MAGALLANES

VALUE INVESTORS

Quarterly Letter to Investors
03/31/2018
MAGALLANES VALUE INVESTORS, S.A. SGIIC

Dear Investor,

The performance of our funds for the quarter, thereby, accumulated for the year, has been as follows: **Iberian +1.9%**, **European -2.9%**, and **Microcaps -2.6%.**

As of the launch date of the Iberian and European strategies, more than three years ago, accumulated returns have amounted to **+45.8%** for the Iberian fund and **+37.9%** for the European fund, well above their respective benchmarks of -3.1% and +8.7%[1].

The global economy continues to firm up. In fact, the most recent available IMF forecasts for global economic growth in 2018 point to an increase of +3.9%, following a +3.8% hike in 2017.

Nonetheless, the recent increase in the level of strain in US-China trade relations resulting from an announced tariff hike, together with increasingly fraught geopolitical relations with Russia, have significantly augmented market volatility.

Given this scenario, we should single out the strong price increase of Brent oil, reaching $70 per barrel in the first quarter – the highest price since 2014. This increase in crude oil price, together with a slight upswing in inflation forecasts, has pushed interest rates for 10-year US bonds up to 2.75% at the end of Q1. In turn, the FED again increased its benchmark rate by 0.25%, reaching levels of between 1.50% and 1.75%.

We should underscore the high level of volatility in commodities, including steep increases in the prices of molybdenum, nickel and, as mentioned above, oil, as well as the fall in prices of sugar, coal, iron ore and aluminum. We owe a special mention to developments in the Baltic Dry Index, a shipping index created by the Baltic Exchange that measures the changes in raw materials' transportation costs, which dropped by -22.8% over Q1.

[1]Iberian: Magallanes Iberian Equity P. European: Magallanes European Equity P. Microcaps: Magallanes Microcaps Europe B. An Annex attached to this document includes detailed data on returns for each and every one of the investment classes and instruments under the management of, or advised by, Magallanes.

ROCE[2]: Myth and Truth

It is a proven fact that companies with a high ROCE (Return on Capital Employed) tend to typically outperform other listed companies in terms of long-term performance.

Simply put, the ROCE level shows how efficient a company is in generating operating profits as a function of resources employed. Thus, it makes sense that investors should prefer to own more profitable companies, with high ROCE levels, rather than companies that are less profitable and run low ROCE levels.

Investing in high-ROCE companies has recently become extremely popular. In fact, there is some empirical evidence showing that systematic investment in high-return companies may provide long-term financial returns above market levels.

There is no question that this is a winning strategy: the company's operating profitability generates value and ends up reflected in the share price of the company in the long term. This type of company unofficially has been defined as a quality company.

However, taking this idea too far, and turning it into a myth, may tempt investors to look too far to the future, mindless of current share price levels, and give in to an incontrollable buying frenzy of quality companies. At that point, the purchase of stocks pursuant to high-ROCE criteria becomes dangerous.

But the ROCE suffers from several shortcomings. Not only because it is a static accounting metric, but also because buying into high-ROCE companies will not in all cases ensure future returns at the same high rates. And the reason is… that perhaps the price paid for "that" capital employed was excessively high.

By way of example, imagine a company whose main activity is the design, manufacture, and distribution of garments. To simplify, we assume that capital employed is 20 billion euros, including factories, logistics centers, shops, suppliers and inventory. Operating profit after taxes is 6 billion euros, so the ROCE is roughly 30%, not a bad figure at all. Further company data shows activity in over 100 countries, excellent standing and brand image among clients, and additionally we know that the company's founder is its majority shareholder.

Few of us would hesitate to invest in such a company by purchasing a fraction of the total share volume; it makes sense to believe that a 30% ROCE would be far higher than that of almost any other alternative investment instrument.

However, if the sale price were not the abovementioned 20 billion euros but rather 120 billion, a factor of 6, what would the true ROCE be? Would this investment still be worthwhile?

[2] *Return on capital employed*, commonly referred to as ROCE. It is calculated as operating profits after taxes on the total amount of capital employed, both capital assets and operating capital.

This example is a simplified simile of a possible investment in **INDITEX**[3]. This company, possibly one of the world's best, is acknowledged to be the spearhead of the "fast fashion" business model.

The high price commanded by **INDITEX** shares some six months ago led to an excessive valuation, over six times the value of capital employed. At present, after a drop of almost -35%, we estimate that real ROCE rates on investment will be more than 7.5%, not yet 30% but sufficiently attractive for investment in a company known for its high and well-recognized competitive advantages.

Risks. The Power of Diversification

We are occasionally asked to describe how we manage portfolio risk in specific positions. Our response is twofold: on the one hand, ensure in-depth knowledge of those companies we invest in; on the other, implement reasonable diversification and allocation among the various positions.

The question is, what is "reasonable diversification"? In the absence of a single, exact response, our proposal is a number of securities neither excessively high (which would have mediocre results) nor excessively low (which would have abrupt outcomes). Our experience teaches us that approximately a 35-company portfolio is a good number that represents a "reasonable diversification."

We aim to strike the right balance between a relatively focused portfolio and the necessary level of protection against any significant drop in any of our positions.

To this end, our methodology in assigning weights is of special relevance. High potential of revaluation does not necessary mean safety of principal. To this extend, the size of a position in our portfolios is not necessarily closely related to upside potentials but rather to the effects of possible losses, should our investment approach be proven wrong.

In other words, for our portfolio, we would rather size an idea with a +50% potential than an idea with a +100% potential if the former provides better downside protection than the latter, should our calculations be flawed.

Simple but Not Easy

Apart from the fact that it is the title of a book we recommend[4], this concept itself describes how we feel when we are asked to explain the concept of long-term value investing.

[3]Data pertaining to the calculation of capital employed and operating returns are internal Magallanes estimates and have been adjusted to include the repercussion of rental expenses for shops leased but managed as if they were property, which significantly impacts the balance and operating returns. In any case, data included are meant for illustrative purposes and not to indicate values or references of any nature.
[4]"Simple But Not Easy", Richard Oldfield

From a rational point of view, value investing is quite simple: ”buy cheap”. This is a recommendation that would not seem to be limited to our sector of activity, but rather is appropriate to our behavior in general: that is, pay less for more. It sounds more than reasonable.

So yes, easy to understand but in fact, hard to do. Because in the stock market, “buying cheap” means, most often, buying shares that others reject, ignore, or even dislike or despise. This explains the low prices of certain securities. So “buying cheap” calls for large amounts of contrariness, patience, and a tolerance for suffering. And this is not how a human being is programmed; we are wired with little patience in the face of awkward or uncertain situations.

In the past we have achieved record results by investing in ideas that at the time were controversial: **Deutz**, **FCC** or **Verbund**, are clear examples of the above. The average performance of these investments is significantly more than +50%.

More recently, several investments – **Carrefour**, **Metro**, **INDITEX** or **Tarkett** – continue to demand the kind of patience we mentioned previously.

Closure of the Magallanes Microcaps Europe FI Fund

One of our investment principles in Magallanes is a firm commitment to quality in management, over and above size. Accordingly, last April we proceeded to close the Magallanes Microcaps Europe fund, as it reached assets of 100 million.

Closure involves the following: as of 100 million euros, each new shareholder may retain only one share, with the exception of special cases involving redemptions amounting to a loss of 10% of assets within a period equal to or shorter than 10 days. Current shareholders will not be able to subscribe when AuM is more than 100 million.

We have celebrated our III Investors’ Day in Madrid, which you can view on YouTube, and will shortly provide details of the Barcelona edition. Please do not hesitate to contact us by any of the available means for any query or consultation you may wish to resolve.

Thank you for your trust.

Kind regards

Iván Martín Aránguez, CFA
Chief Investment Officer

ANNEX 1. STRUCTURE OF THE FUNDS

MAGALLANES IBERIAN EQUITY FI

The fund closes the quarter with an investment level of 89.2% and a total of 29 Spanish and Portuguese companies.

The fund maintains its exposure towards the services and industrial sectors. May we highlight, among others, holdings like Fluidra, SEMAPA, Sonae, Gas Natural and NOS. Top ten holdings account for 46.2% of the fund.

Spain accounts for 63.1% of the total investment of the fund and Portugal represents 26.1%.

An 75.2% of the fund is invested in large and mid-cap companies. The remaining 14.0% is invested in small-cap companies.

Current investment level of the fund seems appropriate to be for us. The number of companies in the fund will not significantly change in the medium term.

MAGALLANES EUROPEAN EQUITY FI

The fund closes the quarter with an investment level of 89.1% and a total of 37 companies.

The fund has a bias towards the industrial, consumer and energy sectors. Such sectors are mainly represented through holdings like Renault, Aker BP, Porsche Holding, OCI and Carrefour. Top ten holdings account for 38.3% of the fund.

As a result of the holdings in the fund the exposure to Germany, France and Austria is greater compared to other countries. These three countries represent 50.1% of the fund.

A 80.6% of the fund is invested in large and mid-cap companies, with a 45.1% of such weight in companies with market cap of over €5 billion. A 8.5% of the fund is invested in small-cap companies (market cap below €1 billion).

Current investment level of the fund seems to be appropriate for us. The number of companies in the fund will not significantly change in the medium term.

MAGALLANES MICROCAPS EUROPE FI

The fund closes the quarter with an investment level of 86.1% and a total of 52 companies.

The fund has a bias towards the industrial, consumer and financial services sectors. Such sectors are mainly represented through holdings like Orsero, EDAG Engineering, Mutares AG, Italian Wine Brands and Waberer´s. Top ten holdings account for 30.9% of the fund.

As a result of the holdings in the fund the exposure to Italy, Germany and United Kingdom is greater compared to other countries. These three countries represent 52.1% of the fund.

A 67.0% of the fund is invested in companies with an adjusted market cap below 100 million euros, of which 33.4% below 50 million euros.

Current investment level of the fund seems to be appropriate for us. The number of companies in the fund will not significantly change in the medium term.

ANNEX 2. RETURNS BY FUND AND CLASS as of 03/31/18

MAGALLANES IBERIAN EQUITY, FI

FUND	NAV	1 MONTH	3 MONTHS	6 MONTHS	12 MONTHS	2018	2017	2016	2015 [1]	SINCE INCEPTION [1]	INVESTMENT LEVEL
Magallanes Iberian Equity FI "M"	151,0198	**-0,07%**	**1,68%**	**5,44%**	**10,79%**	**1,68%**	**15,45%**	**15,48%**	**8,04%**	**46,45%**	89,2%
Iberian benchmark		-2,11%	-3,14%	-5,10%	-2,46%	-3,14%	12,13%	0,52%	-5,73%	3,16%	
Magallanes Iberian Equity FI "P"	153,4179	**-0,03%**	**1,81%**	**5,71%**	**11,34%**	**1,81%**	**16,03%**	**16,09%**	**6,32%**	**45,81%**	89,2%
Iberian benchmark		-2,11%	-3,14%	-5,10%	-2,46%	-3,14%	12,13%	0,52%	-11,27%	-3,12%	
Magallanes Iberian Equity FI "E"	157,1353	**0,03%**	**2,00%**	**6,10%**	**12,18%**	**2,00%**	**16,91%**	**16,91%**	**12,72%**	**57,14%**	89,2%
Iberian benchmark		-2,11%	-3,14%	-5,10%	-2,46%	-3,14%	12,13%	0,52%	2,57%	12,57%	

[1] *Class M 29/01/2015; Class P 26/02/2015; Class E 09/01/2015. Returns net of fees. Iberian benchmark: 80% Ibex35 Net TR + 20% PSI20 Net TR.*

MAGALLANES VALUE INVESTORS UCITS IBERIAN EQUITY - LUXEMBOURG

FUND	NAV	1 MONTH	3 MONTHS	6 MONTHS	12 MONTHS	2018	2017	2016 [1]	2015	SINCE INCEPTION [1]	INVESTMENT LEVEL
Magallanes Iberian Equity Lux "R"	135,5753	**-0,16%**	**1,52%**	**5,16%**	**10,28%**	**1,52%**	**14,79%**	**16,33%**	**-**	**35,58%**	89,1%
Iberian benchmark		-2,11%	-3,14%	-5,10%	-2,46%	-3,14%	12,13%	0,52%	-	8,02%	
Magallanes Iberian Equity Lux "I"	137,2671	**-0,12%**	**1,66%**	**5,44%**	**10,88%**	**1,66%**	**15,42%**	**16,99%**	**-**	**37,27%**	89,1%
Iberian benchmark		-2,11%	-3,14%	-5,10%	-2,46%	-3,14%	12,13%	0,52%	-	8,02%	

[1] *Class R 31/12/2015; Class I 31/12/2015. Returns net of fees. Iberian benchmark: 80% Ibex35 Net TR + 20% PSI20 Net TR.*

MAGALLANES EUROPEAN EQUITY, FI

FUND	NAV	1 MONTH	3 MONTHS	6 MONTHS	12 MONTHS	2018	2017	2016	2015 [1]	SINCE INCEPTION [1]	INVESTMENT LEVEL
Magallanes European Equity FI "M"	134,8443	**-2,15%**	**-3,03%**	**-1,28%**	**8,17%**	**-3,03%**	**19,52%**	**12,89%**	**3,47%**	**35,38%**	89,1%
European benchmark		-2,02%	-4,30%	-3,70%	-0,43%	-4,30%	10,24%	2,58%	0,42%	8,68%	
Magallanes European Equity FI "P"	137,0267	**-2,11%**	**-2,91%**	**-1,03%**	**8,71%**	**-2,91%**	**20,12%**	**13,45%**	**4,23%**	**37,90%**	89,1%
European benchmark		-2,02%	-4,30%	-3,70%	-0,43%	-4,30%	10,24%	2,58%	0,43%	8,69%	
Magallanes European Equity FI "E"	140,3304	**-2,05%**	**-2,73%**	**-0,66%**	**9,53%**	**-2,73%**	**21,02%**	**14,31%**	**4,29%**	**40,33%**	89,1%
European benchmark		-2,02%	-4,30%	-3,70%	-0,43%	-4,30%	10,24%	2,58%	9,77%	18,79%	

[1] *Class M 27/01/2015; Class P 29/01/2015; Class E 09/01/2015. Returns net of fees. European benchmark: MSCI Europe Net TR.*

MAGALLANES VALUE INVESTORS UCITS EUROPEAN EQUITY - LUXEMBOURG

FUND	NAV	1 MONTH	3 MONTHS	6 MONTHS	12 MONTHS	2018	2017	2016 [1]	2015	SINCE INCEPTION [1]	INVESTMENT LEVEL
Magallanes European Equity Lux "R"	128,4470	**-2,18%**	**-3,03%**	**-1,34%**	**7,92%**	**-3,03%**	**19,11%**	**18,30%**	**-**	**36,64%**	90,3%
European benchmark		-2,02%	-4,30%	-3,70%	-0,43%	-4,30%	10,24%	9,39%	-	15,40%	
Magallanes European Equity Lux "I"	129,9836	**-2,13%**	**-2,90%**	**-1,07%**	**8,51%**	**-2,90%**	**19,76%**	**27,76%**	**-**	**48,57%**	90,3%
European benchmark		-2,02%	-4,30%	-3,70%	-0,43%	-4,30%	10,24%	19,66%	-	26,24%	
Magallanes European Equity Lux "P"	130,8827	**-2,10%**	**-2,82%**	**-0,90%**	**8,88%**	**-2,82%**	**20,16%**	**12,08%**	**-**	**30,88%**	90,3%
European benchmark		-2,02%	-4,30%	-3,70%	-0,43%	-4,30%	10,24%	2,58%	-	8,22%	
Magallanes European Equity Lux "ING"	93,7800	**-3,07%**	**-**	**-**	**-**	**-**	**-**	**-**	**-**	**-6,22%**	90,3%
European benchmark		-2,02%	-4,30%	-3,70%	-0,43%	-4,30%	-	-	-	-6,42%	

[1] *Class R 29/01/2016; Class I 12/02/2016; Class P 31/12/2015; Class ING 17/01/2018. Returns net of fees. European benchmark: MSCI Europe Net TR.*

MAGALLANES MICROCAPS EUROPE, FI

FUND	NAV	1 MONTH	3 MONTHS	6 MONTHS	12 MONTHS	2018	2017 [1]	2016	2015	SINCE INCEPTION [1]	INVESTMENT LEVEL
Magallanes Microcaps Europe, FI "B"	109,4508	**-2,99%**	**-2,60%**	**-1,32%**	**5,89%**	**-2,60%**	**12,37%**			**9,45%**	86,1%
European benchmark		-2,51%	-1,54%	-1,77%	5,74%	-1,54%	8,14%			6,48%	
Magallanes Microcaps Europe, FI "C"	109,1829	**-3,01%**	**-2,66%**	**-1,44%**	**-**	**-2,66%**	**7,81%**			**4,94%**	86,1%
European benchmark		-2,51%	-1,54%	-1,77%	5,74%	-1,54%	7,22%			5,57%	

[1] *Class B 17/03/2017; Class C 31/03/2017. Returns net of fees. European benchmark: MSCI Europe Micro Cap Net Total Return.*