Sparinvest

Letter to Shareholders | Q2 | 11

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

Dear Investor,

Value investing is about consistency: keeping your cool and a long-term perspective, whether the prevailing mood in the world is positive or negative. The first six months of 2011 have certainly been eventful, and mainly in the negative sense: debt crises, social unrest, and natural disasters have dominated the headlines.

Step back one year, and many of the macro-economic themes and concerns are the same, rooted in the heavy indebtedness of Greece, Portugal, Ireland, Spain and Italy. The overarching theme in the developed world is deleveraging, and will be for some time. At present, there is increased uncertainty and concern over the Euro's future, and the direct or indirect effects of a potential collapse in the currency – and this is toxic for stock market sentiment, especially in Europe. As we've written before, we in no way want to understate the seriousness of the current situation, but we see it as an unavoidable step in digesting the credit crisis. It's a tough process in the short term, and in the long term, the most indebted countries need to bring down their borrowing. This will entail significant political and macro-economic changes, both at the national and European level. Every day, across the media we see economists speculating on the potential outcomes and time scale of this process, and we won't add to that speculation. But it is certain the debt levels must come down, and European politicians must work hard to find a long term solution to the current problems.

To a large extent, it has been macro-economic developments and natural disasters than have impacted our funds' performance so far this year, rather than underlying conditions at the individual investments. We have described our approach to macro-economic trends in previous letters, but in light of the last quarter, it's worth running through it again quickly.

Macro and Bottom-Up

At Sparinvest, we have always worked from a bottom-up perspective: the starting point is the individual company. But what does this mean in practice, in these uncertain times? Simply put, it means that we don't alter our portfolio simply as a result of overall macro-economic developments. We think that, in the long run, the best returns will be attained by selecting strong and deeply undervalued companies, and not by trying to time the markets. There are some regional variations, but assessing earnings power and asset value is largely universal. We always concentrate on thorough and in-depth analysis of the individual company.

So does this mean that we ignore macro-economic factors in our investment process? Certainly not. We monitor them closely and factor them to into our overall analysis of each individual company. Investing in a company means evaluating and making assumptions about its earnings power and asset strength. In doing this, our guiding principles are to remain conservative, and think beyond short term market trends or indicators. We don't build assumptions based on the trends of the last two years, or expectations for the next two years. Instead, our analysis looks at back at a longer history, in order to see how the company developed over its lifetime, and evaluate its track record over entire business cycles. Of course, companies don't exist in a vacuum, so it is crucial to gauge the impact of macro-economic factors on the earnings power and asset strength.

When we estimate the intrinsic value of a potential investment, regardless of whether we base this on its assets, earnings power, or a combination of the two, we try to make conservative assumptions and factor in all relevant external factors. We only invest if the company is deeply undervalued relative to this conservatively-estimated intrinsic value. In addition, we demand that our investments have the financial strength to endure difficult periods. This process generates a portfolio of deeply discounted companies that offer long-term quality of earnings and assets – and where the potential return does not depend on a positive macro-economic outlook for the country or region in which the companies are based.

Performance

As mentioned above, the performance of our funds so far in 2011 has generally been negative. Early in the year, there was the impact of unrest in North Africa and Middle East, followed by the tragic events in Japan, and finally, another chapter in the Eurozone debt crisis. We discuss the performance of each individual fund in more depth in the individual fund updates. Inevitably the biggest impact was felt by our Japanese holdings, but recently our European and North American holdings have also suffered somewhat. But we must stress that the negative top-down sentiment has not been matched by underlying fundamental developments at individual holdings - which have on the whole been positive, even for our Japanese companies after the initial problems caused by the earthquake. It is important to remember that when looking at our holdings, there continue to be many signs of improved operating conditions, leading to rising earnings and financial strength. Of course, this recovery might be at a slower pace that in 2009 and 2010, when companies were rebounding from very low bases, but nonetheless, there is continued improvement.

Despite all the doomsday headlines this year, we see much to be optimistic about in our holdings. They have used the macro-economic situation as an opportunity to restructure and cut costs, and we think that many companies will emerge the other side with even stronger business models. Our holdings are well placed to profit from an upswing in external conditions, whatever shape it takes. Moreover, when there is short term market weakness in some of the sectors or regions in which we invest, it often provides a good opportunity to find promising new investment opportunities, or to add to existing holdings. Specific changes in our portfolios are discussed in the individual fund updates.

New Funds and New Capacity

Sparinvest has recently launched four new value funds in Denmark, which have been open for trading since late June. This includes three regional funds – Sparinvest Value USA, Japan, and Europa. These funds clearly overlap with our existing strategies, and indeed share many investments with our existing global funds. The fourth new fund is Sparinvest Value Emerging Markets, which is a new development. We have naturally spent time before the fund launch selecting the right companies, which offer enough undervaluation and are solid enough to be considered value stocks.

Looking at the SICAV fund range, Sparinvest already offers the Sparinvest European Value fund. Naturally there is potential in the future to offer SICAV equivalents of Sparinvest Value USA, Sparinvest Value Japan, and Sparinvest Value Emerging Markets.

While these funds are new, the concept is simple: the application of our tried-and-tested, disciplined value investment process. Naturally, there is a higher workload, and in order to avoid dilution of the team's resources, we have expanded capacity in the form of three new members of the value team. The team now consists of ten people, all seeking compelling value investment opportunities across the markets.

Earnings Power is Cheap

If we look at the valuations of our funds in a historical context in terms of what one pays for the earnings power of the companies, there is no doubt that current valuations are below long-term levels. Indeed, the overall equity market appears cheap relative to the expected earnings (IBES estimates) for 2011 and 2012. Current stock market valuations are well below the long-term average multiples we see in our database of over 850.000 actual corporate takeovers.

As an example, we'll take Enterprise Value to EBITDA (EV/EBITDA), which is a good measure of a company's price compared to its core earnings power. When looking at the prices paid in corporate takeovers we prefer to be conservative, so instead of using average multiples we look at the 40th percentile multiple. Over the past 15 years, across all sectors, this has been 8.0 times EV/EBITDA (the median is 9.5 times). Compared to this, the MSCI World index now looks cheap, at 7.0 times estimated EV/EBITDA for 2011, and 6.6 times estimates for 2012. More importantly, the Sparinvest Global Value fund is trading more cheaply still: at just 5,2x estimated EV/EBITDA for 2011 and 4,7x estimates for 2012.

So we believe equities are cheap now, even considering the current macro-economic developments seen in the world. Compared with the overall equity market, our portfolios look extremely interesting. Our conservative value process has always resulted in portfolios with good earnings power, robust balance sheets, and low valuations. As an example of the quality of our portfolios, we take Sparinvest Global Value, and amalgamate the holdings into one theoretical company. Its earnings power, we discussed above. It has a price-to-book of just 1,02 times, compared to 2,16x times for the MSCI World index. The balance sheet is robust: net-debt-to-equity of just 24%, compared to 45% for the MSCI World, and a relatively low risk of write-downs thanks to low levels of intangible assets (intangibles-to-equity of only 18%, compared with 51% for the index).

The fact that current equity markets are putting low prices on earnings power means that there could be good potential for M&A activity. It is difficult to quantify the exact effects of M&A on the portfolios, but it is certainly a positive factor. There can be direct effects, where portfolio holdings are taken over at premium prices. But there are also indirect effects. For example, increased M&A activity can lead to a specific sector being revalued at higher levels in the stock market. Expectations of a potential takeover can draw attention to a company, driving the share price up in advance – whether or not an actual bid ultimately comes. In other words, even without an ultimate takeover, M&A activity can clearly serve as a share price catalyst. Considering the power, strength, and valuation of our holdings, we believe they are well exposed to this potential, and expect many to be involved in M&A activity in the coming years.

Conclusions

In the first half of 2011, the stock markets have been very much focused on macro-economic events – and rightly so. But underlying conditions at the corporate level have been of a more positive nature. In past letters, we've commented that the coming years would be a period where deleveraging would be a major theme – and certainly this is the case now. Economies – whether at the national, corporate, or personal level – are now struggling with the effects of this deleveraging process. This is one reason why we continue to prefer companies with strong balance sheets and sustainable business models. The companies we hold can withstand an escalation of the problems in the Eurozone. They are able to recover from the earthquake in Japan. We believe that the global economy continues to recover, albeit at a slower pace than one might have hoped for. In such a situation, healthy and financially strong companies have plenty of options: such as supplementing the somewhat low economic growth by carrying out acquisitions, or consolidating operating locations, and so on – thereby increasing their long-term earnings power. So we are convinced of the strength in our portfolio, and are confident in the potential for healthy investment returns.

In stock markets, there is an increasingly short-term focus, an endless desire to have a good story to tell. This is not what matters to the long-term investor. Certainly, such short-termism in the markets can create opportunities to be exploited by long-term investors and especially value investors. But value investing is not about having a good story that is easy to tell, or that fits in neatly with market consensus and general news flows.

On the contrary, our world of value investing is about real values and real valuation, about buying earnings power, strong balance sheets and assets at a discount. Most difficult of all, it is about patience. Of course, one must not be sentimental about one's investments or one's investment process – one must continuously look to improve the process, not just when markets are tough, but every day of the year. Investors must be curious and always looking to do things smarter. But for us as value investors, most crucial of all is never to lose track of our core principles: invest in companies with robust balance sheets and a 40% discount to intrinsic value.

Jens Moestrup Rasmussen
Lead Portfolio Manager
11 July 2011

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UN PRI is an international investor initiative sponsored by the UN and based on six principles for responsible investments. The aim is to help investors actively to incorporate environmental, social and governance issues into their investments.

The mentioned sub-fund is part of Sparinvest SICAV, a Luxembourg-based, open-ended investment company. For further information we refer to the full and/or simplified prospectus and the current annual / semi-annual report of Sparinvest SICAV which can be obtained free of charge at the offices of Sparinvest or of appointed distributors/representatives together with the initial statutes of the funds and any subsequent changes to such statutes. Investments are only made on the basis of these documents. Past performance is no guarantee for future returns. Investors may not get back the full amount invested. Investments may be subject to foreign exchange risks. The investor bears a higher risk for investments into emerging markets. The indicated performance is calculated Net Asset Value to Net Asset Value in the fund's base currency, without consideration of subscription fees. For investors in Switzerland the funds' representative and paying agent is RBC Dexia Investor Services Bank S.A., Zurich Branch, Badenerstrasse 567, P.O. Box 101, CH-8066 Zurich. Published by Sparinvest, 28, Boulevard Royal, L-2449 Luxembourg. Sparinvest makes reservations for typos, calculation mistakes and other possible mistakes in the material.