



## Letter to Shareholders – Value Equities

Q4 2015

Dear Investor,

The last quarter of 2015 ended up being a good one. Markets rebounded strongly from September lows. Over the full year, developed markets delivered strongly positive returns, while emerging markets had somewhat negative returns. The majority of our funds delivered reasonable-to-strong relative returns. For example, Sparinvest Global Value EUR I rose 13.14% versus a return of 10.42% for MSCI World.

Throughout 2015, few things captured investors' attention more than the Federal Reserve and the normalization of U.S. monetary policy. After several meetings without change, the Fed finally took action in December and bumped the rate slightly higher – the first increase in nearly a decade. It was seen as a vote of confidence in the economy, and indications of slow-but-steady increases going forward should ease concerns about rates being raised too quickly and suffocating the economy's growth.

Another major topic in our recent letter was China. China's change in the past few decades has been dramatic. From an agrarian economy, reforms paved the way for building of housing, production plants, dams, roads, railways. While riding an urbanization and industrialization wave, China became what is often called the 'world's factory'. Investors were delighted with double-digit returns, and China's demand for materials helped drive a commodity cycle and benefited other emerging economies. Today, after such growth, China has a vast economy. So now, the size of the economy – the base from which future growth is calculated – is quite simply larger, and one would therefore expect the pace of growth to ease over the years. For some years, it has also been clear that China has no monopoly on being the world's factory. There is competition not only from other emerging markets, but also from some developed markets bringing production "back home". This is not all necessarily negative. As we wrote recently, China is attempting to transition its economic model

from investment to consumption, from exports to domestic spending, from manufacturing to services. But this 'maturing' process is never going to be smooth – there will be bumps in the road.

In 2015, and again in the first week of 2016, after somewhat disappointing economic figures, we saw the bears coming out of the woods, with turmoil in China's stock markets – especially in the mainland China 'A-share' market. It is important not to overreact to this. For some time, we have felt that A-shares were rather expensive, compared to Chinese stocks traded in Hong Kong ('H-shares'), so volatile corrections in A-shares don't necessarily spell doom. In the last few days, the volatility was made worse by temporary technical factors on the exchange – which should be resolved. Meanwhile China's currency has devalued somewhat, and although this certainly does not hurt its exporters, it would be reassuring to see more stability. Going into 2016 there is still fear out there that global growth can suffer if activity in China slows more sharply than anticipated.

Weaker Chinese demand is one of the factors affecting prices of commodities and energy, which continued to decline during the quarter. Predicting energy and commodity prices in the short term has never been our ballgame, and, arguably, the visibility right now is particularly low, as the market digests many moving parts, including lower Chinese growth, OPEC's stance, US oil production and inventories, and shifting currencies. In the medium term, regardless of the level, more stability and visibility in oil and commodity prices would likely be beneficial for the global economy. From a long-term perspective, there is clearly a shift towards more carbon-neutral energy sources, but we also see structural demand for oil continuing for some time. Looking at commodities in general, one thing we have learned over the years is that it is usually a mistake to extrapolate current conditions too far into the future.

In 2015, the commodity weakness clearly had an impact on certain of the commodity-exporting emerging markets. This, together with concerns over growth, and uncertainty over the impact of a US Fed rate hike on emerging currencies and economies, led to a volatile year for emerging markets in general. Although the fourth quarter was somewhat better, they remained lackluster compared to developed markets, and MSCI Emerging Markets ended down around 5%. We think, in fact, that most countries are far better placed to handle rising US rates than they were a few years ago, and from a medium to long-term perspective we see good potential in emerging markets. The current volatility and valuations may prove to be an interesting opportunity.

Finally, the second half of 2015 marked the end of the low volatility days that many investors had just started to get used to. Big intraday market swings began to occur more frequently. After a period of unified, massive support from central banks around the world, monetary policies have started to diverge, which naturally leads to some uncertainty. Add to that various geopolitical issues – including Syria, the refugee crisis, a UK referendum on Europe and a US presidential election – and there are plenty of uncertainties around. But at a basic level we do find the US rate hikes encouraging: while it is important to get the pace right, the hikes are, in a sense, a stamp of health on the economy. We also think the rate hikes can have specific implications for equity investment strategy – as we have discussed before and touch on below. Meanwhile, European macroeconomic figures have been reasonably encouraging lately and the weakening euro continues to bolster corporate profits. With profit margins still below the peak level from eight years ago, increased profitability could create a benign environment for European stocks.

## Portfolio

Our global funds Global Value and Ethical Global Value gave solid returns in 2015, which were broad based with positive contribution from across the regions where we invest. We outperformed markets within Europe and Japan, where our exposure to small- and mid-cap stocks worked in our favour and contributed to our outperformance. Looking at sector attribution, we outperformed the benchmark in all sectors except one (information technology where we noted a 13% return, versus 17% of the index). Notably, we outperformed benchmark in the energy and materials, two sectors that have been battered by falling oil, gas and commodity prices and generated a lot of media attention during the year. In fact, up to November we had even had positive absolute returns in those two sectors.

Many of our investments made headlines during the quarter. A lot were related to M&A, a factor that has helped generate excess returns for us historically. In Q2, we mentioned Delhaize – the Belgian food retailer involved in the value-enhancing merger with Ahold – and in Q4, the share price was rewarded for good progress with the merger and strong quarterly results. The stock was among the funds' top five contributors in the quarter. In November, US pharmaceutical company Pfizer announced its plan to combine with Allergan in the largest healthcare deal in history. In mid-December, Japanese tech company TDK announced a tender offer for our Swiss holding, Micronas. For some time, we have had discussions with Micronas' management about the deep undervaluation of the stock, and the significant value of their cash-rich balance sheet. We were pleased to see management recommending the TDK offer, which, with a price of CHF 7.5, sent the Micronas share price up about 60%. The stock was another top five contributor in the funds.

A few days later, another Japanese company bid for a small-cap holding of ours, Dutch USG People (held in our Danish European Small Cap fund), which sent the share price up by 30%. We won't repeat here the changes we see in Japanese board rooms and corporate governance – please see our previous letters – but these two examples from our portfolios are just two of many outbound deals struck by Japanese companies lately. The pressure to raise return on equity and utilize their excess cash has led to increased dividends and payouts as we have mentioned before, but many are also putting their cash to work overseas.

This gives us a tailwind in two ways. First, we have an overweight in well-capitalized Japanese companies trading at a discount due to perceived inefficiency. The acquisition spree along with all the other governance-related changes could help other investors realize the value potential in many of our holdings. Second, Japanese companies are targeting overseas companies with attractive businesses and assets. We believe our portfolios have potential for further takeovers in the future.

## Active-Passive debate revisited

While our funds generally gave solid relative performance in 2015, many active managers had a disappointing 2015 and investors continue to reduce exposure to active equity managers in favor of passive strategies. Just the other day a Morningstar report stated that 40% of assets in mutual funds and ETFs today are passive. At first glance, such a move seems to make sense, as many active managers underperformed passive funds in the years following the global financial crisis. However, we are still convinced that managers who select

stocks using fundamental research can outperform passive investing in the long run, and there is a lot of academic research supporting this opinion. Meanwhile, since the market lows of March 2009, the high annualized returns of almost 18% for MSCI World have led many investors to believe that you may as well just buy the overall market as cheaply as you can ('cheap beta') instead of trying to search actively for stock-selection based returns (alpha). Amid such high market returns, many of those active managers who have been able to navigate correctly and create alpha, have found that their total return was explained mostly by beta. It was an environment in which 'a rising tide lifts all boats'.

But before any of our readers become index investors, one should remember that after years of solid double-digit returns, the equity market will probably deliver lower returns going forward, and perhaps even losses in certain periods. Stock markets are not as attractively priced as they were years ago, and corporate earnings growth is expected to be moderate in the near term. With stock markets expected to deliver lower returns, investors will once again need to look for alpha opportunities in order to augment their returns. Therefore, the coming years could be a promising environment for stock pickers. We are likely no longer in a 'rising tide lifts all boats' type of environment. Fortunately, while beta risk is increasing, alpha opportunities are still out there.

### Value Investment and Risk

An obvious place to look for investment opportunities is within the universe of value stocks. For more than 18 years, we have been working hard to deliver competitive returns, by focusing on investing in low-priced stocks. This has served us well over that long period, with our longest-running fund Value Aktier (in Denmark) giving +3.8% annualized excess returns since 1997. But it must be noted that since the Global Financial Crisis, the MSCI World Value index has continued to struggle, underperforming for seven years in a row. As we have mentioned a few times – see our previous letters – rising interest rates in the coming years should help pave the way for value investors. On top of this, apparently higher interest rates are also good news for active managers overall. Earlier in 2015, Nomura presented a study showing that there has been a strong correlation between rising interest rates and outperformance of active managers over the last 50 years. One reason for this phenomenon is that when rates rise, smaller companies tend to outperform (since they are generally more sensitive to changes in liquidity) and active managers, and especially value managers, tend to have a higher degree of small-cap exposure. Conversely, as we have seen lately and commented

on before, the blue-chip companies that cap-weighted indices and passive funds are inherently exposed to, tend to outperform in falling rate environments.

We remain invested in a value strategy. We believe that our active management can generate superior returns even in years (like 2015) when value stocks overall underperform, and we see good potential for value in the long term. We remain disciplined and methodical and select securities based on their attractive valuations. We believe strong corporate fundamentals should eventually be reflected in better share prices, and shareholders able to endure today's volatile markets are likely to be well rewarded.

Early in 2015 we discussed how, in recent years, macro and geopolitical events have had large impacts on the returns of active investors, including ourselves. We acknowledged that even long-term value investors are measured on relative performance and often on short time horizons, and we said that we would pay closer attention to country and sector composition going forward. On that note, we enter 2016 with a risk profile that now carries lower risk relative to benchmarks. We maintain obvious exposures to style risk – value and small cap risk – but we have adjusted the breakdown of our risk somewhat: it now comes less from country and sector choices (geopolitical risk) and more from stock specific choices.

### Market bifurcation: the USA and FANGs

The most noticeable change is that we have added another good handful of US stocks in the fourth quarter. Measured in US Dollars, the US stock market was more or less flat in 2015, with a total return of MSCI USA of 0.7%. However, if it had not been for certain pockets of stocks within the market, it could have been worse. One group of stocks – hot internet stocks – did extremely well and helped lift overall index returns. There is a tradition of giving nicknames to groups of popular stocks. Back in the 1960s, a long bull market came to be dominated by the 'Nifty Fifty' of buy-and-hold stocks. These days, people talk of the 'Nifty Nine'. Or FANTA: Facebook, Amazon, Netflix, Tesla, Alphabet (the new name for Google). Or FANG: Facebook, Amazon, Netflix, Google. The FANGs averaged a 20% return in Q4 2015 and a whopping 70%+ total return throughout the year – Incredible numbers for these stocks that now make up 5% of the index. What about the stocks making up the remaining 95% of the market? We calculate that they returned an average of -2%.

In Sparinvest, we continue to believe that investing in undervalued and 'out of favour' stocks is the way to build long-term excess return. Meanwhile, security prices are a result of supply

and demand. Some of the popular companies – the FANGs – are indeed changing the world with disruptive products, and we do see good potential in many of them. However, their stock is also in huge demand, and we note that many are trading at extremely high earnings multiples. In a world of revenue stagnation and worries about the global economy, investors currently flock toward companies that can show strong revenue growth – no matter the valuation. At the risk of sounding like a broken record, we believe that – given the gap in valuation and the rising interest rate scenario – demand will eventually spread more widely, giving healthy relative performance to securities with more attractive pricing characteristics.

## Conclusion

As always, we refrain from trying to predict short-term returns, other than what we have mentioned above. With limited expectations for overall market returns in 2016, stock picking is expected to be an important topic in the near future, and we intend to use the expected increased volatility to add to good companies at attractive prices.

After seven consecutive years where value has underperformed growth, when measured by MSCI global indices, we know how frustrating it can be to stand apart from the herd and occasionally have investment returns that trail the ‘flavour’ of the quarter, or the year. Certainly, the market once again has had little regard for our philosophy, but this year our stock picking generally overcame the headwinds and enabled us to present very satisfying results for both quarter and year for the

majority of our funds. We are certain that value stocks will live to see another day of outperformance, and we look forward to that long awaited tailwind. No matter what happens in the year to come, we believe that paying attention to company fundamentals helps us manage portfolio risks in what could be volatile markets. That should lay the foundation for long-term capital appreciation for our clients. As always, we thank you for your support and we look forward to sharing perspectives with you in 2016.

## 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*

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