

In an Arms Race for Returns

Stockholm (HedgeNordic) – It may sound counterintuitive, almost cynical, that the world's first actively-managed UCITS fund focusing on global defence and security is managed out of peace-loving Sweden, which last went to war in the Swedish-Norwegian War (1814). Sweden was victorious in this war, which led to the Danish king being forced to cede Norway and then a part of Denmark to Sweden. A mere domestic dispute, some may say.

The Global Defence and Security Fund (GDS) launched in February 2019, however, aims to piggyback on the increased awareness and spending for defence and security, be it on a national, corporate or personal level. The products in this field can be as diverse as a security camera you use in your home, or spam filters you use at your workplace to submachine guns and aircraft carriers.

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The fund is managed out of Stockholm by portfolio manager Tor Sinclair (*pictured*), and as the name suggests, rests on two distinct legs in the investment universe: Defence and Security. Defence is arguably the area that brings the most vivid pictures to mind, with military hardware and software. In the security space though, Sinclair argues that “more capital than ever before is being spent on global security, which will benefit companies within this sector.” One area Sinclair highlights is cybersecurity. “Demand for cybersecurity has probably never been greater and cyber expertise is a scarce resource. This means that the premiums that large companies are willing to pay for smaller, more specialized players will skyrocket.

As an investor in cybersecurity companies, we see the opportunity for acquisitions as a spice and a way to take advantage of the explosive growth the industry is facing. The majority of our investments in cybersecurity are certainly made in larger companies, but we have part of the portfolio in smaller and medium-sized players where acquisitions are a probable value driver.” Sinclair has identified around 1,000 companies that make up the fund's investment universe across the defence and security spectrum. Typically, large-cap companies such as Boeing or Raytheon are producers of aircraft, vehicles and other hardware, whereas companies active in software, cybersecurity and similar areas may well be found in the mid- to small-cap space.

Consequently, Global Defence and Security Fund channels at least 51 percent in equity investments with a focus on large-cap companies but may temporarily hold up to 49 percent of its net assets in cash and liquid assets and other similar assets. The statutes also allow for up to 10 percent in non-listed equity “but we have not yet made allocations to non-listed companies,” Sinclair tells HedgeNordic.

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The relatively concentrated portfolio currently consists of 28 companies, with roughly two-thirds of assets “Demand for cybersecurity has probably never been greater and cyber expertise is a scarce resource.” allocated to defence stocks and 35 percent of assets invested in the security area. The portfolio has a dividend yield of about 1.5 percent, which is “not too bad in a negative-yielding

environment". The largest part of the portfolio is made up of companies active in Aerospace & Defence (58.1 percent), followed by IT Services (22.8 percent), and software (4.9 percent). Other areas span Electronic Equipment, Instruments & Components, Computers & Peripherals, as well as Communications Equipment and Industrial Conglomerates.

Despite October looking to be the so far weakest month in the fund's short track record with an indicated decline of 3.25 percent, the fund is up by nearly 11 percent since inception. There is also a case to be made for Global Defence and Security Fund's decorrelation from other portfolios. Typically, in times of geopolitical tensions, escalated terror scenarios or social unrests, investment and spending in security equipment increases.

An experienced investment team with substantial experience from the global security industry, made up of Andreas Wiman, Rainer Korhonen and Mathias Sigvardsson, supports Sinclair in keeping track of developments in the space and evaluating investment cases. "I work with the investment team to identify prospects and sound out investment cases. This combines the traditional fundamental and technical analysis with a qualitative approach that we refer to as Global Intelligence. This is an approach that is applied within the defence industry and a process that Andreas brings from his time in the Swedish Defence Force and Military Intelligence and Security Service."

The investment team meets weekly and covers news and trends. One example Sinclair uses to point out how the interaction with the investment team works was the award by the Swedish Defence Force (FMV) to Raytheon, for its missile defence system Patriot. "There were other companies bidding for this deal with products that could arguably be seen as better and cheaper but FMV selected the Patriot system. While no doubt there are strong and valid arguments for why this equipment was selected by FMV it also increases the likelihood that Swedish defence companies are likely to be the beneficiaries of US defence spending. Saab was up over 10 percent following the TX trainer announcement but the investment team pointed out that this was a very high certainty following the FMV deal."

"We also have an Investment Committee that is comprised of Henrik Sundin (who also acts as the CEO) and Michael Gunnarsson, who review the investment cases put forward by myself and the investment team. The investment team is responsible for the approval process and for ensuring that the investment cases put forward comply with the Screening Policy. The screening policy states, among other things, that companies must comply with United Nations Conventions and Treaties."

The Global Defense and Security Fund is set up under the Finserve umbrella. Other funds within Finserve include Thyra Hedge and Scandinavian Credit Fund, two well-established hedge funds. Asked why Sinclair, given his background and environment at Finserve, does not run GDS as a hedge fund to make use of tools such as shorting, derivatives, leverage and other freedoms, the portfolio manager replied: "We thought about it, and there were some temptations, of course, to run a long/ short equity strategy, or even have a wider mandate. We felt though that the best place to get the strategy started was as a long-only mandate. But who knows what the future holds."

This article featured in HedgeNordic's Special Report on Equity Strategies.