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## Danes trump Greeks

Government bonds have always been seen as a relatively safe asset class. In light of the recent developments in Greece, however, this notion is being challenged. The country is on the brink of bankruptcy. But, some government bonds are still a safe bet: investors should take a close look at the Danish bond market.

Greece is the top story in European bond markets. But, investors are also peering nervously at the situation in Portugal, Spain and Ireland. Until now, government bonds have always been deemed a relatively safe asset class. The current news, however, is stirring doubt about the validity of this common belief. Is there really such thing as a safe haven?

Investors looking for safety without sacrificing returns might be interested in the prospects offered by our northern neighbour. Denmark's bond market is unique. Two-thirds of the overall market comprises mortgage bonds. And Moody's rating agency has declared the Danish mortgage lending system the safest in the world.

It is a system born of a catastrophe that occurred more than 200 years ago: in 1795, central Copenhagen went up in flames, which destroyed a quarter of the houses and buildings within 24 hours. The government at the time did not have the resources to fund a reconstruction programme, for which reason the Credit Association of Copenhagen Homeowners (Kreditkassen for Husejere i Kjøbenhavn) was formed in 1797 as Denmark's first mortgage lending institution. The idea of the programme was to bundle mortgage demand. This allowed borrowers to negotiate better interest rate conditions with the lenders than would be possible on an individual basis. The programme was so successful that the government created a legislative framework for the system, which remains the principal method for the financing of private home purchase in Denmark to this day.

## Not a single default in 200 years

Today, Denmark features one of the best managed and most resilient mortgage markets in the world, with a total value of more than 180 billion euros. This makes it the second largest mortgage market in Europe after Germany. The three largest bond issuers have a rating of AAA. Despite world wars and economic or political crises, Denmark has not seen a single mortgage bond default in 200 years. Danish mortgage bonds are thus among the most secure

investment opportunities anywhere, and feature characteristics that offer investors above average returns.

In Denmark, homeowners enter into a long-term relationship with a mortgage bank at a fixed rate of interest. The purchase of a home can only be financed up to 80 percent, and the purchase of commercial real estate only up to 60 percent through a mortgage. These loans are bundled and sold on the bond market as mortgage bonds with maturities of 10, 20 or 30 years. Danish mortgages are structured in such a way that they are a good value for both mortgage borrowers and investors in the resulting mortgage-backed securities market. As a rule, the investor pool comprises pension funds, investment funds and insurance firms.

### **Advantages for borrowers**

The borrower is protected by a combination of fixed interest rates and the option to redeem the loan before final maturity. Roughly 50 percent of the bonds are callable bonds. The loans can be redeemed early at the nominal amount plus administrative costs. In practical terms, this means that if interest rates rise after purchase of the home, the existing mortgage is not affected. If, on the other hand, interest rates fall, the borrower can repay the loan early and obtain a new mortgage at the lower rate. This right to terminate the loan reduces the probability of default.

### **Advantages for investors**

Danish mortgages are financed by banks that issue tranches of bonds with fixed coupons and long maturities. The mortgage backed securities are packaged into uniform tranches, which makes them very liquid. These bonds are subject to the "Equalisation Principle", which says that the maturity and cash flows of the bonds must almost fully correspond with those of the underlying bonds. In the past, callable bonds have generated greater returns than equivalently rated non-callable bonds. They offer a premium that compensates investors for the risk of early redemption. Callable bonds, however, must be monitored continually to assess the potential risk of the bond being redeemed early. When and at exactly which price a bond is called depends on a variety of factors. The costs of repayment play just as important a role as the amount of the coupon and the potential for more favourable refinancing.

In addition to the high level of safety, Danish mortgage bonds also offer attractive returns. They feature yields roughly one percent higher than Danish government bonds and about two percent higher than German government bonds with a comparable maturity. Danish mortgage bonds also offer another, very different key advantage: they are a suitable instrument for portfolio optimisation. As a result of the completely dissimilar structure of the Danish bond

market as compared to other systems, the Danish bond market provides a channel for risk diversification.

So, the answer is yes: there really is such thing as a safe haven. But, to get there, investors must venture past their own borders and take a look at markets off the beaten path.