Sparinvest

Value Bonds

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Our Value Bonds 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
Institutional Corporate Value Bonds	LU0760185370
Investment Grade Value Bonds	LU0264925727

Detailed information is available on sparinvest.eu

- sparinvest.eu

Dear investor,

A Quick Recap of 2013

The Value Bonds year in fund numbers

Fund Name	Fund*	Index	Diff.
High Yield Value Bonds	7.5%	6.8%	0.7%
Ethical High Yield VB	7.9%	6.8%	1.1%
EM Corp. Value Bonds	0.4%	-0.8%	1.2%
Corp. Value Bonds*	2.8%	0.1%	2.7%
IG Value Bonds	5.3%	-0.2%	5.5%

*Fund performance is shown net of fees

It was a year in which, despite taper madness, the Eurozone Cyprus banking bail-out and a summer sell-off in Emerging Markets, credit markets delivered performances that were closer to historical asset class averages than we have seen for some years. Sparinvest Value Bonds funds ended 2013 comfortably ahead of their respective indices. This is attributable to active management, exploiting value factors in small and off-benchmark issues, default avoidance through our focus on low loan-to-value issues and buying into Investment Grade at ‘panic prices’, especially over summer.

A ‘Carry-Friendly’ World in 2014

We expect 2014 to be a ‘carry-friendly’ year for credit markets, featuring better growth in developed markets with inflation remaining low. The expected growth/inflation combination will keep monetary policy accommodative and underpin continuing low volatility in the credit and stock markets. Given the expectation of low volatility, we believe credits are still attractive compared to government bonds with expected returns for IG and HY close to current yields.

With spreads roughly at fair value, we believe the opportunities for 2014 lie in following relative value themes:

- Financials from developed markets are still the place to be in terms of underlying balance sheet improvement. The process of improving balance sheets and lowering credit risk has gone a long way for Banks, but still has further to go. This will be driven primarily by regulatory changes (Basel III and ECB supervision) but also by better growth in developed markets. As a caveat we think Danish Banks look underappreciated in this respect. We believe the continuing relative improvement of fundamentals amongst Financial corporates will lead to their continued outperformance against Non-Financial companies.
- Bonds from smaller companies whose issues are either not big or not present in the credit indices/benchmarks still represent a good opportunity to earn higher carry than household benchmark names. This of course comes with liquidity risk. (Historically we have been good handling this lower liquidity from small caps). In particular we find Small Caps from the Energy Sector interesting. (For more on liquidity premia see below.)
- Finally, within Non-Financial companies we see value in cyclical laggards with low Loan-to-Value, such as some Industrial Metals and Miners. A common theme for these companies is that they would benefit from a stronger US Dollar – having operational costs in currencies that stand to weaken against the US Dollar.

Risks to Credit Markets in 2014

We see three main risks to credit markets in 2014 as follows:

- The biggest risk to credit markets is a **hard landing in China** following years of too rapid credit growth. We do believe that the government of China is aware of the risks here, but the consequences of a hard landing in China could be very negative to global growth and demand for commodities.
- **Rising interest rates**. To many investors, rising rates is the main risk factor in credit markets. We don't fully agree. In the US, QE is ending because of a return to a sustainable recovery. However, an end to QE does not mean tight monetary policy.

  We believe that unless and until **inflation** expectations shift markedly upwards, the FED will maintain a very accommodative stance. This interpretation of future FED behavior definitely fits well with the appointment of Janet Yellen as the successor to Ben Bernanke (Chairman of the Federal Reserve until Jan 31 2014). Rate hikes in Europe are even further away than in the US. If anything, the European Central Bank should be even more accommod-ative and do more to fight fragmentation in the European financial system. It needs to act to prevent European inflation rates – now at 0.7% - from falling further. Bottom-line: Monetary policy in developed economies will stay accommodative for 'as far as the eye can see', because there is no reason to believe the real economy is about to inflate meaningfully when looking at all the spare capacity out there. **If** rates were to sell off fast with inflation remaining low, then we actually believe rising rates could present more of a buying opportunity – probably most notably for US credits. Irrespective of everything said above about not being (too) nervous about rising rates, we do actively try to have as low a duration as possible in the funds that we manage. Hence in the Sparinvest High Yield Value Bonds and Emerging Markets Corporate Value Bonds we have significant weights in Floating Rate Notes – bonds that pay a floating-rate coupon but with a fixed credit premium. These bonds will pay higher coupons should short rates start to rise.
- **Re-leveraging of companies**. As the economic recovery in the developed markets gains traction, and companies start to believe that it is for real, we can expect company management to begin to adopt a more aggressive stance in terms of chasing opportunities and trying to please shareholders (now used to double digit returns). It will most surely be the development of this type of behavior that will set us up for the next 'downturn' in credit markets and spike in defaults. The good thing is that this will take

some years to play out. And investors can actually do lot here to mitigate this risk by focusing their investments on companies that are in the process of reducing debt – Financials being one example.

Liquidity Premia are Attractive

By any measure, credit markets are less liquid than before the financial crisis started. The financial press has repeatedly highlighted the argument that regulatory changes have curtailed dealers' abilities to take risks and thus severely reduced liquidity in the corporate bond markets. We agree that market liquidity remains worse than it was in the pre-crisis years.

We see two primary drivers of this overall deterioration in liquidity. First, the volatile risk-on/risk-off trading environment, which has been dominant over the last several years, tends to create one-way trading flows, with many customers wanting to buy or sell at the same time. This crowding makes it difficult for dealers to supply liquidity without taking significant risks. The elevated risk premium that investors have demanded from financial sector borrowers has also raised dealers' costs of funding their inventories and hindered their ability to supply liquidity.

Second, we think regulatory changes have also made it more costly for dealers to hold inventory. Data from the Fed's weekly survey of primary dealers appear to show a 40% decline in net dealer positions in 'corporate securities' from their peak in 2007 to April 2013.

Given this scarcity of liquidity, it is no surprise that we find its 'price' is high. One can measure the spread premium on illiquid bonds by regressing bonds' spreads-to-Treasury on proxies for liquidity, controlling for other bond characteristics (like ratings and sectors) so that a clean comparison between liquid and illiquid bonds can be made. The regression results in a summary measure of the 'liquidity premium' (i.e. the pickup in spread that would be available to investors willing to switch from the most liquid to the least liquid bonds holding other bond characteristics constant). Estimates suggest that the liquidity premium was close to zero in the pre-crisis years, and then it rose dramatically around the financial crisis. From mid-2009 to late 2011, the premium generally drifted down, before rising again during 2012 and remaining elevated through most of 2013.

We think this historically high level of the liquidity premium presents an opportunity to pick up additional spread for investors who are in a position to take liquidity risk as we believe the premium will compress as macro risks recede.

Lagging Cyclicals that will Benefit from a Stronger US$

In line with consensus estimates, we expect the US Dollar to appreciate against a number of currencies. In particular, we expect the US Dollar to appreciate meaningfully compared to BRL and SEK. This has potential implications for the companies we invest in, even though the funds are hedging outright currency exposures. One example is Marfrig from Brazil. Marfrig processes beef, pork, lamb, and poultry and produces frozen vegetables, canned meats, fish, ready meals, and pasta. Marfrig operates in South America, the United States, Europe and Asia. Marfrig's costs are predominantly in Brazilian Real, whereas earnings are in US Dollars. We expect demand for Marfrig products to be strong in 2014, helped perhaps by a weakening of the BRL. A weaker BRL should also improve margins of Marfrig. The Marfrig 11.25% 2021 bond is rated B by the major rating agencies and is currently trading around a price of 97 implying a yield of around 12%. That, we believe, is an interesting bond.

Forecast Default Activity for 2014

Conditions are ripe for an extension of the past four years' low default activity. Given our constructive view on fundamentals for the high yield asset class we are forecasting a 2% default rate for high-yield bonds through **2015**, which remains considerably below the long-term average of 4.0%. According to current market expectations, this should be around the same time investors are finally confronting the first hike to the Fed Funds rate, for some perspective. Low rates between now and then should keep demand for high yield strong, access to capital high, and at least the probability of a recession low (the ultimate determinant for when the default cycle turns).

Global default rates will stay at around 2%, helped by higher growth, still low volatility and **proactive behaviour from businesses during the last couple of years** in terms of refinancing short-term debt. This focus by companies on enhancing liquidity and terming out maturities has left only $149bn of HY bonds and loans to come due between now and the beginning of 2016, a figure down from $412bn last June! Another way to look at this is to monitor the proportion of bonds with maximum 3 years to maturity to the total amount outstanding. From the table below you can see that short-term debt as a proportion of total debt has fallen fast in the last couple of years.

	2-yr maturity window as % of outstanding	Amount due US$ bn	3-yr maturity Window as % outstanding	Amount due US$ bn
4Q13	7.2%	103	13.3%	187
4Q12	7.3%	93	15.9%	201
4Q11	7.5%	89	14.6%	173
4Q10	9.2%	103	16.1%	180
4Q09	11.9%	98	21.8%	170

Source = Markit

To summarize, we expect this asset class to continue to perform an extremely useful role in balanced portfolios during 2014.

We anticipate that investors will be paid for taking liquidity risk and believe in cyclicals as the recovery takes hold.

Yours faithfully,

Klaus Blaabjerg
Chief Portfolio Manager
8 January 2014

Key Numbers Sparinvest Value Bond Funds

Key numbers for Sparinvest Value Bond funds	High Yield Value Bonds	Emerging Markets Value Bonds	Corporate Value Bonds	Investment Grade Value Bonds
Yield to Maturity	11.05%	8.17%	5.48%	4.63%
Duration	3.2	3.45	3.86	4.18
Average NDE	105.12%	71.7%	103.99%	47.63%
Avg. Interest Coverage	3.49x	6.82x	5.99x	17.39x
Average Price-to Book	0.9x	1.39x	2.09x	3.41x
Default activity Y2013	0.25%	1.32%	0.1%	0%

Sparinvest Value Bonds-Team

From left to right:

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