SPECIAL REPORT

Michael Petry's Danish hedge fund has returned an impressive 12% a year since 2005, trading fixed income. What he expects in 2017.

Enduring Danish Design

by Eric Uhlfelder

A former central banker, Michael Petry has achieved consistent returns over time by managing risk effectively.

PHOTOGRAPHY by REIMAR JUUL

MICHAEL PETRY ENJOYED HIS JOB IN THE LATE 1990S OVERSEEING foreign-currency reserves at Danmarks Nationalbank, the Danish central bank in Copenhagen. "While ours is a small country of just five million people, managing currencies is the great equalizer, where Denmark can be just as important as Germany and the United Kingdom," says Petry. ● But the more he learned about foreign-exchange cross rates and derivatives trading, the more he realized the many things central bankers couldn't do. "The primary goal of the central bank for the past several decades isn't profits," notes Petry, "but maintaining a tight exchange rate with, first, the German Deutsche mark, then with the euro, which it has done exceedingly well." Denmark never

"We can always get back into a trade if conditions become more compelling," says the hedge fund manager, "but we know markets can stay irrational longer than investors can remain liquid."

joined the euro zone and has its own currency—the krone—though it is a member of the European System of Central Banks. Petry and his co-workers at the central bank bought and sold the krone to keep it aligned with the euro.

In 2000, however, the opportunity to generate profits arrived, and Petry jumped at it, becoming a senior dealer of swaps and options trading at Danske Markets, part of **Danske Bank** (ticker: DANSKE.Denmark), the country's largest lender. Five years later, he moved to an affiliate, Danske Capital, which runs 107 billion euros ($113 billion) for local retail clients and global institutional customers. Petry, now 46, is the chief portfolio manager for the firm's flagship hedge fund, Danske Invest Hedge Fixed Income Strategies, which handles $1.15 billion, making it one of Scandinavia's largest funds.

Petry, who was born in Viborg, a town in northern Denmark, believes global bond investors will have to navigate markets in which a U.S. interest-rate hike in December will be followed by a couple more in 2017. And by the end of next year, he thinks, continental growth will allow the European Central Bank to start tapering its quantitative-easing program. Amid these currents, fixed-income investors will also have to cope with the uncertainties caused by Donald J. Trump's election as president and the U.K.'s decision to exit the European Union.

The fund tends to stay a little closer to home, with the bulk of its portfolio in Scandinavian securities. It does, however, buy euro-, sterling-, yen-, and U.S. dollar–linked products. The firm has used its qualitative and quantitative skills to become one of the top performing fixed-income arbitrage players in the world. Since its inception in 2005, the fund has generated annualized gains, net of fees, of more than 12%, with volatility of less than 9%, through October 2016. Its trailing one- and five-year records are even more impressive, up more than 15% a year, with volatility under 6.4%. That means it generates consistently high returns while effectively managing its risk. It's particularly notable since the fund employs leverage. For this package, it charges a relatively modest 0.75% annual management fee along with a 20% performance fee.

Although the fund uses about 50 different strategies, one of its mainstays is Scandinavian mortgage bonds. Mortgage securities may conjure images of the U.S. financial crisis, but these are highly rated debt issues from mortgage firms that keep the mortgages on their books and are responsible for maintaining a healthy pool of them to support the bonds. The securities have never defaulted in over two centuries.

Since the start of the financial crisis, the fund has been long Swedish and Danish mortgage bonds of various maturities, profiting from the spread between their yields and the fund's hedging and financing costs. Its sweet spot is bonds with three-to-five-year maturities, which it often buys at auction at a slight discount and holds for one to two years. Petry has found this trade to be a consistent winner.

Earlier this year, market turmoil opened a gap between five-year Danish mortgage bond rates and five-year swap rates, which mirror five-year Euribor yields. By buying the mortgage bond and shorting the swap, Petry hedges his interest-rate risk and bets that the rate spread will narrow. Because short-term rates are negative in Europe, he also collects a small profit by borrowing to finance his position. "This extra benefit will likely continue as long as the ECB keeps short-term rates negative," Petry says. So far this year, the trade has added two percentage points to the fund's performance.

The fund's trades can be intricate, but its goals and methods are straightforward. Using proprietary software, Petry and his team of three managers constantly scan millions of pair trades to identify when interest-rate spreads between two fixed-income instruments are reaching historical extremes.

"Focusing on historical-spread shifts instead of short-term blips helps us reduce risk, giving us high conviction about our investments," says Petry. He further limits risk by booking modest gains if spreads start to move in the expected direction, rather than waiting for them to fully normalize.

Late last year, for example, Petry saw that the spread between five-year Swedish swap rates' five-year forwards and equivalent euro rates had spiked to 0.75% from 0.50%, breaking the previous historical high. (Five-year forward rates reflect anticipated yields 60 months into the future.)

Since the Swedish central bank's key inflation target is generally the same as that of the ECB, these rates don't generally deviate much, and Petry couldn't detect a fundamental reason for this anomaly. So the fund went long the Swedish swap and short the euro swap.

The gap quickly widened to a full percentage point, so Petry added to his position. That spread proved to be the inflection point. He started selling when the spread fell back to 0.75% in May 2016. This month, it was down to 0.65%, and the fund continued to book profits. Petry retains 25% of the original stake, believing there is more narrowing to come. To date, the trade has added 0.5 percentage point to the fund's 2016 profit.

Finding a Sweet Spot in Scandinavia

Denmark's Danske Invest Hedge Fixed Income Strategies fund has compiled a remarkable performance record mostly by investing close to home over more than a decade of operation.

	1-Year Return	ANNUALIZED RETURNS 5-Year	10-Year
Danske Invest Hedge FI Strategies (DKK)	15.38%	15.35%	13.93%
BarclayHedge Fixed Income Arb. Index ($)	3.12	5.78	3.32
JPMorgan World Gov't Bond Index (Local)	4.58	3.93	4.31
S&P 500 Total Return Index ($)	4.51	13.57	6.70

Note: Data through October 2016. Source: BarclayHedge

Petry and company have no problem cutting their losses if a trade doesn't seem to be working. "We can always get back into a trade if conditions become more compelling," Petry says, "but we know markets can stay irrational longer than investors can remain liquid."

The fund has to be vigilant about risk because it typically uses 30-to-50 times leverage to enhance returns; low levels for securities with longer duration (and higher volatility), higher amounts for shorter-duration plays. But Petry applies an equal amount of leverage on both sides of most trades, focusing on the change in rate spreads—not the return offered by a single interest-rate move. This means that, unlike traditional fixed-income investors, the fund will have no problem profiting when, as expected, rates start moving up.

The firm's resolve to control losses, as well as its historical perspective, were on display with a bet on 20-year euro swap rates going out two decades. Rates on this derivative have been trending down since 2001 because of Europe's slowing growth and declining interest rates. But when it collapsed below 2% during the financial crisis, rebounded, and then bounced off that level several times during subsequent banking and sovereign debt crises, Petry felt 2% had been set as a bottom for this instrument.

So when it again fell through 2% in the third quarter of 2014 as the ECB started talking about added monetary easing, the fund established a short position that eventually represented 5% of its risk exposure.

"We felt inflation and growth would inevitably return and, with them, normalizing interest rates, which would send this forward rate back well above 2%," explains Petry.

Unfortunately for Danske, the ECB then went further than expected and committed itself to quantitative easing and negative rates, which pulled the floor out from under the trade. So the fund liquidated half the position, taking a half percentage-point loss. But Petry decided to keep a portion because he sees these forward rates as "absurdly low" and believes it won't require much news about growth for them to spike upward.

What does the next year hold for global fixed income? "The election of Trump has introduced all kinds of uncertainty," says Petry. But he sees opportunities, owing to the president-elect's commitment to infrastructure and job creation, which means rising government and consumer spending and the likelihood of higher interest rates. "I'm expecting this to have a spillover effect in Europe, as growth continues to improve and long rates normalize," he says.

But he's most concerned about the return of increasingly nationalistic governments. "Victories for Brexit and Trump are triumphs for more-isolationist policies, ignoring the value that trade treaties have had on the promotion of stability," Petry says. Accordingly, he fears the West may be entering a period in which the lack of cooperation between nations may lead to more international turmoil, capable of turning warm issues hot. "And markets don't like that," he adds.

Trump may remove some bank regulations in the U.S., but Petry thinks European banks will continue to shed their market-making role and sell off debt from their portfolios. Fewer players mean less liquidity and more volatility, especially if conflicts arise. That may be a chilling prospect to many, but it offers opportunities for a nimble trader who profits from mispricing. ■