



Value Equities

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Our Value Equity Funds

Fund	ISIN code
Ethical Global Value	LU0362355355
European Small Cap Value	LU0256591552
European Value	LU0264920413
Global Small Cap Value	LU0264925131
Global Value	LU0138501191

Detailed information is available in the relevant Fund Update.

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Dear Investor

Market rebound and fundamental focus

In sharp contrast to the very poor end to 2011, the first quarter of 2012 has shown a significant rebound in our fund and investment approach in general. Our European stocks and those stocks that are more sensitive to economic cycles have performed particularly well in the first quarter. The result is that fundamental value investors like us have had one of the best starts to the year in a long time, and much has reversed from a performance point of view compared to last year. Stocks considered as 'value' according to classic metrics like price-to-book, price/earnings, price-to-sales, etc. have rebounded from very low levels, and one could say started working again in 2012.

We have a fairly high weighting in cyclical industries such as industrials or consumer-discretionary companies. These sectors – especially in Europe – had a rough time in the end of 2011. However, we could see that the situation was very different to the crisis of 2008-2009. At that time a sudden loss of demand triggered shrinking revenues and left plants running with lots of excess capacity; many companies saw profits collapse into negative territory. This has not been the case in 2011. The difference is that most companies are much leaner, more profitable and financially much stronger than they were in 2008-2009, and the demand for their products is still there. We believe the current low valuations are a clear overreaction for companies with healthy balance sheets and strong cross-cycle earnings power. Indeed, the start to the year 2012 has been positive, with cyclical stocks rebounding strongly, although we still believe there is a good deal more to come when we look at the low valuation of our holdings (see overleaf).

'Euro fear volume II'

There is no doubt that there has been a more fundamental focus in the market at the start of this year and that is positive, but it is still early days. The Euro fear remains very present. We have just seen 'Euro fear volume II' unfold in the past weeks with panic-like selling. Now it is Spain that is in focus, so Europe's work is still far from finished. Europe will be under constant pressure in the coming years to bring down deficits and come up with new reforms of the type that are normally very unpopular with the general populations and put democratically elected governments in very difficult situations. Italy, for example, has seen the consequences and is now governed by a non-elected leader. Europe has made progress, but most people will argue that this is happening at a very slow pace. Nevertheless, Europe's leaders have come up with solutions to address the region's problems. Strong leadership will be a key part in the potential easing of the Euro fear in the future.

There is no doubt that the economic crisis is affecting Europe as a whole, but we also see massive regional differences. The southern part of Europe, in particular, is struggling. Here there will be some serious issues to be dealt with in the coming years. The fear of systemic risk in the region seems difficult to shake off. However, looking at our portfolios, our European stocks have performed very well in the first quarter of 2012, our European Value Fund was up by 18%, over 10% more than MSCI Europe index. In our last letter, we argued that a deep recession was already largely priced in, especially in respect of many European stocks. We think this is still the case, and even more so after the last dip on concerns about Spain. So Europe does have some challenging times ahead, but it is important to remember the fact that we invest in financially-sound companies with strong long-term earnings power that will live to see another day.

As we have stated many times, this time around there will be no new relief rally fuelled by government funding (unlike 2009). This time stronger companies will be able to exploit their strength, and try to consolidate by taking out competition. The stronger will get stronger and the weaker will get weaker. Strategic buyers will pursue M&A opportunities, when trying to compensate for lower organic growth and preparing for better days. However, we are still not overly optimistic people and our investment style is not about calling turning points in the market. We prefer to focus on the fundamental qualities and the valuations of our investments, viewed over the long term.

Accounting

We have written a lot about the importance of business-model and balance-sheet strength in the past. We have also talked about the potential impacts of changes in accounting rules in relation to the overall value of companies. Our daily job is to assess the inherent worth of companies. Such an analysis includes a full review of a company's financial reports, including its Balance Sheet, Income Statement and Cash Flow Statement. There are several items in an Annual Report which have always been subject to our careful analysis, one of which is the accounting for employee benefits which, among other things, involves wages, bonuses and pension benefits.

Pension benefits can seem irrelevant to the short-term investor, but despite the fact that they are long-term liabilities, pensions can have a very immediate impact on a company. We have always considered this along with all other investment risks. While many analysts used to not care about the matter, it seems that they have increased their interest on pension accounting lately. Why is that? Because a change in accounting standards is about to make pension benefits very real to companies and their investors.

The accounting for pension benefits is very complex and poses a list of challenges, which have been discussed over the years. In 2011 the International Accounting Standard on employee benefits, IAS19, which applies to European companies, was amended. The amendments range from fundamental changes like removing the much debated 'corridor mechanism' and the concept of expected returns on plan assets to simple clarifications and re-wording.

We will spare you the details and focus on the 'corridor mechanism' and highlight why this is getting a lot of attention right now. It relates to the concept of actuarial gains and losses, which is the difference between estimates and actual experienced results for rate salary increases, employee tenure, rate of returns, and discount rate on plan obligations in a company's pension plan. Until now companies reporting under IFRS have had the possibility to defer the effect of so-called actuarial gains and losses over a very long time. This has enabled a lot of companies to have severely underfunded pension plans without it being reflected anywhere in the financial statements, except for a small paragraph in the notes. This is now changing. For annual report periods beginning on or after 1 January 2013, the previous deferral mechanisms are removed, resulting in full impact from actuarial gains and losses, as they occur, and full balance-sheet recognition of pension surpluses and deficits.

This change will have a huge impact. Debt levels will change and companies that seemed solid will be more fragile. Some companies will have problems with loan covenants; others will look to the last resort of a capital increase.

In the eyes of fundamental investors like us, the amendment does not really change the intrinsic value of a company. But it does highlight some of the challenges to short-term investors, which might result in some excess return for more patient investors. Of course this is dependent on markets becoming more rational and looking more at fundamentals.

Valuations

Meanwhile, our portfolios are still trading at extremely low valuations. If we take Sparinvest Global Value as an example, and aggregate the data from each individual holding to present the fund as, effectively, one stock, we get a price-to-book ratio of 0.89 times, and an EV/EBITDA of just 4.5 times. For the MSCI World index, the same methodology gives a price-to-book of 1.81 times and an EV/EBITDA of 7.5 times.

Conclusion

Financial markets have been driven more by fundamentals in the first part of 2012 and this is positive for our investment style, but the general mood is still very fragile and a tilt back to sentiment-driven markets is easily triggered by setbacks in the easing of the Euro debt crises, as we have seen lately with Spain.

For the above reason our performance has been good in the first quarter of 2012. Fundamental value investing is by no means dead, but market conviction is still low, as mentioned, and in times like this it is still very important to focus on the basics and remember that once you decide to invest in equities, you are inevitably exposed to market risk. However, the risk related to buying an individual stock can be minimized through careful research. This is why – as always – we are disciplined in sticking to our investment philosophy and process. We look for companies with strong balance sheets and healthy finances. We make cautious assumptions. We do not look only at earnings this quarter or this year, but at earnings over a business cycle. Based on this, we estimate a conservative intrinsic value for a company: a value which would apply if the company were traded as a whole in a merger or take-over situation. If the market value is significantly lower than that intrinsic value, we invest.

The gap between performance of the US and European equity markets in 2011 has not been closed in 2012. Looking at Shiller P/E ratios, stocks in the core of the Eurozone (France and Germany), and even Japan still trade at historically low levels and even more so compared to the US.

We remain convinced of the strength and long-term potential of our investments. We are confident that their balance-sheet strength and robust business models will provide them with a competitive edge in future markets.

Yours faithfully,

Jens Moestrup Rasmussen

Chief Portfolio Manager

16 April 2012

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