Figure 1
**LTIF – Classic EUR**

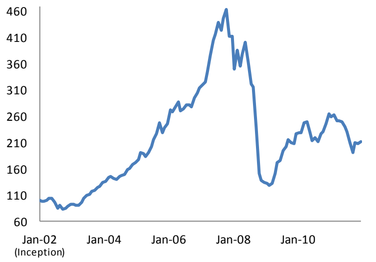



Figure 2
**LTIF – Classic II EUR**

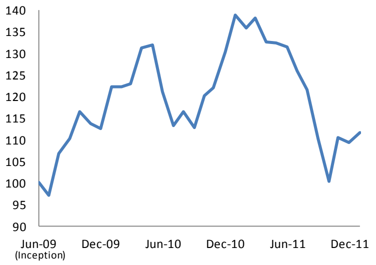



Figure 3
**LTIF – Alpha EUR**

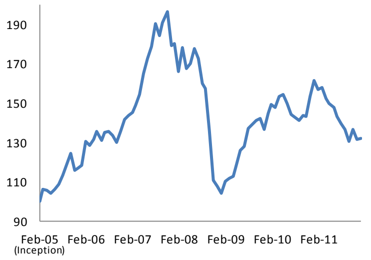
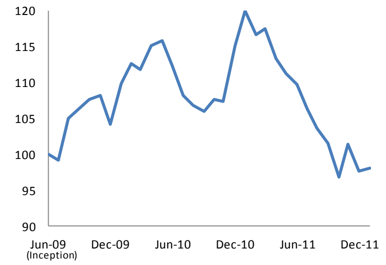



Figure 4
**LTIF – Alpha II EUR**




# Long Term Investment Fund

*In the short term, the market is a voting machine. In the long term, it is a weighing machine.* Benjamin Graham

*Be fearful when everybody is greedy and greedy when everybody is fearful.* Warren Buffet

Table 1 and figures 1 through 8 show the evolution of our funds during the last quarter. This is an end-of-year quarter, and this year marks the tenth anniversary of the start of the LTIF Classic fund. In this Newsletter, we're going to briefly discuss the evolution of the last quarter, provide more details on what's happened with our funds this year, much more detail on what's happened over the last ten years, and our expectations for the coming decade. We hope to show why the good performance we had in the first years of our activities was not an aberration; why the performance over the last few years has been mediocre; and why we believe that investing (or remaining invested) in our funds in 2012 will in all likelihood be very profitable.

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

| December 2011 | NAV | Δ 3m | Δ YTD | Ann. Return since Inception | AUM (in mio) |
|---|---|---|---|---|---|
| LTIF Classic [EUR] | 212.11 | 11.25% | -19.72% | 7.81% | 256.42 * |
| LTIF Classic II [EUR] | 111.60 | 11.26% | -19.70% | 4.34% | ** combined Classic & Classic II* |
| LTIF Alpha [EUR] | 132.04 | 1.22% | -18.24% | 4.10% | 34.82 ** |
| LTIF Alpha II [EUR] | 98.08 | 1.23% | -18.21% | -0.75% | *** combined Alpha & Alpha II* |
| LTIF Natural Resources [EUR] *(former Global Energy Value Fund)* | 99.27 | 16.39% | -33.75% | -0.11% | 54.90 |
| LTIF Emerging Market Value [EUR] | 74.35 | 9.58% | -25.46% | -25.65% | 3.52 |
| LTIF Stability Growth [CHF] *** | 175.90 | -0.23% | -16.12% | 2.04% | 22.27 |
| *** Total Return (incl. Dividend) | 6.50 | | -13.34% | | |
| LTIF Stability Income Plus [CHF] | 175.90 | 1.50% | 1.50% | - | 1.55 |
| MSCI World Index TR [EUR] *(Bloomberg GDDUWI)* | 3'144.16 | 11.79% | -2.04% | 0.31% **** | ***** Inception date of Classic* |

## Comments on the last quarter

As in most of 2011, "macro" issues overwhelmed the last quarter: although the US and Chinese economies are probably doing better than most people expected just a few months ago, the "noise" emanating from Europe has dominated financial markets. We are not going to bore our readers with yet more analyses and predictions regarding the Euro saga. As we said in 2007, this is a "balance sheet" recession created by an excess of debt in developed markets, which take many years to clear up. There is no "solution" to the European crisis: new mechanisms will evolve over time and slow adjustments will eventually bring European econo-



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Figure 5
**LTIF – Natural Resources EUR**

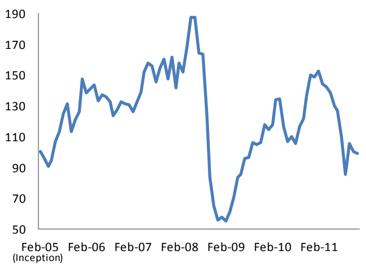



Figure 6
**LTIF – Emerging Market Value**


Figure 7
**LTIF – Stability Growth CHF**

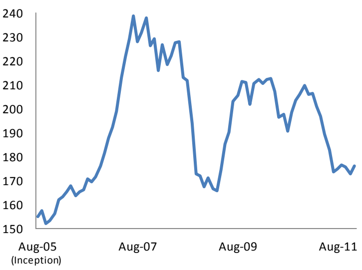
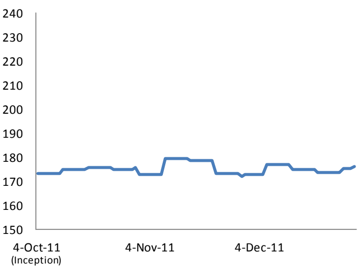


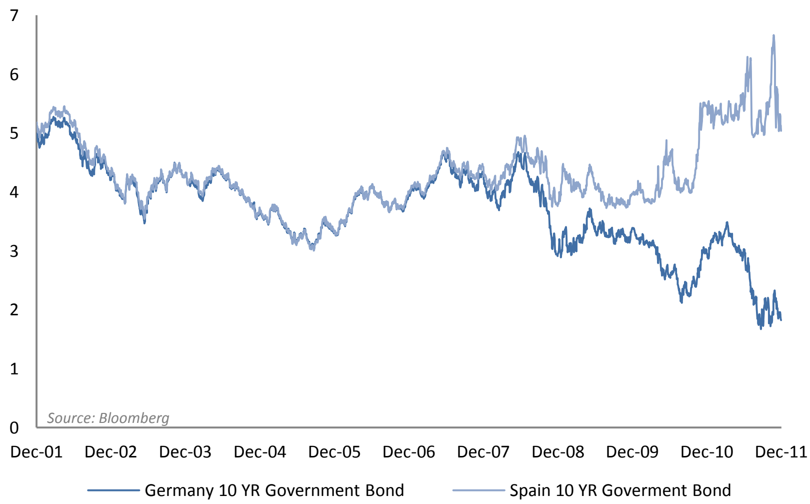

Figure 8
**LTIF – Stability Income Plus CHF**




mies to normal rates of growth – which will probably be somewhat lower than in the past for demographic reasons. The core Euro zone problem is not "excessive spending" by some countries' governments (Greece being an exception) but a crisis of payment arising from the very different productivity evolution in the different countries. This difference in productivity creates permanent imbalances between intra-European exporters (basically Germany) and intra-European importers (mostly the rest). In a large, closed economy, which the Euro Zone has become, these imbalances will take many, many years to correct: it was easy to devalue the lira overnight, but it took ten years (1997-2007) to lower German labor costs to their current competitive position.

So expect punctual "crises" met by punctual "solutions" while the long process of healing the sick economies of Southern (and not so Southern) Europe continues: unproductive government expenditure must decrease, labor productivity must increase. There is no other solution, and this takes years. However, as Germany did not collapse during its "lost decade" when it was dubbed "the sick man of Europe" (just five years ago this was conventional wisdom, believe it or not, and Germany paid more for its debt than Spain – see figure 9), the rest of Europe will not collapse now. European economies will continue running and many companies will continue making money, in Europe and with exports to the rest of a world not suffering these problems.

Figure 9: **10 year Government Bonds, Germany and Spain, last 10 years, in %**




Markets don't like this "protracted uncertainty," of course, and they remain very volatile. Figure 10 shows the level of the VIX, the Chicago Board of Trade volatility index, which is a good gauge of the "fear" in the stock exchange. A remarkable characteristic of the latest spike in volatility is how long it's taken to come down compared with previous spikes. This has been a "prolonged heart attack." We will come back to this figure.



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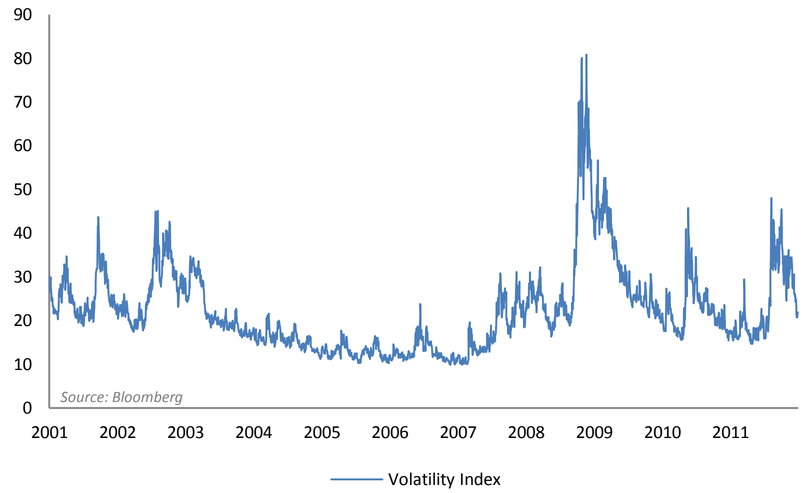
Figure 10: **Chicago Board Options Exchange SPX Volatility Index (VIX), last 10 years**




Ultimately, however, the quarter has been less bad for the stock market than many people feared, and our funds' prices have recovered much of their summer drop.

## Comments on 2011

From our fund management point of view, 2011 has been the most disappointing year since we started. 2008 was not, of course, disappointing: it was disastrous. But that was part of a chaotic, fairly unprecedented market development that took us (and many others!) unawares. This time we did a careful assessment of the markets before the year started, and we were mostly right in our assumptions. Consequently, we did not invest in any areas that have proven to be "value traps," such as European banks, many European utilities and cyclical stocks, the more expensive healthcare companies, etc. In our December 2010 Newsletter, we pointed out the key problems we expected for 2011, and we were spot on:

> *The Euro crisis is obviously far from over. We don't know what's going to happen, but one thing is clear: several Euro members' debt positions are not sustainable, and that which is not sustainable has to change. How this change will occur, we don't know, but investors should expect many panicky headlines when more countries are bailed out, or when the ones already "bailed out" default, or both. Even if nothing happens, which is highly unlikely, the markets will be subject to periodic scares as enormous debt rollovers come due throughout 2011 (...).*
>
> *Most emerging markets face a starkly different problem: not too much debt, but too much growth. If inflation is to be controlled - and it will eventually be, one way or another - interest rates will*



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> *have to go up. This is not bad. When a country raises interest rates because it's growing too fast, its companies tend to do very well. But since most of the world's economic growth comes from emerging markets (particularly China), anything that may imply a slowdown in their growth tends to spook the markets. 2011 will not be different, and this volatility may affect natural resources companies more than others. By now, everybody knows that the key reason for many commodities' historically high prices is demand from emerging markets. Investors will probably assume that, if those markets are going to grow less, commodities prices will go down. Expect exceptional volatility in this area.*

Why has our funds "performance" been so weak? Although we discussed the key issues in the last Newsletter, it may be useful to repeat them. This is important because it is very difficult for an investor to know whether a fund is going to be a good investment in the future or not. Investors usually react to past performance and, if it was bad, tend to get out of the investment to put their money in something that "works." This would be fine, if past performance were a predictor of future returns, which it most definitely is not. It's therefore essential to make an effort to understand why a given fund behaves the way it does if one has to have a chance to predict future performance, not just to extrapolate a past one. Let's take a look at our funds' behavior in 2011, starting with the Classic.

Figure 11 shows the share price evolution of two of our stocks between the end of February this year and the beginning of October: McDonald's and Canadian Natural Resources (CNQ), a fast-food chain and an oil and gas producer. In this period, McDonald's shares went up 15.9%, including its dividends. Canadian Natural Resources' went down 45%. We also show the world index, down 19% during this period, as well as the share price evolution of Schlumberger Ltd., the world's leading oil services company, which we also own.



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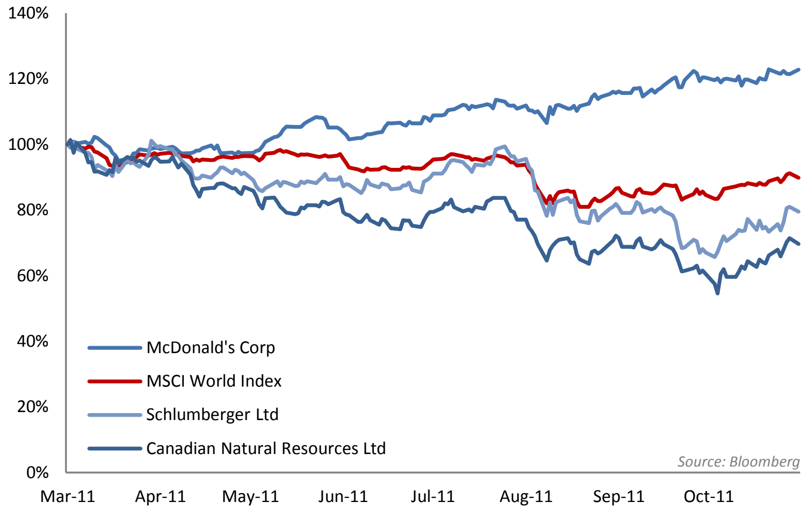
Figure 11: **Share price of Canadian Natural Resources, McDonald's, Schlumberger and MSCI World Index, between end of February and beginning of October 2011, in EUR, indexed**




McDonald's price evolution was remarkable: +35% over the index in eight months. Our decision to purchase companies such as McDonald's (more on this later) was clearly profitable in the short term. But also remarkable is CNQ's drop. This drop would have been less surprising if the company had hit serious trouble, or the oil price had collapsed, or its overall profits were coming down. But the opposite occurred. Figure 12 shows the evolution of the oil price during the year (up 12.89%, more than gold), and figure 13 shows CNQ's profits for the past few years and the expected profit (as per consensus) for next year. It could be argued that the company was very expensive back in February, but none of the multiples typically used (PE, Price to Book, Net Asset Value, etc.) indicate this. And CNQ is just an example of what we see in many other commodity-related companies such as Schlumberger, whose shares dropped as much as those of CNQ during this period although its businesses are doing phenomenally well. With oil prices well above $100, oil producers are increasing their 2012 exploration budgets by more than 10%, which strengthens Schlumberger profits. Almost all new oil fields are difficult to work and are "oil service intensive", meaning that although the same amount of oil will be produced, companies like Schlumberger will increase their sales and profits. By the way, both CNQ and Schlumberger have lower PEs than McDonald's, although they clearly have faster growth ahead.



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Figure 12: **Brent Crude Oil price chart incl. 260 Day Moving Average, in USD, 2011**

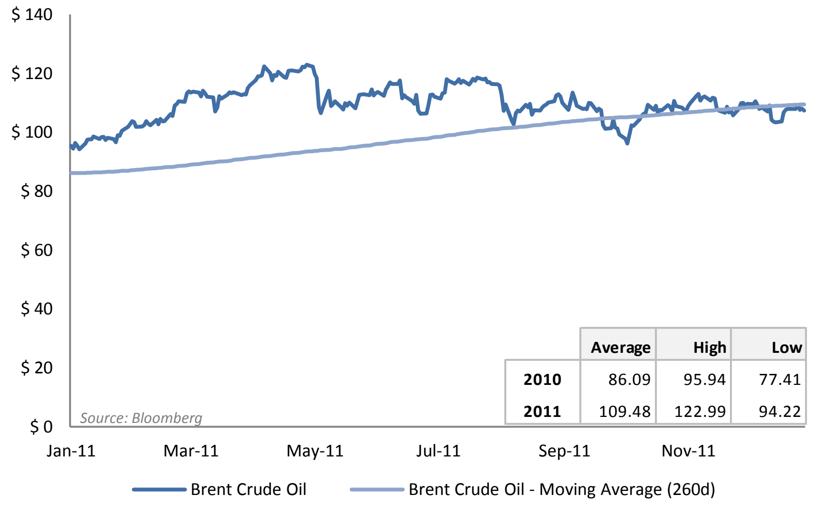
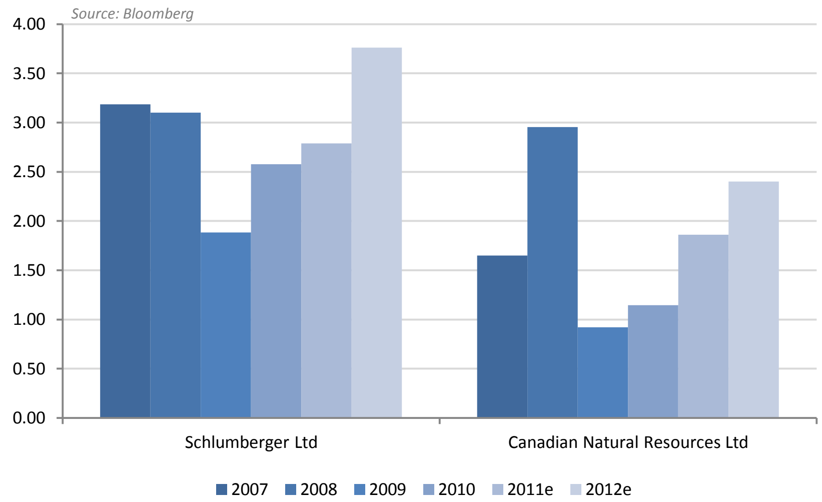



Figure 13: **Earnings per share of Canadian Natural Resources and Schlumberger, in Euro, 2007-2012e**




Another company we've owned for a long time is Quadra Mining. It started the year at about $16 per share. Over the year, again for "sentiment" reasons, the share kept dropping, reaching a bottom price of $8.14 in early October. In early December, KGHM, a Polish copper and silver producer, launched a purchase offer of $15 per share in cash. The share has been trading above that number since then, showing the market's conviction that another player will offer even more. This shows how out of synch with reality the early October price was: at that time, Quadra's shares were trading about 0.6 times book value, without taking the company's huge reserves into account.



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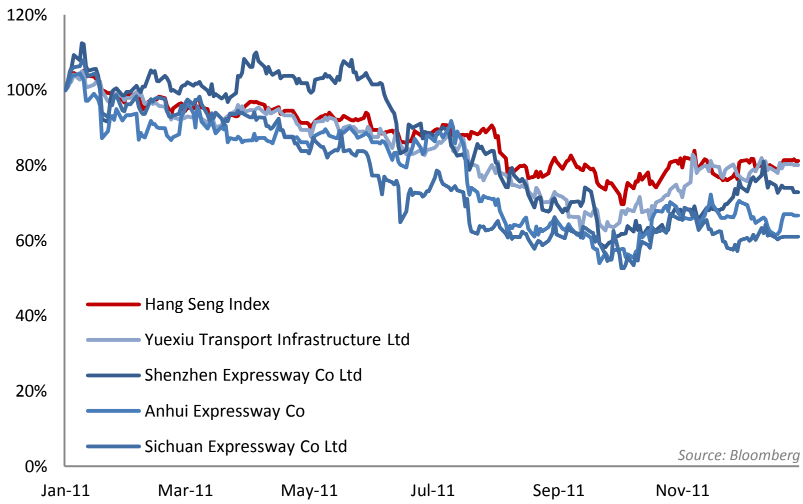
In as much as the share price evolution has been due to sentiment (much more on this later) and not to fundamental factors, the price evolution will reverse itself. It always has and it always will.

A similar story has developed in the other area of our portfolio with very negative performance: Asian shares. Let's take a look at our largest position there: Chinese toll roads.

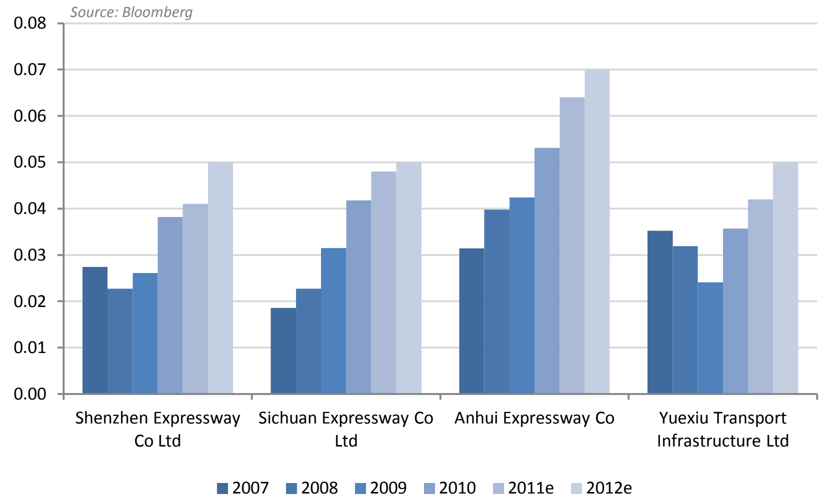
We own (and have owned for several years) four toll-road-owning companies: Shenzhen Expressway, Sichuan Expressway, Anhui Expressway, and Yuexiu Transport Infrastructure (formerly GZI). Figure 14 shows their share price evolution for the year.

**Figure 14: Share price of Shenzhen Expressway, Sichuan Expressway, Anhui Expressway, Yuexiu Transport Infrastructure and Hang Seng Index, 2011, in EUR, indexed**



Again, a very poor performance. But look at their earnings performance:

**Figure 15: Earnings per share of Shenzhen Expressway, Sichuan Expressway, Anhui Expressway and Yuexiu Transport Infrastructure, in Euro, 2009-2012e**




Shenzhen Expressway, for instance, trades with a PE of 8, pays a cash dividend of 6.5%, and has had and will continue to have double-digit earnings growth for many years to come. To compare: European toll roads such as Brisa (Portugal) or Atlantia (Italy) have PEs above 10 and zero or negative growth. Abertis (Spain) expects modest growth (some 3%), but trades at a PE of 13.5. Clearly, sentiment (towards a "hard-landing China" in this case) has determined share prices far more than the fundamentals have.

We therefore have a portfolio that has done very well, with two areas that have done very badly. In our spring presentations (and our March 2011 Newsletter), we even coincidentally picked Nestlé and Peugeot as examples, and showed why we thought Nestlé was a better investment with a PE of 15 than Peugeot with a PE of 5. Figure 16 shows the shares' evolution since then, dividends included: Nestlé is up 5%, Peugeot down 50%, and the world index is down 4%.



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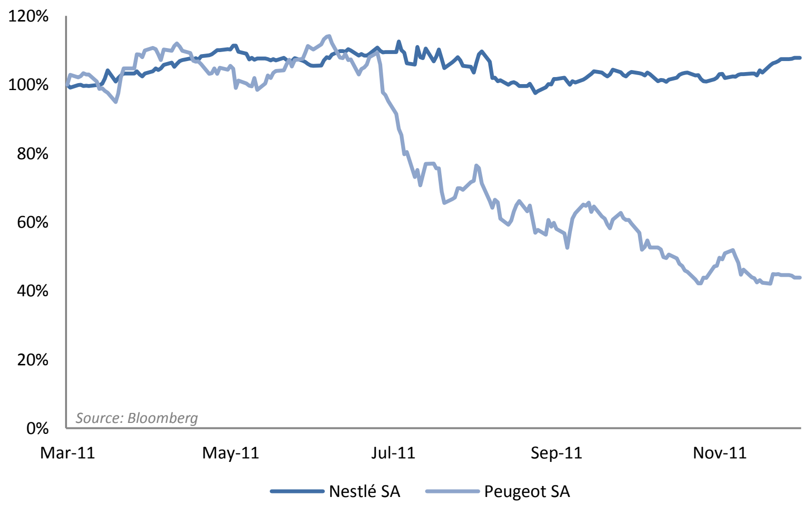
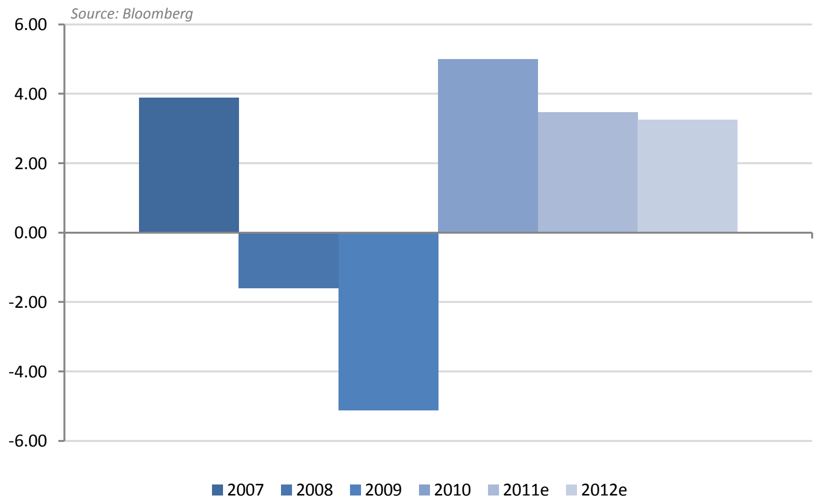
Figure 16: **Share price of Nestlé and Peugeot, between end of March and end of year 2011, in EUR, indexed**




We believe Canadian Natural Resources and Schlumberger share prices will return to where they were before this year's drop (and higher) in the not too distant future. We don't expect this to be the case with Peugeot. Figure 17 shows its profits for the last few years, plus the expectation for next year (which, in our opinion, is far less predictable than that of CNQ or Schlumberger, not to mention the Chinese motorways).

Figure 17: **Earnings per share of Peugeot, in Euro, 2007-2012e**




To summarize: the disappointing performance we've experienced this year was mainly due to deep drops in two kinds of stocks which were, in our view, driven by sentiment but unjustified according to the fundamentals. This means we are extremely disappointed with the funds' perfor-



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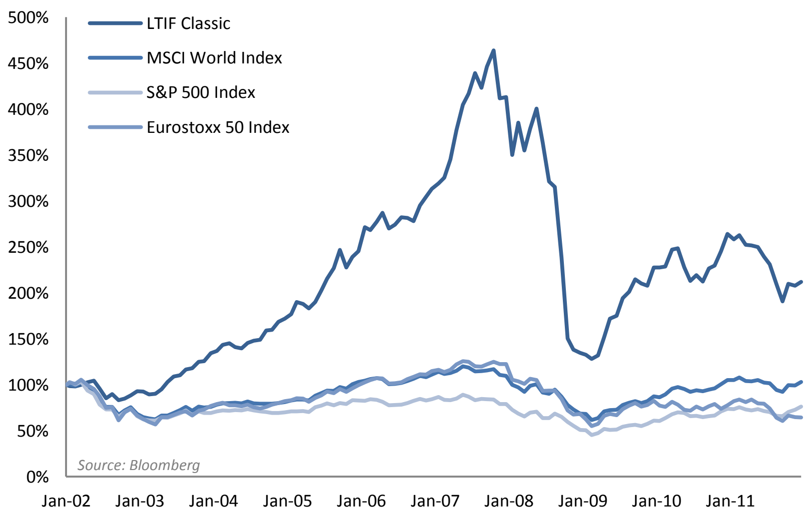
mance, but find consolation in the fact that the economic reality we own (the companies, not the shares) has gone up in value this year, not down.

Having said this, it would not be realistic to deny errors on our side. Some companies we bought turned out to be less good than we thought. These mistakes have consisted, basically, of purchasing companies that seemed to be inexpensive, but had too much debt. In such cases, it's enough for the basic business to do worse than expected to put the company in trouble. Among those companies we could mention Enterprise Inns, a British pub operator; Sare, a Mexican homebuilder; Suzano, a Brazilian pulp and paper manufacturer, and a couple more. These errors tend to happen, but when made in the context of very nervous markets, they show up very quickly. Without entering into all the details (available to interested investors), we have estimated that these errors cost our funds' investors between 2 and 4%.  As noted above, we're convinced that despite this loss, our funds are clearly more valuable today than at the beginning of 2011.

## The first ten years: what has happened, what have we learned, and what can we expect in the next 10 years?

On January 14, 2002 we launched the Long Term Investment Fund with a total value of €5 million. On that day, the Eurostoxx 50 index stood at EUR 3'588.51. At the end of 2011, the Eurostoxx was at EUR 2'316.55 – a drop of 35.44% after 10 years. The World Index has gone from EUR 1'105.59 to EUR 912.49. Our fund has more than doubled, providing an annual return of 7.81%. This performance has been produced in two very different blocks: the first six years and the last four.

**Figure 18: LTIF Classic, Eurostoxx 50 Index, MSCI World Index and S&P 500 Index, from January 2002 to December 2011, in Euro, indexed**



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Over the first six years, the fund went up by 465.87%, with a very regular "outperformance" of the world index of some 20% per year. This was done while keeping the same overall PE and dividend yield, i.e. we did not simply ride a hugely successful bubble, such as that of the Internet stocks in 1997-2000. We did it by buying a multitude of cheap stocks, selling them at a higher price, and buying other cheap stocks again. Although these rankings don't mean much, our Fund's performance was one of the very best in the world.

Thereafter we experienced the big drop of 2008, a partial recovery in 2009, an average year in 2010, and a weak one (at least from the "performance" point of view, as discussed above) in 2011. What happened? Were the first six years just luck? Have we lost our skill? Is it a good idea, in 2012, to invest in funds managed by SIA? This last question is obviously the key one for our investors, but to answer it, we have to explain what we do in detail, and how this translates into performance.

The first explanation for our excellent initial performance and ulterior correction would be that it occurred randomly. This would fit the conventional financial wisdom that nobody can beat the market in the long term. Reality has shown, of course, that some people do beat the markets in the long term, but they are few. Was our "streak" in the first years therefore pure luck?

It's impossible to answer such a question categorically, but some statistical analysis can be applied: the chances of a fund beating the index by more than 5% by pure luck in one year are of 37%. One would therefore expect a large number of funds to do so, even in the absence of particular management skill. Beating the index by more than 5% in two consecutive years is more difficult: only 14% could do it by chance. Doing so for six years is a feat that is, in principle, reserved for only 0.003% of funds (this is a statistical analysis of likelihood: we don't know whether such funds exist). But the LTIF Classic beat the index by 20% per year in those six years. The chances of this happening by chance are 0.0000075%. Not zero, but not very high. It therefore seems reasonable to maintain that we did not do so by pure chance.

How then did we do it? As mentioned before, we didn't just buy stocks that went up a lot. We had an explicit strategy, well documented in our Newsletters, of value investing. We followed this strategy, buying and selling more than one hundred stocks in many different industries and countries during this period. The root of our success therefore lay in a good strategy, well implemented, over more than six years.

We thus have a good strategy, well implemented, that yielded outstanding results for six years, and now seems to work much less well. Why? Has the world changed so much that the strategy is no longer good? Have we become incompetent? In some ways, the surprising answer is that we were indeed rather lucky at the beginning and very unlucky lately. Let's explain this in detail.



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*Our strategy consists (it always has) of looking for companies whose shares are, for whatever reason, selling below what we believe is their "intrinsic value," i.e. a price that will offer us very good long term returns as company owners.*

Our strategy consists (it always has) of looking for companies whose shares are, for whatever reason, selling below what we believe is their "intrinsic value," i.e. a price that will offer us very good long term returns as company owners. We have never made any attempt to "guess" whether the markets, in general, or our shares, in particular, will go up or down. Our basic premise is: get a good business at a low price and let the share price eventually reflect the business earnings. If the analysis is correct (i.e. the earnings do arrive), the strategy will work in terms of share price appreciation over the long term.

But for this strategy to work in the short to medium term (say, one to five years) requires two factors regardless of the analysts' quality: available good companies at low prices and the market assigning prices that take fundamental value into account.

We were fortunate that both factors were true during our fund's first six years. There were enough good, inexpensive companies in which we could invest. The markets had experienced the internet-bubble crash, and had taken good companies with them. These companies had not even gone up because they were not fashionable: Berkshire Hathaway shares, for instance, went down 50% in 1999 because they were not considered part of the "New Economy," although the company itself had produced record profits. In addition to these good, old fashioned, undervalued companies, we "discovered" several areas that were poorly followed after many years of underperformance: energy, mining, shipping, etc. When we started analyzing these companies, we could not believe how cheap they were if one understood their industries' long-term supply/demand dynamics. At the time, very few investors did, and we could buy companies at ridiculous prices (some of them have multiplied by several times, and are still inexpensive). In terms of our strategy, there was an abundance of opportunities.

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The second condition also applied until mid 2007: the markets were relatively prompt in recognizing value. This can be seen indirectly in the Volatility Index, as shown in figure 10. Investors were not "afraid" and kept looking for good investments. If we found one, it didn't take all that much (a few quarters) for the market to recognize its value and mark up the price accordingly. This is important, because this "quick mark-up" allowed us to sell the original shares and buy other shares at low prices (because we kept finding them). The result was an increase of more than 20% per year in the earnings per share of the fund, which very few individual companies can achieve in six consecutive years. Hence, our performance resulted from a world with opportunities, a strategy designed to find and profit from them, and reasonably good work done in applying the strategy.



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*But what's happening now? Our strategy is the same and we have learned a lot about investment over the years. We have not suddenly become stupid. Some external factor must be posing a problem. This external factor can also be found in figure 9: after the huge 2008 crash, investors have become accustomed to trading on macro issues.*

But what's happening now? Our strategy is the same and we have learned a lot about investment over the years. We have not suddenly become stupid. Some external factor must be posing a problem. This external factor can also be found in figure 10: after the huge 2008 crash, investors have become accustomed to trading on macro issues.

In the 25 years before 2008, the markets didn't see any "life-threatening" problems. There were recessions and booms, but they were always moderate and happened in different places at different times. At no point did it seem as if the whole "system" could collapse (whatever this means, which is not much). In fact, once the last bubble had been digested, the early years of this century were known as "the great moderation". Volatility, as measured by the VIX, was at record lows for several years before 2008. Then, suddenly, everything seemed to collapse, and even the bank that holds your life savings could disappear. Asset prices reacted accordingly – panicking. Subsequently, the authorities intervened to save the situation: assets, which had anticipated total collapse, rebound strongly. But then the solutions were not so strong after all, resulting in a new collapse. And so on for four years.

The great long-time value investors, such as Warren Buffett, Sir John Templeton, Peter Lynch, etc. have always said that they pay no attention whatsoever to the macro environment. There are two very good reasons for their lack of interest: one is that no matter how much attention you pay, you don't know what's going to happen. The other is that it does not really matter over the long term: good companies experience all kinds of environments but survive well.

*The great long-time value investors, such as Warren Buffett, Sir John Templeton, Peter Lynch, etc. have always said that they pay no attention whatsoever to the macro environment. There are two very good reasons for their lack of interest: one is that no matter how much attention you pay, you don't know what's going to happen. The other is that it does not really matter over the long term: good companies experience all kinds of environments but survive well.*

However, when the market is fixated on very serious macroeconomic problems, the short term ignores all fundamentals to concentrate on some junior government employee's next utterance about the "problème du jour." It's an environment in which our know-how is totally incapable of producing good "performance" measured as a relatively steady increase in the price of our shares. For us, such an environment is truly random, and there is not much we can do.

Let's return to our investments, using Natural Resources companies as an example. Right now, they are trading at what we consider to be a very low price. We believe that, on average, buying them would give us annual returns well above 16% for a very long time. This does of course imply that oil and copper prices will do more or less what we think they will. We have explained how we do these long-term price estimations in many Newsletters, and we have been proven right now for more than 5 years.

As most of our readers know, oil is right now trading above $100 per barrel. We believe there is a chance that this price will drop over the first few months of 2012 to strongly recover afterwards. Supply from Libya is recovering, and the world economy is growing a bit less than expected. We could see oil go down to $80 and then return to above $100. This is what we have in our estimation of our oil producers' long-term value.



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*It is, therefore very important that our investors recognize what they are buying when they invest in our funds. They are buying positions in companies that we deem to be very good investments over the long term. They are not buying a stock market instrument whose managers will try to "beat" whatever the market is doing. Periods like the current one are difficult in that fundamental analysis counts for little in the short to medium term results. But we believe our strategy is good for the long term, and we think we have done a reasonable job of implementing it.*

We all know that if oil prices drop, oil company shares tend to go down. But our analysis (and just common sense) shows that selling oil at $80 instead of $100 for a few months does not change our companies' intrinsic value. Should we sell because we fear the shares may drop, even if the intrinsic value is there? Should we play the game of trying to anticipate what the market will do, regardless of the fundamental values?

So far, we have followed a "fundamental-based" strategy: we buy what we believe is cheap considering the long-term value of the company, and sell what is expensive. And this is the strategy we want to continue following. We cannot in all honesty sell and buy shares on "hunches" of what the market will do next month, because we have no particular expertise to apply such a strategy successfully. This means that when everybody thinks markets will do badly, we'll probably do badly (because everybody else will sell).

It is therefore very important that our investors recognize what they are buying when they invest in our funds. They are buying positions in companies that we deem to be very good investments over the long term. They are not buying a stock market instrument whose managers will try to "beat" whatever the market is doing. Periods like the current one are difficult in that fundamental analysis counts for little in the short to medium term results. But we believe our strategy is good for the long term, and we think we have done a reasonable job of implementing it.

However, this does not mean we have not made mistakes. We have indeed, and have tried to learn from them. The following paragraphs show some of what we've learned, none of which is a "discovery". If pushed, we will admit that we "knew" these things. But we have seen them play in practice over time, and have now derived specific rules to follow, which we didn't always follow in the past.

What have we learned?

*The most important lesson we've learned, because it has the biggest impact on performance, is that we cannot aim at maximum returns, even in those cases when we are totally convinced that our analysis is correct and events end up showing that we were right.*

1. **Risk/reward balance.** The most important lesson we've learned, because it has the biggest impact on performance, is that we cannot aim at maximum returns, even in those cases when we are totally convinced that our analysis is correct and events end up showing that we were right. Very high return investments come with very high volatility and there are limits to the volatility that a public fund can take. Those cases (fortunately, occurring much less frequently) when we are not right are much worse, of course: the loss is important. We now run a very balanced portfolio, as we'll explain below.

2. **Value traps**. Throughout most of the early years of our work we used, both in stock selection and in our communication to investors, "low PE" as almost synonymous with "inexpensive." We have, of course, always known that low PEs are sometimes not good, and have acted accordingly. We also know the opposite: a



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*However, low PE companies may inherently be value destroyers if they re-invest their profits in ruinous business, as most automobile and airline companies have done, for instance.*

mining company, for instance, that is about to open a new mine and double its production can be very attractive even if it shows a high PE for the current year. This is why we started using "adjusted PE" (as explained in our December 2007 Newsletter), and have recently published our Expected Return for the fund rather than its PE (more on this later). But this is something deeper: a share may be a great investment even if it has a "structurally high PE" and, conversely, a permanently low PE may not be an indicator of a good investment.

We discussed the above in detail in our March 2011 Newsletter, when we showed why we thought Nestlé, with a PE of 15, was a better investment than Peugeot with a PE of 5. The basic reason is that shares are bought forever, which is a long time. Since companies do not pay out all their profits as dividends, the new profits that they make on what they keep are a key determinant of long-term returns. Companies that can re-invest a significant part of their profits in a very profitable business are worth a lot more than those that can't. However, low PE companies may inherently be value destroyers if they re-invest their profits in ruinous business, as most automobile and airline companies have done, for instance.

3. **Management alignment with shareholders is essential**. This is somewhat tied to the previous point. Imagine a company that operates in a very profitable business but where the growth opportunities are not so good, because the market is saturated. How the management handles the "excess cash" will be the key determinant of the company's long-term profitability. Most managers would rather re-invest the cash (even in very bad businesses) than give it to the shareholders. Since, by definition, their core business cannot grow, they will present their investments as great opportunities. Nevertheless, these investments often consist of excursions into other countries or industries where the company has no expertise, or consist of good companies acquired at very high prices, which will destroy value for the acquiring shareholders. It's difficult to find managers – whose rewards in the real world are ultimately related to the size of the companies they run – who would forego unprofitable company growth to give the excess cash to the shareholders.

   This is something we knew, of course, but we have learned the hard way that the management's alignment with the shareholders is one of the key criteria for investment. Even if everything else points to a great investment case (high expected returns, solid competitive position, low share price, etc.), it is to be avoided if there is no alignment between management and shareholder interests. Management can easily destroy much of the value created by a business, so their attitude is a determinant. In essence, the long-term view is required to decide whether a company is a

*Most managers would rather re-invest the cash (even in very bad businesses) than give it to the shareholders.*



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*The game is therefore not to ensure that nothing wrong will happen (an impossible task), but to be invested in companies that can put up with anything the world throws at them.*

*The true problem with debt is that sooner or later the company won't be able to roll it, and will have to liquidate assets – at the lowest price in the cycle.*

*The positive side of analysts' work is that it is largely cumulative: once we understand how a given industry operates, we only have to keep up with the new developments, which takes much less time than the original analysis. Over the years, we have therefore accumulated much insight into how to value cyclical companies, consumer products companies, natural resources producing companies, insurers and reinsurers, etc.*

value investment or not, regardless (to some extent) of the current PE.

4. **Most small companies are too fragile to be safe investments**. It's pretty clear that we live in a fairly unpredictable world. The game is therefore not to ensure that nothing wrong will happen (an impossible task), but to be invested in companies that can put up with anything the world throws at them. Unfortunately, small companies are rarely resilient enough. They tend not to get second opportunities. Only debt-free companies, with a proven track record in a stable industry are of interest.

5. **Debt is toxic**. We have gone from a period in which money was free to one in which there is no money available. As hard as it may be to believe, Spain was paying less than Germany for its government debt just 5 years ago (as mentioned above) and companies could borrow all the money they needed to pursue all kinds of projects. The problem with liquidity is that it is there only until you really need it. Debt is not just an amplifier in the sense that if profits are good they increase and if profits are bad they decrease. If it were just that, the volatility could be handled. The true problem with debt is that sooner or later the company won't be able to roll it, and will have to liquidate assets – at the lowest price in the cycle. Indebted companies (or individuals) will end up with serious permanent losses. It's just a matter of time. One can, however, "get away with it" for a long time. But in a fund like ours, which plans to stay around for a long, long time, debt can only lead to bad returns in the end.

In addition to these "lessons," we have learned a lot about an enormous amount of companies and industries. The positive side of analysts' work is that it is largely cumulative: once we understand how a given industry operates, we only have to keep up with the new developments, which takes much less time than the original analysis. Over the years, we have therefore accumulated much insight into how to value cyclical companies, consumer products companies, natural resources producing companies, insurers and reinsurers, etc. In addition, we're now familiar with the details of many companies and even with their managers. All this makes our fund management more solid, opening up new possibilities for the future.



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### How we currently build our portfolios

All this learning has led us to structure our choice of investments differently, in a way that, we believe, is relatively original and should also help ensure good results. Our investment choices now comprise several key concepts and practices.

1. **The “risk-free stock” concept**. Since our funds want to be mostly invested in common stocks, we start by determining the “least risky” investment we can make. This is a very important question, of course. The whole edifice of academic and professional finance is built on the idea of first determining the return of the “risk-free asset” and then analyzing what the spreads (premia) of all the other assets should be, given their extra risk. We adapt this concept to the world of stocks.

   What is a “risk-free stock”? Is such a thing even possible? Of course, a world that has seen the US Government debt downgraded does not seem to contain too many truly risk-free assets. After all, a nuclear war could start one day. But barring truly extreme cataclysms, there are stocks that, in our opinion, not only are the least risky ones, relative to other stocks, but also are truly free of risk for the long term in absolute terms. Some companies operate in such fields and enjoy such positions that we can expect long-term profitability in almost any circumstances. In this sense, the 2008-09 crisis is useful, for it really provides us with a very serious, real life stress test. Figure 19 shows the earnings per share over the last 20 years of a number of companies: Nestlé, McDonald’s, Coca-Cola, L’Oréal, Unilever.



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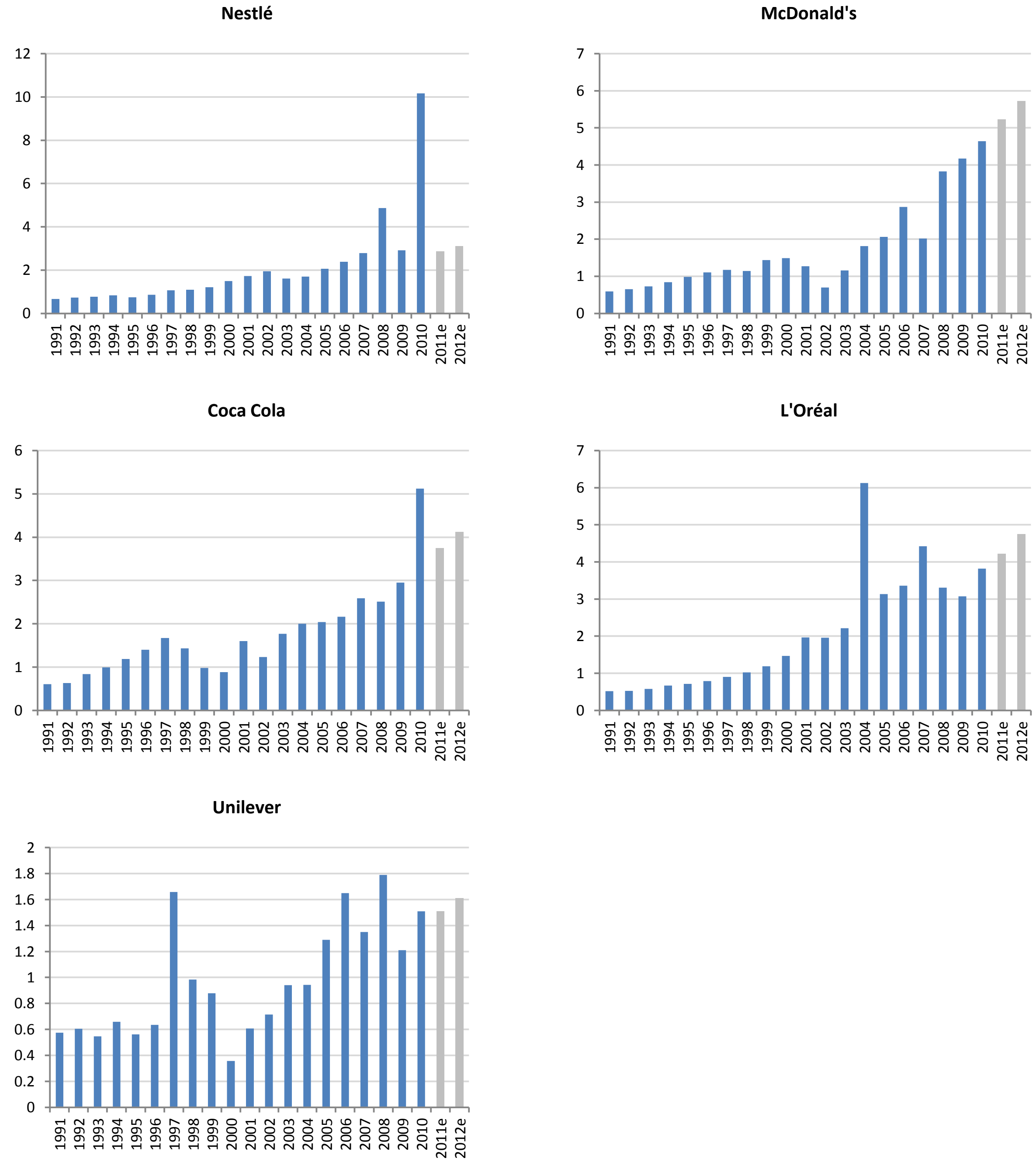
Figure 19: **Earnings per share Nestlé, McDonald's, Coca-Cola, L'Oréal and Unilever, in main currency, last 20 years** *(Source: Bloomberg)*



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Of course, it's not enough to observe a very steady level of profitability. Since the future can (will) differ from the past, we must understand why those companies are so stable. After all, once profitable companies (think Kodak) sometimes stop being so.

Take the case of Nestlé. It's a company that basically operates in the food industry. This is a very stable sector: the amount of food consumed every year is basically the same, regardless of economic circumstances. It thus differs greatly from, say, the automobile or airline sectors, in which a recession has a serious impact on demand. But there are more reasons for Nestlé's stability. It sells many kinds of food under its own, difficult to replicate, brands through distribution channels that are very difficult to penetrate and in more than 113 countries. Nestlé has been doing this for decades, and has built up an enormous expertise in its different businesses. When a product line in a given country is not performing as expected, there are many things the company can try to fix the problem. It is very difficult to imagine why a given year would see a serious drop in profits. In fact, not even the recent "Great Recession" has seen such a drop. The future will no doubt differ from the past, but we see fewer deep challenges to Nestlé than to, say, Apple Inc.: Nestlé is much less dependent on radical, unexpected innovations. It is not at risk of constant government regulations, like banks or utilities are; it bears no currency risk (it sells in all currencies found in the world, and sources its products in most countries); and it has no debt. Its businesses don't require huge up-front capital investments. Furthermore, it can easily increase or decrease its commitment to the different businesses and countries to adjust to unforeseen developments (at least when compared to companies, such as oil refineries, that just own a few completely immovable assets).

Bad things can happen to companies like Nestlé: they've had their share of scandals, someone could tamper with and poison their products or one of their factories could explode, killing many people. But, probably, none of these events would permanently impair the company's profitability.

We can nevertheless lower the risk of owning Nestlé shares by not owning only Nestlé shares, but a basket of the shares shown in figure 19 (plus many other comparable ones). They all share the same strategic characteristics, and their diversity contributes to lowering the risk of the overall portfolio. It's important to underline that, in the real world, such a basket of shares probably bears less risk than any other asset that can be bought. They certainly bear less risk than real estate, investment-grade sovereign bonds (which are seriously subject to inflationary risks), precious metals, etc. As shares, their prices will rise and fall every day, but as profit generators, we can count on these companies' stability.



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Once we have determined that there is indeed a group of stocks that bear very low real economic risk, we must determine how profitable it is to own them. This is very easy with regard to the traditional, "risk-free asset", the short-term government bond: just look it up in the newspaper. 1-year US government bonds pay 0.1% as of today. Valuing stocks is rather more complicated.

In our March 2011 Newsletter, we showed how we value a very stable company such as Nestlé:

> *The company has a very steady Return on Equity of around 18%-20% every year. It pays half the profits it makes in dividends, and re-invests the rest. The dividend yield is currently 3.5%. This means that, as the owner of one Nestlé share, one is paid 3.5% of the current share price in cash (the dividend), while another 3.5% (the other half of the profits) is kept by the company, which re-invests it at an average Return on Equity of, say, 19%. This means the dividend can grow about 8%-10% per year. And this is what has actually happened over the last 20 years… If a given investment pays 3.5% cash and grows that payment by 8% per year, it's the equivalent of an investment paying 11.5% every year. And this is what Nestlé's share price appreciation, including dividends, has done over the last 20 years…*

Applying this approach, the return we can expect at current prices from these "no-risk" stocks is approximately 11% on average over the long run.

We now have an asset (a basket of "risk-free stocks") that yields something like 11%. In a context of extremely low interest rates, we believe this is a very good return: a comparable long-term investment would be the 20-year German Government bond, which now pays 2.5%. And it is important to stress that government bonds run the very real risk of inflation, while stocks are unaffected by it. The *real* differential return is even better for these stocks.

Since these are "risk-free" stocks and they provide us with what we believe is a very satisfactory return, we can simply invest all our money in these stocks. In fact, for us to buy any other kind of stock, we must find an extra return that more than compensates for the risks we'll run by owning it.

2. **The "risk-spread".** Take a company like Intel Corp. (which we own). It's the world absolute leader in CPU chips for computers (the "brains" of the machine): its market share is above 70%, and growing. Its position is hard to attack: its economies of scale are huge, which allows them to outspend any competitor in research



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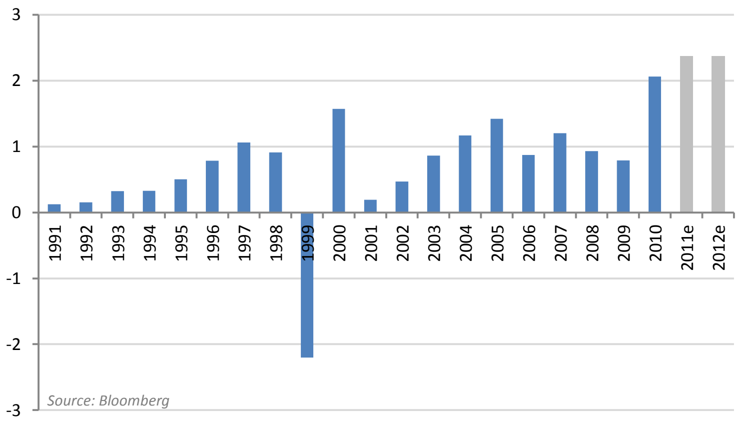
and in plant investment. This has translated into excellent long-term profitability, as shown in figure 20.

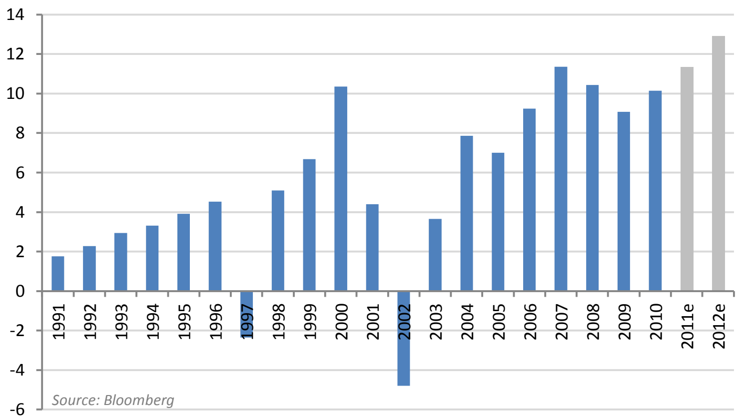
Figure 20: **Earnings per share of Intel, in USD, last 20 years**




But what about the future? Well, it's difficult to imagine Intel losing its position in computers. But the company has been slow in getting into low-power consumption chips, which are at the core of smartphones and tablets. The business is capital-intensive and it does have up and downs. It seems a safer bet that Nestlé will be selling chocolate in 20 years' time than that Intel will retain its current position. Although this position is currently excellent and its growth is higher than that of many of the truly "risk-free" stocks, it's not quite "risk-free." We will therefore only invest in Intel if it gives us an Expected Return clearly above (say, 20% more) that of risk-free stocks.

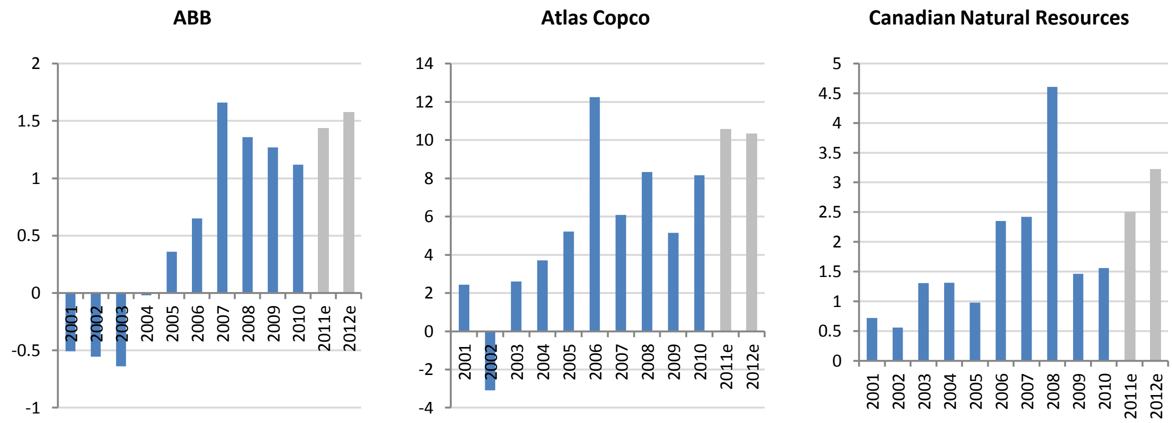
We could continue analyzing stocks and first observing their relative level of risk (i.e. the uncertainty of their returns), and then the "spread" (or lack of it) of those returns compared to that of the "risk-free" ones. At SIA we categorize all stocks into 4 categories, which we simply call category 1 through 4. Category 1 comprises the risk-free stocks. Category 2 comprises companies with extremely solid positions and very little risk, but where there are some question marks (technology, regulation, competition, etc.). Intel would be one such company, as would be Roche (figure 21 shows historical company data). Many re-insurance companies also fit into this category.

Figure 21: **Earnings per share of Roche, in CHF, last 20 years**




Category 3 comprises very solid companies that are subject to their industries' inevitable economic cycle. Solid industrial companies (ABB, Atlas Copco) and leading commodity producers fit into this category (see figure 22 for historical company data).

Figure 22: **Earnings per share of ABB, Atlas Copco and Canadian Natural Resources, in main currency, last 10 years** *(Source: Bloomberg)*




Finally, category 4 companies comprise those where there is some risk of "a bad patch": think of high-cost commodity producers, highly cyclical companies, etc.

When analyzing companies, we first assign them to a given category and only proceed if we believe that the Expected Return is high enough for this category. With current conditions, we demand a 12% Expected Return to buy a new category 1 stock, 14% for a category 2, 16% for a category 3, and 18% for a category 4. We sell them if the Expected Return goes down by more than two points, either because of the share price is up, or because we be-



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*We honestly believe that a portfolio built around very low risk stocks that yield some 10-12%, which is augmented by well-analyzed stocks that yield much more, and is kept balanced, will provide double-digit long-term returns. And this applies especially to the current macroeconomic circumstances.*

lieve the company will permanently make less money than we expected.

3. **Portfolio construction**. We try to maintain a good balance between the different categories, and have a target to invest approximately 25% in each. But this is subject to actually finding good companies that are cheap enough (i.e., yield the desired Expected Return) in each category. Otherwise, we tilt our investments towards categories 1 and 2.

   This categorization helps us explain what happened to our portfolio in 2008: we had a huge proportion of it in categories 3 and 4. When the crisis came, the results suffered. Many of our companies did do well and recovered their profitability. But some didn't. Subsequently, hurt by 2008, we changed our portfolio a bit too much to what we would now call categories 1 and 2 at a time when categories 3 and 4 were in fact extremely cheap after the drop. Which is why, despite the 2009 performance being very strong (68.9%), it fell short of recovering the previous drop.

   Our Classic portfolio now has an expected return above 15%, and a much lower volatility than it used to have. Its success will depend, as usual, on our correctly determining the Expected Returns, and on our discipline in selling stocks once they go up so that the "spread" over the risk-free stocks is no longer interesting enough. This is difficult: it means selling stocks that we have "discovered", which are doing better than the market, and are still not expensive. But if we want to maintain our value approach, we must not fall in love with any stock and must sell once it reaches its price (determined by its category).

## The future

We honestly believe that a portfolio built around very low risk stocks that yield some 10-12%, which is augmented by well-analyzed stocks that yield much more, and is kept balanced, will provide double-digit long-term returns. And this applies especially to the current macroeconomic circumstances.

It is obvious that the current stress in the Euro zone is not going to disappear in the next few weeks. As we've been saying for several years, the process of de-leveraging the developed-market economies is going to take a long time, during which average growth will be mediocre. Logically, some quarters (or even years) will be better than the average and investors may react as though the crisis is over. Necessarily, some quarters (or years) will be worse and investors will react as though we're back to a terrible crisis. Neither will be true. Markets will be volatile, but good companies will continue making money. The Euro will not affect Nestlé's worldwide sales of chocolate or McDonald's sales of hamburgers. Regard-



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*We have decided to remerge our Classic II and Alpha II funds into the Classic I and Alpha I. After the approval by CSSF, the funds will be re-opened for subscriptions.*

less of what happens in Brussels, hundreds of millions of people will move to cities in emerging markets, increasing the consumption of scarce natural resources. It is precisely in times like these, with investors deeply traumatized by steep recent losses, that the best opportunities are to be found for long-term profits.

Will our Classic fund price double over the next 10 years? We'll be very surprised if it does not do clearly better. Unfortunately, there are no "assured" returns when investing. We do, however, believe that the earning power of our portfolio of companies will justify a very good profitability. In many ways, the situation in the markets today does not differ much from 2002, when it was relatively easy to find undervalued companies.

## SIA news

An important announcement is that we have decided to remerge our Classic II and Alpha II funds into the Classic I and Alpha I. The only impact this will have is that the High Water Mark for investors in the II funds will now become what the I funds have, i.e., they will not be charged performance fees until the funds reach the Classic I and Alpha I High Water Marks, which are much higher than those for the II funds. In essence, no performance fees will be charged until the Classic doubles and the Alpha goes up 50%. This will be implemented in the first quarter 2012 (after the approval by the CSSF), accordingly, Classic I and Alpha I will be re-opened for subscriptions.

In the personnel department, we must communicate that Yiyi Jiang has decided to leave SIA for personal reasons. She was an excellent junior analyst and we wish her all the best.

We have programmed public presentations of our Funds in Zurich, Geneva and Madrid for January, where we'll be able to discuss all these issues, and any others our investors may have, in person and in detail.



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## Presentations

We are holding presentations in Zurich and Geneva on January 19th and 20th. Please find below the invitation including the web form to confirm your attendance.

***Presentation in Zurich on Thursday, January 19th 2012 at 5 pm***

1. Introduction: Review of 2011. Market situation and outlook for 2012.
2. LTIF – 10 years of investing: the amazing decade. What we have achieved, what we have learned, and what we expect for the next 10 years.
3. How to build an equity portfolio for double-digit returns and low risk in this environment.
4. General comments on our funds.
5. After the presentation, our fund managers and sector experts in energy, mining, financial services, industrials, consumer, health care and emerging markets will be available for discussions.

Venue: **Hotel Savoy Baur en Ville**. A cocktail will be offered after the Investment Workshop.

***Presentation in Geneva on Friday, January 20th 2012 at 11.45 am***

1. Introduction: Review of 2011. Market situation and outlook for 2012.
2. LTIF – 10 years of investing: the amazing decade. What we have achieved, what we have learned, and what we expect for the next 10 years.
3. How to build an equity portfolio for double-digit returns and low risk in this environment.
4. General comments on our funds.
5. After the presentation, our fund managers and sector experts in energy, mining, financial services, industrials, consumer, health care and emerging markets will be available for discussions.

Venue: **Swissôtel Métropole**. A buffet lunch will be offered after the Investment Workshop.

After each presentation, an open discussion will be held on the ideas discussed. For further discussions, the speakers will be available after the presentation.

Please confirm your attendance by using this web form.



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## Figures of the USD classes

Table 2: **Net Asset Value - Net assets under management in USD**

| December 2011 | NAV | Δ 3m | Δ YTD | Ann. Return since Inception | AUM (in mio) |
|---|---|---|---|---|---|
| LTIF Classic [USD] | 275.35 | 7.64% | -22.32% | 11.90% | 332.87 * |
| LTIF Classic II [USD] | 144.87 | 7.64% | -22.30% | 0.90% | **combined Classic & Classic II* |
| LTIF Alpha [USD] | 171.41 | -2.07% | -20.88% | 4.04% | 45.2 ** |
| LTIF Alpha II [USD] | 127.32 | -2.06% | -20.86% | -4.02% | ***combined Alpha & Alpha II* |
| LTIF Natural Resources [USD] *(former Global Energy Value Fund)* | 128.87 | 12.62% | -35.90% | -0.43% | 71.27 |
| LTIF Emerging Market Value [USD] | 96.52 | 6.03% | -27.87% | -26.60% | 4.57 |
| MSCI World Index TR [USD] *(Bloomberg GDDUWI)* | 4'074.83 | 7.72% | -5.02% | 4.12% *** | ****Inception date of Classic* |

Figure 23
**LTIF – Classic USD**

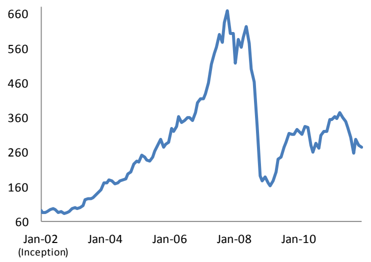



Figure 24
**LTIF – Classic II USD**

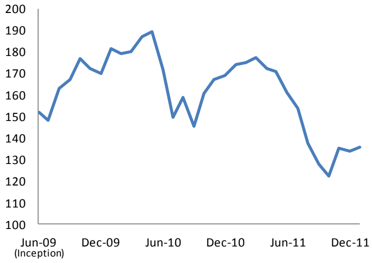



Figure 25
**LTIF – Alpha USD**

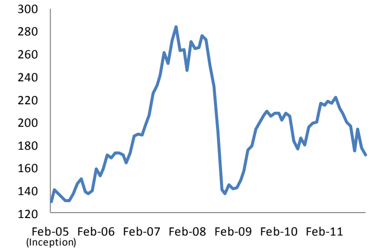



Figure 26
**LTIF – Alpha II USD**

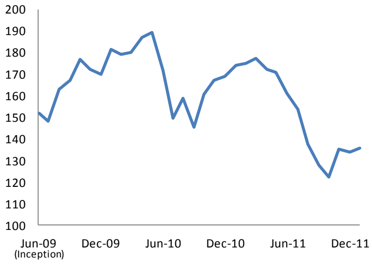



Figure 27
**LTIF – Natural Resources USD**

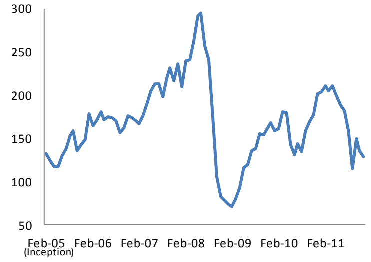
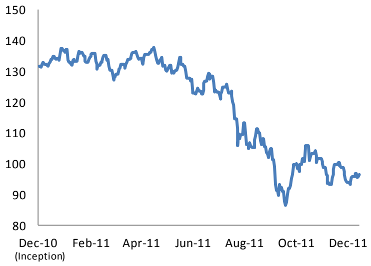



Figure 28
**LTIF – Emerging Market Value USD**



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## Figures of the CHF classes

Table 3: **Net Asset Value - Net assets under management in CHF**

| December 2011 | NAV | Δ 3m | Δ YTD | Ann. Return since Inception | AUM (in mio) |
|---|---|---|---|---|---|
| LTIF Classic [CHF] | 257.48 | 10.82% | -22.07% | 5.69% | 311.27 * |
| LTIF Classic II [CHF] | 135.47 | 10.82% | -22.05% | -4.30% | **combined Classic & Classic II* |
| LTIF Alpha [CHF] | 160.28 | 0.82% | -20.63% | 0.50% | 42.27 ** |
| LTIF Alpha II [CHF] | 119.06 | 0.83% | -20.61% | -8.96% | ***combined Alpha & Alpha II* |
| LTIF Natural Resources [CHF] *(former Global Energy Value Fund)* | 120.50 | 15.93% | -35.69% | -3.57% | 66.64 |
| LTIF Emerging Market Value [CHF] | 90.25 | 9.14% | -27.64% | -29.34% | 4.27 |
| LTIF Stability Series [CHF] *** | 175.90 | -0.23% | -16.12% | 2.04% | 22.27 |
| *** Total Return (incl. Dividend) | 6.50 | | -13.34% | | |
| LTIF Stability Income Plus [CHF] | 175.90 | 1.50% | 1.50% | - | 1.55 |
| MSCI World Index TR [CHF] *(Bloomberg GDDUWI)* | 3'825.05 | 11.83% | -4.53% | -1.61% *** | ****Inception date of Classic* |

Figure 29
**LTIF – Classic CHF**

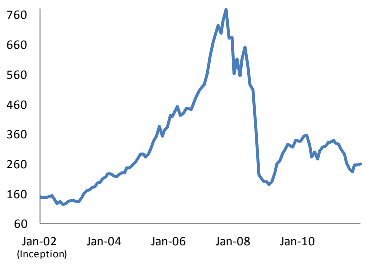



Figure 30
**LTIF – Classic II CHF**

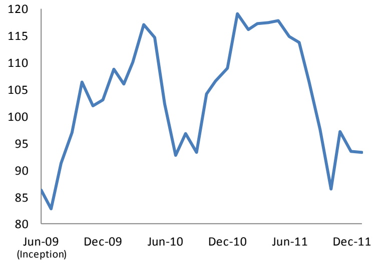



Figure 31
**LTIF – Alpha CHF**

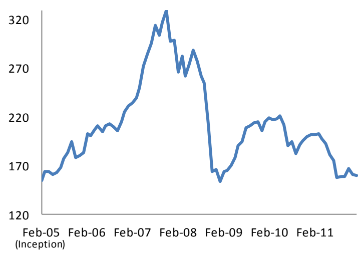



Figure 32
**LTIF – Alpha II CHF**

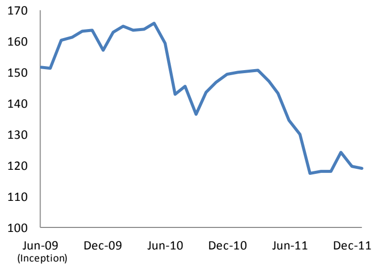



Figure 33
**LTIF – Stability Growth CHF**

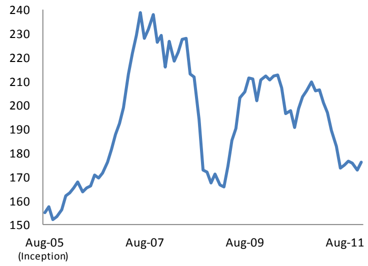



Figure 34
**LTIF – Natural Resources CHF**

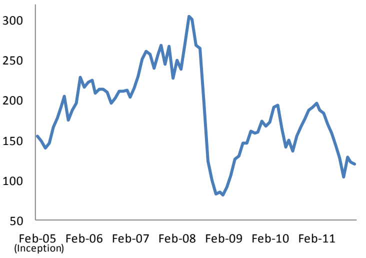
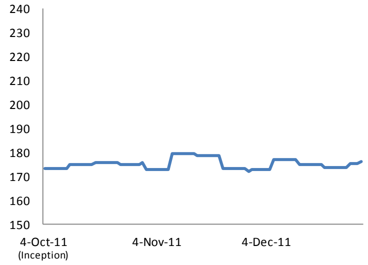



Figure 35
**LTIF – Emerging Market Value CHF**


Figure 36
**LTIF – Stability Income Plus CHF**



## Figures of the GBP classes

Table 4: **Net Asset Value - Net assets under management in GBP** *

| December 2011 | NAV | Δ 3m | Δ YTD | Ann. Return since Inception | AUM (in mio) |
|---|---|---|---|---|---|
| LTIF Classic II [GBP] | 93.22 | 7.89% | -21.72% | 3.09% | 214.19 *(combined Classic & Classic II)* |
| LTIF Alpha II [GBP] | 81.93 | -1.82% | -20.27% | -1.94% | 29.09 *(combined Alpha & Alpha II* |
| LTIF Natural Resources [GBP] *(former Global Energy Value Fund)* | 82.92 | 12.88% | -35.42% | 2.74% | 45.86 |
| LTIF Emerging Market Value [GBP] | 62.10 | 6.26% | -27.33% | -26.95% | 2.94 |
| MSCI World Index TR [GBP] *(Bloomberg GDDUWI)* | 2'627.40 | 8.69% | -4.51% | 11.80% * | ** Inception date of Classic II* |

** Performance up to 05.11.2009 is converted on a simulation basis from EUR into GBP. NAVs from 01.06.2009 to 04.11.2009 are not official.*

Figure 37
**LTIF – Classic II GBP**

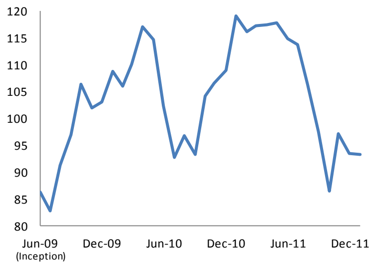



Figure 38
**LTIF – Alpha II GBP**

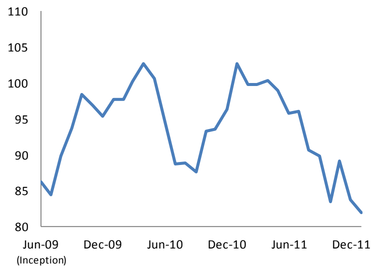



Figure 39
**LTIF – Natural Resources GBP**

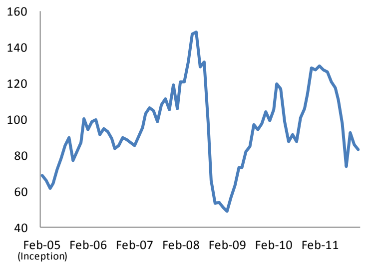
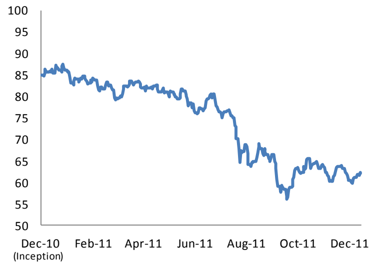



Figure 40
**LTIF – Emerging Market Value GBP**



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Long Term Investment Fund is an open-ended investment company of the umbrella type organized as a “société anonyme” under the laws of the Grand Duchy of Luxembourg and qualifies as a Société d’Investissement à Capital Variable (“SICAV”) under Part I of the Luxembourg law of 20th December, 2002. It has three active compartments, called "Classic," "Alpha," and "Energy," which fully resemble both the Long-Term Investment Fund in BVI (classes “Classic” and “Alpha”) and the Global Energy Value Fund with regard to their investment objectives and operational structure. This newsletter is only addressed to qualified private investors who have expressed a desire to receive it, and by no means constitutes an offer to sell financial products that may not be suitable for its readers.

| | | | | | | | |
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| *ISIN:* | LU0423699429 | *ISIN:* | LU0423699692 | *ISIN:* | LU0423699775 | *ISIN:* | LU0457694296 |
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| *LTIF – Alpha II EUR* | | *LTIF – Alpha II USD* | | *LTIF – Alpha II CHF* | | *LTIF – Alpha II GBP* | |
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| *LTIF – Natural Resources EUR* | | *LTIF – Natural Resources USD* | | *LTIF – Natural Resources CHF* | | *LTIF – Natural Resources GBP* | |
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Long Term Investment Fund Stability (SIA Funds) was approved by the Swiss Banking Commission on July 13, 2006. The fund started trading denominated in Swiss Francs as of October 1st, 2006. This newsletter is only addressed to qualified private investors who have expressed a desire to receive it, and by no means constitutes an offer to sell financial products that may not be suitable for its readers.

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