



## Value Equities

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### Our Value Equity Funds

Fund	ISIN code
Ethical Global Value	LU0362355355
European Value	LU0264920413
Global Small Cap Value	LU0264925131
Global Value	LU0138501191

Detailed information is available in the relevant Fund Update.

- [sparinvest.eu](http://sparinvest.eu)

*Dear Shareholder,*

It has certainly been an eventful first half of 2010. Looking at our holdings, there is considerable evidence of an improving operating environment, with earnings recovering and balance sheets becoming even more solid. Having said that, the past six months, and especially the past quarter, has been a period in which stock markets overall have felt a very large impact from broad macro-economic and country-specific risk, and other external factors.

We touched on the Greek debt problem in our last letter, and of course this has continued to be a dominant theme. From politicians and pundits to central bankers and investors, everybody has been grappling with the potential implications: would Greece's European Union partners be willing and able to bail Greece out? Does a similar fate await other countries? Can the Euro ultimately survive in its current form? These uncertainties have, of course, put tremendous pressure on both the Euro currency and European assets in general, and it is no surprise that, so far in 2010, European stock markets have notably underperformed other major regions – although, as we discuss later in this letter, our European holdings have remained robust.

Meanwhile, much attention has been focused on BP and events in the Gulf of Mexico. In recent years, the world has increasingly been asking itself how long it can continue to depend on fossil fuels. Ironically, just months after world leaders met in Copenhagen to discuss such issues, comes one of the worst environmental disasters of the age of oil. Setting aside the ongoing practical question of just when the leak will finally be fully controlled, there is the issue of the regulatory impact. Clearly, there is no simple solution, and despite all the rhetoric against companies like BP, there is also an underlying awareness that the US – in common with most of the economies and societies of the developed world – has a heavy reliance on oil.

## Our Approach to Macro Conditions

These days, big macro issues seem so dominant in discussions that many – even supposedly bottom-up investors – start sounding like top-down macro investors. At Sparinvest, we are resolutely bottom-up. But what does this mean in practice, especially in such uncertain times? We don't make our regional or sector weightings based on a strategic top-down view. For example, we don't decide that we are particularly bullish on a particular region's stock market or macro-economy and then invest heavily in that region. We believe that, over the years, we can achieve the best investment returns not by trying to time the markets in this way, but by picking strong but deeply undervalued stocks on an individual basis. Of course, there are some regional differences, but earnings power and asset pricing are largely universal. Our focus is always on analysing the specific characteristics of each company.

Does this mean that we ignore macro-economic factors in our investment process? Absolutely not. We pay close attention to them, but as part of the concrete analysis of each individual investment. Ultimately, investing in a company involves making assumptions about its earnings power and asset strength. Our guiding principles are to be conservative and not to be swayed excessively by short-term numbers. We do not simply base our assumptions on the trends of the past couple of years, or expectations for the next couple. Instead, we analyse a longer history, in order to gauge how a company performed and developed over the span of many years and over the course of an entire business cycle.

It is also crucial to consider macro factors. Companies do not exist in a vacuum. Clearly, their asset strength and earnings power are affected by the external environment. As a simple example, consider a company whose balance sheet seems extremely healthy, thanks to considerable real estate assets. Much depends on whether the stated value of those assets is reliable and sustainable. The accounting regime is of course relevant: have the assets been evaluated regularly, with the stated value adjusted appropriately? But the region's land price trends also matter: are there any signs of bubble-like rises, raising the risk of asset write-downs further down the road?

Alternatively, consider a supermarket chain that has a strong track record of boosting its market share, but is situated in a rural region which will likely face population decline as people relocate to urban centres. Naturally, if you were to buy this company, it would be vital to consider what impact this demographic change might have on its earnings power, and to factor this into your calculations of what to pay for it.

So, when we estimate the intrinsic value of a potential investment, whether we base it on assets or earnings power, or a combination of the two, we always factor in prudent assumptions about the relevant external factors. We only invest if the company is deeply undervalued relative to this conservatively-assessed intrinsic value. We also demand that our holdings have the financial strength to endure difficult periods. This process results in a portfolio of deeply undervalued companies that offer long-term quality of earnings and assets – and where the potential return on investment does not rely on a positive macro-economic outlook for the region in which they are based.

## Quality of the Portfolios

As always, specific data for each fund can be found in the individual fund updates, but we'll use the Global Value fund as an example here. Aggregating the fund holdings into one theoretical company, it is trading at a price-to-book of just 0.91 times, while the MSCI World index is at 1.94 times. We have a relatively high exposure to cyclical companies which inevitably saw weaker earnings during the crisis, but are now recovering swiftly.

The speed of this earnings rebound is indicated by valuation measures. Price-to-earnings for the year ended was 36.3 times, a relatively high multiple caused by the short term earnings decline last year. But if we look forward to estimated earnings for 2010, the multiple drops to 12.0 times Bloomberg estimates, and for 2011 it is just 9.3 times, compared with 11.5 times for the MSCI World Index. EV/EBITDA is a useful indicator of the price of a company relative to its raw earnings power. Our fund is trading at 2.8 times 2010 estimates, and 2.5 times 2011 estimates. This compares with 6.9 and 6.2 times for the MSCI World. To us, this demonstrates clear undervaluation: 2.5 times EV/EBITDA is a level at which no sane business owner would consider selling his company.

On top of these compelling earnings valuations, the aggregate balance sheet is solid, with net-debt-to-equity of just 25% (versus 54% for the MSCI World), and intangibles-to-equity of only 19% (versus 51% for the index). We think that this financial strength will be a crucial distinguishing factor in the coming years, as we will discuss in greater depth later in this letter.

## Quality Matters

We've discussed previously that 2009 was, to some extent, a 'relief rally' in which stock markets rose rather indiscriminately, and individual company quality was not always rewarded. Ultimately, though, it is fundamental quality that matters most. From this perspective, it's interesting to consider European markets.

In the first half of 2010, the MSCI Europe index has declined by 2.45%, with growth stocks up by 2.56%, and value stocks down by 7.49%. It has been a period where macro-economic and regulatory risks have come to the top of the agenda – and, compared with other regions, Europe has been hit hard. On the one hand are concerns over national debt and currency, while on the other hand is the risk that as governments cut public spending, the economy will fall into a double-dip recession. However, we have, as always, been keeping a close eye on our investments, and have been reassured to see strong earnings developments and robust balance sheets at our European investments. Interestingly, despite the weakness in the overall European markets so far this year, Sparinvest European value has risen by 5.52% – and the European holdings in our global funds have been similarly strong. Ultimately, we do not read too much into the returns of half a year – but, compared to the worst of the credit crisis in late 2008 and much of 2009, we see some signs that individual corporate quality is being rewarded in the stock markets.

Looking at our investments in Europe, it's notable that our weightings are somewhat skewed towards Northern Europe, and certainly this has benefited us in recent months. This is perhaps a good example of how macro considerations are factored into our assessment of each individual company's earnings power. It's not that we took a strategic decision to avoid – for example – Spanish companies, but it's fair to say that when we have analysed them in recent years, we have not found valuations compelling enough to make them attractive investments. Of course, that may change, depending on share-price movements.

### **Deleveraging: Spend or Save – or Both?**

When we talk about the quality of our holdings, a key issue for us is the level of debt. It is also a highly relevant topic when considering the relationship between the macro-economy and individual companies. Whether we're talking about the man on the street, the company CEO or the leader of a country, high leverage and the subsequent need to deleverage have been dominant themes in recent times.

There's an urban legend of a sign outside a bank which reads, "We can loan you enough money to get you completely out of debt". It sums up a fairly common attitude in recent years – that one loan can always be paid off with another loan, and that someone somewhere will always be willing to lend more money. For individuals, companies and even countries that adopted that approach, the last couple of years have been a reality check. The private sector was hit first and, as

it struggled to reduce debt, governments came to the rescue – whether through direct bail-outs, indirect provision of liquidity or economic stimulus measures. But of course, these measures themselves were not magically funded from nowhere and, for many countries, the end result has been a significant increase in national budget deficits and debt.

Ultimately, despite that alluring sign on the bank, the overall economy cannot simply borrow its way out of debt. "There are but two ways of paying debt: increase of industry in raising income, increase of thrift in laying out". So said Thomas Carlyle in the 19th century, and his words remain just as relevant today: the only real way to deleverage is to earn more, or spend less. But that's easier said than done because, as we noted in our last letter, "You've got to spend money to make money".

That pretty much sums up the dilemma facing leaders at the recent G-20 summit in Toronto. Events in Greece have highlighted the need to bring public-debt levels under control, and one obvious way is to cut public spending. Yet there is a valid concern – raised principally by the US on this occasion – that if government spending is cut too quickly, it could hurt the economic recovery which, ultimately, means lower private-sector income and lower tax income for the state. Inflation is obviously a key part of the equation which, if managed effectively, can help to bring down a country's debt burden. So, when should governments reduce spending and increase saving? Of course, there is no magic answer. The final G-20 declaration basically summed up the dilemma and accepted that each country needs to find its own path out of debt, based on individual circumstances. It is clear, though, that this is not going to be resolved overnight: many countries must walk a long tight-rope, delicately balanced between the need to stimulate growth and the need to implement fiscal austerity.

So what does this background mean for individual stocks? Firstly, let's stress again that it is vital to distinguish between country and company. Fundamental conditions at companies do not necessarily reflect trends in the overall economy of a country. To put it bluntly, we aren't investing in GDP figures or national debt figures, but in the earnings power and balance sheets of individual companies.

But what's interesting about the political debate on national debt is that corporate leaders are almost facing the opposite dilemma: when should they stop saving and start spending again? As the credit crisis hit, companies scrambled to deleverage their balance sheets, cutting debt and building cash. For many, this was, ironically, made easier by the global downturn in demand.

If nobody is buying your products, you don't need to make them and that, in turn, means you don't need to buy anything. The demand slump meant companies spent less on raw materials, avoided restocking inventories, delayed normal maintenance investment and held off on building that new factory.

Of course, for some companies, this wasn't enough, and they needed to take more drastic measures to restructure the balance sheet – such as issuing more equity, which is not particularly pleasant for existing shareholders. But whichever route companies took, the overall picture in the past two years has been clear: debt is bad, and cash is king. If you look at the net-debt-to-equity level of the MSCI World now, compared with March 2009, it has dropped from 59% to 54%.

But the big question is: when should companies start spending again for the economic recovery phase and do they have the financial power to do it? There are, clearly, some positive signs in the overall economy, but recent events have again clouded the horizon, and the timing and nature of any recovery is not clear. So when should a company start to restock its warehouses, buy that badly needed new machinery or break ground on the new factory?

The situation is toughest for companies that remain heavily indebted even now. For one thing, they may not have enough spending power to take full advantage of the recovery, and for another, if they get the timing wrong and start spending too early – before demand recovers – they might face an intolerable burden of higher debt and higher costs. Then there are the many companies that seem to have low debt levels now, but primarily because of short-term cash-generating measures taken in the last couple of years: lower investment, slashed inventories, and so on. They do have a certain amount of financial strength now, but much of it will quickly be exhausted as they restock. In our analysis, it's important to look behind the headline numbers and see what is actually driving changes in ratios like debt-to-equity.

We invest in companies that have low debt levels not just thanks to short-term emergency measures, but to long track records of financial prudence. Our holdings have considerably lower debt than the wider market. We strongly believe this gives them the financial firepower not just to get things back to normal by rebuilding inventory and carrying out maintenance investment, but also to expand into a recovering economy by building that new factory, or buying that struggling competitor. Moreover, their financial strength means they are not walking such a tight-rope in terms of timing. If they start spending, but demand does not recover quite as quickly as anticipated, they can easily withstand it. This quality of our holdings

gives us considerable confidence when thinking of the coming months and years.

## M&A

No letter would be complete without us touching on Mergers and Acquisitions. As we have frequently said, our funds have historically proved to be rich M&A hunting grounds, with a significant number of positions exiting our funds as a result of takeover activity. Many of our holdings also have a strong record of using their financial strength to make accretive acquisitions, bolstering their asset base and earnings power.

We have also noted that, in the past two years, M&A markets have been extremely quiet, and this has inevitably had some impact on our funds. We remain very confident that, as corporate realignment and takeover activity gradually kick into gear again, the funds will reap the benefits. Even during the recent quiet spell in the markets, we have seen takeovers within our portfolios, such as IDS Scheer, Océ, and a pending bid for Gewiss. But numbers have still been relatively low when compared to previous years, as can be seen in the table. We do not see this as a reason for concern – in fact, quite the opposite. Looking at our current holdings, we see plenty of fruit that is ripe for the picking, and we are convinced that as M&A markets gradually gather steam again, the portfolios will feel the benefit.



Having said that, when considering M&A, the focus should not only be on acquisitions or takeovers. Many discussions of M&A overlook the 'M': mergers. Straight acquisitions tend to grab more headlines, especially when they are hostile or involve the payment of a large premium to the existing share price. But, often, mutually-agreed mergers between competitors can be just as beneficial to shareholders in the long-run. An example is the Japanese non-life insurance industry, where the number of players has been gradually decreasing. In April 2010, three of our holdings (Mitsui Sumitomo Insurance, Aioi Insurance, and Nissay Dowa) merged to form MS&AD Insurance Group which, as a result, has become the largest holding in some of our funds. In addition to economies of scale, and reduced competition in the domestic Japanese insurance market, this merger gives the company even

greater financial strength to pursue expansion overseas. This type of corporate realignment can generate very significant shareholder value over the longer term.

## **Conclusion**

Generally, we are encouraged to see that, so far in 2010, our funds are performing reasonably strongly, compared to common benchmarks. Bear in mind that this is despite currency moves working against our global funds which have a relatively high weighting in Euro-denominated stocks. We have a relatively low exposure to US stocks and, with the dollar up 17% against the Euro year-to-date, this alone has cost the fund a few percentage points in performance measured against benchmarks. This is not something that troubles us. Considered over the short term, of course there are quarters when currency moves hurt, and others where it helps. Naturally, we have often studied the long-term impact of currencies on the funds and the potential benefits of hedging the exposures. However, the results have clearly suggested that over the course of the years, relative currency swings have had an extremely limited impact on performance.

At the same time, as we discussed above, the European companies in the portfolios have performed relatively well for us, despite the tough environment. Indeed, in the second quarter, where European indices had a dismal showing compared to other regions, our European holdings performed largely as well as our Japanese and North American positions. Of course, we don't read too much into the performance of one quarter or half year. For us, it always boils down to the actual quality of our investments and what potential they have for the years to come.

After the credit crisis, there was of course a huge wave of relief as people – and stock markets – realised that the world had not ended. But fixing the problem was never going to be easy, or quick. When it comes to the question of deleveraging, there are ultimately no shortcuts available, and it is going to be a long and gradual process. This does not mean that we are particularly negative on the economic outlook – certainly, we see some positive indicators out there – but we do think the outlook remains uncertain. As we have often said, we do not know what shape the recovery will take, or how fast it will be. But what gives us immense confidence in our funds is that our holdings have strong business models and strong balance sheets, which mean that they are not pushed into a corner. They are 'masters of their own houses', able to withstand uncertain times and use their financial strength to benefit significantly as the economy does normalise.

Again, we would stress that valuations of our funds are very attractive and, indeed, still close to historic lows. Meanwhile, we continue to find attractive new investment opportunities in the markets, which we believe can drive performance in times to come. Combining those two factors, we think this could well prove to be a good window of opportunity for value investment for the coming three-to-five years.

### **Jens Moestrup Rasmussen**

Lead Portfolio Manager

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