Pareto
Asset Management

Fixed Income Risk Dispersion in Times of New Risks

From Bond Buying with Quantitative Easing to ECB tapering

With the end of the European Central Bank's (ECB) asset purchases in sight, European fixed income investors are now facing several new challenges. Among the most pressing issues facing any portfolio manager are concerns of the consequences of ECB tapering.

From the financial crisis of 2008, the ECB has grown its asset holdings by some 3.2 trillion Euro, of which the bond buying program makes up for some 2.5 trillion Euro. After years of bond buying – thereby increasing demand for bonds – and in effect trillions of Euros pouring into the market. Now this 'buying spree' is about to end. The US FED had been on a similar bond buying program, which is in process of being reversed already. As the US budget deficit will most likely reach one trillion dollar in 2019, new US bond issues are expected to prevail.

The full consequences of this shift, when trillions of positive cash inflow into bond markets is disappearing, are still unknown. Less demand from bond buyers will probably add to the already steepening interest rate path. In addition, the gradual tightening of monetary policy and global trade and political conflicts will make many investors see an increasingly uncertain environment ahead.

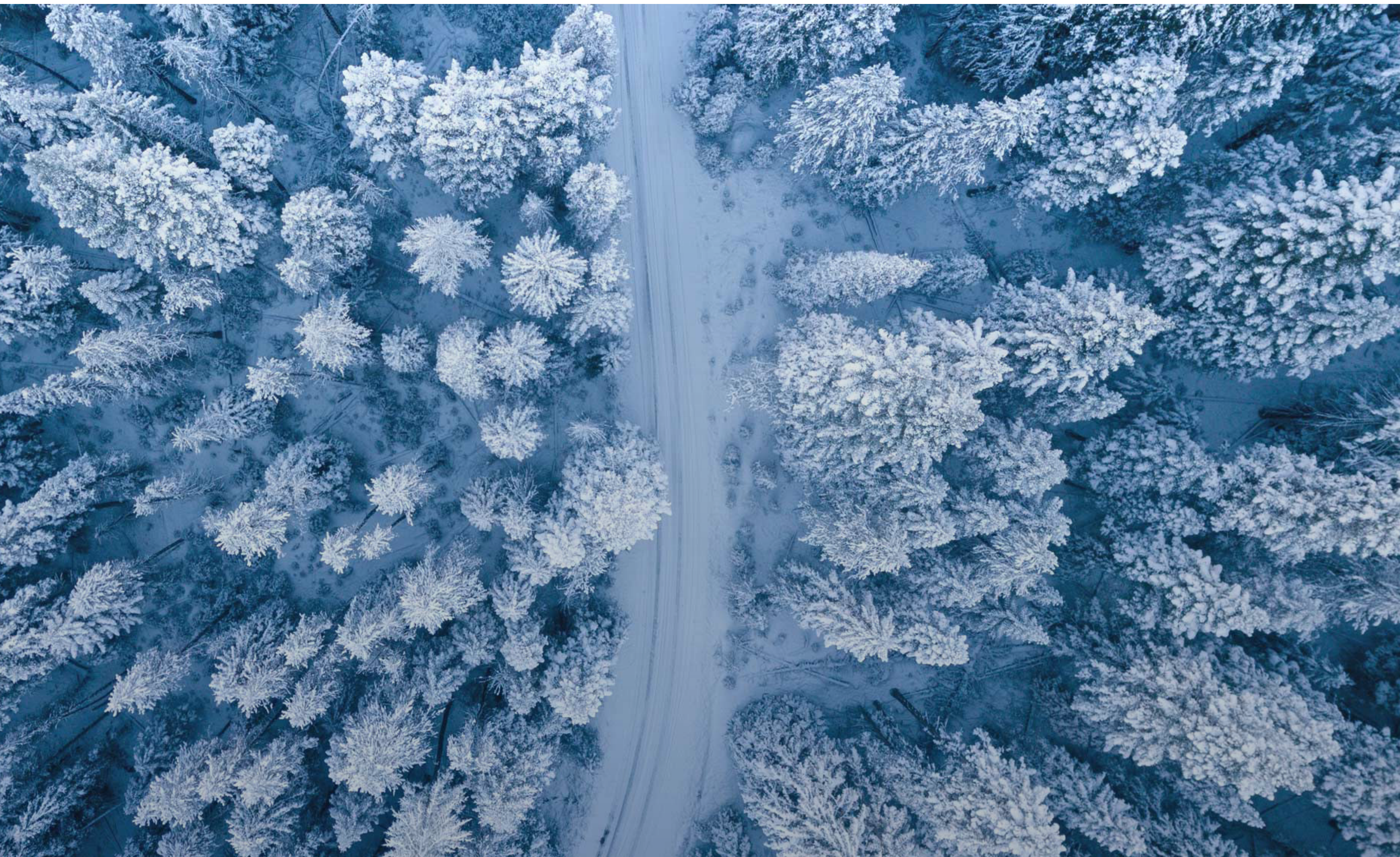
Flight to Safety - or Just Flight Away

Most investors will examine ways how to offset, or at least reduce any exposure which is prone to take a hit by these developments. One possible approach seems to be unwinding risk. Typically reducing equity and high-yield exposure and moving into high quality bonds. Thereby prioritizing your risk budget ahead of your return target. Other investors with more strict return targets are more inclined to keep their existing exposure, thereby increasing the perceived risk level in the portfolio.

For high-yield investors, a third, yet different approach may be to seek an alternative exposure, with diversification qualities that will contribute to de-risking of the portfolio. Such an alternative has to be less affected by tapering of bond-buying programs, interest rate hikes and the consequences of large ETF flows; a flight away from these factors.

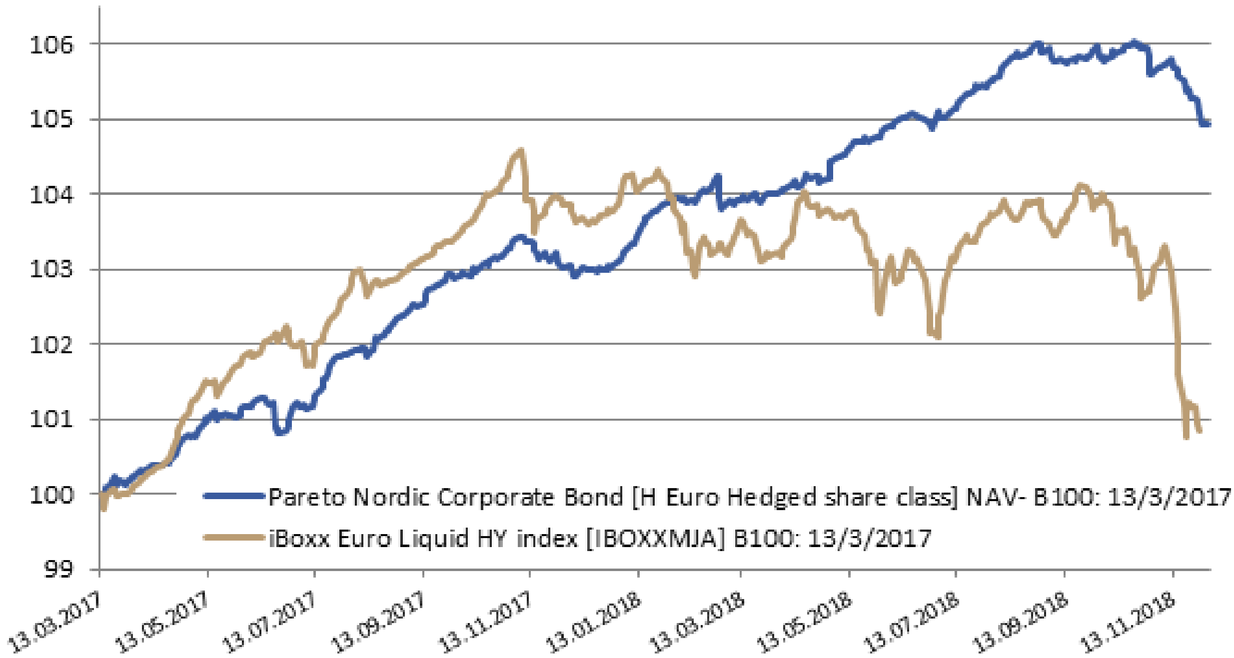
Why Going North may be a Good Way of De-Risking

No credit strategy will be unaffected by market unrest, but some markets have shown more resilience to recent volatility. One such alternative is the Nordic corporate bond market. Representing some 15 % of the total European high-yield market, many institutional investors have come to see the Nordics as very attractive: What used to be a niche segment has evolved into a well-diversified market place, offering short duration and higher credit spreads. The fact that this market is characterised by a stable economic, legal, and political framework (three countries in the Nordics are "AAA" rated), only adds to its new role within any European corporate bond exposure. In this environment of well-developed corporate governance qualities, the role of the credit analyst will be more focused, and in a position to add alpha; evaluate the business model of the issuing company and its specific credit-worthiness.



Diversification Benefits

There are several qualities in the Nordic Corporate Bond Market and Pareto Nordic Corporate Bond in particular, that may offer reduced impact of rising interest rates and central bank tapering: Among these are the risk diversifying effect of being outside the directly affected markets of quantitative easing and the large ETF flows; markets are different, investors are different, and the issuances are different. These factors are well noticeable when comparing the return data of a European high-yield index with Pareto Nordic Corporate Bond (see chart below).



Source: Bloomberg – Calculation by Pareto Asset Management ; data in EUR as of 3. December 2018

The risk dispersion qualities of Pareto Nordic Corporate Bond are remarkable both long- and short-term. Since inception of the Euro hedged share class in March 2017, the Nordic high-yield market did not take part in the strong spread compression during 2017. In spite of stronger running yield, Pareto Nordic Corporate Bond was outperformed by European high-yield in this period. However, spread compression is always a one-time gain, which increases the downside risk. This was made visible from November 2017 and on several occasions throughout the year, when spread compression in European high-yield was reversed.

The majority of issues among Nordic corporates are floating rate notes, an aspect that is a strong contributor to the short duration portfolio of 1 - 1.5 years in Pareto Nordic Corporate Bond. That helps decrease the volatility of the fund in relation to interest rate variations; it also limits the negative consequences of more permanent interest rate increases. When you combine the short duration with a credit spread of approximately 600 bps, the strong cash flow will help resist any downturn caused by interest rate fluctuations, and help cushion credit events within the fund holdings.

Strong Structural Growth in Nordic Corporate Bond Issues

The Nordic corporate bond market of yesterday was not the same as the market of today, nor will it be that of tomorrow.

From the beginning, some 12-15 years back, the Nordic high-yield market consisted mainly of Norwegian asset heavy oil and shipping related issues. During the last 10 years, the Nordic market size has quadrupled, mostly outside Norway, and presently accounts for a sizeable part of the European high-yield market. In terms of new issuance in 2018, the 50 bn Euro Nordic high-yield market is on track to match and potentially exceed the issue volumes from the record year 2017, which was about 12 bn Euro.

This development is expected to continue. Currently, less than 30% of outstanding volume is within shipping, oil E&P and oil service sectors. This is a very welcome development towards much broader diversification, when you compare to the near 50% exposure in these sectors in 2014, and even 75% in 2008. This continued growth offers additional opportunities to reduce risk and volatility.

Premiums Noted: Credit Spreads

Average credit spread levels have been more or less unchanged over the last twelve months at around 600 bps or more, with some widening observed lately. There are some characteristics of the Nordic high-yield market that contribute to these credit spreads: one is the size of the bond issuers, Nordic corporates are often too small to access the rated universe of bond issues. With most issuances being unrated, the market requires some local insight and experience. This also limits large international capital flows, providing a 'universe' for local asset managers and pension funds to take advantage of rather attractive spreads. That is, both a size factor, and a liquidity factor, are at play.

Premiums Noted: Liquidity Factor

The degree of liquidity in the Nordic high-yield market is sometimes questioned, and it is definitely on a somewhat lower level than in large international markets, such as the US or Europe. Estimates from market participants suggest an annual turnover in the secondary market at around 35 - 40%.

The attractive spreads are also supported by the structural shift from "banks to bonds" that adds a continuous flow of issues into the market. The share of corporate lending being securitized in the Nordics is about half that of the rest of Europe, which, again, is about half that of the US. The expected growth of corporate bond issues will contribute to very high growth for the supply side in the Nordic bond market. This may contribute to credit margins to be sustained at higher levels in the Nordics than in Europe and the United States.

Pareto Nordic Corporate Bond Fund: Defensive Strategy with a Focus on Bottom-Up Bond Selection

Going forward, we do see some of the ‘macro risks’ described above possibly affecting various capital markets. This is why we have a meticulous focus and time spent on assessing the credit quality of every holding. Pareto Nordic Corporate Bond-fund is well diversified with some 80 to 90 holdings and with a pronounced objective to limit the size of each holding.

The portfolio managers are seeking diversification by industries/sectors, geographies/regions and, to the extent relevant, specific factor risks may be optimized depending on the market outlook. They constantly follow the primary and the secondary markets, using local expertise and internal bottom-up credit appraisal. On a general note, Pareto will limit pure macro plays as you will find within segments of the financial and real estate sectors. Some of the key characteristics of the fund are summarized in the chart below.

HIGH

ACCUMULATING YIELD	With a current Yield To Maturity of **above 7%**, Pareto Nordic Corporate Bond fund accumulates significant running yield
CREDIT SPREAD SENSITIVITY	The average credit duration of the bond portfolio is **3.0 years** due to short dated bonds, which makes the strategy less sensitive to credit spread variations
INTEREST RATE SENSITIVITY	Pareto Nordic Corporate Bond fund exhibits very low interest rate sensitivity (duration **1.2 year**) due mainly to the **floating rate notes** structure of the Nordic market: ca. 60% of the portfolio are floaters

LOW

The Nordic high-yield market offers ample opportunity for experienced portfolio managers to carefully select bonds and maximize risk adjusted return. The Pareto Nordic Corporate Bond has proven effective during all those weeks of volatility this fall. Even a 30% oil price drop this fall did not substantially affect the oil related bonds in the portfolio. The reporting season after the third quarter reflects an overall positive trend among our holdings.

Positive surprises outnumber negative surprises, and we still hold a positive view of company fundamentals. One opportunity that has played out to the advantage of investors lately is the attractiveness of callable bonds with a probability of being taken out. The fund’s bond holdings in Com Hem, Point Resources and Hurtigruten have all been called for early redemption at prices above par. Earlier our bond in Link Mobility, accumulated from July through September, was taken out at a nice premium in October. Such cash infusions also offered the opportunity to add attractive purchases in the recent volatile environment.

Conclusion:

De-Risking of a Fixed-Income Portfolio with an Allocation to the Nordics

Relative to international bond markets, we continue to see a credit spread pick-up with relative value being further supported by substantially lower interest rate sensitivity, shorter maturities, and limited direct exposure towards ECB buyback programs. The Nordics provide ample opportunity for implementing a credit strategy, with which to keep credit standards invariably high, and yet to earn an attractive risk-adjusted return.

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