Long-Term Investment Fund

Newsletter October 2005

LTIF

Strategic Investors Advisors, SA advises a series of funds, among which the Long-Term Investment Fund and the Global Energy Value Fund. All details regarding our investment philosophy, past returns, and investment restrictions are found on our web site, www.s-i-a.ch.

This newsletter is intended as a comment on the development of those funds and is by no means intended to be an offer to invest in them. Please, read the Legal Notice at the end of the newsletter.

For any inquiries, please write to info@s-i-a.ch

Portfolio results

LTIF Classic's NAV per share is up 43.63% since January 1st, 21.84% for the third quarter.

LTIF Alpha's NAV per share is 24.54% since February 1st, 14.89% for the third quarter.

The Global Energy Value Fund's NAV per share is up 31.58% since March 1st, 23.10% for the quarter.

This third quarter has seen a strong rise in the liquidation value of our portfolios, probably due to a real increase in our companies' profitability. This means that, although the price of the shares is up, the fund is not really more expensive than before: the rise in the share prices just reflects the rise in the underlying profits.

All in all, the NAV of LTIF-Classic is up 21.84% for the quarter, 43.63% since the beginning of the year. For the Alpha series, the numbers are 14.89% and 24.54%. The Global Energy Value Fund's Net Asset Value per share is up 23.10% for the quarter and 31.58% since inception (in March 05). The figures below show this in graphic form.

Figure 1:
LTIF-Classic liquidation value per share, compared to the MSCI World Index

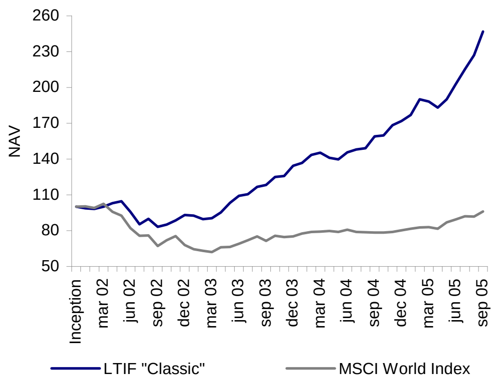
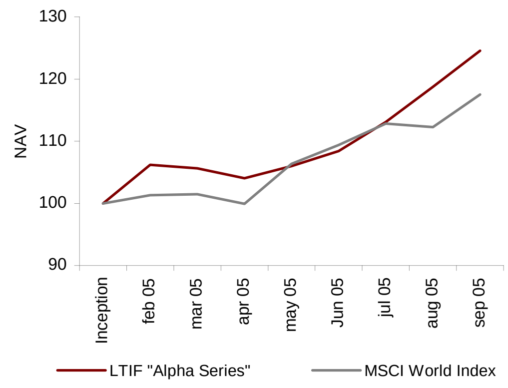


Figure 2:
LTIF-Alpha liquidation value per share, compared to the MSCI World Index



LTIF Directory

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LTIF – Classic *Telekurs*: 1341036 *Bloomberg*: LONGTRM VI	***LTIF – Alpha*** *Telekurs*: 2048550 *Bloomberg*: LONGTRB VI	***LTIF – Stability*** *Telekurs*: 2207914 *Bloomberg*: LONGTRc VI	***GEVF*** *Telekurs*: 2053248 *Bloomberg*: GLOBENV VI	

Figure 3:
Performance comparison:
LTIF "Classic" - LTIF "Alpha Series"

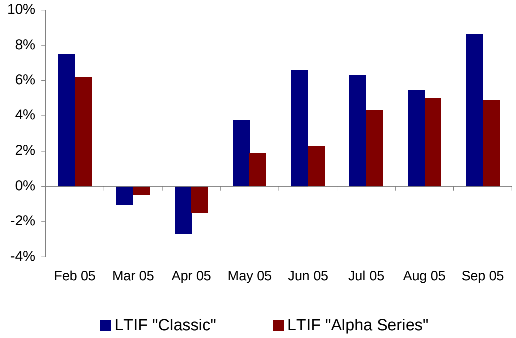
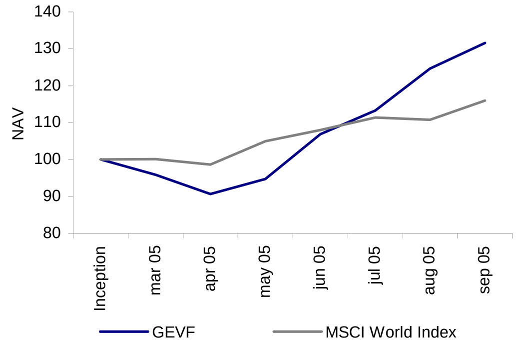


Figure 4:
GEVF liquidation value per share, compared to the MSCI World Index



Information on our investments

Since the Fund's inception, we have been extremely open regarding our investments, listing the whole portfolio on our website and keep readers informed of the companies that we buy and sell in every quarterly newsletter.

We believe this was the right thing to do. After all, we always insist that investors should not regard our funds (or any fund) as a "black box" whose price rises and falls. Rather, they should consider the Fund for what it really is: a collection of companies, whose underlying profitability is the only important issue in the long term, regardless of what the share prices do. Subsequently, it is only logical that the investor should be provided with the actual list of investments.

We have not changed our point of view. However, both the size and the following of the fund have changed: it is now much larger (€150 million is not a very large fund, but it's 30 times larger than its initial size). Moreover, its "performance" (the appreciation of its shares) is becoming more visible: in almost any automatic search for generalist funds with good three-year records (a typical metric of the fund "industry"), LTIF comes up at the very top.

One unintended consequence of all this is the arrival of "free riders": people who are not investors in the fund (or invest only a small amount of money) and simply copy our trades, either for themselves or - believe it or not - to set up similar funds.

That would not bother us too much, except for a crucial problem: that free ride may increase the price of shares that we want to continue buying, and could thus hurt our investors. Contrary to most people, we prefer our shares to go down rather than up, for we intend to continue buying them.

As a result, we've decided to be a bit less open and protect our investors' money better. From now on, we'll only show the main positions and will keep our investors informed of the companies we have sold, not necessarily the ones we have bought as, by definition, the ones sold no longer interest us… except if they go down in price, in which case we may buy them again.

Of course, our investors are more than welcome to discuss the whole portfolio directly with us. We will be happy to oblige whenever they would like us to do so.

Main holdings

Valero Energy Corporation	5.50%
Grupo Mexico SA de CV	5.39%
LEM Holding SA	4.03%
Nexen Inc.	3.91%
Posco	3.71%
Interseroh AG	3.67%
Honam Petrochemical	3.41%
McCarthy & Stone PLC	3.39%

During this quarter, we have sold Neste Oil, Red Eléctrica de España, and Samsung Electronics. In all three cases, they are excellent companies, but we believe they are “fully priced”, i.e., it’s unlikely that they will give us the annual 15% return we seek, starting with the current prices. We had gains of more than 50% in all three cases, which is particularly remarkable in the case of Neste, for we held it for barely four months.

Portfolio composition

Figure 5:
Geographic breakdown

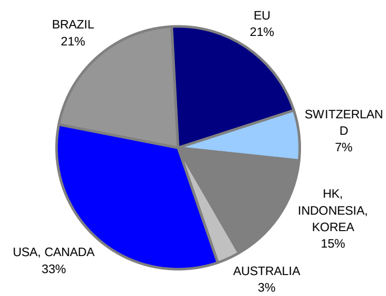
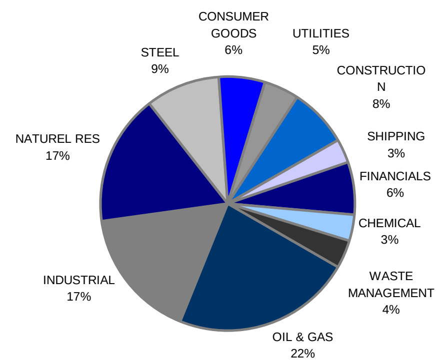


Figure 6:
Industry breakdown



SIA news

We have now finished setting up a new website, www.s-i-a.ch. It has better information and includes the Global Energy Value Fund. It should be “on-line” in a couple of weeks. Try it any time: if it’s not up you’ll be redirected to the old www.ltif.com

In August, we launched the Long-Term Investment Fund, C-Class, "Stability". At the end of this newsletter, you'll find the next that we wrote at the time. The fund started operations on September 1st, and had achieved an appreciation of 1.1% at the end of the month.

J'ai peur

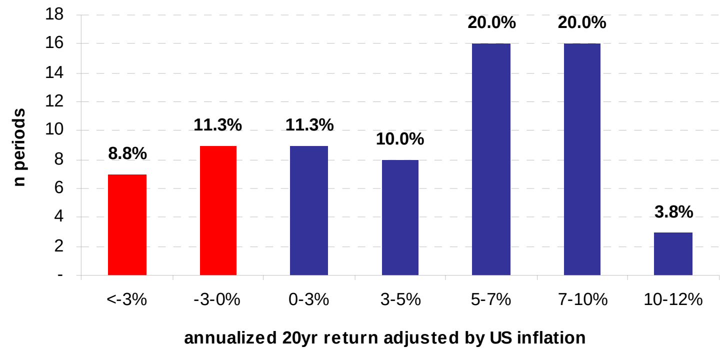
With these words, a friend and successful professional investor headed a recent message to us. He's probably not the only one: many serious observers of the markets are worrying more and more about the serious economic imbalances, unsustainable trade and fiscal policies... and ever-rising share prices. Isn't this bound to end badly? Isn't the proper thing to do to "take some money off the table", reduce one's investment in stocks, and move on to safer assets – whatever those may be? This is an extremely important question, especially in these times with experts in "asset allocation"– supported by lots of statistics – asserting that the important thing is to get the mix of stocks and bonds (the allocation) right, more than the choice of stocks themselves. If the fears of our friend as well as those of many other people are well founded, this might be a time to hold fewer (if any) stocks.

As the managers of some funds largely invested in stocks, we obviously have our views on this. These views do not amount to the widespread mantra of "buy and hold", meaning that, in the long-term, stocks are always a good investment. That is simply not true if "long-term" is rationally defined. Granted, over a period of 100 years, stocks beat bonds in all markets (see figure 7, below).

But we doubt that most investors have a 100-year investing horizon. If we move to investment horizons more akin to a normal human life span, say twenty years, which is the time many people have to accumulate wealth before they start needing it, the results are not so unequivocally positive for stocks. As figure 5 shows, many 20-year periods are not very rewarding for investors: in a fifth of the periods, the investor has *lost* money after twenty years. The fact that on average the periods are rewarding is scant comfort to those investing in the numerous bad ones. Unfortunately, the saying is true: you only live once. Life savings are not something to put on the line merely based on averages when there is a great chance that, in your particular case, it may not work out. Russian roulette is not a sensible game to play, even if you have 5 out of 6 chances of winning.

As you can see, in 20% of the cases, the investor made no money or, in real terms, actually lost money after twenty years of investment in the stock index. And, please note, the figures below don't take taxes and expenses into account.

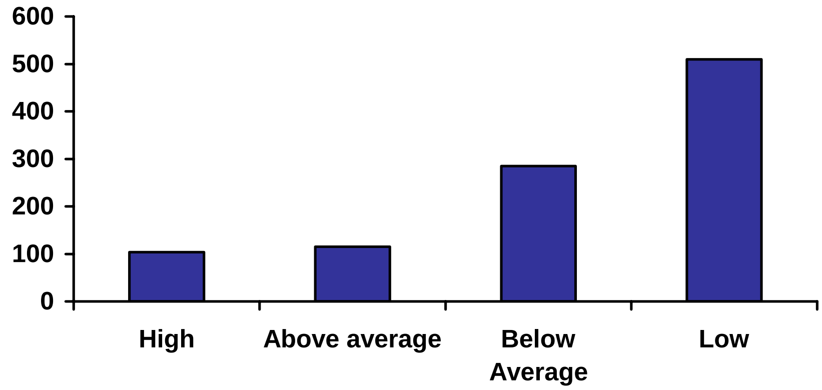
Figure 5:
Real annualized returns of all past 20-year periods, starting in 1902



Source: Datastream, U.S. Bureau of Labor Statistics, SIA Research.

There is a positive point, however. Some solid statistics help us anticipate whether "our" twenty years are going to be good or bad. Figure 6 shows the results achieved by the market over twenty consecutive years based on how expensive (or cheap) the stocks were at the beginning of the period. In plain English: once the market is expensive, the chances are very high that its returns over the following years will be very disappointing (and vice versa).

Figure 6:
Twenty-year average total real return by P/E ratio quartile when purchased, 1902-2001 (high=expensive market; low=inexpensive).



Source: Yes, you can time the market, B. Stein & P. DeMuth, Wiley 203

The good news, then, is that it is possible for us to have an idea of the market's returns over the next few years. The very bad news is that the market is expensive at present – hence our friend's fears. Should we then sell our stocks and take a more conservative position by sticking to cash, bonds or commodities? It depends, of course, on what "our stocks" are.

Practitioners of the "asset allocation" approach (most investment professionals) recommend this on the basis that all stocks are expected to, a priori, behave more or less the same, so they tend to invest in indices. This is consistent with current financial theory: the market is an efficient pricing machine, and all stocks are priced according to their future prospects. Since all the available considerations are already reflected in the price, nobody can predict whether the stock will go up or down, and it will simply move with the market (on average over time, of course). The price of a stock and its value are one and the same thing as far as anyone can tell. People have earned Nobel Prizes for explaining this, although in rather more detail.

Well, we do not believe this: we run a stock-picking fund – and are honest. We believe that the market occasionally mis-prices stocks in ways that we can, at least sometimes, discern. We therefore think that we can find stocks whose true value is higher than their current price. If we buy them, and we are right, we'll make money: either the market will finally start thinking like we do (and increase the price to a value at which we can sell), or we'll just collect dividends that grow at an above-average rate for ever. And this is exactly what we have been doing for the last four years[1]. As Figure 6 above showed, the systematic purchasing of cheap stocks consistently beats the market average.

So, where does this take us in the present circumstances? How much good will our stock-picking ability (assuming it continues!) do us if the market is likely to perform badly? Shouldn't we just sell, raise cash, play safe, and wait for better times? We believe not, and this is why:

If a given stock-picking strategy – in our case, embodied in an investment fund – does better than the market on average, it can make money, even if the market goes down. As we have explained in other newsletters, this can be measured quite rigorously. We can take a time-series of the fund and market's valuations and, through statistical techniques, determine how much of the fund's performance is due to "itself" (its investment strategy) and how much is just due to the market pushing everything up and down. The first magnitude is called "alpha", i.e. what the fund would do if the market did zero, and the second is called "beta", i.e. the percentage of the market movement that affects the fund. Thus a fund with an alpha of 20 and a beta of .5, will increase by 25% per year when the market increases by 10%; it will increase by 15% per year when the market decreases by 10%; and it will decrease by 5% per year when the market decreases by 50%, as Table 1 shows.

Table 1:
Average annual returns for a fund with alpha=20 and beta=0.5

Market	"Own performance"	"Market-influence"	Total return
10%	20%	5%	25%
-10%	20%	-5%	15%
-50%	20%	-25%	-5%

[1] Those Nobel Prize winners weren't, of course, talking nonsense. We believe that the market is not completely efficient, and that's why we can create some value for our investors, but it's not that far from efficiency. We don't think we could currently invest €20 billion with the same success that we enjoyed in the past. There *are* some inefficiencies, but they're probably neither enormous (they tend to be relatively small) nor very long lasting.

(“Own performance” is the fund’s alpha, and “Market influence” is what the market does, multiplied by the fund’s beta).

By definition, market indices have an alpha of 0 and a beta of 1: the index either goes up or down exactly as the index goes. If investing in stocks means investing in the index, investors should be very interested in what the index is going to do within the next years – and probably nervous at present. But if investing in stocks means buying those of good, inexpensive companies included in a well-diversified portfolio that has positive alpha, then, for two reasons, the behavior of the index is much less important:

First, as we have seen, the positive alpha and low beta of such a portfolio can compensate for a market drop, as the second column in Table 1 shows. But even more interestingly, if the investor is seriously worried about what the market is going to do, he or she can simply “hedge away” that risk by betting against the market in the fund’s beta part. This will make the beta equal to zero and, hence, the fund immune to whatever the market does. Over years, its return will approximate its alpha, whether the market has been going up or down.

This is exactly the approach we have taken with the Alpha Series of LTIF. If our chosen stocks continue to do better than the index, the fund will go up, no matter what, because we are insured against market drops (insurance that costs us when the market goes up, as it has done so far this year). It’s interesting, by the way, to note that more money is flowing into the Alpha Series than the Classic Series, in spite of this year’s “relative underperformance”, and that every month some investors switch from Classic to Alpha. This tells us that the preceding argument is well understood by many of our investors… and that they are also nervous about the market’s future evolution.

This takes us to a final, we believe extremely important, point: the difference between investment and speculation. In our opinion, investing is buying something because we have very good reasons to believe that it is intrinsically undervalued or, in other terms, it’s going to give us very good returns in future. Speculating is buying something and hoping that, for some reason, it will go up. In a way, buying indices is speculating. Buying well-researched stocks, based on an understanding of the business, the dynamics of supply and demand, the company’s strategic positioning, etc. is investing. Even after the unavoidable mistakes that trying to look into the future entails, we believe it’s a very good way to build one’s savings over any twenty-year period, regardless of external circumstances. Of course, good speculation, i.e., knowing ex-ante which “asset class” is going to be the best performer in the next year, can be much more profitable. Unfortunately, we have not found a way good enough to do it to convince us to risk our money.

It is, however, worth investing if one knows how to do it. Today’s short-term interest rates are barely above 2%. Putting one’s assets into that kind of investment is certainly much better than losing them, but much worse than putting them in an investment with an alpha clearly above that. Over the years, the magic of compound interest will make an enormous difference to well-invested capital.

Introducing the Long-Term Investment Fund Stability Series

Most investors in LTIF, both in its Classic and Alpha classes, have so far roughly obtained the expected results: a good capital appreciation not based on short-term market movements but on a careful selection of profitable, reasonably-priced companies spread over many different industries worldwide.

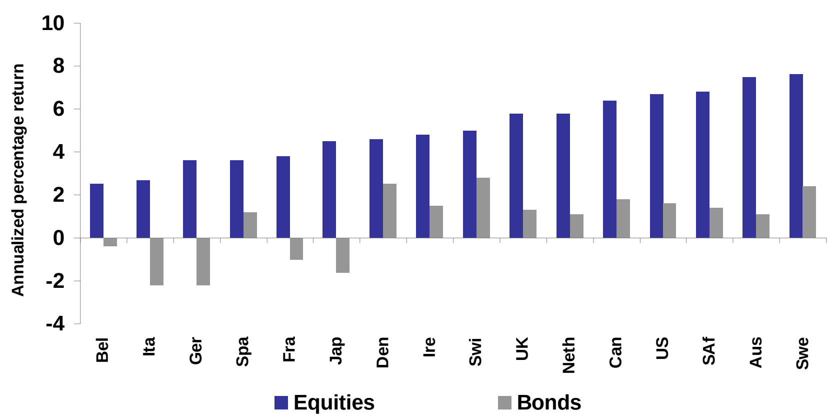
But, as we will explain in detail below, these investments always have a volatility component because the results vary from month to month, sometimes significantly, which many investors want to avoid. In fact, most investors keep a large part of their portfolios in non-equity products such as bonds, hedge funds or structured products that are supposed to offer steadier results, although they are less profitable than equities over the long term. It is for these investors (or, rather, for that part of their portfolios) that we introduce a new fund.

The new variation on the LTIF has the same underlying investment philosophy, but very different intended results: the Stability Series will target an annual return of 8-10%, with a low level of volatility (below 3%).

It is well known that an investment in equities tends to be more profitable over long periods of time than one in any other financial instrument, as figure 7 shows.

The Stability Series will aim at an 8-10% annual return with very low volatility

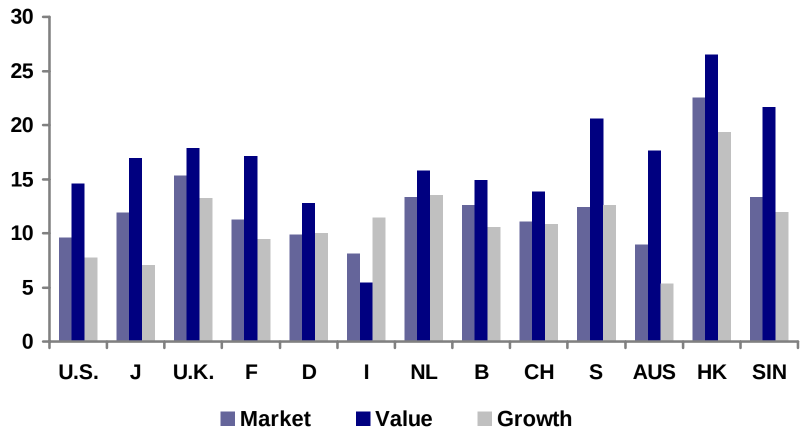
Figure 7:
Real (post-inflation) annualized returns, 1900-2000



Source: E. Dimson, P. Marsh, & M. Staunton, Triumph of the Optimists, 2002

It has also been well established that an investment strategy of buying low-priced equities tends to beat market averages over the long term, as figure 8 shows.

Figure 8:
Annual Returns (Measured in US Dollars) in Excess of US T-Bill Rate for Value and Growth Portfolios (top and bottom 30%) by Country, 1975-1995 (all data in percentages)



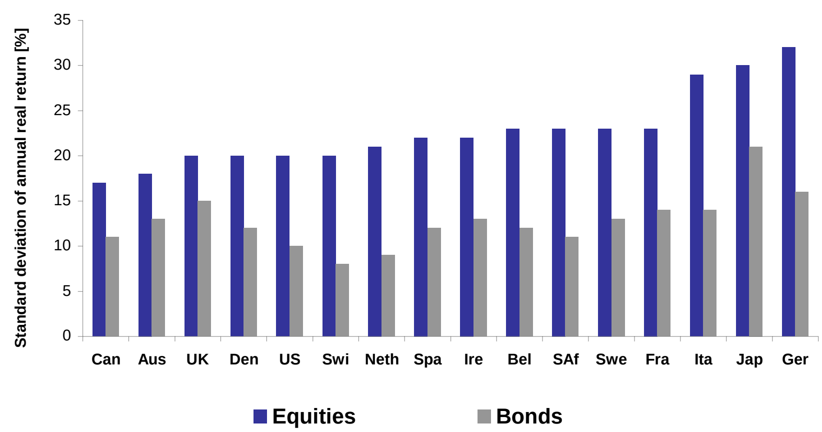
Source: E. Fama and K. French, "Value vs Growth, the international evidence", Journal of Finance, 1998

Historically, equity value investment has been the best strategy available, but it is subject to volatility

It seems, then, that an investment strategy based on a long-term, value approach would be the optimum – precisely the strategy followed by the LTIF.

However, this strategy is subject to an unavoidable volatility: the companies in the portfolio's share prices fluctuate for reasons both intrinsic to each share and general to the market. Although long-term investors know that the share price on a given day (or month) is irrelevant, and that what matters is the company's underlying performance, the truth is that few people like to see their investments "down", particularly if the drop is significant.

Figure 9:
Annualized volatility of stocks and bonds in different countries



Source: E. Dimson, P. Marsh, & M. Staunton, *Triumph of the Optimists,* 2002

Fortunately, a well diversified fund is much less volatile than its component shares: in a given month, the “abnormal” rises and drops cancel each other, with the result that the fund’s overall price is much less volatile than the prices of the underlying shares. But there is volatility, nonetheless. This volatility has been around 11% per year for the LTIF: this means that usually the Fund’s returns move approximately 3% per month around its “average” (which has been around 1.5% per month in the past). But from time to time those changes will be 2 or 3 times that percentage, or even more.

Volatility is generated by general market fluctuations and the ups and downs of each share

This volatility comes from two sources. The first is the market itself: when the entire stock exchange goes up or down, all shares are immediately affected, whether they are on a long-term up-trend or down-trend. The degree to which this market “noise” affects a fund (or a share) is known as beta. A high-beta share (or fund) goes up a lot just because the market goes up, and vice-versa. A low-beta share (or fund) is much less affected by such movements.

The second source is the volatility of the alpha. The “alpha” of a fund is the amount by which it does better (or worse) than the market, regardless of what the market does, i.e., once the “beta” is subtracted. To illustrate, an index fund would have a beta of 1 and an alpha of 0. Most successful funds have alphas below 5%. On average, all funds have slightly negative alphas: the totality of funds cannot do better than the market, and funds have expenses that indices, purely statistical constructs, don’t.

The Alpha Series cancels the first source of volatility, but it can eliminate the second

To eliminate the first source of volatility, we launched the Alpha Series. In this instance, we make a systematic bet against the index so that it does not affect the portfolio. This investment’s alpha (very high so far, around 25%) should then be unaffected by whatever the market does on an annual basis. Of course, if the markets go up (as they have in the last months), the Alpha Series will do worse than the Classic Series, but it will make money, nonetheless. When the markets go down, it will make more money than the Classic.

But this still leaves the second source of volatility: that of the alpha itself. To have an alpha of 25% per year is not the same as having an alpha of 2% *every* month. The annual figure is an average. Thus in February this year, the Alpha Series went up by 6.18%, much more than it “should”, and in April it went down by 1.5%, in spite of its bet against the market – that also went down by 1.5% – being profitable. Obviously, the Classic Series dropped more than the Alpha that month.

The Stability Series will try to minimize all volatility

Now, no long-term investor should be in the least concerned by this relatively small volatility as the investment is well protected against a sharp drop in the markets. But there are investors who don’t want to expose themselves to that kind of incertitude in respect of part of or their entire portfolio. They may expect to need the money in the medium term, for instance, and don’t want to have to sell at a low point; or they may want a part of their portfolio to be more stable in order to stabilize the whole investment. For these investors, we have developed the Stability Series.

Essentially, the Stability Series portfolio will be divided into three parts. The first will invest in the Alpha Series. The second will go to a diversified group of shares of companies that pay high dividends and show low volatility, such as utilities and other companies with relatively stable profits. We may even protect those investments with special hedges to decrease volatility further. The third will be placed in high-quality, fairly safe bonds.

The first third has had a long-term return of above 20%; the second should be above 5%; and the third will not give much more than 2% at interest rates' present levels.

We have run a back-test over three and a half years of those shares and bonds for which we have LTIF data to ascertain what the results of such a portfolio would have been. The following are the resultant graph and table.

The back-test shows a very stable appreciation over time

Figure 10:
Performance of LITF Classic, Alpha, Stability, and MSCI World Index

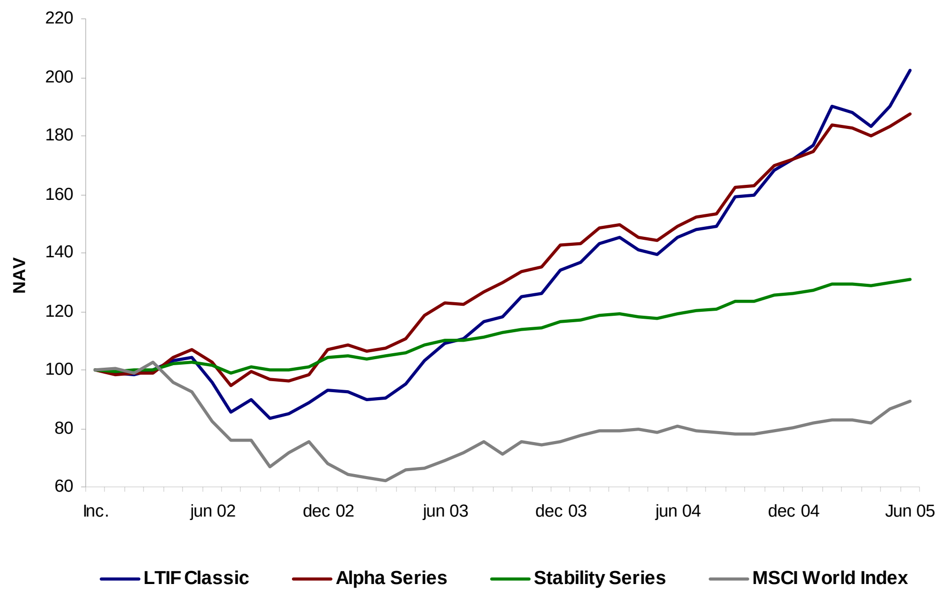


Table 2:
Basic statistics

	LTIF Classic	Alpha Series	Stability Series	MSCI (euro)
Ann. Performance	21.39%	18.64%	7.84%	-1.97%
Standard deviation	10.84%	8.13%	2.84%	11.54%
Sharpe ratio	1.90	2.13	1.80	-0.43
Max. monthly loss	10.90%	7.80%	2.63%	11.70%
Max, drawdown	18.3%	11.3%	3.8%	39.4%
Beta	0.555	0.139	0.048	-
Perf. 2002	-7.44%	7.16%	4.07%	-32.02%
Perf. 2003	44.25%	33.06%	12.13%	10.74%
Perf. 2004	27.95%	20.44%	8.24%	6.46%

These figures are historical, audited figures for LTIF Classic, pro forma figures for Alpha up to February 2005, and historical ones thereafter.

A qualification: this back-test was done by taking one-third of the LTIF Alpha results (pro forma up to February 2005) and two-thirds in bonds that would yield 2% per annum with zero volatility. In reality, we'll only invest one-third in bonds, and they pay a bit more than 2%. The other third will be invested in low-volatility, high dividend shares. Thus the real results should show somewhat more performance, perhaps 1% to 1.5% per annum more, and somewhat more volatility, perhaps around 1% per annum more.

As can be seen, annual results vary between 4.07% and 12.13%. The worst monthly loss is 2.63%, and the worst accumulated loss is 3.82%. Overall volatility is 2.84%, compared with 10.84% for LTIF Classic, 8.13% for LTIF Alpha, and 11.54% for the index.

A back-test is, of course, no assurance of future returns. But if it is consistent – there are no wild variations from month to month – it gives a strong indication of what can be expected. If the Alpha part of the Fund continues generating good returns (this is always the key "if"), i.e., if we continue to choose our investments well, the performance is relatively assured, because the market volatility is covered, and the second and third parts of the portfolio are intrinsically stable.

Overall, the Stability Series could be a useful addition to a portfolio that seeks an element of very low volatility that still rewards the investor with some meaningful results.

We believe that this fund can be a useful investment vehicle for those parts of portfolios currently invested in very low-yielding bonds or in funds of hedge funds. In addition to a satisfying annual return with relatively low volatility, the investor will always know what he is investing in, something that cannot always be said of some complex investment styles. The Stability Series will just be a collection of good companies, a hedge against market vagaries, and some solid bonds. Even a temporary drop in its monthly value, which should always be small, should not be too much cause for concern. In our opinion, this compares favorably with investments that pursue similar levels of profitability and low volatility, but are based on hard to comprehend quantitative strategies. When those go down, the investor is left with a strong sense of having "lost" his money forever.

The Fund is now open for subscriptions. Its basic characteristics are:

- Incorporated in the British Virgin Islands
- Listed on the Irish Stock Exchange
- Fund manager: Van Daalen International Ltd.
- Size limit: €500.000.000
- Administrator: TMF, Rotterdam; Auditor: Ernst & Young
- Depositary: Pictet et Cie, Geneva
- 0.25% management fee, 20% performance fee, high water mark
- Minimum investment: €100.000
- Monthly redemption, subscription, and reporting
- Telekurs number 2207914
- Sole advisor: Strategic Investment Advisors, S.A.

Legal Notice

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