Sparinvest

Letter to Shareholders Q2 | 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,*

## Speeches and Reactions

The second quarter was volatile for global equities, and also for our funds. April saw good equity performance, as central banks maintained their supportive monetary policy. But in May, Chairman Bernanke’s hints that the Fed could start to reduce the pace of asset purchases, if economic data continued to show signs of improvement, spooked the markets. This ‘new’ prospect of the Fed reducing its stimulus measures caused a rise in global bond yields and put pressure on equity markets. The quarter ended with the MSCI World Index down marginally, while Sparinvest Global Value gained close to two percent.

Speeches by central bankers, and market reactions to them, can sometimes seem rather baffling, like an old fortune-teller reading the future in tea leaves. They raise classic questions of behavioural finance and of short-term versus long-term thinking. From our perspective, the markets in May and June reacted excessively negatively to statements from Bernanke that were, in many ways, in line with expectations. After all, what the Fed actually does depends on underlying economic developments: they do not just stick to a plan regardless. As Bernanke said in June, “if you draw the conclusion that I’ve just said that our policies… will end in the middle of next year, you’ve drawn the wrong conclusion because our purchases are tied to what happens in the economy”. Of course, concern about the precise timing of Fed policy impacts stock markets, but ultimately what we are talking about here is the normalisation of the economy leading to a normalisation of monetary policy, and in the medium to long term we see that as positive for global equities – and value stocks eventually.

Nonetheless, short-term market reaction was negative, suggesting that global sentiment remains jittery. The sharpest reaction was in emerging markets, where rising US bond yields led to outflows from emerging market debt, EM currency weakness, and steep equity declines. Moreover, global market sentiment was not helped by concerns about China, where weak trade data combined with fear of a potential credit crunch amid sharp rises in interbank rates.

In Japan, after a flying start to the year, equity markets saw a correction in May and volatility levels near those of post-earthquake 2011. Even so, Japan still posted respectable gains by quarter end, extending the strong performance from Q1.

In the Eurozone, supportive monetary policy was prolonged, with the European Central Bank cutting rates in May to 0.5%. Economic data showed Eurozone economies remain weak, but the direction is encouraging. For example, PMI surveys remained below 50 but rising, with June numbers showing improvements across Europe - with the exception of Germany, which fell back slightly after a solid start to the year. Europe still has its work cut out, but numbers indicate it is in a slow recovery and the recession has stopped.

A lot of what we have seen raises the old question of long-term versus short-term. The Fed's potential tapering of quantitative easing is triggered by and contingent on underlying economic improvement. Japan's politicians, for so many years inactive, are making bold moves designed to put the country back on a competitive path. In China, government steps to restructure the economy from reliance on investment to a more consumption based economy should help the country towards more stable, sustainable long-term growth. All of these do have the potential to cause short-term volatility, but we see them as essentially positive steps which should be supportive of long-term returns.

## Need for Change

Looking at the economies in Europe and Japan there is no doubting the need for change. Politicians in Europe have been slow movers, but now seem to be addressing the problems. One key to Europe regaining competitiveness is reform to create a more flexible labour market: unlike the US, Europe's workers simply have no tradition of moving 1000 km to get a new job – a fact Angela Merkel has noted. Going forward, there needs to be greater coordination of reforms and structures introduced locally in EU nations, to ensure that they will have the desired effect on the European economy as one whole.

In Japan, Prime Minister Abe is pushing ahead with his 'three arrows': monetary easing, fiscal expansion, and reform. The latter has the potential to provide the longest-lasting benefits, but it's also the hardest to grasp. One area is the labour market, where there is a need for more movability and easier hiring and firing. Declining wages – which contribute to a deflationary economy - must stop. Flexible labour laws should help, making companies more efficient in their restructuring and thereby better able to create growth and more valuable jobs in the long-term. Changes to social welfare and structure can help, for example by increasing female labour participation. Recent statistics even suggest that an increase in the number of double income families is positive for the total fertility rate in Japan.

Mr Abe states that he aims to restructure the Japanese economy because there is no alternative. But given the track record of Japanese politicians in recent years, it's likely that many will remain sceptical until clear results are seen.

We have often stated that recovery from the global financial crisis would never be smooth or quick. Reform does not bring overnight results. However, gradual progress brings good potential for global equity markets and for our investments.

## Asset Crystallisation

We previously wrote that during 2013, we expected to see an increase both in investors' risk appetites and, more importantly in their selectivity - with greater focus on fundamentals and the relative merits of individual stocks. In May and June, monetary policy and macro news generally were still major market drivers. However, there is no doubt that we are seeing signs of increasing focus on fundamentals and individual stock valuation. For example, value stocks and small cap stocks have been performing well in the US, and in our portfolios we also see cases where the market is beginning to price in individual corporate value more realistically.

We've often written about the potential of M&A to drive performance and we continue to see the potential for M&A interest in many of our holdings. But we should note that this is not the only way for values to be unlocked. Historically, we've also seen value unlocked when companies carry out asset divestitures, or spin-offs/IPOs of business segments. REITs (Real Estate Investment Trusts) are a good example. These are structures for holding real estate assets that have a reduced corporate tax status, and are required to distribute most of their income to investors. Where a company has stable real estate assets which it uses in its operations, it can often make sense to spin these off into a REIT structure. There are a couple of examples among our current holdings.

**Canadian Tire** is the nation's largest retailer, aiming to have a store 'within 15 minutes of nearly anywhere in Canada', with a wide product range and related operations in petrol stations and credit cards. We invested in early 2010, as it simply looked too cheap compared to its solid and growing earnings profile, potential for strong free cash flows, and conservatively-managed balance sheet. In addition, Canadian Tire owned the bulk of its store network, and although management were conservative, they had showed awareness of the potential value here.

The company performed well over the next couple of years, both operationally and in the stock market, returning over 16% annualised in EUR terms. Then, in May 2013, management announced a plan to spin off 18 million square feet of its real estate into a REIT, with an estimated market value about CAD 3,5bn. In addition to financial and operational benefits, this move focussed investor attention on the value in the company, and the share price promptly jumped a further 14%. We remain invested in Canadian Tire, as we continue to see a healthy discount to its intrinsic value.

Another example is **Oil States International**, held since March 2013. This diverse company has four diverse business areas providing products and services related to oil, gas and mineral production in Canada, Australia and the US, including housing provision for workers. We appreciate the solid track record, diversity, balance sheet strength, and of course, the attractive valuation of this company. In addition, the accommodation business has solid asset backing – modular housing facilities – with stable long-term contracts and cash flows. Discussing these assets with management was encouraging: while they had no immediate plans to create a REIT, they regularly considered the option, aware of the need to maximise shareholder value from these assets. In April 2013, another investor – holding over 14% – began placing pressure on Oil States to consider a REIT spin-off. While nothing concrete has yet been decided, the share price responded quickly. Moreover, we remain positive that management will work to unlock maximum value in the long-term.

These are two very recent examples, and it's encouraging to see these scenarios play out. But we find more comfort in the fact that within our portfolios, we see many stocks where the underlying value of certain assets or operations is barely reflected in today's market price.

## Looking Ahead

The global economy is by no means out of the woods. Recovery takes time and can see volatility on the way. The recent market pullback triggered by talk of Fed tapering is an example of this. But we are encouraged that the equity markets in 2013 have shown more discrimination, with some of the cheaper stocks gaining attention. Moreover, our funds have generally delivered reasonable returns year to date. Pullbacks in the market also provide windows for new investment, and we see interesting opportunities in various markets. As always, we look for companies with healthy finances, and make cautious assumptions – looking at assets or earnings over a business cycle. Based on this, we make a conservative estimate of intrinsic value, and if we see a significant discount to that, we invest. Our portfolios trade at compelling valuations, and over coming years we see good potential for the significant discount to intrinsic value to drive solid investment returns.

*Yours faithfully,*

**Jens Moestrup Rasmussen**
Chief Portfolio Manager
12 July 2013


Upper row, from left to right:

**David Orr**
Senior Portfolio Manager

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**Karsten Løngaard**
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**Trine Uggerhøj**
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**Kasper Billy Jacobsen**
Chief Portfolio Manager

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