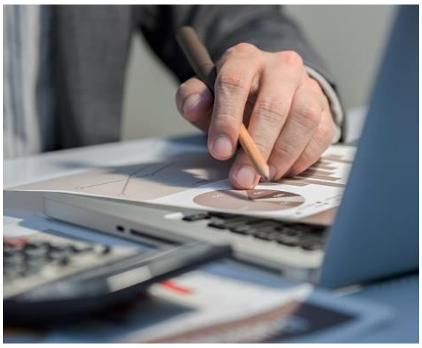
Sparinvest value



# Letter to Shareholders – Value Bonds

Q3 2014

## Contents

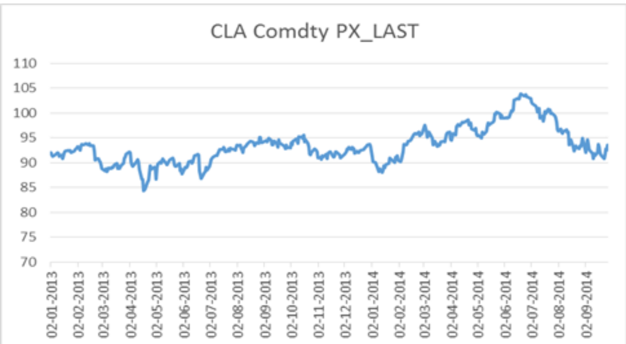


## Fixed Income Overview

The macro-economic outlook became more muddled in Q3 as the major economies started moving along different paths.

Macro-economic data indicates that growth in the United States for 2014 will be around 2.5% which is a bit lower than estimated earlier in the year. In Europe, macro-economic data was disappointing (again) and Eurozone growth estimates have been revised lower to about 0.9% for the year. The underlying picture varies significantly from country to country where the French and Italian economies look particularly challenged mainly due to the continued lack of major structural reforms. Even the German economy is starting to look vulnerable as the weaker JPY is starting to threaten German exports. The slowdown in China continued, despite the reforms that were presented earlier in the year and this had an adverse effect on global commodity prices.

**Development of oil price since 2013 (ticker CLA)**

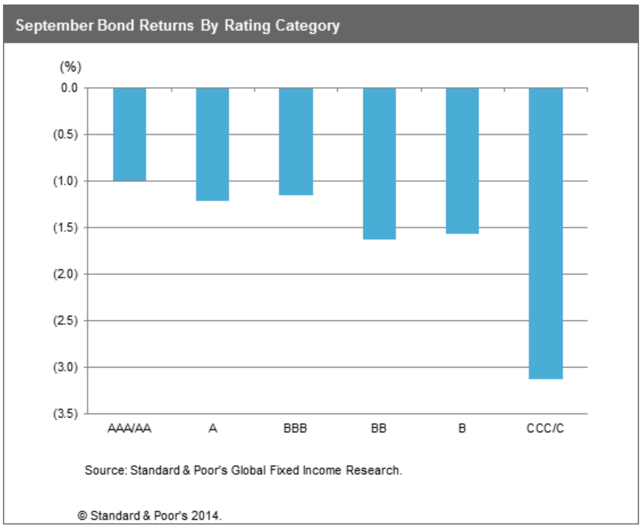



Hard commodities such as Iron-ore and copper hit multi-year lows and energy-related commodity prices such as oil and natural gas hit 2-year lows. Geopolitical risks - from tensions in the Middle East and the military confrontations in Eastern Ukraine – also reared their ugly heads.

Monetary policy conditions continue to be very lax – despite the fact that the Federal Reserve has clearly signalled its intent to roll back the massive Quantitative Easing Programme that has been in place since Q1, 2009. Expectations are also building that the Fed will start raising rates sometime in 2015, though there seems to be an inclination to 'fall behind the curve' and thus raise rates later rather than sooner in order not to damage the somewhat fragile recovery in the US. In August, the European Central Bank cut rates to the low level of 0.05%, but the unwillingness of European politicians to impose further unpopular structural reforms is most likely to force the ECB to commit to some sort of Quantitative Easing – European style.

Market liquidity in all fixed income assets continues to deteriorate significantly, as the increased political regulations of the financial sector (Dodd.Frank, Volcker Act, Basel III) force many banks to restructure their business models – abandoning their investment bank activities such as commodity trading, proprietary trading, market-making et al.

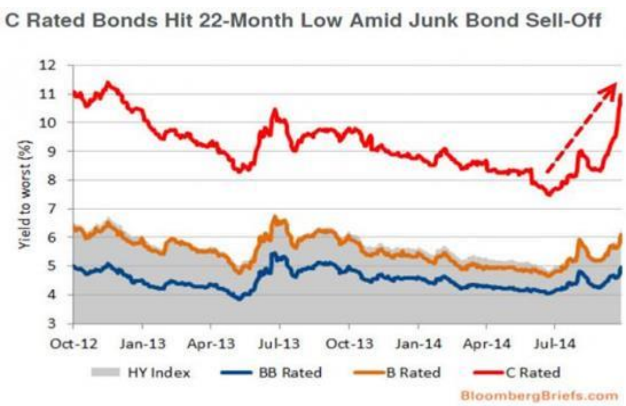
The factors described above contributed strongly to a sell-off in riskier assets in the latter part of Q3. The USD strengthened significantly, Government Bonds rose and the 10-year yield in Germany dipped below 1% as investors sought traditional safe havens. The Kingdom of Denmark sold its 2-year benchmark bond at an auction in August at a yield of -0.04 and German Government Bonds with maturities shorter than 4 years are all trading at negative yield. These are clear signs of stress in the financial markets.




## Value Bonds – High Yield

New issuance volume in European High Yield rose significantly in 2014 and is on course hit its highest ever levels since European corporate borrowing was diverted from its traditional bank-funded route in the aftermath of 2008. The credit quality of the new European issues is, in general, attractive but this is in stark contrast to the new issues in the American High Yield where credit quality is unattractive due to weak covenants and unattractive features such as Payment-In-Kind. This, coupled with the risk of rising US interest rates, leads Sparinvest to continue to be underweight in US bonds.

Sparinvest's High Yield strategies underperformed significantly in August and September as the 'flight-to-quality' herd trade built momentum. As a result, the strategies underperformed due to a general sell-off in High Yield (the biggest since 2011), significantly shorter duration than benchmark as well as the illiquidity factors described above. Small-cap companies underperformed as well and the portfolios' bias towards materials and commodity-related investments (primarily oil and iron-ore) suffered due to falling commodity prices. It should be noted here that the losses incurred in the portfolios are largely due to marked-to-market and not to an increase in defaults. The Value Bonds HY portfolios are well diversified across between 70 and 130 holdings (depending on the portfolio held) and they still experience a low default rate. However, two investments in iron-ore-related companies look particularly challenged due to the fact that the iron-ore price has collapsed by more than 40% in 2014, literally wiping out these companies' business models. We are also experiencing an increase in the number of distressed cases, primarily within the oil sector but also in two Ukraine-related investments, and the team is actively engaged in the restructuring of these transactions in order to maximize the value of the investments.



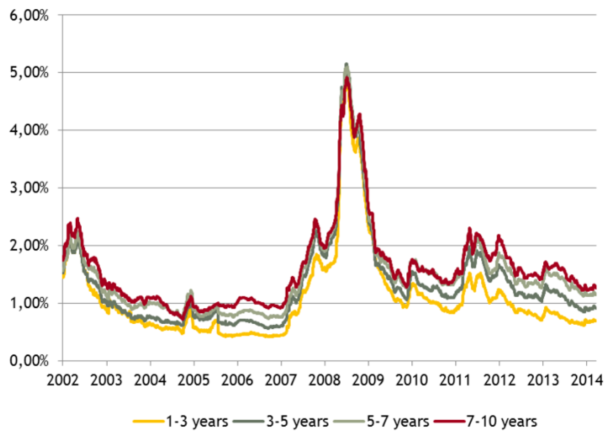

Investors should note that, despite the recent underperformance, the portfolios are invested in corporate bonds with a higher yield than benchmark and the carry of these investments should mitigate the marked-to-market losses. This is basically the essence of Sparinvest's Value Bonds Strategy - that a proprietary bottom-up investment process, with a thorough credit analysis, permits a superior credit carry premium to the benchmark(s).

## Value Bonds – Investment Grade

Investment Grade corporate bonds performed well in Q3, as interest rates generally fell across the board and the credit spread narrowed marginally. Investment Grade-rated companies have largely issued longer-dated debt in the past year(s) in order to lock in funding rates at historically low levels. As a result, the durations of benchmarks have increased and currently the duration of the Merrill Lynch Global Broad Market Corporate Index is around 6 years. The Investment Grade Market is becoming increasingly dominated by issuance of bank debt, as new regulations within the financial industry are forcing many banks to change their funding needs and structures. This creates opportunities for a careful investor such as Sparinvest and is mirrored in the allocation to financials.

The Investment Grade strategy performed marginally better than expected for the period, as the superior quality of the carefully analysed and selected investments mitigated the negative effects from a small(er) cap bias.

Credit spread on Investment Grade Industrials




## Value Bonds – Emerging Markets

Emerging Markets asset classes in general continue to experience some stress due to a risk-off sentiment in a Federal Reserve tapering scenario. Also, geopolitical and macro outlook concerns have increased risk premiums in EM assets. This being said, the devaluation of some local EM currencies has created some attractive Value cases where companies have experienced major cash-flow and profitability improvements due to reduction in local currency-based production costs and a revenue stream denominated in hard currencies such USD. The Value Bonds team have identified (and invested in) a number of EM companies that look considerably more creditworthy than the countries they are domiciled in. However, there are a few cases in the portfolios that are exposed to the Ukrainian crisis as well as to Russia. Here, Sparinvest monitors and follows the official sanctions policy dictated by the European Union

The strategy continues to perform satisfactorily and Sparinvest Emerging Markets Corporate Value Bonds (both EUR R share class and EUR I share class) was recently awarded Morningstar's highest rating – 5 stars.

Sparinvest Value Bonds Team,

06 October 2014

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.

*Signatory of:*

PRI Principles for Responsible Investment