For professional investors - **JULY 2014**

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PERSPECTIVES

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BNPP IP is the source for all data in this document as at end of June 2014, unless otherwise specified.

The 'when' question

Imagine the following scene. It's summertime, a warm and humid evening. People are relaxing, sipping drinks on terraces. The small talk is over and the conversation has shifted to the question of whether rain is on the way.

This is a metaphor for today's market environment. The sunny cyclical picture inspires confidence, with the US seeing strong employment growth, China doing better as of late and the eurozone, despite some softer data recently, remaining on the path of improving economic growth. Moreover, inflation remains so low that central banks can keep their (policy) foot pushing firmly on the monetary throttle. As a consequence, market volatility has been amazingly low for a long time and recent major geopolitical turmoil has barely had an impact.

Year-to-date, this cocktail of factors has supported equities, corporate bonds and emerging debt while also pulling government bond yields lower. While investors should revel in an environment like this, the favourite topic of discussion is now the question of when markets will correct.

More importantly however, the 'when' question signals the intrinsically unbalanced nature of the current climate in which minor surprises can have an unexpectedly large market impact. The sensitivity to surprises is particularly high where it concerns the stance of monetary policy (in line with fundamentals or 'behind the curve'?) and communicating this stance. The role of central banks in making the rain and sunshine in financial markets is as big as it has ever been.

7 July 2014

William De Vijlder
Vice-Chairman of BNPP IP

Andrew Craig
Head of Financial Market Analysis, BNPP IP, Paris

Equity holdings on the rise among official institutions

Assets managed by official institutions have risen significantly in recent years making them a powerful force in financial markets. A recent report highlights the fact that in the face of sub-optimal returns from traditional investment strategies, official institutions are increasingly diversifying their holdings into riskier assets.

A recent report ('The Global Public Investor 2014' published by the Official Monetary and Financial Institutions Forum (OMFIF)) provides a fascinating glimpse of investment trends at official institutions. The report covers three broad (and sometimes overlapping) investor groups that fall within the category of global public investors. Of these three sub-groups the report covers 157 central banks, 87 sovereign wealth funds (SWF) and 156 public pension funds.

Total funds under management at these institutions are USD 29.1tn, the equivalent of 40% of world GDP. Assets under management at official institutions have, says the report, grown "unprecedentedly fast". As a result, the same authorities that are responsible for maintaining financial stability are often the owners of the large funds that have the potential to cause problems.

Growth of assets-under-management at official institutions is in large part explained by the increase in central banks' foreign currency reserves. This in turn reflects world economic imbalances, efforts to counter currency appreciation against the dollar and the euro as well as the objective of holding assets to deal with setbacks. The combined force of central banks, sovereign funds and public pension funds brings great potential for stabilisation but paradoxically the weight of these assets also creates a new source of risk, by adding fresh liquidity and potentially generating destabilising rises in asset prices.

The weight of liquidity held by official institutions, coupled with low interest rates in developed countries, has led to 'sub-optimal' returns from traditional currencies and investment instruments (often short-duration bonds). So the declining profitability of central banks' reserve holdings has prompted a readiness to invest beyond traditional fixed income strategies. The result is increasing diversification into different sectoral and geographical asset classes. The report highlights a trend among central banks, including those in Europe, of building up equity holdings, following the patterns of sovereign and public pension funds. Investments in infrastructure, real estate, commodities and hedge funds are apparently no longer considered 'alternative' by official institutions.

Among the reasons cited in the report for diversification into infrastructure by official institutions is the view that expropriation of hard assets such as property is less likely than currency debasement and/or rescheduling of government debt. Similarly, equity ownership which promises a share of globally diversified earnings appears preferable to a debt note vulnerable to the monetary printing presses.

Should these trends continue, there is scope for official institutions to significantly contribute to promoting financial innovation. Examples include the financing of energy projects, infrastructure and other 'alternative' investments outside public markets or the development of new forms of securitisation to help overcome economic imbalances.

"Government bonds that were once viewed as representing a risk-free rate are now often seen as 'rate-free' risk"

A number of official institutions have been reducing allocations to fixed income reflecting a conviction that the decades-long golden age of fixed income investing is coming to an end. For central banks managing official reserves the potential negative impact of rising interest rates on fixed income allocations means government bonds that were once viewed as representing a risk-free rate are now often seen as 'rate-free risk'. There may well be lessons for other investors in such an analysis.

7 July 2014

EQUITIES

Frederic Surry
Chief Investment Officer equities and convertible bonds, BNPP IP, Paris

Models tell us that equities are currently still the best game in town

Applying the best academic thinking via model-based approaches to forecasting equity returns suggests equity markets can continue their rally in the next 12 months.

While we're not saying they are quite up to Benjamin Franklin's famous line 'nothing is certain in this world but death and taxes', recent academic papers claim that two approaches to forecasting equity market returns do have solid predictive power. So we assessed the expected 12-month returns of equities based on a combination of these academic approaches and recent data.

The first approach, 'sum-of-the-parts', proposed by Ferreira and Santa-Clara[1], is based on the fact that equity market returns can be broken down into three elements: earnings growth, dividend yield and the expected changes in the price earnings ratio. Ferreira and Santa-Clara propose the current dividend yield as the best predictor of future dividend yields. Earnings growth can be best forecast by its long-term trend, so they propose the use of a 20-year historical average. Since the price-earnings multiple (P/E) is hard to predict, Ferreira and Santa-Clara propose that it is kept constant.

The second approach is based on a dividend-discount model as proposed by Binder, Nielsen and Oppenheimer[2] and by Daly, Nielsen and Oppenheimer[3]. The model breaks down equity market returns into two elements: the expected price return and the expected dividend yield. The expected dividend yield over the coming year is estimated from analyst forecasts. The expected price return is obtained from the fair value price in one year from today compared with today's price. The fair value price in one year from today is found by discounting the expected future cash-flows. Important inputs to the model are the discount rate, the sum of bond yields and the equity risk premium. As suggested by Daly, Nielsen and Oppenheimer, we use an equity risk premium that changes with the economic cycle, as this reflects the fact that in poor economic regimes investors are risk averse and demand a higher equity risk premium. In such regimes the discount rate is higher and the fair value of equities lower. The cyclical equity risk premium is derived from the output gap.

In the table here we show the expected returns obtained from these two approaches using earnings and dividend yield data from the I/B/E/S database and the most recent International Monetary Fund forecasts for the output gap.

"The models suggest that investors should remain invested as a continutation of the bull market is still the most probable scenario."

Although these models show more modest forecasts than two years ago, the expected equity market returns remain positive despite the recent bull market. The models suggest that investors should remain invested as a continuation of the bull market is still the most probable scenario. The dividend-discount model, which accounts for the cyclicality of equity risk premium, shows higher expected returns than the sum-of-the-parts model, which does not.

EXPECTED RETURNS	US (USD)	EUROZONE (EUR)
Sum-of-the-parts model	+8.3%	+8.7%
Dividend-discount model	+19.2%	+14.4%

Data source: BNP Paribas Investment Partners, MSCI, Bloomberg, I/B/E/S and IMF. Expected returns for the next 12 months generated by the 'sum-of-the-parts' model for US equities (MSCI US index) and eurozone equities (MSCI EMU index). Expected returns for the next 12 months generated by the 'dividend-discount' model for US equities (S&P 500 index) and eurozone equities (EuroSTOXX index). As of 30 June 2014.

30 June 2014

1 Ferreira, M.A., and P. Santa-Clara. "Forecasting stock market returns: The sum of the parts is more than the whole." Journal of Financial Economics, Vol. 100 (2011), pp. 514-537.
2 Binder, J., E.A.B, Nielsen, and P. Oppenheimer. "Finding Fair Value in Global Equities: Part I" The Journal of Portfolio Management, vol. 36, No. 2 (2010), pp. 80-93.
3 Daly, K., E.A.B, Nielsen, and P.Oppenheimer. "Finding Fair Value in Global Equities: Part II" The Journal of Portfolio Management, vol. 36, No. 3 (2010), pp. 56-70.

Joost van Leenders, CFA
Chief Economist Multi-Asset Solutions, Amsterdam

The bull and bear case for high-yield

High-yield corporate bonds have had a stunning bull run since 2009. The historically low yields we are now seeing beg the question of whether high-yield remains an attractive asset class. We asked credit specialists Boriana Borissova and Pankaj Shah from the Multi-Asset Solutions* team to present the bull and the bear case.

To even up any philosophical biases, we asked Boriana, who tends to see the glass as half full, to present the bear case, while Pankaj, for whom the same glass tends to be half empty, argues for the bulls.

THE BEAR CASE

Boriana gave four arguments:

1. **Valuation**
2. **Liquidity**
3. **Fed tapering**
4. **Leverage**

Regarding **valuation**, spreads are trading at multi-year lows and yields are at record lows, so high-yield offers very little upside potential at this point.

Liquidity is traditionally an issue in this market, especially in turbulent times. High-yield has the same reputation as the Hotel California: you can check out any time you like, but you can never leave. Divesting smoothly was clearly an issue during the financial crisis, but the market's capacity to cope with investors cutting positions may have worsened since. Regulatory changes are one of the reasons why banks have become less willing to trade in high-yield bonds. Primary dealer's holdings of corporate debt instruments fell steeply during the financial crisis and have never recovered. High-yield is also an asset class where gross issuance of new bonds is high relative to secondary market turnover (i.e. the entry would appear to be bigger than the exit).

According to Boriana, the third reason to be bearish is **Fed tapering**. The US Federal Reserve has been slowing its asset purchases by USD 10 billion a month. At this time, nothing suggests that any change in the rhythm of these purchases is imminent. This means the quantitative easing programme is due to end in December at the latest, but possibly as early as October. So far so good: bond yields have stayed low and equity markets are at record highs in the US. We think the Fed's largesse has been instrumental in suppressing market volatility, but this may change towards the end of the tapering process.

Finally, **leverage** may be interpreted as a red flag by credit investors. The value of global high-yield bonds outstanding has surged in recent years. And while a sharp increase in global M&A activity may be beneficial for equity holders, it is usually less favourable for bond holders.

Boriana closed her presentation with the following quote from comments made by Federal Reserve Chairwoman Janet Yellen on 18 June 2014:

> "I've spoken in recent congressional testimonies and speeches about some threats to financial stability that are on our radar screen that we are monitoring, trends in leverage lending and the underwriting standards there, diminished risk spreads in lower-grade corporate bonds. High-yield bonds have certainly caught our attention. There is some evidence of reach for yield behaviour."

This warning follows on the heels of remarks by Federal Reserve Bank Governor Jeremy Stein, who on 6 May said that: "Crucially, in asset markets, it is often the beliefs of the most optimistic investors — rather than those of the moderates — that drive prices, as they are the ones most willing to take large positions based on their beliefs. Moreover, this same optimism can motivate them to leverage their positions aggressively." Governor Stein had previously warned on several occasions about froth in the corporate bond market.

* The Multi-Asset Solutions team (MAS) is the dedicated asset allocation capability within BNP Paribas Investment Partners. The team of 50 investment professionals manages over EUR 50 billion of assets in strategic and flexible asset allocation strategies.

THE BULL CASE

Pankaj started his counter-arguments by pointing out that Chairwoman Yellen's warning may be premature – being right is one thing, what really matters is timing. Pankaj went on to present no less than six arguments in favour of high-yield bonds:

1. Corporate fundamentals/leverage
2. Monetary easing by the BoJ and likely the ECB
3. The macroeonomic environment
4. Hunger for yield
5. Valuation
6. Liquidity

Pankaj' first point was that **corporate fundamentals** are generally sound. Corporate debt may be rising, but this is more a phenomenon in the US than in Europe. Interestingly, risk premiums of US high-yield bonds have kept falling, even though net debt-to-earnings before interest, tax, depreciation and amortisation has worsened. And assets are rising. In fact, **leverage** as a percentage of total assets has been falling in Europe in the past few years. The level of cash on corporate balance sheets is relatively high. Also positive in this respect is that default rates are low and have trended even lower lately.

The second argument is that **monetary policy** is far from becoming restrictive. ECB president Mario Draghi was as clear as any central banker can be in his news conference last month about being ready for further action ("Are we finished? The answer is no"). Having cut rates in June including a negative deposit rate, and announcing a range of other measures the ECB stands ready to do more. As for the Bank of Japan, the main discussion is not about 'if' quantitative easing will be increased, but 'when'.

Also in favour of high-yield is the improving **macroeconomic environment**. Europe's economy is now in recovery, while the US is heading for a strong second quarter. Growth in Europe will not be strong, but modest growth tends to support high-yield.

High-yield corporate bonds should benefit from the **hunger for yield**. In the current low-yield environment, money has steadily flowed to corporate bonds. On a risk-adjusted excess return basis, European high-yield has outperformed all other broad asset classes in the past 12 months. In other words, European high yield has had the highest Sharpe ratio. US high-yield ranked sixth out of 26 asset classes we looked at.

Steady inflows have led to lower spreads and yields, but with spreads still higher than before the financial crisis, **valuations** could rise further. The trend may be your friend.

That brings us to the last argument in favour of the bull case: **liquidity**. Of course, this will be an issue when markets turn, but why look for the door when no exit is needed? There are no signs that the inflows into the asset class are set to reverse.

OUR VIEW

True to her more optimistic view on European high-yield, Boriana emphasised after the presentations that the negative leverage factor applies more to US than to European high-yield where we hold our overweight. As for valuations, we think they are a negative factor for credit, but more so for investment-grade than for high-yield. Overall, with generally strong corporate fundamentals, earnings that in our view should improve, an improving economic environment, central banks keen on keeping interest rates and bond yields low, and continuing inflows into the asset class, we have stuck to our overweight position in European high-yield.

However, we hold this position more to benefit from the carry than from further price gains. We also think the investment horizon has shortened from the initial 12 months.

Graph 1: The absolute level of eurozone high-yield bond yields has reached all-time lows this year.

Source: Barclays Capital, Bloomberg, BNPP IP

Originally written on 16 May 2014, updated 1 July 2014

Interview
SPOTLIGHT

William De Vijlder
Vice-Chairman, BNP Paribas Investment Partners

Mid-year outlook: limited synchronisation

Equity markets have struggled this year, faced with economic and geopolitical headwinds. We continue to anticipate gains driven by stronger corporate earnings. Surprisingly, bond yields have stayed low, despite better economic conditions. They may stay low for a while yet. In this interview, we ask William De Vijlder, vice-chairman of BNP Paribas Investment Partners, and chief economist Joost van Leenders of our Multi-Asset Solutions team about their views on the global economy and markets.

***Perspectives (P):** In 2013, we saw economies diverging, with the US recovering and Japan growing strongly, but the eurozone emerging slowly from recession. Has growth in 2014 been more synchronised between the world's main economic zones?*

Joost van Leenders (JvL): II think that is partly the case. The US economy had a difficult first quarter as it was hit by severe winter weather, but has bouncing back nicely since. The eurozone recovery from recession has continued. So in terms of direction, growth in these large blocks is now more synchronised. One important factor they have in common is less austerity - the drag on growth from government spending cuts is less. Of course, the US is further ahead in the economic cycle than the eurozone. Investment has recovered further in the US and unemployment has already fallen substantially. In the eurozone, the unemployment rate is just starting to stabilise and business investment is still low.

Japan had strong quarters early last year, but growth slowed in the second half. The short-term direction of the economy is being driven strongly by the consumption tax hike in April. This boosted consumption in the first quarter, but should be a drag on demand in the second quarter. The economy could strengthen again later this year since low unemployment should allow wages and business investment to improve. But I would not say that Japan's cycle is synchronised with that of the US or Europe. China's economy historically has a low correlation with the US or the eurozone and this year is no different. Growth has slowed, but appears to be bottoming now. This slowdown affects other emerging economies more than stronger growth in the US and the eurozone. But the first-quarter dip in the US and the very gradual improvement in the eurozone may also have impacted emerging market growth.

***P:** How do these growth differentials affect financial markets?*

William De Vijlder (WDV): The economic cycle is an important factor in our asset allocation. Not only directly, but also through its effect on monetary policy and earnings. Indeed, developed equities have outperformed emerging equities so far this year. Japan's equity market has strongly underperformed, although this is also due to disappointment about the failure of the 'Abenomics' programme to make progress on structural reforms. At this point, we are neutral in our regional equity allocation. We think emerging equities are favourably valued, but we would want to see more evidence of growth recovering before going overweight. We like European equities now that the economy is improving, we see room for higher margins as sales start to grow and valuations are relatively favourable. But we believe European equities are also the asset class most vulnerable to developments in Ukraine, hence our neutral position.

> "Fed set to continue tapering; ECB stands ready to do more; BoJ to persist in quantitative easing or even increase it"

***P:** William mentioned monetary policy. Is there divergence here too?*

JvL: Well, monetary policy is still extremely stimulative in most parts of the world. But yes, the US and UK central banks are closer to normalising policy. The Federal Reserve has been tapering its pro-growth asset purchases steadily in USD 10 billion steps and there are no signs this will change. Fed chair Janet Yellen has said that rate hikes may follow as soon as six months after the end of the asset purchase programme, so that would be in the second quarter of next year. Looking at the growth outlook and labour market dynamics, this looks reasonable to us. The Bank of England may hike rates even sooner. Inflation in the eurozone is far below the ECB's objective, so the ECB announced a package of reflationary measures in early June, including cutting the refi rate, opting for a negative deposit rate, no longer sterilising earlier bond purchases and providing additional loans to banks. Mario Draghi also made it clear that if they felt it necessary they would do more but I think large-scale quantitative easing remains unlikely at the moment. In Japan, I see no other option for the Bank of Japan but to keep buying government bonds. Since the fiscal deficit won't be closed soon and the government pension fund will probably rotate from bonds to equities, the central bank must buy these bonds to prevent yields from rising.

Joost van Leenders, CFA
Chief Economist Multi-Asset Solutions, Amsterdam

***P:** In recent years, monetary policy has been a major driver of financial markets. Is this set to change?*

WDV: I think this is already changing. Just look at the Fed. The decision to start tapering caused some unrest, especially in emerging equities and currencies. But the Fed's game plan is clear: reduce asset purchases gradually, assess the impact on markets and the economy and start hiking rates, most likely towards the end of the second quarter of 2015. With this plan laid out, markets no longer assess every data point in terms of their effect on monetary policy. So, instead of weak data being positive for markets because they could lead to additional stimulus, weak data are now negative and strong data positive. And markets are now actually coping quite well with the Fed's tapering. Emerging markets were underperforming before the tapering started as GDP and earnings growth weakened.

"Monetary policy will remain instrumental in holding down bond yields and keeping risk spreads contained"

The Bank of Japan may actually increase its asset purchases later this year to weaken the yen further and push up inflation. This should support equities, which typically gain as the currency falls. Looking at the bigger picture, it is clear that monetary policy is instrumental in holding down bond yields and keeping risk spreads on 'peripheral' eurozone government bonds to emerging and corporate bonds contained. This is unlikely to change soon, in my view.

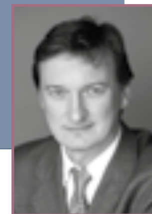
***P:** Finally on China: the views here range from positive, with reforms changing the structure of the economy and driving growth, to negative hard landing scenarios. What is your view here?*

JvL: I think the chance of a hard landing is fairly small. Of course the economy has structural problems such as an outsized dependence on investment and credit growth. But it also boasts a high savings rate, large foreign exchange reserves, low government debt, a closed capital account and a banking system still under government control. Even defaults are tightly controlled by the government and will be tolerated only gradually to induce a better pricing of risk, particularly in the bond market. But a gentle growth slowdown looks inevitable, even if structural reforms are implemented.

WDV: Indeed, even a gradual slowdown would have an impact on markets. Demand for commodities would slow, limiting the potential for price gains. It could also affect emerging market equities, although this must be assessed case by case. It would be more negative for commodity exporters, but could be positive for commodity importers. Suppliers of intermediate goods to China could be insulated insofar as the end products are exported to the industrialised countries. But recent months have shown that increased granularity is needed when investing in emerging markets, something I do not expect to change soon.

3 July 2014

Expert's view
SPOTLIGHT



Damien Kohler
CIO European Equities Small & Mid Caps, BNPP IP, Paris

A compelling case for investing in European small caps

Over the last two years sentiment among investors regarding Europe has been transformed and the euro crisis is now a distant memory. Today, while economies in much of the region still trudge along recovery lane, many entrepreneurially-managed smaller firms are showing they can grow and adapt faster; indeed, small-cap stocks have shown excellent long-term risk-adjusted returns.

Investors in small-cap stocks currently stand to gain from larger, cash-rich companies' M&A ambitions. Financing is readily available to large caps (either from banks or via capital markets where the strength of demand for corporate debt is reflected in very low yields). The prospect of acquisitions of small- and mid-size European companies by larger entities is therefore another compelling aspect in favour of European small caps at this time.

What are small-cap stocks and what advantages can they offer investors?

Small-capitalisation stocks (small caps) are typically listed companies whose market capitalisation falls in the low tier of the market cap range, the two other tiers being mid- and large-cap stocks. The most important point, though, is that small caps are often those of companies in their pioneering or early growth phase. This is perhaps the best angle to approach this group as an investor, since such stocks are a way to 'play' superior growth investment vehicles. In Europe, a common rule of thumb says that small caps have market capitalisations of up to around EUR 3 billion and account for about 15% of the free-float adjusted equity market capitalisation of the region.

Financial theory asserts that small-cap stocks in developed markets should outperform large caps over the long term, although their volatility can be somewhat higher. Eugene Fama, a Nobel economics laureate in 2013, and Ken French produced what is regarded as the definitive study showing that over time, small-cap stocks unmistakably tended to outperform larger-capitalisation companies. Other research supports the same conclusion, even when approaching the subject from different angles. This seems to be a global pattern, since only very rare exceptions invalidate this view, as shown by a study by Elroy Dimson and Paul Marsh, two London Business School academics. And when it does, it seems to be due to the widespread dominance of local oligopolies that leave no room for small caps even to exist, such as in Mexico or Malaysia.

In effect, past performances commonly show that small-cap companies have generated significantly higher annualised returns than both their large-cap counterparts and the World Index, with only moderately higher volatility. In other words, not only has the absolute return been stronger for small-cap stocks, but the risk-adjusted performance (as measured by a Sharpe ratio for instance) has been superior as well (see Exhibit 1).

Exhibit 1: Better risk-adjusted returns for small caps

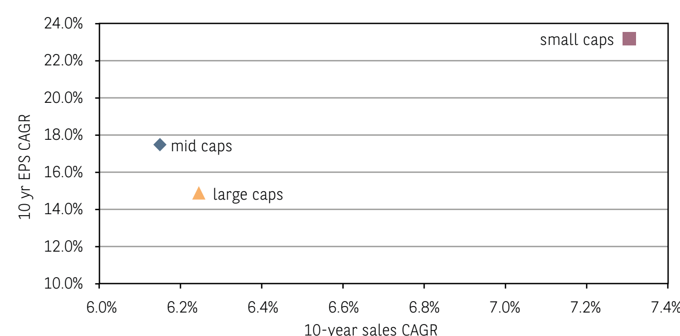
Asset class	15-year annualised returns (%)	15-year annualised standard deviation (%)	15-year Sharpe ratio
Small-cap	9.03	20.46	0.31
Large-cap	4.69	15.47	0.13
World	5.01	16.09	0.14

Source: BNP Paribas as of 28/02/14. Indices used: Small-cap – Russell 2000, Large-cap – S&P 500, World – MSCI World. Past performance is no guarantee of future returns.

What lies behind the outperformance of small-cap stocks in the long run?

Sales and earnings growth are key drivers of long-term performance for equities, and they happen to be often stronger for small-cap stocks than for larger listed companies. Part of the explanation for this is the fact that small caps often invest significantly more, relative to their size, than their larger counterparts. For instance, small caps often spend more on research and development (relative to sales) than large caps. Investing in small-cap stocks also coincides with capturing the returns from the early stages of new industries as they develop and benefit from the more entrepreneurial management and flexible business models inherent to their smaller size. Many such companies can indeed capture new market opportunities and adapt more quickly to changing trends, which is subsequently reflected in more robust sales and earnings growth (see Exhibit 2).

Exhibit 2: Sales and earnings per share (EPS) compound annual growth rate (CAGR) from 2003 to 2013



Source: UBS estimates, Bloomberg. Note: large caps = STOXX large-cap index, mid-caps = STOXX mid-cap index; and small caps = STOXX small-cap index. Financials have been excluded from the indices for the analysis. Historical sales and EPS numbers are for the current members of the respective indices. Past performance is no guarantee for future returns.

1 For a copy of the full-length article, please contact the Publication Centre at publicationcentre@bnpparibas-ip.com

Does the current environment favour European small caps?

Concerns about the eurozone crisis have almost vanished: European institutions have emerged stronger, sometimes strengthened by the addition of new powers (e.g. banking supervision for the ECB). Such developments added further weight to the view that the crisis is over. Besides, peripheral eurozone markets have even seen their bond yields falling dramatically, sometimes to record low levels, which is a good omen for their respective economies. So in an environment where PMIs are recovering, albeit at different speeds across the region, and where the ECB stands ready to counter deflationary risk in part via a very accommodative monetary policy, European small-cap companies should benefit the most from further growth 'normalisation'.

Moreover, European small-cap earnings and dividend growth rates are currently expected to be stronger than those forecast for most of the other developed equity markets. At the same time, their valuation (as illustrated by their price-to-book ratio in Exhibit 3) is generally aligned with the other developed equity markets, and indeed is cheaper than the US market. On these metrics, European small-cap stocks appear therefore more attractive than most developed equity markets.

Exhibit 3: Comparison of valuation characteristics of European small caps with other equity asset classes

	MSCI Europe Small Cap	MSCI Europe	MSCI USA	MSCI World
Div. Yield (%) (Med NTM*)	2.8	3.6	2.1	2.7
Price/Earnings (Med NTM*)	14.8	14.0	15.7	14.3
Enterprise value/EBIT (Med NTM*)	11.8	11.2	11.1	10.7
Price/Book value (Med NTM)	1.7	1.7	2.4	1.9
Earnings Growth (FY0,1,2**)	16.8	9.5	12.9	11.9
Dividend Growth (FY0,1,2**)	13.8	9.4	12.5	11.1

Source: FactSet

Source: BNP Paribas Asset Management, as of end of June 2014.
*Med NTM: median next twelve months
**FY0,1,2: over the next 2 years (fiscal year 0,1,2)

As I have already pointed out, given that growth is recovering in Europe, though timidly, large companies could find it attractive to reposition themselves within the European region through acquisitions of European small caps. Conditions currently look favourable for a significant M&A uplift at the current stage of the economic cycle.

Why is stock selection so important?

Using analyst coverage data for small and large-cap stocks, i.e. the number of analysts providing at least one annual earnings forecast for a company, we found that small-cap companies on average attract nearly three times less research coverage than large caps. This lack of coverage can lead to significant inefficiencies and mispricing of small-cap equities, which can be exploited through a combination of solid proprietary company research and active portfolio management.

Ultimately, our view is that in the small-cap universe, alpha is best generated through a bottom-up approach. However, with around 900 constituents in the MSCI Europe Small Cap index, how does a bottom-up fund manager narrow such a broad universe?

To make such a broad investment universe 'workable', our five-strong European small and mid-cap team - where each member combines analyst and portfolio manager responsibilities and has an average experience of 13 years - has developed, with the help of our Financial Engineering team, a powerful proprietary quantitative screening tool that reduces this vast investment universe to a more accessible one. Filters, such as superior balance sheet quality, growth potential and cash flow returns, are involved in this process.

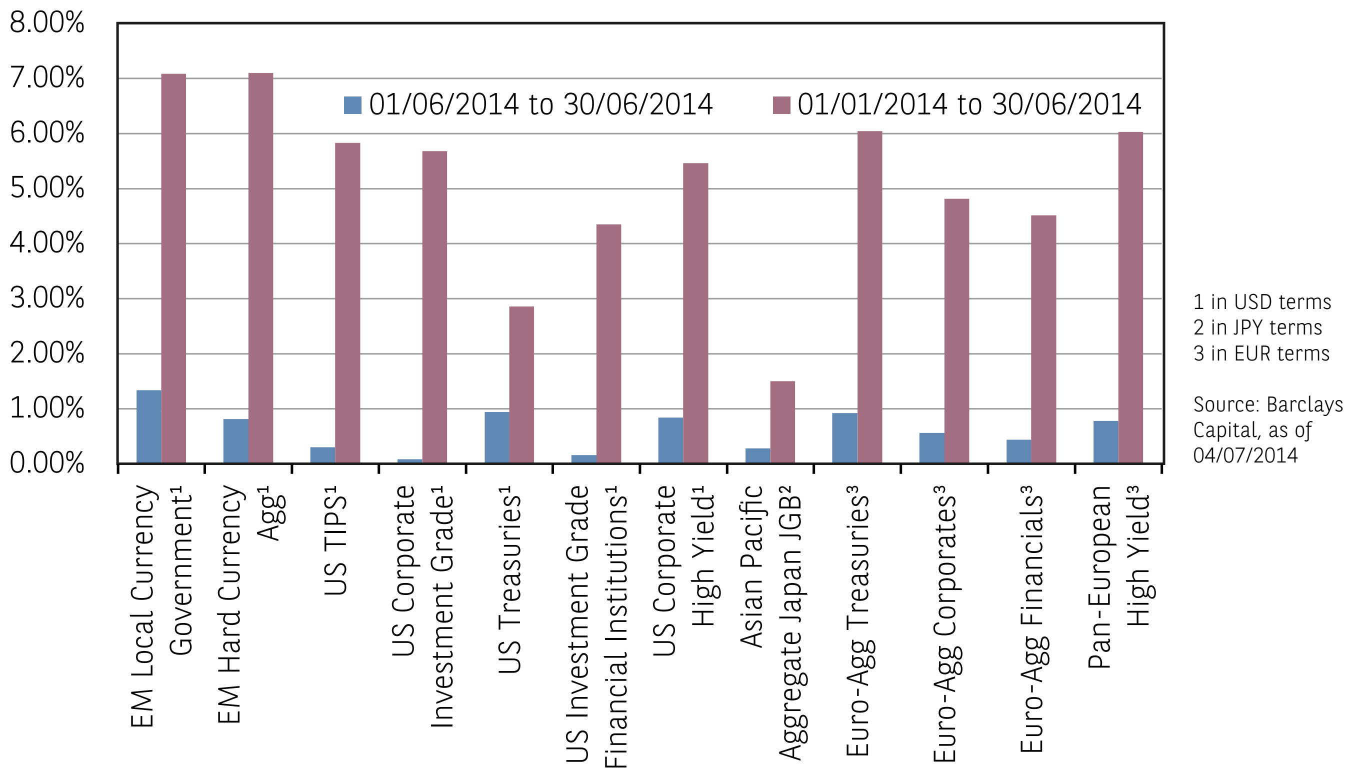
The tool helps portfolio managers spot companies that score highly, and these are then subjected to further in-depth, in-house research. The success of blending quantitative screening with subsequent qualitative research is reflected in the long-term performance of our European small-cap strategy.

Because of the importance of the stock selection process in delivering consistent alpha from this very dense investment universe, we believe that an assessment of the stock selection skills of the portfolio managers is a prerequisite to any investor’s decision to allocate to this rich but broad European small-cap universe.
7 July 2014

Performance focus

SPOTLIGHT

Performance of different fixed-income segments YTD and from 1 June to 30 June 2014



Total returns for all sectors of bond markets were strong in the first half of 2014. Duration has been an important factor in performance this year as government bond yields have fallen. As a result, total returns have exceeded excess returns across all sectors, ratings and currencies in developed bond markets. A number of investment grade indices have even outperformed comparable high-yield indices.

Past performance is no guarantee for future returns.

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If you have any questions or remarks regarding this publication please contact:
publicationcentre@bnpparibas-ip.com

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