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HEDGENORDIC

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EQUITY STRATEGIES & VALUE INVESTING

The Many Shapes and Tastes of Equity Strategies

Value Investing? An Economic Professor´s Take

Surprise! Looking at Long Only

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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.

PUBLICATION PLAN 2020:

January:	2020 Vision
March:	Nordic HF Industry Report
June:	Real Assets
September:	Diversifying Portolios
October:	Systematic Strategies
November:	Alternative Fixed Income

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Editor´s Note...

Alles hat ein Ende, nur die Wurst hat Zwei

Alles hat ein Ende, nur die Wurst hat zwei (literally: everything has an end, only a sausage has two). This German expression is often used to explain– often to children – that all good things eventually come to an end. The phrase also became a children's song that is at times embarrassingly abused during carnival and very well established in German.

The exception to this "rule," if you like, seems to be with global stock markets that continue rising, unimpressed by anything you throw at them. Glooming trade wars, threats of impeachment of a sitting US president, economic slowdown, some signs of a US recession…

You may have already forgotten, but roughly a year ago, between October 3 and December 24, global stock markets plummeted, with the S&P 500 falling by 19.6% and the S&P/TSX Composite Index dropping by 14.2%. It was the first time since 2008 that the S&P 500 showed up dressed in red on New Year's Eve.

It appeared as if the 10-year post-recession bull run was finally reaching its end. While investors tend to overreact anytime the market falls, even by a couple of percentage points, the concern seemed warranted. Company earnings grew by 13.1% in Q4, down from 25.7% in Q3; global GDP growth started to slow; the S&P 500's price-to-earnings ratio was about where it was in mid-2008 and yield curves appeared to invert, which is usually a sign of bad things to come.

But it seemed all it took was a good night's sleep and some Aspirins to get the party going again.

So, why are stocks still climbing? One explanation, of course, is the low yielding environment in fixed income markets, with no signs of rising rates on the horizons. Low rates also mean people can continue borrowing cheaply, which helps fuel consumption and economic growth—and the more people spend the better it is for company earnings. There's also no immediate threat of rising inflation, while job numbers on both sides of the Atlantic are still strong. These are all good things for stocks. In fact, the climb earned itself a nickname, the TINA market. It stands for There Is No Alternative, which simply means that because central banks around the world were holding rates so low, investors had little choice but to buy stocks.

Another reason may be deeply human. Many having been calling an end to this increase in stock market prices, many times in the last decade, and simply cannot bear being wrong again and are riding the wave while it lasts. Not out of conviction but out of resignation and realization that in the end, the market is always right.

In an interview with the New York Times JC O'Hara, the chief market technician at MKM Partners said: "This has been called the most unloved bull market in history, but it will be the most highly anticipated bear market whenever the next one comes around."

One area within the wide field of equity strategies that left a bitter taste to investors for many years now, is Value Investing. HedgeNordic's editor, Eugeniu Guzun though has a sweet tooth for value investing, and is persistently arguing for value investing like an apostel. He highlighted various angles, approaches and styles in the value space in this publication. He even went as far as to bring his former university professor Kenneth Marshall and pick his brains for this issue.

In my native German language, we have another saying involving a sausage. (We do like our sausages!). Es ist mir Wurst! (It is sausage to me!) This expression is used when you want to express "I really don't care". So, in this sense, ideally it should be sausage to investors if equity markets go up or down. Portfolios should be well enough diversified and robust to be able to handle market swings.

Easier said than done.

KAMRAN GHALITSCHI
CEO & PUBLISHER HEDGENORDIC

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left to right: Kaspar Hallsten (Analyst), Henrik Rhenman(CIO), Susanna Urdmark (Portfolio Manager)

Rhenman Healthcare Marks 10 Years

Defensive Growth Story Continues

By Hamlin Lovell – HedgeNordic

The Rhenman healthcare strategy has annualized at an average of c.20% since inception in June 2009. Thanks to the magic of compounding, day one investors have roughly quintupled their money - and those who were also investors with Henrik Rhenman in his former role could have made around 40 times their money by now: the Carnegie Global Healthcare fund he ran was the world's top performing healthcare fund, advancing by 800% between 1998 and 2008. But the performance has not traveled a linear path; there have been flat periods of consolidation and some pullbacks.

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US Politics

"Our worst period was January 2016, in the early days of the US Presidential election campaign, when Trump, Clinton and Sanders were competing with each other to say negative things about pharma. The biotech index was down 20% in a month, which was a very humbling experience, as we could not understand why Twitter comments would have such an impact on stock-market valuations", he says. Recently in 2019, political rhetoric around the 2020 US Presidential elections has also been a source of some volatility in healthcare equities.

Rhenman weighs up the risks as follows: "the worst Democratic candidate scenario would be if people start to view Elizabeth Warren as a credible candidate. The best Democratic candidate scenario would be Joe Biden, as he is an incrementalist who would not try to change much. The best scenario of all would be if Trump (or another Republican) is re-elected. And a US recession is, ironically, the biggest threat to the recession-proof healthcare sector, because a recession would reduce the chances of a Republican President".

But even if a radical Democrat did win the Presidency, they would not be able to make radical changes to US healthcare without the approval of other law makers. For instance, "price control of drugs is extremely difficult, and we do not expect there would be a majority in Congress and the Senate, either now or after the election", says Rhenman. Additionally, "drug pricing is much more than a pricing issue. Americans view access to drugs and healthcare as a right", says portfolio manager, Susanna Urdmark. Indeed, the normal European practice whereby bureaucrats ration some types of healthcare and drugs according to criteria such as age is characterized as "death panels" in the US.

The volatility has provided some trading opportunities, particularly in US HMO groups, but with volatility coming mainly from US political posturing or the geopolitical trade war, overall portfolio turnover in 2019 has come down a bit. There has been more active trading in prior years: a different type of political risk was stalking the markets during the European sovereign debt crisis in 2011, when Rhenman scaled back net long exposure to a low point of 37% around the Greek crisis. On average, the strategy has run at net long exposure of 120%, which peaked at 153%. In 2019, the net exposure remains above 100% partly because Rhenman finds valuations attractive. The biotech index and some single stocks are used on the short side; it is not always possible to obtain stock borrow on the names that Rhenman might want to short.

> "A US recession is, ironically, the biggest threat to the recession-proof healthcare sector, because a recession would reduce the chances of a Republican President."

Attractive valuations

"The overall healthcare sector is on a PE ratio around 17, which is below its historic average. Within this, there is some variation. Medical technology companies are relatively richly valued, which reflects the generally high valuations ascribed to defensive growth stocks across all sectors. On the other hand, some biotechs and pharmas are on PE ratios around 11 or 12, and some services companies are on single digit PE ratios", says Urdmark.

Biotech, pharmaceuticals and specialty pharmaceuticals have been the largest sub-sectors, typically making up over half of the fund. Medical technology and services can be around a third of it. After excluding pure R&D plays with no current earnings, Rhenman's portfolio has a weighted average PE ratio of around 17, in line with the sector. In 2019 to August, Rhenman has had three takeover bids – Array Biopharma, Spark Therapeutics and Allergan – and he reckons three per year has been the average. Another stock, Abeona, recently jumped 100% in a day on a press release.

Rhenman remains very constructive on the growth prospects of the healthcare sector. It is growing faster than the global economy, and is tapped into the faster growth of emerging markets – China recently overtook Japan as the world's second largest healthcare market. Rhenman generally invests in companies that generate revenues globally, rather than local or domestically focused players. The healthcare strategy runs around USD 660 million and for many years there has been a plan to soft close at around USD 1 billion. This is partly because over half of the fund is in small and mid-caps (defined as market caps below $20 billion). But the capacity target should be seen as something of a moving target as the sector itself grows.

Innovation

The portfolio is exposed to treatments for a wide range of conditions including some rare diseases, but in big picture terms, Rhenman identifies two families of treatments as very promising. "Oncology continues to generate many innovations and also offers a broad range of companies to invest in. Gene therapy holds out the prospect of completely new approaches to diseases that had previously been untreatable, and there are hundreds of clinical trials underway. If gene therapy can cure lethal diseases, its threshold for commercialization could be quite low and its pricing power could be high. Rather than viewing costs in isolation, they should be compared with the cost of lifelong care for chronic conditions, which can be many times greater than the cost of some new drugs or treatments".

Similarly, analyst Kaspar Hallsten – who specializes in medical technology – points out that advances could save money by shortening hospital stays, and helping patients to make faster recoveries and return to work sooner. In the most common human ailment – cardio problems – more targeted methods of operating can remove the need to open up the entire chest. One example where European companies are leading the way in innovation, is a company that has developed a cardiovascular valve for heart treatments. Abiomed is another firm involved in cardio treatments that Rhenman likes.

"These are exciting times. We have low PE ratios, low interest rates, a stock-market that is somewhat inclined to defensives, and good demand for healthcare products. We are as excited as we have ever been about our prospects", says Rhenman.

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Tom Berggren
Portfolio Manager
OPM Listed Private Equity

Liquid Alternative to Private Equity

By Eugeniu Guzun – HedgeNordic

One of the trends seen in the past decade has been investors falling in love with private markets. Whereas private equity returns have outperformed public markets over the long term, the private equity asset class does not offer investors the ability to buy and, more importantly for some, sell at a moment's notice.

OPM Listed Private Equity, managed by Tom Berggren – who acted as managing director of the Swedish private equity association for ten years, offers investors the opportunity to earn the juicy returns associated with private equity and access the much-needed liquidity. "By launching our fund ten years ago, we sought to offer liquidity for those investors who wanted to invest in private equity but needed more liquidity," explains Berggren. "Bringing the returns of private equity to investors in a daily format, that is what we do in a nutshell." OPM Listed Private Equity brings the private equity returns to investors by investing in publicly-listed private equity firms rather than investing in private businesses themselves.

OPM'S APPROACH VERSUS TRADITIONAL PRIVATE EQUITY APPROACH

OPM Listed Private Equity operates as a long-only equity fund that invests in listed private equity firms around the globe. Large institutional investors such as pension funds could and do invest in private equity directly, but this traditional approach of investing in private equity might not outclass OPM Listed Private Equity, according to Berggren. The traditional approach comes with the so-called J-Curve, which represents the tendency of private equity funds to post negative returns in the initial years and then delivering increasing returns later on as underlying investments mature.

“With the underlying funds managed by private equity players getting bigger and bigger, management companies become an attractive investment as well.”

“Large investors could invest in big successful private equity managers of the sort we like, but then you face the J-Curve,” says Berggren. “You commit the capital, and you have the money waiting until private equity managers find something interesting to invest in,” explains the portfolio manager. With OPM Listed Private Equity investing in public equities and being almost fully invested at all times, “investors can skip the J-curve.” Interestingly enough, OPM Listed Private Equity managed to outperform the traditional private equity portfolios managed by some of the largest Swedish pension funds in the recent past.

Berggren finds two reasons for the outperformance, one of which involves the spot-on selection of private equity managers. “We have been good at choosing the right companies and private equity managers,” emphasizes Berggren. In addition, by investing in public markets, OPM Listed Private Equity gets a piece of each public private equity firm the fund is invested in. This enables OPM to earn money from the management and performance fees those private equity managers collect on the assets they oversee. “As an owner of public private equity firms, we benefit extra,” explains Berggren. “With the underlying funds managed by private equity players getting bigger and bigger, management companies become an attractive investment as well.”

The fondness for private equity among institutional investors comes down to steady and strong returns, as well as low volatility. Investors in OPM Listed Private Equity, however, should stomach some volatility in order to achieve private equity-like returns over the long term. “In the long term, our fund’s returns should be similar to the returns generated by traditional private equity players,” says Berggren. “Shorter term, however,” notes the portfolio manager, “we have more volatility due to market exposure.” For long-term investors, the higher volatility makes no big difference, argues Berggren. In fact, volatility is welcome and very convenient to investors, he explains, because “private equity managers tend to make very good investments when stock prices go down across the board.”

PORTFOLIO COMPOSITION

From a universe of around 300 listed private equity firms, OPM Listed Private Equity builds and maintains a portfolio of between 30 and 40 names. As Berggren explains, “the universe contains companies that have the majority of their investments in unlisted companies and employ an active ownership approach.” Some companies in the universe include American private equity firms such as Blackstone and Apollo Global Management, Swedish investment company Investor AB, and even Warren Buffet’s Berkshire Hathaway, which owns a fair share of private companies.

OPM Listed Private Equity’s portfolio can be broken down into three smaller pieces: direct private equity funds; funds of private equity funds; and, thirdly, investment companies. Using an approach of buying and developing value assets, Aurelius Group, often referred to as the German Berkshire Hathaway, represents an example of a direct private equity fund. Berkshire Hathaway, meanwhile, fits in the “investment company” bucket. “We include Berkshire Hathaway in our universe because they are active owners in a way, as they own quite a bit of unlisted companies,” explains Berggren. “The reason behind allocating to investment companies is to keep costs down and Berkshire is the number one example of a low-cost investment company.” HarbourVest Global Private Equity and others, meanwhile, use a fund of funds structure to invest in external private equity funds.

Despite the three categories exhibiting subtle differences, all holdings owned by OPM Listed Private Equity seek to create value by allocating capital to private companies. To build their portfolio of public private equity firms, Berggren and the team “look for very experienced fund managers with long track records.” The evaluation process relies on both qualitative and quantitative analysis, which help OPM’s private equity team to understand the quality of the capital allocators at each firm. “We try to assess if the managers add any real contribution as active owners,” emphasizes Berggren, “which many of them do nowadays.” The portfolio manager, however, tries to avoid financial engineers.

“When analyzing a huge private equity player, we cannot look into every single underlying investment that had been made,” says Berggren. Instead, “we look at the big picture and try to get a good understanding of how managers are doing.” OPM Listed Private Equity’s allocation process depends on two main factors. “Firstly, the allocation depends on our view of how good the managers are at allocating capital, and secondly, on the valuation of the company relative to other global companies.” All in all, “really good managers and attractive valuations is what we look for,” emphasizes Berggren.

Large U.S. listed private equity firms are often considered “perpetually undervalued,” as investors and analysts arguably misunderstand the variable cash flows innate to private equity. “In the United Sates, the cash flows from fixed management fees are assigned a price-to-earnings of around 18, for instance, and then the carried interest or the potential performance fees get a PE of one, two or three,” says Berggren. “Private equity managers may be very upset that their valuations are so low, but we have no problem with that as long as managers keep delivering and beating expectations.”

10-YEAR ANNIVERSARY

Launched in October of 2009, OPM Listed Private Equity reached its ten-year anniversary this October. The fund’s institutional share class delivered an annualized return of 16 percent, whereas the more common share class returned around 15 percent per year over the same period. OPM Listed Private Equity is up 40.9 percent year-to-date through the end of September, having beaten broader equity markets with a handy margin. “Lower interest rates and some American companies changing from being a limited partnership to being a corporation helped us a little bit extra this year,” smiles Berggren. The corporation structure is expected to attract more capital from exchange-traded funds, other vehicles and investors.

“We enjoy the power of compounding,” comments Berggren on the fund’s anniversary. “We made four times the money in ten years and we hope this compounding machine will continue to work,” he adds. “We hope to keep delivering high returns, which should not be that difficult because private equity has done that since the 1970s,” notes the portfolio manager. Berggren hopes that one Swedish krona invested in early October of 2009 will become 8 kroner five years from now and 16 kroner ten years from now. The beauty of compounding at its best.

INVESTING IN FOUNDER-LED COMPANIES

By Eugeniu Guzun – HedgeNordic

ANDREAS AAEN
CEO, SYMMETRY INVEST

Andreas Aaen operates under the motto of "putting your money where your mouth is," which has proven successful thus far. After all, Symmetry Invest generated an annualized return of 17.3 percent since launching in March of 2013 despite suffering a bad year in 2018. Mistakes had been made and learned from, says Aaen, and the fund has recouped last year's losses after gaining nearly 28 percent year-to-date.

After successfully managing his own money and capital from friends and family for a few years, Andreas Aaen decided to open up his long/short value equity fund to outside investors. "We have this mindset of putting our investors' capital where our own money is," explains Aaen. With Symmetry Invest currently managing just shy of €10 million, "around 40 percent of the money comes from me, the board members, my family and close friends."

Search for Founder-Led Companies

Symmetry Invest's investment approach is inspired by that of Charlie Munger and Warren Buffett. The approach involves looking for strong businesses that generate high returns on capital for a long time and face a large set of high-return reinvestment opportunities. Aaen predominantly looks for such businesses among European small- and mid-cap companies. More importantly, his way of investing resembles Buffett's approach of acquiring entire businesses led by their founders. "The main characteristic of our holdings is that they are founder-led companies," emphasizes Aaen, usually companies with a founder that acts as president, chief executive, member of the board of directors, or holds some other position of significant influence.

Aaen mentions Italian company Piteco S.p.A., one of their top holdings. "Piteco is a treasury management software (TMS) provider with 99 percent customer retention and high-single-digit organic growth trading at around 13 times free cash flow," says Aaen. On top of that, the Podini Family controls 65 percent of the company and Marco Podini is the chairman of Piteco's board of directors. "The Podini family has created a lot of value in their family business DedaGroup and have done the same so far in Piteco," elaborates Aaen.

> "We have this mindset of putting our investors' capital where our own money is."

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> "It is very important for smaller and mid-cap companies to have the founding entrepreneur or a big investor who can take control and lead these companies."

Besides Podini chairing the board, the company's three founders still hold leading management roles and have high ownership stakes.

The majority of Symmetry Invest's holdings are founder-led, points out Aaen, but "those companies that are not founder-led have a really big shareholder sitting on the board instead." As the portfolio manager explains, "it is very important for smaller and mid-cap companies to have the founding entrepreneur or a big investor who can take control and lead these companies." With a fragmented ownership structure, argues Aaen, the management team can take the business in the wrong direction without shareholders being able to reverse the course at short notice. "A business does not necessarily have to be led by the founder, but I learned that founders normally tend to care about their businesses really well and they do well for themselves and other shareholders," says Aaen.

Good Allocators in Need

Allocating capital is one of the most essential responsibilities of chief executive officers, as long-term wealth creation for shareholders involves reinvesting internally-generated cash and borrowed capital at attractive rates of return. Aaen relies on the measure of return on capital and return on incremental invested capital to judge a company's capital allocation. "Return on capital is the most important bit of information," argues Aaen, who adds that if "companies do not make incremental investments, the returns investors get in the end will never be compelling."

The Aalborg-based manager reckons that the return on incremental invested capital is more important than the return on previously invested capital because reinvestments contribute to the growth of a business. "If companies can get returns of 15 percent or more on reinvested capital, I definitely want them to keep reinvesting rather than pay out dividends, for instance," argues Aaen. "But if they do not find reinvestment opportunities, they should buy back shares to take advantage of cheap valuations or pay dividends." That represents good capital allocation in Aaen's view.

Nonetheless, "companies that pay out almost all their earnings as dividends are not in our interest," points out the portfolio manager. Symmetry Invest aims to achieve an annual return of 20 percent before fees, which implies that "if companies do not find opportunities to reinvest, we need a dividend yield of 20 percent to achieve our target return," explains Aaen. "We really want companies to grow and if businesses keep compounding, we do not care very much if the price-to-earnings goes from 12 to 15." He prefers to never sell if investments go well, arguing that investing in a company is "like going into a marriage." Yet, Aaen is eager to part from holdings if mistakes in the original investment case are found or valuations increase too much relative to intrinsic value.

"If there are flaws in our analysis, we exit," says the Dane, who emphasizes that "if things turn out really well, we are not focused on exiting." But of course, exclaims the portfolio manager, "we will trim a position or sell it out completely if the valuation gets too high and the margin of safety declines." Aaen defines margin of safety as the difference between the present value of future cash flows and the current market capitalization of the business. "We look for a big discrepancy between what a company is worth and what we pay for it," explains Aaen. This value-oriented approach does not restrict Symmetry Invest from investing in companies with high valuation multiples. "We own stocks that trade at high multiples because we anticipate high returns on incremental capital."

Portfolio Concentration and Approach to Shorting

Aaen prefers Symmetry Invest to own between 15 and 20 positions, preferably in founder-led businesses, that can grow by deploying incremental capital at attractive rates of return. The portfolio manager also piles up a less concentrated portfolio of short positions, usually between 30 to 40 names. Whereas "the aim of short selling is to generate returns rather than reduce net exposure," Aaen does not afford to spend a lot of time to analyse short positions and limits each short's position sizing to 1-2 percent of the portfolio. "We cannot spend too much time on a short position. Even if a short position returns over 50 percent, it only adds one or two percent to our overall return."

For efficiency reasons, Aaen put in place a number of systematic processes for the search of short candidates. "We use screens that pop out companies that post really good earnings but bad cash flows, or companies with negative returns on incremental capital, or companies with an unsustainable expansion of debt," says Aaen. "Then we follow what the really good short sellers are shorting." In Europe, investors have to disclose short positions that constitute more than 0.5 percent of a company's shares, whereas in the United States there are lot of activist investors who make their shorts public. Symmetry Invest uses a variety of ways to find short candidates, but the ultimate goal is to make money on shorts. "If we just wanted to reduce exposure, we could simply short index futures."

Learning Curve

As a former accountant, Aaen can put his accounting experience to good use when searching for investment opportunities. Yet, he acknowledges that investing is not all about numbers. "When I read a financial statement, I can see in a really short time if the company is a good long, a short or a pass. But I do not think accounting knowledge alone can make you a good investor." The biggest learning curve for Aaen in recent years involved the human side of investing. "What I really tried to learn over the past couple of years was the human nature of investing," says Aaen. Even the best strategy is made worse in the hands of a frantic manager, which emphasizes the importance of controlling emotion and ego in investing.

That is the reason why Aaen spends a lot of his time reading books on different topics (biographies, psychology, among others). "As I only recently turned 30, I will be in this business for the next 50 years. The best investment I can make is in myself by strengthening my knowledge and capabilities," says the portfolio manager. Aaen also somewhat disagrees with the notion that value investing has underperformed in recent years. "It depends on how you see and define value investing," he argues. "Buying a struggling retailer or a capital intensive industrial with negative cash flows trading at 6-7 times earnings is not value investing to us. That's just bad investing."

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In an Arms Race for Returns

By Kamran Ghalitschi – HedgeNordic

> "More capital than ever before is being spent on global security, which will benefit companies within this sector."

It may sound counterintuitive, almost cynical, that the world's first actively-managed UCITS fund focusing on global defence and security is managed out of peace-loving Sweden, which last went to war in the Swedish–Norwegian War (1814). Sweden was victorious in this war, which led to the Danish king being forced to cede Norway and then a part of Denmark to Sweden. A mere domestic dispute, some may say.

The Global Defence and Security Fund (GDS) launched in February 2019, however, aims to piggyback on the increased awareness and spending for defence and security, be it on a national, corporate or personal level. The products in this field can be as diverse as a security camera you use in your home, or spam filters you use at your workplace to submachine guns and aircraft carriers.

TOR SINCLAIR
PORTFOLIO MANAGER GLOBAL DEFENCE & SECURITY FUND

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The fund is managed out of Stockholm by portfolio manager Tor Sinclair, and as the name suggests, rests on two distinct legs in the investment universe: Defence and Security.

Defence is arguably the area that brings the most vivid pictures to mind, with military hardware and software. In the security space though, Sinclair argues that "more capital than ever before is being spent on global security, which will benefit companies within this sector."

One area Sinclair highlights is cybersecurity. "Demand for cybersecurity has probably never been greater and cyber expertise is a scarce resource. This means that the premiums that large companies are willing to pay for smaller, more specialized players will skyrocket. As an investor in cybersecurity companies, we see the opportunity for acquisitions as a spice and a way to take advantage of the explosive growth the industry is facing. The majority of our investments in cybersecurity are certainly made in larger companies, but we have part of the portfolio in smaller and medium-sized players where acquisitions are a probable value driver."

Sinclair has identified around 1,000 companies that make up the fund's investment universe across the defence and security spectrum. Typically, large-cap companies such as Boeing or Raytheon are producers of aircraft, vehicles and other hardware, whereas companies active in software, cybersecurity and similar areas may well be found in the mid- to small-cap space. Consequently, Global Defence and Security Fund channels at least 51 percent in equity investments with a focus on large-cap companies but may temporarily hold up to 49 percent of its net assets in cash and liquid assets and other similar assets. The statues also allow for up to 10 percent in non-listed equity "but we have not yet made allocations to non-listed companies," Sinclair tells HedgeNordic.

The relatively concentrated portfolio currently consists of 28 companies, with roughly two-thirds of assets

"Demand for cybersecurity has probably never been greater and cyber expertise is a scarce resource."

allocated to defence stocks and 35 percent of assets invested in the security area. The portfolio has a dividend yield of about 1.5 percent , which is "not too bad in a negative-yielding environment".

The largest part of the portfolio is made up of companies active in Aerospace & Defence (58.1 percent), followed by IT Services (22.8 percent), and software (4.9 percent). Other areas span Electronic Equipment, Instruments & Components, Computers & Peripherals, as well as Communications Equipment and Industrial Conglomerates. Despite October looking to be the so far weakest month in the fund's short track record with an indicated decline of 3.25 percent, the fund is up by nearly 11 percent since inception.

There is also a case to be made for Global Defence and Security Fund's decorrelation from other portfolios. Typically, in times of geopolitical tensions, escalated terror scenarios or social unrests, investment and spending in security equipment increases.

An experienced investment team with substantial experience from the global security industry, made up of Andreas Wiman, Rainer Korhonen and Mathias Sigvardsson, supports Sinclair in keeping track of developments in the space and evaluating investment cases.

"I work with the investment team to identify prospects and sound out investment cases. This combines the traditional fundamental and technical analysis with a qualitative approach that we refer to as Global Intelligence. This is an approach that is applied within the defence industry and a process that Andreas brings from his time in the Swedish Defence Force and Military Intelligence and Security Service."

The investment team meets weekly and covers news and trends. One example Sinclair uses to point out how the interaction with the investment team works was the award by the Swedish Defence Force (FMV) to Raytheon, for its missile defence system Patriot. "There were other companies bidding for this deal with products that could arguably be seen as better and cheaper but FMV selected the Patriot system. While no doubt there are strong and valid arguments for why this equipment was selected by FMV it also increases the likelihood that Swedish defence companies are likely to be the beneficiaries of US defence spending. Saab was up over 10 percent following the TX trainer announcement but the investment team pointed out that this was a very high certainty following the FMV deal."

"We also have an Investment Committee that is comprised of Henrik Sundin (who also acts as the CEO) and Michael Gunnarsson, who review the investment cases put forward by myself and the investment team. The investment team is responsible for the approval process and for ensuring that the investment cases put forward comply with the Screening Policy. The screening policy states, among other things, that companies must comply with United Nations Conventions and Treaties."

The Global Defense and Security Fund is set up under the Finserve umbrella. Other funds within Finserve include Thyra Hedge and Scandinavian Credit Fund, two well-established hedge funds. Asked why Sinclair, given his background and environment at Finserve, does not run GDS as a hedge fund to make use of tools such as shorting, derivatives, leverage and other freedoms, the portfolio manager replied: "We thought about it, and there were some temptations, of course, to run a long/short equity strategy, or even have a wider mandate. We felt though that the best place to get the strategy started was as a long-only mandate. But who knows what the future holds."

Broad Pathway to Alpha Generation

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CEO, Sissener AS

Bjørn Tore Urdal
Portfolio Manager, Sissener AS

By Eugeniu Guzun – HedgeNordic

Sissener Canopus ranks as one of the best-performing hedge funds in the Nordics, a feat achieved thanks to an opportunistic search for performance and an ingrained risk-reward mentality. Founded by Norwegian household name Jan Petter Sissener, Sissener Canopus is an absolute return long/short equity fund that has a global mandate with a Nordic focus.

"We search investment opportunities globally, but first and foremost, we think we have an investment edge in the Nordic markets," says Sissener. The Norwegian asset manager's investment philosophy is based on the belief that informational advantage can lead to superior investment results over time. "We believe that the ability to gain knowledge advantage of a company is proportional to the geographical proximity of said company," explains Sissener. To build up the knowledge advantage, the Sissener team seeks access to a company's management, customers, suppliers, and sell-side research.

For investors based in the Nordics, "risk typically increases with the distance from the Nordic region," reckons the founder of Sissener. Whereas Sissener's proximity to Nordic companies represents an edge over international peers, the informational advantage over local players becomes rather immaterial. Yet this risk-reward mentality builds the foundation of Sissener's approach to investing, a mindset that is "important in the stock selection process and, I believe, has served us well over the years."

NOT THE TYPICAL LONG/SHORT EQUITY FUND

Sissener Canopus maintains a long bias and holds a concentrated portfolio of 30 to 35 high-conviction investment ideas, of which up to five are short positions. Besides, the Norwegian fund actively uses financial instruments across the capital structure of companies to optimize expected risk-adjusted returns. "In a nutshell, Sissener Canopus is a bottom-up stock-picking fund utilizing a broad specter of instruments to try to generate alpha returns," says Bjørn Tore Urdal, who works shoulder to shoulder with Jan Petter Sissener.

While Sissener Canopus invests in both good and bad businesses that are mispriced, "we want to own businesses with established business models that generate positive free cash flows; businesses we understand, offer visibility into future cash flows, and have healthy balance sheets." According to Urdal, the companies the Sissener team seeks ideally operate in structurally-attractive industries. But inexpensiveness represents the main prerequisite for adding a company in the fund's portfolio. "An important characteristic of a company is that we believe there is a mispricing of its stock and the stock is undervalued," says Urdal.

To decide whether a stock is cheap, fairly valued or expensive, the Sissener team focuses on cash flows rather than relative multiple valuations. "We believe the best assessment of intrinsic company value is through discounting its stream of estimated future cash flows,"

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states Urdal. "There is an element of truth to the saying that "cash flow never lies" as it reduces the risk of financial engineering," he argues. The focus on cash flows also makes the economics of businesses more comparable, "as cash is cash, regardless if you sell trucks or trousers."

"From time to time, we can even pick up the proverbial cigar-butts from the street as Warren Buffett called them," says Urdal. "Even businesses in structural decline sometimes represent good investments if valuations are low enough," he continues. The Sissener team, comprised of four investment professionals, complements the portfolio of long positions with derivatives.

"We are also very active in derivatives on single securities and are probably more active than most peer funds in this respect," argues Urdal. "Actively using derivatives on single securities are part of our investment strategy of trying to optimize expected risk-return on single names." The team typically writes put options and covered calls to collect premiums and improve overall risk management.

Apart from the active use of derivatives strategies, Sissener Canopus also actively invests in corporate bonds. "We have room to invest up to 20 percent of the fund in bonds," and the fund maintained an average exposure of 14 percent to corporate bonds since inception. With an average performance of around 11 percent since inception, "this exposure contributed nicely to the overall performance of the fund," says Urdal. The Sissener team also makes use of bonds to capitalize on deep balance sheet distressed situations. "When the opportunity set is ripe for shorting the equity while owning underlying corporate bonds, we do this trade," says Urdal.

APPROACH TO REDUCING MARKET EXPOSURE

Sissener Canopus maintained an average net market exposure of 66 percent since its inception in April 2012, with the exposure evolving depending on economic and market conditions. The Sissener team mainly adjusts the exposure through the use of index options. "We typically buy out of the money put options on the large and liquid Nordic, European and US indexes," says Sissener. The fund also maintains a small portfolio of short positions, which also helps the process of adjusting the net exposure to the market. However, "we do not have short positions on individual companies for the sake of taking down the net exposure," emphasizes Sissener.

> "Even businesses in structural decline sometimes represent good investments if valuations are low enough."

"When we have short positions on single companies, we do this with the intention of generating an absolute positive return on the short position," argues Sissener, who points out that selecting short positions is always difficult. "You have the market and 90 percent or more of its players against you," he says. Whereas the selection process of a short may represent a mirror image of the process of building the long book, picking short candidates "demands more." According to Sissener, "high valuation in itself is not enough for selecting a short."

For the short book, Sissener Canopus seeks companies under financial balance sheet distress, which also face deteriorating earnings and market conditions, or companies turning into industry dogs that lose competitiveness. "The likelihood of negative events gives good support and should be considered more in-depth when evaluating short positions," argues Sissener. The team also relies on technical analysis to select short positions. "When the trading pattern of a stock is such that it seems buyers are getting exhausted, and maybe even seems to be under distribution, then that is a strong support signal for a short."

TRACK RECORD

Sissener Canopus generated an annualized return of 12.6 percent since launching in April of 2012, exhibiting an annualized volatility in returns below 10 percent. That translates into an inception-to-date Sharpe ratio of 1.3. "With an average net market exposure of 66 percent, we generated four percent in alpha per year against a benchmark of Nordic, European and US indexes," says Sissener. "Our own assessment of this performance is that we stand very strong against most European absolute return-focused peer funds."

Sissener Canopus consistently hedged its currency exposure back to Norwegian kroner, which has been a drag on performance due to the depreciation of the Norwegian currency over the past several years. "The rationale for hedging the exposure was that we are focused on stock picking and do not take a currency view," says Sissener, which has put the fund at a disadvantage relative to other funds that benefited from a weaker Norwegian kroner. The bottom line, however, is that "the performance contribution over time is well diversified across single positions and sectors, so we do not have large outliers that have skewed performance in any direction."

> "You have the market and 90 percent or more of its players against you."

ERIC STRAND
PORTFOLIO MANAGER
AUAG SILVER BULLET

Sweden's Riskiest Fund – or a Silver Bullet for a Precious Metal Rally?

By Eugeniu Guzun – HedgeNordic

> "If you are in the camp of believing in a strong multi-year phase for gold, you should buy silver."

As the founder of a precious metals-focused fund back in 2016, Eric Strand is now launching a new fund under his own boutique AuAg Fonder. The new fund called AuAg Silver Bullet is the first silver-focused long-only equity fund in Europe, according to Strand. This is perhaps "Sweden's riskiest fund," he considers, despite embracing a zero-leverage policy that does not favor investments in leveraged financial products. AuAg Silver Bullet is a long-only fund maintaining a focused portfolio of 20 to 30 holdings in silver and gold miners. The fund also maintains some exposure to silver for cash management purposes.

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The launch of the fund has coincided with the beginning of a bull market in precious metals. "Precious metals have just confirmed the start of a secular bull market," says Strand, who adds that the "bull markets in equities and bonds are getting long in the tooth." Gold represents the "perfect stabilizer for a portfolio in the short term" and silver- and gold-related stocks tend to exhibit low correlations with the broader equity market in the long term. AuAg Silver Bullet, therefore, is designed to provide benefits beyond attractive returns, such as improved portfolio diversification.

"If you are in the camp of believing in a strong multi-year phase for gold, you should buy silver," argues Strand. Even better, "you should buy the miners for greater returns." The price development of the yellow metal has historically driven the price of silver as well. More importantly, "in a bull market for precious metals, silver normally outperforms gold and silver miners outperform gold miners" according to Strand. This phenomenon partly explains AuAg Silver Bullet's focus on silver and silver miners, which differentiates the fund from other players in the field.

Stock Selection Process, Silver in Focus

From the universe of silver and gold mining companies, AuAg Silver Bullet builds a focused portfolio of 20 to 30 names. Strand has a strong preference for liquidity as "I always think of the "Exit" first, which means that I want equities that are liquid and preferably trading on US stock exchanges." The portfolio manager then examines the output of silver and gold and the demand for the two metals to assess the attractiveness of the white metal. Over the past several years, global demand for silver has exceeded supply, but if investments in silver bars and coins are excluded, then the supply of silver has surpassed demand. Therefore, if owning precious metals becomes attractive to investors, demand for silver as a store of value can increase and dramatically influence prices.

According to Strand, "the price of silver is historically very low compared to the price of gold." Because of fairly inelastic silver mining output (as most silver comes as a byproduct of mining other metals such as gold, copper or zinc) and a looming physical silver shortage, "the dynamics for very high prices are in place for silver-focused miners." As Strand explains the longer-term bull case for silver, "silver is a metal with high resistance to corrosion and oxidation and has the best thermal and electrical conductivity of all metals, which makes the white metal indispensable in our high-tech and green world." There is a broad-based and diverse range of uses for silver in all sorts of technologies, including solar panels, touch screens, water purification, among other things. Silver's unique properties make the white metal attractive as both a precious metal and industrial metal.

> "This can probably be the fund with the greatest risk without incorporating any leverage."

Since miners are never extracting either gold or silver, Strand looks for the mining companies that provide the purest exposure to silver. "Then I want safe jurisdictions for mining operations," adds the portfolio manager. When searching for and examining potential investment candidates, Strand also looks for experienced and high-quality management teams. "It is important to invest in a company with experienced management because mistakes in the mining industry can become very expensive," emphasizes the portfolio manager.

To get the final mix of holdings in his concentrated portfolio, Strand embraces both momentum and value styles. Because AuAg Silver Bullet is a long-only fund, the portfolio manager always searches "for a better option before replacing an existing holding." Ideally, however, he prefers an infinite holding period for all the stocks that pass his stock selection process. "We want to stay invested forever in each stock that passes the selection process."

Perfect Conditions for Launching Sweden's Riskiest Fund

Strand reckons that the current environment with "a lot of money printing" offers the ideal market conditions for AuAg Silver Bullet. This environment "offers a great set-up for a capital rotation to commodities and precious metals in particular," argues the portfolio manager. Because much capital has flown into equity and bond markets in recent years as a result of cheap money, Strand considers that investor capital may leave these richly-valued markets in pursuit of cheaper alternatives.

"Investors cannot lean back on a traditional 60/40 mix of stocks and bonds this time and must look for investments that can provide returns and simultaneously exhibit low correlations with other holdings in existing portfolios." For these reasons, Strand expects AuAg Silver Bullet to thrive in this type of market environment.

"Gold and silver are the only currencies that do not require a counterparty signature," points out Strand, who adds that "credit instruments and fiat currencies depend on the creditworthiness of counterparties." By implementing unconstrained negative interest rate policies, "governments and central banks are not solving the debt problem of the world." These policies are exacerbating the problem instead, argues Strand. "By trying to solve a debt problem with more debt, the problem grows exponentially before it implodes." The world's mounting debt levels, therefore, should also be fundamentally positive for gold and silver prices.

"Silver miners have a history of enjoying returns of up to 600% in bull markets before going down 80% in the following bear market," points out Strand. "With a secular bull market for precious metals starting now, I hope the fund will shine bright."

AuAg Silver Bullet is suitable for both retail investors and institutional investors such as family offices, funds of funds, and others that believe in a strong multi-year bull market for gold and silver. The fund is launching with two types of share classes, one denominated in Swedish krona and other one in Euro, to make the fund attractive to both local and European investors.

Because silver acts as one of the most volatile commodities and mining companies perhaps form one of the most volatile industries in equity markets, Strand expects AuAg Silver Bullet to exhibit high volatility in returns. "This can probably be the fund with the greatest risk without incorporating any leverage," says Strand. "Everything from market conditions, strong return potential to low correlation with traditional equity markets is aligned to make this exciting fund launch a Silver Bullet for a better performing portfolio."

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Concentrate. Focus. Engage.

Kai Tavakka, Henri Österlund and Mark Shay – Accendo Capital

By Eugeniu Guzun – HedgeNordic

Accendo Capital's activist approach to investing reflects a mix of diplomacy, entrepreneurial authority, and sometimes even aggressiveness in the pursuit of creating value for shareholders and investors. "We are an activist fund maintaining a focused portfolio with our absolute best ideas," explains Henri Österlund, who manages the fund alongside Mark H. Shay and Kai Tavakka. How many ideas make the portfolio? Currently six. Sometimes less, sometimes more, but no more than ten at any given point.

High concentration is usually accompanied by elevated volatility in returns, but short-term fluctuations are not on the team's minds. "We seek to find the best ideas and actively engage with those investments to make sure they become solid investments in the long term," says Österlund. "Ten holdings are probably the maximum we can afford before starting to lose focus." And focus is vital for investors like Accendo looking to engage with their investments. "Accendo is an entrepreneurial investor," says Österlund, who emphasizes that "we invest with the same attitude as entrepreneurs invest in their own businesses."

PRIVATE EQUITY MINDSET

Partially originating from Österlund's pre-Accendo background, the activist fund takes a private equity approach to listed equities. In fact, Accendo resembles a typical private equity investor in several respects. First, "similar to traditional private equity players, we embrace a focused and concentrated approach to portfolio construction," explains Österlund. Second, "we also invest with an agenda that puts forward initiatives aimed

> "We are an activist fund maintaining a focused portfolio with our absolute best ideas..."

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at developing those companies." The Accendo team seeks the ability to influence a company's governance and strategy, which enables them to "steer companies from A to B to create value."

In contrast to the private equity space, however, Accendo does not have a preference for high leverage. "Companies in our portfolio have a relatively low level of leverage on average," underlines Österlund. This leverage aversion comes is part of Accendo's own risk management. "It is imperative for us to make sure that we are not thrown out of the driving seat due to financial struggles, when banks take over the governance of the company, for instance," explains the founder of Accendo. "That said, we do prefer to invest in companies with solid balance sheets."

Accendo tends to acquire ownership stakes between five and 25 percent to initiate its collaborative campaign of value creation. The fund also seeks board representation to facilitate this value creation process. "Influencing a company from inside through the board is the most effective approach to creating shareholder value," reckons Österlund. Yet most of the credit should go to the management teams, he argues. "The management should always take the credit for what their companies have achieved," says Österlund, "that is something that we endorse and celebrate."

GOVERNANCE IN LISTED COMPANIES AND SUCCESS STORIES

Accendo has succeeded in creating value through board representation and engagement on numerous occasions. As an active shareholder, Accendo usually puts forward a set of critical ideas that the team believes are essential for the progress of their investments. "In cases where we have been right with the ideas and the management teams have been working hard on them, these initiatives had a big impact on those companies both operationally and in terms of stock price performance," says Österlund.

To facilitate the process of value creation, Accendo searches for companies with a favourable governance framework. "When evaluating investment cases, we always ask ourselves whether we can acquire a sizable enough stake to be in a position to influence a company's strategy and course," says Österlund. The Accendo team also looks for companies where other shareholders are willing to embrace their ideas. "If other shareholders are on board with our initiatives, progress becomes much easier."

Accendo's engagement increases the likelihood that most of their investments end up bearing fruit over time. The activist fund has realized losses on only a single position over the years, as the team does not usually give up easily. Accendo did give up on Swedish IT consulting firm Cybercom. "Probably the biggest risk for us is that we would become mentally attached to underperformers and never give up on them," acknowledges Österlund. More importantly, the activist approach operates as an effective risk management mechanism for Accendo. "The most important risk management for us stems from the work we do with our portfolio companies."

Accendo's investment in Finnish media house Talentum, now part of Swedish Alma Media following a business combination in September of 2015, ensured the company survived the turbulent market environment caused by the financial crisis of 2008. Accendo acquired a stake in former Talentum in 2008 "with the view that the company had great media assets and we wanted to steer the company to embrace the online business," explains Österlund.

The 2008 financial crisis, however, heavily impacted marketing spending and Talentum's revenue stream, which could have become a severe problem due to its indebted balance sheet. "We were able to sell off some assets to repay the debt, and the company was debt-free during the subsequent turbulent years," says Österlund.

"We were able to ride through the storm, and the company turned out to be the best-performing Finnish media stock when other companies were doing horribly." As he explains, "one key aspect of our strategy is to have patience, as there is a lot of work going on behind the scenes."

> "Influencing a company from inside through the board is the most effective approach to creating shareholder value..."

Current portfolio names gaining commercial traction with Accendo's help as owners and board members include Remedy Entertainment (Finland), Doro (Sweden), and Impact Coatings (Sweden).

MISCONCEPTION AND MORE THOUGHTS ON CONCENTRATION

Accendo Capital invests in public companies in Northern Europe, mainly targeting small- and mid-cap companies in the technology industry. "Historically, we have shown a preference for technology-related companies," says Österlund. Some people appear to have misconceptions about Accendo's deal flow and investment process, he points out.

"We do evaluate a broad range of criteria when deciding on which investments to make," says the portfolio manager. In terms of valuation multiples, for instance, Accendo maintains holdings that "are trading around ten times sales and others that are trading at an enterprise value to EBITDA of five," he explains. "It would be unjust to define us as a value investor or a growth investor. Each investment has its own merits and should be evaluated individually."

As a standalone allocation, an investment in Accendo may appear quite volatile due to its portfolio concentration. "The diversification issue disappears on the investor level," argues Österlund, as the fund's investor base – comprising professional investors such as family offices – already maintains a wide range of assets besides Accendo. "When investors invest with us, it is obvious that they back the ideas we have," says Österlund. "For most of our investors, with the exception of the portfolio management team itself, Accendo represents a small portion of their overall portfolios."

Leaving volatility aside, Accendo has delivered an annualized return of 10.4 percent since launching in March of 2008 and has managed to provide annual returns over 20 percent in six of the past 12 years.

Iterative Loop and Energy Transition

By Eugeniu Guzun – HedgeNordic

“We are energy experts who can extract value from the energy transition theme...”

Launched in the volatile market environment of last year’s fourth quarter, the Proxy Renewable Long/Short Energy fund has fared well since launching in December 2018. The long/short equity fund under the umbrella of Stockholm-based Proxy P Management gained 26 percent in the first ten months of its operations after gaining 36 percent in 2019 alone. A ten-month period is too short to judge the performance of a fund, but the fund focused on the megatrend of energy transition, away from fossil fuels managed to give investors a taste of what the fund can do.

Proxy Renewable Long/Short Energy is a long/short equity fund that focuses – as the name suggests – on the renewable energy and energy tech sectors. After closing down their long-biased fund focused on oil and natural gas, the four-member management team at Proxy P Management are putting all their attention and resources on the sustainable energy transition. “We are energy experts who can extract value from the energy transition theme,” claims the firm’s CEO, Dan Lindström.

The decision to shut down the fund focusing on oil and natural gas and focus on the energy transition thematic fund instead is threefold. First and foremost, “too few investors wanted exposure to oil,” explains Lindström. Second, “the opportunity set is much wider in the renewable sector.” Lastly, “the renewable energy sector is more diversified,” according to Lindström, and “offers us

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opportunities to find and generate uncorrelated returns." Proxy P's CEO emphasizes that "investing in renewables is nothing new for us, but having a dedicated fund is."

"Growth opportunities can be found in a lot of different areas," emphasizes Lindström. The wind, solar, biomass, and geothermal sectors have all developed in recent years, but "then you also have energy technology" and many other emerging fields. "Renewable energy is a very wide sector, covering everything from installing solar panels and windmills to developing software that improves energy distribution efficiency." Whereas opportunities do exist in the oil and natural gas sector, acknowledges Lindström, that sector "is not a growth case anymore."

Expecting that "there will be gigantic growth and value creation, and gigantic destruction of value," careful stock selection can make the difference between a strong-performing fund and a mediocre one in the renewable energy space. "We have been successful at extracting uncorrelated returns from the sector," says Lindström. Renewable energy stocks have performed strongly in 2019, which partly explains the strong performance of Proxy Renewable Long/Short Energy. "But we are still 15 percent over the benchmark with a market beta of 0.9, and we have outperformed the index in every month when it was down."

Top-Down, Bottom-Up Iterative Loop

Because the renewable energy sector has entered a phase of rapid change, the Proxy P team relies on a combination of top-down and bottom-up approach to find today's and tomorrow's winners benefiting from energy transition. "We are chasing growth opportunities related to the energy transition theme, which are experiencing growth for the right reasons," explains portfolio manager Jonas Dahlqvist. Growth for the right reasons stems from existing and future themes in the renewable energy and energy tech sectors, identified by the team's top-down thematic analysis.

"Since energy markets are our expertise and our team has extensive experience in the field, our analysis process starts with a bottom-up approach that involves looking for growing companies." To assess whether companies grow for the right reasons, the team aims to "connect individual companies or a group of companies with a specific theme identified by the top-down approach," explains Dahlqvist. "In the end, we are trying to find growth companies with a strong tie or connection with a specific energy transition theme."

"There are thousands of companies in the energy transition area – and when you meet them, you are almost tempted sell your house and invest all the money in them," jokes Lindström. "Unfortunately, though, most of them will fail in the end," he acknowledges. The Proxy P team, therefore, invests in companies that are starting to show progress and are experiencing strong growth. Around 90 percent of the fund's holding companies are profitable. As Dahlqvist explains, "we employ deep classical bottom-up analysis and spend a lot of time understanding the growth opportunities of individual companies."

Despite focusing on finding high-growth opportunities, the quality of a business and valuation are two other essential aspects the team considers. "We are growth investors, but we pay a lot of attention to the valuation component," emphasizes Dahlqvist. "Great companies usually do not come cheap," he adds. "It would be fantastic if we could find the most compelling stories and pay a price-to-earnings of five, but that never happens." The Proxy P team mostly considers valuation on a relative and historical basis.

The team also spends time analyzing the quality characteristics of a business. "Basically, we are looking at the operating cash flows of individual companies, leverage, and their ESG footprint," says Dahlqvist. Higher quality companies tend to generate positive operating cash flows and are showing an ability to turn their EBITDA into real cash, according to the CIO. "The quality characteristics are not really driving the performance when everything else looks good," argues Dahlqvist, "but a portfolio of higher-quality companies will perform better during rainy days than a portfolio with companies that have less impressive quality characteristics."

As Lindström sums up, "the top-down approach involves analyzing subsidies, regulations, competition, as well as understanding the underlying market and the local set up." The whole stock selection process, however, represents "an iterative loop where we move from the top-down approach to the bottom-up approach and back." The process blends a high volume of company-level data with fundamental thematic analysis to capture the success factors of potential winners in the energy transition case.

Dan Lindström

CEO
Proxy P Managemen

Jonas Dahlqvist

Portfolio Manager
Proxy P Management

According to Lindström, one needs to use a top-down approach to understand which companies are most likely to succeed, and within what time frame. "It is important to understand the whole sector." This iterative loop allows the Proxy P team to build a portfolio consisting of 28 long positions and nine short positions, where most of the shorts are paired with long positions. "We aim to maintain a concentrated portfolio to generate alpha," says Dahlqvist.

The long and short positions in the fund's portfolio constitute relative investment opportunities. One such opportunity could involve going long solar stocks and shorting coal producers, "which will be at a disadvantage in the long run as result of the move into renewables," according to Lindström. However, such a bet could trigger losses "as a pair of that composition can be completely uncorrelated for long periods of time." Dahlqvist explains that the team tries to "focus on high probability pairs" instead. "Going long the best positioned wind turbine producer and shorting the one that has failed to scale production or technology" represents one such example.

Advanced System for a Truly Global Focus

The origins of Proxy P Management stem from the current team's time at state-owned energy company Fortum. "The three of us met at Fortum, where I was running a proprietary trading group covering energy commodities," says Lindström on how he met Hans Berglund and Jonas Dahlqvist. At Fortum, the team also started building and maintaining an "inhouse-developed proprietary portfolio and risk management system that resembles a very advanced database that we can extract almost anything from," says Lindström.

"The system helps us in everything, from analysis to portfolio management, risk management and sizing of positions." The reason for building the system was to be able to analyse large quantities of data and enable portfolio managers to focus on where they add the most value. "There is no way one can cover the entire global space as a fundamental and discretionary manager, especially a fast-evolving industry such as the renewable energy space," says Lindström. "We are a global sector fund. To be able to be global, we need a system that can enable us to be truly global."

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IN FOCUS: Value Investing

By Eugeniu Guzun – HedgeNordic

Value investing, as an investment strategy, is often traced back to Benjamin Graham – regarded as the father of value investing – and is based on the notion of buying something for less than its intrinsic worth, ideally with a margin of safety. Graham's "Security Analysis" published in 1934 and "The Intelligent Investor" published in 1949 established the foundations of value investing. The books introduced the concepts of intrinsic value and Mr. Market, and the approach of seeking a margin of safety in the price one pays for a stock versus its intrinsic value.

Besides the two invaluable tomes, perhaps Graham's most lasting contribution to the development of the value strategy is the rise of Warren Buffett, who studied value investing under Graham at Columbia University and worked for Graham's firm for a short period. Graham might have coined the term "value" and established many principles today's value investors are using, but value investing certainly means many things to different people. Value investing does indeed come in many different shapes and colours, mostly because of different interpretations of how "value" can be derived.

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Whereas the central tenet of value investing is to search for stocks priced under their intrinsic values, what exactly a company's intrinsic value is or how it is calculated differs from investor to investor. Warren Buffett defines intrinsic value as the "discounted value of the cash that can be taken out of a business during its remaining life." Just like Buffett, some investors consider future cash flows to determine intrinsic value, while others focus on net worth (assets minus liabilities) and simple valuation multiples to assess what is expensive and what is cheap. Graham's strategy, for instance, was often referred to as "cigar but" investing and involved investing in companies whose shares traded far below their liquidation values.

Intrinsic Values

Benjamin Graham's approach of investing in companies trading below book value (of equity) performed extremely well in Graham's time and up to the late 1980s, as corporate investments were primarily channelled in tangible assets (such as property, plant, equipment, airplanes, among others). Because most of these investments are capitalized rather than expensed, book values reflected these investments and were, therefore, seen as relatively accurate representations of intrinsic values.

With a far-reaching transformation of corporate business models, investments in internally-generated, value-generating intangibles such as research and development, IT, brand development, and human resources (which are expensed rather than capitalized on the balance sheet) have fuelled a book value mismeasurement. Same goes for the popular price-to-earnings ratio. The reported earnings of companies with increasing investments in intangibles are likely understated due to the immediate expensing of intangibles. Popular valuation metrics such as the price-earnings ratio and price-to-book ratio, therefore, do not always paint an accurate picture.

That can be one reason why the stocks many call value – usually referred to as stocks with low price-to-earnings or low price-to-book – underperformed their growth counterparts in recent years. Despite appearing more expensive on a relative basis, certain so-called growth stocks might represent real value if their intrinsic values are lower than their market values.

Investors often think of growth as the opposite of value and the other way around. As Andrew Ang, Head of Factor Investing Strategies at BlackRock, writes, "many investors pit value against growth like two gunslingers in an old western movie." But for Warren Buffett and many others though, all investing (value investing, growth investing, or whatever flavour of investing one may think of) involves buying something for less than worth. As Buffett once wrote, "growth is simply a component – usually a plus, sometimes a minus – in the value equation."

> "Many investors pit value against growth like two gunslingers in an old western movie."

That said, a traditional value stock (the stock of a struggling bank or retailer, for instance) may not represent a value investment, whereas a pricier growth stock can represent a value opportunity if it trades below intrinsic value.

Growth Prospects, Extrapolation and Passive Money

Growth has an irresistible allure for most investors. Many observe that investors are willing to pay a lot more for growth in the current environment, which may stem from the over-extrapolation of growth prospects. Market participants over-extrapolated the growth potential of the Nifty Fifty in the early 1970s and the technology sector in early 2000. History has sent a loud and clear message on multiple occasions. Over-paying for stocks based on unrealistic expectations can lead to a permanent loss of capital (sometimes a lot of money).

The shift to passive investing might have played a role in the outperformance of growth stocks as well. The huge inflows of passive money created a "momentum trade," meaning that more money has been flowing into stocks that had already performed well and hence form a larger weighting in a given index. That certainly does not mean that the FAANG (Facebook, Amazon, Alphabet, Netflix and Google) stocks are currently over-priced and cannot represent value investments. At the end of the day, each investor can have a different assessment of the intrinsic value of a company and several of the FAANG stocks are trading at, or sub, market multiples.

All Good Investing is Value Investing

Buffett and Charlie Munger, arguably today's flag-bearers of value investing, reckon that the term "value investing" is redundant, arguing that all investing should involve the act of seeking value that justifies the amount paid. Many investors and fund managers may pursue value investing without labelling themselves as such.

Not all fund managers and investors who are not embracing value investing aren't good investors. And I would not go so far as to say that anything else other than value investing is speculation (which is neither illegal, immoral nor unintelligent). But in the universe of stock pickers, smart investors and value investors (even those who are not labelling themselves as such) are positioned to perform well if they seek to assess intrinsic value based on long-term fundamentals and seize opportunities with the greatest dislocations between market prices and intrinsic values.

> "Over-paying for stocks based on unrealistic expectations can lead to a permanent loss of capital."

What is Value Investing? Here's what my teacher says.

By Eugeniu Guzun – HedgeNordic

"My target holding period is forever. That forces me to buy assets that strengthen with time, ones that Nassim Taleb would call antifragile."

Most value-oriented fund managers I've met say they were introduced to value investing by Benjamin Graham through his legendary book "The Intelligent Investor." I consider myself to be a value investor; not a professional one, of course, but a value investor still. But my introduction to the field didn't come from Graham. It came from Kenneth Jeffrey Marshall, an author, professor, and value investor. For seven years he has taught the subject in the masters in finance program at the Stockholm School of Economics, as well as at Stanford University. I attended his two courses at the Stockholm School of Economics, and it was there that I fell in love with the discipline.

Value investing is often understood only vaguely, with great imprecision. But in the classroom Marshall provided a straightforward, essential guide. He was an encyclopedia on the subject for me and many of my peers. So I was sure my former teacher would again clarify it for me, and perhaps for others as well. As Marshall tells HedgeNordic, value investing is just "buying assets for less than worth. I get no creativity points for that one."

KENNETH JEFFREY MARSHALL, AUTHOR, PROFESSOR, VALUE INVESTOR

Indeed, the notion of buying something for less than its worth is perhaps the essence of value investing. And that something could be anything: a fast-growing company, a struggling business, a used excavator, or a Van Gogh painting. But Marshall adds that some might lengthen his definition. "They might add '...and selling assets for more than worth.' That wouldn't be wrong. But selling isn't my game."

Even though Marshall has taught at university since 2013, he notes that "academia ain't really my papa. The market is." He first learned about value investing thirty years ago from a childhood friend, whose father had started a value fund back in 1979. "When we graduated from college in 1989, my friend went to work for that fund," Marshall says. "He started sharing with me all kinds of value insights, talking about fundamental analysis, Omaha, the Wesco meetings in Pasadena—all of it." Marshall started investing on his own in 1990.

Marshall is the author of the book Good Stocks Cheap: Value Investing with Confidence for a Lifetime of Stock Market Outperformance published in 2017 by McGraw-Hill. I've been using it as my investing bible since I took his class. The book lays out Marshall's approach, which is simple and intelligent. "I buy good stocks cheap. That's it," he explains. "So there's a lot that I don't do. I don't buy anything expensively, I don't buy bad assets at any price, and I don't sell," he says. "That leaves me with a pretty small sphere of activities to get right."

His no-selling policy stands out. "My target holding period is forever. That forces me to buy assets that strengthen with time, ones that Nassim Taleb would call antifragile." For that reason, macroeconomic considerations don't dominate his decision making. "Forever is going to include a lot of different macro environments. It's going to have high and low interest rates, booms and recessions, high unemployment and full employment." Marshall therefore hunts for companies that will thrive under all sorts of conditions. "I don't spend time trying to guess who's going to win an election, or what interest rates will be, or anything like that," he states.

The Value vs. Growth Distinction: Fuzzy Thinking

Analysts, fund managers and many others usually differentiate between value and growth investing. But Warren Buffett has referred to that distinction as fuzzy thinking. Unsurprisingly, Marshall agrees with the master. "It's fuzzy because, in truth, you want both. You just want to make sure that each term describes the right thing," he says.

"You want value to describe price, and you want growth to describe value. You want to buy a listed equity at a price that makes it a value even if earnings and free cash flow trudge along at some modest run rate. But then once you own the stock, you want earnings and free cash flow to really skyrocket."

Three Reasons Why Value Investing Has Underperformed

The value investing style has lagged the growth investing style since the financial crisis. Marshall sees three reasons for this. "First is the light regulation of many so-called growth companies" like internet media firms. "Most of the big ones are in the United States, where they have a huge domestic market," he states, adding that "in that huge domestic market they are considered platforms, not publishers." This distinction "relieves them of many of the burdens that old-school media companies shoulder."

"Newspapers are responsible for the content on their pages," whereas social media sites are less responsible. As a result, social media firms "are not terrified by libel lawsuits, so they spend relatively less on editing, which gives them a cost advantage," explains Marshall. "American online retailers have also enjoyed light regulation," he adds, since online retailers did not have to collect sales tax for years. Consequently, "consumers who managed to get free shipping—which was not hard—got better deals from the web than they did from physical stores."

Marshall's second reason for the underperformance is the composition of benchmark indexes, many of which are market-weighted. As a company's market cap grows, it becomes a bigger and bigger part of indexes. "This makes indexes start to act a bit like momentum funds, momentum funds fuelled by the ballooning prices of lightly regulated internet companies," he argues. "Benchmarked against this orgy, value lags."

Kenneth Jeffrey Marshall is an author, professor, and value investor. He teaches value investing in the masters in finance program at the Stockholm School of Economics in Sweden, and at Stanford University. He also teaches business at the University of California, Berkeley. Marshall holds a BA in Economics, International Area Studies from the University of California, Los Angeles and an MBA from Harvard University.

His third reason is the bull market. "Value underperforms in bull markets," notes Marshall. "That's established. It's when things crash that value really shines," he emphasizes. But that shining may already be happening. Marshall stresses that while many value-oriented managers have been trailing in recent years, "many of the underperforming value funds are really deep value funds," based on a predominantly quantitative approach. "But remember that there are plenty of value portfolios that consider qualitative factors like moat, customer breadth, and the threat of new entrants. Many of those portfolios are private. They don't report. And they've been doing fine."

Is Value Investing Dead?

I often hear claims that value investing is dead. But Marshall argues that that's impossible. "Let's say that value investing is dead," he hypothesizes. "That would mean that the inverse of value investing is alive. That inverse would be buying assets for more than worth. The path to success would be overpaying. Could that ever be true?" He sees the answer as self-evident: "No."

"Admittedly, there are issues around the definition of worth," reckons Marshall. "It's hard to gauge the worth of an unprofitable enterprise in a new industry that just had its IPO." But he thinks that some fund managers do that well. "They are able to calibrate the worth of such a venture, and to buy it for less," says Marshall. "That is value investing."

The rise of technology giants may have challenged quant-heavy, deep value investors and fund managers. "This is because of how accounting rules force companies in new industries like internet media to report," explains Marshall. "Some transactions that get expensed might be more meaningfully capitalized and depreciated. So purely quantitative value strategies could have a tougher time."

"But it has always been easy to get misled by numbers alone," stresses Marshall. That's why he obsesses over what some might consider to be softer considerations. "I'm very interested in sustainable competitive advantage," says Marshall. "It's just harder to get caught in a value trap when you think about qualitative factors. Not impossible, but harder."

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"Do not start with the valuation of a company. Instead, start with fundamental analysis and get to know the business really well..."

left to right: Karl Eckberg, Stefan Roos, Carl Rydin

If It's Broken, Fix It!

By Eugeniu Guzun– HedgeNordic

Many high-quality businesses are likely to face severe challenges at some point in their business lives. Some problems are short-lived and solvable, whereas others are more structural and can bring a business into the ground. Stockholm-based Origo Quest 1 scouts the Nordic small- and mid-cap space for inexpensive, high-quality businesses with solvable shorter-term issues and engages in active ownership to fix the problems and unlock hidden value.

HUNT FOR STRUGGLING HIGH-QUALITY BUSINESSES

Struggling businesses often sell at cheap share prices, but most of them are cheap for a reason. Finding great businesses with genuine short-term issues (rather than long-term term structural problems) with inexpensive valuations is no easy task, according to Stefan Roos, who co-manages Origo Quest 1 alongside Carl Rydin. "That is the hardest part of our job," exclaims Roos, who points out that "it is easy to stumble into value traps." Roos then offers a piece of advice on how to avoid value traps.

"Do not start with the valuation of a company," says the founder and chief investment officer of Origo Capital. Instead, "start with fundamental analysis and get to know the business really well by following the company for a long time." Using this tactic, the two fund managers aim to identify high-quality businesses with good cultures and strong market positions in the Nordic small- and mid-cap space. Whereas quality can mean different things to different people, Roos describes a quality business as one that has a "pretty strong market position, good track record and some uniqueness in their business model."

Carl Rydin, who joined Origo Capital in mid-2017, explains that "if you look at some of our long-term holdings, one common characteristic is that they are the top players within their niches." Their business operations are not "overly scattered around," argues Rydin, who says that Origo's holdings "are usually more niche players."

The ability to earn money in cash rather than just deliver accounting earnings represents another common characteristic of Origo's positions.

"There are a lot of companies out there today not really earning any cash," says Rydin, who adds that "the visibility for these companies to earn cash in the future is fairly limited." Ideally, the Origo team searches for businesses that are "able to generate cash and grow operations without investing too much." Roos emphasizes that generating cash nowadays is not enough. "We also need to anticipate growth in cash flows, so that we are not stuck with value traps," argues Roos. "Some companies are making a lot of cash today, but we need to have future growth in cash flows as well."

An essential aspect of Origo's stock selection process involves assessing the quality of management teams. The quality of management is crucial in smaller companies, according to the duo, who spends a lot of time trying to understand the quality of each management team. "To identify a good management team, you have to follow them for a while, pay close attention to what they are saying, how they are acting and whether they are delivering on their promises," explains Roos. "Our

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approach is to meet management teams very often to get to know them more than one can learn about them by just reading annual reports." Rydin points out that they "like management teams that are fairly humble, but professional and focused on what they do."

ACTIVE ENGAGEMENT, NET EXPOSURE AND SHORT BETS

Origo Quest 1 engages with the management teams and boards of their portfolio companies in an attempt to steer those businesses in the right direction. "Engaging with companies is what makes us different from other players in this space," argues Rydin. With around 15 to 20 names in the long book at any given time, the Origo team usually acts as "an extra-active owner" in about half of these holdings. The top five holdings usually account for between 40 to 50 percent of Origo's long book. "If you look at our high-conviction cases in the past years, those have been the ones we engaged with more," points out Roos.

Origo's active approach to investing comes hand in hand with a long-term view. Having a long-term perspective is another crucial aspect of Origo's approach, reckons the duo. "We allow ourselves to have a long-term view than most others," argues Rydin, who says that "there are some examples in the fund's history where after three to five years, the business and investment case looks totally different than they did initially." Origo tends to invest in the type of businesses that "one would probably not invest in if you ask the question of how the company is going to do in the next six months." The typical holding period in the fund's long book averages between four-and-a-half to five years. "We might have been too early in some of our previous investments," reckons Roos, "but they start to pay off after a while."

"Actually, we have a quite long horizon for our short positions as well," exclaims Roos. "Seven years back, at the beginning of the fund, we thought we had to have a short-term vision on the short book," says Roos. "But looking back now, we maintained short positions for long periods." Origo Quest 1 maintains a similar number of short positions as long positions, usually between 15 to 20. "Short positions are more equal in terms of sizing," according to Roos. Origo Quest 1 usually maintains an average net market exposure between 30 percent and 50 percent, and ended the month of July with a net exposure of 51 percent.

"If we were to put our short positions in clusters, one type of shorts we do involves finding high-conviction cases with specific catalysts on why a stock should go down in price, and another type covers theme-based shorts," explains Rydin. Short candidates in the first type of shorts include companies with some accounting irregularities, where their cash profiles differ from the accounting earnings displayed in the income statement. The second type includes short positions in companies operating in industries that are in a structural decline. The Origo team looks for companies "that have to invest a whole lot just to stay competitive."

WHAT IS VALUE?

"Value is a very complex theme to discuss," reckons Roos, who next asks the question of what is value? Just as with the term "quality," the "value" term means different things to many people. "As I think about value, a value opportunity could be both a growth company or a non-growing company implementing the right type of actions," explains Roos. "And in the end, all good investing is value investing. I consider myself a value investor, but I may have a different view from others of what value means."

"A value investment for us means that the price we pay is clearly lower than the value of the company," says Roos. "We do not have one super-formula to calculate the value, but we use a mix of formulas instead." Free cash flow and owners' cash flow in combination with long-term growth in cash flow are important metrics for the Origo team.

Explaining the underperformance of so-called value stocks versus growth stocks in recent years, Roos considers that ultra-low interest rates explain most of the relative underperformance. "Investors have been willing to pay more for stocks with high-growth potential," he explains, adding that "this is a typical pattern in bull markets where risk appetite is high and flows into passive funds and momentum stocks are massive."

Cheap money has been the key driver for growth stocks, but Roos expect this to turn around at some point in time. "The environment today looks very similar to the market conditions back in 1999 prior to the tech-bubble," says Roos. "When investors once again go into a risk-neutral or risk-off mode, I think value will make a great comeback," he concludes.

Upside Potential is Overrated. Downside Protection Underrated!

OLA WESSEL-AAS
FOUNDING PARTNER,
PORTFOLIO MANAGER
TAIGA FUND MANAGEMENT AS

By Eugeniu Guzun – HedgeNordic

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

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

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MARGIN OF SAFETY: TAIGA'S STARTING POINT

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

"It is important for us to understand the business and how the business is structured around a commercial activity, which will determine the results but, not least, the risks associated with producing those results,"

Wessel-Aas clarifies Taiga's investment approach. When investment opportunities offer a sufficient margin of safety in terms of business risk, "that is when we can start looking for upside." When downside risk is limited, and the valuation and upside potential are attractive, "then that is a safe bet to make."

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

CONCENTRATION AND PORTFOLIO CHARACTERISTICS

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

> "What I feel we may be doing differently from many equity-focused fund managers is that we always start with the downside."

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

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

APPROACH TO SHORTING

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

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

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

TAIGA'S VIEWS ON VALUE INVESTING

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

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

Pasi Havia
Portfolio Manager HCP Quant
Helsinki Capital Partners

One Value Strategy, Two Sources of Alpha (Perhaps Three)

By Eugeniu Guzun – HedgeNordic

Value investing – buying stocks priced cheaply relative to fundamentals – has simply not worked for most investors over the last decade. "If the last ten years have been challenging to the value investor, then the last five have been pure torture," exclaims Pasi Havia, the portfolio manager of systematic value-focused fund HCP Quant.

The fund was launched under the umbrella of Finnish asset manager Helsinki Capital Partners in June of 2014, at a rather difficult time for most value investors. HCP Quant experienced both up and down years since inception, but Havia predicts (and hopes for) a bright future ahead for value investing. "The underperformance of value investing cannot go on forever; things tend to mean revert," claims Havia.

One Strategy, Two Sources of Alpha, Perhaps Three

HCP Quant is a quant-heavy systematic value fund managed by Pasi Havia, who, in a previous life, was one of Finland's most well-known investment bloggers. The fund currently maintains a concentrated portfolio of 20 cheap stocks from all around the world. HCP Quant mainly focuses on small- and mid-cap stocks, because "these segments of equity markets are often under-analysed," according to Havia. The fund's investable universe, therefore, covers companies with market capitalisations starting from €100 million up to €10 billion.

"Most companies on stock exchanges are small- and mid-sized companies," says Havia, who emphasises that his systematic approach of picking stocks enables him to cover the massive universe of small-cap stocks. "This space is under-analysed, which hopefully gives me an edge," argues the portfolio manager, who has a background in IT and programming. "There are so many professionals doing a really good job at analysing companies in the large-cap space, so my edge is pretty much inexistent in that world using my quantitative strategy," acknowledges Havia.

In essence, HCP Quant attempts to capture both the so-called "size premium" – which states that smaller-cap stocks outperform large-caps on average over time – and the "value premium." Furthermore, inexpensiveness is not the sole parameter in HCP Quant's systematic approach to investing. The fund searches for cheap stocks among a pool of high-quality stocks in the small-cap space.

> "The underperformance of value investing cannot go on forever; things tend to mean revert."

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To define, quantify and identify quality, Havia relies on the so-called Piotroski F-Score. This technique spits out a score between zero and nine that quantifies the strength of a company's financial position. According to Havia, the Piotroski F-Score "considers nine different characteristics of company fundamentals" such as return on assets, gross margin, asset turnover, among others, where each criterion has a binary value of either one or zero. "I use the Piotroski F-Score as a quality check of the companies I invest in," explains Havia.

Because the Piotroski F-Score relies on a considerable volume of accounting data, Havia uses a separate technique to check the possibility of earnings manipulation. "I need to be sure that the numbers that I incorporate in the quantitative model are accurate and are not cooked numbers," says Havia. The portfolio manager uses the Beneish M-Score to safeguard against manipulated earnings. "Using the Beneish M-Score, which gives the probability of a company cooking its books, I make sure that I can trust the data I am feeding my model with."

From a pool of smaller-sized companies with a Piotroski F-Score between seven and nine, HCP Quant builds a concentrated portfolio of, what he considers, extremely cheap stocks. Companies that pass HCP Quant's investment criteria have low valuation on several metrics such as price-to-earnings, price-to-cash flow, price-to-sales and enterprise value to EBITDA. "In the end, I rank all stocks using one valuation metric," with the cheapest stocks ending up in the concentrated portfolio of between 20 to 30 stocks. The fund's existing portfolio of 20 stocks trades at 4.23 times cash flow, 7.83 times earnings and sports an annualised dividend yield of 5.66 percent. Anyone seen anything cheaper?

Behavioural Biases and Risk Management

Because humans are prone to behavioural biases and some value stocks are "unsexy and look scary," Havia executes his quantitative value investing strategy in a systematic way. "Quite often, we as humans, are the enemies of ourselves," claims Havia. For that reason, the portfolio manager avoids market timing by maintaining a fixed holding period of six months for each position. He also uses equal weightings in the portfolio, arguing that "I am not saying that this stock is better than the other one." Because "I do not attempt to engage in market timing, I partly re-balance the portfolio every month," says Havia. "Every month, I am selling a few stocks and adding a few new ones."

Because there is no discretionary approach to portfolio management at HCP Quant, Havia has a safeguard to reduce volatility in the fund's returns. Specifically, the portfolio manager uses a stop loss of 20 percent that "can trigger a sale even though the position did not stay in the portfolio for six months." As Havia explains, "the reason we ended up using the stop loss is partly because of risk management." If HCP Quant had not used a stop loss, the volatility in the portfolio's returns would have been higher. "The stop loss is an important part of risk management because my portfolio already has high volatility stemming from the small-cap-focus."

Thoughts on Value Investing

For Havia, "value investing means low valuations." There is a wide range of valuation metrics one can look at, "but that does not really matter for me," reckons Havia. "No matter which valuation metrics you used in the past decade, you most probably did not end up delivering good results anyway," he argues.

The underperformance of value stocks is partly attributable to the zero-interest-rate environment, argues Havia, who adds that "there is a lot of cheap money flowing into high-tech companies that can fund research and growth easily." Another reason stems from the growing volume of capital flowing into exchange-traded funds and index funds, which tend to favour large-cap stocks at the expense of smaller-sized companies. "These days so many investors put money into ETFs and index funds without considering valuations," says Havia. "Maybe I am biased because I manage a value investing fund myself, but to me, it is a little bit worrying that there is a huge number of investors who do not really care about valuations."

"The valuation spread between value and growth stocks is at the same level as during the tech bubble at the beginning of the century," argues Havia. "I do not know when this gap is going to disappear, but value investing still makes sense." Everything is about probabilities to Havia. He looks at the world through probabilities, and he approaches investing with probabilities. "For me, it is more probable that low-valued stocks will do better than non-value stocks over time," concludes Havia.

Andreas Bomann-Larsen and Christer Bjørndal
CARN Capital

The Value in Sustainability

By Eugeniu Guzun – HedgeNordic

Many investors and fund managers do not want to disregard the well-being of the earth and society, and many investors are eager to generate both business and social returns from their investments. CARN Long Short is an Oslo-based long/short equity fund that aims to "do well by doing good." Relying on a fundamental stock picking approach to investing, the fund founded by Christer Bjørndal and Andreas Bomann-Larsen seeks to build a concentrated portfolio with long-term holdings in sustainable companies in the Nordics.

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CARN Long Short mainly invests in high-quality companies that have "excellent economic characteristics, outstanding management and a sustainable business model," as well as operate "a business model that aligns with solving the Sustainable Development Goals." According to Bjørndal, "as capital allocators, we have a social responsibility to make sure that we are not funding unethical or unsustainable businesses." More importantly, "it is not only crucial that the companies we own are not hurting the planet and consumers," they have to bring business, societal, and ecological benefits as well.

Focus represents an essential pillar of CARN Long Short's investment approach. For that reason, the CARN team concentrates on the Nordics and spends "most of our research efforts on small- and mid-cap companies, as we find the most compelling investment cases in the less-research part of the market," explains Bjørndal. With about 1,500 listed companies in the Nordics, "most market players focus on about 10 percent of these companies," reckons the portfolio manager. The focus on a niche of the market with less research coverage enables Bjørndal and the team to "find companies that are often overlooked and with much larger upside."

MAIN CHARACTERISTICS OF PORTFOLIO AND HOLDINGS

CARN Long Short maintains a concentrated portfolio of maximum 30 positions, with around 20 names on the long side and ten names on the short side. The fund's net market exposure has oscillated between 60 and 80 percent since its launch in late 2015, and "that is where we want to be over time," says Bjørndal. As the CARN team are bottom-up investors, the net exposure depends on the investment opportunity set.

The concentrated approach ensures that CARN Long Short maintains a very low overlap of stocks with stock market indices. "We do not care about market indices," says Bjørndal, who adds that "we are truly active in the sense that we have a close to 100 percent active risk and our portfolio has large deviations from indices." As the portfolio manager further elaborates, "we strongly believe that if a fund is marketed as an active fund, it should be truly active and not a "closet" or "index-hugging" fund."

Bjørndal and his team mostly search the Nordic small- and mid-cap space for high-quality businesses, which usually "have strong balance sheets, are careful with debt, and have strong, resilient and recurring profit streams." As previously highlighted, CARN Long Short invests in sustainable companies that "have the positive impact on society as the driver for value creation." Whereas businesses may sustain poor management for a period, most businesses can eventually be killed by poor management. The CARN team, therefore, prefers investing in companies with good management teams. "We invest with management that has proven to be good at execution and where interests are aligned with us as investors," explains Bjørndal.

As the portfolio manager summarizes, "quality companies have strong balance sheets, a track record of delivering high returns to shareholders, and are in industries with high barriers to entry and good future prospects." The team continuously searches for and monitors such companies, but will only invest when these companies are attractively priced or cheap. "Price is extremely important for us as investors, as that defines the returns we and our investors will get at the end of the day," says Bjørndal. The team invests with a disciplined mindset by assessing how businesses are valued versus their underlying earnings cash flows and assets. "There are many companies we would like to own but are too expensive."

Because the market is a voting machine in the short term and a weighting machine in the long run, according to Benjamin Graham – the father of value investing, investment horizons represent a critical piece in portfolio management. Bjørndal would ideally prefer to own their holdings forever, "but as the world is a constantly evolving place, we regularly re-evaluate our holdings and positioning." Yet, the CARN team have a long-term perspective on their investments. "When we analyze a new potential company for our long book, we typically have a five-to eight-year horizon in our analysis," says Bjørndal. For maximum efficiency, the fund's long-term-oriented approach requires a long- term view from investors as well. CARN Long Short's portfolio management team stands shoulder to shoulder with their investors, as "we have all our money invested in the fund."

> "As capital allocators, we have a social responsibility to make sure that we are not funding unethical or unsustainable businesses."

As for the portfolio of short positions, the team running CARN Long Short mainly looks for "low-quality companies that are facing a structural decline and have high valuations." In other words, the Oslo-based fund predominantly looks for structural shorts in richly-valued companies with business models that are becoming less competitive due to major changes in their respective industries or other internal or external factors. Whereas some may question the ethics of short selling, betting against certain companies can contribute to market efficiency and hence bring societal benefits. CARN Long Short, for instance, occasionally comes across companies with aggressive accounting practices and makes sure to penalize those companies by going short.

THOUGHTS ON VALUE INVESTING

"There are many ways to make money in the market," argues Bjørndal. However, his team views fundamental value investing "as the most robust and time-tested method in the investment management industry." The team use the terms "value investing" and the old-fashioned "fundamental investing" interchangeably. This approach to investing "is all about knowing what we own by doing thorough analysis before investing, taking a long-term view and not overpaying," explains Bjørndal. "We are not stock traders, we are long-term owners of great businesses."

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Small-Cap Premium:

A FACTOR THAT MATTERS

(QUALITY MATTERS, TOO)

Value stocks might have underperformed broader market indices in the past few years, but Kempen Global Small-Cap managed to beat its benchmark despite giving its portfolio a value-tilt. How? Through careful stock selection.

Managed out of Amsterdam by a four-member team comprised of Jan Willem Berghuis, Maarten Vankan, Chris Kaashoek, and Luuk Jagtenberg, the Kempen Global Small-Cap Fund delivered an annualized return of 11.7 percent since launching in June of 2014 versus 10.1 percent for its benchmark, the MSCI World Small Cap Index. And here is their story:

Small-Cap Premium: A Factor That Matters

Pursing an investment philosophy succinctly described as "quality at an attractive price," Kempen's global small-cap team "are bottom-up fundamental stock pickers focused on finding true value opportunities in the small-cap space," according to Jan Willem Berghuis. The small-cap focus enables the team

by Eugeniu Guzun– HedgeNordic

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to practice a very engaged strategy, which involves frequent communication with management teams. "The advantage of investing in small-cap stocks is that we can talk to the management teams," Berghuis tells HedgeNordic, who emphasizes that communication with management "is key to understanding the overall investment case."

Having the small-cap space defined as investment universe enables Kempen Global Small-Cap to harvest the small-cap premium. "Over the long run, small-cap stocks have delivered between 1.5 percent to 2 percent higher returns on average than large-cap stocks," says Maarten Vankan.

The universe of smaller-sized public companies is a better hunting ground for active managers for multiple reasons. "Small-caps are very suited for active management, argues Vankan, "because often there is limited or sometimes no sell-side coverage." This provides ample opportunities to generate alpha, accentuates the portfolio manager.

The global small-cap team at Kempen also considers the intrinsic characteristics of smaller companies as an advantage of investing in small-caps. In this space, "management team members are sometimes the founders of the companies, with them and their families often having significant skin in the game through minority ownership," Vankan points out. "There is often better alignment between the interests of managers and shareholders," he argues.

All the benefits stemming from the exposure to small-caps may come at a cost, particularly for short-term-oriented investors. "Small-cap stocks tend to be more volatile than large-cap stocks," says Vankan, who emphasizes that "if you have a short-term investment horizon, the higher volatility could be a downside." But if you have a longer horizon of three years or more, "volatility is not very relevant as you benefit from the compounding effect of higher returns."

Quality at an Attractive Price

With over 4,000 small-cap stocks in developed markets, there is an immense amount of options when building a concentrated, market-beating portfolio. Kempen's global small-cap team relies on a proprietary in-house stock filters screening to find attractively valued high-quality stocks in that universe of over 4,000 stocks. The first step of Kempen's screening process involves finding higher-quality companies with above-average returns on capital employed, followed by a value screen that excludes three-fourths of the most expensive stocks that remained after the proceeding screening process. "This process reduces our universe from 4,000 to around 500 stocks," says Berghuis.

Jan WIllem Berghuis
Portfolio Manager (Head)

Maarten Vankan, CFA
Portfolio Manager

From there, the global small-cap team roll up their sleeves and get busy building a portfolio of 60 to 90 attractively-priced quality stocks. "From these 500 companies, our research processes focus on finding the quality companies with strong business models and management teams," explains Berghuis. These companies tend to be smaller-sized companies focusing on a particular niche. "These niche leaders enjoy the benefits of scale and are hard to compete with," adds Berghuis. Return on capital employed is a good baseline measure of business quality, and Kempen Global Small-Cap's portfolio exhibits an above-average return on capital employed versus its benchmark.

The team's bottom-up analysis process involves assessing both business and management quality. To evaluate business quality, the team relies on the five forces model developed by Michael Porter, a framework widely used to analyze a company's competitive environment. The assessment of management quality involves evaluating five "management-related items such as capital allocation, strategy, alignment, operations, and ESG," according to Berghuis. "Assessing the quality of a company and its management team are two important aspects of our approach," he outlines, further adding that the assessment of business and management quality "provides us with a margin of safety on the quality side."

After evaluating a company's quality, Kempen's global small-cap team invest in the stocks where they see a margin of safety between price and value. In the small-cap space, "we feel that share prices do not always reflect the intrinsic values of those businesses," reckons Berghuis. "It is our task to identify these mispricings and benefit from them." The Kempen team acknowledges that "investors seem to be paying less attention to valuations in the current market environment, but we want to remain disciplined with our valuation approach," says Berghuis. "Our valuation discipline could be a headwind in the short run, but we believe our approach will pay off in the long run."

> "A company with a low valuation could be true value - but could also be a value trap."

What Kempen Thinks of Value Investing

"Simply buying a stock with a low price-to-earnings multiple" is not value investing, according to Berghuis. For Kempen's global small-cap team, value investing involves finding a quality company that is mispriced. "A company with a low valuation could be true value but could also be a value trap," he continues. For that reason, value investors should arguably do more research than the average investor to avoid value traps by making sure those companies are high quality with strong management teams in charge.

Whereas so-called value stocks as a whole underperformed in the past decade, Kempen's global small-cap team has "been able to compensate for the value-tilt through stock selection over the past five years," says Vankan. "That has been the key to our success" – the key to outperforming its benchmark since launching in 2014. "If we had bought the basket of 500 stocks left after our quality and value screens, we would have underperformed our benchmark as well," adds the portfolio manager. The wide range of investment opportunities available in the small-cap space has also played a role in Kempen Global Small-Cap's outperformance. With an active share of almost 98 percent, the fund is far different from the typical index-hugging fund.

O Value, Where Art Thou?


Peter Lindahl, member of Evli's allocation team and the Head of Systematic Funds at Evli

By Peter Lindahl - Evli Fund Management Company Ltd.

Getting the timing right is always a struggle as irrational periods can last for a good while. But value today is extremely cheap in relative terms and sentiment towards value is extremely pessimistic – and we strongly believe it may be a sensible time to buy value stocks both for the short-term and the long run.

I started my financial career as a young analyst during the mid-1990s in the dry heat of a booming California. Even though the technology sector by then had started to inflate the IT bubble, one of my first job tasks was highly unexpected: to construct a list of cheap stocks based on different valuation measures such as the price-earnings (P/E) and price-to-book (P/B) ratios (a cumbersome task for an analyst in a time period when "the Internet" was a new thing and online databases did not exist). A value case that could interest smart clients, looking to buy low, sell high. A more senior colleague tried to instruct me to look for cheap stocks the "Warren Buffett way." "You better check out his investment style," he strongly advised me.

THE UPS AND DOWNS

Buffett was already quite popular in the 1990s, but back then his devoted followers were more of a "value cult." Later, on December 5th in 1996, Alan Greenspan, the conspicuous Fed Chief at the time, warned that the stock market was suffering from irrational exuberance. In other words, he claimed that the market had entered a mania phase and was becoming too expensive overall. Value investors agreed. However, Greenspan's timing was everything but accurate. Stock markets were in for one of the most exuberant periods in history, and it took more than three years of impressive price gains before the bubble burst.

Value stocks suffered one of its worst periods in the late 1990s, compared to the rest of the stock market, but especially against expensive growth stocks. Increasingly bullish investors lost faith in value – "value investing is dead," many claimed (see Figure 1).

Lo and behold, the early 2000s turned out to be one of the most powerful periods for value stocks in relative

The early 2000s turned out to be one of the most powerful periods for value stocks in relative terms. Warren Buffett and his cohort of value fans were back.

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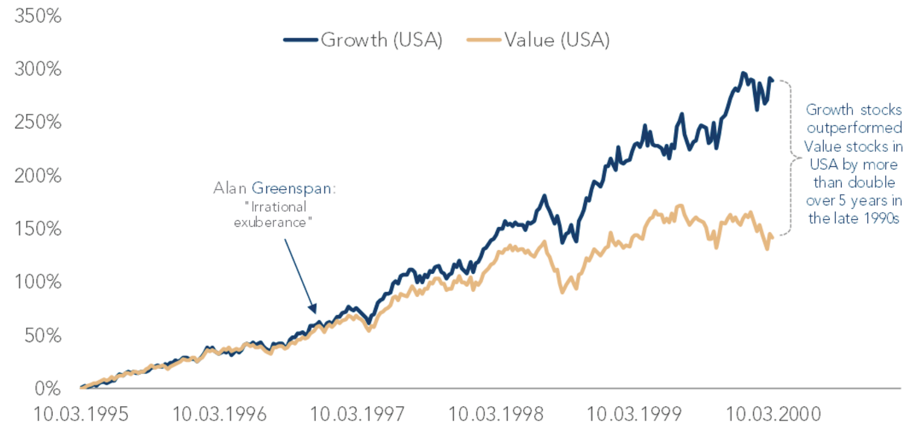

Figure 1: Value versus Growth performance (1995-2000). Source: Evli, Bloomberg, S&P, total returns in USD.

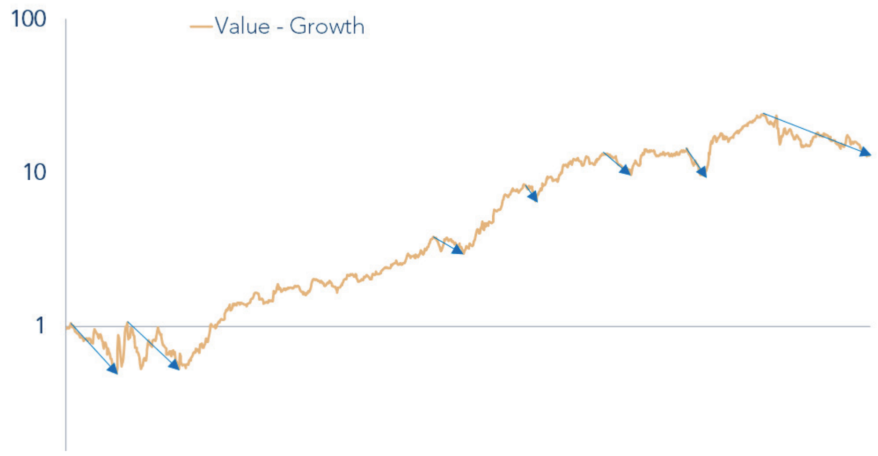

Figure 2: Value versus Growth performance (1926-2019). Source: Evli, Kenneth French website; the US equity market. Time period 07/1926-07/2019. Blue arrows show over -20 percent relative drawdowns. Log scale. For illustrative purposes only.

Figure 3: European value stocks priced at 1/3 of growth stocks (similar extreme discount levels as in 2000). Source: Evli, Bloomberg, MSCI.

terms. Warren Buffett and his cohort of value fans were back. Eventually, the ethos of value investing grew bigger and stronger as Buffett gathered tens of thousands of investors to the middle of nowhere in Omaha every year. Then came the global financial crisis.

Value investing is, without doubt, the most debated investment style among equity investors across the globe. The underperformance since the GFC has created new doubts on whether value is a sensible investment style, not to mention it being a rewarded factor for the long-term investor altogether. Investors in recent years have fled in masses to the more defensive growth stocks which have performed well not only in the past 1-2 years but also over the past ten years. But there's a mounting issue with growth stocks — they have become exceedingly expensive, while value stocks are still cheap.

THE SHORT HISTORY OF VALUE INVESTING

The foundation of value as an investment style was laid out by Benjamin Graham and David Dodd in Security Analysis which was published already in 1934. Subsequently, Graham cemented this style of investing in Intelligent Investor in 1949. Both books have influenced investors around the world, labelling Graham as the "father of value investing." This style of investing influenced the young student Warren Buffett, who already in the 1950s took up practicing value investing according to the disciplines he acquired as Graham's student.

Over recent decades, a well-established body of academic literature has demonstrated a strong case for the value premium. Basu [1977] was the first empirical researcher to demonstrate that value stocks generate higher returns than the market. Fama and French [1992, 1993] presented the value premium in an asset pricing model, labelled the three-factor model (FF3). Their work was in many ways ground-breaking and established the path academic research transformed itself around asset pricing in general, and factor research more specifically.

THE LONG-TERM CASE

Despite the bad periods, the value factor (cheap stocks) displays strong evidence of outperformance against growth stocks (expensive stocks) over long periods as well as across markets in the United States, Europe and Asia. Furthermore, the value premium is present across asset classes, e.g. in bonds and currencies.

According to data by professor Kenneth French, US value stocks have outperformed growth stocks by 3.1 percent per annum between 1926-2019 (see Figure 2). This includes all the poor value periods in history (blue arrows show the periods of over -20 percent relative underperformance). Hence, long-term value investors have got rewarded. Warren Buffett is a living example of this, although all his performance has not only been driven by the value factor.

Even in the more objective perspective as a systematic investor, value is certainly one of the more compelling factors. Value tends to have a low correlation to other factors, especially momentum. Hence, value possesses a great deal of diversification benefits – for any investor.

THE PRESENT CASE FOR VALUE

Observing historical performance, occasionally value tends to experience even long periods of underperformance. Such as in the late 1990s or more recently after the GFC. Fast forward to today, the difference in valuation levels between (inexpensive) value and (expensive) growth stocks in Europe is as extreme as it was in 2000 at the peak of the IT bubble. This goes for P/E, P/B or price-to-free-cash flow ratios. Similar extreme levels can be recognised in US and global markets, as well (see Figure 3).

Getting the timing right is always a struggle as irrational periods can last for a good while. But value is today extremely cheap in relative terms and sentiment towards value is extremely pessimistic — and we strongly believe it may be a sensible time to buy value stocks both for the short-term and the long run.

For the longer-term investor, we think value should be one of the building blocks in a strategic equity portfolio. Not only does empirical research show robust evidence of the value premium in the past, but both risk-based and behavioural theories make sensible cases why value stocks will continue to outperform markets in the long run.

In September, over the course of 1-2 weeks, a rotation in markets occurred as investors switched from styles such as momentum to value stocks. There was an especially large move upwards in value over a couple of days, which may have been an early sign implying that value is poised for outperformance in the near term. In summary, we believe the more recent technical data (extreme cheapness) and arguments advocated by academic research supporting both a tactical and strategic case for value.

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Ernst Grönblom
Portfolio Manager, HCP Focus

An Unorthodox Value Approach

By Eugeniu Guzun – HedgeNordic

Orthodox value investors have usually stayed away from asset-light tech companies, focusing on the quantitative and tangible aspects of a business instead. Finnish portfolio manager Ernst Grönblom, however, has applied many of Warren Buffett's principles of value investing to build a highly concentrated portfolio of undervalued high-quality (mostly tech) businesses such as Amazon.com, PayPal, and others.

HCP Focus, one of the three vehicles under the umbrella of asset manager Helsinki Capital Partners, delivered an annualized return of a little less than 20 percent since launching in December of 2012. This annualized rate of return puts HCP Focus on top of the list of best-performing funds in the Nordic Hedge Index with a track record longer than two years. The fund managed by Grönblom has also been ranked by BarclayHedge as one of the world's top ten equity long-only hedge funds in 11 out of the 14 previous quarters based on three-year annualized returns. No other fund in this 300-member category has managed to make the top ten list more frequently during this period.

"More often than not, companies with strong network effects create a natural monopoly for themselves."

An outsider with little knowledge of Grönblom's investing philosophy may well attribute his fund's stellar performance to the exposure to high-flying tech stocks. Grönblom, however, does not just invest in any tech company. Out of the thousands of public businesses around the world, he searches for a select group of undervalued companies benefiting from a powerful economic moat: network effects.

Grönblom employs a "back-to-basics" investing approach, which relies on a "long-term, valuation-based investment philosophy." More specifically, the portfolio manager attempts to produce good investment returns by (1) "identifying high-quality companies trading at a significant discount to my best estimate of underlying intrinsic value"; (2) assembling a concentrated portfolio of 8 to 12 such investments; (3) ignoring swings in the generally market" and staying put until his investments reach fair value, or he finds markedly superior investment opportunities or he realizes his investment thesis was faulty or changed to worse over time.

FIRST THINGS FIRST: THE IMPORTANCE OF CONCENTRATION

Grönblom's stock selection process is paramount to the fund's success so far, but there is one equally-important aspect of his investment process: portfolio concentration. Diversification is the only free lunch in finance and investing, some argue. But because of the false illusion that "more is better" in terms of diversification, "portfolio managers and money managers alike make the mistake of maximizing diversification instead of optimizing diversification," reckons Grönblom.

"Academia and the investment management industry only talk about the benefits of diversification. They never mention its costs and the diminishing marginal returns," considers Grönblom. The most obvious downside of increased diversification is that one has more positions to monitor. "The investment community forgets that fund managers have a limited amount of resources at their disposal. The industry operates under the illusion that portfolio managers are super-humans who never sleep, never eat and can process an infinite amount of information in zero time," Grönblom says.

With a year consisting of 365 days, a portfolio manager managing a portfolio with 100 stocks can use three and a half days per year of his or her time to analyze one of these stocks, Grönblom's back-of-the-envelope calculation reveals. A manager overseeing a ten-stock portfolio, meanwhile, has 36 and a half days to keep up-to-date with each investment. "Which manager is likely to make more informed decisions?" ponders Grönblom. Other adverse effects of excessive diversification include increased operating costs, portfolio dilution, among others.

Grönblom attempts to simultaneously maximize the benefits of diversification and minimize the downside effects associated with over-diversification. "In my opinion, you optimize diversification by maintaining a portfolio that holds between 10 to 20 positions." Grönblom currently oversees a portfolio containing 12 names, but randomly investing in any 12 stocks out of thousands available in the market won't do the trick.

SLOW TRAVELING IDEA: HIGH-QUALITY BUSINESSES BENEFITING FROM NETWORK EFFECTS

In the attempt to populate his concentrated portfolio with successful investments, Ernst Grönblom searches for so-called "slow traveling ideas," a concept coined by economist Jack Treynor when discussing market efficiency and the possibility of alpha generation. In contrast to simple and straightforward ideas, which require little expertise to evaluate, "slow traveling ideas require more expertise and more effort for their understanding than average ideas" reckons Grönblom. There is one slow traveling idea the portfolio manager likes the most.

"The most important slow traveling idea in my portfolio for a long time has been the concept of demand-side economies of scale, also known as the concept of network effects," he continues. A network represents an accumulation of users or customers, whose value increases as the number of users or customers joining the network increases. "Digital network giant Facebook, perhaps, benefits from the most powerful source of network effects," says Grönblom.

There is a good reason Grönblom focuses on companies that benefit from strong network effects. "Companies with sustainable network effects create winner-takes-all situations, where one company can end up dominating an entire industry due to inherent competitive dynamics," explains the portfolio manager. "More often than not, companies with strong network effects create a natural monopoly for themselves." Long story short, the portfolio manager looks for companies that have the potential to displace their competitors in the long term, thanks to the increasing power of their network effects.

Network effects may represent the holy grail for many Internet start-ups, but this rich-becomes-richer dynamic can work in the opposite direction as well and cause users to quit the network in droves. For that reason, Grönblom seeks to make sure he identifies "superior businesses with favourable long-term prospects", rather than only businesses benefiting from network effects that cannot eventually create economic value. To find these superior businesses, he analyses each company's "financial strength, sustainable competitive advantages, and quality of management."

VALUE INVESTING IN SEEMINGLY OVERVALUED TECH STOCKS

Though perhaps an unorthodox one, Grönblom is a value investor and he attempts to buy high-quality companies at a significant discount to his estimate of their underlying intrinsic values. "If my best estimate of intrinsic value exceeds the market value by a sufficiently significant amount, thus offering a significant margin of safety, I can consider the security in question as an investment," explains Grönblom. According to the Finnish portfolio manager, his approach of long-term-focused and deep-research-based investing improves his probability of good returns "simply because the competition in this particular space is less intense."

Explaining why companies such as Amazon.com trade below their intrinsic values, Grönblom says that "market participants systematically underestimate and misunderstand the power of the winner-take-all phenomenon." Whereas tech stocks have commonly scared away orthodox value investors such as Warren Buffett, Grönblom continues his hunt for value in the narrow segment of the fast-growing technology space benefiting from network effects. As he argues, "in the short run, victory goes to the investor with the most luck, but in the long run, victory goes to the one with the best process."

A BALANCED APPROACH TO GROWTH AND VALUE INVESTING

By Jonathan Barry, FSA, CFA and Indhu Raghavan, CFA - MFS Investment Management

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Managing Director and Senior Retirement Strategist, Investment Solutions Group

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Associate Director, Investment Solutions Group

Executive summary

- With growth indices generally outperforming value indices over the past 10 years (see Exhibit 1), some asset owners may be questioning the prospects for value investing going forward.

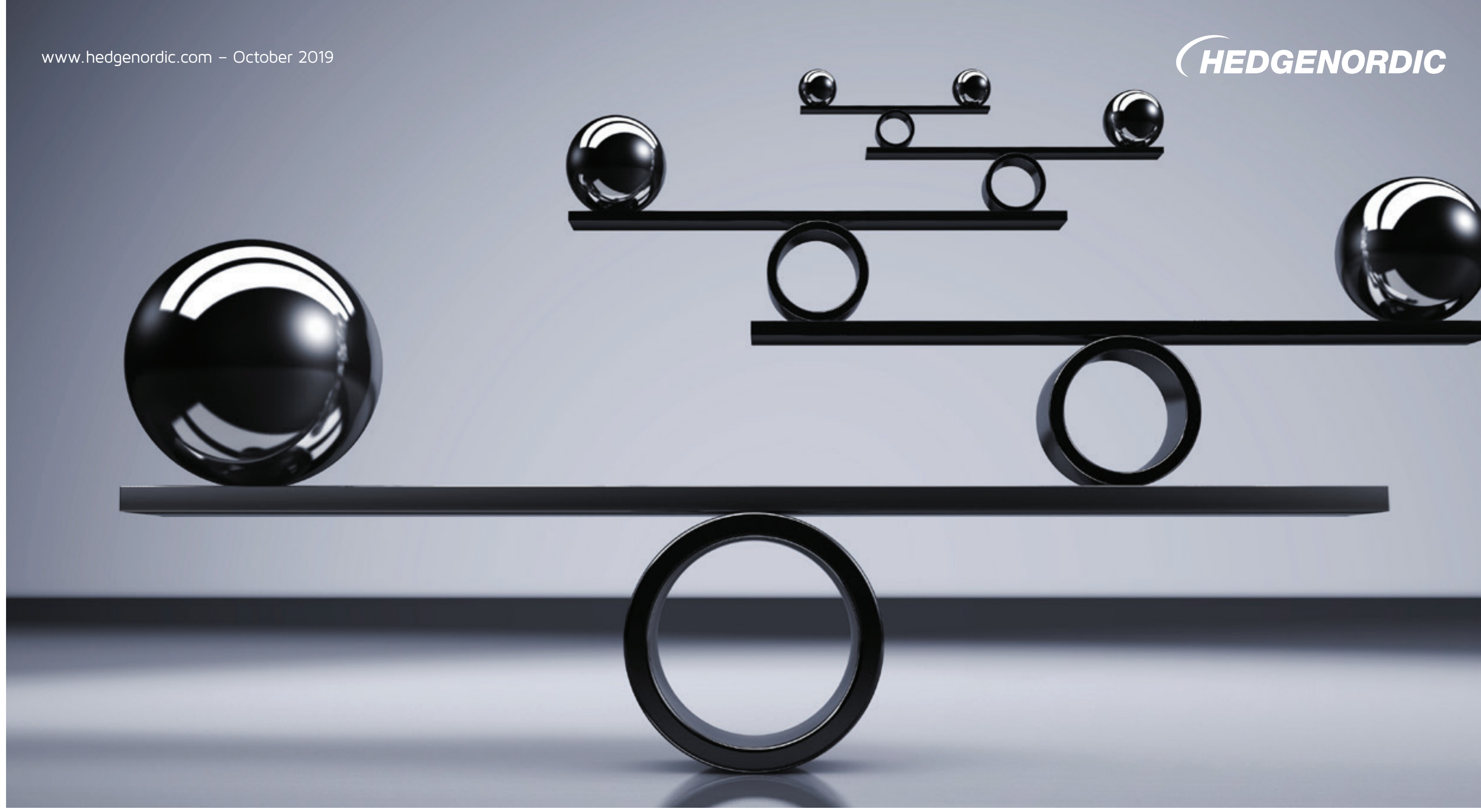
- We view style-based investing as a portfolio construction and implementation consideration rather than a strategic asset allocation issue.

- In the long term, we believe a balanced exposure to both styles leads to a better diversified portfolio both because style leadership rotates for a variety of reasons and style rotation is difficult to time and because skilled active management has generated excess return in both the growth and value styles (see Exhibit 5).[1]

MFS has substantial experience in managing both growth and value style portfolios, and we sometimes field questions around their relative performance and the merits of style-based investing. With value strategies having underperformed growth strategies over the past 10 years, we believe some asset owners may be asking the following:

- Is it time to reallocate the value allocation?

- Is it possible to time styles and factors, or should one tilt toward one or the other style or factor over time?



- Are active managers able to generate excess returns in the value space?

- This paper takes a long-term view in illustrating the relative risk/return profiles, and sector and factor exposures that growth and value style strategies can bring to the overall equity allocation.

Style decision within the investment process

The concept of investment style, such as growth and value, has been used to understand the characteristics of individual stocks, to describe a manager's approach to analyzing securities and to build benchmarks.

Where does the decision on style fit within the overall investment process? At the highest level is the strategic asset allocation and the balance of equities, fixed income and alternative investments and within the equity component, the split between domestic equity and non-domestic equity.[2]

Once the strategic asset allocation is set, portfolio construction comes into play, which may involve decisions around size, such as large cap and small cap, and style, such as growth and value strategies. The final step of the process is implementation, which involves deciding whether to access the strategies on an active or passive basis, and within active investing, decisions around the approach a manager is taking to try to generate excess returns, such as fundamental research or quantitative.

Long-term performance of style-based portfolios

Over the past 10 years, value style indices and portfolios have generally lagged the overall market as represented by the MSCI World index, and their growth counterparts. However, it is worth looking at these indices through a long-term lens. Exhibits 1 and 2 show the 10-year rolling returns and the 10-year rolling risk-adjusted returns (Sharpe ratio) for the MSCI World Growth and MSCI World Value indices, highlighting periods in which the growth index has outperformed the value index and vice versa.

As can be seen in Exhibits 1 and 2, style leadership has varied over time. Even though the most recent 10-year period has seen growth generally outperforming value, there have been long periods during which value has outperformed growth on both an absolute and risk-adjusted basis,such as between 2000 and 2010.

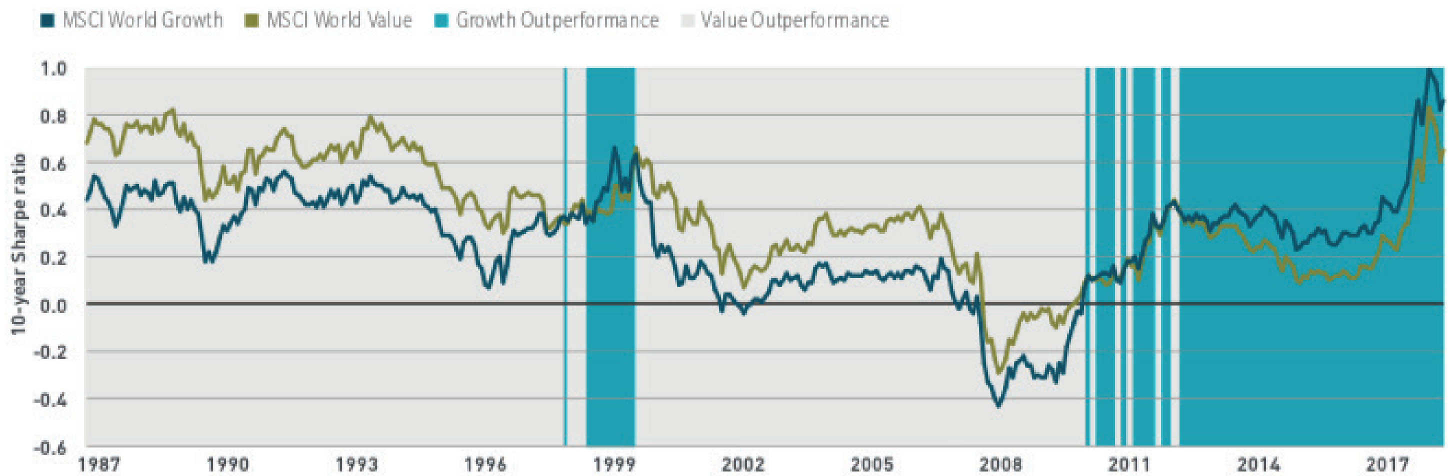
In part, this leadership rotation is due to idiosyncratic sector-specific issues that affect the indices differently. For example, during the global financial crisis of 2008-

2009, the financial sector experienced significant losses that contributed to the value index's relative underperformance in the 10-year rolling periods that include that time period due to its greater exposure to the financial sector, while during the tech crash in the early 2000s, the technology sector experienced significant losses that contributed to the growth index's underperformance. Such sector-specific issues make it difficult to predict leadership going forward.

EXHIBIT 1: ROLLING 10-YEAR RETURN FOR THE MSCI WORLD GROWTH AND MSCI WORLD VALUE INDICES

Source: Factset; as of 30 June 2019. Returns in USD. Past performance is no guarantee of future results. It is not possible to invest directly in an index.

EXHIBIT 2: ROLLING 10-YEAR RISK-ADJUSTED RETURN (SHARPE RATIO) FOR THE MSCI WORLD GROWTH AND MSCI WORLD VALUE INDICES



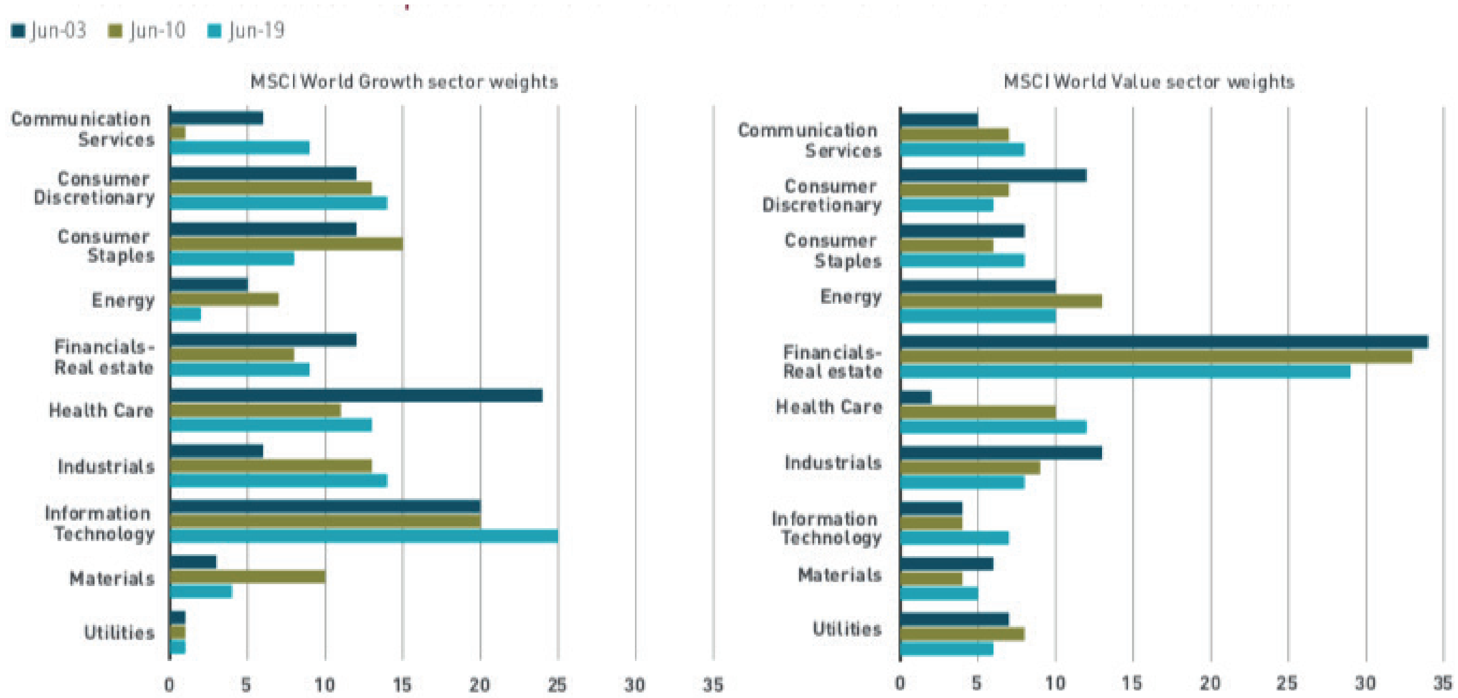
Source: Factset; as of 30 June 2019. Return and risk in USD. FTSE 3-month Treasury bill used as a proxy for risk-free asset to calculate Sharpe Ratio. Past performance is no guarantee of future results. It is not possible to invest directly in an index.

Varying exposures of growth and value styles

As noted above, some of the reasons for varying historical performance come from differing exposures to sectors. In addition, growth and value styles also offer different factor exposures, which can drive performance during various market environments.

Exhibit 3 shows how sector exposures have evolved over time for the MSCI World Growth and MSCI World Value indices. In general, the value index has offered higher exposure to the financial, energy and utilities sectors while the growth index has offered higher exposure to the consumer discretionary, industrials and information technology sectors. Sector exposures evolve along with structural changes within industries as well as the macroeconomic and market environments. For example, over the past 10 years the growth of platform-based technology companies that benefitted from scale has given rise to mega-cap companies that boost the sector weights for information technology. Conversely, valuations for banks have compressed, despite their being better capitalized than before the global financial crisis of 2008-09, and providing decent returns on capital.

EXHIBIT 3: HISTORICAL SECTOR EXPOSURES FOR THE MSCI WORLD GROWTH AND MSCI WORLD VALUE INDICES



Source: Barra model BIM 303L, as of 30 June 2019. Sector weights based on market capitalization.

Moving beyond sectors, we consider key factor exposures that can affect risk and return over time using the MSCI Factor Classification Standard framework, which places each of 16 factors in one of eight factor groups. Exhibit 4 shows the various factor exposures for the MSCI World Growth and MSCI World Value indices.

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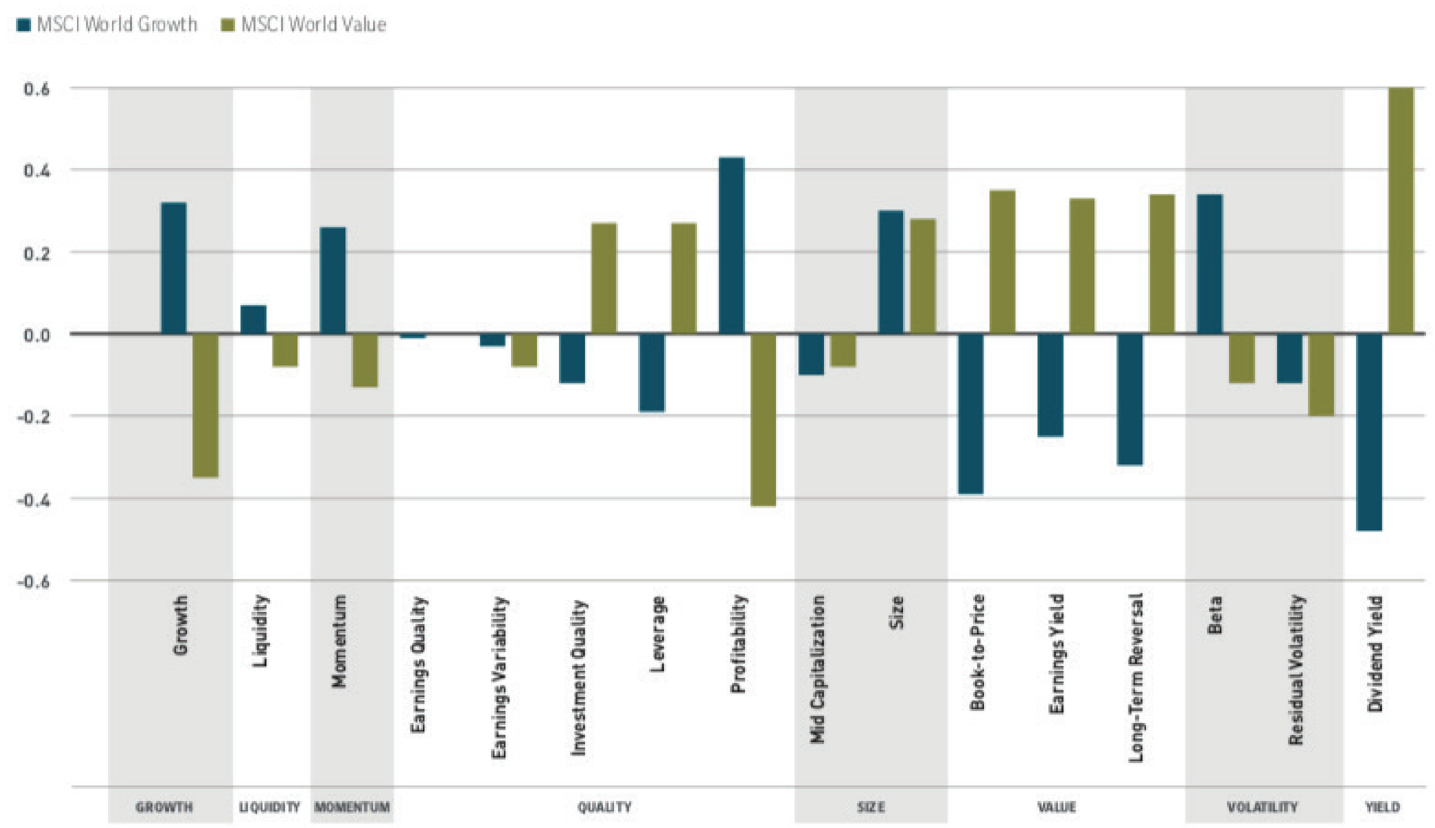
EXHIBIT 4: FACTOR EXPOSURES FOR THE MSCI WORLD GROWTH AND MSCI WORLD VALUE INDICES, JUNE 2019



Source: Barra model BIM303L, as of 30 June 2019.

The factor exposures shown here indicate the sensitivity of the index to a given factor as compared to the world investable equity universe as measured in standard deviations. For example, the constituents of the MSCI World Value Index in aggregate have a book-to-price ratio that is approximately 0.4 standard deviations higher than the median book-to-price ratio for the world investable equity universe while the constituents of the MSCI World Growth Index in aggregate have a book-to-price ratio that is about 0.4 standard deviations lower than the median book-to-price ratio for the world investible equity universe.

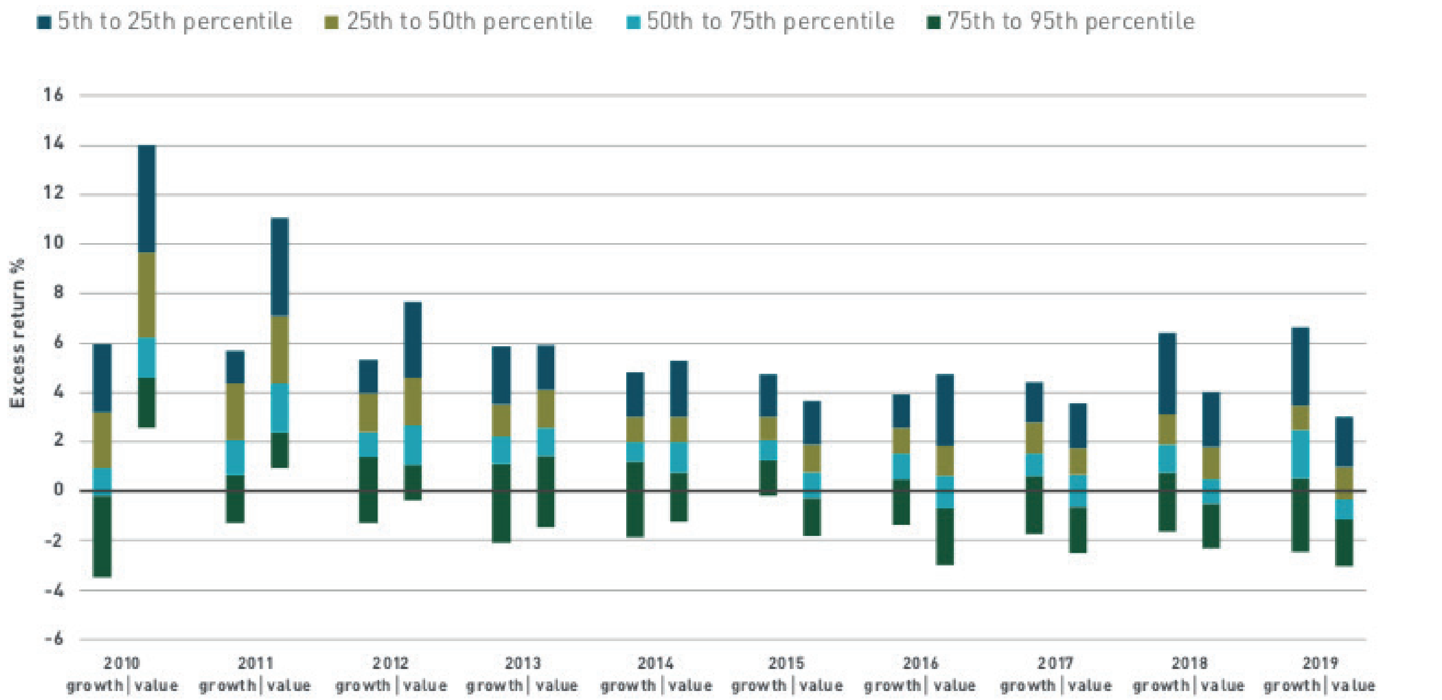
Not surprisingly, the MSCI World Value Index has higher exposure to value-related factors such as book-to-price and dividend yield than the MSCI World Growth Index. The opposite is true for the MSCI World Growth Index, which exhibits higher exposure to momentum and growth factors. The two indices have mixed exposure to quality factors. Finally, the MSCI World Growth Index exhibits higher exposure to the volatility factor (beta) than the MSCI World Value Index.

This analysis suggests that some balance between growth and value styles may be prudent given the varying exposures to these key factors. For example, a portfolio that aims to maximize exposure to quality factors could find opportunities in both the growth and value universe of stocks. Conversely, both growth and value portfolios can provide exposure to quality factors.[3]

Analysis of active management in growth and value styles

Assuming an investor wants to pursue a style-based equity portfolio, a key question to consider as we move down the chain in the investment decision-making process is whether to access a growth or value strategy through an active or a passive approach. To do this, we looked at the rolling 10-year active manager performance by style measured as excess return over the MSCI World Index, as shown in Exhibit 5.

EXHIBIT 5: 10-YEAR ROLLING EXCESS RETURN OF ACTIVE GLOBAL GROWTH AND GLOBAL VALUE MANAGERS RELATIVE TO THE MSCI WORLD INDEX



Source: eVestment. Returns in USD. Excess returns calculated gross relative to the MSCI World Index on a rolling 10-year basis. Each 10-year period includes only those managers for whom data is reported and available for the entire period.

Here we note that in the most recent rolling 10-year period (the period from 1 April 2009 to 31 March 2019) most active growth managers outperformed the index on a gross basis and in this same period top-quartile growth managers outperformed top-quartile value managers by approximately 250 basis points. We can also see that the range of outcomes for active growth and value managers is similar for the 10-year periods ending 2013 through 2017, with active growth managers demonstrating slightly better performance than value managers overall.

Finally, we observe that active value managers demonstrated significantly better results for the 10-year periods ending 2010 and 2011 with top quartile value managers outperforming their growth counterparts by approximately 650 and 275 basis points in those periods, respectively. It is worth noting that the 10-year periods ending 2010 and 2011 incorporate both the Global Financial Crisis as well as the Tech Crash of the early 2000s, which suggests that active value managers have historically had some advantage over active growth managers when considered across multiple down markets.

Conclusion

Over the long run, there have been periods of outperformance for both the value style and the growth style, and there is little evidence to demonstrate the ability to accurately time shifts in styles or factors. That said, it may be reasonable to develop frameworks that systematically rebalance or tilt portfolios based on relative relationships and/or fundamentals compared to a strategic target allocation. Importantly, although past performance is no guarantee of future results, for the time periods shown we do see that skilled active managers have been able to generate excess returns in both the growth and value styles. Thus, we believe a balanced long-term exposure to both styles could lead to a better diversified equity portfolio.

Endnotes

1 We believe skilled active managers are those who can demonstrate conviction through high active share and long holding periods, add value in volatile markets and collaborate on investment decision making.

2 Alternative investments may include private equity, private debt, unlisted real estate, infrastructure, etc.

3 It is important to note that in this analysis factor exposures are the result of an index or equity portfolio construction process, which depends on the index provider's methodology or the portfolio manager's approach (e.g., fundamental or quantitative), respectively.

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