Letter to Shareholders – Value Bonds

Q4 2014

Value Bonds in 2014 – challenging for High Yield, but stellar for Investment Grade

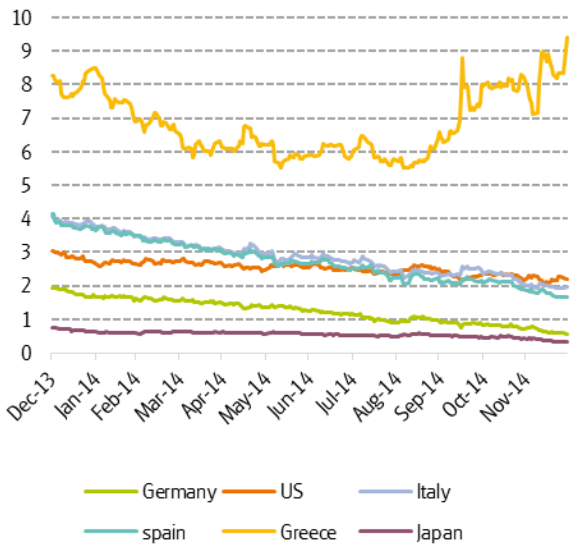
2014 became a challenging year for Sparinvest's Value Bonds strategy. Macro-economic uncertainty and rising geopolitical risks created significant volatility in the international financial markets during Q3 and Q4. This resulted in substantial volatility for many strategies, resulting in a disappointing performance.

Markets

The major international economies started to divert in early 2014 and this trend developed further as the year went on. The economic growth in the United States turned robust and, as growth started to look sustainable, manifested itself in - amongst other things - a lower unemployment rate. The Federal Reserve wound up its quantitative easing (QE) programme in August, and simultaneously signalled that the Fed Fund rates would start to be normalized in early to mid-2015. This lead to a substantial strengthening of the USD, higher short-term interest rates and lower long-term interest rates on American government bonds, a so-called 'bull flattening' of the yield curve.

Europe continued to disappoint on economic growth, and sentiment was not improved by the Ukrainian crisis and subsequent economic sanctions imposed on Russia. The EUR weakened, the European stock market underperformed and 10-year German government bond yields fell to 0.50%, evidence of severe stress in the European financial markets. As political appetite for further (unpopular) fiscal reforms waned throughout Europe, the onus for spurring growth shifted to the ECB. The ECB Governor, Draghi, announced after more disappointing economic data was revealed, that the ECB would look to initiate QE in late 2014.

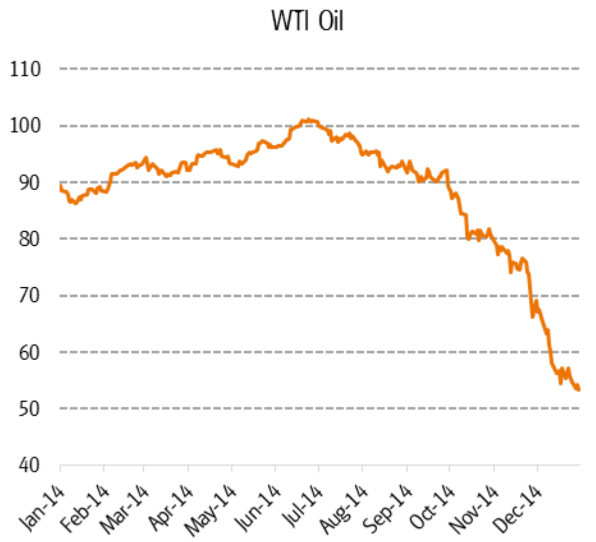
Global Yields – Government Bonds



However, the timing of the implementation of ECB's QE policy was somewhat derailed as a new political crisis erupted in Greece, and general elections were called for late January 2015. Polls are indicating that anti-EU parties stand to gain significant traction with the electorate, and the risk of a Greek exist from the EU has increased significantly. The political crisis in Greece will affect both the timing, as well as the scope, of the ECB's initial QE, and there are some risks of a diluted or ineffective QE operation sometime in Q1 2015 somewhat disappointing market expectations.

The volatility in commodity prices continued in 2014, and a major sell-off in oil prices materialized in the late summer. The sell-off escalated in Q4, as OPEC refused to cut back production and oil prices finished the year at a 5-year low. Other commodity prices also ended the year at multi-year lows and iron-ore, copper, as well as soft commodities, were particularly hard hit, bringing the fall in iron-ore prices to more than 60% over the last two years

Most emerging markets economies were adversely affected by the lower commodity prices and recessions in Russia and Brazil (amongst others) seem inevitable. The Chinese economy continues to disappoint as the country struggles with the transition from being a pure manufacturing and exporting economy to becoming more balanced. Economies like India and Indonesia who are net importers - of oil in particular - stand to benefit significantly from the lower prices.



High Yield strategies (open-ended as well as maturity strategies)

The open-ended HY fund returned a disappointing -14.4% in euro terms in 2014. A high sector allocation to mining (20%) and energy (40%) that had been in place since 2012, contributed with losses of 11% and 8% respectively.

Oil prices were stable throughout the first 6 months of 2014 at USD 105-110/bbl for Brent oil. But expected production growth, combined with a weakening outlook for demand for oil, led to lower oil prices throughout Q3 and early Q4. At the November OPEC meeting, oil prices had fallen to around USD 72/bbl. The oil cartel's decision to leave production unchanged sparked another sell-off and oil prices declined subsequently about 30% and finished the year around USD57/bbl for Brent oil.

The number of distressed cases and cases in default only increased marginally in Q4 2014, but the drastic sell-off in oil and other commodity prices, combined with increasing illiquidity in the secondary markets, led to a number of investments trading at near stressed levels at year-end. Liquidity in the secondary markets for corporates bonds has dissipated and market conditions are now eerily similar to those of December 2008.

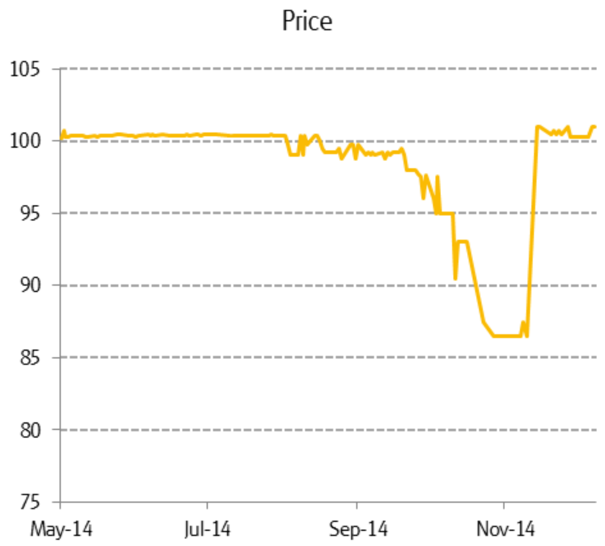
After running at a record pace, new issuance of High Yield bonds completely dried up in Q4.

So, after a disappointing performance year in 2014, where Sparinvest's High Yield Value Bonds strategy has been tested and left wanting in the short term, investors should know that there are several factors pointing to significant upside in the fund.

From an allocation perspective, there are no investments in US shale gas - a market segment where we expect defaults to spike in H1, 2015. Moreover, throughout late Q3 and early Q4, there was a focus on creating greater balance within the portfolio so that a larger share has been allocated to sectors that benefit from lower commodity prices in general, and oil in particular. This rebalancing of the portfolio towards less cyclical sectors is achieved through revenue from coupons and matured bonds.

The strategy still has significant exposure to the energy sector, and the losses incurred late 2014 have been marked-to-market losses rather than losses due to material changes in the underlying credit quality. Furthermore, the energy exposure is primarily in shorter-dated bonds, which are less exposed to refinancing risk than longer-dated bonds.

It should also be noted that the fall in oil prices has left several companies vulnerable to corporate take overs. Major oil companies have primarily spent their excess cash in 2014 on buybacks of their own shares rather than investing in production. Roughly 30% of the significant share-buy-backs that were conducted by S&P 500 companies in 2014 were done by energy companies. Increased M&A activity in the energy sector can be a major alpha-driver, as the High Yield Value Bonds strategy is invested in bonds issued by smaller energy companies. The covenants of these bonds enable a bond holder to sell back bonds typically at a price of 101 in the case of a change of control of a company. An example of this is illustrated in the graph below of the price developments in an oil company, a bond we hold.



Lastly, when we eventually see an aggressive QE plan executed by the ECB, this will lead to a further compression of credit spreads and, though the ECB will not purchase HY bonds, the central bank's purchase of other assets, will force investors out on the credit spectrum into HY bonds.

The Short Duration High Yield Value Bonds strategies were also somewhat affected by the risk factors described above, but here the smaller marked-to-market losses incurred (especially in Q4) were absorbed to a greater extent by the carry earned. Given the amount of stress in the financial markets, the performance of these strategies was actually satisfactory, and the strategies should outperform in 2015, driven by some of the factors described above. It should be noted, that the SD 2018 strategy does not, and will not, have the same sector or geographical allocation as the other High Yield Value Bonds strategies and lower volatility in this strategy should be expected.

Emerging Market Corporates (EMCORP)

The EMCORP strategy also experienced disappointing performance in 2014, with a loss of 6.4% in euro terms. Large sector allocations to mining and energy, as well as exposure to economies with a large dependence on commodity-related exports, such as Russia, Mexico and Brazil contributed negatively to portfolio returns, especially in the latter part of 2014. Many Emerging Market local currencies continued to weaken significantly during the year, putting significant strain on local balance of payments and external balances. As a result, many EM countries have had a significant change in their economic outlook for 2015, and countries such as Ukraine and Venezuela have become candidates for economic aid from e.g. the IMF. Economic assistance from the IMF et al generally comes with harsh conditions attached that recipient countries have to abide by for a number of years - as evidenced by the Asian crisis in the late 1990s.

The dramatic changes in both commodity prices and local currencies have had similarly dramatic effects on many EM corporates' balance sheets. In this regard, the Value Bonds team has diligently analysed these companies to identify and avoid concentration risks from indirect exposures. As such, some changes have already been made to sector and geographical allocations and this trend will continue in the first months of 2015. Allocation to EM financials will remain at negligible levels as there are still challenging times ahead - especially for banks with large EM (and commodity) exposure. Moreover, allocations to the energy and material sectors have been reduced. There have been - and will continue to be - increases in allocations to countries such as India and Indonesia where corporate issuers should benefit from lower commodity prices, as well as from domestic fiscal and political reforms.

Towards the end of 2014, a major mainland Chinese corporate issuer, the developer Kaisa, skipped a payment on its USD denominated bonds (a soft default) and this sent shock waves through the Asian credit markets. Sparinvest's funds are not exposed to this particular issuer, but some Asian investments were affected by this. The Value Bonds team continues to be very cautious with regards to allocation to Chinese corporates bonds, and allocations to financial or property-related issuers in China are unlikely in 2015.

Investment Grade strategy

An investor with allocations to the Investment Grade asset class in general enjoyed stellar performance in 2014. Most benchmarks returned 6-8% for the year, and our strategy returned 8.8% in euro terms. But returns in general were largely due to significant drops in long interest rates rather than spread compression. Investment-grade rated companies have sophisticated treasury departments that have sought to optimize funding opportunities in a very benign interest rate environment. IG issuance has primarily consisted of long-dated bonds and large corporates such as Apple, Pfizer and VW have issued bonds with maturities of +30 years. As a result, most IG benchmarks now have substantial duration components of 6 years or more and thus carry a not insubstantial interest rate risk.

Sparinvest's Value Bonds team has been successful in deploying its unique bottom-up investment strategy in this segment of the corporate bond space, and has generated satisfactory alpha in 2014 by allocating predominantly to 'overlooked' IG credits as well as to relative value trades within the universe of financial debt issuance. It should also be noted that though Sparinvest's IG strategy has a lower interest rate duration, the value premium earned has more than compensated for this.

The outlook for this strategy is somewhat less clear, as higher interest rates in the US appear likely whereas interest rates in the Eurozone will be very low for a long time as inflation expectations continue to fall. The Value Bonds team has taken this into account in its geographical allocations and is aware that there is a significant overweight, vis-à-vis benchmark, to Europe. The relatively high allocation to financials – primarily European banks – will be maintained in the beginning of the New Year, but it will gradually be reduced over the year, as the outlook for European corporates should improve.

Concluding remarks

As mentioned at the outset, 2014 was a challenging year for some of Sparinvest's Value Bonds strategies from a performance perspective. It was also a year where almost the entire Value Bonds team was changed due to resignations in Q4 2014. Normally, portfolio management team changes lead to drastic changes in almost every aspect of investment style such as approach, selections returns, and volatility, as portfolios are turned-over. However, Sparinvest is an investment management boutique, and the value-based bottom-up investment approach is so deeply ingrained in the corporate culture, that Sparinvest's Value Bonds strategy is 70% process driven and 30% human capital. No material changes have been made – or are envisaged - to the investment process, and a new well-educated, highly experienced and motivated team is already in place dedicated to delivering significant long-term alpha generation, albeit at a lower volatility.

Significant academic research continues to support the pillar of Sparinvest's investment philosophy - that factor-driven investment processes also have vital importance and relevance for alpha generation in the corporate bond asset classes through the generation of sustainable and significant risk-adjusted returns. The four main factors of low risk, value, size and momentum are all ingrained in the Value Bonds investment approach albeit with different weights and significance.

Though 2015 looks to be a year with many challenges ahead, factor-based investing is a strategic decision, and Sparinvest is convinced that the Value Bonds strategies will continue to generate long-term alpha through the market cycles to come.

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