Why Nordic Equities and Credit?

Norron Asset Management's 10 years of active alpha

HAMLIN LOVELL

Three of Norron's absolute return funds – Norron Target and Norron Select in the long/short equity strategy, and Norron Preserve in the ESG Absolute Return Bonds category – have been recognised by *The Hedge Fund Journal's* UCITS Hedge Awards 2021, thanks to their excellent risk adjusted returns within the absolute return space. Norron Select has essentially matched MSCI Nordic index returns with roughly half the volatility since inception in 2011.

The Nordic advantage

Norron eat their own cooking by investing in their strategies and their company. The firm is a classic owner-managed boutique with an evergreen partner model that empowers the growing bench of portfolio managers with ownership stakes. Norwegian industrial fishing, construction and engineering conglomerate, Aker ASA, is also a shareholder in Norron.

Norron owe part of their success to the advantages of being based in Norway and Sweden, where the team of 14 people sitting in Oslo and Stockholm can identify compelling investment ideas from their local economies, societies and capital markets.

The Nordic nations are something of a safe haven, which still have sovereigns boasting AAA credit ratings. The political climate is stable and transparent offering predictability for companies, which rank highly on competitiveness, ease of doing business, and innovation. The countries have high ESG scores: their governance shows extremely low corruption scores, and their environmental and social performance demonstrates some of the highest rankings for sustainability and human development.

"Common histories, culture and languages make it easier to compare stories between the companies," says Norron Partner, Hans Bale. Close knit business communities place a premium on maintaining trust and encourage a strong dialogue between investors and companies that Norron actively participates in.

Nordic economies have grown faster than most developed countries and proved to be relatively resilient during the Covid pandemic, despite having some exposure to cyclical sectors. Immigration is relatively high, which contributes to population growth especially in Sweden and Norway, and Nordic GDP per capita is amongst the highest in Europe excluding Switzerland and Luxembourg.

The Nordics have some of the lowest public debt in Europe (even after Covid costs) and while some other countries have unfunded public pension promises on top of their headline public debt, the Nordics have substantial pension funds for both public and private sector workers, and high levels of personal household savings. The rewards of growth are shared in an egalitarian income distribution and 80% of women work. There is also more social mobility thanks in part to high quality free local education, and some support from governments and foundations for studying abroad in the UK and US.

The Nordics are forward-looking societies and economies. Innovative companies are early adopters of technology and digitization in public and private sectors and are also at the leading edge of ESG best practices in terms of corporate behaviour, disclosure and investing. Corporate communication reflects a culture of transparency that is also seen in freedom of information laws and even personal tax returns are public.

"Listed equities in the Nordic countries can be seen as a miniature version of the world, with world leading companies in most industries well represented," says Bale. Sweden boasts financials such as Handelsbanken, SEB, Swedbank and Nordea, and engineering leaders including Volvo, Assa, Atlas and Sandvik, as well as fast fashion firm H&M and telecoms group Ericsson. Norway has more oil and gas related firms such as Equinor (the new name for Statoil), Yara and Hydro, and fisheries, such as Marine Harvest, SalMar and Leroy. Finland has insurance group Sampo, more engineering and forestry such as UPM, Stora and Enso, while Denmark has global winners in pharmaceuticals, such as Novo Nordisk and Genmab, consumer goods like Carlsberg and shipping like Maersk and AP Moller.

Historical average returns have been internationally very competitive for long only investors: between 2000 and 2020 MSCI Nordic has outperformed MSCI US, MSCI Europe and MSCI World equity indices. Local investors also understand the diversification benefits of alternative strategies. Sweden ranks as one of the largest three or four hedge fund management hubs in Europe, after the UK, France and Switzerland, and retail investors have for many years been able to diversify into hedge funds. Nordic equity markets have been a rich canvas for hedge funds' alpha generation, hence Nordic asset managers are punching above their weight at fund performance awards including the UCITS Hedge Awards.

Alpha generation

Norron Select has generated an impressive average annualized alpha of 12% since 2011, which has mostly come from the long book. Norron Target, which has a lower volatility target, has delivered average annual alpha of 8% since 2011 on its equity book.

The long books invest across nearly all sectors. When looking at companies in the Nordics with a market cap above SEK 1 billion, Norron's hard exclusion criteria only reduces the investable market cap by less than 10%, due to excluding

Norron's strategy menu

Norron has a 10-year track record of competitive risk adjusted returns and alpha generation, managing over EUR 1 billion across a menu of six liquid daily dealing UCITS strategies catering for investors' differing alpha, beta, risk and return targets.

In pure credit, Norron Sustainable Premium is investing in high yield credits with its main focus on BB-rating, while Norron Sustainable Preserve owns a mix of higher rated high yield, crossover and investment grade paper. These strategies provide one building block for the flexible multi-strategy vehicle, Norron Target, which also runs long/short equity split into five long book sub-strategy buckets: yield, core alpha picks, unlisted, market neutral long/short and beta/directional, while the short book is split between hedge and some single short positions. Norron Select aims for higher risk and return and follows a long/short strategy with the long book sub strategies being core alpha picks, beta/delta trading and unlisted while the short book mixes index hedges and active hedges.

These strategies invest across all Nordic markets while Norron Active is an actively managed fund focusing on Swedish equities.

The latest launch is pan-Nordic long only strategy, Norron Sustainable Equity, which is benchmarked against the Nordic constituents of MSCI Europe ESG leaders.

pornography, tobacco, weapons, alcohol production, gambling and fossil fuels (oil, gas and coal). It is an all-cap approach that invests across all market capitalization sizes, seeking unique companies with good management. "The "case" sub-strategy is especially likely to be invested in smaller names, such as Nordic Semiconductor, which has grown to a multi-billion USD market capitalisation but was much smaller when Norron first discovered it," says Ulf Frykhammar, co-founder and board member at Norron, who has been a portfolio manager since the late 1980s.

The very smallest companies invested in are likely to be in the private equity sleeve, which is mainly pre-IPO situations. Many long-term core long holdings began life in the private equity book. For instance, one of Norron's biggest winners since March 2020 has been tailored vaccine therapy firm, Vaccibody. The firm floated in May 2021 and Norron has been invested since 2016.

A dynamic, structured process

The asset allocation and sub-strategy allocations move around opportunistically. "The absolute return fund investing in equity and credit has been reducing fixed income exposure as bond yields have come down. It is therefore harder to see fixed income providing a diversification benefit," says Frykhammar. "High yield stocks paying dividends of 8-9% were an important theme four years ago but became a much smaller allocation in 2020 after some companies needed to cancel dividends."

A structured six stage investment process includes traditional fundamental analysis, quantitative analysis including style and risk factor scoring, security specific metrics, more subjective assessments of companies and management, ESG factors and hedging such as stress tests and tail risk. "We generally want to avoid overcrowded positions," says Frykhammar.

Managing exposure, beta and factor risk

Norron are opportunistic in expanding gross exposure to take advantage of alpha streams, while net exposure is a consequence of the fund manager's market view and risk mandate. The portfolios are normally net long, but this can drop rapidly in a market reversal as the gamma from put options and other volatility instruments kicks in. Back in the dark days of 2011 and 2012, in response to the European sovereign crisis, and the Japanese Fukushima disaster, the portfolios had negative beta. They were also briefly net short in 2008.

The short book is designed to reduce volatility and drawdowns. It is more defensive than offensive mainly because Norron do not find enough compelling short ideas in the Nordic region. Short exposure has been predominantly indices, such as the Swedish OMX index, the Norwegian OBX index, or sometimes the STOXX 50 and there are also some single stock shorts (with more single name shorts in the Select strategy). The portfolio hedging approach has been adapted to market conditions. In recent years as corrections have become shorter and sharper, it has been important to monetise part of the protection. In 2021 the choice of instruments has also moved toward variance swaps, which may provide a cheaper and more efficient way to hedge left tail risks in the public equity portfolio.

Norron are increasingly cognizant of the flows of passive, systematic and quantitative capital following factors, such as size, value, growth and momentum and many more that are monitored. Norron makes some marginal tactical factor tilts: "In early 2021 we had a slight growth tilt but shifted this towards a small value wager before moving to a more neutral stance in mid-year," says Frykhammar. Most of the alpha comes from picking companies however, and ESG is a growing source of alpha.

ESG and active management

Norron is not an ESG manager *per se* but ESG is naturally of growing importance, given the local investor base of pension funds, investors and distribution platforms in the Nordic region. The long only sustainable equity fund is classified as category 9 or "dark green" under the EU Sustainable Finance Disclosure Regime (SFDR), while the other five funds are managed with a focus on sustainability and are classified as category 8. The long only sustainable equity fund today has a 40% overlap with the long equity books of Norron Select and Norron Target while the bond portfolio in the sustainable fixed income funds populate the bond allocations in the multi-strategy fund.

Norron integrates ESG into its investment process and applies both negative screening and positive screening, which has been an important source of alpha generation over the past 18 months. "We monitor secular trends including ESG, which is one of the strongest trends that will shape capital markets. Renewables and carbon capture are big themes and there are also lots of enabling technology companies. We expect ESG will tag along with a revival of active management, and engagement with companies to increase their valuations and lower their costs of capital. One notable trend is more mature larger companies spinning off subsidiaries with a pure ESG focus," says Frykhammar.

Norron's approach to ESG is very different from some thematic funds and strategies that might have long term weightings in predefined sectors and sub-sectors. Norron is active, dynamic and selective. "We do not view ESG as a passive buy and hold strategy, because we want to trade around the valuation multiples. ESG stocks at one stage in 2020 reached a 50% premium to the wider stock market. We are alert to both the general valuation volatility of long duration growth stocks and the potential for micro-bubbles in certain sub-sectors. It is also important to realise that when the dust settles there will be a few clear winners but not all the companies will be winners. We have even been short of some ESG stocks," says Frykhammar.

ESG is one element informing Norron's dialogue with companies. "This might start with suggesting they sign up to global standards such as the OECD, ILO, UN GC, UN SDGs and progress with proactive workshops focused on more specific issues. We have been paying attention to the EU taxonomy of sustainable activities and engaging with companies to encourage them to adapt their activities to a greater degree of compliance," says Frykhammar.

Though the taxonomy is not yet complete, Norron estimates that about 40% of the Nordic companies are in the current scope of the taxonomy. However, based on Norron's best guess, only a mid-single percentage of the companies in the Nordics are today aligned with the taxonomy. What is very interesting from an alpha angle is anticipating which companies will become compliant as the taxonomy is broadened out over the coming years. The obvious ESG stocks in clean technology are clearly glamourous growth names, but it is also possible to find value stories in less well followed areas such as building renovation.

Sustainable long positions have included a salmon farmer which has adapted its business model to farm on land to avoid the negative environmental footprint in coastal areas. A more innovative sustainable name, Renewcell, has devised a new technology to recycle cotton, which is very resource and water intensive.

At the same time, Norron has in early 2021 been capitalizing on the recovery in cyclical and value stocks by investing in firms benefitting from higher interest rates, such as Swedish and Norwegian banks, which are not generally viewed as "ESG" or "impact" names, as well as the aforementioned semiconductor specialist that profits from the positive industry dynamics in the chip cycle.

Norron has not generated positive alpha every single year and does not expect to since the opportunity set ebbs and flows. Nonetheless, its long-term record of alpha generation and risk management is highly distinguished in the hedge fund industry. **THFJ**