November 3, 2010

Global Value Equity Portfolio

The Saxo Bank Global Value Equity Portfolio would have made excess returns of 8.6% year-to-date

In October, however, the portfolio would have returned 1.13% compared to the return of our benchmark, the MSCI World EUR index, at 1.81%. Year-to-date our portfolio would have produced excess return of 8.6% compared to the benchmark. Since the back test start the portfolio would have returned 10.7% p.a. vs. the benchmark return of 0.4% p.a.

The portfolio is overweight in financials

The significant overrepresentation of financials in the portfolio clearly indicates financials have been trashed by the market. Fundamentally, an exposure to financials of this magnitude should cause concern, but our interest-bearing debt to equity constraint avoids exposure towards commercial banks. Our portfolio favours real estate and insurance and we think that the valuation metrics for both sectors indicate that there is value to be picked up here.

Tryg is the best value bet in the portfolio

The stock fell 17.86% in October due to a significant downward revision of earnings based on a ruling from the Danish Supreme Court. Another trigger for this was the unusual large cloud-burst in August which has impacted weather-related claims in September. But given the historical trackrecord of Tryg we are led to believe that the price decline is more driven by sentiment rather than fundamentals.

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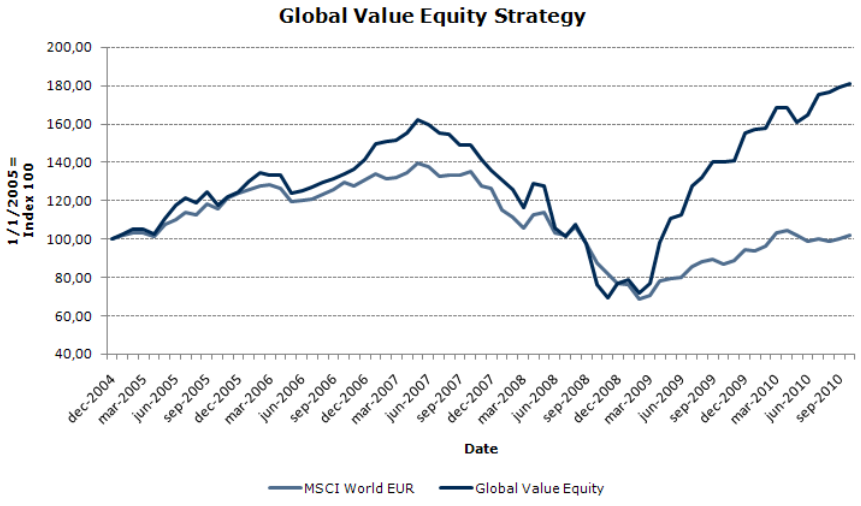

Performance overview

Return	Global Value	MSCI World EUR
YTD	16,6%	8,0%
12 mo.	29,1%	17,3%
36 mo. (ARP)	6,7%	-8,9%
60 mo. (ARP)	9,0%	-2,5%
Since inception (ARP)	10,7%	0,4%

Risk & performance (70 mo.)	Equity Value	MSCI World EUR
Standard deviation	6,8%	4,2%
Sharpe Ratio	0,084	-0,059
Alpha	0,010	0,000
Beta	1,36	1,00
R2	80,7%	
Correlation	81,7%	

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Global Value Equity Portfolio – November 2010

Our November portfolio portfolio is composed of the following stocks:

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Company	Sector	Market Cap (mil. $)	CAPE 3 yr	P/B	Piotroski
Scor SE	Finance	3.317,18	8,02	0,81	7
Catlin Group Ltd.	Finance	1.440,44	5,91	0,75	6
CNP Assurances	Finance	8.520,13	8,65	0,74	7
Seven Group Holdings Ltd.	Miscellaneous	1.587,38	3,25	1,16	6
Shun Tak Holdings Ltd.	Finance	1.030,20	8,62	0,76	6
Piedmont Office Realty Trust Inc.	Finance	1.266,06	5,00	0,10	5
Almirall S.A.	Health Technology	1.129,47	8,03	1,50	8
Hopewell Holdings Ltd.	Finance	1.984,63	5,57	0,83	5
Helvetia Holding AG	Finance	2.194,92	10,69	1,09	6
NWS Holdings Ltd	Transportation	3.699,80	10,87	1,29	7
Amlin PLC	Finance	2.320,11	6,56	1,29	5
BP PLC	Energy Minerals	92.043,52	7,32	1,29	5
Drax Group PLC	Utilities	1.597,79	4,85	1,39	5
Tryg A/S	Finance	2.314,97	10,31	1,76	7
Vodafone Group PLC	Communications	102.496,97	14,48	1,02	6
Cincinnati Financial Corp.	Finance	3.448,14	8,91	1,20	5
CapitaCommercial Trust	Finance	2.336,91	9,52	1,19	5
Champion Real Estate Investment Trust	Finance	1.953,94	11,53	0,78	5
Zurich Financial Services AG	Finance	25.665,49	8,74	1,26	5
Sanofi-Aventis S.A.	Health Technology	65.781,58	13,84	1,36	6
	Median	**2.317,54**	**8,63**	**1,17**	**5,85**

*The Piotroski Score and the return of the portfolio are calculated using average

Portfolio basics

Value creates excess risk-adjusted return. We have introduced this new equity portfolio based on classical deep value criteria mixed with a quality indicator based on a Piotroski score. Our portfolio would have produced excess risk-adjusted return in the back testing period by 10.3%; the annual return was 10.7% p.a. compared to 0.4% p.a. return for our benchmark, the MSCI World Index EUR.

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

The new portfolio. The Global Value Equity Strategy portfolio is an update of the original portfolio we released in September. In further testing we found that by changing the parameter settings we could receive a better risk adjusted return. Furthermore, we now have monthly holding periods creating a composite index.

Research methodology

Saxo Bank's Global Value Equity Strategy 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), Lakonishok, Shleifer and Vishny (1994) and Piotroski (2002)[1] document that significant excess return is possible for high book-to-market portfolios (that is a portfolio with a low price-to-book ratio). 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)[2], amongst other criteria, such as: a trailing earnings yield (more specifically CAPE[3]) greater than twice the corporate bond yield, a dividend

[1] 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; Joseph D. Piotroski (2002), Value Investing: The Use of Historical Financial Statement Information to Separate Winners from Losers, The University of Chigago School of Business.

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

[3] CAPE is the current market price divided with a chosen period of earnings per share (EPS) and the concept was first published and used by Benjamin Graham and David Dodd in their book Security Analysis (1934). They emphasised using no less than five years of annual EPS. The concept is based on adjusting the EPS for cyclical upward or downward extremes (smoothing out the earnings pattern). Through our iterative research we observed that our mix of value criteria produced a too narrow a sample to conduct a diversified portfolio in some early observation (particularly in 2005). From a sensitivity analysis of our parameters the CAPE

yield at least equal to two-thirds of the corporate AAA bond yield and a low debt-to-equity ratio.

The Saxo Bank Global 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). This is mitigated because we are using deep value criteria that will increase the number of companies with depressed valuations, which will lead to higher volatility (beta). Note, higher 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 depressed and neglected companies measured as low P/B stocks.

Our monthly stock sample is selected according to our search criteria and the universe is cash equities available to trade on the Saxo Bank trading platforms[4]. We also limit the universe to primary issues (listings), 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.

Our research design is based on a few screening criteria such as market value, average daily trading volume, cyclical adjusted price earnings (CAPE), dividend yield and interest-bearing debt over equity. To generate a portfolio with medium-to-low business and liquidity risk only stocks (and companies) with a market capitalisation above USD 1 billion (as of 2010 approximately 2,460 companies pass this criterion) and 60-day average daily trading volume above EUR 1.5 million (4,800 stock/companies pass this criterion) are permitted. The CAPE 3-year parameter is set to maximum of 16 which equals a minimum earnings yield of 6.25%. This constraint limits the sample to stocks with conservative valuations (3,400 stocks/companies pass this criterion). The dividend yield should at least equal two-thirds of the corporate AAA bond yield which on average through the back-testing period is a minimum of 3.3% (around 2,200 stocks/companies pass this criterion). Interest-bearing debt should be less than two-thirds equity. This parameter ensures that highly leveraged companies such as commercial banks and real estate stocks do not pass our screening (8,100 stocks/companies pass this criterion). Benjamin Graham preferred stocks with P/B ratios below two which we are also applying in our portfolio (8,100 stocks/companies pass this criterion).

parameter came out as the most sensitive. On this basis we concluded to change our CAPE parameter from originally CAPE 7 yr. (current market price divided with the latest seven years of annual EPS) to CAPE 3 yr. We will use CAPE and CAPE 3 yr. interchangeably in this paper.

[4] See appendix for the stock exchanges on which Saxo Bank facilitates cash equity trading.

The first iteration of the portfolio was built on a trailing earnings (CAPE 7-year) yield greater than twice the corporate AAA bond yield. However, this limited our sample too much (sometimes only five stocks passed our screening in a single month). Thus we changed the parameter to CAPE 3-year below 16 to increase the monthly sample. The problem presented was that a relatively high stable corporate AAA bond yields around five percent, which in return equals an earnings yield of at least 10%. For this to be met CAPE 7-year would have to be below 10, which is virtually impossible to obtain for long periods in the equity market – we would not be able to be invested at all times in the equity market.

Back-testing methodology

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 2004, which means that the portfolio's beginning date is 1 January 2005. This provides us with 69 monthly return observations which are sufficient enough to generate valid statistical analyses such as beta, alpha, Sharpe ratio and Treynor measures.

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 are looking back on the last annual report data, we are receiving 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 for Piotroski score, CAPE and P/B. The 20 stocks with the lowest weighted ranking (most attractive valuation and Piotroski score) are selected as the forthcoming month's portfolio. Based on the monthly price return adjusted to currency cross changes in EUR we calculate the portfolio's equally weighted return for that month.

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 20 most promising stocks in terms of valuation and Piotroski 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 annual gross return, excluding dividend and transaction costs, of 10.5% compared to -0.2% for MSCI World Index 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 World Index EUR in 40 out of 68 months. This corresponds to around 58.8% positive excess return observations throughout the back-testing period. In addition, our portfolio does not include dividends which would have increased the annual performance relatively to MSCI World Index EUR as the portfolio had constantly around 3.5-5.5% dividend yield which has consistently been around 2-4 percentage point above that of MSCI World Index EUR.

We calculate the Sharpe ratio, beta, alpha, R^2 and correlation based on monthly return observations for the portfolio and MSCI World Index EUR. We use the iBoxx EUR Treasuries 1-3Y Total Return Index as our risk-free rate. Beta and alpha are calculated with linear regression of the portfolio's and MSCI World Index EUR's monthly excess return over the risk-free rate. The portfolio performed well over the back-testing period with a positive Sharpe Ratio of 0.08 (on a monthly basis), beta of 1.38 and alpha of 0.01 with R^2 of 80.9% and correlation between monthly return of the portfolio and MSCI World Index EUR of 81.8%.

The portfolio's return distribution over the back-testing period has had a positive skewness and excess kurtosis. Our portfolio has a positive skewness of 0.06 indicating that the return distribution has an asymmetric tail extending towards more positive values. But the value lies within one standard deviation and thus the value is probably just a chance fluctuation from zero – that is the return distribution is probably symmetric. Our portfolio has an excess kurtosis of 4.33 which means that the returns follow a leptokurtic distribution (more peaked values). Our portfolio's kurtosis lies above two standard deviations indicating that our portfolio has significantly peaked return distribution which point towards it having fat tails (higher probabilities of larger positive and negative monthly returns). Thus we should expect large positive as well as negative returns. Historical data also suggests the maximum monthly return since 2005 has been 27.5% for the portfolio compared to 11.1% for MSCI World Index EUR.

Appendix - stock exchanges available for trading (cash equity)

- American Stock Exchange
- Euronext Amsterdam
- Australian Stock Exchange Ltd.
- Euronext Brussels
- OMX Copenhagen
- OMX Copenhagen – First North
- Hong Kong Stock Exchange
- OMX Helsinki
- Euronext Lisbon
- London International Exchange
- London Stock Exchange SEAQ Market
- London Stock Exchange SETS Market
- Milano Stock Exchange
- NASDAQ Global Markets
- NASDAQ Capital Markets
- New York Stock Exchange
- NYSE ARCA
- Oslo Stock Exchange
- OTC Bulletin Board on NASDAQ
- Euronext Paris
- Singapore Exchange Securities Trading Limited
- Sistema De Interconexion Bursatil Espanol
- OMX Stockholm
- OMX Stockholm – First North
- Swiss Exchange
- Wiener Börse (Vienna) Stock Exchange
- SWX Europe

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