

Ethical Global Value Fund Update Q4/08

Performance highlights

Q4 return of -17%
2008 return since launch -34.51%

Ethix SRI Advisors Summary of the exclusion filters

Dear Investor,

2008 brought extremely hostile conditions for equity investors as global stock markets were hit by a global financial crisis of historic proportions and an emerging recession. Whatever the context, we are extremely disappointed with performance in the Sparinvest Global Value fund this year. The fourth quarter saw a loss of 17%, taking the return since launch to -34.51%.

We are, of course, dissatisfied with this return. However, as we will discuss below, we remain convinced of the strengths of our investment strategy and the long-term potential of our portfolio.

In 2008, the general equity market, when measured by the MSCI World Index lost 37.64%, while MSCI World Value and MSCI World Small Cap declined 37.30% and 38.87% respectively. Growth stocks delivered a return of -38.08%. If we look at our performance relative to the indices, our relatively high weighting in cyclical and European stocks hurt, while we benefited from our high Japanese exposure.

The table below shows the returns from the fourth quarter and since launch 30 May 2008, compared with different stock market indices.

| Sparinvest Ethical Global Value versus Index | * Launch date: 30 May 2008 | |
|--|----------------------------|---------|
| | Q4 2008 | 2008* |
| Sparinvest Ethical Global Value (LU0362355355) | -17.00% | -34.51% |
| MSCI World Index | -20.95% | -31.80% |
| MSCI World Value Index | -19.83% | -29.76% |
| MSCI World Growth Index | -22.08% | -33.78% |
| MSCI World Small Cap Index | -24.16% | -34.37% |

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

Norm-based Screening (UN principles)

- Zero tolerance

Sector-based Screening

For Porn, Alcohol, Tobacco and Gambling

- Zero tolerance for production
- 5% tolerance for distribution

Weapons

- Zero tolerance for combat equipment
- 5% tolerance for other military equipment and associated services ■

Markets

2008 was an extraordinary year by any measure. As the quarters progressed, people had to find new ways to describe just how bad the crisis had become. This continued in the fourth quarter, when the turmoil in the financial world was joined by growing evidence of global recession.

We won't attempt to summarise all the negative developments here. We all know this is a significant downturn. Jobs are being lost, plants are being closed – some temporarily, some permanently – and many companies are failing. Government intervention is increasing all the time through regulation and through cash injections.

In any economic downturn, declining earnings mean share prices suffer, especially at cyclical companies. This time round, the financial crisis made it worse. Many factors – like fear, counterparty risk, the lack of liquidity and forced selling – combined, creating a market where share prices often overreacted to news and sometimes moved in ways that had no relation at all to fundamentals.

Just consider Volkswagen. We started buying shares in early 2005 at EUR 32. By summer 2007, VW had started to become a growth stock and reached our target price. We realised a pretty healthy return, selling for EUR 145 a share. However, in autumn 2008, the stock rocketed up and down due to panic-driven short covering after the Lehman Brothers collapse. At one point the stock exceeded EUR 1,000. Within a 24 hour period, VW's market cap rose and fell by EUR 150 billion: more than the combined market caps of Toyota, Honda, Ford, GM, Renault, Peugeot, Fiat and BMW. It goes to show just how far markets were dislocated from fundamentals this year. Incidentally, it's surreal to note that, if we hadn't already sold our position, for a few brief seconds, VW would nominally have accounted for around half of our total fund holdings.

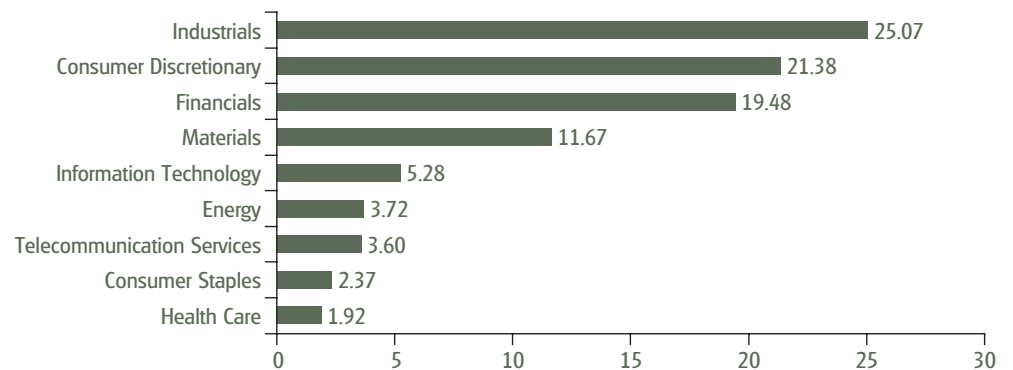
Of course, this kind of market is deeply frustrating. It's hard to see the share prices of strong companies fall, especially when triggered by temporary – or even irrational – factors. However, as value investors, we do not try to play the economic cycle, or to speculate on what short-term market sentiment might do to share prices. We focus on the companies themselves and invest on the basis that we are buying a piece of that company.

Although market focus was often on other factors in 2008, it must ultimately return to fundamentals. We don't like to judge the timing of this but, eventually, fear will recede and strong companies will be rewarded. ■

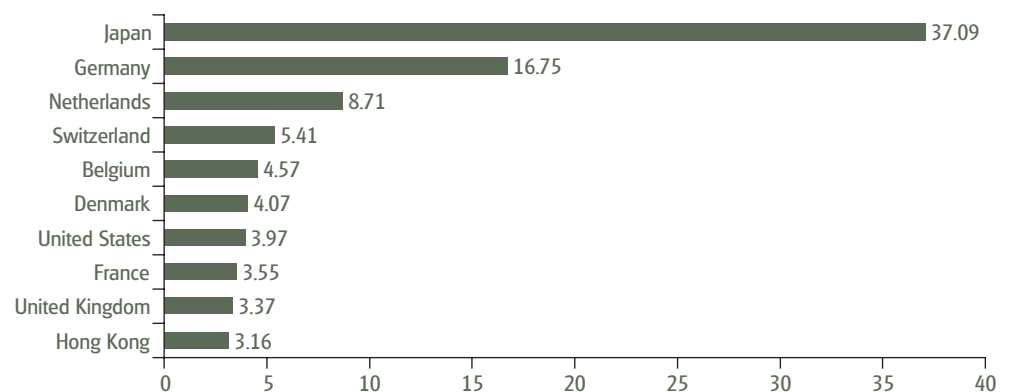
Portfolio update

At the end of the quarter, the cash position was 5.5% of assets under management. The fund had 100 holdings with the following sector and country breakdowns.

Sector allocation (all values in %)



Country allocation (all values in %)



During the quarter, we made new investments in six companies. We bought shares in Royal Dutch Shell and OMV of Austria, both of which are integrated oil and gas companies. We also invested in Japanese electronics majors Sony and Panasonic; Molex, a US maker of electronic components and Singapore Airlines.

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

At the end of the quarter, our 10 largest positions accounted for 32% of total portfolio holdings.

| Top 10 holdings | | | |
|---------------------------------|-------------|----------------------------|--------|
| Holding | Country | Sector | Weight |
| Douglas Holding AG | Germany | Consumer Discretionary | 3.77% |
| Nippon Tel&Tel | Japan | Telecommunication Services | 3.60% |
| MSIG Holdings | Japan | Financials | 3.37% |
| A.P. Moeller - Maersk A/S B | Denmark | Industrials | 3.35% |
| Roy.Philips Electr./Eur 0.2 | Netherlands | Industrials | 3.29% |
| Frankfurt Airport Serv. Worldw. | Germany | Industrials | 3.29% |
| Hutchison Whamp/Hk0.25 | Hong Kong | Industrials | 3.16% |
| Hochtief A.G. | Germany | Industrials | 2.79% |
| Koninklijke DSM NV | Netherlands | Materials | 2.76% |
| Toyo Seikan Kaisha Ltd. | Japan | Materials | 2.67% |

Ethix SRI Advisors Ethical reporting

New holdings currently being monitored

Molex – Weapons/other military equipment

| Issue | Country | Norm-Based Screening | | | Sector-Based Screening: P=0% production, D=5% distribution For weapons: 0% combat equipment; 5% other military equipment | | | | |
|-------|---------|----------------------|-------|-------|---|---------|----------|-------------|---------|
| | | Red | Amber | Green | Weapons | Alcohol | Gambling | Pornography | Tobacco |
| Molex | US | - | - | - | ! | - | - | - | - |

Molex supplies interconnect products to the military/aerospace industry. Such products include: backplane, fibre optics, copper flex products, RF, board-to-board, power, signal, industrial, and high-performance products and associated cabling. Applications for such products include: chemical detection systems, flight control boxes, communication systems, missiles and radar equipment.

The company states: 'Military electronics is also one of our emerging markets. We have found a range of electronic applications for our products in the commercial-off-the-shelf (COTS) segment of this market. Products originally developed for the computer, telecommunications and automotive markets can be used in an increasing number of military applications.' However, no information is available about the share of revenues derived from the sale of military specific components and subcomponents for military equipment. On the basis of the company's overall range of products, Ethix assumes that this share is lower than 5 percent.

Singapore Airlines – Alcohol and tobacco

| Issue | Country | Norm-Based Screening | | | Sector-Based Screening: P=0% production, D=5% distribution For weapons: 0% combat equipment; 5% other military equipment | | | | |
|--------------------|---------|----------------------|-------|-------|---|---------|----------|-------------|---------|
| | | Red | Amber | Green | Weapons | Alcohol | Gambling | Pornography | Tobacco |
| Singapore Airlines | SP | - | - | - | - | ! | - | - | ! |

Singapore Airlines supplies alcoholic beverages and duty-free tobacco products during flights.

The company's total revenue amounted to SGD15.97b in the financial year ended 31 March 2008. However, no information that differentiates the supply of alcoholic beverages or tobacco products from other activities within the company is available. A rough assumption is that combined revenue derived from distribution of alcoholic beverages and tobacco products amounted to less than 5% of total revenue.

OMV AG – Norm-Based Screening - Issue of concern

| Issue | Country | Norm-Based Screening | | | Sector-Based Screening: P=0% production, D=5% distribution For weapons: 0% combat equipment; 5% other military equipment | | | | |
|--------|---------|----------------------|-------|-------|---|---------|----------|-------------|---------|
| | | Red | Amber | Green | Weapons | Alcohol | Gambling | Pornography | Tobacco |
| OMV AG | AT | - | - | - | - | - | - | - | - |

OMV Ag held stakes in two onshore exploration blocks (Blocks 5A and 5B) in Sudan, 26.125% and 24.5%, respectively. OMV sold both stakes to the Indian company ONGC Videsh Ltd in late 2003. However, OMV, together with its former consortium partners, faces allegations of past complicity in grave human rights violations committed by the Sudanese government in connection with operations in Block 5A (then operated by Swedish Lundin Petroleum), as well as environmental pollution.

The human rights violations in Block 5A reportedly included forced displacement of the local population and took place during the period in which Lundin Petroleum held the largest stake in the industrial consortium operating the concession. The companies have also been criticized for lack of transparency in relation to environmental risk-management processes. In 2003 Human Rights Watch, a prominent human rights NGO, called on the companies to disclose the results of an environmental impact study carried out by an independent consultant and commissioned by Lundin Petroleum. The region is particularly environmentally sensitive because the Nile River flows through it. Studies conducted by a German NGO in early 2008 found that the water from a borehole in Rievz, a small village at the edge of the south swamplands in southern Sudan, is contaminated with salts, strontium and nitrate-suggesting contamination with 'produced water' used in oil extraction.

The former operator of Block 5A, Lundin Petroleum, has repeatedly rejected the above allegations. When selling its stake in the Sudanese exploration blocks, OMV emphasized that this was done 'out of need to raise funds for more near-term projects rather than frustration with the war-torn country's political instability'.

Panasonic – Weapons/other military equipment

| Issue | Country | Norm-Based Screening | | | Sector-Based Screening: P=0% production, D=5% distribution For weapons: 0% combat equipment; 5% other military equipment | | | | |
|-----------|---------|----------------------|-------|-------|---|---------|----------|-------------|---------|
| | | Red | Amber | Green | Weapons | Alcohol | Gambling | Pornography | Tobacco |
| Panasonic | JP | - | - | - | ! | - | - | - | - |

The company produces dual-use electronic equipment and provides related services. No detailed information is available about the military end-use of company products and services, and about the amount of revenues derived from this.

Available information suggests that sales to military customers (including sales of dual-use equipment) account for less than 5% of total revenue. Sales of military-specific equipment are assumed to account for a negligible share of total revenues.

The company was not included in the list of 20 largest Japan Defence Agency contractors.

Companies excluded from the portfolio as a result of screening

No company has been excluded from the portfolio as a result of screening during this quarter.

Monitored holdings removed from the portfolio

No monitored holding was removed from the portfolio this quarter. ■

Japanese holdings

During 2008, our Japanese holdings performed relatively well, especially thanks to a rising yen. Our weighting there increased to almost 40% and we took advantage of this strength to reduce some of our positions. We remain very positive on our Japanese holdings, but we do consider almost 40% exposure a high level and anticipate reducing it to levels closer to 30%. Note that while we made two new Japanese investments in the fourth quarter, these purchases were made in parallel with reductions in other large Japanese positions. The current market is depressing the prices of many quality companies, and we consider this an excellent opportunity to diversify.

Our large position in Japan is not the result of an active top-down strategy. We have a bottom-up investment process that looks for attractive value stocks, wherever they might be. Why do we feel comfortable with the high Japanese weighting that this has resulted in?

If we generalise a little, Japanese companies tend to be conservatively managed, especially when it comes to their balance sheets. After some tough decades, the leaders of corporate Japan have learnt some important lessons. This means low debt levels – indeed, some of our holdings have net cash positions greater than their market capitalisation – and conservative investments. In the recent turmoil, Japanese exposure to toxic assets has been notably low.

Strong balance sheets are more important now than ever. As many companies around the world struggle to meet their obligations, it is often Japanese companies that are able to demonstrate that “cash is king”, as they take advantage of difficult markets to make

acquisitions. In the domestic market, Panasonic is acquiring Sanyo Electric and there is talk of major consolidation amongst insurers. Overseas, investment bank Nomura snapped up parts of Lehman Brothers and leading bank, Mitsubishi UFJ invested in Morgan Stanley. In the US, Takeda Pharmaceutical bought Millennium Pharmaceutical and insurer, Tokio Marine bought Philadelphia. Many criticise Japan's aging population as a risk factor but in response, we would point to corporate Japan's ability to develop overseas markets aggressively.

What's more, these strong balance sheets can be bought cheaply. In absolute terms, one can buy the TOPIX or Nikkei indices for below book value, but get an earnings yield over 8%. In relative terms, Japan looks very cheap on price-to-book or price-to-sales ratios. On price-to-earnings, Japan has, historically, looked a little pricier than other developed markets, but that gap has shrunk recently.

Moreover, a major reason for that relatively high price-to-earnings is the low debt level. Arguably, if Japanese companies borrowed more, they could boost earnings per share. The ideal debt level is open for debate. At one extreme are companies so conservative that they sit on piles of cash but generate almost no earnings; at the other extreme are companies that borrow up to their eyeballs, generate significant earnings per share, but easily go under in difficult times. We like what we see in Japan. Management remains conservative and debt averse but is becoming more aware of the need to deliver solid returns on equity.

Domestic shareholders are increasingly active in encouraging management along this path. Many major pension funds in Japan will now vote against re-election of the management where a company's return on equity falls below 8% for too long. The leaders of Japanese companies are becoming increasingly proactive when it comes to shareholder needs. Indeed, we have seen a marked increase in the number of Japanese company leaders wishing to visit us in Denmark to explain their strategies. Returns to shareholders, in the form of dividends and share buybacks, are growing strongly.

Certainly, the current economic environment in Japan is not particularly rosy – but nor is it elsewhere. Japan has low levels of personal and corporate debt, relatively low unemployment, world-beating technology in many areas and experience of hard times. It may well emerge from this crisis relatively quickly and strongly. Yet we are not overly concerned whether it does or not. We remain, as always, bottom-up investors and we are very confident in our investments in Japan. ■

Charle (Ten Arrows) Management buyout failed

In our last update, we noted the announcement of a Management buyout in Japanese clothing company Ten Arrows – which has since reverted to its original name, Charle. The buyout group offered JPY 800 per share, and Charle's Board of Directors initially responded positively, having employed external valuers to evaluate the company.

However, it later emerged that the company president had, among other things, attempted to influence the valuation methods used by the independent valuers. Although his actions do not appear to have had a material impact on the offer price, nonetheless, his behaviour was entirely inappropriate. The Board of Directors responded strictly, removing the president from his position. They had no choice but to withdraw their support for the offer. When the subscription period closed, although many shareholders had chosen to accept the offer, the number fell below the level needed for the takeover to go ahead.

Outlook

It remains to be seen whether the buyout group will launch a new bid. While we are naturally disappointed with the president's actions, we were reassured to see the swift and decisive action by the Board of Directors. Charle remains a company with a strong balance sheet and considerable intrinsic value. ■

Stock markets tend to front run the development in the underlying economy and that is certainly true this time around. There is no doubt that, in the coming quarters, the world is facing a serious economic downturn that will lead to falling growth rates and earnings in companies around the world. There are no short cuts, no quick fixes, for the global economy. However, much of this is already factored into share prices. Equity markets have suffered large declines and our holdings have shared the pain. Many of the value companies that we hold were already cheap, but have become cheaper, and extreme negativity is leading many investors to completely avoid certain sectors and even stocks in general.

So, how did we respond to these volatile markets? In the words of Benjamin Graham: *"Basically, price fluctuations have only one significant meaning for the true investor. They provide him with an opportunity to buy wisely when prices fall sharply and sell wisely when they advance a great deal. At other times he will do better if he forgets about the stock market and pays attention to his dividend returns and to the operating results of his companies"*.

So in 2008 we did what we always do. We focused on our disciplined investment process, both in terms of our existing investments and potential new positions. We scoured the markets to find stocks at attractive discounts to their intrinsic values and invested in them. In other words, we exploited short-term sentiment and fear to buy good stocks at bargain prices and, in 2008, we added sixteen new positions – a relatively high number for our fund.

We rigorously monitored our existing holdings to make sure that intrinsic values were intact. In two cases – Dexia and Agfa – we had serious question marks and exited the positions. But in our other positions, the investment cases remain extremely strong. Although the market makes it hard to believe right now, their fundamentals have not completely changed and their long-term potential remains intact. Share prices may have dropped but this does not turn a good company into a bad one.

Why do we remain confident in our holdings? This comes down to our initial investment process and its focus on the balance sheet and long-term earnings power. In recent years, there was a lot of fuss about the cost of equity and, as a result, many companies took on more debt. They are now feeling the burden, as companies everywhere undergo a kind of "stress test" of their financial health. To continue the cinematic theme of our last letter, it reminds us of the submarine in the classic film 'Das Boot', as its hull creaks and groans from the strain of water pressure at extreme depths. Our process aims to identify the companies that can survive the financial strain of down cycles, come out the other side, and generate solid earnings over the long term.

For example, we actively weed out companies with excessive leasing or pension liabilities. These liabilities are not debt, as such, but can place a similar strain on the balance sheet when times get tough and concrete examples of this are emerging nowadays. Take US retailer Circuit City – a stock we did not invest in – which filed for bankruptcy in early November, struggling under a combination of debt and leasing obligations.

None of this is to deny that many companies – including our holdings – are facing weak earnings at present. Yet cyclical downturns are an inevitable part of investing. This is why our process focuses so much on assessing earnings across the business cycle. Unless one believes that this truly is the end of the world, the cycle will turn upwards eventually. We must remember that, historically, some of the best years for equity investors have come after extremely troubled times with very low valuations – just like those we are experiencing right now.

Even bearing in mind lower short-term earnings expectations, equities in general – and our holdings in particular – are cheap. Machinery stocks are among the most cyclical stocks out there and both the S&P 500 and the TOPIX machinery indices are now trading under 10x price-to-earnings, well below usual bottom-of-the-cycle levels. Another indicator of low valuations is the sheer number of companies passing our basic valuation screenings each month. We have seen the numbers swell throughout 2008. Finally, let us consider the valuation of our fund itself: a price-to-book of 0.80, with net-debt-to-equity of just 10.6% (excluding financials). Given the share price declines of the past year, these low valuations may seem like small consolation but the reality is that the portfolio is trading at a larger discount to intrinsic value than ever before, and that bodes very well for future returns.

We are in no way satisfied with the fund performance of the past year. But we have often said that value investors can look like the foolish student in the class and that success requires stamina and confidence in the inherent value of one's holdings. You must stick to your guns in good times and bad because while value investing may not always deliver immediate returns, it does deliver solid returns over the long term. A global recovery won't happen overnight. Government measures will eventually have an effect – but it's also vital that banks start lending again. Yet, even now, when economic sentiment is as weak as it gets, we are convinced that the strength and low pricing of our portfolio will carry us through tough times and allow us to generate competitive returns in the long run. ■

Yours sincerely,

Sparinvest Asset Management

Jens Moestrup Rasmussen
Chief Portfolio Manager
13th January 2009

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