



Value Bonds

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High Yield Value Bonds

Dear Investor

The credit market made steady progress during the second quarter as increasing optimism and liquidity led to an increase in bond prices. We ended our last letter to investors by stating that we would stick to our investment strategy and that we found the portfolio cheaper than ever. Almost immediately after the quarter ended, the market caught up with us and the situation changed completely from one where no-one wanted to hold the bonds issued by small companies with low price/book ratios (ie. the bonds matching our value-investment strategy) to one where these were exactly the type of bonds that were strongly in demand.

We still find our portfolio cheap – in spite of the increasing bond prices – especially when you take the companies' strong balance sheets into account. At present the portfolio has an yield to maturity of 15.5%.

Reduction in total debt

The global financial crisis has led to a significant drop in company sales figures over the last couple of quarters and sales continue to be well below their pre-crisis levels. As is to be expected, companies have tried to compensate for their loss of sales by reducing staff, inventories, and production. In addition, many companies have used the last quarter to improve their creditworthiness by issuing stocks and/or buying back corporate bonds. Such initiatives are all grist to the credit investors' mill since they mitigate the risk of companies being unable to honour their debt.

Many of the companies in Sparinvest High Yield Value Bonds have also taken the opportunity to improve their balance sheets by issuing stocks and/or buying back debt.

For instance,

- Brigham Exploration – an American energy company – issued stocks and bought back debt for \$35 million.
- Allis-Chalmers expects to reduce total debt by as much as \$120 million, which significantly improves their balance-sheet.
- Petroquest Energy is planning an issue of 10 million new stocks worth \$35 million.

Sparinvest High Yield Value Bonds remains focused on firms with strong balance-sheets. This increases the security of our investments in periods with declining sales.

Energy sector

Despite the increasing focus on renewable energy, the Chinese government expects that their country's demand for oil in 2020 will be equivalent to US consumption in 2007. Therefore, China seeks to secure its future energy supply by acquiring oil reserves in regions like the Middle East and Africa.

For instance, the second largest Chinese oil company bought Addax Petroleum Corp. Addax was the first of two companies to be granted a license to export oil from Kurdistan. The other, Norwegian oil company, DNO, expects oil production levels of around 50,000 barrels per day.

We anticipate that one, or more, of the oil companies in our portfolio will be part of the consolidation in the energy sector – including DNO.

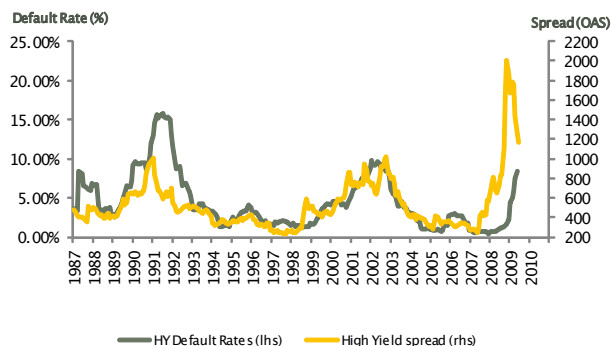
The banking sector

We used the last quarter to increase our exposure to the banking sector by investing in large European Banks with solid capital reserves. At the end of the quarter the portfolio has a market-neutral exposure to the sector.

Among others, we invested in Fortis Bank – today owned by BNP Paribas and the Belgian State. The characteristic of the bond ensures that if Fortis chooses not to buy back the bonds at a predetermined date, the bondholders have the right to force Fortis to issue new stocks and use the proceeds from the stock issue to buy back bonds.

Increasing pace in corporate defaults

The present economic slowdown is likely to result in an increasing number of companies being unable to honour their debt obligations. Historically, the credit spread has tracked the default rate, with only slight and temporary deviations. However, this relationship collapsed in mid-2007 when the credit spread increased significantly – because of the economic uncertainty and low liquidity – while the default rate stayed at a very low level.



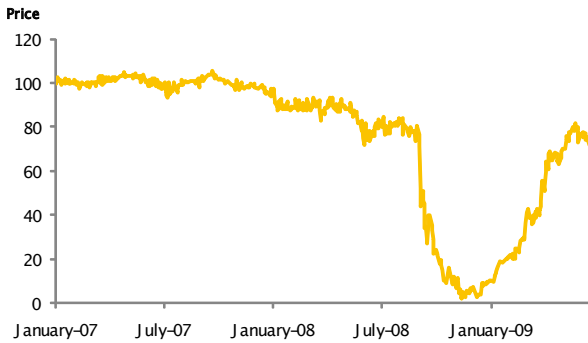
Since December 2008, the credit spread has tightened as liquidity returned to the credit market. Also the default rate has started to rise as a consequence of the economic slowdown.

The global high-yield market has also been hit by a number of defaults. In the second quarter alone, bonds worth \$31 billion – distributed among 22 companies – defaulted. The default by General Motors affected bonds worth around \$12 billion, making it the third largest default year-to-date with Charter Communications (\$ 19 billion) and Lyondell Chemicals (\$ 17 billion) even bigger.

We anticipate an increasing default rate until the slowdown in the global economy turns to growth. This increases the importance for investors in credit bonds to focus on the companies' asset value and thereby minimize the potential loss in case of default.

One of the largest defaults happened during the spring when the American carmaker, General Motors, stopped paying interest and repayments on the huge amount of debt that it had built up in the last couple of years. It is expected that it will take quite some time before the reconstruction is fully finalized, but the credit market expects a recovery on the corporate bonds in the area of 12.5% of the principal. The low expected recovery reflects the fact that the assets of the company are of much lower value than the value of the total debt. General Motors is not considered as a value-company and Sparinvest High Yield Value Bonds did not have any exposure to it. In fact, General Motors represents the precise opposite of a value-bond company.

Another bankrupt company is one of the biggest chicken producers in the world – Pilgrim's Pride. Historically, the company has operated with a strong balance-sheet and low net-debt-to-equity.



At the end of 2008, the company filed for bankruptcy because an unfortunate coincidence whereby Pilgrim's Pride bought another company just as the credit market turned to ice and, at the same time, suffered a downturn in earnings. In other words, the company became a victim of the credit crisis.

Just after the bankruptcy petition, the credit market expected a low recovery on Pilgrim's Pride bonds. The market became better informed, however, as the values of the corporate assets were evaluated. Furthermore, the company is today operating with positive income.

Pilgrim's Pride is a typical value-company that, despite the economic difficulties, still had assets that would minimize the loss for the bondholders in case of default. Today its bonds trade as though the company had never defaulted.

Sparinvest High Yield Value Bonds had no defaults in the second quarter of 2009 and we sustain our value-approach by investing in companies with strong balance-sheets.

Summary

The long-term investment strategy, together with our persistent focus on the companies' balance-sheets, had a positive impact on our performance in the last quarter. The global economic slowdown caused more firms to adjust the net-debt-to-equity ratio by issuing stocks and/or reducing total debt. All in all, we find these initiatives positive for bondholders as less debt means less risk of debt default.

Furthermore, the global economic crisis is still present and whilst we expect a moderate rise in the number of defaults during the second half of 2009 – we don't expect any material defaults in our portfolio. Hence, we feel that the portfolio's yield to maturity of more than 15% continue to offer attractive expected returns going forward. We have confidence in our value-approach whereby we focus on companies' refinancing risks to reduce the likelihood that any of our positions end up in economic troubles. We stick to our investment strategy and search for the liquidity premium among low-priced corporate bonds issued by companies with strong balance-sheets.

Investment Grade Value Bonds

The default by Lehman caused a significant jump in the credit spreads for investment grade corporate bonds. At the end of 2008, the widening of the spreads reached historic proportions and was at the same level as high grade spreads were during the Great Depression in the 1930s. During the spring, the initiatives by the central banks started to work and confidence slowly but steadily returned to the banking sector. As the willingness to take risks increased, we saw a significant spread tightening during the spring 2009.

Despite the large gains during this quarter, it is worth noting that the credit spread at its present level is still wide relative to historical spreads. We anticipate that companies will continue their cost-cutting initiatives – such as reducing staff and inventory costs. Furthermore, a number of companies have issued new stocks and/or reduced total debt to improve their balance-sheets.

Banking sector

The wave of leveraged buyouts (LBOs) was at its highest when the fund was started. And debt-funded takeovers often implied a significant jump in gearing and financial risk, resulting in falling bond prices on the existing debt due to the LBO. Examples of this would be the Scandinavian cases, ISS and TDC. For that reason, we concluded that the credit premiums on industrial company issues did not compensate for the LBO risk. Therefore we invested in bank capital on the grounds of its negligible LBO risk.

Debt issued as Tier 1 capital (part of the bank capital) is perpetual. The issuer has, however, the right but not obligation to buy back the bonds at a predetermined time. If the issuer does not buy back the bonds the future coupon will increase (step up). In addition, the issuer is – in some cases – allowed to miss a coupon payment on the bond. The last point does vary from bond to bond – emphasizing the need for an in-depth analysis of the bond's documentation before investments are made.

The credit crisis had a negative impact on our performance in 2008. First, the credit market feared that more banks besides Lehman would default. The solution came with stimulus packages and direct contribution etc. Next, the credit market feared that the bank capital would take the loss. This did not happen since the large banks were not fully nationalized. Finally, it was feared that banks would choose not to buy back the bonds at the predetermined date. A few banks have done that and also tried to buy back bonds at low prices. This has had the effect of introducing a floor on the bond prices.

Our 2008 performance was negatively impacted by the general economic crisis, together with the uncertainty of

whether the banks would call their Tier 1 bonds or not. We kept our exposure to the financial sector since the world central banks and governments took swift action to re-establish confidence in the banks. During this latest quarter, the credit market for bank capital 'turned on a dime' and Sparinvest Investment Grade Value Bonds returned nearly 60% from the bottom.

Government support of the European banks

It became obvious that the global crisis would not be solved without a well-functioning banking system and the default by Lehman emphasized the need to provide liquidity to other banks in great difficulties. The world central banks and governments introduced several packages to re-establish the trust between the banks.

Besides the state-guaranteed loans to banks, some countries now have part ownership of some banks. For example the UK today owns 71% and 43% of Royal Bank of Scotland and Lloyds Banking Group, respectively. In October 2008, the American central bank invested more than \$240 billion in the American banking system to increase liquidity in the sector. The result of these quick actions also affected the banks' quarterly accounting reports in which most presented positive returns. During this quarter, large American banks have started to pay back the loans to the central bank – importantly this is much faster than expected.

The Baltic countries

The Baltic countries have seen impressive economic growth during the last 10 years, resulting in an economy with very low unemployment and a bubble in the property sector. As the economies progressed, more Scandinavian banks increased their exposure towards the Baltic countries. This has become a very costly strategy because of the economic meltdown. In Lithuania house prices increased by almost 80% from 2005 to 2007 and then made a sudden drop to the 2005 level. Hence, it is of great importance to understand when the banks increased their exposure towards the property sector in the Baltic countries.

Sparinvest Investment Grade Value Bonds owns bonds issued by the large Swedish bank SEB that is the second largest borrower in the market. Despite the continued impressive economic growth in the Baltic regions SEB had already tightened its credit terms by 2006, resulting in a loss of market share.

Summary

The demand for corporate bonds increased during the last quarter as the optimism and liquidity returned to the credit market. In particular, bond prices for bank capital increased significantly because of state-guaranteed loans and direct ownership amongst other things. This has resulted in a banking sector that today looks much better capitalized.

At the moment, the economies in the Baltic countries are in a deep recession. This has increased the importance of analyzing exactly when the banks increased their exposure to the Baltic property market. We own bonds issued by SEB. Fortunately, SEB tighten the lending standards already in 2006 meaning that they are less exposed to the debt issued in the period when Baltic house prices were sky-rocketing.

We sustain our value-approach whereby we aim to reduce the risk that a management will implement initiatives that may hurt bondholder value.



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10 July 2009

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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 for 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 fees. For investors in Switzerland the funds' representative and paying agent is RBC Dexia Services Bank S.A., Zurich Branch, Badenerstrasse 567, P.O. Box 101, CH-8066 Zurich. Published by Sparinvest, 28, Boulevard Royal, L-2449 Luxembourg.