Handelsbanken Hedge Fund Joins the ESG Hunt

Stockholm (HedgeNordic) – More hedge funds and traditional investment funds have been getting an ESG facelift by including sustainability criteria in their investment processes, but few build their strategies centered on environmental, social and governance (ESG) themes. Handelsbanken Hållbarhet Hedge Criteria is an equity market-neutral fund launched by Handelsbanken in early 2018 to exploit opportunities arising due to the fundamental shift in business models caused by sustainability transitions in our economies and societies.

HedgeNordic sat down with lead portfolio manager Viking Kjellström *(pictured)* to understand the strategy employed by Handelsbanken Hållbarhet Hedge Criteria and find out where his team sees opportunities created by the shift towards more sustainable economies and business models.

Sustainability Trend Creates both Disruptions and Opportunities

When assessing the options to expand the suite of absolute return offerings, the Handelsbanken team decided to leverage their expertise in thematic research to meet growing investor interest in sustainability issues and sustainable investment products. As Kjellström describes the thought process that led to the launch, "We are good at thematic research, and ESG is getting a more pronounced place in the research process. Therefore, there should be a way of doing thematic research with an ESG component, and we should be able to combine these in a long/short setting."

The transition to sustainable economies is creating new business models and digging out new sources of value, disrupting unsustainable business models in the process. According to Kjellström, "we see more companies mapping out their businesses according to the 2030 Agenda for Sustainable Development, and as time goes by, we expect businesses to drive their strategies in the direction delineated by the Agenda."

The broader shift towards a more sustainable future does not solely affect business models; an ESG-focus can also lower a company's cost of capital. "We see green bonds affecting supply and demand in the bond market," Kjellström tells HedgeNordic. "It is reasonable to expect a pricing differential or volume differential over time due to the increased focus on sustainable business models," he adds. "The cost of equity for companies with a bad positioning relative to various ESG parameters will see an increase," reckons the lead portfolio manager. "That means the valuations of "bad" companies will go down." Focusing on ESG factors for the sole purposing of pleasing investors is not enough, suggests Kjellström, "we need ESG to manifest itself in the fundamental data as well."

Four Building Blocks to Build an ESG-Focused Market-Neutral Strategy

Handelsbanken Hållbarhet Hedge Criteria uses four main building blocks to form the foundation of its market-neutral strategy: core, case, pairs, and quantamental. The first building block, usually accounting between 20 percent and 70 percent of the fund's assets, consists of quality companies that compound capital owing to their high-returning, sustainable business models. "This block exhibits buy-and-hold characteristics, we can own these companies for years," explains Viking Kjellström.

The second block, meanwhile, houses higher-risk higher-potential investment opportunities. "What differentiates core and case investments is company inherent risk," says Kjellström. "We see a lot of potential in the companies comprising our case block, but these companies are associated with more fundamental risk." The portfolio manager uses TPI Composites, a manufacturer of composite wind turbine blades for the fast-growing wind energy market, as an example of a "case" investment. On the short side, Kjellström points to tobacco stocks. "It takes special care to short tobacco stocks, as they tend to outperform in bear markets," he says. "However, tobacco stocks face significant regulatory risk stemming from the attempt to regulate away flavours, which puts 20-30 percent of earnings before interest and taxes (EBIT) under considerable threat."

In addition to the two blocks above, Handelsbanken Hållbarhet Hedge Criteria runs a quantamental strategy and employs a pair-trading strategy. The pair-trading strategy usually accounts for a smaller portion of the fund's portfolio because it is time- and effort-consuming for a four-member team to find many lucrative pairing opportunities. The quantamental strategy, meanwhile, is a balanced long/short quantitative multi-factor strategy with a strong momentum component. "The strategy is not price-momentum per se," says Kjellström. "It is mostly fundamental-based momentum, but it includes other inputs including valuations and various factors of risk such as leverage," he adds.

Discretionary Approach to Allocate Across Building Blocks

"We have a discretionary view on the market as well," says Viking Kjellström, which means the allocation to the just-mentioned four building blocks shifts over time. "We have been bearish since the summer," which prompted the team running Handelsbanken Hållbarhet Hedge Criteria to take off the momentum-driven strategy completely as struggling deep-value companies started to perform strongly. With the rotation from strong-but-expensive high-growing companies to cheaper value stocks still ongoing, Kjellström and his team are waiting to put the quantamental strategy back on after the financial results for the fourth quarter start piling in. After all, "the model depends on the input."

Because of this discretionary market view, the fund's net market exposure can range between plus and minus 20 percent. "We want to generate more alpha than beta," says Kjellström. "Since beta is not a stable estimate, our market exposure ranges between plus and minus 10 percent, and then we allow for an additional ten percent for a directional bet," he adds.

Viking Kjellström is the lead portfolio manager of Handelsbanken Hållbarhet Hedge Criteria, assisted by two quants, Lars Lundqvist and Fredrik Leffler, and sustainability analyst Simon Park. Kjellström took over the management of the ESG-focused fund in mid-September after the former lead portfolio manager agreed to end his journey with the fund after suffering a sustained period of underperformance since launching the fund in February.