Talking Heads with Anna-Karin Hempel

Chris Iggo: Hello, and welcome to this week's BNP Paribas Asset Management Talking Heads podcast. Every week, Talking Heads will bring you in-depth insights and analysis on topics that really matter to investors. In this episode, we'll be discussing the Nordic high-yield bond market and the fixed income strategy managed by our colleagues at Oslo-based Alfred Burke, part of the BNP Paribas Group. I am Chris Iggo, a member of the Investment Insights team at BNP Paribas Asset Management, and today I'm joined by Anna-Karin Hempel, a Senior Portfolio Manager in the Fixed Income team at Alfred Berg. Anna manages the high-yield Nordic fixed income strategies. Welcome, Anna, and thank you for joining me today.

Anna-Karin Hempel: Thank you very much. It's great to be here.

CI: It's a year where returns have been positive across a broad range of asset classes, and high yield generally has performed very well. Credit conditions globally have remained very supportive to high-yield bond markets. But I guess not many people focus on the Nordic bond market. So maybe you could start by briefly describing the Nordic high-yield market and explain why it is a[n] attractive investment opportunity.

A-KH: More and more people are discovering that the Nordic high yield market is a good place to be. The Nordic region is generally politically, socially and economically stable, with stable framework conditions for industries and for companies in general. That is very positive given everything that is going on in the world today

That also goes for the Nordic high[-yield] market, it's very diverse. Terms are standardised, and returns have been very good over the past few years. The return levels are maybe the main attraction actually when it comes to Nordic high yield.

It's been one of the best performing markets since interest rate hikes began in 2022. It has beaten both equity indices as well as both the European and US high-end market. Since the beginning of 2022, it has returned almost 40% versus I think 20[%]+ for the US high-end market and approximately 15% for the European market, with a materially lower duration and limited volatility.

CI: In our previous conversations, you've talked about the diversification within the market in terms of the issuer bas;, maybe you could comment on that? And, for the benefit of our listeners, what's the currency composition of the bonds in the market?

A-KH: First of all, it isn't the small Norwegian oil bond market it once was. If we go back to the year 2000, the outstanding volume was approximately €1 billion, and is now over €70 billion in volumes outstanding now. So, significant growth – it's a sizeable global market now, approximately 15% of the total European market.

When we talk about the Nordic high-yield market, it's basically two countries: Norway and Sweden. Those two countries make up some 15% of the total European market, and that's quite amazing, actually. But back in the day, it was oil-related and shipping companies, so it was very a very concentrated market. So, even if you had various high[-yield] funds, they were all exposed to the same sector and macro drivers, and that was fine as long as the oil price held up. But when that tanked in 2014/15, many companies became financially distressed, and there were a lot of debt restructurings.

But now it has become much more diversified and robust. It's a completely different market now, I would say, and it's also much more international, both on an issuer level and on an investor level.

This year, 56% of the issued volume has been non-Nordic compared to 33% last year. And when it comes to the investor base, that is now over 70% according to the latest statistics, and was around 40% just four or five years back. So much more international, less pure Nordic companies seeking funding, and less pure Nordic investors.

But it's a good thing. It develops the market. It becomes more professional, more liquid. Another feature worth mentioning is the large share of floating rate notes in the Nordic high[-yield] markets –55% – and that has been helpful for yields when interest rates have come up, and a good thing in an uncertain interest rate environment.

We see now, with more dollar and euro denominated bonds coming to the market, that the duration comes up a bit, but still the credit ration is much lower than the international markets.

CI: The floating rate aspect is interesting because in recent years, with interest rates going up, bond investors in other markets where it's predominantly fixed rate issues have suffered from capital losses. But in a floating rate environment, it's to the benefit of investors when interest rates are going up. In terms of the credit spread, how does that compare with the core European markets or the US dollar market?

A-KH: You get a spread pick-up of approximately 190 basis points versus the European and US high[-yield] markets, and that is very compelling. In Norway, the average credit spread – according to DMV Carnegie's high yield index, a proxy for the Nordic high[-yield] market – that's at 460 basis points; European market, a credit spread of 250 basis points; and in the US, it's 287. So, you do get a premium by investing in the Nordic market.

CI: What does that translate into absolute yields at the moment?

A-KH: The yield in the Nordics is 8% in the euro market, 6.3[%], and in the US 7.2[%], so a compelling return prospect in that market.

CI: Attractive, but with these high yields comes credit risk. In your strategies, how do you and your colleagues manage the credit risk?

A-KH: Of course, there is a correlation between risk and return, as always. And given there is limited upside potential in a fixed income fund versus an equity fund, we have to focus on the downside risk and limit that as much as we can.

For us, diversification is key. You will never see us take a huge bet on any single sector or industry or issue because that's simply too risky. We add another risk filter because the UCITS rules don't take the credit risk of the issue into account, so you can have a large exposure to a very risky company, and, to limit the downside risk, we want to cap that.

So, we add this extra filter, which takes the credit rating into account. If it's a good yield issue – say BB+ – we can have a 5% weight to that issue. If it's CCC rated, we maximise the investment to 1.5%. A minimum 85% of our portfolio is supposed to be yielding and good, but then we also want to take part of this riskier part of the market as well. We minimise that 15%, because there are opportunities there.

There can be mispricing in the markets or other things going on, but it can also be just bad credit where you can lose a lot of money, and we don't want to put ourselves in that position because, as high yield managers, also for our clients, we want to be able to sleep well at night!

In addition, we've had a larger cash position during the last year than previously, because there's been a lot to worry about – both macroeconomic factors and geopolitical factors. So, a higher cash position to cover for potential outflows. We haven't had that much, but, if that would happen, and also to make use of volatility in volatile periods, we can pick up bonds at cheap prices.

We have local expertise. A smaller share of the Nordic high market is publicly rated versus the European and the US markets – about a third or less that has [a] credit rating from S&P or Moody's or Fitch. So, we do the research ourselves – we have the local knowledge. The three portfolio managers we have here in Atterberg are all credit research analysts. This local expertise is very good because we want to be close to the companies we lend money to – to meet them at short notice and read about them in the newspapers. We want to know, and we want to be [in] control of that flow.

CI: I can see how important it is to have that local knowledge and that strong fundamental credit analysis foundation to managing the risks. But what we've seen across high yield markets generally is [that] credit quality has improved, default risk has come down. Is that the same for the Nordic bond market? What's historically been the default rate? Investors are always interested in that, and how do you see that going forward?

A-KH: According to official statistics from Stan Data in the Nordics, the historical default rate is at 5.4% and that goes back to 2007, a very long historical average. Important to note is that this number takes all credit events into account – not necessarily that the company goes bankrupt, but some kind of credit event takes place – a maturity extension, a covenant waiver. [So] It could also be a positive thing, but 5.4% is [the] historical average.

What we see now, given this international trend, with more non-Nordic companies coming here seeking to fund themselves, is that is perhaps riskier than [a] Nordic shipping company coming here to get funding. Covenant wise, term sheets, in our opinion, have become a bit looser. You have to read the term sheets properly before you decide to invest.

Other types of companies coming here might mean that default rates will come up. We haven't seen that yet, and this international trend has been going on for a few years. But that could possibly come going forward. So, we come back to the importance of having portfolio managers knowing what they're doing and investing in the right companies, having that expertise. It is important to do the work and read the term sheets.

Actually, private equity-owned companies are the fastest growing part of the Nordic high

[-yield] market, and that is smart money. They like to take up leverage. They like to do dividend recaps. They like to make a lot of adjustments to the EBITDA (earnings before interest, taxes, depreciation and amortisation). You have to read the term sheets thoroughly. Do your job as a portfolio manager. Pick the right cases where you see the best risk-return.

CI: It certainly seems a very strong selling point for the strategy, having that very high-quality credit analysis, which underpins the performance of the strategy over a period of time.

A-KH: Yes.

CI: Well, thanks, Anna, for joining me today. It's been very interesting. It certainly sounds like an attractive proposition for investors.

That's it for this week's episode of Talking Heads. If you would like to learn more about our investment insights, please reach out to your BNP Paribas Asset Management contact, or check out [our] Viewpoint website for investment insights at Viewpoint.bnpparibas-am.com.

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You've been listening to the BNP Paribas Asset Management Talking Heads podcast with me, Chris Iggo, and Anna-Karin Hempel from the Alfred Berg Fixed Income Team, part of the BNP Paribas Asset Management Group.

Please do join us again on Talking Heads next week. Until then, take care.