Letter to Shareholders Q1 | 14

Sparinvest

Value Bonds

Headlines

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Our Value Bonds Funds

Fund	ISIN code
Corporate Value Bonds	LU0620744002
Emerging Markets Corporate Value Bonds	LU0519053697
Ethical High Yield Value Bonds	LU0473784196
High Yield Value Bonds	LU0232765429
Institutional Corporate Value Bonds	LU0760185370
Investment Grade Value Bonds	LU0264925727

Detailed information is available on sparinvest.eu

- sparinvest.eu

Dear investor,

Slow recovery continues

Without a doubt, the Emerging Markets and China have been the main macro-economic risk factor in Q1. Added to this, we saw tough weather conditions in the US which hit US economic activity quite a lot, resulting in lower than expected numbers. However, as the better weather returns, we can anticipate an improvement in US numbers.

Meanwhile there are encouraging signs recently that momentum has changed regarding the financial markets of Emerging Markets, indicating a greater degree of stability. One such sign is the impressive performance of Brazil's stock market which is up around 5% this year in Euro terms, compared with a comparatively weak 0.04% from the S&P500 and even -1% from the FTSE.

On the whole, the European economy has performed pretty well since last year. Thus, in our view, the recovery continues to march to the slow, relentless beat of the Fed's drum. Ukraine – or should we say Russia? – is the 'wild card' as it continues to represent an unquantifiable political risk. However, we conclude that global economic risks are steadily diminishing.

Rate-driven opportunities in US High Yield

An interesting development since the last time of writing is that in our High Yield fund, we have doubled our portfolio exposure to the US – primarily through the purchase of extremely cheap bonds in a quality shipping company. The bonds came with a pledge in the form of a mortgage on the ships – exactly the kind of asset backing that we love to see. In terms of relative valuation, US High Yield is starting to look cheaper compared with European High Yield (with the notable exception of financials which continue to be a lot cheaper and more attractive in Europe). This change has been driven by expectations of interest rate movements. Whilst Janet Yellen, on behalf of the Fed, indicated that US rates could not be expected to stay low *ad infinitum*, the European Central Banks have not only said that the risk-free rate in Europe is unlikely to rise in the foreseeable future, but that they may seek to lower rates further in order to weaken the EUR.

So the difference is pronounced in the two regions and we see a spill-over effect from this in the High Yield market whereby people now feel safer from interest rate risk in European High Yield than in US HY. As value investors, however, we are on the look-out for opportunities to buy US High Yield on the back of rate volatility because we see a lot of potential attractions in the market – especially in its well-managed small cap bonds.

Two opportunities to beat the market

We currently see two main opportunities to beat the market. One is financials in Europe because they are still deleveraging and repairing balance sheets. The other is among off-benchmark small caps which is where we have our energy exposure.

With this in mind, we have once again increased our exposure to European financials via new bonds issued by the banks. We see no reason to be afraid of the banks failing regulatory 'stress tests' because their underlying capital is building up very nicely. In fact, we are grateful to the regulators for working so very effectively on behalf of bond investors, protecting their interests by making the banks build buffers and reduce leverage. This is precisely what is making financials the best credit story out there.

In other sectors, companies are starting to focus on shareholder value, becoming aggressive in their desire to pay out large dividends or buy back a lot of shares. Such trends are a big danger for credit investors… and exactly what you are not seeing in financials. The combination of regulations forcing the banks to reduce leverage and increase capital ratios and the fact that Banks' losses will be less as the European economy picks up, leads us to expect continued outperformance from this sector – although not to the same extent as has previously been the case. For example, the biggest position in our fund at present is Barclays with a yield on the bond of 6.9% currently but which we expect to go down even further. In the meantime you still get the coupon payment. So from a returns perspective, it's a great place to be.

We continue to favour the energy sector as the best hedge against geo-political risk. When such risks manifest themselves, they are usually accompanied by a hike in the price of oil. So if you are concerned about Russia putting the world at risk over territorial claims in the Crimea, then it makes sense to be exposed to oil. Longer term, we concede that shale gas presents a risk for oil but as bond investors, our oil exposure has limited duration, typically maturing in 3-5 years and we are pretty confident that the world needs oil over that timeframe.

Looking at the market from a bottom-up perspective, Financials are cheaper in Europe and Energy is cheaper in the North Sea, so that explains our allocation and our still comparatively low level of US exposure.

Defaults and deflation

We believe that the global high yield default level will remain below average at between 2-3% over the next two years. The reason is that the growth outlook is OK and because companies have used the good times to refinance so there is no impending 'wall of maturity'. Also, after all the care and attention that has gone into nursing the economy back to health, we don't anticipate any bubbles being burst as a result of sudden rises in interest rates. Finally, we are still not seeing any significant increase in the number of CCC-rated credits as a percentage of the total High Yield market, indicating that quality remains high.

There is increasing talk of potential deflation in Europe. Our view is that such a scenario would necessitate intervention by the ECB which would be good for financial markets. It would bring the banks' spreads down further and make the European credit market trade even tighter. Short term, it would be good for spreads. People would be forced into buying more credit products because of the lack of yields in government bonds.
The illustration of what happens when deflation is not acted upon swiftly is Japan. The Japanese

went for many years refusing to take the nasty medicine that their economy required. It is the fact that the US and Europe have acted differently and realised losses that has enabled them to recover so swiftly. In short, we do not fear deflation in respect of this market.

The off-benchmark advantage

As mentioned in our last letter, we are still attracted by the liquidity premium which we find present in the markets. In the event of any price volatility caused by lack of liquidity we believe that we will not be 'at the eye of the storm'. Our predominantly off-benchmark exposure will protect us from any 'rush for the exits' which is far more likely to affect ETFs and funds that replicate benchmark exposure more closely than ours.

One indication of how actively we manage our fund, and therefore how extremely different it is to the benchmark index, is that we have a high 'active share' score of 80. This means that we only replicate around 20% of what's in the benchmark in our High Yield fund. The rest we select as a result of meticulous bond-picking in areas where the rest of the market is not looking, such as under-researched small caps.

It is our expertise in this area that enables us to forecast a yield of 7-8% from our High Yield Value Bonds fund over the course of 2014.

For specific news of our Emerging Markets Corporate Value Bonds, you can read the recent market comment from joint fund manager, Toke Hjortshøj, available on our website.

An expanding team

In recent years, the risk return profile of corporate bonds in general and the success of our Value Bonds strategy in particular has resulted in a considerable rise in AUM at Sparinvest, not least in the range of fixed-maturity funds that we have launched in the past couple of years. For this reason, we have been seeking new members to add to our value bonds team. I am delighted to announce that we will soon have two new bond analysts on board.

Anders Kjær Glibstrub has joined us already from the University of Copenhagen where he is finishing his Master's degree in Mathematics and Economics. His thesis was on the subject of 'Betting Against Beta'.

In June, Anders Christensen will also join the team. Anders already works at Sparinvest within our Investment Secretariat. Anders has a Master's degree from Copenhagen Business School and has passed the first year of the CFA.

In conclusion, we are still finding value in global high yield and taking advantage of clement economic conditions to enjoy the carry.

Yours faithfully,

Klaus Blaabjerg
Chief Portfolio Manager
10 April 2014

Key Numbers Sparinvest Value Bond Funds

Key numbers for Sparinvest Value Bond funds	High Yield Value Bonds	Emerging Markets Value Bonds	Corporate Value Bonds	Investment Grade Value Bonds
Yield to Maturity	10.32%	8.19%	4.86%	4.57%
Duration	2.99	3.35	3.84	5.60
Average NDE	89.22%	73.30%	102.3%	65.5%
Avg. Interest Coverage	4.76x	7.06x	11.04x	12.19x
Average Price-to Book	1.07x	1.44x	1.97x	1.8x
Default activity ytd 2014	0%	0%	0%	0%

Sparinvest Value Bonds-Team

From left to right:

Toke Katborg Hjortshøj
Senior Portfolio Manager
Sune Højholt Jensen
Senior Portfolio Manager
Klaus Blaabjerg
Lead Portfolio Manager
Peter Dabros
Portfolio Manager

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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

The mentioned sub-fund is part of Sparinvest SICAV, a Luxembourg-based, open-ended investment company. For further information we refer to the prospectus, the key investor information document and the current annual / semi-annual report of Sparinvest SICAV which can be obtained free of charge at the offices of Sparinvest or of appointed distributors together with the initial statutes of the funds and any subsequent changes to such statutes. Investments are only made on the basis of these documents. Past performance is no guarantee for future returns. Investors may not get back the full amount invested. Investments may be subject to foreign exchange risks. The investor bears a higher risk for investments into emerging markets. The indicated performance is calculated Net Asset Value to Net Asset Value in the fund's base currency, without consideration of subscription fees. For investors in Switzerland the funds' representative and paying agent is RBC Investor Services Bank S.A., Zurich Branch, Badenerstrasse 567, P.O. Box 101, CH-8066 Zurich. Published by Sparinvest, 28, Boulevard Royal, L-2449 Luxembourg.