

Sparinvest Value Bonds Strategy Proves a Winner

Late in 2006, Danish fund management group, Sparinvest, introduced a whole new investment concept to Europe with its Sparinvest High Yield Value Bonds fund. Has the fund – which seeks out higher yields from smaller and undervalued companies – delivered the outperformance predicted by the academic evidence?

Sparinvest High Yield Value Bonds fund offers a unique approach, based on academic evidence showing that investors can expect better long-term results if they lend their money to smaller companies, undervalued by the market, than to bigger companies paying a higher yield to compensate for a poorer credit rating.

Sparinvest High Yield Value Bonds fund, with its forensic bottom-up bond selection process, has performed well relative to its bond fund peer group – both in terms of choosing the bonds with the best price development and in terms of avoiding default. During 2009, the fund delivered a return of 80.21%, compared with a return of 60.4% from the Merrill Lynch Global High Yield index. The fund's track record in terms of default avoidance is shown in *Figure 1* opposite.

Morningstar has recently awarded the institutional share class of the fund a four star rating, and the team managing the fund is firmly focused on obtaining five stars by the time the fund reaches its five-year anniversary.

According to Sparinvest, the ideal 'value bond' is issued by a smaller company with a strong balance sheet, good asset coverage and a low debt-to-equity ratio. The key portfolio statistics reveal that the indebtedness (NDE) of the companies in the fund's portfolio is less than one third of the comparable benchmark figure, and that's a very healthy indication that loans to investors will be repaid (see *Figure 2*).

Another attractive feature of Sparinvest's High Yield Value Bonds fund is its focus on cheap companies. These offer potentially very high returns by virtue of the Price-to-Book effect. Why? Because companies that are undervalued by the market are often attractive targets for takeover bids and – provided that the right covenants exist regarding change of ownership – this can be a very positive development for bondholders. The Sparinvest High Yield Value Bonds team includes one member whose entire focus is on analysing the covenants of target bonds before purchase.

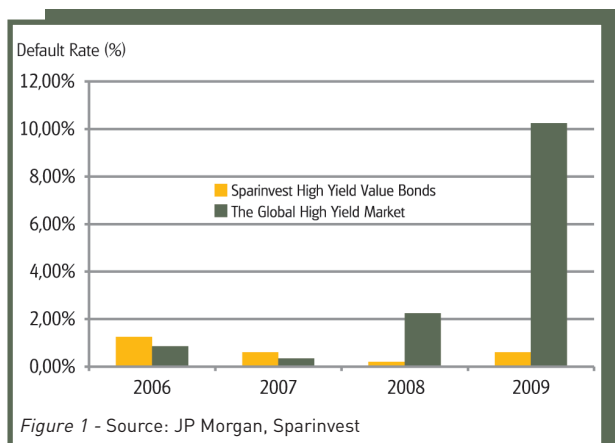


Figure 1 - Source: JP Morgan, Sparinvest

Key Portfolio Statistics Sparinvest High Yield Value Bonds, 1st March 2010

	Fund	Benchmark
Duration	3.58	4.04
Yield	11.7%	9.2%
Average Rating	BB-	B+
Market Cap (bln\$)	8.175*	7.222
Net Debt to Equity	93.12	301.91
Price to Book	1.09	3.21
Interest Cover	3.36	4.69

*Market cap of fund is usually below benchmark but has recently been boosted by an exposure to certain large caps with attractive value bonds and low default risk. These have the added advantage of improving portfolio liquidity

Figure 2

Also available from Sparinvest:

- Sparinvest Ethical High Yield Value Bonds
- Sparinvest Investment Grade Value Bonds

Details of Sparinvest's High Yield Value Bonds fund are available from www.sparinvest.eu.



Sparinvest

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-8006 Zurich. Published by Sparinvest, 28, Boulevard Royal, L-2449 Luxembourg



2009 was a year in which one asset class screamed out for attention. Not only did global high-yield bonds knock spots off the performance of global equities, but the entire market for this asset class increased hugely in importance, especially in Europe.

In many ways, 2009 was a watershed year for high yield. Bloomberg reports that in 2009, corporate bond sales worldwide climbed 31% to \$3.04trn and issuance of high-yield, high-risk securities ballooned by 181% to \$207bn. Of course, the majority (around 75%) of this activity was in the US where high yield is both a mature market and a well-appreciated asset class. But in 2009, high-yield also gained ground in Europe. In a year when banks, post credit crunch, were focused on restoring their balance sheets, their corporate lending activity was minimal. European companies in search of a reliable alternative source of primary funding found it in the credit markets where they could raise finance by issuing bonds. Thus Europe's corporate debt market secured its reputation as a driver of economic growth, assisting the recovery in the broader financial markets by providing companies with the funds needed to move from recession to expansion.

High yield gains respect

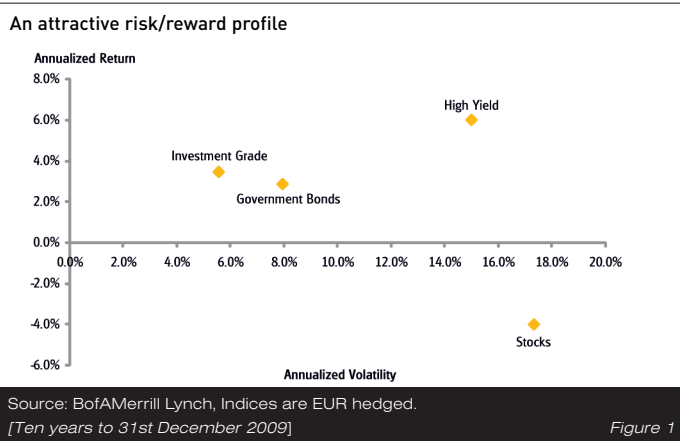


This asset class deserves an allocation argues Sparinvest's Klaus Blaabjerg

In the US, high yield is given its own allocation as an essential component of a well-balanced investment portfolio. In Europe, the majority of investors have, until recently, viewed it as a niche area of the debt markets, easily dismissed with the (often misleading) tag 'junk'. Now, with talk of €50bn worth of new issuance in Europe in 2010, and issuers aware of the need to create bonds that offer creditor-friendly terms, high yield is changing rapidly for the better and the time has come to re-evaluate it as an asset class in its own right.

At the sub-investment grade end of the corporate bond spectrum, yields are higher because default risk is higher. At the beginning of 2009, with both credit and equity markets still in free-fall, the high-yield credit premium was enormous. Effectively the market was pricing

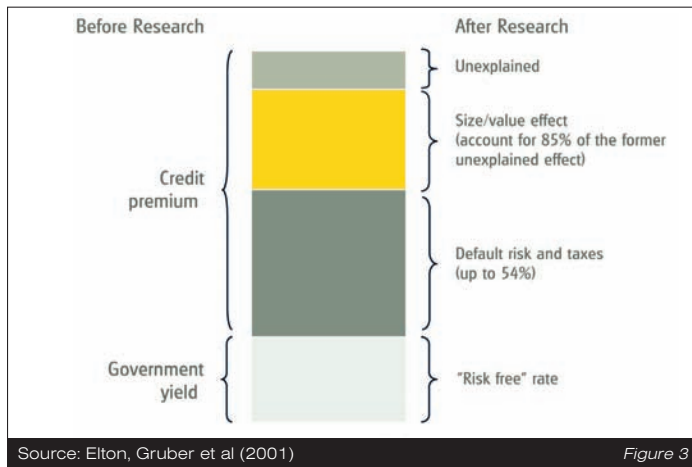
in potentially disastrous levels of default risk. But the caution was overdone. Even bonds issued by companies with strong balance sheets and records of prompt debt repayment were priced as though they would almost certainly default. So the reverse side of this risk coin was that investors who were willing to purchase high-yield bonds at such a premium could potentially achieve unprecedented rewards, provided that the world didn't come to an end and businesses were able to stay in business and repay them. As the year progressed, the default risk receded and high-yield investors were, indeed, well rewarded. The Merrill Lynch Global High Yield index rose by a phenomenal 60.4%, considerably outperforming global equities; the MSCI World registered a 25.9% gain during 2009. But of course for pension fund managers,



Asset class	Correlation with High Yield
Government Bonds JP Morgan Global Govt Bonds	-0.18
Emerging Mkt Bonds JP Morgan EMBI Global Diversified	0.73
Global Investment Grade Merrill Lynch Global Investment Grade	0.55
Property EPRA 45% N. America + 40% EU + 15% Asia	0.69
Equities MSCI World	0.54

Source: Sparinvest Figures calculated from 31/12/1999 to 28/02/2010.

Figure 2



'one swallow doesn't make a summer', so it is intriguing to look at how high yield has performed over the past decade (see *Figure 1* below left).

The figure shows that the returns available from high yield have been considerably greater than those from stocks. But the key point here is those returns have also involved less risk than equity investment. This, of course, is not surprising when you consider that bondholders are priority investors. Companies issuing bonds normally undertake to put creditor repayment at the top of their agenda, ahead of shareholder interests.

But an attractive risk/reward profile is only a part of the argument in favour of high yield. Another is the low correlation between this asset class and other staple pension fund components. Low correlation equals diversification benefits and improved portfolio efficiency (see *Figure 2*).

In order to understand how high-yield bonds generate their returns, it is necessary to understand the risk involved with this asset class. Historically, the higher yields paid by corporate bonds over government bonds have been viewed as being necessary compensation to investors for two reasons. One is that income from corporate bonds is taxable, whereas government bonds are tax free and the other is

that a corporate bond cannot have a higher rating than the country where it is located because the company is more likely to default on its debts than the nation. Tax and default risk were accepted as the logical explanation for the 'credit premium' offered by corporate bonds.

In 2001, Professors Elton, Gruber et al. undertook a study, the purpose of which was to see whether any other risk factors could further explain the spread between yields on corporate and government bonds. They discovered that tax and default risk accounted for only just over half of the credit premium. The remainder of the rate spread was attributable to other, previously unexplained, factors (see *Figure 3*).

This research showed that a significant part of the previously unexplained element was attributable to the same factors identified by Fama & French as being markers for excess returns from equity markets – namely the style factors size and value.

Given that both bond and equity holders are effectively lending their money to a company, it is to be expected that the same size/value risk and reward effects should be apparent in both marketplaces. Like equity investors, bondholders should also be compensated for the greater perceived risks of making loans to smaller and undervalued companies.

But are bonds issued by such companies really more risky? Smaller companies are often penalised in the credit market simply by virtue of their size, and with no regard to their financial statistics. Such companies offer very attractive yields – often because their default-risk rating has been overestimated (or under-researched) by the market when compared with the fundamental strengths of their balance sheets. There is sometimes a liquidity risk involved with trading the bonds of smaller companies but this should not deter the long-term investor.

As regards undervalued companies, part of the additional risk here for bondholders comes from the increased prevalence of M&A activity in the value sector. Credit has been described as a 'binary product' with only two possible outcomes: default or repayment. But the possibility of takeover should also be investigated at the point of purchase. This is where it is extremely important to check that the bond offers guarantees of repayment in case of change of ownership. Provided that the correct covenants are in place, a takeover event or merger can be positive, offering scope for redemption at par and the possibility of a higher rating being assigned to the bond if the acquiring company is considered to offer the target company greater financial strength.

Analysts agree that with a strong demand from investors chasing yield, the high yield sector is likely to continue strong into 2010 with double-digit returns likely. High-yield bonds also tend to perform well during the first few rate rises after a recession, as the economy improves and inflation erodes debt.

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