Quarterly Letter to Investors
09/30/2018
MAGALLANES VALUE INVESTORS, S.A. SGIIC

Dear Investor,

The performance in the third quarter was **-0.95%** for the Iberian strategy, **+0.75%** for the European strategy and **-3.09%** for the Microcaps strategy. The funds accumulate year-to-date returns of **+5.52%**, **-2.51%** and **-8.33%**, respectively[1].

In global terms, trade tension between the USA and China continues unabated as a result of the announcement of tariffs to be imposed. There is growing uncertainty regarding a possible "change in the economic cycle" that, furthered by doubts as to growth, would affect the entire world. This uncertainty would be compounded by the situation caused by the debt incurred by China, which is additionally having a contagion effect on other emerging countries such as Turkey and Argentina. These two economies are suffering severe financial stress leading to major drops in their respective currencies. The combined effects of a strong dollar and growing interest rates does not help at all to reduce this stress and uncertainty; actually, it does just the opposite.

In this context, the Q3 performance of major stock exchanges has been mixed. The MSCI Europe index has been practically flat – it has grown by 0.9%, while the IBEX dropped by 2.4%. We need to additionally mention the negative evolution of the stock indices of some of the main emerging markets. The Istanbul Stock Exchange lost 17.5% and the Argentina Merval Index dropped by more than 9.6%, both in euro values.

Over this past quarter, and just as in the first half of the year, volatility has been a constant presence in European markets. Some of the factors that most contribute to this volatility are the political and economic tensions raging in Italy, controversial Brexit issues pending solution, and the problems generated by the trade war hurting the global economy.

Uncertainty and Volatility

So, in view of all of the above, we reckon that these are difficult times. Key market players believe that the world is increasingly "on a downturn," which affects the majority of markets and listed assets.

This explains why our Funds are suffering downward pressure in the short term. But, at the same time and thanks to the high volatility, the time is ripe to increase exposure to some of the most heavily punished assets and sectors. We abide by our investment philosophy – buy cheap and wait for our long-term approach to bear fruit. This is what we have been doing for years.

Therefore, in the case of our European portfolio, I would underscore our growing exposure to the industrial sector, specifically automotive. Our investments in **Porsche** and **Renault** have grown, punished as they have been by the tariff war, as has our position in **Shelf Drilling**. Furthermore, after our initial Q2 investment in **Signify**, we have continued to increase our stake in this company.

In the Iberia Fund, we have increased our exposure levels in the energy, distribution, and services sectors. We achieved this by boosting our investment in **Siemens Gamesa**, **Inditex** and **Prosegur**, respectively.

As to the Microcaps Fund, in Q3 this fund increased its exposure levels both in the industrial sector, in both **MPC Container Ships** and **KCB**, and in the insurance sector with **Wuestenrot & Wuerttemberg.**

Being a value investor is not easy, since most of the time that calls for an attitude that is different from that of other investors. And defending a contrary stance is even more difficult when, if only temporarily, the market turns its back on you. “Being alone against the world” is not pleasant for anyone. But experience has taught us that it is in these difficult situations that some of the best investment ideas come to us.

Successful management demands being right about the stocks one invests in, but this is not to be confused with being able to foretell the future. Since we don’t know what the future holds for the risk factors detailed initially, we cannot, any better than anyone else, position our portfolios depending on one event or another. We do know, however, that in the long run, and if we are true to our mantra, “Buy cheap!”, once we have weathered the storm, our portfolios will reap their rewards.

Currently we can see – and practically touch – a “fear of the cycle.” Evidently the cycle feared is the one that leads to less growth and to the possible collapse of some markets. There are indeed signs that something is brewing: businesses are harvesting record profits; the world is amassing debt; the ending and exiting of expansionary monetary policies… This is happening, but surprisingly enough there is a widely divergent reaction from one sector to the next and from one geography to another.

So, while in the USA the market is at a historical peak, Europe is in the doldrums, at levels that are not even those of twenty years ago. In sectorial terms, the differences are even more obvious: in an article published in *Valuewalk.com*[1], we read an explanation of how the performance differential between growth stocks (usually linked to tech – see comments about the FAANGs in our Q2 newsletter) and value stocks (companies listed at low multiples) is now greater than at any time in history.

We can vouch for this. For example, the performance of some of the stocks in our portfolio mirrors an average drop of over 30% since peak levels. We do not know what the future holds, but if it is bad, we feel that a big chunk of the “the bad that is yet to come” is already being reflected in some of our investments, in a harsh and dizzying way.

[1]https://www.valuewalk.com/2018/02/performance-differential-growth-stocks-value-stocks-now-greater-time-history/

But not only are tech companies and the USA in general performing at odds with the rest of the markets. In Europe we witness how investing in so-called “quality stocks” stopped making sense time ago, because they were ridiculously overpriced (luxury stocks, stable consumption, major brands… for the most part).

Please do not misunderstand us: we do not mean to imply that our portfolios are risk-free. What we mean is that, if the current cycle materializes, our funds will have already digested, to a greater or lesser degree, the possible adverse effect of a decelerating economy. This compares with the apparent imperviousness of certain sectors and geographies, i.e. the US and its tech stocks, or “quality” expensive stocks, among others.

According to a recent Bloomberg[2] article, the percentage of asset classes (bonds, equities, real estate, commodities, etc.) generating positive returns this year is only 20 percent, a figure that has never been this low outside of 1970s episodes. These assets actually comprise only three categories: the Nasdaq-100 tech company index, some raw materials, and US leveraged loans.

And in relation to this, there have been market over-reactions to profit warnings issued by some specific companies throughout 2018. In general, shares of those companies that “warn negatively” are usually marked down to a degree much greater than the theoretical impact those lesser profits should actually have on their intrinsic valuation.

For instance, if a company announces that this year it expects 95 million in profits instead of 100 (which is a 5% decline), share prices – the market being what it is now – may drop more than that same 5% (being a 5% price drop the logical reaction). That markdown may be of 10% or even more, if the company is in a type of industry that is greatly sensitive to the business cycle.

We believe that this is due to the evolving psychology of cycles: business cycles are the “sideways swings” of the pendulum of economic activity. Just as there seems to be no limit to risk taking when everything goes well, that appetite pretty well dries up when things seem to go awry. It is exceptional for the market to remain balanced for long. This explains why prices vary beyond fundamentals.

Our mandate is to manage fund portfolios that invest in equities, and our positive analysis of these difficult times is that there are investment opportunities to move forward. These opportunities result from the confusion about, fear of and extrapolation to a more adverse setting.

[2] https://www.bloomberg.com/news/articles/2018-10-27/why-do-investors-hate-everything-maybe-paranoia-jpmorgan-says

Cash or Debt

On a different tack, I recently participated in a company presentation to investors. The balance sheet of the business in question showed net cash. The meeting was proceeding smoothly until one of the participants asked about the company's capital structure, implying that it was inefficient.

The company's executives, accustomed to investors asking about strategic plans, corporate deals, dividends policies and so on – as we investors tend to do –, were caught off guard by the question. I must confess, so was I. It got me thinking about our "obsession" with companies with little leverage, or at least a manageable amount of debt, and preferably with a net cash balance sheet. This is just the opposite, of course, of what the investor who posed the question said.

The gist of this question stems from the capital-structure theory developed by Professors Modigliani and Miller[3] over 50 years ago. This theory, from what I know, continues to be a tenet in the academic world and, apparently, also in professional spheres. Professor Modigliani won the Nobel Memorial Prize in Economics in 1985 for this achievement, among others.

The basic Modigliani and Miller Theorem, briefly put, is that the capital structure a company uses to fund its operations is irrelevant to the total value of the company, and that it makes no difference whether the company carries much, little or no debt: its value will not vary.

But additionally, there is another important implication from Modigliani and Miller, which states that if the costs of debt are tax deductible (as is in fact the case), there are benefits to debt because it will allow the company to make good on the leverage. In other words, there is an incentive, the tax incentive, to using debt instead of equity. Thus the well-known concept of "balance sheet optimization," or the attainment of balance between equity and debt.

Common sense tells me that, if two companies are equal, but one with debt, the other with only cash, necessarily the second company will be worth more. We have always believed that a debt-free business cannot go under – at least, not for financial reasons –, and this must carry some weight.

Thus, even though we run the risk of running counter to the market and going against the academic canon, we prefer to invest in companies with the least debt possible. If they have a positive cash position, we like them even more and prefer them to companies carrying a greater financial burden. Unexpected events such as the Great Financial Crisis of 2007-2008 are solid proof that carrying a large amount of debt on the balance sheet can spell the end of even the best possible business models.

[3] http://lib.cufe.edu.cn/upload_files/other/3_20140507105115_01.pdf

Magallanes Impacto FIL

At the end of September, we launched **Magallanes Impacto FIL** in Spain. This is the first fund in Spain devoted exclusively to social-impact investments, and it is a not-for-profit fund for Magallanes Value Investors.

We have launched this fund to invest with a social impact. **Magallanes Impacto's** objective is to make a yearly return (not guaranteed) of between 2% and 4% while simultaneously achieving a sustainable, measurable social impact.

Magallanes Impacto FIL targets funding financial entities that grant micro-credits to the poor in developing countries. This will allow for the inclusion of the underprivileged into the financial system, it will help better their living conditions, and it will foster economic development. Micro-credits have proven historically to be an asset class that is at a great distance from other financial markets: it links diversification to a sustainable social impact that is measurable over time.

But aspiring to achieve a defined social impact does not mean that profits are a minor issue, or of lesser importance. On the contrary: we at Magallanes are persuaded that profits and social impact go hand in hand. This fund is more than just a means to redistribute wealth, it is more than instrument for philanthropic investment. Our customers help the underprivileged progress while having the opportunity of earning attractive profits.

For this, Magallanes relies on the expert advice of **Gawa Capital**, a firm with a long and successful track-record in this asset class. We would like to take this opportunity to congratulate the Gawa Capital team for a recent success: a short time ago, the UN Global Compact and the *Fundación Rafael del Pino* acknowledged Gawa Capital's initiative as one that has most contributed to SDG Goal 1: *End poverty in all its forms everywhere*.

Magallanes' commitment to and support of this Fund is staunch. We launched this fund because we are convinced that it is a new opportunity for our clients; as always, we will invest together with them. Furthermore, we are proud to launch a product that has the double objective of achieving social returns for the recipients of the micro-credits and financial returns for shareholders, while being not for profit for Magallanes. Another new matter has to do with the management fees policy, in that the fee may be waived if the measured social impact does not reach the minimum required levels. The minimum initial investment amount required is 100,000 euros, and the fund is limited to professional investors.

Finally, let me assure you that we at Magallanes work hard to look after your savings and make them grow, just as we do with ours. Our accountability to you and our enthusiasm for our work guarantees our passion and commitment to the job. We greatly appreciate the confidence you place in us, especially in times as uncertain as these. Thank you for trusting us with the management of your money.

If you require any further information, wish to clarify any issue, or would like to make any suggestion, please 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.

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 94.4% and a total of 31 Spanish and Portuguese companies.

The fund maintains its exposure towards the industrial, services and energy sectors. May we highlight, among others, holdings like Almirall, NOS, Gestamp, Naturgy and Repsol. Top ten holdings account for 51.3% of the fund.

Spain accounts for 71.3% of the total investment of the fund and Portugal represents 23.1%.

An 84.1% of the fund is invested in large and mid-cap companies. The remaining 10.3% is invested in small-cap companies.

Current investment level of the fund has been increased recently due to several purchases that have been done during the quarter in order to take advantage of low stock prices caused by recent market sell-off. 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 95.6% and a total of 38 companies.

The fund has a bias towards the industrial, consumer and energy sectors. Such sectors are mainly represented through holdings like Aker BP, Porsche, Renault, OCI and Metro. Top ten holdings account for 43.9% 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 52.1% of the fund.

An 82.9% of the fund is invested in large and mid-cap companies, with a 48.8% of such weight in companies with market cap of over €5 billion. A 12.7% of the fund is invested in small-cap companies (market cap below €1 billion).

Current investment level of the fund has been increased recently due to several purchases that have been done during the quarter in order to take advantage of low stock prices caused by recent market sell-off. 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 92.2 % and a total of 53 companies.

The fund has a bias towards the industrial, consumer and services sectors. Such sectors are mainly represented through holdings like EDAG Engineering, Orsero, Banca Sistema, Italian Wine Brands and MPC Container Ships. Top ten holdings account for 31.0% 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 57.2% of the fund.

A 69.7% of the fund is invested in companies with an adjusted market cap below 100 million euros, of which 29.3% 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 09/30/18

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"	156,1387	**-1,26%**	**-1,07%**	**3,38%**	**9,02%**	**5,13%**	**15,45%**	**15,48%**	**8,04%**	**51,42%**	94,4%
Iberian benchmark		-0,27%	-2,11%	0,17%	-4,94%	-2,98%	12,13%	0,52%	-5,73%	3,33%	
Magallanes Iberian Equity FI "P"	159,0165	**-1,22%**	**-0,95%**	**3,65%**	**9,56%**	**5,52%**	**16,03%**	**16,09%**	**6,32%**	**51,13%**	94,4%
Iberian benchmark		-0,27%	-2,11%	0,17%	-4,94%	-2,98%	12,13%	0,52%	-11,27%	-2,96%	
Magallanes Iberian Equity FI "E"	163,4869	**-1,16%**	**-0,76%**	**4,04%**	**10,39%**	**6,12%**	**16,91%**	**16,91%**	**12,72%**	**63,49%**	94,4%
Iberian benchmark		-0,27%	-2,11%	0,17%	-4,94%	-2,98%	12,13%	0,52%	2,57%	12,76%	

[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"	139,9264	**-1,27%**	**-1,17%**	**3,21%**	**8,53%**	**4,78%**	**14,79%**	**16,33%**	**-**	**39,93%**	94,2%
Iberian benchmark		-0,27%	-2,11%	0,17%	-4,94%	-2,98%	12,13%	0,52%	-	8,20%	
Magallanes Iberian Equity Lux "I"	142,0509	**-1,23%**	**-1,05%**	**3,48%**	**9,12%**	**5,20%**	**15,42%**	**16,99%**	**-**	**42,05%**	94,2%
Iberian benchmark		-0,27%	-2,11%	0,17%	-4,94%	-2,98%	12,13%	0,52%	-	8,20%	

[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"	135,0550	**-0,29%**	**0,63%**	**0,15%**	**-1,13%**	**-2,88%**	**19,52%**	**12,89%**	**3,47%**	**35,59%**	95,6%
European benchmark		0,53%	1,33%	5,37%	1,47%	0,84%	10,24%	2,58%	0,42%	14,52%	
Magallanes European Equity FI "P"	137,5870	**-0,25%**	**0,75%**	**0,41%**	**-0,63%**	**-2,51%**	**20,12%**	**13,45%**	**4,23%**	**38,47%**	95,6%
European benchmark		0,53%	1,33%	5,37%	1,47%	0,84%	10,24%	2,58%	0,43%	14,53%	
Magallanes European Equity FI "E"	141,4350	**-0,19%**	**0,95%**	**0,79%**	**0,12%**	**-1,96%**	**21,02%**	**14,31%**	**4,29%**	**41,44%**	95,6%
European benchmark		0,53%	1,33%	5,37%	1,47%	0,84%	10,24%	2,58%	9,77%	25,18%	

[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"	128,1652	**-0,26%**	**0,46%**	**-0,22%**	**-1,55%**	**-3,24%**	**19,11%**	**18,30%**	**-**	**36,34%**	95,9%
European benchmark		0,53%	1,33%	5,37%	1,47%	0,84%	10,24%	9,39%	-	21,60%	
Magallanes European Equity Lux "I"	130,0447	**-0,22%**	**0,59%**	**0,05%**	**-1,02%**	**-2,85%**	**19,76%**	**27,76%**	**-**	**48,64%**	95,9%
European benchmark		0,53%	1,33%	5,37%	1,47%	0,84%	10,24%	19,66%	-	33,03%	
Magallanes European Equity Lux "P"	131,1967	**-0,19%**	**0,69%**	**0,24%**	**-0,67%**	**-2,59%**	**20,16%**	**12,08%**	**-**	**31,20%**	95,9%
European benchmark		0,53%	1,33%	5,37%	1,47%	0,84%	10,24%	2,58%	-	14,04%	
Magallanes European Equity Lux "ING"	95,3200	**-0,73%**	**1,31%**	**1,64%**	**-**	**-**	**-**	**-**	**-**	**-4,68%**	95,9%
European benchmark		0,53%	1,33%	5,37%	1,47%	0,84%	-	-	-	-1,39%	

[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"	103,0169	**-0,07%**	**-3,09%**	**-5,88%**	**-7,12%**	**-8,33%**	**12,37%**			**3,02%**	92,2%
European benchmark		-0,25%	-0,14%	3,84%	2,00%	2,24%	8,14%			10,57%	
Magallanes Microcaps Europe, FI "C"	102,6360	**-0,09%**	**-3,15%**	**-6,00%**	**-7,35%**	**-8,50%**	**7,81%**			**-1,36%**	92,2%
European benchmark		-0,25%	-0,14%	3,84%	2,00%	2,24%	7,22%			9,62%	

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