Sparinvest

High Yield Value Bonds
Letter to Shareholders
Q3/06

Dear Investor,

General Market trends

The financial markets experienced a positive trend in the third quarter. This happened as expectations for further yield increases in the USA were toned down dramatically due to signs of a minor economic slowdown. The highest returns were produced by emerging market bonds and global equities, which are the most sensitive to tightening of the US monetary policy.

Highest credit ratings performed best in Q3

In the corporate bond market, bonds with a credit rating of BB came out on top. But year-to-date, the lowest-rated corporate bonds (B and CCC bonds) remain the highest performers, led by the two automobile producers GM and Ford. One explanation for the high returns provided by bonds from the two ailing companies, despite declining sales figures, is the possibility of a merger with the French Renault company, which boasts significantly stronger assets and a higher credit rating. However, the latest news shows no indication of a merger being in the offing.

Performance - Selected markets

All in local currency	Q3 2006	2006	2005
Merrill Lynch Global High Yield	3.42%	5.64%	5.84%
Merrill Lynch Global High Yield BB	4.13%	6.22%	6.40%
Merrill Lynch Global High Yield B	3.88%	7.33%	8.80%
Merrill Lynch Global High Yield CCC	3.68%	10.86%	10.84%
Merrill Lynch Global Investment Grade	3.40%	1.83%	2.21%
JP Morgan Emerging Markets	6.55%	5.82%	7.81%
JP Morgan Europe Govt. Bonds	3.18%	0.46%	0.35%
JP Morgan Global Govt. Bonds	2.87%	0.75%	1.06%
MSCI World	4.99%	7.99%	12.77%

The High Yield market remained underpinned by strong fundamentals. This found expression in a historically low number of failing companies. We expect the positive notes and the low number of bankruptcies to continue well into 2007, even if global growth were to slow down a little.

Portfolio performance

The third quarter yielded a return of 2.28% for the Fund. By comparison, the benchmark, Merrill Lynch Global High Yield, provided a return of 3.42%.

Performance - Fund vs. benchmark

	Q3 2006	2006	2005
Sparinvest High Yield Value Bonds	**2.28%**	**1.77%**	-
Benchmark (EUR Hedged)	3.42%	5.64%	5.84%
Benchmark Constrained (EUR Hedged)	3.13%	4.62%	5.05%

Performance affected by fraud in one of the companies in the portfolio

The Fund's negative development in the third quarter relative to the benchmark is primarily due to a fraud problem with one of the Fund's investments.

The company, Ocean Grand Ltd. (Hong Kong), which manufactures aluminium, has been the victim of in-house fraud. The case broke on July 11, when the company issued a press release saying that a financial controller in one of the company's subsidiaries had disappeared with USD 1 million. Although it was initially considered a one-off event, the stock took a 20% tumble and was suspended from trading. The company's corporate bonds also took a dive, plunging from around par to 75.

The subsequent audit revealed that the scale of the fraud was much greater. In fact, the company's entire cash holdings of around USD 110 million had vanished along with several key individuals from a number of subsidiaries. This news was released on Tuesday, 25 July, after which the company was downgraded to D. Sparinvest had complete confidence in the reported key figures from the company, which complied fully with the Fund's conservative strategy of selecting companies with a relatively low debt ratio relative to total capitalization.

ING, one of the largest banks in the Netherlands and in Europe, has organized a group of the major bond holders in order to hold the strongest possible position in negotiations with Ocean Grand's liquidators. ING and the group of bond investors have chosen the British law firm of Cadwalader to represent them. Sparinvest has also chosen representation by Cadwalader. The case is still ongoing, and the Hong Kong authorities are working on bringing the culprits to justice. There is still a chance that the stolen funds may be seized and we may get part of our investment back. How much of a chance is very difficult to quantify. The fund has chosen a conservative approach to pricing the Ocean Grand bonds, however at a price of 10, any further loss will be minimal.

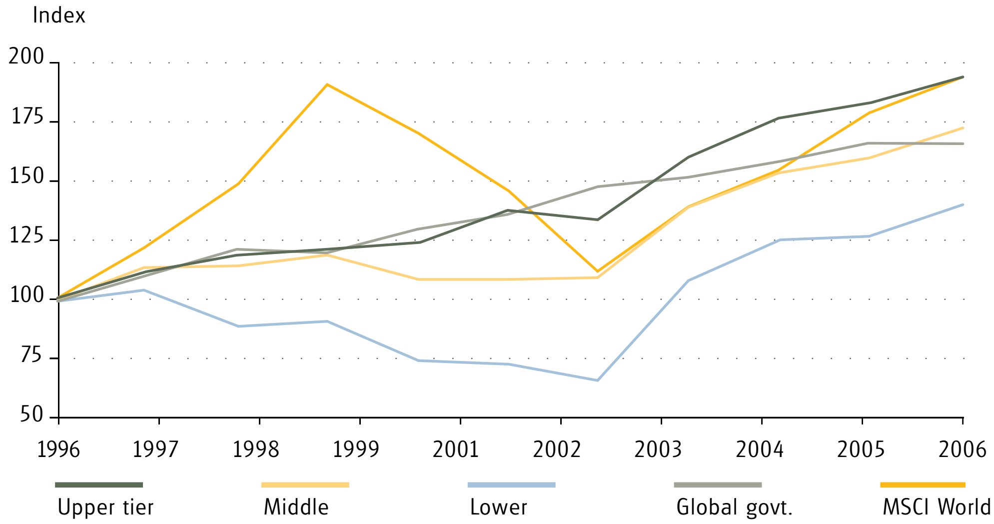
It is impossible as an investor to safeguard yourself against crime such as the Ocean Grand case. The most effective measure investors can take against fraud at a corporate level is by maintaining a diversified portfolio - our fund is therefore invested in 100 different companies.

Continued strong focus on companies with high credit ratings in the high yield market

On a year-to-date basis, the fund's relative yield is negatively affected by the Fund's decision against investing in the lowest-rated CCC companies and GM and Ford. In the long term, we are convinced that our strategy of choosing companies with 'upper tier' credit rating and relatively low risk, measured in terms of debt-to-equity ratio, will yield the most attractive risk-adjusted returns. This view is supported by the below figure, illustrating the development of various asset classes over the past ten years.

The figure shows that a DKK 100 investment in the categories 'upper tier' (covering companies with a BB credit rating) and MSCI World (a global equity index) have yielded the highest returns over the period - for those two asset classes, the investment has grown to almost DKK 200 since 1996. Upper tier corporate bonds outperformed global equities in terms of risk-adjusted return over the period, as the development of total assets in this category was less volatile. The figure also shows that the 'lower tier' category (covering companies with a lower-tier credit rating – CCC) performed the least well in the long term. This is due to the fact that investors in the long term are not compensated sufficiently for buying higher-risk corporate bonds. Our Fund focuses on companies with the highest credit rating in the high yield market.

Market performance



Portfolio statistics

The fund has a higher effective interest rate than the benchmark, despite a higher average rating of the fund's investments, BB for the fund, against BB- for the benchmark. The slightly higher effective interest rate is partially explained by the fund's higher interest-rate sensitivity than the benchmark's.

Another important part of the explanation is that the fund invests utilizing value parameters – i.e. in smaller, less expensively-priced companies.

Portfolio figures - High Yield Value Bonds		
	Fund	Benchmark
Duration	5.29	4.49
Yield	8.1%	8.0%
Rating	BB	BB-
# Issues	100	2058

Portfolio remains economical measured by key figures

Like credit ratings, a glance at the fundamental key financial figures also indicates that the fund generally focuses on more solid companies than is the case with the benchmark. The table below shows that the fund's companies on average have net debt to equity (NDE) ratios of 70.96%. The same ratio for the benchmark is 348.88%. Taking account of the interest cover (earnings relative to interest expenses), the fund's companies on average have earnings that are 4.18 times higher than their interest expenses. For the companies in the benchmark the same ratio is just 2.43. The credit rating (NDE) and the company's ability to service its debt therefore clearly indicate that the fund's companies are more solid (on average). As we also saw in the above table, the fund has a higher effective interest rate than the benchmark. It can thus be said that in the longer term the fund has a higher expected yield than the benchmark and at the same time a lower level of assessed risk (of bankruptcy). This is possible because the fund utilizes value parameters.

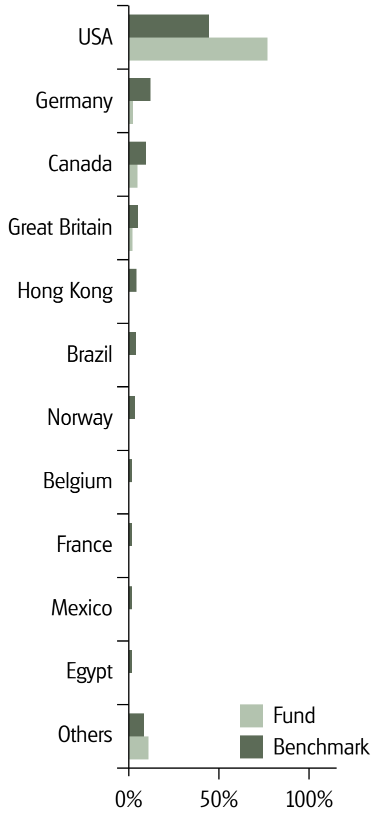
The fund is usually invested in small companies which are priced less expensively, as measured by their price relative to equity (price to book) (P/B), and which have a lower net debt to equity (NDE). The risk of losses should therefore be lower, all other things being equal, than for broad investment in the high-yield bond market.

Portfolio figures - High Yield Value Bonds		
Financials	Fund	Benchmark
Market cap. (mia $)	3,695	6,370
NDE	70.96	348.88
P/B	1.62	3.89
Interest Cover	4.18	2.43

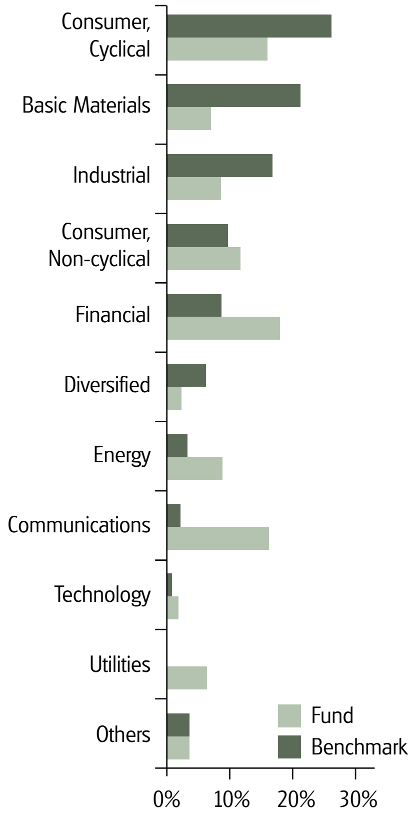
The fund's categorization by country and sector can be seen in the below figures. Like our associated fund Value Aktier, the fund has a major underweighting of US bonds and an overweighting of German bonds. The fund has a relatively large exposure to the Materials sector - including in particular the steel industry, in which the fund has made a large investment in the British company Corus, which in many ways is an attractive candidate for a takeover bid.

Unlike the benchmark, the fund has made few investments in Telecommunications due to the high debt to equity ratio of companies in this sector.

Geographic exposure



Sector exposure



Japanese corporate bonds remain very expensive

Compared with the associated fund Value Aktier, the fund has no exposure to Japanese companies. This is related to the fact that Japanese corporate bonds are still very expensive.

The fund's largest holding is the German Linde AG which, after the acquisition of the British BOC, is among the absolute world leaders in industrial gasses. After Linde comes the European chemical and refinery group Ineos. The company Landry's Restaurants is now among the Fund's top-ten holdings. What is attractive about the two restaurant chains Landry's and O'Charley's - from a value perspective - is that, in addition to being well-run businesses with stable earnings, they also possess real estate. In fact, the values of the two companies' real estate are large enough to cover their debts in principle. This increases the security of our investments.

Major holdings - Selected markets			
Holding	Country	Sector	Pct.
Linde Fin. 7.375% (Tv) 06-14.7.66	Netherlands	Materials	4.0%
Ineos Group 7.875% 06-16 Reg.	Great Britain	Materials	2.8%
Agco 6.875% 04-15.4.14	USA	Industrials	2.6%
Hornbach Bau 6.125% 04-14 Regs	Germany	Consumer Discretionary	2.6%
Corus 7.5% 04-1.10.11 Senior	Great Britain	Materials	2.5%
Solvay Fin. 6.375% 06-2.6.2104	Netherlands	Materials	2.3%
O Charleys 9% 04-01.11.13	USA	Consumer Discretionary	2.2%
Aker 8% 05-2.03.12	Norway	Energy	2.1%
Fresenius Fin. 5.5% 06-16 Reg.S	Netherlands	Health Care	2.0%
Landry S Rest. 7.5% 04-15.12.14	USA	Consumer Discretionary	1.9%

Portfolio transactions

In the third quarter, we made a number of new purchases, and we sold holdings in those companies where our expectations had been met.

New holdings in the portfolio

Linde AG

Linde AG is among the world's leading companies in industrial gasses. Linde also produces machines such as fork-lift trucks etc., although this business is expected to be sold off as soon as possible to reduce the company's debt. The gas business is a very stable earner. The fund purchased its first holding of Linde bonds in June at a price corresponding to a yield of 3.35% above the government yield. The bonds are currently trading at a price corresponding to a yield of 2.6% above the government yield, which means that the credit premium has been narrowed by 0.75%, equaling a return of 6.5% for the period.

US Concrete

The no. 6 concrete producer in the USA with a market share of 1.3%, US Concrete has 3,150 employees and operates in 11 US states. US Concrete has a diversified business, looking at the purchasers of the company's products. 45% is used for private construction, 40% for commercial construction and 15% is purchased by the public sector. The company has felt of a slowdown in the private construction market, which has been countered by increased commercial construction activity. US Concrete trades at a low P/B and its gearing is low. The company is an obvious candidate for a takeover bid.

Petrohawk
US oil and gas company trading at a low P/B, with stable earnings and good prospects of lowering its debt, looking forward.

Holdings sold

During the third quarter, the Fund sold off several companies which had met our expectations. They are: Houston Exploration, Wolverine Tube, Rexel, Gamestop and Goldkist.

Best regards,

Sparinvest Holding A/S
Klaus Blaabjerg & Thomas Bjørn Jensen
October 10th, 2006

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