Sparinvest value

Letter to Shareholders – Value Equities

Q2 2015

Dear Investor,

The second quarter of 2015 ended globally in the red, bringing us back down to earth after the peaks experienced in April and May. Most of our funds outperformed their relative benchmarks. Therefore, we are somewhat satisfied with the quarterly results, but we are aware that we are still in the process of clawing back what was lost (relative to benchmark) last year.

Divergent economies

At this point, halfway through the year, the European recovery seems to be on track - in spite of a few disappointing numbers here and there. There were some obvious benefits in the shape of a weak currency and a low oil price, but the rebound in household and company borrowings - due to improving credit availability - is a strong indication that the monetary policy is starting to filter through to the real economy and that European deflation risks are starting to recede. QE came much later to Europe than elsewhere and there is no doubt that it has been a positive catalyst for European stocks so far this year. Since Europe still represents a big part of global demand, it is also encouraging from a global standpoint.

In Japan, the big theme is still the wave of corporate governance currently sweeping through boardrooms since the new Corporate Governance Code came into effect in June. While capital management is on top of the agenda, we notice that Japanese deflation fears appear to be receding – with consumers showing more willingness to spend and corporate capital investment seeming to have bottomed.

In terms of monetary policy outlook, the growing divergence between the US and the rest of the world seems to weigh on the US stock market. Many investors fear that too sudden an increase in rates could choke the US recovery. The theme is not new to us. Given the economic challenges, which have given rise to significant disparities in global equity prices, we have bought (as you would expect from Value investors) more stocks in attractively priced regions. The Japanese market did well after the introduction of Abenomics and now, finally, it seems that Europe is starting to rise from its sickbed and benefit from quantitative easing.

Company fundamentals

On the back of an optimistic macro environment, we have witnessed a reassuring reporting season – again with geographic differences. US earnings were very much in line with expectations, but sales suffered from the stronger USD, which could hurt earnings going forward. European companies are having an outstanding quarter boosted by 'domestic recovery' and a weaker Euro, while corporate earnings in Japan disappointed slightly after a previous strong quarter. Regarding the health of the portfolio companies, many of them presented solid operating results combined with value-generating transactions that boosted share prices. Other than that, the global funds benefitted from underweights in the US as well as exposure to smaller companies.

As bottom-up stock pickers, we focus strongly on corporate fundamentals. Our investment process seeks to find companies that are inexpensive relative to the profits they generate. As always, we focus on understanding what economic changes mean for specific companies and their profitability. An obvious benefit that our global funds can provide is that we have a greater opportunity set. This allows us to construct portfolios with different from usual characteristics and prevents us from selecting companies simply based on the state of the industry in which they operate or the country in which they operate or have their headquarters.

On the other hand, diversification is a cardinal rule and, while we have great absolute geographic diversification in terms of currency, we are still underweight US stocks in our global funds compared to our benchmark - although less so now than previously. Lately, we have added a small number of US stocks in which the price did not reflect the underlying value. Consequently, our increased US exposure has reduced our relative risk.

Interest rate sensitivity

We know we have mentioned it before; the performance of a value investing strategy is tied to economic cycles and interest rates. Until now, the post-financial-crisis-QE-fuelled stock market has not been a benign environment for value investors. However, we cannot let the results from late 2014 determine whether our value investing strategy is good or bad. We know that one should never extrapolate a short-term trend too far into the future. Having said that, recent developments could be what we have been waiting for.

Since mid-April, government bonds have been very volatile. The rising yields especially at the long end of the curve, and the subsequent curve steepening should - according to the the studies that we have presented in earlier letters - give a tailwind for value stocks and cyclical stocks. Recent performance has shown that we were right in assuming that our funds would start outperforming as the economic recovery started to push inflation and interest rates up just a bit. This was a tailwind for all of our value funds over the recent quarter. The obvious question is whether bond yields will continue to increase.

Current investor uncertainty, and the volatility in bonds and equities, appears to relate to the overall question about whether we are moving into a deflationary or an inflationary scenario. On one hand, some investors fear that economic recovery in developed markets will result in interest rates rising too rapidly; on the other hand, the slowdown in emerging markets, and the risk of a lower than expected growth in Europe and US, could cause deflation. Although the consensus now seems to be somewhere in the middle of the two, we believe that some of the recent market volatility is due to sentiment changes regarding these two outcomes. Aside from secular economic trends, there are still geopolitical tensions in the Middle East, an unresolved issue in Ukraine and of course the never-ending story: Greece.

Greece, a never-ending story

Albeit that we sympathise with the misery of many Greeks, it is our opinion that the country is now going one-step too far in an attempt to take the rest of Europe hostage. The Greeks themselves have exacerbated a bad situation. After many years of malpractice in collecting taxes and low morale in paying them, they have reached a point of no return. It is not hard to understand the frustration some Greeks must feel in this situation. If you are a young person with a very bleak outlook regarding the prospects of your home country, you must be frustrated. If you are a worker on a lower-income who has had to bribe your way through the public welfare system, you would have been much better off with a functioning system, paying your taxes and getting your service.

It seems like the government's strategy when negotiating with the creditors has been to play one card at the time. Now they are running out of cards and have no more aces left to play. As a result, they have placed themselves in a very bizarre situation where they now have to vote on a deal/offer that is no longer on the table. If the referendum result is a 'no', Greece could be on the verge of exiting the Euro and on its way to an economic unknown and very uncertain future. If it is a 'yes', it must result in a new government and Greece getting back on track in introducing reforms and trying to sort out its economy. There are no shortcuts in a process like that; you only need to ask people in Ireland, Spain, Portugal and Italy.

All of this has fuelled the uncertainty and volatility on the financial markets and caused the markets to fall back. The question is how well the EU can isolate the problems in Greece, so they do not spread and create an even worse situation. At this point, it seems like the EU will be able to contain it, even if it ends up in a Greek exit, because the economy is generally doing better, austerity is easing up, banks are better-positioned and the ECB actions continue to give support to the market. The European recovery appears robust to us, and at the same time, it is one of the most interesting places to invest your money in terms of current stock valuations. We still expect earnings growth to stay strong in Japan and hence, we expect Europe and Japan to be the two regions that provide the funds with ample returns going forward, albeit with the risk of some short-term volatility caused by the Greek situation.

Capital management and shareholder interests.

In Japan, companies are currently under increasing pressure to perform well in the short term. The new Corporate Governance Code was introduced but, as we have touched upon before, a lot of the content has been discussed in boardrooms already, and many initiatives had already been decided. For instance, May 2015 was the second-best month in the last 10 years for buyback announcements in Japan, while US buyback activity peaked last year. However, with the Code in place, we expect further acceleration of buybacks and dividend revisions, funded by Japanese companies' rich cash balances.

We are happy to see the record level of share buybacks in Japan, but we think it is important to consider other options as well. The obvious benefit when a company buys back shares is that shareholders end up with a bigger part of the company, and thereby a bigger part of the profits it generates. At the same time, it sends a message that the company is doing well and sees good prospects in its own operations. It is often assumed that buying back shares is done, only if it is more value-enhancing than investing in new growth. In other words when, in management's view, the company is undervalued and therefore represents the best possible 'investment' it can make.

But, share buybacks can also be the result of a poor management decision or, even worse, can be motivated by the desire to see a short-term impact on the share price. Sometimes, it seems like the main aim is to maximize the personal wealth of the executives, when contracts are tied up with share price performance or certain profitability measures. That is just poor management. Similarly, another questionable motivation for buying back shares could be that it is a low-risk decision for management in a cash-rich company compared to investing in more risky R&D or buying a competitor.

No matter what the motivation is, what determines whether a repurchase creates value or not, is the price. In short, when shares are overvalued, a repurchase will destroy shareholder value. In such circumstances, paying out a dividend may be a better option. Furthermore, it can also tempting to use debt financing to fund share buybacks, especially in the current low interest rate environment. This is not a risk-free strategy as it will indebt the company, which could hurt credit ratings, while at the same time making it more vulnerable to short-term headwinds.

We continue to engage with our investments on share buybacks and capital allocation, as with any other matters, but it is important to stress that governance and capital management is about more than just buying back shares. Today many executives around the world often focus more on financial engineering rather than trying to develop the business long term. Financing is cheap, and their compensation is often directly linked to short-term share price performance. It is important not to get too short sighted when it comes to capital management and shareholder value. Some companies could actually benefit from allocating more funds to research and investments instead of dividends and buybacks. Any value created (or destroyed) through R&D is just as enduring as that created (or destroyed) through buybacks. This is why capital allocation cannot be formulaic. We are not short-sighted activists who wants to strip a company of its assets, but we do engage in constructive dialogue with management teams and listen to their arguments while presenting our own.

M&A and asset crystallization

In earlier comments, we have mentioned how several of our investments have tried to shed a light on their true values and how assets can be crystalized. Lately, we have seen many examples of companies with great assets values in land, patents, buildings and so on, who have converted these into cash at some point. Loss-making business units have been divested and profitable units have been spun off to show how attractive they are. The lack of takeover interest from other market participants following the financial crisis has caused these asset conversions to continue recently. At the same time, M&A activity is on the rise. A cocktail of low financing costs, combined with a quest for growth across sectors, has fuelled global M&A markets, albeit more in the US than elsewhere.

When investing in assets that are not fully utilised for one reason or the other, the challenge is that it is not easy to predict when such an event, conversion or takeover, will happen. This is one of the reasons, why value investing is possible. We try to find the non-utilized assets and wait for them to be converted into profits. We do not possess any special knowledge – often sell-side analysts comment on the same assets, saying that they 'just don't see any apparent catalyst' and they do not ascribe much value to it. This is what some people call 'time arbitrage'. We are long-term investors and we have the patience and the endurance to wait it out.

If a company has secular tailwind, we do not mind if there are short-term challenges. Such companies can still be quality companies that will slowly grow their intrinsic values over time. Obviously the sooner any 'hidden' value is unlocked, the greater the return our investors will have. In the long run, such a strategy pays off. On that note, one of our larger positions, Belgian food retailer Delhaize, was involved in a value-enhancing transaction just as the quarter ended, when Ahold and Delhaize announced their intention to combine their businesses through a 'merger of equals'. Delhaize has been a solid performer for our funds in recent months, partly due to anticipation of such a potential deal. In practice, the shares have actually fallen slightly since the deal was finally announced, as the market tries to digest the deal technicalities. But the fact that we see this sort of activity in the portfolio within Europe is definitely encouraging.

Conclusion/outlook

The investment environment has been uncertain in many ways for a number of years now, and it seems to continue to be the case for the immediate future as well. However, in spite of the uncertainty and volatility, the long-term drivers of the global economy have not changed.

We expect global growth to continue to be relatively modest. While a budding 'recovery' phase in developed markets, especially in Europe, may stimulate global GDP growth, one should not forget the secular demographic challenges and a slowdown in China that will have wider consequences for emerging market commodity exporters. We believe that modest global growth will continue to lead to general corporate earnings growth, which should support equities going forward. Meanwhile, the attractiveness of equity valuations is debatable, but compared to other assets, for instance developed market government bonds, the relative attractiveness is still obvious to us.

When looking only at equity markets, the same rationale applies to value stocks. Considering the valuation disparities within equities that we have often commented on before, we are still of the opinion that there are more attractive opportunities within low-priced value stocks and cyclical stocks relative to the perceived 'safe heaven' stocks. As bond yields stop falling and maybe gradually start to increase with inflation and growth, the valuation gap is expected to narrow. Value-enhancing transactions – whether it be buybacks in Japan, divestments in the US or mergers in Europe - all work as catalysts today, and we are convinced that our funds are well positioned for strong future relative performance even in the near term.

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