



Headlines

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Value Bonds

Dear Investor,

Economic Perspective on the High Yield Market

Following the rally in markets over the past few weeks, the question foremost in the minds of investors is whether it is sustainable – or yet another false start. We believe that the latest rally will have stronger legs, and thus marks an inflexion point. After a prolonged period in which market lows kept getting lower, investors lost faith and marked down expectations to extreme pessimism. Meanwhile, policymakers in many countries have become more aggressive in their efforts to revive economic growth and financial markets. At the same time, output is now falling significantly faster than demand, producing a massive decline in inventories that sets the stage for better economic readings looking ahead.

Importantly, there are signs to suggest that some parts of the global economy may have bottomed already and are now in the early stages of recovery. Such signs are particularly evident in parts of Asia (ex-Japan), including China and Korea where, interestingly, production cut-backs were particularly sharp. Also helping, of course, has been the massive and focused stimulus provided by the Chinese government. Indeed, most indicators suggest that economic activity in China has already started to pick up: money and credit growth have accelerated, industrial production has started to rise and purchasing managers' surveys have reversed more than half their declines. A rebound in the rest of emerging Asia seems to have begun a bit later and evidence is still quite tentative (e.g. Korea), but given the high levels of trade and industrial integration among the Asian economies, we believe that recovery is now underway in emerging Asia generally and growth will be solid in the coming months. It is revealing that the equity markets of Asia (ex-Japan) have outperformed massively thus far this year which shows that in the current environment of extreme investor pessimism,

better-than-expected economic data can have a major market impact.

Encouragingly for our fund, there are signs that supply side developments are also starting to exert an influence, proving supportive for oil prices and hence our allocation of 23% towards the Energy sector. In crude oil, the contraction of the nearby contango, and sharp move up in prices at the front end of the futures curves, is a signal that OPEC cuts are starting to tighten the market. Actually one could make a case for yet another spike in oil prices, once global growth reverts to trend, given the cutbacks we have seen from the oil producers in their investment programs. They are not investing sufficiently to keep up production in the future.

Performance of High Yield Value Bonds

Unfortunately, our fund has been unable to match the rally seen in the broad market during the last month of this first quarter. I would like to stress that this is not because of defaults – we perform much better than the market on this front.

The explanation for the underperformance is a combination of 2 very powerful things that have arisen following the simultaneous arrival of a serious liquidity crisis and the worst recession since the Great Depression of the 30's.

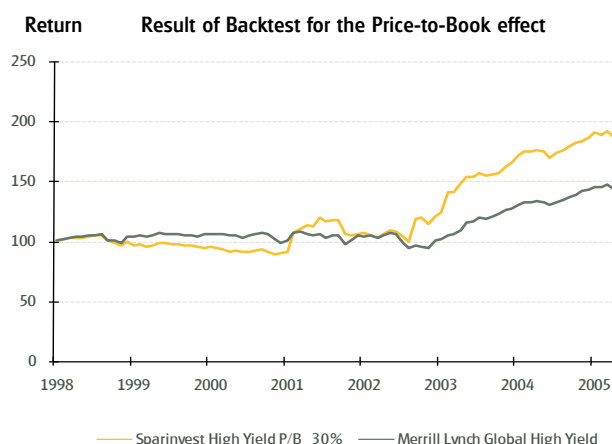
First, we invest in the cheapest companies measured by low price-to-book values. Unfortunately these companies happen to be the cyclical companies that are out of favour to an extreme degree. The degree to which low price-to-book is out of favour can most easily be seen in the stock market.

USA	YTD
US Growth	0.44%
US Small Cap	-7.51%
US Value	-13.24%

Europa	YTD
Europe Growth	-7.23%
Europe Small Cap	-2.40%
Europe Value	-14.07%

The relative performance of value versus growth during recessions is very well documented in the academic literature. Typically, value underperforms during the initial phase of the recession, but outperforms once the business cycle turns. The underperformance of the low price-to-book effect in the high-yield market was also discovered in a back-test conducted by Sparinvest

prior to launching this fund. Below, you see the result of this back-test which uses data from 1998 until 2005. It shows you that a systematic investment in the high-yield bonds of the 30% cheapest companies (measured on a price-to-book basis) will outperform the market in the long run, but will underperform when the economy turns down. Now, there is no guarantee that this will happen in the future just because it has happened in the past but, if you read on, I will present some examples of real bond yields that I believe support the result of the back-test and illustrate what it means to become 'out of favour in the market'.



In terms of its exposure to low price-to-book companies, our fund behaves like the yellow line from the back-test above. As you see, by end March 2000, the low price-to-book portfolio (yellow line) had underperformed the market by an accumulated 13%.

This time, the recession is even more severe than during the IT crash used in the back-test above, so the performance of the low price-to-book portfolio might be even worse. We can also see a hint of this in the stock market performance, as mentioned before, where value has underperformed growth so massively. But as history shows, this situation can quickly be reversed – especially because we have fewer defaults in the fund than the average market for high-yield bonds.

Examples of how yields are affected by market popularity

The examples below will hopefully show you how being 'out of favour' with the market is reflected in current bond pricing and yields.

Example number 1 (Petroquest)

Petroquest is a US oil and gas company – so it is cyclical. The company has a low gearing of 51.88% net-debt-to-equity, compared to a market average of around 400%. The company trades very cheap based on price-to-book at 0.13 times book. Petroquest is also a small cap – so in every respect, Petroquest is a classic value bond.

The yield on the Petroquest bond is 30% per annum until maturity in 2012.

Example number 2 (Stoneridge)

Stoneridge is a US manufacturer of electronic devices for cars and tractors – with a very small part of sales being to Ford and GM. The company has a low gearing of 77.45% net-debt-to-equity, compared to a market average of around 400%. The company trades very cheap based on price-to-book at 0.26 times book. Stoneridge is also a small cap.

The yield on the Stoneridge bond is 25% per annum until maturity in 2012 and the company is buying back bonds from time to time.

Not in our Portfolio - Example number 3 (El Paso)

In contrast to examples 1 and 2, here is an example of the type of large-cap, non-cyclical company that is in favour with the market right now. El Paso is a US utility and very much 'flavour of the month'. The company has a gearing of 281.85% net-debt-to-equity, compared to a market average of around 400% - this is much higher than what we are willing to accept. Price-to-book is around what's average for the market.

Because it's a large cap, non-cyclical, the El Paso bond – with similar maturity to the Petroquest and Stoneridge bonds above – yields just 11% per annum.

Obviously, the Petroquest and Stoneridge bonds that we hold in our portfolio are very cheap compared to the El Paso bond, unless this is the end of the world.

Another factor exacerbating our position vis-à-vis the average market rally is our focus on small caps. These are – to an extreme degree – out of favour in the high-yield market (also highlighted by the examples above). Right now, it's very expensive for small companies to be unknown – i.e. the premium attached to being unknown is very high. Most investors in the high-yield sector are looking to buy 'on the run' issues; issues where you have good liquidity so you can get out if you need to do some quick-fire selling – i.e. if you have redemptions, etc.

Summary

So to sum it up, we have the bonds that are currently out of favour – the small, cyclical companies – and hence, obviously, extremely cheap. Who knows how long these companies and their bonds will stay out of favour? As the famous economist, Keynes, put it during the last depression in the 30's: *"The market can stay irrational longer than you can stay solvent"*. In other words, there is a likelihood that you as an investor will leave the cheap bonds eventually because you can no longer sit and stare at underperformance. Then you will probably do like all the others – buy the safe telecoms and utilities. Then, when the market suddenly turns, you will underperform

once again because you don't hold the cheap cyclical stuff that was thrown out. Our message therefore is this: we want to stay the course and we have no thoughts of abandoning our beliefs. In the long run, it pays to invest in the out of favour bonds from the out of favour companies.

If history is any guide, low price-to-book and small-cap companies will outperform again at some point. That point in time is not set randomly. It is, of course, linked to the business cycle of the real economies. Once the economy improves, our bonds and companies will become the targets of interest. In the meantime, our time is spent trying to do the best we can to secure the long-term foundation of the portfolio – i.e. by investing in bonds with first priority pledges in real assets where possible. We believe we have a very cheap portfolio, cheaper than ever compared to the overall market. Sparinvest's focus is providing a superior long-term return and you must remember that we have always spoken in terms of a three to five-year investment horizon. We believe the next two years will be good!



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8 April 2009

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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.