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Our Value Bond 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

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Value Bonds

Dear Investor,

The second quarter of 2012 saw a return to fear of Eurozone break up and global recession. Returns for corporate bonds and equities followed this change of sentiment.

Macroeconomics

Austerity is taking its toll on Europe and the rest of the world seems unable to fill the gap. Global growth and growth momentum has been weakening during the second quarter of 2012. Simultaneous public and private sector savings in Europe are taking their toll on European growth. And political incompetence in Europe is preventing a return of 'animal spirits' – even though real interest rates in many countries are now negative. The Eurozone crisis follows a now familiar pattern; stress brings response. Response brings improvement. Improvement brings complacency. Then stress returns. A policy error in Europe cannot be ruled out unfortunately.

For European growth we do have two large positives though. First of all the Euro has depreciated a lot this year already, with more to come. This will help the rebalancing of the southern part of Europe away from too much domestic consumption towards more exports – a process that is already taking place. Second, the price of oil has fallen some 20% compared to this spring.

In the US, the job market has lost some momentum. But more importantly, we see increasing signs that the US housing market has bottomed out. Even small increases in US home prices would be great news for the global financial market.

Emerging Markets countries have seen deceleration in growth and growth momentum as well. But these countries – unlike Europe or the US – still have the opportunity to deploy both fiscal and monetary stimulus

to their economies. Emerging Markets' central banks have already lowered rates and look set to continue to do so into the third quarter.

Microeconomics

The 'good' thing about the stress in financial markets is that it keeps businesses unusually focused on balance-sheet quality – which is good for credit investors because this focus is often centered on debt buybacks rather than shareholder dividends. For financial businesses we see a tremendous effort by European banks to deliver – i.e. European Loan/Deposit ratios are improving faster than those of Japan did in the early 1990's. Again, this fact is something that – over the medium term – should imply lower default risk and hence credit premiums.

Technicals

Deleveraging again is keeping **supply low**, which is obviously a support to corporate bond prices. Investor positioning is light and the lack of 'animal spirits' and the perception that 'there will be no tomorrow' are supportive of flows into fixed income. Comparing current yield less one-year average loss rate to one-year historical realized volatility for all the standard asset classes we find that European high yield is much cheaper than 'safe' government bonds of Germany or US, but also much less volatile than equities – even though the yield on DAX appears marginally higher. Another historical observation to be made is that credit doesn't need high growth to perform. Looking at data back to 1948, the highest excess returns for credit appeared to happen when real rates of growth were in the range from 1% to 2%. On further investigation, one finds that real rates of growth in the range of -3% to 0% have historically been as good for credit as periods above 5%! This, of course, is related to the microeconomic decision-making process in companies. When times are tough, companies work to save themselves – i.e. they try to reduce debt and become less aggressive – for example in terms of

paying dividends to shareholders or making acquisitions. Another important technical observation is the fact that dealer holdings of corporate bonds are the lowest they have been for 10 years (the street is not long as it used to be). This is bad for liquidity but very good in terms of avoiding massive forced selling pressure.

Valuation

Valuations are attractive relative to our expectations of default risk going forward. Some markets are more attractive than others. For example, European high yield bonds yield substantially more than US high yield bonds because of the crisis in the Eurozone. Our view is that this premium is too high. But instead of investing heavily into the Eurozone area we have invested in Norway, UK and Sweden. Here you also get high premiums compared to US high yield, but these countries have their own central banks behind them – something that unfortunately can't be said for the Eurozone countries.

Company news

Edcon

Edcon is one of the largest retailers in South Africa. During the quarter Edcon decided to sell its credit card business to reduce debt and reinvest into new shops. The sale of the credit card business was something we had been waiting for in order for the market to realize the value of the Edcon business. We hold Edcon bonds in several of our Value Bond funds. Even though the Edcon bonds have risen a lot this year already, we have no plans to reduce our holdings as we await an exit from the owner and expect this to deliver even further value.

Yours faithfully,

Klaus Blaabjerg

Lead Portfolio Manager

9 July 2012

Sparinvest Value Bonds-Team



From left to right:

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