Fund Update – Special Edition

August 2020

Harvesting value in a complex sector

Nordea 1 – European Financial Debt Fund

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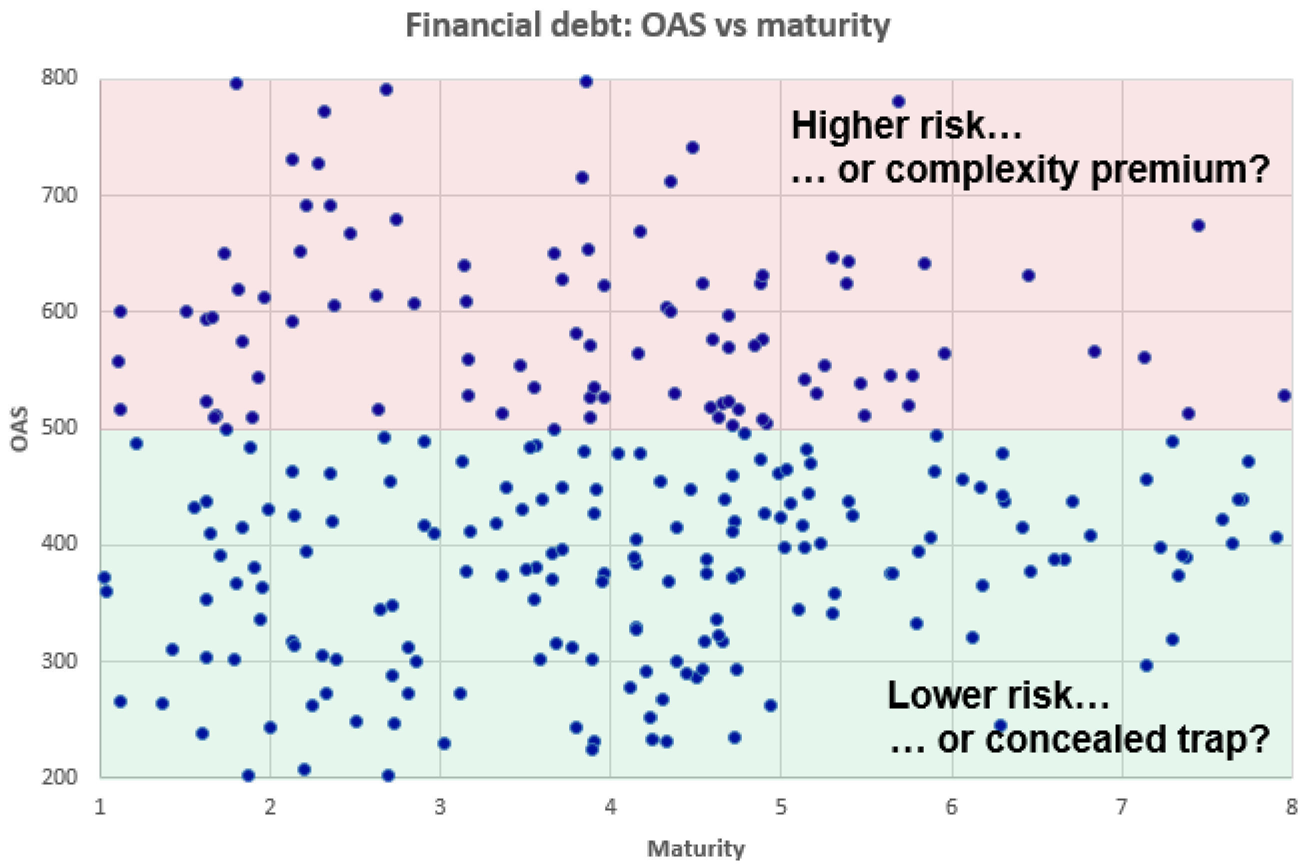
European financial debt is a dynamic asset class whose **value proposition** revolves around two key aspects:

- **Regulatory tailwind**: regulators have been continuously inducing reduction of risks in financial institutions. Since the global financial crisis, banks have built up substantial levels of capital and liquidity in excess of regulatory minimums and buffers. This is intuitively beneficial to creditors.
- **Complexity bears opportunities**: countless regulations, the idiosyncratic nature of the industry and issuer developments provide for the perfect arena for active management. Careful issuer selection is essential for generation of value.

But what does this mean in practice? In this document we would like to zoom on some numbers and practical examples to better gauge the opportunities offered by the asset class and the **Nordea 1 – European Financial Debt Fund** before reiterating our outlook and positioning for the months to come.

Visualizing European Financial Debt Dispersion

The chart below is one way to look at the **dispersion** within the financial debt asset class. It pictures the spread of bonds which compose the European financial high yield and CoCo bonds indexes vs their respective maturities:



Source: ICE, Nordea Investment Fund SA.

Much of the dispersion is clearly linked to the **fundamentals** of the underlying issuer as well as specific issue characteristics, however there's more than meets the eye. Intuitively, **regulatory and technical complexity** as well as **idiosyncratic uncertainty** often provide for attractive investment opportunities that a pair of experienced hands can harvest.

From time to time, complacency can prevail towards segments where a striking lack of concern veils material risks. On the other side, the news flow can open **opportunistic windows** as the market is uncertain on how to price in new information, as well as fear premiums are often embedded in price developments on a name specific basis.

On this note, in the next section we bring in focus the case of Banca Monte dei Paschi, one of the strongest performing issuers in Q2 2020, as well as one of our main performance contributors along the quarter.

The case of Banca Monte dei Paschi

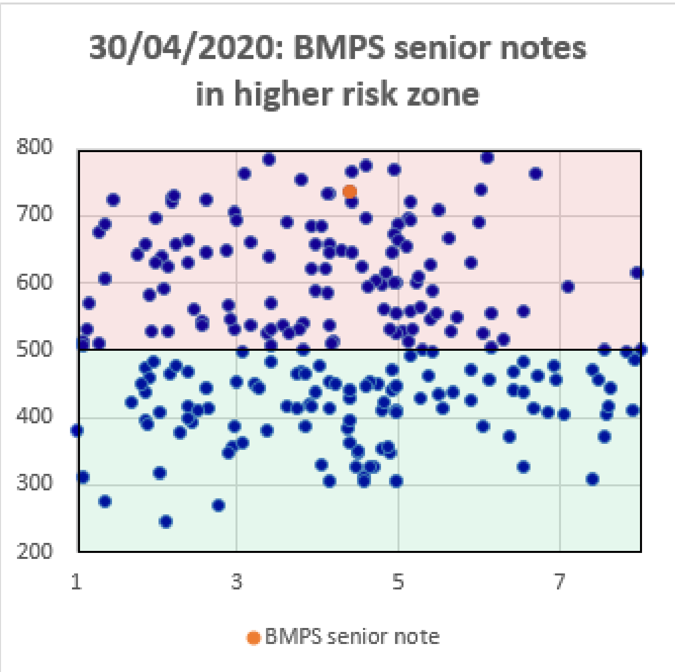
Banca Monte dei Paschi (BMPS) is a challenged Italian bank which appeared often in the news due to capitalization concerns and continuous dialogues with European regulators to handle the delicate situation. In May 2020 the bank has been hitting the news again, this time with **positive developments**, that will allow the institution to reduce holdings of non-performing loans strongly.

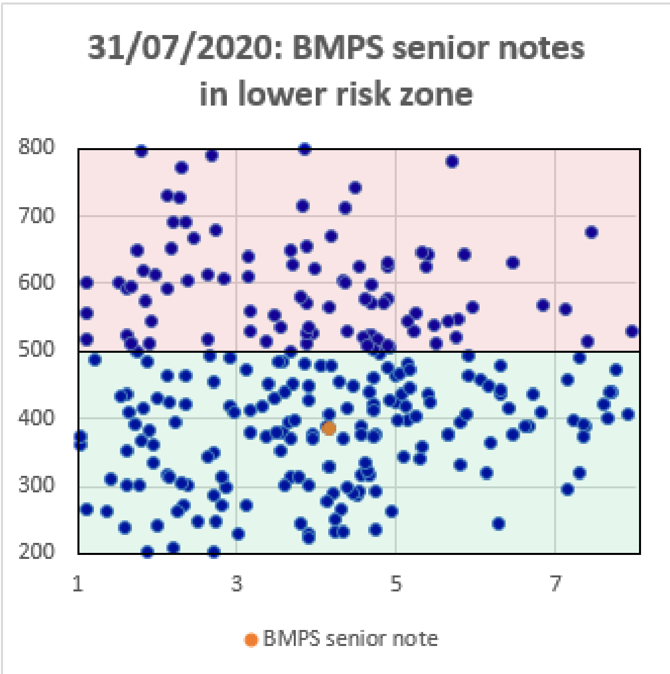
We have been anticipating positive developments for the issuer for a while and gradually built up a relatively large position in the name as our conviction stood firmly against market consensus. In Q2 2020, subordinated notes from BMPS **rallied as much as +50%-60%** after regulatory approval of a historic deal that marks a turning point for the issuer, proving our positioning worth. At the same time, senior notes quickly moved from ranking among highest risk as measured by spread at the end of April to the lower risk segment of the universe at the end of July.

What happened? On the 29th of May 2020, BMPS received an informal approval by the European Commission to proceed with the disposal of a large quantity of Non-Performing Loans (NPLs). The loans are to be bought by AMCO, that is an asset manager closely linked to the Italian government (which added to uncertainty over the case).

Why is this relevant for BMPS? This is a huge step for the bank which marks enormous progress since the restructuring plan was last approved in 2017. Monte dei Paschi bonds cheered at the news with a massive rally in the secondary market.

Why is this relevant for the fund and our investor? We held a sizeable position in Monte dei Paschi bonds, both Tier 2 and senior. We have been anticipating such developments for a while and invested back in February 2019. For good reasons, we never lost conviction, even when the market lost faith in the issuer and punished it during March Covid-19 selloff. We even increased our position when prices once more hit the low. While this was one of the main performance detractors along the selloff, the risk we have selectively taken is proving worth now.





Source: ICE, Nordea Investment Fund SA.

Why was our conviction so high and what did we do? The issuer has not been granted much trust from investors, especially along the selloff in March, and the spread on its subordinated bonds was among the highest in the asset class. While still a challenged case, we saw at least 4 reasons why the name deserved attention:

1) The bank had not been breaching capital supervisory capital requirements since the past restructuring plan was confirmed and had been following-up closely on regulatory requests;

2) It had also completed the near-entirety of NPL disposals agreed with the European Commission for end-2021;

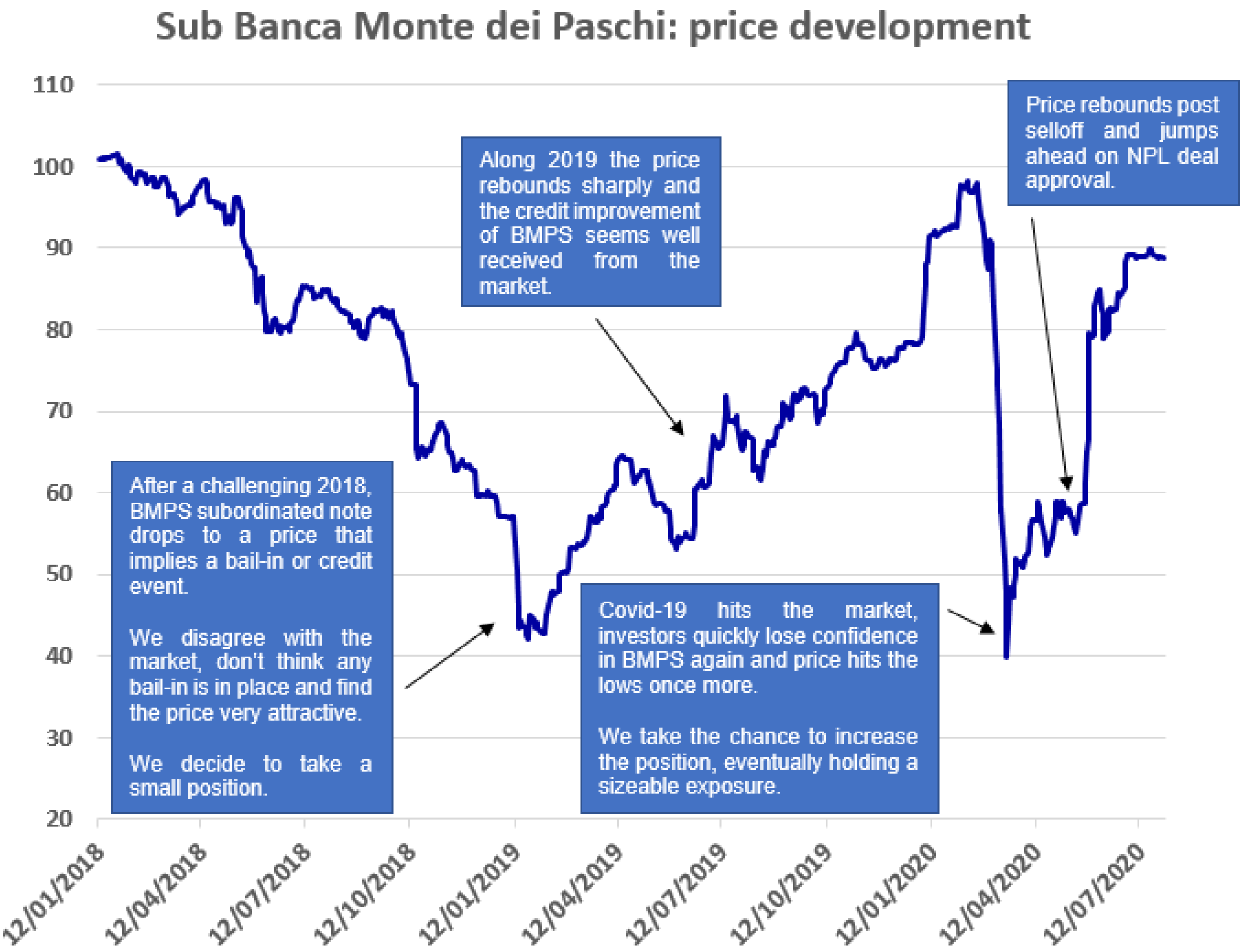
3) Valuations were facing further stress that was triggered by external events, such as Italian politics derailing efforts, rather than internal issues;

4) A resolution of the bank would have likely led to an adverse impact on the country's financial stability and was hence no ideal event for any party in the game;

After a challenging 2018 end, on the back of a broader risk-off sentiment, the subordinated instruments of Banca Monte dei Paschi declined to a **price that was discounting a bail-in event**, implying the bank was close to a failing or likely-to-fail position. Based on our considerations of the case, this looked like the **best entry point** to invest, with a high potential and a **large gap vs market consensus**.

We hence started to gradually build up on the position in February 2019 and slowly increased the exposure as the credit story was improving. We **held on to our position** in the name in the stressed markets we saw earlier this year and **even increased** in the subordinated instruments mid-March, considering that the bank had overshot its commitments to the regulator which made the likelihood of support for further progress very likely, even in troubled times. Eventually, BMPS turns out to be one of the **strongest issuers** in terms of performance in Q2 2020, both for the fund and the asset class.

From now on, a further normalization of asset quality is on the cards, and we see BMPS better positioned than peers to face the expected stress on loan books once moratoria and government support are lifted later this year. More importantly, this now leaves open the door for a potential merger of the lender with another domestic issuer, an option that is likely to provide further support to the bonds.



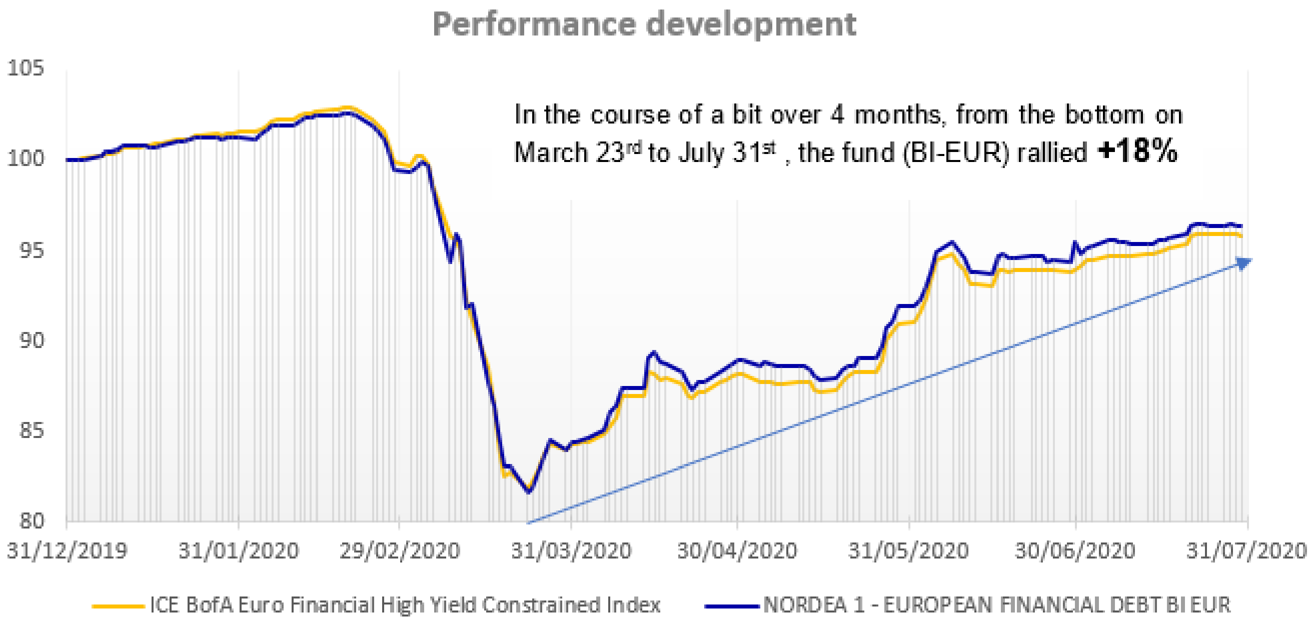
Source: Datastream, Nordea Investment Fund SA. **The performance represented is historical; past performance is not a reliable indicator of future results and investors may not recover the full amount invested. The value of your investment can go up and down, and you could lose some or all of your invested money.**

A huge step for Banca Monte dei Paschi and a strong signal for the banking sector. What's next? Outlook for the months to come.

With the approval of this deal the European Commission continues to signal the **strong support** it has committed to the banking sector in the current recession. European authorities have been very vocal in stressing that banks are **part of the solution**, and not the core of the problem in the ongoing crisis. On the other hand, there is no doubt that the pandemic will have an effect on bank capitalization as it will generate losses: the question is rather, where is risk concentrated? In our opinion, mounting NPLs provisions should at least give some worry in relation to discretionary payments. Just like dividends and bonuses, **AT1 coupons** are in fact discretionary and next for cancellation. For banks with low buffers, coupon cancellation may not even be so much of a choice but rather a mechanical regulatory effect. As a reminder, in the (very gentle) 2018 EU stress test **52% of banks breached their requirements** and applied distribution restrictions which impacted all discretionary payments alike. The cancellation of the accrued 2019 dividend/buyback programmes may well be a short-term help, but the coupon cancellation risk on junior debt is still material. Having said that, it is clear that regulators and governments are running the extra mile to support financial institutions, and this in practice means that banks of a certain size should be expected to operate orderly, a common interest for authorities and society alike. In turn, this indicates in our opinion that instruments such as **subordinated Tier 2 bonds** (structures with mandatory coupons) should be well serviced. For this reason, we have reduced our exposure to AT1/CoCos after the selloff, favoring instead Tier 2 bonds whose coupon is mandatory.

As opposed to many banks, insurance companies went into the current crisis with a **significantly higher capitalisation** above minimum requirements on average. To put things in perspective, in 2019 many insurers were more than adequately reserved for solvency capital requirements (SCR) with a coverage of **roughly 2 times** the regulatory threshold. This doesn't mean that the sector is immune to the crisis of course. On the contrary, future economic impacts on the wider economy will translate into concrete financial difficulties for companies, which could lead to rating downgrades, thus increasing capital requirement, as well as potential defaults. As for direct impacts related to insurance policies, there are of course several lines impacted. Event cancellation will bear losses that should however remain manageable. European health insurers should see claims, yet most of these costs should be borne by states and the like. Business interruption could be more of an issue, even if it is clearly excluded from most policies. Potential losses are difficult to estimate on aggregate, but could be sizeable for the industry in total. Yet, we are only exposed to the risk through **globally diversified insurers** and we do not currently foresee large solvency impacts on the insurers we are exposed to. A number of Tier 2 bonds within the sector actually showed encouraging valuations so we have **added selective exposure** to the insurance sector as of Q1 end.

As we believe we stand ready for the months to come, our positioning has also proved worth so far, and has allowed us to **outperform** (net of fees, BI-EUR) **the broader European financial high yield market along the rebound despite a 40%+ allocation to investment grade bonds.**



Please notice that the Nordea 1 – European Financial Debt Fund has no official benchmark. **Comparison with other financial products or benchmarks is only meant for indicative purposes. 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.** Source: Datastream, Nordea Investment Funds S.A.