Sparinvest

Letter to Shareholders Q3 | 13

Value Equities

Headlines

- A Good Q3
- Asset Crystallization – Case Studies
  - Nokia
  - Noble Corp
- The More Things Change, The More They Stay the Same
- Europe – Back on the Investment Radar
- Japan – Showing Dynamism
- Value: It's About the Price Tag

Our Value Equity Funds

Fund	ISIN code
Emerging Markets Value	LU0760183672
Ethical Emerging Mkts 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

- sparinvest.eu

Dear investor,

A Good Q3

The third quarter was good for global equities, and also for our funds. Towards the end of the quarter, the Fed reined in its talk of tapering, which was well received by global stock markets and emerging markets in particular. But the big driver this quarter was Europe. Confidence is picking up that the region is achieving a reasonable balance between growth and austerity. Its underlying macro indicators may not be rocketing, but are moving in the right direction. For the first time in 5-6 years, investors globally are starting to allocate money back to Europe, as we saw in Japan earlier this year on the back of fresh political winds.

As we write, all focus is on the circus in Washington DC, with sentiment hurt by the partial government shut down and the potential failure to renew the debt ceiling later this month. This game of chicken between the Republicans (or at least some of them) and the Democrats is taking the global financial markets hostage in the short term. But this should not distract from the encouraging signs we see around the world. Moreover, we note that markets are continuing to show a little more focus on underlying fundamentals: volatility has eased, correlations between stocks have come down and, increasingly, companies are rewarded and punished for their individual strengths and weaknesses. In short, the equity market has normalized somewhat, and that is very encouraging for bottom-up value investors.

Asset Crystallization

Last time, we wrote about unlocking value through asset divestures. We saw more of this over the summer months.

Nokia
Nokia's divesture of its handset business to Microsoft has grabbed most headlines and clearly had a positive impact on our funds. Undoubtedly, things have not been easy for Nokia in the past few years, and strategic mistakes were made. The handset business was burning cash and, at stages, most investors were assuming a negative value for this unit, or even doubting survival of the group. We took a conservative view on Nokia, but nonetheless concluded that even the handset unit retained positive intrinsic value, supported by its distribution network, supply chain management skills, and decades of research and development in the production of handsets. Selling the business effectively monetized all of those elements, and shows a simple point: what is a cash burning unit to one company can be an attractive asset to another. It also shows that when M&A markets are relatively healthy, and when industrial buyers have some degree of optimism about the future, this can be a significant tailwind for value investors.

The perception of Nokia has changed from being a cash burning platform to a company that should pay a super dividend, or consolidate the network equipment business. The share price rose from EUR 3 to almost EUR 5 in a matter of weeks.

Noble Corp.
Another example is Noble Corp, an American company which operates and leases out oil drilling rigs. When we first bought shares in 2010, the company had a net cash position, and since then management have steadily deployed the cash, tripling Noble's fleet of high-end drill ships, doubling the net fixed asset base, and buying back shares. Over the same time, the share price has underperformed major indices, but we are reassured that management is doing a fine job in increasing the company's long-term earnings power. In such investment cases, patience matters.

In fact, Noble's management share our view that the company is undervalued, and have taken a pro-active step to unlock the value – by splitting it up. The company's newer drill rigs will go in one company, and everything else in another. This should give investors better insight into the different characteristics and advantages of both types of asset. Investors tend to pay more for companies with newer equipment, which tend to enjoy higher barriers of entry, longer contracts, more stable pricing, and a better supply-demand balance. On the other hand, a company containing only old equipment can generate very strong cash flows, leading to solid dividend potential. Obviously, this is not as dramatic as selling off half the company at a big premium, but it's encouraging to see management seeking ways to shine a light on the corporate value. Similar examples in the US energy sector – at ConocoPhillips and Hess – give us confidence that such strategies can work.

The More Things Change, the More They Stay the Same

Value investors sometimes get accused of being old fashioned. We don't mind. We believe the old line: 'the more things change, the more they stay the same'.

During the crisis many voices argued that the world will never be the same again, that there is a 'new normal'. Certainly, many things have changed on the surface. One example is that many investors have become much more risk averse than they were only a few years ago. But we don't think this means a fundamentally new world order. The reality is that most of the old patterns remain in place. One of these patterns is that, for the most part, things revert to norm.

Over the last few years it sometimes seemed as though every week brought more dramatic news and wild market fluctuations, so it's understandable that many market participants have become more short-term in their perspective. Companies doing badly were sold off as if there was no tomorrow, while companies with growing or even just stable earnings were rewarded with very high multiples – as if they would never falter. But this doesn't strike us as very realistic. Sure, some companies stay bad for years and some remain great for years. Coca Cola is an example. But the vast majority of companies move around a bit. So when we see a company with short-term pain, we ask whether there's potential for a turnaround and whether the current share price is too low compared to its long term worth. A good balance sheet helps. Likewise, when we see a company with fantastic results driving a high share price, we have to ask if it's sustainable. In some cases, it is – but in most, it's not.

Think of an electronics company with a hit consumer product that everybody wants. Competitors introduce rival products, but it makes no difference: the company and its stock price go from strength to strength. Except for the fact that, ultimately, those competing products do gain ground, consumer preferences shift, prices come down – and the 'unbeatable' company loses its edge. You were maybe thinking about Apple and the iPhone – a stock that went from being a darling of the market to dropping over 40% in a couple of months in late 2012. But we could just as easily be talking about Sony and the Walkman in the early 1980s, or Nokia and its phones at the turn of the century. Time and again, we see companies with successful products treated as if 'this time it's different – this company will sustain its momentum', only for those expectations to be dashed. Similarly, we see struggling companies treated as if they can never recover. Indeed, in mid-2012 the market treated Nokia and Sony as if they were failed companies. We looked at them and, while we didn't see 'great' companies, on our analysis they were clearly worth far more in the long-run. Since then both stocks have more than doubled. Obviously this is a simplistic comparison, but it's to demonstrate a simple point: the market behaves time and again as if 'this time it's different'. Most of the time, it's not.

Europe – Back on the Investment Radar

Just as the market can be excessively optimistic or pessimistic about individual companies, so it goes with countries. In recent years, both Europe and Japan have been off the radar for many people. We wrote last time of the inherent potential of these regions, and the need for reform to unlock that potential. We continue to see encouraging signs, and recently the stock markets seem to be buying into the story.

While European stock markets were flattish in the first half, they were the standout performers of Q3. Ten years ago, Germany was widely called 'the sick man of Europe' due to its low economic growth rates. Nowadays Germany is seen as the hegemon of Europe due to its economic strengths. So it serves as a good example for other European countries that if problems are addressed, improvements will be achieved in due course.

Recently France has taken over the scapegoat role. Some experts judge France 'out', but the country is working to tackle its problems – even though sometimes we might be frustrated by the pace and disagree with the methods. The lack of labour flexibility is a key problem. As a short-term remedy, France is reducing corporate tax burdens to offset labour costs. This obviously gives an immediate boost in competitiveness, but more importantly, reforms are being passed which should address the underlying problem, increasing the flexibility of the corporate cost base. Despite sometimes old-fashioned political rhetoric, there are changes taking place which should help the French economy move forward again. The French market was among the strongest in the last three months, and our French holdings generally rebounded strongly. Consider Peugeot: a company which clearly had – and still has – its problems, but had been priced for total failure. The stock gained 180% since November 2012, and rose 90% in the last 3 months alone.

Japan – Showing Dynamism

While the US is suffering from a high-risk game of political gridlock, Japan is enjoying a period of relatively dynamic politics. Prime Minister Abe had already launched his 'Three Arrows' to revitalise Japan (see our last letter), but in July elections his Liberal Democratic Party won back the Upper House of the Diet: this strong public endorsement makes it easier to implement his reform programme.

Although the Japanese stock market remains the strongest major market year-to-date, it had more modest returns in Q3 (along with the US). So has 'Abenomics' achieved all it can? Certainly, much of the initial surge in Japanese equities was driven by the weakening yen, and the yen been flattish for the last few months. But the crucial point is that it remains considerably weaker than it had been for the previous three years, making a much better competitive environment for Japan's exporters: and that can be a gift that keeps on giving. Moreover, as we noted previously, Abenomic's greatest potential probably lies in the 'Third Arrow' – reform – but the results will not come overnight. In the short term, there has been debate over whether to go ahead with planned hikes to VAT, which is currently at just 5%. Hikes have long been seen as a potential way to help ease Japan's fiscal difficulties, but obviously can impact domestic demand in the short term. Abe has now confirmed the plan to hike VAT to 8% in 2014, and announced a major stimulus plan to offset the short-term negative impact on the economy. Such steps are never easy – but they are steps forward.

Our global funds have benefitted from the strong performance of Japan this year. However, note that in Japan, both value stocks and small cap stocks performed relatively poorly. What explains this? It's partly because as the world woke up to Japan some of the 'fast money' flowed into the big names, and partly because certain parts of the market – like major exporters and real estate - were clear initial beneficiaries of the weak yen and inflation targeting. But we see potential for stronger future performance from smaller companies, and more domestic spill-over effects in the rest of the economy.

Value: It's About the Price Tag

So, when we see certain sections of the stock market carrying high valuations, we always raise a cynical eyebrow. Sure, we can see arguments why certain stocks – or countries - are in a relatively strong position, but usually the market overestimates how long that will last. One big picture from recent years was that people crowded into parts of the market seen as 'safe', such as defensive stocks, low beta stocks and high dividend yield stocks, and to some extent, US stocks. We could understand some of the logic, and indeed we have increased our US exposure and made strong returns there. But we couldn't ignore the fact that stocks in these categories were becoming steadily more expensive – while more economically sensitive stocks became very cheap.

We take a long-term view, and we anticipated that history would repeat itself, that the economic cycle and earnings at these more sensitive companies would eventually pick up – so we did not aggressively move our portfolios into the more crowded and more expensive sections of the market. Admittedly, the global macro environment suffered more blows and for longer than we expected: sub-prime became the Global Financial Crisis, Europe stepped in with its sovereign debt crisis, and Japan suffered a devastating tsunami. This clearly delayed any recovery – but it did not prevent it. Over the last twelve months, as global conditions have started to improve and markets have started to accept that there is, in fact, a future, we have seen many of our more cyclical holdings perform admirably, both in terms of their earnings, and in the stock market. This has driven strong performance from our funds.

But we are not 'married' to any exposures. It may be that the expensive stocks of today are the cheap stocks of tomorrow, and our job as value investors is always to seek out those companies which are cheapest relative to their own true worth. Whether we're looking at a stereotypically 'quality' company with stable earnings, or a turnaround case, or a break-up story with solid assets – the value is revealed in the price tag.

In the meantime, we are encouraged to see that global market attention has shifted somewhat. Value stocks had been out of vogue globally for some time, and in previous letters we have noted that a resurgence in value was inevitable. But one of the classic ironies is that when value funds offer the biggest upside potential, they seem least compelling to investors. Recently, though, the stock markets are showing more focus on fundamentals and perhaps on the long-term potential in companies. This is a supportive environment for our bottom-up value investing approach, and performance of our funds has been encouraging. At the fundamental level, our holdings are progressing well. And yet the stock markets continue to offer us many compelling new investment opportunities, which we are confident will drive solid long-term performance. The outlook is bright.

Yours faithfully,

Jens Moestrup Rasmussen
Chief Portfolio Manager
09 October 2013

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:

- **Karsten Løngaard**
  Senior Portfolio Manager
- **Jens Moestrup Rasmussen**
  Team Leader / Chief Portfolio Manager
- **Trine Uggerhøj**
  Portfolio Manager
- **Kasper Billy Jacobsen**
  Chief Portfolio Manager

Sparinvest is a signatory of UN PRI and member of Eurosif and Dansif. UN PRI is an international investor initiative sponsored by the UN and based on six principles for responsible investments. The aim is to help investors actively to incorporate environmental, social and governance issues into their investments.

Signatory of:

PRI | Principles for Responsible Investment