azValor
asset management

1st August 2017

Dear investor,

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

The results obtained by our funds are reflected in the tables below. The individual return of each investor depends on the net asset value at which they subscribed:

	Jan-June	YTD*
azValor Internacional FI	-0.7%	2.2%
MSCI Daily Net TR Europe Euro **	6.7%	7.5%
Return vs. Index	-7.4%	-5.3%
MSCI World	9.4%	12.1%
Return vs. Index	-10.1%	-9.9%
Includes dividends		*27/07/2017

	Jan-June	YTD*
azValor Iberia FI	13.9%	14.7%
IGBM Total **	14.0%	16.5%
Return vs. Index	-0.1%	-1.8%
IGBM	11.5%	13.3%
Return vs. Index	2.4%	1.4%
85% IGTBM / 15% PSI 20 TR	13.3%	15.8%
Return vs. Index	0.6%	-1.1%
Includes dividends		*27/07/2017

The Iberian Portfolio

Our azValor Iberia fund has gone up by 14% so far this year. This is a 30% appreciation since its inception just under two years ago. In 2017, our results also compare favorably with those obtained by the benchmarks.

These results have been achieved without exposure to banks (which stock prices have increased significantly) and with a liquidity position close to 20% (liquidity does not yield anything nowadays). Thus, results have been achieved with very significant revaluations across a range of companies. The universe we can invest in for this fund (about 100 Spanish and Portuguese companies) is much more limited than in azValor Internacional (over 10,000!) and this is clearly a drawback. However, we are closer to them and know them better and, consequently, the error rate is smaller. We hope to continue making the most of our knowledge and contact with these firms in the future, with very clear purchasing and sales levels for each of them, in order to obtain as much return possible given market swings.

We continue with a high level of liquidity in azValor Iberia (around 20%). We don't like having so much "idle" money not generating revenue, and we are aware that liquidity as an asset class has lost 97% of its value in the past 100 years. However, we believe this is temporary, since the market provides us with opportunities almost every quarter. Nonetheless, we keep in mind the following warning:

> "Holding cash is uncomfortable, but not as uncomfortable as doing something stupid". Warren Buffett

azValor Iberia's medium term outlook is reasonably good. The portfolio is made up of undervalued companies that are generally very well managed, with strong balance sheets and favorable prospects for future returns. The upside potential in the medium term is 40%. This is why we continue to recommend that our clients of assign to azValor Iberia 20% of the total assets they invest with us. This is the proportion in which Fernando Bernad and I, as the fund managers, are invested.

The International Portfolio

After increasing by 20% last year, our fund azValor Internacional fund had a slightly negative return as at 30th June, close to -1%. So far this year, the benchmarks have offered returns of between 7% and 9%, depending on whether we take European or World indices. **We believe that this a temporary phenomenon, with a high probability of reverting in the medium term.**

1. azValor Internacional, worse than the indices in the first half of the year

In our last quarterly letter we warned you about the dangers of investing in indices at this time. Our experience tells us that, in general, most clients want to "rise more than the stock market when it rises", and don't want to fall or be outside the stock market during corrections. The target is to outperform the market, quarter after quarter, year after year, sometimes week after week. The press, with its eye-catching headlines, encourages this tendency in human beings to want to be on the "winning" side.

However, we believe such an attitude is harmful and finally ends in negative returns for those who practice it. Evidence suggests most clients do NOT achieve the average return of the fund they are invested in because they purchase it when it is performing well, and sell it when it is performing badly. In azValor, our co-investors have shown a different attitude from the start, notably adding to their positions at the beginning of 2016, when the fund was dropping by 20%, and then increasing their positions after the Brexit announcement. We not only thank you for your trust which enables us to create value but also encourage you to maintain it in the future.

History is full of times when the indices "outperform" fund managers in a "temporary victory" which sows the seeds of a "definitive defeat". For example, in 1989 the MSCI index had over 40% of its weight in Japan, and MSCI investors were "winning" … until the bubble burst and the Japanese stock market lost 75% of its value. The same thing happened with the energy sector in 1980, which reached a weight of 27% in the S&P500 index, and collapsed in the following 20 years until it got to a weight of only 6.6% in the year 2000. The telecommunications and information technology sector took a leading role at the turn of the century, and its most representative index, the NASDAQ, devastated every fund manager… until it collapsed more than 75% in the following two years.

So, as we have said on numerous occasions, making good investments on a recurring basis over the years sometimes entails being temporarily "out of the party" or in apparently more boring "parties". Our obsession is twofold: firstly, protect capital, and secondly, make it grow at above-market rates in time horizons measured in years, not quarters.

To protect capital, we avoid investing in expensive assets where "everyone is invested", as we believe this is where there is greater risk. To help it grow, we look for opportunities where the price already reflects some pessimism, provided that our analysis tells us that such pessimism is not justified in the light of objective data. This dual obsession of protecting capital and making it grow has led us historically to periods of great intellectual solitude. Sometimes that is due to too much liquidity, other times to being invested in unpopular assets. Our fiduciary duty is to endure these periods in order to protect our clients' assets, as well as our own.

Many people called us 'gurus' after the 50% increase of our fund azValor Internacional over just a few months last year. We never accepted this. A 'guru' is infallible, and we are not. We are experienced professionals, with 20 years doing JUST business analysis. We don't know what will happen tomorrow, but we do know what happened yesterday and what is happening today. And that is enough to make wise investments, provided that our co-pilots (clients) place in us the necessary trust to be able to take a long-term view. In our case, clients have proven to be true co-investors. The returns we achieve depend to a large extent on their attitude. We hope to continue achieving better returns than the market in the future, with a long-term vision. If we are called 'gurus' again we will point at our more than 15,000 copilots: this is where a large part of the formula is hidden… Thank you all!

2. The good news: More future upside potential

The best news this quarter has been the opportunity to purchase new companies which have reached our entrance price levels after falls in their stock market prices, as well as adding to those we already had, at very attractive prices.

This has caused the following:

• We have reduced our cash position to below 10%.

• The potential of the fund has increased significantly. We believe azValor Internacional is worth more than 210 EUR.

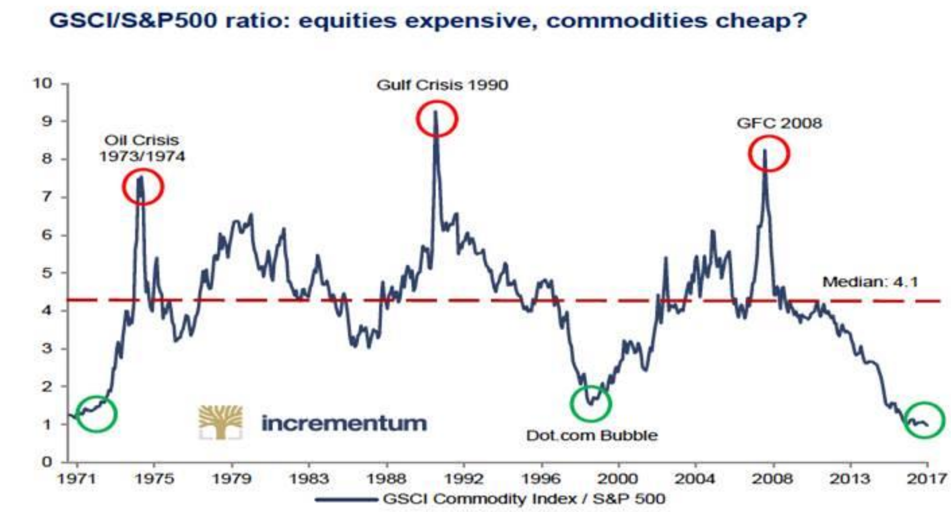
• In our opinion, this has not been achieved by increasing risk as, in general, our companies enjoy strong balance sheets with little debt.

• The portfolio has concentrated even further on the ideas where our conviction is greater, and today the top 11 holdings account for 52% of the portfolio.

The portfolio is made up of growing companies which trade at a good price and are run by managers whose system of incentives is to make money in the long term. Listed below are the reasons for our optimism from these levels.

a. *Most of our companies have already fallen considerably…*

To this day we have about 18% in commodities companies (copper, uranium and nickel), close to 14% in gold mining companies and about 20% in the energy sector. Thus, again more than half of the portfolio is invested in raw material companies (like at the beginning of 2016). These weighed 14% in the S&P500 index in 1980 and today they barely weigh 3%, the minimum level in the past 40 years. In our opinion, this indicates excessive pessimism on the part of investors towards a sector which actually presents excellent growth prospects, based on the increasing urbanization of emerging countries. The graph below shows the magnitude of the current underestimation of this sector from a historical perspective.



Source: Dr. Torsten Dennin, Incrementum AG

With regard to energy companies, the Financial Times reported that the first half of this year has been the worst for this sector since 1990, on the back of fears that production surpluses would knock down the price of oil. The SP500 Energy sub-index dropped by 14.7%, against an 8.7% increase of the general index S&P500.

We are therefore investing in severely punished sectors. Some people could argue that these price levels are due to poor future prospects anticipated by the market. However, we are very optimistic.

b. *Our businesses have good medium-term prospects*

There is a general consensus that there will be a shortage of copper in the world in a couple of years (unless there is a global recession), and that new supply will take time to respond with capacity increases, which will only take place if prices rise even further.

In the longer term, China has an accumulated stock of copper of only 30 million tons, as opposed to more than 100 million tons in the Western world. We believe that their future demand will grow for many years. Electric cars need four times more copper than normal cars. Therefore, it seems clear that the world will need a lot of copper. **The company which produces it cheapest and has more reserves is Southern Copper, whose owner (89%) is Grupo Mexico, a company in azValor Internacional, with a weight close to 6%.**

The mining company Compañía de Minas Buenaventura (9% weight in the fund) will also be able to take advantage of the favorable long term copper prospects through its 20% participation in Cerro Verde, the third biggest copper mine in the world, with costs in the second quartile. We believe that the value of this participation is equivalent to the stock market value, which leaves its other great asset for free: 600,000 ounces of gold per year produced at a cost of $1,200/ounce.

In the energy world, US oil and gas producers have experienced a revolution with "fracking", which has led the United States to become an exporter of crude oil when it was in fact an importer until very recently. Consequently, low crude oil prices may seem normal: they are supposedly due to excess supply. Our analysis, however, shows that the majority of companies that have participated in this revolution do NOT generate positive economic returns for their shareholders. This is because the rate of decline of oil wells is so high that they must continuously invest in new wells to maintain productivity levels. Therefore, when shareholders get tired of turning to recurring capital increases, or when interest rates go up (whatever happens first), we believe that a rationalization of supply will take place.

Consol Energy (6.7% weight in the fund), which already produces gas on a profitable basis in the lower-cost basin of the country (Marcellus/Utica), will take advantage of this situation. More generally, the low crude oil prices which have been with us for more than two years have made it necessary to withdraw a lot of production, and most experts agree that a price of at least $60/barrel will be necessary for supply to meet demand. We agree with this, and **Tullow Oil (5% of the fund)**, which produces in Ghana more than 100,000 barrels of crude oil daily at a cost below $35/barrel, will take advantage of the situation.

c. *What are the risks?*

• In the event of a major recession, these businesses could suffer and their share prices drop even further. But we believe they would fall substantially less than the benchmarks, and we would take advantage of the liquidity we have left to continue purchasing.

• In general, most of these raw material companies trade in USD. The historical experience is that when the US dollar falls, this is compensated by increasing share prices. But this process does not occur mathematically every day and therefore a deep and sustained weakness of the Dollar against the Euro could temporarily damage our net asset value. In fact, since its maximum high, the currency has 'cost' us a return of just over 4%. We could consider covering the currency, but we have never done it before, and we do not have an opinion as to the value of EUR/USD at 1.17. We believe that in the long run the currency impact will be absorbed in stock prices, as always, and we assume the effect on the net asset value in the short term.

d. *The Alphabet case*

In our previous quarterly letter we explained the investment thesis which supported the purchase of shares in Alphabet, the parent company of Google. We did so because we believed that the novel aspect of the investment (unfortunately, we had never had shares at lower prices before) and the high weighting it reached (6% of the fund) deserved an explanation. We have sold the entire position with a return of between 15% and 20% in a very short time. Why? There are several simple reasons:

1. As it is a company with so much cash, shares become expensive extremely rapidly when share prices rise. Thus, at levels of US$800/share we had a potential of 50% in a good, liquid company, managed by its owners and with little risk of falling (precisely because falls in the price of shares mark down valuation multiples extremely rapidly, also due to high cash in the company). That said, when in just a few months the share price almost reached US$1,000/share, the potential we were comfortable with had gone down to 20%. Alphabet is probably worth much more than the US$1,200/share we had set as target price, but in order to realize this potential we believe we had to form a stronger opinion about the future of certain areas OUTSIDE our circle of competence TODAY, such as Artificial Intelligence. This last 20% of potential is what we use as a reference to measure the relative attractiveness of Alphabet compared with other alternatives.

2. While Alphabet stock price increased by 20%, other companies saw their share prices drop in this same proportion or greater, significantly worsening the relative attractiveness of Alphabet relative to other options.

3. A good example of the above is that when we invested in Alphabet we had a liquidity of almost 18% (which would have been 24% if we hadn't invested). In this sense, at US$800/share, Alphabet was clearly a better alternative than a liquidity

which wasn't generating any return. Today, liquidity has dropped below 10%, which shows that we are finding more opportunities and, therefore, that the threshold to access the portfolio is higher.

This is why we decided to sell, replacing Alphabet with other companies which, in our view, were more undervalued. This is a sale which could seem a little erratic from the outside, but that responds to a dynamic of 'competition between candidates' which we have been applying for over 15 years for the sake of always having a portfolio that is as strong and undervalued as possible.

We conclude comment about our international portfolio by pointing out that both Fernando and I have used these past weeks to add to the positions we already had in both the International fund and in azValor Blue Chips.

azValor news

We continue to maintain about 1.7 billion EUR under management, approaching the maximum level reached since our inception in November 2015. Although we have registered some outflows in some months, these have been kept at very low levels of below 1% of assets. We take this opportunity to thank you for the trust you have placed in our management.

This partly explains why we will keep our commitment to our clients of closing funds if the company reaches €2.5 billion under management. In our opinion, an excessive level of assets under management is detrimental to future returns. It is more difficult, by definition, to invest 10 billion than 2.5 billion, and we have decided to set this limit to avoid succumbing to the temptation we have repeatedly seen in the sector: when a successful fund manager accumulates assets, these generate more and more fees for the fund manager, who eventually finds an argument to explain that he can continue growing without damaging returns. This necessarily forces him to have more opinions on more realities, thus diluting the focus of analysis. We prefer the path paved by an old friend of ours…

> "Our job is to find a few intelligent things to do, not to keep up with every damn thing in the world". **Charlie Munger**

In the first half of this year, we have received 9,000 purchase orders from investors, of which 3,500 correspond to new fund investors and around 1,100 to Pension Funds.

Regarding the analysis team, together with the partners Jorge Cruz, Fernando Bernad and myself, five new members are about to complete their first year in azValor. They have integrated perfectly into our ecosystem of company analysis, which includes preparing model spreadsheets, conference calls with sectorial experts, trips to visit companies, etc. We take this opportunity to thank them for the enormous commitment they have shown, as well as for the enthusiasm and passion they bring to work every day.

Last but not least, our solidarity initiative daValor has been launched and we have raised more than €100,000 since inception, which is waiting to be assigned to several humanitarian aid projects. At the end of September, we will have a presentation about daValor by José María Márquez, director of the non-profit organization Africa Directo, and our collaborator for over 10 years in this field. Don't miss it if you can join us. In the words of José María, someone who helps often ends up being helped…

As we end this letter, we would like to express our gratitude once again for your trust. The Investor Relations team, led by Beltrán Parages, will be pleased to answer any questions you may have.

Álvaro Guzmán de Lázaro
Chief Investment Officer and CEO