Azvalor.

July 29th, 2020

Dear co-investor:

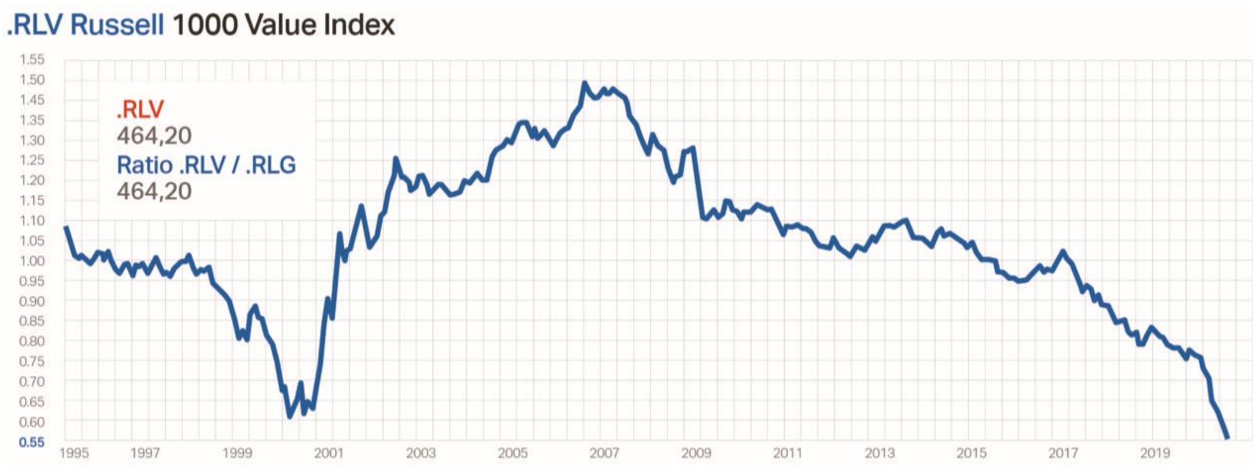
At the end of the second quarter, our funds have recovered much lost ground from the lows hit this year (+41% in Azvalor Internacional, +20% in Azvalor Iberia and +59% in Azvalor Blue Chips), although they are still far from their historic highs (-35% in Azvalor Internacional, -43% in Azvalor Iberia and -34% in Blue Chips from highs).

The legitimate question you are probably asking yourself is WHEN will we reach these highs again.

When will we reach these highs again?

First of all, we would like to contextualize the situation of low returns (atypical with respect to our track record), almost 5 years after the launch of the funds. Is this problem specific to Azvalor or is it a more widespread phenomenon?

The following chart shows the performance of "value" investing **(buying companies that are undervalued, which is what we try to do at Azvalor)** vs "growth" investing **(buying companies that GROW at above-average rates and selling them before this growth stops). Historically, value investing has proven to outperform growth investing. However, if we look at the chart below: This has not been the case for the past 13 years!**



Without pretending to make excuses, the prolonged underperformance of value stocks in recent years does not seem to be something specific to Azvalor funds, but rather something related to value investing in general. Never before had the discrepancy between the performance of value and of the indices lasted so long, and perhaps this is why we never had to "wait" so long to reap the fruits of our investments in the form of real positive returns **(we had always achieved good returns within 5 years)**.

This takes us to the next question. Is there some endemic problem with value investing that will prevent us all from achieving the historical returns that we were used to?

We can tell you the answer: We think there isn't.

And we would add that, in our opinion, we are on the verge of a reversal of this trend which will deliver extraordinary returns for many years. Why?

1. We are in a market of extremes and history has taught us that extremes don't last forever and always end up reverting to the mean. This is why we believe that value investing will "make a comeback", which may be "violent", like in 1929, the 1970s or the late 1990s. This will mean a very favorable tailwind for all value portfolios, which include Azvalor.

2. In the specific case of our portfolio, we believe that we will be able to beat the average return of value indices as we have done historically, anchored in the simple principles of our investment philosophy and our years of experience applying these tenets.

If these two hypotheses are correct, we can expect many years of very attractive relative returns, bouncing back not only to match the all-time highs achieved but also to exceed them and reach the target value of the funds, that is, an upside potential of more than 100%* from the current levels of the net asset value. It wouldn't be the first time!

Remember the sharp fall suffered between June 2007 and March 2009 (-60%), a period in which today's question was particularly relevant. Back then, as today, investors asked themselves, "How long should I wait?", while many thought of a level to "exit and sell". Looking back at March 2009 (the lowest point), the answer, with the benefit of hindsight, was that those who sold at rock-bottom prices lost 60% of their money, while those who withstood the headwinds with us recovered the 2007 highs as early as the end of 2011; and then continued to earn an additional 60% at the end of 2014 (exceeding the 2009 lows by 4 times).

* Upside potential obtained as a result of the difference between the estimated value of each of the underlying assets, based on our internal valuation models, and the prices at which each of them is currently traded on the stock markets.

We will try, therefore, to offer the arguments that support and allow us to trust the above hypotheses this time:

1. Extremes eventually revert to the mean

Today there are three extreme trends in markets. Firstly, the return on financial assets (bonds) vs real assets (commodities). Secondly, the aforementioned return on growth investing vs value investing, which has underperformed over the past 13 years. And finally, the bubble in passive investing vs active investing. The concurrence of these three extremes alerts us that we may be close to a paradigm shift.

- Real assets vs financial assets

Today, government bonds usually offer negative or close to zero nominal yields, and certainly very negative yields if you discount inflation. Fixed-income securities are generally considered safe-haven investments. Since the bond market is much larger than the stock market, it seems odd that such a large market would be "wrong" as an aggregate class. However, it wouldn't be the first time that bond prices contain a "big mistake" …

During the 1980s, bonds offered double-digit returns, and nobody wanted them. In fact, bonds came to be known as "certificates of confiscation" because the double-digit return they offered came to nothing in real terms when inflation was detracted. As you know, bonds fell to a record low and since then (almost 4 decades) bond yields have been extraordinary. The market of the early 1980s couldn't be more wrong about the "right" price of bonds as a class!

For a German or US 10-year bond to be a good investment today, a number of conditions would have to be met for which we see a very low (or zero) probability. This is clearly an excess that we believe will be reversed.

- Active management vs passive management

Similarly, this time in the context of equities, recent years have seen an unprecedented boom in passive investing. After all, the US index *par excellence* has generated 14% annually between January 2009 and today, while the NASDAQ has generated 19% annually (over 12 years, which is almost 9 times the investment). This has led more and more investors to choose this option ("what has worked") as opposed to the worse performance (and higher fees) of active management (which "has not worked"). Warren Buffett warned us on several occasions, using a sports analogy, that in investments you shouldn't go "where the ball has landed" but rather "where the ball is heading". Today the ball "is in the indices", but… will it stay there?

The problem resulting from passive investing is that more and more money is going into the most expensive assets, making them "even more expensive" and generating a feedback loop that does not show signs of ever reverting. **For instance, the top seven US companies are worth more than all the companies listed in the UK and Germany PUT TOGETHER!**

History shows that the key to generating returns is to buy stocks that are trading at low valuations, and since current valuations are very high (some say "the highest ever") it is logical to think that at these levels, the risk is also very high. We prefer not to invest at these high valuations in order to protect our money, and although we understand how difficult it is to detach from "what has worked", we believe it is our duty to warn you… and to remain faithful to our philosophy. There are some (still weak) signs that the "growth dike" has cracks and the time for testing these expensive assets may not be far off.

- Value vs growth: Starting level of valuations

At the beginning of the year 2000, there was, as there is today, a great discrepancy between value and growth. A well-known newspaper criticized Warren Buffett (the greatest exponent of conservative value investing) at the time for his company's underperformance vis-à-vis the US index, claiming that "King Midas had lost his magic touch". Of course, what happened next was that the US index lost 50% of its value in just over a few years while Buffett's investments continued to grow.

After underperforming the US index by almost 20% in 2020, the question of whether or not Buffett has lost his touch is, once again, making the rounds. **We believe, as we did back in 2000, that this is sign that things may be about to change.** We find other illustrative excesses of the chart at the beginning of this letter in the apparent overvaluation of some companies.

For example, Tesla, a company that has not generated recurring profits, has quadrupled its stock price since January this year and is now worth close to $300 billion, almost more than all the companies in the sector combined (which do generate profits).

There is an eternal temptation among many investors to justify high prices with narratives about paradigm shifts, something that has cost them dearly several times throughout history. It is clear that these overvaluations are based on something "real" (Tesla is a company that could revolutionize the automotive and battery industry). But everything comes at a price. Let's look at a few examples.

In the 1970s, many (fabulous!) companies lost 75% of their value, even though they continued being fabulous 50 years later. The same thing happened with the Japanese miracle, which seemed infallible after the extraordinary returns of the 1980s, and culminated with the Japanese NIKKEI index hitting a record high of almost 40.000 points in 1989. Today, 30 years down the line, the index is still at half of that pinnacle.

In the late 1990s, technology companies seemed impregnable after generating returns similar to those of their current cousins. Cisco was perhaps the best example of that bubble, when after multiplying by 50 in ten years, it peaked at over USD 70/share only to tumble and lose 90% of its value in the next year and a half. Cisco continues to be a great company today. But being "a good company" does not mean that investing in it is always a good business, because if you buy high, shareholder returns can become a horror movie even if the company continues to perform well.

What is happening now is not very different from what has happened before. There was always an argument (created ex post) for the overvaluation of "popular" asset classes, and it always ended in total disaster for the shareholders of these assets. Perhaps it is different this time. We believe it isn't, and we certainly don't want to risk our money and yours in this endeavor, even at the expense of the strength we know it takes to "hold on".

As always, the arguments of why it could be different this time, (expensive companies would continue to rise), abound.

Firstly, there is much talk about the role of the central bank and the famous "they won't let it fall". If central banks were the solution to the problem of generating wealth, Japan would be a star today and, without belittling the country, the shareholders of its most representative index are "shattered": after more than 30 years since the Japanese stock market hit its peak, there are still halfway there!

Another repeated argument is that today's tech monopolies (Amazon, Facebook, Google, Netflix) are different this time as they have barriers to entry, access to a "gold mine" of valuable consumer data, financial lungs in the form of great sums of cash and a certain affinity with the governments in power. All of this is true, but these characteristics were also found in the leading companies of the aforementioned periods, and none of them could "cope" with such a strong overvaluation beyond a few years. As a class, we are certain that it will come to a bad end, without prejudice to some companies eventually escaping (perhaps only partially) the major falls in their share price from current levels.

2. Why we consider our portfolio to be particularly attractive

First and foremost, it is our conviction that most well-executed value strategies will be rewarded for their patience in the form of above-market relative returns over the next ten years.

However, the current technological revolution is extremely significant and has brought about radical changes, with permanent damage to many businesses. There is a real risk that many of these businesses will never return to the level of profits they had 10 years ago. There is, in other words, a risk that many seemingly cheap businesses today are ultimately "value traps", and that their stock price will never fully recover.

For instance, we may go to stores less and buy more on Amazon (and some shares of physical trading companies may be "deservedly" cheap); we may switch from free-to-air TV advertising to Facebook or YouTube advertising (and TV shares may be "deservedly" cheap and unlikely to go up), and so on with many of the sectors that have seen their business models suffer from the aptly named "digital revolution".

Aware of this risk, we have been extremely prudent in our portfolio from the outset, trying to avoid these types of companies, and therefore, we do not consider the "risk of technological disruption" to be relevant in our common investments with you.

Finally, our portfolio has a very significant level of undervaluation, which is the true cornerstone of our philosophy. Some co-investors long for "the quality" of our past investments (Wolters, BMW, Schindler) and miss it terribly today. However, it is important to remember that the key to the returns achieved in these three companies was the low starting price at which we entered. We bought Wolters at less than PER 10, BMW was nearly free, and for Schindler, our average purchase price did not exceed 10 times the profits back then. Today our investments are "as cheap as they come", and with no risk of technological disruption.

Going back to the initial question, and by way of conclusion: We don't know when we will reach the previous highs again nor the target price of our portfolio, but there are elements to think that a trend is beginning in this direction.

However, it is more relevant for our financial health to get the "WHAT" right than the "WHEN". And everything seems to suggest that the investment alternatives in bonds, liquidity or the most popular stocks carry an unbearable risk for us today due to their high starting price; while our portfolio, with its level of undervaluation, and the earnings prospects of the companies that comprise it, not only has the potential to bounce back to all-time highs, but, in our opinion, also aspires to exceed them very comfortably in the coming years.

The price to pay for it, as always, is patience. We recognize that this time the price may be too high for some investors, but this is precisely why we believe that the magnitude and the duration in time of the recovery will also be equally high.

Iberian portfolio

We have taken advantage of the strong volatility of recent months to make a few changes in our Iberian portfolio. The main additions to the portfolio or increases in position have been **Logista, Semapa/Navigator, Prosegur Cash and Acerinox**.

These are companies that we have known and followed for many years and which we have had in the portfolio at different times. The financing of these investments has been done by reducing the weight of **Sonaecom, Galp and AENA**. The first two are still significant investments in the Iberian portfolio, and the second results from our new more conservative break-even price for crude oil at $50 per barrel. In the case of **AENA**, sales are due to its stocks' rebounding during the quarter from the March lows.

Logista is a quasi-monopoly in the wholesale distribution of tobacco in Spain, France and Italy. It is a solid business with strong barriers to entry, a renewed (and excellent) management team, and which we bought after it fell by almost 40%.

Semapa/Navigator is a group which became the biggest position of the Iberian portfolio in our previous stage, back in 2010-12. It is the most efficient producer of printing paper in Europe, controlled by the Queiroz Pereira family, and with hardly any debt. And we bought the shares after falling 40% in the year, and 65% from 2018 highs.

Prosegur Cash is the subsidiary of Prosegur group, controlled by the Gut Revoredo family, leader in cash management services in Spain, Brazil and Argentina, and with a presence in other Latin American countries and Europe. The business has significant competitive advantages, good return on invested capital, and we bought after a 50% drop since the beginning of the year.

Acerinox is a company we have had in the portfolio on many occasions over the last 18 years, and where we have always generated good returns. It is one of the world leaders in the production of stainless steel, a cyclical business, but with a solid long-term growth rate. Acerinox has a good corporate culture, a great management team and a strong balance sheet. We purchased after a 40% drop since the beginning of the year.

These changes have not increased the estimated value of the Iberian portfolio, but they have enhanced the quality of its businesses, a turn we have successfully taken in the past when the market has fallen sharply.

The estimated value of the Iberian portfolio amounts to **EUR 186 per share**, which matches to an upside potential of 130%* compared to its current level.

* Upside potential obtained as a result of the difference between the estimated value of each of the underlying assets, based on our internal valuation models, and the prices at which each of them is currently traded on the stock markets.

International portfolio

After the recover from lows –especially in gold, uranium and copper mining companies– we have seized the opportunity to improve the quality and the potential of the International portfolio. The latest additions to the portfolio –CNH Industrial, Teck Resources and First Quantum–, financed with sales in Barrick Gold, Cameco or Sol Spa after their good relative performance, are particularly noteworthy.

CNH Industrial is a company we know well, in which we already invested almost 10 years ago, and whose stock has plummeted by nearly 50% since the beginning of the Covid-19 pandemic outbreak. Its main business is the manufacture of agricultural machinery, a global oligopoly with significant entry barriers and where CNH ranks second after the world leader, John Deere.

Teck Resources is a leading producer of metallurgical coal, zinc and copper with mines and crude oil fields in the US, Canada, Peru and Chile. The company has a family culture, a solid balance sheet, and we purchased its shares after an accumulated decline of 75% from recent highs.

First Quantum is a copper company, in which we successfully invested in 2016. We have bought it back after accumulating falls of around 50% since the Covid-19 crisis broke out, and almost 70% from 2018 highs.

Following these changes, our estimated value for the International portfolio amounts to EUR 216 per share, which suggests an upside potential of 143%* compared to its current level. Please note that this estimate includes crude oil prices of $50 per barrel, and would be slightly higher if these prices are exceeded.

The "backbone" of the portfolio has remained relatively stable over the past two years. We believe this is a good indication that it is not easy to improve on what we already have: a large collection of assets, generally with strong balance sheets and the right culture. And more importantly, trading at very attractive prices, which is the true cornerstone of investing, in our opinion.

* Upside potential obtained as a result of the difference between the estimated value of each of the underlying assets, based on our internal valuation models, and the prices at which each of them is currently traded on the stock markets.

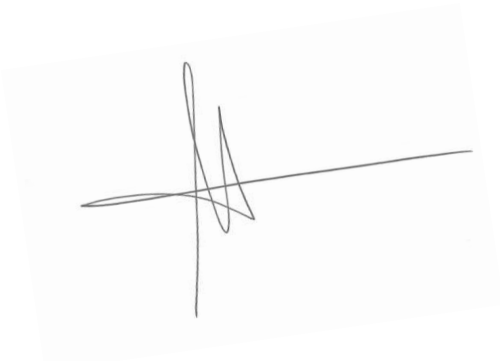
Azvalor news

Despite the Covid-19 pandemic, remote working has enabled almost all of the company's functions to be covered without incidents. The improvement of the health situation has allowed us to gradually return to normal over the last few weeks, and currently one third of Azvalor's employees are back at the office, working safely in compliance with the recommended preventive measures and having passed the mandatory serological tests. This test reinforces our conviction to continue investing in technology in order to move forward in the digitalization of the company, a key aspect both in our internal processes and in our relationship with investors. We will inform you in due time of our progress and new functionalities over the coming months.

In terms of inflows and outflows from our funds, during this second quarter of 2020 subscriptions have amounted to €20M while redemptions have reached €34M, meaning net outflows of €14M. This is a small figure (barely 1% of total assets) which shows the commitment of our co-investors in times of high volatility. In addition to "resilient" unitholders, we have the most liquid portfolio in our entire history (80% of investments could be settled in just a few days); this is a protection for our long-term investors: in the event of future redemptions, these could be dealt with without major problems.

We would like to conclude this letter thanking you again for your trust and reminding you that you may contact us at any time through the various communication channels or directly reaching our investor relations team.

Sincerely,



Azvalor Team