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The Mechanics Behind Atlant Protect

Stockholm (HedgeNordic) – As markets tumbled in early August, some attention naturally shifted to strategies capable of safeguarding capital during a downturn. Atlant Protect, designed by the team at Atlant Fonder primarily for its own use, proved its mettle during the sell-off. The fund surged 7.2 percent in just a few days through August 5, before giving up some of those gains as the market rebounded.

"Atlant Protect was initially created for our own needs," says Taner Pikdöken, portfolio manager at Atlant Fonder. While one institution uses Atlant Protect as a de-risking tool, the fund is primarily employed within Atlant Fonder's multi-strategy fund-of-funds. "The goal was to create a fund that could provide at least a zero return when markets go up but deliver a very predictable return when everything goes down," Pikdöken explains. "Knowing they have something to offset risk allows investors to take more risk in the rest of the portfolio."

A Blend of Fixed Income and Derivatives

Similar to other funds in the Atlant Fonder lineup, Atlant Protect combines fixed-income investments with derivatives to fulfill its primary goal of generating returns during market downturns. "The derivatives are, of course, tilted towards downside protection," says Pikdöken, noting that Atlant Protect uses put options and other short-tilted derivatives on broad stock market indices such as the S&P 500, Euro Stoxx, and OMX 30. The fund allocates 10 to 15 percent of its capital to derivatives, with the remainder invested in relatively safe fixed-income instruments, including corporate bonds.

"We use the capital to buy corporate bonds, but it doesn't make sense to take on significant risk in the corporate bond portfolio that could hurt us when markets decline," explains Pikdöken. Consequently, Atlant Protect focuses on higher-quality, short-duration bonds. "We seek bonds that have a high correlation on the downside," he elaborates. "We don't want a scenario where we make money on the put side while the bond portfolio implodes."

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The bond portfolio contributed to Atlant Protect's 3.6 percent advance year-to-date through the end of July despite a rising broader market. "That gain is purely from the fixed-income portfolio, as derivatives drag on performance in a bull market," notes Pikdöken. The current higher interest rate environment, which Pikdöken refers to as a "normal rate regime," benefits the fund because bonds now offer yields of four to five percent without carrying much risk. "Three years ago, you had to dip into high-yield bonds to find yields of 5.5 to six percent," recalls Pikdöken, adding that the higher-risk investments on the fixed-income spectrum are incompatible with Atlant Protect's strategy.

The Derivatives Payoff Profile

Atlant Protect's payoff structure is highly predictable during market downturns, Pikdöken emphasizes. More interestingly, the fund's gains escalate as markets decline further. "When markets go down, the fund starts to earn money, and the deeper the decline, the more our net exposure on the downside increases, leading to greater profits," he explains. For instance, if the broader equity market falls by one percent, Atlant Protect gains about 0.70 to 0.80 percent. But if the market drops by three percent, the fund could earn 3.5 to 4.0 percent, following an accelerating scale. "When markets plummet by eight percent over a few days, that pushes the fund into making a lot of money."

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When Atlant Protect generates gains in a declining market, the challenge becomes deciding when to lock in those gains to guard against a potential rebound. "The tricky part for us is determining what to do after a sell-off," says Pikdöken. In early August, Atlant Protect was up nearly ten percent at one point, but the market quickly recovered. "If everything goes back to square one, do we want to lose all those gains we have made on the put options or other short-tilted derivatives," asks Pikdöken. "Certainly not."

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To mitigate this risk, the team reinvests some of the gains from the put options into instruments that offer upside potential. "When markets go down, we make a lot of money on the downside and we use part of those gains to buy some calls, preparing for a potential rebound," he explains. "If markets rise, we still lose some of the accumulated gains, but less than we would have otherwise." While Atlant Protect gave up some of its early August gains, the fund remains up 2.8 percent month-to-date through August 23 and 6.5 percent year-to-date.

Reflecting on Past Performance

The market environment in early August was not the first time Atlant Protect demonstrated its "protective" qualities. The fund gained over 11 percent through mid-March during the pandemic-induced market turmoil before markets rebounded sharply. Similar to August this year, Atlant Fonder's team used some of the downside gains to hedge against a rebound. The fund also capitalized on deeply discounted bonds during massive sell-offs. "The reason the fund ended the year up nine percent was largely due to the bonds we bought during the turmoil because we had so much cash on the sidelines," Pikdöken recalls.

However, Atlant Protect struggled during 2022, when both bonds and equities incurred simultaneous losses. “2022 was a challenging year, with markets oscillating up and down,” Pikdöken recalls. “We’d lose money during the rallies, make it back during declines, and then lose it again during the next upswing,” he elaborates. That was a frustrating cycle that prevented Atlant Protect from generating a positive return. Despite these challenges, the fund finished the year down 2.3 percent.

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The most difficult environment for Atlant Protect is a continuously rising market. Such was the case in 2023 when the fund lost 14.8 percent for the year. “In 2023, the market rebounded sharply from 2022, with consistent monthly gains,” says Pikdöken. “As a result, all our derivatives expired worthless.” Yet, Atlant Protect remains focused on its primary objective: protecting against market downturns. “This product is for investors who want something to offset risk,” concludes Pikdöken.