



Value Bonds

Headlines

- What a quarter!
- The Energy Sector
- Financials
- M&A activity
- The default rate is expected to be stable

Our Value Bond Funds

Fund	ISIN code
Emerging Markets Corporate Value Bonds	LU0519053697
Ethical High Yield Value Bonds	LU0473784196
High Yield Value Bonds	LU0232765429
Investment Grade Value Bonds	LU0264925727

Detailed information is available in the relevant Fund Update.

- sparinvest.eu

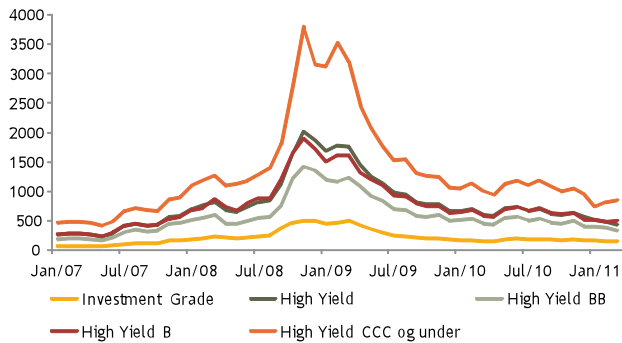
First of all we hope that all our investors have had a good start to 2011.

What a quarter!

The excess of unexpected events witnessed in the last few months has been nothing short of remarkable. These include spiralling revolutions in the Middle East, natural disasters and nuclear leaks in Japan, NATO airborne assaults on behalf of Libyan rebels and the market still faces the slow-burning fuses on public finance debt bombs in the US, Japan and Europe. Through it all, global credit markets have remained remarkably well-supported.

The suddenness and breadth of the political change in the Middle East and North Africa, and the extent of the human and physical devastation wrought by the earthquake in Japan are hard to grasp fully and entirely unexpected. While adding a significant degree of uncertainty to the outlook, we do not believe that these developments will be the key drivers of economic or market performance in the coming months. On the contrary, while geopolitical risks may stay elevated for some time to come, we remain confident that the global and emerging market expansion will continue on track through the remainder of this year. Figure 1 shows that the development of the credit spreads across ratings has not widened during the first quarter of 2011 (except for corporate bonds with the lowest rating), despite the overload of unexpected events.

Figure 1: Credit Spreads



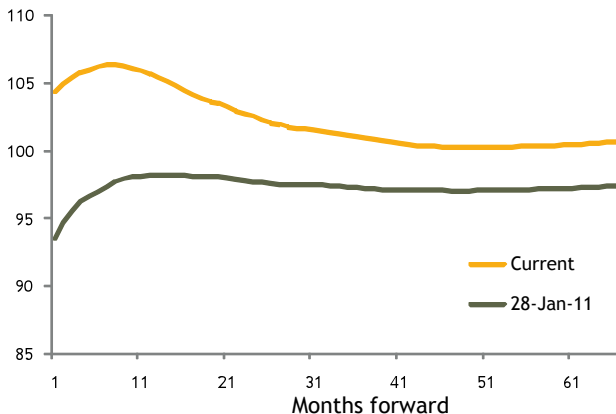
Source: Bloomberg and BofA Merrill Lynch

As Figure 1 shows, there still is some value present in corporate bonds investments. However, the spreads are close to pre-crisis levels. We are no longer in an environment where confirmation of the sustainability of economic recovery reduces risk premiums and generates a revaluation of cheaply-priced corporate bonds. Instead, asset prices are closer to fair value and stronger growth is now accompanied by signs of higher inflation and an increased probability of policy tightening. This means that investors will need to pay more attention to security selection. As value investors with a ‘bottom up’ investment philosophy focused on small cap companies with a low ‘price to book’ and ‘net debt to equity’, this is an environment that we do well in.

The Energy Sector

In our High Yield Value Bonds and Emerging Markets Corporate Value Bonds funds we have a high exposure towards the energy sector compared to our benchmarks. This exposure has been a result of our ‘bottom up’ investment philosophy, as this has been a sector we have found good value in for a long time. The disturbances in the Middle East have resulted in an increasing oil price, which our investments in the energy sector benefit from.

Figure 2: The oil future curve has moved up



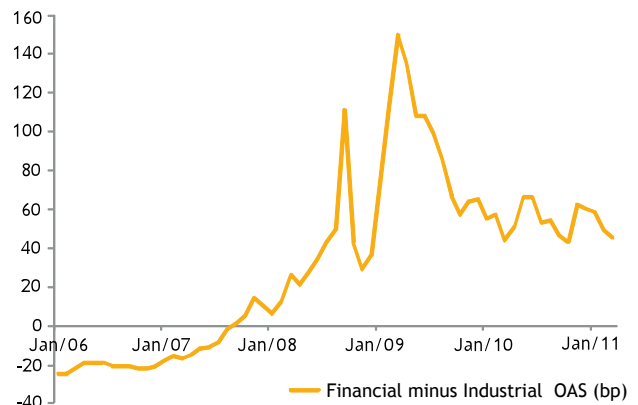
Source: NYMEX WTI Future Curve (\$/barrel), Bloomberg.

The oil futures curve shows the oil price over different time periods. Figure 2 shows the oil futures curves, one from the beginning of the quarter, and one from the end of the quarter. You can see that increasing production costs, global economic growth and the loss of supply from Libya – as well as the risk of more extended supply interruptions in other oil-producing nations – has resulted in a rise in the front end of the oil futures curve during the last quarter, while from two years out, the curve has moved only modestly to reflect a higher long-term risk premium. It has been common knowledge for some time that ‘OPEC equals Saudi Arabia’. Like many other regimes in the Middle East Saudi Arabia’s King Abdulla also faces turbulence in the oil-producing eastern province of his kingdom. These turbulences have forced King Abdulla to make an increased investment USD of 90 bn. to boost social services and calm the riots. As a consequence, Saudi Arabia has an incentive to keep the oil price at a high level to finance the increase in the public budget, and this could hold back an increase in the oil supply. However, the oil price future curve shows that the market does not expect the price to continue its upward trend in the years to come. While prices may rise somewhat over the next few months (to the benefit of our investments in the energy sector), there is still some spare capacity and we do not see the rise in the oil prices as a serious risk to the recoveries in economies or global markets.

Financials

As we have just showed, corporate spreads are now close to pre-crisis levels. While corporate fundamentals remain strong, the industrial segment of the investment grade index is trading only slightly wider than levels achieved pre-crisis. At current levels, the risk/reward profile for many industrial credits appears unfavourable, as they have limited upside in a rally, given the tight spread levels. While many non-financial credits appear fairly priced in the investment grade segment, we still find value in financials, which trade substantially wider than industrials, see Figure 3.

Figure 3: Financial vs Industrial Spreads



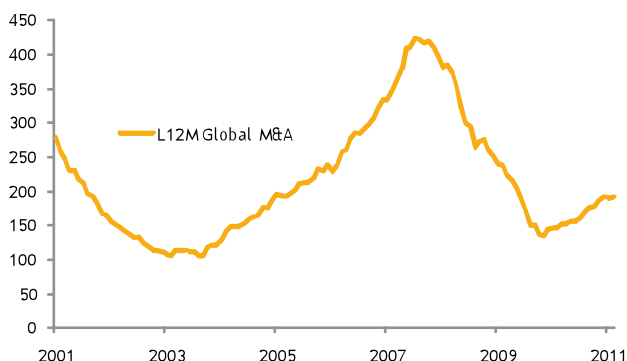
Source: Bloomberg and BofA Merrill Lynch

As we still find value in financials we have an overweight of the sector – particularly in the Investment Grade Value Bonds fund, but also in the High Yield Value Bonds fund. At the moment, we see that the banks are raising capital to meet new capital adequacy requirements. Increasingly, they choose the route of issuing equities to achieve this. This development means that our investments in financial bonds become less risky.

M&A activity

The economic recovery is now firmly underway for companies, and corporate balance sheets are in good health. Many companies have low leverage or have reached their leverage targets, and some hold a considerable amount of cash. Therefore, there will be more pressure for companies to put the cash they have to good use. Companies with high ratings have the capacity to borrow, and there are still a lot of cheap assets available for purchase. This means that companies with available funding will be more willing to seize takeover opportunities. This theme of Mergers and Acquisitions is one we have benefitted from several times previously, and we believe that as value investors we will continue to benefit from M&A activity going forward. Our expectation of an increase in M&A's is not just because of the re-leveraging of corporate balance sheets, but also the fact that companies facing globalization challenges must take such steps – either in pursuit of growth through product line and geographic extensions or to achieve consolidation/cost synergies in sectors with challenging revenue environments. Capital requirements and regulation for banks, and shifts in technological trends for industrials are some of the more specific factors that we expect to drive M&A activity. Figure 4 shows that M&A activity has increased during the last year.

Figure 4: The global M&A announced transactions



Source: Bloomberg

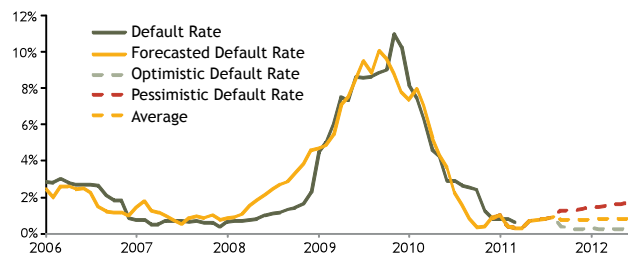
M&A activity can present several opportunities and benefits for us as investors. As part of our investment process, we focus strongly on the covenants, in particular on the 'change of control' covenant¹ attached to the bond. This means that if we assess that a takeover is

financed with too much debt, we have the opportunity to sell our bond back to the company. However, if the company we have invested in is taken over by a stronger company, we will experience an increase in the rating and price of our holding, and instead of using our change of control option to sell around par, we can enjoy a tightening of spread, taking the price further above par. As a value investor we invest in small companies with valuable assets and less debt, and these are exactly the types of companies which are takeover targets.

The default rate is expected to be stable

The strength of corporate balance sheets is reflected by our corporate default model, which we have presented in several previous letters, and which continues to forecast a very low default rate. This means that we invest in an environment with very low risk of seeing a default. Nevertheless, we stick to our strategy of investing in companies with low net-debt-to-equity.

Figure 5: The Sparinvest Value Bonds Default Rate Model



Source: Sparinvest, JP Morgan

The model's forecast of a low future default rate is a result of the positive environment for companies right now. They have easy access to lending and the financing gap shows good health from a cash flow perspective.

To sum up, we are satisfied with the overweighting of the financial and energy sectors in our funds, and expect the outperformance from our funds to be driven by these sectors in the near term. At the same time, we expect to benefit from M&A activity going forward.

For more specific performance and key figures (e.g. effective yield and duration) reporting please refer to the individual fund updates made by the portfolio managers for each of the funds in the Sparinvest Value Bonds range.

Klaus Blaabjerg
Lead Portfolio Manager
11 April 2011

¹ The covenant means that if a change happens in the company's ownership, we have the opportunity as borrowers to sell our bond back to the company at close to or at par.

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