Letter to Shareholders – Value Equities

Q1 2015

Dear Investor,

This year has begun with one of the best quarters ever in the history of our global equity strategies. Unlike last quarter, where exposure – or not – to the US (market and currency) was a key driver, now the equity market in the US is cooling off. The only thing driving US investments up so far this year has been the currency. Meanwhile we have seen European and Japanese markets rally, driven by renewed optimism regarding a European recovery on the back of Super Mario(Draghi)'s bazooka, low oil price, low rates, weak euro and earnings recovery. In Japan, the Nikkei has reached a new post-crisis high, more or less fuelled by the same factors: Abenomics, low oil price, currency, earnings recovery and a new acceptance of, and focus on, corporate governance.

Following two consecutive quarters of underperformance, mostly due to geographic factors, we wrote a few paragraphs in our recent letter about our continued belief in European and Japanese companies. We stated that we expected earnings growth to be strong in Japan, and thought that a gradual recovery in the European economy could provide good returns for companies trading at depressed multiples. Hence, we voiced the opinion that the two regions would provide ample returns going forward. Obviously, we are satisfied to see how things have turned out in our favour this quarter, and while we have enjoyed some tailwinds in terms of performance in Q1, we think there is more to come.

Opportunities in spite of higher valuations

The geographic allocation of the global funds remains broadly unchanged compared to three months ago. In other words, we remain overweight in Europe and Japan at the expense of US exposure, although we have recently added a couple of new US names to our global portfolios.

Value investors often invest in areas of the world that are temporarily out of favour. While our geographic exposure seemed contrarian just six months ago, things have changed. Today, an increasing number of investors share our view of where one can find interesting opportunities. More and more strategists recommend increasing non-US exposure and fund flows show how investors seem to follow that advice.

Recently, we have experienced a trend of strengthening European data across the board: unemployment rates, consumer confidence, new car registrations, PMI and so on. Along with many others, we believe the prospects for the European economy are still good, and that they are likely to be reflected in corporate earnings in the near future. With many strong European franchises still trading at attractive valuations relative to global peers, we see good arguments for holding on to European stocks.

The US market is in a somewhat different place. The slightly weaker data and a strong dollar are tearing into corporate profits, while valuations are still at somewhat elevated levels. Valuations are not at the same extreme levels as previously, but the combination of high stock-to-stock correlation, low volatility, strong momentum and large-cap outperformance reminds us of something we have seen before. As we have stated before, we think that today's US market has certain similarities to that of the late nineties. Consequently, we think this could be the beginning of an environment where fundamental stock analysis, with a value bias, will start to pay off, and where it could be very costly blindly to follow indices with large exposure to top-performing companies and sectors.

Active versus passive investing

That brings us to a topic that has been gaining a lot of attention recently – the debate about active versus passive investing. Recent data from Morningstar shows that investors have developed a strong preference for the so-called 'passively managed' funds that mimic indices, with organic growth rates (fund inflows) dwarfing those of actively managed assets. Obviously, there are pros and cons to both passive and active investing and we are not trying to advocate one or the other. Actually, passive investing and active investing are interdependent. Passive investing can only do well in a universe where there are active investors picking and choosing. Otherwise, stock prices would just be driven by inflow into equities. Meanwhile, the difference between the two approaches often boils down to the fact that passive investing – whilst offering market participation at a fraction of the cost of the typical actively-managed mutual fund – also involves giving up any chance of outperformance. Lately however, the disappointing performance of active managers has pushed more investors into passive funds.

For some years now, there has been an increased demand from investors for the most liquid blue-chip stocks in the world. Typically, these stocks also carry the highest weights in the benchmarks. Consequently, buying benchmark stocks equalled good performance. This created the perfect environment for passive investing and made it difficult for off-benchmark investors to beat an index. In recent years, and especially last year, we – alongside many other active managers around the world – also had a hard time outperforming our benchmark indices, for reasons we have written about in earlier letters.

Certainly, studies have shown that it is difficult for active managers consistently to outperform their benchmarks, and 2014 was a year in which most active managers underperformed their benchmark indices, adding further fuel to the debate. As always, we advocate that one should never let short-term results dictate one's investment decisions – including the decision of whether to invest passively or to use an active manager. Actually, it is very difficult to assess a manager on short-term performance and decide whether he or she is lucky or skilled. For that, you need a longer time horizon; it takes time to be a successful value manager and often there is volatility along the way before the share price reaches intrinsic value. Such volatility causes deviations from benchmark returns, 'tracking error', which today is becoming a more important issue to most investors. In fact, what we have seen since the financial crisis erupted is that more and more investors have leaned towards passive investment strategies, simply because they see them as being less risky.

Risk is more than just a number

In recent letters, we have touched upon the differences between fundamental risk associated with investing in single companies and risk relative to benchmark, when it comes to assessing overall portfolio risk.

Passive funds have had a great tailwind in the past five years. This is not only because they are cheap compared to active funds but also because their extremely low tracking error means that they are considered as being risk free. If a company in an index goes 'belly up', it is not considered a risk, as long as you are not overweight in this stock. To fundamental active investors that is nonsense: it is exactly the ultimate investment risk – losing your principal! Meanwhile, it is a natural consequence of indexing taken to the extreme and the result of the misguided communication about 'relative risk' as opposed to 'fundamental risk'.

So, for many good reasons, passive investing is currently considered very attractive. This is also why you see many people from the academic world commenting disparagingly about the cost of the mutual funds and on the alleged lack of skill amongst active investors. In their eyes, markets are efficient, risk is a number relative to a benchmark index, and retail investors should simply buy index-mimicking passive funds. What they tend to forget is that active managers are able to take advantage of opportunities as they arise, while avoiding high-flying, high-priced areas of the market.

This brings us back to our observation above, that we are seeing certain similarities between today's market and that of the late nineties – the days of 'the Tech. Boom'. Back then, an index portfolio, without benchmark risk, was highly exposed to ridiculously priced tech. stocks, while many active value managers were underweight the exact same stocks, because they could not see the fundamental value in them. We all know what happened in the following years. After the tech. bubble burst there was a 'lost decade for equities'. During the 00's, the MSCI World Index returned 0 pct. to investors when measured in USD terms, while many active investors did much better than that. For instance, over the same decade, Sparinvest Value Aktier returned more than 170 per cent! When active managers underperform in the current environment, it is easy for academics to criticize both them and their fund fees. However, we are sure that investors are able to go back in history (and even draw on their own experience) and realize that a passive approach is not always without risk.

ESG risk, the risk many investors do not talk about.

We will not dig into all the pros and cons of active and passive investing, but we would like to highlight another area, where active investors can make a difference. We have always believed that non-financial considerations such as environmental, social and governance (ESG) issues can create or destroy long-term shareholder value in the companies in which we invest. For this reason, we became a UNPRI signatory in 2009. In the past, a focus on environmental, social and governance (ESG) data has often been considered interesting only to those ethical or socially responsible investors who invested according to their values and put personal or institutional principles ahead of profit. A great deal of confusion exists in the industry – not to mention a plethora of different and overlapping names to describe the different investment approaches that pay attention to ESG risks.

There are at least two different ways to approach the topic: the monetary approach, which prioritises fiduciary duty and considers ESG issues because they might have a material impact on long-term corporate value and the more social approach where such issues are considered on a stand-alone basis from a moral perspective, without taking the potential investment return much into consideration. In our terms, we describe 'Responsible Investing' (with integrated ESG analysis) as being more about 'value' and 'Ethical Investing' as being more about 'values' (which, of course, vary from person to person). Some years ago, when we were at a meeting with one of the biggest pension consultants in the world, we told them very excitedly about our fully-integrated ESG information platform. They just looked at each other and replied; "we have a special team that looks into ethical funds". In other words, at that time, they failed to see the merit of viewing ESG risks in the same light as other traditional investments risks such as high leverage or a weak business model. They saw it only as being about the social side.

A good example of how hard it can be to separate values from value – or social from monetary considerations – could be the tobacco industry. In emerging markets, where regulation is extremely loose, smoking is on the increase – a fact that has driven strong share price returns for tobacco investments in recent years. For those of us who have grown up with tighter regulation and health education around smoking, it is alarming to see the extent to which cigarette packets in developing markets imply lesser health risks and are designed to appeal to children. In a social ESG context, we can see the reputational risk for investors in such an industry, especially due to the rise in child smokers in developing countries.

Longer term, it becomes more of a financial risk. The developed world has seen cigarette manufacturers hit by class action litigation and compensation payments. It is hard to imagine that regulation won't catch up in developing countries, calling into question the sustainability of the earnings power from tobacco assets going forward. Some investment funds already exclude tobacco companies and there is a growing trend across the world for others to follow suit. We do not have any tobacco investments. Meanwhile, however, it is still legal and very profitable to build your wealth by offering products that are scientifically proven to be addictive and the cause of serious health problems. Nevertheless, tobacco is a part of an index and therefore implicitly supported by the passive investor.

Today, there is a growing body of evidence to suggest, we are on the verge of a sea change in the way mainstream corporations and investors look at ESG. Mainstream investors are increasingly aware that numerous non-financial factors can directly affect a company's performance. The fact that a growing number of major asset management firms use ESG analytics to evaluate the unique risk profiles associated with different investment options reflects this. Typically, this whole dimension of ESG risk is ignored in passive funds.

Since we signed UNPRI, this aspect of risk management has now been formalized in our investment process and strengthened through additional research. It gives us an even clearer picture of long-term sector-based trends and risks. We believe that unaddressed ESG factors can increase the risk of permanent loss of capital whereas improvement in a company's ESG record can add overall value. It is the latter that we aim for through our policy of inclusion combined with active ownership. We are closely involved in our active ownership approach, directing voting decisions and entering into respectful dialogue with company management. The intention is always to improve ESG performance to add investment value over time.

Super Mario

In this regard, we would like to highlight Nintendo, a company in which we have been invested since autumn 2011 and where we have been in dialogue with management from the outset. We saw the potential of a company with the world's best franchise of computer games. Mario Brothers, Pokémon, Donkey Kong and Zelda have been household names for decades. Like Walt Disney, we were convinced that Nintendo would continue to find ways to monetize this intellectual property. At the time of investment, its share price had already declined more than 80% as it came out of an extremely successful product cycle with the Wii console and DS handheld devices becoming global hit products. We never thought that Nintendo would be able to repeat this again and we certainly saw challenges for Nintendo going forward. For example, its "Gillette-type" business model of giving away the hardware and earning nearly all profits on the software was increasingly being challenged by the rapid migration to smartphone gaming. However, with all production outsourced, huge restructuring charges were not expected, meaning that downside was protected. Moreover, with a net cash position of EUR 10 bn. (60% of market cap) Nintendo could, in theory, have acquired Nokia (or similar) to get an entry in smartphone gaming.

When we invested, we were aware that Nintendo had never been the 'poster boy' of good corporate governance. In other words, there was a big question mark against the 'G' part of its ESG profile (and for us the 'G' part often also indicates the robustness of the 'E' and 'S' parts). Improvements in corporate governance can be important drivers of corporate value enhancement. Our respectful discussions with Nintendo over the years have therefore focused on two things: crystallising the value of their character franchises and improvement in corporate governance. We have consistently used our voting rights to support resolutions calling for greater independence of Nintendo's board – the lack of outside directors was something that we discussed with them prior to the AGM of 2013. We accepted that Nintendo had proven to be very successful despite its 100% male and all-Japanese non-independent board. Nevertheless, we argued that it could potentially benefit from the nomination of independent board members and diversity. This had become even more urgent as we saw new business models shooting up in Silicon Valley and becoming serious challengers to Nintendo in a very short period. Moreover, already in 2013 more than 80% of the top 100 companies in Japan had at least one outside director. As such, Nintendo was increasingly an outlier – even within Japan.

These kinds of dialogues do not change things overnight, but we were happy to see that Nintendo took the right step by the nomination of an outside director in 2014. The appointment of an external director in itself did not enhance the corporate value of Nintendo. For that, we had to wait until March 2015, when Nintendo finally announced its entry into mobile gaming and a capital alliance with the online platform DeNA. This was as a huge strategic shift and came as a big surprise to the market. Some sources say that Nintendo's president was afraid of being ousted at June's AGM if he had not come up with a mobile gaming strategy by then. We will never know the ultimate driver of this decision, but we do know that one fifth of shareholders voted against him in 2014 and likely more in 2015 if nothing had changed. As a result of the announcement we have reached our target price, while earnings are still weak and thus we decided to sell our shares.

Meanwhile we are also pleased to note that Japan's newly introduced Stewardship Code (and soon to be introduced Corporate Governance Code) both make mention of capital efficiency and the need to recognise that shareholders expect a return on capital, which is very positive for Japanese equity owners in general.

Outlook

It is a daunting task to predict future returns. One can always find a well-publicised strategist predicting a bull market while another predicts a bear market. We refrain from trying to predict returns for the remainder of the year, but we remind you of a simple approach one can use to assess the market. Equity returns can be broken down into three factors: Earnings growth (real and inflation), dividends and multiple expansion/contraction.

With US earnings growth projected to decline in the first quarter following the weak oil prices and a soaring dollar combined with a current dividend yield of about 2%, not much is expected from those two factors. Meanwhile, the outlook for both European corporate earnings is finally becoming brighter thanks to a weak euro and monetary stimulus, and, given the higher dividend yield of above 3%, maybe there is more to come from European stocks. If we look at the last factor, investors should not expect great expansion in valuation multiples going forward considering that the current levels are close to historical averages, with the US market trading a bit higher than Europe and Japan in a historical context. Hence, after a great first quarter for equity investors, we remind you that normalised long-term returns, based on earnings growth and dividends, are more humble. In such a normalised scenario, sensible stock selection, based on corporate fundamentals and business valuation, is much more appreciated by the average investor and could potentially even win over some of the current fans of passive investing.

Meanwhile, we continue to search for investment opportunities in unpopular and undervalued parts of the markets. Our primary task is – through careful analysis – to select the best of the most undervalued opportunities. We are convinced that such an active approach will give our clients the best long-term returns.

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