



## Value Equities

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### Our Value Equity Funds

Fund	ISIN code
Ethical Global Value	LU0362355355
European Value	LU0264920413
Global Small Cap Value	LU0264925131
Global Value	LU0138501191

Detailed information is available in the relevant Fund Update.

- [sparinvest.eu](http://sparinvest.eu)

*Dear Shareholder,*

In many ways, 2010 has been a year of contradictions. On a global basis, value stocks – as defined by the MSCI World Value index, at least – have underperformed growth stocks, yet our value funds have generally delivered returns above both. European markets have been plagued with top-down fears, yet our holdings there have performed strongly, both at a fundamental level as well as in the stock markets. Why? We'll dig into some of the specifics later in this letter, but one key factor is that our value funds focus on active bottom-up selection of individual stocks. We don't aim to replicate the returns of a benchmark, but to find those investments that can provide the strongest absolute returns over the long-term.

From that perspective, 2010 was a strong year for our range of value funds, with all funds returning in excess of 25%, and in some cases significantly more. There are clear factors that helped drive this performance in 2010; for example our cyclical holdings, strong performance in Europe (despite the sovereign debt/Euro crisis), and some very strong individual stock returns across the board, particularly in the United States. It has been a year in which many of the tenets of our investment philosophy have been vindicated. But perhaps more encouragingly, we can see many potential drivers which have not yet kicked into gear. As value investors, what matters most to us is the quality and cheapness of our current portfolio – and this gives us great confidence for the future. We are invested in a diverse range of companies, which are in robust financial health, and which look deeply discounted relative to their long-term earning power and asset strength. Moreover, even as stock markets in general rise, we are convinced that our tried-and-tested stock selection process will continue to find overlooked stocks, allowing us continually to refresh the portfolios, and maintain a deep discount to intrinsic value.

## A Look Back at 2010

You could say that 2008 and 2009 were years when top-down considerations triggered major waves in the ocean of global equity markets: top-down concerns pushing levels down in 2008, and relief helping it to rise again in 2009. In 2010, we saw more regional differentiation. Concerns about Greece led to more widespread concerns about national debt, and the Euro. If you compare MSCI regional indices on a same-currency basis, Europe closed the year roughly 10% behind the US and Japan. Yet our European holdings have been strong: perhaps the clearest indication is the Sparinvest European Value fund, which generated a return of 25.59% compared with just 11.10% for the MSCI Europe index.

Of course, it made a big difference which European countries you invested in. As we often stress, we don't make top-down decisions on regional or country allocation. Instead, we consider companies individually from the bottom-up, although of course we factor the economic environment into our analysis. In recent years, this stock-picking process has simply not led us to many investments in countries like Portugal, Greece, Ireland or Spain, and certainly this benefitted the funds last year. However, equally important was the fact that in those European countries where we do invest heavily – such as Germany, France, the Netherlands, the Nordics and the UK – our selected holdings had strong gains compared to the overall stock markets.

In Europe – but also in other regions such as Japan and North America – our investments in cyclical sectors, such as industrials and consumer discretionary, have generally performed strongly. Over the past couple of years, we've noted that individual companies were cutting costs, restructuring, and generally adapting business models to the changing economic environment. Many of our holdings have lowered their breakeven points so that, from now on, even a modest improvement in the top line can boost profits significantly. For some, their share prices have already begun to reflect this positive development. However, the general economic environment still has a long way to recover - and corporate top lines along with it. Therefore the lowered breakeven points mean that some companies could see very impressive profit levels indeed. Our cyclical holdings continue to look discounted to their long-term earning power. Equally important, even as the overall environment improves, we are confident that our process will continue to uncover attractive investment opportunities within cyclical sectors. We'll take a closer look at this process further on in this letter.

## Opportunities

North America has been an interesting market for us in the past couple of years. Historically, our global funds have had limited exposure to the US and Canada. Global

indices like the MSCI World would typically have around 50% weighting in North America, but our global funds have often had under 5% - albeit slightly higher in the Global Small Cap Value fund. We have no prejudice against these markets, but for a long time we quite simply didn't find many investments that met our strict valuation criteria. But in the past couple of years, we have taken advantage of opportunities presented by the tough market conditions, and made various new investments in North America. At the time of writing, our global funds have around 12% exposure to North America – and the Global Small Cap fund has around 25%. The funds have already experienced some strong returns on these investments – AGCO, Volcom, Fossil, and Columbia Sportswear are all examples of US investments in the past couple of years which have already been divested, having swiftly attained their intrinsic values. However, we have many more which, although they have performed well, continue to offer significant upside to their intrinsic values.

In order to take advantage of such opportunities, one has to be willing to be contrarian: in short, to buy when many are selling. We are no doubt helped in this respect by our strict investment process, which is focused on fundamental analysis and valuation of the companies and not on market preferences. Over the past couple of years, it's noticeable that the market conditions have provided us a window to invest in some large-cap (indeed, blue chip) companies, which are often out of the valuation range of strict value investors. Similarly, in the past year, we have added some oil- and energy-related names, such as Noble and Tidewater, to the portfolios – in addition to names such as Royal Dutch Shell and ENI which we had bought previously. Such stocks have been somewhat out of favour recently, but what matters to us is the deep discount to intrinsic value that they offer. Indeed, elsewhere in our portfolio, there are other sectors – such as financials and materials – that did not have a particularly strong year in 2010. However, as always we monitor our existing positions rigorously, and remain convinced of the fundamental strength and discounts of our holdings in these sectors. We feel confident that they can drive strong returns in the future.

## Definitions of Value and Growth

Meanwhile, as we mentioned above, 2010 was a year in which value stocks – as defined by the MSCI Value index – underperformed growth stocks. Yet our funds generally outperformed both MSCI World Value and MSCI World Growth. How can this be explained?

Firstly, our funds are active, bottom-up stock selection funds that are not constrained by the requirement to follow any benchmark. Yes, we use stock indices like the MSCI World for reference purposes, but we do not think of investment in terms of recreating benchmark returns. We aim for strong long-term absolute returns. As is confirmed

by a glance at our regional or sector weightings, we are happy to vary significantly from common index weightings, and therefore we would not expect our returns to closely match those of the indices.

Moreover, a lot depends on how you define the asset classes of 'value' and 'growth'. It's an obvious but crucial point that index definitions of concepts like 'value' and 'growth' have to be quantitative, based on fixed numerical criteria. It would be impossible to construct an index otherwise. But for classical value investors, 'value' is a qualitative concept. For us, a 'value' stock is one which satisfies our rigorous fundamental analysis, and where the share price offers a satisfactory discount to the company's intrinsic value. This means that our definition of 'value' is not exactly the same as an index's definition.

In fact, there are often stocks which we consider to be clear value stocks, but which are included in an index of growth stocks. For example, let's consider the MSCI World Value and Growth indices. Until 2003, these indices defined 'value' and 'growth' strictly on valuation terms: lower price-book stocks were value stocks, and higher price-book stocks were growth stocks. But since 2003, it has become more complicated. Now, for example, even if a stock is cheaply valued, if it also displays certain earnings growth characteristics, it might enter the MSCI World Growth index. Consider a cyclical stock trading under 1 times book, whose earnings start to recover: this earnings growth might push the stock into the growth index just as the share price is starting to rise. Clearly, such a reclassification can have an effect on the relative returns of the growth and value indices. On top of this, stocks can be included in both the growth and value indices simultaneously. So, within our portfolios, companies like Philips, Danske Bank, UPM-Kymmene, Fraport and Renault are actually in the MSCI World Growth index – and the latter three are also in the MSCI World Value index.

We do think that, in the long run, indices like the MSCI World Value index are broadly indicative of 'value stocks' as an asset class, so they are certainly useful reference indices. However, the difference between the indices' quantitative definition of value and our qualitative assessment of value, may go a long way to explaining why our fund outperformed the MSCI World Value index so significantly in 2010.

### **How We Think About Cyclical**

Let's take a closer look at the cyclical sectors and, in particular, industrials and consumer discretionary. These are diverse sectors. Within our portfolios, industrials includes AP Moller-Maersk (Denmark; shipping), Fraport (Germany; airports), MAN (Germany; trucks), Hutchison Whampoa (Hong Kong; diversified), and Aida Engineering (Japan; manufacturing equipment). In consumer discretionary, we have Renault and Peugeot (France; automobiles),

Millennium & Copthorne (UK; hotels), Tachi S (Japan; auto parts), Medion (Germany; electronics), Columbia Sportswear (US; clothing) and Cabela's and Dillards (US; retailers).

How should one invest in such companies, whose earnings can rise and fall significantly on the back of changing economic conditions? Many investors try to predict when specific economic cycles will start or end; when a certain sector will see a rebound in earnings; or, trickiest of all, when other investors) will start to favour that sector again. In short, they try to time the markets. We don't. If you could predict cyclical swings accurately year in year out, it could be very beneficial to returns – but it would require a crystal ball. Market timing only looks easy with hindsight. We think there are few – if any – fund managers who can genuinely claim to have accurately called such market swings over the long run.

There is a good amount of academic research pointing to this – but let's take one example. Graham and Campbell (1996), US finance professors, analysed 237 investment newsletters from a range of sources, from 1980 to 1992. These letters had tried to predict the short-term direction of the equity market. When the letters recommended an increase in equity weightings, the mean annualised return (above the risk free rate in the following six months) was 12.7%. When the letters recommended a decrease in equities, the mean return was 16.2%. In other words, you would have been better off buying when the letters said 'sell'. The study found no evidence that following the market timing advice would have led to superior investment returns in the long-term.

We take a simpler view. If we can work out what a company is worth in the long run, as if we were actually buying the whole company, then it is less important for us precisely to predict the next swing in economic indicators or investor preferences. Instead, it is far more important that we aim to buy the business well below what it's really worth, and hold it until the share price reaches a level that reflects the business's intrinsic value.

### **Focus on Intrinsic Value**

This means we have to be confident in our assessment of intrinsic value. If earnings are weak, can we be sure they will recover, or is there a chance that this decline is permanent? How long can the company put up with the harsh environment? This is where our thorough fundamental analysis comes into its own, running through business models, cost structures, on- and off-balance sheet assets and liabilities, management track records, and so on: all with the aim of identifying the company's intrinsic value, and clarifying how well protected it is.

This 'protection' is a crucial point once you have invested in a company. The fundamental value investor sees a

major distinction between a temporary decline in share prices, and a permanent loss of capital. He owns a piece of the company. When the share price falls, the stock market is telling him that the company has dropped in value: but the fundamental investor makes up his own mind, based on actual conditions at the company and its long-term potential. Of course, if the intrinsic value has suffered and the share price is no longer at a discount to the intrinsic value, then he should sell – and this is a permanent loss of capital. However, if the investment case and intrinsic value remain sound, then he should not capitulate and sell the stock, simply due to a temporary decline in the share price.

Let's take an example: Columbia Sportswear, which we have just sold from our global funds. (We discuss the investment case in more depth in the relevant fund updates.) During much of 2007, Columbia had traded at a share price well above USD 60. By mid-2008, the shares had dropped to under USD 40. Columbia's revenue growth had started to ease off, and the market punished it. We felt this was an overreaction. Although Columbia was indeed facing more competition, and perhaps faced a period of revenue contraction, its long-term earnings power was being seriously undervalued. The strong balance sheet gave us added confidence. We saw a major discount to intrinsic value and invested.

The share price then fell further, hitting USD 25 in March 2009. The market was saying that Columbia's value had dropped by 40% since we invested. Was this justified? Again, we scrutinized the company. Of course, economic conditions were not helping earnings, and there was a lack of short-term visibility, but we remained convinced that the long-term earning power was intact. Despite the temporary share price decline, we could see no decline in intrinsic value. In short, the share price decline would only generate a permanent loss of capital if we chose to sell our shares. Instead, we bought more. In late 2010, we sold our position for USD 60.

This disciplined focus on intrinsic value is a powerful tool which, over the years, has proved to be an extremely effective way of investing in cyclical companies. In searching for new investments, it allows you to be contrarian, and exploit selling by others. For existing investments, it gives you the strength not to capitulate and sell a perfectly good investment just because the market price tells you it has fallen in value. Many of the cyclical holdings listed above were treated viciously in the markets of 2008. In our Letter to Shareholders of Q1, 2009, we wrote that *"for short-sighted market participants, cyclical companies are out of favour right now, as no-one knows the length and depth of the recession"*. Meanwhile, our focus on intrinsic value ensured that we remained invested in those cyclical holdings – and indeed sought

out new investments – and this has certainly benefited the fund significantly in the past year. We are certain that, whatever stock market conditions come, our process will continue to identify strong investment opportunities across the board.

## Currency

Currency exposure is obviously an issue for global equity funds. However, even in a year of extreme currency moves like 2010, the impact on our funds was perhaps less than one might first imagine.

## Direct Currency Risk

Looking at the share price of an individual stock, of course currency can have a major impact. For example, if a euro-denominated fund buys an Australian stock, and then the Australian dollar drops against the euro, the euro-denominated value of that position falls – and this has a negative impact on the fund. But this ignores the balancing effects not only of time, but also of portfolio diversity.

In a diversified portfolio, especially when viewed over the longer term, the shifts in various currencies typically balance each other out to a large extent. We'll take the euro-denominated Sparinvest Global Value fund, in 2010, as an example.

The fund has exposure to over ten different currencies. Let's first consider the 'non-Euro' currencies such as the Japanese yen, US dollar, British pound and Swiss franc. In 2010, most of these strengthened sharply against the Euro, and in absolute terms, this contributed around 6 percentage points to the fund's total return of 26.36%.

However, so far we've not considered the fund's exposure to the euro itself. This is clearer if we compare the fund with a global index like the MSCI World. The MSCI World has roughly 50% in the US dollar and 14% in the Euro – and our fund is roughly the opposite. So in 2010, while the MSCI World was benefitting from its large exposure to the strong USD, the fund was suffering from its large exposure to the weak Euro. This means that relative to benchmark, the fund actually benefitted very little from the currency swings of 2010. Sparinvest Global Value outperformed the MSCI World by 6.83%, but less than 1% of that outperformance was thanks to currency.

One can attempt to hedge the direct currency exposures of a fund. But of course, hedging also has a cost, and we have found hedging our exposures would not have made a significant difference to the long-term performance of our funds.

## Indirect Currency Impact: Corporate Fundamentals

Moreover, currency risk is not just limited to the currency in which a stock is listed. There are also considerable indirect impacts from currencies. Clearly, currency levels also affect operating conditions, earnings levels, and balance sheets at the companies we invest in. The sensitivity to currency varies considerably from sector to sector and company to company, but when exchange rates shift significantly, there are very few companies that do not feel an impact in some way.

Let's use the obvious example of an exporter. Panasonic gets about half of its revenues from outside Japan. Over the years it has increased overseas production, but it remains sensitive to currency moves – not least, when overseas profits are translated into Japanese yen. Over the last few years, the Japanese yen has steadily strengthened against major currencies, and this has naturally hurt Panasonic's profits. In the last fiscal year alone, the strengthening yen hurt Panasonic's operating profit by JPY 42 billion, almost EUR 400 million.

Unsurprisingly, this tough environment has had an impact on Panasonic's share price, which in Japanese yen terms fell 11% during 2010. But remember that while the strong yen hurt earnings, and therefore indirectly hurt the share price, when you translate that share price into Euros, it has actually gained 6% over the year.

Moreover, Panasonic's management are not sitting on their hands and blaming external conditions for weak profits. Instead, they continue to take restructuring measures and reduce their cost base so that they can make healthy earnings – even if the current yen strength continues. The implication is that if the yen weakens, the boost to profits could be even greater than the pain the company suffered from the strong yen. Note, though, that our investment case certainly doesn't rely on a weakening of the yen: we see a healthy discount to intrinsic value even on conservative assumptions.

So, the interplay of direct and indirect currency effects, combined with the effects of diversification, mean that currency risk is neither simple nor transparent. One can try to hedge the direct currency risk but, as noted, this would have made little difference to long-term returns in our funds. Meanwhile, one cannot hedge the indirect effects currency has on one's investments. These depend very much on the financial and operating profile of the individual companies. As with Panasonic, we keep a close eye on these issues, and factor conservative assumptions into our investment cases.

## Valuations and Conclusion

In the past year, many holdings have served us well but, crucially, we see considerably more potential for the future. As always, we have been disciplined in selling stocks that have attained their intrinsic value. As share prices rise, it is sometimes tempting to try to 'ride a wave' and squeeze a few more percent out of a holding. But once the share price exceeds our assessed intrinsic value, the downside risk simply increases. So we sell the stock and reinvest in positions with the greatest discount to intrinsic value. This means that our portfolio valuations remain very attractive.

Let's consider Sparinvest Global Value as an example. As a rough indication of the valuation, we amalgamate the holdings into one theoretical company. This company has a price-to-book of just 1.07 times, compared to 2.24 times for the MSCI World index. Looking at earnings-based multiples, we can see the operating leverage coming into play. EV/EBITDA, which is a useful indicator of the price of companies relative to their raw earnings power, is just 5.3 times 2011 Bloomberg estimates, compared with 6.9 times for the MSCI World. The aggregate balance sheet is strong, with net-debt-to-equity of just 26% (versus 51% for the MSCI World), and intangibles-to-equity of only 17% (versus 51% for the index).

Meanwhile, we see many potential drivers for our holdings going forward – regardless of how long the gradual economic recovery takes. As noted above, many holdings have dramatically lowered their cost bases, creating scope for impressive earnings expansion as macro conditions improve. Our companies' strong balance sheets, which have helped them pull through the lean times, can gradually be put to work exploiting the improving environment. Meanwhile, 2010 saw a gradual increase in the number of mergers and acquisitions – including some among our holdings – but M&A activity has still a long way to recover. We strongly believe that, as has been the case historically, there is significant M&A potential for our holdings, both as buyers and targets.

Looking back at 2010, Sparinvest's value equity funds generally provided healthy absolute and relative returns. Although this is satisfying, what is always most important to us is the current quality and discount of the portfolio – and in this regard, we feel extremely positive. Looking at our current portfolio we see a rich diversity of deeply undervalued stocks, which we feel confident can drive impressive long-term investment returns.

**Jens Moestrup Rasmussen**  
Lead Portfolio Manager  
12 January 2011

## Sparinvest Value Team



**Jens Moestrup Rasmussen**  
Lead Portfolio Manager



**Kasper Billy Jacobsen**  
Lead Portfolio Manager



**Per Kronborg Jensen**  
Senior Portfolio Manager



**David Orr**  
Portfolio Manager



**Jeroen Bresser**  
Equity Analyst



**Morten Rønnow Tandrup**  
Equity Analyst



**Trine Uggerhøj**  
Equity Analyst



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