

# An Opportunity for a Market Neutral Strategy

Stockholm (HedgeNordic) – At Sector Asset Management, Norway's largest independent hedge fund platform, one key to a successful strategy is the wide dispersion of returns within a particular market. Sector Healthcare Fund, the firm's market neutral healthcare strategy has achieved excellent risk-adjusted results since its inception in 2005. A little less than a year ago, Sector launched a Consumer Market Neutral fund, with a PM previously with the healthcare team. Mads Andreassen, the PM for Sector Consumer Fund started as an analyst within the healthcare team in 2007 and later became responsible for the generic pharmaceutical book. We had the opportunity to talk with him and understand the rationale behind his strategy, and how he expects the consumer market's return dispersion to evolve and potentially generate performance.

"There are areas where the two sectors overlap," Andreassen starts. "Some consumer product manufacturers might have a healthcare division, and some pharma conglomerates have a consumer division. Based on my previous experience I believe it is possible to apply a similar type of analysis to the consumer products companies as we did in the generics book."

The Sector Consumer Fund focuses on large and liquid companies in the developed world, both in the consumer staples and consumer discretionary industries. "We believe there are more than enough opportunities amongst consumer product companies alone to make an exciting investment universe and build a robust portfolio," adds Andreassen.

Andreassen believes that the dispersion in the fund universe makes it an attractive sector to implement a market neutral strategy. "We measure dispersion by calculating the standard deviation of all the returns of the companies within our universe. Historically, this number has been just below the return dispersion of healthcare sector, but it is more than enough to be an attractive market for this type of strategy," he explains. "We also monitor the evolution of this figure over time, and it has been relatively stable in the last couple of years, but we expect that it will increase."

There are a couple of reasons why consumer product manufacturers are likely to see higher dispersion. "Firstly, we are coming out of a period of low interest rates, where some consumer stocks have served as bond proxies. We believe that is coming to an end. Secondly, the 'global brand titans' are likely to enter more rough seas, as emerging competition and private labels will challenge their historically healthy top-line growth. We envision that the difference between performance of the winners and the losers will increase and that is a situation where we can find exciting opportunities for our strategy."

The times for new innovative consumer product companies to capture market share from the larger incumbents have never been as promising as they are today. Barriers to entry are lower than ever, thanks to shifting consumer behaviour, and new distribution channels. "We have always had shifting consumer preferences, but nowadays the changes are happening more rapidly," says Andreassen. "Brand loyalty is decreasing. This does not mean that we as consumers are less brand conscious, but we are seeing an increasing willingness to try new brands. Over time, this will challenge traditional brand investment strategies and product life cycles will contract."

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Smaller brands access to the marketplace has changed radically. Online distribution channels, such as Amazon provides new brands with an instant global selling platform. Before, a new product was stymied by a few large retailers with limited shelf space. Now with online channels shelf space is no longer a physical barrier. Marketing practices have also changed dramatically. “We are seeing diminishing returns from traditional advertising campaigns, and the purchase process is often much more information driven. Before, a long-earned brand name was what the consumer had to rely on. Now choice often follows a product’s online ratings and feedback. The level of customer engagement is higher both when acquiring a new product, and when providing information to others. “

With interesting underlying sector dynamics, the key to a thriving market neutral strategy resides in the manager’s ability to put its chips on the right numbers. “We build our portfolio through bottom up process with focus on valuation,” Andreassen adds. “Our procedure is very similar to that of the healthcare fund. We also try to minimise exposure to unwanted factors and style tilts, to obtain as pure a bet as possible on valuation.”

Nevertheless, isolating the fund from other factors has been a challenge so far this year. “Currently price momentum is being favoured. We are holding back on some shorts due to the strong momentum we are experiencing. In addition, growth is also attracting interest, and, in our eyes, is currently rewarded disproportionately,” Andreassen says. “At the same time, some names we would like to have on the long side have yet to show much valuation support.”

Based on his experience in the healthcare sector, Andreassen explains that underperforming and undervalued stocks at some point reach a support level. It is a price at which enough investors see a good deal. “The finesse is to identify the value traps from the rest. Before we invest in a company, we always build a fundamental valuation model. We put much work into breaking down the top line into as much granularity as possible. We then value each product or business segment separately and this sum-of-the-parts model is the most important metric in determining whether a stock is a potential long or short candidate.”

Based on this experience Andreassen has made some adjustments to the fund’s exposure instead of fighting the tide. “Our long-term target is 200% gross exposure, with very little market beta,” he says. “Now we have decreased our gross to 150% and reduced our strongest momentum positions on the short side, which reduces our negative exposure to the factor overall. It is a challenge to find undervalued consumer names with strong momentum in the current environment, and we target to only use single names on both sides to hedge our overall exposure. Hence, we expect to have a slight negative momentum exposure over time. It is a trade-off, and we need to ensure that it does not become a dominating factor. Growth, on the other hand, is easier to manage, as we can find candidates on both sides.”