KNIGHT VINKE

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Dear Investor,

Knight Vinke is a long term equity investor and a specialist in "strategic block investing". In essence, we take minority stakes in complex or underperforming public companies and 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, public pension funds and family offices in the world.

Barron's Top 100 Hedge Fund Ranking

We are pleased to report that in its survey of top performing hedge funds for 2016, Knight Vinke was ranked 7/100 in terms of 3-year performance (2014-16)[1].

Consolidated Performance

The consolidated Knight Vinke portfolio, which includes Knight Vinke Institutional Partners (KVIP), our flagship fund, and related discretionary accounts, delivered a gross return of 10.9% for the first half of 2017, outperforming the FTSE World Europe by 6.0%. Net of all fees and expenses the return amounted to 10.1%.

In EUR	2015	2016	H1 '17	Ann. Since Inception[2]
Portfolio Return (gross)	**22.3%**	**49.9%**	**10.9%**	**12.9%**
FTSE World Europe	**5.5%**	**-0.5%**	**4.9%**	**3.5%**
Difference	**+16.8%**	**+50.4%**	**+6.0%**	**+9.4%**

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(1) Barron's Penta Top 100 Hedge Funds, 17 June 2017. 3 year compound annual return of 17.68%.

(2) Consolidated KVIP returns annualised since inception (2004)

Investment Outlook/ Portfolio Manager's Commentary

In its 2016 annual report, published only a few weeks ago, the Bank for International Settlements (BIS) notes that near-term economic prospects are "the best in a long time". Growth is approaching long term averages, unemployment rates have fallen to pre-crisis levels and inflation rates are edging towards central bank objectives. The report goes on to say that "deflation risks no longer figure in economic projections … gloom has given way to confidence … and concerns about secular stagnation have receded. All the talk is now about revival of animal spirits and reflation on the back of buoyant financial markets."

As the "central banker's central bank", the BIS has adopted a position that naturally resembles that of the Fed and the world's leading monetary authorities. But the very rosy picture it paints may be somewhat self-serving as central banks all need interest rates to rise as soon as possible -- so as to allow them to lower rates when the next recession inevitably arrives. It also contrasts with the more pessimistic outlook held by many leading private investors -- and friends in the investment community with whom we regularly correspond -- although at the end of the day we should all be expecting a downturn so the main difference may just be a question of timing.

There are many reasons for caution. Equity market indices keep hitting all-time highs and the VIX stands at an all-time low despite the fact that in 2016 almost half of all MSCI companies worldwide had negative revenue growth (expressed in USD) and that gross margins have been falling since 2012. With wages, interest rates and corporate taxes all on the way up – and productivity growth stuck at multi-decade lows – returns are increasingly dependent on leverage. War risks (not only in Korea and the Middle East, but also in Crimea and globally via cyber-attack) are rising and geopolitical/ systemic banking risks in Southern Europe (Italy, Greece) are still very real.

Each of these points of view can be debated at length. However, given that the arguments for and against are well documented I thought it might be of greater interest to discuss how we think of asset allocation and portfolio construction in what remains a very difficult market for investors to read.

Road maps

Let me start by saying that, in times such as these, having a road map can be of great value but the map we have is a large scale map that gives us more information about the general direction of travel than it does about the next bend in the road. Paradoxically, it may be easier to have strong convictions about where we will be in 20 years' time than a view as to when the economy and the markets will next turn up or down.

The fact of the matter is that it has been at least 10 years since financial markets were last driven by anything other than debt supported by ultra-lax monetary policy. Fundamentals have been completely overshadowed by policy. Debt-to-GDP levels have been rising steadily since around 1980 and have continued rising even after 2007 -- not only in China and Brazil, but also countries such as Australia, Canada, Sweden and Italy, often in tandem with rising property prices. After a decade of QE, real interest rates are still negative in many parts of the world and the true meaning of the "risk free rate", the foundation on which all financial instruments used to be priced, is but a distant memory.

As signalled by the BIS in its annual report, "the main cause of the next recession will perhaps resemble more closely that of the last one – a financial cycle bust". But if this were to happen I have no doubt at all that Janet Yellen, Mario Draghi and their colleagues around the world would intervene massively, without hesitation and on a coordinated basis.

Far too much time is spent in dissecting every phrase that is uttered by the world's central bankers in the hope of stealing a march on short term policy. The unspoken and far more important message that they give remains crystal clear – an unfailing commitment to do whatever it takes to protect the stability of the banking and financial markets.

Longer term challenges

Investors should focus instead on the challenges and opportunities they will face over the next few decades. Key amongst these challenges is the strong likelihood that investment returns in the future will be significantly lower than they have been since WWII, <u>across all asset classes</u>. If all asset classes, including risk assets, fail to achieve the targeted rate of return for the portfolio as a whole then it follows that there is no way the targeted return can be achieved without resorting to leverage. This is the single most important risk faced by large under-funded public pension schemes in the United States and is now reflected in the lower targeted investment returns many have adopted over the past 12 months and (more worrying still) the fact that some are considering the possibility of leveraging their portfolios in order to meet these targets.

Our conviction that investment returns will decline is partly driven by demographics and partly by lower productivity growth which is itself driven by unproductive investment in an era characterised by too low a cost of capital. Lower GDP growth associated with rising public sector debt leads to growing pressures between the interests of the State, on the one hand, and the interests of the international bond markets on the other -- a conflict that cannot end well. But the day of reckoning can be put off for quite some time -- as we have seen in the case of Japan, China and a number of Western countries -- if the State can borrow from its citizens' pension schemes at artificially low rates, sacrificing the incomes of one or more generations of retirees in the process.

With negative risk free rates that are not determined by market forces, the whole notion of risk and reward needs fundamentally to be re-evaluated. Clearly, the efficient market hypothesis that has served the investment industry for the past 30 years may need to be radically re-thought: what merit is there in continuing to rely on diversification and passive investment to construct "market efficient" portfolios that fail to meet long term required returns unless resorting to leverage?

What can or should investors do in this market?

I suspect that it may take years for academics and market practitioners alike to develop a new framework to suit the extraordinary times in which we live. In the meantime, however, investors should trust their intuition and their experience as to what works best for them.

For investors who can see themselves as "owners" rather than passive investors, who are comfortable taking a longer term perspective and can tolerate short term market volatility, concentration risk may, in certain circumstances, be preferable to taking on additional leverage. A strategy that focuses on genuine value creation rather than stock picking and market timing, and places a smaller number of actively managed assets at the centre of that strategy – alongside a relatively large holding of highly liquid but low yielding risk free assets such as US Treasuries – may result in a far better risk/ reward balance than a traditionally managed portfolio constructed on the basis of what used to be known as modern portfolio theory.

Asset allocation and portfolio construction

This brings us to the following thoughts and recommendations:

1. **Family offices and pension funds should make long term value creation the main focus of their investment strategy.**

   For many family offices, this means focusing on their own businesses and real estate -- but this can be supplemented by adding a small number of high conviction equity market positions either managed in-house or managed externally by a professional strategic block investor such as Knight Vinke.

2. **Avoid over-diversification.**

   Diversification may make the consultants sleep better but leaving any kind of a legacy for the next generations will require some courage.

3. **Minimise the use of costly hedging strategies and remain under-invested if necessary**.

   Given that market volatility and pricing are largely driven by actions taken by politicians and civil servants -- rather than by the business cycle, which used to be more predictable -- it may take far longer than expected for market corrections to materialise. Protecting portfolio assets through derivatives can be prohibitively expensive if the positions need to be rolled over for an extended period of time. Similarly, if the hedge consists of taking short positions on the market, this can also backfire if an exogenous event results in unexpected easing by the central bank ("risk-on").

   Maintaining strict investment discipline and remaining underinvested when appropriate allows investors to have the flexibility and fire power ready to benefit from market corrections as and when they arise.

   We spend a large amount of time and effort analysing stocks which would suit our portfolio in terms of quality and value creation potential but are just too expensive at the present time. For each of these stocks we have a clear opinion, research and a purchase price in mind. Being able to invest in these very quickly is an important part of our strategy.

4. **Rather than holding cash at the bank, investors should consider short-dated US Treasuries**

   Thinking longer term, we all need to consider the possibility that at some point in the future a cyber-attack might succeed in bringing down a major bank. Some banks receive (literally) thousands of cyber-attacks per day. The last crisis was about banks losing their capital but a major bank losing its deposits (which are typically 10-20 times the capital base) would be infinitely more devastating. Some may say this is going too far but if one takes a 20-30 year perspective one cannot exclude new "war risks" of this kind.

US Treasuries are almost as liquid as bank deposits, better protected against cyber-attacks and should benefit from a rising US dollar if there is a sudden “flight to safety”. Equally important, securities should not be hypothecated.

Notwithstanding the Global Financial Crisis of 2008-09 and its aftermath, the road ahead is likely to be tougher than that which most market professionals will ever have experienced. Long term investors have the tools with which to navigate these uncharted territories but we should all recognise that we live in extraordinary times and dealing with future challenges will require careful analysis and preparation. It also will require an open mind.

Kind regards

Eric Knight