# Sparinvest

Letter to Shareholders Q3 | 09

# Value Bonds

**Headlines**

- The economy
- Returns
- Relative returns
- The future

## The economy

The enormous fiscal stimulus packages, as well as the life support provided by central banks to the financial system, have worked. The 'bottoming out' of the global economy is now behind us and the current situation can be described as a financial 'El Dorado' for stock and credit markets. Globally, growth is on the rise and around the world we see very loose monetary and fiscal policies. The Asian economies have been the first to turn around and these are expected to contribute positively to global growth in the time to come. In the beginning of October, the IMF raised the outlook for the global economy. The IMF now forecasts global growth of 3.1% in 2010, up from its previous growth forecast of 2.5% posted in July. However, the IMF still stresses that the crisis is not over yet, and this is particularly the case for the Western economies. The hard work of clearing out the banking system is not yet over, but the process seems to be at a more advanced stage in the US banking sector.

The table below shows the real returns for equities and government bonds in different economic climates following financial crises in the US economy since 1925. Low growth and headline inflation means below-trend growth and inflation. Quite surprisingly, it can be observed that the scenario with low growth and low inflation actually is the 'best' one for the financial markets in terms of returns.

| | Equities | Long-term bonds | Short-term bonds |
|---|---|---|---|
| Low growth and low inflation | 11.4% | 10.1% | 2.8% |
| High growth and low inflation | 10.6% | 5.2% | 1.3% |
| High growth and high inflation | 8.2% | -1.2% | -0.9% |
| Low growth and high inflation | -1.9% | -5.0% | -1.7% |

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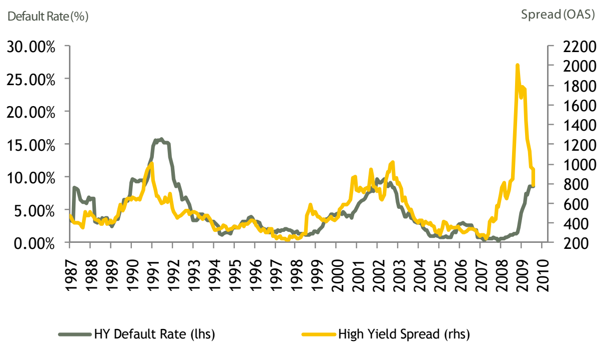
This is the reason why the current financial climate may be described as an 'El Dorado', even though many people do not experience the current situation as particularly favourable.

Accordingly, high inflation stands out as the primary risk for the financial markets. If inflation can be kept under control, the outlook for the credit and stock markets remains positive since low inflation will allow central banks to keep interest rates low. Low short-term interest rates dictated by central banks will also help banks to rebuild their capital base following the credit crunch, since the banks will also be able to borrow funds at a low interest rate and then place the money in the bond market to receive a higher yield. This is what happened in the Japanese banking sector some 20 years ago.

When it comes to inflation, therefore, it is important to note that the unemployment rate in the Western world continues to rise. In the US, unemployment is expected to break the 10% mark in 2009. In Europe, the forecast is almost equally gloomy. However, high unemployment means that salaries and wages will not add to the headline inflation in the near future. The areas were we may see an inflationary pressure is within raw materials since the lack of investment there during the credit crunch may create bottle-neck problems going forward. All things being equal, however, we have low key lending rates in store for us, which will help sustain the progress of credit and stock markets.

## Returns

The outlook for improved growth, the liquidity injections provided by central banks, the recognition that credit markets had substantially overrated the default risk among companies and, finally, a huge amount of cash on the sidelines are all factors that have contributed to the normalization of the credit markets.




Even though we have stated several times that credit bonds were priced down too far during the last year, we are surprised by the pace of the normalization. Consequently, it is only natural to reflect on the situation and ask the following questions:

*Why have credit bonds produced such high returns? Is the performance based on rational factors or is it just a new bubble? Have high-yield bonds gone from being the bargain of a lifetime to being on the expensive side?*

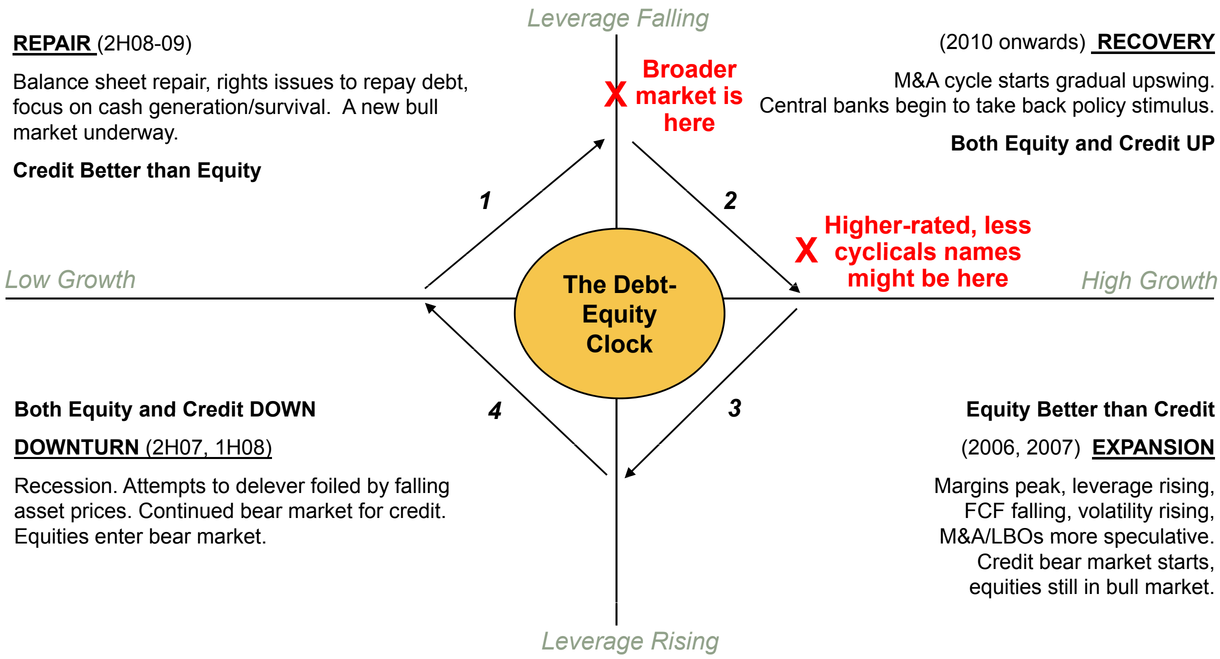
In the autumn of 2008, forced selling in the wake of Lehman's collapse left the credit markets extremely oversold. When prices were at their lowest, the market had already priced in default rates of more than 20% in the coming years. In other words, the point of departure for the calculation of the 2009 returns was extraordinarily low. Consequently, one cannot conclude that high-yield bonds have now become expensive or that we are seeing a new bubble in the market just because we have witnessed a credit rally in 2009. Moreover, we have seen many companies issue new shares/sell off activities in order to reduce debt. Such initiatives have reduced the default risk substantially, which also explains why high-yield bonds have produced higher returns than equities in 2009. The high returns of high-yield bonds are, in other words, rooted in fundamentals and cannot just be explained by improved liquidity conditions in the market.

When looking at the general market, high-yield bonds now seem to be reasonably priced in terms of the default risk. If the market is to gain further, we have to see lower default rates. This is exactly what we should expect for 2010 and 2011 as the global economy returns to growth.

However, not everything is cheap. In our view, the CCC segment now contains many examples of bonds that have become too expensive considering the underlying credit quality. Among the higher-rated bonds we do, however, still find good value in terms of being compensated for expected losses as a result of defaults. Accordingly, it is still possible to find bonds in the BB-B segments offering excess yields of 5-10% when compared with the risk-free yield. These excess yields ought not to be more than 2-6%.

*What should we expect of high-yield bonds in the future?*

This depends on both the macroeconomic trends and on the focus of companies. As for the economy, we have reason to be optimistic in the short to medium term. In terms of companies' focus, investors should be cautious (see the illustration below of the credit market cycle) when it comes to companies with a high credit rating, hunting for target companies to buy up and/or under pressure from shareholders to stimulate the share price by paying out dividends etc. From time to time, we see examples of companies going to the credit markets to raise capital in order to distribute dividends to shareholders and management. We do not invest in these kinds of bond issues. Or, to put it in another way: we do not give loans to companies just for management to fill their pockets.



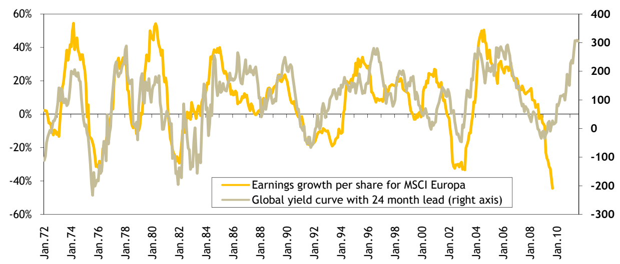

## Relative returns

The fund has made it out of the crisis on top and, when looking back on previous years, the net asset value has never been higher than here at the beginning of the fourth quarter. We have been able to post high relative and absolute returns because the fund has had no defaults and because many of the portfolio companies that were heavily oversold – either because they were small caps or because they belonged to the wrong sector – have now returned to favour. In our Q1 Letter to Shareholders we stated that this catching up for the fund would occur when we reached the bottom of the business cycle. However, we are determined not the rest on our laurels and we still see many interesting opportunities in the market. Our yield-to-maturity of 12% is still very attractive, both in absolute terms and relative to other asset classes.

## The future

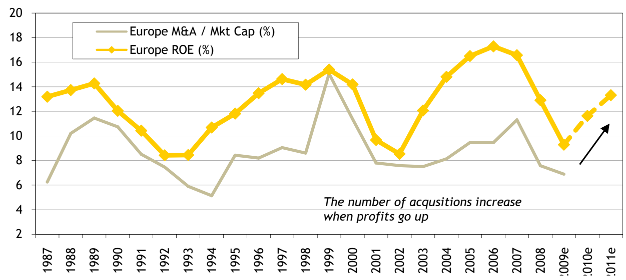
The global yield curves are very steep. We define the yield curve as the difference between a 10-year bond and the three-month interest rate. Historically, steep yield curves have signalled significant earnings growth in the companies – which is not unlikely considering the extent to which companies have cut costs to the bone, combined with the extent to which demand is increasing.

*A steep yield curve signals high earnings growth …*




As earnings rise in companies, we should expect to see merger and acquisition activity pick up. This will be in line with the observations of the past 20 years. Another factor in favour of increased activity is the re-opening of the credit market. Large-cap companies with high credit ratings can achieve long-term financing at very low interest rates in today's credit markets (the risk-free yield is very low). When they are able to raise capital at interest rates of 4-5%, some of these companies may be tempted to engage in buy-out activities. We have already seen Kraft placing a bid for Cadbury.

***… Higher M&A activity in the wake of increasing earnings - grist to the mill for investors.***



When it comes to returns, increased M&A activity will benefit owners of cheap companies since we can assume that the acquisition interest will primarily be directed at cheap companies. This expected trend argues for investing in either value equities or high-yield bonds, depending on the preferences of the individual. For 2010, we expect a positive return of about 10%. High Yield Value Bonds will still focus on companies with relatively strong balance sheets and with a strong focus on deleveraging. We will not end up chasing the most risky credits simply in order to look good in performance charts.

Yours sincerely,

**Klaus Blaabjerg**
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8 October 2009

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