



## Value Equities

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### Our Value Equity Funds

Fund	ISIN code
Ethical Global Value	LU0362355355
European Small Cap Value	LU0256591552
European Value	LU0264920413
Global Small Cap Value	LU0264925131
Global Value	LU0138501191

Detailed information is available in the relevant Fund Update.

- [sparinvest.eu](http://sparinvest.eu)

*Dear Investor,*

Value investing performs best in periods when stock markets are driven by a rational focus on fundamental conditions, on companies' earnings and assets. However, there are periods when markets are driven overwhelmingly by sentiment – by feelings such as uncertainty, panic, fear, excitement, or overconfidence. During these periods, little attention is paid to business models or financial strength. Such periods are not positive for our investment style, or the returns it generates – and this has been the case recently in 2011. We have seen such sentiment-driven periods before. Most recently, the plunging markets after the 'Lehman Shock' of 2008; before that, the booming share prices of the IT bubble in the late 1990s. It is vital to remember that such periods tend to be short-lived, and the focus will always return to fundamental conditions at companies. Our holdings will benefit significantly from such a focus.

In the past three months, stock markets have seen a rising tide of anxiety – to an extent that can only be described as panic, or fear of the unknown. The Eurozone is plagued with concerns over the future of the single currency and potential knock-on effects, and we have no wish to underestimate the challenges faced by European economies, and politicians. This systemic crisis will almost certainly lead to some form of economic slowdown. It is another chapter in the story of the deleveraging of the developed world – an unavoidable stage in digesting the credit crisis. There is not much positive to be said about such a process. However, in recent days, it seems that European leaders – particularly German and French – are treating the situation with increased seriousness. Until recently, the levels of anxiety in stock markets were exacerbated by a general feeling that Europe was suffering from a political vacuum. But one senses that European leaders are now waking up to the reality that more profound and radical measures are needed to restore confidence in the Euro.

Another factor which serves to heighten the current atmosphere of fear and uncertainty, is the fact that the European financial industry is heavily impacted by the current crisis, and needs to be part of the solution. However, many parts of that industry are currently dominated by fear: concerns about tougher regulations, impairments, the risk of declining earnings, and ultimately, the risk of redundancies. This is obviously not an environment that encourages a more optimistic world view.

### **Comparing Now with the Crisis of 2008**

So, we certainly are not suggesting that the economic outlook is bright and rosy. However, neither do we think that the outright pessimism of current stock markets is justified. The 'Lehman Shock' and global financial crisis are still deeply rooted in our consciousness, and rightly so. But the current situation is not entirely comparable with what the corporate world experienced in late 2008. Back then, most firms had been running at full capacity, and that after many years of expansion. So when the crisis hit, the deceleration was brutal – like hitting a wall. Companies saw orders plummet, and in the first few quarters of the crisis, certain divisions at some companies saw revenues down by well over 50%. Visibility on revenues and earnings was at historically low levels. But in the following year, and continuing right up to today, most companies have been using the economic situation as a catalyst to restructure: cutting costs and breakeven points, trimming inventories, and reducing debt levels. Many companies have emerged far stronger on the other side of the crisis. They have adapted to the real economic situation after the global financial crisis, have increased profitability and strengthened balance sheets. They are much leaner than they have been for a long time. They are also cautious – they are well aware of the potential for a downturn in their top lines and, although they do not see it as inevitable, they are prepared for it. This is a major difference from the situation seen in 2008.

### **Companies**

In the fifteen years I have worked in equity investment, I have never experienced such a large gap as now exists between what companies are saying about future expectations, and what is being implied by the equity markets. It's fair to say that there is a great deal of uncertainty in the financial systems of the developed world and that, as a result, economic growth may slow down in Europe, and perhaps elsewhere in the world. But looking at the stock markets, it seems that this uncertainty is very heavily priced in. European companies – and more precisely, Eurozone companies – have been punished most severely. During the last quarter, various European stock market indices have seen their year-to-date returns drop as much as 20% behind the S&P 500. In many cases, these share-price declines seem to happen

without consideration of the underlying company, and where its earnings actually come from. To put it bluntly, some global companies have been priced down by the stock market purely because their postal code is in the Eurozone. To us, that seems like panic.

A simple example we've used a couple of times to illustrate this point is Heineken (in which we do not currently invest). Broadly speaking, both Heineken and its closest North American competitors have similar overall exposures to the low-growth beer markets of the world – Europe and the USA. But Heineken has somewhat higher exposure to emerging markets where beer consumption is rising. Despite this relatively favourable exposure, the Heineken share price has recently dropped around 20% compared to its North American competitors. One gets the feeling that the stock market is quite simply scared of everything European or Euro-related. Another example is Hochtief, a construction company in which we invest. Hochtief is a German company, but has only around 13% of revenues coming from the Eurozone. Nonetheless, in the stock market it has been treated the same as companies which are European 'pure plays'. In markets dominated by fear, it is common that fundamental distinctions between companies are temporarily forgotten. However, this should not be of concern to the long-term value investor. We are focussed on the real value of these companies – their intrinsic value. While market prices may be temporarily depressed, we do not see any deterioration in the real worth of our holdings, and are confident that, as fundamental focus returns to the markets, our holdings will be rewarded. In the meantime, the depressed markets – especially in Europe – are providing plenty of compelling new investment opportunities which we have been exploiting.

Less than two weeks ago, we participated in an investor conference in Munich, where we met with nine varied German companies, including many industrials. Eight of them told us that they had difficulty reconciling the recent crisis in confidence in equity markets with what they are experiencing in their companies – with the development in, and expectations for, revenues and earnings. The ninth company was less positive, but not due to general concerns of economic malaise – rather, the very specific factor that a Chinese train crash had caused the Chinese government to postpone further investment in high-speed trains. Many companies responded directly to the very negative mood among investors and financial analysts, making comments such as, "*running our businesses, we look at the fundamental conditions in our markets – we are not governed by the sentiment in financial markets*"; and "*the atmosphere right now in the stock markets does not reflect the reality we see in our markets, and the next couple of years look promising*".

## **Performance**

The return on our investments for the year-to-date has been negative. Early in the year, there was unrest in North Africa and the Middle East, followed by the tragic events in Japan, and most recently, another chapter in the Eurozone debt crisis. This explains why our European holdings have been battered by stock markets in the third quarter. This has been compounded by fears of a slowdown in the global economy, or perhaps even a recession. Clearly, such fears have an impact on our holdings in more economically sensitive sectors, such as industrials and cyclical consumer goods. We are not satisfied with these negative returns. But, as always, we must ask whether these market reactions truly reflect underlying changes in intrinsic value. The answer is, categorically, no.

Despite all the doomsday headlines this year, there is still plenty to be optimistic about in our holdings. Consider Japan as an example. In late March, immediately after the earthquake, share prices plunged and newspapers were full of fearful articles. We spoke calmly with the management of our holdings there, and were reassured. Since then, the Japanese people, and Japanese corporations, have staged an impressively swift recovery from the earthquake. Our Japanese investments have performed relatively well in recent months. In fact, even on a year-to-date basis, our holdings there have been among our more robust investments in 2011, and this is only partially thanks to a stronger Japanese yen. This is perhaps a simple demonstration of the importance of trusting in fundamental analysis of intrinsic value, rather than giving in to the prevailing panic in markets. Moreover, as discussed above, many of our holdings have used the economic situation as a catalyst for streamlining and are now stronger. Our holdings are in a favourable position to take advantage of the upswing, regardless of its timing or precise nature. And when there is short-term weakness in the stock markets for some of the regions or sectors we invest in, often it is a good opportunity to make new investments or to add to existing holdings. Specific changes in the individual funds are discussed in the quarterly fund updates. Note that the fund range now includes Sparinvest European Small Cap Value, about which more details can be found on our website.

## **Back to the Levels of 2009**

Our conservative value process has always resulted in portfolios of stocks with solid earnings power, robust balance sheets, and low valuations. But looking at the valuation of our funds now, they are clearly low from a historic perspective. Metrics are now back around the lows we saw in March 2009, when markets were deeply depressed by the global financial crisis – when the financial system was closer to a ‘meltdown’ than most care to

think about. Measuring what you pay for the operating earnings power of our companies, there is no doubt that they are very cheap. In fact, looking at earnings expectations for coming years, the entire market looks cheap. We’ll use Sparinvest Global Value as an example, cumulating the data from our individual holdings into one theoretical company – but bear in mind that these low valuations can be seen across all the portfolios in our Value Equities fund range.

Consider analyst consensus estimates for EV/EBITDA, which is a useful indicator of the price of companies relative to their raw earnings power. The fund is priced at just 3.7 times current year estimates, and 3.1 times next year estimates – compared with 5.9 and 5.2 times respectively for the MSCI World.

Considering asset values, the fund is trading at a price-to-book ratio of 0.77 times, compared with 1.52 times for the MSCI World index. The aggregate balance sheet is sturdy, with low financial leverage (net-debt-to-equity of just 5% compared with 29% for the MSCI World) and a relatively lower risk of asset impairment due to, among other factors, a lower proportion of goodwill.

The prices being paid for operating earnings in current stock markets suggest that there is good potential for future activity in M&A markets. For example, if one compares current EV/EBITDA multiples with what is typically paid for companies in M&A transactions, the implicit upside in the entire market, and the fund in particular, looks significant. It is of course difficult to quantify precisely the impact that M&A could have on our funds, beyond the fact that it can serve as a clear positive driver for performance. The positive effects can be direct, such as when a company is itself taken over, but also indirect, when M&A activity in general leads to a given sector being revalued at higher levels. Across our funds, we continue to see takeover activity – Granitifiandre, an Italian tile producer in our Global Small Cap fund, was taken over earlier this year. However, we expect to see more of this type of activity in the coming years.

## **Conclusion**

In recent months, stock markets have been dominated by panic. A whole range of stocks, and especially those in Europe, have been priced down almost as if it were a fire sale. Our funds are now at valuations comparable to those seen in March 2009, after the global financial crisis. This is despite the fact that many of our companies have emerged from that crisis far stronger, and are considerably better placed than they were three to four years ago. But that kind of fundamental distinction doesn’t make much difference in stock markets that are driven by fear and pessimism. Yet the current crisis cannot be wholly compared with the situation in 2008. Not only

have our holdings become stronger, but increasingly, we will be in an environment where that strength matters. Governments are no longer able to unleash a wave of liquidity to save struggling companies; meaning that those with strong business models and greater financial independence (lower leverage) will, increasingly, be able to distinguish themselves. The strong will get stronger, and the weak will get weaker.

Global economic expansion is under pressure and moving at a slower pace than one might have hoped. Under such conditions, healthy and strong companies will be able to compensate for this 'missing' growth with acquisitions and consolidation, thereby raising their long-term earnings power. This is one factor that gives us confidence in the strength of our portfolios, and why we see scope for impressive performance. We have been witnessing extreme times lately, where market focus has not been on corporate fundamentals. But these periods always come to an end – and while they last, they always bring new investment possibilities.

Stock markets seem to have an increasingly short-term focus, an insatiable desire to have a 'good story' to tell, but this is not what matters for the long-term investor. But the long-term investor, and especially the value investor, is certainly able to exploit the opportunities created by such markets. For us, value investing is not about having a good story that is easy to communicate and that sits easily with market consensus and the general atmosphere in the news. Instead, it's about looking at real values and valuation, about identifying profitable companies with strong balance sheets, and buying them at a discount. And last, but not least, it is about patience.

*Yours faithfully,*

**Jens Moestrup Rasmussen**  
Lead Portfolio Manager  
11 October 2011

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