



## Value Bonds

### Headlines

- The global economy is slowing down
- The corporate credit market
- The default model

### Our Value Bond Funds

Fund	ISIN code
Corporate Value Bonds	LU0620744002
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](http://sparinvest.eu)

### Dear Investors

Thank you all for being with us in these challenging times. Autumn certainly hit the market early this year. Our funds have had a tough quarter and underperformed the corporate credit markets in general. This is very similar to what happened with our Value-based corporate bond funds in the autumn of 2008 and the early part of 2009. As the market has priced in recession and liquidity disappeared, Value (low price-to-book) has underperformed. What has made this turmoil even worse is the fact that our funds today have more European exposure than they have had in the past. Nevertheless, looking forward, we are convinced that European assets in general have become too cheap in a global context. We therefore believe that as the market settles down our funds will experience solid comebacks, just as we saw during spring and summer of 2009. What we are doing in the meantime is making sure that drops in NAV are purely based on mark-to-market losses – i.e. we try to sell when the fundamentals of a company no longer fit our criteria of low net-debt-to-equity or low loan-to-value. We also try to position the fund in such a way that the patient investor will experience above-average returns when markets turn for the better. We believe today's market offers a lot of bargains for credit investors – especially as we can see that the underlying fundamentals of companies today are a lot stronger than they were two to three years ago.

### The global economy is slowing down

The global economy has slowed down and we are facing challenges in the developed world related to past exuberance – be it housing in the US or social benefits in Europe. But the chances of experiencing a recession similar to that of 2008/2009 are low. And even though

we believe the developed world is set for years of low growth; this, from a historical perspective, is not such a bad scenario for credit investors since companies in such an environment will stay focused on strengthening balance sheets to survive.

Table 1 below shows the latest IMF world economic forecasts. As shown, the slowdown hits everywhere:

**Table 1: Forecast of global GDP growth (%yoy)**

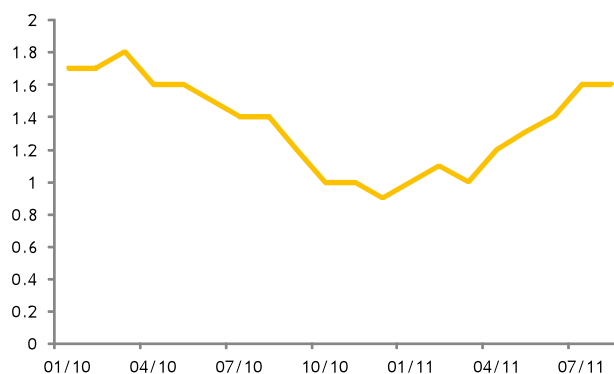
	2010	2011	2012
Global	5.1	4.0	4.0
Advanced Economies	3.1	1.6	1.9
G7	2.7	1.3	1.7
US	3.0	1.5	1.8
Japan	4.0	-0.5	2.3
Euro Area	1.8	1.6	1.1
Emerging Economies	7.3	6.4	6.1
China	10.3	9.5	9.0
India	10.1	7.8	7.5
Russia	4.0	4.3	4.1
Brazil	7.5	3.8	3.6

Source: IMF

## US

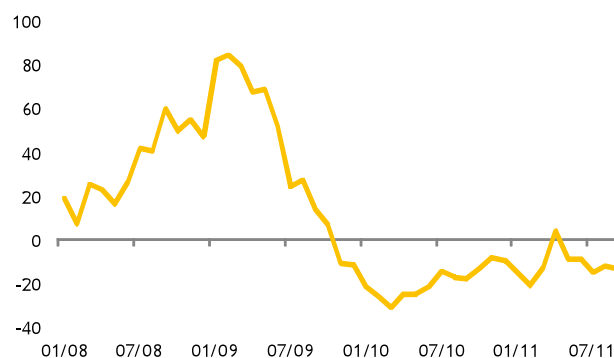
The real GDP growth slowdown hitting the US in the first half of 2011 was mainly caused by Japan's tsunami and disruptions to oil production in North Africa. The influence of both of these factors ought to have decreased by the beginning of the second half of this year – both gasoline prices and interest rates have dropped, and some of the supply-chain disruptions caused by the tsunami have begun to ease. The US economy is therefore facing a brighter second half of 2011, especially if consumer spending increases and begins to boost economic growth. We have actually seen some positive signs on this front from a bottom-up perspective – same store sales numbers for a bunch of retailers have actually beaten estimates lately. So far, the evidence on this front is favourable, as shown in figure 1. On a year-on-year basis, US personal consumption expenditure fell in first quarters of 2011, but has since picked up. Similar to this figure 2 shows that the US initial jobless claims figure has fallen, and is now in negative territory on a year-on-year basis. Such a development would normally be consistent with a pick up in the US economy.

**Figure 1: US Personal Consumption Expenditure, yoy**



Source: Bureau of Economic Analyses, Bloomberg

**Figure 2: US Initial Jobless Claims, yoy**



Source: US Department of Labor

The bottom line regarding the US economy is that already low cyclical activity and moderate inventory stocks are compelling reasons to expect a mild downturn in the US. For example, current housing investment in the US is mostly covering basic wear and tear. On the other hand, it is also a fact that constraints on monetary and fiscal policy limit the strength of any subsequent recovery.

## Europe

In Europe, the deterioration of confidence in European government debt markets still presents the most serious challenge to the global economy. Europe is also the area where IMF expects the slowest economic growth in 2012. The lesson of the past two years is that it takes substantial market pressure to force governments to overcome their differences and to resolve crises. However, we now see signs that European politicians will overcome their differences and put in place plans to resolve the crisis. A deadline for such plans has been set at the end of October this year.

The conundrum that faces investors and policymakers in Europe is clear. In general all European sovereigns – other than Greece – are solvent, as table 2 shows. As long as governments persist in their fiscal adjustment and economic reform programs and, crucially, as long as the market remains confident, they are and will remain solvent. The problem is that even small doubts about solvency quickly become self-fulfilling, as they require bond markets to charge risk premiums that amount to bankruptcy rates of interest for a highly-indebted sovereign. Unfortunately, this confidence has been lost in the Euro area, and it is unlikely that it can be restored through the sole efforts of the directly-affected sovereigns. The cases of Italy and Spain, where government bond spreads have widened despite additional fiscal austerity measures, are illustrative.

**Table 2: General government accounts**

	Fiscal balance (% GDP)			Gross debt (% GDP)		
	2010	2011	2012	2010	2011	2012
Austria	-4.6	-3.9	-3.3	72	73	74
Belgium	-4.1	-3.6	-2.8	97	96	96
Finland	-2.5	-1.1	-0.6	48	47	46
France	-7	-5.7	-4.6	82	84	86
Germany	-3.3	-2.1	-1.3	83	82	82
Greece	-10.5	-9.6	-7.4	143	144	150
Ireland	-32.4	-10.7	-9.2	96	110	117
Italy	-4.6	-4	-2.1	119	120	119
Netherlands	-5.4	-3.8	-3	63	65	66
Portugal	-9.1	-6.3	-5	93	107	113
Spain	-9.2	-6.5	-4.7	60	67	72
Total Euro Area	-6	-4.4	-3.2	85	87	89
Japan	-8.1	-8.9	-8.5	200	213	219
UK	-10.4	-7.5	-7.1	80	80	84
US	-10.2	-8.9	-7.3	99	105	108

Source: IMF (with Sparinvest calculations)

The credit liabilities of the non-financial private and public domestic sectors are measured on a comparable basis in Table 2. This indicates that the aggregate ratio of private and public debt to GDP in the Euro area is similar to that in the US, and substantially below that of Japan. However, the Euro area is clearly still a long way from developing the degree of political integration that would be necessary to collectivise the very different public sector debts across member countries.

### Emerging Markets

In emerging markets the slowdown is not a result of sovereign debt or political disagreements, but is mostly driven by monetary tightening in response to rising inflation, which has been aggressive in some of the major

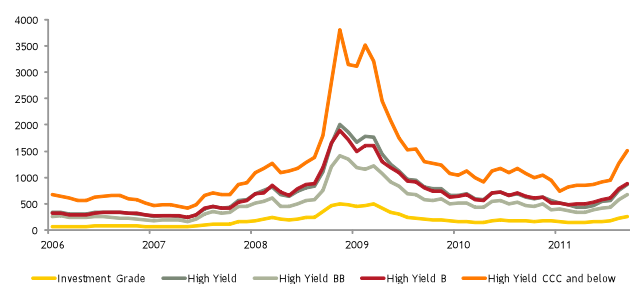
countries such as China and Brazil. The reduced growth in exports, due to the weak demand from advanced economies, has also affected the growth in emerging markets. However, a combination of high levels of near full employment, sustained income growth and, especially in Asia, very low real interest rates appear to be supporting domestic demand better than in the past.

Looking forward, there is substantial scope for fiscal and monetary easing in many emerging economies as a response to slower global economic growth.

### The corporate credit market

Credit spreads continued to widen across regions and across the quality spectrum in the recent quarter. This was driven by fear of the European debt crisis and increased macroeconomic risks (Figure 3). The sell-off has been rapid, with the bulk of the widening occurring in August and September. Unsurprisingly, given the focus on sovereigns, European credit has underperformed other regions.

**Figure 3: Credit spreads across different rating categories**



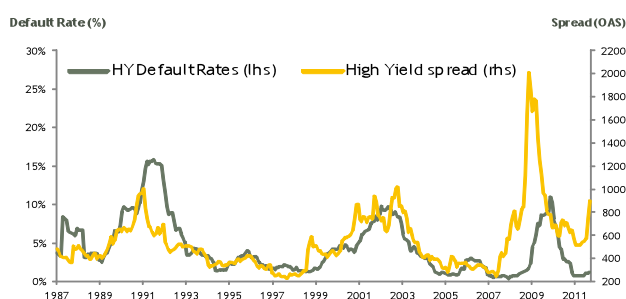
Source: Bloomberg and Merrill Lynch

As we have discussed in previous letters, corporate sector balance sheets are generally strong, and companies are in a much stronger position than they were in 2008. At current levels, credit spreads are consistent with a moderate recession. Companies have repaired balance sheets, reduced leverage, and increased cash in response to the funding problems they experienced in the credit crisis of 08/09. They are now well positioned to withstand moderately weak economic environments. In Europe in particular, companies are being forced to continue this credit friendly agenda as European banks are being forced by the market to deliver even faster on their programmes than they have been doing to date, to be able to comply with Basel III requirements after additional haircuts to Greek debt.

We believe today's spreads are reflective of a binary outcome, where markets will either improve significantly in response to increased stability in Europe or deteriorate further in the face of a disorderly resolution of Greece and/or other peripherals. We subscribe to the first – that we will soon see tighter spreads.

Looking at the corporate credit market beyond macro and political risk, with a bottom-up view, the market appears to provide a ton of value. Figure 4 shows that if we compare the recent spread widening for the high yield markets to the current corporate default rate we see significant value. Actually, from the beginning of 1987 until today we have rarely seen such large differences between spreads and default rates.

**Figure 4: Corporate default rates vs High Yield spreads**

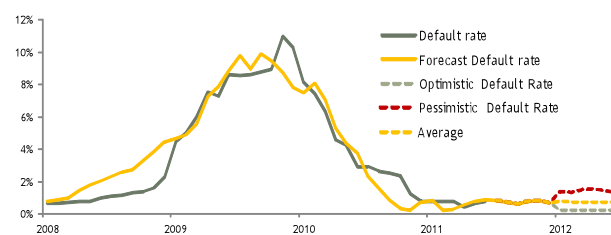


This means that corporate financial and non-financial credits at current yields contain significant risk premiums, reflecting high political event risks related to the Euro area. Should a deep economic crisis fail to materialise (in line with our expectations), the value proposition becomes powerful, particularly for European financials which have been trading close to post-Lehman lows.

## The default model

Our forecast of the future default rate fits with our view of a strong corporate sector, and suggests that the significant risk premium shown in figure 4 will not be eaten up by an increase in the corporate default rate in the near future. The model has been presented in previous letters. It forecasts the future corporate default rate as a function of macroeconomic fundamentals.

**Figure 5: The Sparinvest Value Bonds Default Rate Model**



Source: Sparinvest and JP Morgan

From Figure 5 it can be seen that the model forecasts that the corporate default rate will remain low into 2012 – a view confirmed recently by Moody's. This, together with our focus on low loan-to-value and low net-debt-to-equity, argues for buying Sparinvest High Yield Value Bonds.

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 October 2011

## Sparinvest Value Bonds-Team



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