Covered Bonds - the Hidden Treasure amongst Fixed Income Asset Classes

January 2024

Executive Summary

In this document, we aim to outline the compelling investment case for Covered Bonds as potential substitute for high grade IG Credit in 2024. In brief, Covered Bonds spreads now stand at high levels vs. high grade corporates, driven by specific supply technicals. The fundamentals of the covered bond asset class do not justify such wide spread-levels, in our opinion.

Given the uncertain outlook for 2024 (soft or hard landing?), we believe Covered Bonds are now in an excellent position to deliver strong performance vs. EU IG Corporates. The stars are aligned and we are taking a closer look at this asset class.

That said, the investment case of Covered Bonds as a substitute for EU government still holds (which is the more traditional way to implement Covered Bonds in a portfolio context). In fact, we also believe that Covered Bonds are likely to outperform EU government debt (of same duration), due to high net supply in government debt issuance likely to be seen in 2024.

The Covered Bond Asset Class in a nutshell

Covered Bonds are a safe, low-risk asset class. There has **never been a default in the over 200 year-history** of Covered Bonds, while delivering steady and attractive returns.[1]

The Covered Bond market is very large: as of 2022, the volume outstanding was about EUR 3 trillion[2] . The largest country issuers are Denmark, Germany, France, Spain, and Sweden.

Covered Bonds are "dual-recourse" debt instruments secured by

1. a claim against the issuing institution (this *differs* to ABS and MBS) and
2. a cover pool of mortgage loans (property as collateral) or public sector debt

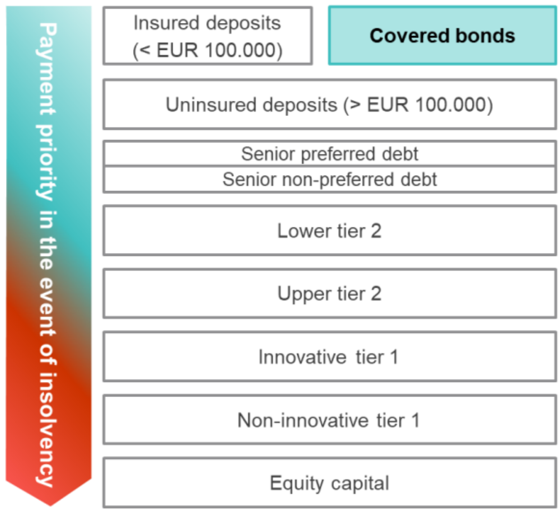
Cover Pool

- Strict local legislation and supervision
- Stringent LTV Requirements (Loan To Value)
- Over-collateralized
- Actively managed to ensure a continuous over-collateralization

Unlike MBS or ABS, the collateral pool in Covered Bonds is dynamic, i.e. non-performing loans must be replaced by performing loans.

Moreover, Covered Bonds are highly regulated and Covered Bonds' safety has been further increased by EU Regulation, i.e. under the Bank Recovery and Resolution Directive (BRRD), Covered Bonds are exempted from bail-in (unlike e.g. senior bonds).

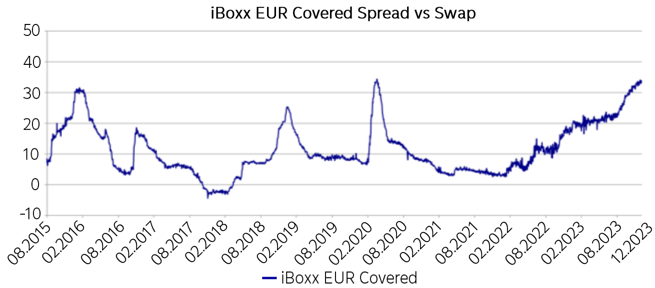
As can be seen in the below overview, these security features put Covered Bonds on par with insured deposits, from a seniority perspective, in the event of insolvency.



No covered bond has defaulted in over 200 years

What happened in 2023

Covered Bonds spreads widened out by 14 basis points[3] in 2023, continuing a trend that began in 2022 . This contrasts to a solid spread tightening in credit markets overall in 2023 – from IG, HY to EMD - in line with the general risk-on sentiment. This happened due to the large and unexpected issuance of Covered Bonds in 2023.



Generally, Covered Bond issuance is driven by activity in the mortgage markets. Given the strong increase in interest rates

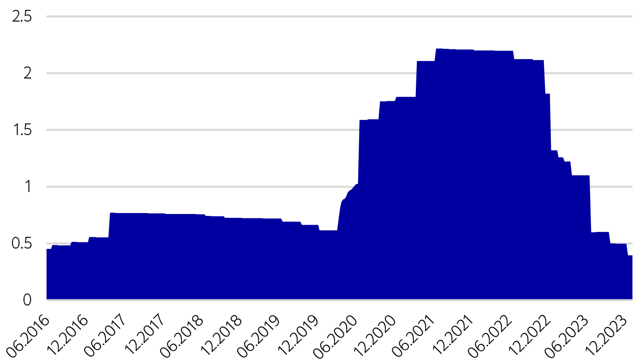
[1] Past performance does not predict future results; losses may be made.
[2] ECBC European Fact Book 2023

[3] As measured by the IBOXX EUR Covered Total Return Index vs. Swap

in 2022, it was expected that the issuance of Covered Bonds would decline in 2023. The opposite occurred due to the fact that in late autumn 2022, the ECB announced changes to the terms of the TLTRO program, effectively making it more expensive for banks to borrow money from the ECB through the TLTRO program[4] . The ECB took the liberty of changing the conditions on the TLTRO program due to its battle against inflation (making monetary policy more restrictive), and thereby caught banks and market participants off-guard.

As a result of this change in the TLTRO conditions, banks rushed to repay their TLTROs by issuing Covered Bonds, which proved to be the cheaper financing option for banks than utilizing the TLTRO program under the new terms. This resulted in a larger-than-expected issuance (supply) of Covered Bonds in 2023. More than EUR 1.6 trn in TLTRO had been repaid in 2023[5].

Outstanding LTRO of EA Banks in trn EUR:



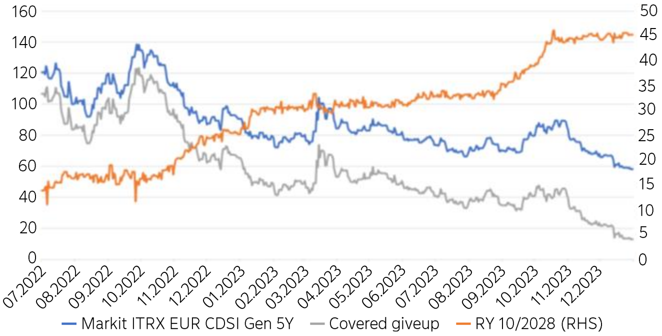
Source: ECB as of 23.01.2023

The strong issuance of Covered Bonds in 2023 – which was related to the repayment of TLTROs, caused Covered Bonds spreads to widen out in 2023 by 14 basis points[6]. As already stated, this was in sharp contrast to the general spread tightening seen in credit markets in 2023. In our view, the spread widening in Covered Bonds in 2023 was driven by the aforementioned supply technical, not by fundamental concerns.

The Investment Case: Covered Bonds vs. IG corporates

Given the aforementioned spread widening in Covered Bonds vs. swap compared to spread tightening in the IG corporates vs. swap, Covered Bonds now stand at very attractive levels. From our analysis, the pick-up when investing in IG Corporates vs. Covered Bonds has rarely been this low. Allow us to illustrate an example.

Covered Bonds very attractive vs credit bonds:
AAA covered trading wider than some senior bonds



Source Nordea Investment Management AB, Barclays Bank PLC Live as of 04.01.2024

In the above graph, we illustrate that the credit spread vs. swap of the Covered Bond issued by the Royal Bank of Canada[7] maturing in Oct 2028 with a AAA rating, issued by a AA-rated bank (RBC), from a AAA-rated sovereign (Canada) **widened 30 basis points** (RHS) from summer 2022 until beginning of January 2024.

During this same time, the credit spreads vs. swap of the broad EUR corporate bond index, as represented by the Markit ITRX EUR CDSI Gen 5Y, **tightened from 120 bps to 60 bps** (LHS)

This means that the pick-up of corporates (historically around 100 bps) vs. this AAA-rated Covered Bond now stands at around 10 bps (LHS). In our opinion, this offers a very attractive entry level.

In 2024, we therefore believe:

- Issuance of Covered Bonds should decline due to less mortgage activity (TLTRO largely repaid, thus no repeat)
- Spreads in Covered Bonds trading wide to IG corporates
- Market is optimistically priced for soft-landing. We expect Covered Bonds to offer more protection than corporates in a choppy environment. We expect Covered Bonds to perform (at a minimum) in line with Corporates if a risk-on environment endures in 2024
- In 2024, Covered Bonds should perform well in a risk-on or risk-off environment, while in our view, offering greater risk-adjusted returns compared to IG corporates, considering the conservative character of covered Bonds

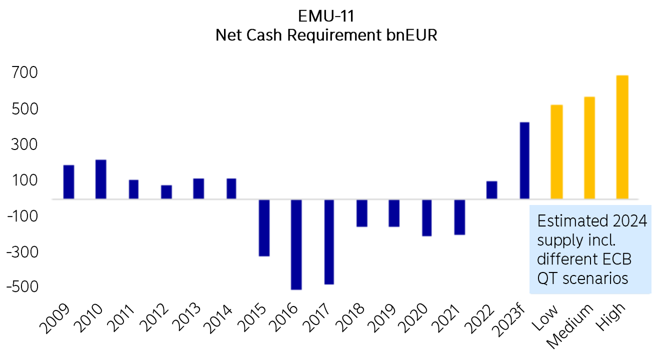
[4] https://www.reuters.com/markets/europe/ecb-gets-rid-subsidy-bank-loans-mop-up-cash-2022-10-27/
[5] Source: ECB as of 23.01.2023
[6] As measured by the IBOXX Covered Bond Index

[7] Measured by outstanding market volume as of end of 2022, Canada is the 8th largest covered bond market . The various ECB programs (APP, PEP, etc.) did not invest in non-European covered bonds, so looking at Canadian covered bonds is particularly interesting as they were priced by the market and not influenced by ECB intervention.

The Investment Case: Covered Bonds vs. EU Govies

Covered Bonds are a very defensive, high quality fixed income asset class and as such, often considered by many investors to be a substitute for EU government debt. As already outlined above, the supply technicals are a large performance driver for Covered Bonds. This is also a relative story when comparing supply of Covered Bonds to supply of EU government debt. All else equal, if the issuance (supply) of Covered Bonds shrinks while the issuance (supply) of government debt increases, this is supportive of Covered Bonds.

The net supply of EU government debt (given that most government are running deficits) is expected to be high in 2024. As one can see in the below chart, the net supply of EU government debt in 2024 is expected to increase. This contrasts sharply to the expected decline in Covered Bonds.



Source: Citi Research, Treasuries

In 2024, we therefore believe:

- Issuance of Covered Bonds should decline due to less mortgage activity (TLTRO largely repaid, thus no repeat)
- Covered Bonds, like government debt, offer solid protection in risk-off environments
- Covered Bonds currently offer a better expected return than government debt (yield pick-up over govies)
- Active management in Covered Bonds allows for additional alpha-generation on top of the duration premium.
- High expected net supply will put pressure on government bonds.

Our Value Proposition as Active Bond Managers

Nordea is one of the largest players in the Covered Bond market in Europe, managing around EUR 40 bn in the asset class[8]. With an average of 20 years of experience, Nordea's Danish Fixed Income & European Covered Bond Team consist of a stable team of portfolio managers, who have worked together for more than 15 years.

As Covered Bonds are very secure and highly regulated investments, many consider the asset class rather "boring", generally turning to passive allocation or buy-and-hold strategies. Although investing in Covered Bonds looks rather straightforward at first sight, this is a huge fallacy. The Covered Bond market is inefficient and nuanced in many ways: from new issuers that pay a premium to attract investors, to the effect of rating methodologies that do not fully capture the business model of certain issuers.

The inefficiencies and complexities of the market offer a wide range of opportunities for active managers such as Nordea. We have the flexibility of investing outside of the EUR-denominated universe (with no currency risk as the portfolio is hedged to EUR), leveraging our expertise in the Nordic markets, and taking advantage of ratings inefficiencies and market players' constraints. We seek to invest in Covered Bonds that offer attractive relative value compared to investment alternatives with similar risk characteristics. Nordea a proven track of generating alpha in the Covered Bond space.

[8] As of end of 2023

Nordea's Flagship UCITS Covered Bond Fund Offering

Nordea's Covered Bond Family

With a **dedicated investment team managing around €40bn of assets** across Danish and European Covered Bonds strategies, we stay true to our safe investment offering: **managing covered bonds in a very active and dynamic way is our expertise.**

Our investment strategy is the common ground of our covered bond solutions: three portfolios that adapt the exposures of the strategy, providing solutions with tailored duration and spread risks. **Our covered bond investment solutions seek high-quality investments combined with the attractive return potential that only an active and seasoned manager can bring to your portfolio!**

Nordea 1 – European Covered Bond Fund

The quality upgrade for your investment grade fixed income allocation!

Risk budget	Interest rate duration ≈ 4 - 5 years and spread exposure ≈ x1
Currency	EUR
ISIN codes	LU0076315455 (BP-EUR) / LU0733666746 (AP-EUR) LU0539144625 (BI-EUR) / LU0733665771 (AI-EUR)
Annual Man. Fee	0.60% (BP-EUR/AP-EUR) 0.30% (BI-EUR/AI-EUR)
Reference Index	iBoxx Euro Covered Total Return Index
Launch date	30.01.2012

Nordea 1 – Low Duration European Covered Bond Fund

Think out of the box for your short-term allocation!

From our European covered bond strategy, we lower the duration which leads to a portfolio less sensitive to rates movements.

Risk budget	Interest rate duration ≈ 1 year and spread exposure ≈ x1
Currency	EUR
ISIN codes	LU1694212348 (BP-EUR) / LU1694213072 (AP-EUR) LU1694214633 (BI-EUR) / LU1857276965 (AI-EUR)
Annual Man. Fee	0.50 % (BP-EUR / AP-EUR) 0.25 % (BI-EUR / AI-EUR)
Reference Index[7]	Iboxx Euro Covered Interest Rate 1Y Duration Hedged
Launch date	24.10.2017

Nordea 1 – European Covered Bond Opportunities Fund

Get the best out of the covered bonds' inefficiencies!

Relative to our European covered bond strategy, we lower the duration and we increase the spread exposure which leads to a high conviction portfolio less sensitive to rates movements and more exposed to spread, the expertise of our team.

Risk budget	Interest rate duration ≈ 1 year and spread exposure ≈ x2
Currency	EUR
ISIN codes	LU1915690595 (BP-EUR) / LU1915690835 (BI-EUR)
Annual Man. Fee	0.70 % (BP-EUR) / 0.35 % (BI-EUR)
Reference Index[7]	Iboxx Euro Covered Interest Rate 1Y Duration Hedged
Launch date	29.01.2019

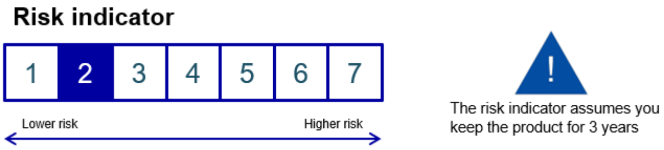
Source: Nordea Investment Funds S.A., as of 31.12.2023. In the prospectus dated 30 January 2012 the Nordea 1 – Euro Bond Fund was renamed to Nordea 1 – European Covered Bond Fund, the investment policy of the sub-fund was modified and the NAV history prior to this date is not used for performance measurement. **There can be no warranty that an investment objective, targeted returns and results of an investment structure is achieved. The value of your investment can go up and down, and you could lose some or all of your invested money.** With effect from December 2020, the official reference index of the Nordea 1 – Low Duration European Covered Bond fund and of the Nordea 1 – European Covered Bond Opportunities Fund is the Iboxx Euro Covered Interest Rate 1Y Duration Hedged. Prior to this date, the funds did not have an official reference index

Conclusion

- The timing to invest in Covered Bonds as an asset class has potentially never been better, in our opinion.
- Covered bonds can be an interesting allocation within the SAA. Covered Bonds as an asset class are typically not a designated building block within an asset allocation, but the size and depth of the Covered Bond market merit it to be
- For risk averse appetites, diverging from exposure to corporates into covered bonds is in our view, a better allocation considering the attractive and comparable returns at lower risk (high sharpe ratio).
- Nordea is one of the leading active managers in the Covered Bond space in Europe, managing around EUR 40 bn in AuM[9] in the asset class.
- Nordea has a proven track of delivering alpha in the Covered Bond space.

[9] As of end 2023

Risk considerations – Nordea 1- European Covered Bond Fund (BI-EUR)



The summary risk indicator is a guide to the level of risk of this product compared to other products. It shows how likely it is that the product will lose money because of movements in the markets or because we are not able to pay you. We have classified this Fund as 2 out of 7, which is a low risk class. This rates the potential losses from future performance at a low level, and poor market conditions are very unlikely to impact the Fund's capacity to pay you. Be aware of currency risk. In some circumstances you will receive payments in a different currency, so the final return you will get depend on the exchange rate between the two currencies. This risk is not considered in the indicator shown above. For more information on risks the fund is exposed to, please refer to the section "Risk Descriptions" of the prospectus. Other risks materially relevant to the PRIIP not included in the summary risk indicator:

- **Derivatives risk**: Small movements in the value of an underlying asset can create large changes in the value of a derivative, making derivatives highly volatile in general, and exposing the fund to potential losses significantly greater than the cost of the derivative.

- **Prepayment and extension risk**: Any unexpected behaviour in interest rates could hurt the performance of callable debt securities (securities whose issuers have the right to pay off the security's principal before the maturity date).

- **Covered Bond risk**: Covered bonds are bonds usually issued by financial institutions, backed by a pool of assets (typically, but not exclusively, mortgages and public sector debt) that secure or “cover” the bond if the issuer becomes insolvent. With covered bonds the assets being used as collateral remain on the issuer's balance sheet, giving bondholders additional recourse against the issuer in case of default. In addition to carrying credit, default and interest rate risks, covered bonds could face the risk that the collateral set aside to secure bond principal could decline in value.

- **Credit risk**: A bond or money market security, whether from a public or private issuer, could lose value if the issuer's financial health deteriorates.

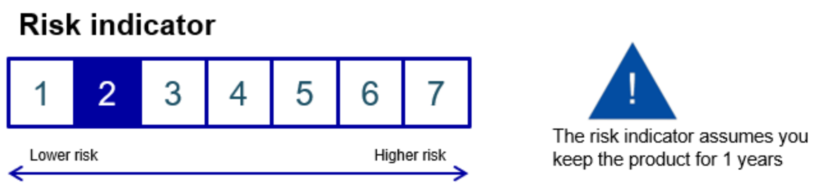
- **Hedging risk**: Any attempts to reduce or eliminate certain risks may not work as intended, and to the extent that they do work, they will generally eliminate potentials for gain along with risks of loss.

This product does not include any protection from future market performance so you could lose some or all of your investment

Calendar Year Returns in %	Fund	Reference index
2013	3.47%	1.88%
2014	10.75%	7.23%
2015	1.01%	0.41%
2016	4.53%	2.06%
2017	1.76%	0.59%
2018	1.23%	0.24%
2019	5.35%	2.79%
2020	3.59%	1.91%
2021	-1.96%	-2.12%
2022	-12.28%	-13.27%
YTD	4.74%	5.55%

Source: Nordea Investment Funds S.A. Period under consideration: 09/12/2011 - 29/12/2023. 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 29/12/2023. 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. The sub-fund's reference index changed on 07/03/2014. The past performance data shown prior to that date is related to the sub-fund's previous reference indexes, 50% Iboxx Germany, 40% Iboxx France and 10% Iboxx Spain until 07/03/2014.This reference index is used for performance comparison purposes. With effect as of 30/01/2012 the investment policy of the sub-fund was modified. The performance figures shown prior to that date were achieved under circumstances that no longer apply.

Risk considerations – Nordea 1- Low Duration European Covered Bond Fund (BI-EUR)



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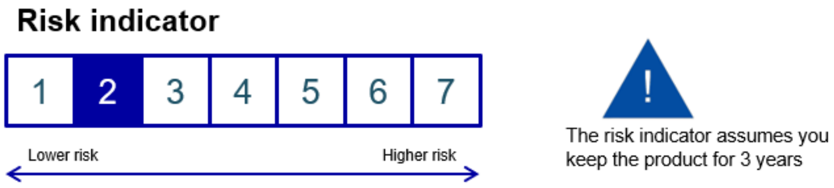
Calendar Year Returns in %	Fund	Reference index
2018	-0.09%	-1.29%
2019	2.78%	1.56%
2020	1.58%	0.60%
2021	-0.53%	-1.38%
2022	-0.89%	-4.30%
YTD	2.43%	3.94%

Source (unless otherwise stated): Nordea Investment Funds S.A. Period under consideration (unless otherwise stated): 24/10/2017 - 29/12/2023. 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 29/12/2023. 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.** With effect from 14/12/2020, the official reference index of the fund is Iboxx Euro Covered Interest Rate 1Y Duration Hedged. Prior to this date, the fund did not have an official reference index. The performance of the reference index before this date is provided for convenience purposes.This reference index is used for performance comparison purposes.

Risk considerations – Nordea 1- European Covered Bond Opportunities Fund (BI-EUR)



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Calendar Year Returns in %	Fund	Reference index
2020	3.34%	0.60%
2021	0.92%	-1.38%
2022	2.33%	-4.30%
YTD	2.20%	3.94%

Source (unless otherwise stated): Nordea Investment Funds S.A. Period under consideration (unless otherwise stated): 29/01/2019 - 29/12/2023. 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 29/12/2023. 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.** With effect from 14/12/2020, the official reference index of the fund is Iboxx Euro Covered Interest Rate 1Y Duration Hedged. Prior to this date, the fund did not have an official reference index. The performance of the reference index before this date is provided for convenience purposes.This reference index is used for performance comparison purposes.