Annual letter to investors 2009

January 4th 2010

Dear Investor,

In 2009 our investment methodology proved its mettle, as it had already done in the earlier financial crises of 1998 and 2001-2003. Thanks to it, all our portfolios managed, in 2009, to post annual performances of more than 50%.

The recent period has once again shown how difficult, if not impossible, it is to forecast the extent and timing of stock prices movements. This is why our investment approach focuses instead on the concept of what the intrinsic value of a business is. An approach that has proved particularly rewarding and robust over time, as demonstrated by the track records of our oldest funds.

	Returns in 2009	Cumulative returns since inception	Inception date
Valeur Intrinsèque (P class)	**+57.2%**	**+54.7%**	**June 6th, 2001**
MSCI World (EUR) dividends reinvested	*+26.7%*	*-25.6%*	
Margin of Safety Fund (USD) (P class)	**+69.9%**	**+240.0%**	**February 2nd, 1998**
MSCI World (USD) dividends reinvested	*+35.6%*	*+55.7%*	

**From 31/12/2008 to 31/12/2009 for Valeur Intrinsèque (P class) and from 24/12/2008 to 31/12/2009 for Margin of Safety Fund (USD) (P class). The MSCI World performance has been provided herein for information purposes only. It should be reminded that 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.*

We will be pleased in 2010 to celebrate our twelfth anniversary year, with more than €250 million under management, a strengthened financial analysis and investment team, and a proven methodology.

We believe that, in the current economic and market environment, the concepts of intrinsic value, margin of safety, and independent research and financial analysis are all the more relevant. In 2010, we will continue to manage our portfolios with the same discipline, the same methodology and the same indifference to the fashions and themes of the moment as we have for the last 12 years.

I. 2009: the financial and economic crisis continues

The crisis that still engulfs the world today has highlighted some serious shortcomings currently at work in the financial system. Three are particularly worth looking at in detail:

a) The excessive weight of financial services within the economy.

In 1980, the financial services industry generated 3.4% of GDP in the United States 5.8% in the United Kingdom and 4.9% in France. By 2007, these proportions had risen to 5.9%, 8.0% and 5.5%, respectively. This expansion of the financial sphere within the general economy has been accompanied by a worrying deterioration in the sector's corporate standards and ethics. At several of these institutions, employees and their leaders have simply given up on notions of fiduciary duties to their clients and shareholders. At the same time, a mindset of impunity and amorality seems to have gradually pervaded these firms' ranks and files.
Let us remind you of the jaw-dropping comments of Chuck Prince, CEO of Citigroup to the Financial Times in spring 2007, comparing the syndication of LBO loans (see below: “Bubbles waiting to burst?”) to a game of musical chairs: “As long as the music is playing, you’ve got to get up and dance. We’re still dancing”. Thanks to this metaphor, Chick Prince has probably earned a lasting place in history books, albeit quite an infamous one.
Less well known outside the investment banking world, but even more damning, is the acronym often used by industry employees and their executives (bankers, traders, etc.) to describe a deal that is risky but would generate short-term profits and hence bonuses: IBGYBG, standing for “I’ll be gone, you’ll be gone” (when the consequences of the transaction finally come to light).
Yet more worrying is the resistance now being mounted by the financial services industry to any radical reform of its workings. However, unless current systems of remuneration and notions of acceptable levels of risk are challenged, the present crisis may turn out to be just a foretaste of a systemic catastrophe with, hard to measure, social and political consequences.
Even so, at the moment any attempt at reform is met with unflinching opposition backed by powerful lobby groups, particularly in Washington. Witness, for instance, the revolt by staff members at AIG Financial Products demanding big bonuses for 2008 and 2009, even though their employer is still on life-support from the Federal government and had, through its mistakes, helped trigger the current crisis. And what to make of the $11.4 billion provisioned by Goldman Sachs to pay its 31,000 employees for their work during the first nine months of 2009, allegedly at no cost to taxpayers as advances from the Treasury and the Federal Reserve in 2008 had been paid back during the year? That argument sounds pretty hollow as, without the intervention of the US governmental authorities, the whole financial system would have gone under in 2008, and Goldman Sachs along with it. Had it happened, instead of bonuses, employees of the famous investment bank would, then, have had to cash in unemployment benefits from the state and City of New York.

b) Inadequate, and at times plainly erroneous, academic and professional approaches to measures of risk and financial added value.

There is no doubt that academia played a decisive role in the financial excesses of the last few years. Along with many others, we have said so for several years. To take a few examples:
The surge in the trading volume of credit derivatives went hand-in-hand with, and would have been impossible without, well-known university academics designing and refining valuation models to make them easier and faster for the financial system to use.
These models assume that the laws governing the distribution of returns from financial assets follow normal or log-normal distributions even though basic statistical tests show this not to be the case (see the work of Benoît Mandelbrot). We might also question the relevance of applying probabilistic techniques to analyzing the behavior of stock market prices…
Warren Buffet's 2002 description of derivatives as "financial weapons of mass destruction" evoked only scornful comments from the profession at the time. After the financial travail, and in some cases even plain bankruptcies, of Lehman Brothers, Merrill Lynch, AIG, and others, it now sounds strikingly prophetic.
We could also cite, as another problem, the systematic use in recent years of VAR (Value At Risk) to measure the maximum risk of loss both on and off banks' balance sheets. This approach, which is based on assumptions of stable correlations between the prices of financial assets, also helped trigger the crisis by downplaying the actual level of risk being run by financial institutions. Despite being regularly contradicted by experience (most notably at the time of the near-collapse of the LTCM hedge fund in 1998), VAR remains the standard technique used in the risk management departments of most financial institutions.
Such persistence in error is hard to understand. But the close relationship between academia and the financial sector may well have something to do with it. The private sector's adoption of models and techniques that had been refined by university departments and their professors represented for the academics not only a validation of their work but also a considerable source of revenue in the form of consultancy fees and research funding (grants, etc.).
The tyranny of alpha is another example of inappropriate math concepts being shoehorned into a stubborn financial reality.
Seeking to better understand the functioning of financial markets, US academics in the fifties and sixties (Markowitz, Sharpe, etc.) created an intellectually impressive body of work, that nonetheless had little to do with the reality on the trading floor. Once again, instead of sticking to the original, academics set about transforming it using the raw materials and tools they had available. In this case, this meant making reality compatible with the most sophisticated linear optimization models of the time.
This deceptive representation of the real world led, among other things, to the theory of efficient markets and the concepts of portfolio alpha and beta. "alpha" and "beta" in these models represent, respectively, the constant and the coefficient of regression in a linear regression of portfolio returns against the differential between the benchmark index and the risk-free asset (*sic*!).
The parameters used to calculate alpha and beta variables are so loosely defined that there are virtually as many different alphas and betas as specialists struggling to calculate them.
Which benchmark to choose? What time interval to use for the regression? How often to calculate it? Not forgetting the thorny issue of choosing the risk-free asset.
Similar objections apply to the concepts of volatility, Sharp or Treynor ratios, etc.

These concepts are nonetheless now regularly used to identify the "best" investment managers. Just to dispel any suspicion that our criticisms are motivated by resentment or envy, we would like to remind readers that our funds have repeatedly, and most recently in October 2009, won honors and prizes for the excellence of their "alpha" by recognized "professional" bodies.

Conflict-of-interests analysis may prove quite useful in explaining the stubborn persistence of the financial system in using models whose value is at the very least debatable. The use of these models could provide a pseudo-scientific gloss to the stock-picking and fund-picking procedures of investment advisers at banks and consultancy firms. Which gloss, in turn, could serve as both a marketing weapon and a powerful legal shield. In exchange, academics, by legitimizing, through their papers and lectures, banks' and others' reliance on such quantitative tools, would secure their relationships with these generous financial sponsors.

We could keep elaborating on the many examples of dubious or even hazardous use of economic modeling. Such as, for instance, the notorious case of the credit rating agencies who played a key role in inflating the US real estate bubble. Instead, though, we will wind up this brief tour through the world of applied finance with two quotations, one from Charlie Munger and the other from Warren Buffett, respectively Vice President and President of Berkshire Hathaway group:

"To a man with a hammer, every problem looks pretty much like a nail".

"It's better to be approximately right than precisely wrong".

c) Bubbles waiting to burst?

The financial crisis now seems to have entered a remission phase that hopefully will prove to be long lasting. But there are still clouds on the horizon. We will highlight herein three different types of risks:

Loans to the commercial real estate sector made in 2007-2008 could turn to be a major source of losses to the global financial system.

We can only hope that the programs designed by G8 central banks and finance ministers to prop up the financial system will be powerful enough to contain this likely wave of defaults. That said, according to IMF estimates, the scale of the harm still to come looks a lot smaller than that already unleashed by the residential real estate crisis. However, one might call into question the validity of forecasts coming from such a "conflicted" body.

Two other worrisome and still inflating bubbles cannot, in our view, be as easily dismissed: the growth of hedge funds' assets over the last two decades and the build-up of so-called "LBO" loans by private equity investment structures, especially between 2005 and 2007. Analysis of the performance of financial markets over several decades shows that speculative bubbles tend to burst suddenly rather than deflate gradually. We must simply hope that the two listed above will prove less uncontrollable than their predecessors.

Private equity and so-called "alternative" management approaches (marketed as hedge funds) have proved, over recent years, quite successful with some segments of the financial institutions market (pension funds, endowments,…) as well as with wealthy private investors (through family offices and financial advisors).

This success is based on several technical features of the investment vehicles on offer. We will only look at two here: these products' seemingly lower volatility and their levels of financial leverage. Their lower volatility derives mainly from far less frequent computation and much more restricted dissemination of their NAVs than for open-ended funds (regulations, for instance, require daily NAV computation and dissemination for our Valeur Intrinsèque fund).

This lower volatility has an artificial, and often deceptive, calming effect on the investor and/or their proxies. It is hard for regulated and liquid mutual funds such as ours (except for our limited range of non-public vehicles) to compete with investment products offering such "psychological" comfort.
These products also rely on a heavy use of leverage.
In the case of private equity, it, basically, involves boosting the profitability of the fund's investments by injecting a big, if not massive, dose of debt. As a result of which, many a company have, over the last ten years, seen their capital change hands at what are often excessive prices since the low cost of debt makes up, on paper at least, for the expensiveness of the acquisition. In practice, these transactions, which can rarely be done without financial leverage, have disastrous economic and social consequences: lay-offs, offshoring, systematic outsourcing, undermining of suppliers by repeated and unilateral extensions of payment terms and inadequate investment in plants, equipments and R&D.
These measures, which may sometimes be required as part of very specific strategies designed for long-term development or survival, have thus become the norm. Short-term profit growth has been turned into the mantra of corporate management teams of companies controlled by private equity groups.
Today, reality is catching up with the world of the LBOs. Their excessive debt levels have already translated in several covenant breaches, and in some cases even technical defaults of renowned and previously very profitable corporations. This phenomenon has more room to go while the economic recovery under way may not be strong enough to offset it.

II. What outlook for 2010 and beyond?

"That is all fine - replied Candide - but we have to cultivate our garden"
(Candide ou l'optimisme - Voltaire).

Given this partial and perhaps less-than-objective analysis, what is the outlook for the long-term investor? As in previous years, we will not be presenting here any forecasts about the evolution, in 2010, of either the stock markets or our funds' NAVs.
We will rather remind investors that our funds' portfolios are currently made up of companies that tend to share some common features:

- **Their financial structure is solid** and debt levels are reasonable in light of their ability to generate cash through economic cycles.

- **Their business model has proved its profitability** over long periods, as illustrated by their superior levels, over an economic cycle, of operating margins as well as returns on equity and employed capital.

- **They hold strong and sustainable competitive positions** which should allow them to keep, or even increase, market share against competitors that might be weakened by a lengthy economic slowdown.

- **They are headed by experienced managers**, whose personal wealth is often invested in their company's capital and therefore tied to its long-term future.

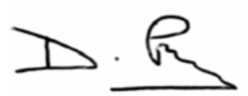
Moreover, the shares of these high-quality companies are trading today at attractive, and even in many cases at bargain, prices when compared to our estimates of intrinsic value.

To sum up our letter, the out-performance of our funds in 2009 has only confirmed the extreme undervaluation of our portfolios at the depth of the crisis, but should not, at least in our view, be construed as detracting in ant way from their future return potential.

For more about our funds, see our website: www.pastel.fr.

Thank you for your confidence and wishing you an excellent 2010.

Yours sincerely



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