

Inside Hedge's Systematic Approach to Mimicking Insiders

Stockholm (HedgeNordic) – High-ranking executives of public companies are believed to enjoy an informational advantage over investors, analysts and other market participants. The idea, therefore, of making money by piggybacking corporate insiders has long been embraced by money managers. Long/short equity fund Inside Hedge has implemented a systematic approach to mimic certain patterns in corporate insider trading at Swedish listed companies.

In an interview with HedgeNordic, portfolio manager Erik Lidén describes the investment strategy employed by Inside Hedge, explains the quant-driven model behind the strategy and outlines some distinctive features of this vehicle.

A long/short strategy designed to perform best in declining markets

Inside Hedge, the only long/short vehicle in a range of funds managed by Insiderfonder AB, produced an average annual return of 7.2 percent since launching in the June of 2009, but the fund is yet to operate in the market environment it was designed to perform best. According to Lidén, “our long-biased long/short fund was launched in the aftermath of the financial crisis with the aim of outperforming the Swedish stock market with lower risk over rolling five-year periods.” Inside Hedge makes gold- and oil-related investments, which tend to balance returns over long periods of time, and reduces equity market exposure by shorting the largest Swedish stocks not included in the fund's basket of long positions. “We employ a long/short approach to investing, but historically we had a long bias of about 70 percent,” says Lidén.

However, hedging practices tend to have a negative impact on performance in never-ending bull markets. “The stock market has been climbing since the financial crisis, with a brief halt in 2011, so we are still waiting for a period when stocks go out of fashion for real,” says Lidén. “In such a market environment we expect the fund to outperform the market,” he adds. Inside Hedge returned an aggregated 90.9 percent since incepting in June 2009, whereas the OMX Stockholm All Share Index gained 145.1 percent over the same period. As equity markets are running out of fuel, the long/short fund is starting to perform much better in relative terms. Inside Hedge produced a cumulative return of 28.6 percent in the past three years, for instance, compared to a similar return (28.9 percent) for the OMX Stockholm All Share Index.

The Insidermodel behind Inside Hedge's strategy

In Sweden, corporate insiders are defined as members of a company's administrative, management or supervisory body, or other senior executives who have regular access to inside information. All corporate insiders at Swedish public companies are required to report their holdings and transactions to the Finansinspektionen within five working days from the transaction date. Since the Swedish securities regulator makes all insider transactions publicly available to market participants, investors and funds similar to Inside Hedge can mimic the transactions reported on Finansinspektionen's public ledger.

The composition of the fund's basket of long positions is determined by an internally-developed algorithm called the Insidermodel. “The investment process is one hundred percent quant-driven,” states Erik Lidén. “The Insidermodel is a systematic approach containing more than one hundred rules,” says the portfolio manager. The computer-driven systematic algorithm searches for a variety

of profitable patterns in corporate insider trading on the Swedish stock market, but the algorithm mainly focuses on the trades conducted by CEOs, CFOs and Chairmen of Boards. After all, these high-ranking executives have more knowledge and insight concerning the state of their companies and possible future developments within their industries, one should assume.

"We invest in companies where insiders buy in big amounts relative to their previous holdings, and we only invest in sectors where investors have historically outperformed the sector as a whole," explains Lidén. "We also look for big purchases on the part of insiders who have not conducted any trades for a long time," he adds. "The security selection process depends on how positive a company's insiders are based on their trading activity." In addition to publicly available insider trading data, the model also incorporates traditional fundamental value inputs. "The Insidermodel excludes companies with extreme valuations relative to their respective sectors," says Lidén.

The basket of long positions typically includes between 30 to 35 names at any given time. The typical holding period of these investments "ranges from a couple of months to many years." "Since we have a rule-based management, our holding periods are typically shorter," explains Lidén. "The exit process depends on several factors such as relative strengths to insider-signals in other stocks and the relative historical outperformance of insiders in the sector, but our exit decisions are mostly influenced by the trades conducted by corporate insiders at the companies we own," the portfolio manager explains. If the CEO, CFO and the Chairman sell large portions of their stakes, the fund's positions are unloaded as well.