Market Neutral and Volatility Strategies Under the Spotlight

(HedgeNordic) – The Nordic Hedge Award has been recognising the best Nordic hedge fund managers every year since 2012. After a quantitative screening finds the nominees in each category, a jury composed of Nordic institutional investors determines the winner. The jury's selection criteria go beyond numbers, by taking into account other elements that investors typically consider, such as reputation or fund organisation. We have asked two of this year's Nordic Hedge Award jury members to share their personal view on what they look at when making an investment decision in a hedge fund. Claudia Stanghellini, Head of external management at Swedish National pension fund AP3, and Malin Hallén, Senior Portfolio Manager, Manager Selection at Swedbank Robur, have accepted to answer our questions.

When considering a hedge fund, the first question is how the strategy fits within the firm's broader asset allocation. For example, AP3 excludes directional managers from its hedge fund allocation. "We don't want to pay for beta at hedge fund prices," justifies Stanghellini. "Hedge funds should not correlate with the equity market to be part of our absolute-return bucket." In addition to external hedge funds, AP3 also includes its internal alpha strategies, which are in-house long/short hedge fund mandates, as well as risk-premia strategies, in the absolute-return section of its overall portfolio. "Some people assign risk premia to the beta allocation of their portfolio, but we don't. But it depends on what type of risk premia you choose and we try also to build a risk-premia portfolio which is uncorrelated to the market. Currently, we have more risk allocated to these strategies than to hedge funds, as we are looking to harvest risk premia in the long-term."

At Swedbank Robur, portfolio construction is, of course, crucial, explains Hallén. "It is a mix of art and science," she says. "Our hedge fund allocation is primarily included to add diversification but also value to our traditional asset classes. Our view of the market will determine how much we allocate to each bucket. The hedge fund portion of the portfolio has to fit with what the rest of the portfolio looks like." Currently, the hedge fund selection consists mostly of absolute return strategies such as equity market neutral and trend following strategies. "Within a strategy, the weights of the different funds are adjusted depending on our conviction, and on the correlation, they have with the other hedge funds in the portfolio, as well as the portfolio as a whole for example. In general, we want our holdings to complement one another in terms of investment strategy, approach and performance and risk patterns and so forth."

Numbers are evidently paramount in any manager selection process, but for both Stanghellini and Hallén, there is more to it than a mere quantitative screening. "There isn't a single most important factor," starts Hallén. "They all need to make sense, and we need to acquire a conviction in the management process, as well as the organisation behind the fund. The most important is the quality and the experience of the team. Once we have assessed that, the rest is more likely to follow."

At AP3, Stanghellini reminds us, the "4Ps" are a guiding principle. " People, Process, Performance and Protection, these are the first things we consider. Practically, we like to see at least three years of track record, because we want to see how the managers handle drawdowns and risk. They must show that they have control of their portfolio in a stressed market. We don't look for the next hedge fund stars who will produce 50 percent performance in one year with painful drawdowns when markets move against them. We want to have a fund with stable performance, that is mostly alpha. Our managers must have the ability to deliver on target given their mandate. Cost is an important consideration in our overall portfolio strategy, and a hedge fund's fee structure must be in line with our means." In addition to the actual selection criteria, AP3 also looks for a long-term strategic partnership with its hedge fund managers, Stanghellini reveals. "We select skilled managers in niche markets. At the same time, we want to grow our capabilities internally and look for managers that are open to share and discuss research, investment ideas and market views with us. We like knowledge sharing."

Hallén mentions a new consideration in her selection process. "This may not be the most important criteria right now, but it has become more prominent in our manager selection process. We have added sustainability to our due diligence process a couple of years ago. It is a factor we take into consideration. We favour managers that have signed the PRI and incorporate those principles on a day-to-day basis. We are aware that it is easier for some strategies, such as equity long/short, than for others like trend followers. Hedge funds have started incorporating sustainable investing practices across the board; the change is happening as we speak, and we are happy to see that."

Concretely, Stanghellini and Hallén are looking for hedge fund strategies that complement their firm's portfolio, and therefore they need to be de-correlated from traditional asset classes. "We don't cover all the styles," says Stanghellini. "We have selected some strategies, such as global macro and CTA, niche long/short structured credit, or even emerging market hedge funds. We try to find strategies that fit into the wider allocation, and that we cannot manage internally because we don't have the expertise or the scale." Stanghellini concurs with Hallén's view.

"In strong beta markets," Stanghellini continues, "interesting managers are those that are more market neutral. Volatility strategies are also interesting, even though they are getting crowded perhaps. It is still a niche space." At Swedbank, volatility strategies have also been part of the portfolio. "Our long volatility position paid off in the recent market downturn. This type of market is notoriously difficult to navigate, especially for CTAs and trend followers. There is one fund however which distinguished itself during the recent turmoil, a Nordic shorter-term trend following strategy, Estlander & Partners Freedom. All our CTA positions had negative performance during the turmoil, but this one was down less than one percent. Among our market-neutral positions, on average the performance was slightly negative, but a bright spot was Pictet Asset Management's Agora fund. It has managed to deliver a consistently positive return, even in choppy markets."

Both Hallén and Stanghellini believe in long-term commitments once they have invested with any given manager, provided things pan out as expected of course. "Our holding time is long-term if the manager is on target," says Stanghellini. "We target high single digits for volatility around or over 10 percent, and a Sharpe ratio of at least 0.7 for each of the funds."

Swedbank Robur has gradually integrated hedge funds into its portfolio since 2012. "We have not exited that many of our investments, to be honest," says Hallén. "In some cases, we did, because the fund didn't fit into our portfolio construction, or because we saw better opportunities elsewhere. Our shortest holding period was one year; the fund didn't live up to our expectations, but there were several other factors at play. It was an exception."

This article is part of HedgeNordic's Industry Report on Nordic Hedge Funds 2018. Download the full report here!