May 2016

HEDGENORDIC

Corporate Governance
What makes Finland and other Nordic markets so attractive

Finnish Hedge Funds
Introducing key players of the Finnish Hedge Fund Universe

VARMA
Punching above its weight in Hedge Fund Allocation

Challenges
Facing the Finnish Economy

Alternative Investments in Finland
A Closer look at the Nordics smallest Hedge Fund Market

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INTRODUCTION

HedgeNordic is the leading media covering the Nordic alternative investment and hedge fund universe. The website brings daily news, research, analysis and background that is relevant to Nordic hedge fund professionals and those who take an interest in the region.

HedgeNordic publishes monthly, quarterly and annual reports on recent developments in her core market as well as special, indepth reports on "hot topics".

HedgeNordic also calculates and publishes the Nordic Hedge Index (NHX) and is host to the Nordic Hedge Award and organizes round tables and seminars for investment professionals.

Upcoming Industry & Special Reports:

June 2016:
HedgeNordic Industry Report

June 2016:
Alternative Fixed Income Strategies

September 2016:
ESG / SRI in the alternative space

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The Editor

On why we decided to do a special report on Finland...

With only 15 funds out of the 154 constituents of the Nordic Hedge Index (NHX) being classified as Finnish, Finland represents the smallest group of managers in the country breakdown of the Nordic Hedge Fund Universe (disregarding Iceland, which has no managers or funds listed in the NHX). The quantity, however, tells us little about the quality of the managers and the outstanding talent active in numerous fields of the hedge fund space.

> **Finland has much to offer for those looking for long-term business relationships based on mutual trust**

Aside from hedge fund managers, there is a wealth of local players active in the alternative investment universe, ranging from real estate to private equity and venturecapital, alongside even more exotic investment propositions.

Finnish institutional investors are well-experienced, sophisticated and eager allocators to alternative investments. For a long time a quick trip to Helsinki has been an insider tip among eager sales people looking for big tickets - but the word is out! Especially the large Finnish institutions are regularly pursued as much appreciated investors. Finnish mangers however, find it harder to attract due-diligence, research and investment teams for an on-site visit as the country is out of the travel path of the main financial centers.

The fund management industry is relatively nascent in Finland, which makes it less prone to path dependencies and more open to new innovative approaches and practices. Due to the nature of Finnish regulation many hedge funds are open for retail investors and not only for institutions. The economy also ranks high, at second place, on the global anti-corruption index.

Finland has much to offer those who are looking for partners for long-term business relationships based on mutual trust, in a stable business environment enhanced by cutting-edge technology.

Economy with many strengths and distinctive culture and traditions

Besides local strong IT know-how that supports operational efficiency, Finland has a strong democratic tradition with many products and services designed especially for the main population - the most known phenomena of which are the minimalist and functional Nordic design goods.

Strong rule of law, as Finland is ranked at 4th place on the index, is also especially favorable for investor protection. Nordic asset managers have a high percentage number of signatories with the United Nations Principles of Responsible Investing (UNPRI). The large institutional investors in this region have taken an active lead in promoting it and requesting their invested asset managers to sign up to these principles. Responsible investing is still an item that continues to be defined and measured by many market participants.

Another notable area where there has been world-leading progress is Gender equality. Finland ranks second on the Global Gender Gap index and is globally known for its progressive gender equality. Finland has strong traditions in this respect, it was the first country in Europe to introduce voting rights to women. Nevertheless, there is still an uneven gender ratio in asset management even in Finland.

Gender equality issues are relevant to the company culture and whole the financial services sector. For example, if a system appears unfair to its participants, it adds more uncertainty and short termist thinking. The financial sector as a whole does employ a large number of women, but still the asset management sub-sector seems to attract a disproportionately low amount of women.

Indices that underline strong Finnish economic and business environment:

- Reporters Without Borders - World Press Freedom Index 2016 rank: 1/180
- Transparency International – Corruption Perceptions Index 2015 rank: 2/168
- World Justice Project – Rule of Law Index 2015 rank: 4/102
- European Patent office – European patent applications per capital 2015: 4/50
- World Economic Forum – Global Competitiveness Index 2014 rank: 4/144
- World Economic Forum – Sustainability adjusted GCI Index 2014 rank: 3/113
- World Economic Forum – Global Gender Gap Index 2014: 2/142
- The Fund for Peace – Fragile States Index 2014 rank: 1/178
- The Cato Institute – Human Freedom Index 2012 rank: 3/152
- Martin Prosperity Institute – Global Creativity Index 2011 rank: 3/82

Despite all this, the feeling is, as Monty Python famously put it, "Finland, Finland, you´re so sadly neglected." And we must admit, even as a publication focusing on the Nordic Hedge Fund and alternative investment space, we may not yet have given the market the attention it deserves. In this special report on the Finnish alternative investment universe we want to make up for it by playing our part to put Finland on the map!

The publication shall not just focus on the hedge fund space, introducing local managers and allocators alike, as well as foreign players active on the market. Much more, the report shall act as a one stop shop and give the Finnish alternative investment space an opportunity to present themselves as a whole.

Enjoy the HedgeNordic Special Report on the Finnish Alternative Investment Space!

Kamran G. Ghalitschi
CEO / Publisher HedgeNordic

HEDGE FUNDS IN FINLAND

Finnish institutions adds to hedge fund exposure but largely ignore home market

By Jonathan Furelid – HedgeNordic

Finnish institutional investors are among the most active when it comes to hedge fund investments, however the lack of local options has made institutions focus on foreign funds rather than adhering to the ”home bias” often present when sourcing managers.

From an institutional investor standpoint, Finland is well-known for favouring hedge funds as portfolio diversifiers when creating multi-asset portfolios. Next after Sweden, Finland has the largest number of hedge fund investors in the Nordics, according to data from alternative investment database Preqin.

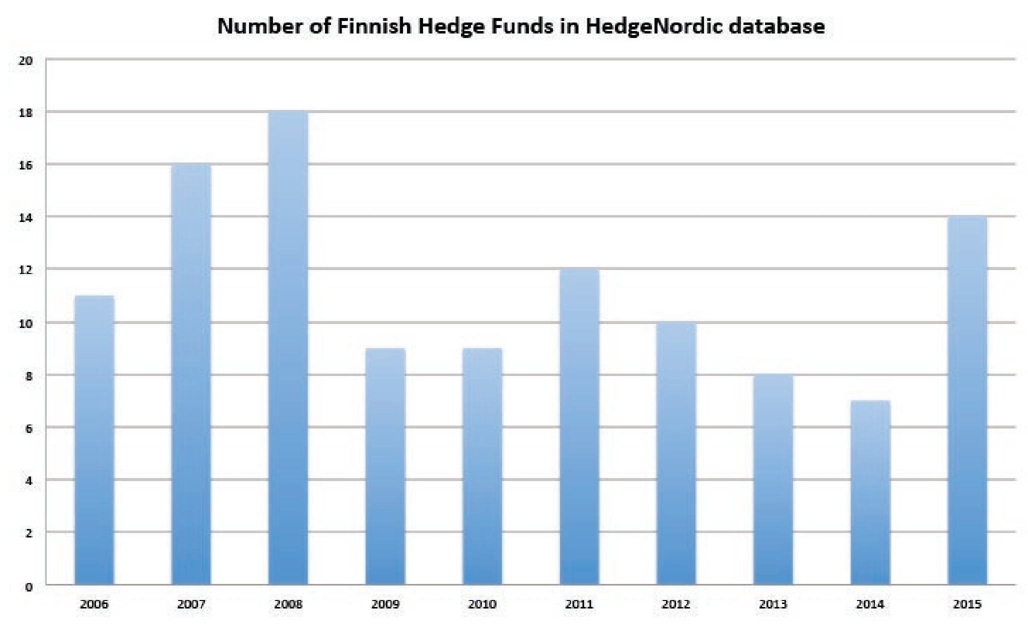
Despite lackluster returns in recent years and an intensifying debate regarding the high fees charged by hedge funds, Finnish institutions have been active in adding to their hedge fund exposures as of late. Earlier this year, VER, Finland´s state pension fund communicated it intended to increase its allocations to hedge funds and other complex strategies to 6 per cent of its total USD 20 billion portfolio. This despite its hedge fund portfolio only returning 2.5 per cent in 2015 while its overall portfolio returned 4.9 per cent.

Another large Finnish allocator, Elo, that was formed through the merger between Pension Fennia and LocalTapiola also added to its hedge fund exposure in 2015. According to an interim report, the allocation to hedge funds stood at 13. 3 per cent by the end of September compared to 10.3 per cent 12 months prior.

Varma, Finland’s largest earnings-related pension insurer and private investor with assets of EUR 40 billion reported it had 16 per cent allocated to ”other investments” as of March 2016. Out of these 16 per cent, 15 were allocated to hedge funds while the remainder being in inflation-linked investments and commodities.

While Finnish institutions are active in allocating to hedge funds, most of the investments are likely to end up in the hands of foreign asset managers. At the end of 2014, around half of Finnish pension fund investments were outside the euro-zone, while 25% were invested in Finland, and 25% in other euro-zone countries. Non-euro investments rose by 4.3 percentage points during 2014, a report from pension fund alliance TELA states.

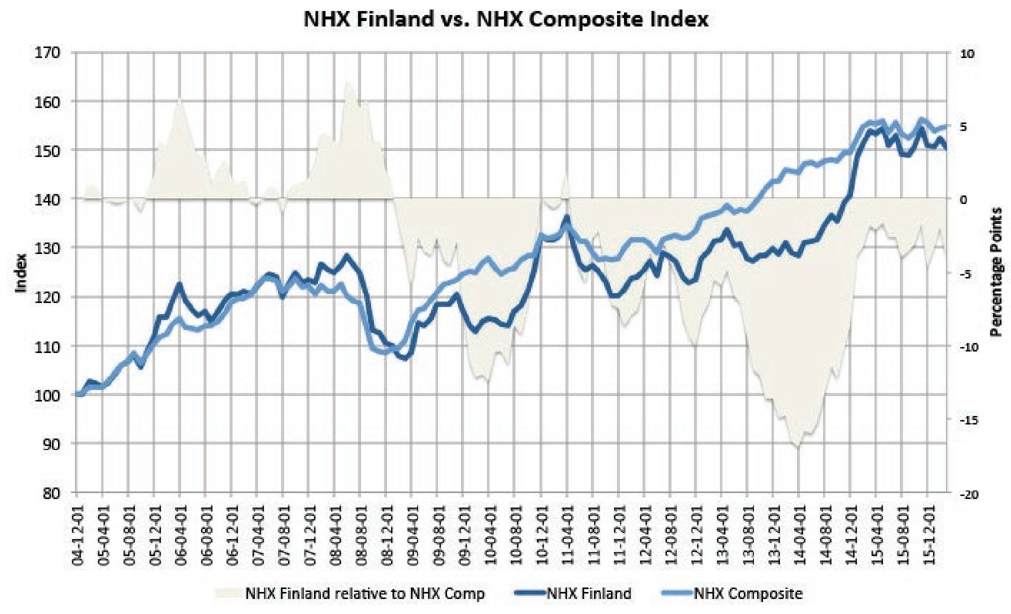
Looking at the universe of Finnish hedge funds, the lack of local options for institutional investors to consider is apparent and has shrunk considerably since the financial crisis in 2008. According to data from HedgeNordic, only 14 individual hedge fund programs were active as of April 2016, out of these 14, 4 were from Estlander & Partners. In 2008 the total number of Finnish hedge funds stood at 18.



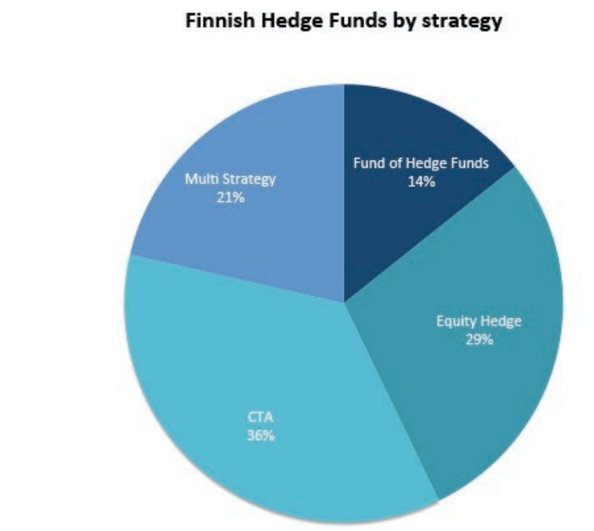
Number of Finnish hedge funds on December 31 of each respective year. Source: HedgeNordic

Program Name	Description
Danske Invest Eliksir FoHF	Fund Of Hedge Funds
Danske Invest, Europe Long-Short Dynamic Class	Equity Hedge
Estlander & Partner Freedom	CTA
Estlander & Partners Alpha Trend II - Class P	CTA
Estlander & Partners Alpha Trend Program	CTA
Estlander & Partners, Presto	CTA
FIM Orient Alpha	Fund Of Hedge Funds
Gramont Equity Opportunities	Equity Hedge
HCP Black Fund	Multi Strategy
HCP Focus Fund	Equity Hedge
HCP Quant	Equity Hedge
MG Commodity	CTA
VISIO Allocator Fund	Multi Strategy
VISIO EM Multi Strategy B	Multi Strategy

Finnish hedge funds as registered by the HedgeNordic database as of April 2016. Source: HedgeNordic



Long term performance of Finnish hedge funds compared to the Nordic hedge fund universe. Source: HedgeNordic



Finnish hedge funds by strategy. Source: HedgeNordic

The fact that Finnish institutions look abroad to find investment opportunities is likely to apply to hedge funds as well as to other asset classes given the limited number of investment options on the home market.

The performance of Finnish hedge funds has also been relatively weak compared to the universe of Nordic funds, even though it has picked up significantly since mid 2014. Looking at the universe of Finnish funds represented in the HedgeNordic database, the underperformance since 2005 compared to the entire Nordic hedge fund industry (as represented by the NHX composite) is around 5 percentage points.

Performance of Finnish hedge funds (NHX Finland) as compared to the NHX Composite, an aggregated index of Nordic hedge fund programmes since 2005. Filled area indicates over- and underperformance of Finnish funds over time. Source: HedgeNordic

The recent outperformance of the Finnish hedge fund industry is linked to its reliance on CTA strategies which makes out 36 per cent of the universe, according to HedgeNordic data. A solid 2104 from Estlander and Partners as well as from commodity-focused CTA, MG Commodity, has had a positive effect on returns relative to the Nordic hedge fund industry.

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"Due to the weakness in global demand the Finnish economy cannot realistically rely on massive increases in exports."

"Sanctions on Russia due to the Ukrainian situation have had a very negative impact on the Finnish economy, and it has suffered from it more than the average European country because Russia is one of its most important trading partners."

A panoramic view of Challenges facing the Finnish Economy

Jari Järvinen, Lähi-Tapiola Asset Management's chief economist, discusses the current state of the Finnish economy and some of the challenges he envisages for the foreseeable future in an interview for HedgeNordic. Järvinen serves as economist and investment manager with oversight of two global equity funds and a fixed income fund. He leads a team of eight, managing around nine billion Euros of Lähi-Tapiola Group assets, alongside external institutional mandates.

Having contracted the past three years in a row, the preliminary figures for 2015 indicate that the Finnish economy is experiencing its first year of growth in four years. Jari views this, understandably, as a very welcome piece of news. It came as a surprise, especially considering that Finland has been one of the weakest economies in the entire Euro zone and has had the worst GDP growth rate expectations for quite some time. Several structural issues relate to this, such as the ageing population and Finland's undiversified industry.

Competitive Demands, Structural Compromises

The primary challenge facing the Finnish economy is to diversify a monotonous industrial base and heavy capital goods industry to areas such as consumer goods. Järvinen's perspective, therefore, is that the current labour force needs to produce more. Due to the weakness in global demand, the Finnish economy also cannot realistically rely on large increases in exports, among other things because of price competitiveness, as wages have increased at a faster pace in comparison to competitors such as Germany or Sweden, which has been the case since the financial crisis starting in 2007.

Finland, therefore, must broaden its product portfolio to become more attractive, e.g. to middle-class Asian consumers, while moderating its wage explosion. "After Nokia and the forest industry, there was a revolution going on," Järvinen explains. "To help remedy the situation, wage growth requires moderation. This will be painful process for the next few years, but it will be good for the economy in the long run. At the moment, various interest groups led by the centre-right government are negotiating labour laws to make the economy more competitive."

Drawing on examples from other economies, Järvinen expects that the negotiating power of trade unions will diminish over time, underlining that smaller companies already obtain reprieve from some of the more stringent labour laws in Finland. Larger companies may also be able to circumvent these by moving jobs outside of Finland. The bottom line, however, is that the new industries that are having a notably positive

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impact on the Finnish economy belong to the broader software industry, where the flexibility of the labour force is central to its success. Järvinen points towards a number of international Finnish successes in this sector, such as Supercell.

> "The government needs to do more to provide incentives for entrepreneurialism and foreign investment. "

In Järvinen's view, the government needs to do more to provide incentives for entrepreneurialism and foreign investment. Lowering the personal income tax, for example, which currently stands at almost 50%, would be one such incentive. And, although the corporate tax has been reduced and currently stands at a moderate 20%, Finland's geographical location at the fringes of the main European markets underlines that this rate should be far lower than in core European economies. Järvinen therefore thinks the government should consider new tax structures in general, and points towards a possible solution in the current Estonian corporate tax structure that makes tax payable only on dividends, and where no payments are required if earnings are retained within the company.

Plans for further incentivizing foreign investment would also be well received. The Finnish educational system, among the best in the world, is a stabilizing factor contributing to the competitive advantages of the Finnish economy, but cannot be enough by itself if there is no hiring in the job market. In Järvinen's view, individuals must also be encouraged to shoulder the entrepreneurial risk, and the barriers to this risk must be lowered. In addition to tax rate deductions, regulation and bureaucracy, especially for small businesses, also needs to be trimmed.

Jari Järvinen, Chief Economist
Lähi-Tapiola Asset Management

Destabilizing Factors Abroad

There are also factors beyond Finland's immediate control that have a disproportionate effect on the Finnish economy. Sanctions on Russia due to the Ukrainian situation have had a very negative impact on the Finnish economy, for instance, and Finland has suffered from it more than the average European country because Russia is one of its most important trading partners. Low oil and commodities prices also hurt Russian demand, which keeps Finnish exports muted, and, in addition, hurts Finland's tourism industry by keeping Russians away.

> "There are factors beyond Finland's control that have a disproportionate effect on the Finnish economy."

Järvinen expects overcapacity in oil and commodities production to keep prices low for some time. In general, lower oil and commodity prices are a mixed bag for Finland. It is good news for oil importers, as it creates more purchasing power for private consumption, but it is not good news for oil-exporting trading partners, as these lower prices can have an impact on international market stability, due to widening credit spreads and possible bankruptcies of energy companies.

In addition, there is the looming threat of Brexit, which was not taken seriously in Finland until recently, but which now stands to become a political reality. Järvinen lists it as a worrisome outcome that could start a chain reaction that could break the European Union apart, and which would not be good news for the Finnish economy. "Quantifying the effects of a Brexit is difficult, but it will leave no winners except extremist UK citizens," Järvinen says. "UK industries will benefit from the lower pound, but large companies will look to move their main operations to the continent due to the impact on trade restrictions.

Many are looking at what is happening in the UK, and some, perhaps Eastern European countries or even France or Finland, might seek to exit the European Union, or at least the Euro." Conversely, if the UK stays in with its newly negotiated deal, he says, those footing the bill of those amendments will be countries like Finland. Another on-going issue is the Greek debt crisis, which Järvinen doubts is over and suspects Finland could again wind up financing.

Immediate Investment Prospects

Asked about Finnish investor prospects, Järvinen suggests that Finnish retail investors are relatively conservative, currently holding almost €80bn in bank accounts. Considering how risky assets have performed in recent years, he does not blame investors for this cautious stance, but feels it would be wise to start investing a portion of this in fixed income, property and equities in the future. Finnish institutions, on the other hand, have been more aggressive investors in comparison to other Nordic countries, and have higher allocations to equities, also allocating more to alternative investments.

In terms of the property market, Järvinen explains that even though the Helsinki area and the southern part of Finland generally have high property prices, it is not due to a bubble, as there is still a continuing positive stream of movement into these areas. Low interest rates have also contributed to higher prices. There is, however, a marked divergence in interregional house prices. As many cities in Finland suffer from high unemployment, property prices in these areas can be remarkably low, which raises the question as to how much this might affect national property prices when the wage growth stops or experiences downward pressure, combined with interest rates going up.

It will be necessary to monitor developments among all these elements closely, and for Finnish industries and the government to modulate their policies carefully, if the apparent uptick in the performance of the Finnish economy this past year is not to register as a mere blip in a continuing downward spiral.

by Tatja Karkkainen – HedgeNordic

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ALTERNATIVE INVESTMENT FUND REGULATION IN FINLAND -SELECTED ISSUES-

By Samuli Pyy-Zhong, Attorney-at-law / Partner
Magnusson Helsinki Attorneys-at-Law Ltd

This article contains selected basic issues of the regulatory aspects of alternative investment funds ("AIFs") in Finland and the private placement and offering of foreign or Finnish fund shares. The Alternative Investment Fund Managers Directive 2011/61/EU ("AIFMD") came into force in Finland on 15 March 2014 by the enactment of the Finnish Act on Alternative Investment Fund Managers (Fi: laki vaihtoehtorahastojen hoitajista, 162/2014) ("AIFMA"). After its entry into force, the AIFMA has been complemented by a number of decrees and regulation by the Finnish Financial Supervisory Authority ("FIN-FSA").

For the purposes of this article it is assumed that the entity offering shares is a fund, in addition to which the funds are categorized in a twofold manner: namely, UCITS funds are funds that fulfill the requirements of the EU directives on UCITS funds and all the other funds are qualified as AIFs. Moreover, the AIFMA applies to all funds and offerings that do not fall under the UCITS rules.

PRIVATE PLACEMENT & PROSPECTUS OBLIGATION

Finnish legislation does not contain a specific definition of 'private placement'. However, it is generally understood to mean an offering of securities that are exempted from (i) the requirement to publish a prospectus or (ii) the requirement to obtain a license of a fund management company and to either register the fund with the FIN-FSA or use the passporting regime (under the UCITS Directive 2009/65/EC or the AIFMD) to market the funds in Finland.

The Finnish Securities Markets Act (Fi: arvopaperimarkkinalaki, 746/2012) ("SMA") contains provisions about the obligation to publish a prospectus in case the fund interests qualify as transferable securities. However, pursuant to the SMA there is no obligation to publish a prospectus if the fund interests are offered

- solely to qualified investors;
- to fewer than 150 investors other than qualified investors;
- for a consideration of at least 100,000 euros per investor or in portions of at least 100,000 euros in nominal value;
- with the total consideration in the EEA under 2,500,000 euros over a 12 month period; or
- with the total consideration in the EEA under 5,000,000 euros over a 12 month period.

If any one or more of the above requirements are met, the private placement exemption does not apply if the distribution of the securities to investors does not meet the requirements of the exemption. Moreover, it should be noted that all non-UCITS funds, i.e. AIFs, are subject to the requirements set forth by the AIFMA: in other words, if a fund is categorized as a transferable security within the meaning of the SMA, such fund would be governed by both the AIFMA and SMA under the applicable legislation.

FINNISH AIFM

An alternative investment fund manager ("AIFM") that is domestic, must be a Finnish limited liability company having its head office in Finland. Moreover, a domestic AIFM must have a minimum capital of at least 125,000 euros (externally managed) or 300,000 euros (internally managed). In addition the AIFM must have its management and shareholders approved by the FIN-FSA.

Under the AIFMA, the AIFMs are subject to either authorization (licensing) or registration whether the fund interests are offered to professional or non-professional investors or not. The AIFMA licensing thresholds are 100 million euros (leveraged funds) or 500 million euros (unleveraged funds). If either threshold is triggered, the AIFM must obtain an authorization from the FIN-FSA; and if not triggered, the AIFM must register with the FIN-FSA.

Only the licensed AIFMs are allowed to offer fund interests to retail clients unless the FIN-FSA grants an exemption from certain statutory requirements. Under the AIFMA rules, if a fund does not qualify as an UCITS fund, the fund will be categorized as an AIF, and the fund is required to comply with the AIFMA.

EEA AIFM OFFERING

A non-Finnish AIFM located in the EEA is allowed to manage and market Finnish AIFs under the same conditions as Finnish AIFMs. The actual management and marketing in Finland is allowed after the AIFMD passporting process whereby the AIFM has made a notification to the competent financial supervisory authority of its home country, and the home country's authority has issued the notification and approvals thereof to the FIN-FSA.

Marketing of fund interests to retail clients is, however, allowed only to licensed AIFMs unless the FIN-FSA grants an exemption from certain statutory requirements. In addition to submitting the necessary notifications, if an AIFM intends to market EEA AIFs to Finnish retail clients, it must fulfil certain other requirements (e.g. KIIDs) pursuant to the AIFMA.

FINNISH AIFM OFFERING NON-EEA AIFS

A licensed Finnish AIFM is allowed to manage a non-EEA AIFs provided that the AIFM follows the rules set forth by the AIFMA. Moreover, a Finnish AIFM is also allowed to market a non-EEA AIFs in Finland to professional investors after making a notification to the FIN-FSA and after receiving a confirmation thereof from the FIN-FSA.

NON-EEA OFFERING

Finland has not implemented national requirements that would go beyond the requirements set forth in Article 42 of the AIFMD. A non-EEA AIFM may offer EEA or non-EEA AIFs only to professional investors after making a notification to the FIN-FSA and receiving a confirmation thereof from the FIN-FSA. The FIN-FSA will assess whether the non-EEA AIFM fulfils the requirements of the AIFMA to market in Finland.

SUMMARY

- No private placement exemptions are available for offering of fund interests in Finland as all funds are classified as either UCITS funds or AIFs. With regard to the prospectus obligation, proper disclaimers and legends should be inserted to the marketing material.
- EEA AIFMs may use the AIFMD passporting regime.
- Non-EEA AIFMs must obtain an approval from the FIN-FSA to market fund interests in Finland.
- Non-EEA AIFMs may only be marketed to professional investors.

ABOUT MAGNUSSON

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Samuli Pyy-Zhong, Attorney-at-law / Partner
Head of China Desk Finland, Magnusson
Helsinki Attorneys-at-Law Ltd

Interview with
Jarkko Martilainen
Director Hedgefuds, Varma

VARMA PUNCHING ABOVE ITS WEIGHT IN HEDGE FUND ALLOCATION

by Pirkko Juntunen – HedgeNordic

Finnish institutional investors seem to have taken to hedge funds more than their peers elsewhere. According to statistics from TELA, The Finnish Pension Alliance, the average allocation among pension and insurance providers at the end of 2015 was 9.6% and 7.7% among all pension funds, which includes the country's industry-wide, company and public sector funds. In general, European pension funds have a median allocation of 7%, according to a recent Deutsche Bank survey.

Finland's largest pension and insurance provider, Varma, has gone even further than its country peers with a whopping 16% allocation to hedge funds. Varma has an investment portfolio of over Euro 41 billion, making it one of the largest hedge fund allocators in the region. Even on a global basis pension funds of similar size to Varma, between $10 and $50 billion, Varma invests well above the median of 7% shown in the Deutsche Bank study.

Jarkko Martilainen, head of hedge funds at Varma does not have any other explanation to the popularity of hedge funds in Finland than that of trust and early adoption of the strategies as a result of good performance. "The good returns have continued to convince investors that their initial and early trust in hedge funds has paid off and continue to do so," he said.

Others argue that the pro-cyclical nature of the Finnish solvency regulation allows more risk-taking. As solvency ratios rise so do return requirements which means investors such as Varma can take on more risk including allocation to hedge funds. The average solvency ratio at the end of 2015 was 28.2% and has varied between 15 and 41% in the last decade, according to TELA. At the end of 2015 Varma had a relatively high solvency level of 31.4%.

Varma began investing in hedge funds in 2002 and the idea was to diversify and have a return and risk profile somewhere in between fixed income and equities, Matilainen said.

Since 2003 the hedge fund investments have returned 6.7% compared to 5.8% for the overall portfolio. Over a 10 year period the overall portfolio returned 4.8% compared to 5.8% for the hedge fund investments and 5.1% over 5 years compared to 5.8% for the hedge funds. For the full year 2015 Varma's investment returned 4.2% whereas hedge funds returned 3.9%. The strengthening US dollar contributed to the returns and the best performers where market neutral strategies. Opportunistic strategies suffered in a challenging environment.

Varma's initial investments into hedge funds began with fund of hedge funds but has since evolved into direct investments with single manager funds. Currently 90% of Varma's hedge fund investments are direct and 10% in fund of hedge funds, where it works with Blackstone. "We started with a modest allocation and built it over time and by 2007/8 we wanted to make a more significant allocation, of around 10%," Matilainen said.

Some of the main reasons for investing in hedge funds was performance, diversification and risk reduction, which continue to be key, he said.

Matilainen heads a team of 3 who are monitoring the ca. 45 hedge fund managers used. "We are not envisaging any major changes but continuously monitor the managers and look at new managers and ideas," he said. Blackstone is also used for research and risk management, he added.

Full operational and legal due diligence is conducted by external providers, Matilainen said, adding that the process from idea to investment takes many months.

The main criteria for manager selection is continuous long-term performance and talent. "The strategies also have to fit within the hedge fund portfolio but also make sense in the overall allocation so that the part fits the whole," Matilainen explained.

"Generally the managers we select are above Euro 200 million AuM,..."

Considering the size of Varma, it rarely invests less than Euro 30 million with a managers, therefore the size of the AUM of the manager is also of some importance. "Generally the managers we select are above Euro 200 million," Matilainen said.

Investors are often said to have a home bias both when it comes to asset allocation and managers selection. This may be true in the long-only side for many but Varma's hedge fund portfolio certainly does not have a home or even Nordic bias. Currently all its managers are from North America and Europe with a global reach. "We do not have a home bias at all and the main reason is that on the long-only side we manage our Nordic and European portfolios internally. We are not interested in paying high fees for hedge funds to pick the overlapping long names with our long-only portfolios so we don't really invest in long-biased hedge funds focusing on Europe in general or the Nordics in particular," Matilanen said.

For market neutral strategies he would consider Nordic managers. "The main thing still is performance, talent and that the manager and strategy fits the bigger overall portfolio," he noted.

Matilainen said Varma's hedge fund investments are well-diversified and can be put in two categories: a core portfolio with an absolute return focus, which has returned 5.7% annually since inception and the opportunistic portfolio, which has returned 10.0 % since start. "In terms of the variety, in the core portfolio we have a broad range of strategies favouring a relative-value mind set. The opportunistic portfolio can be more concentrated and directional."

"...in the core portfolio we have a broad range of strategies favouring a relative-value mind set."

In 2014 CTAs in general generated some of the highest annualised returns since 2010 but these strategies has not been favoured by Varma, which only has a small allocation. "In our opinion CTAs have relatively poor consistency, and tend to lag when markets turn rapidly" Matilainen said. Indeed 2015 was a much tougher year for CTAs with oil prices falling and demand from China slowing resulting in below par returns.

In the spring of 2014 Varma further reduced its equity allocation as the return outlook was weakening. Instead of switching to bonds the allocation was put into hedge funds as the outlook for fixed income was also gloomy. Asset allocation at the end of 2015 was, apart from 17% in alternatives, out of which 1% is invested in inflation-linked investments and commodities, 45% in equities, 30% in bonds and 9% in real estate. Varma has a total of Euro 41.3 billion in AUM and is one of Finland's largest pension and insurance providers.

Matilainen does not envisage the 16% allocation growing much in coming years. "We have a mature, stable roster of managers with few changes expected in the core portfolio. On the opportunistic side there can be larger rotations but those changes are typically not frequent. We don't see big new investment themes entering into our opportunistic portfolio right now, though shakes in the credit markets can create some opportunities in the future," he said.

If managers are underperforming they are still given the opportunity to prove themselves over 18-24 months before being terminated. "These things rarely come as a surprise," Matilainen added.

Despite the positive contribution to returns Matilainen admits there are challenges such as high fees. "The higher than average fees are only justifiable if we also get higher-than-average net returns. In addition investors need to be very vigilant in manager selection because of the vast number of strategies and styles available. In 2008 it was easy to negotiate fees but this only lasted about 2 years. It is a question of supply and demand and demand is again high so it is a seller's market now," he said.

Matilainen said there is still some room for negotiation of fees adding that Varma's policy of all investors being treated equally would require the hedge fund to be transparent about any discounts and also offer it to all other investors. Transparency in general is not a problem, Matilainen said, adding that this has always been the case. "We have never had any problems with getting the information we need in terms of where the risks are within a specific strategy or even position transparency. Since the crisis there have been general improvements and much has to do with technology with system improvements in risk monitoring and risk aggregation," he said.

One of the key aspects to Varma's investments is its Principles of Responsible Investments. In 2014 Varma decided to include the principles for its hedge fund portfolio. At the beginning of 2015 Varma started using these principles and created a questionnaire for its hedge fund managers. This questionnaire was sent out for Varma to assess the status of responsible investments at the hedge funds it uses and how well the hedge funds fulfil Varma's principles which include environmental, social and governance criteria, ie no difference to other asset classes. "In addition we also take into account the special character of hedge funds such as the specific strategies or investment techniques used," Matilainen said.

The criteria for assessment of hedge funds within the responsible principles include assessing governance, i.e. reviewing incentive systems, conflicts of interests, internal processes and control measures. Regarding the oversight of the operations Varma recommends that the majority of the board of directors are independent. Varma encourages fund management companies to define their own principles for responsible investment and to apply those.

Not all responses to the questionnaire have been returned, understandably, as it comprises some 30 pages of detailed questions that managers are required to answer. So far responses indicate that a lot of principles are already present among many of the managers even if they have not been specifically named them as responsible investment principles or stated them as policies, Matilainen said, jokingly calling them closeted responsible investors. He is now urging hedge funds to come out of the responsible investment closet.

Going forward, Matilainen hopes that the funds used will take the ESG principles into consideration in a more systematic manner and as a part of the investment process and including this in the reporting to investors. "Also, the responses to the questionnaire is only one of many criteria we use when evaluating managers," Matilainen.

Apart from its own responsible investment principles Varma is also active internationally within the Hedge Fund Standards Board as well as the Principles of Responsible Investment hedge fund work group.

The HFSB is working with investors such as Varma in encouraging the hedge fund industry to adopt its standards. Varma is using the 'comply or explain' approach with respect to HFSB standards.

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A FINNISH INVESTOR'S PERSPECTIVE ON ASIAN HEDGE FUNDS

By Päivi Riutta-Nykvist and Mark Mattila– Portfolio managers of FIM Alpha

Most investors would agree that hedge funds should be viewed as an extreme degree of active management, an unrestricted way to manage money, not as an asset class of its own. The fund manager's skill dictates returns, instead of an arbitrary benchmark. Hence an investor does not want exposure to the average return of hedge funds as a group, but to the best decile of the managers. Even assuming that the lion's share of alpha could be explained and captured by smart beta; i.e. styles and risk premia, it still takes skill to harvest them.

How does one begin to look for the most skilled managers? Is it enough to get access to a database and find out the past winners, optimize a portfolio based on past correlations and hope for the past to repeat itself? Unfortunately persistency of hedge fund returns is not high, and strategy performance alone varies drastically over years. In the humble opinion of the writers, finding the best skill and future performance is a combination of science and art. The minimum level is knowing the research target well in quantitative terms to know what behavior to expect, but that tells you nothing of the managers' likelihood of succeeding in the future. The differentiating work starts by understanding what makes the managers tick, to be able to evaluate their probability of success and the factors affecting that.

So, you want a handful of really great managers who deliver uncorrelated returns, but you cannot find them based on past performance alone, and have to put in some cumbersome footwork to get to know the targets well. There is however one way to improve your chances of finding winners; look in places where you have a disproportionately larger concentration of them. Asia represent one such anomaly. Asian hedge funds have over performed their global peers strongly for 4 straight years.

Why is this? The obvious answer is the inefficiency of the Asian markets offering an environment with plenty of mispricings that can be utilized. In Asia retail investors represent ~80% of the market volume, whereas in the US over 90% of market participants are professional investors. Another explanation would be the lesser dilution by more institutional funds, as in Asia funds have a high turnover reflecting the urgency to succeed, or close shop and do something else. Time really does turn into money in Asia - and if not, the opportunity cost is high.

The return of the fund of hedge funds

Although the key question for the investor is still portrayed as single funds or a portfolio of them, it is really only about who builds the portfolio, as everyone by now agrees that at least a handful of hedge funds is better than one. The fund of hedge funds could indeed be staging a comeback, as in today's world a fund of hedge funds pooling the underlying investments under its fund wrapper is again an attractive proposition. The search for skill, monitoring, risk management, fee negotiation power and reporting provided by a pooled vehicle would require plenty of resources from a direct investor. This becomes even more important the more specialized or remote the targeted investment universe is. All of this applies to Asia; it is far away and a relatively small part of the global hedge fund universe, yet with the potential to generate above average returns. As hedge fund investing matures the portfolios are often built to reflect specific requirements of the investor, be it zero correlation to the rest of the portfolio or ESG considerations. At the end of the road lies the total demolishing of asset class boundaries, and hedge funds being picked just as alpha sources, but this is science fiction still in Finland, where the regulatory frameworks seem to uphold traditional asset class silos.

Asian hedge funds remain undiscovered jewels

Asia-Pacific as a destination for hedge fund management has been expanding over the past few years, however, it still accounts for only 7% of the global hedge fund assets under management. Why is that? There are many reasons, shortage of domestic institutional capital, short track records, a lot of new launches but also a lot of closures, liquidity issues and smaller capital markets making hedging difficult, to name a few. The sandbox is simply too small for the largest hedge fund investors to play in. Oddly this has not led to the smaller investors, who could take advantage of this smaller sized opportunity, to hop in enthusiastically, but perhaps taking their lead from the big investors, they too stay away. The smart money, represented by the North American university foundations, is however well represented at most Asian hedge fund conferences, and anecdotal evidence points to sizeable allocations to Asian hedge funds.

Figure 1: Hedge fund strategies returns during 2001-2015

2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
20%	18%	25%	16%	17%	16%	17%	18%	27%	14%	6%	12%	18%	18%	4%
18%	18%	20%	14%	12%	16%	14%	15%	25%	13%	5%	11%	16%	6%	4%
11%	15%	19%	13%	10%	15%	13%	-5%	21%	13%	4%	11%	15%	6%	2%
9%	7%	18%	12%	10%	14%	13%	-18%	21%	13%	4%	11%	12%	6%	2%
8%	6%	17%	8%	9%	14%	10%	-18%	20%	12%	2%	11%	11%	4%	1%
5%	6%	15%	8%	9%	14%	9%	-20%	19%	10%	1%	8%	9%	3%	1%
5%	5%	14%	7%	8%	11%	8%	-20%	12%	9%	-4%	5%	4%	3%	0%
2%	0%	8%	6%	6%	9%	6%	-24%	4%	9%	-4%	1%	4%	2%	-1%
-4%	-1%	7%	6%	1%	8%	6%	-29%	-7%	-1%	-7%	-3%	-3%	-1%	-5%
-4%	-2%	-33%	-8%	0%	-7%	4%	-40%	-25%	-22%	-9%	-20%	-25%	-6%	-6%

- Macro
- Equity L/S
- CTA
- Event Driven
- Relative Value
- Market neutral
- Multistrategy
- Distressed
- Short bias
- Credit L/S

Source: Bloomberg, CS hedge fund strategy indices

Figure 2: Asian hedge funds have outperformed both global hedge funds and the equity market

Source: Bloomberg

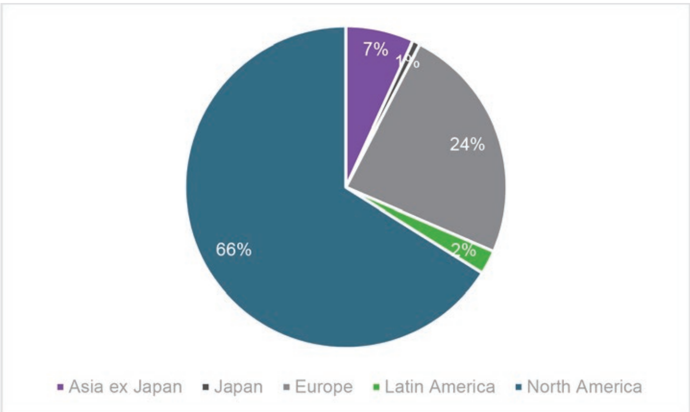
Most (~ 2/3) of the strategies are equity related strategies in Asia. In the remaining part, there are a lot of unique strategies with varying degrees of market neutrality. This is the part we focus mostly on. The opportunity set across Asia continues to be vast for hedge funds. We are witnessing significant changes and growth in the capital markets in the area; a lot of corporate restructurings, changes in competitive dynamics within industries, new products and disruptive technologies, which all present opportunities for exciting long and short investments and opportunities across the capital structures.

For example, there are funds that are exploiting the volatility of the discount for a Chinese company's stock between the listings of A shares and H shares. There are event driven funds who focus on short-dated and liquid hard catalyst events, with a particular emphasis on merger arbitrage opportunities. There is a lot of activity in the M&A market with idiosyncratic drivers of deal breaks, but the requirement of knowing the many jurisdictions in Asia make the entry barriers high.

Finding the best managers requires a lot of legwork, good connections and due diligence hours. During the five years of our research in the area we have come to the conclusion that it is very hard to put a magic formula in a presentation and say you want your managers to fulfil these criteria. Asian hedge funds come in so many different shapes, flavors and sizes that very strict search criteria is the surest way to miss some very good funds. When building a portfolio we first of all wish to populate it with managers who are as different from each other as possible, and exposed to different risk factors.

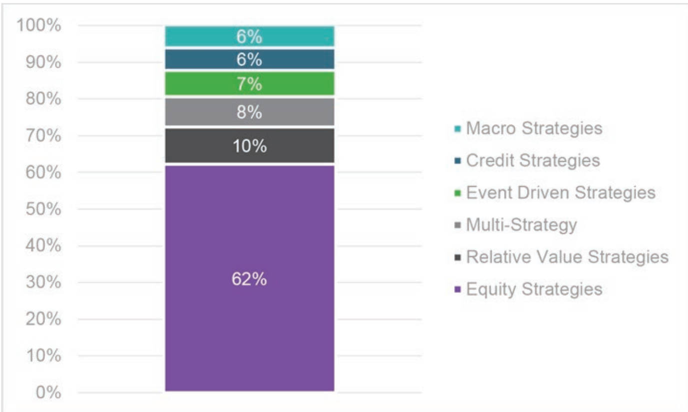
Some common key success factors shine through: it is essential for the manager to be on the ground, the local knowledge of the markets in the region has enabled them to generate both higher returns, and better risk-adjusted returns, than their counterparts investing from beyond the region. They should have a long proven history of having practiced their skill. Their abilities should be well thought of by their competitors and brokers (Asia is like Helsinki, everyone knows each other). The fund company should have sufficient financial resources to provide robust portfolio management systems and to keep the fund managers by their desks, not travelling raising assets.

Figure 3: Breakdown of geographical hedge fund AUM split



Source: Eurekahedge

Figure 4: Breakdown of Asia-Pacific-Focused Hedge Funds by Core Strategy

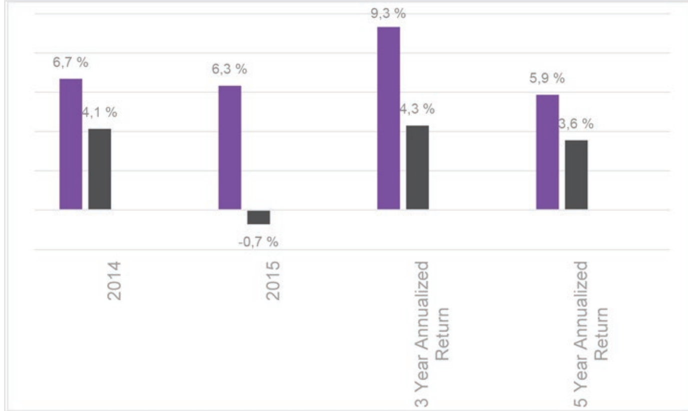


Source: Preqin

Asian hedge funds have delivered 9.3% annualized returns over the past 3 years. Compared to global hedge funds that represents a 5% outperformance. Asian hedge funds tends to have higher volatility, still, when looking at the returns on a risk-adjusted basis the results are still better for Asian hedge funds. Especially in a down market alpha is amplified in Asia.

In some ways investing in Asian hedge funds is like taking a time machine to the '90's. The opportunity set is rich and alpha opportunities are not arbitraged away by too heavy competition. The fund managers speak to you in clear language, telling you exactly what they do instead of hiding behind consultant made presentations and confusing jargon. At the same time Asia is not another planet; global improvement in regulation, transparency and standards has affected the Asian hedge fund industry for the better. We went to Asia in the belief of finding more alpha, and found it aplenty in an industry that is exciting, ever-changing, not overly polished or institutionalized, but full of the dynamism of the East.

Figure 5: Performance of Asian hedge funds vs. global hedge funds



Source: Bloomberg

Mark Mattila and Päivi Riutta-Nykvist / Portfolio managers of FIM Alpha

New Fund Launch: Gramont Capital

An opportunistic approach to long/short equity investing

by Jonathan Furelid – HedgeNordic

Miikka Hautamäki, a former proprietary equity trader at Goldman Sachs in London and portfolio manager for Brummer & Partners Avenir, launched Gramont Equity Opportunities Fund with Janne Järvinen and Jaakko Huhtala. Janne's background is from the Special Situations group at Goldman Sachs and private equity firm Nordic Capital. Jaakko Huhtala joined from Carnegie to run the operational side of the business.

In late 2014 the team launched the Gramont Equity Opportunities Fund. "When we started out, the idea was to offer something that could make money in all market environments, was truly uncorrelated to the equity markets, and that we could build on our experience from previous roles", Hautamäki, Gramont's CIO, says. The fund's recent performance is testimony to the low correlation – while from the beginning of 2016 global equity markets first sold off sharply and then rallied back close to earlier highs, Gramont returned 8.5% by the end of April, making profits in three out of four months. In 2015, the fund ended up 11%.

Gramont builds on three distinct investment strategies; macro thematic, single stock strategies and special situations. The allocation between the three strategy groups has varied significantly since the launch, driven by the opportunity set perceived by the managers.

"In this challenging macro environment we want to remain nimble and opportunistic. Unlike many hedge funds that have strict allocations in terms of strategy, sector or geographical region, our mandate is flexible, allowing us to invest where we see the greatest opportunities at any given point in time", Hautamäki says.

The thematic strategy focuses on broader macroeconomic themes in the equity markets while the single stock strategy focuses on company fundamentals, technical factors and relative valuation. The special situations part of the portfolio aims at identifying arbitrage opportunities that could appear in isolated events such as a M&A deals, right issues and index changes.

"We've managed to make money from all three strategy groups this year. On the macro side, our negative view on equities has paid off. Also on the single stock side we have benefitted from shorts in companies that have unsustainable valuation multiples and stretched price momentum. In special situations we closed out a number of M&A arbitrage positions on back of rapid tightening in the spreads", Hautamäki says.

As the typical holding period of the fund's investments is relatively short, usually from 1 to 12 months, the managers are more focused on the near term investment environment instead of trying to make longer term forecasts. At the time of writing this article, the team continues to have a negative outlook on equities.

Gramont's founding partners, left to right: Janne Järvinen, Miikka Hautamäki and Jaakko Huhtala

"In our view the equity risk premium currently compensates poorly for incremental risk taking given rapidly deteriorating fundamentals. However, given that we only invest in highly liquid securities, we are able to flip our overall positioning from net short to net long and vice versa quite easily. That has enabled us to be opportunistic amidst the increased volatility on the equity market. We don't anticipate the uncertainty to go away anytime soon, so there should be plenty of opportunities for our trading oriented strategies going forward too", Hautamäki argues.

"High liquidity also makes the strategy scalable and allows the fund itself to provide its investors with monthly liquidity without any lock-ups or gates, which many institutions seem to appreciate these days", he continues.

While at any given point the fund may have equity market exposure, either net long or short, the team expects that to average to zero over a longer time horizon. The risk levels are constantly being reviewed:

"We recognize that we are in a highly volatile environment and risk management is always an integral part of our portfolio construction", Hautamäki explains, continuing:

"We have stop loss limits on individual trades as well as on a portfolio level. The limit for individual trades is at 2 percent of AUM. At the portfolio level we reduce gross exposure by a third, should we experience a drawdown of 5 percent. This helps us stay disciplined and forces us out of positions with negative momentum", Hautamäki argues.

So far, the Gramont fund has been running quietly under the radar for most investors outside the fund's hometown, Helsinki. According to Hautamäki, Gramont will be looking to make a mark internationally after passing the 2-year mark in August:

"We wanted to build a track record before pursuing broader distribution. Obviously our current investor base is primarily Finnish institutions, but in addition to already having a couple of international investors on board, it seems that our recent performance is creating more and more traction from abroad as well", Hautamäki concludes.

FACT BOX

Fund Name:	Gramont Equity Opportunities Fund
Strategy:	Long/Short Equity - Opportunistic
Fund Company:	Gramont Capital Ltd.
Launch Date:	August 2014
Portfolio Managers:	Miikka Hautamäki, Janne Järvinen
Web:	www.gramont.fi

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Old Cable Factory


Tommi Kemppainen, HCP CEO


HCP Offices

The Art of utilizing Science in Asset Management

by Glenn Leaper – HedgeNordic

HELSINKI CAPITAL PARTNERS specialises in global multi-strategy and value driven equity strategies. Founded in 2007, Helsinki Capital Partners (HCP) offers asset management as well as financial advice and cultural collaboration and offers services to institutional as well as private clients. HCP is distinguished by its commitment to CSR (Corporate Social Responsibility) and its unorthodox inclusion of creative groups among its stakeholders, as part of the firm's effort to set an example to industry peers and make much needed changes to "business as usual" across the financial industry.

HCP Asset Management manages three Finland-domiciled AIF funds. Its flagship fund, HCP Black, is a multi-strategy fund managed by CEO Tommi Kemppainen, and aims for high risk-adjusted returns through active diversification. The main objective is the preservation of wealth across business cycles. It achieves this by working on the fundamentals of each investment and estimating future returns and differences in risks to achieve as wide a diversification as possible, as opposed to buying as many assets within asset classes as possible or analyzing the historical correlation between securities.

HCP's two other funds aim to create wealth through taking measured long-term equity-risk. HCP Focus, managed by Ernst Grönblom, is a concentrated global long-only equity strategy with high upside potential and has a target portfolio of 8-15 companies. Its inclusion of companies is determined according to their financial strength, their identifiable and sustainable competitive advantage, and their quality of management.

The firm's youngest fund, HCP Quant, managed by Pasi Havia, was launched in 2014 and follows a global long-only equity strategy concentrating on small and mid-size companies. It uses systematic, quantitative and statistical methods to identify stocks that are undervalued, as indicated by multi-factor modeling. HCP fund strategies are also offered as managed accounts without a collective investment structure.

PRIDE AMONG STAKEHOLDERS

Whereas independent hedge funds often provide a high threshold to investments or provide this access through a distributor, HCP makes their funds available from a minimum initial investment of 5.000 Euros. In addition, considering changes in the European wealth management space, where individuals have increased responsibility for their savings and have access to a wealth of information through online sources, HCP increasingly uses social media to both find and exchange investment solutions and educate the public, most notably through its #HCPSPIRIT initiative.

HCP considers itself an example of a small but growing company built on the idea of social responsibility, as opposed to one grudgingly adapting to emerging CSR standards. The financial industry has been under much justified criticism since the financial crisis, and companies often consider CSR issues only once they reach a certain size. Typically, they are compelled to do so by legal requirements and external pressures.

By contrast, in attempting to return a sense of pride to stakeholders, HCP believes that CSR should be programmed into the DNA of company culture from the outset. It does this by focusing on the transparency of products (subtended by its fee-only policy), responsible investment, business stability, gender equality, what it calls "meaningful work" and, by extension, "cultural collaboration."

This means that HCP also takes the unusual measure of considering artists and athletes among its stakeholders, alongside private investors, entrepreneurs and institutions. Its service to professional athletes, for example, is customized to build support for the athlete's life and performance by taking into account aspects specific to the athlete's career and season. Its collaboration with artists contributes to defining the socially responsible relationship of the company to its surrounding society.

VISION AND NECESSITY

The reasoning behind this is driven by both vision and necessity. Ever since the dawn of the industrial revolution, there has been a gradual – but accelerating – shift in the source of value creation, from physical capital to intellectual capital: "from atoms to bits." Part of intellectual capital in a broad sense, therefore, naturally includes art and culture. HCP acknowledges that a healthy, productive society is equally dependent on a vibrant culture. While the social utility of culture is no doubt challenging to measure in purely monetary terms, numerous studies have established a positive correlation between societal well-being and the extent and influence of cultural events. Contributing to culture is also important to HCP for the reason that artists continue to be under-financed relative to the breadth and depth of their potentially positive social impact.

Moreover, in post-industrial societies such as Finland and many other Western countries, the importance of creativity as a productive factor is starting to eclipse that of traditional factors of production, such as commodities or industrial infrastructure. Culture also seems to enjoy some long-term macro tailwinds. As an increasing portion of the world population is beginning to meet basic physical needs like food, shelter, health-care, etc., the demand for goods situated atop the "Maslow pyramid of needs" (e.g. art) is likely to continue to increase.

HCP offices are located at Kaapelitehdas, an old industrial building which, probably inhabits the largest single concentration of culture in the Nordic countries. What could be a better symbol of the changes currently taking place in the West than a heavy industrial base transformed into an intellectual property hub?

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Insurance-linked securities

Growing investor demand for insurance risk exposure

by Laura Wickström, CAIA - President, Partner at AIM Capital Oy

Insurance-linked securities (ILS) offer exposure to insurance risk. They are similar to asset-backed securities such as securitized loans that generate cash flow from collecting interest or rental income. The uniqueness of ILS comes from the source of income, the insurance premiums, and the underlying risk, insurance risk. A security is considered insurance-linked when it provides exposure to the risk and return of the assumed insurance liability.

Securitization is the means for insurance companies to transfer insurance risk to the capital markets. This risk transfer resembles traditional reinsurance with the exception that the risk is taken by capital markets instead of a traditional reinsurance company.

From the investor perspective, investing in ILS offers good return potential and risk diversification. Since insurance risk is uncorrelated with capital market risks, the risk-return profile of investment portfolios may be improved by ILS.

How ILS works?

ILS investments are limited liability investments in a sense that investor's losses may not exceed invested capital. The ILS securitization structure involves a licensed insurer, in practice a non-rated special purpose vehicle (SPV). The SPV may be affiliated with a larger (re)insurance company, the sponsor which is also the beneficiary, a third party facilitating the risk transformation, or a dedicated ILS fund providing the insurance cover.

Typically the assumed insurance liabilities are fully collateralized. The SPV provides reinsurance and collateralizes the obligation. The collateral funds come from issuance of financial instruments by the SPV. The collateral is held in liquid and safe assets such as money-market funds or short-term treasuries. The structure is designed to exclude market risk, credit risk, and other capital market risk. The end result is a pure play investment in insurance risk. ILS represents a pass-through instrument where the return is determined by premium income minus insurance loss claims under an insurance policy.

Return generation

As the underlying insurance contracts attached to ILS instruments do not have a secondary market, the valuation is based on accounting-based accrual of premium income and reserving for expected loss claims. Contrast this valuation with real estate appraisal which values the investment on the basis of expected future cash flows. In ILS the contract maturities tend to be quite short 12 months to 36 months. Like third-party appraisal of real estate can result in a write-down of value, the value of ILS investments can be similarly written down based on an actuarial opinion before any loss crystallization.

Cyclical variation in reinsurance affects directly the pricing of ILS. Following large losses, insurance premiums paid tend to be higher. In addition, premium accrual exhibits seasonality e.g. North Atlantic hurricanes occur during certain months. The insurance losses, reserves for expected claims, are based on actuarial estimates. The actual process of paying claims and settling the contracts may be a prolonged one, typically extending to several years depending on the size and complexity of both the event and the underlying contract.

ILS, based on publicly traded catastrophe bond historical return data, has provided return enhancement to a portfolio. Over their relatively short history from the beginning of 1990's, catastrophe bonds have been yielding better than similarly rated corporate debt, although the spreads have narrowed over time. The narrowing of spreads has been a result of the absence of major catastrophic events in recent years as well as additional investor capital coming to the markets.

About AIM Capital

AIM Capital is an alternative investment fund manager (AIFM) spezialising in researching, planning and implementing alternative investment strategies. Clients are well-established institutional investors – including insurance companies, pension fund managers, endowments and foundations. AIM Capital was founded in 2007 and is based in Helsinki, Finland and is authorized by the Finnish Financial Supervisory Authority (FIN-FSA).

ILS risk exposure concentrated in natural catastrophe risk

ILS generates cash flow from collecting premium income for assuming the risk of insured claims. Investors make money if premium income exceeds insured losses over time.

Risks typically insured by capital markets are catastrophe risks, such as hurricanes and earthquakes, which occur at certain geographical regions. They are risks that are difficult to bear by primary insurers as the annual variation around the expectation, the mean of the distribution, may be extreme. This type of loss profile is commonly referred to as "low frequency, high severity" risk.

ILS is generally used to hedge an insurance company's own capital from occasional but severe losses arising from catastrophic events. The supply of ILS is thus governed by the needs of insurance companies. It is beneficial to transfer specific parts of assumed liabilities to capital markets. The risk typically transferred is concentrated and thus costly or impossible for the insurer to keep on its balance sheet.

The main difference between ILS and securities issued by insurance companies is that ILS exclude or minimize all risks and returns other than those coming from insurance activities. ILS exposure is also more concentrated geographically and to peak perils.

ILS market expanding

The ILS market has expanded in recent years. Despite of this ILS may still be considered a niche market driven by the reinsurer needs to transfer insurance risk concentration. Investor access to ILS can currently be obtained mainly through dedicated ILS funds or catastrophe bonds. Given the economic benefits for insurance companies from risk diversification and expansion of insurance capacity, we expect the ILS market to expand further. There will be increasing demand for insurance risk transfer and securitization due to rise in insurance coverage and an increased need to insure against natural catastrophe risk. The similarities in the structure of ILS to other securitized assets combined with the relatively independent nature of the underlying risk should continue to increase demand for ILS from capital market investors. For investors ILS provides return enhancement and diversification to portfolios. These factors will in our view support continued allocation to ILS and contribute to the growth of the ILS market.

Recent ILS market growth has come primarily from collateralized reinsurance dominated by dedicated ILS funds. Fund selection is thus important for investors looking to invest in ILS. In addition to developing a good understanding of the ILS market, investors need to conduct comprehensive due diligence on the potential ILS funds. It is our focus to provide that for our clients.

www.hedgenordic.com - May 2016 HEDGENORDIC

by Tatja Kärkkäinen– HedgeNordic

Älä laita kaikkia munia samaan koriin* –

Commodity Investments in Finland

In an interview with Karri Lehtinen, the Managing Director of Helsinki based MG Commodity Corporation, Mr. Lehtinen gives an overview of commodity investments in Finland, which has emerged in fits and starts over the past two decades. He discusses some of the challenges that have faced the asset class in the country, alongside its prospects in the next years. Finland, he says, provides few built-in advantages for CTAs, but these can only succeed by providing a commodity 'niche' and attracting international investment.

A SLOWLY EMERGING ASSET CLASS

Karri Lehtinen describes the emerging culture of institutional and retail commodity investment in Finland as a protracted process spanning 20 years. He believes larger Finnish institutions have become very sophisticated investors nowadays, "with some even running their own hedge fund departments to diversify their portfolio and maximize their optimum risk/return parameters. Strategy-wise, they have the capacity to invest in many different types of commodity strategies," he explains.

"When I moved back to Finland in 1996," Mr. Lehtinen recalls, "commodity investments were in their infancy. Only a few physical operators, like Outokumpu and Neste, did active hedging on commodities in order to smooth their cash flow from sudden raw material price jumps that they worked on. Large institutions started to allocate more funds to commodities during the last so-called 'super cycle' driven by China starting in the early 2000s."

"First came various kinds of long only exposed commodity indexes that performed excellently, as they should do when commodity demand factors are strong," he continues. "Then, in the late 2000s, institutions moved towards more active investments products. In the beginning of the decade, large institutions allocated around 1-3% to commodities. Nowadays, the figure might be closer to 8-10%. Retail investors woke up following 2005, after commodity indexes had more than doubled since 2002."

"Electronic systems drive lots of ETF liquidity, amid other instruments new to markets that might push the market price even further than fundamental information would suggest. On the other hand, electronic trading systems with increased liquidity have removed limitations on the ups or downs experienced in the marketplace. I can remember times in 1990s when pork bellies were limited for up to almost two weeks! Can you imagine finding yourself on the wrong side of the market and then you can't get out of your position?"

Mr. Lehtinen has been a commodities trader since 1993 and he notes that market dynamics have changed a lot since then. "I have had some traders shift from trend and curve strategies towards volatility trading. Lots of commodity liquidity comes in a good macro environment, and it is then very difficult to analyze demand and supply scenarios with relation to specific commodities."

Looking for reasons for the initially slow adoption of commodity investments by Finnish allocators, Mr.Lehtinen recalls the problems, for example, of explaining commodity-return drivers to retail side investors. Retail investors soon learned about spot return drivers, but explaining curve or term structures was basically unheard of at that time. Even today he believes, retail investors are looking for returns on spot prices and nothing else. "In any event," Mr. Lehtinen suggests, "the Yale and Harvard Endowment Optimum Asset Allocation Method indicates that individuals should have 30% in real asset with along side their traditional investments, such as stocks and bonds."

LIMITED EXPOSURE TO COMMODITY FUNDS

"Nowadays, large investors all use commodity instruments, ranging from derivatives and indexes to mutual and hedge funds and ETFs," says Mr. Lehtinen. "Commodity funds are used, especially if their strategy is a potential niche product offering diversifying aspects. They are however required to have a sizable AUM of well over €100m in order to have even the slightest chance of attracting investment from the big players. Smaller investors, for their part, invest in Commodity-structured notes, ETC's and indexes."

Asked about a tradition in Finland to invest in physical commodities, like gold and silver, to weather hard times, Mr. Lehtinen explains that there have been a few asset management companies that sold physical gold and silver right after the financial crisis and during the unrest in Europe. "I believe they were somewhat successful, but demand has dropped dramatically after the return to a more stable economic environment. It is much easier and cheaper to buy ETF/ETCs and derivatives than physical products with the same exposure. There is, though, always some demand for physical gold, when times get tough and stocks lose value."

"There have basically been index long only commodity products offered by banks available since 2002," he says. They were mainly sold in the period between 2002-06, when indexes gained around 40% per year, but these lost their luster after the financial crisis due to the fact that all gains were lost across 2008-09."

FINNISH HORIZONS FOR CTAS

That same period of course was fertile soil for CTAs and Managed Futures funds, and Mr. Lehtinen ascribes part of the emergence of Finnish commodity funds to the early role played by Estlander & Partners. "Estlander has been the most successful active player and commodity service provider to both large and small investors, certainly in Finland, but to some extent also in Europe as well as in the U.S. Estlander has a long tradition with commodities and is an active manager, although they also trade other asset classes."

Of his own experience, Mr. Lehtinen cites CFM Contango Fund Management, that ran active long/short multi-strategies between 2006-12. However, "the company gained market share fast, but lost lots of AUM after the financial crisis, even if its performance was no way near as bad by comparison to how much indexes lost value. It was at a time when many small companies lost AUM due to the uncertain times. Since then, there have not been any other pure commodity funds coming up in Finland other than MG Commodity Corporation Mr. Lehtinen's current company, "which itself is in the start up phase."

Despite the infrastructure, reputation and skill Estlander & Partners brought to the small market, Mr. Lehtinen does not sense a spark went out to trigger more startups in the field. "I do not think there are any natural advantages to get started for a commodity manager in Finland. There is not enough of an investment culture or investable assets for this assets class locally. Basically, it is a matter of choice to operate a commodity fund in Finland, but one must be prepared to attract foreign investors to be successful. One's product must be a true 'commodity niche'."

Karri Lehtinen, Managing Director MG Commodity Corporation (Helsinki)

However, markets will change a lot and regulation is already forcing both service providers and investors towards more regulated products and transparency. "In the next 10 years the majority of all funds in the Nordic area will be managed and valued by respected large European fund administrators and their bank counterparts. Setups will be similar to what there is in Luxembourg, but spread out across all central European locations. This might be costly to investors, but it will leave fund managers more time to operate their strategies on behalf of the investor, rather than spending time on fund's daily operational tasks." To be successful in the Nordic area, Mr. Lehtinen is convinced one needs to be open-minded and maintain an international focus.

* Don't put all your eggs in one basket.

www.hedgenordic.com - May 2016
HEDGENORDIC

Passion Palette of a CTA Pioneer

by Kamran Ghalitschi – HedgeNordic

Finnish men are not famed nor do they have a worldwide reputation for being very outspoken about their emotions, and expressing them in many words and vivid colors.

This is also a rare breed among sober and cool, systematic, traders in the Managed Futures space. What stands out therefore, when reading interviews or listening to podcasts with Martin Estlander, the founding partner of Finnish CTA Estlander & Partners, is how passionate and emotional he is about financial markets, quantitative models and mathematical problems. And this becomes even more evident when talking to him in person.

Traders in niche sectors or geographies that are able to acquire an edge over time and be successful are a rare group. The challenge is multiplied in case of a Managed Futures fund manager. CTAs are truly playing with, and most of the time against, the big boys. In futures and FX markets, you are competing with the brightest and sharpest traders not just around the corner - but in the world. On the other end of your trade are hungry wolves at the top of their game, highly skilled and trained and extremely motivated and focused on success. Many may have near endless resources of capital, research and technology available, in a global arena that spins 24/7 and is dictated by cruel but honest numbers. Martin Estlander describes the challenge like this: "What we really like and enjoy, what I love about the job is staying on top of the very exciting problem to solve of how to keep on being efficient on capital markets."

Tracing foundations of a CTA

Estlander & Rönnlund, as the company was then called, was one of the pioneers in the European CTA space and traces back to 1991, when Martin Estlander and Kaj Rönnlund started trading and market making in options. It was not

Martin Estlander, Founder of Estlander & Partners

until later, Martin Estlander with academic degrees in computer sciences and economics started experimenting with building more long term, stable models to efficiently trade futures markets and discovering trend following as a strategy. At the time they were unaware that such a thing as a Managed Futures Industry even existed. Yet they were laying the foundation of what was to become one of the major players in the Nordic CTA space.

"What I love is staying on top of the very exciting problem to solve of how to keep on being efficient on capital markets."

It would take more than ten years until Estlander & Rönnlund focused entirely on the CTA models that started picking up more and more attention. The option trading and market-making was decreased until it evaporated away. It was not always clear that setting up a fund business and accepting outside money would be the path the firm would take. In the beginning, the drive was much more to prop-trade their own money. At the very beginning a no more romantic objective than to finance the studies of the founders was the main driver. "Initially there was never any thought of trading external money. But it so started happening, in particular when we came across an early partner, Commodities Corporation of Princeton, New Jersey. We then noticed there was capacity in the market and identified a big need for these kind of uncorrelated investments among allocators. The business model, being able to make fees on external assets, of course was also attractive", Martin Estlander remembers.

The option background is still deep rooted in E&P and Estlander believes it very much defines how the asset manager works today. He sees modelling as a way to understand and explain mathematically why trend following makes money for investors. While the options trading is no longer part of the business, it remains an important driver in the research work. "We finally have a complete explanation as to why these type of trend following models actually do work when you can define the environment mathematically", Martin Estlander explains.

Repatriating to Finland

After being situated in Stockholm, Frankfurt and later Dublin with the funds and management company, a change in legislation made it possible also for commodity funds to be regulated, domiciled and marketed out of Finland. After more than ten years abroad, the decision to repatriate back to their home country Finland was taken in 2000. "That decision then became very easy", Estlander remembers. "Finland is – of course – the best place to live and raise a family in the world", Estlander claims with a chuckle. "Besides that there is good business environment, a very high level of education with good universities with an abundance of skilled talent and an open, innovative culture. There is a lot going for opening shop in Finland."

The major flip side Estlander sees in being located in Finland is the limited access to institutional investors. Vaasa, the firms head quarter, or Helsinki typically do not tend to be on highly frequented travel paths of due diligence and investment teams. Asset raising therefore requires a lot more effort, research and discipline and passion to be successful.

Estlander & Partners acknowledges the company might have become an entirely different beast if they had pursued a more conventional path and domiciled in a financial hub such as London. "With some likelihood we

"If you really want to bring out the best in people you've got to inspire them."

would have been bigger today and be managing more assets. We may have been exposed to more or different types of investors or in more general terms been more attractive to institutional investors earlier. We may have ran into different people, be it on the development side or in research who knows, we may have lost or never attracted the right people that made Estlander & Partners great in the first place. Maybe we would have become part of a larger organization. But there are many advantages of being away from the buzz in the street. It is easier to think differently and walk your own path being a smaller outfit under your own control in a smaller city."

There was never any regret though in taking the decision to move back, or at a later stage stay, in Finland and Martin Estlander today identifies that step as one of the major milestones in defining the companies' history.

Helsinki vs. Stockholm

Finland, and Helsinki as its dominant financial hotspot, though, never quite managed to establish itself as breeding ground for successful managers building sustainable track records and businesses in numbers and it was Stockholm that became the center of the hedge fund community in the Nordics.

In part it may be owed to the success of Brummer & Partners that Sweden became the more prosperous and fertile ground for hedge fund managers to emerge in greater numbers in neighboring Sweden. "Brummer has done a fantastic job. Putting together so many diversified and successful strategies under one roof is an excellent business strategy to pursue. But it is definitely not easy. Brummer had sufficient investors around them and was successful in its own original strategy, Zenit, and then attracted other people and successful management teams to join. It does take the right environment, the right people, and loyal and committed investors. Simply put, you need enough of an industry around you and a good entrepreneur leading the way to be successful. "Certainly becoming a major hub is more difficult for a smaller market such as Helsinki and Finland. " Estlander & Partners, too, have looked into expanding their fund range. Today, the company runs two trend following programs, (one short term and one systematic commodity fund) and one asset allocation fund. The business therefore is still focused and evolves around the core trend following products.

Passion in Finance

One of the major strengths Estlander identifies, being a Finnish company, is the team Estlander & Partners managed to put together. "I am very proud of the team, it consists of people of both experience and highest academic standards. I Also feel very proud of the values driven corportate culture, the strength of which shows in a very low turnover of key people. Part of that is owed to the flat hierarchies and open and direct business culture we treasure in Finland. Gathering the right people around you, as business partners, investors but most notably employees and keeping them loyal and motivated can only be done by passion" Estlander is convinced.

"You can always motivate people to do what you ask them to do by bribing them with money. If you really want to bring out the best in people though, really want them to think along, you've got to inspire them. For that, you have to be inspired deep down in yourself This is where the culture plays a central role. It takes that passion to meet big convictions and strong commitment to the whole big process. You must be convinced you will to stick to the masterplan even in hard times. The conviction must be there while in a drawdown, miles away from high water marks and the possibility of making performance fees. The world moves in cycles, which becomes evident when you look back 50 – 60 years and more, so you truly need to be in it for the long run. Therefore it is so essential to choose to do what you really like."

" OUR DIFFERENCE" - Excerpt from E&P website:

"Operating out of Helsinki and Vaasa, away from the main financial centers, we promote a unique approach to systematic trading and risk management. Our location provides a solid base for rigorous independent research and innovation that lies at the core of our systematic investment strategies."

THE FINNISH REAL ESTATE MARKET

By Jonathan Furelid - HedgeNordic

Rising volumes despite poor economic development

Transaction volumes in the Finnish real estate sector are significantly on the rise. According to data from analyst house CBRE, the first quarter of 2016 saw a year-on-year growth of 144 percent and volumes of 1.8 billion euro. Retail properties were the most sought-after asset during the quarter representing half of the total volume traded.

> "Of total transaction volumes in Finland, a fair estimate is that half of these are foreign, primarily Swedish..."

Aki Kostiander, lead portfolio manager of Finnish asset manager United Bankers who are trading real estate on a global basis, says that the strong start to the year is a continuation of the significant activity experienced during last year in Finland.

"The Finnish market was very active last year and that trend seem to be extended into 2016. Last year, transaction volumes exceeded 5 billion euro which is close to the record set in 2007 of 6 billion euro", Kostiander says.

According to Kostiander, the activity of foreign investors is highly present and foreign funds seem to be willing to pay a premium for larger portfolios of Finnish real estate assets as these are rare to find.

"Of total transaction volumes in Finland, a fair estimate is that half of these are foreign, primarily Swedish. Foreign real estate funds are still looking to buy larger portfolios of properties in Finland but those are not easy to find. As a result, there is today a premium associated with these portfolios which has made the expected returns to be reduced, currently standing at below 5% for prime objects in the Helsinki area", Kostiander says.

Looking at the different segments of the market, the Finnish housing market has outperformed and is likely to continue to do so given that demographics support the demand picture while on the supply side, there is simply too little production to support demand, Kostiander argues.

> "The office market in Finland is however heavily affected by the country's poor economic trends..."

"We continue to see rising rents in Finland despite the fact that overall economic conditions remain weak. It is possible that the housing market will experience a slowdown and that the growth in rents will weaken from here, however, there is still a lack of properties in Finland, especially in central locations. The population is growing by 20.000 each year and there is too little new production, especially with regards to smaller and cheaper objects."

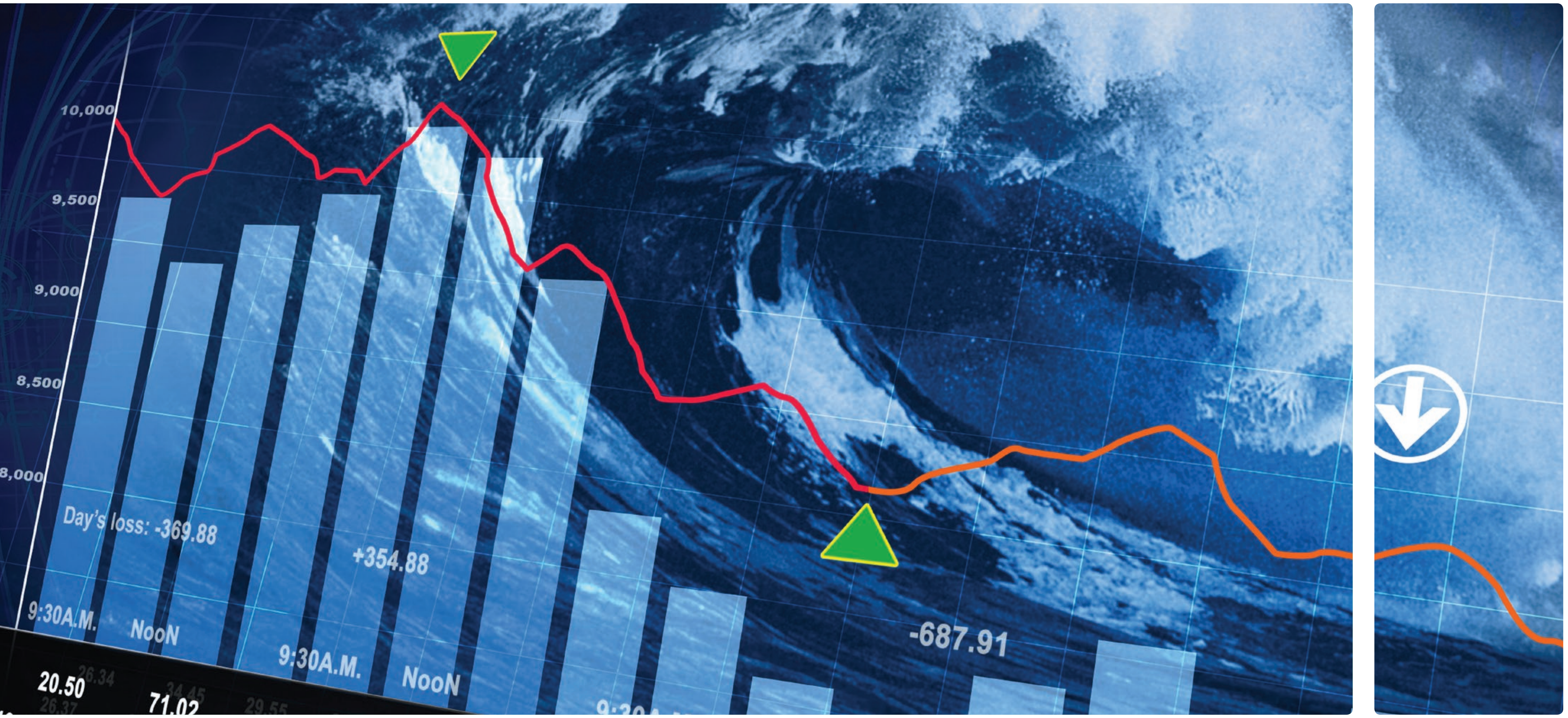
The office market in Finland is however heavily affected by the country's poor economic trends and rationalized use of premises. According to a recent report from Catella, the vacancy rate for office space passed the 13 percent level last year. The report states that office space occupancy has been declining for three years while at the same time new offices are continuously being built.

Catella also sees that demand remains focused on prime targets and large properties, so-called core properties. This is also were investment funds are focusing their investments and an area that is likely to see continued buyer potential even going forward. Catella believes that core properties will act as a safe haven in times where investors are increasingly looking for interest rates to rise. Catella also see yield requirements coming down given the political and economic uncertainty in Europe. In a forward looking statement, Catella writes:

"As for Finland, the yield requirement estimate entails both threats and opportunities. If our economy turns back towards growth, the growth potential will be greater here due to the long recession. On the other hand, Finland is at risk of being trapped if the Euro zone's interest rates go up before our economy starts growing."

IMPROVING NET RETURNS IN CHALLENGED TIMES

by Tatja Kärkkäinen – HedgeNordic



Dr. Jaako P. Kärki, CEO and Founding Partner of BWAI Ltd, discusses the current challenging markets, where good ideas and approaches can seem like gold dust for investors. Decent returns on investments in the current low inflation, low yield, low growth and low volatility but high credit-spread environment are hard to come by, even when taking higher risks. Identifying the nature of the underlying problems, therefore, is indispensable to finding remedies for the affliction of low returns. Some of the most obvious problems, Dr. Kärki suggests, can be remedied by investors' own actions.

CHALLENGES AND SOLUTIONS IN A CONFLICTED MARKET

"Average information, average skills and average execution are bound to give only average returns," Dr. Kärki states. "After all fees and expenses are taken into account, investors are left with very low, if any, return. Such average returns are acceptable to end investors only if there are virtually no fees or other costs in obtaining them. Loading more risk helps only if 'good risks' are taken - those that carry premia for bearing bespoke risks."

> "It makes no sense to pay high fees of 1-3% for active long-only equity management..."

So how can institutional and high net-worth investors improve their net returns in this challenging environment? The most obvious first step towards improving net returns to end investors, Dr. Kärki submits, is to renegotiate fees paid to intermediaries to a more affordable and competitive level:

"It makes no sense to pay high fees of 1-3% for active long-only equity management, as this activity only destroys value on average. It is widely reported, since the 1970's, that almost 90% of actively managed equity funds underperform their passive alternative. Also, paying a 2% management fee and 20% performance fee for Hedge Fund (HF) investments, plus other expenses of up to 14% p.a. or even worse, plus adding an extra Fund of Funds (FofF) layer at an additional layer of fees of 1-1.5% and 5-15%, plus expenses of 1-4%, make no sense whatsoever to any end investor."

Dr. Kärki cites the example of the Anglo-American markets, where the FofF layer has been largely eliminated and replaced by more specialised alpha return-seeking in-house HF portfolios. By contrast, "90% of the returns generated by the HFs (and FofFs) are systematic beta type returns that are available in the market in much more liquid forms for fees of 8–40 basis points only, or even lower if conducted through exchange-traded futures markets, and for zero performance fees and no Total Expense Ratio (TER). As these beta or premia returns are provided by the market and are not due to a manager's skills, performance fees are no longer justified. Warren Buffett, as is well known, advocates passive funds to avoid high fees and underperformance."

IMPROVING NET RETURNS: ALPHA BEFORE BETA

By comparison, Dr. Kärki suggests performance fee structures for skills-based alpha return-producing products are fine, as long as the returns are truly skills-based alpha returns and leave adequate net returns to the investor. "The alpha return performance fees should be contingent on the actual delivery of such alpha returns and payable only for the actual value created, and measured as such. Ideally, the remuneration scheme should be a symmetrical linear function, as any convex function provides the temptation to play the 'heads the manager wins, tails the investors lose' game. If the remuneration function is of a 'hockey stick'- type, at least it should have a High Water Mark and no resetting." In Dr. Kärki's opinion, no sensible investor should pay entry or exit fees, or accept any TER higher than a few percentage points, except for the trading costs of a high frequency trading fund.

Dr. Kärki suggests a second way to improve net returns, which is to smartly structure the portfolio to add value and reduce the possibility of significant losses (unwanted tail events) at the portfolio level. This can be done by tilting the portfolio towards rewarding systematic factors. "An equally weighted equity portfolio tends to outperform a comparable but market capitalisation-weighted portfolio, such as S&P500 or MSCI World," he says. "Also, a low past return volatility equity portfolio outperforms a similar but capitalisation-weighted portfolio over significant periods of time, especially when rebalanced periodically."

"A third way of improving net returns in the long run," he continues, "is to build the portfolio with protection against significant draw-downs (losses in tail events), or to benefit from an increased uncertainty, that is, to be "antifragile" [in Nassim Taleb's famous term, signifying 'things that gain from disorder']. Such a portfolio would be long in volatility, positively convex, have 'tails up' and resemble a straddle."

Dr. Kärki identifies alternative investment strategies as some of the more promising contemporary approaches to investment management, including related asymmetrical return distributions and their joint distributions, especially at the tails of the distributions:

"...if you have adequate skills and experience, do it in-house. Otherwise, outsource to better equipped and skilled specialists,..."

"Some of these alternative approaches to investment and risk management are much more demanding and require new types of thinking about returns and risk, as well as who is best equipped to generate such returns and manage the related risks. The main approach should be: if you have adequate skills and experience, do it in-house. Otherwise, outsource to better equipped and skilled specialists," he proposes.

INVESTMENT MANAGEMENT: LIQUID EXCHANGE VS. DEFINED LIABILITIES

Dr. Kärki explains how premium harvesting has been the talk of the town since a number of HF beta return replicating funds were initiated roughly a decade ago. A number of HF beta return replicating funds were set up in 2007 by JPMorgan, Goldman Sachs, Deutsche Bank, Merrill Lynch and BWAI Ltd, the latter in co-operation with finance professors from the UK (LBS) and U.S. (Duke University). London Business School, Chicago University and Columbia University have also been early and ardent advocates of premium harvesting and factor investing.

So how do these return-replicating funds work? "The latest approaches are known as traditional-, dumb-, scientific-, smart- and dynamic beta return, factor investing or factor tilting," explains Dr. Kärki. "There are some 12–20 such systematic factors that carry a premium that can be harvested over time, such as the value, size, momentum, quality, liquidity, credit and low volatility factors. The premia-return capturing can be accomplished using highly liquid exchange-traded instruments, such as futures, traded cash instruments, bespoke tracking portfolios, ETFs. Premia are known to be time varying, and cyclical and dynamic adjustment of the premium portfolio is therefore preferable, depending on the investor's skills and understanding of the macro environment."

Dr. Kärki underlines that the demand for such products or services is one of the fastest growing areas in investment management across the globe, with opportunity extending to trillions of dollars.

"In the 'core – satellite' structure, multiple premium harvesting activities typically take place in the low-cost and relatively stable core portfolio," he continues. "For investors with defined liabilities, such as pension funds and insurance companies, the core needs to be structured to satisfy the asset-liability and regulatory requirements."

"Typically, this premium harvesting core portfolio is complemented by a number of independent skills and experience-based alpha return capturing investments through specialised HFs or other alternative investment vehicles, and then managed as an alpha-return portfolio. As these alpha returns are not co-dependent with premia returns, the risks and returns of this satellite portfolio can be considered and managed independently from core premium investments. In our experience, less than 10% of all HFs are successful in capturing alpha returns, while up to 90% of them have been selling beta returns at alpha fees!," Dr. Kärki recalls.

RETURN AND RISK MANAGEMENT: THE BENEFITS OF VOLATILITY

Another set of issues relate to the difficulties inherent in measuring risk in a coherent manner. It is acknowledged that neither volatility nor its derivatives, such as Value-at-Risk (VAR) or even Conditional Value-at-Risk (CVAR), are capable of doing so adequately. An example was the January 15, 2015 Swiss Franc move against EURO, an amount that would have been a 189 standard deviation move under a Gaussian VAR model and which is expected to occur only once in 1089 years. As a result of the move, many Swiss Franc-exposed investors lost heavily and many funds had to be shut down.

"The probabilities of future events in the capital markets are rarely symmetrical and certainly not normally distributed," Dr. Kärki states. "The true investment risks are invariably at the tails of such non-normal distributions and, as such, outside the set VAR limits."

"As volatilities are inadequate and incoherent risk measures for end investors, they need to focus instead on the proper investment risks," offers Dr. Kärki. "These include the risk of their capital being destroyed (significant peak-to-valley drawdowns), and the risk of them not meeting their return targets ".

"Fortunately, such risk approaches and concepts are readily available in the well-established insurance world," he continues. "To protect against losses stemming from a contingent adverse tail events, investors need 'insurance policy', economically similar to holding life-, motor-, fire- or health insurance policies. In investment risk management, equivalent concepts resemble economically long option positions, like holding an Out-of-the-Money put, often synthetically and dynamically created to reduce the cost." Generally, linear hedging instruments are not suitable for portfolio level hedging as they just shrink the distribution. With a perfect hedge there is no edge, only an expensive synthetic Treasury bill.

For BWAI Ltd, volatility and its derivatives are not sufficient risk measures: "Instead of perceiving volatility as an enemy we take it as a good friend, generating value-adding opportunities to skilled and savvy investors," says Dr. Kärki. "Prices are volatile because new information arrives randomly to the market. Without this 'randomness', all instruments would just yield a return close to the Treasury bill rate - which is currently close to zero. Investment risk is best described as the occurrence of an unwanted unexpected event: the probability of such a tail event occurring and the investor's exposure to such an event."

NEW TIMES, NEW THEORIES?

There has been tremendous progress in the natural sciences and information technology over the course of the past 60 years. Yet, in finance, some people still talk about 50-year old "Modern Portfolio Theory". This raises the question of whether a re-evaluation of a number of old finance theories is urgently needed, or, indeed, whether any traditional financial theory is capable of encompassing these momentous and continuous changes without a comparable progress, understanding of behavioural components and lateral thinking.

"...half a century old ideas with simplistic assumptions and theories are no longer good enough..."

"The best practice is based on a good theory – but half a century old ideas with simplistic assumptions and theories are no longer good enough: many of the concepts and approaches widely taught at business schools and used by many practitioners since the 1952 Markowitz era are too simplistic and do not work in the current competitive, fast moving and information-linked markets," Dr. Kärki proposes. For example, "often regurgitated 'risk measures', like standard deviations and their derivatives, Sharpe and Sortino ratios, VAR, CVAR and the like would measure risk only in a normally distributed world. But, nothing in the investment world is normally distributed, save some measurement errors and academic ivory tower hallucinations. Fat tails and skewed distributions are the norm rather than an exception."

Value adding traders and investment managers actively try to find or construct non-normal return distributions, preferably positively skewed ones. As Dr. Kärki stresses above, volatility-based "risk measures" miss the true investment position risks, which by their very nature lie in the tails of highly non-normal distributions: "Also from expected return or premia point of view," he adds, "the standard deviation (volatility) is not a risk factor and, therefore, bearing it will not result in higher returns. The (equity) risk premia derives from the possibility of adverse tail events and how much such events hurt investors, not from volatility. It is well documented that low volatility portfolios tend to outperform higher volatility portfolios. For us, volatility is neither an enemy, nor a coherent risk measure. It is a good friend creating value adding opportunities."

"Furthermore, for these 'fat tail' distributions linear correlation is neither an applicable nor a useful concept," Dr. Kärki continues. "For portfolio risk mitigation, it is more effective if the portfolio is constructed in such a manner that the co-concurrence of such tail events in the portfolio is minimised. These tail co-dependencies tend to be highly time-varying and are notoriously difficult to gauge but 'bearing one's head in the sand' can lead to major destruction of investors' capital."

ASYMMETRICAL THINKING FOR ASYMMETRICAL TIMES

Finally, the concept of diversification, which is widely used in the insurance world and generally known as 'pooling,' does not work in the financial world. "In investments, diversification only works when it is not needed; when it is needed, it doesn't work," says Dr. Kärki. In the insurance world, 'pooling' across a large number of policy holders that are by and large independent processes, works due to the 'law of large numbers'. In the financial world, however, there are only a limited number of security positions in a portfolio, and their price processes are not independent. On the contrary, in certain circumstances they can be highly co-dependent, driven by third factors like lack of liquidity or lack of market confidence, so the 'pooling' does not work like it would in the insurance world. "The setback of diversification was clearly demonstrated during the crisis of 2008, when the values of many portfolio constituents 'fell off the bed at the same time'," Dr. Kärki recaps.

In the currently challenging markets, therefore, investors need fresh new ideas and approaches. "We see all investment and trading as exchanging future return distributions to other more favourable distributions. Our starting point is that the entire market is full of asymmetries and imperfections: not only are all return distributions asymmetrical, but so are also investors' preferences and risk tolerances, available information and investors' ability to act on it."

Consequently, today's successful investor needs fresh and even lateral thinking: fresh "horses for courses," as Dr. Kärki puts it. "Premium harvesting, factor investing and tilting, alpha return capturing, alpha-beta separation (also in fee structuring), cost cutting, proper tail risk management and aligning interests are a good starting point," he concludes.

Jaakko P. Kärki

PhD (Finance, LBS), MPhil and MSc (Econ), UK ICM, CAIA TM (2002-2015)

CEO/CIO and Founding Partner of BWAI Ltd in Helsinki and London

NOKIA – FINLAND'S SACRED PHONEHENGE

By David J. Cord

For more than twenty years Nokia dominated the Finnish economy and capital markets. That legacy runs deep. Even today Finnish publications display Nokia's share price on their front page, alongside major financial indicators like Euribor, Euro-Dollar exchange rates and stock market indices.

At their height Nokia wielded enormous influence over Finland. They could – and did – convince Finland to change laws or enter treaties to benefit their business. I don't know who could get a call through to the Finnish Prime Minister no questions asked – maybe Vladimir Putin and Barrack Obama – but Nokia's chairman was undoubtedly one of them.

"Nokia contributed 23% of all corporate taxes in Finland and made up 70% of the entire capitalisation of the Helsinki stock market."

The company contributed 23% of all corporate taxes in the country and made up 70% of the entire capitalisation of the Helsinki stock market. They were directly responsible for over 2% of all jobs and were indirectly responsible for quite a bit more.

Things are certainly different now, but even though Nokia is no longer the largest company in Finland it remains the most important for international investors. The story of Nokia's rise, fall and miraculous recovery is, in many ways, a story of Finland's economy and capital markets.

SUICIDAL CEO

At the end of the 1980s Nokia was known as a forestry company, which it had been for the previous 120 years. It made more than paper, though. It made industrial chemicals, cables, tires, rubber boots, televisions and computers. In polite terminology Nokia was a conglomerate, but calling it a medusa is more apt. All the different heads moved and hissed at their own will.

The head of Consumer Electronics even decided to leave Finland altogether and set up a semi-independent fiefdom in Geneva. Other executives fought bitterly among themselves.

The CEO Kari Kairamo had even more problems than rebellious executives. The main owners were two banks whose heads hated each other intensely and refused to agree on anything just as a matter of principle. This sounds bad, but in reality it was even worse. Kairamo eventually hung himself.

OLLILA AND MOBILE TELECOM

Finally fed up with the infighting, a coalition was formed. One of the banks sold off their stake, and the remaining bank worked with other owners to get things under control. They fired rebellious or incompetent executives and cleaned out the board of directions. Jorma Ollila was crowned CEO.

Ollila saw the future in mobile telecommunications. He shuttered or sold off everything except Mobile Phones and Networks. The old forestry company which had turned into a conglomerate had now moved to telecommunications, just at the perfect time. 2G was taking off, taking digital mobile communications to the masses.

Nokia had begun to view themselves as a European company in the late 1980s, having their shares first listed in Stockholm and then in London, Paris and Frankfurt in rapid succession. Under Ollila they considered themselves as a global company and wanted to attract global investors. They dumped a class of shares which gave control to Finnish institutional investors and listed on the New York Stock Exchange. Business was booming and practically every day international investors came to Nokia House.

THE MOST VALUABLE EUROPEAN COMPANY

In 1998 Nokia overtook Motorola as the largest mobile phone maker in the world. They were fast, decentralised and pursued growth and market share at all costs. Some years Nokia hired almost every engineering graduate in Finland.

While much of the world considered the end of the 1990s the dot-com era of the stock market, in Finland it was the Nokia era. The public was fascinated by both long-time investors and company executives who became 'Nokia millionaires'. Newspapers were filled with stories of people who had purchased stock in decades past and suddenly discovered they were rich.

"Nokia was indeed the darling of the European tech hype, even becoming the most valuable company on the continent in 2000."

Ollila put great emphasis on shareholder return and used buybacks and splits as much as he could. Nokia was indeed the darling of the European tech hype, even becoming the most valuable company on the continent in 2000.

When the mobile market showed signs of maturing Nokia broadened their offering. They created smartphones, cheap models for emerging markets and specialty phones for particular consumer niches. In addition they focused on efficiency and costs. Nokia centralised power and added more bureaucratic layers to better control operations. They needed these organisational changes at the time, but soon their new structure would become a significant problem.

MURDERED BY APPLE AND GOOGLE

In 2006 Jorma Ollila retired from his active role at Nokia but remained chairman of the board. He was replaced by Olli-Pekka Kallasvuo who dealt with the third great mobile revolution, which was the convergence of multiple devices under the 3G standard.

Nokia successfully guided the additions of cameras, music players and GPS receivers into mobile devices, but the great disruption came from Apple and Google. They offered online content via an integrated experience which was much better than anything Nokia could offer.

The irony is Nokia was not caught by surprise. In fact, they were the ones to help push many of these changes along. One of the main reasons Apple decided to make the iPhone was defensive: Nokia had put MP3-players on their phones to compete against the iPod. The surprising thing was Nokia was unable to execute.

The company had become a consumer products firm, not a player in a high-tech, fast-moving industry. They were bloated and inefficient. It was like an obese person who wastes most of his energy simply pumping blood through the bulk instead of in work and action. To make matters worse their decision making process was hampered by an unwieldy two dimensional organisational structure, and just when they needed to be more agile they bizarrely increased rigidity by adding a third dimension. One engineer determined he reported to fourteen different people.

Another great anecdote is their corporate values. In 1992 six top executives, members of the so-called Dream Team, formulated four simple core beliefs. In 2007 Nokia redefined their values, but this time 10,000 employees participated. The process was a bureaucratic nightmare and the result was watered down. The first value had once been 'customer satisfaction,' but this was changed to 'engaging you,' meaning it was acceptable to simply engage all relevant stakeholders instead of satisfying the person buying your product.

THE EVIL EMPIRE AS A WHITE KNIGHT

Nokia lurched from crisis to crisis until they finally called in Stephen Elop from Microsoft to make changes. He signed a long-term exclusive contract to switch to the Windows operating system, which was doing poorly. Their new strategy had to work because there was no plan B.

That strategy did not work. Nokia had 40% of the smartphone market in 2010 and 3% three years later. Desperate to raise cash, they tried to get hedge funds to buy NSN, their joint project with Siemens in the networks industry. But network infrastructure requires massive capital the hedge funds would not provide. They did like Nokia's enormous library of patents, but didn't like Nokia's asking price.

"Finns still had faith in Nokia, if few others did. Over 7% of all households held Nokia stock and rode the downward slide."

Credit ratings agencies placed their debt in junk status and Nokia had to offer high interest on a convertible bonds issue. The big mutual funds began to sell off much of their stakes, which were picked up by Finnish households. Finns still had faith in Nokia, if few others did. Over 7% of all households held Nokia stock and rode the downward slide.

Finally the inevitable happened. Nokia bought the rest of the networks business and sold the mobile devices division to Microsoft. It was the end of an era. The very word 'Nokia' had once been synonymous with mobile phones. But just like it had done in the past, Nokia reinvented itself once again.

NOKIA TODAY

Nokia got an extremely good deal for their Devices & Services division. In the spring of 2014 Microsoft completed the purchase for a final cost of $9.5 billion. Within a year they had written off almost the entire amount as a loss. They couldn't sell mobile devices any better than Nokia could at the end.
But Nokia now had billions in excess cash to focus on the mobile network infrastructure business. A few hedge funds which specialised in change management and special situations took stakes in the company and profited as debt was written off, credit ratings improved, and a big chunk of money was returned to owners. New CEO Rajeev Suri still had enough left over to buy Alcatel-Lucent and become the second largest company in the networks industry.

Nokia is profitable again, but its influence has waned. Ten years ago Nokia employed about 24,000 people in Finland. Now they have 5,400. Still, a money-making smaller company is better than a bankrupt large one. Nokia remains a potent force in the telecom industry and in Finland. They have also not promised to stay out of mobile devices in the future, and the public is eager to learn what they will do next.

About the author

David J. Cord is the author of The Decline and Fall of Nokia, Dead Romans and Mohamed 2.0. He has been published in nine languages. The second edition of The Decline and Fall of Nokia is being released in the spring of 2016.

CORPORATE GOVERNANCE – IN FINLAND AND THE NORDIC REGION

by Pirkko Juntunen – HedgeNordic

The Nordic region often punches above its weight when it comes to various global lifestyle and economic rankings. For its size, it also has a wide range of global companies from cars, design, furniture, technology and machinery sectors. So what makes Nordic companies successful?

Some argue that the culture of consensus-based decision making, transparency and political stability are part of the success and that this has translated into the way companies are managed. Perhaps the time has come for the world to take note of the Nordic way of corporate governance, rather than just for its design, music and flat-pack furniture.

Friederike Helfer, partner at Cevian Capital, the activist investor, is of the opinion that Finland and the other Nordics could teach the world a few things about good governance and is urging institutional investors such as pension funds to step up to the task. Talking of her experience on Nordic boards, including recently on the board of Valmet, the Finnish developer and supplier of technology and automation systems and services for the pulp, paper and energy industries, Helfer explains some of the advantages of the Nordic way.

> **"The style of governance is unsurprisingly directly a reflection of the culture and in Finland this tends to be fairly monosyllabic and true to the saying of 'say what you mean and mean what you say'."**

The style of governance is unsurprisingly directly a reflection of the culture and in Finland this tends to be fairly monosyllabic and true to the saying of 'say what you mean and mean what you say'. Helfer said subtlety is not understood and directness is appreciated and respected. Out of the Nordic countries Finland is the most hierarchical whereas the Swedes discuss everything perpetually. "Being Austrian and having worked in Switzerland most of my career I can clearly see distinct differences. The Swiss do not exaggerate and are careful with words but careful to the extent that criticism might not be heard. Germans are more direct and blunt and employees appreciate a leader that takes charge. They would be at a loss with a Swedish-consensus seeking boss," she explained.

"The first distinctive feature in the Nordics is the pronounced ownership mentality. There is a high private share ownership rate – a large majority of Swedes own shares, for instance. In addition, there is a history of "spheres" which own 15-20% of total Swedish Stock Exchange, and most of the largest companies have a large private family owner, the biggest and most well-known being the Wallenbergs", she explained.

In Finland large institutional investors such as Ilmarinen take large stakes in companies thereby making them influential owners.

Another feature is that shareholders determine the board composition directly through nomination committees. The typical Anglo-Saxon model is that boards nominate themselves. In the Nordics, the committee that nominates the board of directors is composed of the four largest shareholders in the register and the chairman of the board. "The biggest differentiator, compared to the Anglo-Saxon world is the clearer feeling of accountability of the board members. The members understand they need to report to the shareholders, rather than to the chairman and the other members," Helfer said.

She also pointed out that the CEO is an employee and not the king, as is often the case in the US, and the Nordic boards take a consensus oriented, pragmatic, meritocratic approach, creating more checks and balances.

Issues in the US or UK, where ownership has become so dispersed that no one actually feels responsible for the long term. "Institutions tend to vote for management or vote with their feet – i.e. sell their stake. This has led to the CEOs of the companies essentially becoming and behaving like kings, even though they should actually be the first employee, but there is nobody left to control them. You read about the downside of these systems every day in the news – exploding remuneration and value-destroying acquisitions, and too much risk-taking for short term profits, as shown by the banks in the run-up to the financial crisis", she explained, adding that the shareholder activism in the US has partially developed as a counter-movement, to rebalance the system. "In Sweden, the Wallenbergs and other spheres have always acted in this counterbalancing way", she said.

> **"Employee representatives are from the company not from a nation-wide union aiming at achieving a greater goal rather than solving the issue at hand. "**

Helfer also said that the co-determination structure is more constructive than in many other countries. "Employee representatives are from the company not from a nation-wide union aiming at achieving a greater goal rather than solving the issue at hand. A negative example is Germany, where national unions such as the IG Metall have representatives on the boards. Those representatives could actually have a very different agenda, strongly influenced by politics or decisions based on principles or ideologies", she said. She compared this with Finland and the case of lay-offs at Valmet. "It is good to have strong unions as long as it is a two-way dialogue with all the parties working for constructive solutions, which was the case at Valmet", Helfer said.

In addition, the Nordic corporate structure tends to be non-hierarchical so there is less need for 'face saving', she explained. "The boss doesn't need to have all the answers, doesn't need to be always right, so there are less ego driven fights for power in contrast to the US where the CEO is the Chairman, who is the one who rules", she said.

"The established discussion culture makes sure every voice on the table is heard. This is good for board dynamics as everybody is encouraged to speak up and importance is placed on that the board is not composed of yes-men and box tickers." she added, noting discussions do not slow down corporate decision-making.

Another reflection of society on boards is equality, even if there is still a way to go, Helfer said. Legislation has forced boards in Norway to take on more women and other countries are considering similar steps. "It is often a generational issue. I know this from my work on the Valmet board, which is a male-dominated, traditional company. The older men may think you are less qualified because of your age, not just gender. I would say it is equally hard for a man under 40 as it is for a woman in general to get heard. Being on a board can be brutal and if you are seen as less qualified it will be noticeable. You just have to be persistent and make yourself heard," she said, adding that having a strong backer, i.e. Cevian with a 14% stake in Valmet at the time, helped.

Despite the many positives, issues remain, Helfer said. "In Sweden the dual share classes enable dynasties such as the Wallenbergs to control more companies with limited amount of capital," she added.

Votes could historically be as low as 1:1000, now limited by law to 1:10. "The pro argument for ratio shares is fundamentally that it enables the company to tap international capital markets while at the same time keeping Swedish, long-term ownership and therefore continuity and oversight. Often mentioned is the example of the bad short-term hedge funds that are just in there to make a quick buck. Contra arguments are that it violates the key democratic principle of 1 share 1 vote, making all investors equal and that it protects the incumbent, implying that the incumbent is the better owner. History tells of course that this is not always the case", she explained, pointing to the recent corporate scandals showing that even the incumbents might need some oversight.

Recently Finland has had a difficult time economically but Helfer puts this down to the traditional industries, rather than corporate structures or governance. However, there are still improvements to be made on the corporate governance level too. She said one of the problems comes from the mix of political and economic interests. The Finnish government, through Solidium, is holding big stakes in listed companies. In the cases of Valmet and Metso, Solidium is holding above 10% of shares. "The conflict of interest becomes apparent in discussions whether or not Solidium should be able to invest outside Finland? Should it be able to divest stakes in important companies and who they could potentially sell to," Helfer said, adding that the current discussion focuses on what the purpose or goal of Solidium's involvement is. "It seems the pendulum is swinging more towards the political role/involvement, meaning that the government keeps a controlling stake in companies it defines as key to influence, but disposes of the rest", she noted.

> **"The Nordics remain a very important part and currently Cevian has about 1/3 of its AuM invested in the region. "**

Cevian has its origin in the Nordics and brands itself a constructive activist as opposed to an event-driven or hostile activist investor. Its first fund, Cevian Capital I, was purely focused on the Nordics whereas the second Fund, Cevian Capital II, expanded towards other Northern European Countries, notably Germany and the UK. The Nordics remain a very important part and currently Cevian has about 1/3 of its AuM invested in the region. Cevian's disclosed investments in the Nordics include Danske Bank, Volvo Trucks, Tieto, Metso, and Valmet. The two founding partners are Swedish and have learned their nuts and bolts about investing and have developed their strategy in a Nordic corporate governance environment. Cevian aims to be the biggest minority shareholder when it takes a stake in a company, Helfer explained.

"We see ourselves as owners of companies who have rights, but also obligations to contribute to the long-term value of the company, which we do through participation in nomination committees and boards. We see our role especially in companies with fragmented ownership that actually lack a committed shareholder. Our own firms culture and our constructive interaction style has been successful", Helfer said, adding that culturally having public fights, i.e. in the media, is not the done thing in Finland.

ABOUT CEVIAN CAPITAL

Cevian Capital is the largest European constructive activist equity manager at about $13bn in AUM:

- Founded by Christer Gardell and Lars Förberg in 2001
- Focused on Northern Europe: Nordics, UK and German speaking parts of Europe
- Holding a concentrated portfolio of 10-15 holdings at one point in time
- No hedging, no leverage, therefore full alignment of incentives with other investors and the company
- Taking significant minority stakes in publicly listed companies, frequently taking board seats in investee companies.
- Strategy is supported by a stable capital structure, where over 90% of the fund AuM is locked for 3 or more years on a rolling basis
- Investment team: 31 investment professionals in Stockholm, Zurich and London offices
- Current investments in the Nordics are Tieto, Metso, Volvo, Danske Bank. Previous investments include Valmet (just exited), Telia Sonera, Intrum Justitia.

Friederike Helfer - Partner
Cevian Capital

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