June 2016

HEDGENORDIC

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New in the North...
Introducing new fund launches and a guide to set up shop in Sweden

When Fundamentals Play out
IPM celebrating the first decade of Systematic Macro

Protecting Portfolios from Downside Risks
What can investors do to protect the value of their portfolios?

Nordics by Numbers
A scrutiny of the Nordic Hedge Fund Space and its players

Nordic Hedge Fund Industry Report

Your Single Access Point to the Nordic Hedge Fund Industry

Contents

WHEN INVESTING IN A SPECIALIST MAKES SENSE 86

TURNING STYLE PREMIA INTO TRUE STYLES 28

RESEARCH BRIEF - THE LIMITS OF COMPLEXITY IN FINANCE 66

CHICKEN OR EGG? THE TRIALS AND TRIBULATIONS OF NEWBIES IN STOCKHOLM 80

PROTECTING PORTFOLIOS FROM DOWNSIDE RISKS INVESTMENTS 18

PREFFERED SECURITIES 32

BENEFITING FROM A MARKET REGIME SHIFT 26

WHAT'S NEXT FOR A HEDGE FUND BUSINESS? 12

WHEN FUNDAMENTALS PLAY OUT 14

4 The Editor – My opening lines...

6 Nordic Hedge Funds see Steady Inflows in 2015 Despite Industry Slump

12 What´s next for a hedge fund business

14 When Fundamentals Play Out

18 Protecting Portfolios From Downside Risk

20 New Dawn Rising for Aktie-Ansvar

23 Disciplined Approach in Merger Arb avoiding most Deal Breaks

26 Benefiting from a Market Regime Shift

28 Turning Style Premia into True Styles

32 Preferred Securities

35 A Calmer Approach to Credit Markets

38 Finding Positive Returns in an uncertain Interest Rate Environment

42 Atlant Fonder expands Opportunity - set with new launches

46 Company-centric small-cap approach paid off for Elementa

48 Finding long-term value in a disruptive market environment

51 Varma - Punching above its weight in hedge fund allocation

54 The Case for Real Estate Investment Trusts

58 When Equity Market Neutral meets Momentum

61 With the Benefit of Hindsight

64 A defensive approach to hedge fund investing

66 Research Brief - The Limits of Complexity in Finance

72 Navigating through unbundling Regulatory Changes

76 Opportunistic Approach to Long/ Short Equity investing

78 Excalibur launches new Credit Hedge Fund Trude

80 The Trials and Tribulations of Newbies in Stockholm

76 When investing in a specialist makes Sense

78 Interview Jarle Birkeland - Alchemy Trading

80 NHX at a Glance

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INTRODUCTION

HedgeNordic is the leading media covering the Nordic alternative investment and hedge fund universe. The website brings daily news, research, analysis and background that is relevant to Nordic hedge fund professionals from the sell and buy side from all tiers.

HedgeNordic publishes monthly, quarterly and annual reports on recent developments in her core market as well as special, indepth reports on "hot topics".

HedgeNordic also calculates and publishes the Nordic Hedge Index (NHX) and is host to the Nordic Hedge Award and organizes round tables and seminars.

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> **Many forms of Government have been tried, and will be tried in this world of sin and woe. No one pretends that democracy is perfect or all-wise. Indeed it has been said that democracy is the worst form of Government except for all those other forms that have been tried from time to time…**
>
> **Winston Churchill, House of Commons on 11 November 1947**

The Editor

It all feels a bit scary…

With Euro2016 in France about to kick off, temperatures getting warmer, children leaving school for the summer break and suitcases being fetched from attics and garages before accompanying us on journeys to exiting and exotic vacations, there is distraction aplenty and all may seem in order around us.

Outside of the leisure world, there are of course big things happening in the next weeks and months. And, to me, going into this summer it all feels a little bit scary, as if something rather unpleasant were hovering in the air.

Likely, more than anything, it will be the big, major geopolitical issues that will, once again, dominate financial markets. Except this time, the epicenters will likely be much closer to home. Europe, and the European Union especially it feels, are at a breaking point. Reigning and established governments are losing the faith and confidence of the people and parties far left and right of "the center" are gaining ground. We are experiencing that the freedom and openness of our societies are cut back. And too often, the one thing that may define us as Western countries, democracy itself is being questioned as a viable form of government way to live our lives.

The cry for a strong man to "fix it" is becoming deafening in some corners of the world, also very close to home. And that call is being magnified and answered. It is easy for many of us Europeans to look across the Atlantic with some astonishment and disbelief accompanied by a chuckle (and again, maybe also a form of fear) at the astonishing support and success Donald Trump is having which, with no doubt, will secure him the Republican nomination for the most powerful office on the globe, as president of the United States,

Britain will be holding a referendum to leave the - granted - all but perfect European Union, that accompanied us through decades of unprecedented wealth, prosperity and peace. What we as ordinary people can touch and feel of the EU, and have come to appreciate, are our single currency, the Euro, and free travel across the borders of the member states.

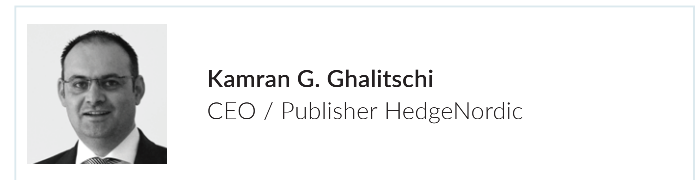
But free travel through Schengenland is no more a given, with states reinstating border controls, walls and fences. And the announcement of discontinuing production of the 500 Euro bill not just conspiracy theorists see as a first step to get rid of physical payment methods altogether. (Many Scandinavians may need be reminded: on the mainland we pay with printed paper and graved metal pieces for goods and services!)

The abolishment of cash, too, of course is argued with the fight against money laundering, corruption and terrorist financing. Big brother is watching ever closer and once again we are surrendering freedom for order and security.

We have come to accept having heavy armed soldiers patrolling our subway stations, streets and airports, not to carry toothpaste or water bottles on to planes, be suspicious of a lonely rucksack in a dark corner, and certainly since Edward Snowden, we are aware someone is reading your email and listening into your phone calls.

For some managers and strategies, a pick up in volatility, changes in correlations, regime shifts, uncertainties and changes in policies may of course offer opportunities. The aim therefor in this publication is too highlight some of the managers and strategies who may be able to prosper in this environment. This edition of the HedgeNordic Industry report goes deeper introducing individual managers views and approaches than we had done in the past. As always, we took a strong bias to the Nordic region but extended the angle further to those "foreign" managers who are active in the Nordic region, or take an interest in it.

The report once again is a mix of home grown, editorial articles and specialist views and expert opinions written by those who know best, in their own words without the filter of a journalist diluting the message. We hope you enjoy the HedgeNordic Industry Report and find some casual entertainment, food for thought and new gems, ideally under a palm tree with your feet buried in warm, white sand and a Margarita within reach.



Kamran G. Ghalitschi
CEO / Publisher HedgeNordic

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NORDIC HEDGE FUNDS SEE STEADY INFLOWS IN 2015 DESPITE INDUSTRY SLUMP

by Jonathan Furelid – HedgeNordic

The largest Nordic hedge funds saw steady inflows in 2015 with assets under management (AuM) gaining 16.2%. This should be compared to a year-on-year gain of 15.8% in 2014, according to data gathered by HedgeNordic.

The big winner on the asset raising front during the last two years has been Catella Hedgefond which managed 4,4 billion SEK by the end of 2013, only to report a total AuM figure of 15,5 billion by the end of 2015, a net gain of 254% during the last two years.

The largest Nordic hedge fund, Lynx, has also seen massive inflows during the same period. Closing 2013 with a total AuM figure of approximately 32 billion SEK, the systematic trend follower reportedly managed in excess of 50 billion SEK by the end of December 2015, a net gain of 56% in two years time.

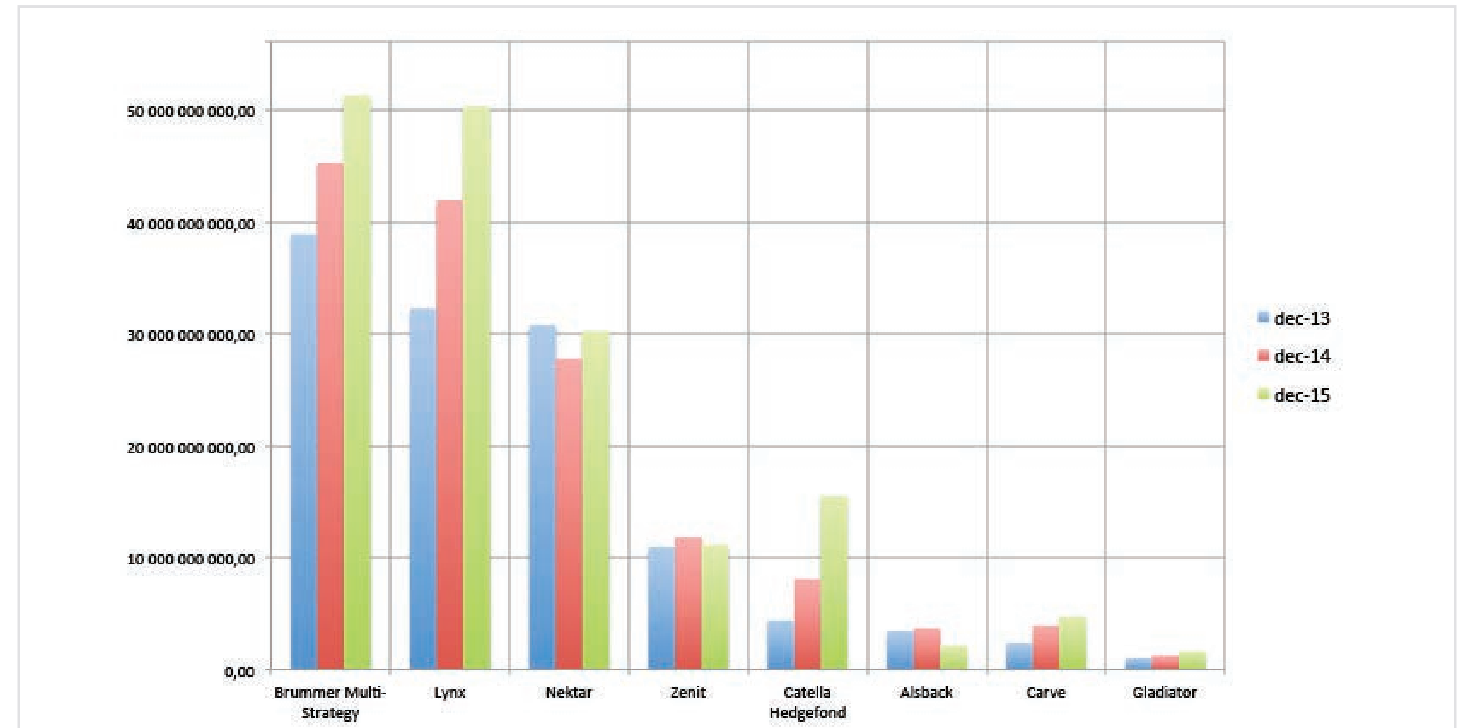
The strong inflows among Nordic hedge funds are particularly noteworthy given the slump seen in total industry flows in 2015. According to data from hedge fund data provider eVestment, total industry flows declined by roughly 40% in 2015 compared to the previous year.

According to eVestment, the estimated inflow to hedge funds globally in 2015 amounted to 66,6 billion USD as of end November. This compares to 111.4 billion USD for the same period in 2014.

The two primary drivers of 2015's slump were dramatic changes in investor appetite for event-driven funds and credit exposure through hedge fund structures, the eVestment report states. However, the overall industry inflow was supported by renewed interest in managed futures, macro, and multi-strategy funds.

Looking ahead, flows into the hedge fund industry are likely to be guided by the performance and opportunity-set offered by other asset classes, equities in particular. Some signs are already showing that major institutional investors are redeeming their hedge fund allocations as a result of dissappinting returns. If hedge fund performance continue to be weak we are likely to see more institutions follow in their footsteps. The reason Nordic hedge funds have managed to stay attractive is likely to be the resilience of returns in recent years.

CHART 1. AUM GROWTH LARGEST NORDIC HEDGE FUNDS



Source: HedgeNordic

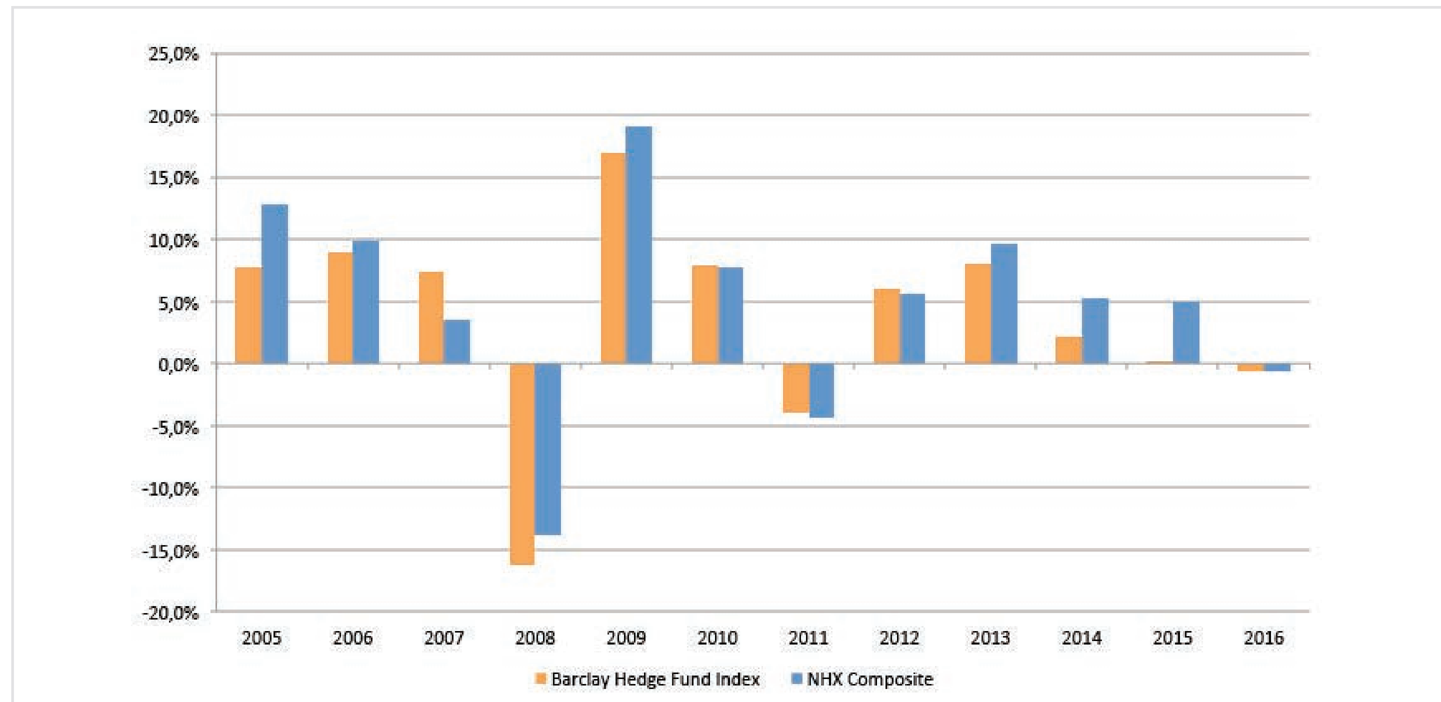
NORDIC HEDGE FUNDS CONTINUE TO OUTPERFORM IN 2015

by Jonathan Furelid – HedgeNordic

Having consistently beaten industry benchmarks throughout the last 10 years, Nordic hedge funds extended their run of outperformance in 2015. The NHX composite, which is an aggregate of 152 nordic hedge funds tracked by the HedgeNordic database, gained 4.6% during the year which could be compared to the Barclay hedge fund index that was just about flat by the end of the year. During the first quarter of 2016, the NHX index as well as the Barclayhedge index are slightly down following a very difficult January that saw the NHX index falling by in excess of 1% while the Barclay index dropped almost 3%.

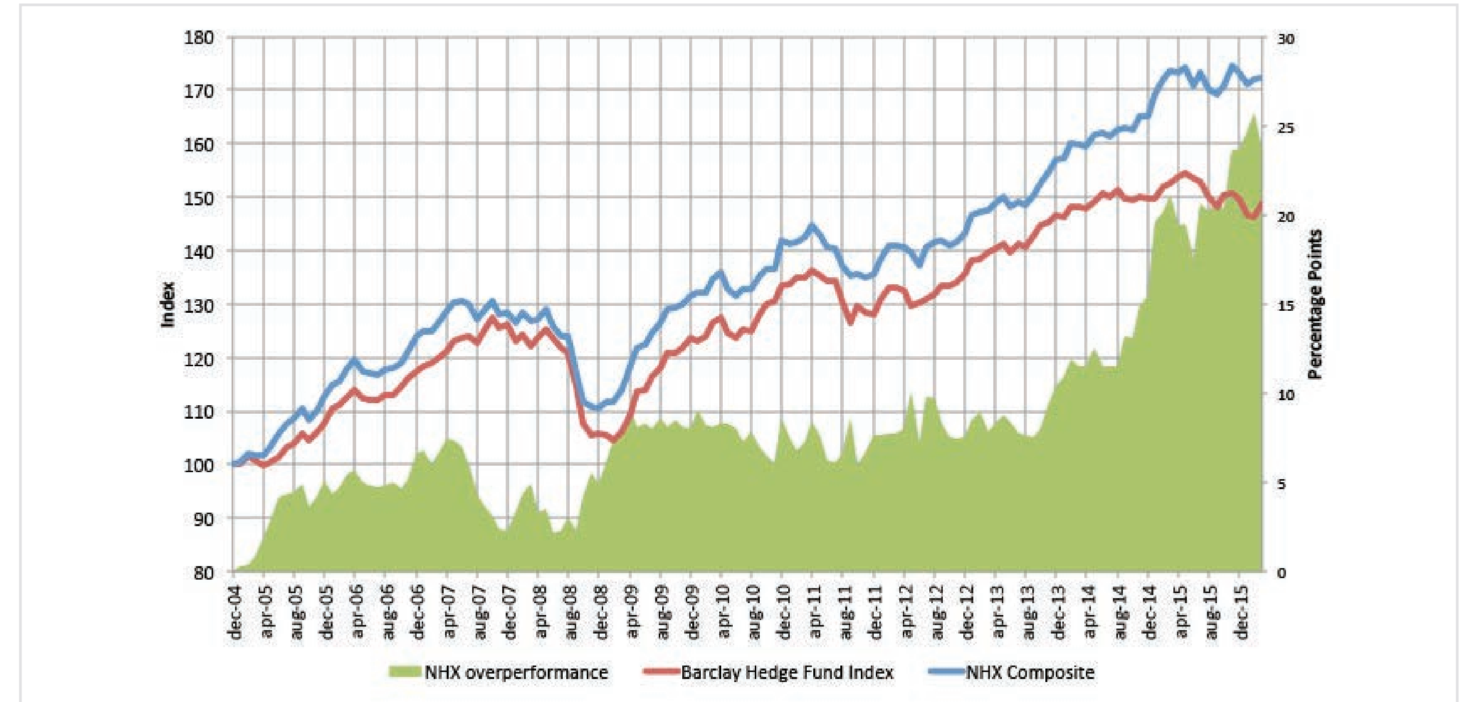
Chart 1 displays the performance of NHX compared to the Barclay Hedge Fund Index, with both indices adjusted to an annualised volatility of 5%. The outperformance of Nordic managers is clearly visible in 2015 as well as in 2104. The relative performance over time is shown in Chart 2, indicating that the NHX has outperformed by close to 25 percentage points during the last 10 years (green area).

CHART 1: NHX COMPOSITE VS. BARCLAY HEDGE FUND INDEX (EQUAL VOLATILITY 5%)



Source: HedgeNordic

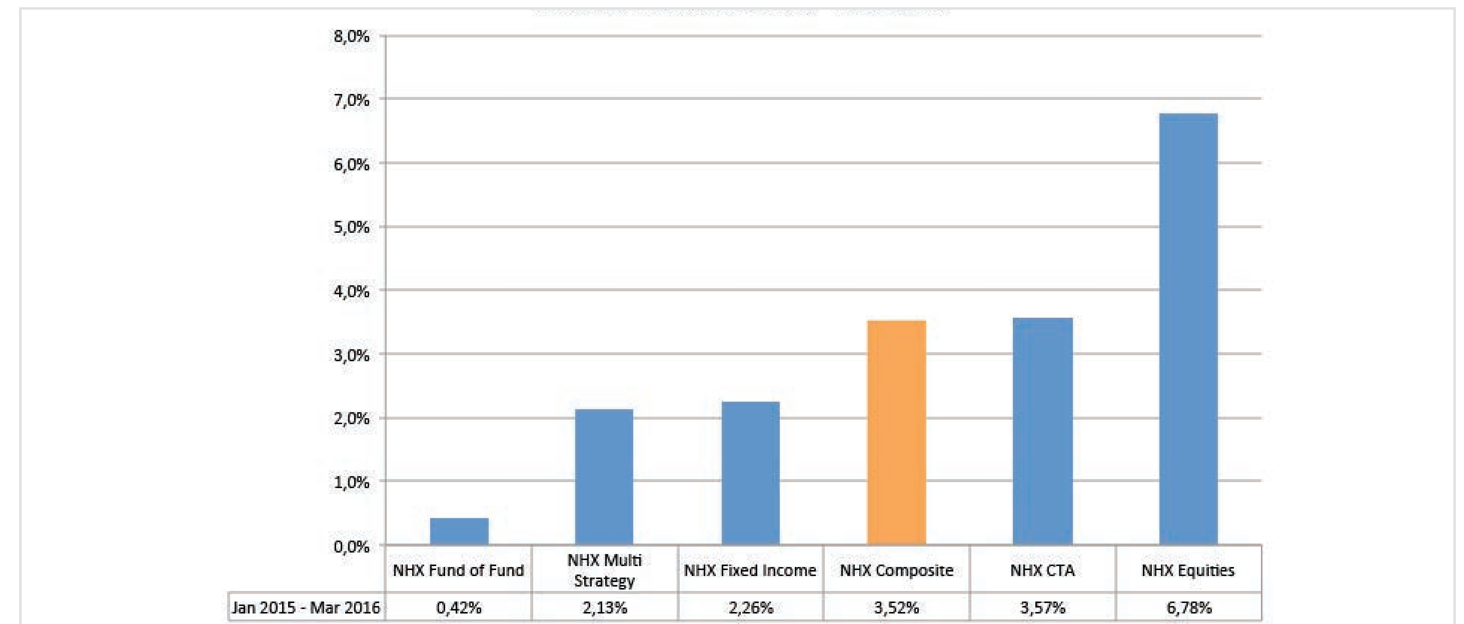
CHART 2: NHX COMPOSITE VS. BARCLAY HEDGE FUND INDEX (@ 5% VOLATILITY)



Source: HedgeNordic

Looking at the period from January 2015 to March 2016 (see Chart 3), equity hedge strategies are once again the best performers among Nordic names, it is also the category holding the largest number of individual fund listings in NHX. By the end of the first quarter 2016, there were 54 listed equity programs in the database translating into 36% of the total universe (see Chart 4). The fact that all sub categories in the NHX have generated positive performance during the last year is noticeable given that hedge funds overall has struggled do deliver any meaningful return during this period.

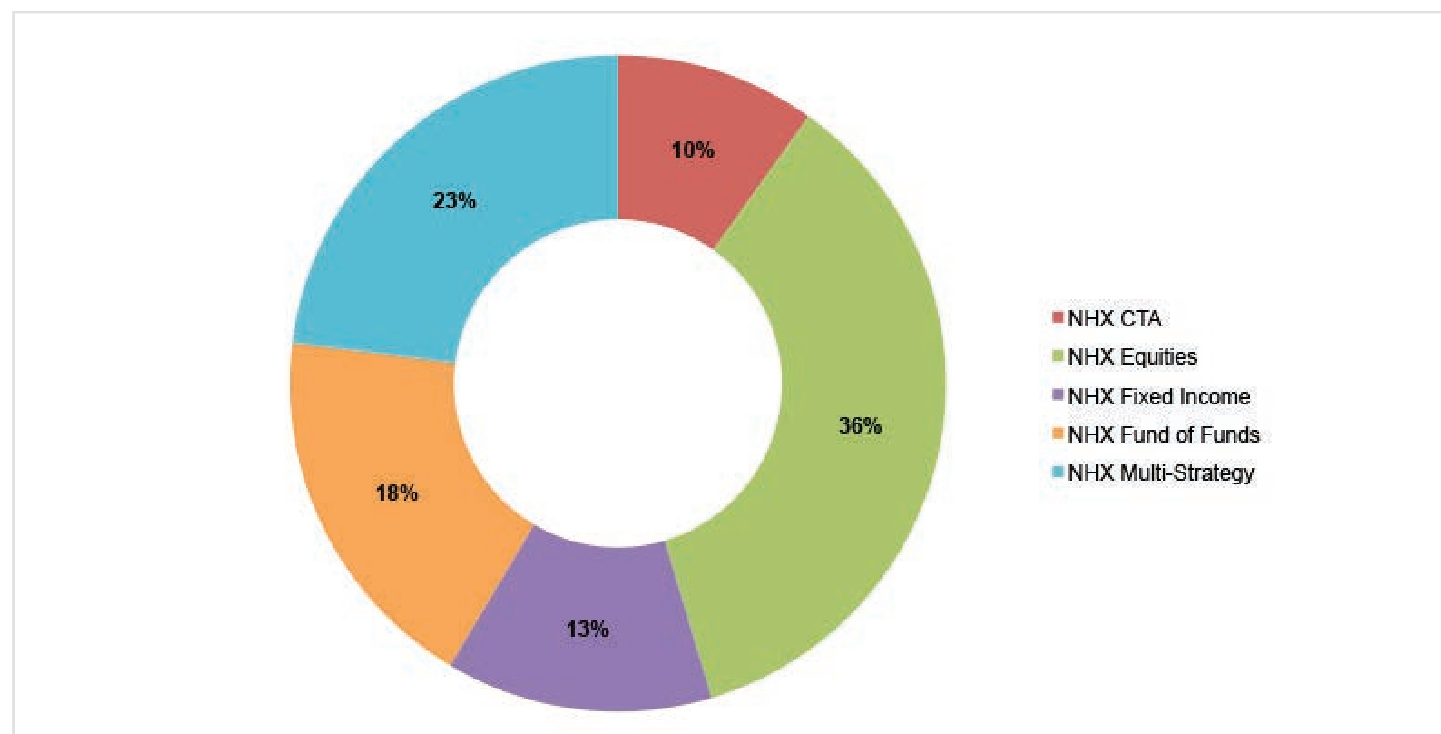
CHART 3: NHX SUB-INDICES JAN 2015 – MAR 2016



	NHX Fund of Fund	NHX Multi Strategy	NHX Fixed Income	NHX Composite	NHX CTA	NHX Equities
Jan 2015 - Mar 2016	0,42%	2,13%	2,26%	3,52%	3,57%	6,78%

Source: HedgeNordic

CHART 4: NHX COMPOSITE VS. BARCLAY HEDGE FUND INDEX (EQUAL VOLATILITY 5%)



Source: HedgeNordic

CTAs have seen a pick-up in performance lately and is the second best performing NHX category looking at last year and including this year´s first quarter. The NHX CTA index was actually down 2.2% in 2015 but following a strong rally on the back of the market turmoil during the first quarter of 2016, the strategy has recovered. Nordic CTAs have also shown consistent outperformance during the last years and 2016 has got off to a strong start with the NHX CTA being up around 6% as of March, well ahead of the Barclay CTA index and other comparable benchmarks.

Nordic fixed income hedge funds have also shown resilience in a market environment that has proved challenging for the sector. With a zero interest rate environment, there has been little yield to chase for these strategies and the turmoil in the corporate bond sector in January and February put additional pressure on the strategy group. Yet, the best overall Nordic hedge fund in the HedgeNordic performance ranking for 2015 was within fixed income (see separate chapter outlining the winners of the Nordic Hedge Awards).

Nordic multi-strategy funds is the most diverse index category, ranging from sector specific strategies to programs using a broad range of strategies and markets. The category includes both systematic and fundamental strategies. The multi strategy sub index has performed in line with fixed income category as of late, gaining a solid 3,6% in 2015 but giving back part of that in early 2016.

The NHX fund-of-funds index has been lagging but holds a very low volatility profile as these funds typically focus on reducing risk by holding a diversified portfolio of non-correlated strategies.

Summarizing the year 2015 for the Nordic hedge fund space, there is reason to be impressed by the consistency of returns. Despite a difficult environment for alpha generation and with the zero interest rate environment adding to the challenge, Nordic hedge fund managers have overall kept up well and continued to outperform global industry benchmarks. As financial markets have turned increasingly volatile in the first quarter of 2016, the Nordic hedge fund industry has kept up well, despite being heavily tilted towards equity hedge strategies that inherently suffer from a long bias to the stock market in times of distress.

COUNTRY BREAKDOWN

+10.9 %

NHX Norway
21 Constituents

+7.2 %

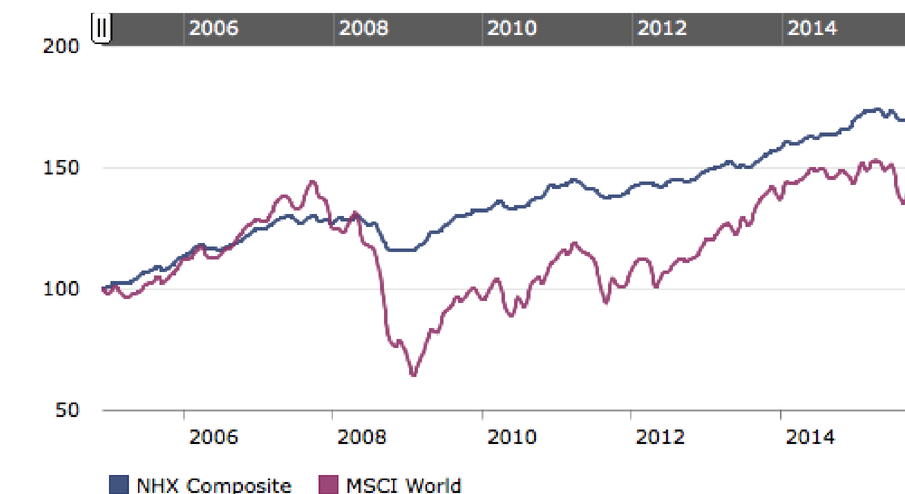
NHX FINLAND
15 Constituents

+6.0 %

NHX Denmark
22 Constituents

+2.5 %

NHX Sweden
92 Constituents



The Nordic Hedge Index (NHX) in 2015 again outpaced international hedgefund indices

A country breakdown of the NHX sub-indices brings to light a significant dispersion in performance among the contries contributing to the NHX Compostite Index.

While NHX-Composite manged to increase by 4,6% in 2015, the result in country by country breakdown deviate quite significantly from that number. NHX Denmark, which except for a few equity and multi strategy funds is dominated by its fixed income managers increased by 6%.

CTA-heavy NHX-Finland, the smallest of the Nordic markets by its constituents to the NHX-Composite Index gained in excess of 7,2%. Finland has seen some additions though decreasing its dependancy on Estlander & Partners results, notably by the addition of Helsinki Capital Partners and Gramont.

The strongest contribution came from Norway, where tradtionally equity strategies leave a strong footprint. A large group of the funds are from within the Sector Asset Management Group, which traditionally has a strong focus on equity markets. NHX Norway significantly outpaced the overall Nordic market advancing 10.9%. Major contributors to that strength fall to the likes of the single best performing Nordic hedge fund, Oslo Asset Management and Taiga.

The largest Nordic hedge fund market, Sweden, with 92 of the NHX constituents, was the only country underperforming the composite index, dragging the equal-weigthed NHX-Composite index down. With 2,5% NHX Sweden was just over half as strong as the aggregated Nordic hedge fund.

Panelists (left to right): Struan Malcolm, Erik Eidolf, Despina Xanthopoulou, Mats Langensjö

Nordic Hedge Award Podium Discussion: What's next for a hedge fund business?

by Pirkko Juntunen – HedgeNordic

Attracting institutional assets is often seen as the Holy Grail for hedge fund managers but with the opportunity also comes challenges. As the industry becomes more institutional demands on performance, liquidity, transparency and infrastructure increase.

At this year's fourth Nordic Hedge Award, held in Stockholm, the podium discussion focused on how to meet these challenges. The panellists discussed strategies for hedge funds trying to grow assets, develop their businesses or simply seeking to protect the status quo. The discussion was moderated by Struan Malcolm, Head of Nordic Sales at Northern Trust.

Struan Malcolm started the discussion by asking what key drivers are impacting the interaction between hedge funds and hedge fund investors.

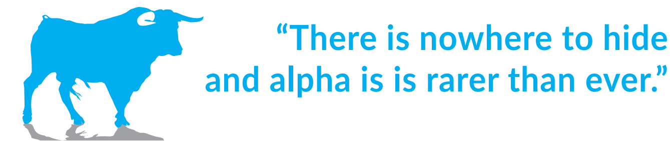
Mats Langensjö of Lombard Odier Investment Management, said hedge funds have a role to play as institutional investors' appetite for returns continue, adding that hedge funds offer a counter weight to the herding mentality in traditional asset classes by offering uncorrelated strategies. "But the question is price and whether they can afford a meaningful allocation," he said.

"When you focus on returns, the assets will come."

Despina Xanthopoulou, who has been with Lynx asset Management for the past 6 months and still has much of an 'external view', said the firm is very much focused on performance rather than growing assets. The CTA managed by Lynx is one of the largest in the world with $6.5 billion in AUM and as such is very resource intense. Last year the company hired 15 people in total and quite a few in the analyst team in order to improve the models. "When you focus on returns, the assets will come," she said. She also said that by diversifying the client base by region and by client type such as institutional investors, foundations, HNW and fund of funds you ensure stability in the asset base as clients have diverse needs, targets and customised demands.

Erik Eidolf of Nordkinn Asset Management, said the interaction with investors varies because of their varied needs as well as the understanding of what hedge funds actually are and are able to offer. He also said that the buying behaviour has changed over the years as the Nordic hedge fund industry has grown and investors have become more knowledgeable and sophisticated.

Despina Xanthopoulou agreed, noting that investors, such as her previous employer Länsförsäkringar Asset Management, are now more influential and demanding, expecting hedge funds to play a specific role in the wider portfolio. At Lynx this manifests itself in the growing popularity of managed accounts where clients have more control, she said, adding that clients help devise new products this way. Adding new products to an existing range is a generally observed phenomenon but Lynx has made the strategic decision to continue to dedicate all resources to its existing strategy, she noted.



"There is nowhere to hide and alpha is is rarer than ever."

Erik Eidolf said coming from a fund with one strategy and one product and no plans to change, has not deterred investors, which include pension funds, endowments as well as fund of funds. "We started with seven institutional investors and now have 45. We take a pedagogical approach and explain how we run our money and stick to our approach," he added.

Mats Langensjö said the hedge fund industry has changed as a result of the inflow of institutional investor assets, compared to before when the majority of assets were private. "This has led to a focus on infrastructure and the operational capabilities rather than just asset gathering, which is a big change. There is no way back to how things used to be," he noted, adding that hedge funds will have to decide if this is the space they want to operate in and make sure they have an institutional operation. Issues such as transparency and liquidity are also key, he said.

Struan Malcolm questioned whether the institutionalisation of the hedge fund industry implies a constant raising of the bar. Mats Langensjö agreed it does, adding that it pays to be big. "To attract large institutional investor capital hedge funds need scale. There is a perception that larger firms have the resources to build and attract know-how, but smaller hedge funds perform better" he argued.

Despina Xanthopoulou disagreed, arguing that within the CTA sector you need scale in order to perform and while smaller may be more nimble, the resources required for successful CTA models makes it difficult for smaller firms to compete.

The panellists all conceded that certain strategies do require scale whereas in others it is better to be smaller when it comes to performance.

Struan Malcolm continued the discussion by questioning the panellists about their views on the opportunities and challenges for a Nordic fund looking to grow outside the region and vice versa, a non-Nordic manager coming to the region.

Mats Langensjö said that in order to be successful in the region you simply have to be good because the Nordic investors are among the most sophisticated in the world. "In the past there was a tendency for home bias but this has diminished over the years.

Despina Xanthopoulou pointed out that within the region there are differences with Finland being the largest allocator. "We haven't actually had a home-bias so are focused on getting more Nordic clients," she said. She also noted that despite the differences and varied requirements Lynx would never jeopardise its programme. "In terms of sophisticated investors, I would also argue that the US investors are ahead of the curve and really know what they want, while European investors still make relative performance evaluations across asset classes," she said, adding that Lynx recently opened an office in the US.

Struan Malcolm continued the discussion by asking how investors would be accessing hedge funds in the future with the rise of various FinTech trends and Robo-advisors and other technological developments. Despina Xanthopoulou said that so far in the Nordic region there were some simple forms of automated asset allocation and fund selection tools on bank platforms and online fund hubs. "This trend is much more prominent in the US but is likely going to develop here too," she said.

The panellists concluded the discussion by agreeing that while there are tremendous opportunities for hedge funds going forward they will have to deliver on all areas such as performance, transparency, liquidity, infrastructure which is posing a huge challenge. "There is nowhere to hide and alpha is rarer than ever. Compared to a few years ago, justifying the fees, even the fixed fees, is becoming harder," Mats Langensjö concluded.

by Jonathan Furelid - HedgeNordic

Stefan Nydahl
CEO, IPM

When fundamentals play out

Swedish quantitative asset manager Informed Portfolio Management, IPM, are celebrating the 10th anniversary of their systematic macro fund this year. By systematically exploiting fundamental relationships in global financial markets, the asset manager has built a reputation of being one of the world's leading hedge funds within its niche. Today IPM manages over 2 billion USD in its flagship macro strategy and has never been on a firmer footing as a company, according to CEO Stefan Nydahl.

"We have come a long way to get to where we are today, but I think the key to our success is that we always stood true to our fundamental, relative value, approach, always seeking to improve on our models and offering an uncorrelated return profile", Nydahl says.

IPM was originally formed by Anders Lindell and Jonas Rinné who came out of the fixed income trading division at JP Bank seeking to start their own venture in the mid-90s. The trading approach, by then little known within the asset management industry and primarily developed among US hedge funds, was later to become a strategy that industry practitioners would classify as Global Tactical Asset Allocation or GTAA.

The art of using well-researched quantitative models to exploit fundamental relationships in global financial markets is today a well-established strategy in the hedge fund space. The fact that the world´s largest hedge fund, Bridgewater, are adhering to a similar

> "These days informed investors know what we do and what our models try to achieve, that was not the case when we started out."

approach has helped put IPM on the map, Nydahl says. "These days informed investors know what we do and what our models try to achieve, that was not the case when we started out. I think that our particular niche has been helped by the success of the likes of Bridgewater. At the same time, we are often benchmarked against them which of course makes it a tough competition", Nydahl explains.

By and large, the IPM Systematic Macro strategy looks to create uncorrelated returns through exploiting fundamental relationships in global financial markets. The execution is primarily carried out in highly liquid futures markets which makes the strategy scalable. The quantitative models used are well-documented and build on high-level academic research, however the models and the way they are executed are undergoing constant revisions and developments along the way.

"There is no such thing as a standstill-mode in our industry. Markets change and develop and we need to stay ahead of that development. Luckily, we have a very strong research team taking care of that", Nydahl explains.

> "Even though we are constantly looking at how to improve things, we are not changing our basic concepts of managing money."

"Even though we are constantly looking at how to improve things, we are not changing our basic concepts of managing money. The changes are more incremental in nature looking to improve the overall characteristics of the program. For example we have added emerging market currencies to the portfolio in late 2013 which we see as a possibility to expand the opportunity-set for our models to extract additional alpha".

Much of IPM´s asset growth in recent years has come from the US, which Nydahl sees as being a result of their increased presence on this market. The fact that US investors have a long history allocating to systematic macro strategies has also helped drive interest, Nydahl reasons. There is however a significant pick-up in activity among European investors which is why IPM decided to launch a UCITS version of their program in 2015.

"We have seen a significant increase in demand from the European investor community for our systematic macro strategy which is why we decided to launch a UCITS version of our product on the Morgan Stanley Fundlogic platform. This product has already gathered a lot of interest and has 390 MUSD allocated to", Nydahl says.

> "We currently have a core of institutional investors who have been with us for a long time but we work hard to diversify our investor base and to improve on our geographical coverage."

Another change that was brought about at IPM in 2014 was a change in the ownership structure. Swedish asset manager Catella then bought a majority share in the company and thereby increased their 25 per cent ownership that was acquired in 2011 and 2012. It was in mid-2015 that Stefan Nydahl was appointed as CEO for IPM with the ambition of growing the company further.

"Having Catella as majority owner is not only a question of financing, they also bring with them a long experience from distributing financial products which feeds directly into our distribution strategy", Nydahl says.

"With the strong research and trading team we have in place, and knowing that in good hands, it allows me to also focus more on the business side of our industry. IPM strives to be attractive for additional investments to our strategy and identify new client groups. We currently have a core of institutional investors who have been with us for a long time but we work hard to diversify our investor base and to improve on our geographical coverage."

IPM today employs 45 people, all of which are based in the Stockholm office. Looking forward, Nydahl sees potential of adding more local presence and expand on the company strong track record of building tailor-made investment solutions.

"We have a fantastic track record and we are very good at dealing with managed accounts. The managed accounts approach put a lot of requirements on internal structures and efficient administration which we have built throughout the years. Our vision is now to build on these capacities and support more institutions with their asset allocation mandates".

For the US market, IPM has a local third-party marketing relationship established since many years. Nydahl however sees a potential of adding local offices to be able to support clients in their respective markets going forward.

"We are reviewing this possibility. The fact that all our employees are based in Stockholm means a lot of travelling for the people involved in business development functions. In order to support different client groups in their respective time-zones we would of course benefit from having local presence in that respect".

A short-term highlight for IPM is just around the corner. IPM will be celebrating the 10-year anniversary of their off-shore macro fund in the Stockholm archipelago this summer with selected investors and allocators who will enjoy a compact program of presentations and panels by industry experts.

"We are exited and truly looking forward to welcoming so many of our international clients and relations to Stockholm. We are humbled by the interest and encouragement we are getting from all corners of the world wanting to share this milestone-moment with us. It will be interesting hosting such an event that will hopefully be larger than the IPM Christmas party", Nydahl says with a smile.

90 KONTO SVENSK INSAMLINGS KONTROLL
Jag vill uppfinna en medicin så man slipper nålstick
Freja, 11 år
Alla barn som kämpar mot cancer är riktiga hjältar. Stöd barncancerforskningen med 100 kr i månaden så bidrar du till att fler barn överlever sin sjukdom.
Bli Barnsupporter idag på barncancerfonden.se
BARNCANCER FONDEN
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Protecting Portfolios from Downside Risks

by Samantha Sobkowich & Klaus Paesler – Russell Investments

Many institutions remain significantly exposed to downside risk. Managing this risk can be complex and costly. What, if anything, can investors do to protect the value of their portfolios?

Downside risk can be managed in various ways. At Russell Investments, we work with large global institutional clients to provide various protection strategies. Tactical downside protection works well for clients with shorter-term and tail-risk market concerns. Those with a longer-term strategy for whom on-going asset level protection is key, a strategic overlay may be an ideal solution.

In this article, Russell Investments explores various derivative based protection strategies for investors wherein more conventional measures (e.g. reducing equity exposure, seeking low-volatility equity exposures, increasing the diversity of the portfolio structure) may prove inadequate.

Downside protection overlays can be designed in various ways. Here we present two types of downside strategies which we categorise as (1) tactical or (2) strategic.

A **tactical hedge** is one that has a short time horizon, but provides fairly solid protection. These are usually implemented with index or equity options.

A **strategic hedging programme** is one that can be maintained on an ongoing basis. Strategic hedges can accomplish several goals – including reducing volatility, offsetting drawdowns and embedding asymmetry in the potential return distribution (where value can go up more than it can go down).

TACTICAL HEDGES

For specific portfolio insurance or protection in certain market environments and projections, one avenue to protect portfolios from downside and tail-risk are options based strategies. These would involve the purchase of a put (or a cheaper put spread) at a desired strike level.

The rationale for tactical protection strategies is optionality to benefit from a potential equity market pullback. The options market offers investors the ability to target a wide range of portfolio outcomes. Different option strategies are designed to meet different goals, have different potential payoffs, carry different risks and costs, and are attractive at different points in time based on many market factors. Some option strategies are intended to change the returns of long-term asset classes, while others are more tactical, based on shorter-term views of market levels or the attractiveness of option strategies.

Option strategies, though providing protection at a cost, are better suited for shorter term market outlooks where current capital markets views suggest an expected market level for which one is willing to sacrifice upside.

Pure tail-risk hedges using puts are meant to function on a stand-alone basis, similarly to a traditional investment mandate. Capital allocated to the account sets the maximum possible loss over the time horizon of concern. Such solutions have a performance pattern that gradually declines over most periods, but benefits from a large gain when significant market corrections occur.

Though providing absolute protection below a certain market level, put strategies in isolation can be very expensive. For example a 90% put on the EuroStoxx 50 Index for 1 year costs over 6% in premium as of the end of March 2016 (2.7% premium can be saved if a 75% put is written, this is referred to as a put spread). In limited circumstances, upside can also be sold (writing a call) to finance protection via puts, however, the attractiveness of a protection strategy is its ability to capture upside in a trending rally. When the put spread is purchased, and financed entirely by writing a call, that structure is referred to as a put spread collar.

Investing in options-based risk management strategies requires two critical elements to be successful: an infrastructure and investment platform that enables timely implementation of solutions, and a total-fund risk management program that can measure, evaluate, and manage the impact of options exposures on underlying portfolios.

An investor entering into any option needs to gain a clear understanding of the relevant strategies, and of the investment outcomes they are designed to achieve; the investor needs also to give due consideration to the option's current pricing and attractiveness, factors that can change significantly even over short time periods.

STRATEGIC HEDGES

As paying for pure tail-risk insurance with options can be prohibitively expensive on a recurring basis, an ongoing futures-based strategy can provide significant downside protection and provide a long-term equity risk management strategy. A futures based strategy allows plans to maintain higher exposures to equity markets, in a cost effective and more efficient manner than using option strategies.

The strategy aims to eliminate extreme downside tail outcomes and deliver a balance between upside capture and downside protection and provides an improvement in wealth compounding by reducing the impact of negative market returns; a feature in which during times of reduced equity exposure, maintain the alpha of active management while avoiding negative returns by reducing or eliminating market beta.

A dynamic strategy provides a soft asset floor level which is effective under most circumstances - certain dramatic market declines may result in asset value falling below the intended protection floor, but accepting this residual tail-risk dramatically reduces the cost of protection.

This type of mandate is structured as complementary protection of an underlying portfolio holding. In this instance, performance of the sum of the underlying holding and the protective overlay is the appropriate focus. Such protection allows for the creation of a holistic protection with set floors and more precise drawdown limitations or target volatility levels.

The ongoing overlay provides flexibility and adjusts equity exposure, potentially intra-day, taking into account the above factors. The flexibility provided by the futures based solution allows for more protection when there is additional downside concern, or more upside participation when forecasts are positive.

SUMMARY

In the present rocky market environment, many investors find themselves significantly exposed to extreme market falls. Others are looking to enhance traditional static allocation with more dynamic behaviour so as to protect previous gains. Russell Investments has been managing a number of downside protection strategies for large institutional investors globally for several years.

Where investors in practice struggle to manage their strategic asset allocation effectively in order to meet the demand of their liabilities, dynamic asset floor protections strategies provide a risk-controlled framework for achieving this. As such, this is an important ingredient of institutional balance sheet management for the 21st Century. In our current climate of heightened risk and low returns, investors should seek overlay professionals who have the experience and capabilities necessary to manage this critical aspect of portfolio risk.

RUSSELL INVESTMENTS

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New dawn rising for Aktie-Ansvar

by Jonathan Furelid, HedgeNordic

Widely known for their Graal hedge funds, Aktie-Ansvar is one of the oldest fund management companies on the Swedish market with its roots dating back to 1965. In 2016, a new dawn seems to be rising for the firm as two senior hires; Philip Wendt, previously with Länsförsäkringar and Marie Ljungqvist, previously with Alfred Berg, were added to its team of portfolio managers. The ambition is clear, Aktie-Ansvar is looking to remain a competitive player on the Swedish hedge fund scene, just as they have been since they started its first hedge fund, Graal, in 2002.

”With Philip and Marie onboard, we feel very comfortable that our hedge fund offering will continue to deliver on its promises, meaning generating consistent returns independent of the overall market environment. The fact that they come from different backgrounds, with Philip from the equity side and Maria with a background in macro strategy and credits, gives a very interesting dynamic to the management of Graal and Graal Aktiehedge products”, Sina Mostafavi, CEO of Aktie-Ansvar says.

The Graal and Graal Aktiehedge funds share the same underlying investment strategy that is to combine an actively managed portfolio of equities and corporate bonds with the aim of generating stable long-term performance to a limited risk. The funds use derivatives on equity indices to manage the equity exposure and can go net short the equity market, although there is an inherent long bias.

The difference between the two funds is their fee structure and liquidity terms which has resulted in a difference in the underlying investor base. While Graal has attracted institutional clients through offering a lower fee base and monthly dealing. Graal Aktiehedge has more of a retail audience, which is likely a result of the daily liquidity terms according to Carl Bergenstråhle, head of sales and distribution at Aktie-Ansvar.

”The Aktiehedge product is more suited for the retail distribution platforms out there as it allows for daily dealing. Apart from the difference in fee structures, the funds are identical with regards to trading strategy which is also reflected in the performance”, Bergenstråhle says.

The fact that Graal and Graal Aktiehedge share a low volatility target means that there is a limitation as to how much can be changed in the performance and risk profiles of the respective funds. However the incremental changes that will result from the change in management is not to be overlooked and lies in how the investment process is being reshaped, according to Philip Wendt and Marie Ljungqvist.

”I think what our investment process brings to the table is a long-term macro road-map, creating a framework for how much risk we will take on at any given point in time. Also the fact that we will work closely together discussing individual positions from different standpoints, i.e. shall we have the stock or the corporate credit for a specific company, is a change”, Ljungqvist says.

”The investment mandate is obviously setting the framework for our day-to-day management of the funds. The idea is for these funds to stay low-risk, meaning a risk target, expressed as annualized volatility, of 2-5 per cent. Today we are right in the middle of that range which is a result of the underlying investment process. This process is a combination of Maria´s top-down macro views and the more bottom-up stock picking approach employed by myself”, Wendt says continuing;

”Our allocations are based on a main market scenario and combines that with alternate scenarios in order to reflect potential risks ahead. The main scenario is then compared to the current market valuations, giving us a sense of what is priced in and not. We look at things like projected earnings growth and earnings revisions and compare that to the overall trends in the markets. Our market view then decides the allocation between equities and corporate credits. In May the net exposure fluctuated between 80% equities and 20% corporate credits, to 70% equities and 30% corporate credits, back and forth showing the actively management of the funds.

Currently, we judge that the investment cycle is not quite over and this still favors risk assets. However, we are entering a face that may bring more rather than less volatility. The funds are therefore trading at around the base case allocation according to Maria Ljungqvist.

”Our main scenario is that the current investment cycle is set to continue translating into higher interest rates before we see a turnaround in overall economic conditions for the worse. At the same time, there is a possibility that we could see a downturn in economic activity without a traditional rise in interest rates. The fact that we see such an alternate scenario as not too farfetched make us somewhat defensive despite a positive main scenario”, Ljungqvist explains.

On the credit side, Ljungqvist foresees that the new investment process will focus more on the purpose of each investment, both from a liquidity and risk/return standpoint.

”Right now we have a rather conservative credit exposure, but it is spread in different parts of the credit spectra. Looking forward I see the credit exposure as being more divided according to its purpose. One part of the credit book will be leaned towards liquidity management, which of course filters out the less liquid bonds and in essence works as an alternative to cash. On the other hand you have the alpha-generating part where credits are seen competing more with the equities part of the portfolio, either in terms of dividend yields or as a value case.”

Within credits, the investment mandate allows for the fund to take on exposures further out in the high-yield segment, however, Ljungqvist highlights that the new investment process is still being developed.

”Since we are likely to enter the later part of the investment cycle, this is not the time to be massively exposed to the high yield segment. We also foresee that the number of defaults will rise further, particularly within certain sectors of the market such as energy”

Within the equity book, Wendt sees significant changes to come about as a result of the change in the portfolio management set-up.

Marie Ljungqvist, Philip Wendt - Portfolio Managers at Aktie-Ansvar

”The equity part of the portfolio used to be very focused on so-called yield plays, meaning real estate and banks, given our positive main scenario, we have now increased the weight to cyclical stocks to reflect that view. Also when we came to Aktie-Ansvar we naturally started a discussion with Lars Erik Lundgren, the current manager of Swedish equities to have his inputs and views, as he had recently increased the weights to cyclicals, there was an obvious consensus about where we were going which reinforced our view”

The team effort is also something that Aktie-Ansvars CEO Sina Mostafavi, highlights as being a key ingredient in the new organization.

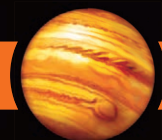
”With the addition of Philip and Maria, we have gathered a number of specialists, within credit and macro as well as in equities. However, we do not see each position as an individual part but rather look to benefit from a symbiosis effect combining all these competencies and lay the ground for ongoing discussions between the teams. Although we have only had the new team in place for a couple of months, we see that there is already an increased activity in terms of positioning in the funds, which I see as a positive sign”, Mostafavi concludes.

OUTCOME

Same ingredients. Different results.

A talented professional can create extraordinary results from the same ingredients that everybody else has access to. In the same way, our investment specialists take market information and apply their unique insights with the aim to deliver outperformance. Our fund managers' talent combined with the freedom to actively invest with conviction is what, we believe, sets us apart. Jupiter Asset Management – committed to active fund management across equities, fixed income, multi asset and absolute return. For more information on Jupiter's offering in the Nordic region, please visit **jupiteram.com** or call **+46 (0)8 767 4000**.

Market and exchange rate movements can cause the value of an investment to fall as well as rise, and you may get back less than originally invested.



ACTIVE FUND MANAGEMENT

JUPITER Asset Management

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DISCIPLINED APPROACH IN MERGER ARB HAS AVOIDED MOST DEAL BREAKS

by Hamlin Lovell, HedgeNordic

Merger arbitrage or 'risk arbitrage' comes in many flavours. Managers differ in terms of the balance between systematic rules and discretion, portfolio concentration and diversification criteria, exposure to leveraged and hostile deals, whether they invest before official announcements, the size of targets they will invest in, their selling discipline before or after deal breaks, and so forth. Consequently, return and volatility targets for merger arbitrage funds can range from low single digits to low double digits, in our experience.

Bond Substitute and Portfolio Diversifier

We would categorise the AllianzGI strategy as being towards the lower end of the risk spectrum, targeting 'cash plus' returns of 2-5% over the risk free rate (EONIA) and indeed AllianzGI view the strategy as 'yield enhancement' or 'bond substitute'. AllianzGI argues that range of holding periods between one month and one year (with an average of four months) combined with the level of spreads makes the return profile of the strategy akin to short maturity high yield bonds.

The strategy has attained its return target every year, making 2.47% in 2013, 1.83% in 2014 and 4.33% in 2015 (and returns are GIPS-compliant since December 2012). Average annualised returns of 2.87% and volatility of 1.59% have generated a Sharpe ratio of 1.77. In addition, the strategy offers diversification from conventional asset classes: its correlation to world equity markets, at just 0.07 to the MSCI World Equity, is lower than some other merger arbitrage funds, but the equity beta might of course increase under stressed market conditions, according to lead manager Dr Tim Wooge. The strategy has been tested under such conditions: before the UCITS was launched in 2012, AllianzGI ran a merger arbitrage strategy that was resilient in 2008. Wooge recalls how "lower risk deals in 2008 saw their spreads widen into our range".

Systematic Rules Reduce Deal Break Risk

The strategy is distinguished by a series of systematic rules providing the foundation of portfolio construction, and

accounting for a significant part of the investment process of the investment process, according Wooge, who has a PhD in Global M&A from Cambridge University. AllianzGI has devised a set of rules that are designed to mitigate downside risk when investing in merger arbitrage deals, mainly by reducing the risk of deals breaking.

Firstly, AllianzGI is more diversified than some merger arbitrage funds. The strategy has at least 25 positions and sizes them at a maximum of 3%, with riskier deals such as leveraged buyouts or those in emerging markets more likely to be 1.5% positions. These concentration limits are tighter than the 5/10/40 rules applying to UCITS. AllianzGI's probabilistic simulation suggests that diversification greatly reduces the magnitude of expected losses.

> **"AllianzGI only invests after official announcements and therefore avoids 'rumourtrage'."**

As well as diversifying across more deals, AllianzGI wants each individual deal to avoid certain risk factors. AllianzGI only invests in friendly or agreed merger deals and avoids hostile bids. AllianzGI only invests after official announcements and therefore avoids 'rumourtrage'. Target positions are mainly in developed markets with the USA the largest allocation. AllianzGI is size, region and sector agnostic, which does in fact allow for a substantial allocation of around 30% to small caps, defined as market cap between $200mm and $2bn.

AllianzGI only invests in deals with annualised spreads of between 2% and 5% (factoring in costs including stock borrow and any derivative related returns where relevant), which rules out some deals that are perceived to be higher risk such as Pfizer's offer for Allergan, which was not consummated. The spread criterion only applies at the inception of deals, so Allianz Global Investors is not automatically forced to sell positions after spreads widen, as has happened in 2016. AllianzGI may sell deals if the spread tightens to below EONIA, to lock in profits rather than waiting for the last few basis points of possible return.

But one exception can apply when a target stock trades above the level of an initial offer, due to counterbidders entering the fray (meaning that the spread to the original offer price is in effect negative). AllianzGI can then exercise discretion to remain invested, and has done so with electronics retailer Darty.

Discretion also enters the process in several areas. Deals perceived to have a high termination risk can be avoided even if their spreads are within the target range. The break of the Abbvie/Shire deal in 2014 prompted the team to rethink tax inversion risk, and therefore AllianzGI's position in the Shire/Baxalta deal is sized smaller while some other deals involving tax inversion have not been invested in at all. Allianz Global Investors abides by a hard rule of exiting if acquirers withdraw offers. AllianzGI can also exit or reduce positions out if key deal milestones, such as regulatory or antitrust approvals or changes in legislation, go the wrong way - and AllianzGIs has sold out of, or scaled back, some positions before deal breaks. For instance, a position in Baker Hughes/Halliburton was halved after regulators starting scrutinizing the deal more closely and suggesting that disposals would be needed. Back in 2007, Sallie Mae was sold after a public announcement indicated that the bidder might renege. The combination of systematic rules and some discretion has allowed AllianzGI to avoid most deal breaks: it has suffered 2% breaks whereas 13% of deals overall have broken between Q1 2006 and Q4 2015 (source: Bloomberg data).

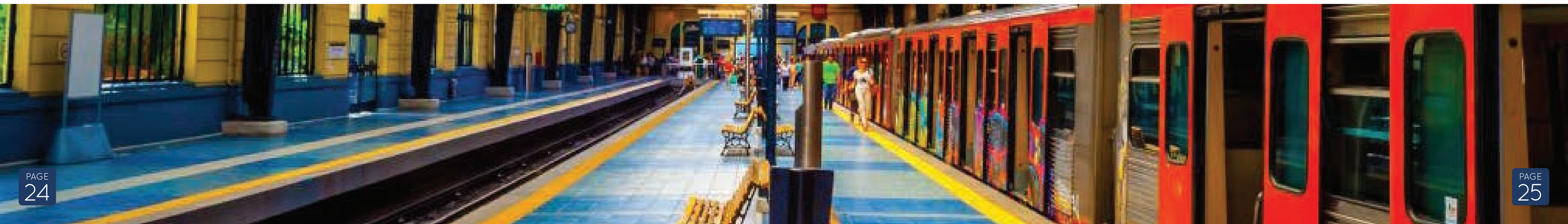
Trade construction most often buys cash physical stock and shorts, or buys puts on, any acquirer equity, but trades can be constructed in two other ways. The use of derivatives can sometimes make it worthwhile to invest in deals that would otherwise not meet AllianzGI's minimum return target of 2% annualised. For instance if implied volatility is high, AllianzGI may sell puts – and will size the position (its delta-adjusted notional exposure) at the same level as for a cash stock position. Occasionally, AllianzGI will also construct a 'buy write' trade selling calls against a long stock position. At present only one out of 61 deals is a short put however.

Dr. Tim Wooge, Co-Portfolio Manager of the Allianz Merger Arbitrage

AllianzGI's Alternative UCITS Capabilities

AllianzGI does macro and micro research on nearly all asset classes. AllianzGI has been managing alternatives for 10 years, runs a total of $14bn in alternatives, with the firm managing $400bn altogether. The alternatives teams are based in Frankfurt, Munich, Hong Kong, San Francisco and New York. The merger arbitrage team sit in Frankfurt with an equity research team on the same floor. The merger group makes use of market intelligence from providers such as MergerMarket and Deal Reporter. There is also a dedicated trading desk. Internal risk management is complemented by external independent risk management from IDS.

AllianzGI set up the regulated, daily dealing UCITS in October 2012 partly for the proprietary capital of a groups, in order to avoid the 49% capital charge under Solvency II that can apply to hedge funds that are classified as 'opaque'. The transparency afforded by a UCITS structure is one way in which to reduce the capital charge, in this case to 38%. The Luxembourg CSSF regulator provides additional oversight of the strategy. Currently all $650mm of assets are in the UCITS.



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BENEFITING FROM A MARKET REGIME SHIFT

by Jonathan Furelid – HedgeNordic

James Clunie, Head of Strategy, Absolute Return at Jupiter Asset Management, discusses the benefits of a flexible approach to long/short equity investing in times when markets are repricing risk.

The last several years of risk seeking investor sentiment has made growth stocks significantly outperform value stocks. Going into 2016, the valuation gap was at levels not seen since the peak of the internet bubble in the late 1990s. According to James Clunie, Head of Strategy, Absolute Return at Jupiter Asset Management, the market correction in the first two months of 2016 might well indicate that this anomaly is about to unwind, potentially creating rich opportunities for a flexible long/short equity strategy.

"We see the recent change in risk appetite as beneficial to the way we approach markets. Rather than holding a structural long bias to the equity market, we seek to maintain a flexible investment mandate over time, particularly looking to exploit opportunities in the short book", Clunie explains.

According to Clunie, who runs a Jupiter Global Absolute Return Strategy at Jupiter, a long/short equity strategy with a variable bias, the current environment is opportune for the way he approaches portfolio construction, in his views.

"Our approach builds on creating robust portfolios that are able to cope with sudden shifts in risk appetite. Our focus on adding diversifying short positions to a long book of what we believe to be under-priced securities under most scenarios, has shown great resilience during the market turmoil in the early parts of 2016", Clunie says.

As part of the strategy employed by Clunie, tactical positions are traded around a portfolio of long and short holdings that are more structural in nature. Admittedly hard to time, Clunie is currently adding to the tactical short book of the portfolio.

"There is always a critical timing component to finding profitable tactical trades, especially when shorting stocks. Our strength I believe lies in our understanding of stock lending and short selling data that feeds into the investment process. By reviewing this data on a daily basis we get a good feel for when to enter a trade and when to stay out, besides it give us valuable information about the overall market sentiment".

"We see rich opportunities in the short book as what we perceive to be over-priced growth stocks now are undergoing a re-evaluation compared to value stocks. Value companies have been out of fashion for quite some time but as investors are re-pricing risk in the wake of increased uncertainty about the global economy, these are representing good value from a risk/return standpoint", Clunie explains;

Clunie argues that many of the high profile growth stocks that have seen massive rallies in recent years have profited from the combination of a risk seeking environment and successful "storytelling". By storytelling he refers to a behavioural aspect where stakeholders in a company, such as the management team, brokers and investors, rely upon a compelling story to propel valuations to levels seemingly difficult to justify using standard valuation metrices.

"The value of a good story tends to play a more significant part in the market´s perceptions of acceptable valuations when stock prices become disengaged from fundamentals", Clunie says;

"With economic growth scarce and interest rates extremely low, the market has been willing to chase companies with optimistic growth strategies, which include a high amount of leverage and a tendency to make serial acquisitions and to use cash flows for share buybacks - a short sighted strategy that could prove devastating for long term shareholder value", he argues.

As examples of companies benefiting from storytelling, Clunie mentions the so-called "fangs" (Facebook, Amazon, Netflix and Google) where he sees risks in how the market is pricing these stocks relative to their fundamental characteristics.

"The prices these stocks command suggest the market is certain of these companies succeeding and not discounting any probability that they might fail, or at the very least hit speed bumps along the way", Clunie says.

Clunie mentions Netflix as an example of a stock which he believes has been overly rewarded for its growth prospects where investors are buying into its disruptive force in the television market.

"Netflix is a prime example of a company with disruptive technology that commands a high market premium, it is emblematic of the sort of 'glamour' growth stock that is very much in vogue. It currently trades at a price to earnings ratio of 285 times as compared to a sector average of about 16. At that level, the market is expecting an exponential growth in subscriber numbers and unfettered execution of the company´s business strategy. There is little discount for risks such as an increase in content costs or competition from the likes of Amazon and Yahoo.

Clunie also recognizes how little emphasis is put on the impact of global economic events on these growth companies.

Investors have bought into the disruption story with full force and largely ignored events in the larger economy, such as worries about China and the efficacy of central bank policy to stimulate growth, that has had signficant negative effects on the commodity sector for example. There has been a sense that fangs and growth stocks like them have somehow been immune to macroeconomic risk factors."

Clunie and his investment team have found opportunities to "trade against the grain" as the valuation gap between growth and value stocks has widened and are currently net short of equities in the investment mandates they are running.

"We have a meaningful short exposure to growth businesses in the US that we believe either have hubristic capital intensive growth strategies and/or unsustainable market ratings. These positions are balanced against a long book of "value out of fashion" stocks that we believe are undervalued in relative terms and that we anticipate have the potential to outperform as the current risk regime unwinds and investors start focusing on fundamentals again."

TURNING STYLE PREMIA INTO TRUE Styles

by Jonathan Furelid – HedgeNordic

Erik Rubingh, Head of Systematic Strategies
BMO Global Asset Management

Erik Rubingh, head of systematic strategies at BMO Global Asset Management, explains how a modified approach to style premia investing can lead to greater predictive power of styles while at the same time improving long-term portfolio returns and increase diversification.

Investing into so-called style factors, most widely applied to the stock market, has seen increased interest among institutional investors in recent years. Based on extensive academic research, a number of exploitable styles have been identified to prove long-term postive returns across markets and asset groups. These include factors such as value, size and momentum and build to a significant extent on the findings of the influential academics Eugene Fama and Kenneth French.

Simply put, investing in styles is investing in relationships that are backed by robust data and economic theory. By applying it in a market neutral framework, the style premia can be isolated from the equity market risk, offering returns uncorrelated to traditional asset classes.

A classical example of a style factor is "value". Research shows that, over time, so-called value stocks, meaning stocks that are trading at low levels compared to their book value, tend to outperform stocks trading at high price-to-book ratios. By going long cheap stocks and shorting expensive stocks an investor could isolate the "value style premia" and thereby, in theory, outperform the market over time.

"The interesting thing about style factors is that they isolate the behavioural aspects of the equity market. The fact that equities that are cheap relative to their fundamental value over time has outperformed stocks that are trading at a high price-to-book, is inherent in investors´ thinking of buying low and selling high" Rubingh explains continuing;

"What we at BMO Global Asset Management aim to achieve in our style premia investment mandates is to generate positive excess returns through systematically exploiting the premia associated with factors such as value, size, momentum, volatility and GARP (growth at a reasonable price) and applying it in a market neutral framework in order to extract these premia without exposing investors to the equity market risk".

TURNING STYLES INTO TRUE STYLES

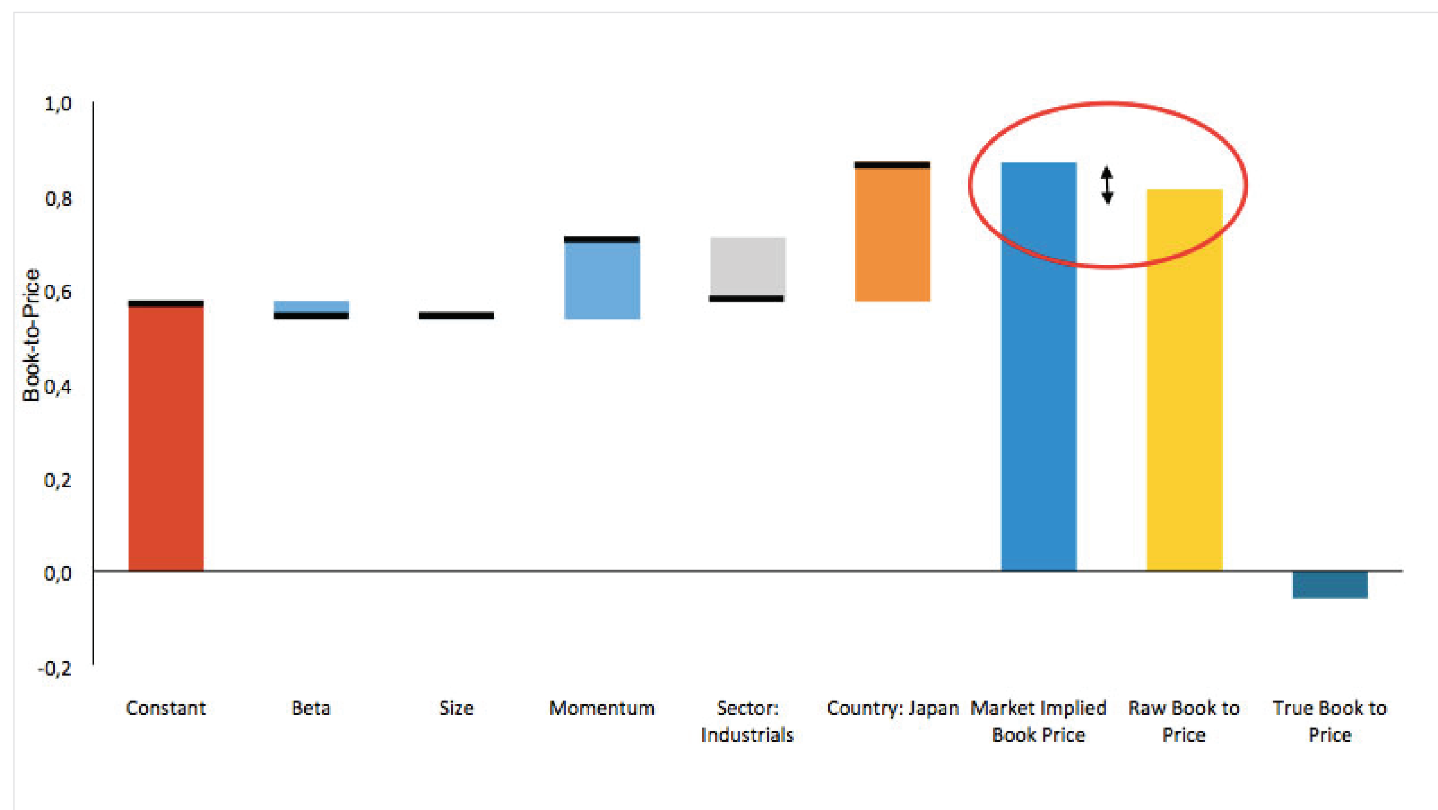
According to Rubingh, style premia offers compelling risk return characteristics and interesting diversification benefits, however, a potential problem is that various styles are not independent, leading to overlapping characteristics not sought after when constructing portfolios of styles. For example a stock can be considered a buy on the grounds of value but offer poor momentum leading to a suboptimal position from a style perspective. This is the reason Rubingh and the investment team at BMO Global Asset Management has created what they refer to as a "true styles" approach.

"The fact that styles are not independent can lead to worse risk/return characteristics and lower diversification

STYLES

True value	Excessive pessimism with respect to the prospects for 'cheap' companies leads to higher returns
True size*	Higher (diversifiable) risk of smaller companies leads to better returns of smaller companies as a group
True momentum	Under reaction to news and extrapolation of past trends leads to past winners continuing to win and past losers continuing to lose
Low volatility	Aversion to leverage and the 'lottery effect' lead to low risk stocks outperforming high risk stocks
True growth at a reasonable price	Stocks with good growth, moderate valuations and good quality financial statements represent 'the best of all worlds'

TRUE VALUE



benefits than anticipated. Our unique true styles approach isolates the desired style to capture independent of other styles and market factors. This leads to a greatly improved predictive power of the style while at the same time lowering the correlation between styles, improving the diversification benefits."

To give an example of how the true styles approach is implemented and leads to differences in position-taking compared to a traditional or "raw" style approach, Rubingh mentions Japanese electronic manufacturer Toshiba.

"Toshiba is a stock that has experienced significant headwinds in the past year which cumulated when the company admitted to accounting irregularities. As a result Toshiba shares have underperformed both the MSCI World and MSCI Japan by a wide margin lately, the question is, does Toshiba offer a good value opportunity", Rubingh asks himself.

"From a book-to-price perspective, Toshiba appears cheap. However, when considering styles factors and how the market values Toshiba one might come to a different conclusion. In our true styles approach we incorporate factors such as momentum, size, sector and country in order to create an understanding how the market values these factors in relation to the book value of the stock", Rubingh explains.

"Looking at Toshiba, when we combine the style factors that make up the valuation, the so-called market implied price-to-book, and compare it to our raw book to price number, it actually comes out fairly valued, even a bit expensive", Rubingh says.

Comparing the true styles approach to a traditional approach using the raw book-to-price has added significant value over time, according to Rubingh.

"The true styles approach not only increases your annualised return compared to the raw style approach, it significantly reduces the volatility as well resulting in a much improved risk adjusted return profile. The true styles approach simply get rid of all the nasty time variation in returns and results in a predictive power that is three times as high compared to using the raw variable."

Another point that Rubingh wants to make with using the true styles approach is that the correlation between the different styles is significantly reduced.

"The correlation between our different true style factors is close to zero giving us a great benefit when putting everything together in a portfolio context", Rubingh argues.

CONSTRUCTING A PORTFOLIO OF TRUE STYLES

When constructing the portfolio, the five style factors chosen by the team at BMO Global Asset Management; value, size, momentum, volatility and GARP are grouped into separate sub-portfolios. Through an optimizer, the style factor for each portfolio is then maximized to get rid of other factors influencing its performance such as the equity market beta. The style portfolios also aim to minimize stock specific risks.

"As a quant, you want to limit the stock specific risks as these tend to make returns less predictable", Rubingh explains.

When combining the styles into a portfolio, BMO Global Asset Management uses an active equal risk contribution methodology.

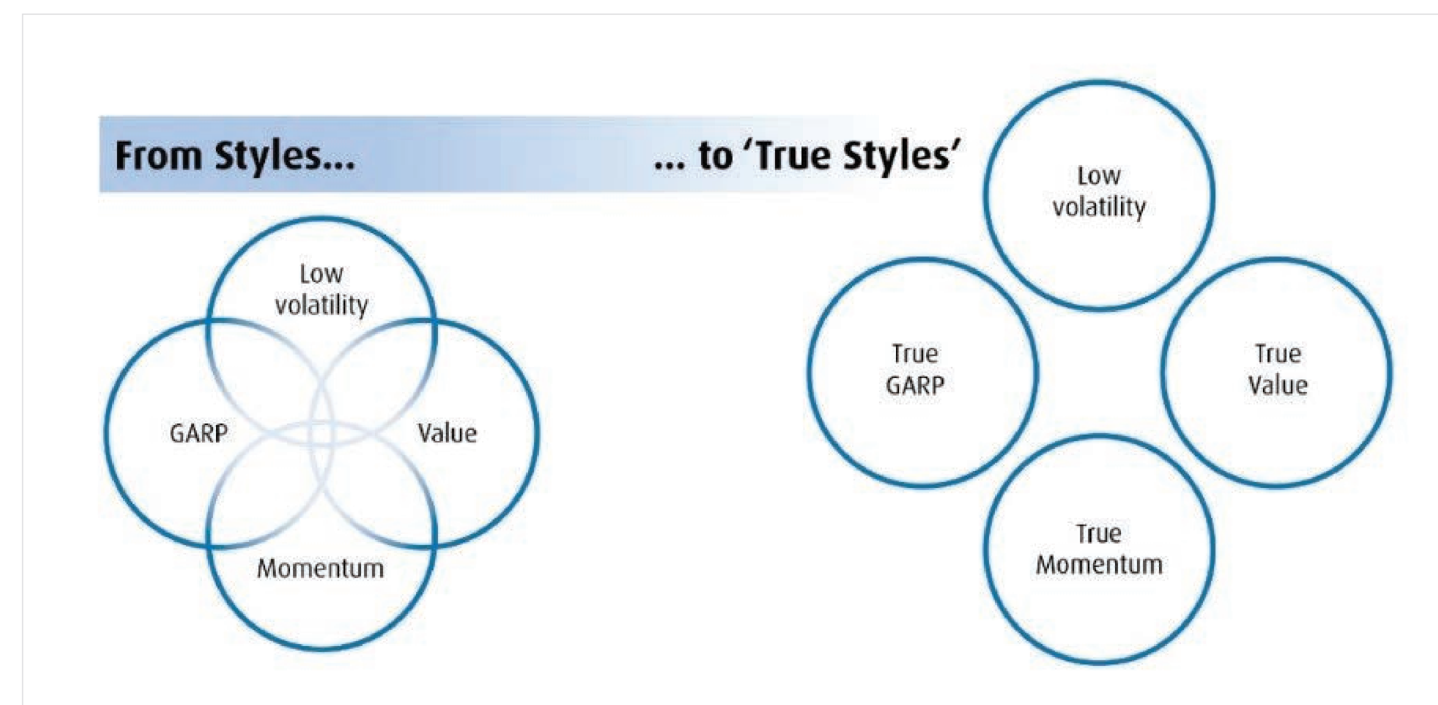
"We do not believe in trying to time style factors and because of the true styles approach we see no reason to time the factors. We are happy with our styles and we want exposure to each factor but aim for a stable exposure. The most natural way then becomes to give each style an equal risk allocation, a risk parity approach", Rubingh says.

The final portfolio is a market neutral composition of individual names with 300-400 names on the long side and an equal amount of individual stocks on the short side. The resulting volatility is around 4-5 percent, which could be geared using leverage. The strategy only invests in developed market equities which according to Rubingh is a conscious choice.

"While we are confident our factors work in emerging markets too the reality is that these markets are more prone to be influenced by external factors such as shorting bans which would disturb our investment process in the short term, possibly forcing us to liquidate positions. We see return potential in Emerging Markets (EM), but has chosen not to include these markets".

The current assets under management (AuM) of the style premia strategy that BMO Global Asset Management runs is around 348 million USD as of 30/4-16 and Rubingh see capacity far greater than that. The team also rolled out a SICAV structure in April targeting European investors with locally hedged share-classes.

FROM STYLES TO TRUE STYLES



PREFERRED SECURITIES

by Mark Lieb, Spectrum Asset Management

An oasis in the fixed income desert?

Following the global financial crisis, the restructuring and recapitalisation of financial firms have made banks and insurance companies an attractive sector for fixed income investors. The widespread regulatory change embodied in the Dodd-Frank Act, Basel III, and Solvency II, among others, have reduced many of the risks in the banking and financial sectors. Preferred securities may not be a familiar sector to European fixed income investors, but in an ongoing era of low interest rates, quantitative easing, global deflation, and fiscal repression, they offer an attractive risk-return proposition and modest correlations with other fixed income asset classes.

Fixed income yields, as a whole, remain at historic lows. Quantitative easing throughout the world, extraordinarily accommodative monetary policy, and global demand for yield have driven fixed income returns to levels unseen in virtually any prior market cycle. As a result, investors are finding it a challenge to obtain acceptable returns without taking greater credit and interest rate risk in this yield-starved environment. Spectrum Asset Management, an affiliate of Principal Global Investors, believes that preferred securities are a compelling addition to a fixed income portfolio and an opportunity to provide attractive returns with relatively moderate incremental risk.

What are "preferred securities"?

Preferred securities are the collection of structurally subordinated fixed income instruments that are issued by companies around the globe. The largest issuers are banking and insurance companies who issue preferred securities to provide them with regulatory capital or ratings agency equity credit at a lower cost than common stock. Preferred securities structures include issues that are subordinate to senior debt and senior to common stock with a distribution rate or yield.

These structures include; subordinated debt, trust preferred securities, contingent convertible capital securities ("CoCos"), additional tier 1 capital instruments, cumulative preferred stock, and non-cumulative preferred stock.

Focusing on the U.S. dollar market, the preferred securities market comprises approximately $500 billion in outstanding par value paper as of 31 December 2015[1] and is issued by geographically diverse companies from the United States, Europe, Asia, Japan and Latin America. Unique to the U.S. dollar market, there are two trading markets for preferred securities - $25 par and $1,000 par.

In terms of credit quality, the preferred securities market is approximately 50% investment-grade rated and 50% below investment-grade rated[2].

If one examines the issuers of preferred securities from an overall issuer credit quality perspective, the ratings distribution of their senior debt is almost 90% investment-grade rated[3]. The universe of preferred securities issuers has substantially greater overlap with the investment-grade fixed income market than with the high-yield fixed income market.

1,2,3 Source: Spectrum Asset Management, Inc., Moody's Investor Service, Standard and Poor's, and Bloomberg LLP as at 31 December 2015.

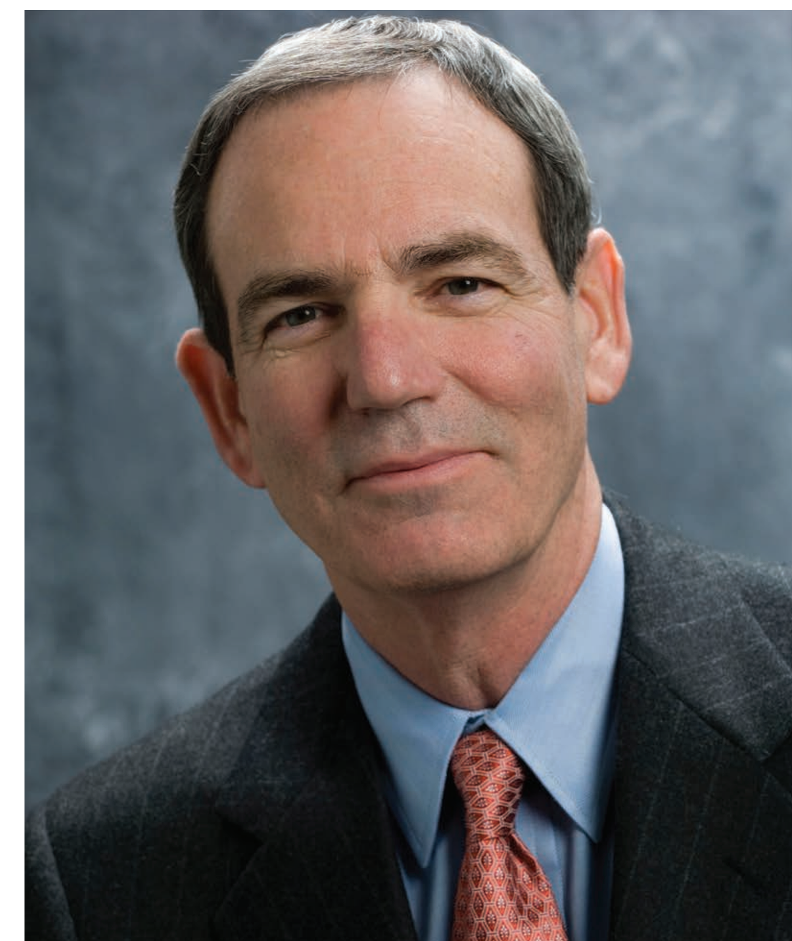
Despite this ratings distribution, the preferred securities market is dominated by industry sectors that have been forced to de-risk over the last five years. Between the Dodd-Frank Act, Basel III, and Solvency II, financial services companies have been required by law and regulation to increase capital, reduce operating leverage, reduce balance sheet leverage, and manage to a more conservative approach. This creates an attractive backdrop for fixed income investors.

Why invest in preferred securities?

In short, preferred securities are a potentially effective tool for the diversified fixed income investor seeking to enhance total return and moderate portfolio volatility. Due to the dual $1,000 par and $25 par markets, the significant presence of retail investors in the $25 par market, and the concentrated emphasis on financial services sectors a managed allocation to preferred securities can offer an attractive diversification tool for a fixed income investor.

An oasis in the fixed income desert...?

In today's market, fixed income investors are continuously challenged to find quality yield of any kind. Quantitative easing, designed to stimulate economies around the world, has bought down sovereign debt curves and forced investors into lower credit and longer duration paper as they seek income in an otherwise income-starved environment. Despite this dynamic, preferred securities remain an



Mark Lieb
Founder, President, and Chief Executive Officer
Spectrum Asset Management, Inc., an affiliate of Principal Global Investors

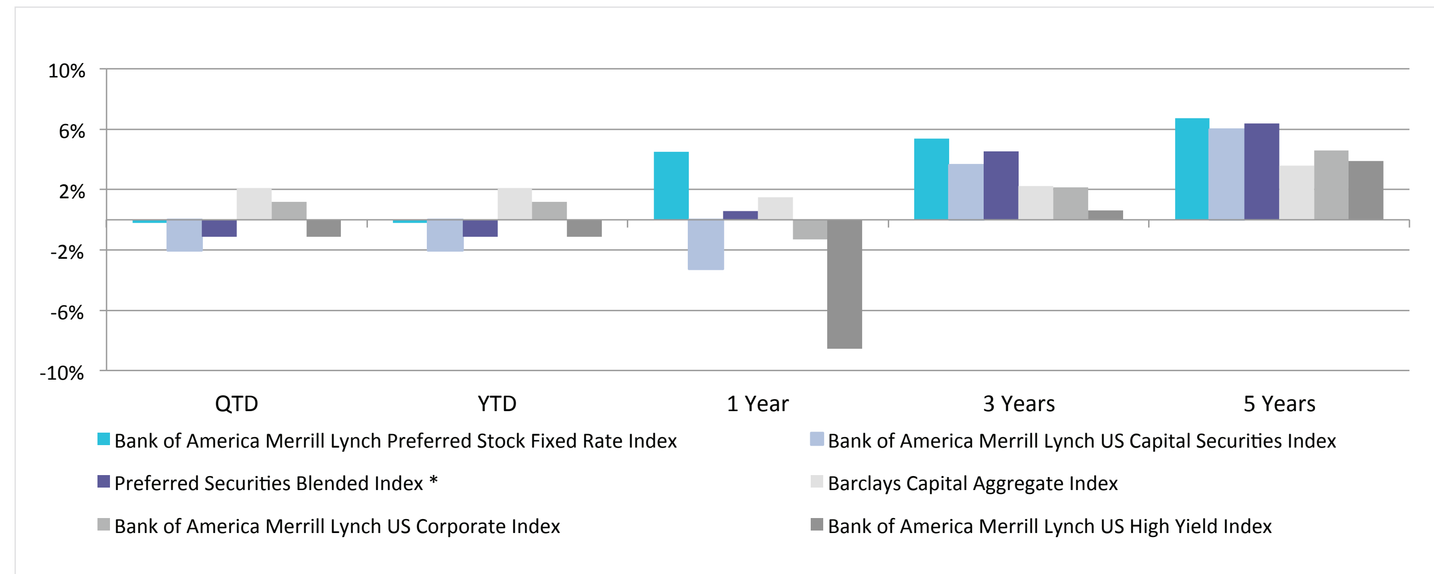
attractive sector in fixed income. Spreads from treasuries to preferred securities and from corporate senior debt to preferred securities remain wider than historical averages. At the same time, spreads from preferred securities to high-yield are tighter than historical averages. While all of these areas of fixed income appear expensive on an absolute return basis, the spread environment presents preferred securities as an attractive alternative on a relative return basis.

As shown in below table, preferred securities have performed favourably compared to the Barclays Aggregate Index and U.S. High Yield, and Corporate indices over the last one, three, and five years.

Although structurally complex, preferred securities offer fixed income investors the opportunity for incremental returns in an area of the capital markets dominated by banks and other financial services companies.

This is an area that has been underutilised by European fixed income investors. While issuers have been forced to reduce risk following the global financial crisis, the market continues to price in an attractive spread when compared to other higher quality areas of fixed income. Despite their longer duration, preferred securities may have the ability to hold value well into and potentially through a rising rate cycle as a result of the spread cushion present in the market.

Index Performance Comparison



As of 29 February 2016.

* Preferred Securities Blended Index is made up of 50% Bank of America Merrill Lynch Preferred Stock Fixed Rate Index and 50% Bank of America Merrill Lynch U.S. Capital Securities Index. It is not possible to invest directly in an index. Past index performance is not indicative of future return.

How do preferred securities behave in a rising rate environment?

Preferred securities may offer some resistance to rising rates and may perform favourably in a rising rate environment. In general, rising rates follow inflation, economic expansion, and improved credit fundamentals. Such market dynamics are favourable for credit and preferred securities as they tend to hold value and perform well in this market environment. A strategic allocation to fixed-to-floating rate and fixed-to-variable rate preferred securities structures can help to defend against rising interest. The Preferred Securities Blended Index has delivered positive returns relative to the overall bond market during the three most recent periods of interest rate increases in the U.S.

Returns can be further enhanced by effective selection of individual securities with more favourable coupon and capital change event characteristics. This complex market requires specialist skills and as one of the world's largest managers dedicated solely to preferred securities, Spectrum Asset Management, part of Principal Global Investors, is exceptionally well-placed to provide investors with access.

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A CALMER APPROACH TO CREDIT MARKETS

By John McNeill, Fixed Income Investment Manager and Co-manager of the Kames Absolute Return Bond Global Fund

Fixed income markets have begun 2016 with a bang. While higher-yielding credit securities have been unloved, government markets have seen yields fall to record-low levels, particularly in Europe and Japan. The increase in market volatility has been uncomfortable for many European bond investors. In addition, cash interest rates remain in negative territory, and the European Central Bank's (ECB) quantitative easing programme continues to suppress yields.

Given the prevailing environment, European investors continue to look for low-risk alternatives for their cash deposits. They have no motivation to invest in cash and are looking for higher-value propositions that offer a credible low-risk/low-return solution and a capital preservation target.

There is clear demand for highly liquid investment strategies that provide an alternative to cash. With our company's market-neutral philosophy towards absolute return investing, our funds offer uncorrelated investment

opportunities with a focus on liquidity, diversification and volatility management. And in fixed income specifically, the five-year track record of our absolute return bond strategy highlights our ability to manage a low-risk fund and deliver returns that meet our investors' expectations.

OUR PHILOSOPHY FOR ABSOLUTE RETURN INVESTING

When we are managing absolute return bond funds, we focus on delivering three key objectives.

1. We focus on key constraints around duration and credit exposure, and we seek to ensure that risks are effectively managed and not correlated with underlying markets.

2. We focus on our core capabilities within fixed-income asset management. We believe that clients of our absolute return bond funds are reassured that our fund managers are not distracted by seeking to exploit sources of volatility in foreign exchange or equity markets.

3. And we focus on investing in liquid markets. This is at the heart of how we build our funds: G7 government bond markets and the largest investment grade issuers represent the overwhelming majority of our absolute return funds' investments.

Our absolute return bond strategies are designed to fit portfolios where clients have concerns over the likely volatility and returns in their core fixed income strategies. Despite a divergent rate outlook in the major world economies, we coherently build returns from liquid fixed-income asset classes with a well-established and clear process. By seeking diversity within rates and investment-grade credit markets, we are less exposed to sharp and unexpected moves. Our strategies have proved their consistency since 2011, and they represent an effective way of diversifying exposure to more inherently volatile absolute return strategies.

A LOW-RISK APPROACH TO BOND INVESTING

Kames Capital's absolute return bond funds demonstrate consistent low volatility and managed correlation, as well as a strong track record of delivering positive returns.

The Kames Absolute Return Bond Global Fund (KARB Global) allows investors to take advantage of our full range of capabilities in fixed income and absolute return investing. The Fund seeks to deliver three key benefits to investors:

1. Generate positive absolute return in all market conditions.

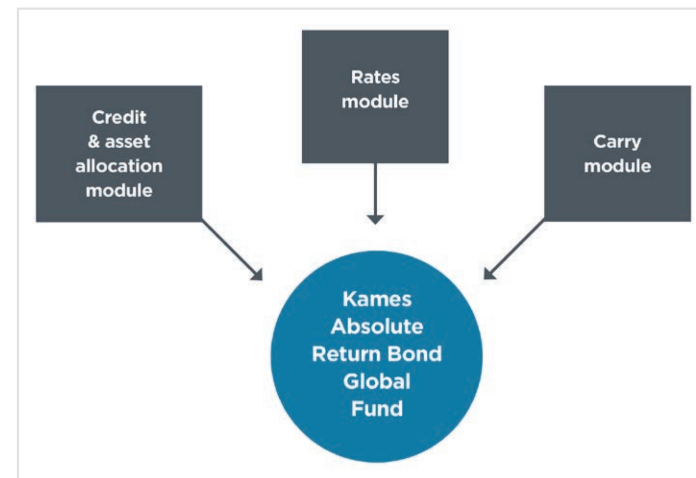
2. Maintain a low level of volatility.

3. Provide portfolio diversification through low correlation to underlying markets.

MULTIPLE SOURCES OF ALPHA

As our firm's broad philosophy towards absolute return investing is market neutral (rather than market directional) in nature, we aim to deliver returns for investors not through capturing beta but through producing alpha. To accomplish this, we have designed three distinct modules: Carry, Rates and Credit & Asset Allocation.

The **Carry** module gives the Fund the foundation for generating the required positive absolute returns. To achieve this goal, the module invests in a diversified range of short-dated investment-grade bonds with a maturity of less than five years. We aim to hold them to maturity to generate an income for the Fund.



The **Rates** module focuses primarily on adding value through duration-neutral relative-value positions in government bond markets. In addition, this module will manage the yield curve and duration risk for the Fund. Examples of trades in this module might include: relative-value trades across markets; yield curve positioning trades; and inflation breakeven positions.

The **Credit & Asset Allocation** module seeks to generate positive returns through high-conviction credit and fixed-income asset class preferences. We look for alpha-generating opportunities by exercising our capability in top-down asset allocation and bottom-up credit selection. For this Fund, our views could be expressed in preferences such as: credit stock selection; relative value trades between fixed income sectors, regions and credit curves; views on interest rates, inflation and credit markets.

Our alpha generation activities are managed with a high degree of risk oversight and control. We have set strict risk limits, covering holding size, duration range, interest rate risk, credit quality and portfolio-level value at risk. Risk control also includes position-sizing relative to asset-class correlations and market sensitivities, as well as formal reviews for positions that have added or detracted more than 10 basis points to or from the Fund's performance.

CONCLUSION

In volatile bond markets, we think the Kames Absolute Return Bond Global Fund offers investors an attractive low-risk solution that limits downside volatility and preserves capital over the medium term. With an aim to deliver a stable return profile and low correlation to underlying fixed income markets, the Fund can provide genuine diversification for a bond portfolio – and a calmer approach to generating returns in testing credit markets.

ABOUT KAMES CAPITAL

Kames Capital is a specialist investment management business. From our offices in Edinburgh and London we manage EUR 76 billion (30 September 2015) on behalf of UK and international clients - including wealth managers, financial institutions, pension funds, charities and financial advisers.

Our heritage dates back to 1831, when the Scottish Equitable Life Assurance Society was founded. The re-branding to Kames Capital in 2011 has helped us build recognition in our chosen markets, while differentiating our capabilities from other companies within the Aegon group.

Investment management is our only business, ensuring we have no competing priorities or distractions. We focus exclusively on the six areas in which we believe we can offer our clients a compelling proposition - fixed income, equities, property, absolute return, ethical and multi-asset investing - and have a stable and experienced team of 92 investment professionals, who have an average experience of 19 years (31 December 2015). They have managed portfolios across numerous market cycles and have the skill and judgment to make the right investment decisions for our clients.

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by Neil Mason, Portfolio Manager
GLG European Long-Short strategy

FINDING POSITIVE RETURNS IN AN UNCERTAIN, LOW INTEREST RATE ENVIRONMENT

NOT ALL EQUITY MARKET NEUTRAL STRATEGIES ARE MADE EQUAL

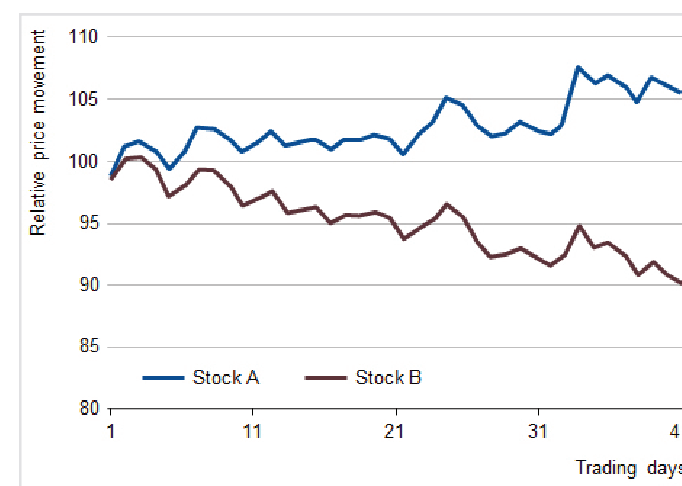
What do we mean by 'dispersion'?

We operate in an industry which is frequently characterised by misconceptions over the meaning of different terms, and misunderstandings over whether any two given terms are interchangeable. For example, we often hear and read that an environment in which asset prices are highly correlated is a difficult one for discretionary fund managers, but is this really the case?

Chart 1 illustrates the performance of two stocks with a very high correlation (<0.9), which is illustrated by their tendency to move in the same direction and by a similar magnitude on any given day. However, over 41 trading sessions, the divergence in returns is 16%, demonstrating that it is possible to generate significant trading profits by holding long and short positions in two stocks that are highly correlated with one another, as long as dispersion is evident.

The alpha extraction potential of a skilled, long/short stock picker is determined by the difference between the returns of the best performing stocks, in any given universe, and those of the laggards (a more intuitive definition of dispersion). As we can see below, dispersion is a persistent phenomenon across different timeframes, and the same can be said of regions, countries and sectors around the globe.

Chart 1: Correlated but divergent returns



Source: Cambrian Quantitative Research (November 2015). Schematic illustration

Chart 2 on the following page analyses recurring return dispersion over a relatively short timeframe (3 months). The opportunities for a fund manager to add value arise as a result of pricing dislocations, within historical ranges and relationships, and these can be harnessed through a 'mean reversion' approach. 'Co-integration' is a term that describes a relationship between the prices of two different stocks in which they diverge and then re-converge. This tendency to re-align is quite different from a correlation relationship.

An intuitive example of co-integration is to think of a dog owner taking their pet for a walk on an extendable leash. When the owner considers it safe to do so, the dog can diverge from its owner's path to the full extent of the leash's range, but not further. The owner will then rein in the slack as they approach a road to ensure that their paths re-converge before they reach the danger.

Similarly, when the spread in price of two co-integrated shares reaches the outer boundaries of the historical range, this is the optimal time to implement the convergence trade.

There is plenty of academic research in support of this type of mean reversion trading approach, suggesting that it is capable of generating positive excess returns over time[1].

Fundamental dispersion: something different altogether

An approach seeking to exploit fundamental dispersion differs from a mean reversion strategy in that it analyses fundamental reasons why share prices should continue to diverge. For example, one company might have recently gained a technological advantage over a big rival.

This could trigger an unrelenting dispersion in fundamentals (sales, profits and earnings), with a commensurate effect on share prices. The challenge for the fund manager, therefore, is to identify businesses that are likely to outperform over an extended period. As such, the exploitation of fundamental dispersion is a longer-term, pro-momentum strategy, but the potential returns from any given positions are significantly greater than those associated with shorter-term mean reversion.

Again, there is significant academic research in support of the concept of pro-momentum strategies as a potential source of excess returns over time[2]. Intuitively, a further study[3] has proven that a combination of momentum and mean reversion strategies outperforms both of the individual approaches in isolation, by virtue of the diversification benefit.

This constitutes a powerful argument for a 'decentralisation of investment decisions', whereby a number of individuals pursuing different, and potentially complementary, approaches have collective responsibility for stock selection; not least because it is likely to prove very difficult for one manager to be successful in executing two strategies which demand a completely different analytical approach.

Factor exposures are unpredictable

The value of the equity market-neutral (EMN) proposition is that it seeks to minimise exposure to the unpredictable component of investment returns (market directionality or 'beta') and emphasise fund manager skill ('alpha'), which can be effectively monitored and enhanced over time.

However, not all EMN strategies are made equal because some have larger permissible beta ranges and most fail to adequately constrain factor exposures, which can frequently display beta-like properties.

For example, one of the most interesting properties of momentum is that it tends to display very significant seasonal and cyclical variations. Consequently, momentum can be viewed as both an opportunity and a risk depending on where we are in terms of both the calendar and the market cycle.

Chart 3 illustrates the seasonality tilts displayed by the momentum factor. In the monthly return series of European

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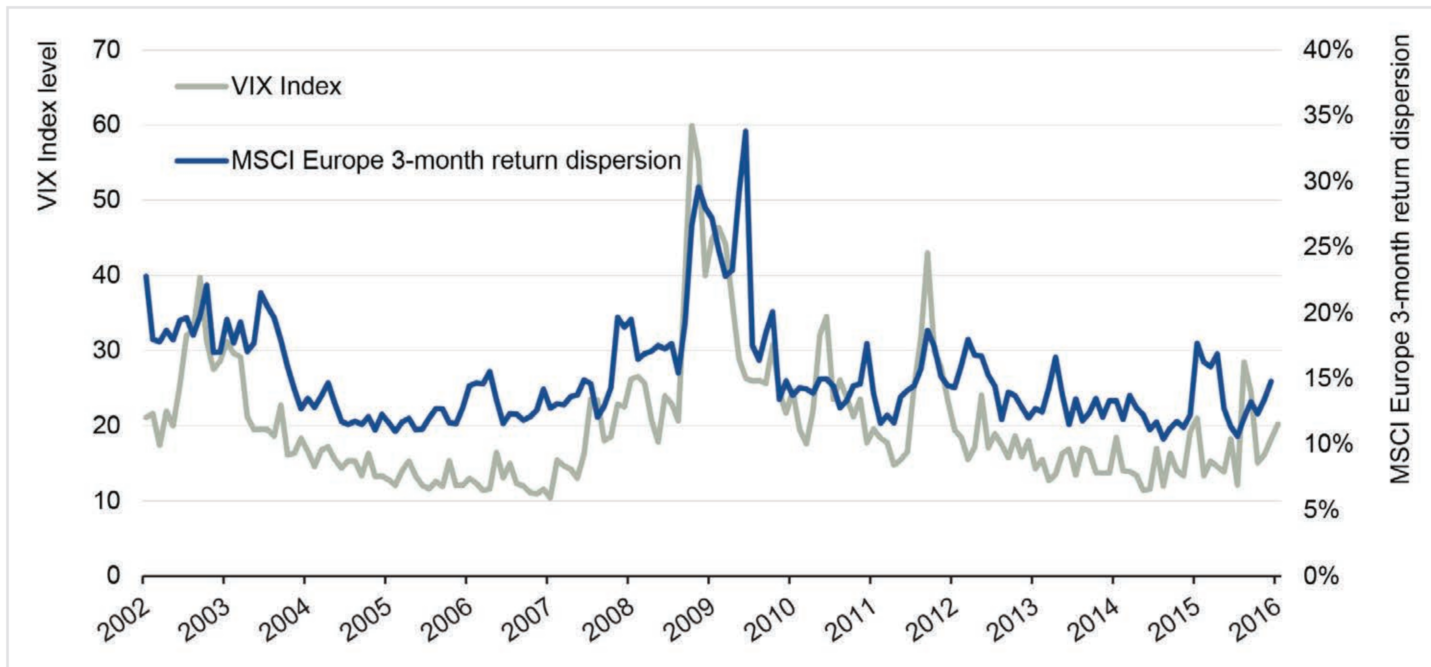
Chart 2: Dispersion: a persistent phenomenon that increases with volatility



Source: Bloomberg (February 2016)

12-month momentum, we see evidence of stronger returns towards the end of the year.

Our second factor example is free cash flow (FCF). The issue with FCF is that its usefulness varies significantly in terms of the nature of the business being analysed. Consequently, it is therefore essential to assess FCF within an industry context, in order to mitigate the possibility of basing portfolio composition, and exposure to the FCF factor, on potentially misleading information.

For example, real estate companies are clearly in the business of buying land and/or buildings to (re)develop. So, in any given year, investment in new assets could exceed operating income, leading to negative FCF.

Similarly, the role of the regulators of gas and electricity suppliers is to ensure that end customers get a fair deal for such an essential service. As such, the FCF of these businesses is heavily scrutinised to ensure that they are not making 'too much' money. This, therefore, constitutes an incentive for utilities to deliberately understate their FCF.

Consequently, it is important to appreciate that accurate measurement of factor exposures is itself a challenge, since factors can form in different ways and statistical analysis may therefore be highly subjective. Indeed, any positive influence from factor exposures is likely to be attributed to manager skill, potentially incurring unjustified performance fees and overestimating both the value of the existing track record and the sustainability of future returns.

Can we make the unsustainable sustainable?

In conclusion, it is vital to appreciate that these factors do not always behave consistently when determining whether to constrain or neutralise factor exposures. As we have seen, momentum is both seasonal and cyclical, while FCF is far more relevant to some industries than others. This is one of the reasons why we advocate a risk management framework that operates at both the sector and total portfolio levels.

Furthermore, the accurate measurement of exposures to factors can be very challenging. Clearly, without the proper statistical models, investors may be misinformed about, or misconstrue, the true level of downside risk that their assets are potentially exposed to.

We also believe that no risk management framework can be considered holistic, unless it takes steps to measure and constrain what we refer to as 'human risk'. This is a concept derived from behavioural finance – we all understand the basic premise of 'buying low and selling high', but human beings are psychologically conditioned to do the opposite... as many fund managers and private investors alike will have experienced to their detriment.

As such, our own framework includes a process in which objective analysis and feedback relating to past investment decisions is provided, while our investment professionals are also coached in order to improve the effectiveness of stock selection. This objective is also supported through devolving responsibilities for overall stock selection to teams of specialists who 'fish' in small pools of expertise.

Finally, it is worth reiterating that dispersion is a persistent phenomenon across different timeframes, regions, countries and sectors around the globe. Consequently, the equity market environment is one that is typically supportive of persistent alpha capture that can potentially generate the consistent and incrementally-positive returns that institutional investors crave.

The challenge is to find a manager with the capabilities to repeatedly harness a broad range of dispersion opportunities through complementary trading approaches, while effectively constraining all undesirable risk exposures.

Chart 3: The seasonality of momentum

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
2006	1.21%	0.62%	0.78%	1.34%	-0.79%	-0.18%	-0.22%	-0.66%	-0.27%	0.21%	0.50%	0.97%
2007	-0.11%	-0.18%	0.80%	0.01%	0.40%	-0.17%	0.59%	-0.68%	1.81%	0.60%	0.74%	1.30%
2008	-0.12%	0.97%	0.39%	-0.14%	1.17%	5.15%	-0.54%	-3.00%	1.19%	3.00%	1.81%	-0.32%
2009	0.68%	1.61%	-4.48%	-8.39%	-3.11%	-0.26%	-1.86%	-3.32%	-1.54%	0.90%	1.18%	-0.27%
2010	-0.12%	0.17%	1.51%	0.86%	0.45%	0.95%	-0.09%	1.28%	0.28%	-0.13%	2.79%	0.58%
2011	-3.39%	0.11%	0.71%	1.21%	0.69%	1.81%	1.50%	0.12%	0.60%	-0.66%	2.14%	0.69%
2012	-3.58%	-0.51%	1.09%	3.91%	3.45%	-2.03%	0.38%	-1.22%	0.35%	0.95%	0.83%	-0.32%
2013	-0.07%	2.16%	1.51%	0.26%	0.01%	1.19%	0.93%	-1.29%	0.17%	1.42%	0.56%	0.51%
2014	0.33%	1.10%	-0.47%	-1.83%	0.12%	0.37%	0.12%	-0.27%	1.44%	0.85%	-0.34%	0.71%
2015	1.32%	-1.76%	0.66%	-1.11%	0.75%	0.56%	1.45%	0.88%	2.25%	-0.28%	0.88%	1.26%
2016	0.28%	-0.90%										
Mean	**-0.39%**	**0.43%**	**0.25%**	**-0.39%**	**0.32%**	**0.74%**	**0.23%**	**-0.82%**	**0.63%**	**0.69%**	**1.11%**	**0.51%**

Source: Bloomberg (February 2016)

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1) Examples include 'Measuring abnormal performance: do stocks overreact?' Chopra et al (1992) and 'Winner-loser reversals in national stock market indices: can they be explained?' A.J. Richards (1997).

2) Examples include 'Momentum and auto correlation in stock returns' J Lewellen (2002) and 'Predictability of short-horizon equity returns in international equity markets' Patro and Wu (2004).

3) 'Momentum and mean reversion across national equity markets' Balvers and Wu (2006).

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by Jonathan Furelid – HedgeNordic

Michael Ekelund
CEO, Atlant

Atlant Fonder expands opportunity-set with new launches

Four new product launches, a new CEO and four additional hires, a lot has happened at Atlant Fonder in the last six months. In an interview with HedgeNordic, Michael Ekelund, the fund company´s newly appointed CEO, explains the reasoning behind the new fund launches, where he believes Atlant is heading and why Atlant´s flagship funds are struggling in the current market environment.

HedgeNordic: Atlant seems to be in an expansionary phase, new CEO, additional hires and a number of new product launches, why do you make these changes and why now?

Ekelund: Atlant has made a quick journey from managing 1 billion SEK to managing 5 billion SEK. Last year we therefore took the decision to expand the operations and the product offering in order to meet an increased demand for our products. With regards to the product offering, we wanted a broader portfolio in order to be able to better cope with different market scenarios.

Among the indivdual funds that were added the Atlant Sharp Europe started in November of last year as a result of increased demand from financial advisory clients. The fund was also added to the PPM platform. The Protect and Opportunity funds were launched in early 2016 in order to fill a gap on the market neutral side and thereby make our offer more complete.

In the beginning of 2016, we also launched the multi-strategy internal fund aiming to give access to the complete Atlant offering without any additional layer of fees. We also made the mutli-strategy external fund, a Fund-of-Fund investing into European hedge funds, more easily accessible to the broader public by decreasing the mininimum investment size and bringing liquidity to daily from monthly.

HedgeNordic: Could you walk us through the new product launches and how you see them adding value to Atlant´s core fund offering?

Ekelund: Atlant Sharp Europe is more or less a copy of Atlant Sharp with the difference being that this fund holds exposure to European equities through the EuroStoxx 50 index instead of the Swedish OMX index. As with Sharp, the ambition is to benefit from rising equity markets but limiting the downside risk through the use of derivatives. In any given year, the fund should not lose more than 10 percent while being exposed to the upside potential in European stocks. The fund got off to a good start but was caught in the market turmoil in December and January and hit the 10 percent drawdown limit in January, it has since traded very defensively. Compared to Atlant Sharp, the fund will be somewhat more volatile given that is is exposed to southern European markets that from time to time experience signficant volatility.

The Atlant Protect fund is, as the name sugggests, a more defensive product which has a market neutral

stance over time and that actively hedge market beta through buying OMX put options. It also holds fixed income positions. The idea with Protect is that it should outperform in times of falling equity markets and outperform when our managers hold a more negative view of the market. Since March, the Protect fund is offered with daily liquidity.

Atlant Opportunity is a fund that occassionally will take on larger bets when we see opportunities in equity and fixed income markets. The fund aims to return risk free plus five percent over the longer term. Since the fund launched, in January 2016, we have already had three occassions where we added signficantly to risk which shows the level of active management in this fund. It has also managed to stay positive in the recent turmoil which is in line with our expectations.

The Atlant Muti-Strategy Internal Fund is finally a way for our clients to get a broad exposure to the full offering of Atlant Fonder (the exception being Atlant Multi-Strategy External which only invests in external hedge funds). The allocations are decided based on how the management team perceieves market opportunities at any given point in time. The core allocation is made out of our market neutral funds Stability, Explora and Opportunity.

We see the new launches as highly complementary to the core fund offering as Protect and Opportunity give us an expanded opportunity-set, allowing for a quicker repositioning when markets enter bear market scenarios. Atlant Europe is at the same time giving us a broader market exposure and therby more diversification in more positive market environments. The Multi-Strategy Internal is an all-weather option for investors seeking to benefit from the diversification benefits inherent in the full Atlant offering.

HedgeNordic: Atlant's flagship funds has experienced a difficult period performance-wise in recent months. At the same time there have been announcements pointing to changes in how the funds will be managed going forward. What has not worked out and what changes are anticipated?

Ekelund: As for many other funds, Atlant has had a difficult time in the recent market turmoil. What has been particularly challenging for us is the falling oil price which has translated into signficant price declines in corporate bonds related to the Norwegian oil sector, to which we have had exposures. Not only have these contracts been subject to massive price reductions, they have also seen very thin liquidity meaning that it has been difficult to reduce exposure in an orderly fasion. At the time of this interview, we have reduced exposures to these contracts but hold on to some of them as we see good upside potential given extremely depressed valuations.

Regarding changes in the management of the funds, we have communicated that Anders Kullberg, who is head of portfolio management, will be more active in the ongoing management of the derivatives portfolio on the fixed income side. The perception is that this part has drifted somewhat from how it behaved historically and we have had Anders reviewing the fixed income book. By the end of February, Anders together with the fixed income team, made some changes to these positions in order to reduce the credit risk and duration. This in order to bring down the volatility in the funds and have them more aligned with historical levels. Going forward, Kullberg will continue to have a more hands on approach in this context.

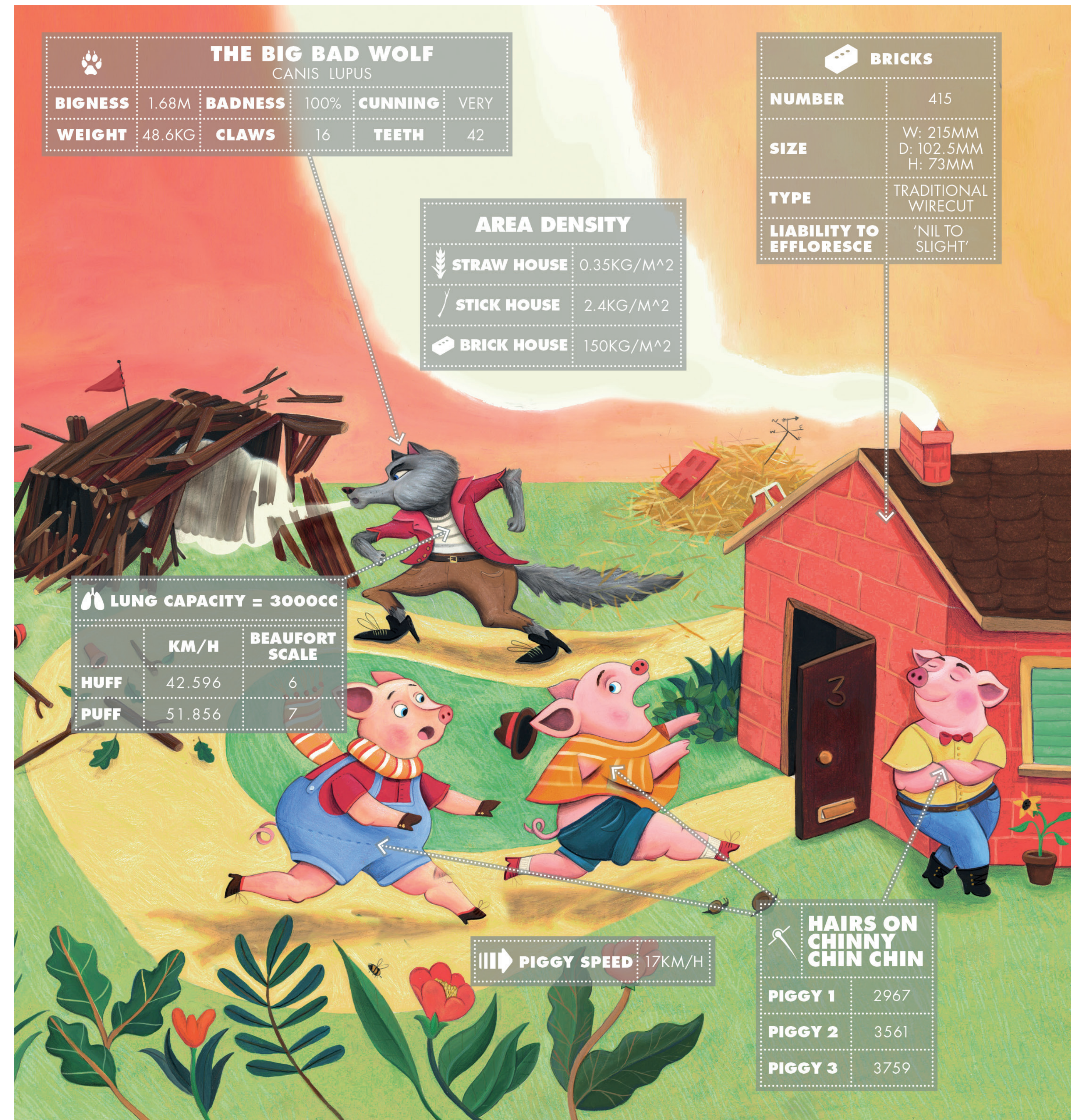
HedgeNordic: Has the recent performance translated in asset outflows?

Ekelund: Most of our clients are on the retail side where investors are quicker to react to short-term performance weaknesses. As a result there have been some outflows. On the other hand, these investors are typically the first to come back when performance picks up. We are confident that our funds will get back on track and hence attract new money again,

HedgeNordic: Where do you see Atlant in five years?

Ekelund: Our long-term goal is to become the natural choice for Nordic investors looking to invest into hedge funds. We are however well aware that the long-term success of our firm is extremely dependent on how we live up to the stated targets for each of the mandates we run.

We are also looking to add some more funds to our offering. As we speak there is a request handled by the Swedish Financial Supervisory Authority for a 2X version of the Atlant Multi-Strategy External Fund. We are also planning on one other product launch that I cannot reveal at this point but that I think will put Atlant in a highly unique position in the Nordic hedge fund space.



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by Jonathan Furelid – HedgeNordic

COMPANY-CENTRIC SMALL-CAP APPROACH PAID OFF FOR ELEMENTA IN 2015

Marcus Wahlberg, CEO Elementa

By employing a company-centric long/short equity strategy focusing on small-cap companies in the Nordics, Swedish hedge fund Elementa was one of the brightest shining stars among Nordic hedge funds in 2015. In an interview with HedgeNordic, portfolio manager Marcus Wahlberg explains the building blocks behind the strategy that returned 15 per cent in 2015, earning Elementa the "rookie of the year" award at this year´s Nordic Hedge Awards.

"Having the ability to stay nimble and focus on the investment ideas that we deem to offer the highest return potential independent of size and liquidity constraints, is what made the fund stand out during the year", Wahlberg says when HedgeNordic meets up with the manager in his Stockholm office.

Having launched the Elementa fund in March of 2015, Wahlberg saw his fund posting 10 consecutive months of positive returns before giving back minor losses in the difficult market environment that marked the first two months of 2016. At the time of writing, the fund has recouped these losses and is in positive territory again for the year after posting solid returns in March and April.

"Our ambition is to look for long-term opportunities by assessing the intrinsic attractiveness of each investment. We have a company-centric approach, meaning that we seek to become intimately familiar with each company – carefully analysing both "hard" dimensions, such as ability to win in the market, industry backdrop, technology/patents, as well as "soft" factors related to company culture and values, management bandwidth and customer satisfaction", Wahlberg explains.

When selecting companies to go long, Wahlberg has very specific requirements and compares the approach to that of a private equity investor.

"The long-book company we look for should have a leading market position and demonstrate an ability to generate profitable growth and cash flow, having a scalable business concept. In some aspects, we believe our way of thinking is more akin to private equity investing. Most of the undervalued jewel companies we look for can typically be found among the smaller names where there is little analyst and media attention, which is why we focus on businesses below 20 billion SEK in market capitalization", Wahlberg says, continuing: Our positions in Swedish IVF-company Vitrolife and the Danish financial technology enabler Simcorp were among the strongest performers.

In explaining how the portfolio is managed, Wahlberg notes that there is an important difference in how the fund structures its holdings on the long and the short side.

"In 2015, we accomplished a satisfactory outcome in terms of stock picking on the long side."

"When we look for investments to go long, we seek robust niche companies with positive cash flow generation and controllable downside features. Our long portfolio is typically very concentrated to a few names as we want to have a significant exposure to a few ideas whilst controlling risk by diversifying over industries and market drivers."

"On the short side, we tend to hold a larger number of positions in order to diversify risks. We look for companies that have structural problems that we deem not to be correctly reflected in the asset pricing. We also seek to find companies where there are unrealistic assumptions regarding growth potential or improved profitability. Highly volatile companies, for example "lumpy" project businesses with a highly variable cash flow profile, are also part of the short book", Wahlberg says.

When sourcing investment ideas, Wahlberg also include a thematic approach in order to find groups of companies that face opportunities or challenges given changes in overall market or industry trends.

"There are many industries today that are facing threats from disruptive forces that are redefining business models and the way future earnings growth will play out. Overall, we currently see the digitalization trend as a potent force, which feeds into many industries. This trend will help drive growth for companies that provide services or infrastructure related to mobile data traffic. In this context, we judge companies like Net Insight and Link Mobility to have bright future prospects. However, in many cases we shy away from direct technology risks, preferring to "sell the shovels" rather than betting on mining gold."

"There are many industries today that are facing threats from disruptive forces that are redefining business models and the way future earnings growth will play out."

"In traditional industries such as banking, there is a disintermediation trend that we see benefiting niche banks like Skandia, Nordax as well as providers of payment solutions such as West International. Environmental and regulatory tailwinds also help pave the way for companies like the Finnish environmental and industrial measurement global market leader, Vaisala."

Apart from buying and selling stocks short, the Elementa strategy also allows Wahlberg to exploit the entire capital structure of his portfolio companies by including corporate bonds. He sees the Nordic high yield market offering opportunities.

"I believe informed investors could benefit from the fact that mid-market issuers have become more and more common in this space. At its core, our company-centric approach is highly applicable to bond investing, which we can leverage to create investment opportunities. We are however only reviewing issuers that offer equity like return dynamics meaning an IRR (internal rate of return) of in excess of 10 per cent."

Elementa has a highly selective approach when appraising bond investments, according to Wahlberg.

"Before making a decision to invest in a corporate credit, we always carefully analyze worst-case scenario outcomes and make sure that its overall portfolio impact is manageable. We see bonds offering a better risk return profile relative to equities only for certain companies. Bonds could theoretically only be 25 per cent of the total portfolio exposure but is typically lower than that", Wahlberg says.

David Rindegren, Portfolio Manager – Carnegie Asset Management

FINDING LONG-TERM VALUE IN A DISRUPTIVE MARKET ENVIRONMENT

by Jonathan Furelid – HedgeNordic

David Rindegren, portfolio manager of the Carnegie Worldwide Long/short Equity Fund, explains to HedgeNordic what industries and companies he sees as tomorrow´s winners and losers and how he looks to benefit from the disruptive market powers that are bringing change and even threatens the entire existence of many industries today.

Having joined Carnegie Asset Management in June 2014, David Rindegren has been on a mission to create a global long/short equity fund with a thematic long-term approach. What used to be a fund that essentially looked to gain short exposure through equity indices, Carnegie Worldwide Long/Short Equity is today a fund that actively seeks company specific opportunities both on the long and the short side. The idea is to build on Rindegren´s previous experience from the technology sector and his time at Brummer & Partners where he co-managed the Manticore Fund.

"My ambition has been to build on my previous experiences from the quant world and from what I learnt at Brummer & Partners and to create a thematic portfolio, both on the long and the short side overlaid with a structured risk framework. Together with the equity team at Carnegie Asset Management, we are building broader themes that then feed into individual stock positions on the basis of who we see winning and losing from the perceived outcomes of our themes", Rindegren explains.

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As an example of how the theme-based approach feeds into actual positions, Rindegren mentions a short position in Swiss watch producer Swatch.

"Swatch is a company that we went short last year given our perception of how the introduction of Apple´s iWatch and the Chinese clampdown on corruption could have a severe impact on the sales of traditional watches."

"In the 1970s and early 1980s the introduction of the quartz watches which largely replaced mechanical watches saw a severe decline in the Swiss watchmaking industry, which chose to remain focused on traditional mechanical watches. We see the current technology shift as being no different and foresee challenging conditions for Swiss watchmakers going forward."

"The idea generation builds on long term thinking rather than "playing quarters."

In order to find opportunities on the short side, Rindegren and his team put a lot of resources into researching industry and macro themes with the aim to find structurally challenged companies. The idea generation builds on long term thinking rather than "playing quarters".

"We look for companies where there is a structural headwind, but we also need to see a pressure point on the individual company level in order to enter a position. This could be anything from constrained balance sheets to cash flow not covering dividends or continued buybacks. We also look for what we call "poor companies priced as good", often restructuring stories that simply fail or take longer to succeed than the market expects. One such local example where we have been successfully short this year is Getinge. We also never short high quality companies supported by a trend simply because they are expensive."

DISRUPTIVE FORCES – MIND THE GAP

Given the technology advances seen in recent years, most of the short candidate research is focused on industries facing disruptive forces where companies pursuing novel ideas are challenging traditional business models. The Carnegie Asset Management team also assess the impact of major technological shifts and its impact on the landscape as we know it today.

"Our global thematic strategist, Morten Springborg, just recently released a report on the disruption of solar power in energy markets. Essentially the conclusion is that the transition away from fossil fuel is irreversible and that the marginal cost of energy will go to zero. In the end, this will result in the auto industry changing completely with new technology, based on cheaper energy sources, dominating in 10 years or so."

Another theme where Rindegren sees significant impact of disruptors is within online retailing where he claims that traditional clothing brands are facing fierce competition from online retailers such as Amazon.

"We currently hold short positions in the clothing franchise GAP and U.S. shoe retailer DSW. This was a result of an internal discussion regarding the online retailing trends seen in the industry. In addition to being challenged by H&M and Inditex with regards to its core brands, these companies are also under attack from online retailers offering much bigger assortments such as ASOS and Amazon."

THE LONG SIDE, NOT A MIRROR IMAGE

Rindegren emphasizes that the positions that the fund initiates on the long side, are not a mirror image of the short book.

"In the long book, we are simply not doing the opposite to the short book. For example, we do not have a long position in Amazon just because we see them as an important disruptor that feeds into our ideas on the short side. Here valuation metrics come into play".

When it comes to core long holdings, we focus on companies that have sustainable competitive advantages that protect superior returns from being eroded. We always buy stocks at what we believe are at attractive valuations and that are supported by underlying thematic views.

According to Rindegren, the long book has a longer investment horizon and is built around a number of core holdings of stable growth companies such as Nestlé, BAT

and Visa, on top of that they add more thematic names such as Facebook and Jungheinrich.

> "In the near term, the market and the market opportunities are dominated by what we call "Grey Swans..."

"Often the best way to capitalize on a theme is an indirect way. Instead of owning Amazon we own Jungheinrich, a German company making warehouse-trucks. As Jungheinrich has 90 percent of its sales in Europe it is a play on an improving European economy, a replacement cycle in trucks and an indirect play on growth of e-commerce. As we send more goods and packages around Europe, companies need warehouses and investments in logistics that leads to increased sales of warehouse trucks. The company grew its sales by more than 10 pct. last year and is looking to repeat that achievement this year. The shares are up more than 30 pct. since we made the investment last summer while the broader European markets are down substantially over the same time period."

"In the near term, the market and the market opportunities are dominated by what we call "Grey Swans", a spin on Nassim Taleb's "Black Swans", these are events that we can talk about but where the full impact is unclear. One such event is obviously the U.K. referendum whether to stay in the EU or not and another is the upcoming U.S. elections. Longer term, industry themes and trends play a greater role and some themes we are digging further into is emerging market competition hitting firms in developed countries, the changing landscape in the energy sector and the "death of the middle man" that is occurring in many sectors."

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Interview with Jarkko Matilainen
Director Hedgefuds, Varma

VARMA PUNCHING ABOVE ITS WEIGHT IN HEDGE FUND ALLOCATION

by Pirkko Juntunen – HedgeNordic

Finnish institutional investors seem to have taken to hedge funds more than their peers elsewhere. According to statistics from TELA, The Finnish Pension Alliance, the average allocation among pension and insurance providers at the end of 2015 was 9.6% and 7.7% among all pension funds, which includes the country's industry-wide, company and public sector funds. In general, European pension funds have a median allocation of 7%, according to a recent Deutsche Bank survey.

Finland's largest pension and insurance provider, Varma, has gone even further than its country peers with a whopping 16% allocation to hedge funds. Varma has an investment portfolio of over Euro 41 billion, making it one of the largest hedge fund allocators in the region. Even on a global basis pension funds of similar size to Varma, between $10 and $50 billion, Varma invests well above the median of 7% shown in the Deutsche Bank study.

Jarkko Matilainen, head of hedge funds at Varma does not have any other explanation to the popularity of hedge funds in Finland than that of trust and early adoption of the strategies as a result of good performance. "The good returns have continued to convince investors that their initial and early trust

in hedge funds has paid off and continue to do so," he said.

Others argue that the pro-cyclical nature of the Finnish solvency regulation allows more risk-taking. As solvency ratios rise so do return requirements which means investors such as Varma can take on more risk including allocation to hedge funds. The average solvency ratio at the end of 2015 was 28.2% and has varied between 15 and 41% in the last decade, according to TELA. At the end of 2015 Varma had a relatively high solvency level of 31.4%.

Varma began investing in hedge funds in 2002 and the idea was to diversify and have a return and risk profile somewhere in between fixed income and equities, Matilainen said.

Since 2003 the hedge fund investments have returned 6.7% compared to 5.8% for the overall portfolio. Over a 10 year period the overall portfolio returned 4.8% compared to 5.8% for the hedge fund investments and 5.1% over 5 years compared to 5.8% for the hedge funds. For the full year 2015 Varma's investment returned 4.2% whereas hedge funds returned 3.9%. The strengthening US dollar contributed to the returns and the best performers where market neutral strategies. Opportunistic strategies suffered in a challenging environment.

Varma's initial investments into hedge funds began with fund of hedge funds but has since evolved into direct investments with single manager funds. Currently 90% of Varma's hedge fund investments are direct and 10% in fund of hedge funds, where it works with Blackstone. "We started with a modest allocation and built it over time and by 2007/8 we wanted to make a more significant allocation, of around 10%," Matilainen said.

Some of the main reasons for investing in hedge funds was performance, diversification and risk reduction, which continue to be key, he said.

Matilainen heads a team of 3 who are monitoring the ca. 45 hedge fund managers used. "We are not envisaging any major changes but continuously monitor the managers and look at new managers and ideas," he said. Blackstone is also used for research and risk management, he added.

Full operational and legal due diligence is conducted by external providers, Matilainen said, adding that the process from idea to investment takes many months.

The main criteria for manager selection is continuous long-term performance and talent. "The strategies also have to fit within the hedge fund portfolio but also make sense in the overall allocation so that the part fits the whole," Matilainen explained.

> **"Generally the managers we select are above Euro 200 million AuM,..."**

Considering the size of Varma, it rarely invests less than Euro 30 million with a managers, therefore the size of the AUM of the manager is also of some importance. "Generally the managers we select are above Euro 200 million," Matilainen said.

Investors are often said to have a home bias both when it comes to asset allocation and managers selection. This may be true in the long-only side for many but Varma's hedge fund portfolio certainly does not have a home or even Nordic bias. Currently all its managers are from North America and Europe with a global reach. "We do not have a home bias at all and the main reason is that on the long-only side we manage our Nordic and European portfolios internally. We are not interested in paying high fees for hedge funds to pick the overlapping long names with our long-only portfolios so we don't really invest in long-biased hedge funds focusing on Europe in general or the Nordics in particular," Matilanen said.

For market neutral strategies he would consider Nordic managers. "The main thing still is performance, talent and that the manager and strategy fits the bigger overall portfolio," he noted.

Matilainen said Varma's hedge fund investments are well-diversified and can be put in two categories: a core portfolio with an absolute return focus, which has returned 5.7% annually since inception and the opportunistic portfolio, which has returned 10.0 % since start. "In terms of the variety, in the core portfolio we have a broad range of strategies favouring a relative-value mind set. The opportunistic portfolio can be more concentrated and directional."

> **"...in the core portfolio we have a broad range of strategies favouring a relative-value mind set."**

In 2014 CTAs in general generated some of the highest annualised returns since 2010 but these strategies has not been favoured by Varma, which only has a small allocation. "In our opinion CTAs have relatively poor consistency, and tend to lag when markets turn rapidly" Matilainen said. Indeed 2015 was a much tougher year for CTAs with oil prices falling and demand from China slowing resulting in below par returns.

In the spring of 2014 Varma further reduced its equity allocation as the return outlook was weakening. Instead of switching to bonds the allocation was put into hedge funds as the outlook for fixed income was also gloomy. Asset allocation at the end of 2015 was, apart from 17% in alternatives, out of which 1% is invested in inflation-linked investments and commodities, 45% in equities, 30% in bonds and 9% in real estate. Varma has a total of Euro 41.3 billion in AUM and is one of Finland's largest pension and insurance providers.

Matilainen does not envisage the 16% allocation growing much in coming years. "We have a mature, stable roster of managers with few changes expected in the core portfolio. On the opportunistic side there can be larger rotations but those changes are typically not frequent. We don't see big new investment themes entering into our opportunistic portfolio right now, though shakes in the credit markets can create some opportunities in the future," he said.

If managers are underperforming they are still given the opportunity to prove themselves over 18-24 months before being terminated. "These things rarely come as a surprise," Matilainen added.

Despite the positive contribution to returns Matilainen admits there are challenges such as high fees. "The higher than average fees are only justifiable if we also get higher-than-average net returns. In addition investors need to be very vigilant in manager selection because of the vast number of strategies and styles available. In 2008 it was easy to negotiate fees but this only lasted about 2 years. It is a question of supply and demand and demand is again high so it is a seller's market now," he said.

Matilainen said there is still some room for negotiation of fees adding that Varma's policy of all investors being treated equally would require the hedge fund to be transparent about any discounts and also offer it to all other investors. Transparency in general is not a problem, Matilainen said, adding that this has always been the case. "We have never had any problems with getting the information we need in terms of where the risks are within a specific strategy or even position transparency. Since the crisis there have been general improvements and much has to do with technology with system improvements in risk monitoring and risk aggregation," he said.

One of the key aspects to Varma's investments is its Principles of Responsible Investments. In 2014 Varma decided to include the principles for its hedge fund portfolio. At the beginning of 2015 Varma started using these principles and created a questionnaire for its hedge fund managers. This questionnaire was sent out for Varma to assess the status of responsible investments at the hedge funds it uses and how well the hedge funds fulfil Varma's principles which include environmental, social and governance criteria, ie no difference to other asset classes. "In addition we also take into account the special character of hedge funds such as the specific strategies or investment techniques used," Matilainen said.

The criteria for assessment of hedge funds within the responsible principles include assessing governance, i.e. reviewing incentive systems, conflicts of interests, internal processes and control measures. Regarding the oversight of the operations Varma recommends that the majority of the board of directors are independent. Varma encourages fund management companies to define their own principles for responsible investment and to apply those.

Not all responses to the questionnaire have been returned, understandably, as it comprises some 30 pages of detailed questions that managers are required to answer. So far responses indicate that a lot of principles are already present among many of the managers even if they have not been specifically named them as responsible investment principles or stated them as policies, Matilainen said, jokingly calling them closeted responsible investors. He is now urging hedge funds to come out of the responsible investment closet.

Going forward, Matilainen hopes that the funds used will take the ESG principles into consideration in a more systematic manner and as a part of the investment process and including this in the reporting to investors. "Also, the responses to the questionnaire is only one of many criteria we use when evaluating managers," Matilainen.

Apart from its own responsible investment principles Varma is also active internationally within the Hedge Fund Standards Board as well as the Principles of Responsible Investment hedge fund work group.

The HFSB is working with investors such as Varma in encouraging the hedge fund industry to adopt its standards. Varma is using the 'comply or explain' approach with respect to HFSB standards.

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THE CASE FOR REAL ESTATE INVESTMENT TRUSTS

BY JONATHAN FURELID – HEDGENORDIC

Aki Kostiander, head of Real Assets at Finnish asset manager United Bankers, discusses why Real Estate Investment Trusts, also known as REITs, should be part of institutional portfolios looking to diversify into real estate investments.

REITs, an exchange traded investment vehicle for real estate that is tax exempt from corporate tax, has for long existed on the U.S. market. In Europe, the utilization of REITs in institutional investment portfolios is a much more recent phenomenon and is still far from the preferred choice when it comes to real estate investments.

In an interview with HedgeNordic, Aki Kostiander, who has been a REIT portfolio manager for over 10 years at Finnish asset manager United Bankers, discusses the benefits of adding REITs to an institutional investment portfolio, why he thinks institutional investors are yet to embrace the REITs concept, and why it makes sense for investors to avoid cheap index trackers and instead focus on quantitatively managed portfolios of REITs.

HedgeNordic: Could you give a brief introduction of the REITs concept and how you at United Bankers work to build investment portfolios of REITs?

Aki Kostiander: REITs is a legal structure that allows real estate companies to invest in real estate without being subject to corporate tax. Instead most of the returns are required to be paid out as dividends to investors in the REIT, who in turn pay taxes on these dividends. This way the dreaded double taxation problem is evaded. REITs are exchange traded, meaning that you as an investor typically get daily liquidity on your holdings It is like any other listed stock producing daily net asset values.

The difference of REITs compared to exchange traded real estate stocks is, as a consequence of the differences in taxation, that the REIT has no incentive of applying excessive leverage to its investments. As a result the REIT becomes more of a pure real estate portfolio, rather than a mixture of high debt instruments and real estate development.

Our approach to investing in REITs is through building what we define as alternative beta portfolios of REITs based on a quantitative approach. We filter out REITs that are good value rather than look at the market capitalization or index composition. This means that we significantly deviate from the different index solutions available on the market today that are based on market capitalization weightings.

We are very much bottom-up as we look for value in individual REITs, but we also have a macro view on top which decides how the portfolios are tilted given the macroeconomic cycle, i.e. how we position between commercial properties vis-à-vis retail properties, for example.

The dividends paid out from the REITs in our portfolios are always re-invested meaning that as an investor you get a compounding effect from that side as well if we do our job well. The compounded cash flow returns over time in a REIT portfolio is what makes them perform so well against other asset classes and the stock markets.

HedgeNordic: What is the appetite for REITs investments among Nordic institutions today?

Aki Kostiander: The REITs legislation is very much linked to national REIT frameworks, and since there is no such thing as a REITs legislation in the Nordics, this has to some extent made Nordic institutions a bit hesitant to incorporate REITs in their investment portfolios, since they are not so familiar with the theme. Historically, REITs have also been lumped together with financial stocks rather than treated as a separate asset class, which I think has blurred the lines between what category to put REITs in. Mostly investors think of them as being a niche stock market sector and treat them as ordinary double taxed listed property stocks.

REITs should really be considered on their own merits. It has outperformed both equities and real estate private equity looking at it historically. It is also a much more liquid asset compared to the direct real estate investments made by institutions today through private equity deals. One often talks about the so-called illiquidity premium when discussing direct real estate investments, i.e. you should be offered a liquidity premium to be part of an investment with scarce liquidity. Regarding REITs the situation is the opposite. You can get a liquid property investment with a discount when in fact you should be paying a premium for it.

HedgeNordic: What value do you see for REITs in a multi-asset portfolio?

Aki Kostiander: Adding REITs to a portfolio of traditional assets such as stocks and bonds greatly enhances the efficient frontier. REITs should be seen as a good diversifier and has added a lot of value compared to both equity and real estate investments over time. The fact that REITs have seen periods of increased volatility in times of equity market distress, such as that experienced in 2008, I believe has a lot to do with the fact that it has historically been linked to the financial equity category. This is likely to change as the large index providers will launch separate REITs indices in August this year, which will more clearly distinguish the asset class. This index classification change by MSCI, S&P and Dow Jones will be a big thing for REITs this year.

HedgeNordic: What are reasons to use an active strategy in the REITs space rather than go the index tracker path?

Aki Kostiander: We believe an alternative beta strategy makes a lot of sense in the REITs space, particularly given that the passive money today has pushed valuations to extreme levels for those REITs that make part of market capitalization weighted indices. To mention one example, the largest REIT in the Europe is Unibail, it is currently traded at a 30 percent premium compared to its underlying real estate holdings. The simple reason being that

Aki Kostiander, Head of Real Assets at Finnish asset manager United Bankers

it is the largest REIT in the index and that the passive money flows in the direction of these names regardless of their valuation. Would you over the long term want to buy real estate at such a high premium? I wouldn't, especially when we can substitute these expensive index blue chip REITs with clearly cheaper mid cap names.

HedgeNordic: Why do you think it makes sense for an institution to outsource its allocations of REITs to an external asset manager such as yourself, rather than building an in-house portfolio of REITs?

Aki Kostiander: We have a long experience from selecting and constructing portfolios of REITs and our quantitative screening process has proven to add significant value over time. By outsourcing the portfolio management you get access to an alpha source without having to deal with much of the administration associated with corporate actions, re-investment of dividends, re-balancing of portfolios etc.

HedgeNordic: Why do you think it is a good opportunity to invest in REITs now? Is REITs a good option in an environment of rising interest rates?

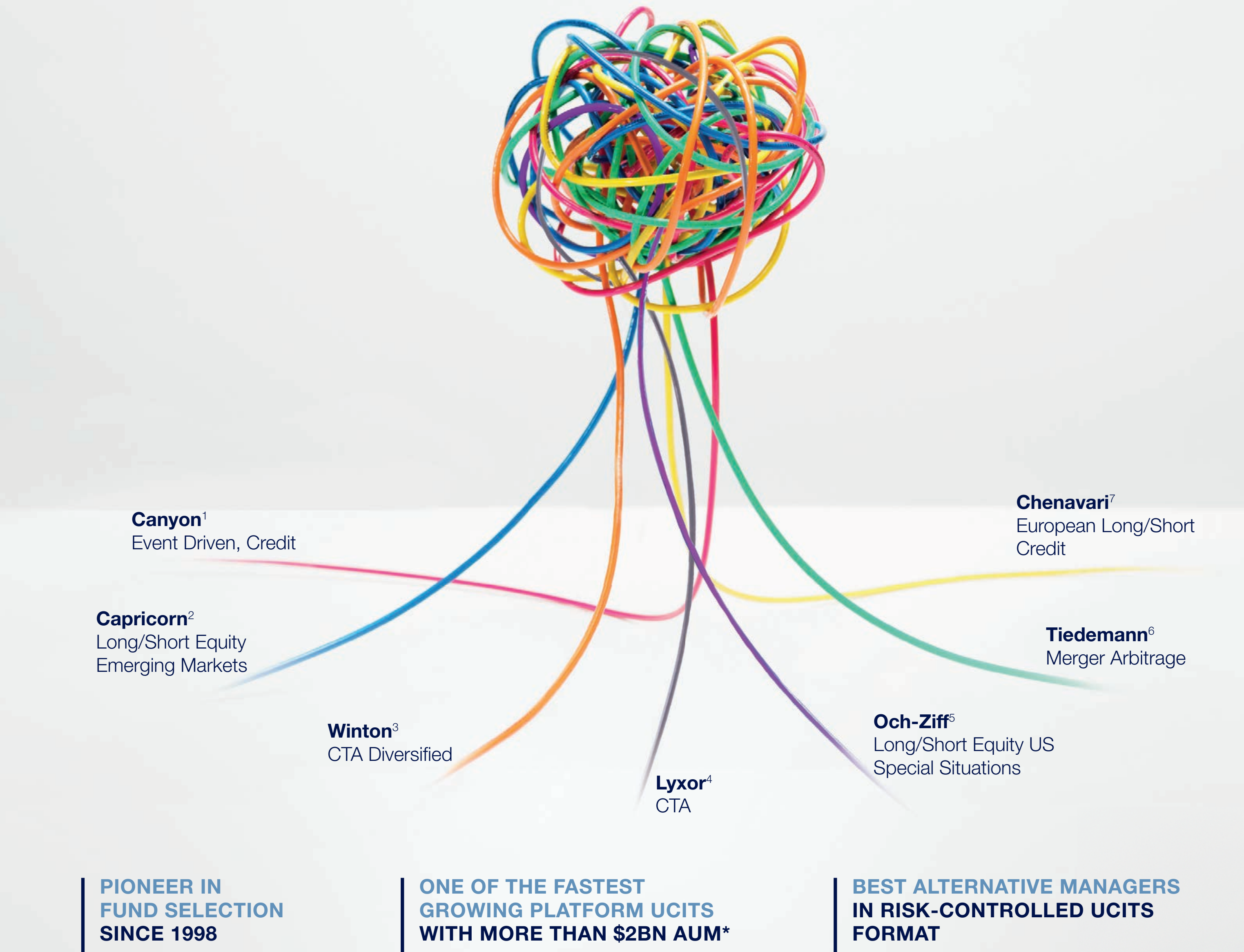
I view the current macro backdrop as very interesting for REITs investments. We have low interest rates coupled with very low inflation; the only place to look for compelling real returns is more or less within the real estate sector. The current net yield for real estate assets is somewhere around 5-6 percent, which could be geared up to offer a yield of up to 10 percent. Real estate also provides you with an inflation hedge, as the sector is indexed to inflation numbers, at the same time the value of properties usually follow the development of consumer prices over the long term.

The way I see it real estate offer the best of two worlds, in a low interest rate environment with deflation you have solid real returns compounding. If interest rates would rise, they typically do so in conjunction with rising inflation numbers. Historically speaking, REITs have usually done well in environments of rising interest rates and rising inflation. However, if interest rates rise without inflation following, that of course poses a risk to real estate and REITs, but I do not see that as the most likely scenario at this point.

HedgeNordic: You also run a REIT hedge fund. Could you tell us more about it?

Yes, the fund is called UB Real REIT and it is an on shore non-UCITS fund that is a leveraged long-only REITs and property stocks fund. The fund can hedge out a part or all of the equity market risk and sometimes also interest rate risks. So we try to capture some of the property market alpha and minimize the equity market related impact on volatility. We have a core portfolio of best of breed REITs globally that we feel comfortable with over the long term.

We then add thematic positions in any property market related themes we feel could add value, and on top of this we make mean reversion bets on REITs and property stocks that are either event related or in our opinion mispriced by the market. We can for instance leverage up the portfolio to some 100-150% REITs and then short equity market risk so that our delta is e.g. between 0.25-1.00. We have a lot of leeway in the hedging and leveraging so the fund could at some point have a zero hedge and a very high exposure to REITs. So far, after a careful start, the fund has been running for almost four years and returned 8.5% annually with a volatility of 10.3 %.



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Lyxor's Alternative UCITS Platform is the result of more than 18 years of analyzing and selecting the best hedge funds in the industry, taking into account the pedigree of the manager, the performance engines, the operational structure and the risk monitoring process.

[1] Canyon Capital Advisors LLC, [2] Capricorn Capital Partners UK Limited, [3] Winton Capital Management Limited, [4] Lyxor Asset Management, [5] Och-Ziff Capital Managment Group LLC, [6] Tiedemann Investment Group Advisors LLC, [7] Chenavari Investment Managers.

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*Source: TOP 10 UCITS Platform by HFM Week (Jan. 2016); Figures as of April 30th, 2016.

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BY JONATHAN FURELID / HEDGENORDIC

When equity market neutral meets momentum

By combining an equity market dollar neutral portfolio with a directional overlay, Naqvi Van Ness Asset Management (NVAM) aims at capturing relative mispricings in the equity space while at the same time benefiting from the irrational behaviour that appears during distressed market conditions as behavioural aspects come into play.

NVAM's Strategy could be characterized as a hybrid between a market neutral long/short equity fund and a CTA. Using a systematic approach the strategy allocates 60 per cent of the risk to the equity book while holding 40 per cent in directional models exploiting investor biases. In describing the fund´s approach, Ali Naqvi, co-founder and portfolio manager, uses a sailing analogy.

"One could say that our long/short equity book is our sail while the directional book is the rudder, helping us manage direction when there is more uncertainty in the waters"

Naqvi, previously a senior portfolio manager at Citibank, together with co-founder Albert Van Ness decided to launch the fund to US investors in 2008, based on their research into behavioural systematic models. They were joined in 2010 by their third partner Charles Dubois who brought 30 years of quantitative strategy design and testing skills to the firm. They were all of the strong belief that a number of biases were present in the market and that these biases could, if properly researched, be systematically tested and serve as an efficeint alpha-engine in a broader portfolio context.

"One could say that our long/short equity book is our sail while the directional book is the rudder, helping us manage direction when there is more uncertainty in the waters"

"We look at fundamental factors through a quantitative lens. Some people call it a "quantimental" process. Such as building multi-factor screens and well-known tecnical models for figuring out market direction. Those approaches are known to have predictive value. We have "gene-spliced" them with our insights into investor biases. It has been our experience, and it is born out in our performance numbers that this approach enhances the alpha extraction on both the long and the short side". Naqvi says.

In the core long/short equity portfolio, NVAM looks for mispricings in a diversified universe of 2500 stocks, selecting around 100 stocks long and 100 stocks short. On the long side, the models look for companies with an attractive combination of free cash flow yield, growth and profitability.

On the short side, the system targets companies that express mutiple signs of possible fundamental vulnerability incuding negative free cash flow, abnormal growth in inventories and excessive capital spending. According to Naqvi, the fact that the fund focuses on free cash flow rather than on earnings gives it an edge with regards to its stock selection capabilities.

"You hear a lot of people talk about free cash flow but actually being able to implement it and use it is a whole other matter."

"Even though it is well understood that free cash flow is a better and more information-rich way of investing in stocks, investors on average prefer to avoid the complexities. You hear a lot of people talk about free cash flow but actually being able to implement it and use it is a whole other matter", Naqvi argues.

Many of the behavioural biases exploited in the program are modeled in the directional overlay part of the strategy fund program. These models base their signals on a number of well- documented factors and are implemented in the US equity markets.

"We use four main factor groups in the directional overlay; technical, sentiment, seasonal and fundamental. Inherent in these factors are a number of repetitive biases that we systematically seek to exploit", Naqvi explains.

Among the behavioural biases that the models aim to extract alpha from are anchoring, ambiguity aversion and herding.

"Anchoring is related to levels in the markets that are often referred to by traders using technical inputs. The anchoring bias comes about as a result of investors having a tendency to get anchored to the price they buy the stock at. These are essentially just numbers that become very important to people even though they have no great relevance. Ambiguity aversion relates to the fact that investors tend to shy away from things they do not understand. Herding relates to a sentiment imbalance that is typically present when momentum dictates market action."

With regards to herding effects, the fund uses proprietary models that are derived from extensive research with the aim of identifying durations of sentiment imbalances.

"We have done exhaustive research into herding effects based on sentiment surveys with long histories and have developed insights regarding the duration of sentiment imbalances. These insights are integrated into our directional models", Naqvi says.

The sentiment-driven part of the portfolio has played an important part in its ability to generate competitive risk adjusted returns and serves as an important diversifier in times of turbulent equity markets such as those experienced in the first two months of 2016, according to Naqvi.

Albert Van Ness, Ali Naqvi and Charles Dubois

”The start of this year was difficult for many long/short equity funds as they tend to have a signficant long bias built into their models. The fact that we are dollar market neutral with a directional overlay has helped us in periods of strong risk aversion in the past and provided us with diversification this time around aound as well”.

“Looking ahead we see both moderate earnings and economic growth. The change in the “multiple” is, as always, uncertain.”

According to Naqvi, the strong results of the strategy are explained by the defensive positioning going into the year and the contribution from sentiment-driven models.

”We started the year rather defensively with a net exposure of around 15 per cent. The strategy returned approximately 1 per cent in January alone and the sentiment driven models generated buy signals by the end of the month which helped us outperform signficantly in March.

In a forward looking statement, Naqvi says that the models remain upbeat about near-term equity market prospects.

”Looking ahead we see both moderate earnings and economic growth. The change in the “multiple” is, as always, uncertain. However, we do expect interest rates and inflation to remain relatively benign. Consequently, the bull market should remain intact.”

”Within this big picture, our indicators currently lean clearly to the favorable side. Fundamentally, the Fed is still accommodative, credit spreads have been narrowing and overall stresses and potential vulnerabilities in the financial system appears to relatively low. Even as the market has recovered there has not been an outbreak of enthusiasm. Separately, our measures of the “technical” environment indicate bull market conditions.”

The NVAM Criteria Investment Partners International Limited fund has been notified in Sweden and is approved for distribution to professional clients as from March 2016.

About Naqvi-Van Ness Asset Management

NVAM was founded in 2001 by Ali Naqvi and Albert Van Ness to manage their own assets and develop a repeatable and alpha-generating investment discipline. Charles DuBois joined the team in 2010 to lead the research and model development effort.

The strategy seeks to deliver absolute returns in all market environments from alpha while experiencing smaller and briefer drawdowns than the stock market by combining a core fundamentally-based long-short equity portfolio with opportunistic directional strategies.

Members of the investment team average 30+ years of portfolio management experience and their collaboration in the field dates back to the 80s and 90s. They each began their investment careers at Citibank Investment Management and held senior positions managing multi-billion dollar portfolios.

Gustav Sjöström, Erik Lundkvist – Portfolio Managers Coeli Multi Strategy

With the benefit of hindsight – Coeli Multi-Strategy

by Jonathan Furelid, HedgeNordic

Being one of the early adopters in the Nordics, Coeli Asset Management launched its fund of hedge funds ”Coeli Multi-Strategy” already in 2004. Benefiting from the experience of more than ten years of hedge fund investing the fund´s current portfolio managers, Erik Lundkvist and Gustav Sjöström, look to create a diversified portfolio of Nordic hedge funds offering a unique blend of investment strategies executed by highly trusted managers.

“When we started investing in the fund of hedge fund format, we were really one of the first players in the Nordics to do so, it was us, Indecap and Brummer”, Lundkvist recalls when HedgeNordic catches up with the team behind the Coeli Multi-Strategy Fund at Coeli’s head office on Sveavägen in Stockholm. Lundkvist has been on the team since the start, whereas Sjöström is a new addition as he left to join Coeli a year ago from Skandia.

Coeli Multi Strategy is one of the asset manager´s most long-lived products. Since its inception in 2004, the fund has generated annualized returns of 3.2% to an annualized standard deviation of 2.7%, translating into a solid Sharp ratio of above 1. The downside risk has also been well contained with a maximum drawdown of 7% and winning months of above 65%. Since inception the fund has only experienced one calendar year with negative results.

"I believe that the fund over time has had a very solid structure and a good mix of high quality managers which led us to outperform most hedge funds during the financial crisis in 2008. We have always been very diligent in our selection of managers and have a well-documented process for our decisions.", Lundkvist says.

"Over the years, the fund has developed from only including external hedge funds to becoming a mixture of Coeli´s own funds and externally managed hedge funds."

Over the years, the fund has developed from only including external hedge funds to becoming a mixture of Coeli´s own funds and externally managed hedge funds. Today the split is around 40 per cent investments in internally managed funds, the rest being managed externally. The fund now also offers daily liquidity and the fee level has been reduced. This means that the requirement on the external hedge funds in terms of liquidity is of high importance in the selection process.

"Over time Coeli has become more active in adding hedge funds to its umbrella organization. One of my main responsibilities is to support in finding new talent to add to our existing lineup of funds", Lundkvist says continuing:

"Given the amount of work we put in when deciding on including a hedge fund in Coeli´s offering, it typically makes sense to also have it included in the multi-strategy fund. The first fund we included was the CTA fund Coeli Spectrum.We later added the market neutral Coeli Norrsken fund. Spectrum in the meantime has been replaced by the most recent addition to the Coeli family of funds, Prognosis Machines.

According to Lundkvist, Prognosis Machines, a fund that builds on machine learning algorithms and artificial intelligence to capture behavioral aspects of financial markets, adds a new dimension to Coeli Multi Strategy.

"Prognosis Machines is a nice addition since it exhibits low correlation to all existing underlying funds. We simply get an additional alpha source while maintaining a highly diversified portfolio", Lundkvist says.

The Norrsken strategy, which has been an investment in the portfolio for the last nine years, represents the kind of return stream we are constantly looking for. It has a market neutral approach with low correlations to the main asset classes. The fund produced flat returns during 2014 to mid 2015. When volatility came back in the summer of 2015 the fund once again produced strong returns in difficult market conditions, which it has also done in the past, most notably returning +15,75% in 2008.

The diversification benefits of allocating to a set of uncorrelated strategies is something Lundkvist and Sjöström come back to during the conversation. It is the reason Coeli Multi Strategy has experienced a well contained downside protection throughout the years the team argues.

"We have allocated to a number of strategies, both directional and non-directional, seeking to generate absolute returns on their own. Given the different ways they approach markets, there is an inherent low correlation between the individual strategies. The overall portfolio therefore is less sensitive to specific market regimes", Sjöström says continuing:

"Our ambition is to be able to generate absolute returns independent of the market environment we are in. This we believe is best achieved through allocating to a set of high quality managers tapping into different market opportunity sets."

Lundkvist emphasizes that Coeli Multi Strategy has adopted a Nordic bias as it is today much easier to find competitive strategies in close proximity to Sweden, he argues.

"What used to be an industry highly dominated by off-shore U.S. funds, hedge funds are now more easily accessible which has made us focus on our home turf. Our relationships with the managers we allocate to are built on trust and it goes without saying that trust is easier to build when you get to meet with managers more often. To most of our managers we have had allocations to for a long time and we know the people well."

Apart from the in-house Coeli funds, Coeli Multi-Strategy holds allocations to a number of well-established Nordic hedge funds. On the market neutral side Norwegian DNB TMT for instance is a core allocation and within long/short equity arena Swedish RAM Equity L/S constitute the main exposures. With regards to directional strategies, Swedish CTA Lynx holds the bulk of the allocation.

"Coeli Multi Strategy has adopted a Nordic bias as it is today much easier to find competitive strategies in close proximity to Sweden."

The Coeli Multi Stratefy actively allocates across underlying strategies, primarily as a means to control the overall risk depending on the market environment. During the first quarter of 2016, the fund has been tilted towards more defensive strategies.

"We are not trying to time strategies as such, this we simply judge to be too difficult. However we look to shift portfolio weights to reflect more broad-based market views. In the first quarter of this year we tilted risk towards more defensive strategies, such as CTA and market neutral, as we saw heightened risk aversion entering the market. This has so far proven to be a correct assessment and the fund has benefited from its CTA exposure in particular", Lundkvist says.

Going forward, Lundkvist and Sjöström are on the lookout for additional hedge funds to add to Coeli´s in-house offering, which could potentially result in new additions to the multi-strategy fund as well.

"We are always open to talk to high quality hedge funds that are looking to develop their business within an existing fund structure such as that offered by Coeli. Given the high costs associated with starting up a hedge fund today we see good potential to add to our internal hedge fund offering and thereby add high profile managers to the multi-strategy fund as well, Lundkvist concludes.

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PEAK ASSET MANAGEMENT

– A defensive approach to hedge fund investing

by Jonathan Furelid, HedgeNordic

Started in 2011 as a partner-owned asset manager with a focus on hedge fund solutions for the institutional audience, Peak Asset Management today runs approximately 1,5 billion SEK across four different hedge fund strategies. Although little known to the wider investor community, Peak has slowly but surely built on their vision to create products offering truly uncorrelated returns with a defensive risk profile.

”Our ambition has been to create something that put great emphasis on the capital preservation characteristics aspect of asset management. Having painfully experienced what the financial crisis did to client portfolios in previous roles, we came into this venture quite disenchanted when it comes to how traditional advised portfolios are structured. We wanted to create an option for those seeking absolute returns with a low dependence on equity beta-risks and a strong focus on risk management”, Per Djerf, CIO of Peak Asset Management explains.

With a team of trusted and experienced partners from the financial advisory and fund management industry, Peak was founded in 2011, shortly thereafter launching its first hedge fund product ”Peak Core Hedge”, a multi-manager fund allocating to a number of market-neutral hedge fund strategies. While the manager today also runs its own successful single strategies, Peak Core Hedge only allocates to external, single manager strategies.

”The Peak Core Hedge product is a fund of market-neutral hedge funds investing into strategies that show consistency and repeatability over time. We need to see that the strategies underlying have been able to perform in all sorts of market scenarios and put a lot of emphasis on trying to understand the alpha-generation part of each program”, Djerf says.

”Initially, we look at a universe of several thousand funds globally and have a systematic, rule-based approach filtering and breaking down that number in order to identify the funds that are subject to inclusion. The portfolio is currently composed of ten so-called primary strategies, which make out the majority of the total allocation. Typically we favor strategies that have low net exposures, low sensitivity to changes in market sentiment and a liquidity profile we feel comfortable with. The bulk of the allocation is within equity market neutral, merger arbitrage and relative value strategies”.

> **“Peak Core Hedge really expresses what we to aim to create in our investment mandates, that is a controlled risk profile with well-defined alpha sources.”**

Peak Core Hedge has had an annualized return of 4.3% with a volatility (annualized standard deviation) of 1.4% since inception, according to the fund´s most recent factsheet. This translates into a Sharpe-ratio of 2.8, certainly a factor weighing high for the fund earning the award as ”Best market-neutral fund of hedge funds” at the most recent International Hedge Fund Awards. The inherently low correlation between the different strategies in the portfolio allows for significant diversification benefits without creating dilution effects with regards to performance”, Djerf says.

Stockholm based Peak Asset Management today run a number of systematic equity and macro strategies developed in-house by a team headed by Djerf with strong quantitative finance backgrounds. Among the internal strategies developed are also more opportunistic value-oriented credit strategies looking to exploit mispricing within corporate capital structures.

Peak Equity Alpha has been trading live since July 2012 and has had an annualized return of 7.6 per cent to an annualized standard deviation of 4.7 per cent. The fact that the program shows very low correlation to the equity market makes it a good portfolio diversifier, according to Marcus Andreis, head of institutional sales at Peak Asset Management

Per Djerf and Marcus Andreis, Peak Asset Management

“The Peak Equity Alpha Fund uses a combination of equity arbitrage and volatility arbitrage strategies and has over time shown as good as market neutral characteristics with a beta of 0.1 in relation to S&P 500 since inception. The fund extracts alpha from relative mispricings in the equity space without holding a positive bias unlike many other equity hedge strategies out there.”

The Peak Global Macro fund is the most recent addition to Peak’s product range and allows for a somewhat higher volatility profile compared to the equity strategies. The new fund combines price-based information with fundamental data, seeking to capture broader market trends in global equities, fixed income, currencies and commodities.

We balance the exposure through the use of counter-trend models which gives the program a smoother return profile and better risk adjusted returns compared to the pure trend following models used by many trend following CTA’s, Djerf explains.

Andreis already notices good interest for the fund but highlights it is still early days and that the aim is to build the track record before marketing the fund more broadly.

”We launched in January this year and already have 100 million SEK allocated to it. Given the difficult market environment we started the fund in, we are quite pleased with how it has been behaving so far”.

> **”The aim for the Global Macro strategy is to capture trends that are results of investor biases such as herding behaviour as well as more fundamentally driven relationships such as value mean reversion. ”**

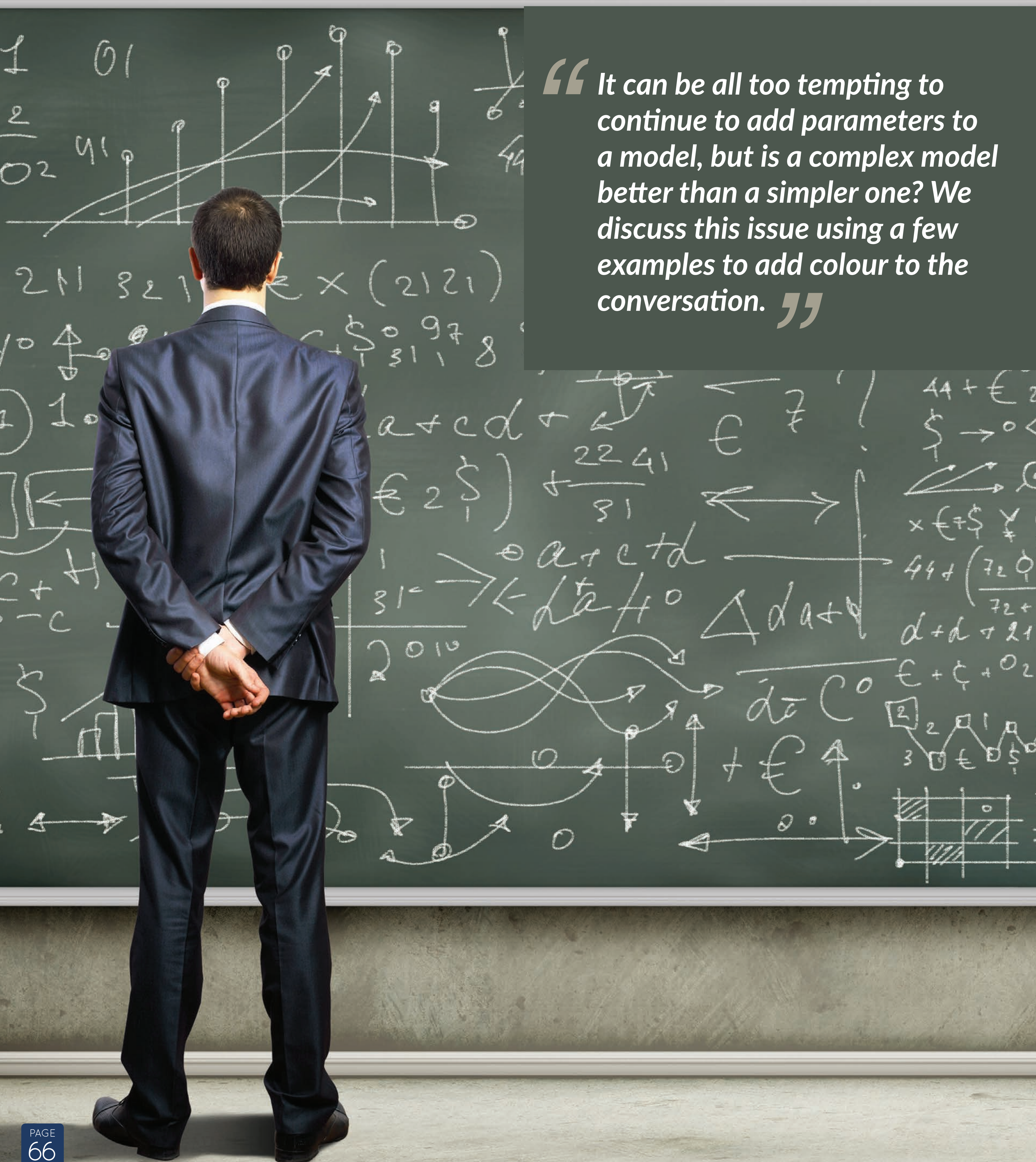
The internal single systematic equity and macro strategies are combined and run side by side other niche strategies in a multi strategy fund called ”Peak Core Strategies”, making available a combination of all in-house approaches in a single product.

”The aim of Peak Core Strategies is to offer to investors a best-of-breed solution combining what we judge to be the best ideas from our own research on quantitative equity and macro strategies as well as within more opportunistic event-driven strategies, mostly related to the credit space”, Marcus Andreis explains, continuing;

”The fact that the equity strategies use a statistical arbitrage approach that is very short-term in nature and close to market neutral, there is a good overlap when combining these with the macro and event driven strategies that allow for more opportunistic trade ideas aiming to capture significant price moves in underlying markets.”

Peak is not actively looking at going the retail path as a distribution strategy, offering its funds to the broader public through platforms. The asset manager will rather focus on maintaining personal relationships with end-clients and build on its institutional client base, keeping the look and feel of a boutique rather than a mega store super market.

”Offering our products to the retail audience would likely make us more well-known, however, our main focus has always been on delivering uncorrelated returns with a low-risk profile which is easier communicated to the institutional investor community. By having clients that truly understand why they are invested makes them more patient and less likely to redeem for the wrong reasons, Andreis concludes.



RESEARCH BRIEF

- The limits of complexity in finance

by Winton Capital

Normally in finance articles we begin with some theory and then go on to look at some empirical results. That said, since complexity in finance is something of a dry topic, it's perhaps best to start with a practical example to motivate the discussion that follows.

Imagine that a research team is tasked with constructing a trend following system for 50 futures markets. One of the key components within that system is the trend following speed. Various trend following speeds can be constructed using the methodology of Jegadeesh and Titman[1] which involves a look-back period, a holding period and a frequency. The look-back period is the amount of price history used to calculate returns - if the return is positive over the look-back period then a long position is initiated and if negative a short position. The holding period is the length of time the position thus determined is held and the frequency denotes the frequency with which the signal is updated and a new position taken. Various different values for the look-back period, holding period and frequency are used, resulting in a broad range of trend following speeds[2].

The time period over which all systems are estimated is 2000 to 2010 and the out-of-sample or test period is from 2010 to 2015[3]. Two approaches are under consideration: the market specific system and the aggregate system. The market specific system finds the Jegadeesh and Titman trend following parameters from the set under consideration that maximize the in-sample Sharpe ratio in each futures market so that fifty individual systems need to be estimated. The aggregate system selects just one set of parameters to maximize the average in-sample Sharpe ratio across all markets so only one system need be estimated.

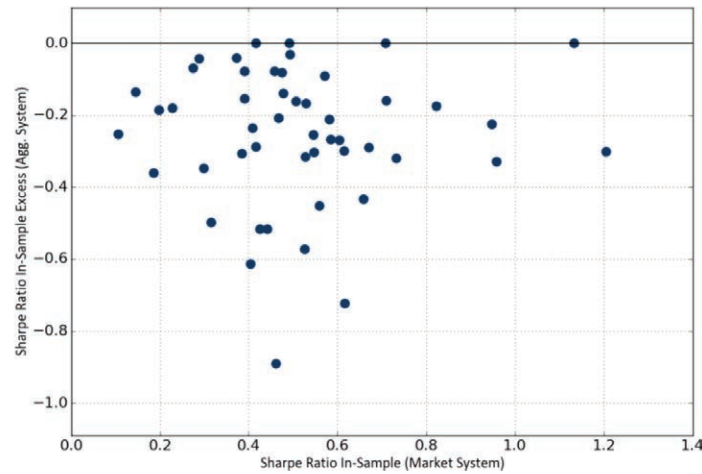
Figure 1 shows the in-sample Sharpe ratio of the market specific system for each futures market on the horizontal axis and the in-sample excess Sharpe ratio for each futures market of the aggregate system on the vertical axis. The excess Sharpe ratio is the difference between the aggregate system Sharpe ratio for each futures market and the market specific system Sharpe ratio for each market. So if the two in-sample Sharpe ratios are the same for a given market the vertical point is zero and if the market system has a higher in-sample Sharpe ratio then the plot point will be less than zero on the vertical axis. The market specific system will always have an in-sample Sharpe ratio greater than or equal to the aggregate system Sharpe for a given market. This must be the case because the market specific system can choose the same parameters as the aggregate system. It will only do that though if that is the highest in-sample Sharpe ratio for that market. The aggregate system performs reasonably well in comparison to the market system for a few markets.

This means that very similar or the same parameters as the aggregate system happen

[1] Jegadeesh and Titman (1993).
[2] There are thirty one candidate models in total.
[3] These were chosen somewhat arbitrarily, but are similar to the time periods over which many CTA replicators decided on their trend following speeds and have been trading from.

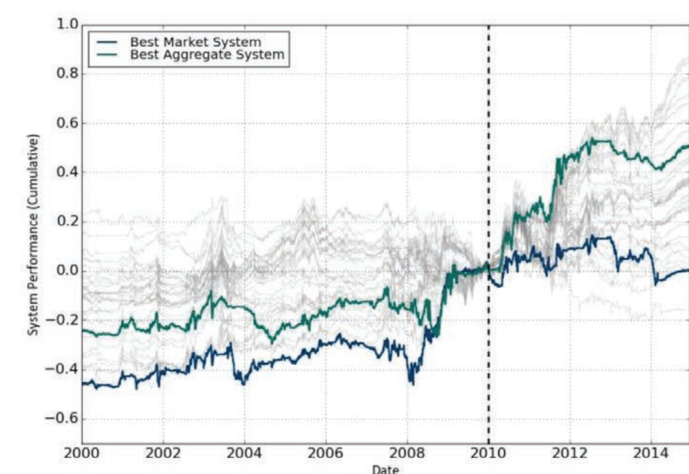
also to be best for that specific market. Overall the market specific system as expected performs much better than the aggregate system in sample. The average in-sample Sharpe ratio for the aggregate system is 0.44 and for the market systems is 0.75 suggesting that the extra complexity of fifty systems is well worth it.

Figure 1: In-sample Sharpe ratio comparison



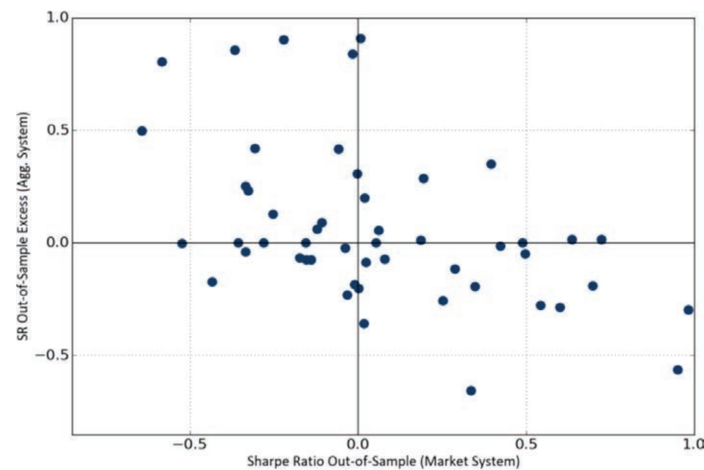
How does the comparison look out of sample? It is instructive to begin by examining the results for a specific market. Accordingly, Figure 2 shows the results of this process for the Euro-Bobl futures market[4]. The blue line represents the cumulative performance of the best market system, the system fit specifically to the Euro-Bobl future. The grey lines show the cumulative performance of the other systems applied to the Euro-Bobl future. The green line is the cumulative performance of the best aggregate fit across all fifty markets applied to the Euro-Bobl future. In sample the market system is clearly superior, but out of sample the performance of the market system deteriorates fairly quickly. This is just one example out of fifty futures markets and of course in some markets the market system does outperform the aggregate system out of sample but the point that there is a marked contrast between in-sample and out-of-sample performance is quite general.

Figure 2: Aggregate vs. market comparison for Euro-Bobl future



[4] By construction the two lines cross at the start of the out-of-sample period.

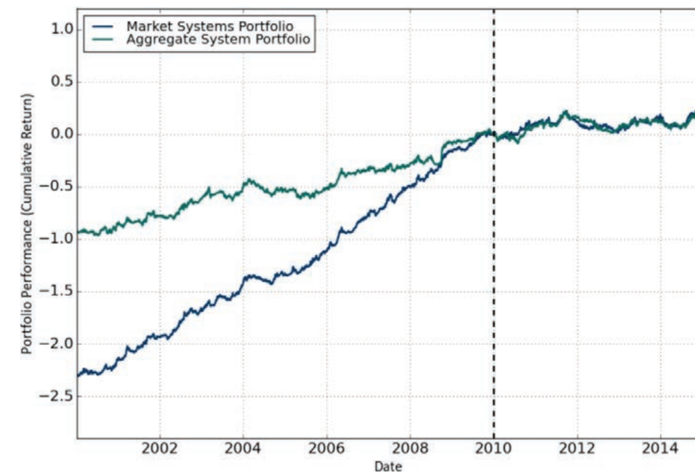
Figure 3: Aggregate vs. market out-of-sample Sharpe ratios



To further illustrate this, Figure 3 shows the out-of-sample Sharpe ratio comparison for all of the futures markets. As in Figure 1, the market system Sharpe ratios for each market are on the horizontal axis and the excess Sharpe ratio on the vertical axis.

By inspection, it is clear that out of sample the more complicated system is not noticeably better than the simple system as there are multiple markets where the simple aggregate system outperforms the more complicated market specific system. To better illustrate this, Figure 4 shows the returns of an equally weighted portfolio of the cumulative return for all 50 markets for the market system and likewise for the aggregate system.

Figure 4: Market vs. aggregate system comparison



So the extra one hundred and forty seven parameters in the market system don't appear to have improved the out-of-sample performance relative to the much simpler system out of sample. Neither track record out of sample for this very simple momentum strategy is particularly impressive but the contrast in the relative performance between the simple and complex approaches in sample and out of sample is striking.

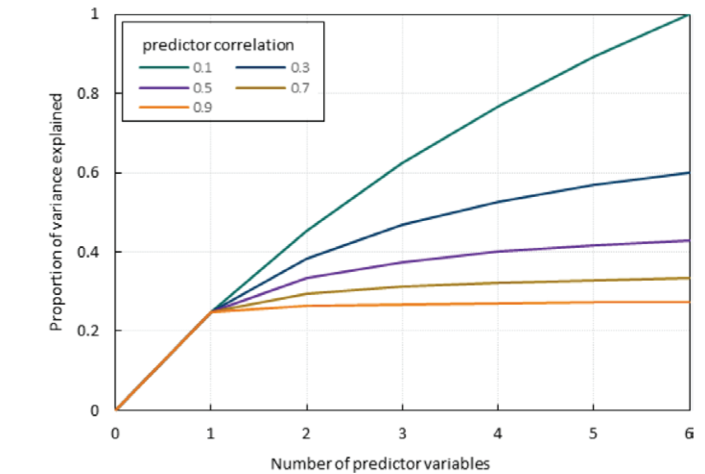
There are several candidate explanations for the deterioration in the relative performance of the market system out of sample. A key possibility, though, is that the additional degrees of freedom in the market system mean that this system has much more room to fit transient features of the data rather than uncovering structure. The extreme case of this would be if there was in fact an aggregate optimal trend following frequency which is observed with error in each market so that all of the variation in frequencies arises from random noise and hence contains no useful information about likely future performance. The more parameters there are in a system the greater the risk of over fitting.

Turning to another pertinent example, in a recent paper[5] which we have previously drawn attention to[6], Vanguard researchers point out the very striking contrast between the in sample simulated performance of the very many new ETFs representing themselves as better indices like minimum variance or smart beta, and the fairly dismal performance of such strategies out of sample. Many of these strategies are based on a linear factor model of some sort. Factor modelling is a rich area for inadvertent over fitting because there is no theoretically correct set of factors and no theoretically correct number of factors. So let us say a researcher had ten candidate factors that will either be in or out of the model. There are 2^10 -1 possible models which is 1023[7] and that number is **before** we consider the additional variations that can be generated by different weighting schemes on the included variables or different ways of calculating those variables. With so many degrees of freedom it is neither surprising that there are many excellent in sample track records nor that the out-of-sample performance has been less compelling.

So complexity clearly comes at a cost in finance and may well result in misleading inferences about likely future performance but is it necessary for investment success? Professor David Hand, Winton's Chief Scientific Advisor, published an interesting paper[8] which argued cogently that complexity is overrated. As well as drawing attention to the risk of over fitting, this paper contains several arguments to suggest that simple approaches may well capture most of the salient features of a given hypothesis and should be on the reading list of any quantitative researcher.

One argument in this paper is particularly germane to finance. Multicollinearity or the tendency for variables to be highly correlated with each other is the rule rather than the exception in finance. A regression example helps demonstrate that additional complexity may not always result in much gain in explanatory power when multicollinearity is present. Assume we have a number of predictor variables and that each of them has a correlation of 0.5 with the variable we are trying to predict. Further assume that each pair of predictor variables is correlated to a given extent. Figure 5 shows the proportion of the variance in the variable we are trying to model explained as the number of predictor variables increases at different levels of collinearity between the predictor variables. The number of predictor variables is on the horizontal axis and the proportion of variance explained on the vertical axis. For example, if the pairwise correlation between all the predictors is 0.1, then a 3 variable model explains roughly 60% of the variance of the target variable.

Figure 5: Proportion of variance explained



So if the predictors are only mildly collinear, then a more complex model is warranted because there are substantial gains in explanatory power but in the more likely example where collinearity is higher, we see much more modest gains in explanatory power as we increase the number of variables. So complexity may not always buy us very much in terms of explanatory power: the law of diminishing returns is very apparent when predictors are correlated.

These arguments, if they have any merit, have very clear implications for quantitative investment firms. They suggest that there may be limited gains to employing complicated

[5] Dickson et al. (2012).
[6] M. Beddall (2013).
[7] In fact, a recent paper by Levi and Welch (2014) describes no fewer than 600 factors which have either appeared in academic papers or have been used by practitioners.
[8] D.J. Hand (2006).

approaches like neural networks, random forests and so on. Instead, such firms should focus on acquiring or building datasets other managers may not have and applying simple models to those datasets which hopefully span a long enough time period for more stable relationships to be extracted from the data.

Complexity in finance is very much a double edged sword. On the one hand it enables impressive in-sample results to be generated which may then be used to demonstrate the virtues of investing in such a model. On the other, there are substantial arguments suggesting that the out-of-sample performance of these complex models may not be any better than much simpler models.

Narasimhan Jegadeesh and Sheridan Titman
"Returns to Buying Winners and Selling Losers: Implications for Stock Market Efficiency"
The Journal of Finance, Vol. 48, Issue 1

Matthew Beddall
"Designing an Investment system"
Winton Newsletter April 2013

Joel M. Dickson, Sachin Padmawar and Sarah Hammer
"Joined at the hip: ETF and index development"
Vanguard Research 2012

David J. Hand
"Classifier Technology and the Illusion of Progress"
Statistical Science, Vol. 21, No.1

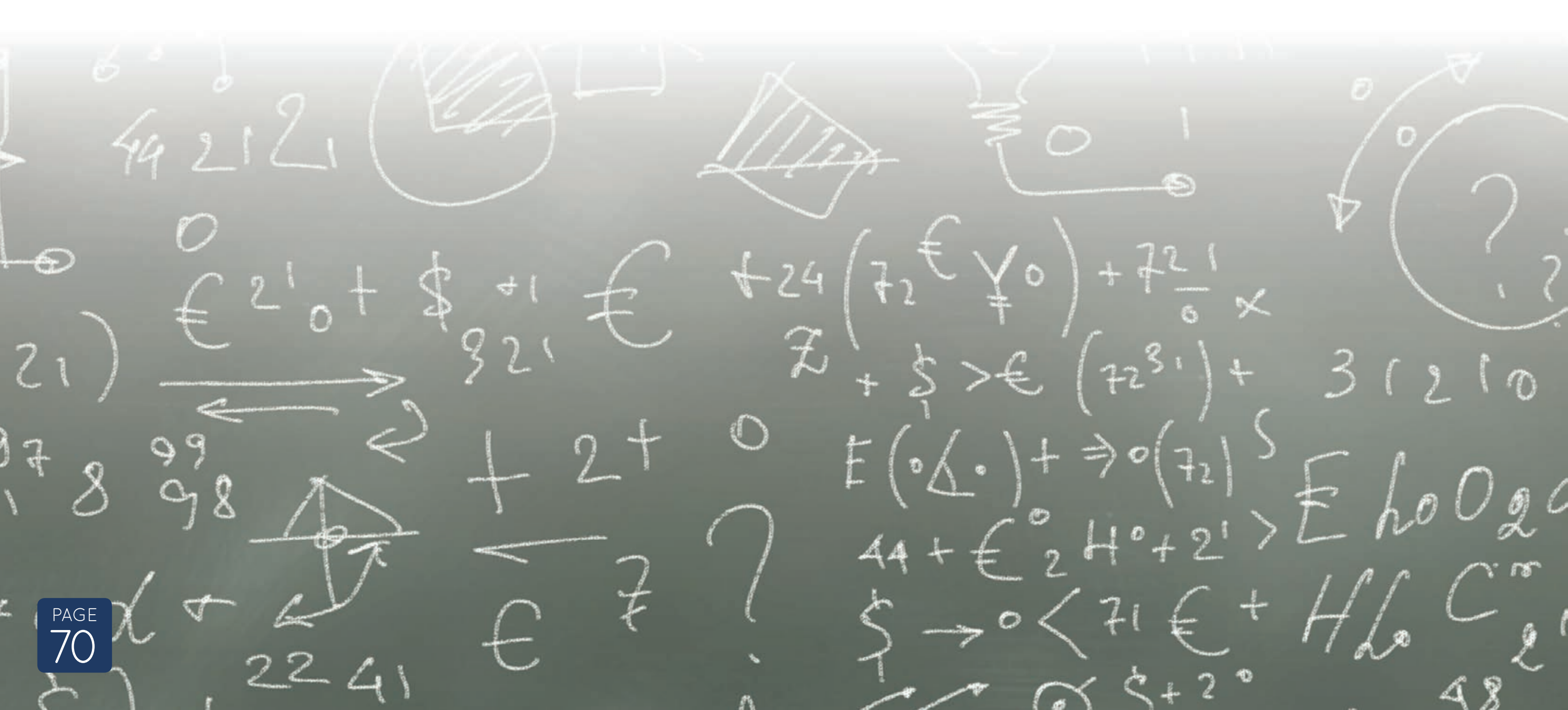
Yaron Levi and Ivo Welch
"Long Term Capital Budgeting"
Working Paper 2014

About Winton Capital:

Founded in 1997, Winton is a systematic investment manager that uses the scientific method to develop advanced investment systems.

Winton believes their approach to investment management, which does not subscribe to economic orthodoxy, can provide genuine diversification benefits. Winton currently has over $30 billion in assets under advice and employs over 400 people in nine locations around the world.

Through statistical analysis and mathematical modelling of historical data, Winton strives to identify profitable investment opportunities. Products range from highly diversified multi-asset solutions to regional long-only equities, available in a variety of wrappers and customisable managed accounts.



HEDGENORDIC

"Chance favors the prepared mind."

Louis Pasteur

Navigating Through Unbundling Regulatory Changes

BY JACK POLLINA, MANAGING DIRECTOR, GLOBAL HEAD OF COMMISSION MANAGEMENT, INVESTMENT TECHNOLOGY GROUP

The long-awaited MiFID II Delegated Acts were released on April 7, outlining some important points about how EU-based asset managers will value and pay for research. However, some key questions remain up to interpretation by local regulators. What is clear is that unbundling of research and execution will be required, and with it comes an increase in the administrative load for the asset manager.

Generally, the outcome presents a choice of two models. You can implement a Research Payment Account (RPA) if an asset manager wishes to use direct client funds to pay for research. Or you can continue to use an arrangement similar to a CSA process to fund the RPA account alongside client assets.

We expect the Financial Conduct Authority will publish a consultation paper sometime in September to address areas that might lend themselves to interpretation, and that other European regulators will do the same.

AGGREGATION UNDER THE RPA MODEL

The market participants' concern remains how the U.K.'s FCA regulatory body will interpret the delegated acts. We expect the FCA will allow commissions to be used for payment of research in the form of a tack-on, similar to the existing CSA model. Asset managers will also be able to use direct client money to pay for research. Doing so will require operating an RPA, which can be funded with direct client money or an arrangement similar to the current CSA process.

Under an RPA model, it might be beneficial to use an aggregator. Basically, you would still build research credits at individual brokers but you would use an aggregator to pool all credits and client funds into one central account managed by the asset manager and the broker or firm holding the RPA. Using an aggregator such as ITG would alleviate the administrative work and centralize the credit and payment activity.

CURRENT CSA USE IN EUROPE

The current structure in Europe, known as CSA, has a process that is equivalent to a tack-on commission to pay for either broker or independent research. This structure allows transparency between cost of execution and cost of research, and it is a widely accepted practice in most European countries. France has been especially vocal that it would like some key aspects of CSAs used in their current form to remain as a standard for payment of research. Countries that have historically been bundled, such as Italy and Spain, now face the challenge of establishing programs to implement unbundling and monitor research cost and consumption.

SWEDISH MODEL

The Swedish market consists mostly of large institutional investors trading a smaller universe of assets. A few of these Swedish funds use the Swedish model, where the account is funded by charging clients directly.

Recommended best practices of asset managers (non-exclusive list): While implementation is not expected until January 3, 2018, and further clarifications are likely, we recommend some considerations that demonstrate best practices for a typical asset manager.	
Set your firm's rules.	Put policies and procedures in place that state how you will adhere to new MiFID II rules.
Select your policy manager.	Assign a dedicated person to oversee internal procedures.
Determine a research budget.	Set your research budget in advance and receive approval from clients before procuring such research.
Outline asset manager and broker responsibilities.	Enter into a CSA and/or RPA agreement with brokers clearly outlining the roles both asset manager and broker will play.
Put management systems in place.	Make sure the broker has systems to track and report on commission(s)/dollar balances and research payments.
Designate a payment workflow.	Assign an authorized individual who can request research payments and another who can approve the payment.
Accurately document research payments.	Make sure research payments are documented properly. The broker or firm managing the RPA account should receive an invoice that indicates research description, service period, cost of research and who used the service.
Review and approve new research.	Any new service requested by an analyst should be reviewed and approved by an authorized individual before purchasing research. The research budget should also be updated with additional costs to budget.
Review balances and approvals regularly.	The fund manager should conduct a periodic review of CSA/RPA account managers to ensure CSA/RPA credits/dollars received are accurate and services being paid for are approved by internal and regulatory guidelines.

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CHOOSING AN RPA/CSA MANAGER

Selecting a management service for the RPA or CSA model may be easier than you think. We encourage you to research solutions that work best for you. As part of the process, ask yourself these questions to determine the provider of commission management services that fits your needs.

Commission Management Providers Checklist	Yes	No
Do they run their program as a business or accommodation service?	☐	☐
Do they have dedicated client services staff?	☐	☐
Do they take the administrative burden away for the client?	☐	☐
Do they have a global team with staff in each region?	☐	☐
Do they have global regulatory expertise?	☐	☐
Do they have a client web portal to track and report on commission(s)/dollar balances and research payments?	☐	☐

WINNERS

Nordic Hedge Award 2015

Best Nordic Hedge Fund Overall 2015
Supported by Northern Trust

1. Asgard Fixed Income
2. Taiga Fund
3. AAM Absolute Return

Best Nordic Equity Focused Hedge Fund
Supported by Novus

1. Alchemy Trading
2. Origo Quest
3. Taiga Fund

Best Nordic Fixed Income Focused Hedge Fund
Supported by Stockholm School of Economics/SIFR

1. Asgard Fixed Income Fund
2. Midgard Fixed Income Fund
3. Nykredit Kobra

Best Nordic Fund of Hedge Funds
Magnusson

1. SEB True Market Neutral
2. Danske Invest Eliksir
3. Merrant Alpha Select

Best Nordic Multi Strategy Hedge Fund
Supported by ITG

1. Nektar
2. Visio Allocator
3. Catella Hedgefond

Best Nordic CTA
Supported by Efficient Capital

1. IPM Systematic Macro
2. SEB Asset Selection
3. Estlander & Partners Alpha Trend

Rookie of the year award
Supported by HedgeNordic

Winner: PSG Capital - Elementa

Performance Awards
Supported by Mackmyra

1 year:
Oslo Asset Management - AAM Absolute Return
3 years:
Rhenman & Partners - Rhenman Healthcare Equity L/S
5 years:
Rhenman & Partners - Rhenman Healthcare Equity L/S

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New Fund Launch: Gramont Capital

An opportunistic approach to long/short equity investing

by Jonathan Furelid – HedgeNordic

Miikka Hautamäki, a former proprietary equity trader at Goldman Sachs in London and portfolio manager for Brummer & Partners Avenir, launched Gramont Equity Opportunities Fund with Janne Järvinen and Jaakko Huhtala. Janne's background is from the Special Situations group at Goldman Sachs and private equity firm Nordic Capital. Jaakko Huhtala joined from Carnegie to run the operational side of the business.

In late 2014 the team launched the Gramont Equity Opportunities Fund. "When we started out, the idea was to offer something that could make money in all market environments, was truly uncorrelated to the equity markets, and that we could build on our experience from previous roles", Hautamäki, Gramont's CIO, says. The fund's recent performance is testimony to the low correlation – while from the beginning of 2016 global equity markets first sold off sharply and then rallied back close to earlier highs, Gramont returned 8.5% by the end of April, making profits in three out of four months. In 2015, the fund ended up 11%.

Gramont builds on three distinct investment strategies; macro thematic, single stock strategies and special situations. The allocation between the three strategy groups has varied significantly since the launch, driven by the opportunity set perceived by the managers.

"In this challenging macro environment we want to remain nimble and opportunistic. Unlike many hedge funds that have strict allocations in terms of strategy, sector or geographical region, our mandate is flexible, allowing us to invest where we see the greatest opportunities at any given point in time", Hautamäki says.

The thematic strategy focuses on broader macroeconomic themes in the equity markets while the single stock strategy focuses on company fundamentals, technical factors and relative valuation. The special situations part of the portfolio aims at identifying arbitrage opportunities that could appear in isolated events such as a M&A deals, right issues and index changes.

"We've managed to make money from all three strategy groups this year. On the macro side, our negative view on equities has paid off. Also on the single stock side we have benefitted from shorts in companies that have unsustainable valuation multiples and stretched price momentum. In special situations we closed out a number of M&A arbitrage positions on back of rapid tightening in the spreads", Hautamäki says.

As the typical holding period of the fund's investments is relatively short, usually from 1 to 12 months, the managers are more focused on the near term investment environment instead of trying to make longer term forecasts. At the time of writing this article, the team continues to have a negative outlook on equities.

Gramont's founding partners, left to right: Janne Järvinen, Miikka Hautamäki and Jaakko Huhtala

"In our view the equity risk premium currently compensates poorly for incremental risk taking given rapidly deteriorating fundamentals. However, given that we only invest in highly liquid securities, we are able to flip our overall positioning from net short to net long and vice versa quite easily. That has enabled us to be opportunistic amidst the increased volatility on the equity market. We don't anticipate the uncertainty to go away anytime soon, so there should be plenty of opportunities for our trading oriented strategies going forward too", Hautamäki argues.

"High liquidity also makes the strategy scalable and allows the fund itself to provide its investors with monthly liquidity without any lock-ups or gates, which many institutions seem to appreciate these days", he continues.

While at any given point the fund may have equity market exposure, either net long or short, the team expects that to average to zero over a longer time horizon. The risk levels are constantly being reviewed:

"We recognize that we are in a highly volatile environment and risk management is always an integral part of our portfolio construction", Hautamäki explains, continuing:

"We have stop loss limits on individual trades as well as on a portfolio level. The limit for individual trades is at 2 percent of AUM. At the portfolio level we reduce gross exposure by a third, should we experience a drawdown of 5 percent. This helps us stay disciplined and forces us out of positions with negative momentum", Hautamäki argues.

So far, the Gramont fund has been running quietly under the radar for most investors outside the fund's hometown, Helsinki. According to Hautamäki, Gramont will be looking to make a mark internationally after passing the 2-year mark in August:

"We wanted to build a track record before pursuing broader distribution. Obviously our current investor base is primarily Finnish institutions, but in addition to already having a couple of international investors on board, it seems that our recent performance is creating more and more traction from abroad as well", Hautamäki concludes.

FACT BOX

Fund Name:	Gramont Equity Opportunities Fund
Strategy:	Long/Short Equity - Opportunistic
Fund Company:	Gramont Capital Ltd.
Launch Date:	August 2014
Portfolio Managers:	Miikka Hautamäki, Janne Järvinen
Web:	www.gramont.fi

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Excalibur launches new credit hedge fund: Trude

- sees unique opportunity set

by Jonathan Furelid

In October 2015, Swedish hedge fund manager Excalibur added a new fund to its product offering. The fund, named Trude, is focused on exploiting inefficiencies in credit markets through advanced quantitative models. Industry veterans Marek Ozana and Anders Nordborg will be managing the fund alongside the existing, award-winning, fixed income hedge fund Excalibur.

”We are launching Trude as we want to be able to offer investors a unique strategy that can offer absolute returns in a time where we consider many markets as being in for a challenging period. This applies to fixed income as well as to equities and real estate, founding partner Marek Ozana explains and continues:

”The 20-year rally in bonds and the outsized returns offered by equity and real estate markets during the last 6-7 years is about to come to an end. Valuations have been inflated by central bank interventions. Regulatory requirements have also made credit markets less efficient the way we see it, offering a unique opportunity-set for Trude, Ozana says.

The investment philosophy behind Trude is to find relative value opportunities in credit markets through investing in the full range of debt instruments offered by companies. This means that the fund could take advantage of a company´s entire capital structure.

”We will have a very flexible mandate, allowing us for example to buy senior debt while at the same time go short tier-two debt in the same company. We will also be using derivatives and take positions in credit indices to fully exploit the opportunities we find. In turbulent times, the fund can also invest in more liquid instrument such as government- and mortgage bonds”, Ozana explains.

The fund will screen a large investment universe through a quantitative model developed by Ozana in order to find interesting opportunities. Once these have been detected, an in-depth fundamental analysis filters out the actual investments that the fund enters into.

”The idea is to find cheap and solid credits and buy them while at the same time go short bad credits that we believe to be too expensive, alternatively to short credit indices. Using this approach there are many interesting themes that could be exploited. For example, we could trade perceived bad companies against perceived good ones in the same sector”, Ozana explains.

The return profile of Trude will be completely uncorrelated to equity and fixed income markets, according to the manager. As a result, the portfolio risk will not be dependent of whether markets are going up or down, rather it is a result of how the position strategies in the fund develop.

”We will be running 7-8 strategies in the portfolio. Each strategy has been given a fixed risk weight and the total risk will be the sum of these weights added together. We will be following each strategy in real time and the goal is for these strategies to be uncorrelated in order to reduce risk on portfolio level”, Ozana says.

Given that the fund aims to be completely uncorrelated to the returns of traditional long only funds investing into fixed income or equity markets, Ozana believes it to be an interesting complement for investors that seek diversification.

”We believe that the market environment will be more challenging going forward and that it will require more from investors. You cannot put your money into any fund and expect it to work. Our ambition is to be immune against structural economic trends and market moves. We rather try to find inefficiencies in specific segments of the market”, Ozana says, continuing:

”The return of the fund will be completely independent of whether interest rates or equity indices rise or fall and as a result also be uncorrelated to traditional funds. This should make it a good complement to most investors’ investment portfolios”, Ozana concludes.

FACT BOX

Fund Name:	Trude
Strategy:	Credit, Multi-Strategy
Fund Company:	Excalibur Asset Management AB
Expected return/ risk:	5-10 % over risk free rate with 4-7 % volatility
Launch Date:	2015-10-01
Portfolio Managers:	**Marek Ozana**, CFA and Ph.D. in Theoretical Physics, background with SEB as PM of quant and credit funds, quant analyst at Algorithmica Research, optimization expert at Jeppesen Boeing. **Anders Nordborg**, background with SEB and Nordea as PM for fixed income funds, index linked expert and proprietary trading. Fixed income trader for Spütz AG in Germany.
AUM:	550 MSEK (seeded by the fund’s portfolio managers and Rune Andersson’s Mellby Gård)

Chicken or egg?

THE TRIALS AND TRIBULATIONS OF NEWBIES IN STOCKHOLM

by Aline Reichenberg Gustafsson - HedgeNordic

As aspiring new fund managers dream of starting their new fund, they focus on how to develop a new attractive investment strategy which will generate superior risk adjusted returns. Quickly however, the prosaic reality hits them. In the current regulatory environment, how can they raise assets without a fund and how can they start a new fund without any assets?

Today more than ever, professional investors want more than a new strategy idea. They want a structure around it, a sound asset management business model, and this structure has a cost. How much exactly depends on the strategy itself and future ambitions.

Pre-AIFMD (Alternative Investment Fund Management Directive), it was easy to start up an alternative investment fund (AIF) in Sweden. "You used to be able to put together an AB (a regular limited liability company) and invest anyone's money in high-risk private equity-like targets in the North of Sweden for example", says Björn Wendleby at Magnusson. Wendleby has witnessed hedge funds births throughout his career, first at Finansinspektionen, the Swedish FSA, and as a lawyer from 2004. The protection for retail investors was virtually inexistent in this type of set up, but it made alternative returns available to many.

"The protection for retail investors was virtually inexistent in this type of set up, but it made alternative returns available to many."

Alternatively, you could seek a license from the Swedish FSA to manage a special fund. Such a fund could seek exceptions from the traditional mutual fund-type license opening up for hedge fund-like investment features (leverage, use of derivatives, short-selling etc.) while marketing to quasi-retail investors. This was made possible in Sweden already in the second part of the 1990s, unlike in many other countries, where hedge funds were always reserved to qualified investors. The most famous pioneers of this opportunity were Brummer & Partners, who made alpha accessible to Swedish investors through their first fund, Zenit, already in 1996. Slowly but surely, the number of special funds started growing. According to Wendleby, perhaps 30 or 35 out of 800 registered funds were special funds in 1998, of which a few hedge funds. Their number culminated in 2007 when you saw a massive number of new funds, many of which are no longer active today. After the debacle that followed post Lehman Brothers, new openings slowed down sharply.

In the meantime, European regulators put their heads together to implement new rules meant to prevent a similar systematic meltdown in the future. UCITS IV rules came out in 2011 followed by the AIFMD in 2014. As a result, new levels of control were imposed on special funds, as well as other alternative investments like Private Equity and Real Estate managers, including those simple AB structures mentioned above. This meant additional protection for investors as well as a dramatic increase in costs, especially for smaller managers who lack scale to support the new imposed functions such as independent risk management. "The regulation is positive... mostly for lawyers", says Wendleby with a twinkle in the eye. "Seriously, I believe that all these levels of controls make products safer, but the regulator should go further in allowing more of the alternative investments to reach non-professional investors. As a non-professional, you can invest in an ELTIF (European Long-Term Investment Fund, a new vehicle recently approved by the European Commission) but not in a regular Real Estate fund."

Today, there are approximately 400 Sweden based special funds and 400 UCITS funds. Out of the special funds, 30 to 40 are actual hedge funds. The rest is made up of traditional long only funds that are exempted from some of the tighter UCITS limits. Between 60 and 65 AIFMs (Alternative Investment Fund Managers) are licensed in Sweden and almost the same number are management companies that are only registered rather than licensed (meaning they manage below EUR 100 million including leverage). For the past 12 to 18 months, thanks to stronger investor appetite, new fund openings are growing once again. Wendleby estimates that he sees at least one new team every week with questions on how to go ahead with their plans to start up a fund. "Some of them have a solid business plan already, while others have merely an idea", says Wendleby. "We can provide guidance whatever stage they are at."

BJÖRN WENDLEBY, MAGNUSSON

The AB option is still available for those who want to start up with minimum costs and plan to stay below the EUR 100 million threshold (including leverage), which of course is more constraining than it first appears for products with high gross exposure meant to return double digit growth in the high teens. "You have to make sure", warns Wendleby, "that only professional investors are involved, or you will find yourself

having to ask your investors for their explicit agreement every time you make a new investment. Of course", he adds, "you will need a good management agreement and a solid shareholder agreement." Other than that, the registration with the Swedish FSA will only set you back SEK 22,000. This is a cost effective option for someone who wants to build a track record, or wants to run a niche strategy. However, many newbies shun this option, as a mere registration does not allow them to market their product and grow AUM through new subscriptions in the same way a fund structure does. And who wants to be constrained by a EUR 100 million ceiling?

> "The application process with the regulator costs more than ten times the price of a simple registration, and together with the lawyers' time a newbie could have to put up half a million SEK or more just to get the company licensed."

At the other end of the spectrum is the setting up of a brand new AIFM company. This will require a solid and very detailed business plan, covering all operational and regulatory aspects of running and controlling the fund. The application process with the regulator costs more than ten times the price of a simple registration, and together with the lawyers' time a newbie could have to put up half a million SEK or more just to get the company licensed. Many of the back- and middle-office functions can be outsourced effectively locally, provided the fund is not trading assets that are too exotic. Typically, compliance and back-office operations are outsourced, and often risk management is too; sometimes all of the functions can be delegated to a one-stop-provider.

Whichever the chosen solution, the day-to-day running of a new fund will require a certain scale. The cost of a good board of directors should also be added to the bill. Depending on the investment strategy and if the manager's own time is to be remunerated, it could require between SEK 200 million and 500 million in start-up AUM to break even given the standard fee level (which is slightly lower in Sweden than the traditional 2/20 model applied elsewhere). It can also be expected that running an AIFM will require much administrative focus, which a newbie manager typically wants to avoid, if he or she is to keep an eye on the portfolio and make money.

At Ambrosia, a new multi-strategy fund management company born at the beginning of this year, the preferred route was to establish a Swedish AIFM structure from the start. According to Torbjörn Olofsson, one of Ambrosia's four founders, it was the founding team's familiarity with the structure that guided their decision. That being said, the structure was initially designed to be the founders' wealth management vehicle and seed funding was not an issue. "Early on, we decided to start the fund with our own money regardless how much outside capital we could attract from the start" says Olofsson. This is not to say that the plan was not well thought through. First, the team made a thorough business plan including an analysis of external conditions, the design of the product, competitors and pricing amongst other considerations. In order to assess the minimum AUM

TORBJÖRN OLOFSSON, AMBROSIA

needed to start the fund, the team made a financing budget for 2.5 years of operation, without including any potential capital from outside investors. "We also made a number of sensitivity analyses of how much funding the management company needed under different scenarios" adds Olofsson. "All founders then committed themselves to fund the company under these conditions." Given Ambrosia's level of management fees, which is rather low compared to other hedge funds (between 0.3% and 0.75% depending on the

ALEX GIOULEKAS, PROGNOSIS MACHINES

share class), Olofsson admits that the breakeven AUM is rather high at SEK 1.5 billion. At that level, the partners are not yet remunerated at all. The hope is to grow the fund over time to its ideal size of SEK 5-10 billion.

> "My strategy is highly scalable and well suited to international institutional investors. Given my previous experience, I know that Luxembourg is a jurisdiction that most are comfortable with"

Alex Gioulekas who launched a multi-asset quantitative strategy aided by machine learning algorithms went about choosing a structure in a different way. Given the hurdle of raising sufficient AUM at the onset to build a standalone AIFM, Gioulekas instead struck a deal with Coeli Asset Management, a larger platform who not only provided the licensed umbrella and covered the fund's costs but also seed funding of more than SEK 150 million as well as an experienced distribution team. Gioulekas has the option to open a new management company as soon as his fund has grown sufficiently to make it profitable. In addition, Coeli gave Gioulekas a choice to open a Luxembourg fund instead of a Swedish fund, which he believes was very valuable. "My strategy is highly scalable and well suited to international institutional investors. Given my previous experience, I know that Luxembourg is a jurisdiction that most are comfortable with", explains Gioulekas. For Ambrosia, the choice of a Swedish Special Fund structure was driven by the fact that its potential investors are primarily based in Sweden. "Also, we believe that most of the sophisticated foreign investors have learned about the Swedish structure, and actually think that it is pretty good", adds Olofsson. In fact, this is one of Wendleby's pieces of advice to aspiring new fund managers: "Unless your investor base requires you to do otherwise, open your fund locally – everything will just be easier for you."

Marcus Wahlberg who a year ago launched Elementa, a fundamental long/short equity fund, launched the fund with PSG Capital AB, an AIFM licensed company managing the PSG Micro Cap fund. The co-operation has been very successful and Elementa's AUM is today seven times larger than at launch. Just like Gioulekas, when his fund is large enough, Wahlberg has the possibility to move the fund to a newly started management company, in which PSG Capital AB will become part-owner.

Anders Palmqvist who is planning on launching his new fund of fund, Archipelago Multi-Strategy, at the latest in December, decided to use a fund hotel, a novelty in the

MARCUS WAHLBERG, ELEMENTA

Swedish market. This meant that he still had to apply for a license with the Swedish FSA, a securities company license (värdepappersbolag), which costs approximately the same as an AIFM license. The fund hotel will take care of all the functions he would have outsourced if he owned a full AIFM license, which might not provide a large cost advantage. However, the administration headache is most likely less painful, even if he has to relinquish some control to the hotel. For example, the board of the AIFM who ultimately controls the fund is the hotel's board. Also, with all the services supplied by the hotel, changing provider could prove tricky down the line. According to Wendleby, this type of solution is new in Sweden, but has been tried and tested in Luxembourg for several years now. Both investors and fund managers are generally comfortable with such a set up. In fact, sometimes investors might prefer a fund hosted by an established "household name" hotel rather than a new and untried standalone AIFM.

"... sometimes investors might prefer a fund hosted by an established "household name" hotel rather than a new and untried standalone AIFM."

ANDERS PALMQVIST, ARCHIPELAGO MULTI-STRATEGY

Probably, what allowed Palmqvist to choose this solution is the scale of his seed funding. After a long and successful career as Managing Director at UBS, Palmqvist together with some friends and family has enough capital to seed his new fund entirely. While the amount of capital is undisclosed he says: "I have given myself until the end of the year to market the fund. Before launch, I want to build the book in a way where investors do not get turned away because the fund is below their minimum size threshold. But in the end I am going to launch anyway with the assets I already have."

ADDITIONAL LEARNINGS

When it comes to their journey so far, all managers had some useful insights to share in addition to their choice of set up. For Gioulekas, the experience was more positive than he had first expected. That is probably because he was not a first-timer when it came to building up a quant fund. He had already been part of the founding team at IPM and exited the company successfully. This bought him credit when talking to potential partners locally and it actually took him only 6 months to find and negotiate the right deal, less than he had anticipated. Timewise, Palmqvist on the other hand was surprised by the time it took the FSA to grant him his license as a securities company – it took 9 months after the application was submitted. Wendleby confirms that this is a problem at the moment. Oddly enough, an AIFM can get a license within just a couple of months with some luck, but a securities company has to wait much longer. This is also something to take into account when choosing a set up.

It took Ambrosia only 5 months to get its AIFM licence from the time the application was submitted, after a team of two spent about 3 month preparing it. While this process was relatively smooth, Olofsson admits that the finding the right outsourcing partners for functions such as back-office, compliance and internal audit was fairly lengthy and complex. Olofsson's advice to new managers is to "have a complete team that can handle all aspects of running a fund management business". Palmqvist who chose to outsource all functions to his fund hotel and other suppliers, might consider moving from this variable cost model to a fixed one, provided the total cost is lower. Even if Gioulekas did not have to worry about such questions, his admin learning curve was very steep. Given the type of assets he trades and the high volatility at which he wanted to run his strategy (20%), he had to spend a significant amount of time negotiating with counterparties before he could get going.

"... an AIFM can get a license within just a couple of months with some luck, but a securities company has to wait much longer."

Finally, for both Wahlberg and Palmqvist, you shouldn't wait until you are old to start your fund. For Palmqvist "many people working in the financial industry want to have their own fund or business, because that's ultimately what they like doing. The question is at what point in your life are you financially secure enough to have the capital to invest while you are not too old yet." "When you manage a hedge fund, you need to play a special game", says Wahlberg. "You need to be able to change your mind quickly at all times, and be hungry."

STRATEGY DESCRIPTION OF FEATURED MANAGERS:

Prognosis Machines – Alex Gioulekas, Fund manager

The Prognosis Machines is a strategy for volatile times based on artificial intelligence and proven financial models. The Prognosis Machines' solution is to use new technology to discover what themes investors favor as unknowable events (policy errors, crises, disasters) shake the markets. New machine learning algorithms choose between macroeconomic or behavioral forecasting models. The strategy then builds the portfolio based on the selected models and new macro data. The Prognosis Machines trades the most liquid markets in the world: equity, interest rate and commodity futures and currency forwards, around 100 instruments in total.

Elementa – Marcus Wahlberg, Fund manager

Elementa is a niche L/S equity fund, targeting to generate high absolute returns over time independently of general market cycles. It specializes in Nordic small to mid-sized companies, both for longs and shorts. Elementa proactively seeks "x factor" opportunities with tangible growth prospects, business model scalability and strong cash flow generation, or the opposite for the short book. The Fund leverages a research intense investment approach to identify and develop its own investment ideas. Elementa's primary focus is equities but the Fund may also opportunistically invest in corporate bonds in situations offering attractive "equity like" return dynamics.

Ambrosia – Torbjörn Olofsson, Fund manager

Ambrosia's is a multi-strategy fund whose investments can be divided into three sub-strategies: market risk, macro/directional and relative value. The managers seek to capture long-term risk premiums through continuous, but dynamically allocated, exposure to market risk such as equites, credit, duration, commodities, infrastructure etc. The exposure to idiosyncratic risk is achieved through positioning within directional trading and relative value trading, mainly in fixed income and FX. The portfolio is designed to be resilient to various market outcomes. An important element of the portfolio analysis is to capitalize on opportunities to reduce risk, or increase returns, due to diversification effects between the market risk and the idiosyncratic risk.

Archipelago Multi-Strategy – Anders Palmqvist, CEO and Fund manager

Archipelago Multi-Strategy is a concentrated fund of hedge funds with a multi-strategy focus. By investing in different hedge funds the Fund draws from a broad portfolio management expertise within various global investment strategies across many asset classes. By investing primarily in hedge funds with different specializations, the aim is to offer an investment with long-term (3-5 years) competitive return to a lower level of risk than equities. The fund's objective is to have a relatively low correlation with the returns from traditional asset classes of equities and bonds, and strive to achieve positive / absolute return each year. The fund consists of +750 years combined investment experience among risk takers, long individual team & fund performance and several award winning teams.

By Stan Altshuller, Chief Research Officer - Novus

When Investing in a Specialist Makes Sense

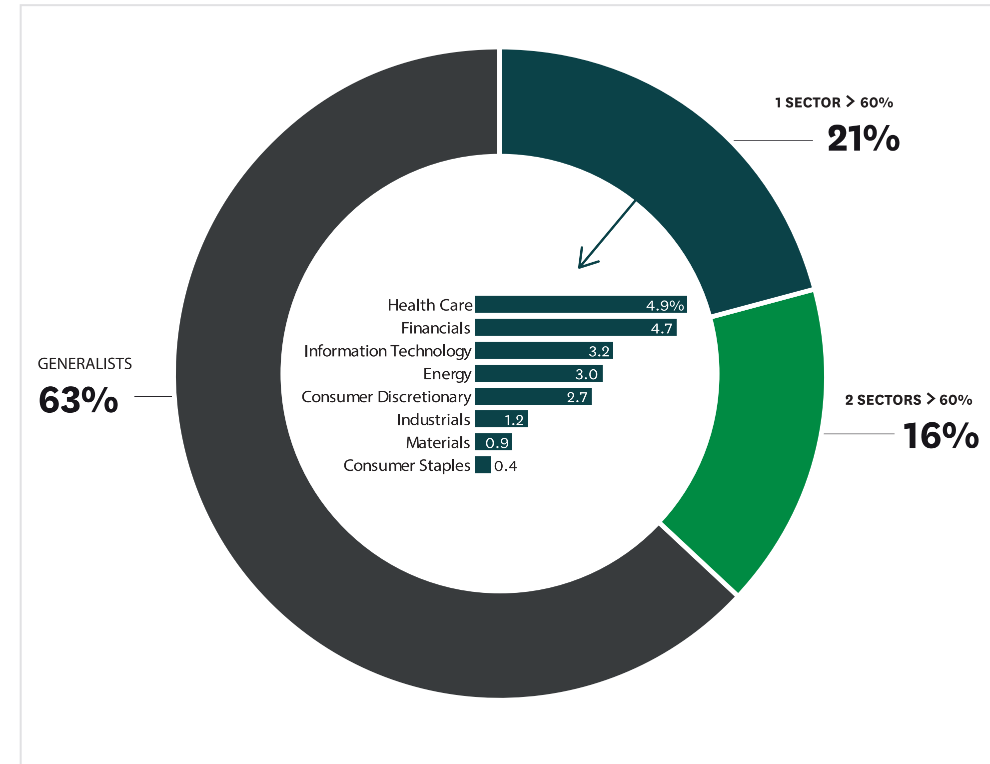
Investing in hedge funds shouldn't be rocket science. In theory, you choose the managers that you feel will deliver strong risk-adjusted returns over a long period and provide various benefits such as diversification to your portfolio. At the same time, there are countless nuances when choosing managers given there are thousands of them out there running dozens of different strategies, charging high fees and sure enough, half of them are below average. More and more investors turn to ownership data to help them choose. There are many ways in which analysis of ownership data can help with manager selection.

One question our clients have asked is whether or not it pays to invest money with a sector specialist that sticks to one sector they know well, over a generalist that invests in a mix of different sectors. There are clear benefits of investing with a specialist. The manager's unique domain expertise in a particular area probably offers them opportunities that a non-specialist will not be able to exploit. At the same time when a sector is out of favor, a generalist may opportunistically shift assets, while a specialist is tied up in an area of limited opportunity. Our data shows that some sectors are worth specializing in while others are not. Let's dive in:

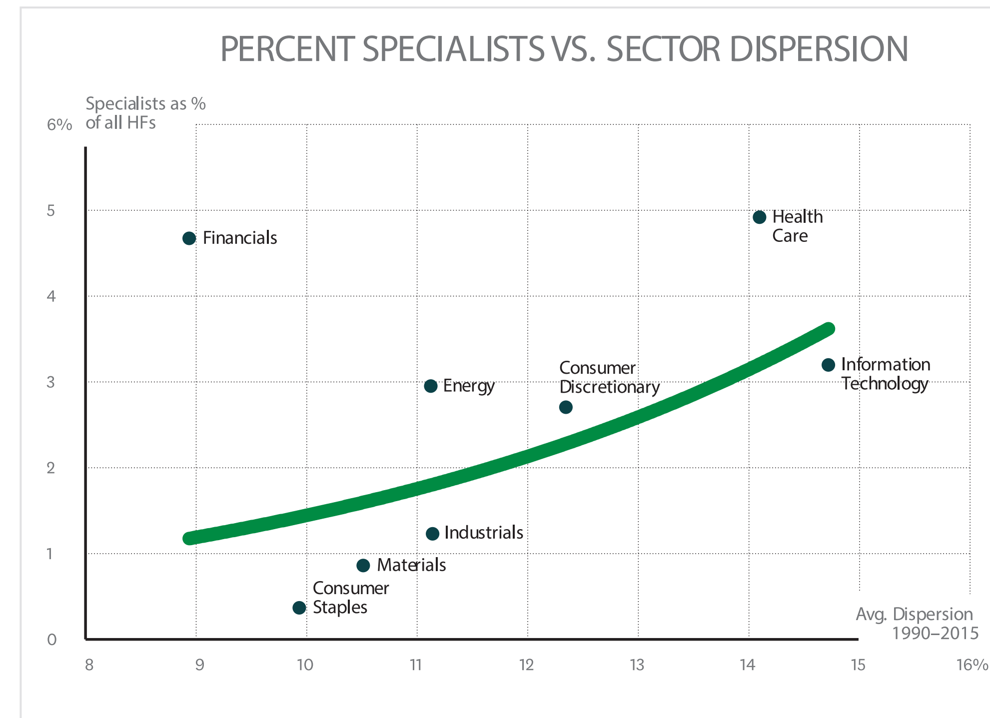
Specialists and Generalists

We defined a specialist as a manager having over 60% of their public portfolio invested in one of the eight GICS sectors. By that definition, there were 170 specialist managers out of our universe of 813 managers active in 2014. That comes out to 21% of all funds having a specialist focus in 2014. Another 131 managers (16%) were dual sector focused and had over 60% of their portfolios in 2 top sectors. Thus we can say that 37% of all managers have a single or a dual focus in certain sectors.

The most popular sector to specialize in for 2014 was the Healthcare sector, as 4.9% of managers focused over 60% of their books there. We spoke about the Healthcare trend in our recent work on the most prominent hedge fund trends in charts. The runner up was financials with 4.7% of all managers.



Compared to the landscape in 2010, managers became slightly more focused. Five years ago, only 17.7% of managers were single sector specialists and 13.7% were dual sector focused. Also interesting to note, the most popular sector to specialize in back then was Information Technology.



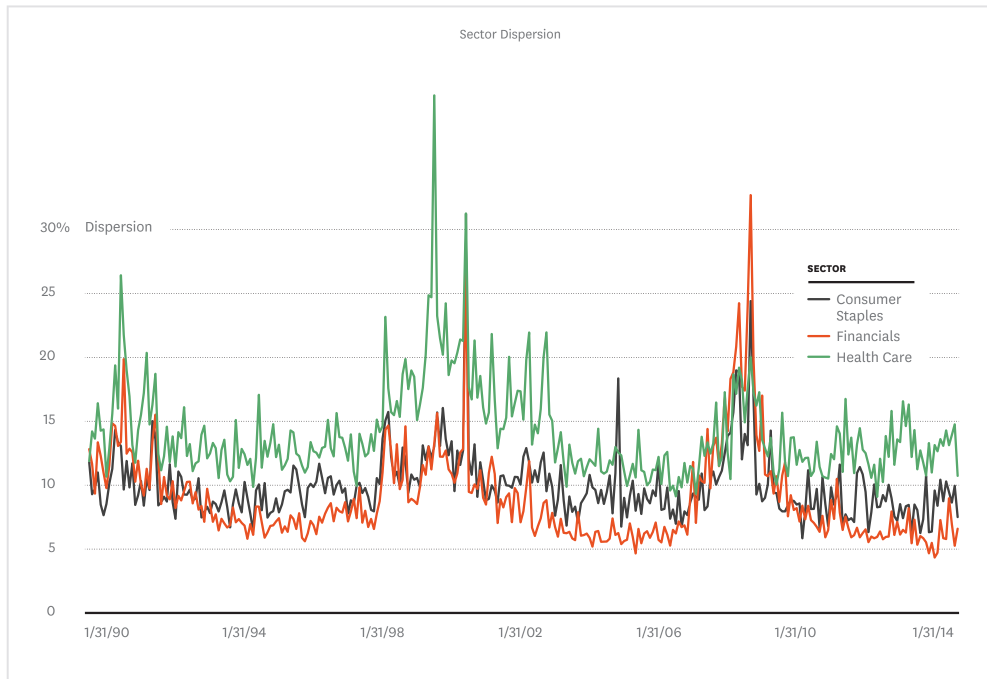
Which Sectors are Ripe for Opportunity?

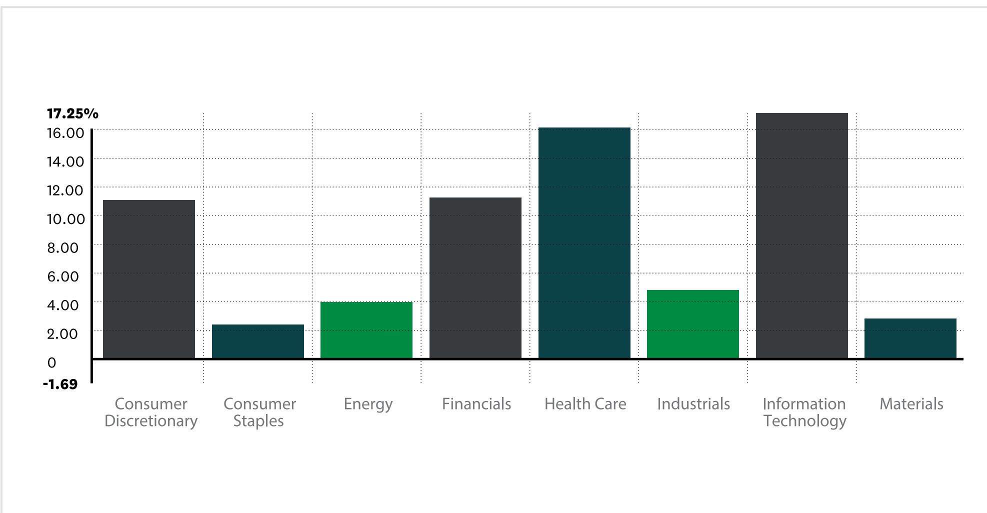
Earlier this year we published two works on the recent market environment and its effect on active management. The first paper showed why 2014 was the worst year for hedge funds in that the very skills managers use to generate alpha were not as valuable in 2014 as they were historically. The next paper analyzed the market environment from the lens of correlations and dispersion and came up with a similar conclusion that poor performance is not always tied to manager ability. Our data showed that the ideal environment for active managers to generate alpha, or, even absolute return, is one of low correlation and high dispersion. Here we take the same concept and apply it to the eight GICS sectors to see if dispersion within sectors matters for managers' ability to generate alpha within those sectors.

Dispersion Matters

More dispersion means more opportunity for a long/short strategy to make outsized alpha. Let's say you want to go long one stock and short another in a certain sector. If all the stocks hug the index tightly (low dispersion) you will make very little profit, even if you are right. On the other hand, high dispersion sectors pay stock pickers to make similar kinds of trades.

We found compelling evidence of managers choosing to specialize in sectors with greater historical dispersion, with the one clear exception being financials. Given that financials have the lowest average dispersion of all the sectors it is surprising to see almost 5% of all managers choosing to specialize in that sector. Financials have not rewarded great stock pickers as much as, say, Health Care stocks have. At the same time the numbers make sense for Consumer Discretionary, IT and Healthcare.





The above chart paints quite a depressing picture for financials specialists. Recently, dispersion in financials has been lower than the manager-forsaken sector of consumer staples, yet many more managers still choose to specialize there. We would then expect hedge fund managers to generate significantly less Alpha in financials. That, however is not the case.

What This Means for Alpha Generation

To find out what dispersion and specialization mean for actual Alpha generation, we ran an attribution analysis for all the hedge funds in our universe and decomposed the returns using the Novus Framework. The framework allows us to isolate the portion of returns attributable to picking stocks within a sector. The time period we used was March 1999 through May 2015. Below you can see the results. Consistent with our dispersion findings, the highest Alpha numbers belong to the highest dispersion sectors, namely, Healthcare and IT with Consumer Discretionary not far behind.

It is not surprising that Staples and Materials were almost void of Alpha – those were two of the lowest dispersion sectors. Both dispersion and Alpha numbers suggest those are not great sectors in which to specialize. But Financials again defies all odds and comes out with strong Alpha numbers, even being the lowest dispersion sector. Another way of saying this is that even given a relatively low dispersion environment Financials specialists had to exercise immense skill to generate similar Alpha levels to high-dispersion Consumer Discretionary. Don't fire your Financials managers just yet.

INTERVIEW JARLE BIRKELAND ALCHEMY TRADING

BY GLENN LEAPER, PHD – HEDGENORDIC

Jarle Birkeland, founder and portfolio manager of Norwegian long/short equity fund Alchemy Trading, talks to HedgeNordic about Alchemy's strategy, revealing, along the way, how a career in professional football has helped to enforce trading discipline.

Alchemy Trading is a long/short equity fund with a variable bias aiming to generate returns of 10-15%. Its volatility budget is roughly half this. Jarle Birkeland, the fund's portfolio manager, underlines how treating the cash balance with care is a top priority - while nonetheless deploying capital as opportunity arises. Alchemy's turnover is high, as Birkeland emphasizes, but varies depending on its trading expectancy and the portfolio sizing principles the Fund employs.

Whereas trade expectancy is, generally speaking, probability-adjusted historical returns of winning versus losing trades, the Fund uses the 'Kelly Criterion' for guidance on the optimal sizing of ideas contained in the portfolio, in order to reduce volatility. Alchemy's stock-selection process is top-down, and its sizing reflects assessments of risk-adjusted returns of the idea in question. "Sizing can be a function of visual confirmation of multiple time frames

or conviction in a certain short term catalyst," Birkeland says. "Short-term catalysts that combine seasonality and behavioral components often send powerful signals. Our Fund has a particular knack for capturing Alpha from the behavioral bias of local asset allocators." Alchemy therefore finds it unnecessary to be beta-neutral, through its short positions in index futures, or shorts in general. It does recognize pair-trading is currently out of favor.

WHAT´S IN A NAME?

There is a specific meaning behind the Fund's name, "Alchemy Trading". "Remaining flexible and open-minded is a virtue," Birkeland states. "When things stop working, it is imperative to reassess the objective, external environment." Birkeland traces the Fund's namesake to Louis Kevran's empirical observations of the alchemical transformations in - chickens. As Birkeland tells the story, Kevran demonstrated to the French physics establishment, the mathematical proof that free-range chickens are able to transform potassium found in soil into calcium. This violated an important assumption in the law of conservation mass – and, above all, underlined the need to keep an open mind.

"We started with super-rigid risk management guidelines, but maintained a flexible approach, involving reverse-engineering what works, rather than adopting a particular category or style"

Alchemy's origins are also rooted in Birkeland's own background. He stood out among his peers growing up, opting to spend his weekly allowance on odds coupons rather than candy, which, he says, gave him "insight into the nature of staking your odds." He later had a brief stint as a professional football player in Werder Bremen's U23, and made several appearances for the Norwegian youth national team. During this period, he became acquainted with Frank Beck, the foremost pioneer of mental training for athletes in Scandinavia. Beck gave Birkeland valuable advice on performance endurance and enhancement techniques. Birkeland was able to transform the lessons in discipline from these experiences into an investment philosophy subtending his early days as an aspiring independent trader:

"We built Alchemy Trading from scratch through the help of friends and family. We started with super-rigid risk management guidelines, but maintained a flexible approach, involving reverse-engineering what works, rather than adopting a particular category or style. Three and a half years out, our performance ratios are consequently in line with pre-Alchemy returns, in a variable-bias long/short strategy."

STRATEGY AND STATURE

Birkeland explains that Alchemy identifies the most liquid possibilities on a weekly basis, drawing from a universe of 300-400 names, and assesses whether anything stands out, as far as visual trends on short, medium and long time frames are concerned. "Any match with historical value-traded bands that visualize large volumes at key areas of support or resistance adds further significance to those time frames, as they give an excellent proxy for where liquidity increases or decreases," he explains. "We believe that liquidity is a great proxy for future multiple expansion or contraction. By identifying these paths of least resistance, we can eke out gains."

Birkeland underlines that the sizing of positions reflects the level of the Fund's conviction: full weighting can only be achieved if there is a visual confirmation of multiple time frames, or a short-term catalyst on the horizon skewing risk-reward significantly during the specific time frame

The sweet spot for this approach may be in mid-caps. "Mid-cap companies that manage to achieve traction within global market themes in Scandinavia often see hefty bouts of multiple expansions, as local asset allocators replicate each other's portfolios," he explains, ascribing an explanatory qualitative factor to the tradition of trying to overcome 'invisible barriers,' such as the 'local monopoly'. Mid-cap companies are often acquired by such a monopoly, as the local market is too small and the monopoly has a global range. Activist shareholders then make tactical changes within companies to increase liquidity in the short term.

Alchemy determines its asset allocation and identifies its investment candidates by aggregating the best individual risk-reward setups within its liquidity screenings. Waiting with ample cash for the right opportunities is significant, as these always emerge – but this requires flexibility. "If there is an underlying style bias at all in our stock selection, it is a focus on quality companies without balance sheet issues."

ALCHEMY… NOT MAGIC, INTELLIGENCE

Alchemy's risk management process focuses on maintaining a trading expectancy where wins exceed losses by a factor of two. "Birkeland explains that Alchemy "reduces gross exposure substantially after moderate drawdowns, whether it's through cutting individual positions with low weightings or top slicing the holdings in the portfolio as a whole." Returning to the Kelly Criterion, Birkeland elaborates on Ed Thorpe's adaptation of it: "You use the handicap to size your positions. Thorpe figured out that halving maximum bet sizes derived from the Kelly Criterion reduces volatility of returns by 75%." It's not perfect, Birkeland concedes, yet successful fiduciaries of external mandates employ it, and with good reason: "There are similarities to the guidelines e.g. Mr. Freeman-Shor, of Old Mutual, uses to select his managers. He tracks their ability to run concentrated portfolios of 10 names, maintaining a positive trade expectancy (no large drawdowns), combined with 1 or maximum 2 outsized gains."

"In a world of Facebook and Twitter, 'strong opinions' on anything outside of the long game easily fade."

Based on this, HedgeNordic was curious how Birkeland manages Alchemy's risk level, and what does the Fund base its active decisions on? "I start out initiating an idea on a theme with a 1-2% allocation and apply a stop-loss with a time-limit qualification. If it works, I'll add a bit more. If there is an edge in identifying a short-term catalyst that local asset allocators have not discounted because of their behavioral biases, I'll add - a lot more." Alchemy tries to limit the number of concentrated bets within a theme by trading liquid blue-chips. "It helps to reduce large drawdowns during market dislocations. The overriding long-term goal is to keep a high Calmar Ratio.

Crucial factors for portfolio construction are of course the size of trading positing and determining holding periods. "Sizing varies significantly between 1- 15%, with 0 to 15 names in the portfolio. The average holding period has been 13 years, but we try to keep the tally as systematic as possible, based on measurements of conviction. The average holding period of our best ideas can exceed a year. One idea captured close to a 100% return in 2015 with a 6% average weighting, which helped an otherwise tough year of grinding markets in 2015. Still, only 5% of our ideas see realized gains of more than 20%, and less than 1% of our ideas see realized losses exceeding 10%. We have an ADP on longs of 27 days on gains and 5 days on losses, where our ADP on shorts of 5 days on gains and 4 days on losses. Since ADP of shorts is much shorter, we can see where there is room for improvement."

AN INDEPENDENT MINDSET

Birkeland and Alchemy, however, are not necessarily trend followers. Fundamentals weigh heavily in the Fund's assessment, in terms of higher conviction ideas, than trend followers who place less emphasis on valuations. "We value a good entry point because it keeps trade expectancy relatively consistent," says Birkeland.

"Using contrarian indicators such as sentiment and breadth indicators to time return-reversal price action systematically seems complicated," Birkeland explains. "We do try to empirically test breadth at key resistance or support levels where there is a lot of historical volume. Having the right mindset and trading philosophy we feel it is crucial. The probabilistic approach to assessing risk reward of individual ideas, rather than timing market directions is more compatible with this.

In a world of Facebook and Twitter, 'strong opinions' on anything outside of the long game easily fade. We routinely go through the same mental exercise, assigning probabilities on a certain action affects outcomes. Still, avoiding pride in our own analysis when something comes along and disproves it, is so much more important. "

Alchemy employs a home bias in terms of its country exposure, which is a reflection of the differences in the market capitalization between Nordic countries. "We employ a top-down identification process of identifying positively skewed risk-returns is focused on the most liquid securities. There are many more attractive risk-reward setups on medium-term timeframes than short- term timeframes, many of which currently exist in blue-chips across all Nordic regions, particularly in Sweden.

Biggest percentage gainers by NHX chategory and country

NHX-FIXED INCOME
9,9%
ASGARD

NHX - SWE
49%
ACCENDO

NHX-EQUITY / NHX - NOR
58,5%
AAM ABSOLUTE RETURN FUND

NHX-CTA
12,5%
MG COMMODITY FUND

NHX - FIN
26,7%
HCP FOCUS

NHX-FOHF
5,5%
DI ELIKSIR

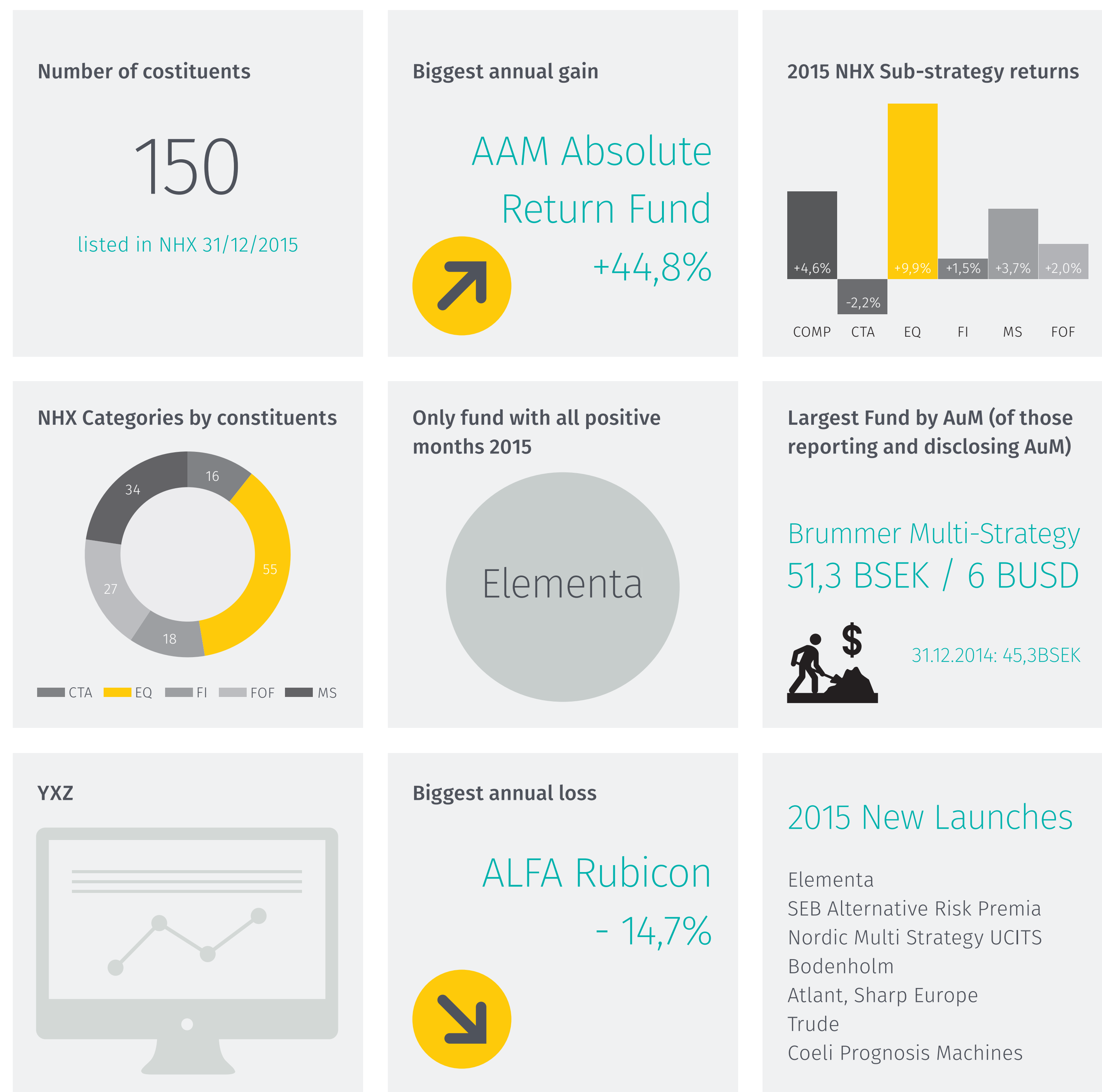
NHX-MULTI STRATEGY
+15,0%
ELEMENTA

NHX-DK
17,6%
DI EUROPEAN EQUITIES ABSOLUTE FUND

Source: NHX.HedgeNordic.com
all numbers per 31.12.2015

NHX Key Facts at a Glance

Below data is drawn from the HedgeNordic databses covering constituents to the Nordic Hedge Index, as of December 31 2015.



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