



Value Equities

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Dear Shareholder,

It's no surprise that the tough markets of the past couple of years have made people cautious. For every headline pointing to recent improvements in financial markets and economic indicators, there is another stressing the risks that remain and arguing that this is simply a false dawn. At Sparinvest, we try not to expend too much energy debating these points. We don't like to get too excited by rising stock markets or improving economic outlooks, nor do we like to get too downbeat during the lows. Instead, we always focus on the long-term: we look at the cross-cycle earnings power of the companies we invest in, and we aim to generate solid returns from our portfolios over the long term.

That said, we don't deny that the environment of the past three months has been encouraging. Equity markets have done well, and our funds have put in a generally strong showing. In many industries, there are tentative signs of improving fundamentals, thanks to a mix of both internal factors – such as cost cutting and capacity reduction, and external factors – such as improving demand, public money, and so on. However, few would claim that the global economy is now free of risks, and one has to wonder – once public money stops flowing; once emergency injections and 'cash for clunkers' and other schemes start to wind down – how strong are underlying conditions? We certainly do not expect any recovery to be smooth sailing. We are confident in our holdings because they have the robust balance sheets and earnings models to stay the course, even if the waters become rough once more.

Companies are certainly having an easier time accessing capital, which is a fairly fundamental requirement for any recovery. Banks are gradually starting to function again as one source of liquidity. Corporate bond issuance has become dramatically easier, and cheaper. Last year, companies were lucky if they were able to place

paper at all and, where it was possible, the yields were burdensome. Meanwhile, every day seems to bring news of another equity offering. For many, the aim is to improve capital ratios, but for some it's to fund expansion, and it is encouraging to see that these offerings are, for the most part, well received. If nothing else, the greater ease in raising funds suggests a general confidence that recovery is possible; that companies will indeed pull through the crisis and generate the earnings and cash flows to keep up their interest and dividend payments.

Improving M&A Markets

We've previously commented that the weak M&A markets of the past year or so have made our funds – which historically have enjoyed a large number of corporate takeovers – like eight-cylinder engines firing on just four cylinders. We're fairly cautious by nature and we don't like to suggest that those four dormant cylinders will roar into life tomorrow but, as financing conditions ease, corporate buyers in various sectors are starting to move.

This can be seen within our portfolios. IDS Scheer is a German software and IT consulting company which we bought for our Global Small Cap Value and European Value funds during the latter half of 2008. In July 2009, Software AG made a takeover offer of EUR 15 per share. This was in excess of our assessment of the company's intrinsic value, and over double the price we had paid, so we accepted the offer and received payment in late September.

This consolidation activity is not limited to Europe and North America. We have previously noted that many Japanese companies made significant overseas acquisitions in the distressed markets of the last year, but we are also seeing domestic consolidation. We have investments in several of the large Japanese non-life insurance companies, which for many years have struck us as undervalued and potential beneficiaries of industry realignment. That realignment is now taking place, with a merger between Nipponkoa and Sompo Japan, and a three way tie-up between Mitsui Sumitomo Insurance, Aioi Insurance, and Nissay Dowa Insurance. These are not takeovers in which hefty premiums are paid by the acquirer, but a consolidation of the industry which should pave the way for cost savings, potentially a better pricing environment, and a solid base for expansion into new markets. We believe these moves will serve the sector well over the longer term.

Quality and Valuation

Of course, even if the M&A environment is improving, buyers are not simply throwing money around and perhaps one effect of the past year or so will be to make corporate buyers into more discerning shoppers. M&A will focus on quality companies. In this respect, we think

our portfolios are extremely well placed. The individual fund updates contain information on each fund, but if we use the Global Value fund as an example, and aggregate the data from its holdings to present the fund as one stock, it has a net-debt-to-equity ratio of 24%, versus 61% for the MSCI World and a ratio of intangible-assets-to-equity of just 17%, versus 53% for the index. Yet this balance sheet quality is not expensive. While the MSCI World index is trading at a price-to-book of 1.96 times, the fund is at just 0.87 times. In fact, the market capitalization of the fund is equal to the net fixed asset value of our holdings: for every Euro invested in the fund, you get a Euro of net fixed assets. Looking at earnings-based valuations, the index trades at an EV/EBITDA of 7.9 times Bloomberg's 2009 estimates – or 6.9 times 2010 estimates while for the fund, the multiples are just 3.6 times and 2.9 times. In other words, our portfolios are full of solid companies at extremely tempting prices.

Advantage of Low Debt Levels

One key quality we see in our holdings, and look for in potential new investments, is low indebtedness. During the past 18 months, it has certainly been no bad thing to be relatively unleveraged. Indeed in some industries it made the difference between failure and survival. Low debt levels have allowed management to 'batten down the hatches' and wait for the storm to pass.

However, during the credit crunch, low debt levels were not of much use in securing new borrowing. Last year, new bank loans or corporate bond issues were not much of an option for any company, no matter how healthy its balance sheet. In the past six months, as public injections kicked in and banks became more able to extend credit, the liquidity situation eased. However, the most immediate beneficiaries of this 'hosepipe of liquidity' have been the weak companies that were most at risk of failure. As banks have recovered, their first priority has been to keep their most vulnerable customers afloat by amending and extending loans. This is perhaps one of the reasons for what some commentators call 'the dash to trash', in which the low quality stocks which had been pushed down furthest become those that rebound fastest, driven by a wave of relief that they have survived.

But a dash to trash is not long lasting. As extraordinary measures to help struggling companies wind down, quality returns to the top of the agenda as investors ask: which companies have the strength of balance sheet, of earnings model and of management to generate solid earnings in the new environment? As recession gradually shifts to expansion; as banks begin to seek new business and as corporate bond markets warm up, companies with low debt levels are well positioned to secure debt financing at attractive rates – enabling them to leverage into the improving economic conditions. Meanwhile, equity financing is also picking up and we think there

is a big difference between a heavily-indebted company issuing equity (and diluting existing shareholders) simply to pay down debt and a company issuing equity to fund business expansion. In short, low debt levels not only help companies to get through an economic crisis, they also put them in a far stronger position to benefit from the subsequent recovery.

Political Environment

Government action continues to play a role in the recovery. We are not political commentators, but we have naturally been following the recent political shifts in the markets in which we invest. Germany re-elected Angela Merkel, now at the helm of a centre-right coalition which some consider to be more business friendly. The German economy does have its problems – unemployment being a notable one – but overall, we see it as a competitive economy which should benefit nicely from a global recovery. Meanwhile, Japan saw a seismic shift as it threw out the Liberal Democratic Party that has ruled – pretty much unbroken – since the early post-war years. We don't want to speculate on the potential policies and impacts of the new Democratic government, but in a country that has basically been ruled by one party for sixty years, you could argue that any change is good and could lead to more productive, reform-minded politics.

Environmental Technology and Competitive Advantage

It's not often that Copenhagen finds itself in the global spotlight, so when it happens, we tend to take notice. With December's climate conference fast approaching, it is hard not to contemplate environmental trends. The overall shift to being 'green' is often seen as a negative factor for the corporate and industrial world: companies must bear the cost of compliance with ever-tougher environmental regulations, but receive little in return.

But there are two sides to every story. Environmentalism has become a mainstream consumer movement, with increasing demand for greener products such as hybrid cars, household solar panels, light bulbs, or organic foods – for which, in many cases, people are prepared to pay a premium. In some cases, such products already carry a large profit margin for the producer, while in others, the up-front costs now are justified by the chance to win major market share in a new and expanding field.

The positives are not just limited to companies making 'green products'. Even in mature, heavy industries, tighter environmental regulation can be beneficial, leading to increased efficiency in production techniques and the development of environmental technologies. These technologies can sometimes be sold on to the highest bidder, or used to leverage the company into new markets. It is worth noting that developed nations – Germany

and Japan spring to mind – have a strong lead in such technologies, with strong initiatives in both the public and private sectors. In mature economies and industries, the sheer wealth of overall industrial know-how will be a major asset as global industry shifts towards tighter environmental regulations and greener products. As countries like China come under pressure to limit their emissions, they will require access to that know-how and, although they will not be keen to pay excessively for it, we think this is one route for companies from developed nations to tap into the more rapid economic growth of the developing world.

We believe that many of our own holdings enjoy potential in this respect. In our funds, we have always taken a very cautious attitude to risk, and that has extended to environmental risk. In industries where there are clearly environmental issues, we prefer to see that management have a long-term view of the potential environmental risks and opportunities, and that they have taken appropriate steps both to mitigate the risks and exploit the opportunities.

Conclusions

At the start of this letter, we commented that at Sparinvest, we don't like to get too excited when times are good or too gloomy when they are bad. When the crisis was in full flow, many analysts were slashing earnings estimates and investment ratings for numerous stocks. In many cases, this is now going the other way. We prefer not to be swayed by short-term volatility in earnings or share prices. Instead, we keep an eye on the distant horizon, concentrating on the long-term earnings power and balance sheet strength of our investments.

Of course, we are encouraged to see some of the positive developments of recent months, but we do not think the global economy is out of the woods yet and the recovery will not be smooth. Once you decide to invest in equities, you are inevitably exposed to market risk. However, the risk related to buying an individual stock can be minimized through careful research. This is why now – as always – we are disciplined in sticking to our investment philosophy and process. We look for companies with strong balance sheets and healthy finances. We make cautious assumptions. We do not look only at earnings this quarter or this year, but at earnings over a business cycle. Based on this, we estimate a conservative intrinsic value for a company: a value which would apply if the company were traded as a whole in a merger or take-over situation. If the market value is significantly lower than that intrinsic value, we invest. In other words, our process is about buying 100 Euros for 50 Euros.

Looking forward to coming quarters, many questions remain and such periods of uncertainty are never relaxing for any investor. As we like to say, investing is much

about patience and, at times like these, one has to keep in mind the long-term investment philosophy behind our funds. Looking at our funds today, we see a portfolio of stable companies with solid futures, trading at extremely attractive prices. The current valuation of our funds gives an opportunity to get invested in stocks that will offer healthy performance over the coming three, five, ten years.

Yours sincerely,

Jens Moestrup Rasmussen
Lead Portfolio Manager
8 October 2009

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