The Pursuit of Perfect Neutrality

Stockholm (HedgeNordic) – Once every few years, a high-caliber Swedish money manager working in the world's largest financial hubs of London and New York is returning to Sweden to start a new adventure on home turf. Jakob Nordestedt, who became a portfolio manager at the young age of 30 at HSBC in London and moved back to Stockholm in 2018, is now running a market-neutral strategy under the umbrella of Nordea Asset Management.

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"I used to run the same strategy in London between 2010 and 2016," Jakob Nordestedt tells HedgeNordic. "After I joined Bodenholm in London in 2017 and one year later in Stockholm, I realized that I wanted to do the same thing I had done before, which is being in charge of my own strategy," says Nordestedt, who joined HSBC Asset Management in May of 2010 as a senior portfolio manager of HSBC's market-neutral HSBC European Alpha Fund. He spun out the strategy into Mojna Capital Partners during the summer of 2013.

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After three years at Mojna and almost two years as a partner at the now-closed Bodenholm, Nordestedt partnered up with Nordea to launch a fund – **Nordea 1 – Global Equity Market Neutral Fund** – that employs the market-neutral strategy he used to run at HSBC and Mojna. "Nordea is known for being a long-term player and there is no pressure to start performing from day one," Nordestedt explains the decision to partner up with Nordea. "When we launched the fund last year, we encountered some challenges getting our factor hedges right, but there was never any pressure. We had the time and the freedom to refine our approach."

Net Neutral, Beta Neutral and Style Factor Neutral

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Building a truly market-neutral strategy is no easy task, as various risk premia may be lurking in disguise and can be mistaken for alpha. "Our key objective is to build a fund that is truly market neutral," says Nordestedt. "The performance should come solely from alpha generation and should not be impacted by any market moves or driven by any factor exposures."

"We are only in the hands of our stock picking. But there are many good stock pickers out there," points out Nordestedt. "I hope I am a good stock picker, but at the end of the day, we do the same bottom-up stock picking work like everyone else," he acknowledges. "What I feel many managers are missing however is that the portfolio construction is super important. The portfolio construction process is key for me."

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"We use a statistical framework where everything is preset to keep market neutrality," explains Nordestedt. The former Bodenholm partner combines two separate market-neutral portfolios, one focused on Europe and one on North America. The individual books are built to be net neutral, beta neutral and style-factor neutral. "Each book is completely market neutral and exhibits a certain risk profile, certain volatility and a certain return profile," says Nordestedt. "Because we target pure alpha in both the European and North American book, the correlation between them is basically zero. The absence of correlation of the two books lowers the overall volatility when the two books are combined."

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Each book is composed of 16-20 long positions and 16-20 shorts, with the size of all positions adjusted for the risk profile of each individual stock and its market capitalization category. Each stock picked by Nordestedt should have the same risk contribution to the overall portfolio. "This is very important for us as our volatility profile will not be sidetracked by being right or wrong in individual stock calls. Instead, we have great visibility on the volatility of the fund," explains Nordestedt.

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"In running Nordea 1 – Global Equity Market Neutral Fund, we target a specific volatility level, rather than a return for the fund. By targeting a yearly volatility of four percent for the fund, we run a constant risk profile that will be independent of market conditions," explains Nordestedt. "Investors buying into this type of product need to know what they are buying and what type of risk profile they are buying into," continues the fund manager. "While we are not committing to a return target, our aim is for the individual books to run a Sharpe ratio of 1, which combined will lead to a Sharpe of 1.5."

Factor Hedging Ain't Easy

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"Once the longs and shorts are in place, we run the individual books through a portfolio management system in order to detect unwarranted style factor exposures," says Nordestedt. "There are a dozen style factors such as momentum, value or size. We are adding between 25-30 names on each side in each book with small weights for each individual stock to neutralize unwanted factor exposure in the overall portfolio," explains the fund manager. "This process makes the portfolio much more predictable, which means that you can run a higher gross exposure and generate more returns by employing more leverage. You don't sit there and worry about a possible rotation in the market."

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Designing and implementing the factor hedging overlay has been an ongoing process for Nordestedt and his team. The original hedging overlay designed for the launch of Nordea 1 – Global Equity Market Neutral Fund encountered some challenges. “Momentum and size are perhaps the most volatile factor exposures,” says Nordestedt. “When we analyzed our portfolio at the beginning, it turned out that we were long momentum on the North American long side and the overall book, so we needed to hedge that out,” he adds. “What we then shorted was work-from-home or COVID-19-related stocks that benefit from the working-from-home trend. But we didn’t realize that these stocks were actually traded on the COVID-19-related news, so every time we had bad COVID-19 news, all the stocks just went through the roof.”

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“We improved our hedging process several times last year,” says Nordestedt. “We excluded certain industries, we added more names and we excluded newly IPO-ed companies, among other things,” adds the fund manager. “Since we implemented the last changes in November last year, the hedging overlay is doing what it should be doing. We reduced the volatility when the risk factors swing in the market, which means that our overall volatility became much more predictable.”