Sparinvest

Letter to Shareholders Q3 I 12

Value Equities

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Our Value Equity Funds

Fund	ISIN code
Emerging Markets Value	LU0760183672
Ethical Emerging Markets 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,

In the last weekend of the quarter, I was watching this year's Ryder Cup, broadcast from some golf course in the suburbs of Chicago. For those of you not into sports, this is a golf competition between teams from the US and Europe. On Saturday morning, Europe was hopelessly behind the US and, by the end of the day when they were down by 10 to 4; I think most people had given up on the Europeans. But Sunday offered one of the strongest comebacks seen in the history of the tournament from the European side, and the team ended up as winners on Sunday afternoon with a score of 14½ to 13½. In comparing this to the current sovereign debt crisis in Europe, I am not suggesting by any means that we are out of the woods yet. The current score is maybe 10 to 6 or 10 to 5, but my point is that Europe has the 'players' (some stronger than others) and the willpower and potential to pull it off. So maybe we should not give up on Europe just yet.

Political solutions in Europe

Sentiment concerning Europe is by no means good, but lately it has improved slightly. There are signs of more political direction, which gives hope for Europe´s chances of working its way out the crisis over the coming years. It is said that the political commitment behind the scenes in the European system is much higher than the impression you get from reading the headlines in the media. There are high ambitions for introducing major structural reforms in the struggling countries in Southern Europe. Reading IMF reports you get an idea of how these reforms are actually designed; the overall aim being to re-establish long-term competiveness and growth in these economies. Ireland, Greece, Portugal, Italy and Spain are all in the process of introducing reforms in relation to the public sectors, pensions, financial sectors, labour markets and more liberalization to promote growth and entrepreneurship. This would mean more efficient and better working public sectors, increased pension age, stronger and better-functioning financial sectors, more flexible labour markets, increased competitiveness and eventually more future job creation. They are all tough measures and most of them also very unpopular with the public, but there are no short cuts. At the end of the day, I think that deep down most Europeans understand the need for these kinds of measures. Reluctance to take these kinds of decisions is not particularly a European phenomenon. Most politicians around the world are more focused on getting themselves re-elected in the near future – and know that elections occur within shorter timeframes than it will take to see the full effects of the suggested reforms. In this light it is encouraging to see that the new non-elected prime minister in Italy currently holds the highest popularity rating of any Italian leader in years, even after introducing very tough reforms in his home country.

The key to solving the current crisis is to ensure that plans are kept and targets are met. This will no doubt have a dampening effect on the European growth outlooks in the coming years.

Monetary easing

While politicians around the world struggle with stretched balance sheets, the central banks are not lazing all day. In the end of the quarter we saw the central banks around the world step up to the plate concerning monetary easing. The FED announced QE3, with MBS purchases up to 40 bn. dollars each month. In Europe Draghi promised that the ECB will do *"whatever it takes"* with unlimited supportive purchases of government bonds in the struggling euro countries, and in Japan the Bank of Japan intervened to weaken the strengthening yen. During September one off the biggest hurdles in relation to the implementation of political change in Europe was cleared, when the German federal constitutional court approved German participation in the European rescue fund, ESM.

All this has been well received by the equity markets and we have seen our funds gaining – both in real terms and relative to benchmarks – particularly in the last month of the quarter. We know that this is really short term, but it is positive to see that our value strategies perform when general fear loosens its grip in the market – even slightly.

But regardless of the fact that both central banks and politicians around the world are trying to stimulate and stabilise, the global economy is not the best shape and the uncertainty is notable. Not all investors are convinced that the European crisis is under control. In the US people are waiting for the coming presidential election and the expected tightening of the fiscal policy in the US, widely known under the frightening name 'Fiscal Cliff', is lurking in future. Finally Japan and China are fighting out a dispute over some small islands situated between the two countries, which have caused boycotts of Japanese products in China.

Is fundamental value investing dead … again?

Macro-economic developments and political concerns have been on top of the agenda for 5 years. This has been very challenging for fundamental value investors like ourselves, and we are not happy with the results in this period.

I started out as a value investor more than 15 years ago. It was during a period where markets were driven by a phenomenon called the 'New Economy'. The New Economy was invented because most of the old economic wisdom was declared more or less useless. 'Successful' investing was all about dot-com´s, growth and blue-chip stocks while value investing was down and out. A value investing strategy couldn't really cope with the new times, and the valuation techniques used to price the 'interesting' stocks. Value investing was pronounced dead in the late 90´s, just as it was in the 70s and the 80s – and just as it is today.

Periods where markets are driven by extremely strong consensus views create big valuation gaps. In today's market, fear or uncertainty is the main driver, and there is a lot to be frightened of; Europe melting down, global economy stalling, the US fiscal cliff, volatility, career risk and much more. This has created an extreme demand for perceived 'safe' assets, creating a bubble in US government bonds, growth stocks and stable earners, so-called quality stocks. In the stock market investors are herding in the blue chip/high-return-on-equity universe.

The fact that fear and uncertainty will not loosen its grip was clearly seen after the last series of liquidity injections into the market and political action in the Eurozone. Despite these efforts, investors have continued to follow the same pattern. I have highlighted the work of Eugene Fama and Kenneth French and other academics so many times in this letter that I can understand if some of you are getting tired of the topic. But, despite all the research pointing to long-term outperformance of value stocks over time, classic value factors (price-to-book, price-to-earnings, price-to-sales, dividend yield) haven´t really worked in the last 18 months. In fact, we have seen a period of more than 5 years where growth has outperformed value.

One of the fundamental factors that has been used historically to show how cheap stocks outperform expensive stocks over time is price-to-book. In relation to European stocks, we are currently at a point where you need to go back more than 30 years to find a similar environment where the low price-to-book factor was as out of favour relative to the opposite factors like EPS growth and momentum. It's been very rare indeed for value factors to lag growth factors for as long as they have recently. Nevertheless, and this is key, on those few past occasions where value was a laggard, as soon as the environment improved, it soon produced huge relative returns. For that reason, it's time to expect that the tide will turn and value will re-emerge as the more lucrative investment strategy.

The world has been tumultuous lately, but some things do not change. In the long-run, cheap stocks do outperform strongly. Shorter periods of growth stock outperformance are seen from time to time, but history has shown that these periods end – and often end quickly with strong value stock rallies. So there is no doubt that value investing has lost a lot of fans in the past 5 years, but to declare it dead again is maybe a bit drastic.

A Bank that has performed well during the financial crisis

Despite the general recent underperformance of the value style, we have still had good investments in our portfolio. Banque Cantonale Vaudoise (BCV) is the largest bank in the Swiss canton region Vaud, headquartered in Lausanne, with 67 branches and 54 automated service centres across the region. It serves private individuals as well as small and mid-sized companies, offering a full range of bank products, e.g. deposits, mortgages, and asset management.

We invested in BCV in Jan 2006. Although BCV was impacted by the financial crisis, it entered the financial crisis extremely well capitalized – indeed far beyond regulatory requirements. Furthermore, conservative lending policies resulted in low delinquency rates. Therefore BCV's earnings power remained resilient during a period that has turned out to be challenging for most banks. Avoiding capital issues and remaining profitable were the key success criteria of the business model of BCV. Coming out of the financial crisis unscratched, BCV is well equipped to emerge even stronger than before.

At time of investment valuations multiples were low. BCV was trading around one times book value clearly below the normal levels at the time and a price-to-earnings ratio around 9 times, despite the massive overcapitalization. Whether looking at assets or earnings, we saw an opportunity to buy quality cheaply. The example of BCV illustrates that in spite of negative sentiment towards financials, banks that are well-run, well-capitalized and severely mispriced will, in due course, attain their true worth. Having bought shares for CHF 420 in Jan 2006, we sold our position at around 500 CHF during the course of 2012 – on top of this, we received 183 CHF in dividends during the holding period. This translates to a total return of 140% in Euro terms during the investment period. During the same period, European financials saw a total return of minus 50%.

Are management buy-outs a new trend in Japan?

Another value case I would like to highlight is a Japanese company called Sonton Food. It is a Japanese peanut butter maker which diversified into jams and fillings for bakery products. We first bought it in Dec 2006. The company was trading with a low P/B and a strong net cash position. On top of that, it was cheap on medium-term earnings assumptions. Not long after the first investment, earnings suffered. Raw materials prices rose (sugars, oils, dairy, fruits), but the company couldn't fully pass this cost on to product prices. From 2006 to 2009, operating profit margin was halved and the share price fell by 45%. In 2010, earnings rebounded and jumped 150% to a 5-year high. The company had been cutting costs, boosted energy efficiency and saw raw materials prices easing. From April 2009 to April 2010, the shares were up 52%. In next couple of years, earnings retreated somewhat again and raw material prices went up again, so the company responded by cutting costs again. In August 2012 we were happily surprised when the company announced a management buy-out (MBO). The shares jumped by 46% upon this announcement. The total return on our investment including dividends is 52% (7.7% annualized), compared to a total return for the MSCI World of 9.3% (1.6% annual).

In a country where hostile takeovers are considered unacceptable, it's fair to say that not many saw this coming. But it seems like MBOs are seen in a different light today. Falling share prices, cheap financing and the changed attitude towards MBOs have driven an increase in Japanese MBOs. So far, this has only been seen with small companies, trading at extremely low multiples. According to an article in Barron's (August 27, 2012), 18% of all small caps trades below 0.4 times book value while 20% have an enterprise value of less than 3 times cash flow. This means that there is a massive potential to take small listed companies private, because they have no real need for being listed.

M&A activity frozen in Europe

M&A activity has always been one way for value investors to crystalize the values in their investments, and we are happy to see a management buy-out in a Japanese holding. Meanwhile, despite the new MBO trend in Japan, global activity within mergers and acquisitions is at the lowest levels since 2008. Buyers are currently ignoring the attractively low share prices and the cash rich balance sheets in companies around the world. The reasons for the limited M&A activity are the European crisis and the fact that banks not being active in this area. Plenty of companies have the cash at hand to acquire assets, but they don't have faith in the economy and don't dare to make a move. Looking at global M&A activity, Europe is the most affected region in the world, recording the lowest number of deals in many years. Industrial buyers would usually take advantage of times like this to go 'bargain-hunting' for the long-term. But, just like we saw in 2008-2009, the difficulties in the financial markets have made even relatively strong companies reluctant to pursue M&A activity. In such turbulent times, why stick out your neck and take on debt in order to expand? However, acquisitions will pick up again. Japan offers proof of that – in the past years, it's been Japanese companies that have stood out as active acquirers, making use of their cash piles to go shopping overseas. So, gradually, buyers will emerge to reinvigorate the M&A market. For our funds, over a third of investment exits have been due to M&A activity and our current portfolios hold plenty of ripe targets, especially in Europe and Japan.

Japanese stocks have historically looked cheaper than most regions on some key ratios like price-to-book, but usually more expensive on others like price-to-earnings. It is significant that they are now trading equal to, or slightly cheaper than, US stocks on price-to-earnings today. Secondly, European stocks are also heavily discounted. These multiples are based on earnings forecasts which aim to factor in top-down risks to earnings, but despite that, multiples are lower than in other regions – so the stock markets are either factoring in some very negative scenarios or just avoiding European equities in general. The reality is that the corporate world is in a better shape than it was when the financial crisis hit four years ago. Restructuring has left the world with healthier balance sheets and leaner cost structures, so that even assuming tough external conditions, corporate profits are not expected to collapse again as happened in 2008.

Conclusion

But what is crucial is that our portfolios look cheaper than the wider market, while offering robust financial health. Consider Sparinvest Global Value as an example. On most metrics, valuations are around the historically low levels we saw in March 2009 – at the peak of the global financial crisis. The price-to-book ratio of 0.79 times is under half the MSCI World's level (1.73 times). On price-to-earnings, the fund trades at 11.86 times estimated earnings for the next fiscal year, compared with 12.90 times for the MSCI World. The picture is similar whether one looks at EV/EBITDA (3.42 times, versus 5.79 times for the index), or price to cash flow (4.82 times, versus 6.68 times for the index). The fund offers a dividend yield of 2.97%, compared with 2.75% for the index.

So, recent markets have not been kind. As Benjamin Graham would argue, investing for the long term allows the investor to exploit market prices when it suits him, and largely ignore them when it does not. In dark days of falling markets, it is more important than ever to get back to 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 will not attempt to forecast the precise timing, but we do know that when markets shift back to a focus on real value, it can happen quickly, like the start of this year. In the meantime, we will be monitoring our holdings closely for any significant developments or changes in intrinsic value, and scouring the markets for the most compelling long-term investments. We remain confident that our portfolios offer large discounts to intrinsic value, and this will drive strong long-term performance again.

Yours faithfully,

Jens Moestrup Rasmussen
Chief Portfolio Manager
15 October 2012

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