

15th November 2017

Dear Investor,

The underlying reason for writing a letter to our investors is to discuss our performance and detail our investment outlook. In an ideal world, this letter would be written every five years, in keeping with our minimum investment horizon. However, we believe our Investors should have all the necessary transparency to judge our work and evaluate our evolving viewpoints. It is in this spirit that we formulate this quarterly correspondence, which we hope you will find useful to better understand our firm and our investment process.

Our funds' performance is reflected in the tables below, though the individual return of each Investor depends on the net asset value at which they subscribed:

	Jan-Sept		Jan-Sept
azValor Internacional FI	3,3%	azValor Iberia FI	15,4%
MSCI Daily Net TR Europe Euro **	9,6%	IGBM	11,1%
Return Vs. Index	-6,3%	Return Vs. Index	4,3%
**Includes dividends		85% IGBMT / 15% PSI 20 TR	15,4%
		Return Vs. Index	0,1%

azValor turns TWO years old, and we bring good news!

Since azValor was founded two years ago, our Iberian portfolio has returned +30% and the International portfolio has returned +20%. Both portfolios are up close to +50% since their lows back in January 2016 (congratulations and many thanks for the fidelity and courage of those who trusted us at that time!). Both portfolios are also trading at historic highs, which also means no Investor has currently suffered a negative return. However, this is the "past", and what really matters to all Investors, and to azValor, is prospective returns. Happily, we feel that the return potential in our funds has not diminished: we estimate that our Iberian portfolio harbors upside potential of 55% and that of our International portfolio is 85%.

Not everything is good news... Or is it?

azValor is underperforming our benchmark indexes in the year to date 2017. Though our investments have not yet delivered this year, we see opportunity in the volatility some of our positions have experienced. We have shared this perspective in our two previous quarterly letters published in [March](#) and [June](#). Though our portfolios' construction departs from the Indexes, in light of their mediocre relative performance so far in 2017, we believe it is important to review our investment process in some detail.

We have always said that, in order to buy “cheap” in the market, in general, it is necessary to look for companies with real or perceived problems, particularly with regards to their future sustainable earnings power. To that end, we believe that we often have to go “against the crowd” to deliver performance that bests the crowd.

This is not easy, from a psychological point of view, but there are “tools” that help - chiefly developing a profound knowledge of our portfolio companies through research. At azValor, we spend long hours analysing historical financial statements and making adjustments to public figures in order to derive a “true” representation of a company’s underlying profitability. We do the same exercise with the company’s competitors to try to understand why some companies in the sector benchmark better than others across a suite of key performance indicators. This is where the value added part of the analysis really takes root. The main objective remains to discern if a company’s future economic return is more or less sustainable, predictable, and understand why.

With that in mind, we often go on the road to meet companies, competitors, suppliers and clients. We speak to industry experts about the main long term business drivers and controversies to generate and cement conviction. Our forensic process progresses to one end: trying to estimate an approximate level of sustainable earnings of the company in the future.

Unfortunately, no matter how solid our investment process might be, it will never eliminate mistakes completely. We look for companies with enough undervaluation (margin of safety) to allow us to still make a profit even if we were wrong in a facet of our analysis. Obviously, we would lose money if we were completely wrong and, even if this type of mistake has been infrequent during our 20 year track record. Our investment style ensures that there will be temporary stretches with significant stock price falls among some of our investments. In those cases, we will review our investment thesis honestly and thoroughly to ensure that changing circumstances have not left it impaired. Sometimes, we harness volatility by buying more as the stock price falls. Sometimes we do nothing, and other times we sell (if it was a research mistake). Most of the time, though painful, remaining patient is the correct approach, but there are exceptions. If the investment thesis was simply incorrect, the right course of action is to humbly recognise the mistake and sell before it hurts you further. In this sense, we find wisdom in von Mises’ words:

“Man is not infallible. He searches for truth, that is, for the most adequate comprehension of reality as far as the structure of his mind and reason makes it accessible to him. Man can never become omniscient. He can never be absolutely certain that his inquiries were not misled and that what he considers as certain truth is not error. All that man can do is submit all his theories again and again to the most critical reexamination. This means for the economist to trace back all theorems to their unquestionable and certain ultimate basis, the category of human action, and to test by most careful scrutiny all assumptions and inferences leading from this basis to the theorem under examination. It cannot be contended that this procedure is a guarantee against error. But it is undoubtedly the most effective method of avoiding error”.

Ludwig von Mises, *Human Action*

We are convinced that the immense majority of those investing in the stock market today do not follow this process. This does not guarantee our success, but does illustrate how difficult it is to challenge consensus today. There are more than one million indexes worldwide even though the total number of public companies is only approximately 43 thousand, or 3 thousand if we only consider those with a certain minimum liquidity (Bernstein data). Companies which are part of indexes can suffer from all kind of problems or be badly run, yet thousands of investors/institutions will buy them because they have no choice as indexation agents. While every incremental dollar invested in an index is “blindly” used to buy the same set of constituent companies, thus bidding up their value, azValor only invests in stocks of undervalued companies. These are generally not part of the main indexes, and only carefully chosen after a rigorous research process. More than ever, we believe that this is exactly what we should do to outperform, with a mid to long term perspective. In fact, as we write this letter, both Fernando and I have increased our investment in the funds.

Iberian Portfolio

In our previous letter, we quoted Buffett when he said that “holding cash is uncomfortable but not as uncomfortable as doing something stupid”. At the end of the 2Q we had 22% cash in our Iberian portfolio. As we always said, situations like this are temporary as the market usually does not take too long to create investment opportunities. This is exactly what happened during the 3Q as we reduced cash to 15% by the end of September.

Today, one month after the end of 3Q, cash is even less at 5%, as we have been able to make investments at good prices during the turmoil in the Spanish market due to the Catalan issue. Thanks to these additional investments as well as due to our usual rebalancing of the portfolio towards those companies whose stock prices are most depressed, we have been able to create value, as expressed by a higher estimated upside potential of the fund of 55% currently, up from the 40% estimated at the end of June 2017. **We believe that the Iberian fund is now worth 200€ per share.** We do not know when the fund will reach that value, though if it only takes 3 years, it would mean a compound annual return of 15% from today's market price of 130€ per share. If it takes 5 years, the compound annual return would still be a respectable 9%. In the interim, we focus on what we can control, which is the quality of the companies in the portfolio, the alignment of its management teams with shareholders, and in its degree of undervaluation. With that in mind, the Iberian fund is now at its most attractive since launch (a reflection of the underperformance of the Spanish stock market vs other European markets) in terms of the gap between price and value.

Most of the cash we had in the fund has been used to invest in “new” names like Almirall, FCC and Jeronimo Martins as well as to increase the weight of other companies like Técnicas Reunidas. The portfolio is now highly concentrated, with the top 10 investments accounting for 57% weight.

When asked about the issues around the Independence of Catalonia, our answer is that we can hardly add any value as to knowing how it might all end. As economists, we are incompetent to value the ends and means of the different sides, and can only try to estimate the economic impact of the different scenarios. If the conflict is not solved, it is logical to expect falling investment rates, productivity and, thus, economic growth. We would all suffer though we attribute only a small probability to this scenario, as we doubt that a majority would choose to accept deliberate economic impairment. Again, von Mises cogently guides us:

"The nationalists stress the point that there is an irreconcilable conflict between the interests of various nations, but that, on the other hand the rightly understood interests of all citizens within the nation are harmonious. A nation can prosper only at the expense of other nations; the individual citizen can fare well only if his nation flourishes. The liberals have a different opinion. They believe that the interests of various nations harmonize no less than those of the various groups, classes, and strata of individuals within a nation. They believe that peaceful international cooperation is a more appropriate means than conflict for attainment of the end which they and the nationalists are both aiming at: their own nation's welfare. They do not, as the nationalists charge, advocate peace and free trade in order to betray their own nation's interests to those of foreigners. On the contrary, they consider peace and free trade the best means to make their own nation wealthy. What separates the free traders from the nationalists is not ends, but the means recommended for attainment of the ends common to both."

Ludwig von Mises, *Human Action*

International Portfolio

The 3Q has given us the opportunity to sell a bunch of companies after making good returns (Samsung, DEA, FFP, Thyssen, Savills, Amsterdam Commodities, Dassault Aviation, Fairfax India, Ryanair, Vivendi and Via Varejo). Those sales have permitted us to increase the weight of some of our other investments like Cameco, Grupo México, Norilsk Nickel, Consol Energy and Eurocash, as well as to buy an "old friend", Range Resources.

Again, the best news to report in this letter is the increase in the upside potential of the fund, today 87%, equivalent to 225€ per share.

The portfolio is highly concentrated as the 10 biggest investments weigh 57%, and the 20 biggest comprise 80% of the NAV. We remain highly exposed to commodities, with a total weight in this sector of 63%, split into copper, nickel, uranium, gold, oil and gas; the remaining 32% is invested in a heterogeneous group of companies whose common denominator is, in our view, an evident undervaluation relative to their earnings power, as reflected by the prices at which we are buying their stock in the market.

We believe that the majority of the companies traded in our "home turf" of Europe are overvalued. Investors, trying to escape the scant yield that one can find today in the bond market, have become "forced buyers" of European equities, and have been

ready to pay high multiples on earnings which are, also, at high levels. This unenviable combination could produce sharp and sudden losses. By way of example:

Company A earns 100 million € in 2017. It made 40 million € at the trough of the previous cycle and 80 million € at the peak. It expects to earn 110 million € in 2018. The company trades at 17 times expected 2018 earnings, which means $17 \times 110 = 1.870$ million €. Let us imagine just a slight fall in earnings of 20%. And then think what happens if the market would be ready to "pay" no more than 14 times earnings. The new arithmetic would mean a valuation of $14 \times 88 = 1.232$ million € or a stock price fall of 35%.

Many believe that earnings falls and valuation multiples contraction is a "combo" which only happens during recessions. We disagree. During recessions companies' earnings can easily fall 40% and valuation multiples retreat to around 10x. Under such scenario, Company A's value would be $10 \times 66 = 660$ or a fall of 65%!

In light of this, some argue that the only protection is to buy solid and resilient companies with the ability to better weather the vagaries of the cycle. However, we are today witnessing an acceleration of the fall of barriers to entry (the famous "disruption") which have historically protected these businesses. This is why we believe that being confident that the present is the best guide to project the future is especially dangerous these days.

Although we do not pretend to be exempt from such risks, the companies which are part of our International portfolio have a lower probability of being a victim of disruption (a copper mine, for example, is very difficult, and ever more expensive, to replicate) and, more importantly, trade at half the multiple of the market. With a portfolio at 8x earnings, if these risks are not totally eliminated, they are dramatically reduced.

Blue Chips Portfolio

Our Blue Chips fund has not changed much since the last quarter. We have completely sold our investments in Dassault Aviation, Alphabet, Franco Nevada and Samsung after good returns, and bought Tenaris and Barrick Gold. We have reduced the weight of our investment in Vivendi, after a strong performance, and have increased the weight of Buenaventura, Cameco, Consol Energy, Grupo México and Range Resources.

This portfolio is also highly concentrated, with the top 10 positions amounting to a 60% weight. In terms of overlap with the International portfolio, investments in companies with market capitalisation above 3 billion € are very similar. What is missing in this fund is those attractive investments in smaller companies like Danieli, Sol, ITE Group, Sprott, Ophir, Eurocash, Odet or Serco, among others. If the performance of these small companies, which are less well known by the "Street", is as good as we expect, the Blue Chips portfolio should provide returns below those of the International Portfolio.

But this relative performance need not always and immediately be like this and, on occasion, the Blue Chips fund may very well outperform the International portfolio.

At this time, Fernando and I have an exposure to the Blue Chips fund of around 10-20% of the total investments we have in the 3 different portfolios. We currently recommend to distribute investments between the 3 portfolios with the following proportions: 20% in the Iberian portfolio, 60% in the International and 20% in the Blue Chips.

azValor News

At the second anniversary since the start of our "second voyage" as investment professionals, we would like to express our profound gratitude to the more than 16 thousand clients who have trusted us enough to bring aggregate AUM to 1,700 million €. We will keep working as hard as we can to create value and generate good returns. We are aligned with investors, as we have the immense majority of our financial assets in the same funds.

We have a team of 37 professionals, each of whom does his best trying to be excellent in his job, with the well founded wish that such excellence will result in admission into the Partnership after a relatively short time. In the next quarterly letter we will make public the new Partners who will join the current 9 who conform the partnership of azValor today. We want to give special credit to our team of Analysts, whose effort and rigour deserve a cum laude recognition.

With the aim of making our investment philosophy more accessible to our Investors, we have created the online video channel [azValor you](#). With it, we will try to explain with simplicity some essential issues about investing and other related aspects of interest to all our clients.

Our philanthropic initiative daValor celebrated its first event with clients and was an undisputable success on all facets: attendance, excitement, and commitment to grow this fund aimed to help those most in need. We hope to make it easy for those interested in this type of projects to become involved and be able to engage on our website.

Finally, thank you again for your trust. The returns we have been able to achieve are absolutely not only the result of our work and dedication, but also of your patience and commitment. Without it, we could not do much. We hope to be able to reward our Investors in the future by delivering strong returns. For any issue or question you may have, please contact our Investor Relations team led by Beltrán Parages.

Alvaro Guzmán de Lázaro

CEO and CIO