In Focus

For professional investors only*

June 2017

Playing the European equity momentum via a unique value approach

Nordea 1 – European Value Fund

ISIN: LU0064319337 (BP-EUR)

Following the French election, European equity markets are breathing a sigh of relief. Some structural challenges remain. However, strong fundamentals point towards continued support for European equities, triggered by reduced political tail risks.

What's triggering European equities momentum?

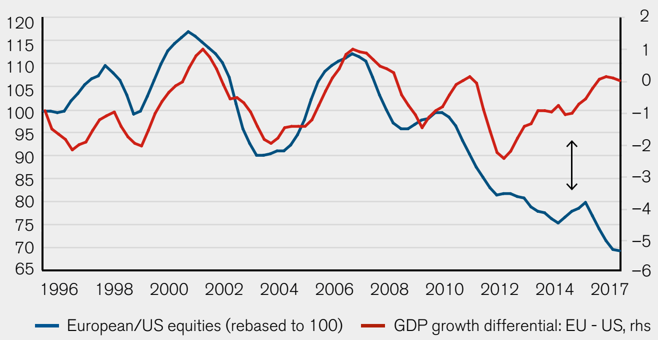
1. Reduced political risks

With 2017 dubbed a super election year for Europe, the lag of conviction was first and foremost tied to one factor: As long as political risks loomed large, investors feared to invest their money into European equities. Political risks receding were therefore a precondition for the deeply entrenched scepticism on European equities to wane.

2. Strong economic momentum

Growth indicators are still going strong in Europe. We expect them to continue to do so, especially relative to other major regions. In 2016, GDP in the Euro Area grew at 1.8 %, outpacing the US growing at 1.6 %. This is unseen since 2008. In other words, the growth differential between Europe and the US has narrowed substantially over the recent years. This has not been reflected in the performance of European equities relative to the US (see graph). The catch-up potential is tangible.

Europe Equity performance & growth trends



Source: Nordea Asset Management and Macrobond. Date: 31.03.2017

From a fundamental perspective, companies' earnings confirm that Europe is turning the corner. Earnings surprises are set up for the best season in a decade. So far, earnings in the first quarter are on track to grow 23% compared to Q1 last year, much better than expected.

3. Relatively easy central bank policy

Although the ECB is tightening on an absolute basis through reduced asset purchases, monetary conditions are still much easier in the Euro Area relatively speaking. While policy rates are rising in China and the US, the ECB is staying put on rates, only making minor adjustments to its macroeconomic risk assessment. This leaves the Euro Area with the most dovish central bank out of the three biggest economic regions.

4. Attractive valuation

Based on classic valuation metrics like price to book values (P/B), European stocks look cheap. Europe is currently 3 % cheaper than its long term median P/B, whereas the US is 10 % more expensive. When looking through cyclical swings in earnings relative to prices (Shiller P/E), European companies trade 5 % below their average, becoming historically cheap relative to their US peers trading 38 % above their average.

So far, so good?

All this being said, simply piling into European stock indices might not do the trick. First there is significant divergence in valuation, revenue exposure etc. between European countries and sectors. Second, we are at the late stage of the global business cycle, pointing towards higher dispersion. While generally a good environment for European equities, late cycle dynamics also result in higher macro uncertainty as such, potentially increasing the divergence between sectors as well as countries.

As political risks are reduced, it's now time to get back to the basics: Going forward, European performance should be **driven by robust and improving fundamentals** in a context of favourable valuation, and active management should play a central part.

Playing the European recovery theme with our unique value approach

With one of the longest track records in European Equities, Tom Stubbe Olsen, portfolio manager of the Nordea 1 – European Value Fund since 1998 and founder of Mensarius in January 2008, has developed a **modern approach** to value investing. For Mensarius, value investing does not simply mean investing in less expensive companies (e.g. low price earnings ratios (P/E) and high dividend yields (D/P)) or more mature companies with lower growth potential.

* Investing for their own account – according to MiFID definition

Instead, the investment team invests with the mindset of buying the whole company. **Understanding the underlying fundamentals** is the key to assess the real risk and opportunities in the investments and avoids stepping into a pure value trap.

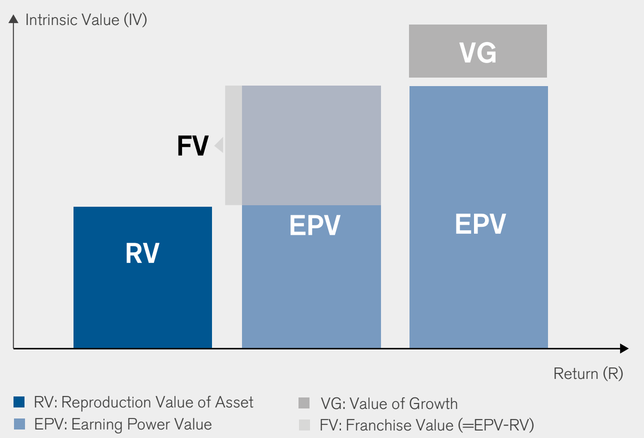
The team's value approach means buying something which is worth more than its current price, in other words the assessment of a company is based on the value of its current and future earnings.

In a thorough due diligence analysis, the intrinsic value of the company is determined. This can be broken down into three elements:

- The reproduction value of the assets
- The value of the earning power
- The value of growth

The most attractive investment opportunities stem from companies with sustainable **returns above the cost of capital.** This ability is expressed in the valuation, when the intrinsic value of the company is higher than the value of the assets, resulting in an identified **earning power** value. A company with a significant earning power may even be valued with a growth component, adding the value of growth to the assessment.

Determining the intrinsic value



Source: Mensarius. Date: 31.03.2017

Margin of safety

In addition to focussing on the company's earnings power, Mensarius also makes sure the company is traded at a healthy **margin of safety**. An investment will only be made when a company can be bought at a minimum discount of 40 % to the intrinsic value. This helps protecting investors in falling markets: the team's conception of value investing could also be seen as a more risk-averse way of equity investing.

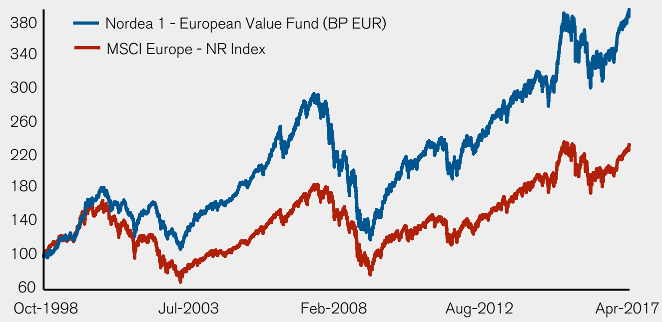
The flipside of the coin: not fitting into clusters

As a side effect of this established investment process, not solely relying on some fundamental financial measures, but also built on a rigorous company analysis, the Nordea 1 – European Value Fund does not fit into the **traditional clusters of value funds**. Whereas Morningstar, among other data providers, sees and categorizes value funds through their investments in stocks with low P/E and low growth, the companies Mensarius invests in may show e.g. a high P/E ratio and significant growth, as long as the earning power and margin of safety justify this investment. This is one of the reasons, along with the fund's mid-cap tilt (≈ 30 - 40 % of the portfolio), why the fund is not part of the EEA Fund Europe Large-Cap Value Equity peer group, where clients would typically look for it. On the contrary, the fund belongs to the EEA Fund Europe Flex-Cap Equity peer group, which is more flexible in terms of investment style and stock universe.

The unique value approach makes the difference

We at Nordea believe that our approach of value investing gives us greater flexibility in our investment process to offer a unique value proposition to our clients. This enhanced flexibility pays off, as the below chart illustrates. Since inception on 30th October 1998, the Nordea 1 – European Value Fund outperformed its benchmark (the MSCI Europe – NR Index) by more than 165 %, **leading to an annualized outperformance of 3.09 % and demonstrating the need for active management.**

Performance since common inception



Source: Nordea Investment Funds S.A.. Period under consideration: 31.10.1998 – 28.04.2017. **The performance represented is historical; past performance is not a reliable indicator of future results and investors may not recover the full amount invested. The value of shares can greatly fluctuate as a result of the sub-fund's investment policy and cannot be ensured.** If the base currency of the respective sub-fund differs from the currency of the country where the investor resides the represented performance might vary due to currency fluctuations.

Source (unless otherwise stated): Nordea Investment Funds S.A. Period under consideration (unless otherwise stated): 31.10.1998 to 28.04.2017. Performance calculated NAV to NAV (net of fees and Luxembourg taxes) gross income and dividends reinvested, in the base currency of the respective sub-fund, excluding initial and exit charges as per 28.04.2017. Initial and exit charges could affect the value of the performance. **The performance represented is historical; past performance is not a reliable indicator of future results and investors may not recover the full amount invested. The value of shares can greatly fluctuate as a result of the sub-fund's investment policy and cannot be ensured.** If the base currency of the respective sub-fund differs from the currency of the country where the investor resides the represented performance might vary due to currency fluctuations. 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