



## Value Equities

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*Dear Shareholder,*

The last two years have been very eventful, with tumultuous markets and economic conditions. As we write now, in January 2010, conditions have improved considerably from a year ago. We are not in the game of calling market bottoms or speculating on the coming few months, but we can see encouraging signs in the economic environment. More importantly, we believe the outlook for our funds is very promising but, as always, this is based purely on the fundamental conditions at the individual holdings. Our funds generally rose by about 20 to 30 per cent in 2009, but valuations remain extremely attractive, with market prices still at significant discounts to intrinsic value. We believe this can fuel significant performance in years to come. As ever, we are not trying to guess when our holdings will attain their intrinsic values but simply focusing on our process, making sure that we have a strong portfolio of deeply undervalued stocks. We are convinced that this is the best road to achieving strong long-term returns.

### Equity Markets in 2009

2008 was obviously a harsh year for equity markets as the financial crisis spilled over into the wider economy and corporate earnings plummeted. 2009 brought something of a recovery, both in earnings and share prices. However, this rebound has neither been smooth nor has it been equal across sectors or regions. There have been significant shifts in short-term market direction.

One major feature – mentioned in our last letter – was the ‘dash to trash’. When emergency measures came in, the biggest beneficiaries were weak companies that had been struggling. For those that survived, the wave of relief inevitably gave their share prices a big boost. Against that wave of relief, the shares of strong companies with healthy, low-debt balance sheets and little need for external help often lagged a little. But this

trend is short-lived: emergency measures do not last forever. As Warren Buffet once wrote, *"You only find out who is swimming naked when the tide goes out"*. As conditions normalise, companies will find themselves on a level playing field again, and quality companies will enjoy the benefits of their robust balance sheets and business models.

Another feature in the extraordinary conditions of 2009 – as in 2008 – was that the ‘herd’ mentality of the market was even stronger and horizons even shorter term than usual. We frequently saw very large sentiment-driven swings in the performance of entire sectors or regions, with perhaps even less focus than usual on the long-term fundamentals of individual companies. For investors like us, focused on bottom-up stock picking of quality companies, such markets create both opportunity and frustration: the opportunity to buy great companies at knock-down prices, but the frustration of seeing existing investments punished in the market, despite no change in their long-term prospects.

We have a fairly high weighting in cyclical areas such as industrial or consumer discretionary companies. These sectors – especially in Europe – had a rough time in early 2009. With shrinking revenues and plants running with lots of excess capacity, many companies saw profits collapse into losses. As we wrote at the time, these stocks were being priced as if there was no tomorrow, which seemed like a clear overreaction for companies with healthy balance sheets and strong cross-cycle earnings power. Indeed, as the year progressed, cyclical stocks rebounded strongly, although we believe there is a good deal more to come when we look at the low valuation of our holdings.

### **Market Fluctuations, Value Investing and Risk**

It's worth remembering that the forefather of value investing – Benjamin Graham – developed many of his principles after experiencing the tumultuous markets of 1929-1932. The same is true of John Maynard Keynes, who is best remembered as an economist but had an outstanding track record as an investor. Keynes started out as a market timer, chasing the short-term rises and falls of certain sectors, but his experience in the early 1930s convinced him that this was not a prudent investment strategy. His approach shifted towards value: his purpose was *"to buy securities where I am satisfied as to assets and ultimate earnings power and where the market price seems cheap in relation to these"*.

This is the heart of value investing: the concept that every listed company has a market price but also an intrinsic value – what the company is actually worth based on

its assets and long-term earning power. The two don't always match, and the value investor sees this as an advantage: when the market price is considerably lower than the intrinsic value, he can invest with a large 'margin of safety'. He may pay 40 cents to get one dollar of value.

But how should the value investor respond to volatility in the market prices of stocks he already owns? In *The Intelligent Investor*, Benjamin Graham gave the parable of 'Mr Market', which we think is always worth reading – or rereading. Of course we all prefer to see the share price of our investments rising, but what matters for the long-term investor is whether intrinsic value is intact. As Graham wrote, *"The investor who permits himself to be stampeded or unduly worried by unjustified market declines in his holdings is perversely transforming his basic advantage into a basic disadvantage"*. In other words, the investor should focus on fundamentals at his holdings and, if those are encouraging, he should not be overly distracted by short-term share price moves.

This is closely linked with how one perceives risk. It's often assumed that 'risk' in equities boils down to how volatile a share price is relative to a benchmark of other stocks. But to the value investor, consideration of risk is focused more on the intrinsic value of each individual holding. In fact, if fundamentals in a company stay the same while its market price drops, it is actually becoming less risky.

An example; in 2002 we invested in De Vere Group. It was trading at a price-to-book ratio of 0.5, and we bought our first shares at GBP 3.76, with a conservatively estimated intrinsic value in the range of GBP 7.50 to 8.00, based on the value of the hotels. After buying, the share price fell again to around GBP 2.50, and we bought more shares. Most people would consider the stock more volatile and thus more risky. To us this company now provided an even higher margin of safety and therefore relatively lower risk. The company was cash positive, paid a dividend and had limited debt compared to its significant real estate holdings. In June 2006, the company accepted a final takeover bid from property developer, Richard Balfour-Lynn, pricing the company at GBP 8.75 per share.

As Benjamin Graham wrote, *"Real investment risk is measured not by the percent that a stock may decline in price in relation to the general market in a given period, but by the danger of a loss of quality and earnings power through economic changes or deterioration in management"*.

## Fundamentals at our holdings

Of course, in the difficult operating environment of the past two years, many companies have seen red ink creeping onto their income statements and balance sheets taking a battering. Does this mean that intrinsic value has suffered? Not necessarily.

Perhaps because value investing was a 'child of the Great Depression', one of its big advantages is that it is inherently sceptical. It does not assume a rosy economic future but accepts that down cycles do occur. When we talk about investing in healthy companies, we are not looking for companies that will never face bad years. Such companies do not exist. Instead, we assume that all companies will go through tough times, and we seek out the ones with the strength to emerge healthy on the other side. When we assess the intrinsic value of potential investments, we look at earnings power across the cycle – in other words, our initial valuation factors in the bad years as well as the good.

Normally, downturns should not surprise us. More importantly, they should not mean deterioration in the intrinsic value of our holdings. But naturally, we monitor the impact closely. Admittedly, the scale of the recent downturn has been extreme and in a small minority of our holdings it caused severe, long-lasting damage to the business model. As a result, we exited those positions. However, our process accepts that there will always be some investment cases that do not work out and this is why we have diversified portfolios.

For the vast majority of our holdings, though, business models and intrinsic values remain intact. Their balance-sheet strength has served them well. Some have seen competitors forced out of business, which may create long-term opportunities. Most of our holdings have seen a significant downturn in revenues and profits, but we have been impressed with the management response. Cost cutting has been implemented across the board, with companies looking to reduce both fixed and variable costs. Although some of these cost cuts will be reversed when improved revenues make it possible, management generally appear determined to maintain the leaner cost base going forwards.

It's worth noting that this response has been seen across all the regions in which we invest – including Japan. There is something of a stereotype that Japanese management are slow to react, but that has certainly not been our experience in this downturn, whether we look at our own Japanese holdings or the wider universe. Revenues fell sharply in late 2008 and early 2009 and, as a result, profit margins in the first quarter of 2009 slumped dramatically. Since then, although revenues have only improved slightly, profit margins have staged

a rapid recovery. Earnings have, for the most part, been beating expectations, and despite this, companies remain cautious for the future, working to keep costs at a low level. This could make for a very positive situation as global demand increases.

## Value Stocks and Growth Stocks

It's also important to consider the wider context of value stocks versus growth stocks. Our investment aim is to generate healthy long-term returns, and there is a wealth of research – both old and new – showing that value outperforms growth over time. But of course there will always be brief periods when growth stocks gain the upper hand. In fact, in both 2007 and 2009, the MSCI World Growth index outperformed the World Value index, and in 2008, both suffered roughly equally.

Should value investors be worried by a couple of years of growth outperformance? Absolutely not. Such periods are to be expected and do not change the long-term superiority of value stocks as an asset class. Moreover, it's important not to fall into the trap of speculating on the timing of these periods: such market timing risks damaging one's long term returns. Eugene Shahan did some interesting research on seven value fund managers whom Warren Buffet considered to be 'super-investors'. Shahan noted that the seven significantly outperformed the Dow Jones or S&P 500 over the long term, but, along the way, they had periods of short-term underperformance. However, even with the help of a rear-view mirror, we can see that, there would have been little way to predict when the short periods of underperformance would begin or end. In other words, the safest way to benefit from their long-term outperformance would have been a buy-and-hold strategy.

## Quality and Valuation

If we take a look at some of the valuation measures and financial ratios for our holdings, we think they give a good indication of the quality of our portfolios. As always, specific details for each fund can be found in the individual fund updates, but let's take the Global Value fund as an example here. Although valuations have naturally risen along with recent share price gains, they remain extremely attractive. If we aggregate the holdings to present the fund as one stock, it trades at a price-to-book of just 0.97 times, compared with the MSCI World's 2.11 times. On earnings-based valuations, the fund trades at an EV/EBITDA of 3.3 times Bloomberg's 2009 estimates and 2.7 times 2010 estimates. This compares with 8.2 times and 7.1 times for the MSCI World. Financial strength is also impressive: the fund has a net-debt-to-equity ratio of 25% versus 62% for the index, and intangibles-to-equity of 17%, versus 53% for the index.

## Takeover Activity

The M&A environment has always been an important factor for our funds. After the takeover of our German IT holding IDS Scheer last quarter, the fourth quarter saw global electronics giant Canon launch a bid for Océ of the Netherlands, which we hold in all of our value funds. We discuss this in more detail in the individual fund updates, but it is encouraging to see industrial buyers on the move again. We think it's also significant that this deal is yet another example of corporate Japan using the strength of its balance sheet to expand overseas.

So, takeover activity is rising gradually, but is still a long way from being fully normalised. It will inevitably increase as economic and financial conditions ease. From late 2008, many companies around the world essentially put a freeze on M&A activity, allowing them to preserve cash and focus on surviving the crisis. Now, some of those companies have started spending again and even more are at least window shopping, looking for potential acquisitions. Financial buyers – such as private equity funds – will probably take longer to get back to the levels of activity that we saw in the recent years. Over the years, we've had a fair amount of experience with holdings being taken over and we can say that, when we look at our current portfolio, there are some extremely attractive potential targets for both industrial and financial buyers. Bear in mind also that many of our holdings have the potential to use their strong balance sheets to be acquirers – using their cash to take advantage of the pain of competitors to buy up assets or businesses cheaply. We think that, whether as buyers or targets, many of our holdings face some very exciting M&A opportunities in the coming years.

## Regional Weightings

Within our global funds, we continue to have high weightings in Europe and Japan and a low weighting in North America. This is not a strategic top-down decision. We apply our strictly bottom-up analytical process to our universe of potential investments around the world and invest in the most promising cases. Our regional weightings are simply the residual of this process. How our weightings will change in coming years therefore depends on where, and in which sectors, we find the most compelling value investment cases.

Naturally, our analysis of each individual company includes a consideration of the macro or external factors affecting it. When assessing intrinsic value, we make conservative assumptions across the board, and we only invest if the market price is significantly lower than the intrinsic value. This means that whatever region our holdings are in, the investment cases do not rely on positive macro-economic scenarios to help the companies. We do not have high weightings in Europe or Japan because we are particularly positive on their macro environments, nor do we have a low weighting in the United States because we are particularly negative on its economy.

This means that our regional or sector weightings can vary considerably from benchmark indices, which can of course have a significant impact on our short-term performance relative to those indices. However, we think it is important that our investment process is not swayed by short-term sentiment for or against a particular region or sector. As we discussed earlier, we have a relatively high weight in European industrial companies which started 2009, amid extreme pessimism and weak share prices, but rallied later in the year. Japan is another example of a high weighting caused by our value process. Japanese equities were among the strongest of developed markets for much of the year, but they weakened from autumn and by year-end, the MSCI Japan index had considerably underperformed the MSCI World. We can see various possible explanations for this short-term shift, and various potential triggers for it to reverse, but such considerations are a long way from what we focus on as value investors.

We don't think in terms of being bullish or bearish on a particular region. What matters are the specific factors affecting our individual holdings. Looking at the wider macro environment in Japan in terms of its impact on our specific holdings there, we can see both positive and negative factors, and these are naturally factored into our assessment of intrinsic value in our investments there. It is also worth noting that in recent years Japan – like all regions – has had periods of significantly outperforming and underperforming other regions, but over the span of the past decade, it has performed roughly in line with the MSCI World and rather better than the US. We do not see anything unique in Japan, or indeed in other areas in which we invest heavily, to make us abandon our strict bottom-up focus in favour of market sentiment.

## Conclusions

Standing at the end of 2009, there is plenty to be positive about. Despite rises over the past year, our funds offer low valuations and considerable potential. We can see at least four clear factors which worked against our funds in the past year and which could well serve as drivers in the future – although, of course, we will not try to predict the movements of the coming year.

Firstly, 2009 was ultimately a year in which growth stocks outperformed value. We do not see this as a reason for concern. There always have been short periods where growth stocks outperform, but the long-term pattern remains clear: over the long term, value stocks offer the healthier returns. Secondly, M&A markets were hit hard by the crisis and, although they are starting to come to life again, they are still not on full throttle. Our funds have historically been rich hunting grounds for both financial and industrial buyers and, looking at our current portfolios, we see many attractive targets. The third factor is Japan, which underperformed during the final few months of 2009. We see various possible explanations for Japan's recent weakness and various potential triggers to reverse it, but these factors are not our focus as value investors. What we can say is that we have been keeping a close eye on our investments everywhere, and the macro-economic factors affecting them, and we remain positive on their outlook: intrinsic values are robust. Finally, we must remember that 2009 was a year in which quality was not always the focus of the markets. Weak companies rose on relief that they had managed to stay alive or be rescued – while low-debt companies which didn't need rescuing were often left unrewarded in the stock markets. However, as conditions normalise, quality will make itself known, and the strong companies with financial firepower will benefit. In the extreme falls of 2008 and rebound of 2009, there was not so much focus on individual quality. But we know that in the long-run, quality companies are rewarded.

History suggests that it is relatively fruitless to try guessing when stocks will attain their intrinsic value, and we certainly don't have a crystal ball here at Sparinvest. We strongly believe that, over the long term, investors are poorly served by slavery to market sentiment. Instead, we are patient and maintain a disciplined focus on our process, knowing that both the process and the value investment philosophy behind it have stood the test of

time. So, we screen for and analyse companies from a bottom-up perspective, assess intrinsic value based on cross-cycle earning power and asset backing and only invest in companies whose market prices are at a significant discount to that intrinsic value. Investors in our funds own a diverse portfolio of quality companies with solid track records and sound finances, which are well placed for the coming years. We are confident in the long-term outlook for our funds.

Yours sincerely,

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Lead Portfolio Manager

8 January 2010

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