



The Academic Background

Benjamin Graham

Sparinvest gratefully acknowledges the influence of the following great academics whose research and opinions have guided us in our approach to value investing:

The strategy of value investment was first developed in 1934 by Columbia University professor, Benjamin Graham (1894 – 1976). His book, 'The Intelligent Investor' remains essential reading for all practitioners of value investment. Graham prioritised capital preservation over all other investment concerns and encouraged an analytical approach to identifying undervalued securities. He defined the difference between 'intelligent investment' and speculation as follows:

"An investment operation is one which, upon thorough analysis of the facts, promises safety of principal and an adequate return. Operations not meeting these requirements are speculative".

Fama & French –
The Size/Value Effect

Eugene Fama and Kenneth French plotted the returns from the US Stock Market for the three decades from 1964 to 1995, on a model that categorized stocks by their size and price-to-book characteristics. The results demonstrated that, above and beyond a stock's beta, there were two further factors that could have a positive impact on investment returns – a company's size and its value. ■

Efficient Market Hypothesis

Eugene Fama's 1960's PhD dissertation also gave rise to the hugely influential 'Efficient Market Hypothesis' which states that, at any given time, security prices fully reflect all the information available to market participants. Therefore, if a market is efficient, no individual investor should expect to be able to outperform its benchmark on a sustained basis. By the same token, if the market is fully aware of all the available information about a given company, then its share price should ultimately be an accurate reflection of its business value.

"If a business is worth a dollar and I can buy it for 40 cents, something good may happen to me."

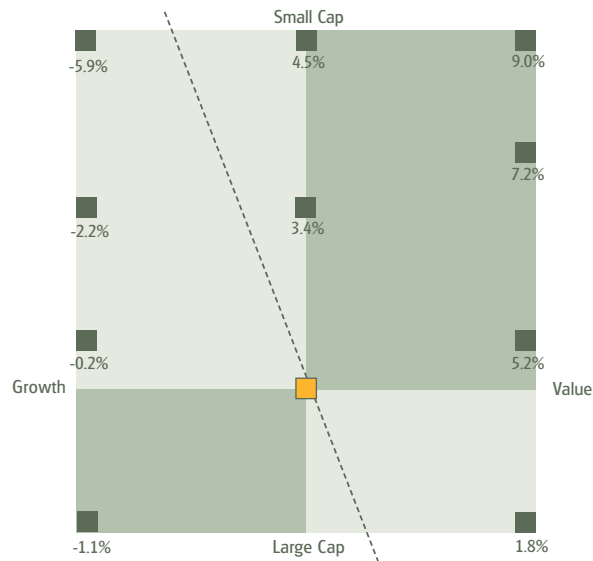
Walter Schloss (who was a student of Benjamin Graham along with elite investors, Warren Buffett, William J. Ruane, Irving Kahn, and Charles Brandes) ■

Historical Evidence for the Success of Value Investing

The body of evidence for the longer-term outperformance of value stocks compared with other asset classes has been supplied by the American academics, Fama & French. Their famous study on the returns from the US stock market, published in 1996, investigated the 'style factor' and concluded that investors were likely to be better compensated for risk if their investment portfolios were skewed towards those companies occupying the value and the small-cap sectors of the market. Fama & French subsequently researched international market data – and found the same effect. ■

Value Equities Strategy

A Study of Excess Returns – US Market 1963 - 2006

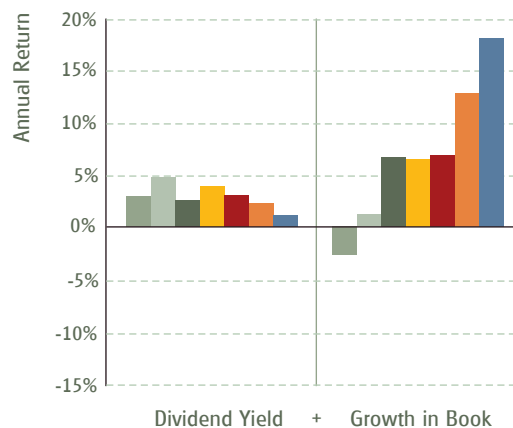


Based on Value-weighted data for US market over a period of 40 years, the matrix shows the results of an annual division of the universe into 25 portfolios based on 'style exposure'. Thus each portfolio is ranked according to the size and price-to-book-ratios of the companies that it theoretically invests in.

Data source: Kenneth French CRSP database. Calculations: Sparinvest

The Crucial Price-to-Book-Factor

The figure below is based on a working paper from Fama & French and shows how different factors influence the returns on an investment over time. Adding a further decade's worth of data to previous studies, it reconfirms the relative outperformance of investments in the smaller-cap and value sectors over the longer term.



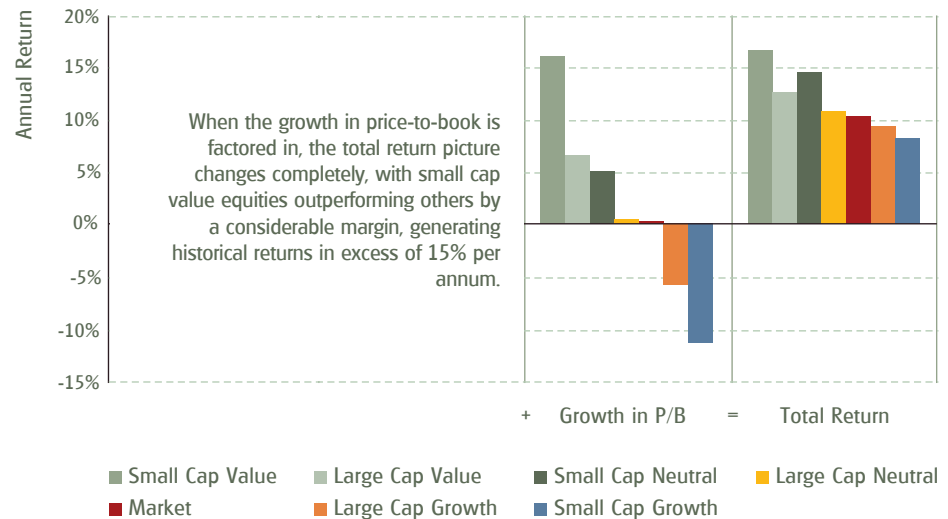
Most analysts evaluate companies for investment on the basis of their earnings power (an indicator of likely dividend yield) and their general prospects (an indicator of likely growth in book).

On the basis of these criteria alone, it would appear that there is a very strong argument for investing in small and large-cap growth funds.

- Small Cap Value
- Large Cap Value
- Small Cap Neutral
- Large Cap Neutral
- Market
- Large Cap Growth
- Small Cap Growth

However, once you factor in the growth in price-to-book for these assets over the holding period, thereby showing the revaluation of the stocks carried out by the market, the picture changes completely.

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Source – Fama & French The Anatomy of Value and Growth Stock Returns US Equities 1963 - 2004

Fama & French also discovered that from the point where a stock is designated as 'value', its earnings tend to increase whereas the opposite is true for growth stocks. Unable to keep up the high profits that have brought them into the growth category, their earnings tend to decrease – hence the market revaluation in terms of price-to-book.

The conclusion is that **'good' companies are bad investments, 'bad' companies are good investments.** ■

Value Investing – The Theory

All traded companies have two values, two prices. Value investing starts with the premise that any company traded on a stock exchange effectively has two values and that to make an 'intelligent' investment requires knowledge of both.

A company's **'market value'**, indicated by its publicly-quoted share price, is the price that investors are prepared to pay at any given time to obtain a stake in its future. Its **'intrinsic'** or **'business value'**, on the other hand, indicates its true worth.

In an efficient market, the two values should converge but market sentiment can drive a share price far above or below the company's intrinsic value, leaving scope for value investors to profit from the discrepancies between the two.

There is no set formula for the calculation of intrinsic value. It can only be discovered by means of a 'thorough analysis of the facts'. For a value investor, however, the calculation is based on establishing the likely price that would be paid for a company in the event of a merger or takeover bid. A value investor will only purchase shares in a company at a price representing a considerable discount to intrinsic value. ■

Value Investing – The Benefits

The value investment strategy has been shown to provide:

- Excellent returns over the longer term, historically better than growth investing
- A 'margin of safety' to protect against permanent loss of capital (Although not immune to market downturns, the strategy of investing in shares that are already heavily discounted means a higher probability that investors will get their money back)
- Excellent portfolio diversification properties

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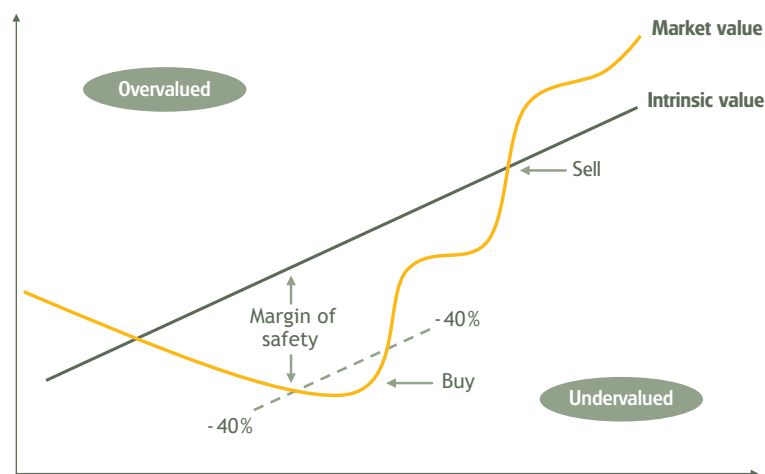
- Reduced turnover
- A systematic and disciplined investment style that is based on fundamental business analysis, not on the vagaries of market sentiment
- The opportunity to participate in the share price premiums involved with LBOs and takeover bids. This is because the companies that seek to take over other companies are also strategists and value hunters. ■

Buy Shares at a Discount, with a 'Margin of Safety'. Sell them at Intrinsic Value

A company becomes 'undervalued' when its market value drops considerably below its intrinsic value. At this point, the opportunity arises for buying shares in what may be a fundamentally sound business at a considerable discount and with a built-in 'margin of safety'. This offers scope for capital gain with a reduced risk of capital loss. ■

At Sparinvest our investment team consists of professionals who are admirers, disciples and successful practitioners of the Benjamin Graham style of value investment. Whilst applying the same fundamental analysis criteria and intellectual rigour to the identification of investment opportunities as Graham did, Sparinvest's team has expanded the search for value internationally and harnessed the power of new technology to provide extra analytical capabilities.

What is Value?



Sparinvest is Committed to Value

In adopting value investment as one of our key portfolio strategies back in 1996, the management team at Sparinvest decided to remain true to the value strategy that originated with Benjamin Graham in 1934. After a thorough review of all the academic evidence, the whole company became convinced that value investment offered investors better long-term compensation for risk than investment methods relying on market timing. Over the last decade, we have built up our expertise and stuck with the value approach through rising and falling stock markets. Our investors can be assured that there will be no style drift from the fund managers – even when growth stocks are outperforming value stocks.

The Benjamin Graham Formula for Successful Value Investing

The Sparinvest Formula for Successful Value Investing

The Sparinvest Approach to Value Investment

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Modern Systems, A Strong Process and a Talented Team

Over the past 10 years, we have brought the value strategy up-to-date, applied it to global stock markets, and built proprietary systems to streamline the process of finding deep value from a universe of over 22,000 equities.

Successful value investing requires a strong process to identify the most promising stocks from a universe of the undervalued stocks and disciplined security analysis to identify each company's intrinsic value. Within Sparinvest, this is achieved by a talented team comprising experienced fund managers, equity analysts and researchers each of whom brings different skills and background knowledge to the process.

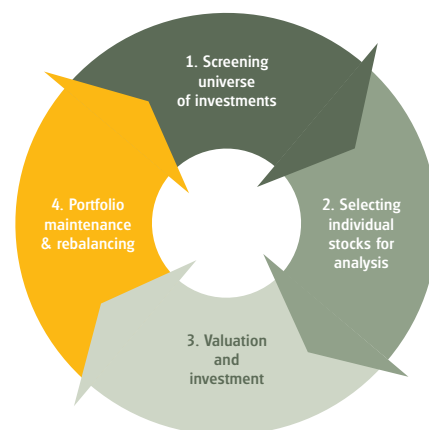
Capital Preservation and a 40% Minimum Discount

Sparinvest's key objective on behalf of investors is to preserve capital by always focusing on the potential downside risks involved when investing. In order to minimize the risks of value investment, we impose certain capital preservation strategies. One is that we invest only in the more mature stock markets of the world where accountancy standards and corporate governance requirements are more reliable. Another is to invest with the widest possible margin of safety. Our experienced value team looks to achieve a minimum discount of 40%, with larger discounts preferred and sought wherever possible. Finally, we ensure that all investment opportunities have been thoroughly researched, analysed and risk-assessed prior to investment.

An Excellent Track Record

Our track record confirms the robustness of our value investment process and its potential for delivering attractive benefits to longer-term investors. We are also highly regarded by Europe's top ratings agencies. ■

Sparinvest's Value Investment Process



A Closer Look at the Process

Rigorous analysis is essential for the discovery of value stocks. The true financial state of a company can only be revealed by a thorough examination of its balance sheet by the skilled analyst by looking at its business fundamentals. At Sparinvest, our investment process comprises four stages of rigorous analysis:

1) Screening

The first part of the process is quantitative. It involves the screening of some 22,000 potential stocks to see which of them meet our value criteria. We confine our search for value to developed markets where political risk is low. We look for factors which

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indicate that the company's share price is at a discount to its intrinsic value. Our value 'signals' include low ratios of: price-to-book (P/B); enterprise multiples (EM); (EV/EBITDA); enterprise-value-to-earnings before interest, taxes, depreciation and amortization expense; price-to-earnings (P/E); price-to-cash-flow (P/CF), and net-debt-to-equity (NDE). We also look for strong balance sheets with low leverage or hidden values.

2) Analysis

Our screening process will give us about 100 companies worthy of further investigation. At this point, our experienced team of analysts and fund managers will generate detailed fact sheets about each of these companies. On the basis of this information, the investment team draws up a short-list for further research using both information that is in the public domain (annual reports, web-sites & investor relations publications) and financial information requiring interpretation. We conduct security analysis of operations, income statement and balance sheets. Internal research is checked against other research papers from analysts (if available).

3) Valuation (Establishing Intrinsic Value)

During this stage of the process, we are looking to establish the 'intrinsic value' of the company (which is also our target sell price). We do this by defining the valuation case (i.e. what price would the company fetch if broken-up or sold as a going concern?); assessing the value of its assets and calculating its long term 'earnings-power'. Our database of over 400,000 industry takeover transactions and the actual prices paid assists us in determining comparable transaction values. Once we have arrived at a calculation of intrinsic value, we check whether the company's share price is available at an attractive discount (we look for a minimum of 40%). If it is, we invest. If not, we classify it as a target stock and continue to monitor it on a daily basis.

4) Portfolio Monitoring

Our portfolios tend to consist of about 100 companies to ensure risk diversification. We continue to monitor both our target stocks and our portfolio stocks on a daily basis, looking for buy and sell triggers. Our portfolio managers are unconstrained by any requirement to track a given benchmark. For internal risk management and risk control, we apply 'return based style analysis' to manage the return and investment style of the fund, ensuring that there is no style drift away from the pure value strategy. We set great store by our 'good housekeeping'. All data relating to the entire investment process is filed electronically and remains the property of Sparinvest investors. If the fund manager goes, the information stays. ■

Value Equities Strategy

Summary

Sparinvest's value investment objectives are:

- To preserve the capital of our investors by evaluating downside risk before we consider upside potential
- To provide investors with superior long-term positive returns from value investments
- To remain disciplined towards our value investment philosophy at all times
- To buy the business and not the stock.

Our prudent attitude towards risk and our commitment to a deep analysis of business fundamentals means that we have been able to provide our investors with a degree of immunity to speculative frenzies – such as the dot-com bubble of the late 1990's.

The merit of our investment process is demonstrated by:

- Our track record
- Our ratings from top European ratings agencies
- Our success in selecting companies for our portfolios that subsequently become the subject of takeover bids from other companies or financiers that have identified their intrinsic value in the same way. Approximately one third of the companies we have exited have become acquisition targets. ■

The mentioned sub-fund is part of Sparinvest SICAV, a Luxembourg-based, open-ended investment company. For further information we refer to the full and/or simplified prospectus and the current annual / semi-annual report of Sparinvest SICAV which can be obtained free of charge at the offices of Sparinvest or of appointed distributors together with the initial statutes of the funds and any subsequent changes to such statutes. Investments are only made on the basis of these documents. Past performance is no guarantee for future returns. Investors may not get back the full amount invested. Investments may be subject to foreign exchange risks. The investor bears a higher risk for investments into emerging markets. The indicated performance is calculated Net Asset Value to Net Asset Value in the fund's base currency, without consideration of subscription fees. For investors in Switzerland the funds' representative and paying agent is RBC Dexia Services Bank S.A., Zurich Branch, Badenerstrasse 567, P.O. Box 101, CH-8066 Zurich. Published by Sparinvest, 28, Boulevard Royal, L-2449 Luxembourg.