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PARTICIPANTS:
AP3, Bodenholm Capital, Coeli Asset Management, Handelsbanken Asset Management, Origo Capital, Taiga Fund, Erik Penser Bank

Positioning Hedge Funds To Withstand a storm

Placing a High Bar for Hedge Funds

Hedge Funds and Sustainability

Uncovering Alpha in a "Fat and Flat" Equity Market

Topics Discussed:


Hedge Funds and Sustainability


Turning Volatility into a friend


Alpha on the Short Side


Positioning Equity Strategies to Withstand a Storm

> "We work intensively on the diversification of the portfolio. This is one of the reasons we invest in hedge funds. We aim for... low beta hedge funds, that do not correlate with the equity market."

Editor´s Note:

Equity markets have enjoyed an almost uninterrupted run upward ever since bottoming out in early 2009, after the fallout of the financial crisis. Being exposed to „the market ", being exposed to Beta, or even leveraged Beta was a winning strategy over the last years.

Hedge funds, as a whole, have been painfully made aware by media, and more crucially investors, that they have been failing to piggyback on these megatrends and are falling behind on performance as well as defaulting on other promises they had been making. Managers struggle increasingly to justify fees they charge investors. Or, indeed, often fail to make the case to be a valid investment.

One of the allocators joining our discussion, Jonas Thulin who heads the asset management team at Swedish Erik Penser Bank falls in line with these observations, and is continuously exiting disappointing hedge fund managers to replace them with ETFs.

Claudia Stanghellini, who is responsible for the selection of external managers for Swedish pension fund AP3 with more than SEK 350 billion in AuM, too, has been cutting down on the number of external hedge fund managers to a few core names.

Tomas Gylfe works on the asset allocation team at Handelsbanken Asset Management. Most of his portfolio exposure is towards Beta, as the mandate is long-only bringing the identification of Alpha into the focus, as well.

With Origo Capital, Bodenholm Capital and Taiga Fund there were three managers at the table with us relying on long/short equity strategies. Tilted towards the Nordic markets, often with a long bias – especially stock picking, and a good hand identifying those crucial shorts are important Alpha contributors. A rich addition to the discussion came from newly launched Coeli Altrua Macro, a linear macro allocation strategy where the managers actively allocate between equities, US interest rates and FX.

The discussion led by Aline Reichenberg Gustafsson looked into how hedge fund managers, and indeed allocators, may be preparing for a perfect storm on global equity markets, the increasing role sustainable investing has and the opportunities and challenges it brings, how market volatility can become more of a friend, rather than just a risk factor, and how new technologies, such as the blockchain, artificial intelligence and big data may transform the financial industry.

In all, some great topics to get some Nordic Insights on!

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PARTICIPANTS:

THE ROUND TABLE DISCUSSION TOOK PLACE IN STOCKHOLM, SWEDEN, SEPTEMBER 12TH 2018

Carl Rydin co-manages Origo Quest 1, a fund consisting of a long/short equity portfolio, within Nordic small-caps. With a high concentration on the long side, the fund exhibits a low correlation to the general market. The portfolio concentration allows the managers to take a very active approach with the management of each company. While the managers may choose not to sit on the board, they participate actively in selecting the right directors. Each new position requires an in-depth research case and a catalyst (value driver) to trigger the trade. Origo's investment philosophy is built on long-term, active ownership engagement. The competition for such a strategy is scarce in the Nordic small-cap universe and allows the portfolio to generate alpha, both on the long and on the short side.

Ola Wessel-Aas is co-founder and portfolio manager at Taiga Fund, a long-short, long-bias equity fund with a European mandate, and a strong focus on the Nordic region. The strategy relies on pure stock selection, supported by an appropriate portfolio construction process. The managers aim to capture high returns with an acceptable risk level. While not scientific about market exposure, they carefully manage the fundamental risk exposure to each stock and their correlation. An active management approach to many of the largest positions has contributed to both returns and managing risk. As a result of the investment strategy, the beta exposure, as well as the volatility are low.

Filip Kozlowski co-manages a new global macro hedge fund at Coeli, Altrua Macro. This vehicle offers a quant-fundamental approach. At the core lies a linear macro allocation strategy where the managers actively allocate between equities, US interest rates and FX based on a quantitative framework using fundamental macro inputs. The aim is to achieve an optimum portfolio allocation for every part of the business cycle. This linear approach is then supplemented by non-linear strategies, primarily focused on tail-risk to protect the portfolio from the market exposure under challenging times. The fund offers a beta exposure, enhanced with crisis alpha.

Erik Orving works for Bodenholm, a $1bn European equity long/short fund, which predominantly invests in mid- and large-cap European names. While Erik claims Bodenholm is not scientific about alpha and beta separation, the strategy's returns should be driven by stock selection and not market returns. The fund is concentrated, and with relatively large absolute long and short positions the objective is to generate alpha from both the longs and the shorts of the portfolio.

Claudia Stanghellini is responsible for the selection of external managers for the large Swedish state buffer pension fund AP3, which holds more than SEK 350 billion. The portfolio is broad and its structure complex: 50% lies in equity investments, most of which are either passive or enhanced. The external management team, which Claudia leads, is responsible for the part of that allocation that comes from external managers. Over 20% of the overall AP3 portfolio lies in the illiquid assets and the rest in fixed income and credit, and a small part in absolute return strategies, of which hedge funds compose an essential role. Claudia's team also selects external hedge funds that complement the internal hedge funds and risk premia strategies.

Jonas Thulin is head of Asset Management at Erik Penser Bank. He has taken over the team after leaving a previous post as Nordea's head of asset allocation. Since Jonas's arrival, the team has changed its distribution significantly between passive and active strategies, or in other words between beta and alpha. The new model relies mainly on the team's direct views on the market, based on an enhanced macroeconomic analysis. As a result, the portfolio includes most asset classes at any time, but it also has significantly reduced its exposure to hedge funds, as it will soon contain only a couple of external hedge fund managers. The current allocation relies heavily on ETFs, in combinations with single bets, where the team finds value and generate its own alpha.

Tomas Gylfe works with Handelsbanken's asset allocation team, where he invests in hedge funds, among a wide range of products in various asset classes, including beta strategies. Tomas's team selects both active and passive manager, and most of the exposure is beta, as the mandate is long-only, but identifying alpha is of course in focus as well.

Moderator:

Aline Reichenberg Gustafsson, CFA is Editor-in-Chief of HedgeNordic and NordSIP.com. She has experience in the asset management industry in Stockholm, London and Geneva, including as a long/short equity hedge fund portfolio manager, and buy-side analyst, but also as CFO and COO in various firms. Aline holds an MBA from Harvard Business School and a License in Economic Sciences from the University of Geneva.

TAIGA FUND ERIK PENSER BANK BODENHOLM Capital ORIGO CAPITAL Handelsbanken Coeli ASSET MANAGEMENT AP3

Participants, left to right in front row: Carl Rydin (Origo Capital), Claudia Stanghellini (AP3), Kamran Ghalitschi and Aline Reichenberg Gustafsson (both HedgeNordic) and Filip Kozloswki (Coeli Asset Management). Back row: Jonas Thulin (Erik Penser Bank) Eugeniu Guzun (HedgeNordic), Ola Wessel Aas (Taiga Fund), Erik Orving (Bodenholm Capital) and Tomas Gylfe (Handelsbanken Asset Management).

Stockholm, September 12 2018

ROUND TABLE DISCUSSION

UNCOVERING ALPHA IN A "FAT AND FLAT" EQUITY MARKET

Turbulence ahead: positioning equity strategies to withstand a storm

Securing adequate insurance

While Kozlowski's approach covers more than just equity, he is in the right place to comment on crisis management, since part of his mandate is to provide downside tail-risk protection. "A core part of our strategy is to provide long volatility exposure, which represents a significant opportunity this far into the market cycle", starts Kozlowski. "We adapt the level of protection we take on the portfolio depending on our beta exposure. We stress-test our beta exposure to determine what our beta risk is, which helps calculate the level of protection we need to hold.

We see ourselves as an insurance broker. We believe that every investor needs an insurance policy just as house owners do. As such, we act as a broker who, at every point in time, finds where the cheapest insurance is and provides investors with an adequate cover in case of damage. In practice, we observe equity beta risk, which is the most significant beta risk we are exposed to so we rely heavily on listed equity index options. A normal perception is that tail-risk hedging only involves buying put options and letting them expire which becomes very costly. Our strategies are more complex and involve holding a continuous exposure constantly rotating in and out of positions. It is rather easy to quantify and model linear behaviours. Managing a non-linear portfolio in a cost efficient way is different. It is possible to achieve, and it is not as much science as an art form. We use different market characteristics in the volatility space such as skew, term structure and supply demand imbalances in order to position ourselves and achieve our desired protection in an as cost-efficient way as possible."


Aline Reichenberg Gustafsson - HedgeNordic

"The afore-mentioned supply-demand imbalances are, to an increasing extent, driven by passive or quant-driven flows, whether they are risk premia, or other systematically generated strategies. It will take time for us to prove the success of our strategy, of course, but we find that today's market provides a great opportunity, particularly since the supply and demand imbalance for insurance is skewed in the benefit of the buyer."

Beware unwanted factor exposure

For Orving, preparing for a sharp sell-off is not so much about timing the market. "Frankly we are not going to call the market better than all macro economists out there" he says. "What we can do is make sure that we

"We use different market characteristics in the volatility space such as skew, term structure and supply demand imbalances in order to position ourselves and achieve our desired protection in a as cost-efficient way as possible."


Filip Kozlowski, Coeli Asset Management

have a robust portfolio construction, with limited downside risk at all times. In a crisis or a sharp sell-off, we expect to see our long book as an alpha generator. Our long book has a quality bias, and we only invest in companies with strong balance sheets, which can limit the downside in a crisis. In the sell-offs we have seen over the last couple of years this has served us well, and we have observed that our long book holds up much better than the broader equity markets. As a margin of safety, we don't expect our short book return any better or worse than the market in a sharply falling market. In summary, with limited market risk and successful stock picking, we should be able to deliver positive returns irrespective of the market direction."

"Having said that, one shouldn't put too much emphasis on a low beta in the portfolio, as it lulls investors into a sense of false security. Equally important are style and factor risks. We spend a lot of time running simulations of outcomes triggered by overconcentration risks or unwanted factor exposure in the portfolio. Given our quality bias we can, at times, end up in a situation where our long book, hypothetically, does not hold up as well as expected, for example in a bond-proxy sell-off. Whenever we observe an overconcentration risk that will impact the total drawdown risk of the portfolio, we immediately adjust the portfolio by either trimming longs or adding shorts."

Watch for liquidity risk and start a short-list

While Orving's fund invests mostly in companies with high liquidity, Origo´s Rydin believes liquidity risk should not be underestimated. "We are active in the small-cap space, so, for us, liquidity is a critical issue in each one of our portfolio holdings. Just as Erik at Bodenholm, we are not claiming that we are better at forecasting the next downturn than anyone else. We do try to position our portfolio into names that are more liquid, which matters a great deal in the small-cap market. Our investor base is long-term, however, and they should be patient. Even in the case of a downturn, we may not be able to keep it flat, but we would want to make sure that we can still take advantage of the subsequent upturn. We ensure that our investors can withstand the volatility of our portfolio. In parallel, of course, we can adjust our net exposure very easily. We have quite a long list of names

> "Value investing exploits the bipolar tendencies of financial markets, which result in stocks becoming overvalued when investors are manic with everyone chasing the same, big fat carrot, and undervalued when they are depressive."

of potential short trades, which, for various reasons, we haven't entered into. The timing, for instance, may not be adequate in normal times, we could easily use those ideas in a crisis, in addition to shorting futures, which is a very flexible tool we have at our disposal."

Focus on valuation and build a cash pile

Wessel-Aas elaborates on his experience as a stock picker at Taiga Fund and exposes different triggers for stock prices. "There are three reasons a stock may change course," he explains. "First, the underlying results of the company may change. Second, the valuation investors attribute to the company may evolve. And third, the market sentiment can turn around. This last element changes randomly. We have little control over it. The second, however, a stock's valuation is something we have to have a firm view on as a stock picker. We need to be confident about a company's fair value so that we can evaluate when it is cheap or expensive. This process needs to be somewhat independent of the rest of the market, which means that we often sit at the contrarian end. However, even when we rely purely on valuation, investment decisions may be influenced by the current environment. In some cases, we may accept slightly more expensive stocks given the general outlook of the economy. Generally, over time, however, we need to remain disciplined."

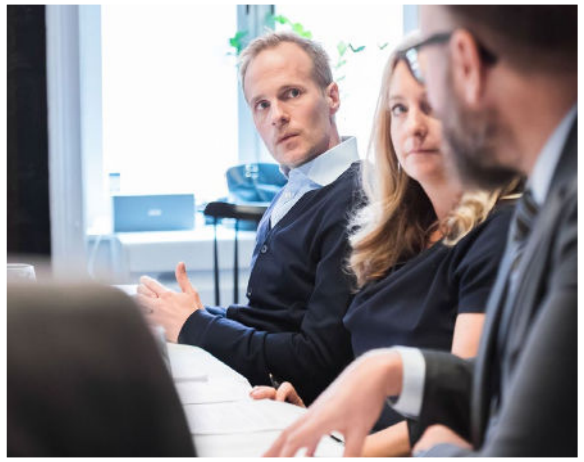
Wessel-Aas believes in an impending market correction, even if, like Orving and Rydin, he doesn't bank on timing it. "The market, at the moment, does not present as many opportunities to go long, in our view," he adds. "Being able to sit on cash, from our perspective, is the only viable alternative. Shorts are also dangerous currently, and a lot of accidents can happen. M&A activity is strong, and this makes selecting shorts even more difficult than usual. Therefore, we don't believe that building a short portfolio is necessarily the answer. Building up a cash position is appropriate, however, and we are partly resorting to that. We do watch the companies' revenues however as macro factors impact them. How we do depends on what will be leading the correction. Will the market correct ahead of the macro, or is it the macro that will drive the change? It doesn't matter. In many of the economies we look at, the macro is as good as it gets and a downturn is coming. We don't know if it will happen next year, or the year after, or the year after that, but that view impacts our fundamental valuation of stocks, and we need more protection than usual."

Beware the double whammy

As investors like Gylfe at Handelsbanken Asset Management select hedge funds, does it make sense to choose managers that hold cash ahead of the storm? "One of the problems we have when we look at hedge funds," Gylfe says, "is that the risks levels are too low, in a lot of products, and that has been the case for the past three to five years. From our side, we aim to achieve a given risk level for our overall alternative portfolio, and we find it hard to do so in the current environment. In our asset allocation, we do try to time the market. It is our job, and it is interesting to hear the managers getting worried about the market. This may generate a double protection effect. If managers who run our products build up cash, they may reduce the risk even further. We need to take into account in our allocation, that managers may reduce their own exposure. In that respect, buying hedge funds is harder than investing purely in beta. We do look for alpha, but given the risk level of hedge funds in the recent past, we have found it difficult to identify really good investments. Besides, we are constrained structurally sometimes, as we have to invest a majority of our capital in UCITS structures within our funds, which does make it more difficult when looking at alternative strategies."

Putting diversification first

Stanghellini goes back to the process her organisation, the giant Swedish pension fund AP3 uses in the asset allocation and explains why she invests in hedge funds with low correlation with equity markets, but she has encountered the same obstacles as Gylfe. "The lack of risk also is a problem we have faced with our hedge fund portfolio, which we started building it 2007. We noticed that systematic funds were able to keep up the volatility, but the fundamental managers have not. They have



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good information ratios, but we don't know what to do with their three or four percent returns. It's too low for us. There is also another point which is very important for our management: if we have to invest money externally, that money has to return at least as much as what we can generate internally. We definitely aim for high single digits at the hedge fund level. The hedge funds have not returned that in the last three to four years, so we have also had to reduce our exposure to hedge funds as a result, unfortunately.

"We have a strategic allocation team," continues Stanghellini. "As the portfolio is quite large, and we consider three different layers: the first one is long-term and is a classic asset allocation between equity, fixed income, and illiquid assets, which is determined by assets and liabilities management (ALM) analysis. The second layer is a medium-term strategic asset allocation which relies on models to position the portfolio based on where we are in the business cycle (1-3 years period). The third is a short-term layer, which includes very short-term trading strategies, as well as our internal alpha mandates. In parallel, we work intensively on the diversification of the portfolio. This is one of the reasons we invest in hedge funds, and it is also why we have reinvested a part our equity allocation into risk premia strategies. We, therefore, aim for low net, low beta hedge funds, and risk premia that do not correlate with the equity market. The threat to the AP3 portfolio is a sharp correction such as the one we experienced in 2008, and we would like to avoid that. We are also interested in getting a purer alpha from the hedge funds because we already have a large market exposure in other parts of the global portfolio. We don't need directionality from the hedge fund bucket. We want the hedge fund bucket to be decorrelated, especially from the equity market."

"Also, we have been working on the asset allocation side on internal overlays to trying and avoid future drawdown as much as possible. We have dedicated resources, and a chief strategist, to focus on selecting options and implement tail-risk hedging, at the global portfolio level, to help mitigate any potential drawdown, especially of the equity allocation. Our work to protect ourselves from an impending storm has taken several aspects."

Claudia Stanghellini, AP3

"We work intensively on the diversification of the portfolio. This is one of the reasons we invest in hedge funds, and it is also why we have reinvested a part our equity allocation into risk premia strategies. We, therefore, aim for low net, low beta hedge funds, and risk premia that do not correlate with the equity market."

Replicate hedge funds

For Thulin, the key to avoiding downturns in his clients' portfolios at Erik Penser Bank is to remain smart and agile. "We do try to time the macro and translate that into a market view," he says. "We have spoken to the hedge funds around the world that have proven track records, and they have shown that they were able to hedge different kinds of turmoil. Then, we break down the strategy and replicate it, through ETFs. Sometimes, it is easier said than done. At times, however, we were quite surprised that all these managers are doing depends on a few basic building blocks that they trade and use as hedges. With a sophisticated system, many times, we can easily time and buy those ourselves. When we look at hedge funds, they need to stand out, because, otherwise, the ETFs are just as good. They may be eating up the hedge fund space as they are a lot cheaper and there is such a large range of them that we can get anything we need. We can select factors, or combine them, we can time them, and it provides us with enormous flexibility. As a result, we are selling off hedge funds one by one. We stress-test the entire portfolio, every single day, against new investment opportunities. We believe that it is a fair competition. If we find a Yen or a Swiss Franc strategy that seems to beat the equity market, for the time being, then we will roll into that. It's not more difficult than that."

Thulin gives a couple of examples of what strategies he has been able to replicate: "We look at a hedge fund, we break down its strategy and study it. We find out where the returns originate. If in doing so, we find a factor, or just a trade, like the Yen for instance, which is one example of a risk aversion trade, which hedge funds are usually good at, then we can buy the Yen on our own. It is easy and cheap. If we realise that the strategy is something that we cannot replicate, then, of course, we are interested in making a proper investment in that hedge fund. It does happen, but less and less often.

The known knowns, known unknowns and unknown unknowns

Kozlowski looks at the replicating strategies with a critical eye and asks Thulin to explain how he knows: "Obviously, what you suggest is to look at the past, replicate what the hedge funds did, and expressing those strategies through ETFs, and reducing your risks, while, at

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the same time, these ETFs are products with a limited amount of history. Taking into account other factors that are now considered being known unknowns, which could be a correlation crisis between rates and equities. How do you backtest this kind of scenario with ETFs, as they weren't available before 1998, for example, when you had a positive correlation between those two asset classes? Or worse, how do you back-test unknown unknowns?

Thulin explains how he evaluates ETFs: "We certainly don't want to end up in illiquid ETFs. We don't want to buy any ETF wrapped around illiquid derivatives, for example, which is the kind of products that didn't work last spring. We find that those are easily avoidable. We are not too concerned about a new risk popping up that we haven't traded in the past. The fundamental building blocks of the strategies we implement have existed for a long time. If we were afraid of the correlation, we could also trade the correlation through an ETF. The field is opening up quicker than we can model and keep up with, and that's why we perform a daily screening of our portfolio against new products. Think about it: there are a couple of million different structures that are out there on Bloomberg, Morningstar, and other platforms, and we are comparing our portfolio against all of those! The churn rate in our portfolio has gone up, as you can imagine, but it remains reasonable. It is quite rare that we find the need to do something brand new, that the market hasn't tested before. We try to keep it simple and stick to the basic building blocks.

Kozlowski goes back to where he sees the most significant potential risk. "The unknown unknowns often come out of the known knowns. The biggest risk we see at the moment is the market structure. The fragility around liquidity is not a new concept, and it has been making headlines for some time now. The market structure has become more fragile with high-frequency trading, as well as ETFs and other passive investments, to some extent. Crowding into specific areas of the market might be creating big pockets of unknown risks. Even though our fund was not yet launched at the time of the February market turmoil, I was already keeping a close eye on the option markets for the type of instruments that we would potentially have traded. We aim to be liquidity providers in times of crisis, by providing tail-risk protection, so it was a good time to watch how the market behaved. What I saw, in that relatively small move in February, was that the options market stopped working completely.

During previous similar short-term periods of stress such as the US elections, the flash-crash of 2010 or in 2008, when everyone was trying to buy CDS at whatever price, people became price takers and took away liquidity. In February, the market broke down, without any price taker. The issue didn't depend on flow. The market stopped working due to a reset in market sentiment. It was scary, especially for someone in the short volatility space. I would seriously consider how to manage that liquidity risk."

Thulin answers Kozlowski's concerns: "Our job is to predict the market. I have worked in the market since the end of 1999, but I haven't seen a crisis here that was not predictable. I was lucky to be in New York, during the Lehman crisis, and we were already trading that in 2006. In 2007, we were all done. We tried to get Europeans to understand what was going to happen, but no one bought it, because Greenspan said, 'Everything's going to be fine.' We depend heavily on anticipating and predicting Trump's election win, for example. We generated 14% in two weeks with a couple of great trades over that. Sometimes we lose some as well, but our hit ratio, so far, has been rather good. We find that we are competing with some actors that need to stick to their mandates. As we are a little more flexible, we can see these pockets without too much stress, or too much work. We do need to find a clue in the market with which to start. Like in the case of the Lehman crisis, what was the evidence that gave it away, and how could it end up there? If you find it, then it becomes a fantastic investment opportunity."

Thulin continues: "We are not too concerned about the fragility of the market, but that said, we do heavy background work. Before investing in a hedge fund, for example, we look at their underlying fundamental analysis. We try to understand how they look at different markets. How do they compare? If we want to have a stricter, long-only mandate, there is an abundance of replica products available, that we can choose from, given the fact that we try to sell underlying liquidity."

Stanghellini, however, finds that timing the market is not as straightforward: "Forecasting is quite difficult, and everybody knows that. Perhaps nowadays there is a bubble in the illiquid bucket, or we knew that there was a bubble in the dotcom era before it burst. But predicting the catalyst and timing it, is hard. If you are too early, you could lose out on a lot of money. Calling the right time is the most difficult thing you can do. I'm not sure how you go about that," she asks.

Thulin responds: "We have a methodology for that. As I said before, we translate the macro to the market. When I was prop trading in New York, we thought we were so right on the macro. But we were killed because we were just too early or too late. Then we started to build a huge quant team, and tried to figure out how to transition from macro to market? And that is pretty much what I am still working on. We believe to have found a few pieces of the puzzle. As a result, we don't want to either front-run too much, not miss the trade by coming in too

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late. We also need to remember what the customers are expecting from us. How aggressively do they need us to trade, or how passive can they afford us to be? To define that balance is a little more art than science, and it constantly changes as well."

"About 90% of my working day is spent trying to figure out if the tools that I have at my disposal today, whether we use them or not, are the best tools. We are always working with the Royal Institute of Technology (KTH) here in Stockholm every single semester, by supporting more quant projects, to stress test what we do, and makes sure that we are as good as we possibly can be. So far so good."

Damage control for long-only multi-asset managers

While Thulin runs an absolute return portfolio, Gylfe operates in a long-only world, and if asset prices drop in concert across classes, he may be less well positioned to avoid losses. "It is a challenge for us," he admits. "As we stand, we will reduce the total risk of our portfolios ahead of any market correction. It is an inherent feature of long-only investments and the way we handle an upcoming risks of bonds and equities moving in the same direction is by reducing the overall risk of our investments, which could include increasing exposure to alternative investments. In that respect, our worst fear is that it indeed will happen at the same time. I am not excessively worried that it will, but if it did, it would be a challenge for us. The interests rate may arise, of course, but would a crash in the equity market happen precisely at the same time? I am not convinced that it will. One thing we do expect about future returns is that they might be lower than those we have had in the past."

For Thulin, who can go short entire asset classes, the answer is simple: "If we are afraid of things going down, we short it." He is also able to trade in an out of products, in a tactical manner: "At the moment, we are selling off some fixed-income managers. This is not a criticism of their competence, but they need to respect their investment protocol, and they can only invest long in corporate bonds, for example. Investing in such a manager, you know that you will lose if you believe in one market scenario. These could be excellent managers, but they might not be allowed to short or hedge their market exposure.

Tomas Gylfe, Handelsbanken Asset Management

"It is an inherent feature of long-only investments and the way we handle an upcoming risks of bonds and equities moving in the same direction is by reducing the overall risk of our investments, which could include increasing exposure to alternative investments. In that respect, our worst fear is that it indeed will happen at the same time.

In the past, when we closed positions with these types of managers, we replaced them with views of our own. The same is true for inflation expectations in the US. If we believe they will rise, we buy the inflation expectations.

However, Thulin also empathises with Gylfe, as he used to work in an institution with similar traditions to those of Handelsbanken. "I can understand your point of view, Tomas," he says. "After I left my former employer and I moved into my new position, I made sure when I build up this operation, that we would not have the same legacy constraints that I had before. We had to stick to fixed asset-class weights. Now we have a much freer mandate, which, of course, makes it a lot easier to be long or short in everything. I'm starting to sound like a hedge fund now!"

Learning from experience

Based on the cautious outlook Gylfe has hinted to, Wessel-Aas argues that piling cash may not be such as bad idea after all, based on experience. "I understand that investors may want to manage their market exposure on their own, and of course, that they are looking for alpha, and that we should provide them with maximum exposure. One of the reason why we don't, however, is that in the last crisis, in 2008, we encountered an environment where all of our collective expectations broke down, regarding any level of comfort we could rely on based on historical data and statistics, including liquidity. In difficult times, the question becomes: 'who can take a contrarian view of that market, and find value when everyone else is scared?' Managers like us are often sceptical when we are asked to take on risk, with investors arguing: 'That's what we're paying you for, and we are ready to take the downturn. We understand; we are big boys!' But this is not how investors reacted in 2008, and our experience from that time is that we need to have flexibility in our mandate and a pile of cash. As long as our investors continue to back us during that time, that's when the value investing is at its best, with some guts and experience, of course. I understand why institutional investors want us to take on risk, but I'd rather stay away now. Perhaps our cautious stance is reflected by other actors in the market and then is probably healthy, as the next crash may not be as severe as the last one. But, unfortunately, I sense that there are many other pockets out there, where risk is not an issue."

"Hedge funds took a severe beating in 2008, relative to expectations," continues Wessel-Aas. "I don't mean relative to other asset classes, but relative to what many hedge funds had promised. They had said that the downturn wouldn't impact them, and they argued, they had strategies that would protect the investor. But that turned out to be untrue to some extent, but partially also a misunderstanding. Which asset class is safe in the next downturn? Everyone should expect equities to tank in the next downturn, but in my opinion, it may be just because they are the most liquid assets, so that is where institutions can sell down first to adjust their portfolios the quickest. Real estate, private equity, fixed income funds, and many other asset classes don't suffer the same type of immediate pricing impact. The reason we are prudent is to be able to uphold our promises."

Jonas Thulin, Erik Penser Bank

Turning volatility into a friend

Within an environment of muted volatility, hedge fund managers may prepare for a crisis by piling into cash, but being too early may be detrimental to their AUM, with large institutions withdrawing their investments. Could we draw a parallel between the 'fear of missing out' on risk in 2018 with the famous analogy of the Chuck Price's musical chairs? "While the music plays, you have to keep on dancing", he said in the wake of the sub-prime crisis.

Securing availability of cash in difficult times

Kozlowski believes that tail-risk prevention may be an essential tool to address the issue of timing market crashes. "In a perfect world, an asset allocator shouldn't have to sell off liquid positions if there is adequate tail-risk or portfolio protection in place. The cash from the portfolio insurance triggered by the crisis could go to alpha generators. Bodenholm seems to be doing just that, I understand, running a long/short book where alpha generation exists. Its short book is similar to a long gamma strategy on its own alpha. When the market drops, short positions can be cashed in, and managers can reallocate it to cheaper longs, where they see true alpha."

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"The positives of tail risk protection are not talked about enough in the investment community," Kozlowski continues. "The benefit of being able to raise cash in times of crisis is often not valued enough. There is a psychological benefit of not having to fear liquidation. Even from the investors' perspectives, just being able to raise cash in a market downturn can dampen other collateral losses. We need to explain and educate investors about the effect this has on compounded returns over many cycles. Some understand it, but not that many, and the longer we are into the bull market the more we forget it. There is so much focus on shorter-term returns, whereas our strategy is built to survive many business cycles and many market cycles. It might underperform during shorter discrete time periods but in the longer run the benefits should become obvious."

"Coming back to the level of desired volatility in hedge fund investments, the same logic applies. Our fund, for instance, has a large exposure to hedging strategies at the moment, which will create a very low volatility because we are very balanced at this point. What we expect is that, if the current trend in the market continues, our fund's volatility will remain low. On the other hand, if the market crashes, our fund's volatility would most likely increase but with a forecasted associated positive return. This forward-looking dynamic is sometimes missed in translation when investors look at past return characteristics."

Volatility creates entry points

For Orving, the availability of cash when volatility spikes presents real opportunities. "Philosophically," he explains, "volatile periods are difficult for equity long/short managers. Intra-stock correlations go up, and it becomes harder to find true fundamental drivers in stock prices. We try to be disciplined investors. If volatility spikes, it may create entry points for us to build positions, both in the long and the short side. For example, when the news of Brexit broke, everything was down 10%. That was a good time to have dry powder to invest. It is difficult, but we try to use volatile moments to invest and add to positions that will generate alpha thereafter, when markets return to the mean and the stock correlations come down."

Is small cap volatility underestimated?

In the small-cap space, could illiquidity give a false reading of the volatility? Wessel Aas believe this is a fairly

Ola Wessel-Aas, Taiga Fund

common misconception. "Some think that our stocks are less volatile because people aren't buying and selling. We haven't seen any evidence of that. Many small-cap managers, certainly those with concentrated portfolios, often have a value orientation, which is less volatile, and this fuels the suspicion about the difference in liquidity. The underlying fundamental changes in these companies are not as dramatic as for the overall markets. This is the main reason why those stocks do not react as quickly to the typical fear factors which are leading to market selloffs. There are also some individual stocks where bids are lacking, or where there isn't much liquidity. It also happens in the large-cap space. Investors have been taking comfort in the past few years in changes in liquidity, especially in large-caps. But that is a false sense of security. Liquidity is very difficult to measure accurately. Every observation in a given period will be valid only for that period. Crisis provides a real test, and at that time different patterns form, depending on buying and selling activity. Some stocks will have a shareholder base that does not need extra liquidity, and others will have shareholders that will need to sell, and the stock price is going to reflect that. These different behaviours happen across the board. I could predict that, in the next

> "The liquidity premium is what we are trying to capture at the fund level with our exposure to illiquid assets. It has paid off quite well, over the years, and we try to diversify that exposure via different investments such as private equity, real estate, infrastructure, insurance-linked securities or timberland."

crisis, you'll see a rush to the door in other names than the small-cap ones. We have been observing for the last 12 months that there is a lot more caution in the small-cap space. If there is a disappointment, the stock price will integrate the information fairly quickly.

Meanwhile, we see that there is a lot of forgiveness in the large-cap space, and that is because there is confidence in the liquidity. But I predict that this is going to break down, and the liquidity that seemed to be available will vanish. In large caps, many similar investors hold similar views and similar outlooks, and they build their positions with the same rationale. This kind of crowd thinking is less prevalent in small caps than in large caps."

"Even though we live off the fact that we don't believe in the efficient markets, I think it's a good starting presumption, that most equities that are listed are fairly efficiently priced. Therefore, the volatility, over time, measured in the appropriate timeframe, is more or less an appropriate reflection of the underlying risk."

Filip Kozlowski, Coeli Asset Management

Volatility and Liquidity premia

Stanghellini comments on the liquidity aspect of investing from her perspective, given the type of internal mandate she has, and the size of the commitments her team makes. "We like both the liquidity premium, as well as the volatility premium. On the liquidity premium, we have a larger allocation to illiquid assets at the fund level, but also to small-cap. In the last couple of years, we have even entered emerging markets small-cap, because we think they are under-researched, and they have been delivering superior alpha. We tend to look at small-cap often on a traditional long-only basis, so we measure it against a benchmark."

"The liquidity premium is what we are trying to capture at the fund level with our exposure to illiquid assets. It has paid off quite well, over the years, and we try to diversify that exposure via different investments such as private equity, real estate, infrastructure, insurance-linked securities or timberland."

"Concerning volatility, we need to monitor it at the total portfolio level, and we are trying to hedge in order to limit the drawdown effect, if we believe a big hit is coming. At the same time, because we are a long-term investor, we can sustain volatility. Therefore, over the past few years, we have been allocating a small slice of our portfolio to dedicated volatility strategies that have paid off well. Short volatility strategies have worked over time, but they are subject to big hits. In any case, we have noticed that those trades are getting crowded and it's something to keep in mind. The volatility premium is becoming a more popular trade, and that's the type we look for: more exotic exposure to obtain extra returns, but we do need to watch out."

Carl Rydin, Origo Capital

Rydin illustrates how his fund takes advantage of volatility, whether there is a crisis or not. "On the long side, being in small-caps, I think you do experience more volatility in each of the underlying names. We have seen plenty of situations where we feel like we have done great homework. We have quite a contrarian view, even though a lot of times there is no sell-side coverage on our names. Some of the names in our portfolio may experience daily price fluctuations of five, ten percent or more, purely based on noise. That is when we have to act and take advantage of that volatility because we get those opportunities for free! When it comes to market downturns, we do have to be somewhat careful. Small-caps are usually hit harder in a liquidity crisis. There is more risk than in large-caps, and we are aware of that. This is why we have to position ourselves in the longer-term, and our investors have to evaluate our performance with the long-term in mind. To some extent, we have to run with that volatility and take advantage of it on an individual stock level."

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Generating alpha on the short side

"On the short side, we run a completely different book than on the long side," states Rydin. "We have to manage risk differently. Regarding positioning, we have a lot more names on the short book. We can run 25 to 30 names if we find enough good cases. However, no position ever exceeds 3 to 4% of the entire portfolio, even with high conviction. Ideally, we stay at 1 to 2%. There is also the asymmetry inherent to shorts, and the more it works, the less the weight remains in the portfolio, which means that if we are right on some of our high-conviction shorts, eventually, we will need to find new ones very quickly. On the long side, the opposite is true. We can ride the position for a much longer time."

"Timing-wise, I do agree that being a value investor, we tend to be early in many situations. On the short side, we often have to be early, because, borrowing shares may become an issue later. Even if the price of a stock drops 30 or 40%, it could turn out to be an even better short, in fundamental terms, as new information has come to light. However, it could become difficult to find borrow at a reasonable rate. It is one important risk we need to consider. Lastly, regarding stock picking, the short side presents more than one pitfall. It is not sufficient to analyse a market and decide to go long the cheapest and go short the most expensive stocks.

In the past five years, expensive stocks have just been getting more expensive so that this strategy would have failed. To find good shorts, you have to find something else than just valuation. Accounting irregularities is a common theme among the short sellers for instance. Management might have incentives to show numbers in a certain way that might not reflect reality exactly. Looking at accounting figures compared to cash generation can prove quite useful. Sectoral and structural declines are other examples of places where we look for shorts."

Orving explains what he believes is key to alpha generation on the short side. "First and foremost, I must say that in the market, there are very few equity long/short managers that make money consistently on their shorts. Particularly in the last three years, it has been very tough. We believe that shorting is not something you can do with your left hand. You need dedicated resources and processes. We have a team of three people focusing only on short selling, supported by two forensic accounting consultants. Our shorting strategy is based on finding accounting irregularities, coupled with other deteriorating factors in the business models. Those are strong indications that the profits of a company might not be as good as they are portrayed in the financial reports. With a good strategy and a dedicated team, finding good shorting cases is not that difficult. The difficulty in shorting is more to do with timing of the short. Is this a good time to put on a short? At Bodenholm, we put great emphasis on articulating to ourselves why the timing (or "trigger" as we call it) is right at any certain point of time. Typically, our timing of a short is reliant on a combination of quantitative and behavioural factors."


Erik Orving, Bodenholm Capital

"Having said that, the most important alpha generator of shorting is probably the risk management process," Orving says. "Ola mentioned the danger of take-outs and increased M&A activity. We have noticed that as well and M&A risk is a key part of risk management in our short book. If we are not diligent on continuous M&A risk assessment, we could easily have one or two take-outs, out of our 30 short positions, every year. We have learnt this the hard way. The first year, we had two take-outs, the second year we had one, this year we've had none. To put it in perspective, for each take-out in the short book, we probably need 5 winners to make up for the loss. Hence risk management and minimizing your large losses is key in order to generate alpha from shorting."

> "The ability to use the media or other techniques to draw attention to a short case, in an unethical manner, is, obviously, problematic. However, I don't believe it is more problematic than the overselling of the long cases Carl mentioned, which is an institutional issue."

Hedge Funds and Sustainability

Ethical considerations on the short side

For Rydin, shorts are not unethical as they allow expressing a different opinion on a stock, which goes against the mainstream. "Let us put shorting aside for the time being, and think about the long side at first. There are so many participants in the financial markets' ecosystem today that are driven by one thing: stocks should go up. There may be an IPO or a placing in store, or a management team looking to get their bonus triggered. Sell-side analysts might be bound to investment bankers who want to get the corporate finance deals from a particular company. There are lots of incentives for those people to drive sales higher.

Then you add leverage to the mix, and the long side continues its way up. With shorts, if you are a value or contrarian investor, and you are somewhat cynic, or at least, you question some of those things, I do believe that there is a useful function for shorts out there, in addition to what most people advocate for on the short side, which is providing liquidity and facilitating price discovery. Short sellers are incentivised to find issues that we have talked about, concerning accounting irregularities, for example, maybe even fraud, even though that is not so common in the Nordics nowadays. Historically, shorters have proved that they were able to find some of these issues before regulators. Investment bankers or sell-side research analysts won't be the ones seeing them, as they are so incentivised not to."

Wessel-Aas seconds what Rydin says, but he adds: "I think there's an element to shorting, which is unhealthy. We also have an active ownership approach to some of our longs, but on the short side, I believe activism can cause trouble. The ability to use the media or other techniques to draw attention to a short case, in an unethical manner, is, obviously, problematic. However, I don't believe it is more problematic than the overselling of the long cases Carl mentioned, which is an institutional issue. Most of the incentives are to pull shares up, and there aren't enough incentives to pull them down. Some investors help stocks trade back in line with reality. It is healthy and good for society. It was very disappointing to see how many of the most prominent business lead-

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ers reacted in the financial crisis to the shorting activity that took place, and the type of political influence they had. A blame game took place where shorters were made responsible for much of the financial crisis, which I think was ridiculous. The leaders were the same people who made tons of money benefiting from the bias to the long side. Then they scream and yell, and get a lot of attention when all is collapsing for many good reasons."

Engagement and activism

Stanghellini puts the idea of short selling in perspective with engagement. "When it comes to ESG and sustainability," she says, "we generally don't like exclusions but prefer engagement and activism. We do have an exclusion list, but it is minimal. Perhaps activism is a strong word, but do like to engage with companies." Rydin proposes the word "constructivism". Claudia agrees with the term and continues: "We like positive screening. The issue with implementing ESG on the short side, if you are only short based on sustainability issues, you will not have the ability to influence the company in such a constructive way. Short selling may eventually impact the stock price and get it to drop, but no engagement is taking place. Someone else will own the stock in the meantime, and the short seller may not have any influence on the company. Of course, we also use short-selling in our portfolio, but we do it for valuation purposes, and it does provide liquidity to the market. The process is based more on fundamental financial considerations rather than ESG analysis.

Rydin can see two sides to short-seller activism: "I stand a little bit in between. We've seen some of these 60-page research reports, on the short side, that make personal attacks on CEOs, for example. I agree that this is probably not the right way to go. However, I also believe that there is a role for contrarian investors, whether they are short-sellers or not. We have been in a situation where, all of a sudden, we lose access in communicating to a company because they have found out that we are short. In my mind, unless they are committing fraud or the like, they should have an incentive to speak to a short seller, and understand what the short case looks like so that they can address these questions, even if in a public forum. Once a short goes public, we often lose the dialogue altogether. I wouldn't call this activism per se, but I do believe a short seller should be able to expose their views and let the management team or someone else prove them wrong."

Gylfe takes a bird's eye view of the situation and argues for the benefits of taking ESG considerations into the investment process in general. "There is evidence out there that sustainable company do better over time. In that case, non-sustainable companies should do worse. There is a case to be made here."

Kozlowski points out that market supply-and-demand dynamics could be a separate driver behind the large-scale effects of sustainability besides fundamentals. "Investment flows may have been allowing companies with better ESG scores to outperform," he cautions. "As the investor community moves into ESG mandates, demand for these stocks will increase in relative terms. Often factor outperformance is driven by flows into that factor, a chasing returns effect. As a macro hedge fund only trading listed futures and options, we are very top down, and we have little possibility to do any screening on the type of positions we take. The only part of our portfolio where we could implement ESG criteria is on the equity side. We want to stick to the readily available exchange-traded products, and there are no ESG futures at the moment, but this will certainly change in the near future."

At Handelsbanken, Gylfe argues, exclusions may have their place. "At Handelsbanken, we have a list of companies we decided not to buy. Our choice relies on this notion that there are unsustainable business models, and that we do not want to associate with those." Companies Gylfe refers to may include nuclear weapons manufacturers or those that breach international treaties. We may engage with the companies when possible, but if there is nothing that can be done to alter the underlying issues, then they need to be on our blacklist."

Wessel-Aas cautions that data in ESG is still lackluster in many areas, and therefore the basis for decision making, particularly regarding exclusions, should be evaluated carefully. "A lot of the ESG analysis process is about producing the data and having companies reporting on it in the right way. Many of the companies that end up with poor ESG scores, and may become uninvestable for that reason, can't produce the data. We are cautious in our analysis not to discard companies from our universe on that basis," he says.

Placing a high bar for hedge funds

Thulin sets the bar high for hedge funds to convince him to invest. "We made a very simplistic screening the other day, just to train some of the newer students" he starts. "Together with them, we defined what criteria to apply to screen 597 possible investments. We decided to go simply for positive returns on a three month, one year and three-year horizon, a correlation to the equity market of 0.3, a Sharp ratio of 0.6. It is lower than our internal requirements because we believe that at that level of Sharp we would give away some of our risk-budget to something that detracts from the portfolio. Even with those loose requirements, only five hedge funds out of 597 made it through the screen. Then my team wrote up a weekly report arguing: 'What should we do with hedge funds when we can do it better ourselves?' It was published internally before I got back. I thought it was a bit too aggressive because hedge funds do add value. Our challenge is to find those funds that can add to our portfolio specifically."

"We have our limitations, and one of them is, we want to be in Swedish Kronor, but the hedging cost, if done passively, eats away a lot of the performance from the UK, or US hedge funds. Hence in our case, the hedge fund has to add value beyond that. As I said, if we can break the strategy down and replicate it, we probably will. On the equity market, for example, we don't have one single currency index, and we have specific strategies in every region. We have long/short spreads, and we trade a slope, and all this happens in the ETF space. To find a hedge fund that can complement that and fit into the portfolio has become more complicated. There was one manager that presented an attractive risk-aversion trade, but that went against strategies that were running. Then, it didn't make sense. On the bottom line, performance will also count, and if a hedge fund does well, then we will buy it. It's interesting to note, however, that only five funds made the cut, over what I thought was a relatively low bar. We might

have used the wrong metrics; we are entirely open to that critique. We have an ongoing dialogue with a couple of names around here, in Stockholm, because they want to 'qualify' for our screening because they think it's a great branding exercise for them. We are continually evaluating and trying to figure out what we are doing, and checking that we are not shutting the door unnecessarily hard."

Wessel-Aas picks up on Thulin's screening and comments on the choice of parameters. "The period you look at will greatly influence the results of a screen, and Jonas used a fairly short time horizon of three months, among other things. Being a manager and living in different types of environments makes it tricky to look at shorter periods. This is a testing time for managers with our particular type of strategy, and others as well, given the way the world reacts in this low-interest-rate environment. Many goalposts have moved. I get a bit scared when I hear people relying on statistics, or throwing in some students to do data research and try to find hedge funds. That is not what we think we are about. We are people with expertise in a particular area, and we can profit from that over time. We believe that there are investors who want exposure to that expertise and that they will pay for it. There will be periods of time, however, when this expertise doesn't yield the same results as in other periods when it will produce much greater results. It is all about surviving the trough. When you manage other people's money, you're not in control of that. It may require us to give our investors more attention and provide them with better communication then we did so far. We are reaching the end of this prolonged period, and everyone is looking for normalisation. Whenever that happens, it's not going to be quite what it was for the last ten years. In two months, or whenever, we may return to a possible financial downturn. There are plenty of people in the market right now, who have not lived through the financial crisis, and who have the responsibility to deliver returns. They will look at this slightly differently and justify their existence with different data than I think is appropriate, from a risk perspective."

For Kozlowski timeframe is also of the essence. "What is the correct timeframe to analyse the returns from a hedge fund?" he asks. "The selection criteria you use should fit your investment mandate and objective, both backward and forward looking. For example, if the statistics rely on three months or one year, and the criteria is that our correlation to the equity market shouldn't exceed 0.3, our strategy is not going to pass the test. We are supposed to exhibit a high correlation to the equity market during good times, but also a negative correlation to the equity markets during bad times, when that negative correlation is most needed. For now, we don't have a track record to speak off, not more than a couple of months, but this is what we expect to happen over longer periods of time."

Looking towards a data-driven future

Stanghellini offers a question to the hedge fund managers: "Nowadays, there are so many strategies that attempt to use artificial intelligence and systematic programming. May it pose a competitive challenge?" she asks. "Most of you are fundamentalists. How do we see that type of innovation? Do you feel threatened, or you feel you have a competitive advantage? As a fundamental manager, you may never be able to examine and analyse the same quantities of data as a computer program." From Wessel-Aas's perspective, people's input will never disappear. "We've always emphasised the people component of what we do, especially when it comes to investing in equities, in the context of our particular strategy. We have always been very clear about the fact that we don't have target prices or stop losses. We fundamentally believe that there is a dynamic in understanding what we are looking at, which is complex. Artificial intelligence, I know, can become very complex, but there is a human element to companies. They are organic and not statistical entities. The human element is the reason our fund exists, and that breaks through the statistical or the data-driven part. Humans, I strongly believe, will continue to be an integral part of finance. A part of the universe will become data-driven, that is certain. ETFs already are an example of data-driven financial products. Our fundamental strategies will stay in a tiny niche part of the market, but I expect that there will always be demand for such expertise.

Irrationality in the market will exist, and there will be periods of time when we struggle, and one of them is now, as we are underperforming, relative to these passive data-driven strategies. We just have to continue to communicate what we do, and some investors will take comfort in knowing that we are competent fundamental investors, and others may give up, or look elsewhere. Changes are taking place, but I am not worried about the potential in our strategy. I am more concerned about where the market is going while relying on all this data, and the fact that it may give investors a false sense of comfort."

Kozlowski thinks the discussions around data and computer driven investments is very focused on the positive aspects but could be ignoring some of the possible negatives. "We hear that computers can do the job of a thousand analysts, but this mostly emphasises the positive aspects of replicating the human brain. The computers integrate the positive characteristics of the work a human being can do, and the computing power extrapolates that to the work capacity of one thousand people. But human performance also has negative attributes like biases and errors. Consider biases such as crowding, reinforcement, or reflexivity; those will also be extrapolated. It is something to keep an eye on as there is minimal talk about that and what unknown effects non-human investment decisions will have in the future."

Orving points out that the value of big data in niche areas where a high level of expertise is required is limited. "Machine learning is not as strong in places that require a high degree of specialisation. We don't invest in small-caps, which are typically mentioned when discussing under-researched investment opportunities, but our strategy is heavily allocated to conglomerates that are 'deconglomerizing' and spin-offs; both situations are reliant on deep fundamental work and understanding of the underlying drivers of value creation. It is of course a small part of the market, but we believe that finding pockets in the market that are less well understood is key to our success and value proposition to investors."

Rydin also reminds us that his notion of "constructivism" will always retain a human element. "Regarding the gathering information, we probably have no chance against a computer. However, as an engaged shareholder, looking to create some change in an underperforming company, there is an opportunity to generate positive shareholder value through active, and competent work with the company. There is no point in comparing this type of work with a quant strategy, even though it may still qualify as a hedge fund."

NordicInsights

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The HedgeNordic series of round table discussions titled "Nordic Insights" aim to bring together industry professionals and experts in their field in a vivid discussion. The setup allows to look at and discuss a specific topic within the financial industry from various different angles, and hear of different opinions and approaches. The group would typically consist of a colourful mix of representatives from the financial industry. The combination of having a relatively small, intimate group of individuals for the discussion behind closed doors in combination with a wide circulation to a relevant audience in the Nordic region through a summary of the discussion in a convenient read-up paper combines the best of the two worlds of professional and personal relationship building and broad communication and branding.

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