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Our Value Equity Funds

Fund	ISIN code
Emerging Markets Value	LU0760183672
Ethical Emerging Mkts Value	LU0760183912
Ethical Global Value	LU0362355355
European Small Cap Value	LU0256591552
European Value	LU0264920413
Global Small Cap Value	LU0264925131
Global Value	LU0138501191

Detailed information is available on sparinvest.eu

- sparinvest.eu

Value Equities

Dear Investor,

The performance of the Value Equities funds has generally been positive in the first quarter of 2014, and we are still optimistic about the rest of the year as regards both the economy and the markets. Even after the strong performance seen from equities during 2013, we still believe that they remain the most attractive asset class, and that strong flows into them will continue in 2014. What we find most promising is that we still see low valuations and high quality in our portfolios. Stocks in general look neither too highly priced nor especially cheap but, at today's prices, there are certainly some parts of the market that look unattractive or downright expensive.

How expensive are stocks?

In the last five years we have seen investors channelling new money into the same confined area of stock markets. Driven by uncertainty, investors have sought out the perceived 'safe stocks', by which we mean the so-called quality stocks, high ROE stocks, stable earners and mega-cap growth stocks. This has driven the prices of such stocks to new highs. In the recent macro-driven risk-on/risk-off environment, investors have been looking for the stocks that most resembled bonds, those offering stable and growing earnings regardless of economic sentiment. This heightened demand or excessive allocation in one area has made valuations in a lot of these stocks look stretched, leading some investors to mark down the risk premium on the same stocks to justify the current high levels of valuation.

From my experience as a fund manager investing actively in equities for almost two decades, it has

never been a healthy sign when people are herding in the stock markets, piling up money in the same small corner of the market. To some extent it reminds us about what it was like to work as a value investor in the late nineties during the IT bubble. Admittedly, demand for these stocks has also led to solid returns over the past five years. For this reason, it has been a very good environment for investors in mega-cap stocks. Had you bought the biggest and most liquid names you would have performed well and index investing, with its inherent exposure to the same large companies, has enjoyed fantastic times.

This situation has led to the disparity in valuations that we have mentioned in a number of previous letters. The disparity exists, and therefore presents opportunities, in all markets - even including the broad US market which, when compared against others, stands out as being the least undervalued. But if we look more closely at the extremities of the US market (excluding stocks below 1bn US Dollar in market cap), we can see that the cheapest segment, measured by a simple price-to-book ratio, is actually cheaper today than before the financial crisis. Meanwhile, the most expensive part (the target of the investor herding) is now trading at a higher valuation than it did before the crisis. Hence the 5% of stocks with the highest P/B multiples are now up to 12.4x compared to 10.7x before the crisis, while the 20% of stocks with the lowest P/B multiples are down to 1.2x compared to 1.5x before the crisis. Similar results are found in Europe and Japan - albeit at lower valuations than in the US.

It is precisely this disparity that slowly started to narrow last year, giving us some tailwind in terms of performance. We believe the gap will continue to narrow in future - to the further benefit of value investors who concentrate on inexpensive stocks and avoid expensive ones. We are aware that a raw price-to-book ratio is a very simple way to dissect a market and you can be assured that there are many more factors that we consider beyond this simple ratio, when we go bargain hunting for value stocks.

Value and cyclicity

We have often touched on the subject of the comparative performance of value stocks against growth stocks. We certainly believe that there is

sufficient data to support the idea of value stocks outperforming in the long run. However, as mentioned above, there are times when the strategy underperforms. Since the crisis started, value indices have performed worse than the market and such a prolonged period of underperformance had led many investors to try to identify patterns which they can then apply to the timing of their exposure to value stocks.

There are many opinions about when one should be exposed to value and they are often backed by logical explanations. For instance, some people believe that value stocks tend to outperform growth stocks as the economy slows down and falls into recession. The reasoning here is that due to their already low valuation (P/E and P/B etc.), they are already relatively undervalued and therefore they should depreciate less than growth stocks during a recession. When the economy starts to recover, growth stocks capture more of the upswing because they have higher growth rates and reinvest their profits. This theory can be backed in some historical scenarios, but not in others. (Although an argument can make intuitive sense, it cannot necessarily be backed by evidence.) Conversely, we at Sparinvest have presented the alternative argument which is that value stocks can suffer more going into a recession and outperform coming out of it. The main reason is that when recession strikes, value companies tend to be less able to adapt due to a much higher level of 'assets in place' and hence greater fixed costs. However, as the economy expands, the assets in place become a benefit and utilization rates and earnings recover, leading to outperformance. No matter which explanation makes more sense to you, no one seems to be able to predict when a business cycle will begin and end anyway.

Value stocks and interest rates

Another angle we have discussed with many investors recently offers one of several plausible explanations of the value premium - known as the 'duration-based explanation'. This is born out of fixed-income theory, where duration shows the sensitivity in price to a change in interest rates. Literature on the topic emerged ten years ago where it argued that value stocks have a lower maturity of cash flow - they have 'front-loaded' cash flows - while the cash flows of growth stocks

are more 'back-loaded', with a relatively large fraction of their cash flows occurring in a distant future. Thus the equity duration framework implies that growth stocks have higher duration than value stocks and therefore growth stocks are more sensitive to the changes in the discount rate. Obviously a discount rate for a stock consists of both interest rates and a risk premium, but it is still possible to find a relationship between long-term interest rates and style performance over time. The fact that we look at longer-term interest rates fits well with the long-term nature of all corporate cash flows, and hence equity investing in general.

In recent years there seems to have been a discernible relationship between long-term interest rates and the underperformance of value stocks. In both Europe and the US, we have seen a tendency for value stocks to underperform as long-term interest rates have decreased, giving greater benefits to growth stocks with the longer duration. The current situation is one where interest rates are at a low level but they will likely trend towards normal behaviour in the coming years, especially in the US with the expectation of tapering and rising rates. If/when that happens, we expect value stocks to outperform and we believe that many investors completely overlook the current inherent interest risk in growth stocks.

Bearing in mind the valuation disparity mentioned above and this duration-based explanation for stock performance, we see parts of the market not only being overbought and overvalued but also very sensitive to discount rate changes.

Ongoing asset crystallisation

Over the years, we have discussed the impact of M&A activity on our performance. In the last year or two we have also increasingly highlighted the theme of unlocking of value through asset divestures. Canadian Tire, Oil States International, Nokia, Noble, Maersk were a few examples that we touched upon in recent letters. The theme has continued in 2014.

Hutchison Whampoa is a Hong Kong based conglomerate with operations in ports, telecoms, property & hotels, retail, energy and infrastructure. It has a strong presence in six of the ten largest ports in world. Its '3' telecom

brand operates in 11 countries, while the retail operations comprise more than 10,000 stores around the world. Hutchison recently announced the sale of a 25% stake in its retail franchise to Temasek of Singapore for 5.7 bn US Dollars. Both parties have the intention to grow the business further and to list this company in 2-3 years. By undertaking this transaction, equity investors have been given a better insight in the real value of this retail business, meaning that the intrinsic values attached it have generally been increased. For example, the transaction value is more than double our own assessment. Most of the special gains will be distributed to shareholders through a special dividend. We continue to believe that the outlook for these kinds of deals is rapidly improving, which bodes well for our portfolio holdings.

Japan - the return of political dynamism

In global equity markets, there is clear long-term outperformance by value stocks. The so-called 'value premium' exists at the individual stock level (within a specific stock market, the cheap stocks tend to outperform in the long run). But the value premium also exists at the country level: buying cheaper countries tends to augment the long-term return. Whether at the company, sector or the country level, one must always ask why something is cheap. Value investors often invest in companies that are cheap because their earnings performance has been below par - but where there is good potential for that performance to improve with time. This return to par or 'reversion to mean' can drive serious share price gains.

Similarly, when countries are cheap overall, it is often because they have been performing below par. We previously wrote of France, and the potential of labour reform to boost competitiveness. Japan is another example. Ultimately, we invest in companies, not countries, so what interests us most is the asset and earnings potential of our individual holdings. But if we look at Japan at the country macro level, one of the long-standing frustrations was that it had clear wasted potential due to political paralysis - and this certainly was a factor in causing low valuations for Japanese stocks. There were bright spots. From 2001 to 2006, Prime Minister Junichiro Koizumi enjoyed solid support levels, partly for his

lion-like hair and dashing good looks, but also for his reform agenda. Progress was made, and Japanese equities enjoyed some robust periods, particularly in 2005. But the momentum faded after Mr Koizumi exited office in 2006, with a sequence of prime ministers failing to achieve much at all.

This changed dramatically with the current prime minister, Shinzo Abe, and his three economic arrows. Firstly, monetary expansion with a 2% inflation target for the Bank of Japan, and secondly, flexible fiscal policy, with expansion in the short-term to bolster growth, but consolidation in the long-term to address Japan's large public debt. These two arrows are making some progress. April brings the first step towards fiscal consolidation: Japan's consumption tax rises from 5% to 8%. The government is pulling out all stops to prevent this from derailing the economic recovery by introducing a stimulus package and also by pressuring companies to raise wages. In recent weeks, annual wage negotiations have brought encouraging results, with large corporates like Toyota, Nissan and Honda raising base salaries, many for the first time years. If this momentum spreads through to SMEs, the impact could be significant.

But the third arrow - reform for growth - is the most interesting, and hardest to grasp. Mr Abe is keen to break through so-called 'bedrock' regulations which protect vested interests across a range of industries, from agriculture to medicine. At the recent World Economic Forum, he made his so called 'Davos Promise' on his reform agenda. The Trans-Pacific Partnership (TPP), a major trade pact involving Japan, the US, Canada, and many other Asian and American nations, is a central pillar. He plans to introduce Special Economic Zones as catalysts for deregulation. Cuts to the corporate tax rate (one of the world's highest) should boost Japanese firms' ability to compete internationally. Government pension schemes are to be reformed. And in light of Japan's demographic outlook, Mr Abe speaks boldly of opening the country up to more foreign labour. For example, he mentions foreign labour to support housework and care of the elderly, which could be a tool to boost Japan's female labour participation rate.

So, Mr Abe can certainly talk the talk. Of course, his plans are not without opposition and we will

watch the coming months closely. So far, it is encouraging to see that public support remains relatively strong. Our investments in Japan are not based on rosy expectations of Mr Abe's achievements, but rather on individual assumptions relating to the specific companies invested in. However, there is no doubt that the return of political dynamism in Japan is breathing oxygen into the country's stock markets, drawing attention to the fact that there is, in fact, a lot of value to be found there.

Case study - Yamaha Corp

In no way does this mean that our Japanese exposure cannot change. In all regions and sectors, our investment decisions are based on how much of a discount exists between the share price, and the intrinsic value of the company. For us as bottom-up value investors, one of the key roles played by macro-economic developments and stock market reactions to them, is that they can give opportunities to buy stocks at solid discounts to their long-term worth - or sell stocks as they reach their intrinsic value. As Japan's stock market has responded to Abenomics, we have of course taken profits where appropriate. One example is Yamaha Corp, which rose from JPY 1000 in early 2011 to JPY 1550 in November 2013.

Yamaha Corp is a global market leader in musical instruments with a 20% market share. In many ways it's an emerging market play, thanks to increasing Chinese demand for its products. We invested in early 2011 after weak share price performance due to sluggish final demand and high restructuring charges. Strong market share reassured us that when demand picked up, Yamaha would benefit. And to us, the restructuring was a bold move which demonstrated management's determination to turn things around. Having made pianos at its main Japanese site for over a hundred years, it was stopping, and moving production overseas: localising production in areas with growing demand.

We bought shares in 2011 at around 0.75x price to book, with a net cash position equivalent to over one-third of the market capitalisation. The company had shown its willingness to use this cash, paying out special dividends, expanding overseas, making acquisitions, and restructuring. In 2013, the earnings outlook recovered as final

demand started to normalize and the yen weakened. We sold as the share price reached our estimate of intrinsic value.

Positive outlook for 2014

For a long time, we have been positive on equities in general. Our consistently positive view on global equities has been followed by great returns to investors. With a five-year annual return on the MSCI World Index of above 17%, this cannot be expected to continue. As mentioned above, some stock indices look less undervalued today and some parts of the market are downright expensive. That does not mean that equity investors are doomed. Even in a fairly-priced market there will be reasonable returns for equity investors. And for value investors hunting for bargains, there are always opportunities.

We believe that the overall global economy is still in recovery, and we see further potential for earnings recovery or earnings growth in many companies. This is expected to be a driver for global stock markets in 2014, and in this respect we find more potential for positive surprises within Europe and Japan. Our positive outlook on global economic growth (which, by the way, is confirmed by IMF) would also favour the more cyclical or economically-sensitive stocks, which should see brighter days. With our exposure to many such companies, it would have a positive effect on a lot of our investments and the overall performance of the portfolio. We will not attempt to forecast the development in interest rates, but if the economic growth continues as we expect, we can imagine interest rates could be somewhat higher in a near future. From this perspective also, as we have argued above, value investors are set for a comfortable ride.

Our continued enthusiasm for value stocks should not be confused with a naïve belief that there aren't any risks out there. There are always stories that will make investors nervous and cause some volatility in the markets. The situation in Ukraine and the rising speculation about Chinese growth could easily give a bumpy ride, but as value investors we maintain a long-term investment horizon. Value investing is all about consistency: keeping your cool and your long-term perspective, whether the world around us is plunged in negativity or buoyed by excessive optimism.

Yours faithfully,

Jens Moestrup Rasmussen
Chief Portfolio Manager
09 April 2014



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