

## Europe is alive and leading to outperformance

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**January was a good month for value stocks thanks to the ECB's LTRO programme which resulted in good debt auctions in Europe and a Eurozone Composite PMI figure above 50 again.**

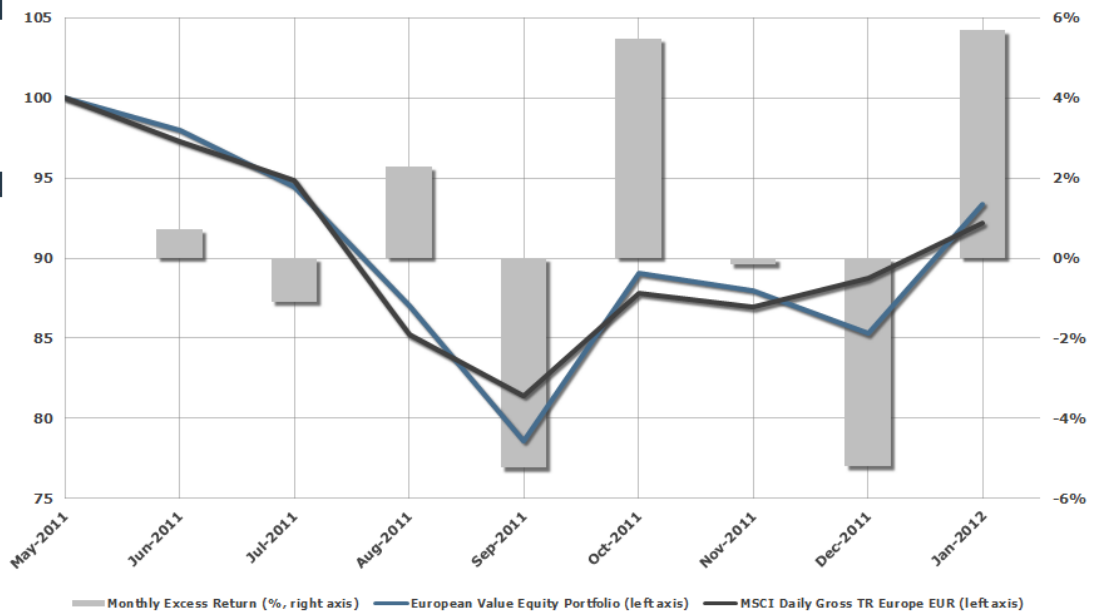
- The European Value Equity Portfolio was up 9.5 percent in January and outperformed the MSCI Daily Gross TR Europe EUR which only climbed 3.8 percent. Cumulative outperformance since inception is now 1.3 percentage points.
- The best performer in January was KGHM Polska up 33.1 percent in EUR.
- The following stocks have been added to the portfolio for February: Deutshce Lufthansa, E.ON, Lagardere, Voestalpine, A2A, Celesio, GDF Suez, Allianz, Logica and Mediaset SpA.

### Actual Performance

Return (%)	Portfolio	Benchmark
1 month	9.5	3.8
3 months	4.8	4.9
6 months	-1.2	-2.9
Since inception	-6.6	-7.9
Annualised return	-9.8	-11.6

Historical return (%)	2011	2012
January	N/A	9.5
February	N/A	
March	N/A	
April	N/A	
May	N/A	
June	-2.0	
July	-3.6	
August	-7.9	
September	-9.7	
October	13.3	
November	-1.2	
December	-3.1	

European Value Equity Portfolio vs. Benchmark



Source: FactSet, Bloomberg and Saxo Bank Research & Strategy

### 1. past performance disclaimer

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## European Value Equity Portfolio – February 2012

The table below details the December portfolio and allocations, with the two largest positions in SCOR and Deutsche Lufthansa - a combined weight of 22.0 percent.

**The following stocks have been added to the portfolio:** Deutsche Lufthansa, E.ON, Lagardere, Voestalpine, A2A, Celesio, GDF Suez, Allianz, Logica and Mediaset SpA.

**The following stocks have been removed from the portfolio:** Persimmon, Nexans, Norsk Hydro, St-Gobain, Nokia, A.P. Moeller – Maersk, Travis Perkins, KGHM Polska, Michelin and

Company	Sector	Market Cap.	Est. P/E 1Yr	P/B	Weight
Deutsche Lufthansa AG	Industrials	4,838.1	19.8	0.6	11.5%
E.ON AG	Utilities	32,798.4	10.3	0.8	10.1%
ArcelorMittal	Materials	24,014.7	9.1	0.5	8.6%
Lagardere SCA	Consumer Discretionary	2,849.5	9.9	0.7	7.2%
Voestalpine AG	Materials	4,237.2	7.9	0.9	5.6%
Delhaize Group SA	Consumer Staples	4,242.3	7.8	0.8	7.0%
A2A SpA	Utilities	2,279.2	15.7	0.7	4.7%
OMV AG	Energy	8,173.0	6.4	0.9	9.5%
Celesio AG	Health Care	2,506.4	11.5	1.0	4.3%
GDF Suez	Utilities	46,742.2	11.8	0.8	4.3%
Allianz SE	Financials	38,541.1	7.5	0.9	4.0%
SCOR SE	Financials	3,693.5	7.2	0.9	10.5%
Logica PLC	Information Technology	1,472.2	7.2	0.6	3.3%
Mediaset SpA	Consumer Discretionary	2,667.2	9.7	1.1	3.3%
Mediaset Espana Comunicac	Consumer Discretionary	1,817.5	13.3	1.4	6.2%
<b>Portfolio</b>	<b>Median</b>	<b>4,237.2</b>	<b>9.7</b>	<b>0.8</b>	<b>100.0%</b>

\* Source: Bloomberg, FactSet and Saxo Bank Research & Strategy

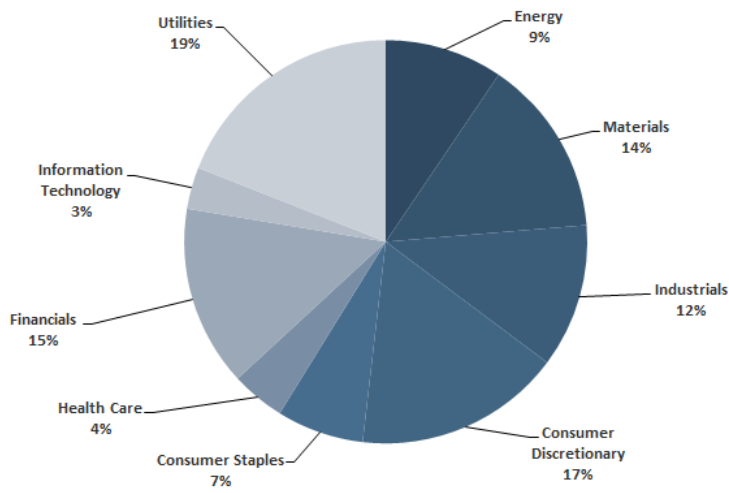
\*\* Market Cap is in EUR millions, Est. P/E 1Yr is next fiscal year's expected P/E ratio

\*\*\* Total returns are adjusted for changes in EUR compared to the instruments' currency

\*\*\*\* Total returns include reinvestment of gross dividends on ex-date

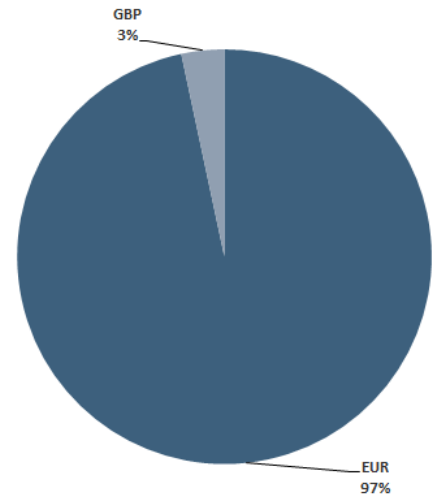
Boliden.

Sector Allocation - February 2012



Source: Bloomberg and our calculations

Currency Exposure - February 2012



Source: Bloomberg and our calculations

## European Value Equity Portfolio – January 2012

The table below shows the performance of the individual stocks in January. The best performing stock was KGHM Polska up 33.1 percent in EUR. The worst performer was Logica down 21.3 percent in EUR.

Company	Sector	Market Cap.	Est. P/E 1Yr	P/B	Weight	Total Return
Persimmon PLC	Consumer Discretionary	1,699.6	11.8	0.9	9.6%	12.8%
ArcelorMittal	Materials	22,055.7	9.1	0.5	8.7%	8.9%
Delhaize Group SA	Consumer Staples	4,420.6	7.8	0.8	8.0%	-4.1%
OMV AG	Energy	7,643.2	6.4	0.9	9.7%	6.9%
Nexans SA	Industrials	1,151.8	12.6	0.7	6.2%	18.4%
Norsk Hydro ASA	Materials	7,410.8	19.0	0.8	7.4%	12.9%
Cie de St-Gobain	Industrials	15,887.5	10.2	1.0	4.8%	14.7%
SCOR SE	Financials	3,390.4	7.2	0.9	10.8%	6.5%
Mediaset Espana Comunicac	Consumer Discretionary	1,794.3	13.4	1.4	6.7%	1.3%
Nokia OYJ	Information Technology	14,126.0	12.4	1.2	5.3%	1.2%
AP Moeller - Maersk A/S	Industrials	21,808.5	13.7	1.1	5.3%	10.4%
Travis Perkins PLC	Industrials	2,321.0	9.7	1.1	5.0%	11.0%
KGHM Polska Miedz SA	Materials	4,957.1	6.3	1.4	2.7%	33.1%
Cie Generale des Etablisse	Consumer Discretionary	8,222.3	7.4	1.1	2.7%	14.5%
Boliden AB	Materials	3,082.1	8.7	1.6	7.3%	15.9%
<b>Portfolio</b>	<b>Median</b>	<b>4,957.1</b>	<b>9.7</b>	<b>1.0</b>	<b>100.0%</b>	<b>9.5%</b>

\* Source: Bloomberg, FactSet and Saxo Bank Research & Strategy

\*\* Market Cap is in EUR millions, Est. P/E 1Yr is next fiscal year's expected P/E ratio

\*\*\* Total returns are adjusted for changes in EUR compared to the instruments' currency

\*\*\*\* Total returns include reinvestment of gross dividends on ex-date

## Portfolio basics

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**Value creates excess risk-adjusted return.** Our portfolio would have produced 10.4 percent excess annualised return in the 101 months back-testing period (2003-2011)<sup>1</sup>; the annual return was 17.6 percent annualised compared to 7.2 percent annualised return for our benchmark, the MSCI Daily TR Gross Europe EUR.

**Stocks are selected from a combined value score.** This equity portfolio is based on classical value criteria. From this approach each stock from our screening is gets a combined score that returns a ranked list of the stocks from our screening.

**European portfolio without constraints.** Our equity portfolio has no constraints in terms of exposure restrictions towards geography or sectors. The portfolio seeks to exploit value opportunities wherever they are located in the European countries. We have found during back-testing that the additional risk taken by this approach is sufficiently offset by the extra return received.

**The portfolio has dynamic weights.** The portfolio is based on dynamic weights that roll over from month to month. So, if a stock had a 15 percent weight to start the month then its ending weight would be determined by the stock's return and the other stocks' returns, assuming the stock remains among the 15 most undervalued stocks in the next month. If several stocks leave the portfolio, the combined weights of the stocks leaving the portfolio in a given month are distributed among the new stocks coming based on a proprietary scaling technique linked to the new stocks' combined score relatively to each other.

**The portfolio is not hedged to offset movements in the currency markets.** If an investor wants to reduce the impact on returns from currency fluctuations they should hedge all currency exposure to the account's currency denomination on a monthly basis using the currency exposure pie chart that can found in the publication.

**The portfolio's returns are calculated on a gross basis (i.e., not including transaction cost and taxes), but it does include the reinvestment of dividends on the ex-date.** Returns are gross because the model cannot account for taxes that may vary between investors due to different tax treatments on dividends and capital gains for their tax jurisdiction. Transaction costs may vary between different brokers and, indeed, between clients.

**Historically the portfolio has had two stocks going in and out, on average, each month, creating six transactions.** These would approximately correspond to between 0.2-0.4 percent annually transaction costs of the portfolio's value depending on the commission terms.

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## Research methodology

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**The European Value Equity Portfolio is designed to address the classic challenge in equity portfolio research: how to produce excess return given a benchmark index.** The aim, therefore, is to create a portfolio that generates a positive Sharpe Ratio indicating the portfolio produced excess return over the risk-free rate for each unit of risk taken.

**According to the existing literature in the field it is possible, using various value criteria, to create a portfolio that outperforms the chosen benchmark index on a risk-adjusted basis.** Studies such as Fama and French (1992) and Lakonishok, Shleifer & Vishny (1994)<sup>2</sup> document high book-to-market portfolios can produce significant excess return. Following this line of research our portfolio uses Benjamin Graham deep value criteria (published by Rea in a *Journal of Portfolio Management* article from 1977)<sup>3</sup>.

**The European Value Equity Portfolio is constructed using a bottom-up approach which de-emphasises the significance of economic and market cycles. On this basis, the portfolio will be fully-invested at all times.** One of the consequences of being invested at all times is downward pressure on the portfolio's alpha while creating a higher beta. The latter argument is not that intuitive because value stocks are typically perceived as producing stable returns (low beta and positive alpha). Note, higher price volatility does not necessarily mean higher risk (as in underlying business risk). Our hypothesis is the portfolio will compensate on a risk-adjusted basis for our risk-taking in these combined value companies.

**Our monthly stock sample is selected according to our search criteria and the universe is selected from the cash equities available to trade on the Saxo Bank trading platforms<sup>4</sup>.** We also limit the universe to primary issues (listings) on the European exchanges, but include inactive stocks to ensure the population does not include survivorship bias from excluding bankruptcies, mergers and delisting etc. The difference between active and inactive population of stocks is 19,490 and 37,301 irrespectively.

## Back-testing methodology

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**We set the last day of the prior month as our back-testing date.** For example when back-testing January 2006 we use the back-testing date of 31 December 2005. Each monthly screening provides the stocks that pass our criteria and returns all relevant parameter data. The start back-test date is set at 31 December 2002, which means that the portfolio's beginning date is 1 January 2003. This provides us with 97 monthly return observations which are sufficient enough to generate valid statistical analyses such as beta, alpha, Sharpe Ratio and Information Ratio.

**In order to avoid having look-ahead bias in our portfolio we use lagging arguments on all relevant parameters in the portfolio.** Our data provider does not have a point-in-time database on fundamental data, meaning that if our back-testing date is 31 January 2006 and we look back on the last annual report data, we receive annual report data from 2005 instead of 2004 despite the information first being available to the public in February or March 2005. By implementing three month lagging arguments on all relevant parameters, we avoid having look-ahead bias in our portfolio.

**Each month the screening output is analysed and the stocks are ranked based on a weighted average of separate rankings of our value factors. We name it combined score.** The 15 stocks with the lowest combined score are selected as the forthcoming month's

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<sup>2</sup> Eugene F. Fama and Kenneth R. French (1992), The Cross-Section of Expected Returns, *The Journal of Finance*, vol. XLVII, no. 2, pp. 427-465; Josef Lakonishok, Andrei Shleifer and Robert W. Vishny (1994), Contrarian Investment, Extrapolation, and Risk, *The Journal of Finance*, vol. 49, no. 5, pp. 1541-1578.

<sup>3</sup> James B. Rea (1977), Remembering Benjamin Graham – Teacher and Friend, *Journal of Portfolio Management*, vol. 3, no. 4, pp. 66-72.

<sup>4</sup> See appendix for the stock exchanges on which Saxo Bank facilitates cash equity trading.

portfolio. We calculate the portfolio's weighted return for that month based on the monthly price EUR adjusted return.

**The portfolio is rebalanced every month, thus the holding period is dynamic in the sense that a stock will be re-elected to our portfolio if it still is among the 15 most promising stocks based on our combined score.** A stock that increases far more in price relative to other value stocks will probably have a short holding period. If the potential price appreciation has not materialised yet the stock will usually remain in the portfolio.

**In back-testing, our portfolio would have produced an annualised gross return, including the reinvestment of gross dividends ex-date, but before transaction costs (see comment under portfolio basics) and taxes of 17.6 percent compared to 7.2 percent for MSCI Daily TR Gross Europe EUR.** Even though our weighted holding period is shorter compared to the normal value philosophy the total return compensates for the additional costs related to our monthly rebalancing. Our portfolio produced excess return over the MSCI Daily TR Gross Europe EUR in 60 out of 101 months. This corresponds to around 59.4 percent positive excess return observations throughout the back-testing period.

**We calculate the Sharpe Ratio, Tracking Error, Information Ratio and correlation based on monthly return observations for the portfolio and MSCI Daily TR Gross Europe EUR.** We use the Bloomberg/EFFAS Bond Indices Euro Govt 1-3 Yr TR as our risk-free rate. The portfolio performed well over the back-testing period with a positive annualised Sharpe Ratio of 0.75 compared to 0.25 for the benchmark indicating that our model produces attractive risk adjusted returns. The Information Ratio is correspondingly showing attractive returns over the risk taken with 1.00 for the portfolio in the back-testing period. The correlation between monthly return of the portfolio and MSCI Daily TR Gross Europe EUR was 82.8 percent.

**In order to gauge the risk profile of the portfolio we have calculated a one-month modified Value-at-Risk (VaR) with 95 percent significance level on the European Value Equity Portfolio and MSCI Daily TR Gross Europe EUR respectively.** The modified VaR is -8.3 percent and -6.9 percent for the portfolio and benchmark respectively. This implies that there is 5 percent probability that our portfolio will lose more than 8.3 percent in a single month compared to 6.8 percent for MSCI Daily TR Gross Europe EUR. We calculate a modified VaR<sup>5</sup> to take into account that the portfolio's returns do not follow a normal distribution.

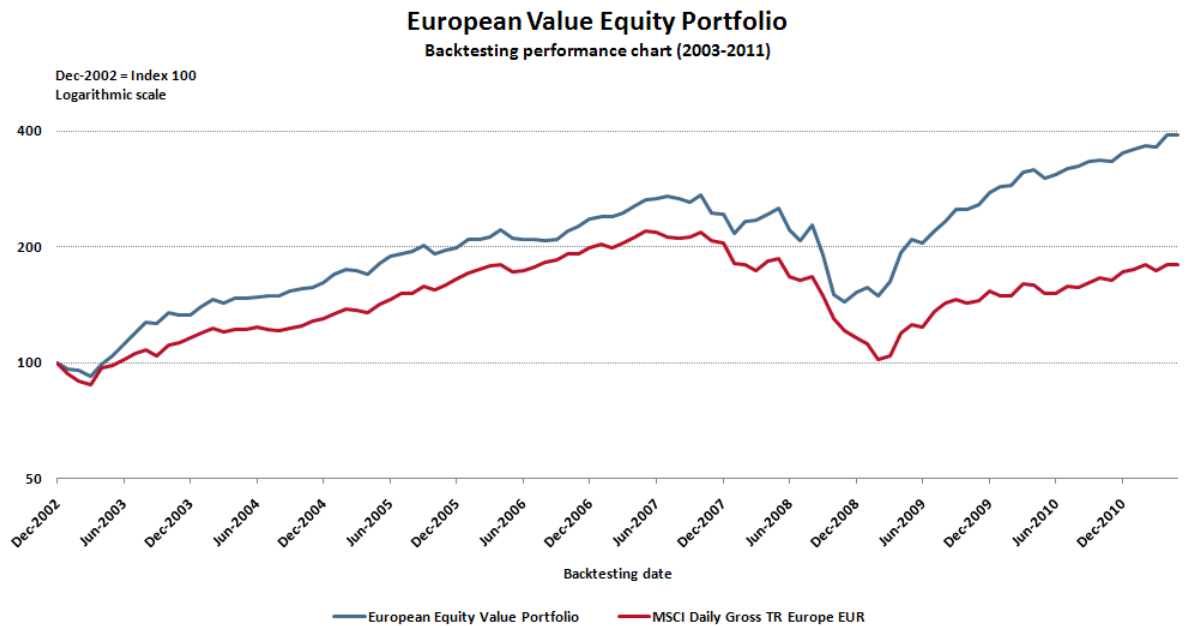
**The portfolio's return distribution over the back-testing period had a negative skewness and excess kurtosis.** Our portfolio has a negative skewness of -1.09 indicating that the return distribution has an asymmetric tail extending towards more negative values. Our portfolio has an excess kurtosis of 4.03 which means that the returns follow a leptokurtic distribution (more peaked values and fatter tails).

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<sup>5</sup> The limitations of mean Value-at-Risk are well covered in the literature. The limitations of traditional mean-VaR are all related to the use of a symmetrical distribution function. Use of simulations, resampling, or Pareto distributions all help in making a more accurate prediction, but they are still flawed for assets with significantly non-normal (skewed or kurtotic) distributions. Zangari (1996) and Favre and Galeano(2002) provide a modified VaR calculation that takes the higher moments of non-normal distributions (skewness, kurtosis) into account through the use of a Cornish Fisher expansion, and collapses to standard (traditional) mean-VaR if the return stream follows a standard distribution. This measure is now widely cited and used in the literature, and is usually referred to as "Modified VaR" or "Modified Cornish-Fisher VaR".

## Appendix 1 – Backtesting performance

The chart below shows the European Value Equity Portfolio's performance in the backtesting period from January 2003 until May 2011 comprising of 101 months.



Source: FactSet, Bloomberg and Saxo Bank Research & Strategy

### Backtesting (2003-2011)

Performance & risk (101 mo.)	Euro Value	Benchmark
Annualised return	17.6%	7.2%
Annualised standard deviation	18.5%	15.2%
Modified VaR (one-month)	8.3%	6.9%
Annualised Sharpe Ratio	0.75	0.25
Annualised Tracking Error	0.10	
Annualised Information Ratio	1.00	

## Appendix 2 - stock exchanges available for trading (cash equity)

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- Euronext Amsterdam
- Euronext Brussels
- OMX Copenhagen
- OMX Copenhagen – First North
- Frankfurt Stock Exchange (XETRA)
- OMX Helsinki
- Euronext Lisbon
- London International Exchange
- London Stock Exchange SEAQ Market
- London Stock Exchange SETS Market
- Milano Stock Exchange
- Oslo Stock Exchange
- Euronext Paris
- Sistema De Interconexion Bursatil Espanol
- OMX Stockholm
- OMX Stockholm – First North
- Swiss Exchange
- Wiener Börse (Vienna) Stock Exchange
- SWX Europe
- Warsaw Stock Exchange

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