May 7th, 2019

Fernando Bernad
Founding Partner and Co-Chief Investment Officer at Azvalor

Dear investor,

The underlying reason for writing a letter to our investors is to illustrate the way in which we work to deliver returns. In an ideal world, this letter would be written every five years, as this is our minimum investment horizon. However, we believe our investors should have all the necessary information to judge our work. It is in this spirit that we address these quarterly missives.

Our funds' performance during the first quarter of 2019 is reflected in the tables below.

The individual return of each investor depends on the net asset value at which they subscribed:

Jan-Mar 2019	
Azvalor Internacional FI	14.8%
MSCI Daily Net TR Europe Euro**	12.8%
Return vs. Index	2.0%

**Includes dividends

Jan-Mar 2019	
Azvalor Iberia FI	5.5%
85% IGTBM** / 15% PSI 20 TR	9.0%
Return vs. Index	-3.5%

**Includes dividends

From a longer-term perspective, the table below shows the total returns obtained by our funds since their launch at the end of 2015, compared with their benchmarks.

ITD*	
Azvalor Internacional FI	22.6%
MSCI Daily Net TR Europe Euro**	12.8%
Return vs. Index	9.8%

**Includes dividends *13/11/2015

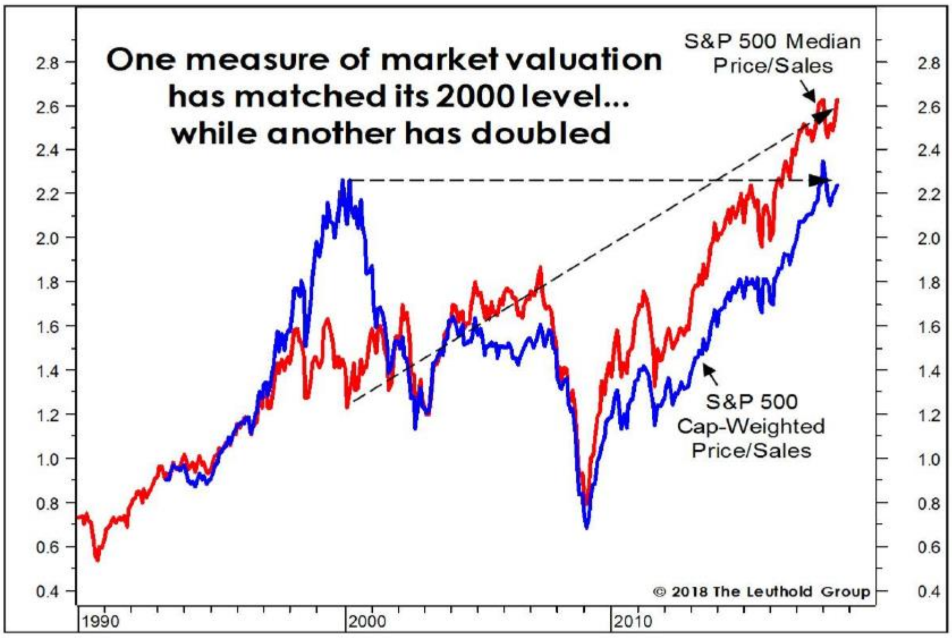
ITD*	
Azvalor Iberia FI	19.4%
85% IGTBM** / 15% PSI 20 TR	6.6%
Return vs. Index	12.8%

**Includes dividends *13/11/2015

As these figures illustrate, after approximately three and a half years, our funds have delivered positive returns and outperformed their benchmarks in both cases.

We undertake investment decisions with the aim of preserving our capital and that of our co-investors, guard it from the effects of inflation and compound it over the long term. With this objectives in mind we have managed to beat the market year after year. Although we do not want to forecast what will happen in the future, at the present time we continue to see a huge discrepancy between the attractiveness of our portfolios and that of the broad market.

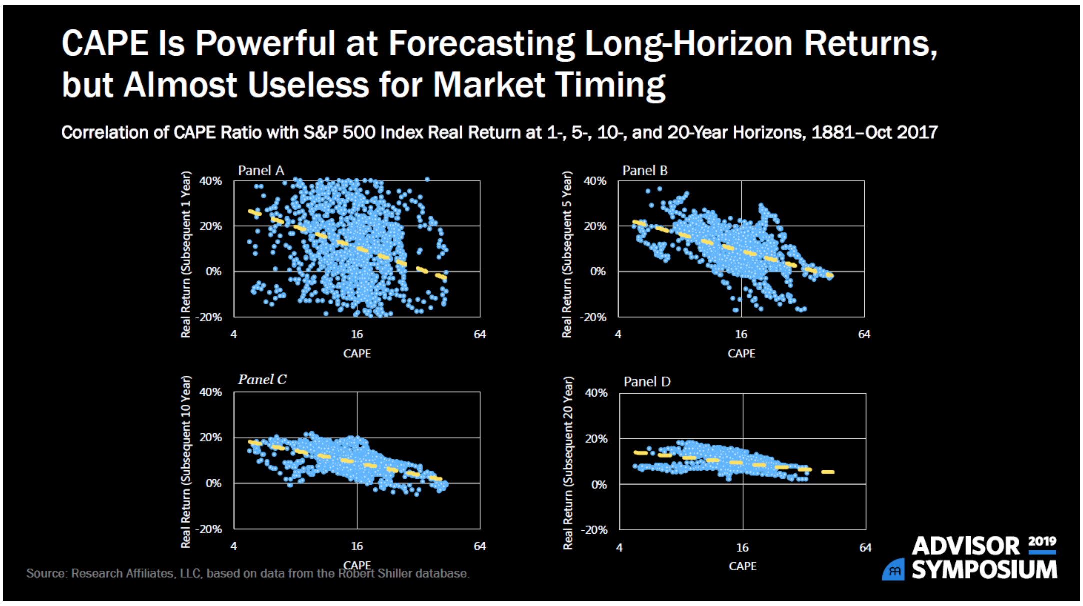
We have been saying for some time now that **Western stock markets** (and in particular US equities), **are expensive**. We can clearly see this from our bottom-up (company by company) analysis. But one can reach the same conclusion from the top-down, when looking at some aggregate ratios. For example, if we look at the famous "Buffett Indicator" (total US stock market capitalization divided by GDP) we see that it is at an all-time high. Or if we look at the following chart, which shows the S&P 500's price-to-sales ratio, we find that it has matched or exceeded its 2000 level, which was reached during the "dotcom" bubble (it has long exceeded this ratio at the median reading, since tech companies were particularly expensive and distorted the data in 2000).



If we look at the P/E ratio, we see that the US stock market is trading at about 29x vs. a historical average of about 16x. This reading uses the Shiller CAPE or the Cyclically Adjusted PE ratio which takes the average earnings from the previous 10 years and adjusts them to correct for the impact of an economic cycle on the profits of a particular year.

The valuation of European stocks is slightly less extreme but not very different, especially if we neutralize for the impact of the steep losses accumulated since the previous peak by the banking sector (for reasons which would require a separate analysis). This is particularly true, for example, for the Italian or Spanish stock markets given the financial sector's significant weight in those indices.

Of course, this does not mean that stock markets will crash tomorrow! Indeed, the starting point of valuations does not explain stock performance in the short term, but rather in the long term. The following chart illustrates the correlation from 1881 to 2017 between the return from US stocks and the starting level of valuations (Shiller CAPE) for periods of 1 year (Panel A), 5 years (Panel B), 10 years (Panel C) and 20 years (Panel D).



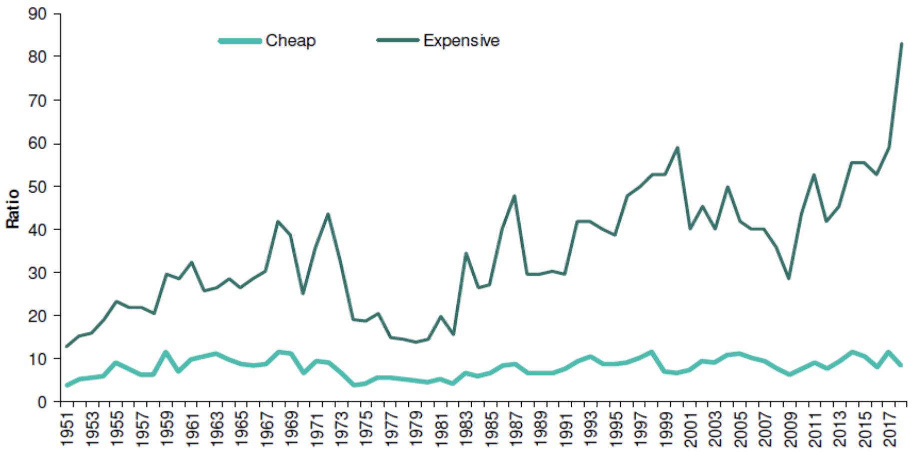
As the graph shows, the 10-year correlation is already very strong and even stronger for 20-year horizons. In panel C, for example, we observe that with a starting point currently at 29x Shiller CAPE, the historical expectation of real return (deflated by CPI) in the following 10 years would be around 0% annually (i.e. in nominal terms it would only rise as much as inflation does). Do NOT take our words literally. We deeply distrust the accuracy of these forecasts using these historical regressions, but we do believe it provides a baseline to express a central tenet of investing: expensive valuations = poor returns in the long term.

If stock-market valuations are NOT attractive in general, **the situation in the bond market is even worse**, as we warned in our [previous quarterly letter]. In our opinion, we are witnessing the biggest valuation bubble in history, which has gone so far as to result in negative nominal returns in a significant part of sovereign debt of developed countries! This is *contra natura* (from the point of view of human action) and the last straw for savers who decide to lend to hyper-indebted countries.

In this scenario, we understand it may be tempting to hold cash, despite the fact that, not only does it not yield anything, but it also loses purchasing power because of inflation. Indeed, cash possesses option value; the chance of investing at more attractive valuations in the event of market declines. But I would warn you that "market timing" has proven to be a very difficult thing to do successfully. How do you think you will react if the stock markets, instead of falling, continue to rise? Will you remain calm and patient or will you throw in the towel and end up investing at higher valuations? How much should the market fall for a real buying opportunity to emerge? Let me remind you that the overwhelming evidence shows that most investors fail in trying to "time" the market right.

However difficult the environment in which we operate, we must remember that stock markets encompass thousands of different companies, each subject to their own "reality" and which is, to some extent, unique. This explains why we can always find cheap companies and investment opportunities.

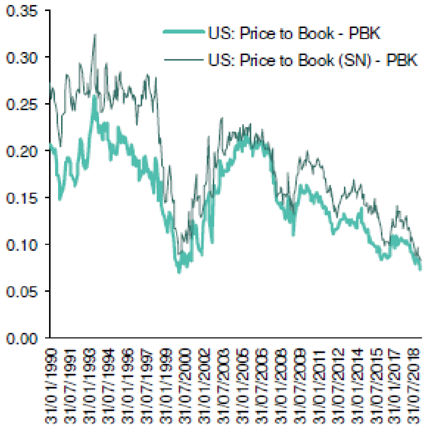
In fact, the analysis of some stock market strategists confirms that, **even though stocks are expensive on average, the distribution of company valuations is, nonetheless, highly polarized**. Indeed, the DISCREPANCY between the most expensive and the cheapest companies is GREATER than EVER. The following graph of the US stock market, for example, reflects the P/E ratio of the 20% most expensive stocks and the 20% cheapest stocks since 1951.



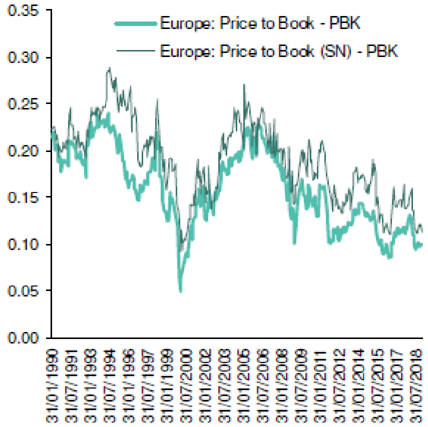
Source: Ken French Data Library, Bernstein analysis

From a similar perspective, the two charts below outline the division of the price-to-book ratio of 20% of the companies ranked with the lowest ratio and 20% of the companies with the highest ratio, for the US and Europe since 1990. It also shows that the year 2000 and today are the two moments when the discrepancy in valuation of both extremes has been greater.

US Price to Book valuation



Europe Price to Book valuation



Fuente: Bernstein Research

Although there is always some discrepancy in valuation (some companies are more expensive than others) these charts also illustrate how the magnitude of this discrepancy is very cyclical, with large fluctuations between highs and lows over the years. In the previous example, the ratio has fluctuated between a multiple of 3x and 20x since 1990! (which would be the inverse of what we see in the chart). At this moment in time we believe that, in relative terms, expensive companies are very expensive, or, to put it the other way around, cheap companies are very cheap.

But, watch out! This should not mislead you into thinking it is as easy as extracting the data from analysis like the above and choosing companies with low multiples and avoiding the rest. IT IS NOT THAT SIMPLE. There are many companies that trade at low multiples and can turn into terrible investments because of structural problems; for example, because their business is in steep decline, they suffer from disruption due to new technologies, regulatory causes or changes in consumer behavior. They may fall victim to competition or harbor balance sheet problems which can result in a permanent impairment of value. Our simple analysis highlights that market valuations are more polarized than ever (at least since 2000, at the time of the dotcom bubble).

We have also mentioned on other occasions **the factors that might explain this**:

- The growing trend towards passive management and the rampant proliferation of other passive vehicles such as ETFs.
- Financial repression (absence of yields on bonds) has led to the "forced" purchase of companies perceived as "quality" companies with apparently stable profits, as substitutes for bonds.
- Purchases by some central banks that, with "bulging pockets", do not abide by the rules of other market agents (for example, the Swiss National Bank has become a big buyer of shares).
- Disruption, almost omnipresent today and especially driven by the online phenomenon that is affecting a large number of industries and that causes many companies to trade at low multiples for the "right reasons".

In this context, of wide dispersion between apparent future "winners" and "losers", we believe the "prize" for those who get the winners right will be more important than usual.

We happen to think that our portfolios are particularly cheap and a much more attractive investment alternative than investing in the indices. This, in a way, is no more than the reflection of the disparity in behavior between the companies that make up our portfolio (the clearest example is our international portfolio where we have bought stocks after cumulative price falls of 50% since their previous highs in 2011) and the indices (the S&P 500 has multiplied by 1.6x since then).This point is reflected in the graph below.

Indeed, our portfolios are, in our opinion, an extraordinary investment opportunity. We are buying good assets at prices that are, in many cases, knockdown prices (we gave several examples of this in our previous letter which we recommend you read again). Moreover, our companies have solid balance sheets and are led by owners and/or strong management teams with the right incentive schemes, who "risk their necks" with us. **According to our valuation on a company-by-company basis, the international and the Iberian portfolios have an upside potential of 119% and 80% respectively.**

The following table shows in a simple and summarized way the very large "discount" at which we are investing compared with the indices.

	Estimated P/E ratio
S&P 500	17.5
Stoxx 600	14.3
Azvalor Internacional	6.4
IGBM	14.2
Azvalor Iberia	7.3

Source: Factset, Azvalor

The current opportunity is historically relevant because a part of the market is very expensive and the other part is very cheap. **But watch out! Although we cannot predict when, in the stock market investment opportunities tend to run out abruptly – even in just a few months.** For example, this happened in 2009, in our previous roles, when the International Portfolio increased by 100% in just 9 months – or in 2016, at Azvalor, when it was up by 45% in just 8 months.

Azvalor news

"Great Place to Work"

It is a pleasure to announce that we have received two awards which shine a spotlight on Azvalor as being one of Spain's best companies to work. For the second consecutive year, we have been awarded, by the international organization Great Place to Work, the Best Workplaces certification in the category of 50 to 500 employees. Moreover, we have come first in the Better For Business category, which recognizes the company's vision, mission and values, the alignment of employee interests, and business results. These are two awards that give recognition to our teamwork and our pursuit of excellence - something which we are not only very proud of but wish to share with you our co-investors, as you are the people whose trust in us makes this possible.

Team

After more than 4 years working as an analyst at Azvalor, Jorge Cruz has decided to return to the oil industry after receiving an offer from Saudi Aramco, the largest oil company in the world, to work as an engineer in its headquarters in Saudi Arabia. I want to thank him on behalf of the whole company for the impeccable attitude of dedication and professionalism with which he has always carried out his work and wish him the best of luck in his new venture.

At the same time, we welcome Philip Ngotho, CFA, a renowned analyst with an excellent track record who joins the Azvalor team from the firm ABN Amro based in Amsterdam, where he has been working for the past 7 years. Philip develops his work in our Madrid offices and covers the mining sector since May 6th.

Azvalor Managers

Launched at the end of last year, the fund is now fully invested with a sufficient critical size (about €15 million) and, in general, "at cruising speed" in all aspects. Therefore, we have decided to reduce the minimum investment amount to €5,000, in line with the rest of our funds. If you are interested, you may find all the necessary information and characteristics of the fund in our website.

I would like to conclude this letter by thanking you again for your trust, without which our work would be fruitless. We try to respond to it by striving daily to be faithful to our principles of excellence and humility.

Furthermore, we continue to build on the principle of "skin in the game", as in the last quarter, Azvalor's employees have stepped up their investment in the funds, thereby strengthening their collective position as the biggest investors in size.

I would also like to thank the 40 people who make up the Azvalor team for their endless effort and enthusiasm, and we reaffirm our commitment to continue investing resources to improve it with the incorporation of new talent.

Kind regards,

Fernando Bernad