



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

Dear Shareholder,

It has been a disappointing year. As we have stated many times before, value investing is all about consistency: keeping your cool and long-term perspective, whether the world around you is plunged in negativity or buoyed by excessive optimism. Looking at our performance in 2011, it ended up being a very disappointing year for our fund and investment approach. We were invested in some of the worst-performing areas of the equity markets in 2011 compared to benchmark. We had a high exposure to Europe with its sovereign debt crises; to economically sensitive stocks (with higher volatility and therefore to some people riskier), smaller-market caps and low-price-to-book stocks. The conclusion is that fundamental value investors, in general, had one of the toughest years in a long time, and we must conclude that our investment approach struggled a lot in 2011.

Our investment style tends to underperform in sentiment-driven markets, like in the years from late 2007 to 2009 and again in 2011, but then it tends to outperform when markets are driven by fundamentals, like in 2010. We use the word 'sentiment' driven to describe markets where fear, uncertainty or relief (like in 2009) are causing the biggest part of stock-market movements. On the positive side, historically there have been more 'fundamental' years than 'sentiment' years, which have resulted in good long-term returns for fundamental value investors. Trying to describe the nature of the global financial markets in 2011, there is one word that dominates, and that is 'fear'. It is fear for the unknown; what if the Euro breaks up and we will fall into a global recession, etc.?

European recession?

“How long will it last?” It’s never been our style to try to answer such questions. What is certain is that we need the fear of systemic risk in Europe to ease and a clearer picture to emerge of the total impact on the real economy. However, looking at our portfolios, we would argue that a deep recession is already largely priced in, especially in the European cyclical stocks. Are we currently in a recession in Europe? Even if that is so, one must remember that we invest in financially-sound companies, with strong long-term earnings power, which will live to see another day. This time around there will be no new relief rally fuelled by government funding (unlike 2009), now the stronger companies will be able to exploit their strength and try to consolidate by removing competition. The stronger will be stronger and the weaker will get weaker. Strategic buyers will pursue M&A opportunities, try to compensate for lower organic growth and prepare for better days. However, we are still not overly optimistic people and our investment style is not about calling turning points in the market. We prefer to focus on the fundamental qualities and the valuations of our investments, viewed over the long term.

Risk

I still remember the day, almost a decade ago, when our colleague Thomas had organized for William Sharpe to come and visit our Sparinvest office in Avedøre a small sleepy Copenhagen suburb. It was a great day for any trained economist to have a Nobel Prize winner in Economics standing in your office having a look ‘over your shoulder’ at your models and spreadsheets. Even so, as a convinced Benjamin Graham-style value investor, I have never been a big fan of either the Efficient Market Hypothesis (EMH states that stocks are never mispriced as markets incorporate and reflect all relevant information immediately) or the CAPM-model. The Capital Asset Pricing Model developed by Sharpe was based on the theory of market equilibrium. Both assume positive correlation between risk (defined as volatility) and return.

The word ‘risk’ has been one of the favorite written and spoken words in the past 6-9 months, and the stocks’ volatility has been used as a measure for their risk. A long-term value investor would argue that risk cannot be measured by a single number; it doesn’t really pay full credit to the concept of risk. I think any credit analyst knows that the idea of single ‘super multiples’ that include everything is a bit unrealistic. Benjamin Graham did not believe in the idea that risk equals volatility, it also shows in his work:

“...the idea of risk is often extended to apply to a possible decline in the price of a security, even though the

decline may be of a cyclical and temporary nature and even though the holder is unlikely to be forced to sell at such times. These chances are present in all securities... But we believe that what is here involved is not a true risk in the useful sense of the term... the risk attached to an ordinary commercial business is measured by the chance of its losing money, not by what would happen if the owner were forced to sell”¹.

“...the fact that a decline [in market price] may occur does not mean that he is running a true risk of loss. If a group of well-selected common-stock investments shows a satisfactory overall return, as measured through a fair number of years, then this group investment has proved to be ‘safe’. During that period its market value is bound to fluctuate, and as likely as not it will sell for a while under the buyer’s cost. If that fact makes the investment ‘risky’ it would then have to be called both risky and safe at the same time. This confusion may be avoided if we apply the concept of risk solely to a loss of value which either is realized through actual sale, or is caused by a significant deterioration in the company’s position”¹.

We are not naive. We know that for much of the finance industry, risk has now come to be defined precisely in the way which Graham rejected: the risk of a decline in market price, or more succinctly, market-price volatility. So, for many working in finance, volatility is considered the biggest risk to be avoided, and declines in market prices are treated with great skepticism. We must also acknowledge that a lot of investors work within structures that are governed by strict regulation and where they are measured on their short-term performance, and we respect that. But value investors see it differently. We are of course human, so when we see share price declines, it’s not nice. But we certainly do not panic. Volatility and temporary share-price declines are nothing new. As Graham wrote, *“market value is bound to fluctuate, and as likely as not it will sell for a while under the buyer’s cost”¹*. This is no reason to run scared from an investment. We care about two things. One, has there been a deterioration in the company’s business model and position or intrinsic value? If not, it would be a basic mistake to capitulate to market volatility and sell the position. Two, do the market declines provide fresh opportunities for good long-term investments? If so, the value investor should exploit them.

It is this kind of approach that we are referring to when we talk about Sparinvest *“Investing for the long-term in a short-term world”*. We know that much of the financial world is focused on short-term trends and concerned about market volatility. But we have our eyes firmly focused on the long-term and how to maximize long-term returns. To be precise, we work to exploit volatility, not to capitulate to it. This approach to the concepts of risk

¹ B. Graham: The Intelligent Investor (1973)

and volatility lies at the very heart of value investing. Do not let market volatility dictate your investing behavior; instead, over the long-term, exploit that market volatility.

Quality Companies

Value investing is inherently sceptical. It does not assume a rosy economic future, but accepts that down-cycles do occur. When we talk about investing in 'healthy' companies, we are not looking for companies that will never face bad years. Such companies do not exist. Instead, we assume that all companies will go through tough times, and we seek out the ones with the strength to emerge healthy on the other side. When we assess the intrinsic value of potential investments, we look at earning power across the cycle – in other words, our initial valuation factors in the bad years as well as the good ones.

We have written a lot about the negative sentiment on the financial markets and its current focus. But when we are looking at the underlying fundamentals, and more specifically the companies, a lot of sectors are seeing consolidation right now. Some have seen competitors forced out of business, which may create long term opportunities. For the vast majority of our holdings, though, business models and intrinsic value remain intact. Their balance sheet strength has served them well.

Valuations

Meanwhile, our portfolios are trading at extremely low valuations. Average valuations for the funds can be seen in the individual fund updates. However, if we take Sparinvest Global Value as an example, and aggregate the data from each individual holding to present the fund as, effectively, one stock, we get a price-to-book ratio of 0.77 times, and an EV/EBITDA of just 3.6 times. For the MSCI World index, the same methodology gives a price-to-book of 1.63 times and an EV/EBITDA of 6.3 times.

Naturally, valuation measures should always be taken with a pinch of salt. A company that looks cheap can quickly lose its glamour. Earnings estimates can be cut – as is happening now – and asset values can fall. Accounting practices can make companies look cheaper than they really are, by massaging asset values or earnings levels. We look at earnings, assets, cash flows (and proxies for cash flow) and the sustainability of the business model. In all of this we consider the long term and make conservative assumptions.

This disciplined focus on intrinsic value is a powerful tool which, over the years, has proved to be an extremely effective way of investing in companies. In searching for new investments, it allows you to be contrarian, and exploit selling by others. For existing investments, it gives you the strength not to capitulate and sell a

perfectly good investment just because the market price tells you it has fallen in value. Many of the cyclical holdings were treated viciously in the markets of 2008 and this is now happening again. We 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. 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, after many years of expansion. So when the crisis hit, the deceleration was brutal – like hitting a wall. Visibility on revenues and earnings was at historically low levels. But in the following year, and continuing right up until today, most companies have been using the economic situation as a catalyst to restructure: cutting costs and breakeven levels, trimming inventories and reducing debt levels. Many companies have emerged far stronger on the other side of the crisis. They are much leaner and more cautious.

Conclusion

It seems like the financial markets have tried to price in not only defaults in Greece and Italy, but also a systemic crisis in the European banking sector and finally a breakup of the Euro as a consequence. The gap between performance of the US and European equity markets in 2011 has been significant. Looking at Shiller P/E's for stocks in the core of the Eurozone (France and Germany) and even Japan currently trade at close to 30-year lows. Financial markets have been sentiment-driven in the latter part of 2011, for the above-mentioned reasons, and our performance has struggled this year. Is this the end of fundamental value investing? We think not. We have previously seen similar situations, and been the 'ugly duckling' before. When markets are like this, it is more important than ever to focus on basics and remember the simple idea of Graham and Dodd: most of the time, the investor is better rewarded if he forgets about the stock price and focuses on the company, its assets and its operations. We know that our fund has some catching up to do and we remain convinced that the strength and long-term potential of our investments will enable it to do just that. We believe we will reach a point where common sense and the recognition that investment means true ownership of a part of real companies, with real assets and earnings, will become more important to all investors and lead value investors to solid returns.

Yours sincerely,

Jens Moestrup Rasmussen

Chief Portfolio Manager

11 January 2012

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