

European Value Fund Update Q3/08

Performance highlights

Q3 return of -15.25%

Dear Investor

During Q3 2008, global stock markets have suffered considerably, and this is also true of Sparinvest European Value Fund. The third quarter brought a loss of 15.25%, taking our year-to-date return to a negative 32.00%.

The European equity market, when measured by the MSCI Europe Index, lost 11.13% in the quarter, while MSCI Europe Value and MSCI Europe Small Cap declined 10.93% and 17.08% respectively. European growth stocks also performed poorly, with a return of -11.32%.

Whatever the state of the markets, we are very dissatisfied with this performance. However, as we will discuss further below, we believe markets are currently paying attention neither to long-term fundamental earnings nor to valuations. Instead, they are being swayed by short-term factors, both real and psychological. Despite the fluctuations in market prices, we are as confident as ever in the intrinsic value of our holdings, and in the long-term performance potential of our funds.

The table below shows the returns from the third quarter and from 2008 year-to-date, and the return from 2007, compared with different stock market indices.

Sparinvest European Value versus Index			
	Q3 2008	YTD	2007
Sparinvest European Value (LU0264920413)	-15.25%	-32.00%	-4.13%
MSCI Europe Index	-11.13%	-27.77%	2.69%
MSCI Europe Value Index	-10.93%	-30.67%	-2.38%
MSCI Europe Growth Index	-11.33%	-24.88%	7.82%
MSCI Europe Small Cap Index	-17.08%	-31.23%	-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. ■

Markets

The past three months have been historic. We will not try to recap all the bad news from the financial sector this quarter. As we write, the amount of negativity is massive and panic is increasing. Just turn on the news and it seems we are facing a financial Armageddon. The financial sector has been playing musical chairs for most of the year, but lately it has become more like a domino game, with the lack of liquidity knocking over one piece after another. At times, it has felt like the financial world of the past few decades is coming to an end. It has seemed like the idea of self-regulating markets is just an illusion, shattered by a crisis caused by unprecedented greed and lack of control. This is hard talk, but nevertheless closer to recent reality than one would like.

So is this the end of the world as we know it? Probably not, but there will be big changes for sure. Banks and financial institutions are disappearing from the map and governments are getting more and more involved, with rescue plans and expanded regulation. People will demand more transparency in the financial sector, and that will be a big part of the solution to stabilize the markets going forward.

We know that these are hard times, and that these days it hurts a lot to look at the year-to-date performance of most investments. In the current market conditions, a lot of people are selling stocks because they are forced to, because they do not believe in the asset class any more, or because they are panicking. In other words, some people are selling without any consideration of either short-term or long-term fundamentals, dumping the shares of fine companies. From our experience, this is the time to buy shares.

We care about fundamentals – both over the short term and the long term. Our investment horizon does not change, even when a downturn is expected in most economies around the world. To our minds, in good times and bad, screening the markets and sticking with our investment strategy is how we will deliver good returns in the long run.

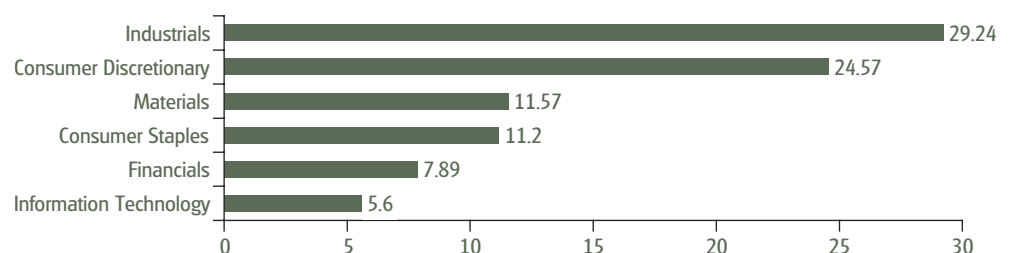
Even factoring in the likelihood of lower earnings for many of our holdings, through-the-cycle earnings levels and asset values show that our portfolio of companies is very cheap. The price correction has been excessive relative to the underlying intrinsic value of our companies. Companies with a proven track record of through-the-cycle earnings and strong balance sheets will persist. For both cyclical and non-cyclical companies, share prices are falling sharper than is justified by changes in the underlying intrinsic value of the companies. This means that our shareholdings offer very good value. The portfolio is trading at more attractive prices than we can recall: at an average 0.80 times price-to-book, and a median 4.2 times EV/EBITDA (a measure of earnings power). The net-debt-to-equity is only 13% - meaning our holdings have considerable financial strength compared to their peers, and indeed, half of our companies have net cash positions.

It is true that the current lack of liquidity has a knock-on effect outside the financial sector – and on our portfolio of companies – by reducing a lot of the M&A activity one would normally see in an economic down-cycle. The financial buyers are long gone, and industrial buyers - who would normally be more active in times like this when acquisition multiples are coming down - are temporarily unable to move due to the same problem, liquidity. But they will make their moves, once the markets start functioning again. From this point of view, the potential for M&A activity involving our portfolio holdings is even greater than before. ■

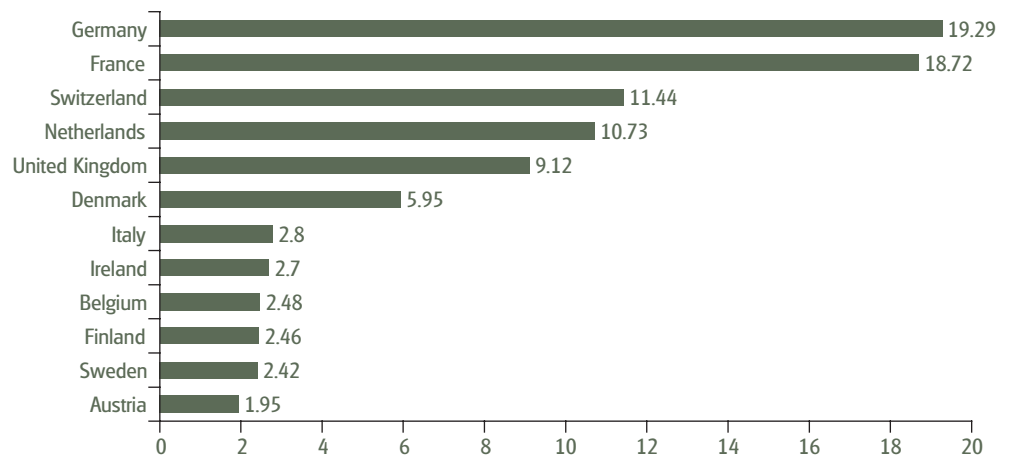
Portfolio update

At the end of the quarter, the cash position was 9.9% of assets under management. The fund had 65 holdings, with the following sector and country breakdowns.

Sector allocation (all Values in %)



Country allocation (all Values in %)



During the quarter, we made three new investments. We bought shares in Italian clothing company, Benetton Group; German consulting company, IDS Scheer, and Finnish paper and pulp company, UPM-Kymmene.

In general rebalancing of the portfolio, we have made additional investments in some existing stocks.

At the end of the quarter, our 10 largest positions accounted for 27.5% of total portfolio holdings.

Top 10 holdings

Holding	Country	Sector	Weight
A.P. Moeller - Maersk A/S B	Denmark	Industrials	3.69%
J.Sainsbury Plc	United Kingdom	Consumer Staples	3.08%
Frankfurt Airport Serv.Worldw.	Germany	Industrials	3.04%
Koninklijke Dsm Nv	Netherlands	Materials	2.90%
Roy.Philips Electr./Eur 0.2	Netherlands	Industrials	2.82%
Tessenderlo Chemie	Belgium	Materials	2.48%
Ericsson Tel. B	Sweden	Information Technology	2.42%
Renault Sa	France	Consumer Discretionary	2.40%
Ste L D C Sa	France	Consumer Staples	2.33%
Peugeot Sa	France	Consumer Discretionary	2.30%

Looking at the past quarter, we have been hurt by our exposure to cyclical companies in general and, looking at single countries, our German industrial exposure has been costly. Should we sell most of our cyclical companies? Certainly not, when there is already a lot of recession priced in. Why did we not buy commodities and oil-related stocks? Because we found them, and many of the non-cyclical companies, too expensive. We do not think there is anything fundamentally wrong with our investment model and strategy, in which we buy companies that are cheap on long-term earnings power and avoid companies that are only cheap on peak earnings.

DEXIA

Sold with loss.

In terms of the financial sector, we have made our mistakes in not realising earlier the sheer magnitude of the meltdown. We think this has to do with the fact that when you analyse a financial company, certain systems and processes in the financial market tend to be taken for granted. Those systems, such as inter-bank lending, have stopped working in the past three months in a way that few anticipated. We have, of course, thoroughly reviewed our exposure to the sector, as will be seen with Dexia, below.

Dexia was created by the 1996 merger of Crédit Communal de Belgique and Crédit Local de France. The company is based in Belgium, and has two main areas of operation: retail banking (with 5.5 million customers in Belgium, Luxembourg, Slovakia and Turkey) and public sector finance.

We first bought shares in December 2006, for around EUR 20.80. The stock was trading at reasonable levels on both earnings- and asset-based valuations, and offered a generous dividend yield. Core-capital and solvency ratios were healthy, and management had a conservative, risk-averse track record. The company was steadily expanding earnings, and generating over 20% returns on equity.

For Dexia and its US subsidiary FSA, which engages in bond insurance, the operating environment is now completely different from when we first invested. Risk has increased, and balance sheet visibility has been clouded, which seriously damages the investment case and effectively removes any certainty in calculating a margin of safety. We therefore decided to exit our position in Dexia in September 2008, and realised an average price of EUR 9. This amounts to a total loss on the investment of approximately 55%. While we are by no means satisfied with this return, we consider it important to apply our investment criteria with discipline, not only in entering stocks, but also in exiting. ■

Outlook

In the past three to six months one could start feeling a bit like Bill Murray in the film "Groundhog Day" – reliving the same day over and over again - with the relentless flow of bad news, falling markets, rising pessimism and doomsday headlines on the front pages of the newspapers.

This is not the end of the world. Times are more challenging than they have been in the past decades, so patience is vital. It's important to realise that the efforts being made by politicians and regulators to save the financial system will not have full traction from day one. The financial sector is key, and it will take some time for it to get back on its feet, but markets will normalize eventually - and that tends to happen when the herd least expects it. It is worth noting that historically, a large proportion of total returns on equity investments have been made during brief upswings – and it is important to be invested during those upswings.

As we noted previously, a downturn will 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 rising prices, and this inevitably hurts earnings in companies. The pertinent question is not whether cyclical companies will cut short-term earnings forecasts, but by how much. Yet the valuations of many companies suggest that a severe impact is already being priced in, and we find comfort in this. Our companies – and especially the cyclicals – are now priced with major discounts to their historical average multiples, which suggests a significant decoupling from their fundamentals.

There are some brighter notes. We have previously argued that commodities and oil were forming the latest bubble in the market. Since July, that bubble has largely deflated, and this may give global industry and consumers something of a break from relentless cost increases. As we write, various central banks have announced coordinated rate cuts, and there is the possibility of more to come. So the outlook is not entirely dark.

The world has experienced economic and market downturns before, perhaps not as severe as this one, but it will land on its feet again. In such times, we think it's especially important to remain disciplined and stick with our strategy. We continue to focus on the operational value of our companies and not short-term fluctuations in the market price. Once you decide to invest in equities, you also expose yourself to market risk. On the other hand, risk on individual stocks can be minimized through careful research, and this has led to our portfolio of companies with impressive long-term earnings power and strong balance sheets. Even though we have seen very volatile markets in the past quarter, with much uncertainty and panic, and although we see few signs of an improving environment in the short term, we have a genuinely positive conviction on the future potential of our investments, due to the quality of the companies in the portfolio. ■

Yours sincerely,

Sparinvest Asset Management

Jens Moestrup Rasmussen
Chief Portfolio Manager
10th October 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.