KNIGHT VINKE

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4 January 2017

Dear Investor,

I am pleased to report that Knight Vinke Institutional Partners (KVIP), our flagship fund, has had another successful year.

**The consolidated KVIP portfolio, which includes the Fund and related discretionary accounts, delivered a gross return of 49.2% for 2016, outperforming the FTSE World Europe index by 49.7%. Net of all fees and expenses the return amounted to 45.6%.**

The table below shows the consolidated KVIP returns for 2016 and 2015 as well as the annualised returns for the past 5, 7 and 10 years and since inception (2004):

| In EUR | 2016 | 2015 | 5 Year | 7 Year | 10 Year | Since Inception |
|---|---|---|---|---|---|---|
| Portfolio Return (gross) | **49.2%** | **22.3%** | **19.8%** | **10.8%** | **5.1%** | **12.5%** |
| FTSE World Europe | **-0.5%** | **5.5%** | **7.7%** | **4.7%** | **-0.3%** | **3.3%** |
| Difference | **+49.7%** | **+16.8%** | **+12.1%** | **+6.1%** | **+5.4%** | **+9.2%** |

**Disclosed portfolio investments**

During 2016 performance was largely driven by the merger of FNAC and Darty, a transaction that we initiated and proactively supported by accepting to take FNAC shares instead of cash. As a result, we are now one of FNAC's largest shareholders, with approximately 10% of its outstanding share capital, and have an excellent relationship with the Company and its management. The synergies which we saw in combining the two companies are starting to be recognised by the market and this is reflected in FNAC's share price which has risen by approximately 30% since the offer became unconditional.

As previously reported, we also have a strategic investment in E.ON. In October 2014 we proposed that E.ON should spin off and list its regulated network assets – much as RWE has done by spinning off Innogy – thereby setting the stage for the E.ON spin-off to become one of the most attractive infrastructure investments in a market that is craving for low risk, high yielding assets. Rather than pursuing this path, E.ON's management chose to dispose of its conventional power generation and commodity trading units by spinning off 53% of Uniper (which owns those assets) and committing to sell the remaining 47% interest by 2017-18.

Although sub-optimal, we have supported the spin-off of Uniper in the belief that it represents a major first step towards our vision of E.ON as a pure play regulated Network Company. The Company's focus over the past year has been on executing the spin-off and negotiating a settlement with the German Federal Government regarding the decommissioning of its nuclear power stations (see below) but we believe that E.ON could benefit from further restructuring so as to improve its credit profile, underpin its dividend and enhance its ability to invest and create jobs.

In this context, we approached E.ON in early August with a proposal to acquire its remaining 47% holding in Uniper at a valuation of EUR 3.0 billion (i.e. at around EUR 8.00 per Uniper share) so as to eliminate the overhang resulting from so large a block of stock being sold on the market in the next 18-24 months. In addition we also proposed to inject EUR 600 million of new equity into E.ON and EUR 300 million into Uniper so as to strengthen their balance sheets. Our proposal was rejected – mainly, we believe, due to adverse tax consequences that could not be mitigated and E.ON's unwillingness to negotiate on price – but we remain significant shareholders of E.ON and will continue to engage with its Board and Management cordially and constructively.

Separately, and as expected, E.ON's liability for the long term storage and disposal of radioactive nuclear waste will be transferred to a state-controlled trust together with cash equal to its related provisions. The Federal Government will also assume liability for any storage and disposal costs in excess of E.ON's provisions – on payment of a single insurance premium amounting to approx. € 2 billion. We do not believe that E.ON requires additional capital to support the payment of this insurance premium as (1) it has sufficient non-core assets which could be sold to fund it and (2) the insurance policy will provide benefits for many decades to come and should therefore be viewed as an asset (at least from an economic perspective).

Following the rally in banking stocks that followed the U.S. presidential elections we chose to take our profits on our main holding in this sector but will continue to evaluate the possibility of reinvesting if the opportunity to do so arises at more attractive prices.

**Long term investment outlook**

Knight Vinke's investment philosophy is built on the conviction that rising levels of public sector debt combined with slower economic growth in most major economies will result in central banks having no choice but to keep the return on financial assets artificially low – thereby depreciating their currencies and increasing the risk of speculative bubbles and short term volatility.

Our view on interest rates is not based on the so-called "savings glut" hypothesis which sees the global demand for capital from those who intend to invest being systematically lower than the global supply of capital from those who intend to save. Contrary to those who attribute declining productivity to lack of investment, we tend to side with those who believe that poor productivity is the result of chronic over-investment – not only in the United States but also in Europe and in China. The dynamics of intended (or ex ante) saving and investment are complex and hard to observe. What we can observe, however, is that real capital expenditure in the United States has been steadily growing since the 1950s and now stands at an all-time high relative to GDP[1].

[1] See Deutsche Bank Multi-Asset Essay (20 12 16): real expenditure on equipment (based on producer prices) has risen from 2% of real GDP to 6% today. Using a more general GDP deflator produces the opposite result.

We attribute chronic over-investment to the cost of capital being too low for industry – from utilities to pharmaceuticals – and this in turn may be attributed to two factors: (a) the uncontrolled explosion in the availability of credit since financial markets were liberalised in the early 1980s; and (b) the banking industry's assumed cost of capital being far lower than the observed cost of capital (itself a consequence of state guarantees on deposit liabilities). None of this has yet been corrected – despite the Global Financial Crisis – so companies will continue to over-invest (unless disciplined by strategic investors such as ourselves or private equity), growth will continue to be anaemic, and passive equity investors will fail to receive a return that is commensurate with the risks they are taking.

Institutional investors typically allocate portfolio assets based on the assumption that the returns they make from each asset class in the future will match those they have earned in the past – and this has proved to be a reasonable working hypothesis for quite some time. But what if the future were to be radically different? Most investors would not question the view that the 40 year bull market in bonds has almost certainly reached the end of the road but many have yet to take into account that equity market returns may also be lower in the future[2]. If the returns that are available from investing in "risk" or "growth" asset classes end up being significantly lower than the returns targeted for the portfolio as a whole, there is mathematically no way that the targets can be achieved – unless investors resort to leverage.

We believe that the answer to this existential crisis lies in focusing on genuine value creation rather than investing passively, resorting to leverage or seeking to time the markets – but for the largest institutional investors the real challenge lies in finding a way of doing so on a scale that "moves the dial". Investing strategically in large cap public equities is one of the few ways they can do so.

Knight Vinke is a long term equity investor and specialises in "strategic block investing". In essence, we take minority stakes in large cap public companies and then work with their key stakeholders to unlock value through restructuring and promoting better performance (often by curbing over-investment). We have been doing this for almost 15 years with the backing of many of the largest sovereign wealth and public pension funds in the world and have tailored our strategy to their needs. We generally plan on holding investments for a minimum of 3-5 years and do not use leverage. A large part of the capital that we invest comes from co-investment.

**Short term investment outlook**

Market sentiment in 2017 will increasingly be dominated by geopolitical issues rather than macro-economic policies.

The policies of the incoming U.S. Administration have not yet been fully articulated but have led many (including the Fed) to believe that the U.S. economy is on the verge of a major recovery that could reverse the steady decline in global growth rates. Our own view is that the impact of U.S. fiscal stimulus is likely to be weaker than expected since U.S. businesses will also have to contend with higher interest rates, higher wages, higher oil prices and a stronger currency.

Economic growth in Europe will continue to be supported by fiscal expansion, ultra-lax monetary policy and a more competitive currency, but structural reform will slow down until key elections take place in France, the Netherlands, Germany and possibly Italy. The prospect of a complete break-up of

[2] See McKinsey Global Institute, "Diminishing Returns : Why Investors May Need to Lower Their Expectations" (May 2016)

the Eurozone remains remote, in our opinion, but were some of its weaker members to leave, this would transform the Euro into a natural hard currency backed by several of the world's most resilient economies – and a strong contender for reserve currency status.

China's economic agenda in 2017 will be dominated by internal politics – in particular the need for economic growth to remain on track during the run-up to the all-important 19th Party Congress which will consolidate President Xi's control over the country. Given the importance of avoiding any form of economic trouble, this may result in some overshooting in terms of monetary or fiscal response, thereby providing a welcome boost to global demand. By the same token, however, President Xi will also be under great pressure to respond strongly to any foreign challenge to national interests – including in particular any challenges emanating from the United States.

In summary, we see growth rates in each of the world's three main economies – the United States, Europe and China – slowly converging onto a predictable but declining trend driven by adverse demographics and sub-par growth in productivity. This is fully consistent with our view that investment returns in the future will not match those of the past half century and is why we intend to keep our eyes firmly on the longer term horizon rather than seeking to time the markets as so many of our peers appear to be doing.

During 2017 we plan to pursue the restructuring of several large and complex utilities and will be keeping a close watch on opportunities within the global banking sector, particularly in Switzerland, where market forces combined with regulatory pressure are combining to force change upon the industry.

I wish you a healthy and prosperous New Year

Yours sincerely

Eric Knight

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