



WHITE PAPER

The case for Nordic Small Cap Equities



EXECUTIVE SUMMARY

Small Cap stocks, particularly the Nordic, have historically provided strong returns. Still, most individual investors remain largely biased in their equity allocations toward large- and mega-cap stocks. In this white paper, we make the case for Nordic Small Cap stocks and explain why we believe active management is important to exploit the inefficiencies inherent in this market.

Author



Petter Löfqvist is a senior portfolio manager at Alfred Berg. He has 17 years' experience of Nordic Small Caps. After finishing his studies at Gothenburg School of Economics and Commercial law, Petter joined Carnegie as a junior sell-side analyst covering Nordic small and mid cap industrials and raw materials companies. Petter has also spent 7 years in corporate finance before he started as a Swedish small cap portfolio manager in 2008. In 2014 he joined Alfred Berg as the head portfolio manager for Nordic and Swedish Small Caps. In 2014 he was awarded a silver medal by Morningstar in the Star Manager of the Year award in the Small Cap category.



DEFINITION OF SMALL CAP

Although there is no official definition in the asset management industry, small capitalisation companies (small caps) are typically defined as the lower quintile of listed companies by market capitalisation. Another definition used is all companies smaller than 1% of the total market capitalization of the stock exchange.

OUR DEFINITION OF NORDIC SMALL CAPS

We define the Nordic small cap universe based on Carnegie's definition¹. The universe consists of 575 companies listed on the stock exchanges in Sweden, Norway, Finland and Denmark.

The market value of the companies in the universe varies between EUR 0.3 million to EUR 5.3 billion with an average market cap of approx. EUR 500 million.

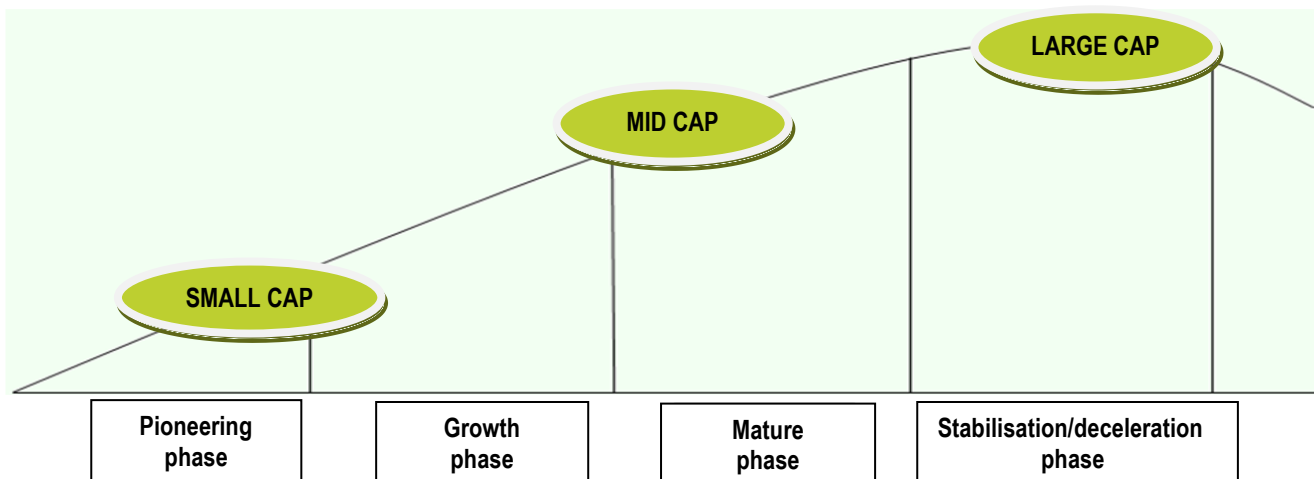
¹ Carnegie provides one of the most comprehensive Index families for Nordic Small Cap Universe.

THE MAIN ATTRACTION OF INVESTING IN NORDIC SMALL CAP

One of the key attractions of investing in small cap companies is the greater potential as businesses evolve from the start-up and growth phases to the mature phase of the business cycle.

It is easier to grow from EUR 100 million in sales revenue than from EUR 50 billion. Investing in this asset class usually coincides with capturing the returns from the early stages of new industries as they develop and benefit from the entrepreneurial type of management inherent in smaller companies.

Traditional business cycle of a company

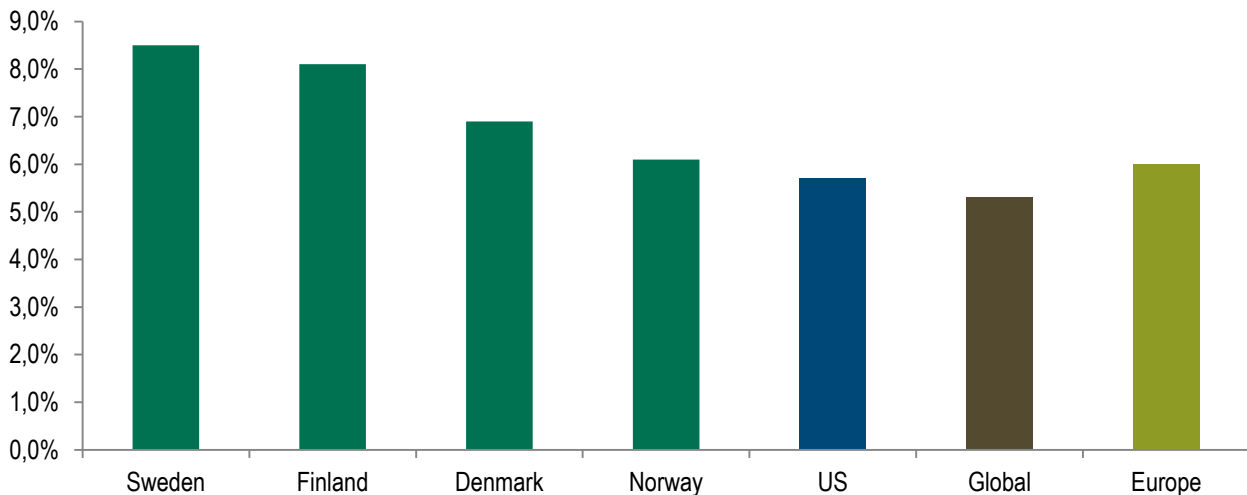


Source: Chartered Financial Analyst Association, as of 31/10/13; For illustrative purposes only

NORDIC EQUITY HAS GENERATED LONG TERM OUTPERFORMANCE.

Nordic equity markets have provided strong historical returns. They outperformed US, European and Global equity markets during the period 1965-2014.

Annualized real return: 1965-2014



Source: Credit Suisse Global Investment Returns Yearbook 2015 Elroy Dimson, Paul Marsh and Mike Staunton, London Business School

With a broad variety of natural resources, healthy macroeconomic environment and a strong innovative culture, Nordic countries provide a favorable environment for growth and stock market returns. The stronger long term equity returns generated in the Nordic market could be explained by a long history of stability and solid macroeconomic financials paired with vast and varied natural resources and small home markets which have forced Nordic companies to go global and become very competitive.

The stability and predictability is evidenced; Denmark is the World's least corrupted country² and no 4 in "Ease of Doing Business"³. Finland has the World's best education according to OECD and has been awarded "Best country in the World". Sweden is the "World's most innovative" country⁴ and has the 3rd lowest infant mortality rate in the world⁵. Norway ranks no 3 in the world on GDP per capita and ranks no 1 on Human Development Index.

The Nordic region has provided a long list of global industrial success stories; IKEA, Tetrapak, Electrolux, H&M, Volvo, Novo Nordisk, Statoil. The region is also the origin of number of technology success stories such as Spotify, Skype, King (Candy Crush Saga), Rovio (Angry Birds), Mojang (Minecraft), Ericsson and Nokia.

We consider this favorable environment for Nordic Equity still to be valid in the foreseeable future.

² Transparency International, Corruption Perception Index 2014

³ Worldbank, Doing Business 2015

⁴ Innovation index 2013

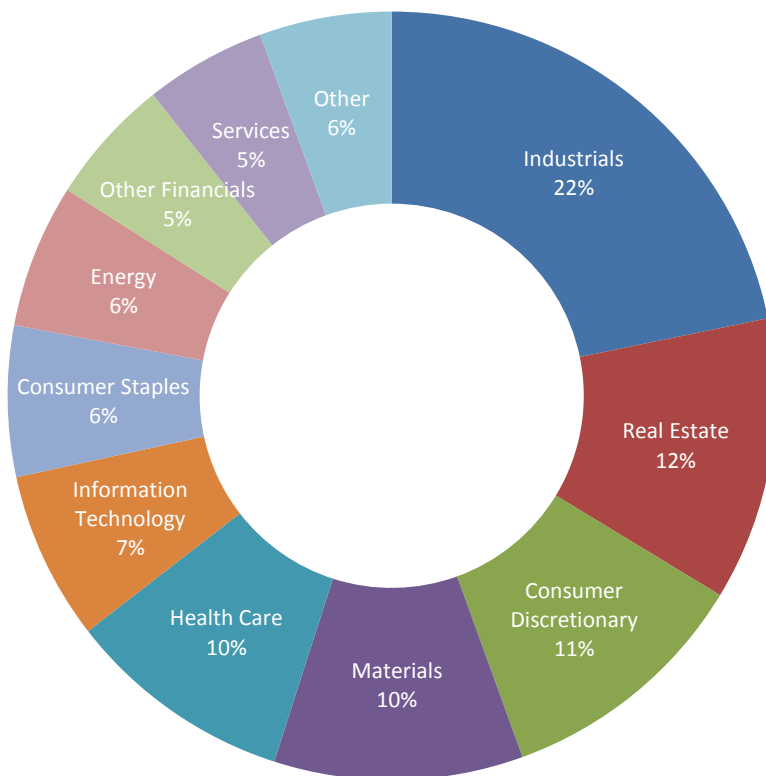
⁵ United Nations



NORDIC SMALL CAPS COMPARED TO NORDIC LARGE CAPS

Comparing Nordic small caps to Nordic large caps crystallises certain differences; firstly the Nordic small cap universe is more diversified in terms of sector distribution and secondly it has a stronger tilt towards growth sectors.

Sector weights Carnegie Nordic Small Cap Index



Source: Carnegie Nordic Small Cap Index, June 2015

THE STRONG PERFORMANCE HISTORY OF NORDIC SMALL CAP

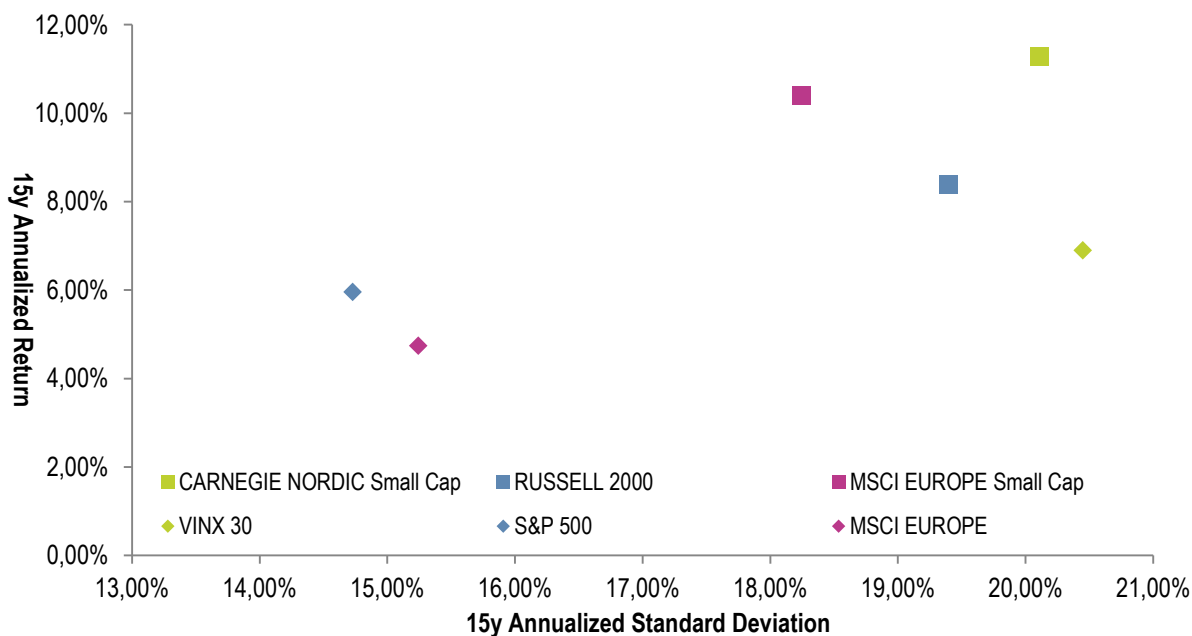
Several studies have been conducted confirming that size of a company is an explanatory variable for stock market returns.

Financial theory asserts that small cap stocks in developed markets should offer greater long-term performance than large-cap stocks at the expense of greater volatility.

To verify this assertion, Alfred Berg ran a performance analysis using the Russel 2000 and S&P 500 indices representing US Small and Large Caps. To depict European Small and Large Caps we used MSCI Europe Small Cap and MSCI Europe. We also plotted Carnegie Nordic Small Cap Index and VINX 30 (representing Nordic Large Caps) in our analysis below.

The result showed that small cap companies have significantly outperformed their large cap counterparts in terms of annualized returns with only moderately higher volatility over the last 15 years. The conclusion is that the small cap stocks delivered the strongest risk-adjusted performance.

15 year annualized returns vs 15 year annualized standard deviation



Source: Bloomberg, June 2015

Past performance or achievement is not indicative of current or future performance



NORDIC SMALL CAP RETURNS COMPARED TO GLOBAL SMALL CAPS

Comparing Nordic small caps to US and European small caps gives the same picture and an even more interesting story for Nordic small caps. The table highlights the long term outperformance of Nordic small caps.

Annual performance data Nordic, US and European Small Cap

YEAR	CSX Nordic	Russel 2000	MSCI Europe Small
2002	-18%	-22%	-27%
2003	43%	45%	31%
2004	28%	17%	20%
2005	48%	3%	34%
2006	34%	17%	28%
2007	-9%	-3%	-9%
2008	-58%	-35%	-53%
2009	68%	25%	56%
2010	32%	25%	27%
2011	-22%	-5%	-19%
2012	15%	15%	24%
2013	24%	37%	30%
2014	4%	4%	4%
YTD 15	19%	-6%	22%
Total return '02-14	247%	133%	176%
Annualized return	11%	8%	10%
Standard deviation	20%	19%	18%
Annualized /Sd	0,56	0,43	0,57

Source: All performance series calculated in EUR. Price source Bloomberg. Carnegie Small CSX Return Nordic – EUR (representing Nordic Small Cap Universe), MSCI Daily TR Net Small Cap Europe USD (representing European Small Cap Universe), Russell 2000 Index (representing US Small Cap Universe).

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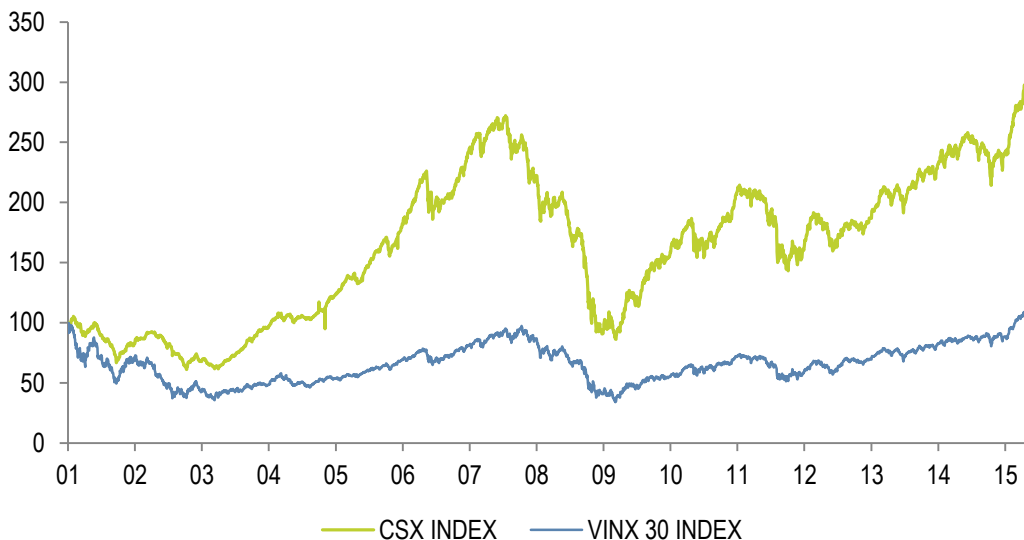


NORDIC SMALL CAP STOCKS HAVE PERFORMED WELL COMING OUT OF RECESSIONS

In addition to the risk and return potential Nordic small cap stocks offer, they also have historically performed better than large cap stocks when coming out of market downturns.

The figure below shows the return of Nordic small cap stocks and large cap stocks coming out of the last two economic downturns. Nordic small cap stocks recovered from the bursting of the technology bubble by returning 28% in 2004 vs. 11% for large cap stocks. Subsequently, Nordic small cap stocks also recovered more quickly from the recent financial crisis by returning 68% in 2009 vs. 33% for large cap stocks.

Nordic Large Cap vs Nordic Small Cap returns



Source: Alfred Berg, Bloomberg June 2015

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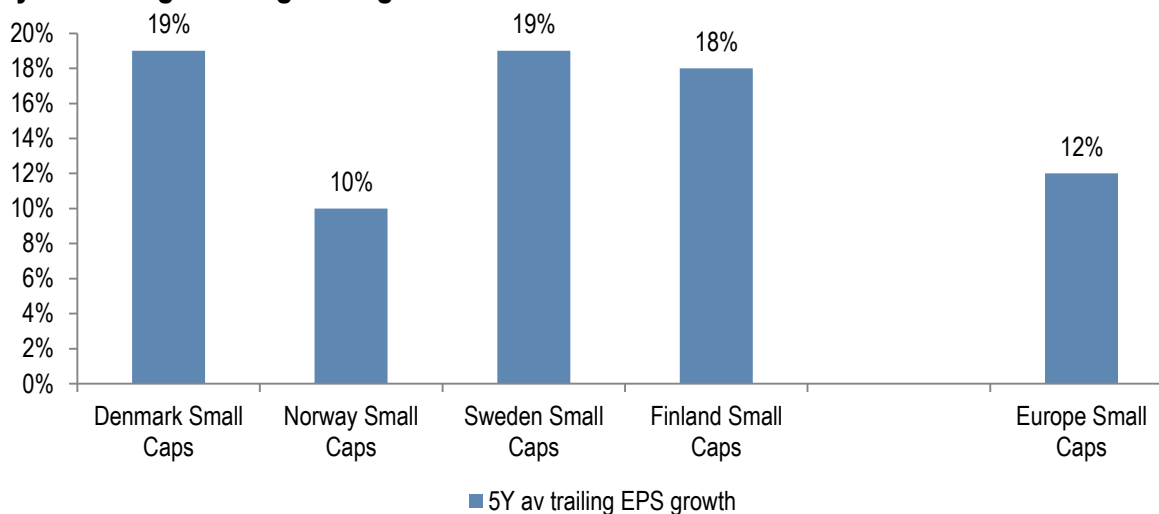
There are certain reasons why small cap stocks are able to recover more quickly than large cap stocks coming out of recessions. Small cap companies are generally more nimble and able to modify their strategies and reposition products quicker than larger corporations. As a result, small cap companies can quickly add to their work force and increase production when economic activity begins to improve.



NORDIC SMALL CAPS HAVE HISTORICALLY SHOWN STRONG EARNINGS GROWTH

Small caps have strongly outperformed large caps and global indices in the past few decades both in absolute return and risk-adjusted terms. This trend has been driven by greater growth prospects for smaller companies. Their inherently flexible and entrepreneurial structures are often well-suited to capture market opportunities and adapt to changing trends. This is reflected in higher sales and earnings growth.

5 year average trailing EPS* growth



Source: ABG Sundal Collier, Datastream, I/B/E/S, June 2015.

* Earning Per Share

It is our view that investment in the Nordic small caps economies has the potential to generate above average returns over the long term based on its long term historical performance and current fundamentals.

Additionally, the increasing amount of cash reserves held by large caps combined with significant signs of uplift in global M&A activities could benefit the performance of small cap & mid cap stocks in the coming period.



AN EVOLVING UNIVERSE - THE SOURCE OF FUTURE BIG CAPS?

The Nordic small cap universe is constantly evolving. New companies enter through IPO's. Consolidation takes place through pursuing M/A strategies and public to private transactions. Companies also exit the market through bankruptcies or financial distress. Success stories evolve through companies developing strong positions within certain high growth niches.

The table below depicts the 20 largest companies in the CSX index as of April 30, 2015 ranked by weight in index, comparing it to its position in index by January 1, 2001. Looking through the rank as of 2015 it is interesting to see that among the largest companies two are fallen angels coming down from the large cap index (Boliden and Securitas), 4 companies were not listed by 2001 and 9 companies have been significant growth stories outpacing market performance significantly.

20 LARGEST COMPANIES IN CSX NORDIC SMALL CAP INDEX JUNE 2015

Company	Country	MCAP (EUR bn)	Rank 2015	Rank 2001
Meda	Sweden	5,5	1	489
Boliden	Sweden	5,3	2	Large cap
Securitas	Sweden	4,9	3	Large cap
Trelleborg	Sweden	4,7	4	51
Lundin Petroleum	Sweden	4,5	5	218
Latour	Sweden	4,4	6	37
Genmab	Denmark	4,0	7	93
Swedish Orphan Biovitrum	Sweden	3,9	8	Not listed
Husqvarna	Sweden	3,8	9	Not listed
Hexpol	Sweden	3,3	10	Not listed
BillerudKorsnäs	Sweden	3,2	11	Not listed
Elekta	Sweden	3,2	12	341
NCC	Sweden	3,2	13	46
Huhtamäki	Finland	3,1	14	39
SSAB	Sweden	3,0	15	28
Axfood	Sweden	2,9	16	149
Amer Sports	Finland	2,7	17	76
NIBE Industrier	Sweden	2,6	18	333
Hufvudstaden A	Sweden	2,6	19	63
Rockwool International	Denmark	2,6	20	129

Source: Bloomberg, June 2015, Alfred Berg, Carnegie Indices



Looking back at the index composition of January 1, 2001, ranked by index weight tells another interesting story. 7 of 20 companies have been bought out in a public to private transaction. 7 companies have exited the small cap index to become large caps. Only 3 are companies where the business models have failed since 2001.

20 LARGEST COMPANIES IN CSX NORDIC SMALL CAP INDEX JANUARY 2001

Company	Country	MCAP EUR bn	Rank 2001	Rank 2015
Holmen	Sweden	2,8	1	25
Gambro	Sweden	2,6	2	Exit buyout
AssiDomän	Sweden	2,5	3	Exit buyout
OM HEX	Sweden	2,2	4	Exit buyout
SanomaWSOY	Finland	2,2	5	117
Pohjola-Yhtymä	Finland	2,0	6	Exit buyout
WM-data	Sweden	1,9	7	Exit buyout
SKF, AB	Sweden	1,8	8	Large cap
Modern Times Group MTG	Sweden	1,7	9	26
Swedish Match	Sweden	1,6	10	Large cap
Novozymes	Denmark	1,6	11	Large cap
Metso	Finland	1,6	12	Large cap
Eniro	Sweden	1,6	13	360
Orion-yhtymä	Finland	1,6	14	Large cap
Comptel	Finland	1,6	15	401
Kone	Finland	1,5	16	Large cap
Gjensidige NOR	Norway	1,5	17	Large cap
Petroleum Geo-Services	Norway	1,4	18	73
Drott AB ser. B	Sweden	1,4	19	Exit buyout
NEG Micon	Denmark	1,4	20	Exit buyout

Source: Bloomberg, June 2015, Alfred Berg, Carnegie Indices

Judging from the evolvement of the top 20 companies in the index from 2001 until today it is fair to say that in order to successfully manage a long term small cap portfolio it is wise not only to look in the top 20 list of the index. Even though it seems you will have a fair chance of companies developing into large cap companies, the highest return is found through looking further down in market cap rank to capture the companies that will have the potential develop to become the next top 20 companies 5 to 10 years from now.



SMALL CAP INVESTING REQUIRES ACTIVE MANAGEMENT

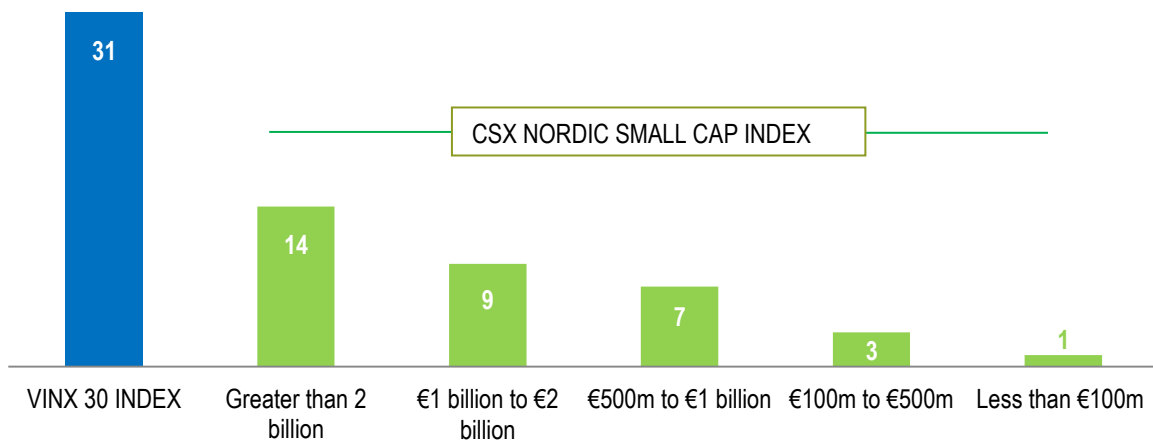
THERE IS NO PASSIVE WAY INTO INVESTING IN NORDIC SMALL CAPS

The Nordic Small Cap market is under-researched. The most common Benchmark index (Carnegie Nordic Small Cap Index) constitutes some 575 companies, of which around half are covered by one or no equity research analyst.

It is our firm view that there are substantial opportunities for good active managers to outperform the benchmark over time in the Nordic Small and Mid-Cap space.

A closer look at analyst coverage per stock further strengthens our view that stock selection skills are crucial. Using analyst coverage data for small and large cap stocks, i.e the number of analysts providing at least one annual earnings forecast for company, the findings are interesting; Nordic Small Cap companies on average attract nearly a third of the research coverage compared to large cap counterparts.

Average analyst coverage per stock by market capitalisation



Source: Bloomberg, January 2015

This lack of research can lead to significant inefficiencies and mispricing in this part of the equity market that can be exploited through a combination of solid proprietary company research and active portfolio management.



ASSET MANAGEMENT AT ALFRED BERG

Alfred Berg is a leading asset manager in the Nordic and Baltic region. As part of BNP Paribas we are recognized for a global reach and a true passion to deliver quality to our clients.

The importance of stock picking and the limited analyst coverage strongly support Alfred Berg's view that in the Nordic small cap universe, alpha is best generated through a bottom-up approach.

With 575 constituents in the Carnegie Nordic Small Cap index, one fundamental question arises: how does a bottom-up fund manager narrow such a broad universe?

All Nordic Small Cap companies are not investible. Liquidity constraints eliminate a significant share of the companies in the universe. A quantitative screening based on liquidity parameters is a first step. Depending on the investment strategy and style of the manager, a natural second step is quantitative screening typically including financial parameters, earnings expectations and valuation metrics. This process will narrow down the investment universe further; however it does not alone provide a good Nordic small cap portfolio.

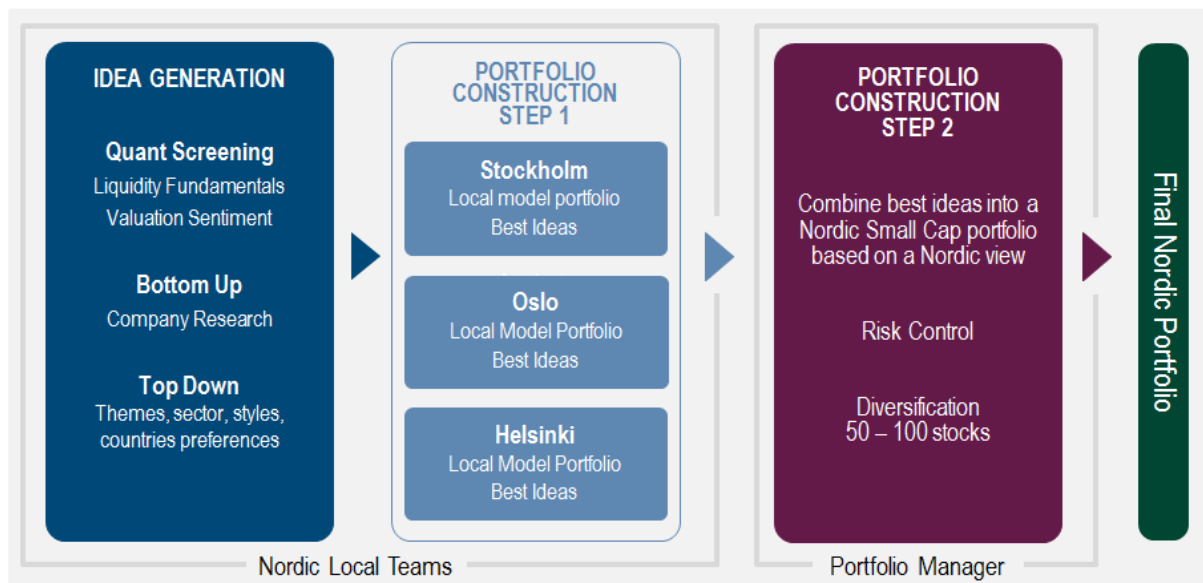
At Alfred Berg, the Nordic small cap equities team consists of six portfolio managers with an average of 18 years of work experience. The extensive resources and strong adherence to a disciplined investment process are the cornerstones of a successful track record and have positioned us at the top of our peer groups.

The Nordic small cap investment process is based on being close to the local markets, companies and research resources. Alfred Berg has small cap specialists located on ground in Stockholm, Oslo and Helsinki, that all contribute to the Nordic small cap investment process. Our portfolio managers cover the investment space with a pure bottom up investment focus.

It is our firm belief that in order to make a difference in the Nordic small cap investment space, proximity to companies is a key factor. We conduct more than 400 company and management meetings annually, in order to have our own view of the long term potential of the companies and the environment they operate.



INVESTMENT PROCESS



Source: Alfred Berg, 2015

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