Upside Potential is Overrated. Downside Protection Underrated!

Stockholm (HedgeNordic) – Over the past several years, equity markets have been mostly powered by growth stocks, with expensive names becoming even more expensive and cheap stocks becoming even cheaper. Against this backdrop, long-biased long/short value-oriented **Taiga Fund** managed to perform well in the not-so-fertile environment for price-conscious value investors.

Managed by Ola Wessel-Aas *(pictured)* and Andreas Petterøe out of Oslo, Taiga Fund's NOK share class delivered an annualized return of 15.5 percent since launching in May 2008. The duo attained this feat by fixating on limiting downside risk rather than focusing on finding huge upside potential.

Margin of Safety: Taiga's Starting Point

"Margin of safety is where you start out in any investments," claims Wessel-Aas. "What I feel we may be doing differently from many equity-focused fund managers is that we always start with the downside," argues the portfolio manager. One of the attractions of equity investing is the opportunity of virtually unlimited upside. The temptation for some investors, therefore, is to start looking for the greatest upside potential immediately. Taiga Fund, however, does not search for "situations that represent unlimited upside" that simultaneously carry a high risk of loss. Instead, the Taiga team seeks reasonable or attractive upside, yet "the starting point is that we carefully scrutinize cases where the downside is protected," explains Wessel-Aas. "We make sure that investors do not get wiped out – even in a worst-case scenario."

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"It is important for us to understand the business and how the business is structured around a commercial activity, which will determine the results but, not least, the risks associated with producing those results," Wessel-Aas clarifies Taiga's investment approach. When investment opportunities offer a sufficient margin of safety in terms of business risk, "that is when we can start looking for upside." When downside risk is limited, and the valuation and upside potential are attractive, "then that is a safe bet to make."

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"We recognize that we will not know everything about the investments we make, but we have to be aware of the possible risks that can cause our investments not to perform as well as we had been expecting," emphasizes Wessel-Aas. Then the next step of the decision-making process involves "being comfortable that the price we are paying is not expensive relative to those risk factors." The focus on reducing downside risk and taking a sufficiently large margin of safety when making an investment appears to be paramount in managing a concentrated portfolio similar to the one of Taiga Fund.

Concentration and Portfolio Characteristics

Taiga Fund currently maintains a concentrated portfolio of 15 long and ten short positions. Portfolio concentration is an essential pillar of Taiga's investment approach. The long portfolio is mostly comprised of core holdings, defined as high conviction investment ideas. Each of the core holdings, described by Wessel-Aas as positions they have a lot of confidence in, accounts for at least three percent of the fund’s net asset value. The top ten positions generally account for more than half the portfolio, which currently holds 27 percent cash.

Describing the main characteristics of the long portfolio, Wessel-Aas says that “all core holdings are in industries with attractive characteristics, where there are healthy margins to be made and the competition is not very severe.” In addition, “core holdings have a value proposition to their customers, offering products and/or services that are sustainable and attractive over time,” says the portfolio manager, who further points out that “these companies generally have solid balance sheets and produce healthy cash flows.” Last but not least, these businesses should be growing and should “have a reasonable ability to do so going forward.” In a nutshell, Taiga Fund invests in robust companies with sustainable business models that lay the foundations for long term capital appreciation.

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Taiga Fund has a mandate to invest across Europe, but the team is very focused on the Nordic region and small-caps within a “global” context, “which can be fairly large stocks in the Nordics.” From a global perspective, “we maintain a solid small-cap portfolio.” This is a large enough universe for the Taiga team to find businesses with mature business models, operating in healthy industries, maintaining solid balance sheets, producing cash flows and offering a value proposition that is sustainable over time. Taiga’s monitoring list, therefore, comprises around 100 companies, “but only a minority of them are representing value.” If they do become value opportunities, “we should be putting them in our portfolio.”

Approach to Shorting

“The easy way to describe our approach to shorting is to say that we look at the opposite of what we have in our long positions,” explains Wessel-Aas. Yet, there are two fundamental differences in Taiga’s approach to going long versus their shorts. “In the long book, we accept some liquidity risk,” acknowledges the portfolio manager, who adds that liquidity “is the one risk that we can get comfortable with.” This is a temporary risk, according to Wessel-Aas, if one has done an appropriate analysis. In addition, “the criteria for getting a company in the long book is value," reiterates Wessel-Aas. "In the short book, however, we try to minimize liquidity risk, and we do not short for high valuations only."

Short positions are predominantly catalyst driven, with the Taiga team "looking for structurally challenged industries, where companies are exposed to a downturn or challenging market, and where investors have not recognized the most likely development of their businesses and results." The research process for selecting short positions, therefore, involves more industry analysis than the process for picking long positions.

Explaining the difference between longs and shorts, Wessel-Aas says that "in the longs, we typically have one company within a healthy and attractive sector that is the best and structured correctly to capture upside." Therefore, the team does not "take a lot of bets in every industry because we are concentrated, and we ought to be selective." On the short side, "if we recognize that an entire sector is under threat and a number of companies are very vulnerable, we can take sector bets with smaller positions in many companies to reduce liquidity risk." The success to shorting requires a good understanding of how businesses are set up in challenged industries, which allows "you to recognize where equity is extremely vulnerable and allows you to find opportunities where you can make the biggest bang for your buck."

Taiga's Views on Value Investing

"I do not think value investing is a clearly defined strategy," acknowledges Wessel-Aas. The founder of Taiga reckons that "it is the development of business results that drives a stock over time" and value investing involves buying at a cheap value relative to future business prospects. According to Wessel-Aas, "value is something that fundamentally makes sense in that it is the underlying results development of the business that determines the performance."

Some investors are purely looking at valuation metrics relative to historical levels without understanding a business, admits Wessel-Aas. "Value traps are very easy to fall into in that type of strategy if you do not recognize what is going on with the company," he adds.

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Photo taken at HedgeNordic Round Table: [Uncovering Alpha in a “Fat and Flat” Equity Market]