

Long-Term Investment Fund

Newsletter July 2005

LTIF

As explained in the owner's manual, investors in LTIF should look at the results of our companies to gauge how we are doing, more than at the price of their shares (and the liquidation value of the fund, which is simply the sum of the price of the shares we own in a particular date). That's why we essentially talk about "intrinsic performance", more than the performance of the shares.

For a complete description of LTIF's investment philosophy, and its "user manual", that explains in detail our measurement concepts, such as "intrinsic value" and "fund's earnings per share", please refer to our internet site at www.ltif.com. You can also find there previous past letters, as well as detailed results for the fund since its inception.

For any inquiries, please write to info@ltif.com.

Results on our portfolio

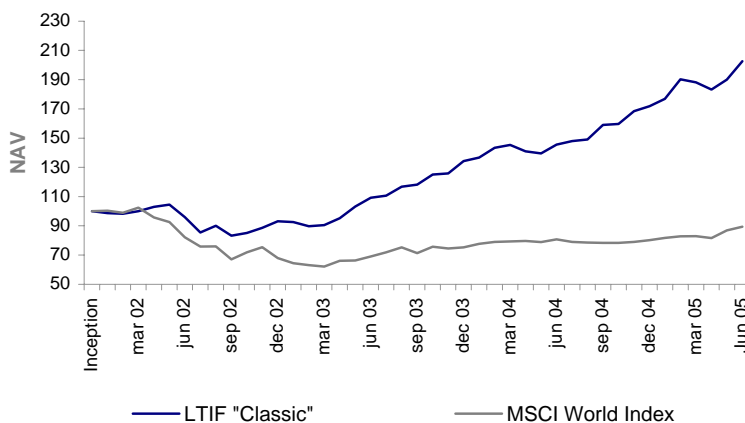
This second quarter has been, in many ways, a continuation of the previous one: we have added a few companies (6) and sold even fewer (just 1). There was no remarkable news at our companies: they all performed more or less as was expected. From the point of view of the share prices, it was also a bit of the same: most of our European shares went up, as did those of energy companies, while the shares of our Brazilian and Korean companies went mostly down. Overall, the liquidation value of our portfolio is up by 17.88% since the beginning of the year (more than 7% for the second quarter itself), thus putting the Net Value of the Fund's shares at €202.57.

NAV is up 17.88% since January 1st.

Total assets under management now exceed €100 million.

Figure 1:

LTIF liquidation value per share, compared to the MSCI World Index



LTIF Directory

Administrator:

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P.O. Box 25121
3001 HC Rotterdam
The Netherlands

Investment Manager:

Van Daalen International Ltd
Kings Court, Bay Street
P.O. Box N-1417
Nassau, Bahamas

Registered Office:

Mill Mall, P.O. Box 964
Road Town, Tortola
British Virgin Islands

Custodian:

Pictet & Cie
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Georges Favon
1204 Geneva
Switzerland

Investment Advisor:

Strategic Investment Advisors SA
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1205 Geneva
Switzerland

LTIF – Class A

Telekurs: 1341036
Bloomberg: LONGTRM VI

LTIF – Class B

Telekurs: 2048550
Bloomberg: LONGTRB VI

GEVF

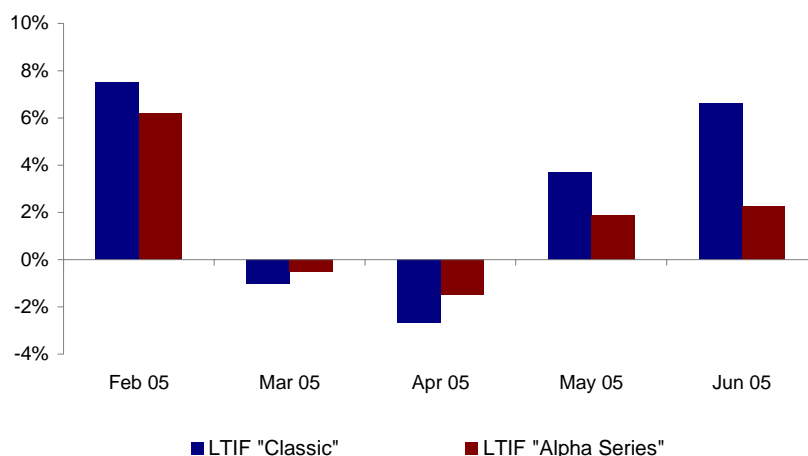
Telekurs: 2053248

The Alpha Series is up 8.40% since its inception in February, with low volatility.

This is slightly more than double the original €100, which means we have doubled our money in about 3 ½ years, for a roughly 20% annual appreciation (the MSCI World Index in euros, dividends included, is essentially flat over this time). The total size of the fund, both A series ("Classic") and B series ("Alpha") is now over €100 million.

The Alpha Series' NAV is 8.40% up since February, when it was started and, as expected, has been less volatile (smaller increases and decreases) on a monthly basis than the "Classic" Series. Total returns are lower than for the LTIF "Classic" because indices are up on average 7% for the year.

Figure 2:
 Performance comparison: LTIF "Classic" - LTIF Alpha Series



Companies we sold

The only company we sold during the quarter was Sadia, the Brazilian pork and poultry products company. We own its main competitor, Perdigao, and after further consideration, decided it was a better choice to concentrate our position on just the second company.

Companies we bought

As mentioned, we bought six companies, most of them in Europe. Although our approach is "bottom up" (we just look for good, inexpensive companies, wherever they are), we have made an effort to balance our portfolio a bit towards European companies, of which we had very few in the end. The companies we have bought are:

- **Interseroh**, a German company specializing in the recycling of materials (discarded packaging, old appliances, etc.) German (and European) laws are increasing demand for recycling and Interseroh has the scope and technology to profit from it.

- **Balda AG** produces components and subassemblies for mobile phones. Although based in Germany, it has moved most of its production operations to Eastern Europe and China.
- **Neste** is a Finnish oil transporter, refiner, and retailer. It can handle heavy oil, much cheaper than light oil, more scarce, which gives it good margins. It serves the Baltic area, which enjoys above-average economic growth.
- **Valero** is also an oil refiner and retailer (the third largest in the US), truly focused on refining heavy oil, thus enjoying excellent margins.
- **ING Canada** is an insurance company, majority owned by ING of the Netherlands, with a very strong market position, excellent profitability and a low price.
- **Grupo México** is one of the world's largest producers of copper, and it holds its largest reserves. As is the case with many commodities, markets are discount a very sharp drop in the price of copper, which makes the company very inexpensive (its dividend yield is now 12%). We believe a big drop is already in the share price, and any surprise on the upside (clearly possible, even likely) would provide outstanding profits.

Portfolio news

As announced, both series are now listed in the Irish Stock Exchange (to see the price, click on <http://www.ise.ie/app/showFund.asp?fundID=13284>), and thus subject to the supervision of that market's regulator. A practical implication is that €100,000 must now effectively be the minimum investment (that was the case in the past, but the Fund's board could waive it. Now it is strictly enforced).

*Both classes (A-
"Classic" and B-
"Alpha") are
now listed in
the Irish Stock
Exchange*

We have an addition to the Strategic Investment Advisors team in the person of Maria Vázquez. Maria has a very solid experience in all back-office functions, having spent many years at BSCH and JP Morgan in Geneva in management positions. We are very happy she has decided to join us and are sure her presence will contribute to the rigor of our operations and will free time to concentrate on research for good and undervalued companies.

*María Vázquez
joins SIA, SA as
Office Manager*

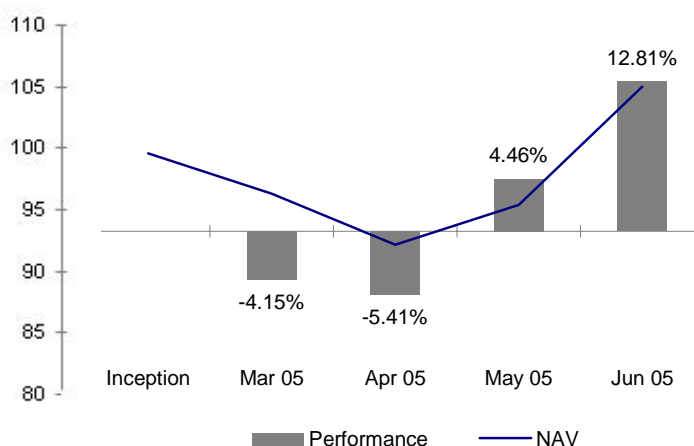
Two smaller notices are that we are moving offices, to 11 Cours de Rive, in Geneva (we could not really fit in the old ones), and that Strategic Investment Advisors, Sociedad Anónima, has been incorporated in Spain to take care of the business over there. Although Spain may not be the first market to go after, the truth is that Walter Scherk's reputation there makes it almost impossible not to develop a solid business. We plan to begin operations in March 2006 with essentially the same funds we are advising now.

The Global Energy Value Fund

The GEVF is up 6.83% since its inception in March this year, although with strong volatility

As our investors know, we started the Global Energy Value Fund (GEVF) in March 1st, 2005. During this time investors have been bombarded with headlines saying that oil's price is going to \$100 a barrel... or is about to collapse under the weight of unbridled speculation. Since the volatility of returns may give indications in either direction, (see figure 3), we believe it is particularly important that investors understand the fundamental analysis behind our conviction that energy in general, and the GEVF in particular, is one of the very best investments available in the world right now, regardless on any short-term variation in the price of oil or the shares of oil-producing companies. From an investor's point of view, oil companies have two key attractions: not only are they massively undervalued, but the analysis that leads to the previous conclusion is relatively straightforward. We thus have clearly visible important potential gains, something simply not available elsewhere in today's markets.

Figure 3:
 GEVF monthly Net Asset Value per share



To make the argument clear we have to cover basically two points: what the future price of oil is likely to be; and how to value an oil company based on that price forecast. Let's now turn to the first one.

The future price of oil

Much current talk about the evolution of oil prices is wholly unsubstantiated

As mentioned above, it's not infrequent to read in the business press statements like "the current price of oil carries a 'terror premium' of \$20", "based on fundamentals, the 'right' price of oil is \$25 to \$35", "we are witnessing a speculative bubble in oil"... but also talks about "super-spikes", pushing the price of oil above \$100 a barrel. Which is it? Who is right?

A first characteristic of most, if not all, those statements, is that they are wholly unsubstantiated. How do people estimate a "terror premium"? How do they know what the "fundamental" price of oil should be? Let's see if, drawing from sound microeconomic theory and real-world data we can establish a solid, rigorous line of thinking that will point us in the right direction.

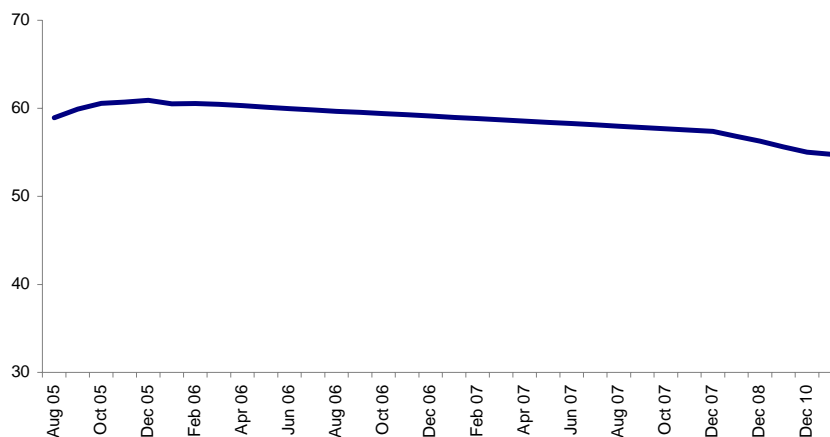
“Spot” prices of commodities that cannot be stocked are rarely affected by speculation; they are determined by supply and demand.

All prices are determined, in a free market, by supply and demand. The market price is simply that which satisfies most consumers and most producers. Markets will gravitate towards it, more or less quickly depending on some specific characteristics, some of which we’ll discuss later.

One point we can already introduce, but over which we’ll come back, is that spot prices for commodities that cannot be stocked away are not normally subject to speculation¹. Let us give an example. If word came out that there would a severe shortage of soap in three months’ time, most of us would react by buying today more of it than usual, just to be safe. This, of course, would push up soap’s current price, for demand would be stronger and supply the same. But if the rumored future shortage concerned fresh apples, not much would happen to their price today, for stocking them would be useless (so current demand would not shoot up).

When we see that oil is trading in the spot market at any price, we can be pretty sure that that is the “right” market price (the one that clears real supply and real demand at that precise time), for the world’s capacity to stock oil is very small compared to total use. Thus, there is no speculation in the spot price. There can be (indeed, there *must* be) speculation in the futures prices, for they are essentially a bet on what the spot price will be in the future. Interestingly, today’s prices for oil are not very different for delivery next week or in three years’ time.

Figure 4:
Prices of oil for future delivery (NYMEX), mid-July 2005



If price is determined by supply and demand, we must then understand the evolution of those two forces to confidently predict the evolution of prices. Let’s start with demand.

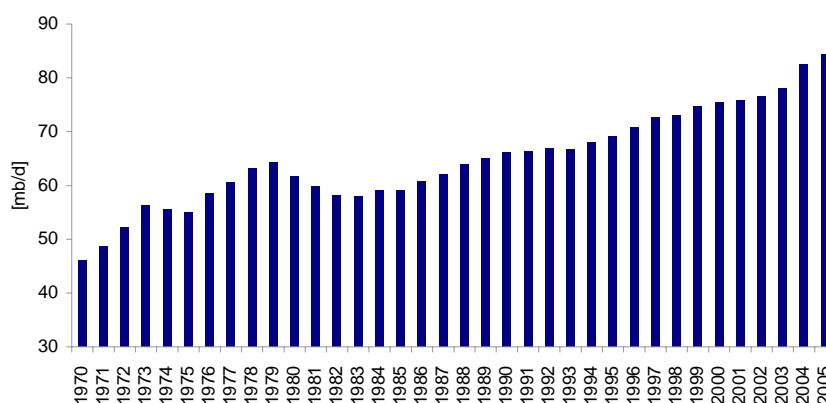
The demand for oil

According to the International Energy Agency, world’s oil consumption in 2005 will average 84.3 millions of barrels per day (mb/d). This is an

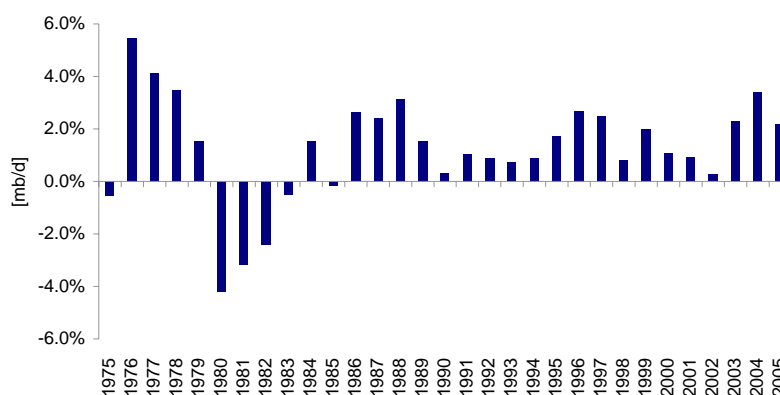
¹ A “spot” price is the price paid, cash, for something bought and delivered immediately. A “future” price is the already-fixed price that will be paid for delivery sometime in the future, be it next month or in five years’ time.

average, not a constant daily number, for two reasons: demand is seasonal (stronger in summer and winter, weaker in fall and spring of the Northern Hemisphere); and it is growing: there is more consumption, seasonally adjusted, at the end than at the beginning of the year, because the trend is going up. The future rate of growth is, of course, not known, but this is the past:

Figure 5:
 Total world oil consumption and rate of growth



Source: International Energy Agency

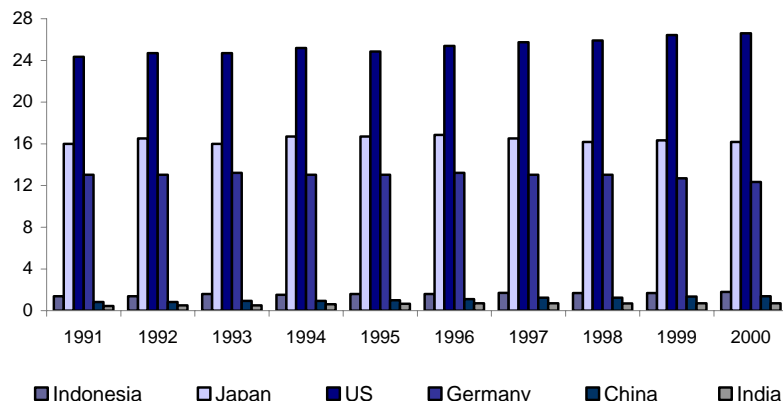


Source: International Energy Agency, SIA

As can be seen, only during an extreme recession did consumption actually go down. For the most part, it just keeps going up, at varying rates.

Much has been made of the acceleration of the growth rate in the past few years and the development of China. This is logical, for China is an enormous country, experiencing fast economic growth, and starting with an extremely low consumption of oil per capita (something similar can be said of India, by the way), as shown in figure 6.

Figure 6:
 Per capita oil consumption of several countries, including China and India



But let's notice that the second biggest absolute amount of new demand keeps coming from the USA, which guzzles more than a quarter of all of the world's oil production.

How will demand evolve? We believe there are strong reasons to think it will continue growing. World oil consumption shot up from 10 mb/d in 1950 to 50 mb/d in 1970 (that's an annual compound growth rate of 8.38%), just because the middle classes in the West (500 million people) bought a car. Well, car purchases went up by 24% in China last May over the previous year, and by 20% in India. It is clear that, with ups and downs, hundreds of millions of human beings are going to try to enjoy the basic conveniences (motor driving, air conditioning) that we in the West (and now in Japan, Korea, Taiwan, etc.) take for granted, and it is hard to see why they should not achieve what we did. This will represent an enormous increase in demand. Of course, there may be recessions along the route, but the overall trend is clear. (It is worth pointing out, however, that China is growing more slowly than Japan, Korea, and Taiwan did when they were at the same stage of development China is now. Japan went for 40 straight years without a recession)

It is hard to imagine a growing world economy that does not entail a strong growth in the demand for oil

What does all this mean? That in a world whose population is growing, whose economy is growing, and that yearns for niceties that require energy (and fertilizers, by the way, because more people surely means more food), demand for oil can only keep growing. Whether it is at 1.5% or 3% per year, we do not know (remember, it was more than 8% in the 50's and 60's). But we can be fairly confident that demand, over the medium term, will grow significantly.

The supply of oil

Let us now turn to supply. The world produces about 84.3 mb/d of oil: roughly the same as it consumes for, remember, there is not much storage capacity. This is the level that, given current demand, produces the current price. But could that price be lower, as many analysts indicate? To come to a solid answer, you'll have to bear with us for a couple of paragraphs on microeconomic theory.

In a competitive market, the price of a commodity equals the marginal cost of the marginal supplier. In simpler words, the price is determined by how much it costs the supplier with the highest costs to produce an extra barrel. If the price goes below that level, the supplier does not produce, for nobody likes to lose money, and the price goes up. Over the short term, the price that matter is the marginal "cash cost": how much it costs, in purely variable terms, to extract an extra barrel of oil from a well that is already there. Over the medium term, the price must be seen to cover also the cost of setting up the well, otherwise nobody will do it (and, since wells age fast, production would go down).

If a producer with low costs (say, Saudi Arabia), has enough capacity to satisfy all the world's demand, then the price is low, and all other competitors go out of business. But that producer can decide not to supply all the demand, and keep some of its reserves for the future. Then the price will be set by the next-most expensive producer. Of course, this one can do the same, and the price keeps going up, until it is high enough that somebody starts to think that, at current prices, they better produce more (better bird in the hand than in the bush...), and the price finally finds a (more or less stable) equilibrium.

In that sense, the price may be higher than the pure theory would predict, because some low-cost producers may restrain production, thus letting the high-cost producers set the price. This is exactly what OPEP has been trying to do, with more or less success, over the last 30 years.

The implications are very important: if OPEP (basically, Saudi Arabia) has extra capacity at low cost, the price of oil can easily be pushed down by their increasing production. But if that is not the case, then OPEP is completely irrelevant: everybody produces as much as they can, and the price is set by the marginal cost of the least efficient producer. There are sound reasons to believe that this is the situation today: after years of keeping spare capacity, the growth in demand has finally soaked it up, and Saudi Arabia cannot simply produce more oil. Most people don't know that, arguably, Saudi Arabia may be producing right now less oil than last year.

In these circumstances, when demand is ready to absorb all available short-term production, an auction starts, where buyers bid up the price of oil, until some potential buyers desist. Today, there is enough interest to buy 84 mb/d at more than \$55, and this is what determines the price.

The world has run out of spare production capacity for two reasons: growth in demand, already discussed, and "depletion", a much more important, little discussed factor.

All oil fields are, obviously, finite. After a point, dependent on how large the field is, how quickly oil has been extracted, and its own geological characteristics, every oil field starts producing less oil than in the past. In most cases, the decline is gentle, a few percentage points per year. In others, it's sharp: up to 10% less production per year (this is the current rate of depletion of the North Sea fields). In this case, the oil field is abandoned in a few years. This phenomenon is happening every day, since the first day oil was extracted, but it has been compensated by new discoveries and increased production from fields in exploitation.

The World has run out of spare capacity because demand has grown and not enough has been invested, precisely because prices were too low in the past. It takes many years to ramp up production.

A key determinant of supply is "depletion", the amount by which old oil fields decrease production every year.

It is a very serious, often overlooked problem.

According to the International Energy Agency, the world depletion runs now at about 5% per year. This means that, to remain flat, production must in fact increase by 5% per year (that, at current rates, is more than 4 mb/d, or almost twice the peak of Iraq's production). It is remarkable that in the last two years, many oil producing nations, such as Norway, the UK, Australia and, possibly, Russia, have passed their peak (they are producing less oil now every year); and that several exporters have become importers (such as Indonesia, Australia or the UK itself).

Of course, the world is trying to increase production: most oil companies have plans to expand some fields they already operate or to open up new ones. But oil works take a long time to bring production to market, generally at least five years, except for the simplest de-bottlenecking operations. That means that we know now how much oil can be produced in the next five years: today's production, plus all the new operations being set up, minus depletion. If new, big discoveries are made (something that has not happened in more than 30 years, but that could happen), they will not affect the supply/demand situation for at least five years, which is the minimum time it would take to bring that oil to market (in reality, it would be more, for discoveries are being made only in very difficult-to-work-in places, the last ones to be explored).

Table 1 summarizes these numbers, and gives us an indication of the world's maximum production in the next few years. We start with today's capacity, add the new operations that are scheduled, and subtract depletion. Intentionally, we've "cheated" in this table: expected additions are lower, and depletion is most likely to be much higher. What we have wanted to be very conservative when estimating the future price of oil, so we have made optimistic assumptions about supply.

Table 1:
Maximum possible supply for the next five years.

[Mn barrels / day]	2005	2006	2007	2008	2009	2010
Previous year production	82.5	85.0	85.5	85.9	86.3	86.7
Spare capacity	1.5	1.0	0.5	0.0	0.0	0.0
Additions	3.5	2.0	2.5	3.0	3.0	3.0
Depletion	2.5	2.6	2.6	2.6	2.6	2.6
Total capacity	85.0	85.5	85.9	86.3	86.7	87.1

Source: International Energy Agency, CIBC, SIA

Now we have to compare that supply with possible demand. Of course, demand cannot be higher than supply: we cannot consume what we don't produce (remember, there are no meaningful stocks). So if demand has a "natural" tendency to grow (all that economic development we discussed) faster than supply, then the price will have to go higher to "restrain" that demand. How higher?

This is the last bit of economic theory we need to close our argument: demand elasticity. In most cases, when the price of a commodity goes up, demand for it goes down (and vice versa). But the proportions

Oil demand is price-inelastic in the short term: people need energy, even if its price goes up.

vary. Demand for life-saving medicine is fairly inelastic: it does not vary with price, at least not much. People will buy the drug, literally, at any price, provided they can afford it at all. Conversely, if the price goes down, not many more people will buy it, if they don't need it. On the other hand, demand for apples is elastic: if the price goes up, people buy pears or any other fruit.

When demand is elastic, a small change in price changes people's attitudes fast. When it is inelastic, people keep demanding the same amount, regardless of price. This means that, if demand has to be restrained (or augmented), the price has to move a lot. This is the case with oil.

According to the US Department of Energy, oil has an overall elasticity of 0.2. This means that a 10% increase in price implies a 2% decrease in demand. Of course, this varies by product (fuel oil for energy production is more elastic, because electricity can be made with natural gas, than gasoline, for which there is no short-term substitute). Of course, this is short- to medium-term elasticity: if prices are very high or very low for long, people will change their cars and they way they heat their homes, but those changes take a long time to make an impact on overall demand: it took many years of very cheap oil to move people to swap their "normal" cars for SUVs. It will also take many years for them to go back to less-consuming vehicles.

We now have all the elements needed to estimate where the price of oil can be in the next few years: Table 2 shows the calculations. We take the maximum possible supply, estimate several levels of demand, see if there is "excess demand" and then, using the estimated elasticity, calculate how high the price has to be so that demand will "fit" within the available supply. For our calculations, we start with a market-clearing price of \$55 (in reality, it's close to \$60, as we write this).

Table 2:
Projections for oil prices taking into account supply and demand

	2005	2006	2007	2008	2009	2010
Demand growth, per year						
1.5%	84.5	85.8	87.1	88.4	89.7	91.0
2.0%	84.5	86.2	87.9	89.7	91.5	93.3
2.5%	84.5	86.6	88.8	91.0	93.3	95.6
Excess demand (compared to total capacity, as of Table 1)						
1.5%	-0.5	0.3	1.1	2.0	2.9	3.9
2.0%	-0.5	0.7	2.0	3.3	4.7	6.2
2.5%	-0.5	1.1	2.9	4.7	6.5	8.5
Price needed to balance supply and demand, given a 0.2 elasticity						
1.5%	55.00	55.94	58.61	61.31	64.02	66.75
2.0%	55.00	57.28	61.27	65.24	69.20	73.14
2.5%	55.00	58.61	63.88	69.10	74.25	79.34

Although we can't forecast oil prices year per year (much less quarter per quarter), we can understand that they are going to stay at current levels for a long time, with the risk on the upside, even if some short-term drops are possible from time to time.

Obviously, these results are estimates. Nobody knows what the price will be, and it will certainly fluctuate, for all four key numbers (production additions, depletion, demand growth, and demand elasticity) are but approximations. These estimated prices will perhaps happen one or two years sooner or later than expected.

This table is thus not a year-to-year forecast of what the price of oil is going to be, but an estimation of where the balance between supply and demand may take it. There will probably be wild swings, because if there is no spare capacity, and something happens to supply, short-term panic will ensue. But this much is clear: for the price of oil to fall significantly below its current level for a significant amount of time, one of two things must happen: a lot of oil is found that can be extracted immediately at low costs; or demand collapses permanently, perhaps because a very long-lasting, deep, worldwide recession, or because a new technology allows us to immediately replace oil with some other fuel. Short of this, it is very difficult to imagine how the price could go down from its present level. (It is easy, on the other hand, to imagine how it could go even higher: an accident may happen to the production capacity; or depletion could be faster than expected. There are good reasons not to discount either possibility too much).

A last point: what about supply elasticity? If the price of oil goes up, so goes the incentive to produce it. This is exactly what is happening: the GEV is a big investor in Canadian oil sands, a type of oil production that can only be justified by oil prices above \$25. As it is becoming clear that prices will stay above that level, companies are starting to commit the many billions of dollars necessary to extract that oil. In addition to more oil supply, high prices will eventually bring substitutes, such as liquefied coal, wind power, or any kind of new technology that may be invented (watch for a big comeback of nuclear power). The world has not run out of oil. It has run out of cheap oil. It is estimated that Canada holds, in its oil sands, as much oil as the rest of the world put together... except for the Venezuelan oil sands, where there is as much oil as in Canada. But that oil is expensive to extract, and it will take a long time to make a difference in world supply. The world will not run out of energy, but we are going to see a few years of great tension, because bringing in new production and substitutes takes a long time, and everybody thought two years ago (some even think so today) that oil prices will revert to \$25, and any new project would then be ruinous, so nobody invested. The world is fairly unprepared for a situation where oil production grows by less than demand.

If we accept then that the price of oil is going to be at least more or less where it is now for the foreseeable future, we can start valuing oil companies.

Valuing an oil company

An oil company has two activities whose profitability depends on the price of oil, and, sometimes, a third one, not so related. The first two are the exploitation of its reserves and its capacity to find more oil. The third one is, for so-called "integrated" companies, transporting, refining and retailing operations. The profitability of these last series of activities is not really affected by the price of oil, which is just a "raw material" to them.

*Our proprietary
research based
valuation
methodology
emphasizes
reserves over
current cash-flow*

Valuing reserves is not too difficult conceptually: companies must report how much oil they have, and it's enough to multiply that number by the expected price of oil, minus extraction ("lifting") costs, over the time it will take to exhaust the reserves. Of course, in the real world estimating reserves is a bit more of an art than a science, but we can have reasonable estimates, nonetheless.

Valuing exploration activities is trickier, for we don't know how much oil the company will find in the future. The truth is that, for most companies, the amount of oil they have been finding in the last few years is going down, in some cases sharply so (some of the "majors" are now finding every year less than half the oil they are producing). Obviously, the value of an exploration unit that does not find oil is negative, for it costs a lot of money to keep trying. For these reasons, we assign a very conservative value to exploration activities, preferring companies with a high level of proven reserves.

With this approach, we have taken a look at a large number of oil companies, and estimated a "current Net Asset Value" for each of them at several levels of oil prices. That value is the value of their reserves (taking into account the kind of oil they have, their lifting costs, extraction rhythm, etc.), plus some value for their exploration activities, minus their financial debt. We then compare that with the market value of the company, and determine whether the company is overvalued, undervalued, or at "fair price".

According to our calculations, most companies would be at "fair price" if oil price stays forever around \$35. "Fair value" means that an investment in the company would return 10% per year over the life of the investment. If we put a constant price of \$55 in our calculations, many of the companies we have selected are worth in reality twice as much, at least, as their current price. And this does not take inflation into account. And some of these companies have more than 40 years worth of reserves. All the arguments made above make us think that it is extremely unlikely that the price of oil will on average stay for the next 40 years below \$40 (it's already at \$60), and therefore, there is a huge amount of value in these companies.

We believe that the GEVF is a good way to exploit this value because through our proprietary research we concentrate on reserve life and future production, more than on current-year earnings or cash-flow, which are the most commonly-watched indicators. We invest in companies which are only now being recognized by the market, where the undervaluation is greatest. We believe it's an investment with an enormous "margin of safety" (even with oil at \$40, these would be profitable companies) and with a huge upside (they can easily double their share price in the next very few years). In addition, it provides a "hedge" for any portfolio: if oil prices do go severely up, other sectors will suffer.

We keep monitoring our portfolio, refining our analysis, and adjusting our positions accordingly. Some of our companies are sharply up in the market this year (by more than 50% in some cases), but there is even more value than before, for that rise does not fully reflect the rise in the oil price, which we believe to be more or less sustainable, as discussed.

The GEVF should prove to be a highly profitable, if volatile, investment for the long term.

But it is going to be a volatile investment: since GEVF concentrates in only one sector, there cannot be a “diversification smoothing” of results, as happens in generalist funds such as LTIF. Thus we won’t be surprised to see the fund’s NAV go down several percentage points for one or more months (as it did in March-April this year), nor should we expect constant 12.81% monthly increases, as in last June. (Perhaps, that volatility should be welcome by investors, for it has no correlation –or even a negative one– with most other investments). But investors should know that, as long as long-dated distant futures prices (oil for delivery in five years’ time) are well above \$40 (they are more than \$55 today), the GEVF could prove to be one of their best investments ever.

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