Long Term Investment Fund

Status of the Funds

As of June the Long-Term Investment Funds had the following evolution in NAV per share and net assets under management.

Table 1: Net Asset Value - Net assets under management

June 2006	NAV	Δ June	Δ 3 months	Δ 12 months	Δ Year to Date
LTIF - Classic	274.19	1.56%	-1.11%	35.36%	11.71%
LTIF - Alpha	134.93	2.95%	2.76%	24.47%	14.13%
LTIF - Stability	105.48	0.68%	0.91%	n.a.	5.01%
LTIF - Energy	136.86	2.71%	-3.10%	28.04%	8.51%
AC MSCI World Index	3,079	0.46%	-5.67%	11.24%	-1.88%

This last quarter has seen the LTIF transferred from the British Virgin Islands to Luxembourg (the new Bloomberg tickers are shown at the end of this Newsletter). The relatively complicated operation went well, largely due to the excellent job done by the old fund's administrator, TMF in Rotterdam. A small amount has not as yet been transferred, but we expect it to move to Luxembourg over the next few months, with the BVI funds being closed at the end of the summer.

The Fund's registration process is still continuing in all main European countries. By the end of summer the Fund should be freely available to retail investors in most of these countries.

Figure 1
LTIF - Classic

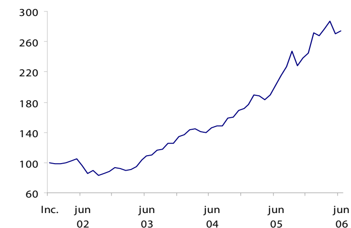


Figure 2
LTIF – Alpha Series

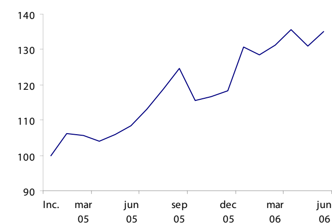


Figure 3
LTIF – Energy

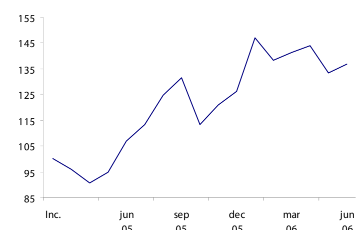
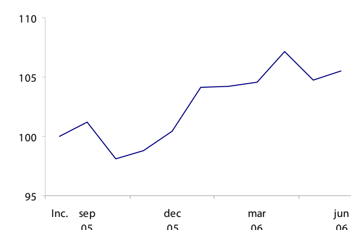


Figure 4
LTIF – Stability Series



Evolution of the funds

During the last quarter, the evolution of the companies we own was generally highly satisfactory, although there were some exceptions:

- Clinton Cards, a British producer and retailer of greeting cards has had a much harder time integrating their largest competitor, acquired last year, than expected. This difficulty coincided with a weak overall retail environment and a general decrease in greeting cards sales. We sold the position.

- Sanderson Farms, poultry producer in the US also had a difficult time coping with the reduced demand due to the avian flu scare. Overcapacity in the industry has led to very low prices, and the company booked a small loss for the last quarter.

- Some commodity producers we own had large accounting write-offs due to hedging. Many commodity producers sell their future production in the futures markets to "lock in" a given price. This can be a prudent way of ensuring that the company will have enough cash to fund its capital expansion projects, regardless of what commodity prices do. But when

Strategic Investment Advisors S.A. 11, cours de Rive CH-1204 Geneva
tel : +41 22 707 07 80 fax : +41 22 707 07 89 info@s-i-a.ch www.s-i-a.ch

those prices rise above the hedges, new accounting rules often demand that the difference between the actual selling price (determined by the hedge) and the commodity's market price be immediately recognized as a loss, even in respect of future sales. This can produce an enormous accounting loss in a given quarter if the commodity's price has risen sharply and the hedges cover several quarters of production. But this is merely an accounting loss: future sales will be recorded at market prices, although they will in fact be made at the hedging prices. It's a loss that does not really matter much.

- More important is the fact that quite a few mining companies are reporting slightly (or not so slightly) disappointing production results. In some cases, the ore is of inferior quality (less concentrated) than expected. In other cases, accidents occurred, shutting production down for days or weeks. Finally, strikes by workers demanding their share of the booming profits are becoming more frequent. All these incidents affect companies' profits, but also ensure that commodity prices stay high, as we will discuss later.

However, despite these qualifications, it should be noted that the Fund's overall profitability (that of its companies) is excellent. We estimate a "normalized see-through profit" of about €7 for the quarter. This normalized see through profit is an extremely important concept, which we believe is worth dwelling upon again.

The charts below show the Fund's industry and geographic composition:

Figure 5
Breakdown by industry

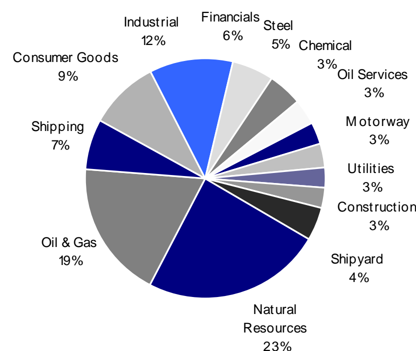
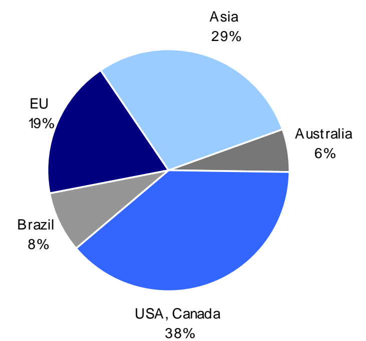


Figure 6
Breakdown by geographic area



Prices and profits: the "see-through" concept

We've repeatedly said that any investment can be regarded in two different ways. In the first way, the investment's market price is what matters, and one makes money when selling the investment at a higher price than its purchase price. We have called this approach "trading", or even "speculating". The successful speculator does not really need to know much about the asset he buys, as long as the price goes up.

Strategic Investment Advisors S.A. 11, cours de Rive CH-1204 Geneva
tel : +41 22 707 07 80 fax : +41 22 707 07 89 info@s-i-a.ch www.s-i-a.ch

The second approach concentrates on assets' profitability. Investors buy an asset that delivers a profit, and make money through the "rents" paid by that asset, which must be commensurate with the purchase price. In this approach, the asset' subsequent market price is not very important, except that the investor will probably prefer to sell it if the prices increases sharply in order to buy another, cheaper asset that will bring in more profits. We have called this approach "strategic investing", which is, of course, the strategy we follow with the LTIF.

Speculators can track their investments almost minute by minute if they want to: they need only check their investments' market price on the Internet, Bloomberg, CNBC or in the morning newspaper. If their shares are up, they're making money. If they're down, they're losing.

Strategic investors, however, cannot have this immediate knowledge of how they're doing, because the figure they are interested in is not the price of their shares, but the profits made by the companies they own, and companies do not constantly update reports on their profitability. Furthermore, this profitability is easy to know (once a quarter) when the investor owns the companies directly, but practically impossible to determine if the investor owns them through a fund, because the fund does not normally disclose the portfolio's exact composition. Even if it were to, calculating all the companies' aggregated profits in the appropriate proportion and determining the "earnings per share of the fund" would be a cumbersome task.

Yet that figure, which is also called the "see-through profits", as it implies looking beyond the fund's legal structure to the economic reality of the underlying assets, is the one that really matters to a strategic investor.

As mentioned above, we estimate that our see-through profits for 2006 will be around €30 per share of the Fund. This means that, currently, the Fund returns 10.9% to its investors (because the Fund's share price was 274.19 at the end of June). And it is worth noting those profits' upward trend: in 2005, the fund earned €20 per share. We expect it to earn some €40 in 2007. We believe that, so far, an investment in the Fund has turned out extremely well, *regardless of what the share prices do.* But if the market were to accord a PE to our shares of 10 (the average for the whole market is now around 15), the Fund's Net Asset Value per share would go next year to €400, almost 50% above its current price.

Of course, these numbers apply to the Classic compartment. The Alpha compartment will be affected by what the market does: if the market does well, the Alpha's NAV per share will go up by less than that of the Classic; they other way around if the market does badly. If past performance were an indication of the future, the Alpha compartment should basically return an annualized 15% to 20% regardless of what the market does.

The Energy fund has obviously a different dynamic. Interest in energy investing has gone down dramatically, yet the price of oil is $73.85 per barrel as of this writing. After re-calculating for a thousandth time the intrinsic value of our shares, we stand convinced that this is one of the best investments that can be made today, taking into account both the upside potential and the visibility of that potential.

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Share prices during the last three months: of “bubbles” and “black holes”

In the previous newsletter, three months ago, we wrote:

> “it is entirely possible that commodity prices could drop temporarily, as oil prices do every six months or so. If that happens, it is also entirely possible (even likely) that our mining companies' share prices will fall”.

Well, we were right. After a few more weeks of sharp rises, metal prices went down, and all the metals producers with them. Shares in all emerging markets and their currencies went also sharply down. This entire drop has led to a decrease of 1.2% in our Net Asset Value since the end of March. We believe, however, that our investments are excellent (see the above analysis of the see through profits). Why are our shares so inexpensive then?

The first point that we must accept is that, from time to time, there will be a wide divergence between (some) shares’ real value - as determined by their future profits - and their price. The best example of this was, of course, the infamous “Internet bubble” during last century’s final years. Looking back, it is hard to believe that people paid so much for shares that were obviously worth nothing. Even those shares that were worth *something* changed hands at prices that made it impossible for the buyer to earn a profit. This is how Scott McNealy, founder and Chairman of Sun Microsystems put it to angry shareholders (for the record, we include figure 7, which shows a chart of Sun’s share price during the last ten years):

> “But two years ago we were selling at 10 times revenues when we were at 64. At 10 times revenues, to give you a 10-year payback, I have to pay you 100% of revenues for 10 straight years in dividends. That assumes I can get that by my shareholders. That assumes I have zero cost of goods sold, which is very hard for a computer company. That assumes zero expenses, which is really hard with 39,000 employees. That assumes I pay no taxes, which is very hard. And that assumes you pay no taxes on your dividends, which is kind of illegal. And that assumes with zero RD for the next 10 years, I can maintain the current revenue run rate. Now, having done that, would any of you like to buy my stock at $64? Do you realize how ridiculous those basic assumptions are? You don't need any transparency. You don't need any footnotes. What were you thinking?” Scott McNealy, *BusinessWeek,* April 2002)

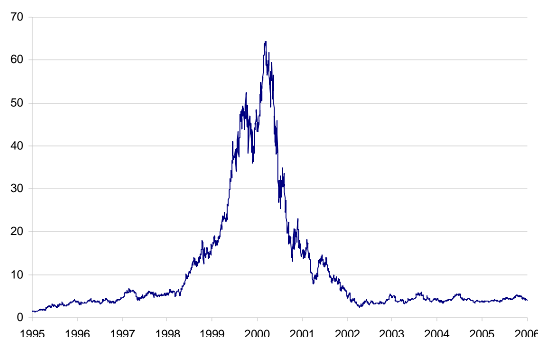

Figure 7
Sun Microsystems – Share price 1995-2006 (USD)

Source: Datastream

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Well, we would like to submit the idea that, form time to time, we can fall into "black holes", symmetrical to those "bubbles". When the stock market, or part of it, enters a "black hole", people will sell shares with the same irrational fervor they show when buying them during "bubbles". In our opinion, the shares of many resource-based companies, from oil producers to copper miners, from off-shore drillers to aluminum smelters, are going through such a "black hole".

Consider one of the copper companies we own: Quadra Mining. This is a Canadian-incorporated company, operating in the US and Canada. To calculate its future profits we must, of course, make an assumption about the copper price. Right now, the London Metals Exchange trades futures at $3.40. We have very strong reasons to believe that the copper price cannot go permanently below $2.5, as this is the full cost of opening and operating new mines, and the old mines are rapidly being exhausted. But, to be very conservative, we assume a future price of $2.2. With this assumption, Quadra will make a profit of $2.1 per share next year. But its shares are trading at $10, which gives investors an expected profitability, on highly conservative assumptions, of 21%. And this is but one example: some off-shore oil drillers, such as Todco, will have a free cash flow (that is, money left to distribute, after paying all expenses and re-investments) of more than 20% per share next year. Nevertheless, figure 8 shows the evolution of Quadra's and Todco's share price.

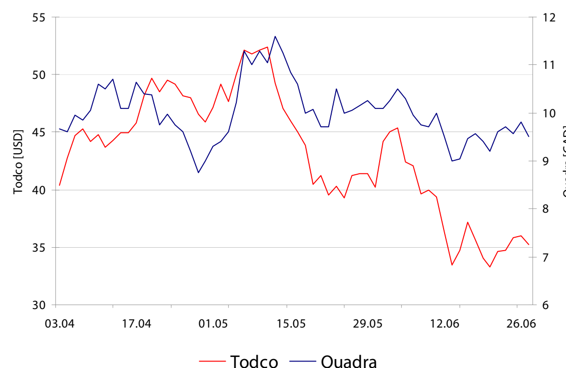

Figure 8
Quadra & Todco – Share price in the last quarter

Source: Datastream

Of course, if the world stops using copper its price will collapse. But how likely is that? Figure 9 shows the historical copper demand: you don't see many drops there. Copper represents only a tiny percentage of a new house or a new car's price. Nobody is going to defer purchasing a house because the copper in it now costs €100 more. Now consider off-shore oil drillers. The market sells those shares when the price of oil drops a bit. But this is ridiculous: drilling for oil is profitable as long as oil prices stay above $50, and the current price is $73 for delivery next month and almost $70 for the next seven years. This means demand for oil drilling services is practically assured for many years to come. Or simply look at our old friends, the Canadian oil sands companies. We spent a good part of the Christmas break re-calculating their intrinsic value. We came to the conclusion that, at the oil prices current at that time, they were an outstanding investment, equivalent to a bond that would yield more than 15% in Canadian dollars for the next 40 years. Well, since then the price of oil has increased by 20% and the shares are either flat or even slightly lower, as shown in figure 10.

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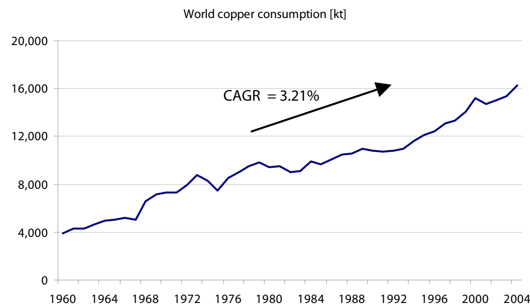
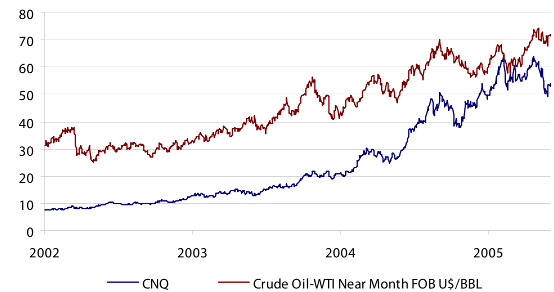
Figure 9
World Copper Consumption [kt]



Source: Datastream, SIA Reserach

Figure 10
CNQ vs Crude Oil Near Month FOB



Source: Datastream

But these are not the arguments one hears. We have been reading all along about the "bubble" in commodities and commodity producing companies. How can we talk of a bubble when the companies literally don't know what to do with the incoming cash and their multiples (PE and such) are one half those of the overall market? How can we talk of a bubble when there is simply no forthcoming supply to meet normal demand? Few people realize, for instance, that the OPEC countries produced 3% less oil in the first six months of 2006 than they did last year. Or that only one copper mine of a substantial size will be opening in the period 2005-2010, while many key mines are depleting fast.

We could spend as much time trying to rationalize these drops as was spent rationalizing Internet share valuations, but it would be a waste of time. Strategic investors know that price and value diverge from time to time, because the market goes through irrational phases, and just take advantage of it.

This takes us to a last and, in our opinion, very important point: that of volatility and its relationship to risk.

What is risk?

One of the investing world's tenets is that risk and reward go together. It is intuitively obvious: if the investment is perceived to be at risk, nobody will invest unless the possible gain would compensate for the risk (and vice versa for a riskless investment). Modern financial theory has built an impressive, rigorous analytical apparatus that is based basically on this insight.

However, there is a problem in that apparatus for the individual investor: the technical definition of risk is not the same as the day-to-day definition of risk. When standard investors think of investment risk, they normally think of the probability of permanently losing some of their capital. When investment professionals think of risk, they are thinking of the volatility of the investment's price. Thus a share is considered to be risky if its price fluctuates a lot, and there are

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many extremely sophisticated techniques in “risk management” that are essentially based on this notion of risk as volatility.

We would, however, like to argue that, for the long-term unleveraged (i.e., debt-free) investor, this assimilation of risk and volatility simply makes no sense. Go back to Scott McNealy’s comment on Sun’s shares trading at ten times sales. Do you think that was a risky investment? The truth is, your chances of losing money (a lot of money) were basically 100%. But that has nothing to do with volatility: it has to do with price.

Imagine a share that goes up smoothly every month, with very little volatility, until it becomes very expensive in terms of its underlying profits. According to “professional finance”, it’s not a particularly risky investment: for instance, General Electric in the final years of the last decade (figure 11). In fact, every day that its price goes up smoothly, its volatility decreases, and so does its “technical” risk. But you are clearly getting into an ever more dangerous territory. Figure 12 shows what happens when the market discovers that the emperor’s clothes are not as pretty as claimed. In fact, when was it riskier to buy GE, in April 2000, when it was trading above $59 and the share showed little historical volatility (and the company had earnings per share of $1.18), or now, when it’s trading at $33.27 (with earnings per share of $1.56) and a much higher historical volatility?

Figure 11
GE share price (1990-2000)

Figure 12
GE share price (2000-2006)

You can thus have investments that are stable and dangerous, and you can have wild and safe investments. Let’s again look at our Canadian oil sands companies. Canadian Natural Resources has, imbedded in its oil sands, oil reserves for the next forty years. The oil is there: there is no exploration risk. The company operates in Canada: there is not much political risk. They are about to complete their enormous facility to treat the oil: there is very little project risk left. And you can buy the shares at a price that implies a value of $40 per barrel for their reserves. Where is the risk? Would the risk be the same if the implied price per barrel were $90? Or $20? Of course not. At current prices, the risk (of permanently losing an important part of your capital by investing in the company) is very low. Yet the volatility of the share is very high, as shown by chart 10. But how does that volatility affect the long-term investor? Who cares if some people panic and dump their shares at ridiculous prices because everybody else is doing it? Or if some sophisticated institutions must sell at any price because their computer-driven Value At Risk models

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tel : +41 22 707 07 80 fax : +41 22 707 07 89 info@s-i-a.ch www.s-i-a.ch

tells them to do so, accentuating the share price's downwards spiral, thus pushing it into a "black hole"?

At LTIF, we bought Canadian Natural Resources three years ago at CAD$ 13 (split-adjusted). It has gone up a lot, and down a lot but, three years later, it trades around CAD$ 60. Where is the risk? Yes, it dropped 25% during this month of May. And? We bought more, courtesy of the irrational sellers.

Investors who know what they are doing should completely ignore volatility. True, if one buys shares without knowing what one is buying, it's obvious that one will start getting nervous if they drop 20%. But if one invests in companies with well-analyzed good prospects at low prices (which is what we try to do at LTIF), volatility simply offers entry (or exit) points, and it creates no particular problems. That is why the concept of "see-through profits" discussed above is so important: throughout this little "black hole" that we have gone through, we have simply kept our sights on the profits that our companies are making, re-evaluating and re-analyzing them, trying to ignore the surrounding noise. And it is important that investors do likewise: if they try to avoid volatility at all costs, they will simply forfeit excellent investment opportunities. In this sense, we are very happy that our investors seem to understand what we are trying to do: during these months of dropping share prices, the ratio of new investments in the Fund to redemptions has been ten to one.

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tel : +41 22 707 07 80 fax : +41 22 707 07 89 info@s-i-a.ch www.s-i-a.ch

Legal Notice - Luxembourg

Performance up to 31.05.06 is that of the BVI-based LTIF, of which the LTIF Luxembourg is an identical successor. Previous performance is audited by Ernst & Young. Reports are available from SIA Funds AG. Past performance is no guarantee of future trends.

Long Term Investment Fund is an open-ended investment company of the umbrella type organised 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.

LTIF (Luxembourg) - Directory

Administrator:

Pictet & Cie (Europe) S.A.
1, Boulevard Royal
L-2016 Luxembourg
Luxembourg

Investment Manager:

Pictet & Cie
29, boulevard Georges Favon
CH-1204 Geneva
Switzerland

Registered Office:

1, Boulevard Royal
L-2016 Luxembourg
Luxembourg

Custodian:

Pictet & Cie (Europe) S.A.
1, Boulevard Royal
L-2016 Luxembourg
Luxembourg

Investment Advisor:

SIA Funds AG
3, Seedammstrasse
CH-8808 Pfäffikon
Switzerland

LTIF – Classic
ISIN: LU0244071956
Telekurs: CH2432569
Bloomberg: LTIFCLA LX

LTIF – Alpha
ISIN: LU0244072178
Telekurs: CH2432573
Bloomberg: LTIFALP LX

LTIF – Global Energy Value
ISIN: LU0244072335
Telekurs: CH2432575
Bloomberg: LTIFGEV LX

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tel : +41 22 707 07 80 fax : +41 22 707 07 89 info@s-i-a.ch www.s-i-a.ch