Nordea

In Focus

For professional investors only*

December 2018

The comeback of Stable Equities

Nordea 1 – Global Stable Equity Fund

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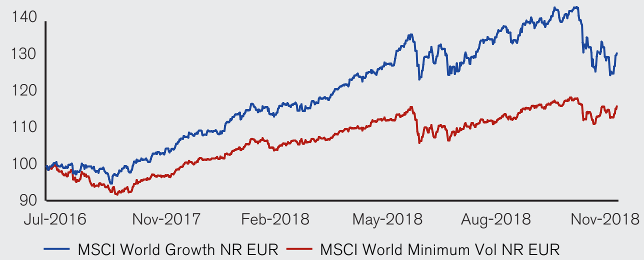
- Stable Equities **underperformed** during the last two years **(since August 2016)**…
- …but the **trend** is turning with **Growth momentum fading** and defensive equities outperforming
- Stable equities offer **attractive valuation** and are well positioned for late cycle concerns

After a difficult period…

During the last two years, we experienced a strong cyclical rally (mainly in Tech companies with stretched valuations) with an unusual strong earnings growth fuelled by the US tax reform in 2017. During this period, our Global Stable Equities lagged as investors were in favour of more cyclical/growth companies (see chart below), with quality/defensive stocks clearly underperforming as displayed by MSCI Min Volatility, which reached a peak of **more than 20%** at the end of August 2018.

2 Years Performance



Since the beginning of 2018, this dispersion in style widened with growth strongly outperformed quality stocks. This situation changed later during the year where we saw a sector rotation in favour of more defensive companies. At the end of November, the clear preference for growth stocks vanished, and thereby they underperformed (see next chart).

All in all, investors' focus on growth in 2018, has led to a clear preference for momentum stocks with high growth and high valuation, which have considerably outperformed the most reasonably priced names that we typically own.

YTD Performance

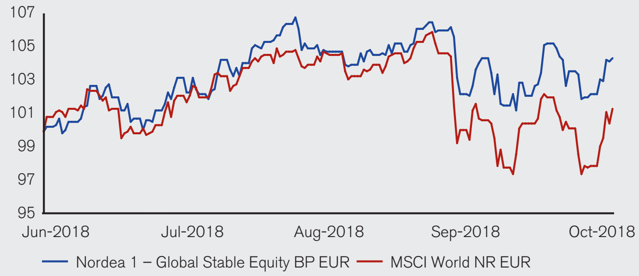
Our portfolio overweight companies whose expected growth is around 5–7%, and in terms of valuations **overweight companies with a PE (price earnings) ratio of around 14 and trades at a discount to the market.** Additionally, it is important to bear in mind that although investors were more positive in growth stocks, our Stable companies **still delivered a positive performance in 2018 with lower drawdown.**

…Stable Equities are coming back

In comparison to the beginning of the year, the general market environment has changed and investors are looking at fundamentals again.

Our Global Stable Equities benefitted from the renewed focus on fundamentals and caught-up since the summer, and specially in October (see chart below), by showing more resilience.

Performance 2018 (H2)



 The performance represented is historical; past performance is not a reliable indicator of future results and investors may not recover the full amount invested.

* investing for their own account – according to MiFID definition

Our Stable Equities unveiled part of the value they have accumulated during the underperformance since August 2016, when investors started focusing more on growth. Indeed, in this late cycle phase, characterized by increased fear of recession and earnings at the peak, their solid fundamentals became a competitive advantage, allowing them to have a strong comeback, posting positive performance and clearly outperforming the general market. In addition, the more favourable valuation of Stable Equities in our portfolio allowed us to catch up in terms of performance compared to overall markets.

Since the start of the summer, we experienced a behavioural discrepancy which was also reflected amidst the FAANG (Facebook, Amazon, Apple, Netflix and Google), as the stocks with more stretched valuations experienced a new swan dive, with Facebook and Netflix losing around 20% in October. In that scenario, our Global Stable Equity Fund delivered a steady performance during the selloff in October in comparison with hot Tech companies.

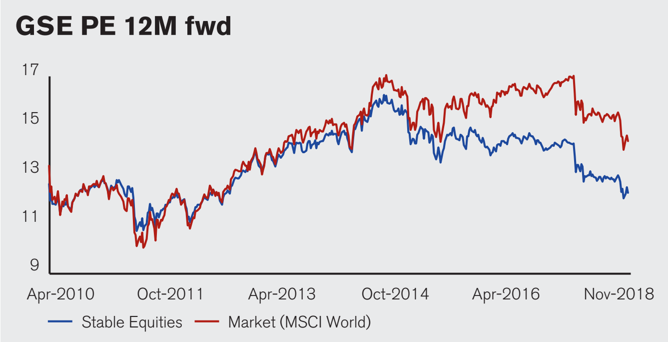
Amongst others this is due to the valuation overlay used in the stock selection process (quality stocks characterized by lower risk, stable fundamentals and attractive valuation). This **prevents to invest in companies that are not attractively valued,** and in doing so **protects the portfolio from the sharp drawdowns often associated to these high growth momentum stocks** (like Netflix when it did not meet investors' expectations). The stretched valuation in these kind of Tech companies is something that we have been cautious about.

...and well positioned for the future

After a bubbly soar of technology and social media stocks since 2016, these sectors displayed stellar performances especially after 2016 US election and as new US fiscal policy ramped up and pulled investors' focus on high growth companies. As an illustration of investors' hysteria for these market darlings, at some point during H1-2018 the FAANG represented almost 98% of the S&P 500 index expansion. This irrational ebullience led to historical high Price Earnings Ratios (PER) that has not been seen since the Internet Bubble.

Our Stable Equities, **continue to trade at a historically high valuation discount** not only relative to their low risk peers (i.e. MSCI World Min Vol.) but more importantly also vs. the overall equity market (MSCI World), as shown in the following chart.

Hence, there is a lot of value building up and this gap could very well close either if markets were to face recessionary fears, or once markets start to recognize the upside potential that this inconsistency of the current valuation levels displays.



Source: Bloomberg, Nordea Investment Management AB. As of 16.11.2018.

We remain confident in our portfolio as we see very good value in its components. We have seen how similar gaps in the past, when the difference in valuation was also not supported by fundamentals, have always been closed. We believe this difference will start to tighten and our Stable Equities will once again deliver superior risk-adjusted performance and unveil their unlocked value accumulated over the last two years.

In this late cycle phase, investors started to come back to high quality stocks that were out of favour since the US election, owed to their lower sensitivity to the economic cycle as well as investors´ bias to the more cyclical driven sectors of the market. Paired with both normalized valuation and higher business resilience, this trend could accelerate if the markets are foreseeing a more recessionary environment in the future.

In this context, our fund has posted positive performance and represents an effective tool to control the drawdown risks that are rising in the market, due to the potential trade war, the increased political risks and the concerns about global growth.

Stable equities are a strategy that is existing for over 10 years already and has been able to deliver superior risk-adjusted returns. Already in the past stable equities have had periods of relative underperformance, especially in periods of growth when investors are chasing growth at all costs. We know that these periods can be tricky and this is nothing new. However, in the long run the stable equities have always shown their resilience and have been able to come back and outperform the broader market, especially when looking at the risk-adjusted performance. This is why the portfolio management team stays true to its investment philosophy and is still very confident in their current portfolio holdings.

Overall our stable equities have never been so attractive from a valuation perspective also considering the underlying quality of our stocks in the portfolio. If investors are looking for appealing long-term return potential then this is a very attractive investment opportunity.

Whatever the future brings, portfolios that display quality defensive characteristics should navigate the future better.

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