



Letter to Shareholders – Value Equities

Q4 2014

Dear Investor,

The term 'God's own country' has often been used to refer to the United States, especially by people from that country. As the New Year begins, many equity investors may think of the US market in 2014 as 'God's own market'. We saw the S&P 500 reaching new highs, and acting with more or less bullet-proof behaviour in the blue chip space of the index, regardless of global turmoil in the latter part of 2014.

Overall global investor anxiety increased late in the year, on the back of weak economic developments in the Eurozone, Japan and China. Furthermore, geopolitical risks rose, with the Islamic State causing unrest in the Middle East, the European relationship with Russia deteriorating and Ebola sweeping through West Africa, just to mention a few.

Market disparities

Despite that backdrop, the US market continued its rally, leaving the rest of the world behind. This made the fourth quarter a difficult time for investors like us with a bias towards Europe and Japan. Clearly, both performance and valuation among equities have become increasingly dispersed in recent months, as the steady rise of US stocks continued to attract capital. Spurred by inbound investment, the US Dollar continued to strengthen against both the Euro and the Yen.

The negative trend in our fund, relative to benchmark, started in Q3 and continued in Q4, and was primarily caused by a lack of exposure to the aforementioned appreciating US dollar and the US equity market. This alone caused around 70% of our relative underperformance for the full year. With hindsight, we should have had more dollar assets in our portfolio, but on

the other hand, going into the second half of 2014, much of the US equity market looked like it was 'priced to perfection'. Attending a value investing conference in New York in early September, we found little to change our view that the US was - in general - an expensive market, while Europe offered many interesting traditional long investments. The overall profile of our portfolios did not change dramatically during the quarter, and the main geographic features of the global funds remain the same, with a relative overweight in Europe and Japan at the expense of US exposure.

But late 2014 was not simply a question of the US strongly outperforming other regions. If we compare small caps with large caps, and value stocks with growth stocks, we see that the market diverged on both these metrics. This was true at the global level, and even in the US. Using Kenneth French's data to construct a style box, we see that value stocks and small-cap stocks underperformed massively during the year.

Global Markets, Jun 2014 - Dec 2014

		Small cap						
		-11.8%	-12.0%	-8.3%	-10.5%	-10.6%		
		-3.8%	-5.1%	-6.5%	-8.9%	-14.1%		
Growth		-1.2%	-5.3%	-7.6%	-9.9%	-8.9%	Value	
		-0.7%	-3.8%	-6.3%	-5.9%	-11.6%		
		1.2%	-0.7%	-6.1%	-6.8%	-6.5%		
		Large Cap						

US Markets, Jun 2014 - Nov 2014							
		Small cap					
		-11.0%	-2.7%	-6.2%	-4.0%	-4.1%	
		2.1%	0.2%	-1.2%	-3.3%	-11.6%	
Growth		6.3%	-0.5%	-3.9%	-5.3%	-3.8%	Value
		7.5%	-1.4%	2.6%	-2.2%	-7.2%	
		9.2%	4.9%	6.6%	-1.5%	0.3%	
		Large Cap					

For a value fund with an average market cap around one-third that of the benchmark, this style performance obviously had implications for our funds' returns compared to benchmark. Similarly, as bond yields compressed in the US, the markets saw very strong performance from the more the 'bond-like' sectors – health care, utilities, and consumer staples, a topic we have discussed in previous letters.

This discrepancy in performance and valuations also has implications for future potential investments. With US stocks having risen further, the implication is that they have become yet more expensive. However, individual opportunities do exist, and when we find them, we are certainly willing to increase our US and US Dollar exposure. Indeed, Sparinvest Global Value recently made new investments in two US stocks: Regions Financial, a bank, and Ascena Retail Group, which runs a national chain of women's clothing stores.

European challenges

With European shares once again significantly underperforming in the quarter, partly due to the above mentioned currency development, it still feels like a replay of 2011, when European assets were considered to be toxic, with markets perhaps responding more to the macro developments than to business fundamentals or where companies generate their earnings. It is important to remember that, when it comes to investing in stocks, you're buying companies, not countries. Instead of looking at where a company is domiciled or listed, we look at where a company sources its revenue. Compared to many US-domiciled stocks, we simply believed that we could buy the same calibre companies listed in Europe at a discount earlier this year. With the global portfolios geared towards European domiciled companies, it had a material negative impact on performance relative to benchmark during the quarter.

Meanwhile, in our view, investors looking for growth potential at a very compelling price should not be frightened by Europe's economic malaise. Sure, economic growth in Europe has slowed, and we understand why investors are concerned about the combination of low growth and low inflation. And yes, there is a risk that the European economy gets worse before it gets better. Fortunately, the European Central Bank seems to recognize the risk and has signalled its intentions to expand monetary stimulus. There are of course execution risks, but we believe that further economic stimulus could steer the Eurozone away from deflation, and we believe that a gradual recovery in the European economy may provide further upside for the cyclical European stocks in which we have invested.

Japanese progress

In previous letters we have extensively covered the improving fundamentals in Japan. Recent economic data has been somewhat weak, although that was, to some extent, expected after Japan raised its consumption tax earlier in 2014. Prime Minister Abe has just been re-elected, with a refreshed mandate to push ahead with his reform package – in the fields of the labour market, agriculture, pensions, taxation, corporate governance and the setting up of special economic zones. We see increasing signs of almost revolutionary change in attitudes to corporate governance, and think that this – ultimately expressed in changing capital allocation and increased return-on-equity – can be a key driver.

Corporate Japan has also worked hard to restructure over past years since the global financial crisis, but the positive effects were initially overshadowed by the negative impact of an excessively strong yen. The yen weakening since December 2012 has of course changed that, and many companies are showing a very strong improvement in earnings. In 2015 it is again expected that Japan's earnings growth will outpace that of the US and Europe, while it still is trading at lower valuations.

In the last few letters, we illustrated a few company examples that demonstrate successful repositioning. In that regard, Sony and Panasonic also spring to mind. Both companies have now realized that consumer electronics has commoditized and therefore they have lowered their exposure to these businesses. Both companies are now on the verge of seeing the best or second best operating earnings in 15 years. As a result of these repositionings, and of course the Abenomics environment, both companies saw their share prices almost triple over the last 2 years. These are not the only examples in Japan of

companies that have seen very significant share price increases over the last few years and therefore more and more previously undervalued companies are moving closer to their intrinsic values. We have already sold some of our positions recently and expect some more divestment in the coming months as well.

Oil collapse

Among the worst hit stocks in the fourth quarter were those in energy and materials – in particular, oil services, metals and mining. This had a negative impact on many of our funds, with energy stocks among the biggest single detractors in our funds: some saw share price declines of up to 30-40% in a few weeks.

After a handful of stable years, crude oil tumbled around 40% over the quarter. Even as recently as the summer, there was very little talk of falling oil prices. In fact there was some concern that geopolitical unrest and production disruptions could push oil upwards. We, like most, did not foresee the collapsing oil price. We have always said that we cannot estimate the intrinsic value of a barrel of oil – an asset that does not generate any income stream other than what it can be sold for at any given time. However, we still believe we are able to invest in oil-related businesses, and have a view on the pricing of oil.

We believe that, in the long run a commodity should be priced somewhere above the production cost of marginal producers. There are various estimates of the production cost curve of oil around the world, and precise conclusions are impossible – but certainly it appears that current prices are lower than cash costs in many current projects, and in potential future projects.

In the short run, however, volatility can be huge, and prices can fall even further. Several factors seem to have triggered the decline. On the supply side, production from non-OPEC countries has risen sharply since the global financial crisis, driven especially by US shale (“tight oil”) production. On the demand side, growth has slowed, particularly in China and Europe in 2014. Then, surprisingly for most observers, Saudi Arabia – and therefore OPEC – showed that they are no longer willing to play a balancing role, curtailing production to support the oil price. (Among the range of potential motives for their new strategy, the most likely are the desire to limit non-OPEC production growth by discouraging investment in US shale projects, and wanting to show other OPEC members like Iran that Saudi Arabia will no longer take the pain of production cuts alone).

We do think this supply-demand imbalance can and will be resolved, but not overnight. A price recovery could be very gradual, although we all know that things can change very quickly in the oil markets. Oil production needs intense investment just to keep production flat, and usually a low oil price leads producers to review spending plans. Some projects will be delayed or cancelled. The impact may be relatively quick in US shale, where individual asset life-cycles are short due to rapid decline rates. For some players that have borrowed heavily, the cash squeeze will be even harder. We have already seen various oil companies reducing capex plans, and drilling activity in North America has peaked. This doesn’t imply an immediate impact on production, but as spending declines, spare capacity shrinks, and ultimately production growth slows, and this supports the oil price. Meanwhile, a declining oil price may produce a demand response, for example in fuel consumption. One thing is for sure: from the US to Russia to Saudi Arabia – nobody in the oil business is enjoying the current price.

Some of our investments in energy are within oil service companies which, in general, have suffered in the recent months as a result of falling service prices and expectations of reduced investment by oil majors. It is painful to watch in the short run, but the more they deplete their existing resource bases, the more necessary it will be to find new resources at a later stage. We have retained exposure to the industry, anticipating a recovery over time. This contrarian view can look painful in the short term, but we expect it to deliver in the long-run. We still have exposure to the industry, where, as always, we look for asset quality and balance-sheet strength to weather the storm. Strong players often emerge from such times in even more dominant positions.

Volatility and risk

For a while we have found commodity-related stocks – and cyclical stocks in general – to be compelling as many investors have undervalued such investments due to simple risk measures like price volatility. Many investors incurred losses due to general market volatility in 2008 and again in 2011, and this has led them to avoid businesses with cash flow profiles which are volatile, or perceived to be volatile – ignoring many industrials, materials and energy stocks regardless of the price. As these stocks plunged in the fourth quarter – due to weakening commodity prices, the strengthening dollar, and increasing concerns of a global economic slowdown – investors continued to pile into stocks with smooth cash flows (despite lofty valuations – a topic we have also touched upon in earlier

comments). Defensive companies with stable cash flow profiles rallied, supported by falling interest rates. As a result, the valuation disparity between cyclical and defensives has grown even larger today.

But this does not change the fact that low-volatility, defensive stocks have yet again outperformed, while we trailed the index. It shows how current negative sentiment toward cyclical stocks is a self-perpetuating pattern that takes time to reverse, which is why a value investor needs to take a long-term view. Often we buy stocks and only to see them go down further in price. We do not claim to have the skills to time the market, and we humbly admit that we are not able to pick the bottom on a single stock, sector or region. We encourage shareholders to evaluate returns over the medium to long-term. As we have mentioned in the past, we expect our strategy to experience short-term volatility at times. However, price volatility does not equate to permanent loss of capital. Often the decline in the quoted stock price exceeds the deterioration in company fundamentals. This kind of volatility or 'quotational risk' can be very difficult to guard against as value investors, as it often has more to do with the condition of other shareholders than with the financial status of a cyclical company.

Nokia

One stock that has suffered from negative sentiment and price declines in the recent past is Nokia. We invested in August 2011. The share price had dropped from EUR 25 in 2007 to less than EUR 4, due to lost market share in mobile phones. Despite the challenging outlook, Nokia was still profitable, had 40% of its market capitalization in net cash, and its shares were trading around book value. It had a strong patent portfolio, and was about to finish restructuring its networks division, a promising business which had perhaps been overlooked by some who were focused on the pain in mobile phones.

In mobiles, Nokia maintained a solid position in emerging markets, and we viewed its cooperation with Microsoft as a serious attempt to address its weak smartphone line-up. Microsoft was not new to the mobile industry, having successfully introduced a mobile operating system with a strong position in Asia. We noted that in China, the brand names of Nokia and Microsoft remained stronger than Apple and Google. Meanwhile other handset makers and telecom operators welcomed a third ecosystem, giving some competition to Apple and Android.

So we saw challenges, but considered Nokia to be closer to a solution, than to the start of the problem. Soon after our

investment, Nokia successfully entered the US with its newly created Lumia brand and its share price started to rise. But in spring 2012, things quickly started to sour. Amid a European debt crisis, the heavily anticipated Lumia introduction disappointed, while the migration from mobile phones to smartphones went much quicker than anticipated. Nokia's market share dropped sharply as investors became increasingly concerned about cash flows. By July 2012, Nokia's shares were priced at one-third of our initial investment level.

We are always concerned about the risk of permanent loss of capital, so the potential cash flow and balance sheet deterioration had our full attention. Interim results in 2012 showed the net cash position remained strong – 80% of market capitalization – and phone volumes exceeding expectations. Our analysis suggested that while developments were certainly not rosy, the risks had been excessively factored in to the share price, and Nokia's underlying value remained largely intact. We assumed that management would ultimately take significant action, and not remain inactive while cash was depleted year after year. Rumours began to circulate about a breakup of the company, which could crystallize some of the value.

Things really began to turn in summer 2013. Nokia assured itself a future by buying out its long term networks partner Siemens, getting full ownership of this now solid business. In September, Nokia announced it would divest the handset business to Microsoft. The shares swiftly rose to EUR 5, well above our initial investment. We remained invested, awaiting the deal's conclusion and Nokia's announcement in early 2014 of how it would allocate its generous capital.

Ultimately, we sold our Nokia shares in late 2014, at EUR 6.6, which was close to the intrinsic value estimate we had calculated back in summer 2011. It was a bumpy road, and the investment case did not play out exactly as we expected, but from initial investment to sale, the total return, including dividends, was a satisfactory 22% per annum.

Conclusion

We have always had the opinion that neither macroeconomic nor geopolitical risks should be ignored. However, we also believe that they generally shouldn't be placed at the centre of stock-picking decisions either. As we see it, investors should focus on how individual companies might be affected by what is happening. But even bottom-up value investors need to consider how geopolitical events can affect our entire portfolio. And we acknowledge that even long-term value investors are measured on relative performance and often on short time

horizons. A lesson learned in the recent past, and particularly the last two quarters of 2014, is that geopolitical outcome should not be a primary driver of relative returns. This means that we will pay closer attention to the country and sector composition of portfolios going forward. From a geographical perspective, the obvious risks, relative to benchmark, are our high exposures to Europe and Japan. We do see good potential in our holdings in both regions, and find that markets are being overly bearish on the Eurozone, meaning that there are some appealing undervaluations on offer. However, as discussed above, while significant parts of the US market have lofty valuations, there has been variance in performance, with dispersion of sectors, market caps and styles. This means that there is potential to increase our exposure to US assets.

The last two quarters have now been frustrating for asset-focused value investors like us. In spite of the poor relative share price performance, we believe that our investments still repre-

sent good value and that they are likely to recover with patience. In each of the individual cases that suffered from large quotational declines, we check our assumptions and make sure that the investment thesis is intact. We only stay invested if we believe the stocks remain undervalued, the argument for investment remains strong, and the share price decline has been of a magnitude materially greater than warranted by corporate fundamentals.

In a time when negative news flow and deteriorating investor sentiment dominate the regions and sectors in which we invest, it takes discipline to remain invested. We try to keep in mind the old principle of safety being a function of the price one pays, and that good investments are often those made when others shy away from the investment case. In this way, valuation is key and we continue to work thoroughly to keep the portfolio invested in the companies that we believe are among the most discounted out there today.

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