PASTEL & ASSOCIÉS

SOCIÉTÉ DE GESTION DE PORTEFEUILLE

Annual letter to investors 2010

January 3rd, 2011

"All that is very well," answered Candide, "but let us cultivate our garden".
(Voltaire, *Candide*)

Dear Investor,

In 2010, despite turbulence in the financial markets, our funds generated substantially positive returns, thereby increasing their long-term outperformance compared to major stock market indices (see table below). These results confirm the value that our management style, based on consistency, long-haul investing and independence, brings to patient and rational investors, whether individual or institutional ones. Therefore, to use a terminology dear to consultants and professional fund selectors, our funds, instead of being "satellite" holdings, truly belong to the "core" of our investors' portfolios.

	Inception date	Performance in 2010*	Cumulative performance since inception
Valeur Intrinsèque (P class)	**June 6th, 2001**	**+19.7%**	**+85.2%**
MSCI World (EUR) dividends reinvested		*+20.1%*	*-10.6%*
Margin of Safety Fund (USD) (P class)	**February 2nd, 1998**	**+16.2%**	**+295.1%**
MSCI World (USD) dividends reinvested		*+12.3%*	*+74.9%*

**From 12/31/2009 to 12/31/2010. This table includes all of our existing funds that have been in operation for more than five years. 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.*

I. 2010: highlights and insights

a) A financial world still at a loss.

The ongoing crisis has already caused experts of all stripes to lose their luster: macroeconomists, econometricians, quantitativists, but also top bankers at both public and private financial institutions, although these were supposed to know the ins and outs of the financial world*. Rather than starting a lengthy and probably boresome "exposé" (see last year's annual letter), I have chosen, this year, to illustrate our views through an authentic anecdote involving Ben Bernanke, the current chairman of the US Federal Reserve Board.
I have recently come across a speech given by Bernanke, on February 20th, 2004, before taking up his current position. Entitled "The Great Moderation", it aimed to provide the theoretical justification for a supposedly lasting decline in the volatility of economic indicators. Bernanke closed his remarks with the following statement which, in light of the housing and subprime mortgage crisis of 2006-2009, requires no additional comment: "This conclusion on my part makes me optimistic for the future, because I am confident that monetary policymakers will not forget the lessons of the 1970s". Sic transit gloria mundi.
The tarnished credibility of financial "experts", whether these are bank executives, central bankers, or academics of varying renown, reinforces the climate of uncertainty in which investors make their decisions. This situation makes an investment approach relying on macroeconomic models and forecasts even more difficult to apply.
In such an environment, it is certainly more prudent to base one's decisions on independent microeconomic analyses, looking at selected individual companies, as is done every day by the research team at Pastel & Associés.

b) Liquidity's shortcomings.

The increased role played by liquidity, whether for direct investment in securities, or indirect investment in such instruments via funds, has shown, in recent years, its limitations.
However, industry regulators and accounting standard setters continue to grant preferential treatment to financial instruments that are the easiest to dispose of and account for at any moment.
End investors are thus deemed to be better protected, owing to their ability to know the price of the assets held at any time and to decide, on the basis of the information available, whether or not to keep holding them. Unfortunately, these advantages are offset by several major drawbacks.

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*The political courage of European central bankers would be the rare exception worth noting, in particular Jean-Claude Trichet's statements relating to the budget policies required at times of economic recovery (see Trichet's interview with the *Financial Times* published on July 23rd, 2010).

Let us first call attention to the increasing lack of accountability on the part of investors, which is the direct result of their ability to change their minds at any time: why make a commitment to a company's development when it can so easily be jettisoned, at the first hint of trouble? Worse still, why bother analyzing an investment target in depth if one can easily reverse the decision made and start again with a clean slate?
At many publicly-owned firms, management teams have lost track of the identity of their shareholders, so high has become the turnover on the share register. According to some industry estimates, the average holding period today for one share of a US stock is less than six months. The growth, in recent years, of shareholder activism has only exacerbated the situation. What are we to make of investors who, immediately upon acquiring a stake in a company, are prepared to give lessons to experienced, responsible and competent managers? The choice made by many executives to listen to the siren songs of the private equity funds is without a doubt, the result of the drift in investor behavior that has taken place over the last few decades. However, let us not be too naive either: the lure of the profit-sharing plans set up by private equity funds must, also, be a powerful incentive to "going the private way" for executives at public companies.

Only a multi-dimensional approach can offer a way out of the current dead end, by, for instance:

- Encouraging, through tax incentives, the holding of equities or funds invested in equities for periods of several years;
- deterring investors, again through proper taxation, from disposing of their investments within too short a time frame; and finally,
- granting, by way of changes in corporate law, voting rights only to shareholders having held a stake in the company for a long enough period of three or perhaps five years, the most effective timeframe being open to discussion. Can a newly arrived immigrant in France claim citizenship as of the first day of residence in the country?

c) 2010: another year of high market volatility.

As in previous years, the financial markets saw high levels of volatility in 2010. As the same causes produce the same effects, in our opinion this situation might well persist for some time. Among the factors contributing to this phenomenon we might mention:

- increasingly rapid and democratized access to information as a result of irreversible technological progress. Information disseminated in this manner is by its very nature nearly instantaneous, and tends to be broken down in bits and pieces which means that stock market players are increasingly unlikely to get a full picture of what has been happening. Continually bombarded with a flow of often contradictory signals, these players, whether investors or speculators, tend to react quickly rather than taking the time to digest and assimilate these fragments of information. The mental instability of the decision-maker, itself a direct consequence of the heavily mediatized society in which we live, gets reinforced by a second factor,

- Leveraging as a routine investment technique. Real interest rates maintained at excessively low levels by central banks, first among them the US Federal Reserve, have fostered the increased use of "carry trades", by which a player obtains funds on the money markets at very attractive rates and reinvests them in risky assets. These types of trades are the norm today for many hedge funds and like investment vehicles.
  The leveraging of investment positions makes market players much more sensitive to the potentially adverse effects of any hint of bad news, in turn leading to over-reactive and short-term decisions, which then result in herd behavior and increasing price volatility.

In light of this situation, equity investors must adopt strategies that enable them to function in, and perhaps profit from, a highly volatile environment.
A few common-sense recommendations:
- refrain from using financial leverage as a means to acquire equities;
- consider equity investments as virtually unavailable for at least five years and thus invest in equities only the percentage of your assets that would be compatible with such virtual circumstances;
- assume that the potential accounting loss for equity investment may reach or even exceed 50%, and adjust the percentage invested in this asset class accordingly.

d) Speculative bubbles might make a comeback.

It did not take long for the US housing bubble to be followed by other bull runs in selected markets and regions. These runs might well be the harbinger of the next bubbles to burst.

These include, for instance:
- the emerging economies. The new conventional wisdom states that emerging markets are the new investment Holy Grail. Asset allocators and other investment strategists repeat this mantra ad infinitum: tomorrow's stock market fortunes will be made in the BRICs (Brazil, Russia, India and China). But this enthusiasm is only mildly rational. As has been the case on every other occasion (such as the Internet bubble in 2000, or US railroad stocks around 1900), growth potential is being confused with return on investment. As has been the case on every other occasion, capital expenditures requirements (especially infrastructure), probably huge, have been left out of the economic equation, and with them the risks of wide-scale resource squandering and poor capital allocation. Moreover, sociopolitical risks have been ignored or wrongly minimized. Hence the hastily drawn and misguided conclusions already discussed herein.
  If the emergence of the middle class, especially in China and India, will allow for the growth of new consumption patterns and thus new markets, who will profit from them: the consumer, the investment banker or the investor? Under what conditions? And, above all, when?

Furthermore, the current profitability level of private and semi-private entities in the emerging economies seems to be based on waning factors, in particular:

  - low labor costs, which have been increasing markedly over the last year,
  - undervalued currencies, which have recently begun to undergo a revaluation process induced by, among other causes, the European sovereign debt crisis and the US Federal Reserve's quantitative easing policy.

  In these circumstances, and given the risk-adjusted valuation of their financial markets, is it really more reasonable to invest in the BRICs than in the developed economies?
- commodity markets and mining companies. Here again, one could easily question the justifications set forth by the vocal and quite popular proponents of such investments.

Speculative bubbles are recurring phenomena of financial markets, and rational investors must try to avoid them even if it might entail, during euphoric runs, missing out on attractive short-term returns. If History is a guide, backlashes tend to be always stronger than their initial booms, and consequently the losses suffered by investors much greater than their preceding gains. But how can one detect the emergence of a bubble? Several indicators should raise concern:

- the inability to justify, using traditional valuation tools, the price levels observed,
- the need, in order to justify paying market prices, to assume the continuation of a period of prosperity that is already exceptional in terms of growth and profitability,
- the pervasive argument, which would have it that "this time, we have entered a new social, political or economic era", and finally
- an imperious need to take part in the movement under way, for fear of "missing the bandwagon" and convinced that, at worst, it will be possible to pass on the investment to other parties, before it is too late".

e) On the importance of staying the course.

"Nothing in the world can take the place of persistence. Talent will not; nothing is more common than unsuccessful men with talent. Genius will not; unrewarded genius is almost a proverb. Education will not; the world is full of educated derelicts. Persistence and determination alone are omnipotent". (Ray Kroc, co-founder of McDonald's, 1969)

Once again, 2010 provided an opportunity to demonstrate the superior effectiveness of an approach favoring **concentration**, a concept we apply at all levels of our work:

- concentration on our profession as corporate financial analysts,
- concentration of our research on companies we understand, and with which we have been familiar, in most cases, for a long time,
- concentration on our principles: independence, importance of high margins of safety, monitoring of the intrinsic value of investments made in order to maintain a reasonably valued portfolio,
- concentration of the portfolio around several key positions (usually between 15 and 30 positions).

The returns achieved in 2010, on the heels of those obtained in 2009, were the direct result of our staying the course in 2009 as well as 2010: no changes were made to the portfolio structure unless justified by some truly attractive arbitrage opportunities. No ad-hoc or knee-jerk decision interfered with our investment process. Hence, rather than listening to the doomsayers who predicted the large-scale collapse of economies in April-May this year, then again over the summer, and while our funds went from a positive return of approximately 22% in the spring to a negative return of a few percentage points in the fall, we stuck with our investments, confident in the validity of our analyses and our approach.

II. What prospects for 2011 and beyond?

From the preceding observations, one might conclude that there might not be, today, many attractive investment opportunities, in terms of valuation and risk. Nothing could be further from the truth. If, in our opinion, the emerging economies are overweighted within many investors'portfolios, the Western industrialized countries (for our purposes, chiefly continental Europe, the United Kingdom, and North America), somewhat neglected by investors today, constitute a fertile hunting ground. In the "developed world", there is, at the moment, a reservoir of well-managed companies, more reliable from an accounting and corporate governance standpoint, and which have taken advantage of the crisis to leverage their experience, their culture, and their existing asset base, thus improving their cost structures and gaining ground against weaker competitors.
Our **microeconomic and long-term oriented financial analysis** has allowed us to identify, value and invest in such companies (see in this regard our annual *portfolio highlights* issued for each of the funds managed by Pastel & Associés, which may be accessed on our Web site).

In sum, the portfolios of your funds are currently made up of companies that tend to share some common features:

- **They have sound financial structures** and their debt levels are reasonable in relation to their capacity to generate cash flows across economic cycles.
- **Their business models have proven their effectiveness at generating profits** over long periods, reflected in average operating margins, returns on equity and on invested capital, generally higher than those of their competitors.
- **They enjoy strong and sustainable competitive positions** likely to allow them to maintain, or gain, market shares against competitors weakened by the consequences of a potentially extended economic downturn.
- **They are headed by experienced management teams**, who most often also hold equity interests in their companies and are thus committed to their development over the long term.

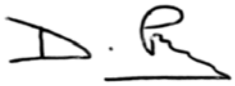
The shares of these high-quality companies are trading today at **prices that remain attractive** when compared to our intrinsic value estimates.

Finally, it is important to note that the gains made by our funds in the last two years merely confirm, in our view, the extreme undervaluation of our portfolios at the height of the crisis and do not detract in any way from their future upside potential.

For additional information about any of our funds, 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 2011.

Sincerely yours,



David Pastel

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