Sparinvest

Letter to Shareholders

VALUE BONDS

Strong quarter for credit markets

It has been a very strong quarter for credit markets, although June turned out weaker

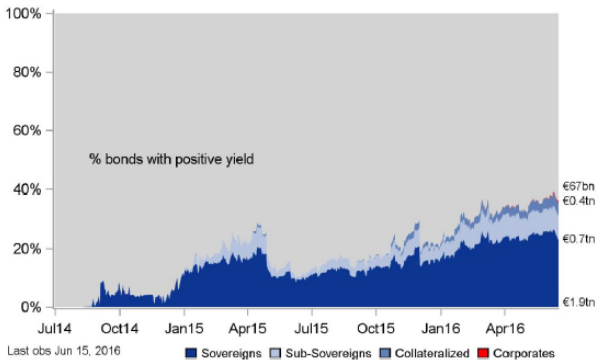
Dear Investor,

The instability and uncertainty of markets continues to be supportive for both investment grade and high yield credit markets, because when outlooks are too bright, investors lose focus on credit metrics and focus on equity returns instead. Britain voted to leave the European Union but global credit markets took it very mildly. Why? Our guess would be that many credit investors saw limited upside in a remain outcome but significant downside in a leave outcome. When the results were announced, we all sat there strategizing on when and how to add risk. As a result, the first dip has been rather short lived in credit.

Tailwind for most markets

Emerging markets are thriving, primarily as a consequence of lower rate increase expectations. For EM managers, political risk is always part of equation, but for developed markets it is rather novel. US high yield and investment grade are generally benefiting from inflows away from Europe. As for the European market, it is well supported by the ECB buying of bonds which kicked off this quarter. Sterling bonds have suffered, but nothing close to the pain seen in equities or FX.
The big question is whether Brexit is only the beginning of something bigger. It definitely adds to uncertainty – not least because many of the people investing and trading are personally affected by living in London. Brexit, however, will no doubt become the scapegoat for many of the other problems in Europe, as we have just seen with the Italian bank problems. From a global point of view, however, the referendum outcome for Britain is a luxury many nations in the world would dream of: to have such a vote and not fear a military coup, an invasion, crushing sanctions or anarchy on the streets. It's a bit like a rich kid moving out because he doesn't want to work in the family business, but wants to work on his start-up. There will be many fights, hugging and crying in the process and, as such, credit will not be a bad place to be during these uncertain times.

Exhibit 5: A record €3 trillion of EUR-denominated bonds, including €64 billion of corporate bonds, are in negative yield territory



Source: iBoxx, Goldman Sachs Global Investment Research

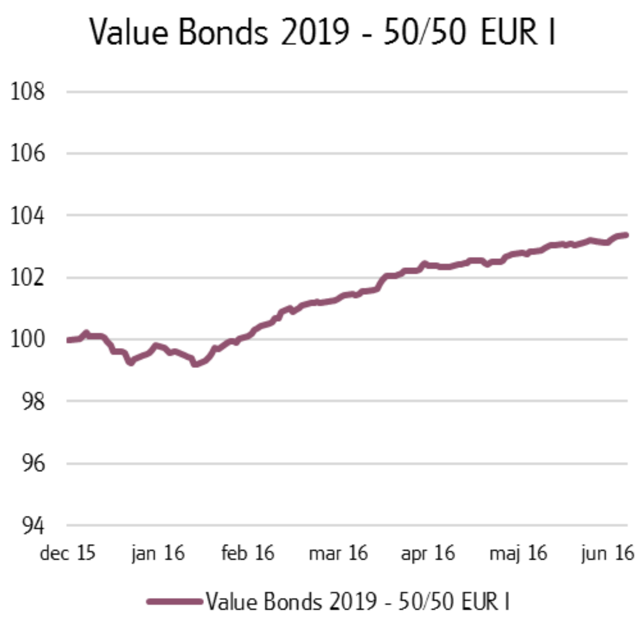
Record-low yields support credit

Credit is also supported by the new records that Government bonds keep setting. These records are not ones we have read in our finance textbooks, the figures represent uncharted territory, and are no doubt a treasure trove for today's academics. The statistics we refer to here are the percentage of bonds trading at negative interest rates. Our wonderful Central Banks have been so anxious to support our markets after the crisis of 2008 that they have reacted to every negative event we have seen since with new QE bazookas - until we have reached these current levels of negative rates.

The consequence for us credit investors is clear, demand for corporate credit risk will continue to strengthen, with fundamentals being firmly in the background. We will not even be surprised to see negative yields creep into the short end of our space!

Continued demand for credit bonds

The interesting question is how we will respond as we experience rising default rates. These have historically led to underperformance in high yield, but there is a case to be made that yields have compressed so far that underlying vacuum of yields in government bonds will cushion any rise in default statistics. For active managers, an environment of rising default rates is one where bond selection skills come into play, and allow for relative outperformance!



We have seen a continued rise in investor interest in short-duration credit as investors look to capture returns from credit spreads and separate these from underlying government yields. We expect this interest only to continue to rise in current markets, not least as performance has been very strong in these products.

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