

# All-Weather Sailing

Stockholm (HedgeNordic) – It is inherently essential to catch the upside, but arguably, even more important to protect the downside to achieve long-term wealth accumulation. Downside protection allows a portfolio to spend more time compounding instead of playing catch up by recovering from losses.

“The most solid way to improve long-term compounding is by focusing on mitigating the effects of rough downturns on investor portfolios,” says Martin Estlander, the founder of Finnish systematic asset manager Estlander & Partners. “If you invest and lose 50 percent, you have to gain a hundred percent to make up for the losses,” continues Estlander. “To achieve a good compounding rate of return, you better take care of your dips. That is where you can really make the difference.”

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With Estlander & Partners up-and-running for more than 30 years, the systematic asset manager faced 16 market corrections and bear markets, and we are still counting. “We have seen 16 big dips over the years. Ever since our initial start as market makers in Stockholm in 1987, we understood the importance of downside protection,” says Estlander. “At the end of 1987 in October, we experienced the Black Monday and that was a life-changing experience because we got to see what it means to have the tail protected and what difference downside protection makes,” he continues. “It has always been in our DNA to watch the tail and historically, our best moments have been in situations where the market was coming down. Today we cover our tail with systematic tail-hedging strategies.”

Estlander & Partners’ legacy trend-following strategy AlphaTrend enjoyed 20 consecutive years of positive performance up until 2011. The 20-year period covered the financial crisis of 2007-2008, the busting of the dot-com bubble in the early 2000s, and many other events. The strategy’s best-ever annual performance of about 37 percent was recorded in 2008. With central banks taking their roles as volatility suppressors in chief in the post-2008 era, pure trend-following strategies have not been able to shine again.

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“After the financial crisis, when the central banks and governments embarked on this zero-interest-rate policy, they forced down the volatility and imposed stability on the markets,” explains Estlander. “Pushing down volatility by using all means possible has been challenging for the market structure. That is one of the key reasons why we converted from being a pure trend-follower to a multi-strategy player.”

## All-Weather Sailing

In response to an increasingly-challenging market environment for pure trend-following strategies, Estlander & Partners has developed an “All-weather” philosophy that is now applied in its recently-launched Glacies fund and the older-running Freedom Fund. This “All-weather” philosophy resembles Martin Estlander’s approach to boat sailing. “If you are a sailor and you go out sailing, you want to have a good boat, you have to have a good team to manage the boat, and then you need to be equipped with different types of systems and settings for different weather conditions,” explains Estlander.

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Martin Estlander to the right.

“In fair weather downwind sailing, you take out your spinnaker and enjoy the ride. And if the wind turns against you, you have to take down the spinnaker and do some beating to take a zig-zag course and make progress directly into the wind with a jib,” says Estlander, who has years of experience of competitive sailboat racing. “Then you also need to have your storm sails ready for thunderstorms,” he adds. “Whereas a long-only equity manager, for instance, sails with the spinnaker up all the time regardless of the weather conditions knowing that the fair weather is dominant over time, our approach adapts and applies different sails depending on the weather and thus helps us on our journey of uninterrupted compounding.”

“That is how we approach trading nowadays,” says Estlander. “We have a strong boat. We have a good foundation with the technology that has been developed over many years and the big computing power that we can use to run a lot of simulations. And we have a strong and very experienced team.”

## Same Three Components for Multi-Strategy Funds Freedom and Glacies

Estlander & Partners' "All-weather" approach, applied by both Freedom and Glacies, is designed to navigate three main types of market environments: calm and low-volatility markets; rising volatility and behavioral-driven markets; and chaos or mayhem. "There are three main components of the "All-weather" approach. First, "the calm, normal market conditions are taken care of by econometric models," explains Estlander. "We have a number of different econometric-based carry models for each of the main asset classes like equities bonds, foreign exchange, interest rates, and volatility that work well in risk on-environments."

"Then the second component is the behavioral models, which try to capture investor behavior and react more quickly to market changes," continues Estlander. "This component encompasses a vast set of directional price-driven models, both shorter-term and a little bit longer term, that are long volatility."

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The third component is tail hedging. "The tail hedging involves consistently holding out-of-the-money equity put options in a systematic way, always having cost-efficient exposure that pays off in an equity crisis," explains Estlander. "As an investor, we have to assume that we have not seen our worst trading day yet." The tail hedging strategy is designed to protect the portfolio when that trading day comes. "The tail hedge solution is the outcome of all our knowledge and experience over many years put together to create a "real kicker" for improving the compounding returns," says Estlander. "If properly managed, an equity tail-hedging strategy becomes a profitable bet in addition to serving as great insurance. Now we use it systematically in our multi-strategy funds."

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In early 2019, the Finnish manager expanded its fund range with the launch of Estlander & Partners Glacies AIF, which entirely relies on the "All-weather" approach. Glacies has generated an annualized return of 7.9 percent since launching in February 2019 and is on track for its third consecutive year of positive returns. Glacies returned 4.6 percent in the first quarter of 2020 to end the year up 5.8 percent. Estlander & Partners' longer-running Freedom, meanwhile, has been using a higher risk, higher return version of the "All-weather" approach since 2019. The fund gained almost 13 percent last year and is up 17.3 percent year-to-date through the end of August.

## Process and Execution

"Our econometrics models rely on academically proven, well-known strategies. Many of the econometric models are based on known fundamental drivers," explains Martin Estlander. "We know that volatility is overpriced on average, that dividend yield has a certain return component, that relative-value in bond markets is a good source of return, and that there are term structure phenomena in commodity markets, etc.," he continues. "These are well-known phenomena." Whereas Estlander & Partners may rely on the same models as many other managers, the Finnish asset manager tries to set itself apart "through the way we implement the models, how we execute and how we manage the risk. Because we trade over a hundred thousand times a year, the execution is really key in the process of running this all-weather approach."

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"The process and discipline are everything in this all-weather approach," emphasizes Estlander. "The process and the discipline are the most important part of the journey." Estlander & Partners relies on a so-called "Achilles" risk management, which Estlander describes as a methodology that involves the simulation of a large number of events into the future. The asset manager collects and analyzes tens of millions of data points every day and runs 10 to the power of 84 risk scenario calculations every day, which is more than the total of atoms on earth ( $\approx 10^{50}$ ). "With these computations, we simulate to make sure our portfolios are designed to cope with different situations," says Estlander. "We have a strong boat and we have everything we need to successfully run our all-weather approach."