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PWM

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MORTGAGE BOND FUNDS

PREMIUM YIELDS BASED ON SECURE FOUNDATIONS

The Danish choice for achieving excess gain in a unique and rock-solid asset class

Mortgage bond funds, which can be marketed on a cross-border basis through an open-ended Sicav structure, are fast developing as a vehicle of choice to achieve premium yields.

For product manufacturers in the Scandinavian market, these yields may be in excess of comparable bond offerings from governments such as Denmark's. Successful fund managers may use a controlled and selective process of investing in highly secure and higher yielding Danish mortgage bonds, for example.

Rated double or triple 'A' by Moody's Investors Service, Danish mortgage bonds trade at an attractive yield spread over government issues, mainly because the market is callable.

To take full advantage of the yield premium, this call risk must be effectively managed – hence the attraction of a specialist fund such as the Nordea 1 – Danish Mortgage Bond Fund.

SECURITY

Another beneficial aspect is the built-in security of the asset class. Underpinning Danish mortgage bonds is Denmark's extremely strong legal framework, to the extent that Moody's has pronounced the Danish mortgage system the safest in the world. The asset class enjoys a very good performance record: there has been only one case of late payment (in 1933) and no instances of default in over 200 years of operation.

Any investment portfolio – irrespective of its composition – would be wise to have a weighting in this asset class in order to diversify allocation and reduce risk, since the correlation of this market is clearly less than that of conventional bond investments.

WHY INVEST?

What makes our mortgage bond fund attractive? A typical portfolio can invest primarily in callable Danish mortgage-backed bonds that are listed on the Copenhagen Stock Exchange.

Holdings of Danish mortgage-backed bonds will typically have high coupons in comparison with the general yield level of bonds with similar durations. Investments in Danish government bonds may also be permitted by some funds.

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Michael Metcalfe, Nordea

Such a strategy represents an interesting and limited-risk product for the portfolios of European investors, as exchange-rate fluctuations remain confined thanks to a special central bank agreement.

According to the ERM 2 exchange-rate agreement between the Danish Nationalbank in Copenhagen and

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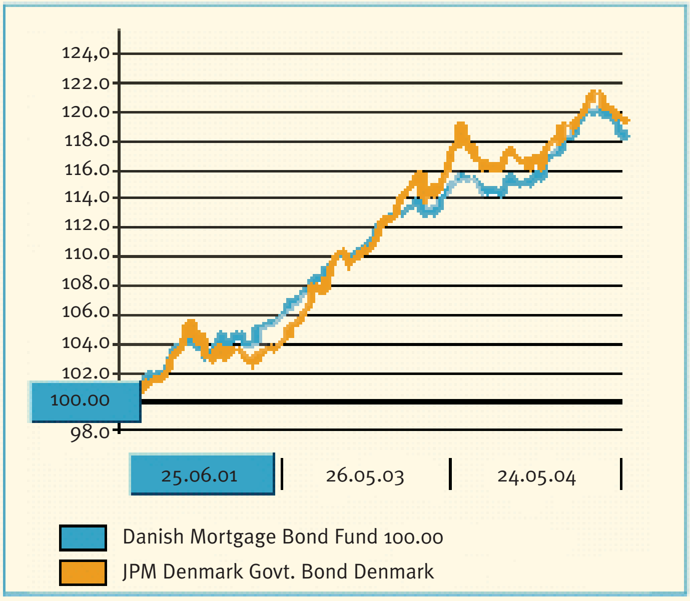
Danish Mortgage Bond Fund



Source: Nordea Bank S.A.

the European Central Bank (ECB) in Frankfurt, the permissible margin of fluctuation applying to the Danish krone is not allowed to exceed 2.25 per cent. In other words, the risk of larger losses stemming from exchange-rate movements is reduced. In fact, it is the intention of the Danish central bank to keep the fluctuation within a margin of 1 per cent.

Over the past three years or so when credit-related bonds were subject to widening spreads, which saw many players hurt by performance dipping into red ink, the Nordea 1 – Danish Mortgage Bond Fund yielded returns that stand up to any comparison.

This type of product benefited from the fact that, notwithstanding the high ratings generally accorded mortgage institutions, the yield on Danish mortgage bonds is typically 50-100 basis points (bps) over that of government equivalents.

STRICT PROCESS

Flemming Thestrup, portfolio manager for the Nordea fund, applies a pro-active and selective approach in investing in Danish mortgage bonds.

These are exclusively issued by highly reputable Danish mortgage institutions to fund loans for the purchase of houses and commercial property in Denmark.

Danish mortgage institutions are restricted to lending a maximum of 80 per cent of the value of a residential property and a maximum of 60 per cent of the value of a commercial building, and the loan is secured on the property.

Investors in Danish mortgage bonds do not have recourse to the underlying security itself, but to the mortgage institution that holds the portfolio of loans, each of which are secured.

STRONG BRAND

Five of Denmark's largest issuing mortgage institutions enjoy triple 'A' ratings from Moody's. All of them share the distinction of representing a well-established brand with a significant presence in the market. In addition, they benefit from a strong domestic franchise in most of the mortgage-lending segments.

Moreover, they have solid asset quality, backed as they are by the maintenance of adequate capital levels as enshrined in Danish law. The cornerstone of the initial legislation as passed in 1850 was to safeguard investors against risk and thereby create cheap funding for homeowners.

‘The Danish mortgage system boasts a long tradition of security and reliability. In existence since 1797, it ranks among the oldest in the world, with the first mortgage credit institution set up to provide finance to homeowners who had lost their homes in the Great Fire of Copenhagen two years earlier’

The Danish mortgage system also boasts a long tradition of security and reliability. In existence since 1797, the system ranks among the oldest in the world, with the first mortgage credit institution set up to provide finance to homeowners who had lost their homes in the Great Fire of Copenhagen two years earlier.

The strict legal safeguards have ensured that there has been only one case of late payment (this occurred in 1933 and investors ultimately received full payment) and no instances of default or bankruptcy in over 200 years of operation.

LIQUID MARKET

Other benefits of such a strategy include the inherent characteristics of the Danish mortgage bond market. With a total market volume of around €170bn, the Danish mortgage bond market is Europe’s second-largest mortgage market after Germany.

With over €1000bn of issuance, only the German Pfandbrief market is larger in Europe. But this also includes almost €900bn in bonds that are backed by public sector loans. In per capita terms, however, the Danish mortgage bond market is indeed the largest in the world.

The market volume in Danish mortgage bonds makes it approximately twice the size of the Danish government bond market. Hence, the market is highly liquid, making most of the bonds highly marketable.

CALL FEATURE

The substantive reason that Danish mortgage bonds trade at such an attractive yield premium in relation to government issuance is the call feature. This is available to the borrower throughout a bond’s term to trigger redemption at par.

The vast bulk of the Nordea 1 – Danish Mortgage Bond Fund is currently callable. Managing the risk of being called and correctly valuing the issuer call option is key to successfully investing in Danish mortgage bonds.

In order to be called, a bond must be trading above par. However, in practice a bond will not be called until it is trading somewhat above 100 because of the costs involved in redeeming the bond early. The decision to call a bond early will depend on the bond’s current coupon and whether the issuer has a realistic chance of refinancing at a lower cost.

RISK EVALUATION

Whether to invest or continue to hold a callable bond trading above par will depend on the anticipated prepayment risk and how accurately the market price reflects this risk. The situation is complicated by the fact that multiple institutions may take part in an individual issue and each will take a different view on whether to call the bonds.

Forward thinking portfolio managers use proprietary statistical models to evaluate this risk and model the probability of the value of a callable bond.

This process must take into account different prepayment amounts, yield levels and market spreads. The key features of a bond – expected return, duration, spread and convexity – must be adjusted to reflect the prepayment risk. The relative value analysis that results is deemed to be of greater importance in judging which bond to buy than the fund manager’s macro-economic viewpoint.

Michael Metcalfe, international media manager, Nordea