A good quarter for our investors

The last quarter of 2016 was without doubt eventful. Trump won the race to become the next president of the USA. That itself was not a surprise given the close odds for quite some time, but what most investors did not expect was the market reaction to his win. In short the outcome was good for risk assets and bad for rates. As a result high yield had strong returns in the quarter and negative performance for investment grade and emerging markets. It was a very good quarter for our investors as almost all of our funds outperformed their benchmarks, especially in investment grade and emerging markets we outperformed nicely.

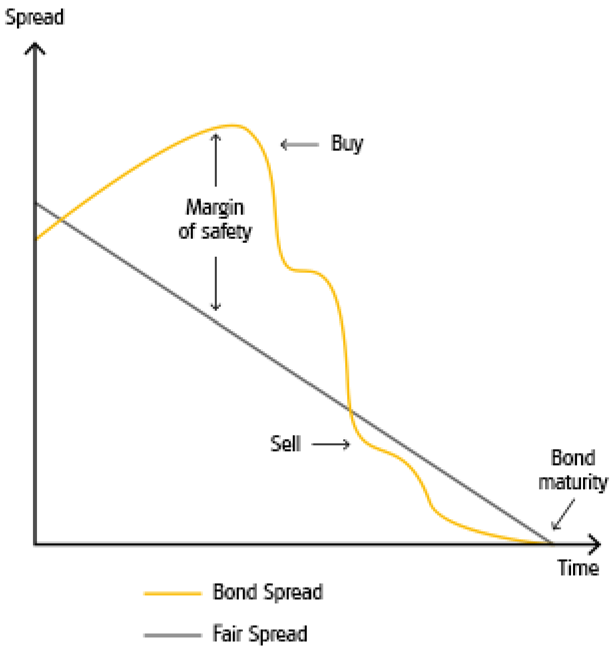
> *Almost all of our funds outperformed their benchmarks especially in investment grade and emerging markets we outperformed nicely*

With Trump taking over as president we expect uncertainty with a positive bias. Trump has surrounded himself with individuals primarily from the commercial sector, and as a result changes should benefit our overall long position in US credit markets. The impact outside the USA is much more difficult to judge, in particular in emerging markets. In the Eurozone, the central bank has been in the driving seat for so long that we see limited downside to be underweight the region also in light of the Brexit driven crisis of the European Union and upcoming elections across Europe.

In high yield we have continued our work on the three drivers of our performance: (i) Investment universe screening and scoring; (ii) Bottom up credit analysis with focus on cashflow; (iii) Risk adjusted approach to returns. Our success in these three areas will be measured by performance but more importantly, where the performance is generated. So far we are very pleased with initial results showing performance spread across sectors and regions and not concentrated on one particular area.

As Value investing is seeing a renaissance on the equity side, we are increasingly asked what is Value on the bond side. Value in corporate bonds is about selecting bonds where the spread you are paid is higher than that of comparable bonds with similar risk. Similar risk means similar financial leverage and more. The details of how ones' process defines "and more" are key to performance of the strategy.

Simple illustration of buying Value in corporate bonds



The simplistic illustrates the concept. This is the approach most investors use when looking at various bonds from one issuer, i.e. when looking at the curve of an issuer. It is however less obvious when faced with the choice between a healthcare bond and a telecom bond. This is where we spend extensive time on screening the universe before diving into fundamental bottom up analysis.

An important observation is that a value equity investment does not necessarily mean that the companies' bonds are a value investment. Bond investors live in a finite time due to their bond maturities. If you happen to hold a bond that matures in the middle of a crisis, you do not have the time option for the valuation to recover to its fair valuation. Such bonds default, and unless you have a distressed mandate, you need to exit the position and crystalize a loss. Based on our experience and research we find that care needs to be applied when using equity value definitions to screening for bond investment opportunities.

> *A value equity investment does not necessarily mean that the companies' bonds are a value investment*

Academic papers on the topic of value in corporate bonds are limited, not least, the four we have reviewed have very different definitions of what value means. The one we would recommend for further reading is "Value Investing in Credit Markets" by Correia et al.(2012) in Review of Accounting Studies.

On a final note, we would encourage everyone to read our monthly commentary on their respective funds to get insight into current events happening in the market and more specific fund developments.

Published February, 15 2017

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