SIA
Strategic Investment Advisors Group

Long Term Investment Fund

Newsletter

of March 2020

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

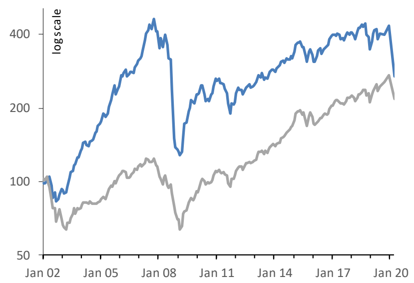


Figure 2: **LTIF Stability A Cap EUR**
vs. HFRX Global Hedge Fund Index EUR

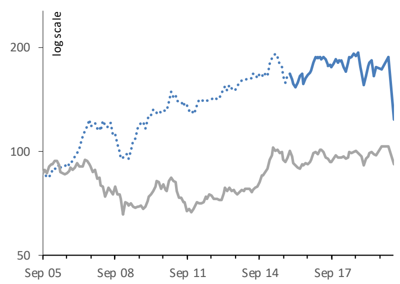


Figure 3: **LTIF Natural Resources EUR**
vs. S&P Global Nat. Res. Net TR Index EUR

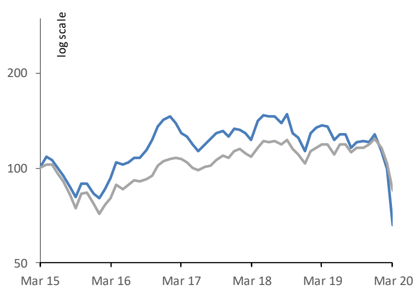
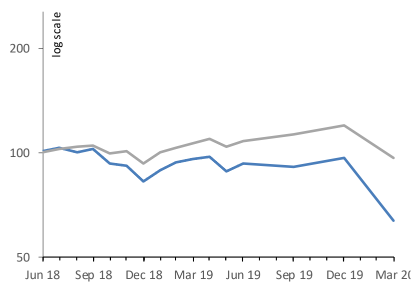


Figure 4: **LTIF SRI EUR**
vs. MSCI Daily T R Net World Index EUR



"A stock is not just a ticker symbol or an electronic blip; it is an ownership interest in an actual business, with an underlying value that does not depend on its share price."

Benjamin Graham

Overview of our funds

The LTIF Classic fell by 37% in Q120, although we have recovered 4pp in April

At the end of Q1, the Classic was down 37% YTD from the EUR 434 level at the end of 2019 to EUR 270 per share. The fund has somewhat underperformed the main indices (MSCI World, SPX etc. ... down around 20-25% by the end of March), but is very much in line with the stock market declines on some European markets and emerging markets, as well as, broadly speaking, with the large falls seen in small to mid caps, cyclical companies, energy, mining, and value. In April, the NAV recovered some lost ground, surpassing EUR 282 per share (+4%), although the current volatility is so high that short-term changes have become meaningless.

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

March 31, 2020	NAV	Δ 3m	Δ 12m	Annualized return (s.i.)	AUM *(in mio)*
LTIF Classic [EUR]	269.02	-38.0%	-35.4%	5.6%	70
LTIF SRI (EUR)	63.59	-34.3%	-33.6%	-22.6%	4
LTIF Natural Resources [EUR]	54.49	-48.4%	-52.1%	-3.9%	12
LTIF Stability A Cap [EUR]	124.26	-33.7%	-31.6%	1.5%	5

Source: SIA Group

Although the Classic is a very solid portfolio, strongly diversified by business, geography, and risk categories, our investments have a large exposure to value (our investment philosophy), cycle (30% ex-mines and oil), mines (10%), and oil (10%). This exposure, which follows opportunities, has had a strong impact on the Classic YTD's decline, but we understand that nothing has changed structurally and we should recover everything within 12-18 months, if not sooner.

Within this market correction, the Classic shares that have fallen more than 25% are: Metso, Prysmian, GriegSeafood, Sodexo, ISS, ING, HeidelbergCement, Wienerberger, United Technologies, as well

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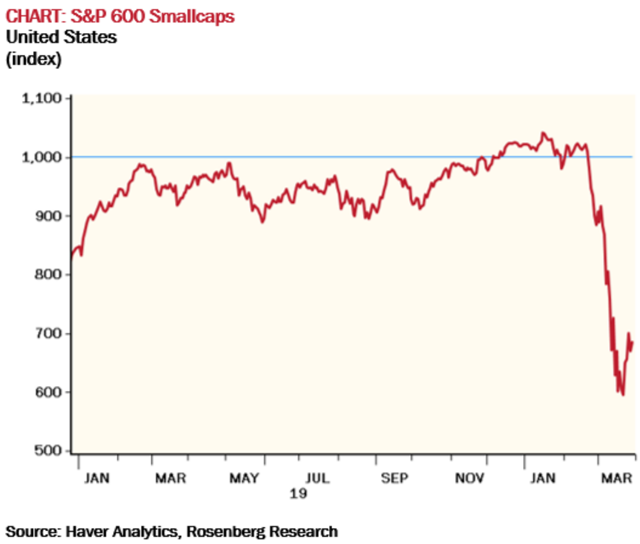
as all the oil companies (PremierOil, Suncor, Cenovus, CaliforniaResources) and mining companies (Antofagasta, KAZ Minerals, FirstQuantum, and Hudbay).

The companies that have fallen by less than 25% are Thales, Nestle, ReckittBeckinser, Unilever, Viscofan, Devro, Coke, LeroySeafood, Pandora, Grifols, Medtronic, ASML, Apple, AirLiquide, NorthernDynasty and Visa. As always at times of economic uncertainty, risk categories 1-2 (low risk) have performed much better than cyclical companies (cat3) and commodities (cat3-4).

Ultimately, it is really simple: everything cyclical, value, and small cap has underperformed large cap, growth, compounders, defensive, etc. as the short-term manual sets. In our case, the oil sector alone has made a negative contribution of almost -8 points in the first quarter, following the drop in oil prices due to the expected decline in demand and the "pump at will" decision taken by OPEC+ in early March.



Real impact on the Classic in 2020 and 2021

We carried out a stress test of our companies' profits this year, and although it is still too early to make robust estimates, the impact on earnings would, in summary, be as follows.

- **Marginal/low impact:** Grifols, Medtronic, ASML, Leroy Seafood, Grieg Seafood, Devro, Reckitt Beckinser, Unilever, Viscofan, Coke, Thales, Northern Dynasty, AirLiquide, and Nestlé, which jointly account for 50% of the Classic.
- **Medium impact:** ISS, HeidelbergCement, ING, Metso, Sodexo, Wienerberger, VISA, Apple, Prysmian, Henkel, United Technologies, and Pandora. These companies account for 35% of the Classic.
- **Large impact:** energy (oil) and mines will have close to break-even results and, in some cases, losses in 2020.

This is not so bad either. This is what happens to business, and a bad year doesn't make the value of franchises fall at all.

Much more important than making precise calculations of 2020’s impact is to look at 2021-22, years in which we believe all our companies will be back to normal, including the mining and oil companies.

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We also carried out a liquidity and solvency stress test. The Classic has no risk
We carried out a stress test of our Classic companies to check their financial risk in the face of the recession, and the results confirm that we have not deviated from our rule of not having companies with large indebtedness. Of our 35 companies, only California Resources, which after falling 80%+ is currently 1% of the Classic, faces a financial risk if oil prices remain below $30 throughout 2020, which we do not believe will happen.

There will always be unpredictable recessions and crises, and we have to live with them. In order to avoid permanent losses, it is key not to have companies with high levels of debt, as these may "sink" in a crisis. We need to focus on the medium and long term.

The Classic looks just fine: 99% of our companies have no or very limited financial risk, including the rest of the oil and mining companies, which may obviously suffer a lot during economic crises. This means that within a relatively short period (12-18 months in our base scenario), our companies will have survived the crisis and returned to normal.

IRR over 25% and significant potential in the medium/long term
We still believe that we will recover the Q120 loss relatively quickly, although this will depend on the pandemic's evolution and the implementation of the various governments' aid. Our target of EUR 474 per share set for December 2020 (up from EUR 434 from December 2019) remains unchanged; however, we think it may take more time to get there. We will continue giving annual targets, because it is important to have valuation references, but given the current macroeconomic and microeconomic uncertainties, and in order to be aligned with our base case scenario of a 12-18 months recovery period, we set a target of EUR 500 per share by the end of 2021.

At the current prices, the Classic fund has an average IRR of 27% (the weighted average IRR of its holdings) with a long-term intrinsic value of over EUR 700 per share. These targets are theoretical and do not take mistakes, which we will make, into account. However, both figures suggest a very large medium/long-term upside potential at the current price levels. It is no coincidence that investing at times of recession, such as in 2000/01, 2008/09 and now, in 2020, achieves the best returns.

As we mentioned at the beginning of the document, a clear distinction should be made between price and value. The companies in which we have invested have a value that can be reasonably estimated, and this value is currently much higher than the prices we see on the stock market — prices that the pandemic and its effects on the economy have depressed a great deal.

A simple example highlights this issue: should we sell our homes at a 25-30% discount due to the Covid-19 crisis? Of course not! A house has a value that can be estimated, either via the replacement cost (when it is worth buying the land, materials, architect, etc.) or by discounting the income from rent, and these methods usually yield a similar number.

At times of crisis, potential buyers (the market) offer us incredibly discounted prices for our assets. The same applies to our companies; consequently, we won't sell a single one. At these prices, we are buyers.

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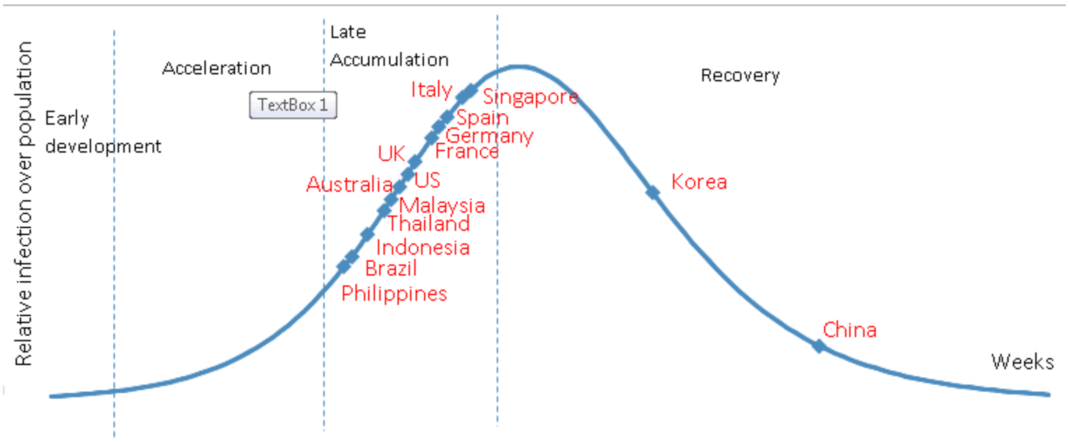
Base scenario: Deep recession and fast recovery, 12-18 months
As we mentioned in our extraordinary update in mid-March 2020, our scenario is one of a deep, but fast recession, with a global recovery starting in Q320.

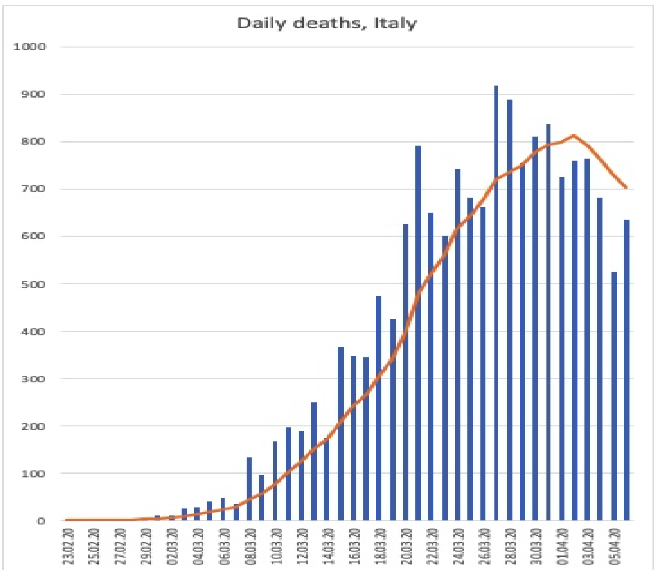
The reality is that we are seeing the Covid-19 infection curve already slowing down in most of the affected European countries, while the US is a month behind. In addition, a number of monetary and fiscal measures will help the recovery. Last, but not least, both drugs and vaccines are being tested on humans, with first results expected within 4-8 weeks, but the vaccines will take longer, although they may be available in less than a year.

Yes, there is actually light at the end of the tunnel!



Source: JP Morgan

We observe the same trend in Italy, where the number of daily deaths peaked 10 days ago. This is good news.



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It is quite normal to be carried away by the current negativity and extrapolate it. However, the reality is that we are fast approaching the peak of the virus's growth (which should be in May in the US). The economy will start recovering once the quarantine measures are relaxed. These two points are key references for markets to start pricing in the recovery. Furthermore, we are convinced that the recovery will be faster than many expect if labor and/or credit are protected for 2-3 months.

China, with its output capacity at around 90% currently, is proving that the recovery can be fast (albeit not full). It is clear that sectors such as transport, entertainment, or even banks will take longer before returning to normal, but should not, in our opinion, take much longer than 12-18 months.

The Covid-19 recession is accelerating the restructuring of the oil sector

Our thesis of a renegotiation and a new OPEC+ agreement (perhaps also including other countries) is materializing, with a first meeting scheduled for April 9. It is common sense that there should be another cut to contain the drop in demand's effects, which many experts estimate at more than 15 m b/d. Nevertheless, nothing will prevent very low oil prices in Q2, possibly below the marginal cash cost of $35-40 Brent.

We are not going to focus on the short term by trying to quantify how much demand is falling. It will be a lot, but what's really relevant is that the current demand crisis will be temporary (and return to normal in 12-18 months), although it will have a deep/structural impact on the supply. We believe that about 3 m b/d of shale oil will "disappear" and that 1 m b/d of marginal barrels will also be shut in.

These 4 m b/d is more or less the global spare capacity, leaving the sector with no room for maneuver whenever demand returns. Consequently, oil prices will move toward the incentive levels (again, within 12-18 months) of around $70 Brent per barrel to attract investment in new barrels.

We thus believe that oil will move toward $50 Brent by the end of 2020 and $65-70 Brent by the end of 2021.

There is a long-term issue that needs to be addressed: the dramatic cut in offshore capex since 2014. Offshore projects take 6-7 years to produce the first oil and we are still benefitting from projects approved before 2014. Upstream, capex must return offshore or its contribution will fade substantially within the next few years, due to the 6-7 years gap. We must also incentivize shale oil, which needs $60 to stay flat and $70+ to grow. This one, at least, reacts much faster than offshore.

These two resources will be required in the coming years, since demand will be back to a normal growth rate of 1.2 m b/d per year and the global decline is about 3 m b/d per year.

It seems foolish, but the longer the prices remain low, the better for the sector. Low prices will damage marginal producers and, regardless of the scenario, part of the production will not return, balancing the supply-demand equation.

Goldman Sachs has already indicated that they see the possibilities of a strong inflationary process in oil after the crisis. This theory goes back to basics: the inelasticity of demand in terms of the price of oil. If there is a lack of oil, prices are first to discourage demand, although this cannot be achieved below $100 per barrel. We don't think this will happen, but it may, depending on the structural damage to the supply and the strength of the demand recovery.

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LTIF Natural Resources: Can a diversified fund be a 4-bagger?

The LTIF Natural resources has fallen by 48% in Q120, slightly improving in April to a NAV of EUR 60 per share, down 43% YTD. Despite this massive fall, the performance is quite normal in times of recession, because energy and mining, and broadly speaking natural resources, are cyclical sectors that usually underperform during a crisis.

Energy (33% of the LTIF Natural Resources) has, with a 60% fall, been the main drag, underperforming our investments in mining (47% of the fund), which is down 35%, and in food (15% of the fund), which is only down 22%. The smaller part of the fund, Infrastructures (5%), is, like mining, down 35%.

Our LTIF Natural Resources is not investing in majors (neither in energy nor in mining), which explains why we usually do worse during recessions. We have plenty of mid-caps with a substantial higher upside in our scenario of higher oil, copper, and nickel prices in the next few years, but this does not help during an economic crisis.

We carried out the same stress test exercise for the Natural Resources fund, and it is clear that all mining and energy earnings will be heavily affected in 2020. However, we also see a much better 2021, with oil prices moving to 70$ by the end of 2021 and copper and nickel back to their pre-crisis levels.

In terms of the balance sheets, we divided the fund into 3 levels of stress and found that 70% of our companies do not have any solvency or liquidity issue; 23% are, however, experiencing tighter financial conditions, but will make it by either selling assets or tapping the markets; only 7% can be considered as being under financial stress. We classify the companies California Resources, Occidental Petroleum, and Panoramic - a small nickel producer - as "at risk." However, as we foresee oil, copper, and nickel prices recovering by the end of the year, we are confident of a positive outcome for all our holdings.

We have already mentioned our view of oil/energy and are also convinced that the mining sector will be back to normal within the next 12-18 months. Currently, around 20% of the world copper capacity is on care and maintenance, almost offsetting the fall in demand. This figure is similar in nickel and zinc, and growing. This means that supply is fast adjusting to the fall in demand, making rebalancing easier.

Having said this, it is impossible to forecast the timing and pace of the recovery of the supply and the demand (and the excess inventories to work through), but we can say is that there is a capex risk at the current low prices for commodities and that, if the capex slows down, the supply will struggle to follow the recovery in demand expected in 2021 and 2022. Do not forget that China accounts for 50% of the demand for most commodities, and was the first country to exit the lock down. Furthermore, we expect huge infrastructure spending in order to support the economy, which could lead to a repeat of the 2009-11 period following the Global Financial Crisis, during which commodities boomed to previous highs, driven by the Chinese demand.

Our LTIF Natural Resources was extremely cheap at EUR 106 per share at the beginning of the year and now trades at EUR 60. In this regard, we can say (see chart below) that our estimates point to an IRR on investment of 35%+ and an IV around EUR 200 per share for the Fund, almost a 4-bagger. All our valuations are made by using incentive prices for all commodities. We believe that this is a unique opportunity.

By the way, the fund took advantage of the current volatility to rebalance its assets and shifted some exposure from more defensive sectors, such as food and salmon, in order to raise our oil exposure. We will possibly keep doing this during the next few weeks.

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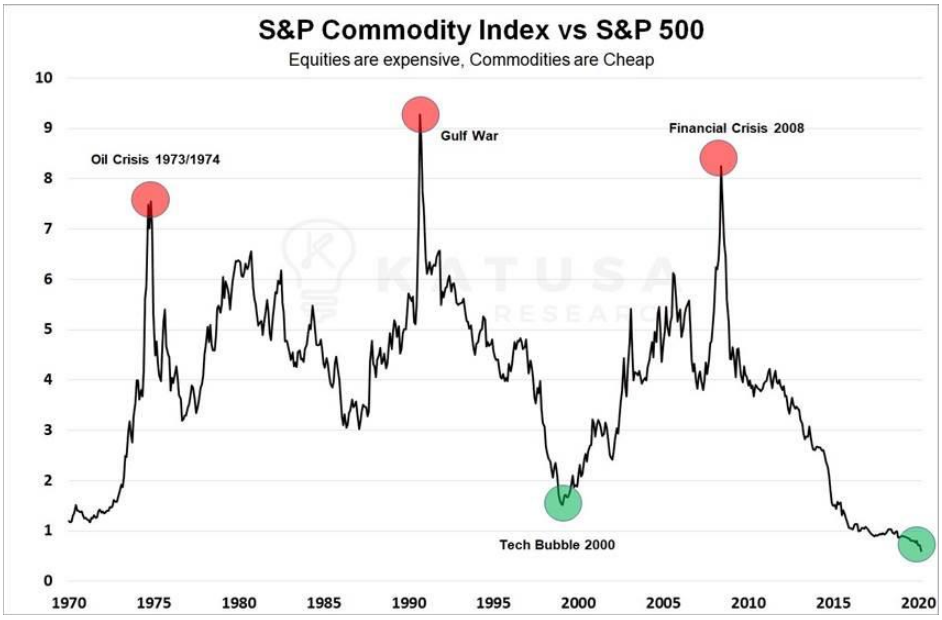

Source: Berenberg

Supply closures and post-crisis demand: How do we deal with this?
Physical precious metal ounces are trading with large premiums at the official prices, as the supply is tight and availability not guaranteed. Demand keeps going up, but production is down, which might be a leading indicator for other commodities, since demand will return later this year.

Should the demand for goods and services normalize, which will surely happen, there might be a growing problem with the supply side of most commodities, because the world's mining/oil production capacity is being shut down.

A good example of this is the Uranium market. Even before Covid-19, the market was already undersupplied by 30% and utilities have been under-contracting for many years. Production has also been declining for years due to under-investments and shut ins; this has now collapsed to a worrying level. Even the largest mines in Canada, Kazakhstan, and Namibia are stopping or reducing production; Kazatomprom is delivering from its inventory, while Cameco is expected to buy around 25 m pounds in the spot market this year in order to provide for its contracts. This represents around 20% of the normalized mine supply.
Obviously, this is not a normal situation. Cameco has some of the best mines in the world with a 15% grade, and should be producing and delivering uranium, not buying it. In our view, the uranium price is ending its bear market and there will be supply issues in years to come.

This situation could also occur in other commodities. At SIA, we have tried to explain this for quite some time. Since 2011, investments have declined sharply and Covid-19 means another leg will be down. Mining has a unique characteristic (oil production is a special form of mining too) in that constant investments are needed to replace declines. Without investments, around 3-4% of the annual production is lost.

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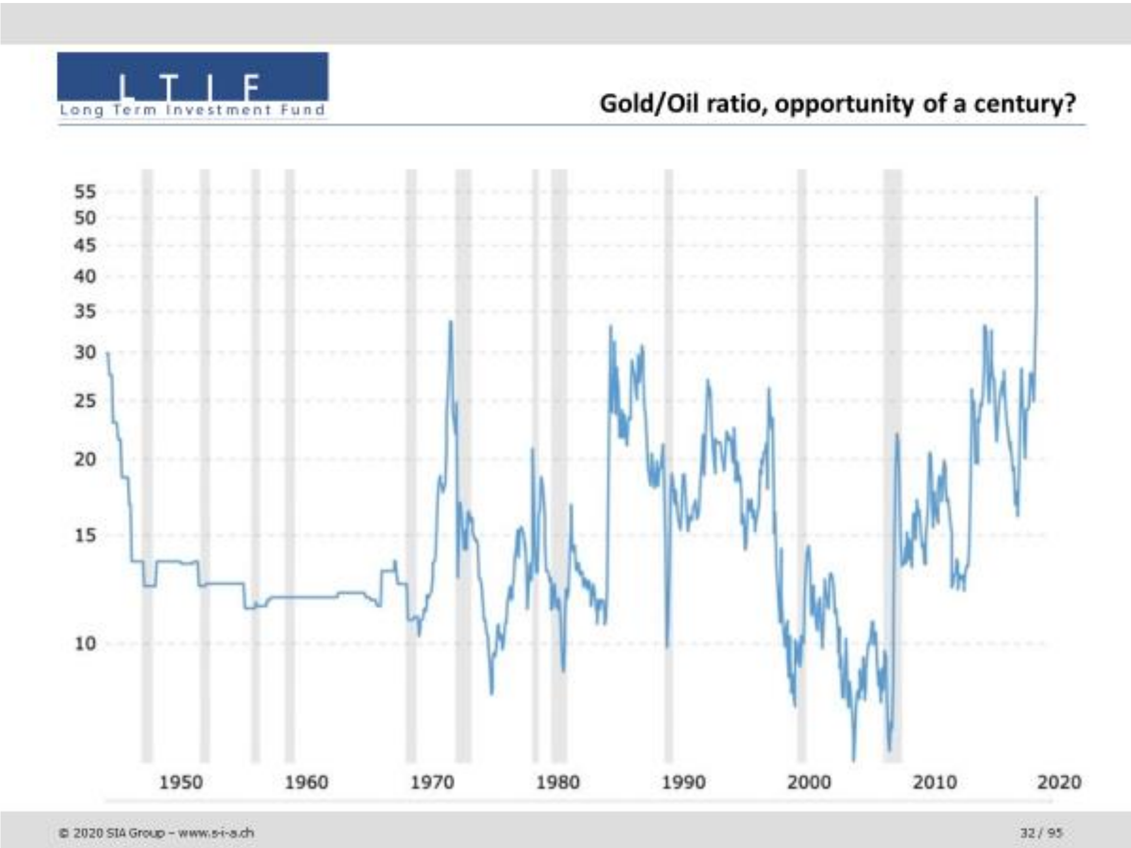
Given the described developments, we expect rising prices for precious metals, other metals, and oil. In real terms (gold), oil prices have never been this low since the start of the oil age. In fact, the US oil production would have declined without Covid-19, due to its shale declines and capex cuts; now it will collapse far more than most people realize.

Finally, the statement from Saudi Arabia seems to be more than questionable. Around 1/3 of its production comes from the biggest oil field in the world, Ghawar. It produces around 3.8 m b/d and the next biggest field is approx. 1.5 m b/d. The oil fields in Saudi Arabia started production 60-70 years ago and, given the lack of transparency, their reserves, production, and decline rates are highly disputed.

An increase of 2 m b/d would mean the country has a hidden Ghawar somewhere, developed and ready to ramp up (by the way, 1 week later, Aramco did announce a 20% capex cut…). It is difficult enough to find and develop oil fields, but doing so without spending money is impossible. They might be able to squeeze a few 100,000 bpd more for some time, either from the existing fields or their inventories. But 2 m b/d is more than questionable.



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Buffett, always Buffett

"Every decade or so, dark clouds will fill the economic skies, and they will briefly rain gold. When downpours of that sort occur, it's imperative that we rush outdoors carrying washtubs, not teaspoons.

Warren Buffett, Letters to the Shareholders of Berkshire

Buffett, with his unique way of commenting on economic and stock market episodes, has two sentences that are worth remembering:

1) "I expect to live through many recessions" and he doesn't mean that he wants to live longer, but that Berkshire Hathaway has made the best investments in times of recession.

2) "It rains gold every 10 years, rush outdoors carrying washtubs."

We are aware of how difficult it is to do this in the midst of a sanitary, economic and news-flow storm, with many commentators predicting the biggest crisis in history (like every crisis), but at today's prices, make no mistake, we have to buy.

Could the stock market fall much more? Sure, it can always fall more, but current levels already discount a normal recession and our base scenario is a 2-quarter recession without deep or structural damage to the labor base or the flows of credit.

Let's go out there and get the gold!

Marcos Hernández Aguado
Urs Marti
SIA Team
April 7th, 2020

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Bloomberg: LTIFCLU LX

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Bloomberg: LTIFSRD

LTIF – Natural Resources EUR
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Bloomberg: LTIFGEV LX

LTIF – Natural Resources USD
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LTIF – Natural Resources CHF
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