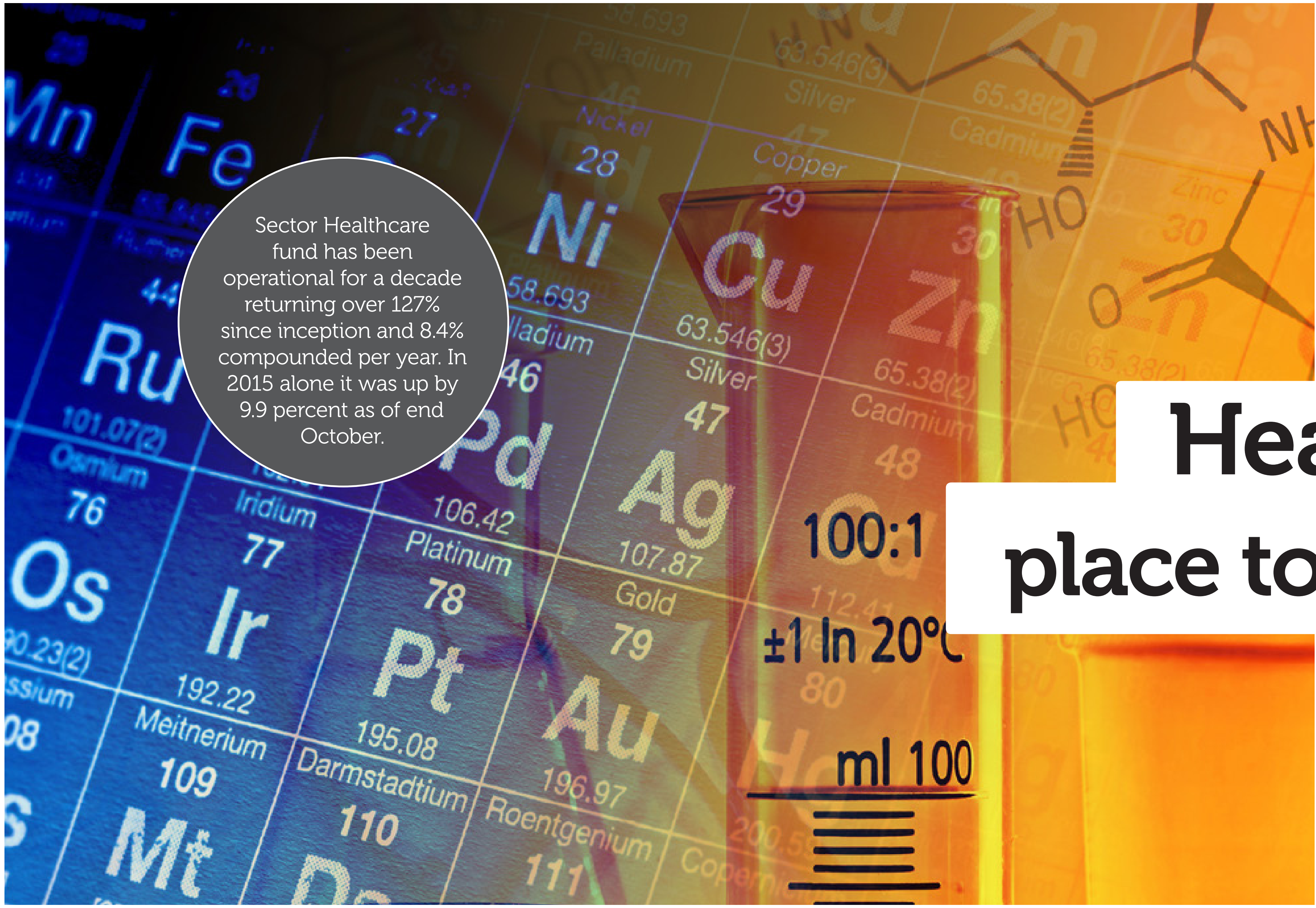


Sector Healthcare fund has been operational for a decade returning over 127% since inception and 8.4% compounded per year. In 2015 alone it was up by 9.9 percent as of end October.

"We loved the fact that the returns would be generated by picking the right stocks rather than determined by systematic market factors."

by Pirkko Juntunen

Health Care - a great place to be market neutral

For the Norwegian based management team of the Sector Health Care fund, the idea to launch a product with a market neutral strategy in the healthcare space was born on the back of some rather simple considerations.

While the team had all the confidence in being good stock pickers, they did not want to be relying on beta or timing skills. There would be plenty company specific risk factors and dispersion in the healthcare space to make attractive returns in a market neutral setup with limited exposure towards systematic market risk factors.

Trond Horneland, co-portfolio manager of the $660 mill. healthcare strategy, said the healthcare sector is particularly well-suited for a Market Neutral strategy. "The healthcare sector is dominated by company-specific factors, such as new product launches, as well as the inherent cyclicality caused by individual patent expirations. Given the dynamic nature of the industry, it has historically been an attractive universe for active stock selection strategies". The healthcare sector consists of large and liquid companies with high historic return dispersion and low correlations. Currently there are well over 3000 listed healthcare companies in developed markets, with an aggregated market value of well over 6 trillion Dollars - about 27 times the value of the Norwegian stock market. The large, liquid and de-risked portion of this healthcare universe, consists of roughly 350 companies with an aggregated market value of well over 5 trillion Dollars. "When we first launched our fund 10 years ago, we had about 220 companies in our core investment universe. This has now expanded to well over 350 companies despite a very active mergers and acquisitions environment during the last ten years. This is a good illustration of how dynamic the overall healthcare universe has been historically.

Market neutrality is achieved by trading on the long or short side of bottom up, fundamentally driven single stock ideas and no options or futures are used. "On a few occasions we have turned to liquid ETFs when we found no suitable short right way, but that has historically not been more than around 5% gross exposure of the short book."

Merger and acquisition activities are a big topic in the industry, and the fund has historically benefited from being on the right side of M&A situations. However, the team tends to avoid merger arbitrage situations, as Horneland does not like the risk reward pattern of these deals having a fixed upside but open downside

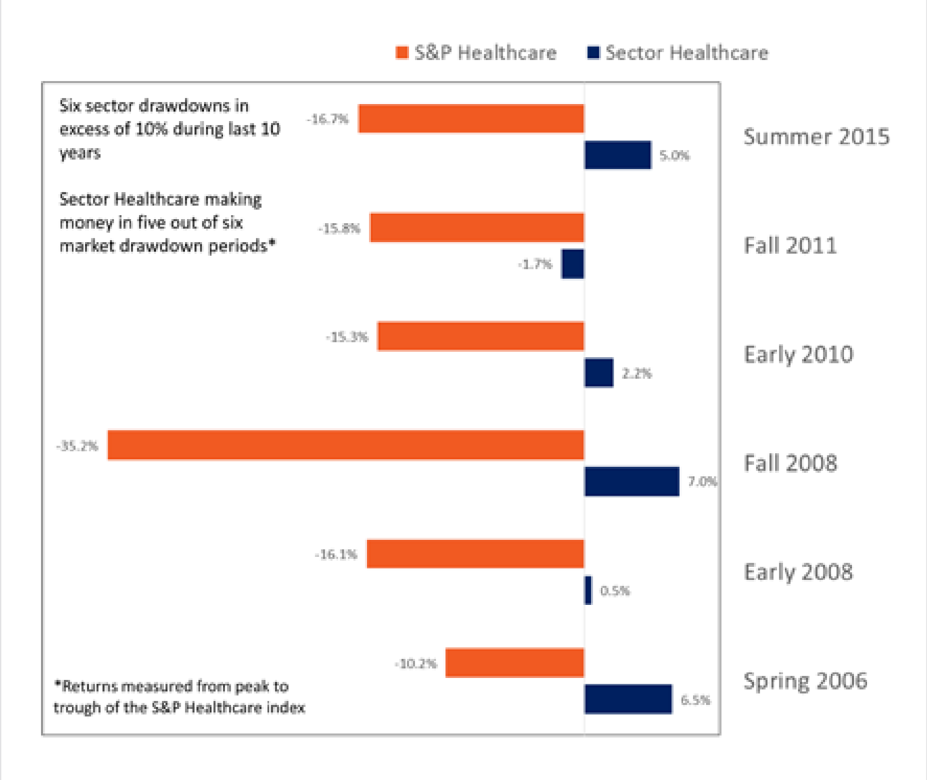
www.hedgenordic.com - December 2015

risk. "We have not been too keen on those arbitrage situations and tend to stay away from them. In general, Sector Health Care does not enter into pair trades, but likes each position to stand on its own merits."

The team historically has been able to extract alpha from both the long as well as the short book. Alpha from shorting has proved more challenging in the healthcare bull market experienced during the last five years, but this year Horneland estimates that 30% of the fund's alpha has come from the short side. Since the inception of the fund, the short book explains nearly 40% of the historic alpha.

The fund has proven its claim to have an uncorrelated return profile and more than stands its ground in periods of significant market stress. In 2008, the fund returned 11 percent. The fund has also had a good period during the last 3-4 months at the same time as the broader healthcare sector had a correction of over 15 percent from peak. "We think our history of doing well in periods of market stress is due to a disciplined risk construction framework as well as an active management of all systematic risk elements. Our contrarian tilt has also proven valuable in these periods since crowded positions often take outsized losses in flow driven market selloffs"

Sector Healthcare´s two founding investment managers, ,Trond Horneland and Trond Tviberg, launched the fund in 2005. Currently, the investment team consists of 5 experienced healthcare investment professionals that invest globally in developed markets and across most sub–sectors of healthcare, including pharmaceuticals, medical technology, healthcare services and developed biotech. The team manages the market neutral Sector Healthcare Fund as well as the long only UCITS fund, Sector Healthcare Value Fund. The latter was launched five years ago, and is largely a replication of the long book of the market neutral hedge fund.



Even with the pedigree of a hedge fund manager, Hornelund insists there is nothing wrong per se with being exposed to Beta. Especially with the privilege of looking at the last years of returns of the healthcare space in the rear view mirror, the sector was a great place to be exposed to Beta."You can also have a very active portfolio and be a good or bad stock picker in a long only setup. The return and risk factors are likely to be different and much more determined by the performance of the general market or sector and of course one must monitor how the strategy performs in situations of severe market stress and be able to stomach potentially hefty draw downs. That is clearly not the mandate of a market neutral setup. We don't start at plus ten or minus ten dictated by market Beta or other systematic risk factors. We start at zero, and then from there onward it is our skills that will determine the results." he says.

The team aspire to add value through fundamental research, a rigorous investment process and an adaptive portfolio construction process. As a bottom-up value-based investor, the portfolios often have a contrarian tilt and early-stage biotech investments are largely avoided due to risk considerations.

Horneland said trading is an integral part of the fund's success, contributing 20% to its historical performance. "Our position taking is long term in nature but we are very active in sizing our positions around changes in risk, price levels and fundamental news flow. The majority of our trading is not in and out of names but rather up and down in the sizing of the position. Our timing in making these changes to the portfolio has historically been profitable"The team is financially oriented with a value approach to stock pricking. Horneland also emphasized that their valuation focus is not the same thing as being a traditional value investor. The team is looking beyond the P/E ratios to determine if a stock is over- or under-valued. "Many of our most profitable positions have been undervalued high P/E stocks on the long side and overvalued low P/E stocks on the short side. Sustainability, quality and duration of earnings is a key variable for us when looking at stocks. Being valuation oriented most often leads to having a contrarian tilt to the portfolio"

The investment process is based on a scorecard model for stock selection. This model is built to improve the timing in the investment decision by accounting for shorter-term factors such as earnings momentum and sentiment, Horneland said. "The input into the model is based on bottom-up fundamental analysis by the analyst and portfolio manager, and is not a quant model," he said.

The portfolio typically consists of 30-50 long and 35-50 short positions. Position sizes are determined by the alpha estimate relative to the non-systematic risk of the security, and option implied volatility is used to estimate company-specific risk. At the same time unintended factor exposure is actively monitored and managed. Risk is based on the commercial and financial outlook rather than pipelines, and unintended systematic risk is minimized.

Mr. Horneland believes the health care sector continues to offer great opportunities for stock picking. The investable universe of stocks has grown, dispersion has picked up and their core style (valuation and mean reversion driven) is more in favour. One needs talent, or skill to pick the stocks, but there also has to be the right investment universe to offer those possibilities, combined with the

Trond Horneland, Portfolio Manager

opportunities that allow to execute on those ideas. The healthcare space offers all these prerogatives for a market neutral strategy."

On the issue of capacity Horneland said all active portfolio management strategies have capacity constraints. "Given the growth in our investable universe, improved liquidity in the underlying positions and an uptick in dispersion, we think a conservative capacity limit for our fund is around US$750 million," he said. The team manages a total of $660 mill. out of which US$420 mill. is in the fund and the rest in managed accounts. The fund has had several soft-closures already and does not foresee problems reaching capacity restrictions in the coming years.