Sparinvest

Letter to Shareholders **Q1|13**

Value Equities

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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,

Q1 Review

In our last letter, we noted our expectations for 2013: that investors' risk appetites would gradually return and become more discerning, lifting global stock markets generally. We tentatively hoped that increased stock picking, supported by M&A activity, would prompt a renewed focus on fundamentals, benefiting our classic value style. The first quarter has been reasonably supportive of those expectations.

Outlook Europe: Signs of Progress with Less Panic

Equity markets have had a reasonable start to the year, with our global equity funds gaining around 9% in the first quarter. This rise in markets has come despite the return of headline risks in Europe: the indecisive election in Italy and the last minute bailout for Cyprus. Europe is not out of the woods yet but progress is being made and, more importantly, it seems that investors are reacting more calmly. In 2012, European stocks had a great start to the year, but fell to negative territory when concern about Spain hit markets. In 2013 so far, Cyprus has certainly had an impact, but European stocks still posted 5-6% absolute gains in the first quarter. In recent years we've often noted that markets have been driven more by sentiment, or even panic, than fundamentals. Judging from the market reaction to Cyprus, it could be that the panic-driven swings in markets are getting less extreme.

Having said that, Europe underperformed other major regions such as Japan and the US in the last

3 months, and this explains why our funds – with a relatively high exposure to Europe – were slightly behind the global index. It did not help that within Europe, value stocks – those that are cheap on measures like price-to-book or price-to-earnings – significantly underperformed. But we note that European stock valuations remain compellingly low, and let's not forget that in 2012, despite the early pain from Spain, Europe ultimately delivered higher returns than the US and Japan.

Outlook Japan: Is Rally Sustainable?

In our last letter, we noted that Japan offered grounds for optimism. Indeed, it has been the best-performing major market so far in 2013. Our funds have significant exposure to Japan. While we are by no means in love with Japanese companies, over our years of value investing we have often found extremely cheap and compelling opportunities there. Moreover, in a long-term global context, Japanese value stocks have performed well. That said, the past few years of yen strength, compounded by factors like the 2011 earthquake, have caused underperformance, inevitably leading to some questions about the potential of the Japanese stock market.

The recent rally has been driven by a combination of low valuations and the policies of the new Abe government. The weaker yen is the most obvious result, but equally significant are inflation targets and deregulation. Let us try to focus a bit more on the yen impact. There is still a lot of scepticism about recent developments in Japan, like: "Japan has seen a weaker yen before, and it never helps – especially if you are a Euro or USD-denominated investor". We disagree. Probably the most significant example is 2005, when the reform agenda of Prime Minister Koizumi had a serious impact on the Japanese market. From Dec 2004 to Nov 2005, the yen weakened by 14% against the USD, and Japanese equities significantly outperformed globally, in both USD and EUR terms.

Investment Implications of Weaker Yen

We think the effects of a weakening yen can be illustrated in three very simplified stages.

1. Initial Weakness – Market Gains, Currency Losses

The initial swing to a weaker yen gives an immediate sentiment-driven boost to share prices, particularly for exporters. Share price gains in yen typically exceed the currency losses, giving positive returns - even in Euro or USD terms. We saw this stage begin from mid-November 2012; some stock examples include FujiFilm, Sony, Toyota Industries and Yamaha Motor.

2. Weakening Stops Leading to Profit-Taking

In stage 2, the Yen stops weakening so fast, or even strengthens a bit. This inevitably causes profit taking in some of the stocks that had rallied most. We saw this in Feb 2013, as the yen strengthened slightly versus USD and EUR. That coincided with Japan's 3rd quarter results season, which perhaps disappointed some observers: despite the weaker yen, companies did not make major upward revisions to earnings estimates. During this stage returns can be a little weak, but this period is too early to judge the real fundamental impact of the weaker currency.

3. Stabilization Leads to Higher Earnings, Higher Prices with Less FOREX Pain

In stage 3, the Yen stabilizes at a new, weaker level, and companies start delivering the fundamental benefit in earnings. Higher earnings start to appear in results and forecasts, pushing down valuation metrics like P/E and P/B. This can drive share prices in yen terms, while the currency is no longer weakening dramatically: so EUR or USD investors benefit. This means that we don't need to see the yen weakening further and further to have a positive effect: simply stabilising at a new level helps companies massively.

Further to this, bear in mind that on top the straightforward currency impact on earnings, many Japanese companies have been competitively disadvantaged by the strong yen – and that can change dramatically as the currency weakens. Current valuations do not take in to account the increased business activity that a lot of companies will see in the coming quarters.

Swimming Against the Tide

The other night I was reading about the death of Margaret Thatcher, and found the following quote: "To me, consensus seems to be the process of abandoning all beliefs, principles, values and policies. So it is something in which no one believes and to which no one objects". Swimming against the tide is one of the hardest things about being a value investor. We have stated so many times during the course of the past years, that value investing is all about consistency: sticking with your strategy when you are being tested on your beliefs. That has certainly been the case in the past five years, when on-going economic turmoil has frequently taken attention away from individual company fundamentals, and on to reactions to macro and political events.

Financial markets have been driven even more by consensus-seeking activity than normal, as investors have herded together into perceived safe havens, such as traditionally defensive sectors, US stocks, or blue chips. This has been driven by a wish for short-term stability and predictability, more than by compelling valuations. People have been trying not to stand out from the pack. But when people are all running one way, it is normally time to run in the other direction.

The history of markets globally has shown time and again that, in the long run, cheap stocks do outperform. Value outperforms. We have therefore stuck with our strategy of investing in stocks which strike us as heavily discounted to their long-term worth. The reality is that in the past few years, this has not paid off: classic value factors like low price-to-book and low price-to-earnings have been ignored, and instead it has been a period where it has paid off to "hug the benchmark". Stocks have been highly correlated to each other, moving in large groups based on which country or sector or index they belong to. Hugging the benchmark pays off – so long as everybody keeps doing it. But history shows that such periods always come to an end. When that happens, the rewards for value investors can be swift and large. Value investing focusses on buying discounted companies, because this is what generates the strongest long-term returns.

Conclusion

Encouragingly, in the first quarter of 2013, we have seen correlations between stocks coming down somewhat, and some tentative signs that markets are starting to look beyond short-term macro noise, and focus again on long-term potential. We still believe that investors risk appetites will gradually return and become more discerning, lifting global stock markets generally. We are encouraged by recent developments in the Japanese market, and the potential for a rebound in the European market with classic value factors starting to perform again. Meanwhile, we continue to find compelling new investments around the world. So there is plenty to be upbeat about. As mentioned above, the low valuations of our portfolios are attractive, and the fact that the companies we hold still have room for improvement makes us optimistic.

Yours faithfully,

Jens Moestrup Rasmussen
Chief Portfolio Manager
17 April 2013

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