Sparinvest

Letter to Shareholders | Q4 | 10

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

First of all we want to thank all investors for sharing a good 2010 with us. We wish everyone a great 2011.

Macro Economics

Economic data over the past few months clearly indicate that the global recovery is intact, and fears of a double-dip recession have abated. Pressures around European debt persist, but growth in the euro area as a whole has held up quite well, led by surprising strength in Germany. Concerns about excessive slowing in China have been replaced by worries about how much policymakers will have to tighten to slow down the economy, which has exhibited renewed strength. Meanwhile, nearly all signs in the US point to a modest reacceleration in growth from the slowdown observed in the middle of the year, and recently proposed tax cuts strongly suggest that activity will continue to pick up into 2011.

Even with the improved tone of the economic data, policy has become even more supportive, especially on the monetary side. The Federal Reserve has embarked on a new round of quantitative easing that is likely to absorb all of the substantial new US Treasury issuance through June of 2011. The ECB has decided to postpone its policy normalization, extend its liquidity facilities and step up its purchases of government bonds. And even while China begins to tighten monetary policy, it is doing so only modestly relative to the strength observed in the economy, and continues to resist currency appreciation.

The combination of sustained economic recovery and increasing policy stimulus sets up a constructive environment for corporate bonds and stocks, at least in the near term. The case is bolstered by high profit margins, strong corporate balance sheets and negligible financing costs.

Pressures around European debt are likely to persist in the near term, but we believe the situation there will ultimately be contained – see next page.

Europe

The Euro-zone exited 2010 and entered 2011 on a note very similar to that of the last 12 months: good macro data and nervous markets still sceptical about the outcome of the peripheral crisis. The latest macro data include a further strengthening of the manufacturing PMI and some weakening of the services PMI (still at a strong level). This bodes well for the start of 2011 and, considering the gap between new orders and finished goods inventories, this continues to be very favourable for France, the Netherlands and Germany in particular, but also for the periphery countries Italy, Ireland and Spain. Which we view this as a very encouraging sign that the financial market tensions about sovereign debt have, so far, not been strong enough to impede the generally upbeat mood prevailing in global manufacturing. Only the comparatively small Greek manufacturing sector seems not to be benefiting from the general improvement apparent elsewhere. Also strong savings balances and improving bank lending data bode well for Q1.

We expect the sovereign crisis to settle down, but the timing is highly uncertain given that this is a confidence game: macro fundamentals continue to improve – including in Spain, the world remains flush with liquidity and the policy commitment remains unquestionable; yet the financial sector remains full of anxiety.

2010 has been characterized by a battle between, on the one hand, better growth in the real economy and ample liquidity, and, on the other hand, troubled financial markets partly on strike and policy actions to prevent a European credit event that could have broader and systemic implications. This battle is likely to continue into 2011 and, as long as the political commitment remains in place (and of that we have no doubt), eventually, macro fundamentals ought to win the battle against financial markets' anxiety. When exactly markets will calm down is difficult to say because, ultimately, this is a confidence game.

US – Why high unemployment is not all bad

The combination of accelerating GDP growth and a large 'output gap' is likely to result in rapid corporate profit gains in 2011 and 2012. The change in nominal GDP growth and the lagged output gap as estimated by the Congressional Budget Office (CBO) implies high profit growth rates for 2011 and 2012.

This profit growth is driven mostly by the large output gap, which historically tends to foreshadow a rising profit share of GDP. Eventually the pendulum is likely to swing back towards a higher labour income share, but probably not until the output gap has shrunk substantially and, in particular, unemployment is again much closer to normal levels.

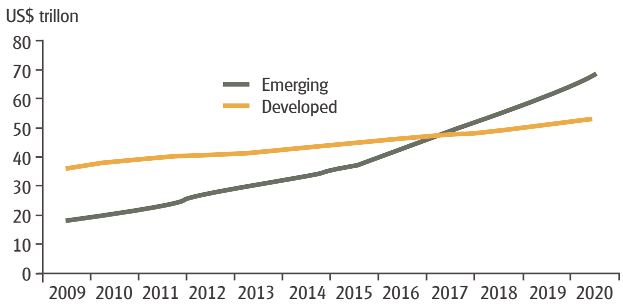
The US economy has plenty of 'room to grow'. Because the recession was so deep, the levels of output and employment are likely to remain below potential for several years to come, even though the growth rates of output and employment are likely to be well above potential.

Why is the output gap such a powerful predictor of subsequent profit growth? Empirically, a large amount of slack in the economy – and specifically in the labour market – tends to reduce the share of output going toward labour costs, which make up about 60% of total business costs. Eventually the pendulum is likely to swing back toward a higher labour income share, which in turn will weigh on profit growth.

Emerging Markets

Industrial countries can see that the balance of power is shifting. Emerging Markets continue to outpace the former economic and political superpowers like England, Japan and US. Hence, the date at which emerging markets are expected to generate more than half of the world's GDP has moved forward to 2017 from 2020, as previously estimated. This means that emerging markets are very important to investors today. In September 2010 we introduced Sparinvest Emerging Markets Corporate Value Bonds. The fund builds upon the same principles as Sparinvest High Yield Value Bonds. Sparinvest Emerging Markets Value Bonds has had a good start.

Distribution of global GDP:



Source: JP Morgan, EM Moves into the Mainstream as an asset class.

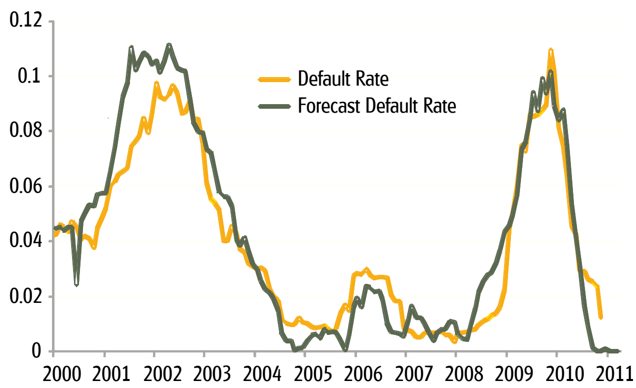
The increase in the balance of trade generated by emerging market nations trading with each other is one of the explanations for the continuing positive growth in emerging markets. Purchasing power has increased as the size of the middle class has grown. Among other things, this means that today not all cars produced in Argentina and Mexico are shipped to the US or Europe, and that more Indian- or Chinese-produced high-technology products are bought buy emerging markets consumers as their disposable income continues to grow.

Emerging Markets companies appear low leveraged
Emerging markets companies appear lowly leveraged, relative to US companies within the same rating bucket. Investors are at the same time paid a higher credit premium for buying emerging markets corporate bonds.

One explanation for the extra premium appears to be that rating agencies, such as Moody's and S&P, consider the country risk greater than the companies' fundamental health. The country risk is without doubt higher when investing in emerging markets because of greater political risk, lower transparency and weaker property rights. However, investors are able to lower the country risk by diversifying the exposure across countries and regions. This enables investors to take the extra credit premium paid for investing in bonds issued by lowly-geared emerging markets companies. At the same time, it is worth noticing that many emerging market countries are currently improving the functioning of their capital markets together with a move towards increased transparency in companies' financial reports.

The default outlook

Macroeconomic improvements and companies' focus on cost control and debt reduction have been the drivers behind a substantial drop in default activity during 2010 (see below). During 2010 the global default rate fell from 8.13% to 0.79%. We expect this low level of default activity to continue for the foreseeable future. We base this forecast on our default rate model.

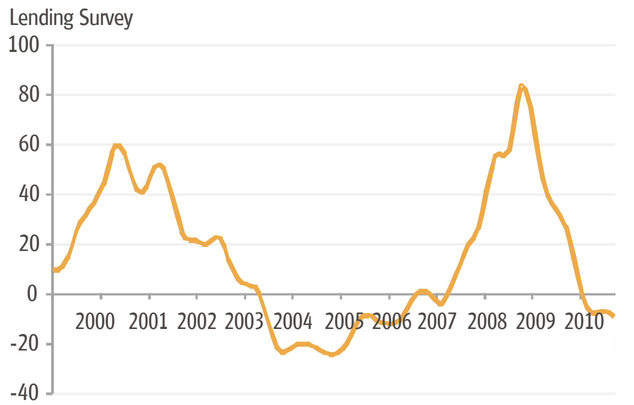


Source: JP Morgan og Sparinvest's own estimate.

Our default rate model explains the evolution of the global default rate using three explanatory variables. These are: the Senior Loan Officers Survey, Industrial Production and the Financing Gap. All three variables are US numbers. This is a fair approximation since 80% of the market is US based. All three variables currently indicate good times ahead for credit investors.

The Senior Loan Officers Survey builds on the lending terms by 50 American and 20 Non-American bankers, this survey shows that the banks are continuing to lend money

The Senior Loan Officers Survey



Source: The Federal Reserve's quarterly survey 'Senior Loan Officers Opinion Survey on Bank Lending Practices'.

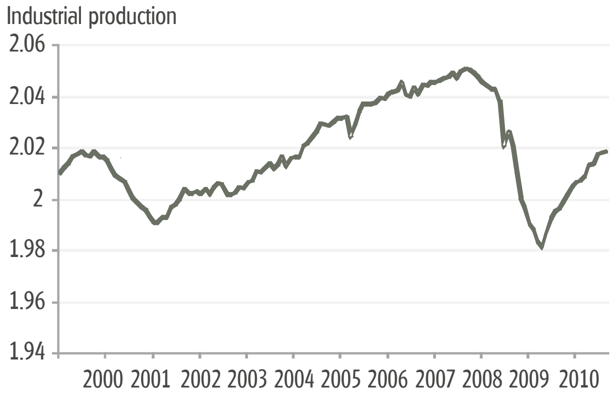
The figure shows that the banks are now as willing to lend as they were before the crisis. This is very much in line with what we observe looking at the Federal Reserve's financing gap; here we see that companies are moving towards normalization.

Financing Gap

Source: Federal Reserve's Flow of Funds account.

The only explainable variable, which has some way to go before it reaches its pre-crisis level, is the Industrial Production. Industrial production continues to grow though and the near term prospects seem good (se earlier part of this letter).

The Industrial Production



Source: Federal Reserve Dallas.

The developments in these three explanatory variables take us to an optimistic estimate of defaults for 2011 of around 1%. Sparinvest High Yield Value Bonds and Sparinvest Emerging Markets Corporate Value Bonds, yielding 10% and 8% respectively, are therefore still cheap irrespective of their past performance. Another factor that argues in favour of our value-based corporate bond funds is Mergers and Acquisitions.

Mergers and Acquisitions

On January 10, 2011 alone, more than $20 billion worth of takeovers were announced. This may signal multi-billion dollar deals are making a comeback after a dearth of large transactions in 2010.

Duke Energy Corp. plans to buy Progress Energy Inc. for $13.7 billion, and DuPont Co. agreed to acquire Danisco A/S for $5.8 billion. There were fewer than 20 deals valued at more than $10 billion last year compared with nearly 40 during the height of the M&A boom in 2007.

Many of 2010's biggest deals fell through, including BHP Billiton Ltd's $40 billion bid to buy Potash Corp. of Saskatchewan Inc. and Prudential Plc's failed attempt to acquire American International Group Inc's Asian business for $35.5 billion. This year may be different because companies have available funding and are more willing to seize takeover opportunities.

There is going to be more pressure for companies to use the cash they have. Strategic companies with high ratings have the capacity to borrow and there are a lot of cheap assets available.

This theme of Mergers and Acquisitions is one we benefitted from during 2010 on several occasions. We believe that, as value investors, we will continue to benefit from M&A during 2011.

Klaus Blaabjerg
Lead Portfolio Manager
12 January 2011

Sparinvest Value Bonds-Team

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