Sparinvest

Letter to Shareholders Q2 | 14

Value Equities

Headlines

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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

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Dear Investor,

Over the quarter, the US and Japan performed strongly, both at the market level, and for our funds. Within Sparinvest Global Value, our Japanese holdings gained 9.9% and our US holdings gained 7.8%, both of which were better than the index returns. Meanwhile, Europe was the strongest region early in the quarter, but lost ground to other regions from mid-May onwards. After disappointing Eurozone inflation and GDP figures, the European Central Bank first of all hinted at, and then actually took action, introducing lower rates and more long-term loans for banks.

We have previously argued that in recent times, when there have been concerns over economic growth, many equity investors have crowded into parts of the market perceived as safe. Over time this has led to a wide valuation gap between cheap and expensive, cyclical and defensive, high beta and low beta, value and growth stocks. We have also noted that the performance of value stocks shows links with interest rates: as rates rise, value stocks outperform, and vice-versa.

We think that these points were well demonstrated in the second quarter, particularly as expectations of ECB action increased. Bonds rallied, and equities were sluggish. As bond yields fell, value stocks underperformed. Similarly, cyclical stocks underperformed defensives, and small caps underperformed large caps. This was reflected in our funds' performance. Following a strong first quarter, Sparinvest European Value returned 1.76% in the second quarter, compared with a gain of 4.17% for the MSCI Europe index. Similarly, Global Value's 4.7% return in the second quarter was 1.6% behind the MSCI World Index, with the gap explained by the fund's relatively high exposure to Europe.

Value in recovery

So what should we expect going forward? Firstly, we think the economic recovery is gaining momentum, both globally but also in Europe, despite the recent disappointing numbers mentioned above. Both Eurozone private consumption and the construction industry are showing the strongest annual growth since 2007. The unemployment rate is finally pointing consistently in a downward direction and PMI (Purchasing Managers Index) figures are generally encouraging.

As the recovery gains traction, operating leverage could drive impressive earnings growth at cyclical companies. Some observers have noted that despite encouraging signs of confidence this has not so far resulted in increases to corporate earnings expectations in Europe. But the devil is in the detail. Since the start of the year, 12-month-forward earnings estimates for defensive companies have in fact been cut, while those for cyclical companies have been raised. It's ironic that during the last quarter, economic concerns pushed defensive sectors to outperform cyclicals in the stock market, just as their earnings expectations were getting less attractive. So this only stretched the valuation gap, making cyclical stocks look even better value: we feel comfortable with our relatively high exposure to cyclicals at this juncture.

Secondly, we think the interest rate environment should be supportive. Generally speaking, bond yields look to be around trough levels; German Bunds are at yields close to the lows seen in 2012, which was a notably more uncertain economic environment than we have today. We do accept that, whether you call it the "new normal" or the "new neutral", monetary policy is likely to remain very accommodative from a historical perspective, with average interest rates over the coming five to ten years likely somewhat lower than those of the past cycle. But it seems reasonable to expect that rates will gradually migrate upwards. This could be a strong combination for value investors. On one hand, rising interest rates could help close the valuation gap between value stocks and growth stocks. (See our last letter for more on this). On the other hand, if rate hikes are limited and monetary policy remains generally accommodative, this should be supportive of healthy economic expansion – allowing operating leverage to drive earnings growth.

Meanwhile, the crisis generally pushed corporate management into a conservative "cash is king" mind-set. That was reasonable, but as confidence increases one would expect more flexible capital allocation: utilising cash and relatively cheap debt to invest in growth via capex or M&A, or to adjust existing capital structures through share buybacks.

Of course, the appropriate choice varies significantly from company to company. If we had to generalise, we would say that American companies tend to be very diligent in allocating capital as efficiently as possible to boost shareholder value. Meanwhile European and especially Japanese companies take a more conservative approach to their balance sheets, which can lead to accusations of inefficiency. Of course, things can change – as we will discuss below.

Japan - improving capital efficiency

Japanese markets had a lacklustre first few months in 2014, underperforming the US and Europe. But we weren't too worried to see some signs of profit taking. After all, from November 2012 to December 2013, Japanese equities had gained 80% as the world woke up to Abenomics and a weaker yen. Over that period, foreign investors shifted a huge JPY 17 trillion (EUR 130bn) into Japanese stocks. It was inevitable that the initial wave of enthusiasm would ease, and give way to sober focus on the scope, pace, and efficacy of the reforms that Mr Abe actually introduces. Note that since May, Japanese stocks have picked up steam and outperformed the US and Europe.

One interesting development is in attitudes to capital allocation. We'll take a closer look at this, because it has profound implications, and perhaps says something about the nature of value investing.

Traditionally, many Japanese companies' balance sheets were simply too strong: they sat on huge piles of cash or securities. This meant low capital efficiency – for example measured by ROE –

particularly if they also held assets or businesses which were largely irrelevant to their core business and which didn't generate significant earnings. (One of the wackier examples was Honda Motor losing about USD 180 million due to irregularities in its seafood trading division.)

Inefficiency equals potential

This low capital efficiency is often used to explain Japan's cheapness. But where some see inefficiency, the value investor sees potential. Over the years, many investors – including us – have encouraged management at Japanese companies to boost long-term corporate value by utilising their financial strength more effectively: e.g. by investing to expand the business, or by returning capital to shareholders via dividends or share buybacks.

Things have changed over the years. By 2008, Nikkei 225 companies were paying out around 5% of their market cap, either through dividends or share buybacks. The financial crisis then pushed management back to more conservative attitudes to capital allocation – but things are progressing again.

Over the last two to three years, we have found management at our investments - particularly at small caps – increasingly open to discussions on capital efficiency. We'd love to say this is all thanks to us, and we do feel we have played our part. But, more significantly, there is increasing pressure from inside Japan to boost returns on capital. One important step was in 2008, when major Japanese pension funds announced they would start voting against management of companies where ROE was persistently below 8%. But under Abenomics, the pressure is really building. One factor is simply that as Japan shifts from deflation to inflation, it's increasingly wasteful for companies to sit on their cash. But equally important is government reform.

In June 2013, the government issued its *Japan Revitalisation Strategy*. Buried on page 72 was a commitment to "consider ways to desirably manage public and quasi-public funds". This dry statement is turning into a game-changer. Japan's Government Pension Investment Fund (GPIF) is the world's largest, controlling around JPY 130 trillion (EUR 1 trillion) of assets, on top of which other pension funds tend to follow its lead. When these guys move, it has an impact. GPIF needs to change, in order to boost its returns. The government has a second motivation: to change corporate Japan.

- Firstly, the fund is likely to shift more of its vast assets into riskier assets – including Japanese stocks and overseas assets. Especially if other funds follow, this has major implications for asset prices: good for Japanese equities and bad for the yen (which is in itself usually good for Japanese equities).
- Secondly, it will increasingly use active fund management. This matters to listed companies because the more selective GPIF becomes, the less companies can be complacent about relying on it to be a stable, supportive shareholder.
- Thirdly, Japan has a new stock index. Launched this year, the JPX-Nikkei Index 400 includes ROE as one consideration for inclusion: even leading companies can be excluded if their ROE is not up to scratch. The government is making GPIF use this as a new benchmark – which forces Japanese management to become more conscious of capital efficiency.

The Abe administration has also drawn up a set of principles for institutional investors: a 'Stewardship Code'. Its central tenet is that investors have a duty to enhance medium- to long-term investment returns for their clients, and this includes nurturing the long-term value of companies in which they invest. This sends two important messages. It tells the management of listed companies to be open to constructive discussion with shareholders on issues like corporate governance and capital allocation. And it tells Japanese institutional investors to be more active in engaging with their holdings. The code is voluntary, but is attracting widespread support both in Japan and overseas. We see it as a clear long-term positive for corporate governance in Japan, and plan to adopt the code.

Major upside when potential unlocked

Added together, the pressure for change is huge. Consider Amada, which we have held for some years. As a machinery maker it is sensitive to global capex cycles, and it earns roughly half its revenues overseas. So when the global crisis combined with a strong yen, earnings took a severe hit. Management refused to assume the yen would simply swing back in their favour someday, and instead focussed on reducing their breakeven point. This impressed us. When the initial Abenomics rally came, Amada's combination of operating leverage and overseas exposure led to stellar performance: from October 2012 to December 2013, it returned 175% in JPY or 91% in EUR.

But Amada traditionally had very conservative capital allocation: large cash and securities holdings which generated little value. Our discussions with the company over the last couple of years left us cautiously optimistic that management recognised the potential to change. Amada had once been dominated by its founding family, but few members of that family now remained in the company – and we were intrigued by comments that this was 'liberating'.

Change did come, with a major additional catalyst. When the new JPX-Nikkei Index 400 was announced, Amada was not included. The clear problem was its low ROE. In May, management responded by announcing that, for at least the next two years, it would spend 50% of its profits in dividends, and the other 50% on share buybacks. This created a storm of attention: not only would the company pay out all of its profits to shareholders, but it was doing so specifically to boost ROE. Since that announcement, the stock has gained another 40%.

Amada is a healthy reminder of the potential impact of changing management attitudes – which is precisely what Japan's government is trying to do. For value investors, this is most encouraging. The point is not that all companies should pay out as much capital as possible to shareholders; rather, that management should allocate capital in the optimal way to generate long-term returns for shareholders. We will continue to encourage our holdings in that direction.

Across our portfolios, 28 holdings have announced buybacks so far in 2014. Some of these are of significant size. In Japan, small-cap chemicals company Tenma is buying back 7% of shares, and kitchen & bathroom maker Cleanup Corp 11%. These are significant numbers compared to the overall levels in Japan. In the US, where companies in general have shown more commitment to returning excess cash to shareholders, Microsoft received a lot of attention back in September when it announced a USD 40 billion share buyback program along with a hike in dividend. 40 billion dollars is a lot of money but, in relative terms, we hold companies that have done better. An insurer, Travelers, which announced a new USD 5 billion buyback plan in October, has bought back about 40% of shares outstanding since our first investment 5 years ago. And in Europe, where dividends are often preferred over buybacks, Nokia recently announced it would spend up to EUR 1.25 billion to buy back around 10% of stock. That's some statement from a company which, only a year ago, had people worried it might run short of cash. As we have written before, value investing is a lot about patience!

Secular tailwinds and cyclical potential

These days, you see plenty of headlines about strong stock markets: mostly commonly, stressing that the S&P 500 is at a record high and therefore at risk of declining. Headlines inevitably simplify things and tend to forget that the record level is accompanied by record margins and record profits. Comparing current valuations against earnings across a cycle, one could argue that markets look relatively expensive, but measured against current record profits, valuations are more reasonable. To put it another way, if margins and profits can remain high, for whatever underlying reason, equities are still reasonably priced. We would note that any stock market being at a record high is not in itself a sign that it is expensive: it may be well justified by the underlying value creation, earnings expansion, or earnings potential of the companies.

For years US companies have benefitted from technological innovations, structural demand growth from emerging markets and lower borrowing costs, all of which are often seen as secular drivers for increased margin. Lately we could add weak labour markets, lower energy costs and recovery in private consumption after the crisis to the list of benefits. A bearish investor will argue that US corporate profits are unsustainably high and likely to revert to the mean, while a more bullish investor would not expect margin compression going forward and would view current earnings as sustainable.

In either case, it's important to be selective, and we are happiest when invested in companies with both secular tailwinds and cyclical potential. When we look at our portfolios, more than 90% of our holdings remain below their peak earnings. This is obviously a crude measure, but it does point to under-utilised assets and the potential for further earnings improvement or recovery. We see plenty of scope for value creation, whether through companies unleashing the financial firepower of their balance sheets, M&A leading to sector consolidation, or corporate restructuring to unlock value – many examples of which we have written of lately.

What is most important for us is valuation dispersion: we wrote recently of the sheer valuation gap between cheap and expensive. This is what provides opportunities for value investors. Our portfolios remain attractively valued and trade at substantial discounts to the overall market. Today's valuations naturally leave equity investors with less of a cushion against geo-political risk or macro surprises than two to three years ago, but that is a natural reflection of the improved environment – and, as always, one has to consider the alternative investments available, where arguably less of a buffer may exist. For a long-term oriented investor, the case for equities, and value equities in particular, remains compelling.

Yours faithfully,

Jens Moestrup Rasmussen
Chief Portfolio Manager
09 July 2014

Upper row, from left to right:

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