



Value Bonds

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Our Value Bond Funds

Fund	ISIN code
Emerging Markets Corporate Value Bonds	LU0519053697
Ethical High Yield Value Bonds	LU0473784196
High Yield Value Bonds	LU0232765429
Investment Grade Value Bonds	LU0264925727

Detailed information is available in the relevant Fund Update.

- sparinvest.eu

Dear Shareholder,

The third quarter was a good one for the three funds that follow the Sparinvest Value Bonds strategy. All benefitted from clarification regarding the long-awaited new regulation for Banks – The Basel III rules – and from the containment of systemic risk in Europe. We also benefitted from increased M&A activity in the stock markets through a couple of takeovers whereby some of our bonds rose by around 20%. At the same time, the high quality of the funds has kept default activity at 0%. Looking into the fourth quarter we expect more of the same in terms of the positives mentioned above – quality is high and underlying assets still cheap.

Economic outlook

The slowdown in the global economy that began in the spring has generated concerns that the recovery is in jeopardy. We believe these concerns are largely misplaced and that the odds of a renewed recession are remote. Mid-cycle economic slowdowns are not unusual, and typically occur some 4-6 quarters into an economic recovery. However, economies are not especially susceptible to sharp pullbacks in mid-cycle. This is partly because not enough time has elapsed to generate the kind of excesses that leave economies vulnerable to collapse, and also because levels of activity are not nearly high enough to warrant inflation concerns, thereby keeping monetary policy accommodative (extremely so in the case of the current cycle). As a result, the next phase of the cycle is much more likely to be a re-acceleration in growth – albeit a modest one – than a renewed downward spiral.

Economic activity in most of the world has continued to recover. Recent data releases in China signal that the slowdown phase is likely over, as policymakers have eased up on tightening measures. In Europe, activity has generally surprised on the upside, and significant policy measures to address fiscal problems are already

underway. At this point, it is the US that is generating the bulk of the concerns. Uncertainty regarding mid-term elections and tax policy poses a risk. But we believe that the below-trend growth of the second quarter – generated by a dramatic swing in trade – was an aberration and that growth will accelerate modestly during the remainder of the year.

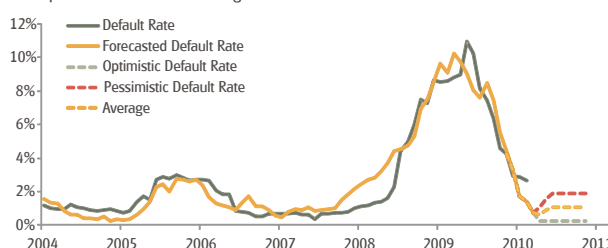
Importantly, one response to the slowdown is that monetary policy has become even easier. While growth in most emerging-market countries remains strong, central bankers almost everywhere have signalled that they intend to refrain from further tightening, and this has already produced lower money market rates. In the US and Japan, the central banks have signalled an intention to embark on a new round of asset purchases unless growth picks up, and this has caused a bull flattening of the yield curve. Lower bond yields are already generating a wave of mortgage refinancing and a significant pickup in corporate bond issuance, supporting our forecast of a modest growth pickup in the second half of the year.

Weak recoveries do not necessarily signal weak financial markets. On the contrary, the combination of extraordinarily easy monetary policy with a pace of economic growth that points to better times ahead – but does not generate threats of tighter policy – provides a backdrop quite favourable to most financial asset prices.

Outlook for Non-Financial Debt

Most businesses are still in recovery mode and are neither hiring nor investing above and beyond what is required from a pure maintenance perspective. So debt is either stable or decreasing and measures of financial gearing are improving. Roughly 70% of all companies with bonds outstanding are currently deleveraging. Free cash flow and measures of liquidity point to low default risk going forward. This is captured by our model for forecasting default activity during the coming quarters. The model mirrors actual default activity very well, as can be seen below.

The Sparinvest default forecasting model



The model forecasts future default activity using the Senior Loan Officer's Survey (based on 50 US banks and 20 Non-US banks), industrial production figures and the Financing Gap from the FED.

Industrial production is the only explanatory variable currently showing weakness. Using the 'worst' forecast among all publicly available forecasts for industrial production indicates that default activity will converge to around 2% globally from 3% currently. If one uses 50% as a rough guess for recovery rates then a 2%-default level gives a 1% expected loss rate from investing in Global High Yield. The option-adjusted spread on the Merrill Lynch Global High Yield Index is currently 6%. So 6% easily covers the 1% expected loss from defaults and still offers the prospect of further return-generation despite the fact that market has come a long way towards normalization. One good thing about lower industrial production is the fact that it will keep a lid on balance-sheet destroying behaviour among business leaders. In other words, CEO's will tend to keep cash rather than spend it on dividends and share buy-backs when growth is moderate.

But the corporate bond market remains open and we expect more and more companies to take advantage of this. As companies reach targeted leverage ratios and top-line growth becomes harder for them to achieve because of below-trend growth in the underlying economies, we expect that cash-rich companies with high credit ratings will feel compelled to borrow in the corporate bond market (at rates around 3-4%) and add market share or capacity. Hence we expect 'Value' companies to benefit in this environment. First of all they have strong balance sheets so they should have no problems surviving growth rates of 1-2%. Second, because they are cheap on various metrics, they are the takeover targets. As bond investors with appropriate change of control covenants in place, we will also enjoy takeovers of our small cap companies. Something we have seen this summer a couple of times already.

Outlook for Financial Debt

For a long time now, we have believed that the bonds from financial companies such as banks and insurance companies were very cheap. This has been most obvious for the debt of insurance companies since the majority of these companies learnt the lesson during the downturn of 2000-2002 and so escaped the credit crisis of 2007-2008 in fairly good shape. In terms of debt from banks, it was a classic credit story of 'repair'. Following the credit crisis, it was clear that banks had to raise equity and reduce leverage. A strong catalyst in this respect has been new regulation in the form of Basel III. The table below provides some bottom-up proof for the renewed strength of the European Banking industry. As can be seen in the table below, all banks have strengthened their balance

sheets, raising capital in the form of the 'Core Tier 1 Ratio' with a very few exceptions. UK banks seem to be leading the Euro zone here, but are not as 'strong' as the Scandinavian and Swiss banks. The Scandinavian, Swiss and UK banks also seem to be leading the banks of the Euro zone in terms of getting earnings back on track. One obvious point of weakness here seems to be the banks of Southern Europe – Spain and Greece – which should come as no surprise.

Looking forward to the rest of 2010, and into 2011, we believe that the debt of banks is still attractive compared to debt of non-financial companies.

Klaus Blaabjerg
Lead Portfolio Manager
12 October 2010

Name	Capital		Assets (reporting ccy bn)		Wholesale Dependence		Net Income		Fwd Net Income	
	Core T1 Ratio	1Y Δ	Current	1Y Δ	Current	1Y Δ	1H10	1Y Δ	2H10e	1H10 Δ
Banco Popolare	7.3%	1.0%	136	12%	50%	2%	322	58%	122	-62%
Banco Popular Espanol	8.6%	1.2%	129	9%	44%	-2%	355	-20%	296	-16%
Banesto	8.0%	1.3%	126	8%	44%	-8%	382	-7%	234	-39%
Bank of Ireland	9.5%	-	194	0%	48%	-	140	-	-	-
BBVA	8.1%	1.0%	535	-1%	42%	-1%	2,527	-10%	2,309	-9%
BNP Paribas	9.0%	1.3%	2,058	-10%	60%	-3%	4,388	39%	3,678	-16%
Commerzbank	3.3%	-0.8%	844	-7%	52%	-1%	1,060	-	442	-58%
Credit Agricole	9.1%	0.5%	1,557	-3%	43%	-1%	849	111%	1,817	114%
Deutsche Bank	7.5%	-0.3%	1,501	-13%	71%	-3%	2,922	28%	1,726	-41%
ING GROEP	8.6%	1.3%	1,164	-2%	n/a	-	2,416	-	2,530	5%
Intesa	7.7%	0.8%	625	-2%	51%	2%	1,690	6%	1,813	7%
KBC Groep	4.3%	-	324	-6%	48%	18%	591	-	860	46%
La Caixa	8.6%	-0.2%	272	1%	38%	-	902	-	-	-
Monte dei Paschi	6.1%	0.0%	225	6%	53%	5%	261	-21%	445	70%
NBG	10.4%	-	113	3%	22%	1%	146	-79%	772	430%
Postbank	4.4%	-	227	-4%	31%	-2%	153	35%	240	57%
Santander	8.6%	1.1%	1,111	-3%	41%	-6%	4,445	-2%	4,350	-2%
Societe Generale	8.5%	1.2%	1,024	-3%	58%	-2%	2,147	-	1,284	-40%
Unicredit	8.4%	1.6%	929	-5%	45%	0%	668	-29%	1,770	165%
Eurozone Median	8.4%	1.0%		-2.1%	46%	-1%		-2%		-2%
Barclays	10.0%	2.9%	1,379	-11%	63%	-8%	2,431	29%	2,110	-13%
HSBC	9.9%	1.1%	2,364	-2%	35%	-1%	6,763	102%	6,571	-3%
Lloyds	9.0%	2.7%	1,027	-3%	49%	2%	596	-92%	1,510	153%
RBS	10.5%	3.5%	1,696	-7%	50%	-7%	133	-	-478	NM
Standard Chartered	8.9%	1.3%	437	6%	20%	-4%	2,148	11%	2,067	-4%
UK Median	9.9%	2.7%		-3.4%	49%	-4%		20%		-3%
Credit Suisse	11.4%	1.0%	1,031	-6%	42%	1%	3,648	2%	3,535	-3%
Danske Bank	9.1%	0.9%	3,098	-4%	61%	-1%	1,706	131%	3,255	91%
DNBNor	11.5%	-	1,823	0%	57%	2%	6,381	49%	6,966	9%
Handelsbanken	11.6%	-	2,123	-2%	60%	3%	5,426	2%	5,831	7%
Nordea	9.0%	-0.2%	508	7%	59%	1%	1,179	-5%	1,210	3%
SEB	12.1%	0.4%	2,308	-3%	45%	-3%	2,661	220%	2,914	10%
Swedbank	12.7%	2.9%	1,795	-5%	60%	-	381	-	3,785	NM
UBS	13.0%	2.9%	1,341	-16%	64%	-3%	4,207	-	3,755	-11%
Other Europe Median	11.6%	1.0%		-3.6%	60%	1%		26%		7%
All Banks Median	8.9%	1.1%		-2.9%	49%	-1%		6%		0%

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