Sparinvest

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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

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Dear Investor,

2013 ended up being a very good year for us, and for equity investors in general, leaving most of our funds well ahead of benchmarks at year end. The fourth quarter generally brought solid absolute returns. In 2013 the stock markets have shown a renewed focus on fundamentals and on the long-term potential in companies. This is what we, as fundamental value investors, had been waiting for during one of the longest periods in history where classic value factors had underperformed. Now we are seeing a supportive environment for our bottom-up value investing approach again and, as a result of this, the performance of our funds has been encouraging in 2013.

2013 – Just the start of normalisation?

The correlation between stocks on the stock market has come down sharply during the course of the past year, meaning that stocks have started to respond more to individual news again. Remember that this differentiation or “sorting the sheep” is exactly what the stock market does in the long run, and effectively a key reason why bottom-up value investment works. In 2013, the US, Japan and Europe exposures within our global funds outperformed their regional benchmarks, driven by positive selection returns, meaning that our specific stock choices have been successful. This is ‘stock-picking’, and 2013 has been much more of a stock-picker’s year than we have seen in a long time. For the previous several years the financial markets had exhibited extreme behaviour, with most stocks moving in unison, along with the rest of their sector, country or region, driven largely by fear and doubt. This was not normal – and shows that one must be careful not to operate with expectations based only on the experience of the 'running 3-year historical window'.

Where are we in the valuation cycle?

So where are we now? Major US indices have topped the peaks reached before the global financial crisis. The Nasdaq is even back above the level it hit in December 1999, just before the dot-com bubble burst. But European and Japanese indices are still 10-30% below the peaks they set in mid-2007. So where are we in the valuation cycle?

With economic growth picking up and interest rates remaining at generally low levels – despite some increase in bond yields - it wouldn't be surprising to see a contraction in equity risk premiums, and a rise in valuations. Indeed, this is what we saw in 2013. In the US and Europe, the main driver of share price gains was expansion in price-earnings multiples, and not actual earnings growth. Multiples also rose somewhat in Japan, but actually the main driver for the sharp gains of Japanese stocks was significant earnings growth, helped by the weakening yen. Overall, this does not mean that equities are now expensive. Remember that a year ago, valuations were at extremely low levels, so we have simply seen some reversion towards normal levels. Moreover, the improvement in global growth has so far manifested itself mainly in economic indicators, but from now on should increasingly feed into corporate earnings.

But for us, as stock-picking value investors, any discussion of overall equity valuations can seem excessively generalised. What interests us more are valuation disparities, and what drives them. If we take a comparative look at the development of price-to-book ratios of US, European and Japanese companies with market capitalisations over USD one billion, obviously the basic pattern is that multiples peaked around 2006-07, fell sharply with the financial crisis, and then began recovering. Beyond this, there are two interesting trends.

Valuations loftier in US

Firstly, the recovery has been sharpest in the US: the median price-to-book of 3.6x is now some 20% above the peak from 2006. In contrast, Europe and Japan remain cheaper than their pre-crisis peaks. Europe's median multiple is 2.6x, 14% below the peak, while Japan's is 1.5x, 28% below the peak. What explains this? Most simply, the US has recovered faster from the global financial crisis, while Europe has been hampered by the sovereign debt crisis, and Japan by an earthquake and a persistently strong currency. . Earnings recovered more sharply in US companies since the crisis. In addition, US equity markets were supported by changes in capital structure: many US companies bought back shares in recent years. So, viewed in this context, the sharper recovery in valuation multiples in the US is understandable. But we would be wary of extrapolating this trend too far, particularly when European and Japanese companies are emerging from a period where they have been restricted from achieving their full potential.

The EU still faces a delicate balance between the needs of the core and the periphery, but we see positive underlying moves in individual countries (we commented on French reforms in our last letter) and some encouraging data. As Japan enters the second year of Abenomics, two key questions are how quickly and effectively Mr Abe can deliver his third arrow – reform – and whether companies will deliver wage hikes. But positive results so far include the pick-up in inflation, and the weaker yen giving oxygen to exporters. So in both regions, economic headwinds are gradually abating and, after years of cost cutting, operating leverage could drive impressive earnings growth. Meanwhile, it is not only US companies that can deliver positive changes in corporate and capital structures. During 2013, against a backdrop of global M&A markets warming up, we wrote about value crystallisation through asset divestitures at Canadian Tire, Oil States International, and Nokia. Now, we have Maersk divesting its supermarket business (see below). In Japan, we see various catalysts for more focus on capital efficiency: from a new Nikkei/Tokyo Stock Exchange index whose constituents are chosen based on ROE and corporate governance factors, to a new code of conduct requiring greater engagement with listed companies on issues like capital structure and dividend pay-outs. Moreover, in a deflationary environment, companies were not incentivized to put cash to work: as inflation kicks in and leads to negative real interest rates, companies will be under increasing pressure to utilize cash effectively, or pay it out to shareholders.

Opportunities in Wide Valuation Gap between 'Cheap' and 'Expensive'

The second trend of note in price-book ratio movement since the global financial crisis is that the steepest increases have been in those quintiles which were already most expensive beforehand. Pricey stocks got even pricier relative to cheap stocks. This demonstrates a point we made in earlier letters: during the recent turbulent years, many investors have crowded into parts of the market seen as safe, such as defensive stocks, low beta stocks, and high dividend stocks. These typically come with a high price tag, and the crowding pushed it even higher. We could see some of the attractions of such stocks, but as value investors we must always consider the price.

Moreover, we do not think that low beta or volatility alone serve as a reasonable gauge of long-term investment risk. BofA Merrill Lynch did a recent study on the ten sectors of the S&P, comparing stock price beta with fundamental risk - a measure of earnings quality based on ten-year earnings stability and growth. Interestingly, the sector with the smallest proportion of companies with stable earnings was telecommunications: a sector which is typically seen as defensive, and has the second lowest price beta of all sectors. Meanwhile, the sector with the highest proportion of stable earnings stocks was industrials – commonly seen as highly cyclical, and certainly high beta. As we often argued in recent years, it has been a period where stocks moved in highly-correlated groups based on sector or regional classifications: to some extent, dislocated from company fundamentals, and mispricing long-term investment risk.

During this period, the valuation gap that opened up between cheap and expensive, 'cyclical' and 'defensive', low beta and high beta, was nothing short of extreme polarisation. As we know, this was tough for classic value investing. However, we were confident that this would not last, and took comfort in the fact that large valuation dispersions give large potential returns for value investors. 2013 provided some vindication of that. Globally, value stocks and growth stocks gave roughly equal returns. However, we saw clear outperformance of some cyclical sectors, particularly in Europe. Our global fund outperformed the MSCI World in all major regions, with absolute returns of 26-30% in all of them. But even more encouraging, is that the valuation gap remains wide. The spread between the highest and lowest price-book quintiles remains around the widest in many years, both globally and in each region. From a long-term perspective, the more cyclical sectors still look heavily discounted to defensive sectors. And our funds remain notably cheap compared to stock indices, measured on asset-based or earnings-based valuation metrics. This bodes well for the future.

Note also that bond yields are rising, driven primarily by faster global growth and Fed tapering. This can be a supportive environment for value stocks. Faster growth should in itself be beneficial, spreading earnings wider through the economy, boosting asset utilisation, and allowing operating leverage to kick in – as discussed above. But also, higher risk free rates reduce the value of cash flows which are further in the future relative to the value of today's earnings. High P/E growth stocks typically have more of their expected cash flows in the distant future, and therefore as bond yields rise, become relatively less attractive – while value stocks become relatively more attractive.

Value crystallisation

One of the themes in 2013 was unlocking value through asset divestitures. 2014 has got off to an interesting start, with Danish giant Maersk announcing the sale of most of its stake in Denmark's largest retailer, Dansk Supermarked. This will generate proceeds of about DKK 17bn (EUR 2.3bn) and a gain of about DKK 14bn (EUR 1.9bn). This is the latest – and largest - in a series of divestments that leave Maersk with a clearer focus on its core businesses: container shipping, ports, oil exploration, and drilling. It also boosts the firm's financial firepower, potentially allowing investment in those core areas, but also – in the words of the CFO – leaving "an opening for increased dividend capacity". We have been long-term investors in Maersk, drawn by low valuations, financial strength, and long-term management thinking. We see this latest move as positive – and it was certainly well received in the stock market.

Emerging Markets

In emerging markets, the biggest theme of 2013 was clearly Fed tapering. May brought expectations of an early start to tapering, and almost immediately many emerging market equities and currencies were sold off. The concern was that the cheap liquidity that had flowed into these markets in recent years would now flow back out, and into the US in search of yield. In the short term some emerging markets do appear more vulnerable than others to such investment flow impact. However, we believe that the key long-term structural drivers for emerging market economies and equities remain in place: low debt levels, current accounts in surplus overall, an expanding middle-class, and a need for increased capital stock and infrastructure. These are of course generalisations, and at the individual country level, it is more nuanced.

China is an interesting example. Many have been concerned that China faces a hard landing, but in 2013 it was not so much hard landing as hard currency: both the renminbi and Chinese equity markets stood out for their strength. Of course, concerns remain. The Chinese government's agenda of reform and shifting the economic growth model from export-driven to consumer-driven, could bring down growth rates from the lofty levels seen during much of the past decade. We understand these concerns. But reform is rarely pain free, and this shift should be beneficial for the medium to long-term, giving China a platform for more steady and sustainable growth.

But we must not pretend that China, or the "BRIC" nations are the only ones that matter. From our perspective, the key point is that emerging markets offer a diverse universe in which to carry out stock picking. Our emerging market funds – like all our value equity funds – make investments based primarily on individual stock selection of those stocks which strike us as offering significant discounts to their long-term value. This is because in emerging markets, like developed markets, there is a clear long-term trend for value stocks (cheap stocks) to outperform their more expensive peers. In fact, since early 2012, we have entered a period where value stocks have been relative underperformers in emerging markets. But short-term periods of value underperformance are to be expected, and do not change the long-term picture. Meanwhile, we are encouraged by the fact that our emerging market equity funds in fact performed relatively strongly in 2013, despite the tough environment for value. Our emerging market funds outperformed MSCI Emerging Markets by around 1% to 5%, and outperformed MSCI Emerging Markets Value by considerably more. Going forward, we will continue to focus on selecting stocks which we consider to be valued unjustifiably cheaply by the market.

Very positive outlook for Value

So we are optimistic about 2014. Even after the strong performance in 2013, we still believe that equity is the most attractive asset class, and that flows back into equity will continue in 2014. While we do not argue that stocks look especially cheap now, they do not look highly priced.

It is not difficult to imagine triggers for dark clouds to return to financial markets, economies to falter somewhat, or renewed political hiccups in Europe and the US. But the markets seem to be reacting more calmly to such hiccups, and we do think the global economy is recovering slowly, with a potential positive impact on earnings in most companies. So we expect earnings recovery to drive global markets in 2014, and we see particular potential in Europe and Japan, as well as the more cyclical or economically sensitive parts of the market. This should have a positive effect on a lot of our investments.

The stock markets continue to offer us compelling new investment opportunities, which we are confident will drive solid long-term performance. 2013 was a strong year, but we believe it was just the start of normalizing conditions on the stock markets. The outlook is good and we are optimistic, because risk appetites are returning in the equity market, stock to stock correlation is down, valuations of our portfolios are attractive, and we expect increased earnings from the companies. Meanwhile, companies are increasingly looking for opportunities to unlock their value. These are encouraging times for value investors.

Yours faithfully,

Jens Moestrup Rasmussen
Chief Portfolio Manager
09 January 2014

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