

High Yield Value Bonds Letter to Shareholders Q3/07

Summary

Continued instability in the US sub-prime mortgage market

The aftermath of the sub-prime crisis

Market trends

In our last quarterly letter we talked about strong global growth, but also about the troubles in the US housing market representing a potential threat to continued growth. Our conclusion was that the US economy was witnessing a kind of “trench warfare” between the various sectors of the economy – with the housing sector dragging the economy down on the one side and the “other sectors” pulling it up on the other. At the onset of the third quarter, the “other sectors” looked strong enough to resist the pressure, provided that house and equity prices did not drop significantly. ■

The various sectors of the US economy dug the trenches even deeper during the third quarter. The number of non-performing sub-prime loans continued to rise and this, combined with the investment banks’ difficulties in placing loans on their books taken out during the second quarter, contributed to a global financial crisis comparable to that of 1998. The credit spread for subordinate financial capital during the third quarter rose to levels not seen since 2002/03, when the number of defaults globally was much higher than what we are seeing today.

The financial crisis has claimed its victims – principally in Europe, where it was least expected. IKB (German bank) and Northern Rock (UK bank) would both have collapsed, were it not for central bank intervention. Central banks, headed by the FED and ECB, have made available hundreds of billions of US dollars and euros respectively, to cover the cash requirements of the global financial system. In addition, the FED has cut interest rates. The US rate cut, and the fact that no more banks look set to collapse, has led to a gradual normalization of the global financial system – resulting in sharply increasing equity prices in August and the beginning of September. According to monetary policy wisdom, the FED should cut rates further going forward. ■

Unfortunately, the troubles in the US housing market are not over. In fact, the financial crisis has further added to the problems as credit standards were tightened further during the third quarter. Tighter credit standards and the unusually large number of unsold properties have caused US house prices to drop. Certain regions have experienced price drops well in excess of 5%. This is confirmed at a micro level, as US contractors have lowered prices by 10-30% in an attempt to clear their stocks.

In view of the large proportion of total US wealth tied up in the housing stock, one would expect to see a certain decline in US consumer spending, in line with the drop in house prices. This correlation was modeled by the FED. Their calculation indicates that, given the development in the housing market and the expected developments in income and interest rates, consumption as a share of disposable income is set for a slide of at least two percentage points. Rising US equity prices (S&P 500 +10% year-to-date) are having a counterbalancing, positive effect on consumer spending. Precisely how much US consumer spending will fall is difficult to predict at this point however.

The main reason we do not foresee a hard landing for the US economy is that the export sector seems to have gathered momentum, supported by a weaker US dollar rate, which will have a positive impact on US economic growth going forward. At a micro level, this

A positive note for Germany

development is supported by the equity market, where US companies with a global reach are still producing earnings growth.

In the long term, the current situation of moderately declining domestic demand in the form of lower consumer spending and increased foreign demand can be said to have a stabilizing effect on the US economy, which has been completely off balance for some years – as manifested by major trade deficits. In fact, the US trade deficits have been so great that they have been considered a potential threat to the stability of the financial system. In other words, this threat has been reduced. ■

Outside the USA, the economies in Asia and certain parts of Europe remain strong. Once again, the huge improvement in Germany is noteworthy. German competitiveness has improved dramatically in line with the sharp decline in German unit labour costs. This, combined with the favourable sales opportunities for German companies (particularly in Asia), has led to increased German employment.

At the corporate level, positive notes are heard from German companies. They report fair growth levels and full order books, because while US growth has declined, growth in China and India has so far proven more than sufficient to compensate for this.

In the financial markets, government bonds demonstrated the best performance in the third quarter, which was not surprising in light of the financial crisis. Emerging markets came through the financial crisis surprisingly well – which would seem to indicate that this asset class has changed status and is now considered less risky than before.

In the high-yield segment, the highest-rated BB bonds provided the highest returns. However, the lowest-rated CCC bonds made a strong comeback, in line with the more positive equity markets. The returns on CCC rated bonds have remained the highest in the high-yield segment year-to-date.

Performance - Selected markets			
All in local currency	Q3 2007	2007	2006
Merrill Lynch Global High Yield	-0.31%	1.86%	9.43%
Merrill Lynch Global High Yield BB	0.85%	2.36%	9.86%
Merrill Lynch Global High Yield B	0.16%	3.34%	11.59%
Merrill Lynch Global High Yield CCC	-2.20%	3.39%	18.03%
Merrill Lynch Global Investment Grade	1.32%	1.39%	2.64%
JP Morgan Emerging Markets	2.58%	3.54%	9.88%
JP Morgan Europe Govt. Bonds	2.33%	0.13%	0.08%
JP Morgan Global Govt. Bonds	2.64%	1.84%	0.81%
MSCI World	-0.20%	7.96%	15.55%

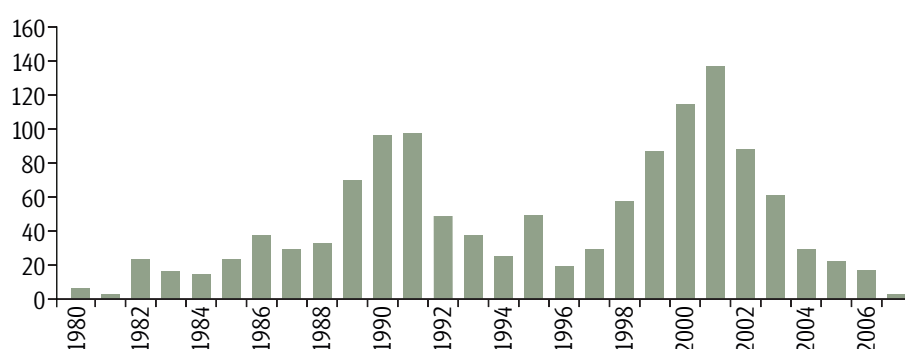
Looking ahead, what can we expect from the credit market?

First of all, it is important to note that the widening of credit spreads has occurred despite relatively stable equity markets (the MSCI World Index is down just 0.2% on the quarter). This means that corporate earnings expectations are intact, despite the sub-prime crisis. In Europe in particular, the ability of high yield companies to service their debt remains high. Whereas back in 1999-2000, companies obtained funding predominantly through short-term debt (thereby significantly increasing the refinancing risk), many companies have

spent recent years focusing on active debt management – settling short-term debt and issuing long-term debt. This has greatly reduced the risk of a sudden surge of defaults due to refinancing problems.

Based on these factors, there appears to be no reason to fear a markedly higher default rate in the short to medium term – assuming, of course, that we do not experience a global recession, which we do not expect. ■

Global default 1980-2007



Source: Moody's

Portfolio returns

The third quarter yielded a negative return of 2% for the fund. By comparison, the benchmark, Merrill Lynch Global High Yield, provided a negative return of 0.3%.

Performance - Fund vs. benchmark

	2007	Month	Q3 2007
Sparinvest High Yield Value Bonds	0.32%	1.68%	-2.03%
Benchmark (EUR Hedged)	1.86%	2.21%	-0.31%

The fund's lower return relative to the benchmark is due to its focus on small companies and Europe.

Portfolio statistics

The Fund has an effective yield of 9.5%, which is 0.7% higher than the benchmark. The fund's yield sensitivity is marginally higher than the benchmark and its average credit rating the same. However, the fund remains underweight in CCC credits.

Portfolio figures - High Yield Value Bonds

	Fund	Benchmark
Duration	4.98	4.68
Yield	9.5%	8.8%
Rating	B+	B+
# Issues	109	208

**Portfolio remains economical
measured by key figures**

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Net-debt-to-equity reduced in the second quarter

A glance at the fundamental key financial figures indicates that the fund generally focuses on more solid companies than the benchmark does. The table below shows that the Fund's companies, on average, have net-debt-to-equity (NDE) ratios of 66%. The same ratio for the benchmark is 391%. In terms of the interest cover (earnings relative to interest expenses), the fund's companies, on average, have earnings that are 4.42 times higher than their interest expenses. For companies in the benchmark, the same ratio is just 2.63. An overall look at NDE ratio and the companies' earnings relative to interest expenses therefore indicates that the fund's companies are more solid, on average, than the market in general.

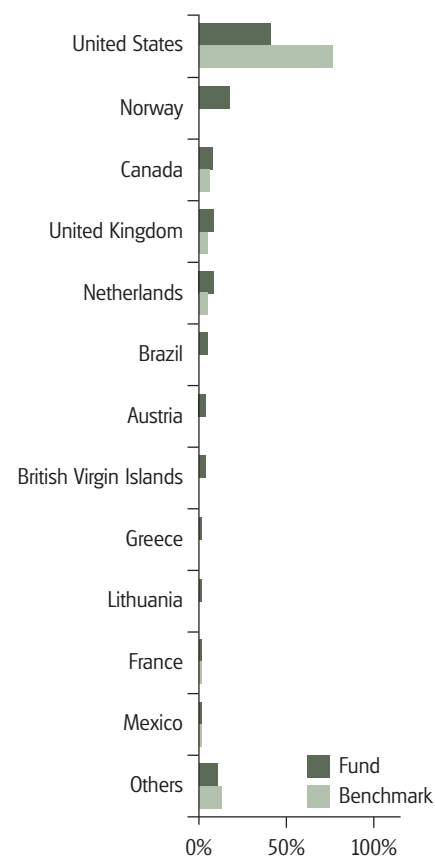
The fund is also invested according to the classical value parameters, i.e. in small companies which are priced less expensively as measured by price-to-book (P/B).

Portfolio figures - High Yield Value Bonds		
Financials	Fund	Benchmark
Market cap. (bln \$)	2.831	6.573
NDE	65.58	391.00
P/B	1.96	5.00
Interest Cover	4.42	2.63

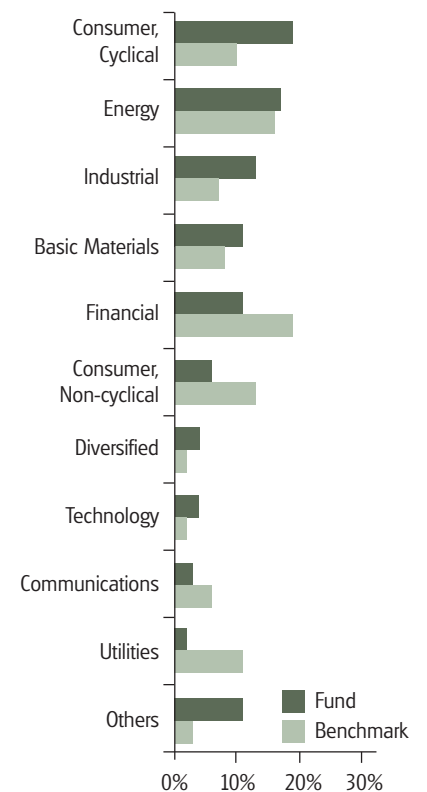
The fund is underweight in the USA and overweight in Europe, particularly Norway.

The fund's categorization by country and sector can be seen in the figures below. The fund remains underweight in the USA and overweight in Europe – particularly Norway.

Geographic exposure



Sector exposure



The fund has relatively large exposures to the Materials, Industrial and Energy sectors. The fund is underweight relative to the benchmark in Telecommunications, Consumer non-cyclical, Financial and Utilities.

The fund's largest holding is still the British company Ineos. The holding of Linde AG and TUI AG bonds has been reduced, as the targets for these two companies were reached. ■

Major holdings - High Yield Value Bonds

Holding	Country	Sector	Pct.
Ineos Group 7,875% 06-16 Reg.	United Kingdom	Materials	4.5%
Norske Skogind 7% 07-26.6.17	Norway	Materials	3.7%
Nxp Bv/Nxp Fd 8.625% 07-15-Wi-	Netherlands	Information Technology	3.6%
Norw. Energy Co 11% 07-13.7.10	Norway	Energy	3.2%
Landry S Rest. 7.5% 04-15.12.14	United States	Consumer Discretionary	2.3%
Chesapeake 6,25% 06-15.1.2017	United States	Energy	2.2%
Sinvest 9,5% 05-22.12.09	Norway	Energy	2.1%
Htm Sport&Freiz. 8.5% 04-14 Reg	Austria	Consumer Staples	2.0%
Agco 6,875% 04-15.4.14	United States	Industrial	1.9%
Firestone Hld 10.125% 06-16 Wi	United States	Information Technology	1.9%

Portfolio transactions

Perry Ellis

Perry Ellis is a US clothing company with a large portfolio of brands. The best known brand is PING, which produces golf clothes. Perry Ellis is inexpensive as measured by price-to-book and an interesting prospect for credit investors as the company has reduced its debt in the past few years. In 2003, Perry Ellis' debt-to-equity ratio was approximately 200%, whereas last quarter it was down to 61%! Furthermore, the yield on Perry Ellis bonds is approximately 9%. ■

Best regards

Sparinvest Asset Management A/S
Klaus Blaabjerg
9 October 2007

New name in the portfolio

Notes

Notes

The mentioned sub-fund is part of Sparinvest SICAV, a Luxembourg-based, open-ended investment company. For further information we refer to the full and/or simplified prospectus and the current annual / semi-annual report of Sparinvest SICAV which can be obtained free of charge at the offices of Sparinvest or of appointed distributors together with the initial statutes of the funds and any subsequent changes to such statutes. Investments are only made on the basis of these documents. Past performance is no guarantee of future returns. Investors may not get back the full amount invested. Investments may be subject to foreign exchange risks. The investor bears a higher risk for investments into emerging markets. The indicated performance is calculated Net Asset Value to Net Asset Value in the fund's base currency, without consideration of subscription or redemption fees. The funds' representative and paying agent in Switzerland is RBC Dexia Investor Services Bank S.A., Esch-sur-Alzette, Zürich branch, Badenerstrasse 567, P.O. Box 101, CH-8066 Zürich. Published by Sparinvest, 28, Boulevard Royal, L-2449 Luxembourg.