

Business-Owner Mindset Helps Sit Through Downturns

Stockholm (HedgeNordic) – Norwegian long/short equity fund Borea Global Equities earned an average compound return of 14.4 percent since inception, ranking among the top five best performers of all up and running members of the Nordic Hedge Index (NHX). A great deal of that success is down to the team's focus on buying mispriced businesses with long-lasting competitive advantages that function as compounding machines. But equally, it is about having a rooted business-owner and long-term-oriented mindset rather than a short-term focus.

In an interview with HedgeNordic, portfolio manager Kjetil Nyland (*pictured*) explains why their team focuses on finding high-quality businesses, defines which investment opportunities they find suitable, and explains how their investing experience in fixed-income markets helps identify short opportunities in equity markets.

Borea's Business-Owner Mindset Favors Great Companies

As bottom-up investors, the three members of the team running Borea Global Equities have a clear understanding of what companies match the criteria for inclusion in their concentrated portfolio, which usually hosts between 10 and 15 companies. According to Nyland, "we want to own companies that can defy capitalism by delivering returns on invested capital above their cost of capital over an extended period, both proven historically, but more importantly, continuing to do so in the future."

Borea Global Equities prefers to "fish in industries and among business models that naturally lend themselves to good business economics" according to Nyland. "By good business economics, we mean high returns on both existing and new capital employed, solid market positions, rational capital allocation and a long runway for profitable growth," he adds.

Borea Global Equities attempts to identify and invest in high-quality businesses at discounted valuations. As the portfolio manager tells HedgeNordic, "we want to familiarize ourselves with the "crème de la crème" of businesses out there, with Europe as our home turf, and do most of the work upfront and then wait for the market to present a favorable price." Company-specific news, general market declines, forced selling on the part of large investors, or many other reasons may, at times, allow long-term-oriented investors to build up positions in high-quality businesses at attractive prices.

The team at Borea Global Equities maintains a list of companies they would like to own at the right price and is ready to invest heavily when good bargains become available. "A good starting point and fertile hunting grounds for good ideas, in general, have been markets, sectors or geographies with a strong negative backdrop of some kind; it could be an index-specific dislocation where great companies are shot by association despite an entirely different set of value drivers," Nyland describes the fund's idea generation process.

"We like to label these type of situations as "perception gaps," where essentially the price mechanism for public companies breaks down and Mr. Market shows its beauty compared to private markets," Nyland adds. Rather than focusing solely on buying stock cheaply, the team attempts to find "competitively positioned businesses compounding intrinsic value at high-teens internal rates of return, preferably using a modest amount of debt" according to Nyland. "If cheapness is your

primary and only filter for sourcing ideas, you may eventually get multiple expansion, which is fine, but often you end up losing in the long-run because of weakening fundamentals and bad capital allocation," he continues.

Borea's Diverse Toolkit

Because of the bottom-up focus, Borea Global Equities does not target a specific gross or net exposure. "Our exposure at any given time is the residual of the number of opportunities we can identify both on the long and short side," Kjetil Nyland tells HedgeNordic. In addition to the concentrated portfolio of long positions, the fund typically holds no more than five short positions. "We generally do not short based on valuation alone," Nyland says about their approach to shorting, adding that "we typically only get involved on the short side if we see a stretched balance sheet and a specific catalyst in place, combined with a lofty valuation."

The team led by CIO Willy Helleland also manages Borea Asset Management's fixed-income hedge fund, Borea Høyrente, which enables them to use their experience in bond investing to find short candidates for the long/short equity vehicle. "Usually the bond market is better at pricing credit risk, and sometimes we find short candidates by comparing how the bond market prices the debt of a company, compared to how the equity is valued," states Nyland. When the team locates discrepancies, they take a more in-depth look at each situation in an attempt to find short candidates.

The team does not constrain themselves to entering long and short positions only. Nyland says they "have quite a flexible toolkit in our arsenal and we use options strategies in certain situations where the overall risk-reward profile looks attractive." The team found long-term equity anticipation securities (LEAPs), or long-dated call options with multi-year duration, quite attractive at least up until the first quarter of last year. "Option-pricing models like Black & Scholes are value-agnostic when it comes to the underlier, and the implicit normal probability distribution assumption does not often reflect the underlying reality of the business, which again provides opportunities, especially when you extend the time horizon," Nyland adds. The Borea team look at LEAPs as "one of many tools which periodically provides cheap non-recourse leverage on a business growing intrinsic value." The team also tracks spin-off opportunities and upcoming index changes, which occasionally offer attractive risk-reward investment opportunities.

Conclusion

As Nyland tells HedgeNordic, Borea Global Equities is "basically sifting the world looking for a handful of extraordinary risk-reward opportunities." The opportunity set for the strategy has been limited in the past two years, with the fund's net market exposure averaging around 70 percent in the past two years and ending 2018 with a net exposure of 79 percent. The relatively high market exposure hurt the fund's performance in the final quarter of last year, which brought its return for the entire year to down 11.7 percent.

The team, however, want to be part-owners of great companies and want to participate in the long-term compounding of intrinsic value rather than engage in in-and-out trading based on changes in investor sentiment. "Due to this approach and having long-term investors, we can afford to sit through downturns," concludes the portfolio manager.