A look north, off the beaten track

CORPORATE CREDIT AND HIGH-YIELD

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This article describes diversification benefits that can be generated in fixed-income portfolios by taking advantage of Nordic high-yield markets. This is a segment with attractive spread premiums, short interest duration and efficient legal framework in stable and growing economies. The Nordic corporate bond market experiences structural growth that contributes to diversification and the opportunity to exploit new alpha sources.

Introduction

At the portfolio level, high-yield bonds have tended to deliver several benefits, such as the potential to improve a credit portfolio's overall risk-adjusted returns. Most portfolios that aim to take advantage of the positive high-yield bond properties will have their exposure aligned with so many of the available global high-yield funds or a combination of US and European high-yield investment strategies. Such a global high-yield fund may typically hold 600-800 issuers, where the US share could be as high as 70-80 percent. From this viewpoint it will make sense to seek a purely European high-yield exposure to offset the strong US dominance in this segment. But even the European high-yield exposure does not give you exposure to the attractive characteristics of the Nordic high-yield market.

On a general note, geographical dispersion will offer diversification benefits. This is especially valid from a European viewpoint, where quantitative easing and the ECB bond buying program have had a profound effect on yield levels. We would argue that additional diversification benefits can be reaped by adding Nordic high-yield exposure to any existing high-yield portfolio. The qualities and opportunities of such an additional exposure will be discussed in the following sections. They relate to some specifics of the Nordic capital markets, with its legal structures underlying the Nordic corporate and high-yield bond markets in particular. Certain business practices and institutions have had beneficial effects in developing Nordic high-yield, making it almost a (sub-) asset class of its own, with some differences from the predominantly American high-yield markets.

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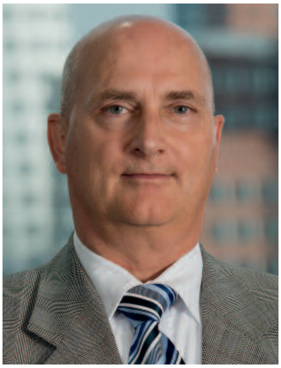

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A less crowded Market Place outside of the Universe of Quantitative Easing

The Nordics are typically defined as comprising the markets of Norway, Sweden, Finland, and Denmark, sometimes Iceland and even Greenland are included, Finland being the only market in the Euro zone.

The 'Nordic Model' has a pedigree of a stable economic and political framework. With a total population of somewhat less than 27 million people, the total GDP of about 1.454 trillion US-Dollar in 2016 gives the economic region a rank of 11 in world economies, comparable to economies like Russia, Canada, or South Korea, but ranking 7 when calculating per capita GDP: ca. 54,000 US-Dollar, compared to ca. 32,400 US-Dollar for the European Union. The Nordics are also characterised by a business environment that delivers steady growth, with the Swedish stock market being among the most long-term profitable in the world.

With its integrated economic and social structure, and a large welfare sector (which comes with a high tax level), the region is characterised by low levels of social unrest and inequality - making it a region favourable to any kind of investment. On the Fragile States Index, which rates countries on 12 indicators, ranging from economy to equality, the Nordic countries cover four of the top five positions being the least fragile.

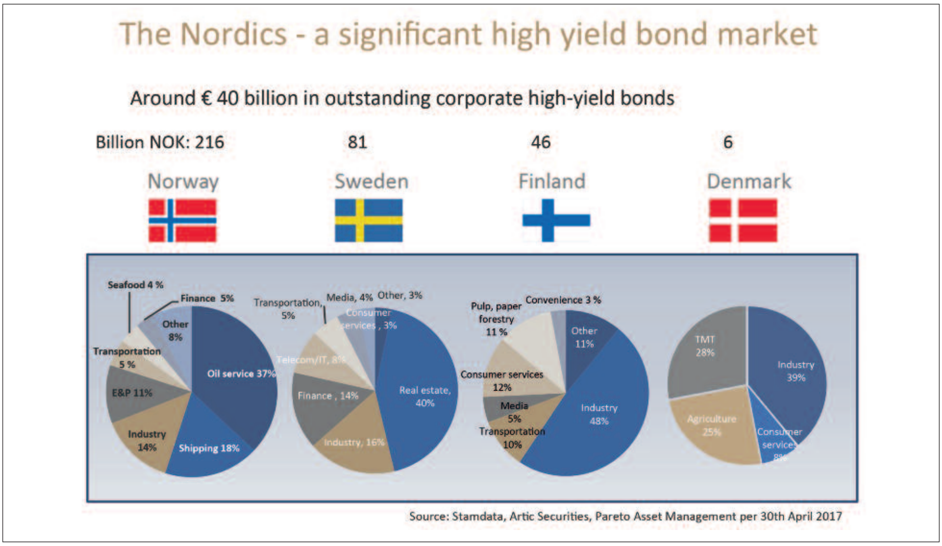

Chart 1: Although the Nordic High-Yield market reflects different sector concentrations within each country, the overall market offers ample opportunities for an active manager to assemble the desired portfolio.

Favourable characteristics of the Nordic high-yield market

Nordic corporate high-yield bonds developed relatively early in Norway, based on demand from asset heavy investments in the shipping and energy sectors. During the last decade this high-yield bond market has developed and grown substantially, as the Norwegian high-yield template became a standardised, region-wide UCITS compliant capital market product and asset class. The mix of issuances evolved rapidly from asset-based Norwegian offshore energy and maritime industries to diversified cash flow-based industries in Sweden, Finland and Denmark. The present growth is structural and includes companies across all industry sectors. This development has improved diversification across more complementary sectors. The size of the Nordic high-yield bond market is estimated to be in the order of magnitude of 40 billion Euro.

To a large extent, the Nordic corporate bond market is dominated by sectors where Norway and the Nordic countries have competitive advantages - making it a region with different opportunities. As an interesting market place 'off the beaten track', the Nordics are home to many companies which simply do not have a public rating. Consequently, their credit assessment is based on analyses from different local corporations and investors' in-house research.There is a price to pay, of course, namely to be willing to analyse and follow the local business community. With that, one may have access to the spread premiums and alpha opportunities offered by the Nordic high-yield market.

Early on, the Nordic high-yield market hinged on the specific role of the institution Nordic Trustee, founded early in the last decade of last century. Nordic Trustee 'bundles' the bondholder community, and acts as the third party between the bondholders and the issuer, and has contributed to the development of extensive and restrictive covenant structures in the Nordic high-yield bond market. This will often contribute to high default statistics since any breach, however small, will be registered. On the other hand, recovery rates are similarly high. Nordic Trustee's 'mediating' role has been bolstered by decisions in court, and could be demonstrated in its real track record in dealing with problems of the issuers.

As civil law countries Norway, Sweden, Finland, and Denmark share traditions based on commercial and legal codes which apply high thresholds of securities fraud litigation, and the Nordic arrangers offer simplified origination processes and lighter documentation. The region's common standards embrace the spirit of international high-yield best practice on creditor protection while maintaining core Nordic high-yield features of simplicity and efficiency. Therefore, an exposure to Nordic high-yield offers investors a spread premium to comparable bonds, as litigation in cases of 'official' defaults is being dealt with in a more local, i.e. pragmatic way.

This lean and efficient legal commercial law avoids some of the cumbersome English law documentation, and with its low cost it has contributed to developing the Nordic market place. One may argue that the standards, which developed in the issuer's documentation - in all its 'template character' - may or may not really help a portfolio manager assess the validity of the financial situation of the bond under consideration. However, the lean and efficient legal framework has given access to smaller issuers and room for possible additional margins.

An interesting sub-set of the Nordic investment universe will remain, namely within the universe of non-rated corporations. High quality non-rated issuers add additional margin to the bonds, made possible by the combination of saved ratings costs and a long-term analysis of local investors. Even if an official rating by a global rating agency provides a certain level of confidence, the earlier 'Nordic shadow ratings' and the present local analyses may sometimes better help improving the overall risk-adjusted return.

Therefore, the additional question is for anybody managing high-yield across the globe is: to what extent do legal frameworks, the covenants, and potentially litigation differ in the major regions, and does that widen the opportunity set?

Managing Nordic Credit and High-Yield Investment Strategies

As a consequence, the value of a more flexible geographic diversification requires an off-benchmark approach to managing the portfolio. However, one could argue that to stay within the global benchmark universes is putting a strain on high-yield investment potential anyway: high-yield investment strategies rely less on interest rate developments, yield curve considerations, and all kinds of top-down and macro-analyses. Rather, high-yield bonds have varying risk-return profiles, which depend on different credit qualities, companies' capital structure, and the individual business case of each issuer. As with equity portfolios, adding new risk variables will often improve expected risk adjusted return. These aspects belong to any addition of Nordic high-yield to a European, or global portfolio. However, these facets would only account for including Nordics in line with the relative size of the market – a sufficient case in point.

Embedding such investment strategies in the investor's overall portfolio is not as easy as with many other asset classes, as one has to forfeit any 'benchmark thinking', and aligning manager and/or fund selection along allocation guidelines. Most benchmarks are either investment-grade, or non-investment-grade. Few blend the two categories, but the problem with that is: when it comes to unrated corporations, many opportunities will be lost.

A returning argument against Nordic high-yield is a lower liquidity compared to US or European markets. This may be a valid contention, but our point is that the liquidity premium adds value well above liquidity risk.

In addition, a special feature of the Norwegian and Nordic markets for corporate bonds is a high proportion of floating rate bonds, as compared to the more common fixed coupon rate bonds. Floating rates reduce interest rate risk and make investment choices even more relevant for any investment strategy's return and risk. A Nordic high-yield portfolio will typically have interest duration of 1-2 years.

The Rationale for Geographic Diversification into the Nordics

While the current low-interest rate regime leaves investors with no return on government bonds, the regulatory pressure on banks in the QE-affected market places to reduce their credit exposure effectuate interesting alternatives for corporations: Their means to refinance and diversify by giving them a broader funding base at attractive rates. Generally, economic environments of slow, but steady growth furnish a good setting for different sorts of credit refinancing, like subordinated debt and high-yield. As an investment strategy, high-yield can easily be implemented in a UCITS fund, which has helped making it almost a kind of mainstream and quite common segment within corporate credit allocations for investors and asset owners.

Typically, different geographic regions make up any global asset class, and the diversification effect may result from differing economic cycles and different, or additional, opportunity sets. These may generally translate into timing benefits, different sector weights, or simply the 'breadth' of the manager's investment strategy, i.e. a larger number of independent active bets (according to the Fundamental Law of Active Management). When seen as a 'bond picking exercise', geographic diversification in corporate credit or high-yield management means that different economic cycles are advantageous to valuation and income, and the sector exposure and widening breadth of the investment strategy can be profitable to the resulting bond portfolio's risk and return.

Nordic high-yield will reflect the specifics of the Nordic markets, and makes up an interesting investment case in its own right, or maybe even an 'emerging asset class', as it used to be called.