



## Value Equities

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*Dear Shareholder,*

Value investing is often about consistency: keeping your cool and your long-term perspective, whether the world around us is plunged into negativity or buoyed by excessive optimism. Actually, sitting here in April 2010, the world feels rather more positive than it has done in many recent quarters. Although there are signs that the economic rebound has lost some steam, things seem to be heading in the right direction. Of course, looking at the newspapers can sometimes make you feel like the world is lurching from one crisis to another. Lately, it's been Greece and the fall-out in Europe that have been in the headlines. We don't want to understate the seriousness of these events but, if we place them in context, they are in many ways part of the necessary digestion of the credit crisis. They may not be pleasant steps, but they are steps forward. We'll return to this a little later in the letter.

Most importantly, we are encouraged by fundamental developments at our holdings. Performance of the funds has generally been positive in the first quarter of 2010 – and is of course discussed in more detail in the individual fund updates. But what we find most promising are the low valuations and high quality of our portfolios. It is worth noting that during the first quarter, our European holdings faced considerable headwinds in the markets as Greece's problems echoed throughout the continent, but we have not seen an underlying deterioration in fundamentals at those holdings. Below, we discuss why we are confident that our holdings are positioned to do well in the coming years, whether the global economy's road out of the crisis turns out to be easy or difficult.

## Transferral of Problem Balance Sheets

The past several weeks have seen close scrutiny of Greece's difficulty in refinancing its considerable government debt and trimming its large annual deficit. Inevitably, there has been contagion around Europe, with concern over the potential cost to the wider Euro zone of any potential rescue package. The rather harsh nickname "PIGS" – referring to Portugal, Italy (or Ireland), Greece and Spain, the European countries which are perceived to have relatively weak economies – has been around for a while, but has been all over the headlines recently, with speculation rife about which country might follow Greece's unfortunate path.

Greece was on that path well before the global economic crisis pushed it further into the red, but in many ways, its current problems are emblematic of the recent transfer of balance-sheet difficulties from the private to the public sector. The world was hit by a global economic crisis in late 2008 and, as earnings plummeted, huge pressure was placed on the corporate sector – and especially on companies with weaker asset bases or high debt levels. Many of these companies were saved by outsiders – typically by their own banks or by emergency public measures. (We've already discussed in previous letters the subsequent 'dash to trash', as investors flooded back into weak companies that had appeared at risk of going under). So, governments shelled out billions to assist the private sector, whether through direct injections and loans, public spending projects, or other means. Balance-sheet difficulties were transferred from the private sector to the public sector. While Greece's problems have thrown this into stark focus, we do not think there is a reason for panic. The 'quick fix' of government bail outs was always going to have a major impact on public finances for the coming years – digesting the credit crisis could not happen overnight.

These concerns have triggered both a weakening of the Euro, and a general wariness in the market towards holding European assets. Looking at equity indices, the MSCI Europe index has been the weakest of the major regions so far in 2010. Of course, this has been something of a headwind for performance in both our European Value Fund, and the global funds, which have a relatively high weighting in European equities. But this does not concern us overly. Looking at short-term considerations, there are positives as well as negatives: for example, a weak Euro can give a good boost to earnings for European exporters.

But more importantly, as we have said time and again, as disciplined value investors, our chief concern is long-term operating fundamentals at our individual holdings. Despite all the doom-and-gloom headlines about Europe

recently, we see plenty to be optimistic about in our European holdings. We don't concentrate a great deal on whether one quarter – or even one year – has particularly good or bad earnings – but we do take a close look at changes in earnings structures, asset bases or business models. There is a cliché that 'crisis' is just another word for 'opportunity', but many of our holdings have shown this to be true: using the harsh environment as a chance to take austere measures to restructure and trim costs. In many cases, we believe companies will emerge with even stronger business models.

So, whether we look at Europe or other regions, the earnings environment is still by no means easy – and any companies that hoped a swift recovery would save them may well be proved wrong. As we consider below, it does not seem likely that a sudden wave of massive corporate spending will erupt to drive an overnight recovery. However, we are confident that our holdings are very well placed to take advantage of the recovery, whether it is gradual or sharp. Meanwhile, when there is short-term market weakness in any of the regions or sectors we invest in, it often provides a good opportunity to find compelling new investment cases, or to add to existing holdings. Specific changes in our portfolios are discussed in the individual fund updates.

## Corporate Balance Sheets – When and How Does Low Debt Help?

We've always paid close attention to corporate attitudes to cash and debt. At one extreme are companies with little cash, and borrowings up to their eyeballs. This highly-leveraged approach can make management look like heroes in boom times, but is risky and leaves little room for manoeuvre when times get tough. At the other extreme are debt-free companies hoarding piles of cash. Cash is basically a resource and one does not want to see any company sitting on excess resources forever, and never putting them to work.

In reality, the ideal approach lies somewhere between these two extremes. Much depends on the industry and business model of each specific company, but also on prevailing economic conditions – it is cyclical. During periods of economic growth, it's often necessary to take on some debt to fund expansion. As they say, *"You've got to spend money to make money"*. Meanwhile, when times turn ugly, it's natural to tighten the purse strings. Certainly, in the last year or so, many companies have reduced inventories and cut capital spending, allowing them to build cash.

So what do we look for in potential investments? We like companies with the financial strength to withstand highs and lows – and the firepower to take advantage of

opportunities when they arise. We do think it's important that management respond flexibly to changing external conditions, but we also like to see a prudent 'buffer' kept in place, even in the good times.

Having said that, cautious company owners whose prudent management and healthy balance sheets saved them from the crisis must have found the past two years frustrating at times. First, they saw weaker competitors bailed out of their difficulties by banks or governments. Then, the bail-outs resulted in weakened government finances – as in Greece – which have triggered concerns over regional economies and currency moves. This is, admittedly, a highly-simplified version of events, but the owner of a well-run, cash-rich company might be forgiven for thinking, *“What have I done to deserve this? Where are the benefits of a prudent balance sheet?”*

Firstly, remember that although many highly-indebted companies have been saved by outside measures, they will ultimately have a bill to pay. There is no such thing as a free lunch.

Secondly, and perhaps most importantly, remember that capital strength performs different roles at different stages of the operating cycle. During a severe downturn, a lowly-leveraged balance sheet can help a company survive. But when demand is slumping, the earnings environment is tough for everybody, so it can be hard to see the difference between a company that survived thanks to its own strength and another that benefited from emergency measures.

However, if one considers the next stage in the cycle – the recovery or expansionary phase – then the benefits of a strong balance sheet become clear. Emerging from the downturn with a 'war chest' of cash makes you better able to restock, boost capital expenditure, pursue M&A opportunities, and take advantage of business opportunities. Companies that are burdened with high debts, who relied heavily on banks or governments to keep them going, will have fewer resources available and fewer options overall. Many might have their hands tied by loan covenants, or may need to turn to equity markets for additional financing. We believe that prudently-managed, low-debt companies should be well positioned to benefit from recovering demand in the coming years.

### **Recovery in Capital Spending & M&A**

Of course, we must remember that there is something of a 'chicken and egg' situation here. Unless there is an increase in corporate spending overall, it is difficult to imagine a fully-fledged economic recovery.

During the crisis, many companies cut inventories and

capital investment to the bare minimum in an attempt to cut costs and build their cash position. Some observers might be hoping that corporate spending will now recover rapidly, helping to drive a swift economic rebound. We are certainly not pinning any hopes on that kind of scenario. When talking to companies that we are invested in, although they clearly have the resources to spend when they see fit, their mood is generally rather tentative: they are opening their purses a little wider than in 2009, but are not about to embark on a huge spending spree. It seems probable that the coming cycle of corporate spending – whether we're talking capital investment or M&A – will be characterised by a degree of conservatism, at least in the early stages. We actually find this rather comforting. Instead of a 'boom-bust' cycle of massive corporate spending, followed by the need for severe tightening of the purse strings, we like to see companies operate on a more prudent basis, not pursuing expansion at any cost, but making investments with a close eye on profitability and balance-sheet risk.

So, what does this mean for M&A markets? Many companies that we communicate with tell us that after effectively freezing M&A activity during the worst of the crisis, they have started to contemplate it again. Often, they speak of being more 'selective' going forward, and we do not get the impression that M&A markets will erupt overnight. We think that such an environment can be very positive for our portfolios, which are rich in candidates for M&A, on both sides of the table. The financial strength of our holdings means that many are well placed to take advantage of opportunities to acquire competitors. Meanwhile, in an M&A environment with a renewed focus on avoiding excess risk, we believe that many of our holdings will emerge as strong takeover candidates. In our investment process, we have always taken a close and conservative look at both on- and off-balance sheet pitfalls such as excessive goodwill, pension and leasing obligations, contingent liabilities, and so on. This has resulted in a portfolio of companies with strong asset bases, trading at attractive valuations.

### **Value, Growth, and Thoughts on Benchmarks**

In our last letter, we touched briefly on the relative performance of growth and value stocks. We noted that while a wealth of research shows that value stocks outclass growth stocks in the long run, there are of course short periods where growth stocks outperform. If we use the MSCI classifications of value stocks and growth stocks as a guide, we can see that on a global basis, the period from 2007 to 2009 was one such period of growth stock outperformance. Of course, there are differences by region: in fact, in 2009, value stocks were stronger in both Europe and Japan, but notably weaker in the US. As

for 2010, so far we have seen value stocks leading the way in both the US and Japan, but not in Europe.

Although it's interesting to keep an eye on these trends, it is important not be sidetracked: what matters to us is simply the long-term superiority of value stocks as an asset class. Effectively, this superior asset class is our investment universe.

Beyond that, we are not overly concerned with indices or benchmarks. For us, value investing is not about slavishly investing in those stocks which are quantitatively classified by indices as 'value stocks'. Our investment process is one of qualitative, fundamental analysis, close to the classic value investment doctrine of Benjamin Graham and David Dodd. Index classification methodologies can change, so that what is called 'value' one year might be reclassified as 'growth' a year later. We try not to be distracted by these shifts. Instead, we focus on our disciplined process, looking for deeply-undervalued stocks which are heavily discounted to their intrinsic value.

This discussion brings up the broader question of indices and benchmarks in general. In this industry, it is hard to avoid benchmarks. While we comply with industry convention in providing certain reference indices by which to gauge our funds, we must stress that our investment process is not concerned with benchmarking. We do not focus on relative returns, but aim to provide healthy positive returns over the longer term. Often, investment risk is equated with tracking error versus a benchmark. We do not consider a stock to be less risky simply because its share-price movement closely mirrors an index. It is quite possible for an entire index to build up excessive risk, if for example an entire asset class is subject to a liquidity bubble. Of course, we can all find a sense of comfort from being part of a herd, but ultimately, it does not reduce risk. When lemmings decide to jump off a cliff, it is no less dangerous just because they all do it together.

As we discussed in our last letter, our view of risk is more fundamental: it is the risk of permanent loss of capital stemming from deterioration in asset quality or operating power at our holdings. It is the risk of degradation of their intrinsic value. Our mission is to preserve and increase the capital of our investors over the longer term, and we are convinced that this is best achieved by disciplined application of our conservative value process.

### Quality of the Portfolios

This conservative value process has resulted in portfolios of stocks with robust earnings power, strong balance sheets and low valuations. As ever, we think that a glance at some of the valuation measures and financial ratios of our holdings gives a good indication of their

quality. Specific data for each fund can be found in the individual fund updates, but we'll take the Global Value fund as an example. If we aggregate the data from the holdings into one theoretical company, it is trading at a price-to-book of just 0.99 times. Looking at earnings, EV/EBITDA is 3.1 times 2010 Bloomberg estimates, and just 2.7 times 2011 estimates. The aggregate balance sheet is solid, with net-debt-to-equity of just 28% (versus 55% for the MSCI World), and intangibles-to-equity of only 17% (versus 51% for the index). We remain confident in the quality of our holdings, both in terms of their balance sheets and the robustness of their business models.

### Conclusions

The 'dash-for-trash' theme has been a frequent topic in our recent letters. As bottom-up value investors we favour strong balance sheets and sustainable business models, which did not benefit as much as weaker companies from the strong liquidity injections in equity markets.

Let us give an example. The biggest beneficiary of this theme in 2009 has been the financial sector, especially in the US and Europe. That was sometimes frustrating for investors like us, who have a high exposure to the Japanese insurance sector. Despite the fact that none of the Japanese insurance companies needed government help during the crisis, their share prices lagged their Western peers substantially during the relief rally. In short, quality was not rewarded.

During the first quarter of 2010, however, we have seen the first signs that quality is returning to favour. Discussions on Basel III and Solvency II returned to the top of the agenda. Investors in financials locked in last years' gains and the 'crap rally' in financials lost some steam. Our funds were not much impacted by this. On the contrary, all our Japanese insurers saw solid gains in first quarter. The USD 11 billion IPO in Dai-ichi Life also drew attention back to the sector. Although we invest in property and casualty insurers and not in a life insurer like Dai-ichi Life, this largest IPO in two years put focus on the relatively attractive valuations of Japanese insurance companies compared to their global peers. We did not predict that this IPO could drive the share prices of our holdings, but again it shows us that we should not care too much about short-term share price movements. Fundamentals and valuations are the things we care about on a daily basis.

After a period like the one that we experienced from Q3 2007 to Q1 2009, where our process did not generate the results that one would hope for, it is natural to see some questions about our process and investment philosophy. Within the industry, there's a lot of focus on the short term: a never-ending wish for 'good stories to

communicate'. We think that adopting such an approach can be one of the worst enemies for value investors and the generation of healthy long-term returns. Value investing is not about telling the hot story that is easy to communicate, because it is in sync with the market consensus and the general news. On the contrary, in our world it is always about fundamentals and valuation, buying earnings power, strong balance sheets and assets with a discount – and the tough one: patience.

The attempt to improve an investment process should be constant, and not in focus only when performance is below par. Process improvement should be on the agenda every day, all year round, in ups and downs. There will never be such a thing as the final, definitive version of our process – it does not exist. We need to be curious and try to do things smarter all the time, without selling out on core principles, like the 40% discount and

strong balance sheets that are so vital to us.

Here in early 2010, there is plenty to be upbeat about. As mentioned above, the low valuations of our portfolios are attractive, and the fact that the companies we hold still have room for improvement makes us optimistic. We are convinced that this will be a major driver for the performance of our funds in the coming years, in combination with the positive effects of increased M&A activity.

Yours sincerely,

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Lead Portfolio Manager

12 April 2010

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