

# European Value Fund Update Q2/08

## Performance highlights

Q2 return of -8.04%

## Economics

### Dear Investor

European stock markets have continued to decline in Q2 2008, and the Sparinvest European Value fund has also suffered. The second quarter brought a loss of 8.04%, taking our year-to-date return to a negative 19.77%.

The European equity market, when measured by the MSCI Europe Index, lost 3.60% in the quarter, while MSCI Europe Value and MSCI Europe Small Cap indices declined 5.94% and 5.18% respectively. European growth stocks performed somewhat better, with a return of -1.31%. We are certainly dissatisfied with the year to date, but our confidence in long-term performance remains unshaken. Despite the combined pain of credit crisis and rising inflation, the long-term earnings power and balance sheets of our holdings remain strong.

The table below shows the returns from the second quarter and first half of 2008, and the return from 2007, compared with different stock market indices.

Sparinvest European Value versus Index			
	Q2 2008	H1 2008	2007
Sparinvest European Value	-8.04%	-19.77%	-4.13%
MSCI Europe Index	-3.60%	-18.72%	2.69%
MSCI Europe Value Index	-5.94%	-22.17%	-2.38%
MSCI Europe Growth Index	-1.31%	-15.28%	7.82%
MSCI Europe Small Cap Index	-5.18%	-17.07%	-7.51%

MSCI Europe Index, MSCI Europe Value Index, MSCI Europe Growth Index and MSCI Europe Small Cap Index are all indices that contain a broad selection of companies from all over Europe. All returns on investment are in EUR. ■

As Q2 began, Fed chairman Ben Bernanke testified to Congress of the risk that the US economy could “contract slightly” in H1 2008. Full-blown recession or not, there is no doubt the economy is now in a weak state. ‘Stagflation’ is an ugly word for an ugly phenomenon. Policymakers face a dilemma when setting interest rates, caught between inflation risks on the one hand, and unimpressive growth expectations and continuing uncertainty in the financial sector on the other. Making the decision even harder is the fact that inflation is currently being driven by energy and food prices. Rather than generating a virtuous circle of earnings and spending, this type of inflation triggers a tightening of personal and corporate purse strings.

In the US, Q1 GDP was revised upwards to 1.0% annualised, but expectations are that growth slowed to an annualised 0.45% in Q2. Consumer spending got a temporary boost from tax rebates, but wage growth and consumer confidence figures are weak. June became the sixth straight month of job cuts. In Europe, unemployment figures remain fairly encouraging, and May retail sales were reasonably healthy. However, economic confidence is taking a battering here too, with June indicators at their lowest in 3 years. Q1 GDP was estimated at 0.8% (quarterly).

The common theme is inflation. Consumer price indices around the world rose sharply, with food and energy prices the main culprits. Oil continued its ascent during Q2 to surpass

USD 145 per barrel in early July, putting heavy pressure on consumers and companies alike. Once oil exceeded USD 140, gold prices were pushed back up by investors seeking an inflation hedge.

The ongoing impact of the credit crunch meant that Q2 began with further monetary easing in the developed markets. The Bank of England cut rates from 5.25% to 5.00% on April 10, while the Fed followed Q1's many cuts with a further 25 basis-point reduction on April 30. However, as Q2 progressed, the concerns of central banks everywhere became increasingly focused on inflation.

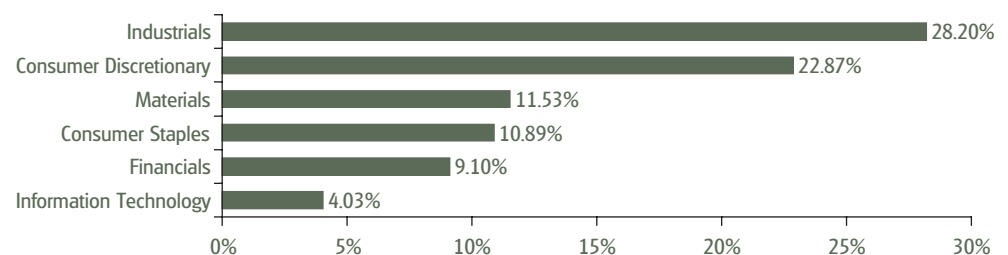
In late June, the Fed stated that downside risks to growth had diminished, and indicated that its focus was now more on the risk of rising inflation - although the language was not hawkish enough to suggest an imminent hike. The ECB, however, implemented a 25 basis-point rate hike on July 3, despite opposition from many (such as French President, Sarkozy) who were worried that a rate hike would threaten growth and exacerbate overvaluation of the Euro.

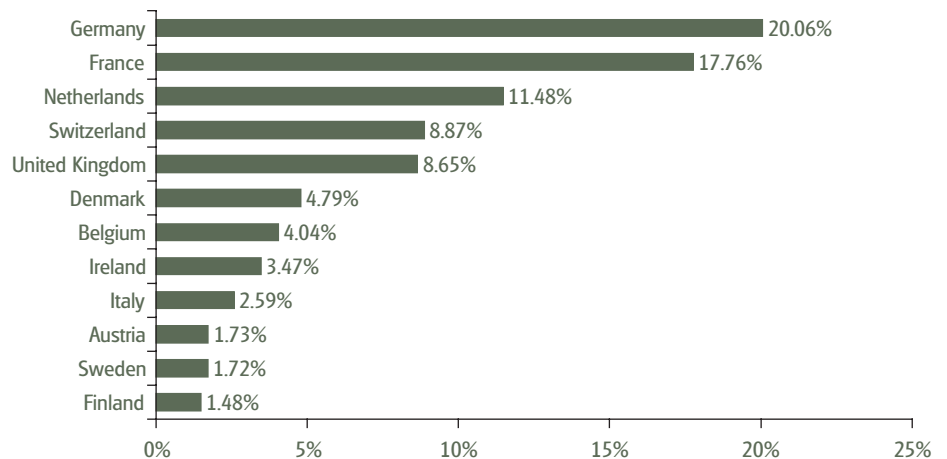
By comparison with its weak Q1 performance, the US Dollar was fairly stable during Q2. It strengthened slightly against the Euro, only to fall back at the quarter end to the levels of late March at USD 1.57 per Euro. Meanwhile the Japanese Yen reversed its first quarter strength, weakening by around 7% against both the US Dollar and the Euro to end Q2 at JPY 106 per USD and JPY 167 per EUR. ■

### Portfolio update

At the end of the quarter, the cash position was 13.4% of assets under management. The fund had 61 holdings, with the following sector and country breakdowns.

#### Sector allocation



**Country allocation**

During the quarter, we invested in two new companies. We acquired shares in Danske Bank, a leading Scandinavian financial conglomerate, and in BIC, the French maker of disposable pens and lighters.

We made additional investments in three existing portfolio stocks.

At the end of the quarter, our 10 largest positions accounted for 27.0% of total portfolio holdings.

**Top 10 holdings**

Holding	Sector	Weight
A.P. Moeller - Maersk A/S B	Industrials	4.10%
Deutsche Postbank Ag/Namen-Akt	Financials	2.95%
Koninklijke Dsm Nv	Materials	2.87%
Roy.Philips Electr./Eur 0.2	Industrials	2.82%
Rsdb Nv	Industrials	2.70%
Peugeot Sa	Consumer Discretionary	2.45%
Grammer Ag	Consumer Discretionary	2.34%
Renault Sa	Consumer Discretionary	2.28%
Frankfurt Airport Serv.Worldw.	Industrials	2.26%
Ste L D C Sa	Consumer Staples	2.25%

**PZ Cussons**  
Sold with profit

PZ Cussons' origins lie in soap manufacturing, but the group is now one of the world's leading producers of toiletries, while other business areas include household cleaning products and pharmaceuticals. It operates in Europe, Africa and Asia, and controls household brands such as Imperial Leather, Carex, and Original Source.

We first invested in PZ Cussons in December 2006, paying GBP 1.66 per share. The balance sheet enjoyed a healthy net cash position, and earnings were stable if not expanding rapidly. The stock was trading close to book value, and was also cheap on earnings-based valuation measures. It had historically offered a dividend yield of 4-8%.

Since the 1990s, PZ Cussons has steadily expanded its operations. The management has used cash to acquire strong brands such as Original Source (in 2002) and Charles

Worthington (2004). Sales are now over 25% above the 2003 level. Most impressive of all has been the company's success in improving profitability.

The market has steadily rewarded PZ Cussons with increasing valuations. We sold our holding at an average price of GBP 1.94, giving us a total return on the initial investment of 20.3% annualised. ■

### Outlook

It is fair to say that both our fund and value investing as an investment style are having a hard time under current market conditions. Many value companies that are already cheap are getting cheaper, and extreme negativity is creating a herd mentality where many investors focus strongly on certain sectors and completely avoid others. As a portfolio manager, it does not feel good to underperform - and nor should it. However, it is vital not to lose faith and essential to "stick to your guns" in good times and bad. A successful value strategy will always require discipline, patience, and more importantly, stamina.

Have current global conditions changed the fundamentals of our holdings completely, damaging the long-term potential of their future earnings power? Clearly not, but many companies have suffered share price declines due to the low short-term visibility, caused by the 'perfect storm' of economic conditions mentioned earlier in this letter. This does not turn a good company into a bad company, and as always, if the global economic downturn creates issues in relation to any of our holdings, we will of course address those issues. But clearly, a fund manager must not only possess the courage of his analytical convictions, he must also be able to withstand the widespread negativity roaring in today's markets.

Value funds have faced hard times before. When I joined Sparinvest in the summer of 1997, value investing was completely out of fashion. From then until the bubble burst in the spring of the new millennium, growth stocks outperformed value stocks by around 50% cumulatively. It is an inherent characteristic of market behaviour that at some points, growth stocks will outperform value stocks. But, over the long term, value stocks do generate superior returns.

Our portfolio has been hurt to a degree where the general valuation of our holdings is now around all time lows. Today the Sparinvest European Value fund trades at an average Price-to-Book-Ratio of 1.0, a median EV/EBITDA ratio of 4.6, and has a weighted Net-Debt-to-Equity excluding financials of 15.2%.

Why has the defensive nature of value investing not crystallised this time around? One factor is that confidence in corporate balance sheets generally has been damaged. The sub-prime collapse forced financial institutions to make large write downs of credit derivative products and other assets, shaking faith in the asset quality. Subsequently, the credit crunch on financials evolved into a wider trend of both corporate and private deleveraging. For several years, in the US and UK especially, debt had expanded considerably faster than GDP. As that leverage decreases - as less credit is available - asset prices also decline. This means that losses spread to other sections of the economy (for example, we see homebuilders cutting the value of their land banks), compounding the lack of trust in balance sheets.

Meanwhile, the universe of value stocks tends to include many cyclical companies. In such companies, a short-term downturn may temporarily lead to a reduced use of production capacity with a knock-on effect on earnings. Viewed over the longer term, however, the production capacity remains a strong and enduring asset, assuring future earnings. At present, consumer spending is being hurt by a combination of private deleveraging and inflation of

energy and food prices, and this inevitably hurts cyclical companies. The pertinent question is not whether cyclicals will cut short term earnings forecasts, but by how much. The valuations of many companies suggest that a severe impact is already being priced in.

A further factor hurting value performance at present is that energy and commodity stocks have outperformed at a pace usually seen in bubbles. But value investors tend to avoid buying companies that could be trading on peak earnings, even though valuations might look attractive in the short term.

At present, there is fear, uncertainty and a relative lack of interest in the world's stock markets. In these market conditions, the number of stocks entering our investment universe is increasing, and that is positive. It is an opportunity for us to do what we do best: finding companies with strong long term outlooks, and buying them cheaply.

Of course, this environment also hurts our fund's performance over the short term. However, we remain confident about the fundamental strength of our holdings. Our process has always emphasised the rigorous checking of balance sheet quality, and in addition, the low debt burden of our holdings should put them in strong positions as the global deleveraging process continues, creating business opportunities for them in the future.

Value investing is based on the assumption that a company has two values attached to it: the market value, as seen on the stock exchange, and the intrinsic business value, reflecting the 'true' value of the business if it were to be traded as a whole, based on net asset values and the power to generate earnings. We invest in companies where we believe the market price does not reflect the true intrinsic value of the company. Under recent conditions, market prices have fallen, but we are encouraged by the fact that we are finding no cause to reduce our assessments of the intrinsic value of our holdings, which we continue to believe will be reflected over the long term. In other words, the loss of capital caused by the current market turmoil is likely to be temporary and does not reflect the underlying strength of the companies we hold.

Investing is much about patience, and it is after a quarter like the second of this year that one must keep in mind the long-term focus in the Sparinvest Value investment philosophy. We continue to see considerable upside in our investments, and are confident in the future potential of our holdings. ■

Yours sincerely,

Sparinvest Asset Management

Jens Moestrup Rasmussen  
Chief Portfolio Manager  
8<sup>th</sup> July 2008

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 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 Services Bank S.A., Zurich Branch, Badenerstrasse 567, P.O. Box 101, CH-8066 Zurich. Published by Sparinvest, 28, Boulevard Royal, L-2449 Luxembourg.