Know Your Playground

Why the Nordic Equity Market is so Well Suited for an Absolute Return Focused Fund with an Equity Long / Short Strategy.

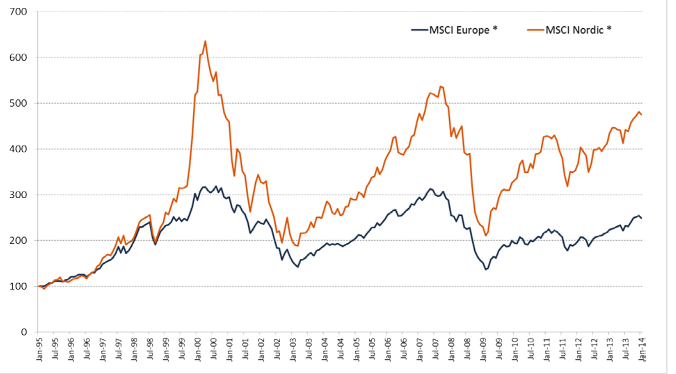
“If you had to be reborn anywhere in the world as a person with average talents and income, you would want to be a Viking. The Nordics cluster at the top of league tables of everything from economic competitiveness to social health to happiness” is how The Economist put it a year ago in a Special Report entitled “The Next Supermodel”, dated February 2, 2013. The renowned magazine went further, suggesting that the Nordic model offers a blueprint for how to reform the public sector, with a political system far more efficient and responsive in times of crises versus most European counterparts, as well as intent on combining social welfare goals with a framework for securing competitive capitalism.

As examples, the article points to Denmark that has a system of “flexicurity” that makes it easier for employers to sack people but provides support and training for the unemployed, and Finland which organizes venture-capital networks.

The superlatives above may not be unfamiliar to any investor who has received a sales pitch to invest in a Nordic-focused long only equity fund. In fact, Nordic long-only fund prospectuses all cite The Global Competitiveness Report, listing up how the Nordic countries rank among the top in; competitiveness; stabile regulatory environments; low political risk; high level of education; high degree of techno-logical innovation; low corruption; high degree of trust and transparency, to name a few. And of course, they highlight the large exposure Nordic companies -that by and large are export-oriented - have to the global markets.

We agree with the long only guys that the Nordic equity market is an attractive place to be – in the long run. Value creation as reflected in the long-term performance of the MSCI Nordic Index has far outstripped compounded returns in both European and global equities. Since 1995 the Nordic MSCI Index has outperformed the MSCI Europe Index by a factor of 2, while measured all the way back to 1971 the MSCI Nordic Index has outperformed the MSCI World Index by an impressive factor of 4,3.

Figure 1. The Nordics outperform in the long run, but be aware of the draw-downs

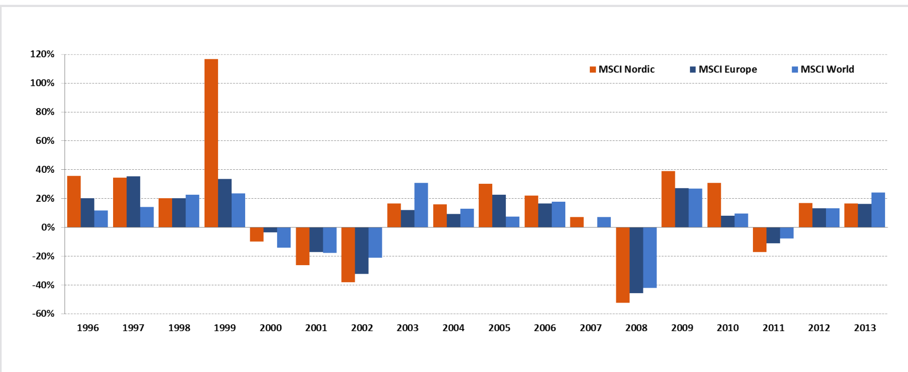


Source: Bloomberg, MSCI Nordic vs. MSCI Europe, total return, rebased in EUR

However, the Nordics are far more volatile compared to other developed markets, and investors are at risk of losing serious money (and patience) along the way in the rather violent and large draw-downs if past history is any guide. The composition of listed companies in the Nordic universe offers a rational explanation for a volatile market, with roughly 50% of total market capitalization of USD 1.5 trillion classified within cyclical sectors as opposed to the remaining 50% in non-cyclical sectors. Another possible explanation for the volatility in the Nordic equity market (perhaps perceived from the outside as "esoteric" despite its high rankings in competitiveness), with large swings in expected annual returns over the course of a global business cycle, is that volatility is amplified by large foreign ownership changes in Nordic equities.

Foreign investors tend to adjust their allocation to the Nordic markets, individually or on a regional basis, rather aggressively and opportunistically across sectors, in concert with the changing outlook for global growth. For instance, the foreign ownership ratio in the Finnish stock market increased from around 36% in 1996 to nearly 75% at peak in 2000, driven by frenzy in the tech and telecom sector, before crashing to an intermediate low of 49% in 2004. In Denmark, the foreign ownership share of the stock market has grown from 24% in 2005 to 44% at end of 2013, mainly driven by investment in the market's large cluster of pharmaceutical and life science

Figure 2. The Nordic equity market consistently over-shoots on the upside and under-shoots on the downside

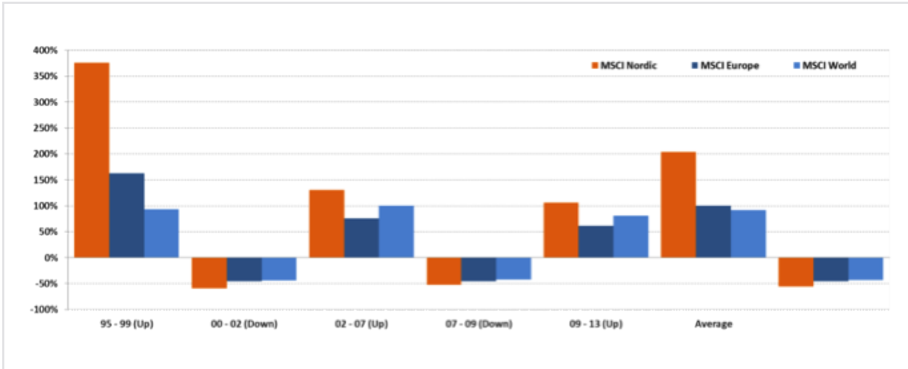


Source: Bloomberg, annual total return %

related companies. Foreigners are a large swing factor in the Nordic markets and exaggerate movements in stock prices on the upside and to the downside.

The effect of these volatile swings can be seen in the chart above. Since 1996 the Nordic equity market has shown a near consistent pattern of outperforming in positive years, while underperforming in negative ones. This pattern holds especially true vs. Europe, where Europe has outperformed the MSCI Nordic in only one year during the last 17 years in positive years, while the MSCI Nordic has underperformed in every single down year over the last 17 years. Furthermore, the movements from bottom to peak and back to the bottom of the markets are larger in the Nordic equity market, as can be seen in the chart below. Average total return in Nordic market from bottom to peak has far exceeded that of Europe, while falling harder from peak to bottom again. This backdrop provides an excellent investment environment for an active, long-short equity mandate such as the Sector Sigma Nordic Fund. Through risk management, with targeted volatility well below the historical average for the Nordic equity market, the Fund aims to capture the Nordics record of superior long-term value creation while reducing the variability of the Fund's returns.

Figure 3. Total return from bottom through to peak, and from peak through to bottom



Source: Bloomberg

The Fund's investment strategy is anchored in a thematic approach based on identifying structural trends and assessing their financial impact on individual sectors and companies within our Nordic universe. We define a structural trend as period of time, or an underlying development, that is not tied to the business cycle or the prevailing market phase, but most often overrides it. Value creation, as well as value destruction, is more apparent in the wake of a structural trend, and offers both more profitable and less risky investment opportunities. A few examples of our thematic approach - as applied over the past year in our investment choices - are discussed below.

Thematic approach to investing

At the beginning of last year, our analysis convinced us that Western oil majors would be forced to significantly reduce multi-year, double-digit growth in spending for exploration and production (E&P). Although a non-consensual view at the time, we established and have held net short positions on companies within the oil services sector since then. In the meantime, most oil majors have announced plans for large E&P spending cuts, highlighting a focus on capital discipline and ROACE (i.e. return on average capital employed). The oil majors' focus on capital discipline commences with plans for "no-growth" budgets for E&P spending beginning in 2014, and extending over a period of several years after that. Although oil services companies' share prices in our Nordic universe have massively underperformed the broader market over the past year, we think it is too early to go "bottom-fishing" in the sector. Oil services companies, especially with exposure to offshore E&P activity, will soon be faced with idled capacity, competitive pricing pressures, and bloated SG&A costs. Earnings estimates within the sector will most likely be reduced further, perhaps significantly, and news flow will continue to be decidedly negative. Valuations have come down, but do not reflect the structural nature of the trend, i.e. the risk of a prolonged downturn due to the Western oil majors' newly refocused long-term commitment to increasing ROACE.

Among the individual Nordic equity markets, Norway is the most cyclical, and the country's economic fortunes rest primarily on activity in the oil and gas sector. With "capital discipline" the current watchword for Western oil producers, including Statoil, and without the prospects for a sudden and sharp increase in the price of oil, investment and employment in the domestic oil and gas sector is set to decline. A weakening of the Norwegian economy has been signaled throughout the past year, with a depreciation of the Norwegian krone (NOK) against the EURO of 13% in 2013. With muted expectations for the price of oil, resulting in a projected decline in oil and gas-related investments from a peak of NOK 224 billion in 2014 to around NOK 200 billion annually beginning in 2015, the whole Norwegian economy will likely see negative ripple effects.

As a consequence, our investment focus on the long side in Norway is focused solely on export-oriented companies with a large NOK cost base. Norway emerged virtually unscathed from the effects of the 2008 financial crisis, and exceptionally low interest rates (thanks to global central banks' ZIRP policy – i.e. Zero Interest Rate Policy) have boosted household wages and spending, residential and commercial real estate prices, and public sector largesse to unsustainable levels. Structurally, Norway appears set for an economic downturn.

Another structural theme in our investment approach is tied to the advent of a new consuming class in Emerging Markets (EM) economies. In our Nordic investment universe we have consistently pursued a strategy of seeking out long exposure to the global consumer, and more specifically to the EM consumer. Underlying growth in consumerism in EM economies is structural, fairly stable and predictable. Furthermore, with a larger share of EM growth attributable to consumption by a rapidly increasing pool of middle class consumers, the structural aspect of this consumption is that it mirrors Western patterns. As an example of how we have been playing this structural theme of the emerging EM consumer we have invested in a Nordic company, unknown by name to most, that is in the business of making the paper cup you get when you buy a coffee at for instance Starbucks. This company saw their business growth in emerging markets accelerating to an annual rate of 14% in the last quarter of 2013, benefiting from two megatrends; increased packaging of daily consumer goods (food and hygiene products) due to growth in modern retailing and the rapid growth of fast food and coffee chain outlets. As the company put it "the foodservice playground is shifting towards emerging markets". To further put this into perspective; as of the end of 2013 there were 34,480 McDonalds in the world, 24% of these were in emerging markets.

"It is hard to explain to naïve data-driven people that risk is in the future, not in the past." (Nassim Taleb)

There were 20,891 Starbucks coffee shops, 17.5% of these were in emerging markets. Making paper cups for Starbucks may not be glamorous, but millions of middle class consumers in the emerging markets also want to hang out at a Starbucks coffee shop! If weaker than projected Chinese growth in 2014 occurs, or in EM economies in general, it most likely will happen because of less investment in capital formation, which is commodity-intensive. Lower EM growth will most likely continue to be more negative for resource-oriented companies in our Nordic universe, who have exposure to commodities prices and investment in commodities extraction, than for non-resource-oriented companies.

To sum up, the Nordic equity market is especially well-suited for an active, long-short equity mandate such as the Sector Sigma Nordic Fund. With risk management targeting volatility well below the historical average for the Nordic equity market, the Fund aims to capture the Nordics' record of superior long-term value creation while reducing the variability of the Fund's returns. Market timing is not a science, nor volatility a constant. Risk, however, is always present.

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