homes at auctions, bondholders carried on clipping their coupons, and saw a strong recovery in 2009.

MIKAEL HULDT

HEAD OF ALTERNATIVE INVESTMENTS

AFA INSURANCE





# Q&A with AFA´s Mikael Huldt on Direct Lending

***By Kamran Ghalitschi, HedgeNordic***

“My conclusion was that banks will find it harder to lend to these companies under the new regulations. They want to work more as syndication partners, which has been a long lasting trend in the US where banks have a very small part of the lending activities.”

**AFA Insurance was one of the early adopters in the Nordics when it comes to private debt. In recent years, the Swedish insurance company has added exposure to direct lending as they see opportunities for the asset class in the light of changing banking regulations. In an interview with Hedgenordic, AFAs head of alternative investments, Mikael Huldt (pictured), gives his view on direct lending as an asset class and shed some light on AFAs investments in the space.**

## How does AFA incorporate direct lending into its alternatives portfolio?

AFA made their first investments into private debt a long time ago, I think the first investment that was done within loans stretches back to 2007/2008. These investments were then put on hold for a number of years and no targeted allocation towards the space was done during this time period. Private debt investments were not separated during this time but rather put into the Private Equity portfolio.

When I joined AFA in the autumn of 2015, I quickly realized that private debt was going to be a very interesting investment but it needed to find a “home” in our investment universe. It was not fair to compare the returns of private debt to those of PE-investments, we argued.

I therefore created a private debt bucket amounting to approximately 3 percent, corresponding to approximately SEK 6 billion, with the purpose of being able to invest in things that has lower expected return and risk compared to PE. What we today have is a barbel strategy within the alternative investment portfolio where the private equity investments are there to generate higher returns to a higher risk whereas private debt is the low return/low risk part.

## What expected return do you set for the strategy?

We have a return target of the private debt portfolio over the longer term of 6-7 percent. The goal we had when setting up the private debt structure was to find strategies that would prevail for the longer term and that were not dependent on shorter term market conditions, for example we were looking for strategies that would still work well should the interest rate environment normalize.

## Why did AFA decide to go with direct lending?

I believe currently that there are a number of strategies within the private debt space that are doing well simply as a result of the low rate environment, some strategies within infrastructure debt would be some of those examples.

I started looking at strategies within private debt where I believed returns came from something else than just as a result of the low rate environment and the quantitative easing from central banks. What I looked specifically at was the changes in regulations such as the Basel accords and what impact that had on the bank's lending activities to small and mid-sized companies.

My conclusion was that banks will find it harder to lend to these companies under the new regulations. They want to work more as syndication partners, which has been a long lasting trend in the US where banks have a very small part of the lending activities, in Europe, the banks are still the major lenders but that will likely change. As a result of this we believe direct lending will be a strategy that will prevail for longer, which is why we invest in the strategy today.

## Describe the manager sourcing process and implementation in portfolios

What we have done in the direct lending space is that we have focused on the US and Europe. We did a

> "We believe the skill of a manager in the direct lending space shows in how well he manages the downside of the portfolio. One of the most important differences we see with this asset class compared to high yield and levered loans, is that recovery rates are much higher. "

thorough research before deciding on the allocations where we screened about 70 managers in the US and around 40 in Europe. We mapped the market according to the size of the managers, how they lend and what individual qualities they had. We have decided to go with larger and established managers since we believe this is a volume business, especially when sourcing deals you need to have a wide range of capabilities, which smaller managers typically don't have, We also decided to go with names that have managed assets in difficult environments such as during the financial crisis, and who have proven their abilities in these markets.

We believe the skill of a manager in the direct lending space shows in how well he manages the downside of the portfolio. One of the most important differences we see with this asset class compared to high yield and levered loans, is that recovery rates are much higher. This I believe has to do with the fact that there is a closer and more long term relationship between lender and borrower within direct lending than compared to levered loan syndicates, for example.

Our investments are done through funds and we have allocated a majority of what we had anticipated in the first round. Now it is all about evaluating how they have performed and whether they deliver in line with expectations.

Regarding the liquidity of the investment, one positive thing is that the Solvency 2 framework sees non-rated and non-traded loans as less risky than traded high yield loans for example. This is an advantage for us being an insurance company where we can allocate from liquid rates to direct lending and lock-up capital, thereby gaining an illiquidity premium of 150 to 200 basis points to the same risk profile.

## What risks do you see with the asset class?

The risk I see with the investment is that direct lending has seen tremendous inflows in recent years, which could potentially lead to a less disciplined approach as managers are eager to gather as much assets as possible.

I see some managers being influenced by the levered loan market where there is a large portion of non-covenant deals. Should this enter into direct lending, that would be s warning sign for me since it means that the ability to act swiftly when markets turn more difficult disappears.

What is important as an investor in the space is that you can trust the manager not to tamper with the credit quality of the underlying investments. It is very difficult to have a detailed view on the covenants in the underlying deals, you need to have faith in the process and the manager behind the program.

In terms of transparency, we have full transparency on the loans underlying the investment.

One piece of research we have done is that we looked into the managers that are receiving the highest inflows and see to what extent they have also increased the investment teams. Our conclusion was that some of the managers with the largest inflows are doing twice the number of deals per employee compared to others, the question you then need to ask is whether they then can keep the same investment discipline and credit quality.

**ABOU AFA:**

AFA Insurance is owned by Sweden's labour market parties: the Confederation of Swedish Enterprise, the Swedish Trade Union Confederation (LO) and The Council for Negotiation and Co-operation (PTK). We insure employees within the private sector, municipalities and county councils. AFA Insurance does not seek to generate a profit, which implies that no dividends are paid to the shareholders.

Insurance plans are based on collective agreements or other agreements between Sweden's labour market parties.

AFA Insurance administers the insurance provided through these plans..

AFA had its first insurance claim in 1963, and since processed more than 10 million claims

**AFA INSURANCE IN FIGURES:**

Approximately 650 employees

Number of insureds: 4,7 million

Benefits paid to insureds: just under SEK 10 billion

Assets under management: approximately SEK 200 billion

According to Bezalel, being unconstrained is key as financial markets are shifting gears, likely entering a period of more volatility as the credit cycle is nearing its end.


# Dynamically Different

***By Kamran Ghalitschi – HedgeNordic***

Jupiter's Ariel Bezalel on why a truly unconstrained approach to bond investing is key as we are nearing the end of the credit cycle.

Ariel Bezalel is the fund manager behind the Jupiter Dynamic Bond, a fund that uses an unconstrained approach to investing in fixed income markets globally. According to Bezalel, being unconstrained is key as financial markets are shifting gears, likely entering a period of more volatility as the credit cycle is nearing its end.

"The low volatility regime has run its course and we are seeing more challenging market conditions ahead. This requires a very flexible approach in order to find pockets of alpha and to swiftly shift exposures and to actively hedge currency and credit risks", Bezalel explains continuing:

"Financial markets are currently in a state where macro events globally are making volatility creep into the markets. We have seen significant volatility in currencies, especially within emerging markets. Government bond markets have definitely been more concerned about rates. In credit markets, there are elevated concerns that we are coming to the end of the credit cycle."

"The beauty of having an unconstrained approach is that you have a wide array of tools ready to express your views according to how you may see the landscape evolving. We can trade everything from government bonds all the way down to distressed. As we currently believe that we are near the end of the credit cycle we are moving up in the credit rating spectrum buying into higher rated assets. Within our mandate we can also hedge out some risks using credit default swaps."

Bezalel highlights the fund's flexibility in terms of adjusting duration.

"We have enormous flexibility in terms of adjusting duration exposure. We have the ability to reduce spread duration in corporate debt, which is what we have been doing, but on top of that, given our view that growth is to disappoint in the coming months and that we are in a lower for longer interest rate environment, we have the ability to increase duration through the government bond market."

## An approach benefiting from increased uncertainty

It is not the first time Bezalel is up against volatile markets. He has successfully managed the fund through all sorts of market scenarios and it is in more stressed market environments that his approach, in relative terms, has added the most value to competing products.

"I think the way we manage the fund is really quite different. There are other so-called unconstrained funds out there but they are typically limited as to how much risk they can put in different parts of the market and don't tend to be as macro aware as we are. We form our view of global financial markets through extensive macro analysis and take positions where in the parts of the fixed income markets that will perform best in certain scenarios."

We have been running this strategy since 2008 and this SICAV fund since 2012, and have weathered storms before.

## A non-consensus view

The fundamentals that Bezalel refers to are very much linked to the development of the US economy, where the manager sees conditions as being late cycle with low risk of significant inflationary pressures going forward. This is in contrast to the consensus view that higher inflation will filter through to the US Federal Reserve hiking rates more aggressively.

"If we were to see aggressive reflationary policies around the world we would need to revisit our view, but what we are seeing is very much the opposite." Bezalel says citing tighter liquidity conditions, tighter monetary policy from the Fed and ongoing tightening of policy as the Fed is reducing the balance sheet, a process know as Quantitative Tightening. This is currently running at a pace of USD 50 billion a month. All this tightening is likely going to be too much for the global economy to bear so the recent spurt in volatility is not too much of a surprise to Bezalel.

The big move that the portfolio is positioned for is, according to Bezalel, a situation where the Fed capitulates on it's attempt to "nomalise" rates and may even have to consider easing policy once again.

"We are looking for an event where the Fed says, ´ok we are not going to hike four times in the coming twelve months'. Beyond the December hike, which looks baked in, we think that the prospects for further hikes is a bit more clouded. Given concerns about trade wars, Italy, worries about the growth picture in China and recent concerns around corporate profits, there is potential for decent downside, especially given that we have had a bull run for ten years now and credit spreads in developed markets are pretty much at the tights."

"We are holding on to our lower for longer stance and are not afraid of duration at this juncture. We have been buying US treasuries as well as Australian government bonds to reflect this view. It's important to note that because of our growth concerns surrounding Australia we have hedged out the currency risk here."

> "The beauty of having an unconstrained approach is that you have a wide array of tools ready to express your views according to how you may see the landscape evolving."

## The case for a diversified fixed income exposure

Bezalel makes the point of having a diversified approach to fixed income investing, which can become even more important at times when the market looks vulnerable.

"There are currently a lot of pockets of idiosyncratic risk that investors need to be aware of and positioned for. We are seeing risk creeping into corporate credit markets with individual bonds collapsing 10 to 20 points on a more frequent basis."

"There is a great quote by Warren Buffett saying that when the tide goes out we will see who is swimming naked. We are beginning to see concerns about individual businesses and potential black holes in the accountings of certain companies, which is symptomatic of late cycle."

"The way we approach the bond market is that we are running a fairly diversified portfolio, essentially a barbell strategy, where we have our top picks and trade across many markets, including emerging markets. We use the high quality triple A government bond markets as risk mitigation from a deflationary shock, which we see as increasingly likely. From an investor standpoint I think it makes sense to apply a dynamic approach to bond investing and in our case you get an approach that is dynamic and very different to most other funds out there."

## ESG Investing in Fixed Income:

# A proprietary and tailored approach is needed

An ESG approach applying to equities cannot be transplanted to corporate bonds. There may be much common ground on the 'E' (Environmental) and 'S' (Social) but there could be conflicts on the 'G' because, "good equity governance is not necessarily good bond governance" says Kames Capital Co-Head of Fixed Income, Adrian Hull. Shareholder friendly behaviour may be creditor unfriendly.

An easily foreseeable example is when borrowing to fund buybacks or dividends reduces a company's cash-flow and collateral coverage ratios, and its credit rating. More egregious examples can include shareholders (possibly using so-called "phantom guarantees" or "trapdoors") appropriating assets out of creditors' reach, which can reduce recoveries upon default. And management remuneration is usually geared to shareholder and not creditor returns. Kames does its own analysis as "many third-party suppliers of ESG ratings view governance through the lens of an equity investor" according to Hull.

The modus operandi is also different because shareholders can use proxy voting as one avenue for influencing change, whereas bondholders can only engage – and ultimately not invest. Recently, Kames has engaged with UK water companies, and alerted them to its concerns about the public perception of offshore jurisdictions as "tax havens"; Kames has received constructive feedback from the companies.

By Hamlin Lovell, HedgeNordic

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Corporate bond ESG runs into other challenges in terms of data. "Large listed companies tend to have an investor relations (IR) department providing user friendly data. High yield issuers may not have an IR function, and their finance directors or Treasurers may not know the data or collate it in a helpful way" says Hull. In addition, "whereas public companies tend to have better, more transparent and more consistent reporting, private companies have more latitude to be opaquer" says Hull. High yield issuers are a mix of public and private companies.

Is Kames an ESG house? Yes and no. "The vast majority of mandates currently have no ESG screen and are about performance" says Hull.

The Edinburgh based asset manager does have some designated ESG funds: Ethical Corporate Bond, Ethical Mix and Ethical Equity. Hull, however, does not believe that ESG is germane to Kames' government bond mandates, which the mandates require investment in developed market government debt. Exclusions criteria for funds are implemented by a dedicated ESG team of four, led by Ryan Smith, who has been with the firm for 20 years.

The ESG team also define a framework applying throughout the firm - ESG is integrated into Kames' investment process: "our key philosophy is that if analysts are not thinking about ESG, they are not tied into the process. ESG is not an adjunct, it is drilled into the process" says Hull, who argues that, "sustainable companies need sustainable cash-flows to repay coupons and principal. Companies with good ESG scores usually also look good in terms of credit quality".

In simple terms, for non-ESG mandates Kames expects a discounted valuation as compensation for a low ESG score, subject to the overriding constraint of expecting the issuer to repay coupon and principal: "we cannot manage money and ignore issuers, absent a contract to deliver an ESG mandate" says Hull.

## ESG IMPROVERS

Demanding a higher yield from issuers with ESG shortcomings may contribute to raising those companies' costs of capital, which may give them an incentive to improve their ESG behaviour. This is important because some types of ESG mandates give asset managers the flexibility to invest in issuers with sub-optimal ESG scores that are addressing ESG issues. An example is UK electric power generation company, Drax, which has shifted its fuel mix from 85-90% thermal coal to one third wood pellets in recent years, and has also bought some hydroelectric assets. "A binary approach, or a formulaic approach such as Norges Bank Investment Management's (NBIM) 30% cap on coal, would deny capital to a company that wants to improve" observes Hull. The Drax case study could also be seen as an example of "impact investing", an area where Hull also owns a number of "green bonds" in ESG and non-ESG mandates, but stresses, "there has to be a valuation argument, and sometimes the valuation is not compelling".

## ETHICAL, SUSTAINABLE, RESPONSIBLE, AND ESG

For ESG mandates, Kames excludes certain issuers, which can vary greatly according to client policies. Kames has defined a pyramid of four types of ESG mandates. While the EU, for instance, is seeking to create a common taxonomy for ESG investment product labelling, but the whole area is so nuanced that there will probably still be significant differences within the eventual labels, anyway.


At the top of Kames' pyramid are its existing Ethical mandates, "which have for 30 years delivered results similar to its non-ESG sterling corporate bond mandates" says Hull. This is despite applying strict criteria excluding approximately 50% of the universe of UK corporate bonds, including those companies that use animal testing.

**ADRIAN HULL**

**CO-HEAD OF FIXED INCOME
KAMES CAPITAL**

> "...our key philosophy is that if analysts are not thinking about ESG, they are not tied into the process. ESG is not an adjunct, it is drilled into the process."

It is not possible to generalise about what percentage of the universe would be excluded by the other three types of mandates, because they can be customised to investor preferences. It is possible to say, with confidence, that investment grade issuers tend to have higher ESG scores than high yield issuers. By its nature a larger part of the high yield market than the investment grade universe is likely to be excluded by typical ESG criteria.

The second strictest mandate is "sustainable", which is likely to have a high active share and excludes individual companies based on a range of factors agreed with investors.

The third strictest mandate is "responsible" which takes a vertical approach, excluding whole industries such as tobacco, defence and coal.

Kames proposes that ESG mandates could: exclude tobacco, coal and defence; exclude tar sands; managed to the NBIM exclusion lists; report non-compliance with the UN Global Compact, and continue the current firm-wide policy of integrating ESG into investment and valuation analysis. Hull is open to receiving feedback on these proposals from the ESG investing community.

## UNPRI AND AEGON

Kames has been making submissions to UN PRI (Principles for Responsible Investment) for about 10 years, and has found the body has progressively scrutinised data more closely. Kames has continued to attain the UK PRI rating of A+, the highest rating offered for the credit sub-asset classes it invest in.

Kames has a good dialogue with Aegon around ESG, but both of them tailor policies to mandates. "We and Aegon do compare notes on key ESG themes, share some principles, and pursue some common ESG initiatives. Individual fund managers need to take responsibility for their own portfolios and mandates" says Hull.

PETER HANSSON

RETIRED CEO, SENIOR ADVISOR AT SPK
SPARINSTITUTENS PENSIONSKASSA

CHAIRMAN OF THE INVESTMENT COMMITTEE AT
BARNCANCERFONDEN





# HEDGE FUNDS: A SWEDISH PENSION FUND CEO'S EXPERIENCE OVER 25 YEARS

**by Pirkko Juntunen – HedgeNordic**

**Peter Hansson, former CEO of Sparinstitutens Pensionskassa (SPK), is a true pension and investments veteran and has in his 37-year career in banking and finance seem many things change, not least in the way we work but also the industry perception of hedge funds.**

"The introduction of the internet has played a major role in how we work and communicate and with this the asset management and pensions industries have undergone a major change to become more professional, process-led entities. This has not only been brought about by technological advancements but also regulatory pressure," he summarised.

This pressure has led to demands for increased competency and communication and ultimately transparency, not only towards regulators and governments but also members or customers, he said. "This requirement of transparency has only accelerated after the Global Financial Crisis and one area where it is very prominent transparency requirements that institutional investors now have for their providers at all levels. This is least not true for hedge funds," he added, pointing out that it is a mistake to categorise hedge funds as an asset class rather than a wide range of unconstrained strategies. "Gone are the 'I know what I am doing but I don't need to explain it to you'-type of players. Or at least gone from the institutional sector.

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"Gone are the 'I know what I am doing but I don't need to explain it to you'-type of players. Or at least gone from the institutional sector."

Hansson, who decided to retire after 25 years with SPK, where he was CEO for the past 14 years, said there has been not only a major perception change when it comes to hedge funds but also real change. "They have gone from a bunch of somewhat shady and unregulated investment firms with high-risk strategies to professional outfits that can handle the most zealous due diligence queries," he said.

These days hedge funds are no longer at the fringes of the investment world but part of most institutional portfolios. "As institutional investors themselves become more sophisticated and under more scrutiny be it through regulation, media or client-involvement, the more they demand that their providers are equally professional. There has to be transparency and accountability from all parties," Hansson said.

Hansson has an anecdote about a company; we can call the Secret Hedge Fund that lived well off its 2 and 20 fees and 'pension funds are not sophisticated enough to understand our way of managing money'-mentality. "What I have noticed, and not only among hedge funds, but in the pensions and investment industry in general is that those that are competent do not mind explaining what they are doing and why," he said.

Since the GFC the fee structure of hedge funds also came under the spotlight and the 2 and 20 structure is all but gone for most. "I do not want to pay for luck or beta. Show me what your skill is and I will pay for that," Hansson said, noting that this has given rise to the performance fee structure. "I would say this is really true in all asset classes. I want to pay for alpha not beta," he added.

"Unfortunately there is often a great deal of beta in hedge fund performance. You have to be able to see how it affects the risk in the overall portfolio. You also need to be able to see the characteristics and risk of the fund and that was hard to get 15 years ago, he said. Hedge funds should be uncorrelated and make you money irrespective of whether the interest rates or markets go up or down.

Hedge funds, as well as private equity or real estate, is a relationship business Hansson said, adding that you have to be able to look under the hood to see what is going on.

"You have to have the kind of relationship where they answer in details when you ask the initiated, awkward or stupid questions to fully understand what's going on, because when the proverbial hits the fan, and it will because it always does, you have to understand why this is happening. Have they deviated from their strategy i.e is what I bought no longer the same product? Have mistakes been made or is it other external factors or something more sinister such as fraud that has caused it," Hansson explained. Hedge funds have freer reins which means investors have to engage more and they in turn have to explain their why and how, he said.

Before anything, however, investors need to start by asking themselves why want hedge funds in the portfolio and what it means for the overall portfolio.

When it comes to transparency, SPK does not only talk the talk but walks the walk and has for a few years not only published the names of the asset managers it uses on its website but also a motivation to why they were picked.

SPK invests 10% of assets in hedge funds and has recently hired an external provider to evaluate and monitor its hedge fund investments.

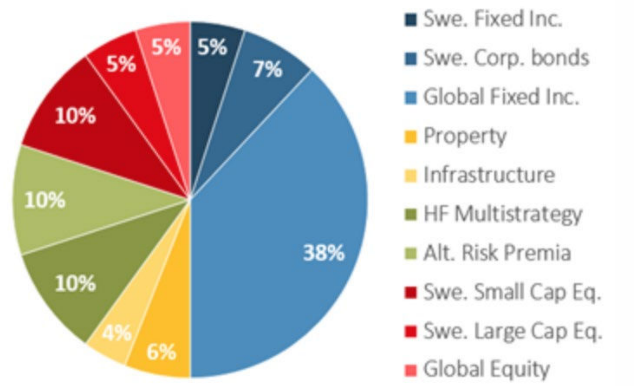
During Hansson's leadership SPK has grown from a SEK6n fund to SEK27bn." Hansson is also very proud that there has only beet two negative years in 25 (2002 and 2007). (Swedish banking problems 2002 -4,4 and GFC 2007 -1,9.)

The fund has returned 7% annually over 25 years with a Sharp-ratio of 0.9 and a conservative risk budget. Pensions it a matter of trust and Hansson has delivered above set targets.

**SPK´s Long term asset allocation strategy**

In determining the long term strategy, the portfolio's normal risk level is chosen with consideration of SPK's long-term need for asset return. However, if the capital is adversely affected to such an extent that solvency is deemed to be in jeopardy, then capital protection is prioritized in the short run. Actual asset return is subsequently controlled for adequacy in relation to the long-term need. If deemed not be adequate, this could lead to a reassessment of the investment strategy or increased contributions from employers. The long-term need for asset return does not constitute an upper limit for SPK's ambitions. Within the risk limits given, SPK should work for achieving the best possible long term return in addition to the long term need if opportunities arise.

SPK has decided to use the following long term asset allocation strategy:




A Letter from London:

# Effects of Brexit on Credit and Fixed Income

By Pirkko Juntunen – HedgeNordic



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It is mid-November in London and Brexit is on everyone's lips but trying to get investment professionals to put their name to a comment predicting the effects on the fixed income and credit markets is like trying to boil the ocean it seems.

Before we get into the specific event risks for credit and fixed income we must briefly talk politics and sterling; both seem equally volatile at the moment

This morning (Nov15) **Dominic Raab, the Brexit secretary,** resigned and others followed suit, leaving Theresa May's deal in tatters. It resulted in the Sterling initially falling more than 100bps against the dollar and 80 against the Euro leaving market observers to conclude that a no-deal may after all be a likely outcome. This has added to not only concerns over UK leaving the EU without a deal but also the stability of the UK government. If the deal fails to go through parliament it could lead to a general election, a new referendum or both.

**David Lamb, head of dealing at forex specialists Fexco Corporate Payments**, likened sterling to a cat on a hot tin roof as leaping to month-highs one day only to sag the next, depending on Brexit news. "After two-years of pot-holed progress, Britain's Brexit negotiations are approaching the end of the road. Expectations, and heartbeats, are accelerating – but it's still not clear if what lies beyond is a smooth exit or an abyss," he said.

The constantly evolving political environment is creating uncertainty in the markets and this Brexit cloud over the UK 'and that is the front and centre of the Bank of England's, and Mark Carney's mind, according to **Alasdair Ross, head of investment grade Credit, EMEA at Columbia Threadneedle Investments**. He predicts that the current environment means the BoE will be cautious about raising rates too aggressively ahead of the Brexit deadline of March 29, 2019 or beyond, until there is more clarity on what the future holds. "The market is priced for about 50/50 chance of the next rate rise happening in August 2019," he said.

Moving onto the event risks or what a hard Brexit or no-deal might mean. Today's events and consensus suggest that further collapse of the sterling is in the cards. A weaker currency in turn would lead to a potentially sharp hike in UK breakeven rates as index-linked gilts factor in rising UK inflation, as a result of rising import costs. This is a familiar scenario as it also happened in the months following the 2016 referendum. The impact on gilt yields is more difficult to estimate. The BoE might respond with interest rate cuts to stimulate the economy which could be expected to dampen gilt yields. On the other hand, the political turbulence could result in higher yields. Whichever way the dice rolls, expect significant volatility in the gilt market.

Another risk is, as mentioned above, if the Prime Minister does not get her deal through parliament and there is another general election and the Labour Party, led by leftist Jeremy Corbyn, comes to power, a fall in sterling is again expected as his anti-capitalist stance is likely going to make investors jittery, moving capital away from the UK. As in the no-deal scenario a rise in UK breakeven rates would follow. Some argue that the biggest impact of a left-wing government would be in increased government spending, requiring more gilt issuance, pushing up gilt yields.

Most bond market observers agree with Ross' assessment and predict that should negotiations continue to be problematic the BoE may be forced to adopt a more accommodating monetary policy, likely pushing bond-yields lower.

While UK markets have performed well in general after the Brexit vote in June 2016 the economic indicators are not as rosey particularly as retail sales slumped to a six-month low in mid-November

**Michael Siviter, Senior Portfolio Manager at Invesco**, said in the Invesco Global Fixed Income Strategy paper: "We are currently 'neutral' on sterling credit. Sterling credit yields do not currently build in much of 'Brexit' risk premium vs European credit (after hedging costs). We are specifically cautious on consumer discretionary names given continued weakness in UK consumer confidence figures and the impact of higher inflation (from the fall in sterling) on real wages. However, we continue to see pockets of opportunities for non-UK exposed global companies who have issued in the sterling market."

The exact impact of a messy Brexit is anyone's guess but UK investment consultants are advising clients to conduct scenario and worst-case scenario testing and reduce risk as well as revising their investment strategies to fit a more volatile environment and perhaps even prepare for a hard or no-deal Brexit.

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# Did Nordic High Yield Put Difficulties Behind?

By Eugeniu Guzun – HedgeNordic


**The Nordic corporate bond market has grown meaningfully in recent years, as companies have been turning away from traditional bank lending due to difficulties in obtaining funding from banks. Since many Nordic issuers are too small to find the expensive and resource-demanding official ratings suitable, much of the just-mentioned growth has come from the unrated segment of the Nordic corporate bond market. With more than half of all issuers in the Nordic corporate debt market having no official ratings, should investors be concerned about a potential pick up in default rates? How have Nordic high-yield rated and unrated bond issuances performed in recent years?**

## The Nordic corporate bond market and the dilemma of unrated debt

According to data provided by fund management boutique Evli, there is an estimated €225 billion in bonds outstanding in the Nordic non-financial corporate bond market as of the end of September 2018, a market currently comprised of 480 issuers (figures reflect only issuers with amount outstanding in excess of €30 million). The size of the region's corporate bond market increased from €192 billion at the end of 2015 to €205 billion at the end of last year. The number of Nordic issuers, meanwhile, rose from a total of 430 in 2015 to 480 issuers at the end of September of this year.

Around 54 percent of the 480 issuers do not have official credit ratings and roughly 29 percent of the €225 billion in bonds is unrated. Nordic non-rated issuers are estimated to offer an excess yield of 50 to 150 basis points more than their rated European peers, representing a risk premium for the absence of credit ratings rather than higher risk or insufficient liquidity. Many Nordic firms are small, and their average issue volumes are not large enough to turn the resources required to receive an official rating into a good investment. Official ratings allow issuers to receive cheaper funding, but the upfront fees and annual maintenance fees paid to rating agencies can more than offset the benefits of an official rating when issue volumes are small and infrequent.

## Hidden gems and lemons

In mid-September, Swedish telecom operator Tele2 received a 'BBB' credit rating from S&P Global Ratings, the lowest rung of investment grade. Danish logistics provider DSV, meanwhile, was assigned an even stronger rating of 'BBB+' a couple of days later, yet another piece of evidence of good quality issuers among companies with financing needs in the unrated corporate bond market. Partly because of the abundance of unrated issuers, some Nordic funds focus on the crossover segment of the corporate bond market. This segment contains corporate bonds that, as a group, offer higher yields than most investment-grade bonds, yet have less or similar credit risk than some investment-grade bonds.

"If issuers do not have an official rating, many investors treat those as high-yield by definition," Petter von Bonsdorff, Head of International Business Development for Evli's funds, tells HedgeNordic. "But in reality, unrated does not automatically mean high-yield. That creates opportunities for an active manager," he adds. Many fund managers look for hidden gems in this segment. But there are lemons too.

Dutch provider of mobile phone cards Lebara has been making headlines in recent months. The SIM-card company raised €350 million in capital through a bond issue in the Nordic bond market in the August of 2017, but the bond is trading at distressed levels after the company suffered a string of financial reporting issues and faced market concerns over its profitability. Lebara has not defaulted just yet, but many issuers have.

## Default rates in the Nordic high-yield corporate bond market

In the global corporate bond market, only two investment-grade firms have defaulted since the beginning of 2010

**GUSTAV FRANSSON**

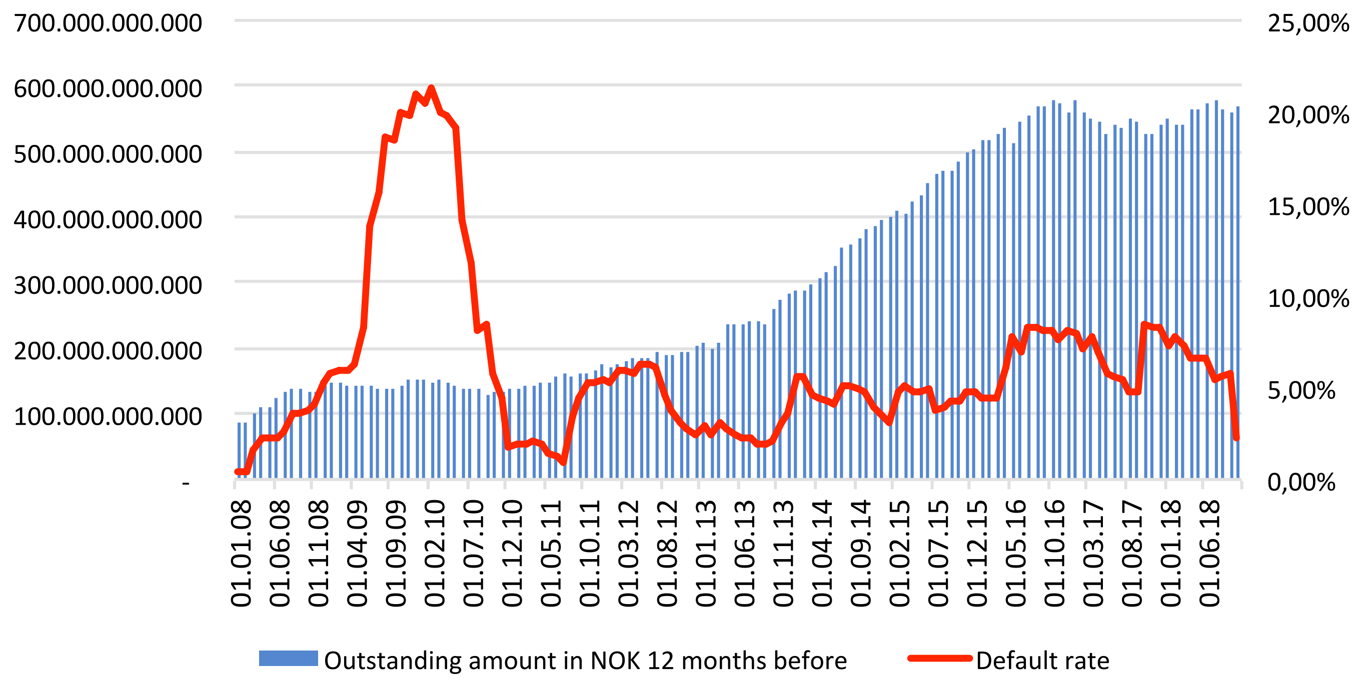
**PORTFOLIO MANAGER**
**COELI ASSET MANAGEMENT**

"The tide has turned in the Norwegian market as oil prices have risen and companies with weaker balance sheets have been acquired."





**DEFAULT RATE IN THE NORDIC HIGH-YIELD CORPORATE BOND MARKET**




(one of which is US-based futures broker MF Global which filed for Chapter 11 bankruptcy protection in 2011), data from Standard & Poor's Global Ratings reveal. Defaults in the higher-risk speculative-grade corner of the Nordic corporate bond markets, meanwhile, have been a more frequent occurrence.

According to data provided by Stamdata, the leading provider of reference data for debt securities in the Nordic markets, there is a total of 353 defaulted bond issues since the beginning of 2008, approximately 41 percent of which occurred during 2015 and onwards. 28 bond issues defaulted this year alone by the end of September, compared to 48 defaults recorded last year and a yet higher figure of 50 in 2016. Despite the historically high number of bond issues defaulting, the total volume of high-yield debt defaulting has not been equally high.

The trailing 12-month speculative-grade default rate closed at 2.19 percent at the end of September, which implies that a little more than two percent of the €60.62 billion (NOK 570.42 billion) in rated and unrated high-yield bonds outstanding in the Nordic countries at the end of September last year defaulted. The Nordic market

**PETTER VON BONSDORFF**

**HEAD OF INT. BUSINESS DEVELOPMENT**
**EVLI FUNDS**

"Deteriorating company fundamentals are the root of defaults."

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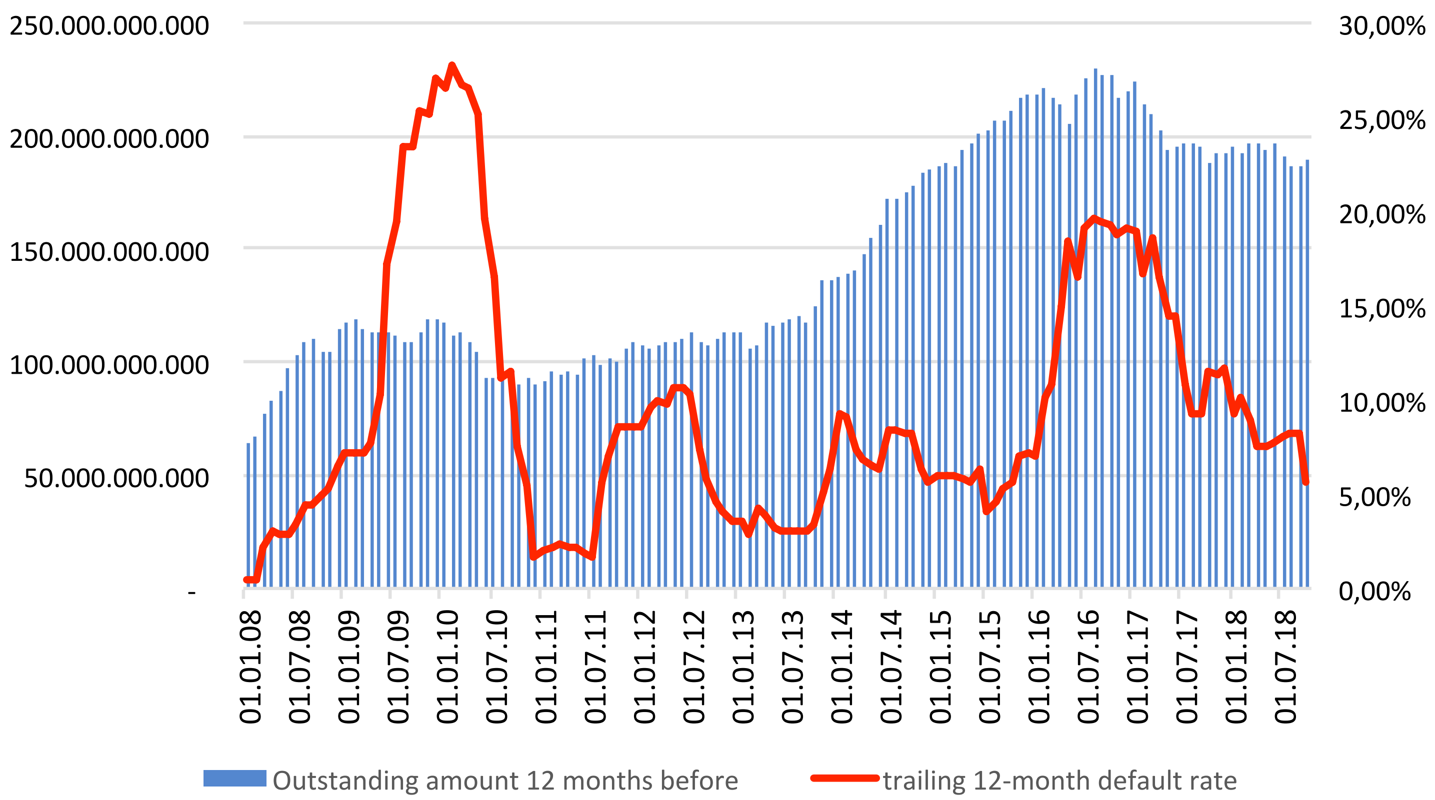
DEFAULT RATE IN THE NORWEGIAN HIGH-YIELD CORPORATE BOND MARKET




of high-yield corporate bonds has been navigating a though period starting with 2014, as defaults and restructurings hit the Norwegian energy sector as a result of plunging oil prices. The trailing 12-month speculative-grade default rate closed at 3.12 percent at the end of 2014 but increased to 4.50 percent at the end of 2015 and a much higher default rate of 8.02 percent at the end of 2016.

The Norwegian high-yield market, dominated by companies operating in the energy sector, has been hit particularly hard due to the collapse in oil prices. The trailing 12-month default rate in the Norwegian high-yield market was hovering around or above the ten percent-level throughout 2016 and 2017, reaching a high of 19.57 percent at the end of July in 2016. Around 5.59 percent of the €20.16 billion (NOK 189.75 billion) in Norwegian high-yield bonds outstanding at the end of September of last year defaulted. However, Gustav Fransson, portfolio manager at Coeli Asset Management's fixed-income funds, reckons that "the Norwegian energy high-yield sector is currently out of the woods to some extent. The tide has turned in the Norwegian market as oil prices have risen and companies with weaker balance sheets have been acquired," Fransson tells HedgeNordic.

The defaulted volume of high-yield bonds issued by Swedish issuers has been significantly lower in the past several years. Out of the €11.06 billion (NOK 104.08 billion) in high-yield bonds issued by Swedish firms that were outstanding in September of last year, only 1.38 percent defaulted as of the end of September. The trailing 12-month default rate among Swedish issuers reached a high of 4.43 percent at the end of October in 2013.

## Expectations for default rates in the Nordic high-yield corporate bond market going forward

Amid rising interest rates and ballooning levels of debt, the evolution of default rates in the past several years may give some comfort to credit investors at the moment. Several Nordic fund managers running vehicles investing in Nordic corporate bonds and other specialists with in-depth knowledge of the market do not anticipate rising interest rates to lead to a spike in debt defaults. As Petter von Bonsdorff tells HedgeNordic, "deteriorating company fundamentals are the root of defaults."

Bonsdorff used Norwegian producer of publication paper Norske Skog, which filed for bankruptcy at the end of last year, to illustrate that fundamentals represent the primary cause behind defaults. "No one reads printed newspapers anymore, and the company went bust." Gustav Fransson, portfolio manager at Coeli Asset Management's fixed-income funds, corroborates Bonsdorff's view. "Defaults tend to cluster in certain industries affected by external developments such as the decline in oil prices, which affected offshore shipping companies and other companies in the Norwegian energy sector," Fransson tells HedgeNordic.

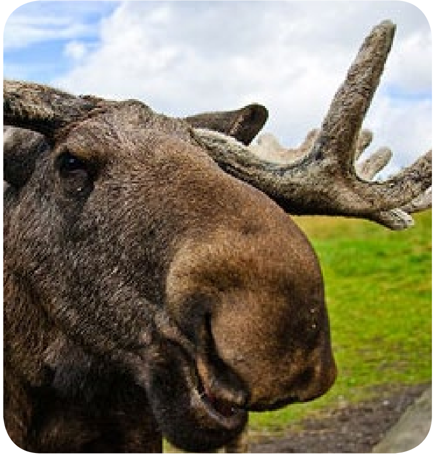
Rising interest rates are not anticipated to lead to defaults in the Nordic high-yield corporate bond market in the near term, but higher rates may have secondary-round effects on Swedish real estate firms exposed to inflated real estate prices, reckons Bonsdorff. Both Stefan Wigstrand, fund manager of Catella Nordic Corporate Bond Flex, and Gustav Fransson seem to agree. "Companies will face no difficulties in meeting their interest payments, yet companies may default because of reduced refinancing options as leverage has come up quite significantly," Wigstrand tells HedgeNordic. "The debt owed by some Swedish real estate developers is maturing in the next couple of years, and the may have a hard time refinancing the debt," says Fransson. "Some of these companies started construction, but have only sold between 60 percent and 80 percent of condominiums," he adds. With lower property prices and the subsequent decline in demand for real estate from already-indebted Swedish households, real estate developers may end up defaulting.

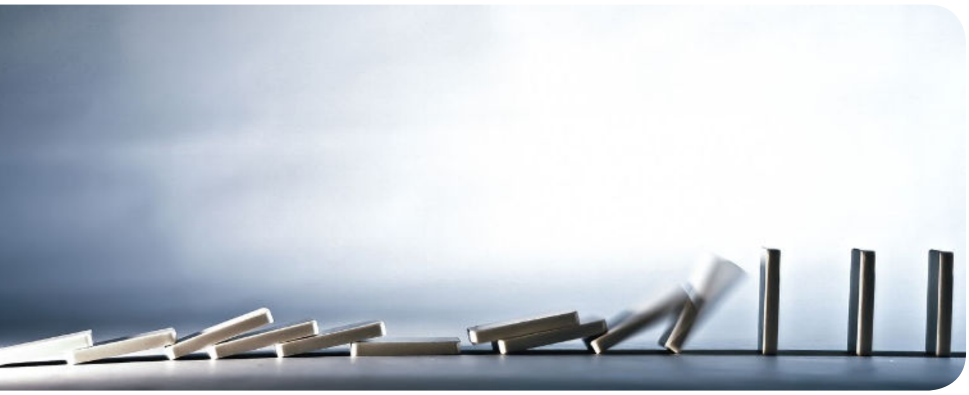
**STEFAN WIGSTRAND**

**FUND MANAGER**
**CATELLA FONDER**

"The debt owed by some Swedish real estate developers is maturing in the next couple of years, and the may have a hard time refinancing the debt..."





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