

Iterative Loop and Energy Transition

Stockholm (HedgeNordic) - Launched in the volatile market environment of last year's fourth quarter, the **Proxy Renewable Long/Short Energy** fund has fared well since launching in December 2018. The long/short equity fund under the umbrella of Stockholm-based Proxy P Management gained 23 percent in the first 11 months of its operations after gaining 33 percent in 2019 alone. An 11-month period is too short to judge the performance of a fund, but the fund focused on the megatrend of energy transition, away from fossil fuels managed to give investors a taste of what the fund can do.

Proxy Renewable Long/Short Energy is a long/short equity fund that focuses - as the name suggests - on the renewable energy and energy tech sectors. After closing down their long-biased fund focused on oil and natural gas, the four-member management team at Proxy P Management are putting all their attention and resources on the sustainable energy transition. "We are energy experts who can extract value from the energy transition theme," claims the firm's CEO, Dan Lindström (*pictured*).

The decision to shut down the fund focusing on oil and natural gas and focus on the energy transition thematic fund instead is threefold. First and foremost, "too few investors wanted exposure to oil," explains Lindström. Second, "the opportunity set is much wider in the renewable sector." Lastly, "the renewable energy sector is more diversified," according to Lindström, and "offers us opportunities to find and generate uncorrelated returns." Proxy P's CEO emphasizes that "investing in renewables is nothing new for us, but having a dedicated fund is."

"Growth opportunities can be found in a lot of different areas," emphasizes Lindström. The wind, solar, biomass, and geothermal sectors have all developed in recent years, but "then you also have energy technology" and many other emerging fields. "Renewable energy is a very wide sector, covering everything from installing solar panels and windmills to developing software that improves energy distribution efficiency." Whereas opportunities do exist in the oil and natural gas sector, acknowledges Lindström, that sector "is not a growth case anymore."

Expecting that "there will be gigantic growth and value creation, and gigantic destruction of value," careful stock selection can make the difference between a strong-performing fund and a mediocre one in the renewable energy space. "We have been successful at extracting uncorrelated returns from the sector," says Lindström. Renewable energy stocks have performed strongly in 2019, which partly explains the strong performance of Proxy Renewable Long/Short Energy. "But we are still 15 percent over the benchmark with a market beta of 0.9, and we have outperformed the index in every month when it was down."

Top-Down, Bottom-Up Iterative Loop



Portfolio manager Jonas
Dahlqvist

Because the renewable energy sector has entered a phase of rapid change, the Proxy P team relies on a combination of top-down and bottom-up approach to find today's and tomorrow's winners benefiting from energy transition. "We are chasing growth opportunities related to the energy transition theme, which are experiencing growth for the right reasons," explains portfolio manager Jonas Dahlqvist. Growth for the right reasons stems from existing and future themes in the renewable energy and energy tech sectors, identified by the team's top-down thematic analysis.

"Since energy markets are our expertise and our team has extensive experience in the field, our analysis process starts with a bottom-up approach that involves looking for growing companies." To assess whether companies grow for the right reasons, the team aims to "connect individual companies or a group of companies with a specific theme identified by the top-down approach," explains Dahlqvist. "In the end, we are trying to find growth companies with a strong tie or connection with a specific energy transition theme."

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"There are thousands of companies in the energy transition area - and when you meet them, you are almost tempted sell your house and invest all the money in them," jokes Lindström. "Unfortunately, though, most of them will fail in the end," he acknowledges. The Proxy P team, therefore, invests in companies that are starting to show progress and are experiencing strong growth. Around 90 percent of the fund's holding companies are profitable. As Dahlqvist explains, "we employ deep classical bottom-up analysis and spend a lot of time understanding the growth opportunities of individual companies."

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Despite focusing on finding high-growth opportunities, the quality of a business and valuation are

two other essential aspects the team considers. “We are growth investors, but we pay a lot of attention to the valuation component,” emphasizes Dahlqvist. “Great companies usually do not come cheap,” he adds. “It would be fantastic if we could find the most compelling stories and pay a price-to-earnings of five, but that never happens.” The Proxy P team mostly considers valuation on a relative and historical basis.

The team also spends time analyzing the quality characteristics of a business. “Basically, we are looking at the operating cash flows of individual companies, leverage, and their ESG footprint,” says Dahlqvist. Higher quality companies tend to generate positive operating cash flows and are showing an ability to turn their EBITDA into real cash, according to the CIO. “The quality characteristics are not really driving the performance when everything else looks good,” argues Dahlqvist, “but a portfolio of higher-quality companies will perform better during rainy days than a portfolio with companies that have less impressive quality characteristics.”

As Lindström sums up, “the top-down approach involves analyzing subsidies, regulations, competition, as well as understanding the underlying market and the local set up.” The whole stock selection process, however, represents “an iterative loop where we move from the top-down approach to the bottom-up approach and back.” The process blends a high volume of company-level data with fundamental thematic analysis to capture the success factors of potential winners in the energy transition case.

According to Lindström, one needs to use a top-down approach to understand which companies are most likely to succeed, and within what time frame. “It is important to understand the whole sector.” This iterative loop allows the Proxy P team to build a portfolio consisting of 28 long positions and nine short positions, where most of the shorts are paired with long positions. “We aim to maintain a concentrated portfolio to generate alpha,” says Dahlqvist.

The long and short positions in the fund’s portfolio constitute relative investment opportunities. One such opportunity could involve going long solar stocks and shorting coal producers, “which will be at a disadvantage in the long run as result of the move into renewables,” according to Lindström. However, such a bet could trigger losses “as a pair of that composition can be completely uncorrelated for long periods of time.” Dahlqvist explains that the team tries to “focus on high probability pairs” instead. “Going long the best positioned wind turbine producer and shorting the one that has failed to scale production or technology” represents one such example.

Advanced System for a Truly Global Focus

The origins of Proxy P Management stem from the current team’s time at state-owned energy company Fortum. “The three of us met at Fortum, where I was running a proprietary trading group covering energy commodities,” says Lindström on how he met Hans Berglund and Jonas Dahlqvist. At Fortum, the team also started building and maintaining an “inhouse-developed proprietary portfolio and risk management system that resembles a very advanced database that we can extract almost anything from,” says Lindström.

“The system helps us in everything, from analysis to portfolio management, risk management and sizing of positions.” The reason for building the system was to be able to analyse large quantities of data and enable portfolio managers to focus on where they add the most value. “There is no way one can cover the entire global space as a fundamental and discretionary manager, especially a fast-evolving industry such as the renewable energy space,” says Lindström. “We are a global sector fund. To be able to be global, we need a system that can enable us to be truly global.”

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