SIA

Strategic Investment Advisors Group

Long Term Investment Fund

Newsletter

of September 2020

SIA Funds AG Alpenblickstrasse 25 8853 Lachen Switzerland

tel : +41 55 617 28 70 fax : +41 55 617 28 71 info@s-i-a.ch www.s-i-a.ch

Figure 1: **LTIF Classic EUR**
vs. MSCI Daily TR Net World Index EUR

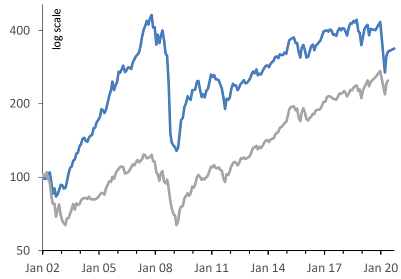


Figure 2: **LTIF Stability A Cap EUR**
vs. HFRX Global Hedge Fund Index EUR

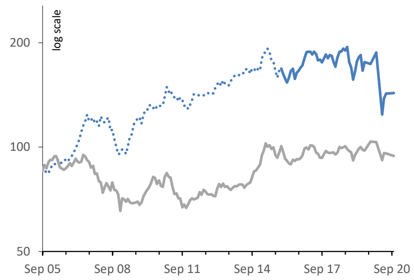


Figure 3: **LTIF Natural Resources EUR**
vs. S&P Global Nat. Res. Net TR Index EUR

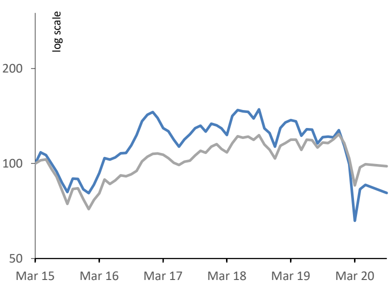
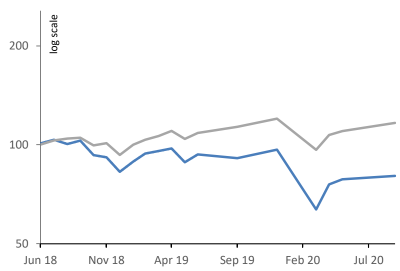


Figure 4: **LTIF SRI EUR**
vs. MSCI Daily T R Net World Index EUR



"Uncertainty is the friend of the buyer of Long-Term Values."

Warren Buffett

Overview of our funds

In mid-October the Classic is at EUR 358 per share (down 17% ytd.) ... in recovery mode

Stock prices' volatility has lately made it quite challenging to write about performance. You start writing and within a few days everything has changed by +/-10%, a volatility that is much, much higher than in the real/industrial world.

The Classic is a global value fund, well diversified in terms of businesses, geography and with limited industrial risk. However, in 2020 the fund's market price has been all over the place: the NAV started 2020 at EUR 434 per share, rose to EUR 450 in January, fell to EUR 235 in March, and is currently around EUR 350-360 (-17/18% yd.). The market has certainly been far from efficient in 2020.

Table 1: **Net Asset Value - Net assets under management of our funds**

Sept 30, 2020	NAV	Δ 3m	Δ 12m	Annualized return (s.i.)	AUM *(in mio)*
LTIF Classic [EUR]	337.47	-1.1%	-15.9%	6.7%	69
LTIF SRI (EUR)	80.46	-4.2%	-11.7%	-9.1%	1
LTIF Natural Resources [EUR]	80.67	-10.5%	-33.5%	-2.6%	19
LTIF Stability A Cap [EUR]	143.14	-2.3%	-17.6%	-4.3%	2

Source: SIA Group

2020 is again being a bad year for *value*, and the Classic is underperforming the wider indices (SPX500 up 3% ytd., European SXXP 600 Index down 13%), although being more in line with value indices such as the Russell 1000 Value Index, down 14% or the MSCI World Value Index, down 17%.

In the context of an economic recession combined with such uncertainty, it is normal for cyclical stocks, small companies and value to underperform (in the short term), but this trend is usually reversed in the following few years. The issue is not *if* but *when* this will happen; narratives such as "value has died", "technology companies are the future and will grow eternally in the double digits", or "Warren Buffett has become obsolete", are as recurrent as they are recurrently proven wrong.

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The Classic aims for an absolute return: 10% net of fees per year; i.e. double the investment every 6-7 years. However, the last 3-4 years have been well below expectations. Since inception in 2002, the Classic has made 7% per year (and 10% per year since GFC lows in 2008/2009), but in the last 5 years only a mediocre 2% per year, in line, however, with the value group.

Measuring the performance of a value fund over less than 5 years does not make much sense, because we are long-term investors and tend to buy troubled (and therefore cheap) companies that take a few years to recover. In our case, the main cause of the Classic's lack of performance has been our exposure to commodities (oil and copper, in particular), which has on average accounted for 20% of the fund and has hurt us a great deal. This investment is still in place and is one of the drivers for the Classic's future recovery, which currently has an expected IRR of 16%. Sometimes patience is required.

The Classic's updated IRR is 16% with an Intrinsic Value of EUR 600

Our numbers suggest that the Classic has an Intrinsic Value of EUR 600 per share and thus a medium-term upside potential of 70%, with an equivalent IRR of 16%. We keep our target of EUR 500 by the end of 2021, with a 40% upside in 15 months' time. This upside is not usual for a diversified value fund, but we have to recover the fall of 2020, and the large underperformance of both *value* and *commodities* in the past 5 years.

Despite our analysis mainly being bottom-up (we consider ourselves stock-pickers and do not start our investments from themes or narratives) and that we usually have some 30-35 companies in the fund, we have ended up with strong exposure to some promising sectors that we believe will lead the Classic's outperformance. These sectors account for around 62% of the fund:

- ⇒ Aerospace sector (8% with MTU Aeroengines, Raytheon and Thales)
- ⇒ Catering and cleaning services sector (9% with Sodexo, Compass and ISS)
- ⇒ Salmon farms (7% with Leroy Seafood, Grieg Seafood and Mowi)
- ⇒ Healthcare (8% with Grifols and Medtronic)
- ⇒ Building materials (10% with Wienerberger and Heidelberg Cement)
- ⇒ Oil (8% with Suncor, Cenovus, EOG, HESS, Premier Oil)
- ⇒ Copper (12% with First Quantum, KAZ, Hudbay, Antofagasta and Northern Dynasty)

The rest of the investments are more specific, such as Prysmian (cables), Pandora (affordable jewelry), ING (banks), VISA (cards), ASML (semiconductor equipment), and our "discounted" consumer compounders, which are Henkel, Unilever, Coke and Reckitt. These companies make up the rest of the Classic, or 38% of the fund.

We will later comment on the bifurcation in the market during the past few years, with a strong pull from certain sectors (technology, software, and staples mainly) and a de-rating from others (energy, commodities, industrials and banking). The value strategy is not about buying companies cheaply, but about buying quality companies at a discount and there are some sectors which should currently be avoided, such as banks, whose business model is facing structural changes, or the automobile industry, which is undergoing electrification and consequently has huge challenges ahead.

In 2020, the best Classic sectors have been technology (+35%), mines (+10%), staples (-3%) discretionary and services (-2%[1]) and the worst, energy (-70%) followed by industrials, construction materials and finance, all falling by c. 20%. Our oil companies have suffered major setbacks (falls of between 50% and 90%), followed by our investments in ING (-43%), Grieg Seafood (-45%), ISS (-47%), Raytheon (-37%), Thales (-30%) and Heidelberg Cement (-20%). On the positive side, we highlight Northern Dynasty (x2),

[1] We have Pandora included in this subsector

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Pandora (+65%), Apple (+50%), Carrier (+25%), Metso (+25%), Prysmian, ASML, and Viscofan (all three at +20%).

In this last quarter, we have taken leave of three long term fellow travelers. **We sold Apple and Nestlé** with tears in our eyes, but the valuation no longer gave us sufficient potential. Both names we had now in the portfolio since September 2011, during this time Nestle (x1.1) and Apple (x10.7). A market mistake allowed us to **get rid of California Resources** at the last minute, allowing us to sell at a lower loss after it filed for bankruptcy. Despite this, California Resources has been a disaster and we lost most of our investment. The company is a good oil company, with quality assets, a good management team, and very large reserves, but it had too much financial debt and the 2 major oil shocks (2015 and 2020) wiped it out. This was our mistake and we will not repeat it: never combine a cyclical business with that much debt.

We also welcome the new entrants: **Compass Group** (catering) and **Hess** (oil), as well as an old friend **Mowi** (salmon), into the Classic, which we hope will bring us great joy in the coming years.

Covid19 is nearing control, despite the 2nd wave

Readers of this Newsletter don't come here for information on Covid-19. However, we cannot avoid saying a few words on how we see the situation evolving, which is important when discussing investments. Let's review some facts and reasonable expectations.

As expected, a treatment based on monoclonal antibodies targeted at some key parts of the virus does work. As we write this, two pharma companies, Regeneron and Eli Lilly, have obtained scientific proof of efficacy. The drugs should be approved within a few weeks. A couple of million doses will be available before year end and many, many more as 2021 progresses. These are treatments, not vaccines. But by drastically decreasing the virus's mortality, they turn the pandemic into a much less severe problem. There are 70 companies more completing similar treatments right now.

Vaccines will take a bit longer, for the simple reason that to prove that a therapy works, it's sufficient to find some already infected people see if it helps improve the situation, but many more people need to be inoculated with a suitable vaccine (to provide statistical validity), after which months might be needed to see if the inoculated people develop the disease or not. Since most people don't contract the disease anyway, very large numbers of people and a long time are needed to have a reasonably scientific view of the vaccine's efficacy.

In spite of this, the first vaccines should be available in western countries before the end of the year (one is already being widely used in China). **Again, expect massive production in early 2021.**

Once the virus is under "control", not everything will immediately return to what it was before. Many companies will go bankrupt, many will be saddled with huge debt incurred to survive 2020, and many will have permanently diluted their shareholders in an effort to continue operating. But from a macroeconomic view, the most reasonable expectation is a relatively rapid recovery in most areas, so that things will quickly start looking "normal" again.

What's the impact of this for an investor? Some companies have obviously been badly hurt. Others have profited. But for most, it will be the equivalent of a deep recession that should be shorter than that of 2008 if the economic authorities take the right measures this time, which they seem to be doing.

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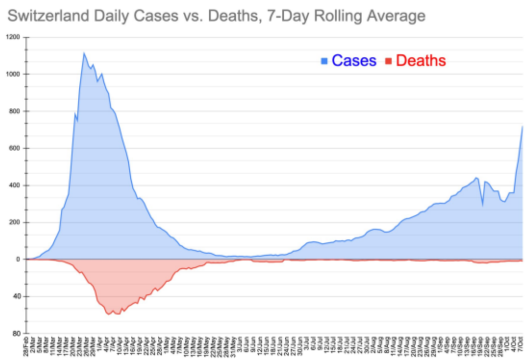
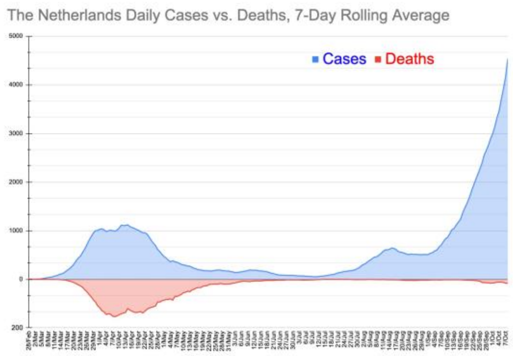
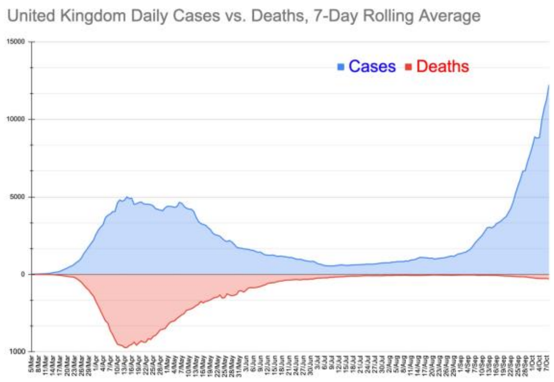
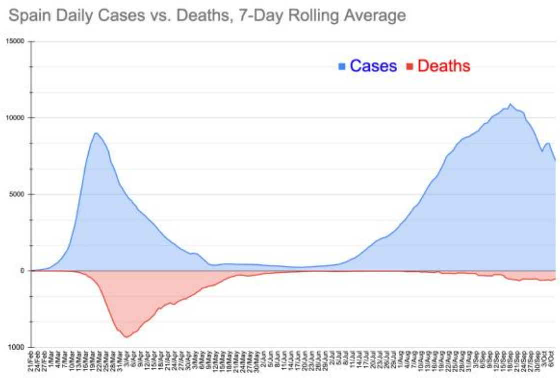
Ultimately, one can compare the situation to an owner of a normally profitable business experiencing a couple of bad years - unpleasant, but not deadly. Unavoidably the risk (and the reality) of these periodic crises is what makes equity investing so profitable in the long term.

We've prepared the charts below to put things in perspective. They show the daily new cases and daily deaths in 4 European countries from the beginning of the pandemic to now.









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Most countries show a similar pattern. It's obvious by looking at it that:

1. **Lockdown works** as people stayed home in May; the virus almost disappeared
2. Traveling during the holiday period and then returning to normal life contributed to the spread of the virus
3. **The level of mortality is currently very, very low**

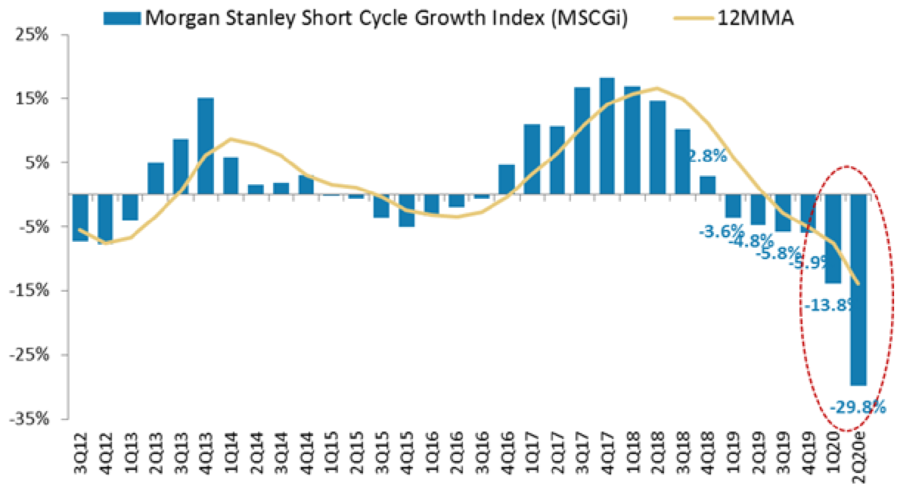
There are obviously many possible reasons for this drastic decrease in mortality, but it's clear that **the situation is currently very different from what it was in April.** Together with the scientific developments described above, it makes us believe that the markets are not so wrong by already discounting an exit from the crisis. This is especially important for those sectors, such as energy, that have been deeply impacted but should recover quickly.

The world economy has already entered a recovery phase

We have not changed our base case scenario, which remains one of economic and industrial recovery since Q220. We will not go into the macroeconomic details in depth, but there are 3 main factors for normalization during 2021:

1) Production of vaccines against and medicines for Covid19 throughout 2021
2) Both the monetary and fiscal policies in most of the countries concerned
3) Chinese leadership in both health and economic recovery.

This is the graph we published in our Q220 newsletter, where we predicted the low point in the industrial cycle:



Source: Morgan Stanley

The following chart is the update to Q3, where two things are indeed verified: 1) the crisis trough was in Q2; and 2) the global industry started recovering in Q3. Normally industrial cycles last about 2 years from peak to trough. Remember that we were already expecting an industrial recovery from Q120 when the Covid19 crisis emerged, delaying the cycle by at least two quarters and making the recovery slower and more gradual.

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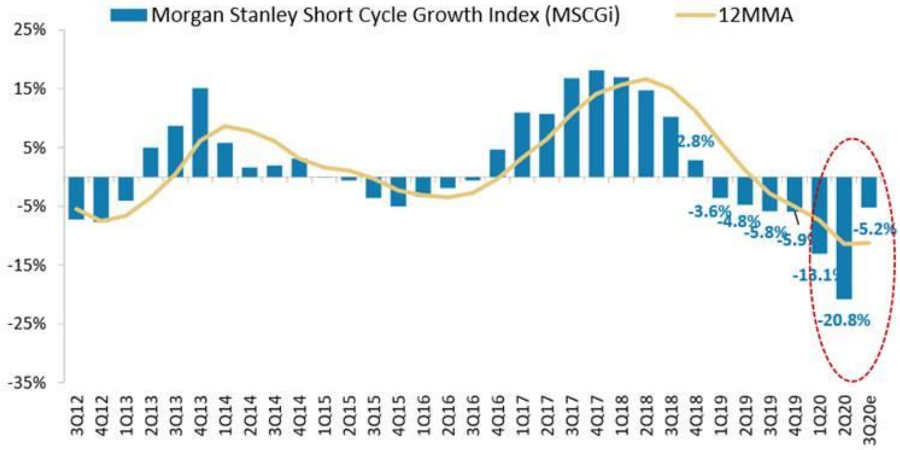
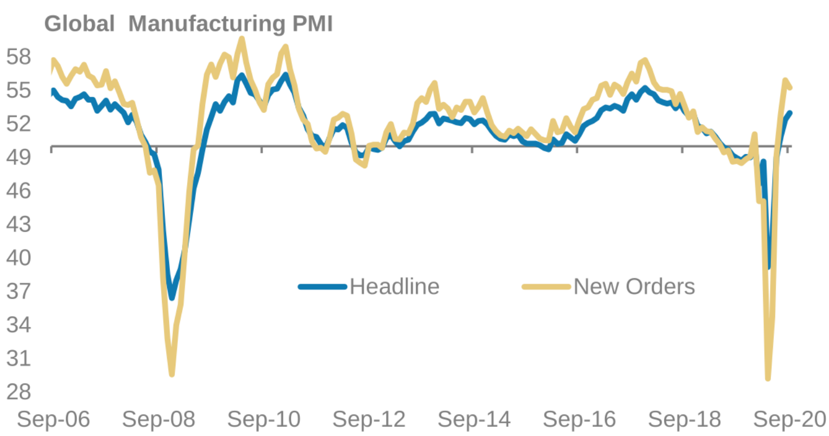


Source: Morgan Stanley

Industrial production indicators (PMI's) have already registered positive levels of activity, indicating that we will gradually return to the economic cycle in force since 2009.

Our initial hypothesis of a deep crisis followed by a faster recovery than in a normal economic cycle is being confirmed, although the key will be how Governments manage the massive fiscal help required in the remainder of 2020 and in 2021, as some sectors have been strongly affected (tourism, hotels, restaurants, airlines, aerospace, banks, insurance, etc.) and economies are experiencing a large negative impact on unemployment, consumption, and investment.



Source: Morgan Stanley

But what about the stock market? Are we really back to highs? There is a deep bifurcation

The current stock market situation is somewhat more complicated than usual, due to the extreme bifurcation of valuations. On the positive side, we have technology and software (led by the largest market caps. Facebook, Amazon, Apple, Microsoft, Google, or FAAMGs), as well as healthcare/staples. These companies are trading at high multiples, and due to their size, they have an enormous impact on Indices and ETFs.

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On the other hand, we have sectors that have been severely de-rated: energy, commodities, banks, cars, materials, and some industrial sub-sectors. There is also some geographical difference, as the large capitalizations are mostly American.

The following graph illustrates how the 10 large American stock market capitalizations are taking the indices to highs, but if we adjust this, the American stock market's performance would be less brilliant and similar to that of Europe (-13% ytd.). The FAAMGs are responsible for a significant part of the Indexes' outperformance (and for *growth* over *value*), but this trend is neither sustainable in the long term, nor can it be.

Figure 1: Outside of 10 mega-cap growth stocks, the S&P 500 market cap tracks much closer to the Stoxx 600 in USD terms

Source : Deutsche Bank, Bloomberg Finance L.P.

We believe that a sector approach can add some light. On the one hand, we have the star sector (technology in a broad sense), which is currently trading at 8x book value, twice its historical average of 3.5-4x and not far from the 2000 technology bubble's peak of 10-12x, with valuations approaching extreme levels.

This does not mean that the sector will collapse tomorrow, but it does mean that expected future returns will be much lower than those obtained in recent years, in average terms of course, given that a further acceleration in sales growth, margins, and returns look very difficult from the current high levels.

Apple is a clear example: when we bought it back in 2011, it was trading at 6x PE (adjusting for cash), because Mr. Market feared a repeat of Nokia's history. Now, 9 years later, the stock is trading at a PE 2021 of 35x. Apple is an excellent company, but half of its business is quite mature, its margins/returns are already very high, and the expected IRR has moved inversely to its share price, down to the single digit territory. Or to put it differently, this very demanding valuation could only be justified by an earnings growth of +20%, but if that were the case in the coming years, then Apple would own the whole world pretty soon due to its size, similar to Microsoft in 2000.

On the opposite side, we have the energy/oil sector, which is currently trading at 0.9x book value against its historical average of 2.1x (within a historical range of 1.3x to 3x), meaning that the sector is well below even the historical low. Based on our assumptions of rebalancing supply and demand over the next 2 years, and therefore higher oil prices, we see this sector as a unique investment opportunity.

Since 2014, the energy sector's evolution has been a disaster, as can be seen in the following graph:

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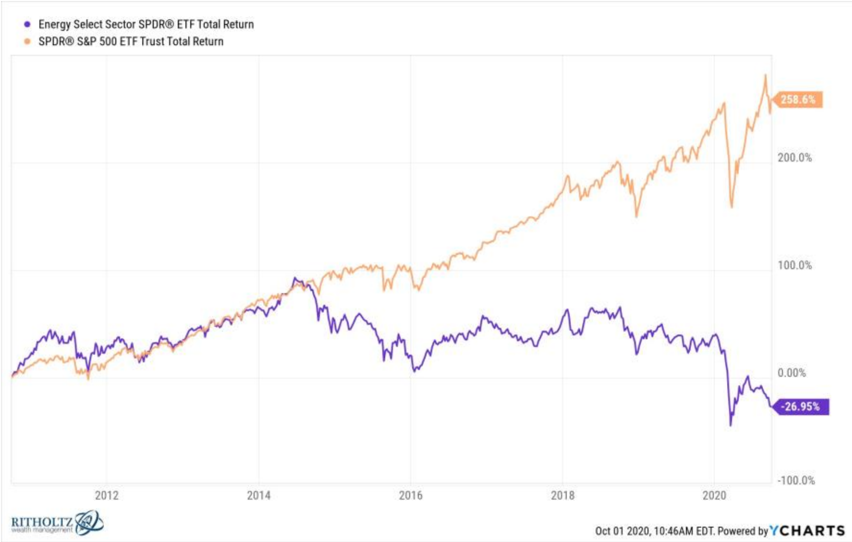

Valuations have obviously followed the fundamentals of both sectors. On the technology side, the ROE has broken away from the last 25 years' historical average (15%), rising to levels of 19/20% in the last 5 years and to 25% in 2020E. Are these returns sustainable? Can they improve? Well, who knows, but 1) the combination of sky-high valuations and sky-high returns is dangerous, with economics calling for a reversion to the mean. 2) High returns attract competition (and legal/regulatory scrutiny), increasing the risk of disappointments.

The opposite has happened with energy, where the ROE will possibly be negative in 2020, but we understand that this situation is not sustainable and will revert to the mean within the next 2-3 years (see the oil part).

Value is a winning strategy in the long term and should make up for lost ground

For most of the last decade V*alue* has massively underperformed *Growth* (see graph below). This is a long time for most investors and there is a growing feeling of despair (we see some surrender from value investors, managers, analysts, media, etc. questioning the validity of the strategy), but value and growth always converge in the very long term, which means that the value strategy is approaching a period of recovery.

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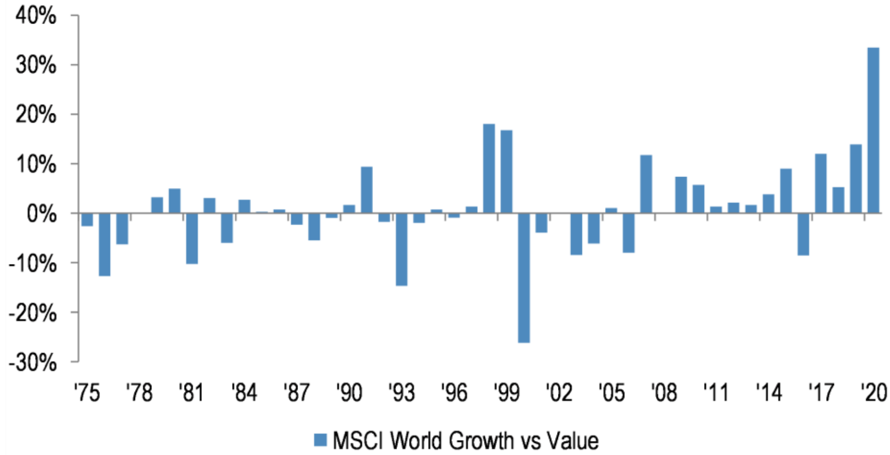

The Classic is a value fund and thus it is being negatively affected by this trend but as the economist Herbert Stein wrote, "*what cannot go on forever must end*". We are convinced that the next few years will be *value* years.

After the current crisis, the value strategy should catch up, given that the cyclical stocks start from low valuations/earnings and will outperform as soon as the economy stabilizes. Conversely, the FAAMGs, which are excellent companies on average, are going to have a very difficult time maintaining their super cycle, because they start with sky-high valuations, market shares, and growths … that cannot accelerate much more, while competition and regulation are on the lurk.

LTIF Natural Resources is up 50% from lows, but still extraordinarily cheap

The Natural Resources Fund has recovered by almost 50% from the March lows and is at a NAV of EUR 65-70 per share, still well below the EUR 100 per share level at the beginning of 2020. On our numbers, the fund has an intrinsic value of over EUR 150 per share, yielding a 23% IRR at current prices. Remember that our Intrinsic Values are calculated applying converged models (mid-cycle commodity prices, earnings and returns), meaning that the upside can be much higher if we move toward peak commodity prices, earnings and valuations.

At the end of September, the fund still holds 40% of the investment in energy/oil and another 40% in mines, with just 20% in agri-food and infrastructure. As already mentioned, we generally try to balance it a little more, with 1/3 in each sector, but given the current valuations, continuing with strong weights in energy and mines, especially energy, is more consistent.

During the third quarter, we made only marginal adjustments to the fund's investments. We sold some of **Prysmian** after a significant rise, using subscriptions to rebalance our energy exposure.

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Houston, stop looking at demand, we have a supply problem

While the economy/demand continues to normalize in 2020 and 2021, many commodities and basic products' supply issues are spreading. This will soon become a structural problem due to a decade of underinvestment.

Let us for a second return to March-April 2020, when it was estimated that the demand shock generated by the Covid19 crisis would reduce the world's oil consumption by 25-30%. Now, a few months later, we see that the impact was closer to 10% and consumption is currently around 95-96 million barrels per day (from a record consumption of 101 million b/d at the end of 2019, pre-Covid19).

This has undoubtedly been the biggest demand shock in history (and a good indicator of the world GDP, given that oil consumption is closely correlated with transport and thus economic activity), but supply has adjusted rapidly. The oversupply situation generated in Q2 has normalized (the steep contango is over), and oil storage is no longer a good business, which the return of supertankers to the transport market indicates.

Frontline is the world's largest crude oil transporter and therefore has a good understanding of the actual development in terms of storage/transport. According to its estimates, oil production is currently c.91 million b/d, leading to a daily drop of approximately 4/5 million bbl. in the world inventory compared to an estimated excess inventory of 400-500 million barrels. Inventories are declining rapidly and will have normalized within two-three quarters. Saudi Arabia, Iran and Russia have some spare capacity, but otherwise the supply picture is bleak.

Conventional production will soon reach 10 years of underinvestment, leading to lower reserves and increased declines. At SIA, we closely followed the American shale miracle, which has never produced positive cash flows or returns, and is now collapsing. There is no capital available and companies are now forced to live within cash flows. The most efficient companies, like EOG and Pioneer, as well as the major ones, like Chevron and Exxon, will survive, but they only represent a small part of shale production. About half of these shale companies are private ones.

Many analysts expect a stable supply of oil from the US, but given the lack of capital and drilling, it is difficult to see how this will happen. The rig count has collapsed from 800 rigs in 2016 to less than 200. This business has a short cycle, with production following the rig count by a few months. It should not be forgotten that shale production registered a record 9 million b/d (9% of the world supply!) more or less the same volume that Saudi Arabia exported in 2018, although Saudi Arabia's exports had already fallen to 8.3 million b/d by 2019.

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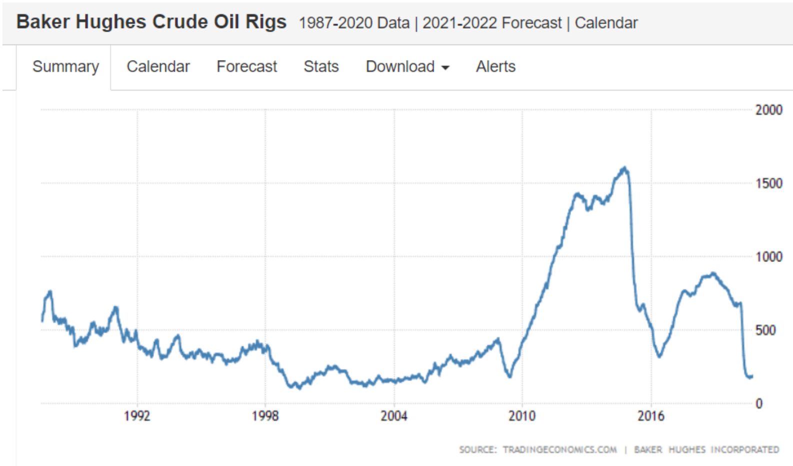

Actual	Previous	Highest	Lowest	Dates	Unit	Frequency
189.00	183.00	1609.00	98.00	1987 - 2020		Weekly

On the oil side, we are quite comfortable, because the market has gone into an undersupply balance after OPEC+ cuts, shale collapse, and marginal well closures caused by low oil prices. Thanks to OPEC+, prices have quickly recovered to marginal cash cost levels (around $40 Brent on our numbers) and the production deficit will gradually consume the inventories that skyrocketed in April 2020.

Generally, and based on our experience, in a context of deficits but high inventories, oil prices gradually recover their upward trend until inventories normalize (Q221 in our model). Thereafter, incentive prices appear on the horizon, as an increase in production will be needed. According to our scenario, we should end 2020 at around $50 per barrel Brent (again thanks to OPEC+) and by 2021 approach the incentive levels, which, in our models, are above $60 Brent for the first responders, shale.

What is the medium-term scenario? We believe that shale is not profitable below $60 and shale production will fall between 3-4m b/d if prices do not rise. OPEC+, which has much lower costs, will replace those 3-4m plus 1.5-2m b/d marginals globally. This scenario foresees OPEC slowly increasing production in 2020 and 2021 in order to reduce inventories and maintain prices within the $60-75 targeted range.

The oil situation may be the most extreme but does not differ much from many other commodities. Given a decade of under-investment, depletion of resources, falling grades, etc., production has begun to struggle, **and we believe that Covid19 is going to be the trigger for a problem that would have materialized anyway.**

Nor can we lose sight of 3 billion people in Asia

As China moves toward its first centennial goal of building a moderately prosperous society by the end of 2020, the forthcoming 14th Five-Year Plan (2021-2025) will attract national and international attention, because it represents a paradigm shift.

Against the backdrop of increasingly complicated links between China and the United States, as well as an external environment characterized by growing protectionism combined with a global economic recession, China has given clear signs that it will put more emphasis on policies that will continue to underpin its economy, as well as on its mass consumer market to cope with rapidly evolving external risks.

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China will stimulate increased consumption, local investment, the Silk Road (along which some 5 billion people live), reduced savings rates, etc. Currently, China only consumes about one third of its resources per capita when compared to the Western world.

India, which will soon have a larger population than China, is currently a fraction of China in terms of GDP per capita. The BRICS countries' strategic shift from a purely export economy to a more balanced economy will have profound repercussions: increasing their domestic consumption of resources, goods, and services. However, they need to adjust their trade balances, reduce foreign exchange reserves, the latter's composition, and their exchange rates. China expects disruptions in trade flows with the West; consequently, its next five-year plan will require an increase in its state reserves of crude oil, strategic metals, and agricultural products. According to the officials involved in drawing up the next Five-Year Plan, Beijing is prepared to pay attention to the lessons learned from the coronavirus crisis and from the deterioration of its relations with the United States and its allies.

Discussions and developments relating to de-dollarization and the internationalization of the yuan, which call for a new reserve currency will intensify and have far-reaching consequences for all the parties involved (the BRICS trade surplus enabled the US to meet its deficits).

Uncertainty is the friend of the buyer of Long-Term Values

Let me end the September Newsletter by turning to Buffett again to remind us that best investment opportunities arise in periods of high uncertainty, when the stock market (or at least part of it) falls. The Classic is fully invested to take advantage of the normalization that will arrive in 2021.

Notwithstanding this, many investors and financial professionals will once again be captivated by the effluvium of recent outperformance and very possibly capital will continue to flow into Indices, ETFs and to the best funds of recent months (technology, healthcare, staples, SPX...) without remembering that strong revaluations are often followed by downward adjustments and underperformance is usually followed by an interesting upward move.

SIA News: Conference call on 12th November 2020

We are pleased to invite you to our next conference call on 12th November 2020 at 10:00 am. The purpose of this call is to inform you on the development of our funds since the beginning of the year. Details will follow.

Marcos Hernández
J. Carlos Jarillo
Urs Marti
SIA Team
October 26th, 2020

SIA Funds AG Alpenblickstrasse 25 8853 Lachen Switzerland
tel : +41 55 617 28 70 fax : +41 55 617 28 71 info@s-i-a.ch www.s-i-a.ch

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SIA Funds AG Alpenblickstrasse 25 8853 Lachen Switzerland
tel : +41 55 617 28 70 fax : +41 55 617 28 71 info@s-i-a.ch www.s-i-a.ch