Nordea

In Focus

For Professionals Only*

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Safe bonds with attractive yields do exist: European Covered Bonds

Nordea 1 – European Covered Bond Fund

ISIN: LU0076315455 (BP-EUR), LU0539144625 (BI-EUR)

- Covered Bonds offer a similar level of safety as sovereign debt, but with enhanced returns
- EU regulatory enhancements grant covered bonds preferential treatment
- Nordea investment team shows concretely that active management is of the utmost importance in this market

On the occasion of its latest meeting, the European Central Bank has once again stressed that it will do whatever it takes to achieve its inflation target of 2%. As action points, rates were lowered and the central bank's bond purchasing programme was further enhanced. The consequence of this announcement has been the **prolongation of the low-yield environment and the realisation that investors are bound to face this challenge on an even longer term basis**. Remarkably, the entire Germany yield curve is at negative rates up to a maturity of 8 years.

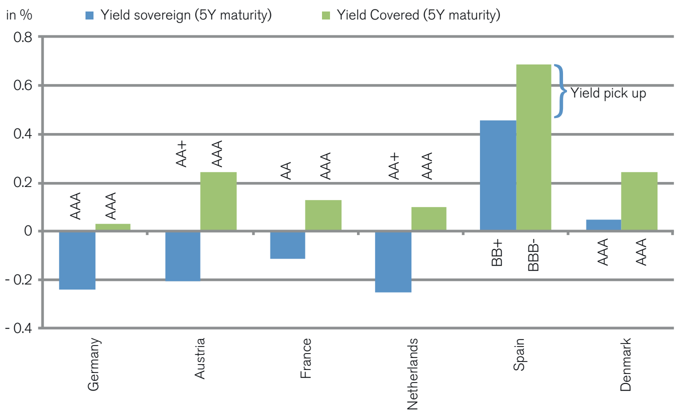
Market conditions put at stake investors in the safe fixed-income spectrum:

- **Banks and retail investors** suffer bitterly from negative yields on deposits. A major concern is therefore finding the right substitute to cash and government bonds which confers a sufficient guarantee of safety and still provides a positive yield.
- **Pension funds and insurance companies** have to cope with restrictions on their investments towards safe assets. Meeting these requirements is not straightforward anymore when looking for positive and consistent returns. They are likely to find it even harder to meet their long-term debts, especially in regards to their defined benefit products with guaranteed rates.

Which instruments other than government bonds nowadays still could fulfil their needs? European Covered Bonds embody a more than attractive investment alternative, as illustrated below.

European Covered Bonds – attractive yields within a very safe asset class

For those investors seeking an asset class which combines safety and attractive returns, European covered bonds are worth taking a closer look. Being a very secure investment, covered bonds offer dual protection, on one side via the issuer´s assets and on the other side via a cover pool. The cover pool has to follow strict rules; requiring for example low loan-to-values and an over-collateralization of the pledged assets. Furthermore, the issuer has the legal obligation to maintain the cover pool's value dynamically, by replenishing it with new assets in case of loan defaults. These features set covered bonds at the same safety footing as sovereign debt; yet, they are still able to offer higher and positive yields in many jurisdictions as illustrated below:



Source: Bloomberg, Date: 10.03.2016

Regulatory environment preferential for Covered Bonds

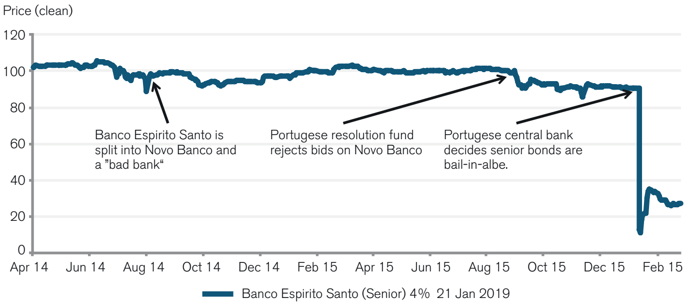
In recent years, covered bonds have been one of the main beneficiaries of enhanced EU legislations, along with sovereign bonds. While the Liquidity Coverage Ratio (LCR) categorises covered bonds as highly liquid assets, the Capital Requirement Regulation (CRR) assigns low risk weights to covered bonds, and, under Solvency II, covered bonds represent very low spread risk factors. The last two mentioned frameworks are

*investing for their own account - according to MiFID definition the most significant regulations to have impacted the banking sector and the insurance industry respectively. Both therefore put covered bonds on a similar level of safety compared to government bonds in terms of risk and significantly higher than all other bonds. **This makes covered bonds an obvious replacement instrument for government bonds within the institutional space.**

Covered Bonds clearly distinguish from other corporate bonds

Covered bonds are exempted 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.

This protection is more relevant than ever, as demonstrated by the experience of the Portuguese Banco Novo (former Banco Espirito Santo) and its creditors. The bank's covered bonds were fully and timely paid back to creditors. On the other hand, Banco Novo's senior debt did not meet the same fate, as the Portuguese Central Bank enforced its "bail-inable" attribute. As illustrated below, this decision led to a massive fall in the price of the bank's senior bonds.



Source: Nordea Investment Management AB, and Bloomberg. Period under consideration: 01.04.2014 – 24.02.2016.

The European Covered Bond Market is highly inefficient

Although investing in covered bonds at first sight looks rather straightforward, this is not the case at all. Indeed, the market is inefficient in many ways.

As an example, it is crucial to analyse issuers coming to the market and to understand their business model. Many issuers often have different funding strategies. As a result, some of them are more willing than others to pay for the access to the market, and therefore offer their bonds at attractive new issue premiums.

The new regulatory frameworks also come along with new market opportunities. Only CRD (Capital Requirement Directive) compliant bonds benefit from preferred treatments, making them also more expensive. This premium does not affect non CRD compliant covered bonds, which can be thus priced with a discount despite even stronger credit quality.

Many covered bond investors have rating restrictions, forcing them to sell their bonds if the rating changes. This represents clear buying opportunities for unconstrained investors on this matter. It is therefore essential to understand the risk of downgrades below certain thresholds like the AA level or the investment grade level.

Nordea – constantly adding value by active management

The Nordea 1 – European Covered Bond Fund since inception in 2012 consistently outperformed its benchmark, the Iboxx EUR Covered Bond Index[1], each year and is also standing out from its peers.

The fund is managed by the **dedicated and specialised Covered Bond Team**, which is part of Nordea's seasoned Danish Fixed Income & Euro Covered Bonds Team. The investment team, accountable for an overall EUR 30bn of assets under management across several funds and mandates, possesses an outstanding track record in managing this asset class.

The investment team truly believes that they can exploit these kinds of inefficiencies in the market by actively managing their portfolio. On top of that, the team is also allowed to invest in non-EUR denominated Covered Bonds, which are issued by European institutions. This is a key differentiator from our competitors and enhances our investment universe, as it enables us to navigate away from the benchmark into a segment, where the ECB cannot interfere in terms of mispricing and reduced liquidity.

It also allows the team to invest into the Scandinavian covered bonds market, which gives the fund a special edge in the process of building a highly secure covered bond portfolio.

To fully understand this complex market and exploit its inefficiencies, one needs to have an experienced investment team. The portfolio management team of the Nordea 1 – European Covered Bond Fund has on average an experience of more than 17 years in the covered bond segment and has built up a strong track record over the past years. This demonstrates their ability to **continuously add alpha** by partially investing outside the benchmark **without adding risk** to the portfolio. Covered bonds seem at first to be an easy investment option. Going deeper into the market, it becomes obvious that passive management is missing opportunities: the added value of an experienced and active management is precious. Nordea offers a strong solution to invest in the European covered bond asset class.

1) Source (unless otherwise stated): Nordea Investment Funds S.A. Period under consideration (unless otherwise stated): 30.01.2012 - 29.02.2016. Performance calculated NAV to NAV (net of fees and Luxembourg taxes) gross income reinvested, in the base currency of the respective sub-fund, excluding initial and exit charges as per 29.02.2016. 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.**

Conclusion:

European Covered Bonds are the alternative in the current market environment, as:

- They still offer positive yields in a risk trade-off environment
- They represent a good substitute for retail investors and banks, when cash is not a source of returns anymore
- They beneficiate from both banking and insurance regulation frameworks
- They support insurance companies and pension schemes in still meeting their long-term debt obligations

However, they take part of a highly inefficient market. Our investment team, as an experienced and active manager, is therefore able to constantly generate enhanced returns.

Calendar year returns in %	Fund[2]	Index[3]
YTD	2.18	1.52
2015	0.51	0.41
2014	10.34	7.23
2013	3.07	1.88

Source: Nordea Investment Funds S.A., Date: 24.03.2016

Nordea 1 – European Covered Bond Fund	
Fund manager	Danish Fixed Income & Euro Covered Bonds Team
Fund domicile	Luxembourg
ISIN codes	LU0539144625 (BI-EUR)[4] LU0076315455 (BP-EUR)
Annual management fees	0.30% p.a. (BI-EUR)[4] 0.60% p.a. (BP-EUR)
Base currency	EUR
Fund size in millions	590
No. of holdings	80
Launch dates	09.12.2011 (BI-EUR)[5] 05.07.1996 (BP-EUR)
Yield to Maturity	1.13%
Duration	4.92

Source: Nordea Investment Funds S.A., Date: 29.02.2016

2) Nordea 1 - European Covered Bond Fund, BP-EUR. 3) Iboxx EUR Covered Bond Index. **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.** 4) BI-EUR share class: only for distribution towards institutional clients. Minimum investment amount: EUR 75,000 (or the equivalent). 5) 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.

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