

Update on our Value equity funds

Long term investing – in a short term world

Our constant objective at Sparinvest is to spare our investors from loss of capital. Occasionally, however, there are periods of extreme turbulence in global equity markets which will inevitably have impact on the entire universe of global equity funds - regardless of the investment style that they follow.

In recent weeks, the performance of our equity funds has been adversely affected by the fall-out from the US sub-prime lending crisis. So, at a time when some of our investors may have experienced short-term loss of capital, we feel it is important for us to share with you the reasons why we remain confident about the future; confident about our abilities to deliver superior long-term performance and, above all, confident about our value investment strategy.

What is Value Investing? A Quick Reminder

To put it simply, value shares are cheap shares. For Sparinvest, true value exists only in those companies whose shares are trading at a discount of a minimum of 40% when we enter a new investment, compared to their intrinsic value.

Although value investing is an old idea (it originated with Benjamin Graham in 1930s America), it continues to generate excess returns. Academic studies by Fama & French have confirmed that the investor who buys cheap shares in a neglected company is likely to be better rewarded for the risk he takes than one who buys shares in the 'must have' trend-setting, top-performing company of the moment - the one that every other investor also wants to own a part of.

Looking at it logically, it is easy to see that there is more downside risk from an investment in a company whose share price has been buoyed up by a 'bubble effect' than there is with a company whose share price is already so depressed that it no longer accurately reflects the financial robustness of the issuing company. That is why value shares offer a 'margin of safety' against capital loss.

At Sparinvest, we have been committed value investors for a decade now and over this time, we have experienced periods of significant market volatility. On each occasion, we have had reason to be grateful for our 'margin of safety' and our experience to date has been that value companies are often the main beneficiaries of a wholesale market reappraisal of business fundamentals.

As an independent investment house, Sparinvest is also committed to a policy of continuously reviewing academic evidence, looking for ways to improve our investment strategies.

The Academic Evidence Strongly Supports Value.

At a Sparinvest conference last week, we were pleased to hear from Professor Dr. Thorsten Hens of Zurich University that as many as 179 separate academic studies had all confirmed the superiority of the value approach for delivering excess returns throughout most of the world's equity markets. So why do investors opt for any other method? As an expert in behavioural finance, Professor Hens identified three principal reasons why

people behave irrationally when it comes to equity investment. He named them as: 'myopia' (a short-term attitude that fails to give undervalued companies time to perform); 'attention bias' (where market participants and media commentators display greater interest in the stocks where all the short-term action is happening); and 'market pressure' (the overwhelming need to obey the herding instinct rather than taking an individual path).

Value investing works because it exploits a 'psychological failure' in the market whereby investors need to see short-term results and consequently everyone invests in the stocks where the momentum is already happening. Meanwhile the prices of the unpopular stocks (the ones that Sparinvest finds interesting) fall. This creates an opportunity for us to identify the long-term winning stocks of the future, knowing that - eventually - the market will detect the fundamental worth of an undervalued company and buy it until its share price returns to a level that reflects its intrinsic value more accurately.

How Do Turbulent Markets Affect Our Investment Process?

Our process is designed to uncover value wherever it may exist in the world and market turbulence is no barrier to this process. In fact, the opposite is the case because falling share prices usually result in a greater number of companies falling into our 'value basket', giving us a wider range of investment opportunities to consider and deepening the discounts available on shares in companies we consider to be fundamentally robust. We may also begin to see a geographical shift if we find value emerging in markets that we would formerly have considered to be overly expensive.

Despite the negative performance that you have seen recently in the value funds, we would like to reassure you that we remain convinced about fundamental business cases behind the selection of the core holdings in our existing portfolios. The companies we are invested in still have good, sound balance sheets and there is no reason why they will not continue to perform well when a sensible equilibrium returns to the markets.

The current market scenario has opened up a number of very interesting investment opportunities for us to explore. Although we cannot go into any detail until we have completed our analysis and buying processes, we will, of course, keep you informed in future updates.

Meanwhile we urge you to trust in the academically proven strategy for longer term equity investment - value.