# Quarterly Report

**Fourth quarter 2018**

## Nordea 1 – US Corporate Bond Fund

ISIN: LU0458979746 (BP-USD)

## Overview

- US corporate spreads widened 48 bps to 153 bps on the back of growing macro concerns[1]
- Poor market technicals, including reduced liquidity, amplified price swings
- Higher quality bonds outperformed due to the flight-to-safety behaviour

1) Sources: Nordea Investment Funds S.A. and Bloomberg Barclays. Period under consideration: 30.09.2018 – 31.12.2018. **The performance represented is historical; past performance is not a reliable indicator of future results and investors may not recover the full amount invested.**

## Investment strategy

The fund seeks to achieve consistent, superior rates of return with low volatility by investing primarily in debt securities rated BBB– or better by S&P or Baa3 or better by Moody's at purchase. The fund manager uses a top-down analysis to exploit opportunities and neutralize unwanted risks, and a bottom-up analysis to maximize total return. The fund manager protects the downside by understanding the risk exposures within the portfolio and the correlation among assets, by diversifying risk factors, by defining/articulating an exit strategy for each position, and by carefully monitoring expected tracking error.

## Fund data

| | |
|---|---|
| Share class | BP-USD |
| Fund category | Accumulating |
| NAV in USD | 14.02 |
| Base Currency | USD |
| Fund AUM Million (USD) | 2,319.99 |
| Front end fee in % | Up to 3.00 |
| Annual management fee in % | 0.70 |
| Launch date | 14.01.2010 |
| ISIN | LU0458979746 |
| Sedol | B3MMLR8 |
| WKN | A0YKE1 |
| Bloomberg ticker | NORBPUS LX |
| No. of holdings | 347 |
| Swing factor / Threshold | Yes/Yes |

Data as of 31.12.2018.

## Portfolio Managers

**MacKay Shields LLC**

Shu-Yang Tan, CFA
Portfolio Manager

## Quarterly commentary Q4 2018

US Treasuries rallied significantly in the fourth quarter while both credit and equity investments sold off on fears of weaker global growth in China, Japan and the European Union, restrictive US Fed policy and the US administration's public criticism of the Fed, trade wars with China, Brexit negotiation uncertainty, mid-term elections and the potential for a government shutdown.

The benchmark 10-year Treasury rate fell nearly 60 bps from its mid-November high to close the year at 2.65%. More disconcerting was the inversion of the front-end of the yield curve during the quarter, as measured between 2-year and 5-year maturities. Although the inversion appeared to be driven by strong technical considerations associated with a flight-to-quality, it is worth noting that an inverted curve has been historically a strong indicator of an economic slowdown.

As expected, the FOMC committee raised the target Fed Funds rate 25 bps in December to 2.25 – 2.50%. This marked the ninth rate hike dating back to December 2015. The decision to raise rates followed a series of mixed comments from Jerome Powell given at two different events during the quarter. During an interview in October, Powell communicated that interest rates were "a long way" from neutral, and in November at the Economic Club of New York he stated that interest rates were "just below" the range for the neutral rate. Additionally, commentary from various Fed governors created further ambiguity rather than transparency, thus contributing to the bout of market volatility in asset prices.

During the quarter the Fed accelerated its quantitative tightening approach, or balance sheet reduction of US Treasuries and mortgage-backed securities from USD25 billion per month to USD50 billion.

The fund returned -0.78% during Q4 while its benchmark, the Bloomberg Barclays Capital US Credit Index, returned -0.22%.[2]

Although we reduced risk in the strategy over the last 12 to 24 months given full valuations, tighter monetary conditions and increased idiosyncratic risk, the fund remained vulnerable to the strong technical in the market. We focused on shortening spread duration, moving up in the capital structure, investing in secured deals for better protection and reducing highly levered, deteriorating credit profiles.

Investment grade corporate spreads, as measured by the Bloomberg Barclays US Corporate Index widened 48 bps to 153 bps at quarter-end. Much of the spread widening can be attributed to poor market technicals, including reduced liquidity that amplified price swings. Additionally, heavy supply, headwinds from FX hedging costs from foreign buyers and reduced demand also played a role. In our view, idiosyncratic risk is much more prevalent in the market today, as we have seen with names such as General Electric and the US auto manufacturers. During the quarter, the commodity sectors including energy and metals & mining lagged the overall market, as did autos, life insurance and subordinated positions of banks. Alternatively, non-cyclical defensive sectors such as wireless, consumer products, healthcare and utilities fared much better. Lower quality BBB rated credits underperformed higher quality credits and longer maturities underperformed shorter maturities.

It's worth noting that high yield spreads, as measured by the Bloomberg Barclays US High Yield Index widened 210 bps to 526 bps during the quarter, bringing the overall market yield to approximately 8%. In percentage terms, the high yield market returned -4.5% over the reporting period. Energy proved to be the weakest performing segment of the market as oil prices declined sharply. Wirelines, retail and basic industry also lagged the overall market, while capital goods, gaming and lodging were among the better performers.

At the portfolio level, duration and yield curve positioning detracted from results during the quarter, as did the off-benchmark allocation to BB rated credits. The lack of exposure to emerging market credit held in the benchmark provided some offset, but not sufficiently. At an industry level, energy, banking, and consumer cyclicals weighed on results within the investment grade market while relative positioning in capital goods, retail and utilities contributed to results.

As we begin a new year, we need to acknowledge both the headwinds and tailwinds facing the markets. In terms of the positives; US economic activity is healthy and inflation is still relatively tame, the consumer is in strong financial condition, the Federal Reserve plans to be "patient" and asset prices are cheaper, and in some cases, more attractive as a result of the recent volatility. Although we believe the volatility is unlikely to recede anytime soon, economic conditions still remain supportive and the current environment has provided opportunities for relative value consideration.

Some of the reasons for caution include tighter monetary conditions in the US coupled with a flat/inverted curve, fading fiscal stimulus, a crisis of confidence building due to Brexit, trade wars and populist elections, and elevated corporate leverage. While we acknowledge that it can be difficult to predict the beginning of the next economic downturn with any degree of precision, it is critically important to be sufficiently early. Accordingly, we believe caution is warranted as we navigate the markets in the new year. The Federal Reserve has embarked on a path of policy normalization for the past three years and they are unlikely to change course in 2019. The Fed may or may not elect to "pause" at some point during the year, but it is important to keep in mind that the reduction of the central bank's balance sheet will continue to restrict credit growth in the US. Vigilance and active management will become increasingly important.

2) Share class: BP-USD. Sources: Nordea Investment Funds S.A. and Bloomberg Barclays. Period under consideration: 30.09.2018 – 31.12.2018. **The performance represented is historical; past performance is not a reliable indicator of future results and investors may not recover the full amount invested.**

## **Cumulative returns** as of 31.12.2018 in %

| Time frame | Fund[3] | Index[4] |
|---|---|---|
| Year to date | -3.74 | -2.34 |
| 1 month | 0.87 | 1.27 |
| 3 months | -0.78 | -0.22 |
| 6 months | 0.00 | 0.67 |
| 1 year | -3.74 | -2.34 |
| 3 years | 7.00 | 9.53 |
| 5 years | 9.79 | 16.87 |
| Since launch | 39.10 | 45.39 |

## **Calendar year returns** in %

| Time frame | Fund[3] | Index[4] |
|---|---|---|
| 2017 | 6.02 | 6.18 |
| 2016 | 4.85 | 5.63 |
| 2015 | -2.55 | -0.77 |
| 2014 | 5.29 | 7.53 |
| 2013 | -0.63 | -2.03 |

## **Performance of the fund versus reference index** (since inception on 14.01.2010)


3) ISIN Code LU0458979746. Inception date: 14.01.2010. 4) Bloomberg Barclays Capital US Credit Index. Source: Nordea Investment Funds S.A. Period under consideration: 14.01.2010 – 31.12.2018. **The performance represented is historical; past performance is not a reliable indicator of future results and investors may not recover the full amount invested.**

## **Top ten holdings** as of 31.12.2018 in %

| Company | ISIN Code | Weight |
|---|---|---|
| United States Treasury Bill 10-01-2019 | US912796QS12 | 4.31 |
| Evergy Inc 4.85% 01-06-2021 | US391164AE09 | 1.22 |
| Morgan Stanley 4.875% 01-11-2022 | US6174824M37 | 1.21 |
| Hewlett Packard Enterprise C 3.6% 15-10-2020 | US42824CAG42 | 0.85 |
| Huntington Bancshares Inc/OH 7% 15-12-2020 | US446150AG96 | 0.85 |
| United Airlines 2014-1 Class 4% 11-04-2026 | US90932PAA66 | 0.83 |
| General Motors Financial Co 3.45% 10-04-2022 | US37045XAW65 | 0.80 |
| Puget Energy Inc 5.625% 15-07-2022 | US745310AF99 | 0.76 |
| Goldman Sachs Group Inc/The 5.75% 24-01-2022 | US38141GGS75 | 0.73 |
| Bank of America Corp 3.004% MULTI 20-12-2023 | US06051GHC69 | 0.72 |

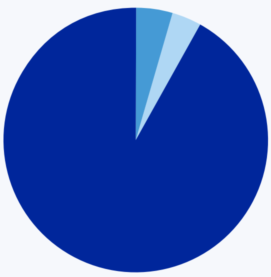
Source: Nordea Investment Funds S.A. Date: 31.12.2018.

## **Rating breakdown** as of 31.12.2018 in %

| Rating | Fund | Index[5] |
|---|---|---|
| AAA | 0.93 | 8.49 |
| AA | 10.68 | 8.25 |
| A | 17.74 | 30.79 |
| BBB | 63.85 | 49.44 |
| BB | 3.36 | 3.04 |
| B | 0.00 | 0.00 |
| CCC and <CCC | 0.00 | 0.00 |
| NR | 0.00 | 0.00 |
| Net liquid assets | 3.44 | 0.00 |

5) Bloomberg Barclays Capital US Credit Index. Source: Nordea Investment Funds S.A. Date: 31.12.2018.

## **Asset allocation** as of 31.12.2018 in %



| | |
|---|---|
| Corporate Bonds | 92.08 |
| Government Bonds | 4.47 |
| Net Liquid Assets | 3.45 |

Source: Nordea Investment Funds S.A. Date 31.12.2018.

## **Maturity breakdown** as of 31.12.2018 in %

| Years | Fund |
|---|---|
| 0 – 1 | 9.71 |
| 1 – 3 | 13.96 |
| 3 – 5 | 19.95 |
| 5 – 7 | 15.05 |
| 7 – 10 | 13.35 |
| 10 – 15 | 2.28 |
| >15 | 22.25 |
| Net liquid assets | 3.45 |

Source: Nordea Investment Funds S.A. Date: 31.12.2018.

## **Risk figures** as of 31.12.2018

| | Fund | Index[5] |
|---|---|---|
| Yield to worst | 4.25% | 4.09% |
| Effective duration | 6.58 | 6.85 |
| Average rating | BBB+ | A |

5) Bloomberg Barclays Capital US Credit Index. Sources: Nordea Investment Funds S.A. and MacKay Shields LLC. Date: 31.12.2018.

## **Treasury Future Exposure** as of 31.12.2018 in %

| | |
|---|---|
| US 2YR NOTE (CBT) 3/2019 | 12.03 |
| US 10yr Ultra Fut 3/2019 | 4.43 |
| US ULTRA BOND CBT 3/2019 | 2.54 |
| US LONG BOND(CBT) 3/2019 | 1.71 |
| US 5YR NOTE (CBT)3/2019 | -2.92 |
| US 10YR NOTE (CBT) 3/2019 | -5.91 |

Source: Nordea Investment Funds S.A. Date: 31.12.2018.