Sparinvest

Letter to Shareholders | Q1 | 10

Value Bonds

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- sparinvest.eu

Economic Recovery

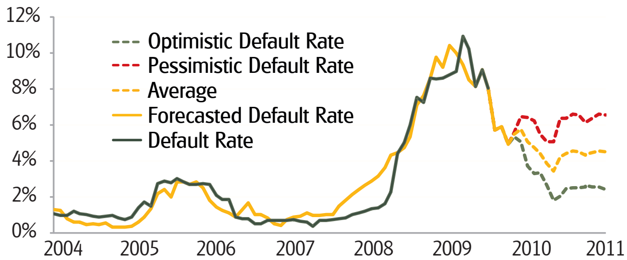
The global economy is improving – albeit slowly. The psychological impact of falling house prices and increasing unemployment is having a softening effect on consumption. Instead of spending, private households are focusing on reducing debt – a trend that is greatly appreciated by the banks.

However, it is an ill wind that blows no good! The slow economic turnaround has increased companies' eagerness to optimize production and reduce debt. These initiatives reduce the credit risk on corporate bonds significantly – a tendency we expect will continue!

Expecting a decreasing default rate

During the last months of 2009, we experienced a steep drop in the number of corporate defaults. This sudden drop closely corresponded with companies' ability to refinance existing debt in a very liquid credit market.

During the first quarter of 2010, the Value Bonds team spent some time developing our own model to predict the default rate one year ahead. With a high degree of accuracy the model allows us to anticipate the likely default rate 12 months ahead, using only four US economic key figures. This gives us an opportunity to analyze the future credit market and possible risk scenarios.



Source: JP Morgan, Sparinvest Value Bonds

Firstly, if we examine the most recent 5-year past period, the figure shows how closely our forecast default rate matched with the realized default rate. In this case we have used only four economic key figures to predict the future default rate four months ahead.

Furthermore, we use our model to predict the default rate for 2010 assuming three macroeconomic scenarios. The model predicts a default rate between 2.5% in an optimistic and 6.3% in a pessimistic scenario. Using the average risk scenario, we expect the default rate to fall from the current 7.4% to 4.4% by the end of 2010.

The hunt for yield continues

The return potential on corporate bonds is still striking. Despite the historically high returns realized in 2009, we still anticipate further credit-spread narrowing ahead because of all the credit-friendly initiatives currently unfolding as well as the continuing hunt by investors for yield.

Corporate bonds are an attractive asset class because of their high fixed-rate coupons and the fact that creditors are given preferential treatment over equity holders in case of default. This also explains the attractive realized returns on corporate bonds over the last 20 years. On average investors get 40% of the face value of a corporate bond back after a company has been liquidated. As a *Value Investor* we seek to minimize every potential loss in case of default by carefully investigating the corporate assets such as raw materials, inventories and properties.

Looking back the last 3 years, investors in Sparinvest High Yield Value Bonds have gained an average yearly return of more than 6%. Despite the worst credit crisis in 100 years!

Increasing value in change-of-control covenants

A document (prospectus) provides a detailed description of each corporate bond issued. This document not only outlines how we – as creditors – stand relative to the other stakeholders in case of a default, it also includes covenants that keep the management on a tight leash with respect to daily corporate operations. The level of restrictions imposed on the management varies widely from bond to bond. Some covenants may, however, have great impact on future bond price performance.

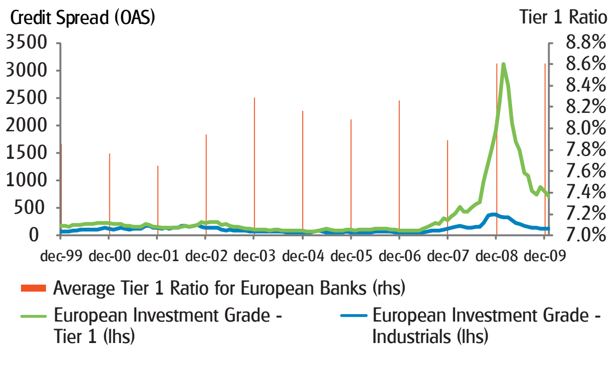
As *Value Investors* we find the investigation into bond documentation an important part of our investment strategy. We favour bonds that keep the management on a tight leash, forcing them to make creditor-friendly operating decisions. For example, a number of our bonds include restrictions on the payment of stock dividends and on share buybacks; two corporate actions that can adversely impact on bond prices by shrinking any 'buffer' funds within the company and thereby increasing the credit risk.

The change-of-control covenant is another very important element in the bond prospectus. In case of merger or acquisition activities, the covenant allows investors to sell the bonds back to the company at the price of 101. This opportunity is particularly valuable in the case of leveraged buyouts (LBO) in which private equity funds finance the takeover by increasing the company's debt burden. LBO risk is a textbook example of how to destroy bondholder value. The increasing debt burden is naturally followed by decreasing bond prices.

We have hardly seen any corporate acquisitions since the economic downturn and meltdown on the financial markets began. However, we expect to see LBO activity growing over time as the cash available for new investments increases in the private equity funds. As *Value Investors,* we regard the change-of-control as an important part of the bond prospectus, especially among companies that are most exposed to LBO risk. In particular, it is no secret that value companies with low price-to-book, valuable assets and strong balance sheets are generally seen as attractive LBO targets. Sparinvest Value Bonds seeks to turn the LBO risk to a positive investment opportunity by including change-of-control covenants, among other security measures.

European subordinated capital

In the beginning of 2009, the Value Bonds team chose to focus on debt issued by the largest European banks, among them Fortis Bank. Fortis Bank had, like most other large European banks, experienced liquidity problems in 2008. The Belgian government supported the bank by taking direct ownership of a major part and the rest was taken over by the French bank, BNP Paribas which is amongst the strongest banks in Europe. A number of governments also put together stimulus packages, besides taking direct ownership in the most shaken banks.



Source: BofA Merrill Lynch & Barclays Capital

The figure shows how the largest European banks are significantly better capitalized today (growing Tier 1 Ratio) than in previous years. (See the red columns in the figure above, the figure's right hand side). The credit spreads on the subordinated bonds are still historically wide, despite the steep de-risking trend that we have seen among the biggest European banks. We still find subordinated bonds attractively priced and expect further spread narrowing in the rest of 2010. However, we have taken profit on some of our initial investments.

Expected return for 2010

We see through positive glasses as we head toward 2011. Companies are expected to increase earnings the rest of 2010 because of more efficient production machinery and growing global economic growth. Corporate profitability is significantly improving and the debt burden is lower. We expect that the fundamental initiatives will continue benefiting corporate bond investors. Throughout the first quarter of 2010, the investment management team behind Sparinvest High Yield Value Bonds has been cherry-picking new and/or less-followed corporate bonds issued by healthy, well-operated companies. The fund has an average coupon of more than 8% with an average bond price of 85 and an effective yield of 11%.

Klaus Blaabjerg
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12 April 2010

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