

# Interview Jarle Birkeland, Alchemy Trading

Stockholm (HedgeNordic) – Jarle Birkeland (pictured) is the founder and portfolio manager of newly launched Norwegian long/short equity fund Alchemy Trading. In an interview with HedgeNordic, Birkeland explains the strategy behind the fund and reveals how his career as a professional football player taught him trading discipline.

**HedgeNordic: How would you describe the fund in a nutshell?**

A: Long short equity fund with a variable bias. Objective is to generate returns of 10-15% with a volatility budget of half that. We treat our cash balance with care and deploying capital when opportunities arise. Turnover is relatively high but varies, dependent on our trading expectancy and portfolio sizing principles engrained in the Kelly Criterion. Trade expectancy is just probability adjusted historical returns of winning versus losing trades. The Kelly Criterion gives guidance on optimal sizing of ideas in portfolios to reduce volatility. Stock selection process is top down and sizing reflects an assessment of risk-adjusted returns of the individual idea. Sizing can be a function of visual confirmation of multiple time frames or conviction in a certain short-term catalyst. Short-term catalysts that combine seasonality and behavioral component often send powerful signals. Fund has a particular knack for capturing alpha from the behavioral bias of local asset allocators. We find it unnecessary to be beta neutral through short positions in index futures or shorts, although recognize pair-trading has been out of favor for quite some time, so never say never.

**HedgeNordic: Is there a long bias in the fund? How much does your net exposure vary?**

A: To a certain extent, the mandate maintains full flexibility within the context of public listed equities and ETFs in the Nordic space. Net exposure has averaged 45%, but overstates the true long bias, as short exposures have tended to be short-term and tactical. Historically, net exposure has had a pretty wide range, from -10% to +80% with gross being capped at 100%.

**HedgeNordic: Why fee structure of 2.5% and 25% above 10% rather than 2/20?**

A: We felt that rather than a 2% and 20% for typical start-ups, 25% above 10% absolute return including watermark would be a good alignment of interests between fiduciary and investors. Most of the investors outside of the 25% held by fiduciaries of Alchemy Trading are high net worth individuals who look for stable returns above a certain benchmark rate of let's say 5%.

**HedgeNordic: Why name the fund Alchemy Trading?**

A: We just want to remind ourselves that remaining flexible and open-minded is a virtue. Especially when things stop working and one needs to reassess the external environment we are in. As for a good metaphorical analogy, there is one in Louis Kevran's empirical observation in the alchemical transformation in chickens. The French physics establishment was reminded of the need to keep an open mind, when Kevran mathematically proofed the free range chickens ability to transform potassium found in the soil into calcium, violating an important assumption in the law of conservation mass.

**HedgeNordic: Tell us more about your background?**

A: As a youngster I'd rather spend my 10 kroner weekly allowance on odds coupon at the local gas station than on candies. I don't recall if there was a lot left for candies after the game week, as it was a totally "try-and-fail" exercise. But it gave me some insight into the nature of staking your odds,

if the intention was to come out positive. Later on, I had a short-lived career as a professional football player in Werder Bremen U23, and several appearances for the Norwegian youth national team. During that timeframe, I got acquainted with the foremost pioneer in Scandinavia for mental training for professional athletes, Frank Beck, who was also from my home town Tønsberg. I received some valuable advice from him on performance endurance and enhancement techniques as a defense player. Being disciplined about certain practice principles in training and the early fascinating for high stakes odds, helped shape my investment philosophy as an aspiring independent trader. We built Alchemy Trading pretty much from scratch through the help of friends and family. We started with our super rigid risk management guidelines, but a flexible approach, trying to reverse engineer what works, rather than adopting a particular category or style. 3.5 years out, our performance ratios are indeed in line with pre-Alchemy returns, in a variable bias long short strategy.

**HedgeNordic: Your strategy focuses on identifying the best risk-reward ideas in liquid stocks in Nordic indices. Can you describe how you identify the best risk-rewards and how do you size those positions?**

A: We start by identifying the most liquid names on a weekly basis from a universe of 300-400 names and assess whether there is anything that stands out as far as visual trends on short, medium and long-term time frames. Any match with historical value-traded bands that visualize large volumes at key areas of support or resistance adds further significance to those time frames as they give an excellent proxy for where liquidity increases or decreases. We believe that liquidity is a great proxy for future multiple expansion or contraction. By identifying these paths of least resistance, we can eke out gains. Sizing of positions reflects levels of conviction. A full weighting in anything is only achieved if there is visual confirmation on multiple time frames or there is a short-term catalyst in the horizon that skews risk-reward significantly during that specific time frame. A catalyst could be anything from a localized theme derived from a global macro/policy action or a buffer from a large dividend payment, amplifying the liquidity in the stock, attracting quantitative flows.

**HedgeNordic: Have you identified a sweet spot where your approach works best, be it geography, a certain sector, market cap or other factors that weigh in?**

A: Mid-cap companies that manage to achieve traction or growth within global market themes in Scandinavia often see hefty bouts of multiple expansions, as local asset allocators replicate each other's portfolios. A qualitative explanatory factor could be a certain tradition of overcoming invisible barriers implicit in the word 'bøygen' that is often used in Nordic folklore. In a modern context, the invisible barrier is the local oligopoly or monopoly. Chances are they either are acquired by the local monopoly protecting their turf, truly has a global edge as local market is too small or often in the shorter time-frames, activist shareholders make tactical changes in the company to increase liquidity.

**HedgeNordic: Can you talk us through your asset allocation, how you identify investment candidates, perform due diligence and determine time and size to enter a position?**

A: We just aggregate the best individual risk-reward setups within our liquidity screenings. Waiting with ample cash for the right opportunities is just important, as they always show up. This requires flexibility. If there is an underlying style bias at all our stock selection, it is a focus on quality companies without balance sheet issues. An example of a 'strong conviction, lightly held' stance within the oil-services sector would be taking an agnostic stance on oil and focusing on seasonality.

Strong appetite to tap capital markets between now and the summer months well ahead of covenant triggers in the third quarter of this year needs to be weighed against seasonal strength going into

May. A return-reversal or short bias pair long BWLPG/ short DETNOR. BWLPG has a favorable balance sheet, long duration contracts and downside support from a hefty dividend payout structure. Meanwhile, DETNOR is invariably incentivized to safeguard any uncertainty in their upcoming covenant negotiations by shoring its capital structure. Another incentive is that It already reflects a hefty takeover premium and a NAV that reflects a forward curve oil price going all the way to like year 2025.

**HedgeNordic: Could you elaborate on the pros and cons of maintaining a fairly large cash position?**

A: There is no target on maintaining a certain cash level. Whether the portfolio construction has a variable long or short bias is fairly arbitrary, as it's a summation of best individual risk-adjusted returns. Having a multiple time framework and combining short-term catalysts allowed us to be selective and as a direct consequence emphasizes IRR on capital deployed. A volatility environment should favor a lower volatility profiles like ours over ultra-low volatility strategies that rely on more leverage. Au contraire, a challenging liquidity environment implies less multiple expansions opportunities. Calibrating this strategy for declining liquidity trend with short biased setups with contrarianism is not easy. Whether that can be combined with a mandate for capital preservation is open question.

**HedgeNordic: What are the specific risk factors you see for an investor investing in your strategy in general. Can you walk through your risk management process?**

A: Our process focuses on maintaining a trading expectancy where wins exceed losses by a factor of two. With a trade of +1,5% per trade and a win rate of 44%, the average gain and loss on a trade is 8% and -3%. We reduce gross exposure substantially after moderate drawdowns, whether it's through cutting individual positions with low weightings or top slicing the holdings in the portfolio as a whole. One risk management guideline we use is mathematician Ed Thorpe's adaptation of the Kelly Criterion we mentioned earlier. You put yourself in a 'gamblers shoes' or in my case an 'athletes shoes' use the handicap to size your positions. Thorpe figured out that halving your maximum bet sizes derived from the Kelly Criterion reduced volatility of returns by 75%. It's not perfect, but some very successful fiduciaries of external mandates use it. We like to think that there are similarities to guidelines Mr. Freeman-Shor of Old Mutual uses to select his managers. He tracks their ability to run concentrated portfolios of 10 names, maintaining a positive trade expectancy (no large drawdowns) combined with 1 or maximum 2 outsized gains.

**HedgeNordic: How do you manage the fund's risk level and what are your active decisions based on?**

A: When I initiate an idea based on a theme, I start out with a 1-2% allocation and apply a stop-loss with a time-limit qualification. That may mean exiting the position at the end of the session or by the end of the week. If it is working, I will add a bit more. If there is an edge in identifying a short-term catalyst that local asset allocators not discount because of their behavioral biases, I will add a lot more. We generally rule, we try to limit the number of concentrated bets within a theme and calibrate gross exposure dynamically by trading liquid blue-chips. That helps reduce large drawdowns during large market dislocations. The overriding long-term goal here is to keep a high Calmar Ratio, defined as historical average returns / maximum drawdown. The better our accumulated returns for the year, the more buffer to take on more risk and vice-versa. In volatile and tactically driven markets, we keep leverage even lower and focus on maintaining our trade expectancy metrics. We are just talking possibilities and probabilities here, but calibrating between a selective portfolio composition of 10 shorts and 5 longs with weights of 2-3% and 3-4% and 10 longs and 5 shorts of 4-5% and 2-3% weighting safeguards the volatility budget. Back-testing our

trade expectancy on our shorts shows that they are accretive. There is some comfort in knowing that the difference in the expectancy with our longs can be largely explained by the relative average holding periods.

**HedgeNordic: How do you determine the size and position and define the duration of the investment?**

A: Sizing varies significantly between 1 to 15% with 0 to 15 names in the portfolio. The average holding over the years is 13, but we try keep the tally as systematic as possible, based on measurements of conviction. Average holding period of our best ideas can exceed a year, just like a best idea in Old Mutual best idea portfolio. One idea captured close to a 100% return in 2015 with a 6% average weighting helped an otherwise tough year of grinding markets in 2015. Still, only 5% of our ideas see realized gains of more than 20% and less than 1% of our ideas see realized losses exceeding 10%. We have an ADP on longs of 27 days on gains and 5 days on losses. ADP on shorts of 5 days on gains and 4 days on losses. Since ADP of shorts is much shorter, we can see where there is room for improvement.

**HedgeNordic: You have 2 risk profiles for your fund. One which limits gross exposure to 100%, the other which can use leverage to reach a gross exposure to 200%. Could you explain the differences between the 2 risk profiles for investors.**

A: We found relatively early on through back-testing results that increasing the gross exposure exclusively to the periods when highest conviction setups exceeded 100% of gross as a result of our allocation process, investors who were willing to accept moderate risk profiles could enhanced returns substantially. A minority of investors have chosen to keep this enhanced risk profile where gross exposure can be taken to 200%.

**HedgeNordic: Aren't you a trend follower? How do you make returns when market are not trending? How do you trade sideways / grinding markets / whipsawing markets?**

A: Trend followers may place less emphasis on fundamentals and valuations on a standalone basis. For us, fundamentals weigh heavily in our assessment on higher conviction ideas. Like trend followers, we value good entry point because it keeps our trade expectancy relatively consistent. Being early makes it difficult to be compatible with a given volatility budget. Historically, the preference is to allow for benchmark indexes to make their move and settle first without taking too much risk. Avoiding large air pockets of volatility and assessing levels where liquidity is on your side makes things simpler. Use contrarian indicators such as sentiment and breadth indicators to time return-reversal price action systematically seems complicated. We do try to empirically test breadth at key resistance or support levels where there is a lot of historical volume. Having the right mindset and trading philosophy we feel it is crucial. The probabilistic approach to assessing risk reward of individual ideas rather than timing market directions is more compatible with this. In a world of Facebook and Twitter, 'strong opinions' on anything outside of the long game is easy faded. We routinely go through the same mental exercise, assigning probabilities on a certain action affects outcomes. Still avoiding pride in our own analysis when something comes along and disproves it is so much more important.

**HedgeNordic: Is there a home bias in your exposures is the country exposure a reflection of the difference in the market capitalization between countries in the Nordics?**

A: Sure. Our investment process is fairly straight-forward in that a top-down identification process of identifying positively skewed risk-returns is focused on the most liquid securities. There are many more attractive risk-reward setups on medium-term timeframes than short-term timeframes, many of

which currently exist in blue-chips across all Nordic regions, particularly in Sweden if benchmark indices are allowed to correct to such levels.

**HedgeNordic: What is the current strength of your forecasting signals, what kind of market environment is the models telling you lies ahead?**

A: It's easier to predict how local market participants will behave over the coming period against a backdrop of strong seasonality in stats that tell you that you are supposed to sell in May and go away. Many overseas investment managers used to often joke around that Norway is the land of cream and honey. We don't hear that much anymore, but we still stick to our long summer holidays. The incentive for energy and oil service companies to make the most out of the pre May 17th window to shore up their capital structure is stronger than most other regions. Quantitative strategies may not be discounting the esoteric risks of how credit ratings will react to continued poor fundamentals.