



Value Equities

Headlines

- Value Stocks and Recessions
- Are Peak Earnings Over?
- Valuations
- M&A Markets
- Outlook

Dear Shareholder,

Let's start by stating the obvious. The crisis of the past year was not – it turns out – the end of the world. In late 2008 there was massive risk of a systemic collapse in the financial system and, at least in that sense, we think the worst is now over. Most readers of this letter will know by now that our investment strategy doesn't rely on macro-economic timing. We have our opinions, but we don't know when the global economy will stage its recovery, or whether it will be V-shaped, W-shaped, or any other shape. However, we do think there is now light at the end of the tunnel – and we're pretty sure that light is not a train charging towards us.

The real economy is now digesting the events of the past year and most macro data remains quite bleak, but it's worth remembering that historically, equity markets have tended to recover in advance, while the data is still dark and depressing. The second quarter of 2009 has given some indications of a changing equity market, with sector rotation kicking in and benefiting some of the sectors that had been hammered down the most. We recently invested in Fossil, a US fashion accessory company which – like so many – had suffered in the latter half of 2008. As the US retail sector rebounded, so did Fossil. In fact, it reached our fair value within two months of the initial investment. Our investment process is thoroughly bottom up, so we don't try to prejudge these market rotations, but of course we don't mind it when they push stocks down to attractive buying levels, or up to our assessment of fair value. In these markets, we find plenty of attractive investment ideas, which we believe can fuel our future performance.

Value Stocks and Recessions

There is a lot of research pointing to the long-term out-performance of value stocks over growth stocks, but at present, naturally, much interest is focused on how value tends to perform in recessions. Looking back at the many recessions of the past century, the typical pattern is to see strong outperformance from value stocks as nations emerge from recession.

Inevitably, there are various theories to explain this. We think a major factor – admittedly simplistic – is that many value stocks tend to be asset rich, which can lead to relatively high fixed costs. When recessions bite and utilisation rates drop, companies will of course try to cut both fixed and variable costs, but it is perhaps unavoidable that earnings tend to suffer the steepest declines at those companies with higher fixed costs – which often means those companies that are rich in productive assets. Of course, the flip side is that those same companies often see the steepest earnings recovery on the other side. In addition, such companies will frequently use recessionary cycles to trim labour costs and excess capacity, and these measures can leave them even better positioned to take advantage of the subsequent macro recovery.

Asset write-downs are also a key issue. As utilisation rates fall, the value of productive assets often needs to be written down. Of course, some companies are more pro-active than others in carrying out such impairments. Asset write-downs look fairly ugly on the way down and certainly, as a value investor, it isn't pleasant to see asset values fall. However, there are positive sides. Not only do asset write-downs often generate a slimmer fixed-cost base, but they can also take the stated asset value to well below its long-term value – creating opportunities for the value investor.

Naturally, a core part of this recovery is the banking system, which needs both to put its own house in order and to get the cycle of lending running healthily again. In recent years, the label “hedge funds” has been twisted a little and is now often used to describe highly-leveraged funds that invest freely across various asset classes, with little consideration of risk. By that definition, you could say that the banks themselves have been the biggest hedge funds. They expanded into non-core business areas, often at the expense of prudent risk management. Now, those banks are cleaning up the wreckage after the storm and we think their asset write-downs will keep coming. Although such write-downs are governed by regulatory and accounting standards, inevitably some banks take a more leisurely approach, while others are stricter with themselves and impair assets aggressively. It can be hard to distinguish between the two, and only time will tell which approach serves the banks best. But for our part, as always, we prefer to see banks taking a

strict line with their balance sheet and cutting away any doubtful asset values.

Are Peak Earnings Over?

Many people are now wondering whether corporate earnings have peaked; whether recent years have been a golden period, never to be repeated. It certainly looks as though the earnings levels of 2006 and 2007 might not return any time soon, but this does not worry us excessively. We invest in companies that look significantly undervalued, based not on their peak earnings, but on their long-term average earnings power. The peaks may or may not return, but we think those average earnings levels can be attained again. Moreover, even if one takes the pessimistic view that average earnings power will be eroded slightly, we take comfort from the conservative assumptions that are at the core of our investment style: the ‘margin of safety’ which lies at the heart of value investing. To quote Benjamin Graham: *“if (value securities) are bought on a bargain basis, even a moderate decline in the earning power need not prevent the investment from showing satisfactory results. The margin of safety will then have served its proper purpose”.*

Despite this, many stocks have been priced down as if there is no tomorrow, which clearly reflects the short-term focus of the markets right now. Looking at the next few months, we can say for certain that many companies – including some of our holdings – are looking at red ink. Industrial conditions have improved slightly from the extreme downturn of late 2008, but times are still far from easy. Some companies will not survive – but those that do come out the other side may well emerge stronger. We strongly believe our investment process leads us to the survivors. What matters is a combination of financial strength and a robust business model. In our investment process, we take a close look at companies' track records over past years and previous downturns. We are looking for evidence of a strong earnings model that can survive hard times and adapt to new realities when necessary. We also demand that our investments have strong, low-debt balance sheets. Many companies have to take tough measures in a downturn and we think that those with financial strength have more room for manoeuvre in making the adjustments necessary for the future.

In that context, we found much to be positive about on a recent visit to Japan to meet some of our holdings. Naturally, with portfolios as diverse as ours, some meetings are more positive than others, but for the vast majority we were very encouraged. With such difficult external conditions, there is a temptation for management to sit on their hands and wait for better days. However, we found that the vast majority of our holdings are using these conditions as a chance to shed some excess weight. There is a perception that Japan's labour market

is inflexible, but we see many of our holdings dramatically cutting labour costs – partly through a reduction in their significant part-time work force. Just before the crisis struck, Japan's workforce consisted of close to 40% non-regular workers – a ratio second only to the Netherlands among major industrialised nations. Of course, many of these non-regular workers are in retail, but even at major industrial companies, such as auto-parts makers, it is fairly common for around a third of the manufacturing work force to be on temporary contracts. That, combined with the Japanese bonus and overtime systems, gives corporate Japan much more flexibility than is often perceived. Costs are under review across the board and we think many companies will emerge leaner and better positioned for the future. Some holdings were able to point to competitors – with weaker balance sheets – who had recently been forced out of business by the tough environment.

We find further comfort from the conservative assumptions being made by many companies – around the world – in terms of end-demand for their products, materials costs, currency levels, and so on. The real economy is certainly poor, but the corporate world is factoring that in. We find that many of our holdings are determined to adjust their cost structure to allow them to break even, even if the coming months turn out to be as tough as the awful few months that followed on from November 2008. For the most part, corporate management is not blindly optimistic in expecting a speedy recovery, but cautious and prudent.

Meanwhile, governments continue to step in to support a recovery. The size of the fiscal packages varies greatly by country, and this will affect the speed with which each country emerges. The Chinese government's response to the crisis has been massive, in both monetary and relative terms: 2009 is set to see the equivalent of about 3.1% of GDP in stimulus measures, with a further 2.7% to follow in 2010. It is not surprising that many see China as likely to recover relatively early.

Our funds do not have direct exposure to emerging markets, but recovery there does of course have knock-on implications. Within major industrialized nations, Japan has the highest weight of its exports – nearly 50% – going to emerging markets. Naturally, some of those exports are intermediate goods, ultimately destined for consumers in the US or Europe, but Japan is also well geared to domestic demand in emerging nations.

This does not mean that the picture in Europe is entirely bleak. Germany – where we have considerable exposure – also has a relatively high export weighting to emerging nations – as well as a large stimulus package of its own. One example of stimulus giving concrete results is the "cash for clunkers" scheme which gives consumers a

cash incentive to scrap and replace their old cars. These schemes have been introduced across Europe, as well as Japan and elsewhere. They are already having an impact: although European car sales were still down year-on-year in second quarter, it was by a considerably smaller margin than the decline of the first quarter.

Valuations

Looking at valuations overall, we see equities around the cheapest levels in our experience. Of course, it's easy to point at price-earnings ratios for 2009 and to say they are at a multi-year high, but it's important to remember that this is mainly because earnings are at a multi-year low – from which they will recover. It has not been pleasant to see share prices fall, but we think now is the time to roll up our sleeves, and find the cheap stocks that will fuel the coming years of performance. In the past few years, we have found it difficult to find true bargains in the US market, but in recent months our potential universe there has expanded considerably. A range of quality companies with strong balance sheets have appeared on our radar. We have started to make use of this in our global funds. Similarly, both in the US and elsewhere, we have been seeing increasing numbers of attractive small-cap stocks coming into our valuation range. Many of these have found their way into our portfolios.

M&A Markets

When we consider the outlook for the markets, and our funds, it's important to consider the M&A environment. For a while now – perhaps since the Lehman shock – the world has not always seemed rational. M&A markets have been weak despite some bizarrely low valuations. The financing of deals has, of course, been tough – and even companies with a 'war chest' of their own cash have been somewhat nervous to go out shopping, due to uncertainty over how long the earnings downturn will last. Cash preservation has been the name of the game. Inevitably, this has had an impact on our funds, which, historically, have seen many holdings subject to takeovers. So in that sense, in recent months our funds have resembled eight-cylinder engines firing on just four cylinders. M&A markets will improve – and we believe many of our holdings could come into play.

Outlook

Up to this point, we haven't mentioned the recent performance of our funds. The specifics are of course dealt with in our individual fund updates, but we can say that the second quarter of 2009 has been largely positive. During the quarter, many of the factors discussed above have come into play and benefited our holdings. However, just as we don't try to call the overall macro-economy,

we won't try to call the equity markets of the coming quarter. What we are certain of is that our holdings are significantly undervalued, with limited downside risk and considerable upside potential. Simply put, the valuations and potential of both our funds and our universe of possible new investments are around the most attractive levels we have ever experienced. We remain convinced of the strength of our portfolios, and confident in the long-term outlook for our funds.

Yours sincerely,



Jens Moestrup Rasmussen
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10 July 2009

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