



Value Equities

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Our Value Equity Funds

Fund	ISIN code
Emerging Markets Value	LU0760183672
Ethical Emerging Markets Value	LU0760183912
Ethical Global Value	LU0362355355
European Small Cap Value	LU0256591552
European Value	LU0264920413
Global Small Cap Value	LU0264925131
Global Value	LU0138501191

Detailed information is available on sparinvest.eu

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Dear Investor,

Global Equity Markets seen from a value investor's perspective*

This quarter's performance has felt like taking part in a game of Ludo, when your piece is captured and you have to return to the start. 2012 started with a few months of more normalized market dynamics. But the fear of 'Greek disease' spreading to Spain hit markets in late Q1, and intensified in Q2 – and then we were in for a rerun of what we saw in the autumn of 2011. The level of noise from macroeconomic worry, fuelled by bankers, politicians and economists, is paralysing the markets' fundamental focus in relation to single companies.

The last eighteen months have brought an earthquake in Japan, the debt crisis in Europe, and a period where global value stocks underperformed growth stocks. For most of this time, markets have not much cared about individual stock qualities, and instead made dramatic, correlated moves. Not the best environment for a qualitative, bottom-up value fund with relatively high exposure to Europe and Japan.

Value Stocks: Long Term versus Short Term

Our qualitative value investing is rooted in the investment philosophy of Benjamin Graham, but supported by various pieces of academic research conducted over the years which have quantified the outperformance of value stocks on various measures, such as price-to-book, price-to-earnings, and price-to-cash flow. We have often spoken of the findings of Fama and French, two US professors. Their matrix of equity returns over time demonstrates that higher returns come from investing

* In future editions we plan to include commentary on emerging markets, once our new funds have more established track records.

in smaller stocks, and value stocks (low price-to-book stocks). The below matrix shows global equity returns from 1990 to 2012, with the highest returns in the northeast corner: small value stocks.

Global markets, June 1990 - Mar 2012

		Small cap						
		6.2%	9.0%	11.7%	13.5%	20.6%		
Growth	Value	1.4%	6.0%	7.9%	9.5%	11.2%		
		3.0%	5.3%	8.1%	8.9%	10.1%		
		5.0%	7.0%	8.2%	8.8%	9.5%		
		5.1%	7.8%	8.6%	8.7%	9.0%		
		Large Cap						

Source: K. French Data Library, USD Returns

This long-term effect can be seen across the world's major equity markets. But short-term periods occur where the pattern changes. In 2011, clearly the best performance came from investing in the southwest corner (large growth stocks), while value stocks generally performed poorly. This continued in Q2 2012: looking at the MSCI World, the cheapest stocks by price-to-book sharply underperformed the more expensive; and the only market cap category with positive returns this last quarter were megacaps: companies over USD 200 billion market capitalisation.

Global markets, Dec 2010 - Dec 2011

		Small cap						
		-18.2%	-15.5%	-16.3%	-14.1%	-9.0%		
Growth	Value	-16.1%	-9.3%	-13.5%	-11.7%	-11.4%		
		-5.2%	-7.0%	-10.3%	-9.3%	-15.7%		
		-6.0%	-7.4%	-8.6%	-8.3%	-12.6%		
		-2.3%	-8.4%	-8.4%	-6.4%	-19.8%		
		Large Cap						

Source: K. French Data Library, USD Returns

Similar things have been seen before. For example, the tech bubble of 1999, when growth stocks dramatically outperformed value stocks as markets went wild for 'new economy' stocks. But remember that both these periods are included in the 1990-2012 data, which nonetheless demonstrates clear value outperformance. The long-term picture remains clear, and it's a good reminder of why value investing is largely about patience and trusting long-term fundamental findings.

Our portfolios are made up of qualitatively-selected stocks, cheap on various value measures and with solid balance sheets; we have exposure across small, mid, and large-cap areas. The world has been tumultuous lately, but some things do not change. In the long-run, cheap stocks do outperform strongly. Shorter periods of growth stock outperformance do come, but history has shown that these periods end – and often end quickly with strong value stock rallies.

Volatility

Two letters ago (Q4 2011), we touched on definitions of risk. We noted that for many in the financial industry, volatility – or variance – has come to be used as the key measure of risk. This strikes us as a dangerous approach. Not only do we get nervous at the idea of reducing risk to a single number, we think that defining risk as volatility can lead to counterintuitive or even illogical conclusions.

We are, of course, not the only ones to question the use of volatility as a measure for risk, and this is not a new debate. Benjamin Graham argued long ago that if a company's underlying business value remained unchanged, it was illogical to say that the investment had become more risky simply because the share price had dropped. That was looking at the company level, but the same can be said of entire asset classes. Typically, in periods of economic expansion asset prices rise fairly steadily, and volatility falls. So, modern portfolio theory would suggest risk has declined, and the asset class has become safer despite getting more expensive – so more money is allocated to it. Ultimately, this is unsustainable, and when underlying data falls slightly short of expectations, the asset class is sold heavily. The resulting price decline pushes volatility up, and the vicious circle begins: risk (volatility) is now higher, so the asset is sold even further. We end up with asset pricing cycles that are far more volatile than the underlying trends, and a tendency to buy when expensive, and sell when cheap.

This phenomenon frustrates many, but with so much of the regulatory framework based on the concept that risk equals volatility, it can be hard to escape. In recent years, there has been a huge amount of negative public sentiment directed towards banks, but we sometimes wonder why there is not more of a public backlash against a regulatory framework that often forces pension

funds to break the cardinal, intuitive rule, of 'buy low and sell high'. As value investors, we are perhaps a little old-fashioned, but we believe in buying good assets at low prices – so if we are able to exploit this volatility, we will do so.

Fear or fundamentals: correlation in stock markets

When major political or macro-economic trends dominate, headlines, commentaries, and financial markets can become extremely short term and binary in nature. Things are seen in black and white, and nuances often ignored. This happens both in times of euphoria, and pessimism. During the tech bubble of the late 1990s, it often seemed like the market only cared whether a company was new or old economy, tech-related or not. Now, during the crisis of faith over Europe, it can sound like politicians must choose either growth or austerity; a summit will be a success or failure; assets should be allocated to Europe or America; it is 'risk on', or 'risk off'.

Of course, reality is not black and white. It is nuanced. And in the long term, nuances get priced in. As bottom-up investors, we aim to select companies with enduring business models, financial strength, and low valuations relative to their long-term worth. We know that these fundamental factors make a crucial difference to long-term investment returns.

But when top-down issues dominate the agenda, fear can drown out fundamentals. The market ignores details, slips into binary mode, and we see fast and large capital flows into or out of entire asset classes, regions, or sectors. At such times, the markets do not discriminate between individual stocks.

We can measure how indiscriminate the market is. For example, take the individual stocks that make up an index, and calculate their share price correlation to the price movement of the overall index. The lower the correlation, the more investors are discriminating between stocks. The higher the correlation, the more stocks are moving as a herd. Taking the S&P 500 as an example, the long-term average correlation is around 25%, and it has been as low as 10% at times. Correlation over 50% could be considered high, but recent years have brought a few periods where it spiked much higher – to 70-80%. These include Oct 2008-Feb 2009 (height of the financial crisis), May-Jun 2010 (initial concerns over Greece coinciding with the Gulf of Mexico oil rig disaster), Mar-Apr 2011 (Japanese earthquake), and Sep-Dec 2011 (Eurozone sovereign debt crisis).

When this happens, share price movements depend primarily on which index, country, or sector a stock belongs to. So, right after the earthquake hit Japan, Japanese equities were sold off aggressively and indiscriminately,

regardless of the actual impact on individual companies. In Europe, mounting concern over the debt crisis in autumn 2011, and again in Q2 2012, led to a 'Postcode Europe' phenomenon, where simply being domiciled or headquartered in Europe was enough to cause sharp share price declines. It didn't matter if the underlying company was in fact multinational with a global spread of assets and earnings. Consider Renault: whatever your view on its European operations, the fact is that Renault costs EUR 32 per share, and for each share you get ownership in Nissan worth EUR 50.

Europe: don't judge a book by its cover

At the political level, Europe – or at least the Eurozone – needs greater levels of cooperation and integration. Looking at the big picture, this is happening. Of course, the devil is often in the details, and European leaders may differ over the exact pace and nature of integration – but there seems to be increasing acceptance that, in the long run, it is needed.

But let's not pretend that Europe is one homogenous area. Stock markets might sometimes behave as if all European stocks are in the same boat, but that's not the long-term reality. For investors seeking strong long-term investments, it will remain crucial to distinguish between countries, but above all, between individual companies.

In our global funds, we have a high proportion of companies domiciled in Europe, so the headline 'European' exposure is around 48%. But we don't judge companies by their postcode. We judge them by where their assets are and where they make money. Looking at our European holdings, around 50% of their revenues come from outside Europe. The portfolio is well diversified in terms of underlying assets, revenues and cash flows.

Moreover, within Europe, the economic picture is not all bleak. Despite all the negativity, Europe as a whole just avoided slipping into recession in 2012's first quarter. Here, the distinction between southern and northern Europe is key. To generalise, the private sector in northern Europe never became as leveraged as the south, has been faster to start deleveraging, and is more exposed to global trade than the locally focused south. Our funds have limited exposure to southern Europe – for example, we have under 3% in Sparinvest Global Value. Over the years, we simply have not found enough compelling bottom-up investment ideas, and of course the external economic circumstances facing companies were part of the explanation for that. Where we do have investments, it tends to be in more globally-exposed companies. Consider ENI, the international oil company, or Buzzi Unicem, a concrete maker domiciled in Italy, but which sells more in the USA and Mexico (28% of revenues) than it does in Italy (20%). Our small cap fund invests in Baron de Ley, a Spanish wine producer which

exports close to 40% of its product, with relatively stable demand and input costs (grape and labour) now falling in Spain.

There is not going to be one obvious day where we can say the Euro Crisis is over. We don't know whether the European economic recovery will stall in the short term, or accelerate. What we do know is that corporate Europe in general, and our holdings in particular, have seen operating results far better than all the nasty headlines might suggest. Cost structures were closely reviewed and heavily cut after the 2008-2009 crisis, making companies more resilient. We have repeatedly said that deleveraging is here for a while, for both the public and private sectors. Balance-sheet strength is likely to matter in coming years. While we may or may not see more rounds of quantitative easing, in the medium term it's clear that governments do not have the firepower to flood the private sector with liquidity. This means that the balance-sheet strength and the financial independence of individual companies should become more of a differentiating factor.

Putting things in perspective

So, highly-correlated moves can lead to irrational pricing of individual stocks. For bottom-up investors like us, it's an opportunity to be exploited. If shares in a strong company are pushed down by short-term capital flows out of its region or sector, giving even greater discount to the company's long-term intrinsic value, then we should consider investing. However, the irrationality can also hurt our funds short term. Our investment process relies on markets pricing in individual company quality, so short-term performance can suffer in periods where markets ignore the differences between companies. Looking at our funds' performance in recent years, the three worst performing periods compared with MSCI World were periods where correlation jumped towards record levels: Q3 2008, Q3-Q4 2011, and Q2 2012.

Is high correlation here to stay? We don't think so. Some argue that correlation between stocks is generally rising, partly due to factors like the expanded scale of index fund investing, and more high-frequency trading. But in recent years, in those periods where top-down noise has quietened, correlation levels dropped sharply: there was a shift back from fear to focus on company fundamentals. In these periods, our holdings have typically performed well. Our fund's three strongest quarters relative to index in recent years (Q2 2009, Q3 2010, and Q1 2012) were quarters where correlation declined. In January and February this year, we noticed a tangible day-to-day difference, as we saw the share prices of our holdings rising and falling on the back of company specific developments. Even in the few cases where we saw falls after disappointing fundamentals, we were encouraged to see that share prices and fundamentals were in tune again. By late February, Sparinvest Global Value fund

was over 5% ahead of the MSCI World, while Sparinvest European Value was 10% ahead of the European index. Since then, as fear, volatility and correlation have increased again, we have seen performance of our funds suffer – but we remain convinced in the potential of the holdings.

In the long run, the private sector requires a stock market that rationally factors in the distinctions between companies, allowing each company to raise equity capital that reasonably reflects its underlying economic value. Companies do not list on stock markets in order to join an index, or be part of a theoretical game where share prices move more-or-less in unison. Companies list to raise equity capital, due to real financing needs.

One would normally expect share price irrationalities to be corrected fairly swiftly in the stock market. If stock market correlation were to remain high for extended periods, then individual share price irrationalities might last a little longer – but would not be tolerated indefinitely. Companies themselves would respond: perhaps becoming less likely to issue fresh equity, or more likely to buy back their own shares. They would reduce the supply of equity. Moreover, industry competitors can step in with takeovers, perhaps the ultimate mechanism to iron out irrational pricing. At certain times in the cycle, private equity investors will also use M&A to exploit unjustifiably low prices. Admittedly, a fully-functioning M&A market does rely to some extent on having a banking sector willing and able to lend – but that will come as conditions gradually normalize.

So, periods of high correlation lead to pricing irrationalities. In the short term, this both creates opportunities, and causes pain. But in the long run, we have no doubt that a disconnect between stock market prices and company fundamentals will not be tolerated. Whatever mechanism it is – reduced stock market correlation, a squeeze on equity supply, strategic or financial M&A – mispricing will ultimately be corrected. We don't aim to say exactly when that will happen. But history has shown us it will happen.

Valuations: deep discounts

We have no doubt our holdings will be rewarded as mispricings are corrected. Equity valuations in general are low from a historical perspective. Equities give high yields, with forward dividend yields for the US (S&P 500) and Japan (TOPIX) at 2.5%, Germany (DAX) at 4.4%, and the UK (FTSE) at 4.6%. On price-to-earnings forecasts for next year, the US is at 11.6 times, Japan 11.5, Germany 8.8, and the UK 9.3. None of these are high, but there are two noteworthy points. Firstly, Japanese stocks have historically looked cheaper than most regions on price-to-book, but usually more expensive on price-to-earnings. It is significant that they are now trading equal to, or slightly cheaper than, US stocks. Secondly, European

stocks are heavily discounted. These multiples are based on earnings forecasts which aim to factor in top-down risks to earnings, but despite that, multiples are sharply lower than other regions – so the stock markets are factoring in some very negative scenarios. The reality is that the corporate world is in far better shape than it was when the financial crisis hit four years ago. Restructuring has left healthier balance sheets and leaner cost structures, so that even assuming tough external conditions, corporate profits are not expected to collapse.

But what is crucial is that our portfolios look cheaper than the wider market, while offering robust financial health. Consider Sparinvest Global Value as an example. On most metrics, valuations are around the historically low levels we saw in March 2009, at the peak of the global financial crisis. The price-to-book ratio of 0.75 times is under half the MSCI World's level (1.68 times). On price-to-earnings, the fund trades at 8.74 times estimated earnings for the next fiscal year, compared with 10.74 times for the MSCI World. The picture is similar whether one looks at EV/EBITDA (3.42 times, versus 5.79 times for the index), or price to cash flow (4.30 times, versus 6.24 times for the index). The fund offers a dividend yield of 3.15%, compared with 2.81% for the index.

We will not attempt to forecast the precise timing, but we do know that when markets shift back to a focus on real value, it can happen quickly. In the meantime, we will be monitoring our holdings closely for any significant developments or changes in intrinsic value, and scouring the markets for the most compelling long-term investments. We remain confident that our portfolios offer large discounts to intrinsic value, and this will drive strong long-term performance.

Yours faithfully,

Jens Moestrup Rasmussen

Chief Portfolio Manager

9 July 2012



Upper row, from left to right:

David Orr
Senior Portfolio Manager

Lisbeth Søgaard Nielsen
Portfolio Manager

Jeroen Bresser
Portfolio Manager

Per Kronborg Jensen
Senior Portfolio Manager

Morten Rønnow Tandrup
Equity Analyst

Bottom row, from left to right:

Mikael Søgaard
Equity Analyst

Karsten Løngaard
Senior Portfolio Manager

Jens Moestrup Rasmussen
Team Leader / Chief Portfolio Manager

Trine Uggerhøj
Portfolio Manager

Kasper Billy Jacobsen
Chief Portfolio Manager

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