In Focus - Special

For professional investors only*

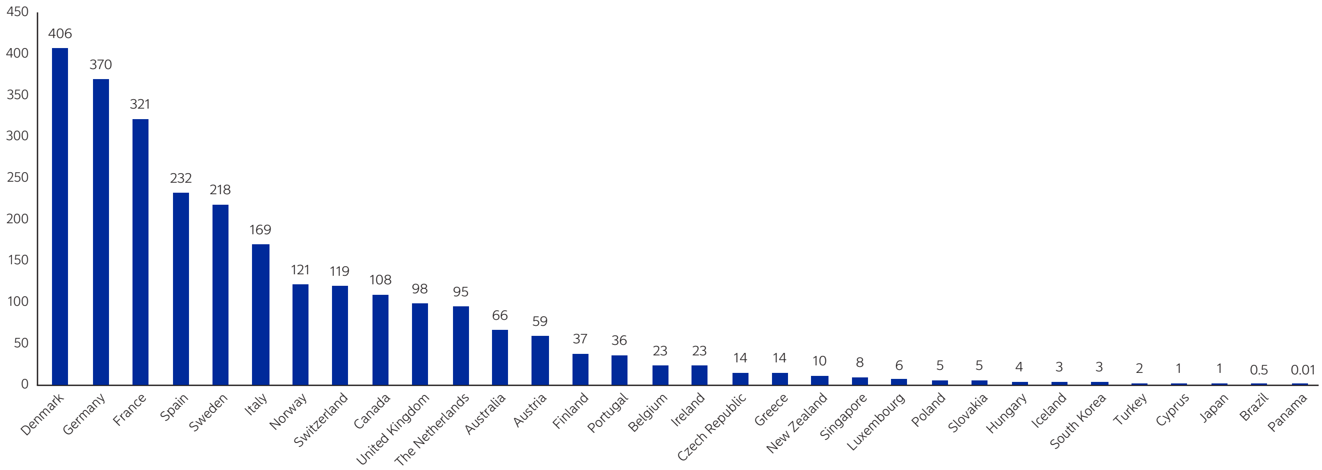
November 2019

The missing piece of your portfolio? A structural allocation to covered bonds.

... you said covered bonds?

A covered bond is a debt instrument issued by a mortgage institution or a bank, which is backed by a pool of assets (cover pool). Covered bonds find their origin in Europe, with markets such as Denmark or Germany reaching more than 200 years old. With a market size close to EUR 2.6 trillion[1], we witness nowadays a broad and liquid market across a diversified set of countries, even reaching jurisdictions outside of the European economic area.

Outstanding Covered Bonds by Country, EUR bn



Source: EMF-ECBC, data from end of 2018

With more than 300 issuers, covered bonds play a crucial role in the funding of financial institutions. By putting covered bond programs into place, issuers can access the market at low expense, good ratings, to finance their activities in mortgage and (to a lesser extent) public-sector loans. As an illustration, covered bonds backed by a pool of mortgages have reached the equivalent size of ≈ 30 % of the outstanding residential mortgages within the EU[1]. In the eyes of investors, this type of bonds is truly attractive, providing a higher quality option in the financial debt space, but more importantly unbeatable features across the entire fixed income space.

Why covered bonds?

Covered bonds offer many advantages within a portfolio context, yet they seem sometimes to be the forgotten piece of the fixed income markets, not traditionally considered as a structural pillar of investment allocations. Covered bonds are not yet a building block in your portfolio? Let's take a long-term perspective of the unique characteristics of this asset class.

1) Source: ECBC Publication, ECBC EUROPEAN COVERED BOND FACT BOOK, 2018.

Safety first: covered bonds would be one of your safest investments

In more than 200 years of history, no covered bond has ever defaulted and there has not been a single delay in coupon or principal payment. Yes, even in the recent traumatic times of financial markets, the asset class has provided an impressive protection. In contrast, the "typical" safe bonds have been taking investors by surprise: e.g. Greek government bonds were restructured earlier in the decade, while Greek covered bonds did not take a loss; we saw banks getting restructured up to senior debt, and even on the deposit above EUR 100,000, yet covered bonds have stood strong and did not default.

Issuers have defaulted ...
... but covered bonds investors have not taken a loss

Issuer	Date of default	Subordinated Debt	Senior Unsecured	Deposits > EUR 100,000	Covered Bonds
Bank of Cyprus public company Ltd	Mar-13	Yes	Yes	Yes	No
Cyprus Popular Bank Public Co Ltd	Jun-12	Yes	No	No	No
Cyprus Popular Bank Public Co Ltd	Mar-13	Yes	Yes	Yes	No
Glitnir Banki hf	Oct-08	Yes	Yes	Yes	No
Kaupthing Bank hf	Oct-08	Yes	Yes	Yes	No
Allied Irish Banks Plc	Jan-11	Yes	No	No	No
Bank of Ireland	Dec-10	Yes	No	No	No
EBS Ltd	Feb-11	Yes	No	No	No
Irish Bank Resolution Corporation Ltd	Nov-10	Yes	Yes	No	No
SNS Bank N.V.	Feb-13	Yes	No	No	No
Banco Espirito Santo	Aug-14	Yes	No	No	No
Banco CEISS	May-13	Yes	No	No	No
Banco de Valencia	Mar-13	Yes	No	No	No
Catalunya Banc SA	Jul-13	Yes	No	No	No
Ibercaja Banco SA	Nov-12	Yes	No	No	No
Liberbank	May-13	Yes	No	No	No
NCG Banco S.A.	Jul-13	Yes	No	No	No
Bradford Bingley Plc	Feb-09	Yes	No	No	No
Chelsea Building Society	Apr-10	Yes	No	No	No
Co-Operative Bank Plc	Dec-13	Yes	No	No	No
Washington Mutual Bank	Sep-08	Yes	Yes	No	No

Source: BBV and Moody's. Defaults as per Moody's definition.

The safety of the asset class resides in its strong framework. To be able to issue covered bonds, the institutions must answer the regulation criteria of their jurisdiction, e.g. obtaining a specific license and providing the quality enforced by the local framework. As part of the prerequisites, covered bonds must offer investors a double layer of protection. The first recourse is a full claim on the issuer's assets, including the fact that that covered bonds are one of the most senior debts on financial institutions' balance sheet. The second recourse is a preferential access to the cover pool, which remains on the issuer's consolidated balance sheet.

All these features put covered bonds on a similar level of safety of government bonds in terms of risk, and significantly higher than investment grade and high yield corporate debt.

Regulatory environment: regulation fosters covered bonds as a financing tool and as an investment

Covered bonds benefit from a great support of the EU regulation. Along with sovereign bonds, covered bonds have been one of the main beneficiaries of the latest enhancements of the EU legislation. One of the key steps has been the exemption of covered bonds from bail-in under the Bank Recovery and Resolution Directive (BRRD). This implies that, in case of a defaulting bank, the BRRD would exclude covered bonds from absorbing any losses via a bail-in. Approved in April 2019, the Covered Bond directive aims moreover at facilitating the use of covered bonds across jurisdictions, and therefore promotes covered bonds further as a stable tool of funding for financial institutions.

Investors in the need to meet regulation requirements would see covered bonds as a great asset, as they benefit from a preferential treatment. The banking regulation categorised covered bonds as highly liquid assets in the Liquidity Coverage Ratio (LCR); while the Capital Requirement Regulation (CRR) has assigned low risk weights to the asset class. Under Solvency II, less capital holding is required on the insurance's balance sheet for securities which offer high standards of credit quality, transparency and simplicity: in this framework covered bonds represent low spread risk factors.

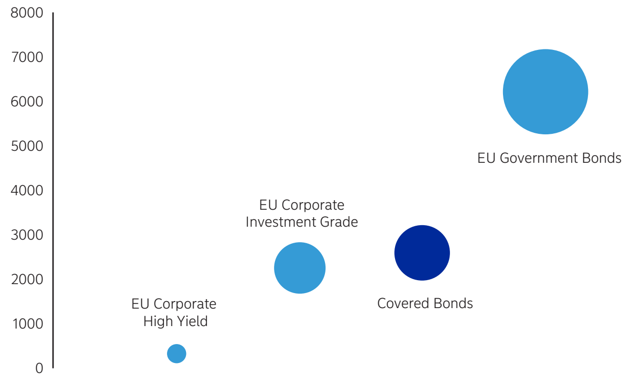
In brief, covered bonds benefit from one of the best regulatory treatments along with government debt, and again, stand in a much better position than investment grade and high yield corporate debt.

Liquidity: covered bonds are far from a niche market

The building blocks of a portfolio allocation traditionally mirror the opportunity set of financial markets. While small and illiquid markets take a minor stake in portfolios, the largest and most liquid markets have an indisputable place. This is then rather surprising to see many investors considering markets such as high yield as a more traditional allocation than covered bonds. With a size close to the EUR investment grade and high yield corporates combined, the covered bond market has proven in addition to be one of the most liquid asset classes. In difficult times, as for example the crisis in 2011 – 2012, some of the Nordic covered bonds were providing even better liquidity than their respective sovereign debt.

Far from a niche investment, covered bonds represent one of the largest fixed income markets in Europe, providing in some jurisdictions an even better liquidity than their respective sovereigns.

Market size, EUR bn



Source: ICE and EMF-ECBC, as of 31.12.2018.

Diversification: covered bonds offer low volatility and downside protection

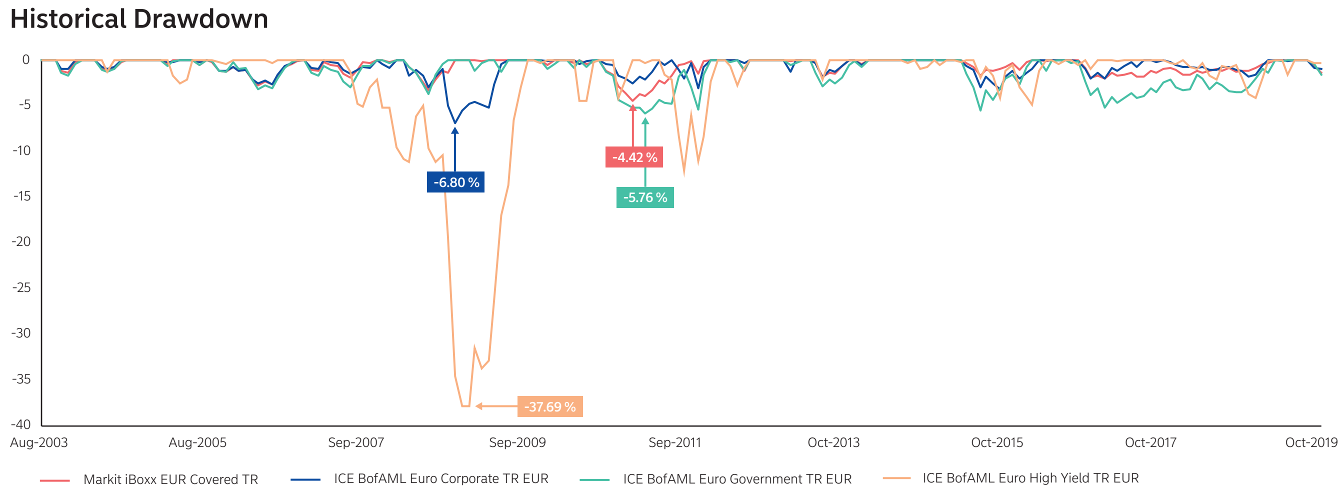
In general, covered bonds behave in a similar way as other credit products, yet with a lower overall credit beta. One the one hand, in a risk-on environment cover bond spreads will tighten, but not as much as other credits. On the other hand, covered bond spreads will typically widen in a risk-off scenario, but not as strongly as other credit products. The low credit beta and the low volatility are attractive features of the asset class within a portfolio context. Even when comparing with government bonds, covered bonds are less volatile in spreads.

Correlation Matrix (Spreads)	Covered Bonds	EU Government Debt	EU Investment Grade Corporate	EU High Yield Corporate
EU Covered Bonds	1			
EU Government Debt	**0.48**	1		
EU Investment Grade Corporate	**0.73**	0.38	1	
EU High Yield Corporate	**0.62**	0.27	0.85	1

Annualized Volatility (Spreads)	
EU Covered Bonds	**29.39**
EU Government Debt	39.41
EU Investment Grade Corporate	41.96
EU High Yield Corporate	140.70

Source: Datastream. Last 10 years based on monthly data. As of 30.09.2019.

In addition, covered bonds offer a great downside protection: as the default risk remains very low, the bonds provide a solid recovery. They usually benefit from pull to par effects: since the issuer is paying back coupon and principal, the price of the bond recovers accordingly.



Source: © 2019 Morningstar, Inc. All Rights Reserved as of 05.11.2019. Period under consideration: 01.08.2003 to 31.10.2019. Based on Monthly data in EUR.

All of this bodes well for a diversified portfolio: a resilient asset class which further improves the resilience to shock of the allocation, and therefore completes very well the traditional mix of government and corporate debt.

In our view, covered bonds are not only an established market, but also a key asset class that investors should consider in their asset allocation framework.

Many benefits come with a structural allocation to covered bonds thanks to their safety, regulatory treatment, liquidity and diversification potential. On the long run, the compelling features of covered bonds make the case for the asset class to find its place in investors' portfolio, alongside the traditional government and corporate debt investments.

Convinced of the beta? If you are, you can even get alpha in this asset class!

Given that covered bonds are very secure and highly regulated investments, many consider the asset class rather "boring" and generally turn 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 in many ways: spread differences can be driven by a variety of drivers e.g. regulatory diversity and rating methodology, different headline risk on the issuing banks, investors not being able – or willing (home bias) – to access certain jurisdictions.

The inefficiencies and complexities of the market offer a wide range of opportunities to investment teams that are truly active and dynamic in their allocation. Nordea Asset Management has considerable expertise in this space, responsible for more than EUR 40 billion of assets[2]. Our investment team has proven an incredible strength in generating alpha over the years with an average of +1.3 % net of fees since inception![3]

Finding an attractive low-risk home for investors in today's market environment is a difficult proposition. Nordea offers you both the asset class and the expertise: a very high-quality investment delivering the attractive returns that only an active and experienced manager can bring to your portfolio.

2) Source: Nordea Investment Management AB. As of 30.09.2019. 3) Average outperformance of the Nordea 1 – European Covered Bond Fund BP-EUR over the Iboxx EUR Covered Bond Index, calendar year basis. Source: Nordea Investment Funds S.A. 30.01.2012 – 30.09.2019. **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.**

Source (unless otherwise stated): Nordea Investment Funds S.A. Period under consideration (unless otherwise stated): 30.01.2012 – 30.09.2019. 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 30.09.2019. 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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