Letter to Shareholders – Value Equities

Q3 2014

Dear Investor,

In recent letters we have drawn attention to the nascent economic recovery in Europe and the impact of this on value stocks. During the quarter we have seen things turn, with weaker data coming out of Europe, in contrast to the US economy which continues to do well. This divergence in macroeconomic data has also been observed for some time in corporate earnings. US equities have hardly seen any negative earnings revisions over the summer and thus have been able to live up to the already high expectations. European companies, however, saw relatively more frequent and larger downward earnings revisions. The decline in expectations has been driven mostly by European exporters, particularly the automotive sector and companies operating in energy and materials.

This divergence between regions was reflected in equity market returns. At the same time, increasing political tensions at the borders of Europe were particularly harmful to European equities. Hence, the US market performed strongly against the backdrop of a strengthening dollar, whereas European equity indices were more or less flat.

Contents

European recovery derailed?

Admittedly Europe is faced with some challenges, but these challenges seem to be more than factored in to the low valuations in the region, and we see four reasons why things are not all bad.

First of all, we think that we are close to the end of negative earnings revisions in Europe. The cycle of declining expectations has lasted for more than last two years, which is a long period from a historical perspective. More importantly, European corporate earnings tend to correlate more with the global economy, which seems to be in better shape than the European economy is at present.

Secondly, the ECB has recognized the 'slow patch' in Europe and is willing to expand its balance sheet again. This is a change from the past two years in which the ECB was the only major central bank in the world to shrink its balance sheet. In other words, we are at the start of a new round of monetary easing in Europe, while the US is closer to tightening. Recent announcements by Mr. Draghi about the central banks' policy have met some criticism, because of the lack of clarity about timing and levels of easing. From our point of view it is more important to understand that the ECB is willing to further improve credit conditions in Europe, an imperative to kick start the region's economy.

A third important factor set to further increase confidence and lending in Europe is the outcome of the Asset Quality Review of European banks. This is due at the end of October. Although, we don't expect outcome to reveal much news, we do think that this exercise has pre-occupied banks during the past year, taking their focus away from their core business, i.e. lending activity. The most recent Bank Lending Data (July) from the ECB showed that – for the first time since 2007 – credit standards for loans to enterprises eased, while loan demand improved. Having said that, there is still need for further improvements, especially as loan demand for capital investments, although positive, is still sluggish.

The fourth positive factor is a side-effect of renewed monetary easing by the ECB – in other words the recent weakening of the euro since end August. The effects of this will filter through to earnings of European exporters in the coming quarters. Combined with the high degree of operating leverage of many European cyclical companies, we see room for dramatic earnings improvements going forward.

A tough quarter, memories of 2011

After ten quarters of good performance for value equities, this third quarter of 2014 was a particularly tough one for our investment style and was reminiscent of Q3 2011. Then, just as now, markets were overwhelmingly driven by sentiment, and US stocks also significantly outperformed European stocks. Back in 2011, people thought we were at the brink of a Eurozone break up. But this time it has more to do with an escalation of uncertainty caused by a number of factors: weak economic data out Europe, the Ukraine conflict, war in Syria and neighboring countries and Islamic State, the Ebola virus in Western Africa, the state of the Chinese economy and the impact from all of this on global economic growth going forward. Mirroring what happened three years ago, the increased uncertainty again caused investors to shy away from high beta stocks, small caps and value stocks. It had a significant negative impact on performance in most of our funds.

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 focused instead on reactions to macro and political events. One effect has been that financial markets have probably been driven even more than normal by consensus-seeking activity, as investors stick closer to benchmarks to avoid standing out: certainly we have seen declining active share ratios from some investors in our universe. A second effect is that many investors have sought refuge in sections of the market considered relatively safe, such as traditionally defensive sectors.

Safe haven strategies – and momentum strategies, where you buy into stocks in which other investors are herding - can often pay off in periods where uncertainty and volatility dominate, but it has led some parts of the market to look very crowded, with excessive valuations. Similarly, hugging the benchmark pays off, so long as most people keep doing it. History has shown that such periods always come to an end. When that happens, the rewards for value investors can be swift and large, as valuations gaps between different parts of the market contract towards more normal levels. Value investing focuses on buying discounted companies, because this is what generates the strongest long-term returns.

Tech stocks

Some of the 'favourites' in the recent quarter have been tech stocks – Biotech and Information Technology. The best performing overall sectors were Health Care and Information Technology. What led the way in Health Care was not big pharma but the biotech stocks. Without going into details, we can reveal that is hard for us to put a value on such companies, which always look pricey on traditional metrics like earnings yield or even price-to-earnings growth. Within IT, companies like Facebook, LinkedIn and Twitter, which were all listed in recent years, were among the best-performing stocks in the quarter. Most of the stocks within this universe are simply not compelling to us. Conventional valuation methods are difficult to apply; Twitter has yet to show a positive quarterly result, and the company is not expected to break even before 2017. We concur with many other market participants when they mention these sectors as being in bubble territory. In the FED Monetary Policy Report of July 15, even Janet Yellen pointed to 'stretched valuation metrics' precisely within the social media and biotechnology industries.

Meanwhile, the term 'Information Technology' covers more than just the social media stocks and we are often asked our opinion about stock market IT-darlings like Apple. Although we do not pretend to have special insights, we do think that its track record is highly impressive. This, however, comes at a price, which to date, has not been appealing for us as value investors. We find it especially difficult to judge for how long Apple will be able to continue its growth without sacrificing its well-above-industry-average margins.

The life of a value investor does not get easier when the share prices of companies like Apple or the social media stocks mentioned above rise sharply – as they have done over the last few years. The pressure and temptation to participate in the rally only gets bigger and bigger. One starts to feel like the dumbest guy in the class. In those situations, however, we remind ourselves, that we have to stick to our style. Besides, the opportunity set is large enough for us to be able to find similar ideas at prices that are far more attractive to us. Hard disk maker Western Digital perfectly describes this.

The investment case for Western Digital is somewhat tied to Apple. In early 2010, Apple announced the introduction of the iPad. People were getting excited about this new product and thought that it would change the PC market in the same way as the I-phone had changed the mobile phone market. On the back of significantly reduced growth expectations for PC's and notebooks, the outlook for hard disks volumes were also lowered, as people were ready to declare the death of the PC. The share price of Western Digital declined sharply from USD 40 in January 2010 to USD 25 in September. When we first bought our shares in in September 2010, Western Digital was trading at 2.3x EV/EBITDA, 4.3x P/E and had 40% of its market capitalization in cash. In other words, it was priced 'as if there was no tomorrow'.

However, we saw a company, that had been able to shift through different technology cycles and was part of a strongly-concentrated industry with better pricing discipline than for example the mobile phone market. In the beginning of the nineties more than 20 companies were fighting for market share, while in 2010 the top three makers had 80% of the market. We also thought that the PC market would not disappear, while growth of the iCloud could possibly offer new opportunities.

Within a year after our investment, Western Digital decided to buy its closest competitor Hitachi Storage to become the worlds' largest maker of data storage solutions with a 50% global market share. From 2012 onwards, the synergy effects from this deal became clear to investors and at the same time people started to realize that the iPad is not a substitute for the PC. During our investment period, Western Digital was able to grow its revenues by 50% and EBITDA by 80%. This was also reflected in the share price and valuations normalized from our point of view. We sold our shares in January 2014 at USD 89, and made a total return of 235% in euro terms.

What happened to Apple during the same period? The introduction of the iPad was indeed a huge success story and a game changer. As a result, Apple was able to triple its revenues and earnings over the same period, while the share price doubled.

So why did the Western Digital beat Apple in this race of best share price performance? If we take a closer look at how the returns of both stocks can be decomposed, we clearly see that earnings and multiple expansion were the drivers of return in the case of Western Digital. In other words, investors had low expectations and were only willing to pay low multiples for Western Digital. However, Apple's return was driven by very strong earnings expansion, while multiples contracted. Therefore, it looks like many investors were already willing to pay high multiples in anticipation of a successful iPad introduction.

To conclude, in times of euphoria for one segment of the market the genuine value investor might miss out on some interesting opportunities. However, this does not mean that other opportunities in his opportunity set of the market do not exist.

Strong earnings revisions out of Japan

While we are looking at opportunities, we must talk about Japan. Despite the very strong share price performance of Japanese equities since November 2012, we still see plenty of opportunities in Japan. One of the reasons is that we have seen earnings improve faster than share prices. Earning growth continues to be higher in Japan than in the US and Europe. The fact that Japanese companies continued to present positive earnings revisions during the summer, against the backdrop of an almost unchanged currency, points to structural earnings improvement for Japanese corporates. A few examples of fundamental improvements within our portfolio holdings are Yamaha Motor and Fujifilm.

Yamaha Motor had 12 production sites in Japan before the global financial crisis started. This has already been reduced to 9, while it is in the process of closing another 3 locations in the country. Other cost-reduction measures being undertaken include better purchasing of goods and new platform strategies. On top of that, the company is becoming better at product differentiation, which increases the pricing power. As a result of these measures Yamaha Motor is on its way to achieving close to record earnings in 2015 – despite the fact that motorcycle sales in developed markets are still 50% lower than before the crisis started and the yen is 10% stronger.

Fujifilm is another company which we have held for many years. Fujifilm realized about 15-20 years ago that it could no longer rely on photographic film (part of the Imaging Solutions segment) in the digital era. The transition to a well-diversified chemical conglomerate has been a long and sometimes painful process. However, one has to realize that once mighty competitors like Kodak and Polaroid have gone out of business during these years. About 10 years ago, Fujifilm started to invest significant amounts in building its Health Care business (part of the Information Solutions Segment), as Health Care has structurally higher growth, higher barriers of entry and a better profitability profile. However, it also requires high R&D spending before any benefits can be reaped. Since 2003 Fujifilm has halved its assets in Imaging Solutions, while doubling Heath Care assets. This strategic change led to continuous losses in Imaging Solutions; while Fujifilm was building its earnings power in Health Care. We have now reached a stage in which Imaging Solutions has turned profitable and Health Care is accelerating topline growth from product introductions. While Fujifilm is still dwarfed by other global Health Care-related companies, it generated a lot of attention this summer on the back of a potential treatment for Ebola. The successful introduction of a new Ebola drug is not the core of our investment case for Fujifilm, but the possibility of such an event could certainly start a re-rating of the company to multiples closer to other Health Care related companies.

Conclusion

We recognize that the global economic recovery is under pressure and much of the recent economic data from the Eurozone has been very downbeat. We have argued that we do not think a European recovery is derailed, but we humbly admit that we have been wrong before in our economic forecasts. The good news is that, despite the mentioned perceived lack of clarity about timing and levels of easing, the ECB is actually responding with a broad range of proposals including the combination of fiscal and monetary stimulus along with structural reforms, termed "Draghinomics" – the exact recipe that seems to work well for Japan.

It is important to remember that our portfolio composition is a result of where we find the best long term investment ideas. It is indeed hard for us to watch the current high-flying stocks (whose gravity defiance cannot be justified by conventional valuation methods) continue to outperform, while solid companies with strong cross-cycle cash-flow generation are priced down because of their geographic origin, size or cyclicality. In times like this, some might question if this is the end of fundamental value investing? We think not. If anything, the observations on biotech and social media stocks remind us about the late nineties where valuations were irrelevant to many investors. They simply didn't matter until a few years later, but then they really mattered. The fact that valuation gaps remain so wide – whether we look at European versus US stocks, defensives versus cyclicals or small caps compared to large caps – cause us to remain convinced about the long-term potential of our investments.

Sparinvest Value Team

Upper row, from left to right:

David Orr
Senior Portfolio Manager

Lisbeth Søgaard Nielsen
Portfolio Manager

Jeroen Bresser
Portfolio Manager

Per Kronborg Jensen
Senior Portfolio Manager

Morten Rønnow Tandrup
Equity Analyst

Bottom row, from left to right::

Karsten Løngaard
Senior Portfolio Manager

Jens Moestrup Rasmussen
Team Leader / Chief Portfolio Manager

Trine Uggerhøj
Portfolio Manager

Kasper Billy Jacobsen
Chief Portfolio Manager

Sparinvest is a signatory of UN PRI and member of Eurosif and Dansif.

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