

One Value Strategy, Two Sources of Alpha

Stockholm (HedgeNordic) – Value investing – buying stocks priced cheaply relative to fundamentals – has simply not worked for most investors over the last decade. “If the last ten years have been challenging to the value investor, then the last five have been pure torture,” exclaims Pasi Havia (*pictured*), the portfolio manager of systematic value-focused fund **HCP Quant**.

The fund was launched under the umbrella of Finnish asset manager Helsinki Capital Partners in June of 2014, at a rather difficult time for most value investors. HCP Quant experienced both up and down years since inception, but Havia predicts (and hopes for) a bright future ahead for value investing. “The underperformance of value investing cannot go on forever; things tend to mean revert,” claims Havia.

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One Strategy, Two Sources of Alpha, Perhaps Three

HCP Quant is a quant-heavy systematic value fund managed by Pasi Havia, who, in a previous life, was one of Finland’s most well-known investment bloggers. The fund currently maintains a concentrated portfolio of 20 cheap stocks from all around the world. HCP Quant mainly focuses on small- and mid-cap stocks, because “these segments of equity markets are often under-analysed,” according to Havia. The fund’s investable universe, therefore, covers companies with market capitalisations starting from €100 million up to €10 billion.

“Most companies on stock exchanges are small- and mid-sized companies,” says Havia, who emphasises that his systematic approach of picking stocks enables him to cover the massive universe of small-cap stocks. “This space is under-analysed, which hopefully gives me an edge,” argues the portfolio manager, who has a background in IT and programming. “There are so many professionals doing a really good job at analysing companies in the large-cap space, so my edge is pretty much inexistent in that world using my quantitative strategy,” acknowledges Havia.

In essence, HCP Quant attempts to capture both the so-called “size premium” – which states that smaller-cap stocks outperform large-caps on average over time – and the “value premium.” Furthermore, inexpensiveness is not the sole parameter in HCP Quant’s systematic approach to investing. The fund searches for cheap stocks among a pool of high-quality stocks in the small-cap space.

To define, quantify and identify quality, Havia relies on the so-called Piotroski F-Score. This technique spits out a score between zero and nine that quantifies the strength of a company’s financial position. According to Havia, the Piotroski F-Score “considers nine different characteristics of company fundamentals” such as return on assets, gross margin, asset turnover, among others, where each criterion has a binary value of either one or zero. “I use the Piotroski F-Score as a quality check of the companies I invest in,” explains Havia.

Because the Piotroski F-Score relies on a considerable volume of accounting data, Havia uses a separate technique to check the possibility of earnings manipulation. “I need to be sure that the numbers that I incorporate in the quantitative model are accurate and are not cooked numbers,” says Havia. The portfolio manager uses the Beneish M-Score to safeguard against manipulated

earnings. "Using the Beneish M-Score, which gives the probability of a company cooking its books, I make sure that I can trust the data I am feeding my model with."

From a pool of smaller-sized companies with a Piotroski F-Score between seven and nine, HCP Quant builds a concentrated portfolio of, what he considers, extremely cheap stocks. Companies that pass HCP Quant's investment criteria have low valuation on several metrics such as price-to-earnings, price-to-cash flow, price-to-sales and enterprise value to EBITDA. "In the end, I rank all stocks using one valuation metric," with the cheapest stocks ending up in the concentrated portfolio of between 20 to 30 stocks. The fund's existing portfolio of 20 stocks trades at 4.23 times cash flow, 7.83 times earnings and sports an annualised dividend yield of 5.66 percent. Anyone seen anything cheaper?

Behavioural Biases and Risk Management

Because humans are prone to behavioural biases and some value stocks are "unsexy and look scary," Havia executes his quantitative value investing strategy in a systematic way. "Quite often, we as humans, are the enemies of ourselves," claims Havia. For that reason, the portfolio manager avoids market timing by maintaining a fixed holding period of six months for each position. He also uses equal weightings in the portfolio, arguing that "I am not saying that this stock is better than the other one." Because "I do not attempt to engage in market timing, I partly re-balance the portfolio every month," says Havia. "Every month, I am selling a few stocks and adding a few new ones."

Because there is no discretionary approach to portfolio management at HCP Quant, Havia has a safeguard to reduce volatility in the fund's returns. Specifically, the portfolio manager uses a stop loss of 20 percent that "can trigger a sale even though the position did not stay in the portfolio for six months." As Havia explains, "the reason we ended up using the stop loss is partly because of risk management." If HCP Quant had not used a stop loss, the volatility in the portfolio's returns would have been higher. "The stop loss is an important part of risk management because my portfolio already has high volatility stemming from the small-cap-focus."

Thoughts on Value Investing

For Havia, "value investing means low valuations." There is a wide range of valuation metrics one can look at, "but that does not really matter for me," reckons Havia. "No matter which valuation metrics you used in the past decade, you most probably did not end up delivering good results anyway," he argues.

The underperformance of value stocks is partly attributable to the zero-interest-rate environment, argues Havia, who adds that "there is a lot of cheap money flowing into high-tech companies that can fund research and growth easily." Another reason stems from the growing volume of capital flowing into exchange-traded funds and index funds, which tend to favour large-cap stocks at the expense of smaller-sized companies. "These days so many investors put money into ETFs and index funds without considering valuations," says Havia. "Maybe I am biased because I manage a value investing fund myself, but to me, it is a little bit worrying that there is a huge number of investors who do not really care about valuations."

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"The valuation spread between value and growth stocks is at the same level as during the tech

bubble at the beginning of the century," argues Havia. "I do not know when this gap is going to disappear, but value investing still makes sense." Everything is about probabilities to Havia. He looks at the world through probabilities, and he approaches investing with probabilities. "For me, it is more probable that low-valued stocks will do better than non-value stocks over time," concludes Havia.