

Annual letter to investors 2011

January 3rd, 2012

“What has been will be again, what has been done will be done again; there is nothing new under the sun”
(Ecclesiastes 1.9)

Dear Investor,

We have rarely seen a year so full of upheavals, from geo-politics (the Arab spring) and finance (crisis in the euro zone, downgrading of the US government's credit rating) to nature (earthquake in Japan, floods in Thailand). Rarely also has the future seemed so uncertain, with presidential elections due to take place in a number of countries in 2012, including Russia, the United States and France, as well as the heightened risk of a new recession in Europe, spurred by a weakened single currency.

Against that backdrop, several major financial markets (notably Frankfurt and Paris) ended 2011 in the red. But there was a silver lining to this predicament, as the stocks of many great companies were, once again, made available at very attractive prices.

The performance of our funds was negative over the year and, generally, below that of benchmarks. However disappointing, 2011 is simply one episode in the history of our funds. These are managed for the long run, and their results should be assessed as such (see table on page 2).

Our methodology, implemented by our team of managers for more than 15 years, results in highly concentrated portfolios of great companies, with geographical and sector weightings very different from their benchmarks, together with a very low turnover rate for the main positions.

Under such circumstances, it is hardly surprising that our funds' performance might diverge from their benchmarks' over time periods as short as a year.

Furthermore, since Pastel & Associés' inception in late 1997, such short-term underperformance has befallen our funds on more than one occasion. This occurred in 1998, over the last six months of 2002, and in 2007-2008 (refer to our past annual letters, which may be accessed on our Web site).

Each time, our funds bounced back strongly, not only outperforming the stock markets but also providing significant appreciation of capital, even over long periods of market stagnation (1998-2011). Of course, it is true that, to reiterate the customary warning, “past performance is no guarantee of future results.”

However, our strong performance in the past did not come about by accident and cannot be attributed to a temporary fit between an investment style and specific economic and financial conditions. On the contrary, it is the result of a rational and replicable approach, implemented by our team with discipline and consistency. Just as our confidence in this methodology remains unshaken, we are also confident in our funds' potential to outperform markets and benchmarks over the long term.

| | 2011 performance | 5-year performance | 10-year performance | Cumulative performance since inception * |
|--|-------------------------|---------------------------|----------------------------|---|
| Valeur Intrinsèque (P class) | -17.4% | -14.7% | +33.3% | +53.1% |
| <i>MSCI World (EUR) dividends reinvested</i> | <i>-1.8%</i> | <i>-7.3%</i> | <i>+1.6%</i> | <i>-12.2%</i> |
| Margin of Safety Fund (USD) (P class) | -19.7% | -8.9% | +89.2% | +217.2% |
| <i>MSCI World (USD) dividends reinvested</i> | <i>-5.0%</i> | <i>-8.8%</i> | <i>+51.2%</i> | <i>+66.2%</i> |

**Valeur Intrinsèque (P class) was launched on June 6th, 2001 and Margin of Safety Fund (USD) (P class) on February 2nd, 1998. This table includes all of our open-ended funds that have been in operation for more than ten years. The MSCI World performance has been provided herein for information purposes only. As a reminder, the investment manager's goal is to generate an absolute return over the long term while allowing for significant deviations from major stock indices. Past performance is no guarantee of future results.*

The following pages aim to address the concerns that one might legitimately have, given the current situation, but from which it is essential to break free. By so doing, one will avoid taking decisions based mainly on emotion and urgency, rather than on common sense and compliance with rules and time-tested processes. Lastly, we cannot emphasize enough the importance, in this context, of not venturing outside one's circle of competence and of relying on one's knowledge of history, not only recent experience, but that of the past decades and centuries, in order to make the most of the opportunities that are currently available.

Debunking a few misconceptions...

Misconception No. 1: It is not reasonable to invest in the European stock markets as the future of the single European currency remains in doubt and some European states are on the brink of default.

Over the past few years, the very definition of risk has profoundly changed. Issuers with triple-A credit ratings went bankrupt or nearly failed before being taken over by the US Federal Government, only a few days after their ratings were affirmed (such as AIG in September 2008). Sovereign states like Italy have seen their solvency put into doubt. As an additional illustration of the currently troubled market environment, on January 3rd, 2012, the yield of Sanofi's euro-denominated bond maturing in 2016 was 20 basis points lower than that of the corresponding French government bonds! Moreover, although it is too early to speak of a lasting comeback for inflation, we are seeing steeper than expected rises in US and UK price indices. At the same time, some central banks have begun to reorder their priorities, with growth initiatives gaining the upper hand over attempts to maintain, at all costs, a stable price environment. In such a context, it might be wise not to overweight bonds, as investors might find themselves caught between the risk of a rise in interest rates and the risk of long-term capital loss due to default by an issuer and/or the erosion of purchasing power.

One might, then, turn to other investment alternatives. But in most cases, the risk of permanent loss of principal would appear, to a rational investor, to be too big. For example, let us consider gold, long considered to be a safe haven investment. Why would you want to buy gold today, on the heels of a five-fold increase in prices over the last ten years that current and past inflationary evidence in developed countries cannot justify. One must also keep in mind that several times in the past, Bullion has not lived up to its safe haven reputation (for instance, between 1981 and 2001, the price of an ounce of gold plummeted by 30%). We won't elaborate here on real estate, but a quick look at price-to-rent and price-to-income ratios would seem to indicate, if not considerable overvaluation, at any rate the absence of discounts able to protect from possible long term loss of capital.

And it is why, almost by default, equities emerge as quite an attractive asset class. Stocks as a way to share in the long term future of industrial and service-oriented corporations might protect one's investments from the excesses of the financial sphere. Today, it is possible to find "gems" in Europe which, in the event of a euro zone breakdown or major government default, will, perhaps, suffer for a while, but will most likely survive before returning to a path of growth and profits. Does it really matter whether the latter are still denominated in euros or in another would-be new currency? At present the best way to safeguard, as much as possible, the long term purchasing power of one's capital might well be to invest selectively in equities.

Although we just made the case for investing in stocks, we still must answer the following question: why should one invest in the euro zone stock markets rather than focus one's investments exclusively in the stock markets of less risky countries, in terms of exchange rates, budget deficits, not to mention social and political instability? The answer is simple: to the best of our knowledge, there are none to be found. The economic and financial situation in the United States is far from stable and one might wonder about the dollar's stability in the medium term and its inflationary consequences. The case of the emerging markets will be examined below in our discussion of Misconception No. 2.

Much more than their geographic location, what matters above all is the inherent quality of the underlying issuers and how cheap their stock prices are.

Misconception No. 2: For one's capital to grow, one needs to invest where there is the most growth.

This is a principle that most investment professionals consider to be cast in stone.

And it was this principle that led many of them to invest massively, between 1995 and 2001, in telecommunications, media and technology (TMT) companies, under the wrong assumption that revenue, market and profit growth go hand in hand. With the exception of those who invested early, in 1995–1996, most individual investors lost substantial sums of money by investing in TMT companies such as France Telecom, AOL-Time Warner or Alcatel. Institutional investors did not fare better, with quite a few pension funds still nursing today their losses from this era.

Another acronym has been all the rage of late, or at least until very recently. BRIC, which refers to the countries of Brazil, Russia, India and China (see our 2010 Annual Letter, accessible on our Web site). However, despite brilliant theses that this time it is different, history will repeat itself, as it is always the case with stock markets. And again many investors will very likely lose a great deal of money, intoxicated by the currently superior economic growth and prospects of these countries, mistakenly equated with stock markets' future returns.

High growth prospects only translate into gains for investors if certain conditions are met. Among other factors, risks need to be identified and minimized (governance issues, political ones, etc.), revenue growth needs to be profitable in terms of the return on capital employed, and the price paid must take into account the possibility that growth forecasts might not materialize.

Investors must carry out the research required to avoid the pitfalls that a prolonged financial euphoria inevitably produces. One must keep in mind the woes, exemplified by the Sino-Forest case, that befell investors (including some "sophisticated" hedge-fund operators) in NASDAQ-listed Chinese companies (double accounting, fictive revenue figures, etc.). Furthermore, in the emerging markets, other risk factors need to be taken into account, such as the instability of business law, the possibility of being expropriated, etc.

Next, revenue growth must result in comparable growth in profits without requiring too much additional capital.

Last but not least, the price must remain reasonable, with regard to all possible scenarios for the future and not only the most optimistic ones. This is rarely the case, with the exception of the first years of growth when investors, and investment bankers, have not yet discovered the new El Dorado.

Conversely, a lot of money can be made in situations of low growth, provided that the company selected for investment can grow market share, that its financial structure is sound, that the allocation of its available resources is rational and, naturally, that the price paid is reasonable.

We believe that by investing, as we do, in a few carefully chosen western based corporations, one may follow a more rational and ultimately more profitable path, albeit hardly fashionable nowadays, than searching for the holy grail of profit at the other end of the world.

Misconception No. 3: Demand for stocks in the developed world is likely to remain depressed for some time to come.

The current economic climate has probably depressed the demand for stocks by households and institutions. According to some experts, these short-term pressures are compounded by longer-term and more structural issues, in particular the sword of Damocles of the European Union's Solvency II Directive and the fact that baby boomers are now heading into retirement. What is at stake here?

The European Union's Solvency II Directive is intended to penalize investment in equities in favor of supposedly less risky asset classes, such as fixed-income products, and principally government bonds. It would be logical to conclude that the European sovereign debt crisis and the US government's loss of its triple-A credit rating would cast doubt over some of the options chosen by the European Commission. Not to mention the fact that the need to have access to liquid assets and the desire for higher real returns should continue to play in favor of stocks when institutional investors decide of their portfolio allocation between asset classes.

We often read that the baby boomers, who are reaching retirement age today (or their representatives, such as pension funds), will be gradually "derisking" their portfolios and dipping into their savings, which should result in a persistent selling pressure in equity markets. The major shortcoming of this theory is that it fails to take into account the behavior of other economic actors, either younger population groups or emerging markets with plentiful savings on the lookout for investment opportunities.

It is clear that nothing is ever simple or certain when forecasting long term stock market returns.

Misconception No. 4: Equity valuations seem to be at bargain-basement levels. However, if the developed economies remained stagnant, current discounts might persist and weigh on future returns. Under such circumstances, stocks could stay undervalued for so long that it should deter any rational investor from investing in equities.

For many, this issue is made all the more relevant that over the past 15 years investing in equity markets has been a long term losing game (after adjusting for inflation). To answer such concerns, one must first oppose investing in indices to investing in carefully selected stocks portfolios. Again, to buttress our case, let us remind you that our funds, from 1998 to today, have generated significantly positive returns while the indices have barely done so. Secondly, it is worth remembering that the annualized return on a long-term equity investment is, approximately, the sum of the growth in earnings per share, the rate of return on dividends, and the percentage change in the price-earnings ratio (PER).

By carefully selecting underlying companies and by trying to maximize one's expectation of the sum of these three parameters, in particular by not paying too high a price in terms of PER, one should expect to obtain satisfactory rates of return over five-to-ten-year holding periods.

From our point of view, generally at odds with trendy investment advice, it is much more attractive to invest in equities after 15 years of flat-to-negative real performance than after 15 years of euphoria. Or, to quote Warren Buffett, one should "be fearful when others are greedy and be greedy only when others are fearful."

Fund performance and outlook

Since their inception, our main funds have substantially outperformed their benchmarks, with the exception of the most recent five-year period, in which a slight underperformance must be mentioned (see table on page 2).

As we see it, our approach delivers outperformance over the long term compared to market returns, due to the originality and rigor of our research and, as a result, the quality of the companies added to our portfolio, but also the emphasis we place on the concepts of valuation and attractive prices.

Under these circumstances, over the next five to ten years, we trust that our funds will be able to generate good to high returns. These could, possibly, be enhanced by our expectation of some catch-up from the under-performance suffered by our funds between 2007 and 2011.

For additional information about any of our funds and to read any of our letters, please visit our Web site at www.pastel.fr.

We thank you for your continuing confidence and support and wish you all the best in 2012.

Sincerely,

David Pastel

Disclaimer:

The analyses presented in this letter should not be construed as an investment advice or a recommendation to buy or sell any security but reflect only the management company's opinion as of its writing, based on the information in the management company's possession at that time. Should this opinion change, at any moment, the management company is under no obligation to inform readers of this letter. Accordingly, the management company may not be held liable for any decision made or action taken by the reader relying upon the information contained in this letter and the attached documents.

The performance of the funds may vary considerably and over long periods of time from that of benchmark indices, provided herein for informational purposes only. In addition, the reader is cautioned that past performance is no guarantee of future results.

The quantitative data provided in this document have been adjusted and restated using the management company's own methods and may differ from other publicly available information.

Pastel & Associés is an independent investment management firm, licensed by the Autorité des Marchés Financiers under registration number GP 97-108.