Quarterly Letter to Investors
30/09/2017
MAGALLANES VALUE INVESTORS, S.A. SGIIC

Dear Investor,

The performance in the third quarter was -0.99% for the Iberian strategy and +5.06% for the European strategy. The funds accumulate year-to-date returns of +11.75% and +17.85%, respectively[1].

As anticipated in the last quarterly Letter, between the second and third quarter we have performed a significant number of transactions.

This was due to the fact that some of the companies we had in our funds reached our target price, such is the case, for example, of **Orkla**, **Sports Direct** and **Hamburger Hafen**, among others, which have been sold from the fund Magallanes European Equity with average appreciations of +50%. On the other hand, we have bought new companies with very attractive valuations in four different penalized sectors: automobile (**Renault, Porsche**), fertilizers (**Potash, OCI**), shipping industry (**Scorpio Tankers, Euronav**) and distribution (**Metro AG**).

In the fund Magallanes Iberian Equity we have sold **Ence** and **REN** after both companies reached our target price, and we have bought the Portuguese **Ramada** and the Spanish **Repsol** and **Siemens Gamesa**, where the upside potential is very large.

This shows that, in a complex environment as the present one, with markets at all-time highs and demanding valuations, we are capable of finding good investment ideas in some sectors which seem to be out of the market consensus. There is always investment opportunities in the market, all that is required is curiosity, discipline and patience.

Emotions. Investing under uncertainty

The study of human psychology should occupy a relevant place in university study programs. It is becoming increasingly clear that to become a successful investor you need further than being great in accounting, arithmetic and discounting cash flows. If we were companies and had to highlight a competitive advantage that would make us standing out from the rest, this would not be, in my opinion, the IQ level but rather the degree of emotional stability of each subject. We tend to think, mistakenly, that the most "intelligent" will be the most "successful".

[1]Iberian strategy: Magallanes Iberian Equity P. European strategy: Magallanes European Equity P. At the end of the Letter you will find an Annex with a detailed performance for each and every investment vehicle and fund class managed and/or advised by Magallanes.

It is crucial the ability to maintain a stable, thoughtful, self-critical and calm emotional degree that can constantly warn us against the possibility of making mistakes when taking important decisions which are led by our emotions.

Before starting into the investment world, as managers and clients, we should raise questions to ourselves such as:

- How would you react under stress conditions where all could go wrong?
- Am I ready to decisively act even if it implies not following the consensus opinion?
- Am I aware of the possibility of making mistakes? Do I have enough self-critical capacity to acknowledge them?
- Do I know and distinguish when the market acts under emotions and when under facts?

One of those mistakes has to be with decision-making under uncertain situations. The human brain is set to take decisions in those things which are familiar and close to us. On the other hand, it tends to avoid unknown situations due to a primitive reflex reaction based on survivorship.

When we take decisions, which are out of our control environment, for example, deciding which company to buy in an uncertain environment, a consistent physiological reaction in the activation of the brain amygdala takes place, where all basic emotions like anger and fear reside. It is the processing center for all emotional reactions. Regarding investments, it is the direct cause of risk aversion and, therefore, responsible for mental block in stressful situations.

The ability to obtain valid conclusions within an environment where information available is imperfect represents a differential factor for the success in investment management. Under poor and confusing information the stock prices are generally low. On the other hand, when we wait for too long for information to be perfect and precise we run the risk of missing out important investment opportunities.

The emotional factor is the worst enemy for the investor, even generating one of the biggest aberrations of the stock market: the paradigm of “quality”. The investment in “quality” companies consists in buying and holding companies with high degree of certainty, which operate in very favourable environments and are welcomed by the investment community, but whose valuations are very high. Investors seem to be emotionally comfortable when it comes to buying stocks of “quality” companies which do not activate their brain amygdala, releasing in the process a great amount of endorphins responsible for well-being and happiness, which will eventually make them pay high prices for such stocks. The price for this apparent safety is to pay high. However, we must not forget that a good company might not be a good investment.

The expectations of “quality” companies are generally high, which makes a large number of individuals to buy their stocks pushing their prices upwards. On the other hand, the expectations of penalized companies tend to be low, sometimes inexistent, and thus, their prices are low, sometimes ridiculously low. Again, it is important to distinguish between a good investment and a good company.

When a company is considered to be “good” its price is high, when it is considered to be “bad” its price is low. When you buy at high prices the probability of making mistakes increases.

In finance, there is a basic rule that amends excesses: “mean reversion”. The translation in colloquial language would be something like “no bad can last forever”, nothing lasts forever. There is no company that can perpetually live in state of grace, nor business condemned to eternal failure, unless there is fraud or bankruptcy. Good companies, sooner or later, will have to face challenges, for example, the increasing number of competitors. This will make good return figures to “reverse the mean”, below levels we were used to.

The above is part of the normal cycles of all businesses. The problem arises when people, moved by emotions, extrapolate such cycles beyond the reasonable, making the “good” companies incredibly expensive and the “unfavorable” ridiculously cheap. Mean reversion fixes, generally in a traumatic way, both ends.

Uniper

On the 12th of September of 2016 we bought **Uniper** at €10 per share[2] becoming one of our main positions in the European fund. At that time hardly nobody believed in the company, some even catalogued it as the dirty energy division (“bad and unfavorable” company) of **E.ON**.

On the 20th of September, just over a year later, the Finnish energy company **Fortum** launched a takeover bid at €22 per share in cash. At the moment I am writing this Letter, the stock is trading at €24, which represents a return of +140% over our average purchase price. We are considering all options regarding the position in the company we still have in the fund.

Uniper, mainly owned by the German giant **E.ON**, is one of the largest conventional electricity generation companies in Europe, basically gas, coal, nuclear and hydro. In addition, the company possesses a global raw material business and an 83.7% share in **Unipro**, third largest private electricity operator in Russia.

As we mentioned in our Letter of 2016, in a world which is dominated by renewable energy it is understandable that the majority of market participants felt low, or null, attraction for a company like this one.

[2]The investment case of Uniper is explained in our Annual Letter to Investors of 2016.

The perception of a bad business brought about a current of low or negative expectations, which made its stock price to be ridiculously low when compared to its market value assets, even trading at a third its book value.

Apparent bad businesses can turn out to be excellent investment ideas. Our ability in **Uniper** was no other than remaining loyal to our analytic activity, buying an asset below its rational price, with information available which was then incomplete and confusing while we remained calm and distant with regard to the prevailing mood of analyst consensus.

European Automotive Sector

In line with the above, we have invested in companies which, in contrast to market opinion, seem to be great opportunities to us. In the last quarterly Letter, we thoroughly explained our investment cases in fertilizers and shipping industry, classic examples of the cycle of capital. We also mentioned our first investment in automobile manufacturers, specifically through the purchases of **Renault** and **Porsche**.

Currently, the European automobile manufacturers industry is the cheapest listed sector.

At geographical level, the traditional automobile industry in Europe is perceived as the main loser in the race for the electric car, against other regions such as the United Sates, cradle of **Tesla**, technological paradigm of the sector. In our opinion, this perception is not quite correct.

Proof of this is the number of registered patents in relation to the electric car. According to a recent study by the Ifo Institute, Europe agglutinates almost half the number of patents, leading the global ranking, well above countries like Japan (23%) and the United States (18%).

On the other hand, a high degree of Research and Development (R+D) expenditure brings about a greater strength of the products and services offered, which allows to positively differentiate from competitors. Bloomberg published a ranking, led by **Amazon**, of the 25 companies that allocate the most of their annual budget in R+D. In such ranking, 11 are tech companies, 7 are pharma, and surprisingly, 7 are manufacturers of traditional cars, out of which, **Volkswagen** is in second place just below **Amazon**, with close to $16 billion. **Tesla** does not appear in such ranking.

Furthermore, we believe the irruption of the electric car will not immediately take place, replacing the whole production of the conventional car. The objective of most manufacturers, starting in 2025, is that, out of the total production, around 20% to be electric, which will imply that diesel and petrol engines will continue to be dominant over the next decades.

Renault is one of the main references in the world in the manufacturing of the electric cars, absolute leader in Europe, with a market share close to 30%. However, this is not our main motivation to buy the company but rather the successful combination of a highly profitable traditional business, based on the internal combustion engine, along with a healthy balance sheet (net cash), which allows the company to generate a high level of cash, to continue investing and providing shareholder return.

Looking at the low multiples at which the stock trades, is seems that the market does not perceive such capacity to reinvest and provide return. According to our numbers (excluding the financial business to book value and the market value of its share in Nissan and Daimler), the pure business of car manufacturing of **Renault** would be trading at 2 times its operating profit, with a cash flow generation over the enterprise value above 30%.

Let me recommend you the reading of the book "*El cerebro del inversor*", by the neuroscience doctor Pedro Bermejo. In line with the mentioned earlier on this Letter, the book addresses how the brain constantly betrays us when making decisions, especially in those of economic and financial nature. The author pretends to approach neuroeconomy to readers so that they can understand how their brain makes investment decisions, and thus to benefit from it.

Thank you to our investors for entrusting us with the management of your savings, it is a great pleasure to work for you.

Please do not hesitate to contact us through any of the channels available for any queries you may have.

Sincerely,

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 92.1% and a total of 28 Spanish and Portuguese companies.

The fund maintains its exposure towards the services and industrial sectors. May we highlight among others stocks like **SEMAPA, Gas Natural, Fluidra** and **Inmobiliaria Colonial**. The top ten positions account for 44.0% of the fund.

Spain accounts for 62.5% of the total investment of the fund and Portugal represents the remaining 29.6%.

A 79.9% of the fund is invested in large and mid-cap companies. The remaining 12.2% 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 85.5% and a total of 39 companies.

The fund is biased towards the industrial, manufacturer and consumer sectors. Such sectors are mainly represented through stocks like **E.ON, Renault, Potash Corp, Porsche Holding** and **Bouygues**. The top ten holdings account for 34.5% of the fund.

As a result of the stocks in the fund the exposure to Germany and France is greater compared to that to other countries. These two countries represent the 38.5% of the fund.

A 75.9% of the fund is invested in large and mid-cap companies, with a 42.8% of such weight in companies with market cap of over €5 billion. A 9.6% 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.

ANNEX 2. RETURNS BY FUND AND CLASS as of 30/09/17

MAGALLANES IBERIAN EQUITY, FI

FUND	NAV	1 MONTH	3 MONTHS	6 MONTHS	12 MONTHS	2017	2016	2015 [1]	SINCE INCEPTION [1]	INVESTMENT LEVEL
Magallanes Iberian Equity FI "M"	143,2253	**1,33%**	**-1,12%**	**5,47%**	**19,55%**	**11,34%**	**15,48%**	**8,04%**	**38,90%**	92,1%
Iberian benchmark		1,23%	0,32%	2,25%	21,79%	13,81%	0,52%	-5,73%	7,85%	
Magallanes Iberian Equity FI "P"	145,1373	**1,37%**	**-0,99%**	**5,73%**	**20,48%**	**11,75%**	**16,09%**	**6,32%**	**37,94%**	92,1%
Iberian benchmark		1,23%	0,32%	2,25%	21,79%	13,81%	0,52%	-11,27%	1,51%	
Magallanes Iberian Equity FI "E"	148,0992	**1,43%**	**-0,81%**	**6,13%**	**21,39%**	**12,38%**	**16,91%**	**12,72%**	**48,10%**	92,1%
Iberian benchmark		1,23%	0,32%	2,25%	21,79%	13,81%	0,52%	2,57%	17,33%	

[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	2017	2016	2015	SINCE INCEPTION [1]	INVESTMENT LEVEL
Magallanes Iberian Equity Lux "R"	128,9235	**1,30%**	**-1,25%**	**5,27%**	**19,02%**	**10,82%**	**16,33%**		**28,92%**	93,1%
Iberian benchmark		1,23%	0,32%	2,25%	21,79%	13,81%	0,52%		14,40%	
Magallanes Iberian Equity Lux "I"	130,1813	**1,34%**	**-1,12%**	**5,56%**	**19,68%**	**11,28%**	**16,99%**		**30,18%**	93,1%
Iberian benchmark		1,23%	0,32%	2,25%	21,79%	13,81%	0,52%		14,40%	

[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	2017	2016	2015 [1]	SINCE INCEPTION [1]	INVESTMENT LEVEL
Magallanes European Equity FI "M"	136,5946	**2,15%**	**4,92%**	**10,29%**	**25,50%**	**17,41%**	**12,89%**	**3,47%**	**37,14%**	85,5%
European benchmark		3,89%	2,70%	3,58%	16,26%	9,56%	2,58%	0,42%	12,85%	
Magallanes European Equity FI "P"	138,4596	**2,19%**	**5,06%**	**10,56%**	**26,13%**	**17,85%**	**13,45%**	**4,23%**	**39,35%**	85,5%
European benchmark		3,89%	2,70%	3,58%	16,26%	9,56%	2,58%	0,43%	12,86%	
Magallanes European Equity FI "E"	141,2686	**2,25%**	**5,25%**	**10,98%**	**28,08%**	**18,51%**	**14,31%**	**4,29%**	**41,27%**	85,5%
European benchmark		3,89%	2,70%	3,58%	16,26%	9,56%	2,58%	9,77%	23,36%	

[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	2017	2016 [1]	2015	SINCE INCEPTION [1]	INVESTMENT LEVEL
Magallanes European Equity Lux "R"	130,1886	**2,11%**	**4,88%**	**10,09%**	**24,66%**	**17,07%**	**18,30%**		**38,49%**	86,6%
European benchmark		3,89%	2,70%	3,58%	16,26%	9,56%	9,39%		19,84%	
Magallanes European Equity Lux "I"	131,3904	**2,15%**	**5,03%**	**10,39%**	**25,35%**	**17,55%**	**27,76%**		**50,18%**	86,6%
European benchmark		3,89%	2,70%	3,58%	16,26%	9,56%	19,66%		31,10%	
Magallanes European Equity Lux "P"	132,0752	**2,18%**	**5,12%**	**10,58%**	**25,75%**	**17,84%**	**12,08%**		**32,08%**	86,6%
European benchmark		3,89%	2,70%	3,58%	16,26%	9,56%	2,58%		12,38%	

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

MAGALLANES MICROCAPS EUROPE, FI

FUND	NAV	1 MONTH	3 MONTHS	6 MONTHS	12 MONTHS	2017 [1]	2016	2015	SINCE INCEPTION [1]	INVESTMENT LEVEL
Magallanes Microcaps Europe, FI "B"	110,9130	**3,59%**	**1,01%**	**7,51%**		**10,91%**			**10,91%**	88,8%
European benchmark		3,44%	2,87%	8,06%		8,40%			8,40%	
Magallanes Microcaps Europe, FI "C"	110,7795	**3,56%**	**0,94%**			**6,47%**			**6,47%**	88,8%
European benchmark		3,44%	2,87%			7,47%			7,47%	

[1] Class B 17/03/2017; Class C 05/04/2017. Returns net of fees. European benchmark: MSCI Europe Micro Cap Net TR.