

Q&A

Nordea European Covered Bond Strategies Webinar with Portfolio Manager Henrik Stille

Key Takeaways:

- In the recent market sell-off the European Covered Bond asset class performed well and demonstrated resilience versus alternative fixed income solutions displaying once again the safety of the asset class
- Active management matters in turbulent times: The Nordea 1 – European Covered Bond Fund (BP-EUR: LU0076315455 / BI-EUR: LU0539144625) continues to deliver alpha with less volatility than other IG classes¹
- The ECB has committed through its purchasing program to buy covered bonds giving further support to the market
- In the next few weeks the PM's will focus on finding buying opportunities in covered bonds that deviated too much from their fair value in the recent sell-off

Please note that the webinar occurred on the 17th of March 2020. All market commentary and information refers to the period before then.

Question 1: The last few weeks have seen the markets disrupted by the impact of COVID-19. In this context, how has the European Covered Bond asset class performed?

The asset class has reacted pretty much as we expected. It's not at all related to covered bonds as such, but all risky assets around the world have been impacted. While we have seen a widening of corporates from around 70 basis points (bps) to 140 bps, covered bonds have only widened around 10 bps.^{1,2}

Question 2: How did the Nordea 1 – European Covered Bond Fund perform and manage this volatility?

The fund has performed as it should in this type of environment. Indeed, the alpha component delivered by the solution has been quite good at around 50 bps year-to-date^{1,3}. Meanwhile the absolute return of the fund is also following the path that it should. The fund⁴ has outperformed both other credit bonds and also government bonds, with covered bonds displaying less volatility than the alternatives in this sell off.^{1,3}

Question 3: Where is the 50 bps of alpha for the fund coming from? Is it more challenging to find alpha sources today compared to a few months ago?

One of the sources of outperformance has been the Danish covered bond market which outperformed the euro market quite significantly. In addition, we also had low exposure to some of the more risky covered bond markets this year. In Italy for example we are underweighted, so this is also helping the alpha component at the moment.

¹ iBoxx EUR Corporates (spread) and iBoxx EUR Sovereigns (spread). The performance represented is historical; past performance is not a reliable indicator of future results and investors may not recover the full amount invested. The value of shares can greatly fluctuate as a result of the sub-fund's investment policy and cannot be ensured, you could lose some or all of your invested money.

² Source Nordea Investment Funds S.A. and Datastream. 31.12.2019-12.03.2020.

³ © 2020 Morningstar, Inc. All Rights Reserved as at: 17.03.2020. European Open End Funds database. Nordea 1 – European Covered Bond Fund (BI-EUR) vs. Morningstar EAA Fund EUR Corporate Bond and Morningstar EAA Fund EUR Government Bond. Period under consideration: 31.12.2019 – 16.03.2020. Performance in EUR.

⁴ BI-EUR share class

Going forward we would probably expect to have more alpha opportunities for the rest of this year than we have had in a quite long time. Given the shock that we have experienced in the markets over the last weeks, you can say that the risk that you have in the various asset classes and also in various covered bonds within the covered bond asset classes are starting to diverge much more. Therefore, we think that there will probably be more relative value opportunities in the covered bond market for the rest of this year than we've had during the last year.

Question 4: What do you expect from the investments in the fund? In an environment where you have volatility, interest rates at record lows, and uncertainty what can investors expect? Where do you see covered bonds in the asset allocation?

It is important to look at what the ECB is doing and what the financial authorities are doing, because that also impacts to a large degree what will happen to different asset classes. If we start with the ECB, last week they decided to increase the QE program. They will buy 120 billion euros of extra bonds for the rest of this year. The purchases will be tilted towards the private sector programs, so that means corporate bonds and covered bonds.

When the dust settles a little we think that this pull to par effect will start to kick in in the covered bond asset class given the very strong regulatory support. That is very different from many of the weaker asset classes where we certainly could start to see some risk of defaults in the wider corporate credit market. For example if we have a severe economic downturn then the market needs to price in some probability of defaults in the wider credit markets and this will make it difficult for the credit markets to tighten significantly in spread for the rest of this year, until these uncertainties are gone. In covered bonds the probability of default is, as we have said many times before, extremely low.

Question 5: One concern from investors at the moment is liquidity. Do you see any liquidity issues on your side?

We have actually seen a new issue enter the bond market today⁵, so the market is open and functioning and that's a very strong sign that a bank is able to issue a new cover bond despite the very difficult market conditions that we are having. Keep in mind that this is actually a Canadian covered bond issuer so the ECB is not buying any bonds at all in this primary deal. Despite that, the last time we checked, they had almost 1 billion euros in orders in this book. When it comes to liquidity the covered bond market is open and working, we are trading covered bonds every day. Although we don't have the same liquidity right now as we had one month ago the market is still working and that's not much different when compared to other asset classes. But covered bonds are still much more liquid and easier to trade than the alternatives at the moment. We can add that since the ECB is now stepping up the purchases this will also help the liquidity to some degree because the market makers they know that they can get rid of the covered bonds easily again to the ECB. Therefore, they are not so hesitant to buy covered bonds if there is someone who wants to sell covered bond, then it's not a problem for them to buy it because they can sell it again to the ECB afterwards.

Question 6: ECB and the purchase program. Do you think there are more actions to follow? Do you think the ECB can support even more? Would it be beneficial for the covered bond market if they would do so?

The ECB is here to make sure that the covered bond market is open and functioning. They will not tolerate that spreads go significantly wider from here, because this is the main tool for banks to use when they are funding mortgage loans. It is extremely important for the financial system that this tool is working. If things stabilize here, the ECB will probably not do more. But if the spreads continue to move wider than we think, we will definitely see more actions from the ECB.

⁵ Date: 17.03.2020

Question 7: We have been discussing the Nordea 1 – European Covered Bond Fund, which has longer duration, but we also have two other lower duration solution: the Nordea 1 – Low Duration European Covered Bond Fund (BP-EUR: LU1694212348 / BI-EUR: LU1694214633) and the Nordea 1- European Covered Bond Opportunities Fund (BP-EUR: LU1915690595 / BI-EUR: LU1915690835). Where do you currently see the opportunities, more in longer duration or would you go for the low duration in your allocation?

From a covered bond perspective there is not much difference between them. The various covered bond exposures are implemented in exactly the same way in all three funds. The covered bond exposure will not differ between the funds. Right now, the question about if you want to be invested in the long fund or in the low duration fund is entirely a question of if you want to have duration exposure or not. The covered bond exposure is the same in the three funds.

Question 8: Where do you see covered bonds in the fixed income portfolio? Are the correlations stable or did you see in recent days the correlations between fixed income asset classes changing quite a bit?

If you look at the correlations between covered bonds and credits they remain very stable and we don't see much difference. The main correlation that has changed over the last week is that we used to have a quite strong negative correlation between the level of interest rates and spreads in general. This broke down totally a week ago. So in the last week we've had higher interest rates at the same time as we have had wider spreads and this is very unusual. This is especially the case in Europe because, and that's partly also due to the ECB, they didn't lower the interest rates. By leaving the interest rates unchanged, the market just pulled off all pricing of interest rate cuts into the future. So bunds and duration didn't have this protection against spread widening as we have seen historically. And that is the main change that we have seen here over the last week.

Question 9: Looking a bit into the future where do you think are the next opportunities. How will you generate alpha in the next months and the years to come?

It is important that the market settles itself first. There are a lot of covered bonds that have probably widened too much in this sell-off and there are also some covered bonds that have widened too little. Now that we have gone through two very volatile and difficult weeks in the general financial markets, we think it's good to wait at least some days or maybe even weeks for things to settle down a little, before making any large changes in the portfolio.

Since this is a sell-off that is very much beta driven pretty much everything just sells off. If we take 20 different covered bonds today from different countries, different issuers, they have widened pretty much the same, there are no large differences between the countries or issuers and this of course is not how it should be. Therefore, what we will focus on over the next weeks is to find the bonds that deviate too much from where they should be.

Question 10: Taking a look at the macro environment and a possible upcoming recession, what if people stopped buying homes? Would that imply there is less need for funding, less issuance of covered bonds?

If the mortgage activity slows down then you will have less issuance of covered bonds. That is not an issue for spreads - that would probably only support spreads. Less mortgage activity means less issuance of covered bonds and then just stronger support for the product in the market.

Source (unless otherwise stated): Nordea Investment Funds S.A. Period under consideration (unless otherwise stated): 30.01.2012 – 12.03.2020. Performance calculated NAV to NAV (net of fees and Luxembourg taxes) in the currency of the respective share class, gross income and dividends reinvested, excluding initial and exit charges as per 12.03.2020. Initial and exit charges could affect the value of the performance. **The performance represented is historical; past performance is not a reliable indicator of future results and investors may not recover the full amount invested. The value of shares can greatly fluctuate as a result of the sub-fund's investment policy and cannot be ensured, you could lose some or all of your invested money.** If the currency of the respective share class differs from the currency of the country where the investor resides the represented performance might vary due to currency fluctuations. 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