Sparinvest

Letter to Shareholders | Q3 | 12

Value Bonds

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Our Value Bond Funds

Fund	ISIN code
Corporate Value Bonds	LU0620744002
Emerging Markets Corporate Value Bonds	LU0519053697
Ethical High Yield Value Bonds	LU0473784196
High Yield Value Bonds	LU0232765429
Institutional Corporate Value Bonds	LU0760185370
Investment Grade Value Bonds	LU0264925727

Detailed information is available on sparinvest.eu

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Dear investor,

Macroeconomics

A recent IMF article, reviewing 100 years of macroeconomic history, indicates that the US has a proven track record for solving debt crises through the use of loose monetary policy. Controversial though it may be, inflation appears to be the ultimate cure for a debt crisis and therefore Quantitative Easing is a right medicine. Right now, Ben Bernanke's use of this medicine seems to be working nicely. Amongst the world's developed economies, it looks very much as though the US is in the vanguard when it comes to getting over the economic crisis. Latest figures indicate a gradual recovery in the US housing market and once we see solid signs of rising house prices we can expect the increase in the consumer spending that is required to boost the world's largest economy.

What is more, the 'We'll do whatever it takes to fix it' attitude seems to be spreading to Europe where the European Central Bank is beginning to behave in a more Fed-like manner. The ECB has now 'pulled rank' over the German Central bank and taken centre stage in determining 'pan-European' policy. The ECB has committed to a proactive programme of support and has stated that it stands firmly behind all European nations for as long as they are in compliance with the agreed reform agendas.

Thus the clear economic positive for this quarter is that the tail-risk for Europe has diminished considerably. The reform agenda will eventually bear fruit in the southern economies where there are some signs of increasing competitiveness and decreasing unit labour costs. A rebalancing is slowly occurring whereby Southern European current account deficits are diminishing and in some cases turning into surpluses. Having said this, the on-going reform/austerity agenda clearly entails a political risk of social unrest that cannot be underestimated.

In the Emerging Markets, we have been negatively surprised by Chinese growth. Here there has been less policy easing than expected and thus the slowdown has been more pronounced. We are seeing high volatility in commodities – the price of iron ore for example, has been very volatile during the third quarter. In the Emerging Markets, we have lowered our exposure to China in favour of the Latin American economies and specifically Mexico which, we believe, will derive benefit from the fledgling US recovery.

Microeconomics

Looking at the world from the bottom up, we see Europe's banks as being very much in the credit 'sweet spot'. They are continuing to deleverage and increase buffers by selling non-core assets for example RBS has announced an IPO for its insurance subsidiary 'Directline', currently valued at £800million. There is also news that RBS will exit the asset protection scheme. RBS is a solid turnaround story, fully justifying our overweight in our High Yield funds. Despite scare stories to the contrary, it is our view that banks are quietly – almost secretly – becoming safer and safer. For the moment, we are more wary of consumer-exposed sectors.

Prospects for Corporate Bonds

What is the effect on the corporate bond market of endless rounds of QE and other government interventions? We would contend that when the Fed is buying both sovereign bonds and mortgage bonds it leads to a diminishing supply of 'risk free' assets and results in low – to negative – interest rates. This forces investors to take on more risk and thus the effect for corporates in the first instance, and equities in the second, is good. It seems that this is the intention behind the Fed's strategy.

Corporate bonds have already performed very well this year. But we still find them attractive from a risk/reward perspective – investors still get better rates of return from corporate bonds than is justified by the underlying risk of investment. But as risk diminishes (which has been the trend), it is logical to expect lower returns, so where does that leave us? Luckily, we still find pockets of value in our universe. Most people have gained their exposure to corporate bonds in recent years through 'exchange traded funds' (ETFs). These instruments seek to copy the corporate bond index by buying exactly the same bonds that appear in the index and in exactly the same proportions. In other words, if a company has issued a lot of bonds it will have a higher index weighting and so the ETFs will try to obtain a similarly high weighting to that company by buying more of its bonds than those of other companies. The effect of this is to drive up the prices of bonds in the most indebted companies in the universe. Any follower of the Sparinvest value bonds strategy will know that if there's one thing we don't like in our holdings, it's too much debt. The ETF effect is advantageous to us because it creates buying opportunities in companies issuing bonds that either do not appear in the index at all (such as small companies) or hardly feature in the index because they have not been issuing vast amounts of debt. At present, we continue to find strong value cases amongst financials, Euro-insurers and energy names. We find high-yielding bonds in non-index companies.

Whether prospects are better in Emerging or Developed Markets is arguable. Each area represents a different kind of risk and therefore 'the investor is wise who diversifies'. The economic growth potential and room for expansionary fiscal and monetary policy is much greater in Emerging Markets but here there is a danger of over-leveraging (witness the fact that the size of the Emerging Market Corporate Debt market is now nearly on a par with that of the US.) This explosion of debt explains why we avoid banks in Emerging Markets – because from our perspective, their loan ratios are growing too fast. However other EM cyclical sectors look more attractive to us than those in Developed Markets.

We believe in more M&A as valuations are low, top line growth hard to achieve and financing ability improves through a reopened corporate bond market. Timing here is difficult though. What we would state, however, is that

The table below shows the key numbers for Sparinvest Value Bond funds.

Key numbers for Sparinvest Value Bond funds	Sparinvest – High Yield Value Bonds	Sparinvest – Emerging Markets Value Bonds	Sparinvest – Investment Grade Value Bonds	Sparinvest – Corporate Value Bonds
Yield (%)	12.3%	8.6%	6.4%	6.6%
Expected returns for 2013	9% - 13%	7% - 11%	6% - 10%	5% - 8%
Duration	3.5	3.5	5.46	4.14
Average Net Debt to Equity	78%	69%	62%	81.2%
Average Interest Coverage	3.9X	7.6X	11.2X	5.2X
Average Price to Book	0.8X	1.3X	0.8X	1.3
Default activity ytd.	0.3%	0.0%	0.0%	0.0%

a development in this direction will be good for the low Price-to-Book holdings in our portfolio, bearing in mind that we have only entered into them after ensuring that we have strong change-of-ownership protection.

Company news

A new bond in our funds is Mirabela Nickel. Listed in Australia, Mirabela Nickel is a nickel producer. It first came to our attention on a low Net-Debt-to-Equity screening. We bought the company's bonds soon after the announcement of an equity issuance which created buffer and convinced us that the company was in a position to absorb losses and survive any market downturn. We were able to buy 10% of the company's bonds without moving the price. This meant an entry level of 75 equivalent to a yield of 15%. Since purchase, the price of nickel has appreciated considerably and we would not be surprised if this company became a takeover target.

Conclusion

It is obvious from the figures in the table that we believe we are looking at very solid yields from our Value based corporate bond funds. To achieve the returns indicated requires that defaults in the portfolios should be minimal, and here we would argue that our default avoidance record to date is very strong, As 'value bond' investors, our 'margin of safety' lies in our overall Net-Debt-to-Equity ratio.

Yours faithfully,

Klaus Blaabjerg
Lead Portfolio Manager
15 October 2012

Sparinvest Value Bonds-Team

From left to right:

Toke Hjortshøj
Portfolio Manager

Sune Højholt Jensen
Senior Portfolio Manager

Klaus Blaabjerg
Lead Portfolio Manager

Peter Dabros
Portfolio Manager

Signatory of:

Principles for Responsible Investment

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.