MAGALLANES
VALUE INVESTORS

Quarterly Letter to Investors
03/31/2019
MAGALLANES VALUE INVESTORS, S.A. SGIIC

Dear Investor,

The performance during the first quarter of 2019, thus accumulated for the year is as follows for our Magallanes funds: **+7.50%** for the **Iberian** fund, **+13.74%** for the **European** fund and **+7.26%** for the **Microcaps** fund. As of the launch date, accumulated performance have amounted to **+40.46%**, **+31.21%** and **-5.97%**, respectively[1].

The defining feature of Q1 in 2019 is the ongoing global economic deceleration. The absence of a final agreement regarding the trade tension between the US, China and Europe is the main reason for such slow-down.

In Europe, Brexit continues to be a dead-end street; no solution seems to be at hand. The most probable event will be an extension of the negotiation period. Italy is another source of concern. The Italian economy is officially undergoing a recession as of the end of 2018 due to negative growth for two consecutive quarters.

The drop-in activity has led central banks to introduce major changes in their monetary policies. The US Federal Reserve announced in its last meeting that it does not plan to further raise interest rates for the rest of 2019. Meanwhile, the ECB has ratified that interest rates will remain at 0% for longer than initially expected.

In this context, the performance of major stock exchanges in Q1 has been positive. The MSCI Europe Index has increased by 12.0%, the Ibex 35 by 8.2% and the S&P 500 by 15.1%, in Euros.

Despite this strong beginning, the investment community is unable to shake off a feeling of uncertainty that has loomed in the market background throughout the first quarter, mainly due to global trade tensions and political issues in the EU, issues which remains unsolved. Furthermore, the anomalous economic policy of zero interest rates seems to be stretching further into the future than initially expected.

[1]Iberian: Magallanes Iberian Equity P. European: Magallanes European Equity P. Microcaps: Magallanes Microcaps Europe B. At the end of the letter please see an Addendum with details about the performance of each and every one of the classes and vehicles under Magallanes management and/or benefitting from advice from Magallanes.

Anatomy of the Stock Exchange

One of the best-known, and most feared, attributes of investing in stocks is their huge volatility. Thus, while in our last letter to you we said that December 2018 was one of the most negative months ever, now the message is that the first quarter of 2019 is turning out to be one of the greatest in recent years.

Which brings to mind that the stock market does not only move, sometimes it swings wildly. It is interesting to analyze how, over the past six months, the Spanish Ibex 35 Index lost, and then recovered, slightly over 1,300 points, ending up at the current 9,600 points. This is exactly the number that we saw in September 2018. Those investors who survive, with pain, the market's daily fluctuations, would have had to overcome the anguish of seeing their investments plummet by -13.5% in a mere three months only to see (if, luckily, they have withstood the previous drops) a fantastic +15% rebound, returning to the initial levels.

But on the other hand, those investors with a long-term view, who only check their positions occasionally, say twice a year, would have been spared seeing their investments take that plunge. The initial amount invested would be exactly the same as the amount six months after the date. The stock market is not a good place for investors with short-term horizons.

Generally, it's fair to say that, when you decide to invest, the most important risk factor, which doesn't receive enough attention to is time. When investing in stocks, one should avoid thinking in terms of bad or good investments. One should think in time horizons and in general the longer the time horizon, the better the chances of success are.

Events such as the one described, in which there are huge variations in share prices, encourage us to remember, when investing into listed companies, some of the more relevant attributes of investing. In other words, *The Anatomy of the Stock Exchange*:

1. In the long term, the best option is the stock market. Statistics prove it in many and varied ways. Better historical returns and the effects of compound interest explain why shares are the only financial instrument that can create, or "make" wealth, as well as protect and help store your capital, something other available asset classes attempt as well. Doing nothing with your savings literally costs you money, as time passes, inflation gnaws away at your savings, slowly, but very surely making them disappear. If your aim is to protect and increase your savings, it is definitely worth your while to seriously consider investing in shares.

2. Time matters. Unlike bonds, which have a clear and known maturity date, shares have not. We could even say that these assets are assets with infinite duration. Of course, companies face difficulties occasionally, but they rarely disappear,

companies recover and are actually strengthened by surviving tough times. In the case of stock markets, time does redeem the errors.

3. The stock market moves, sometimes suddenly and abruptly. As Peter Lynch said to us, “All you need to know when you’re investing is that shares tend to drop by about -10% every 2 years, and up to -20% every six years. The movements are called market *corrections* and bear *markets*, respectively.” So, as a follow-up to what we saw before and bearing in mind events of the past few months, panicking and proceeding to sell after a *market correction* or worse yet in a *bear market* is a terrible investment strategy.

4. If we want a more statistical approach, it is easy to check and see that, on any given day, you have the same odds of making money in the stock market as of as losing it, it really is like flipping a coin. Nevertheless, insofar as we broaden the time horizons, the probability of achieving positive returns increases dramatically. So, for instance, the probability of making positive returns after 5 years is of roughly 90%. For more statistics on this issue, please see *thebalance.com*[2].

5. Market returns are not lineal, though. If we take the USA’s S&P 500 Index, we see that the average yearly returns achieved over the past century is of 10%. Which does not mean that every year it grows by 10%, this has actually happened only very exceptionally, really no more than five times in the period. What usually happens is that the shares deviate themselves greatly from their “normal average”. Any attempt by a naïve investor to compare stock market returns with those of bonds, where the returns are known beforehand and are identical over a period of time, is bound to be frustrating. Indeed, it may lead to rejection upon seeing that said returns do not correspond, annually, with long-term expectations.

In a nutshell, investing in listed companies demands a certain degree of familiarity with their behavior over time. The aim is not to make forecasts, the aim is to recognize what the future holds, in the knowledge that these short-term fluctuations are the price to be paid for better returns over time.

[2] https://www.thebalance.com/rolling-index-returns-1973-mid-2009-4061795

Dispersion of returns

Although the market rises in the long term, it does not do so proportionally to its components. The stock market is made up of a myriad of shares from listed companies which are rarely in motion at the same time and in the same direction. The performance achieved by stock market indices is the result of calculating the weighted average of the movements of the companies that respectively make them up.

During the last few years we have witnessed a massive move from active management to passive management alternatives. According to data gathered by Casey Quirk, the total of passive investments in the world is of some 17 trillion dollars. It is calculated that just last year these strategies attracted about 472 billion dollars, meanwhile, actively managed portfolios lost about 488 billion, according to EPFR. By 2021, says Moody's, passive investments will have easily surpassed active investments in the USA[3].

The main difference between one and the other strategy is, basically, that while active investments try to squeeze value beyond market levels, passive investments merely aim at replicating them.

On the other hand, we can segment the market in as many categories as we want: by market cap, by sector, by geography or by investment style, among others. Under the latter headings, the best-known ones would be the *value* strategy (i.e., those companies that are fundamentally cheap) in the face of the *growth* strategy (i.e., those companies with high hopes for future growth but not very attractive valuations).

At Magallanes we are convinced that active management strategies, based on applying the principles of value investing, can easily overcome the market over the long-term. In this belief, and with over four years' history, our funds have successfully doubled market returns. This is the result of our investment philosophy, and in the case of our Iberian fund the difference is even greater: +40% in the face of local market drops.

However, the fact is that this strategy, known as the *value* strategy, our arena of choice, is being harshly dealt with in comparison with growth companies, led by the actually very popular tech sector. In fact, the dispersion of return and valuation between both categories is to be found in its all-time highs.

At Magallanes we have completed a simple study focusing on the European market taking as a reference the STOXX Europe 600 Index. The results, in line with what was previously discussed, are very telling:

[3] https://www.ft.com/content/5c6bf51a-4660-11e9-a965-23d669740bfb

1. The average returns of the stocks labeled *value* (quoting at a multiple of less than 10x earnings) has been of +11% over a five-year period, in comparison with a more-than-acceptable +128% in the case of stocks labeled *growth* (trading at a multiple of over 25x earnings).

2. If we stretch the time horizon to 15 years, the results are even more striking: *value* companies appreciate by nearly 70%, *growth* companies rise a staggering 900%.

Flourishing passive investments, as we said before, feed back into the system so that whatever goes up in the market will be bought by said strategies, insofar as the instructions are to replicate the market or strategy. This snowballing, at the end of the day, makes expensive stocks pricier, and cheaper stocks cheaper, thus increasing dispersion and asymmetry among stocks and sectors.

This is an ideal scenario for investors as ourselves: we can buy, at good prices, stocks the market does not want at that point in time, because the market is engrossed in buying only whatever stock is popular. All we need, however, is an attractive valuation of the business in question and enough patience to wait until the share price mirrors the fundamental value of our investments. Experience, and results, do tell.

Activity in the Fund Portfolios

In line with the above, our portfolios are currently positioned in companies that have not benefited from the strong revaluations seen in some sectors. But this is why we are optimistic: it is because of this that they are trading at a notable discount vis-à-vis their long-term fundamental valuations.

The slump at the end of 2018 encouraged us to bring our investment level to an historical high in all the years of Magallanes' existence. This was basically by means of the purchase of stocks we had in our portfolio; their upside potential had reached historical highs as well.

This explains our good performance in the first few months of the year. Some of the stocks in our portfolios achieved double-digit returns, as we will see.

In our **European Fund**, we have put more weight into the energy and industry sectors by increasing our positions in **Shelf Drilling** and **Tarkett**, respectively.

In the industrial sector we sold all our **Deutz** shares, as we had reached target price.

Some of the best performers in this first quarter in 2019 are **Aker BP** (+40.8%), **OCI** (+37.6%), **Serco** (+33.9%), **Mytilineos** (+23.6%) and **Antofagasta** (+23.3%). All of these shares had been hard hit during the final months of 2018.

At the end of the period, the investment level in the fund was 97.4%.

In the **Iberian Fund**, we have bought and sold stocks, notably growing our **Prosegur** holdings in the service sector.

Some of the best performers in this first quarter in 2019 are **Siemens Gamesa** (+33.4%), **Lingotes Especiales** (+30.9%), **Faes Farma** (+26.9%), **Corticeira** (+18.2%) and **Inditex** (+17.3%).

At the end of the period, the investment level in the fund was 97.4%.

In the **Microcaps Fund**, we have increased our weighing in the energy and industry sectors by increasing our positions in **IPCO** and **Recticel**, respectively.

Some of the best performers in this first quarter of 2019 are **Elica** (+59.1%), **IPCO** (+50.0%), **Avance Gas** (+39.0%), **Rottneros** (+33.0%) and **Natuzzi** (+30.6%).

At the end of the period, the investment level in the fund was 91.4%.

Has Book Value Lost its Meaning?

Some time ago, I had a very interesting meeting with a renowned fund selector from a major Japanese financial company. As a follow-up to our conversation, he sent me a link to an article published in *The Economist*[4] about an idea I have been mulling over for a time, especially after Warren Buffett's avowed bad experience acknowledging having paid a much too high price for **Kraft Heinz**[5]. In particular, Buffett and his partner 3G Capital paid 100 billion dollars for 7 billion of tangible assets.

As we explained in our Q1 letter last year (**ROCE: Myth and Truth**), **Return on Capital Employed** is not the same as **Return on Capital Invested**. The price we pay for a quoted business is our investment in that concrete business and that is the parameter we have to use to measure our returns, whether we like it or not.

The ROCE is valid for the founder of the business in its early days, or for us if we are able to pay just the Capital Employed. Any decision to pay more than that amount will reduce, significantly, our real return on that investment.

By way of an example, paying nearly 15 times **Kraft Heinz's** tangible assets is why the investment's real returns were much less than the original returns on the capital employed. To be specific, one-fifteenth of those returns.

The article in *The Economist* makes a reference again to the great dispersion between *value* and *growth* strategies, as mentioned above, ultimately pondering on whether the classical metrics to determine value, such as book value, are valid any more.

We must remember that buying below book value has traditionally been considered as to be buying cheap in tune with the *value investing* philosophy. But the problem with this metric is that it cannot capture intangible assets – the brand, the network effect, distribution, strategic contracts, future growth opportunities – all those and so many other reasons why stocks of asset-light companies are priced well beyond their book value. It is definitely the case that a company's book value does not truly reflect all the underlying elements.

I believe that book value continues to be a valid metric for the kind of business that is capital-intensive. But it is not valid for businesses that have a lighter capital-intensive asset base.

Think about a public service company, a utility or a telecom operator, a highway operator, or the operator of any major infrastructure. In these cases, what really matters is the

[4]https://www.economist.com/node/21761908?frsc=dg%7Ce
[5]http://www.expansion.com/empresas/distribucion/2019/02/25/5c74092422601d3f278b45b9.html

tangible asset because it is in fact that asset that generates cash flow for the company, this metric is key. But, on the other side, asset management companies, or engineering companies, for instance, have very high price to book value ratios. The less capital intensive the business model, the higher (and more useless) the metric. So, it really depends to a great degree on the sector you're dealing with. We see that book value is not the metric that perfectly suits all.

In our experience, the book value metric has been very useful within the category of companies based on fixed assets, which has resulted in some of our most successful investments. For instance, the **Port of Hamburg**, the Austrian utility company **Verbund** or Germany's **Uniper**. We were able to double our investments in each of these investments because we managed to buy these *irreplicable* assets at less than their theoretical replacement cost.

Investors Day

We are keen to explain to you first-hand everything related to your Magallanes investments. I am pleased to inform you that on May 9, 2019, at 17:00, we will celebrate our *Annual Investors Conference* in Madrid at the Auditorium of the *Mutua Madrileña* building. As on previous occasions, we will describe our investment philosophy and our portfolios, and we will be very pleased to address any other issue you may deem important. We are honored to confirm that Mr. Francisco Riberas, Chairman of Gestamp, has confirmed that he will join us. Furthermore, on May 28 we will hold the *Annual Investors Conference* in Barcelona at the Auditorium of the *Universidad Pompeu Fabra*.

Until that moment, please do not hesitate get in touch with us if you require any further information, wish to clarify any issue, or would like to many any suggestion. Kindly do so by any one of the means we make available to you. We look forward to increasing and furthering frank and open communications with you.

As always, thank you for trusting us to help manage your assets. We are fully committed to the task, and our accountability to you and our enthusiasm for our work guarantees our passion and commitment to the job of looking after your savings and making them grow, just as we do with ours.

Sincerely yours,

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 97.4% and a total of 29 companies.

The fund maintains its exposure towards the industrial, services and energy sectors. May we highlight, among others, holdings like NOS, Siemens Gamesa, INDITEX, Gestamp and Repsol. Top ten holdings account for 54.4% of the fund.

Spain accounts for 73.1% of the total investment of the fund and Portugal represents 24.3%.

An 89.0% of the fund is invested in large and mid-cap companies. The remaining 8.4% is invested in small-cap companies.

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 EUROPEAN EQUITY FI

The fund closes the quarter with an investment level of 97.4% and a total of 33 companies.

The fund has a bias towards the industrial, consumer and energy sectors. Such sectors are mainly represented through holdings like Porsche, Aker BP, Renault, OCI and Carrefour. Top ten holdings account for 46.8% of the fund.

As a result of the holdings in the fund the exposure to Germany, France and Netherlands is greater compared to other countries. These three countries represent 49.8% of the fund.

An 83.1% of the fund is invested in large and mid-cap companies, with a 57.0% of such weight in companies with market cap of over €5 billion. A 14.3% 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 91.4% and a total of 53 companies.

The fund has a bias towards the industrial, consumer and energy sectors. Such sectors are mainly represented through holdings like Orsero, EDAG Engineering, KRKA, Camellia and SOL. Top ten holdings account for 30.2% of the fund.

As a result of the holdings in the fund the exposure to Italy, United Kingdom and Germany is greater compared to other countries. These three countries represent 54.1% of the fund.

A 72.0% of the fund is invested in companies with an adjusted market cap below 100 million euros, of which 37.7% 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 03/31/19

MAGALLANES IBERIAN EQUITY, FI

FUND	NAV	1 MONTH	3 MONTHS	6 MONTHS	12 MONTHS	2019	2018	2017	2016	2015 [1]	SINCE INCEPTION	INVESTMENT LEVEL
Magallanes Iberian Equity FI "M"	144,7619	**-0,26%**	**7,36%**	**-7,29%**	**-4,14%**	**7,36%**	**-9,22%**	**15,45%**	**15,48%**	**8,04%**	**40,39%**	97,4%
Iberian benchmark		-0,18%	9,04%	-0,64%	-0,47%	9,04%	-11,59%	12,13%	0,52%	-5,73%	2,67%	
Magallanes Iberian Equity FI "P"	147,7980	**-0,22%**	**7,50%**	**-7,05%**	**-3,66%**	**7,50%**	**-8,76%**	**16,03%**	**16,09%**	**6,32%**	**40,46%**	97,4%
Iberian benchmark		-0,18%	9,04%	-0,64%	-0,47%	9,04%	-11,59%	12,13%	0,52%	-11,27%	-3,58%	
Magallanes Iberian Equity FI "E"	152,5224	**-0,15%**	**7,70%**	**-6,71%**	**-2,94%**	**7,70%**	**-8,07%**	**16,91%**	**16,91%**	**12,72%**	**52,52%**	97,4%
Iberian benchmark		-0,18%	9,04%	-0,64%	-0,47%	9,04%	-11,59%	12,13%	0,52%	2,57%	12,04%	

[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	2019	2018	2017	2016 [1]	2015	SINCE INCEPTION	INVESTMENT LEVEL
Magallanes Iberian Equity Lux "R"	129,6013	**-0,28%**	**7,37%**	**-7,38%**	**-4,41%**	**7,37%**	**-9,61%**	**14,79%**	**16,33%**	**-**	**29,60%**	96,4%
Iberian benchmark		-0,18%	9,04%	-0,64%	-0,47%	9,04%	-11,59%	12,13%	0,52%	-	7,51%	
Magallanes Iberian Equity Lux "I"	131,8978	**-0,24%**	**7,50%**	**-7,15%**	**-3,91%**	**7,50%**	**-9,14%**	**15,42%**	**16,99%**	**-**	**31,90%**	96,4%
Iberian benchmark		-0,18%	9,04%	-0,64%	-0,47%	9,04%	-11,59%	12,13%	0,52%	-	7,51%	

[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	2019	2018	2017	2016	2015 [1]	SINCE INCEPTION	INVESTMENT LEVEL
Magallanes European Equity FI "M"	127,6581	**0,28%**	**13,60%**	**-5,48%**	**-5,33%**	**13,60%**	**-19,19%**	**19,52%**	**12,89%**	**3,47%**	**28,16%**	97,4%
European benchmark		2,03%	12,84%	0,07%	5,45%	12,84%	-10,57%	10,24%	2,58%	0,42%	14,60%	
Magallanes European Equity FI "P"	130,3797	**0,32%**	**13,74%**	**-5,24%**	**-4,85%**	**13,74%**	**-18,78%**	**20,12%**	**13,45%**	**4,23%**	**31,21%**	97,4%
European benchmark		2,03%	12,84%	0,07%	5,45%	12,84%	-10,57%	10,24%	2,58%	0,43%	14,61%	
Magallanes European Equity FI "E"	134,5284	**0,38%**	**13,95%**	**-4,88%**	**-4,13%**	**13,95%**	**-18,17%**	**21,02%**	**14,31%**	**4,29%**	**34,53%**	97,4%
European benchmark		2,03%	12,84%	0,07%	5,45%	12,84%	-10,57%	10,24%	2,58%	9,77%	25,27%	

[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	2019	2018	2017	2016 [1]	2015	SINCE INCEPTION	INVESTMENT LEVEL
Magallanes European Equity Lux "R"	121,1684	**0,21%**	**13,53%**	**-5,46%**	**-5,67%**	**13,53%**	**-19,43%**	**19,11%**	**18,30%**	**-**	**28,90%**	97,3%
European benchmark		2,03%	12,84%	0,07%	5,45%	12,84%	-10,57%	10,24%	9,39%	-	21,69%	
Magallanes European Equity Lux "I"	123,2525	**0,25%**	**13,67%**	**-5,22%**	**-5,18%**	**13,67%**	**-19,00%**	**19,76%**	**27,76%**	**-**	**40,88%**	97,3%
European benchmark		2,03%	12,84%	0,07%	5,45%	12,84%	-10,57%	10,24%	19,66%	-	33,12%	
Magallanes European Equity Lux "P"	124,5833	**0,28%**	**13,78%**	**-5,04%**	**-4,81%**	**13,78%**	**-18,70%**	**20,16%**	**12,08%**	**-**	**24,58%**	97,3%
European benchmark		2,03%	12,84%	0,07%	5,45%	12,84%	-10,57%	10,24%	2,58%	-	14,12%	
Magallanes European Equity Lux "ING"	87,4100	**0,91%**	**9,14%**	**-8,30%**	**-6,79%**	**9,14%**	**-19,91%**	**-**	**-**	**-**	**-12,59%**	97,3%
European benchmark		2,03%	12,84%	0,07%	5,45%	12,84%	-10,57%	-	-	-	-1,32%	

[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	2019	2018	2017 [1]	2016	2015	SINCE INCEPTION	INVESTMENT LEVEL
Magallanes Microcaps Europe, FI "B"	94,0341	**0,37%**	**7,26%**	**-8,72%**	**-14,09%**	**7,26%**	**-21,98%**	**12,37%**	**-**	**-**	**-5,97%**	91,4%
European benchmark		-0,27%	8,39%	-8,18%	-4,66%	8,39%	-13,38%	8,14%	-	-	1,52%	
Magallanes Microcaps Europe, FI "C"	93,5701	**0,35%**	**7,19%**	**-8,83%**	**-14,30%**	**7,19%**	**-22,18%**	**7,81%**	**-**	**-**	**-10,07%**	91,4%
European benchmark		-0,27%	8,39%	-8,18%	-4,66%	8,39%	-13,38%	7,22%	-	-	0,65%	

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