HEDGENORDIC

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# SPECIAL REPORT ALTERNATIVE FIXED INCOME


# Contents



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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 2021/2022:

| | |
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| December 2021: | ESG in Alternatives |
| February 2022: | Thematic Investing / Sector Investing |
| March 2022: | Nordic Hedge Fund Industry Report |
| June 2022: | Real Assets / Private Markets |

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# Editor´s Note ...

## Message in a Bottle No More

While real rates may not yet fully reflect looming inflation, looking across financial markets it has become evident we may be ahead of a rate regime shift. Energy and prices and moves on other commodity markets are clear indicators. The "I-word", inflation, has mutated from a lonesome message in a bottle to become the buzz word on the street.

Some smaller economies have already commenced in raising their lead rates; the almighty Federal Reserve Bank has yet to make a move which while likely trigger a domino effect by the largest part of developed economies. But who knows, we might just see these low rates for ever.

Inflation, and how fixed income managers are looking to navigate potential regime shifts, niches for alpha generation and ESG are just some of the topics we are aiming to cover in this publication. We had some interesting interviews and discussions with managers and asset allocators, from the Nordics and beyond which we are pleased to summarize in this publication.

In this special report on "Alternative Fixed Income," we cover the much-discussed topic of inflation and how different traditional, alternative, and niche strategies are positioned for the low-return – yet inflationary and rising rate – environment. We also scrutinize how institutional investors have been navigating this increasingly challenging environment.





Sustainability, has become a key issue, area of development and focus in financial markets and the fixed-income universe. ATP's Head of Liquid Markets, Christian Kjær, tells us more about "ATP's Green Bond Push," which is seeing the Danish pension fund's US high-yield credit bond exposure replaced with investments in European green corporate bonds.

In the difficult low-yield environment that has become more challenging with the prospect of higher inflation and rates, Peter Ragnarsson, Head of Alternative Investments at PRI Pensionsgaranti, explains why alternative fixed income is "En Route to the Mainstream" in the Swedish insurance company's portfolio. The portfolio managers of Sissener Corporate Bond Fund, Philippe Sissener and Mikael Gjerding, describe the suitability of their "Tight Ship of Publicly Issued Short Duration" for the current inflationary and rising rate environment.

With high-yielding opportunities in public fixed-income markets being few and far between, Kreditfonden founder Fredrik Sjöstrand introduces "Kreditfonden's Pockets of Yield," a product range that features two direct lending funds, a factoring fund, and a closed-ended high-yield bond fund. Further, founded by Dag Wardaeus and Carl-Johan Nordquist, Swedish fully-digital mortgage lender Hypoteket provides mortgages financed by institutional investors through mortgage funds within the AIF framework. Hypoteket's Head of Funding and Sustainability, Johan Hasselblad, seeks to answer the question of whether Hypoteket's Mortgage Funds can serve as "Alternative Fixed Income, or Just the New Traditional?"

Jonas Mårtenson of Ress Capital is convinced their strategy investing is US life settlements creates a "Positively Skewed Fixed-Income Alternative," while Michael Falken and William Wilson, joined by fellow Brummer alumni Gunnar Wiljander, have launched Tidan, a new hedge fund which employs a capital structure relative value strategy focusing on the "The Siloing Effect of Equity and Credit Markets."

Stuck between low yields, the prospect of higher rates due to rising inflation and the need to include fixed income in their portfolios, Kari Vatanen, the chief investment officer of Finnish pensions insurer Veritas, says the "Next Stop: Complexity and Illiquidity" for institutional investors. Svein Aage Aanes, Head of Fixed Income at DNB Asset Management, summarizes the evolution of the Nordic high-yield market and describes "DNB's Journey in Nordic High-Yield."

Martin Hagelskjær Nielsen, the Head of Danish Fixed Income and Euro Covered Bonds at Nordea, explains "The Nordea Hunt for Relative Value Opportunities" with its two relative-value hedge funds: Nordic Rates Opportunity Fund II and European Rates Opportunity Fund. Hamlin Lovell's editorial "Wide Dispersion of Returns Opens up Mean Reversion Opportunities in FI Arb" gives us a good summary of recent developments in the "fixed income arbitrage" corner. Lastly, Russell Investments' latest survey reveals "Fixed Income Managers Expect Inflation to Hasten Interest-Rate Hikes," among other findings.

We do hope you find the time and opportunity for some interesting reads here in this pre-holiday season.

**KAMRAN GHALITSCHI**
CEO & PUBLISHER HEDGENORDIC

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# ATP's Green Bond Push

By Eugeniu Guzun – HedgeNordic

Christian Kjær, Head of Liquid Markets – ATP

"The hedging portfolio needs very strong credits, therefore, the green bond exposure within this portfolio is limited to the sovereign and quasi-sovereign green bonds."

Danish pension provider ATP, Europe's fourth-largest pension fund, has announced plans to sharpen its climate ambitions to contribute to the global green transition. "We simply cannot afford not to," said ATP's CEO, Bo Foged, in October. As part of its longer-term objective of having DKK 200 billion in green investments by 2030 and half that by 2025, ATP has embarked on a process of shifting its U.S. high-yield credit bond exposure to investments in European green corporate bonds.

ATP runs a hedging portfolio and an investment portfolio, "with the hedging portfolio taking care of the guarantees that we have and the investment portfolio generating returns on top of the guaranties," explains Christian Kjær, Head of Liquid Markets at ATP. ATP has long been housing green bonds within its hedging portfolio, which oversees DKK 753 billion in assest under management as of the end of June.

"When we started looking at green bonds for the first time, we focused on our hedging portfolio," says Kjær. "The hedging portfolio is huge and we have a lot of capital there to hedge our guarantees, a big part of which is invested in bonds," continues ATP's Head of Liquid Markets. "We have long been working on getting green exposure into the hedging portfolio." At the midpoint of the year, ATP's holdings of green bonds amounted to DKK 36 billion. "The hedging portfolio needs very strong credits, therefore, the green bond exposure within this portfolio is limited to the sovereign and quasi-sovereign green bonds," explains Kjær.

This year, however, the Danish pension fund added green corporate bonds for the first time in its investment portfolio worth DKK 423 billion, which reflects leverage from borrowing from the hedging portfolio. "We are in the process of replacing our U.S. high-yield credit bond exposure with investments in European green corporate bonds," Kjær tells HedgeNordic. "That is one of the transitions within our portfolio. We are building up, quite slowly actually, our green corporate bond portfolio."

## GREEN BOND EXPOSURE IN INVESTMENT PORTFOLIO

ATP's investment portfolio predominantly builds its credit exposure using credit default swaps (CDSs), which give credit exposure to multiple entities at once without holding the underlying bonds. "We have some credit bonds within the portfolio, but we actually prefer the CDS indices in order to preserve capital and get liquidity," says Christian Kjær. "We are not able to get a specific green exposure with the CDS indices, because they are simply indices." In its efforts to contribute to the global green transition, the team led by Kjær decided to replace its traditional corporate bonds with green corporate bonds.

"We decided to take the bonds within our investment portfolio and do whatever we can in terms of the green agenda and get exposure to the green transition," explains Kjær. "We shift as much cash as possible from the credit side within the investment portfolio to the green transition. That is why we started looking at green corporate bonds this year."

## GREEN WASHING

As not all bonds called green are actually green, the ATP team has opted for a slow, measured and careful approach in transitioning a portion of its corporate bond portfolio to green bonds. "There are not that many issuers to analyze on the sovereign and quasi-sovereign side, which makes it much easier to make sure that there is no greenwashing," argues Kjær. The corporate bond market, on the other hand, is more difficult to navigate for a green bond investor. "There are a lot of issuers on the corporate side, so it is a little bit more difficult to make sure there is no greenwashing."

"ATP has been among the first investors in the world to start demanding closer communication with green bond issuers to ensure the greatest possible transparency about the projects they would be used for," says Kjær. "We have been a very active investor in green bonds, being in ongoing discussions with the issuers, which was new to us and to some extent new in the financial market in that the buy-side actually approached the issuers trying to improve the framework, trying to mitigate greenwashing by expressing what our needs would be." ATP has maintained good cooperation with issuers such as the European Investment Bank (EIB), whose Head of Sustainability Funding, Aldo M. Romani, said earlier this year that "ATP has become a strategic business partner in the development of best practice when it comes to how to handle green investments."

"We are very aware of the dangers of greenwashing," points out Kjær. "We have a large team that helps us in the efforts to detect greenwashing. Every single bond is screened in order to minimize the risk of greenwashing," he continues. "We have put together a set of screening criteria, which allow us to assess the quality of the issuance and ensure transparency. We need to feel confident that the bonds that we think are green are actually green." Therefore, ATP continues to be in close dialogue with the issuers of green bonds to ensure that the pension fund is investing sustainably.

The green bond market has been growing significantly in the past few years, reaching a new global supply record in 2020. The global green bond issuance for 2021 is expected to exceed the previous year's level. "The market is growing exponentially in size, but it is also maturing in terms of what is green and what is not green, and all these things around it," says Kjær.

## TWO SIDES OF A COIN

Green bonds tend to offer investors slightly lower yields compared to conventional non-green bonds, with this yield difference known as the green bond premium or greenium. Christian Kjær and his team have also analyzed the green bond premium in the market, with the analyzis showing that "green bonds are priced very similarly to traditional bonds," according to Kjær. "You are more or less paying the same on average compared to other bonds."

Green bonds, however, may also exhibit slightly lower risks compared to their non-green counterparts. "As risk-focused investors, we have seen in our analysis that green bonds actually performed better on the risk side," points out Kjær. "It seems they have a bit more patient investors who do not want to sell that much," he continues. "There are two sides of the coin. The return side seems to be very similar. The other side of the coin is that they seem to be less risky than traditional corporate bonds. Risk mitigation is really important to us. Green bonds with lower risk than other bonds have tangible value to us."

Peter Ragnarsson
Head of Alternative Investments – PRI Pensionsgaranti



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# Alt Fixed Income:
# En Route to the Mainstream

By Eugeniu Guzun – HedgeNordic

Inflation has been at the forefront of investors' minds and concerns this year, forcing them to make difficult decisions about how to protect their portfolios. "That's probably the hottest topic right now and discussed in more or less every meeting we have with managers," confirms Peter Ragnarsson, Head of Alternative Investments at Swedish insurance company PRI Pensionsgaranti. "We are, of course, mindful and concerned about inflation. We start to see general price inflation across different sectors, and this could be more permanent than markets are currently pricing."

For institutional investors with significant assets under their watch, there are alternatives to counter the effects of rising inflation on their portfolios. "There are parts of the alternative investments space that are better suited for climbing inflation than others. The go-to investments are probably real assets with precious metals, forestry, etcetera," argues Ragnarsson. "These are not areas we are invested in at the moment, except for some commodity exposure from our hedge funds," he points out. "I wouldn't say that alternative investments, in general, are a guarantee for inflation protection."

PRI, which guarantees and administers Swedish companies' occupational pension schemes, currently maintains about one-fourth of its portfolio in alternative investments such as real estate,

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“On the private credit side, all loans are floating-rate loans and should not be negatively affected by higher inflation.”

hedge funds, and private credit funds. Although not all alternative investments act as a hedge against inflation by default, PRI's portfolio of alternative investments is well-positioned for rising inflation. “Our real estate portfolio is quite well equipped for higher inflation. We invest across sectors, even if residential real estate, a sector with high underlying demand, is our largest exposure,” says Ragnarsson. “Sure, one will face higher financing costs with rate hikes, but on the other hand, rents are almost always linked to inflation and you usually see a rise in property prices as well in an inflationary environment.”

“On the private credit side, all loans are floating-rate loans and should not be negatively affected by higher inflation,” continues the Head of Alternative Investments at PRI. “What we might see is a second-order effect where inflation hits the underlying companies and their ability to finance their debt,” warns Ragnarsson. “What I personally think is most interesting looking into next year is probably hedge funds and also structured credit exposure, where both categories can capitalize on the higher rates and volatility in the market.”

## ALT FIXED INCOME BECOMING CORE FIXED INCOME ALLOCATION

For decades, investors have relied on traditional fixed-income assets as a low-risk and steady income source for their portfolios. With interest rates around record lows for years, most traditional fixed-income investments have offered virtually nothing in the way of yield. A difficult low-yield environment has gotten more difficult with the prospect of higher inflation. Institutional investors looking to maintain returns on the fixed-income side of their portfolios have been forced to consider alternatives, fixed-income alternatives. PRI Pensionsgaranti, which generally maintains about half of its portfolio in fixed-income investments and the remaining one-fourth in equities, is undergoing changes on its fixed-income allocation.

“We are actually in the middle of a re-shaping of the alternative fixed-income portfolio,” says Ragnarsson. “Historically, we have structured the portfolio with a majority of our exposure in senior secured European direct lending, which we think offers a very attractive risk-adjusted return to the portfolio,” he elaborates. “Then we have had satellite investments surrounding that with other types of yielding investments such as real estate debt, collateralized loan obligations (CLOs) and microfinance. We have been targeting a bit higher returns with a combination of senior secured, unitranche and second lien loans, as well as exposure to the CLO and structured credit markets.”

Although these investments have been part of PRI's portfolio of alternative investments, the senior secured investments will now become part of the insurer's core fixed-income bucket. “Going forward, we see that we can get a more effective asset allocation for the whole PRI portfolio by using illiquid investments to a greater extent than before,” explains Ragnarsson. “By looking at the underlying risk of the investments, we will see alternative fixed-income as a part of the fixed-income portfolio and private equity as a part of the equity portfolio,” he adds. “With this mindset, we will use alternative fixed-income strategies much more as a pure fixed-income replacement than before. We will therefore also go a bit further down the risk scale and invest more in senior secured direct lending, asset-backed lending, etcetera.”

Following PRI's inclusion of alternative fixed-income investments in the traditional fixed-income portfolio, its alternatives portfolio will reflect exposure to domestic real estate, infrastructure and absolute return investments. “This will give us more flexibility to position the portfolio where we see the most attractive return potential going forward,” believes Ragnarsson.

## THE EFFECT OF INFLATION ON THE ALT FIXED-INCOME SPACE

While rising inflation is a fixed-income investor's main enemy, PRI's portfolio of alternative fixed-income investments is well-positioned against this emerging threat. “All our investments have floating rate loans, so if we get rate hikes due to a more lasting inflation, this should be reflected in the underlying loans,” says Peter Ragnarsson. However, a sharp increase in inflation can serve as bad news for borrowers, too, warns Ragnarsson.“A situation with a rapid rise in inflation with increased supply constraints, rising costs for goods and services and wage increases, can, of course, hit hard on some of the borrowers and stress the servicing of debt,” says Ragnarsson. “On the other hand, it will also increase the demand for debt and result in higher margins for the lenders, so a continued vintage diversification is still of great importance.”

The main risk associated with inflation “is a situation with a sudden shock and change in inflation paradigm, which will challenge the service of debt,” according to Ragnarsson. PRI's Head of Alternative Investments believes structured credit strategies such as the equity tranche in the CLO structure can benefit from rising inflation. “The underlying loans are floating rate loans by nature, and I also believe an environment with higher volatility, but still, in my guess, moderate defaults, could suit the asset class well,” says Ragnarsson.

“If we look at the direct lending space, I want to be with the larger names that are well-positioned both in terms of assets under management and resources to get exposure to the upper part of the mid-market,” continues Ragnarsson. “I also want to be with strategies that have a proven track record, that can maintain good covenants and with abilities and skills to handle a workout situation.”

## OUTLOOK ON THE ALTERNATIVE FIXED-INCOME SPACE

“The asset class will continue to be in favor by institutional investors,” reckons Ragnarsson. “It offers an interesting risk-adjusted return with attractive premium to the leveraged loan market,” he continues. “In the same way as we at PRI are allocating more capital to the asset class, I hear the same story from other institutions focusing on income-generating assets.”

“The dry powder in private equity is at an all-time high, fueling more deal activity in the market at the same time as banks are continuing to pull back from the lending market,” explains Ragnarsson. “Private debt is also only a fraction of the private equity landscape, giving it plenty of room to grow in the next coming years.” Many institutional investors face a difficult time finding meaningful, stable sources of income in the traditional fixed-income space. Going into alternative fixed income beyond core fixed income may provide investors an attractive level of income and diversification, as well as protection against the impact of changing interest rates.


From left to right:  Mikael Gjerding, Portfolio Manager  and Philippe Sissener, Portfolio Manager – Sissener AS

“Given the high degree of floating-rate notes in the Nordic high-yield market and our fund in particular, both this market and our fund should suit anyone looking for yield from sustainable businesses that operate in politically stable and economically strong economies.”

Philippe Sissener





# A Tight Ship of Publicly Issued Short Durations

By Eugeniu Guzun – HedgeNordic

With so-called real yields, which reflect the corrosive effects of inflation, hitting lower and lower levels, the riskier corners of the global fixed-income market have become the go-to place despite lower starting yields than before. The Nordic high-yield market, which consists of a higher portion of floating rate notes than peer markets in the United States and Europe, is one corner well placed to navigate an inflationary and rising rate environment.

By running a Nordic-focused high-yield strategy with a very short duration, Norwegian Sissener Corporate Bond Fund appears even better positioned for the current inflationary and rising rate environment. “Given the high degree of floating rate notes in the Nordic high-yield market and our fund in particular, both this market and our fund should suit anyone looking for yield from sustainable businesses that operate in politically stable and economically strong economies,” argues portfolio manager Philippe Sissener. “With the prospect of higher interest rates, the high share of floating rate notes will really benefit investors looking to at least protect themselves against inflation.”

Sissener and co-portfolio manager Mikael Gjerding are looking to populate their portfolio with high-yield bonds that offer spreads of around 500 basis points, hopefully enough to counter the wealth-erroding effects of inflation. “Even if the current environment of negative real yields persists with interest rates not following inflation, our credit spreads are making up for that difference,” says Sissener.

“Our fund suits investors looking for capital preservation, inflation protection, and looking to protect themselves from higher interest rates thanks to the very short duration of the fund.”

The team running the fund has used its NOK 2 billion in assets under management to build a concentrated high-yield bond portfolio with a duration of only 0.4

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years and an yield-to-maturity of 5.4 percent. The 0.4 duration means that a 100 basis points increase in interest rates would result in the value of its bond portfolio declining by only about 0.4 percent. "We hand-pick our credits," Sissener explains the fund's short duration. "When we can choose between fixed rates and floating rates in the current environment, we would choose the floating-rate note," he continues. "We also have the opportunity to do interest rate swaps if we see that the duration becomes too long."

## FOCUSING ON PUBLIC ISSUERS

Sissener Corporate Bond Fund sets itself apart from traditional high-yield funds in the Nordics by focusing on publicly-listed issuers. There is a long list of reasons to invest in high-yield bond issues of public companies, according to the Sissener team. "One of the main reasons is that historically we have observed much lower default rates among publicly-listed companies compared to their private peers," starts Philippe Sissener. "Additionally, the recovery rates in case of default are also higher for the publicly-listed companies and that is purely on the metrics side." There are also advantages on the information side, with higher transparency, better reporting and availability of management at public companies.

"On the information side, it is a lot easier to follow the publicly-listed companies. Both external analysts and the media give much more attention to public companies than private ones," says Sissener. "Any piece of news or anything to do with their competition is flashed in front of your screens within minutes after an announcement or press release," he continues. "And when public companies get into trouble, there is much more pressure on them rather than private companies that may just turn off their phones and and not reply to anything."

Worst case scenario, in case of bankruptcy, the restructuring process can be easier for publicly-listed companies. "It is a lot easier for public companies to convert bankrupted bonds into equity in some sort of restructuring deal or raise equity for a recapitalization process, because there is a liquid instrument available already," explains Sissener. Mikael Gjerding, who co-manages Sissener Corporate Bond Fund, goes on to emphasize that publicly-listed issuers are also associated with greater price discovery.

> "Our fund suits investors looking for capital preservation, inflation protection, and looking to protect themselves from higher interest rates thanks to the very short duration of the fund."
>
> Philippe Sissener

"We find the price discovery in this segment to be much better because you have a continuous pricing of the business and its assets through the listing on the equity market," argues Gjerding. "It is easier to have a more accurate assessment on the worth of assets in public markets compared to private markets where you are in a black box for years," he adds. "Although not essential, this price discovery is also important for our analysis process."

By focusing on publicly-listed issuers, the team running Sissener Corporate Bond Fund also leverages on the experience and knowledge of Sissener's entire team. Founded by Philippe's father, Jan Petter Sissener, Sissener AS has been running a Nordic-focused long/short equity fund since 2009. "Members of our investment team, portfolio managers and analysts have most likely followed the publicly-listed companies in our universe for a number of years already," explains Philippe Sissener. "We have industry specialists on the equity side. It is a bonus to have that long track record of following the public companies from the equity side, because some of them might be new to the bond market, but someone in house here has the knowledge of those companies and can help us reach faster and better conclusions."

## CONCENTRATION

According to Sissener, the traditional way of managing a high-yield bond fund involves spreading out capital and risk across 150 to 200 positions. "The traditional way means you are spreading your risk so much that each default does not hurt that much," explains Sissener. "We want to keep a much tighter ship, a much more concentrated portfolio of 30 to 40 names. In that way, we aim to avoid defaults completely," he continues. "This approach has worked so far and will continue to work as long as we are doing the proper work behind every name."

The Nordic high-yield market has become more mature with a higher volume of outstanding bonds and more diversified issuer base. The marketplace has evolved from a predominantly Norwegian marketplace dominated by industries such as oil services and shipping to a well-diversified pan-Nordic market, and has recently transitioned into a market dominated by the Swedish real estate sector.

> "Even so, there is so much to choose from now that we can really optimize a well-diversified and really hand-pick a portfolio with names across various industries."
>
> Mikael Gjerding

"Even so, there is so much to choose from now that we can really optimize a well-diversified and really hand-pick a portfolio with names across various industries," says Gjerding. "From 2015 and onwards, we have seen a bunch of real estate-linked bonds, yet our exposure is less than three percent compared to the market's 25 percent." Despite the domination of real estate, "there is so much more to choose from, so we managed to build a well-diversified portfolio."

Sissener Corporate Bond Fund has generated an annualized return of 8.2 percent since launching in early 2019, and is on track to receive a five-star rating from Morningstar upon reaching its three-year anniversary in early 2022. "The main alpha is going to come from us avoiding bankruptcies and defaults," argues Sissener. "Looking at this year in isolation, we are not at the top of the category because there have been zero defaults in the market, more or less, because of so much liquidity coming from the authorities in the whole world," says the portfolio manager. "Even the most trashy stuff that in a normal market is not easy to refinance has been refinanced." If and when market conditions get back to normal, Sissener Corporate Bond Fund wants its portfolio clear of any bankrupcies, thereby, achieving better performance than the more traditional, seemingly more diversified high-yield bond portfolios.

# Borea: Long Term Credit Investors

By Hamlin Lovell – HedgeNordic

Peer Hastrup Thorsheim, Portfolio Manager, Willy Helleland, CIO (background) - Borea Asset Management

"In normal market conditions, Norwegian high yield has a bid/offer spread of 25-50 basis points, but in stressed conditions this can widen a lot even for bigger issues."

Peer Hastrup Thorsheim

## YIELD PICKUP PERSISTS IN NORWEGIAN CREDIT MARKETS

Bergen-based Borea Asset Management AS has been investing in Norwegian credit since 2004, and launched its flagship high yield fund in 2011. This period has included Europe's sovereign debt crisis, and oil crises in Norway, but the long-term investor base has held steady. "We have never been forced sellers. We have annualized at over 8% since 2011," says portfolio manager, Peer Hastrup Thorsheim. In March 2020, Borea was the only one of 13 Norwegian high yield managers (Alfred Berg; DNB AM; Eika; First Fondene; Fondsfinans; Handelsbanken; Holberg; Landkreditt; Odin Kreditt; Pareto AM; SR-Forvalting; Storebrand AM) to have seen net inflow, according to data from VFF and Pareto. "We did not have any liquidity issues in March 2020," says Thorsheim.

The credit team including Thorsheim, CIO Willy Helleland, and portfolio manager Magnus Vie Sundal, have focus areas but all of them also work on all credit funds, providing full coverage if anyone is away. "We are co-pilots," says Thorsheim.

Borea currently manages four strategies. The flagship fund, Borea Høyrente which recently received an HFM Emerging Manager Award in the Fixed Income (over USD 100 million) category, does not have a high degree of overlap with the other existing strategies, focused on Norwegian financials. The more than NOK4 billion (c. EUR 400 million) of assets in the flagship fund make it too large to build meaningful positions in some smaller issues. As a result, Borea has launched a new fund - Borea Kreditt – which will focus on high risk-reward opportunities in issues below NOK500 million (EUR50m) to obtain additional yield. It can also invest in larger issues in common with the other strategies, and as such is expected to have some overlap.

## LOWER ASSET PURCHASES AND HIGHER YIELDS

Norway has seen a strong recovery in credit from the Covid lows, mainly due to fundamentals rather than central bank asset purchases. In some markets central banks have become very large buyers of new issuance: the Fed is the biggest buyer of Treasuries and the ECB is the largest buyer of Bunds.

The ECB has been buying corporate bonds since 2016 under several programmes: the asset purchase programme (APP) and corporate sector purchase programme (CSPP) and has recently accelerated its purchases with the Pandemic Emergency Purchase

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Programme (PEPP) initiated in 2020. In Norway, the government only started buying corporate bonds in 2020 after The Norwegian State Bond Fund (Statens Obligasjonsfond) was set up and it remains relatively small. "It has invested only NOK 8.9 billion of its NOK 50 billion mandate both through secondary and primary issuance. This compares to total issuance of NOK90bn in 2020, and more than 170bn so far this year," says Thorsheim. The Norwegian high yield market is valued at NOK 500 billion including financials or NOK 360 billion excluding financials, according to Stamdata. Thus, the state owns less than 2% of the market.

Absolute yields are higher in Norway partly because local interest rates in NOK are a little higher than elsewhere in Western Europe. But credit spreads above interest rate benchmarks are also approximately 150 basis points wider than on European or US high yield, according to Thorsheim.

The reasons for the extra yield have historically included a greater weighting in cyclical energy and shipping sectors, but this has become less relevant as the industrial composition has become more diversified – into Information technology, industrials, consumer discretionary, telecoms and healthcare – and some yield pickup continues. "It is partly an illiquidity premium," says Thorsheim.

"In normal market conditions, Norwegian high yield has a bid/offer spread of 25-50 basis points, but in stressed conditions this can widen a lot even for bigger issues," he adds. Another possible explanation for the premium is that very few Norwegian high yield bonds have a credit rating, and could not be purchased by some ratings-constrained investors.

Smaller issues can offer a premium of 200-250 bps over comparable European or US debt. On top of the "Norway premium," there is an extra illiquidity premium of about 100 basis points for smaller issues below NOK 500 million (EUR 50 million) in size. "This is difficult to measure exactly given the small sample size," says Thorsheim.

## LONGER HOLDING PERIODS, NEW ISSUES AND ALIGNING LIQUIDITY

While Borea wants to find smaller issues, there are also some constraints. The manager would typically not want to invest in issues below NOK 200 million (EUR 20 million) in size and does not want to own more than 25% of outstanding debt in any given issuer. "We always want some room to maneuver and 15-20% is more likely," says Thorsheim.

These large positions are acquired mainly through primary issuance, since the secondary market is generally not liquid enough to provide large volumes, unless there is technical selling or a change in perception. Convertibles, which are occasionally invested in, would typically be acquired in the secondary market after they have cheapened, because the yields at issue are usually not high enough. New issues in the Nordic market usually have a 3–5-year maturity and Borea intends to hold until maturity but in practice better opportunities have historically come along so the average holding period is 2 years.

Although the smaller issues tend to be less liquid, and are priced thereafter, most of Borea's holdings will be quoted in the market by counterparty brokers. Additionally, the new fund can invest up to 25% in direct and bilateral private loans, marked to market. To mitigate potential liquidity mismatches, there is a three-month lockup on the new mandate, which is longer than one month on the flagship fund and one week on the UCITS fund.

## LEVERAGE, FX HEDGES AND RATE RISK

Borea can leverage up to 50% but typically uses leverage of 15-25%, resulting in gross exposure of 115-125%. The credit facility can also be used to manage margin requirements on currency hedging, which is mainly hedging USD, SEK and EUR issues back to NOK.

> "We aim to avoid defaults but if there were any, we would be prepared to play an active role in restructurings."
>
> Peer Hastrup Thorsheim

Interest rate risk could be hedged, but currently interest duration is only around one year because most of the exposure is floating rate. Of course, the floating rate exposure means that companies will have to pay more as NOK or USD interest rates rise, and Borea's credit analysis is designed to ensure that they can afford higher interest payments. "We aim to avoid defaults but if there were any, we would be prepared to play an active role in restructurings," says Thorsheim.

## ESG AND CARBON TRANSITION

All of Borea's strategies are classified as article 6 under SFDR. "ESG is not the main focus for any of our mandates, but we are keenly aware of the risks increased focus on ESG, and especially the "E" poses for companies in our investment universe. To us it seems that two camps in the ESG-discussion have emerged: those who plainly exclude companies, and those who try to influence companies from the inside. We are firmly in the second camp, and try to have a positive influence by lending to companies that want to reduce their carbon footprint or improve sustainability," says Thorsheim.

Borea invests in carbon intensive sectors such as energy and shipping, but seeks to provide financing that helps them to reduce their environmental footprints. "Shipping companies could for instance replace a 20-year-old ship with a new one that has better propulsion technology, or uses LNG (liquid natural gas) rather than crude oil or heavy fuel, which would be a net positive for the environment," Thorsheim points out.

# Kreditfonden's Pockets of Yield

By Eugeniu Guzun – HedgeNordic

With high-yielding opportunities in public fixed-income markets being few and far between, investors have been exploring lesser-known or out-of-the-public-eye corners of finance. Swedish asset manager Skandinaviska Kreditfonden AB (Kreditfonden) has set out on a journey to develop a product range that focuses on some of these corners of fixed-income markets with the aim of becoming a leading player in direct lending to Nordic companies.

Kreditfonden currently manages three – soon-to-be four – alternative investment funds focused on providing capital to Nordic small and mid-size enterprises (SMEs) through different strategies. "First and foremost, we have Scandinavian Credit Fund I that has been up and running since January 2016. The fund provides loans to Nordic SMEs with ticket sizes in the range of SEK 30 to 300 million with tenures of up to 48 months," explains Fredrik Sjöstrand, the founder of Kreditfonden and CIO of SCF I.

The second product is the Nordic Factoring Fund, which buys factoring loans via a third party from companies looking to strengthen their short-term liquidity by selling their account receivables. "In the beginning, we had receivables in Scandinavian Credit Fund I as well. But we liked the characteristics of that asset class so much that we decided to offer investors separate exposure to its attractive risk-return profile," says Sjöstrand. "Of course, liquidity in that fund is not great," he acknowledges.

Investors in the Nordic Factoring Fund have to give a 90 days notice to redeem capital, with redemptions limited to quarter-ends. "You cannot get exposure to something that returns six percent or more per year, with a high Sharpe ratio and a pool of 30,000-40,000 receivables that turn around every 90 days without a price. And the price is illiquidity," explains Sjöstrand. "This fund has a very special risk-return profile."

The last up-and-running fund is the High Yield Opportunity Fund, a closed-ended alternative investment fund that invests in lower-rated loans in the Nordic bond markets. "This fund buys listed high-yield bonds, and benefits from a twist in its construction that limits one's exposure to other



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Fredrik Sjöstrand
founder – Skandinaviska Kreditfonden AB

investors' behavior," particularly indiscriminate selling due to short-term fear. "If an investor has an investment horizon of 3-5 years and the market goes upside down, we will not be forced to sell the assets we want to keep because of big redemptions," says Sjöstrand.

## SOON-TO-BE RELAUNCHED

With its original launch put off by pandemic-induced challenges, Kreditfonden is set to launch its fourth fund – the Nordic Direct Lending Fund – as an evolution of Scandinavian Credit Fund I. Like its predecessor, the Nordic Direct Lending Fund is "a private debt fund focusing on direct lending activities with loans in the range of SEK 150-500 million with much longer tenures," according to Sjöstrand. This fund buys private loans with an average tenure of about 60 months and purely caters to institutional investors that can accept a closed-end structure with an eight-year lock-up period in exchange for an annualized return of 5-7 percent net of fees.

"With our two direct lending strategies, we now cover loans with tenures ranging from three-four months up to eight-nine years," says Sjöstrand. The soon-to-be-launched fund "is a natural progression following on our success with the first fund," he emphasizes. "This launch will help us on our journey to become the leading provider of direct lending strategies in the Nordic region."

## INFLATION AND CREDIT RISK

Inflationary pressures have increased significantly this year, driven by recovering economies, supply chain bottlenecks and higher energy prices, among other things. The true nature of the recent inflation bout has become clearer over time. "I don't think inflation is transitory at all," claims Fredrik Sjöstrand. "Markets should have seen increasing interest rates much earlier than the current forecast in the market right now," he continues. "If central banks did that, they would not have to raise rates as much as they will have to otherwise. Central banks are usually behind the curve."

With inflation on the forefront of investors' minds for much of the year, the main questions focus on how

> "Our job is to produce a steady return, regardless of the direction of interest rates. The thing that we are exposed to is credit risk."

inflation risk and the prospect of higher rates will impact all types of assets and investment products. While publicly-listed fixed-income instruments usually fall in price in a rising rate environment due to their inverse relationship to interest rates, private debt does not lose value in the same way. Credit risk plays a much larger role in determining the value of private debt than in many traditional bonds, so private debt instruments are subject to different accounting treatments.

"Due to the fact that our underlying investments are subject to IFRS 9, their value does not depend on the level of interest rates so much," explains Sjöstrand. "We were not able to increase the value of our assets when interest rates fell during the last couple of years, like all the marked-to-market instruments," he elaborates. "If we see a general increase in interest rates, we will not be forced to decrease the value of our underlying investments. An increase in the level of interest rates means that we can reinvest that money at higher rates when our loans mature."

Kreditfonden's direct lending and factoring funds have both been affected by the low-rate environment of the past decade. "If you go back in time two or three years, we could lend capital at rates that reached an average of 9-11 percent," says Sjöstrand. "In this low-rate environment, we are lending in the range of 7-9 percent." The low rates have acted as a headwind for Kreditfonden's strategies so far and can, in turn, act as a tailwind in a rising rate environment.

"Our job is to produce a steady return, regardless of the direction of interest rates," emphasizes Sjöstrand. "The thing that we are exposed to is credit risk," he asserts. When investors end up evaluating Kreditfonden and its funds, they should assess the team's capacity to perform a proper and thorough credit risk analysis of the underlying issuers of either direct loans, account receivables or high-yield loans.

"For that, we have a team of four people on origination and analysis, the rest of the investment team, the credit committee, our external auditors and internal auditors, and then compliance and independent valuation within Finserve Nordic AB," says Sjöstrand. "There are many, many heads and eyes assessing the credit risk of our potential investments before they get into our funds."

## SUSTAINABILITY AND IMPACT

The asset management industry has seen the embrace of sustainable investing move from exception to expectation and norm. Formalized integration of environmental, social and governance (ESG) considerations has become the norm, with Kreditfonden also formalizing its approach to responsible investing. "We have now formalized our sustainability efforts through an ESG policy and by joining the UN PRI initiative, which was not such a big step for us because we had a soft ESG policy in place since inception," says Sjöstrand. "For us, it has not been a difficult process to convert our efforts into a formalized sustainability policy."

Kreditfonden's Scandinavian Credit Fund I and Nordic Direct Lending Fund are both classified as "light green" (Article 8) funds under the European Commission's Sustainable Finance Disclosure Regulation, which puts funds into one of three categories. A so-called Article 6 fund has no clear environmental, social or governance objectives. An Article 8 fund, commonly referred to as "light green," is broadly defined as one that furthers an environmental or social aim in some way. An Article 9 fund, or "dark green," must have sustainability as its sole objective.

"We do not have the ambition to join the "dark green" group," says Sjöstrand, arguing that "we could not meet the return targets we have by being "dark green" funds." Sjöstrand and his team "want to have the capacity to have a broader investment space than the one that falls under the definition of a "dark green" fund."

Kreditfonden has also been granted a guarantee from the European Investment Fund (EIF), with 70 percent of the credit risk being transferred to the EIF on new loans where the guarantee is applied. The guarantee, deployed through both Scandinavian Credit Fund I and Nordic Direct Lending Fund, makes available up to SEK 3.0 billion in advantageous lending for Swedish, Danish and Finnish companies impacted by the coronavirus pandemic. With the EIF having strict demands on sustainability, Sjöstrand says that "we are proud to have been included in the credit program by the EIF. Being included means that our rigorous analyzing processes as well as our lending and sustainability policies have been extensively tested and approved by the EIF."

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From left to right: Carl-Johan Nordquist and Dag Wardeus – Hypoteket Fondförvaltning

# Mortgage Funds – Alternative Fixed Income, or Just the New Traditional?

By Eugeniu Guzun – HedgeNordic

> "My co-founder and I embarked on this journey to revolutionize the mortgage market and the mortgage offering to customers in Sweden."
>
> Dag Wardaeus

The coronavirus pandemic and associated shutdowns may have forced banks to start thinking about digitizing their mortgage origination processes. Non-bank lenders such as Swedish mortgage challenger Hypoteket have long been giving borrowers a fully-digital mortgage experience that creates transparency, efficiencies and cost savings in loan origination. Founded by Dag Wardaeus and Carl-Johan Nordquist based on the non-bank lending model in the Netherlands, Hypoteket is a fully-digital mortgage lender in the Swedish market that provides mortgages financed by institutional investors through mortgage funds within the Alternative Investment Fund (AIF) framework.

"The mortgage market in Sweden is basically an oligopoly with five, six huge banks. The banks had an information advantage and market power over the small customer, with their intransparent pricing models allowing them to charge excessive interest rates," explains Dag Wardaeus. "The mortgage customer in Sweden has just been a price taker." The fundamental shift in regulations that took place in response to the housing crisis limited the role of banks within the mortgage business, enabling new actors such as Hypoteket to enter the market and put the power back in the hands of the consumer.

"We wanted to create a fully-digital mortgage provider, with very transparent interest rates for the mortgage customer, with a very simple digital process to onboard customers and everything that our generation takes for granted," says the 35-year-old founder, who is the CEO of Hypoteket's fund management company.

"My co-founder and I embarked on this journey to revolutionize the mortgage market and the mortgage offering to customers in Sweden," he emphasizes. The other co-founder, Carl-Johan Nordquist, acts as the CEO of Hypoteket Mortgages, the originator and servicer. "But pretty soon, we realized that if we were going to get any institutional investors interested in our mortgage funds, we needed to give them a higher yield than the alternative exposure."

## PASS-THROUGH MODEL

With two up-and-running mortgage funds, Hypoteket relies on a pass-through model where "investors buy into a pool of mortgages that Hypoteket has originated and earn a yield that reflects the average mortgage rate in the Swedish market," according to Johan Hasselblad, Head of Funding and Sustainability. Covered bonds, the main source of funding for commercial banks, pay very little yield these days. "We only take a small cut and all the remaining yield goes back to institutional investors," emphasizes Wardaeus, who runs Hypoteket's funds alongside fund manager Lotta Åkerlund. "The revolution is not in the structure of the mortgage offering, but in how much yield goes through the system back to end-investors."

"The traditional way of calculating yield in a pass-through model is that investors will get incoming yields less a management fee, sometimes coupled with a performance fee," explains Hasselblad. "We don't do that, as that would mean investors' yield is pegged to the way we set our mortgage rates commercially." Instead, Hypoteket created an index that tracks the average actual lending rates among the largest mortgage institutions in Sweden, with Hypoteket's coupons being based on this index, less a spread.

"This creates transparency, predictability and independence," emphasizes Hasselblad. "Our mortgage funds, therefore, give investors direct exposure to our asset pool and give back a monthly coupon that reflects the average mortgage rate landscape in Sweden. Should market rates rise, our coupon will follow higher, so the investment should be at least somewhat inflation hedged – as long as central banks allow rates to move higher with inflation."

## THE LATEST MORTGAGE FUND

"We have been very conservative with our first two mortgage funds, as we issued mortgages with a maximum loan-to-value (LTV) ratio of 65 percent," says Wardeus. "Our typical client is a person of middle-age who has owned a house or flat for quite some time. This makes a great foundation for asset quality." With Sweden's national pension fund AP4 as an anchor investor, Hypoteket has recently launched a new mortgage fund that is lending with LTVs of up to 75 percent.

> "Investors buy into a pool of mortgages that Hypoteket has originated and earn a yield that reflects the average mortgage rate in the Swedish market."
>
> Johan Hasselblad

"We can allow somewhat higher LTVs in the new fund, so demographics are likely to change slightly towards the younger clients," expects Wardeus. "Coming from a maximum LTV of 65 percent to 75 percent is a milestone in our long-term ambition to become a full-service provider within residential mortgages, which will eventually enable us to service the entire market."

Backed by Nordic media giant Schibsted, Hypoteket has issued more than 10,000 mortgages so far, with the funds overseeing around SEK 12 billion in assets under management. Expectations for asset growth are high, with the Hypoteket team targeting to double assets under management by the end of next year. "Reaching a broader market together with an improved pricing strategy, which should increase the average loan size, will be key elements in achieving this," argues co-founder Carl-Johan Nordquist. "We have had organic yearly growth of around 50 percent since inception, and have now moved away from startup to scale-up in fintech terms."

Backed by an over-collateralization of 1.8 percent, the new mortgage fund has received an investment-grade rating from Moody's. "For the first time, we are adding a credit enhancement element into the fund structure, with this protective layer absorbing any potential losses up to 1.8 percent of the capital," explains Hasselblad. "This may not seem like a lot, but you rarely see any losses in the Swedish residential mortgage market from a historical perspective," he elaborates. "We are basically not expecting any losses at all, so 1.8 percent should go a very long way."

Set to be listed in Luxembourg, Hypoteket's new mortgage fund has a credit rating of Baa2. "We designed the new fund to get an investment-grade rating, and we took it one notch above that. With even more credit enhancement from our side, the rating could have been higher, but investor returns would drop as a result," comments Hasselblad. "We believe investors realize that in a structure like this, the asset pool is what really matters, and that a credit rating is just an extra box ticked," he emphasizes. "The underlying mortgages originated by Hypoteket are probably among the safest assets you could invest in. We originated our first mortgage back in March 2018 and have had zero losses so far. We obviously intend to keep it that way."

## PLACE IN A PORTFOLIO

With still ultra-low mortgage rates in Sweden – an average of 1.32 percent for new agreements for mortgages to households, what role can a Sweden-focused mortgage fund play in investor portfolios? "We are aiming to replace parts of investor portfolios that are not yielding anything at all with something that is still low risk and can offer at least some yield," explains Hasselblad. In the last decade's low-return environment, institutional investors have been forced to climb the credit risk ladder, according to Hypoteket's Head of Funding. "We would like to offer something that does not require investors to take on a lot more credit risk."

Some institutional investors may dismiss an investment in Hypoteket's mortgage funds because of limited liquidity stemming from the closed-end structure with a ten-year lock-up. "We can never promise liquidity with the fund's current structure, but why would a long-term institutional investor need to have the entire fixed-income book liquid?" ponders Hasselblad. "Liquidity is extremely expensive these days, so investors need to ask themselves how much of their books really need to be liquid, and why. A mortgage fund will earn an illiquidity premium from low-risk residential mortgages. This is basically traditional fixed income packaged differently – Fixed Income 2.0."

Hypoteket's mortgage funds "are very much tailored" for pension funds and insurance companies, both because residential mortgages as assets match their long liabilities, but also due to favorable regulations. "Under the Solvency 2 regulation, investing in residential mortgages with full look-through, which our funds enable, is very capital efficient," explains Hasselblad. "It is very much comparable to short-

Johan Hasselblad, Head of Funding and Sustainability – Hypoteket Fondförvaltning

Lotta Åkerlund, Fund Manager – Hypoteket Fondförvaltning

dated covered bonds. If you compare our yields to those on short-term covered bonds on an unleveraged basis, then there is a quite sizable yield pick-up," he continues. "Most, if not all, of these benefits are valid under the IORP II framework as well," adds fund manager Lotta Åkerlund.

## SUSTAINABILITY

"Hypoteket was founded to improve the Swedish residential mortgage market in terms of transparency and ease of use for clients, and in order to give more back to investors than what the banks do," says Hasselblad, who is responsible for sustainability at Hypoteket's fund management firm. "These, at least to us, are very relevant features for the S in ESG – transparency, equality (we treat our clients equally – no individual negotiations) and also that we work for a sound and well-functioning financial market, with no excess profits," he continues.

"In the Netherlands, mortgage funds are also seen as contributing positively to financial stability because of long term, solid investors such as pension funds. The same should hold true for Sweden".

Hypoteket Mortgages, the originator and servicer, is labeled a climate-neutral company by SouthPole. "We have just started a new project together with them (SouthPole) where we will map greenhouse gas emissions and carbon footprints from our mortgage funds as well," says Hasselblad. "Our ambition Is to align the whole company with the net-zero targets and do so by incentivizing our clients to make green investments or conscious energy-related choices."

The funds, meanwhile, are set to fall within the scope of Article 8 of the European Commission's Sustainable Finance Disclosure Regulation – thereby becoming a "light green" fund. "We could potentially do something dark green going forward if we can do a good product both in terms of meaningful volume and having an actual environmental impact."

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Jonas Mårtenson – Founder of Resscapital

# Positively Skewed Fixed-Income Alternative

By Eugeniu Guzun – HedgeNordic

Many Americans rely on life insurance policies as a critical safety net to ensure the economic security of their families through the loss of a loved one, and most often, the primary breadwinner. However, most policies never pay out since policy owners stop paying premiums and allow their policies to lapse.

Older policy owners that have kept their policies have been increasingly opting to sell their policies to third parties in the secondary market for life insurance policies for an amount greater than the policy's cash surrender value but less than the expected payout to the beneficiary upon the policy owner's death. This secondary market exploits an inefficiency that enables both policy owners and third parties to achieve a mutual economic benefit. An alternative investment fund, Ress Life Investments, run by Resscapital's Stockholm-based team has been snapping up such policies in the U.S. secondary market for life settlements since 2011.

The success of a life settlements strategy requires accurate estimates of longevity. "In our view, long longevity in itself is not a risk, the biggest risk comes from how our fund managers are able to estimate and control longevity risk," explains Jonas Mårtenson, the founder of Resscapital. "We have to make sure that our portfolio managers actually understand longevity and understand how to mitigate the risk by selecting lower-risk policies that still provide an attractive return."

Resscapital's approach to mitigating longevity risk involves buying policies from healthy retirees with long life expectancies and choosing conservative estimates of life expectancies. "For us, the name of the game is to buy policies with long life expectancies, based conservative estimates," Mårtenson tells HedgeNordic. "We require at least two estimates of life expectancies when buying policies, and we try to be very cautious by working with niche medical underwriters that tend to provide somewhat conservative, longer life expectancies," he continues. Resscapital's risk-aversion has resulted in more policies paying out than expected in recent years, providing a boost to the fund's performance.

"In our view, long longevity in itself is not a risk, the biggest risk comes from how our fund managers are able to estimate and control longevity risk."

## POSITIVELY SKEWED FIXED-INCOME ALTERNATIVE

Ress Life Investments has generated an annualized return of 7 percent in the past five years, just in line with its return target of 7 percent net of fees in U.S. dollars. "The fund is completely uncorrelated from equities, fixed income and other asset classes, because the main risk we take is longevity," explains Mårtenson. Over the past five years, Ress Life Investments has exhibited a correlation of 0.07 with the MSCI World and 0.04 with the S&P 500. "It is very difficult to find investments that are quite uncorrelated to the major asset classes." With an annualized return of 7 percent in the past five years, Mårtenson views Ress Life Investments as a perfect alternative for fixed-income investments.

"This is a high-yielding fixed-income replacement with a very high credit quality," says the Resscapital founder. "We have policies issued by close to 60 different U.S. life insurance companies with a minimum rating of A-," he continues. "Although the credit risk that we take on U.S. life insurance companies is real, there are no known cases in the United States when policy beneficiaries did not receive death benefits," says Mårtenson. "A life insurance policy will pay out even if the life insurance company goes bankrupt. Bankruptcies have happened many times in the past, but the actual portfolio of life insurance policies from a bankrupted insurance company may then be sold to another life insurance company. The death benefits have always been paid out."

Although Ress Life Investments represents an alternative to fixed-income allocations, its return characteristics differ from those of equity, fixed-income or other investments. "Ress Life investments is not only uncorrelated, but also exhibits return characteristics that are very different," argues Mårtenson. The fund tends to exhibit a distribution of returns that is positively skewed. "About 70 percent of monthly returns are positive and 30 percent are negative. But if you look at the way our performance is derived, we have periods of very flat performance just like this year where nothing much happens," says Mårtenson. "But when the policy pays out, the net asset value will increase quite a lot, which is an interesting and somewhat unique return characteristic. From a diversifying point of view, this is a great counter-cyclical allocation to most other investments."

## INFLATION

With inflation dominating investing conversations so far this year, Mårtenson still views his team's life settlements strategy as an attractive alternative in an inflationary environment. "Since we are delivering a nominal return, increasing inflation does have a negative effect because our returns may become less attractive. Also, of course, the big policy payouts in many years to come would also be affected by inflation," acknowledges Mårtenson. "On the other hand, we would also pay less relatively speaking in premiums. We have the cash outflows in the form of premiums, which are becoming worth less and less because of inflation."

"Compared to a bond strategy, we are less affected by interest rates shifts," argues Mårtenson. "We are picking up quite a lot of extra yield if we buy policies at an expected IRR of 12 percent in U.S. dollars in spite of inflation. There is quite a big cushion here," he adds. "If we can deliver on our target return of 7 percent or even higher, that is still attractive versus many other fixed-income strategies even in an inflationary environment."

## IDEAL PORTFOLIO SIZE

Ress Life Investments gained 2.8 percent in the first nine months of 2021 after booking a gain of 7.2 percent last year, about 8.0 percent in 2019 and a record 9.9 percent in 2018. "The performance is lower than expected so far because we only had a few policies paying out this year," explains Mårtenson. "The portfolio is still rather small with approximately 400 policies, so we still see periods of time when fewer policies pay out," he continues. "Even a 12-month period is quite a short timeframe."

"A portfolio of 1,000 policies could provide a much more stable and less volatile performance," argues Mårtenson. Its $282 million in assets under management are currently invested in over 400 policies with a total face value exceeding $1 billion. "We have had record buying in the last 12 months, with the team buying probably around 100 new policies in the last year. So our aim is to continue to increase the portfolio and generate similar but more stable performance for our investors."

## TERTIARY MARKET JOURNEY

In addition to the mature and growing secondary market for life insurance policies, the so-called tertiary life settlement market, which enables the purchase and sale of larger portfolios of life policies, has also become more active. Resscapital is now planning the launch of a "closed-end fund investing in the tertiary market for larger institutional investors in 2022." According to Mårtenson, "the fund is going to be much more like a private equity fund, a 10-year closed-end fund with minimum ticket sizes probably around $25 million."

Stockholm-based Resscapital has all the ingredients needed for successfully navigating and investing in the tertiary market. "We have built a great ten-year track record, we understand and have deep knowledge of the asset class, and we are a well-established player," says Mårtenson, who is the only non-U.S. board member at the Institutional Life Markets Association (ILMA). "We have also developed our own internal portfolio management systems that enable us to filter and review large quantities of data. All our systems and portfolio management are well adapted for the launch."

"The fund is completely uncorrelated from equities, fixed income and other asset classes, because the main risk we take is longevity."

# The Siloing Effect of Equity and Credit Markets

By Eugeniu Guzun – HedgeNordic

From left to right: Gunnar Wiljander, Michael Falken, William Wilson, Aram Hussein

> "Capital structure relative value is a neglected space. The siloing effect of equity and credit markets means this space falls between the cracks. There are not a lot of managers operating in this area."
>
> Michael Falken

Tidan is different. River Tidan is one of the few rivers in Sweden that flows from south to north. Michael Falken, the CIO of hedge fund start-up Tidan, says their strategy aligns with its namesake. "We view our strategy as fairly unique with the potential to offer investors a differentiated source of alpha."

Michael Falken and William Wilson, joined by fellow Brummer alumni Gunnar Wiljander, have launched a new hedge fund that employs a capital structure relative value strategy. "We benefit from eight years of research and development at Brummer, with myself and Will at Goldman Sachs having over 40 years of combined experience employing capital structure relative value strategies," Falken tells HedgeNordic. "Capital structure relative value is a neglected space. The siloing effect of equity and credit markets means this space falls between the cracks. There are not a lot of managers operating in this area."

"Brummer was a particularly supportive and innovative platform, which we are very happy to have been part of," says Falken. "With the toolset that we developed at Brummer, we felt that it was a great springboard to set up on our own."

The ex-Brummer trio launched Tidan under the umbrella of Tidan Capital in mid-October with the support of cross-asset trader Aram Hussein, formerly at Brummer & Partners. Gunnar Wiljander, the former CEO of Nektar – one of Sweden's oldest and largest hedge funds, is overseeing Tidan Capital as CEO, with Michael Falken and William Wilson having full responsibility for the management of the fund that currently oversees €93.5 million in assets under management.

## THE BASICS OF CAPITAL STRUCTURE RELATIVE VALUE – VALUE TRANSFER ALPHA

The concept of informational effiency suggests that financial markets – equity, fixed income and derivative – should be closely correlated with each other. Occassionally, however, there is some level of lead-lag relationships among stock and bond markets. "Beneath the surface of broad market indices, there are thousands of companies living their own lives, having their own dislocations in their own capital structure," explains Falken. "There are thousands of companies with individual interconnections between their debt and equity securities, where much larger dislocations can emerge."

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"A greater number of capital structure dislocations are being born out of ESG events and that fits our core competence."

William Wilson

Tidan's strategy utilizes mispricings and dislocations within a single company's capital structure. The fund focuses on going long undervalued securities linked to one part of the capital structure and simultaneously going short overvalued securities linked to another part of the capital structure. "Because the space is neglected, employing fundamental research with a focus on understanding a company's capital structure and capital allocation policy allows us to take advantage of these attractive dislocation opportunities."

"Our strategy focuses on the relationship between equity and credit," elaborates Wilson. "When going long credit and short equity, we look for companies that will transfer value from shareholders to bondholders," he explains one of the two types of relative value trades carried out by Tidan. "The simplest example is an over-levered company where the management team realizes the balance sheet is not appropriate and therefore plans to de-lever."

"The other trade is the exact opposite. We are looking for value transfer from bondholders to shareholders," continues Wilson. This situation occurs when a company's management team believes re-levering is appropriate as the business performs well and grows or when third parties such as activists or private equity are circling around.

Tidan's trades are all carefully constructed to be market- and company-neutral. "All of our trades are constructed to isolate our value transfer view, where we feel we have a genuine edge," says Wilson. "We call this Value Transfer alpha," he adds. "We know we have no edge in predicting a company's next earnings results or the next big factor move, so we target to hedge out all of that noise. We believe this contributes to our low correlation to other asset classes."

## ENHANCED TOOLSET

Tidan is employing an evolution of the capital structure relative value strategy run within Brummer & Partners-backed Carve. "We believe the original capital structure relative value strategy from Carve is attractive because there are not a lot of people doing it," argues William Wilson, who left Goldman Sachs in 2018 to join Carve Capital. "But in no way are we relaxing. We are finding more ways to refine the strategy, enhance our toolkit and discover different types of opportunities that exist."

"Tidan's strategy is similar to the one used at Carve in the sense that we participate in the capital structure, we have more than one position in every single company, one being a bullish and one being a bearish position," explains Falken. "Beyond that, everything is different. The way we approach portfolio construction is much different from what we did at Carve. We continued to develop the toolset, which is now much more enhanced. On top of that, we have an overlay hedge that we did not have at Carve."

## MARKET ENVIRONMENT AND ESG VALUE TRANSFER ALPHA

The recently-launched Tidan seeks to invest in around 40 investment opportunities at any given time, with both micro and macro factors constantly creating opportunities. "There are a lot of idiosyncratic events creating dislocation opportunities and we are looking for events driving value transfer across capital structures," Michael Falken tells HedgeNordic. "It is key to have the experience to understand the dislocations that are going on in the market at any particular time," adds Wilson. "These dislocations partly occur because market participants generally trade equity and credit in isolation from each other," he explains. "This happens across all markets."

"The Environmental, Social and Governance (ESG) trend is also creating dislocations across the capital structure," elaborates Wilson. "Our strategy resides within the world of capital allocation. The ESG theme is manifesting itself in the market through how and if capital is allocated to certain sectors and companies, causing capital structure dislocations," he continues. "A greater number of capital structure dislocations are being born out of ESG events and that fits our core competence," Wilson tells HedgeNordic. "If we see a company that has been deficient on the governance or environmental side, and we think that the board has the desire to fix that, that is an opportunity for us. The deficiency may be remediated and the dislocation then closes."

At full speed, Tidan will maintain a portfolio of around 40 investment packages, with every package having at least two opposing positions in different credit instruments, equity, options or a combination of those. Investments are typically held for 6-24 months and the portfolio is expected to achieve a market-neutral target return of 7-10 percent net of fees for its investor base of professional investors.

"There are a lot of idiosyncratic events creating dislocation opportunities and we are looking for events driving value transfer across capital structures."

Michael Falken

Kari Vatanen, CIO – Veritas

# Next Stop: Complexity and Illiquidity

By Eugeniu Guzun – HedgeNordic

Stuck between low yields, the prospect of higher rates due to rising inflation and the need to include fixed income in their portfolios, institutional investors face a difficult task in deciding where to allocate capital. "The major challenge for all the institutional investors in this environment is that there are no diversifying asset classes," confirms Kari Vatanen, the chief investment officer of Finnish pensions insurer Veritas.

"Looking back over decades, fixed income, especially government bonds – the risk-free or almost risk-free investment, has been a good diversifier in history," says Vatanen. "With the zero-rate environment in the Euro area and low rates in the U.S. post-financial crisis, the fixed-income space does not provide a lot of diversification potential for investor portfolios." With inflationary pressures worldwide and the prospect of higher target rates from central banks, an already challenging market environment has become even more difficult for institutional investors.

"There are strong inflationary pressures especially in the U.S. but also in Europe, which means it is quite probable that central banks will tighten monetary policies," argues Vatanen. Markets are already pricing three rate hikes by the U.S. Federal Reserve for 2022. "If inflationary pressures continue, and rates will be rising in response, that means negative returns for risk-free fixed income," points out Vatanen. "That is a difficult environment for fixed-income investors, especially for those who are required to maintain an allocation to risk-free instruments."

Like many other institutional investors, Veritas Pension Insurance is subject to regulatory requirements that force the pension insurer to invest a portion of its assets in low-risk fixed-income investments. "We

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cannot allocate all the assets in risky asset classes such as equities or equity-type of investments," says Vatanen. "Even in illiquid cash flow-generating asset classes such as real estate and infrastructure, we have a limited possibility to allocate there due to regulation," adds the CIO of Veritas. "We are required to stay in fixed income in one way or another, and that represents a little bit of a challenge in the current environment. But we need to take it from here and constantly think of what we can do."

"We cannot be totally out of highly liquid risk-free government bonds due to several reasons," argues Vatanen. "We need them to meet regulatory requirements and we need them for liquidity risk management," he elaborates. "We need to have an allocation in the high-liquidity instruments to be quite sure that we can get liquidity out in every possible time," says Vatanen. "During the last decade, we have tilted our portfolio towards lower credit quality, meaning higher yield, but we might be at the end of that path already."

## CURRENT OBJECTIVE: DECREASE DURATION

With the prospect of rising rates due to inflationary pressures, the primary goal for institutional investors is to lower duration in the portfolio of fixed-income investments to limit the impact of rising rates. "The next step we are taking is decreasing duration, or the interest rate sensitivity of the portfolio in the environment where we expect rates to rise in the face of inflation and central bank actions," confirms Vatanen. "But the problem is that target rates in the Euro area are negative, which means that keeping money in cash is not a good choice for institutional investors."

This environment also forces institutional investors such as Veritas "to hunt for yield in more risky asset classes within the fixed-income space, which means higher exposure to credit risk but also extra complexity and illiquidity from opportunistic credit or illiquid debt asset classes," says Vatanen. "That is a common challenge for all institutional investors," he emphasizes. All institutional investors are hunting for yield and this is not in any way a new phenomenon. "We have been in this kind of environment five years or even more. With interest rates so low, investors

"We are required to stay in fixed income in one way or another, and that represents a little bit of a challenge in the current environment."

have been forced to hunt for yield, but that is now even more problematic due to higher inflation expectations."

The objective, therefore, is to "build a portfolio with lower duration and lower interest-rate sensitivity, but at the same time we have hunt yield in asset classes that are not interest-rate sensitive," argues Vatanen. "We have to shorten duration in the total portfolio and hunt down for yield by going down in the risk spectrum," reiterates the CIO. However, higher-risk interest-floating instruments such as high-yield bonds, which help decrease portfolio duration, are not offering appropriate compensation for the risks associated with these investments, according to Vatanen. "High-yield spreads in the market are starting to be quite low, meaning that there is more risk than yield available in the high-yield market. Again, this forces us to find other places in the fixed-income space."

Veritas and other institutional investors required to hold assets in fixed-income mainly have two alternatives. "One alternative is illiquidity, which involves opportunistic credit, illiquid credit or private debt-type of investments, and the other is complexity," says Vatanen. "We try to find more complex structures to get yield without duration, interest-rate sensitivity."

Although real estate and infrastructure are often considered the go-to asset classes in an inflationary environment, Kari Vatanen argues that the current environment is difficult for these asset classes too. "The cash flow generation from real estate and infrastructure is attractive for the investors seeking a replacement for fixed-income investments," argues Vatanen, who goes on to emphasize that "they are not totally risk-free in an environment of rising rates." According to Vatanen, "there is a lot of implicit duration included in such kind of cash flow-generating investments, which means that the whole inflationary environment is quite challenging."

## INFLATION ISN'T AS TEMPORARY AS EXPECTED

Global inflation, initially believed to be a temporary phenomenon caused by the reopening of the global economy and then by supply chain disruptions, has been on a roller-coaster ride since the beginning of the coronavirus pandemic. Investors are increasingly arriving at the conclusion that inflation is not as temporary as initially expected. "To be honest, our own view on inflation has changed in the previous couple of months," acknowledges Vatanen. "We have observed three waves of inflation. The first wave was demand-based inflation, which started at the end of last year," starts the CIO. "The biggest driver was fiscal support packages from the U.S government meant to keep the economy going."

The second wave started this summer with supply chain disruptions. "We have seen and continue to see bottlenecks and supply chain disruptions that are causing rising prices, which creates supply-side inflation," explains Vatanen. "I have not been worried about these first two waves," he emphasizes, as the forces behind the demand-driven and supply-driven inflation were only temporary. "But now it seems inflationary forces have gone stronger with wage inflation," says Vatanen. "There is higher demand for labor than what is available in the market and that, of course, serves as a tailwind to wage inflation," he continues. "That might be the reason why inflation is not that temporary. Wage inflation means that we have constant inflation. It is not temporary."

"We have to shorten duration in the total portfolio and hunt down for yield by going down in the risk spectrum."

# DNB'S JOURNEY IN NORDIC HIGH-YIELD

By Eugeniu Guzun – HedgeNordic

"We have also seen the market develop from a mainly Norwegian marketplace, where the main sectors used to be oil services and shipping, into a well-diversified market with substantially broader sector diversification."

The search-for-yield behavior has been one of the major investment themes over the past decade. The Nordic high-yield market, which has transformed from a predominantly Norwegian marketplace dominated by industries such as oil services and shipping to a truly well-diversified pan-Nordic market, has been one source of extra yield for income-seeking investors.

"The Nordic high-yield market has grown considerably in size over the last ten years," says Svein Aage Aanes, Head of Fixed Income at DNB Asset Management and portfolio manager of the asset manager's high-yield strategy. "When we started our high-yield strategy back in 2012, the market had just over NOK 200 billion in loans outstanding," points out Aanes. The market has grown to reach NOK 900 billion in loans outstanding, with the number of issuers growing from under 300 back in 2012 to about 700 today.



Svein Aage Aanes, Head of Fixed Income – DNB Asset Management

"We have also seen the market develop from a mainly Norwegian marketplace, where the main sectors used to be oil services and shipping, into a well-diversified market with substantially broader sector diversification," says Aanes. "Sectors such as oil services and oil production, which used to be quite dominant sectors, would now account for below ten percent of the Nordic high-yield market." Each of the Nordic countries contributes with a strong footprint in different areas of the non-financial Nordic high-yield market, facilitating broad sector diversification within the marketplace. "Among the main sectors in the market, you now will find real estate, technology, banking and consumer services, among others."

"On the investor side, the Nordic high-yield market has also developed in a positive direction over the past ten years," argues Aanes. When DNB's €1.7 billion high-yield bond fund was launched back in 2012, the main investors in the Nordic high-yield market were mutual funds and some family offices, according to Aanes. "Although mutual funds still represent an important investor base, the market now also attracts insurance companies, pension funds, and quite a large presence from international hedge funds, which provide liquidity to the marketplace," says DNB's Head of Fixed Income. "The liquidity in the market has improved with the market growth and the widening of the investor base."

"One aspect is that quite a lot of the issuance in the local markets are in floating-rate note format, which implies that the duration in the market is quite short."

## DIFFERENCES FROM THE GLOBAL HIGH-YIELD MARKET

Although the Nordic high-yield market has evolved significantly and transitioned toward the more mature foreign markets, the marketplace exhibits some particular characteristics that differ from major European or U.S. high-yield markets. "One aspect is that quite a lot of the issuance in the local markets are in floating-rate note format, which implies that the duration in the market is quite short," starts Svein Aage Aanes. "Another important aspect to be aware of is that transparency in the market might be a bit lower than in the major global markets, mainly because not all issuers have an official credit rating," he continues. "A third aspect is that the average size of the issuer is somewhat smaller than you would observe in the larger international markets."

"As a compensation for these factors, you typically receive a somewhat higher credit premium in the Nordic high-yield market," emphasizes Aanes. "At present, the difference would be to the tune of 200 basis points." According to Aanes, this "spread pickup in the Nordic market is relatively attractive even after taking into account the lower coverage of ratings and the somewhat smaller issue sizes." Looking ahead, DNB's fixed-income team led by Aanes is "firmly convinced that the Nordic high-yield market will continue the development that we have seen over the last ten years," says Aanes. "The market is going to continue to grow, the number of issuers is going to continue to grow and also sector diversification will continue to grow."

## SUSTAINABILITY IN THE NORDIC HIGH-YIELD MARKET

Sustainability has become a key issue and area of development in financial markets, and the Nordic high-yield market is no exception. "Sustainability and sustainability-related issues have become increasingly important in the financial markets over the past few years. This is a development that we have seen very clearly also in the Nordic high-yield market," confirms Aanes. One indication of the increasing importance of sustainability in this marketplace is the issuance of green bonds. "If you look back to 2014, the outstanding volume of green bonds in the marketplace was around NOK 1 billion. As late as December of last year, this number was NOK 44 billion. And at present, the number is up to NOK 67 billion," says Aanes. "The increase has been very strong and continues to accelerate."

The issuance of green bonds is just one aspect of the sustainability wave, according to Aanes. "If you look at the access to sustainability information from companies, there has been a clear improvement in the market over the last few years," says DNB's Head of Fixed Income. "Presently, there is almost no new bond issuance where the company does not include sustainability information, information on their sustainability strategy and so on." Even so, "there is still some work to be done," emphasizes Aanes. "That particularly goes to the companies' continuous reporting on sustainability, and particularly in hard data format, where you can get access to, for instance, climate gas emissions data and so on."

## DNB'S HIGH-YIELD STRATEGY

The team managing the DNB High Yield Fund relies on a bottom-up strategy to invest in the growing and continuously-diversifying Nordic high-yield market. "Our analysis starts with the individual company or the individual investment case. We will look at the financial information from the company and we will look at the business model and strategy," explains Aanes. "When a company comes to the market looking to borrow, we will also typically meet the top management of the company to get an improved picture of their strategy and business plan," he continues. "Based on the company's specific information and the bond specific information, we will try to make up an opinion about the risk and the credit risk on this investment case. Lastly, we will try to decide what kind of compensation in the form of credit spread we would need to see to make this an interesting investment."

An attractive investment in the high-yield bond market ideally involves a company with both the ability and willingness to repay debt, according to Aanes. This type of company usually has strong balance sheets, enjoys strong earnings potential and also exhibits high visibility in future earnings and cash flows. "Unfortunately, if a company ticks all those boxes, the credit spread would probably be quite low because the credit quality would be very high," argues Aanes. "Often, when deciding on investments, you would have to make trade-offs in the high-yield market. We tend to be willing to trade somewhat higher transparency in future cash flows against somewhat weaker balance sheets."

The DNB High Yield Fund has generated an annualized return of 4.2 percent since its inception in 2012, more than double the 2.1 percent generated by its benchmark. "To be able to deliver a decent return over time, it is also important to have a tight risk control of the overall portfolio," points out Aanes. His team's risk management involves "a top-down overlay where we try to control for sector and factor risks," according to DNB's Head of Fixed Income. "We do not want the portfolio to be too exposed to individual sector or factor risks. Examples of that kind of risks could be the oil price, could be property prices but also other factors."

"We also integrate sustainability and sustainability-related risks in our portfolio management," elaborates Aanes. "This implies that in addition to looking at financial risks, we also look at risks stemming from a company's sustainability strategy or lack thereof," he continues. "We do this both through gathering data on individual companies, but also through looking at the sustainability-related information we receive from companies and entering into dialogue with companies and company management in bond investor meetings. As a major investor in the Nordic high-yield market, we have quite a lot of influence when it comes to discussing sustainability with companies."


In the picture (from left to right): Martin Hagelskjær Nielsen, Christian Birkehøj Jensen and Henrik Stille

# The Nordea Hunt for Relative Value Opportunities

By Eugeniu Guzun – HedgeNordic

The Nordic region has been home to a solid group of fixed-income hedge funds, partly because of the proximity to the large – alpha-rich – Danish covered bond market. Two of the youngest players in this corner of the Nordic hedge fund industry are Nordic Rates Opportunity Fund II and European Rates Opportunity Fund, two relative-value hedge funds run by Nordea Asset Management's Copenhagen-based Fixed Income and Covered Bonds team.

"We launched our Nordic Rates Opportunity Fund in 2017 because of significant demand among our clients for non-directional products driven by the low-yield environment," says Martin Hagelskjær Nielsen, the Head of Danish Fixed Income and Euro Covered Bonds at Nordea. "Investors preferred to invest in products that were not directly exposed to what happened to interest rates, as you typically see in a long-only product," he elaborates. "They were looking for attractive alpha opportunities in fixed-income alternatives."

> "The NRO fund will have a more focused Nordic exposure coupled with higher leverage opportunities due to the high credit quality of the Nordic Markets. The ERO fund, on the other hand, benefits from investing into a broader investment universe."
>
> Martin Hagelskjær Nielsen

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“The Danish callable market in itself is a fantastic source of complexity alpha for hedge funds, for those players who really understand the market.”

Martin Hagelskjær Nielsen

Nordic Rates Opportunity Fund was first launched in 2017 as a closed fund for pension fund clients, with its open-ended version open for a broader investor audience – Nordic Rates Opportunity Fund II – launching in late 2019. “In June 2019, we also launched the European Rates Opportunity Fund, which focuses on the European market,” says Nielsen, who heads a team of five portfolio managers and five analysts out of Copenhagen. “We have these two fixed-income hedge funds being active in the whole investment universe we cover as an investment boutique.”

## SAME PROCESS, DIFFERENT GEOGRAPHICAL FOCUS

Both funds seek to capture apparent deviations from no-arbitrage relationships “within the high-grade area of fixed income.” According to Nielsen, “we seek to avoid credit risk, so we predominantly invest in government bonds, covered bonds, SSAs [sovereign, supranational and agency (SSA) papers].” He goes on to emphasize that “we try very much to avoid directional exposure as much as possible. We focus on finding the best possible relative-value exposures.”

Managed by the same team, Nordic Rates Opportunity Fund II (NRO) and European Rates Opportunity Fund (ERO) share similar investment processes focused on finding the best risk-adjusted relative-value opportunities. “This means the idea generation processes of the two funds supplement each other very well,” argues Nielsen. “However, the NRO fund will have a more focused Nordic exposure coupled with higher leverage opportunities due to the high credit quality of the Nordic Markets. The ERO fund, on the other hand, benefits from investing into a broader investment universe.”

The Nordic-focused fund maintains a higher “covered bonds” exposure compared to the European fund. “The universe of Nordic covered bonds is among the largest and most liquid covered bond markets in Europe and will typically be an important building block in the Nordic Rates Opportunity Fund,” says Nielsen. “At the same time, Nordic covered bonds are supported by a well-functioning repo market creating an important source of funding for hedge funds.”

“In the Danish callable market, for instance, you have 2,000 different ISIN codes and a lot of complexity, as well as embedded options in callable bonds. The callable market in itself is a fantastic source of complexity alpha for hedge funds, for those players who really understand the market,” argues Nielsen. Nordea’s European Rates Fund, meanwhile, “is typically more balanced between Government and SSA risk relative to covered bond risk,” according to Nielsen. “We see it as an investment in the best possible relative-value opportunities we can find in the European investment universe.”

“We are one of the few players covering the whole European market, from the large issues of government-guaranteed and government bonds down to the smallest covered bond issuers,” considers Nielsen. The focus on the entire European rates market provides an ample pool of relative-value opportunities for Nordea’s fixed-income hedge funds. “A quick screen of the whole European market and the local Nordic markets provides a great number of opportunities to find pricing differences.”

“We believe we have superior access to information on what is happening in the whole European fixed-income space given that we are one of the largest asset managers in this area,” says Nielsen, who heads the Danish Fixed Income & Euro Covered Bond Team that oversees more than €45 billion across various products. “This means we have a clear understanding of how to price risk premiums in all these different countries and currencies,” he adds. “We have in-house tools allowing us to compare the risk premium we get in a German Pfandbrief compared to a French covered bond, for instance, and down to the smallest Spanish and Italian covered bond issuers.”

## THE STATE OF MARKETS

A handful of Nordic fixed-income hedge funds have been experiencing a somewhat difficult year so far. A few of them – most notably Brummer & Partners-backed Frost – were caught off guard by a rapid and unexpected flattening of the yield curve in the last week of October amid a repricing of central banks’ path of expected future policy rates. Nordea’s relative-value fixed-income hedge funds fared relatively well both in October and year-to-date.

“In our understanding, some funds have been quite aggressive betting on stable yield curves in the short end of, for instance, the Swedish yield curve,” Martin Hagelskjær Nielsen attempts to explain the heavy losses incurred by some peers in October. “We have avoided this type of exposure. Instead, we have invested in, for instance, Nordic and European covered bonds with attractive carry and roll-down in asset swap spread trades,” continues Nordea’s Head of Danish Fixed Income and Euro Covered Bonds. “Curve exposures on European government bonds have been implemented instead as more risk-mitigating trades, thereby protecting fund performance.”

Discussing the evolution of Nordic covered bond markets, Nielsen says that “we have seen nice relative performance of Norwegian covered bonds.” Swedish covered bonds have also delivered positive performance, according to Nielsen, “but heavy QE from the Riksbank have somewhat distorted this market.” The Danish callable covered bond market, on the other hand, has delivered really poor performance in 2021. “This is driven by high supply, higher rates and lower foreign demand due to less favorable FX hedging back to the U.S. dollar,” explains Nielsen.

The European Rates Opportunity Fund gained 4.6 in the first ten months of 2021, having delivered an annualized return of 8.5 since launching in mid-2019. “The ERO fund has performed better than NRO primarily due to successful allocations into EUR fixed income,” says Nielsen. “This is driven by long/short exposures on the Italian government bond curve, EUR linkers, and selected EUR covered bonds,” he continues. “The NRO has benefitted from larger relative-value exposures on Norwegian covered bonds, but has also suffered from a limited allocation into Danish callable bonds that have underperformed this year.”

# Wide Dispersion of Returns Opens up Mean Reversion Opportunities in FI Arb

By Hamlin Lovell – HedgeNordic

"Another headwind for some strategies has been higher asset swap spreads, and higher spreads between interest rate swaps and government bonds."

Brummer & Partners-backed Frost Asset Management's Scandinavian-focused fixed-income relative value fund is closing down after incurring a loss of 17.6 percent in October. The fund had only launched in January of 2020.

But this was just the most notable and prominent victim in the Nordics. Indeed, a number of fixed income arbitrage strategies including mortgage arbitrage, inside and outside the Nordics, as well as global macro funds that trade relative value fixed income, have seen notable performance losses of between 5% and 20% for the year to date.

The closure of Frost comes after a period in which most fixed income relative value strategies have seen below average returns, with a handful of managers in the NHX Fixed Income index approximately flat for 2021 as a whole. (This index also includes directional and long biased managers taking corporate credit risk, who have generally performed better this year).

Fixed income arbitrage managers tend to be interest rate neutral, and instead some of them may trade the yield curve shape, or various spreads between different markets such as callable and non-callable mortgages, swaps, inflation linked bonds, government bonds and sometimes cross currency swaps. Though higher inflation and interest rates seen in 2021 may not always have any direct impact, they can have an indirect impact - by dislocating the relative value relationships.

For instance, Frost mentioned yield curve flattening in Sweden, though this phenomenon was not unique to the Swedish fixed income markets. Managers active in the UK, US and Asian fixed income markets have also reported losses after their yield curve steepener trades were wrong-footed by the yield curve moving in the opposite direction. The Bank of England has especially disappointed those managers who expected early UK rate rises, which at one stage became a consensus view factored in to the forward markets.

## VOLATILITY AND SWAP SPREADS

The yield curve trades have been most widely reported but are not relevant for all fixed income arbitrage strategies. Not all of them trade the yield curve and even amongst those that do, not all of them had steepener trades on in 2021.

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There have been other challenges for fixed income arbitrage strategies. Many of the Danish mortgage funds had a difficult first half of 2021 as Danish callable mortgage bonds underperformed, and this is often related to interest rate volatility. Some sub-strategies investing in mortgage bonds are in effect short of volatility, sometimes because they are wagering on mean reversion and in other cases because they are short of the embedded prepayment call option in mortgage bonds. Interest rate volatility has therefore been adverse by increasing the value of this optionality. While equity market volatility has been relatively subdued, interest rate and swaption volatility has been high.

Another headwind for some strategies has been higher asset swap spreads, and higher spreads between interest rate swaps and government bonds. There is speculation that widening in shorter term asset spreads could be related to a shortage of collateral, partly because the European Central Bank has now bought so much of it. Asset purchases may be an obvious benefit for long biased managers but if too much liquidity is sucked out of the markets more sophisticated strategies might run into some road bumps.

## LIQUIDITY, LEVERAGE AND LIQUIDATIONS

There have also been reports of liquidity bottlenecks in forward interest rate markets. Thin markets can lead to exaggerated moves, as can the substantial leverage use by some managers. This might be 3 or 4 times when calculated to be equivalent to a ten year government bond, but it could be multiples of that in nominal terms. There is speculation that margin calls on leverage might have forced some liquidations, though it is also probable that managers' own risk management limits would have kicked in well before any counterparty related limits.

Many managers try to keep volatility in a range so will need to scale back exposure if their volatility spikes up. This illustrates how the industry has matured over the past 20 years. Back in 1998, Long Term Capital Management famously blew up due to some leveraged mean reversion trades in bond markets.

> "Though some managers' recent 20% losses may seem like a shock, on a ten year view they have still generated very strong risk adjusted returns."

Though some managers' recent 20% losses may seem like a shock, on a ten year view they have still generated very strong risk adjusted returns.

## POSITIVE RETURNS AND BULLISH OUTLOOK

Several fixed income relative value funds are still positive for 2021 calendar year to date however. "The last 3-5 weeks have been a difficult period for many Fixed Income Hedge Funds. Many funds are in negative territory, and several Fixed Income Hedge funds with double digit negative returns. Therefore, I am also happy to have all 3 Danske Bank Asset Management Fixed Income Hedge funds in positive territory for the year – even though we have also seen some headwinds in the last 3-5 weeks," says Michael Petry of Danske Asset Management. These three funds Danske Invest Fixed Income Global Value, Danske Invest Fixed Income Relative Value, and Danske Invest Hedge Fixed Income Strategies – report data to the HedgeNordic NHX Fixed Income index.

Going forward from here, the outlook now seems positive. "The volatility during the last couple of weeks have given a number of new opportunities and I am therefore optimistic for the upcoming year – and more optimistic than a year ago," says Petry.

Some managers are very excited about their prospects. One told us that,"given the mean reversion nature of our strategy, this has thrown up a huge opportunity set. The fund tends to perform best in periods of uncertainty and as can be seen, the strategy has had some of its best periods of performance post dislocations such as 2008. Should volatility pick up we can easily achieve 10% returns or more. The bounce back can be very strong".

"Buying the dip" has become a meme for equity markets and if we review the long term performance of Nordic fixed income arbitrage managers, those who bought into previous drawdowns were generally rewarded with above average returns. Both the strategy and the return profile of the managers have shown a pattern of mean reversion that bolder investors may be keen to take advantage of.

> "Should volatility pick up we can easily achieve 10% returns or more. The bounce back can be very strong."

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# Fixed Income Managers Expect Inflation to Hasten Interest-Rate Hikes

Russell Investments' latest survey of fixed income managers reveals a majority (55%) expects U.S. inflation to track between 2.26% and 2.75% for the next 12 months, while 20% see it moving above this range. The global survey also revealed a shift in views on timing for the first increase for the U.S. Federal Reserve funds rate. Fifty percent of survey respondents now expect the Fed to make its move in the second half of 2022, versus 80% in the Q2 survey who said they didn't expect the Fed to begin lifting rates until 2023.

"Inflation proved to have a bigger bite than previously thought, forcing managers to consider the prospect of earlier interest rate rises," said Adam Smears, Head of Fixed Income Research at Russell Investments. "However, our survey indicates fixed income managers believe inflation will stay roughly under control in the long term and inflation effects will be transitory. Time will tell if managers have this correct."

The 53 bond and currency managers who responded to Russell Investments' Q4 2021 survey also revealed the following views:

## U.S. YIELD CURVE

35% of survey respondents expect a bear steepening of the yield curve in the next 12 months, while 45% expect a bear flattening. "Managers expect movement in the U.S. yield curve but disagree on which end of the curve the impact will be more significant," Smears said. In addition, 42% of respondents expect the 10-year U.S. Treasury to trade between 1.61% and 2%

Adam Smears
Head of Fixed Income Research – Russell Investments

in the next 12 months, with another 42% expecting rates to trade above 2% in the year ahead. Views are considerably more spread out now versus the last survey in June, when 72% of managers expected 10-year U.S. Treasury to trade in the narrower range of 1.80% to 2.2%.

## INVESTMENT-GRADE CREDIT

30% of respondents expect a moderate widening in spreads over the next 12 months, while 60% still see range-bound spreads. In addition, 52% expect the pace of deleveraging to slow down, dropping from 69% in the Q2 survey. Meanwhile, the percentage who believe current spreads compensate for potential risks of deteriorating credit quality declined from the last survey, and the percentage who believe that caution should be warranted due to current spreads and leverage expectations also decreased. Among regions, Europe (ex-UK) replaced the U.S. as the most attractive for returns.

## LEVERAGED CREDIT

80% of managers expect range-bound spreads over the next 12 months. While no respondent expects a tightening of spreads, 20% anticipate a moderate widening. In addition, survey respondents remain constructive on fundamentals: 25% expect material improvement in corporate fundamentals and 60% expect some modest improvement. Accordingly, the survey found reduced expectation for rising defaults as 95% of managers see defaults below their long-term average of 3% (up from 78% in Q2). Among asset classes, leverage loans ranked as the favoured asset class in the last survey, but they are now ranked equally with both mezzanine collateralised loan obligations and high-yield emerging market bonds. Regarding potential risks, respondents see inflation, rising interest rates and slowing Chinese growth as the most concerning.

## EMERGING MARKET (EM) DEBT - LOCAL CURRENCY

Managers indicate slightly more concern for EM FX as the percentage with positive views declined to 62% this quarter from 71% in Q2. Furthermore, the

> “Inflation proved to have a bigger bite than previously thought, forcing managers to consider the prospect of earlier interest rate rises.”

weighted expected return for next year has fallen from 5.6% to 3.5%. Among specific currencies, managers expect the Russian ruble, Brazilian real and the Egyptian pound to be the best-performing currencies in the next 12 months, while 32% of managers expect the Turkish lira to be the worst-performing currency.

## EMERGING MARKET DEBT - HARD CURRENCY

Only 29% of respondents expect spreads in the HC EMD index to tighten in the next 12 months, versus 33% in the Q2 survey, while 17% of managers expect spreads to widen. Regarding specific currencies, respondents listed Egypt, Ukraine and Mexico as the countries with the highest expected return over the next 12 months. China and the Philippines again ranked as the least attractive.

## CURRENCIES

63% of respondents expect the U.S. dollar to gain value versus the euro and to trade below the current 1.16 EUR/USD exchange rate. About 80% of managers expected the pair to trade in the 1.21/1.30 range in the Q2 survey.

## SECURITISED CREDIT

The proportion of respondents seeking to reduce securitised risk declined from the last survey, while the proportion seeking to maintain or add, slightly rose. BBB collateralised-loan obligations ranks as the most preferred securitised segment, followed closely by BBB- commercial mortgage-backed securities. Preference for residential mortgage exposure, which had ranked the highest, modestly declined. In addition, 50% of managers expect non-agency spreads to moderately tighten in the next 12 months. Moreover, 31% of respondents expect spreads to range bound.

Managers also expressed more balanced views regarding concerns for the CLO market with 69% mentioning broad risk-off market sentiment as main the risk, followed by underlying loan collateral credit deterioration.

> “Our survey indicates fixed income managers believe inflation will stay roughly under control in the long term and inflation effects will be transitory. Time will tell if managers have this correct.”

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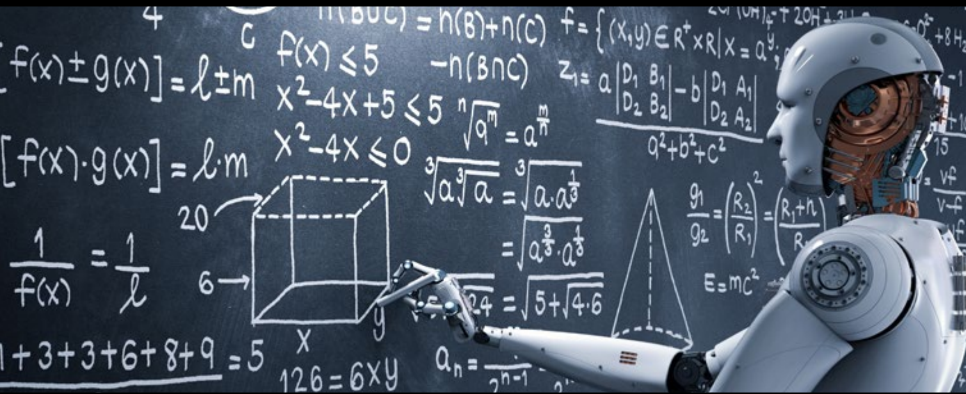


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