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BESTINVER
Asset Management

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Quarterly Insight

Nº 2, JULY 2008.

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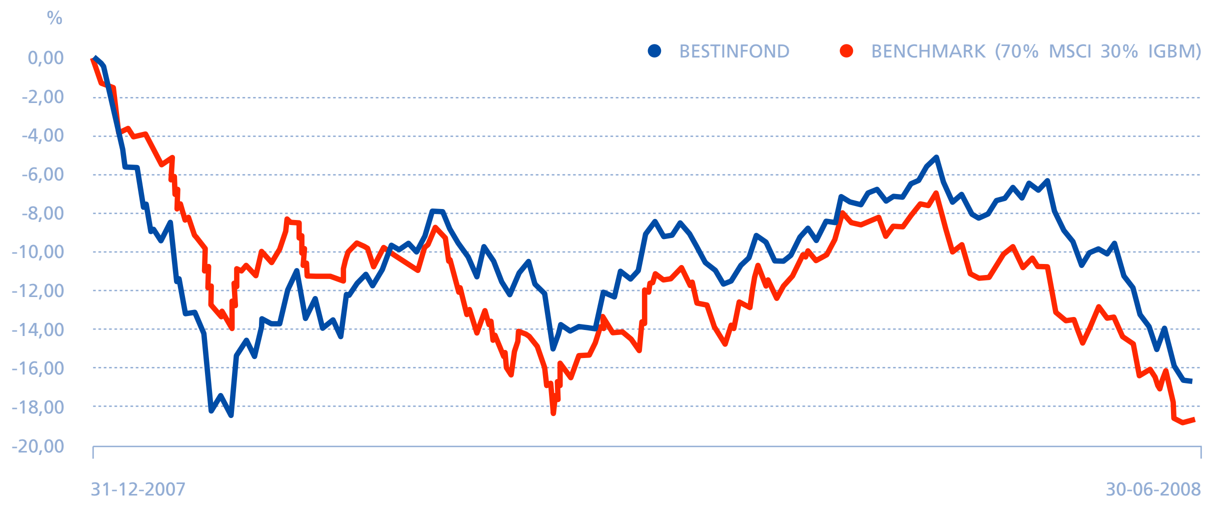
"...our investment strategy does not seek to minimise volatility. In fact, we seek to take advantage of volatility to invest for the long term..."

The main global indices have dropped back to 2008 lows. The MSCI World index is back where it was 10 years ago and the Madrid SE General Index (IGBM) has slipped to levels last seen in the summer of 2006. The Ibex-35, for instance, has had the worst half-year in its history. As we have been warning, the financial systems in some economies are now paying the price for prior years' excesses.

Our investment strategy (reflected in our Bestinfond mutual fund and our Bestinver Global pension fund) has witnessed negative yields of 16.78% vs. a drop of 18.8% in its benchmark index (70% MSCI and 30% IGBM). Fortunately, despite the temporary drawdown by the funds, we eliminated all our positions in financial sector stocks some time ago, so our portfolio has escaped any *permanent damage*. The temporary impact on our portfolios stemmed from "oil consumer" stocks such as BMW, Ciba and Clariant, which have not yet had time to pass on the costs of higher oil inputs to their selling prices, and have therefore been marked down in the short term by a deeply jittery market.

PERIOD (31-12-2007 / 30-06-2008)

Bestinfond vs. its benchmark (first quarter 2008).



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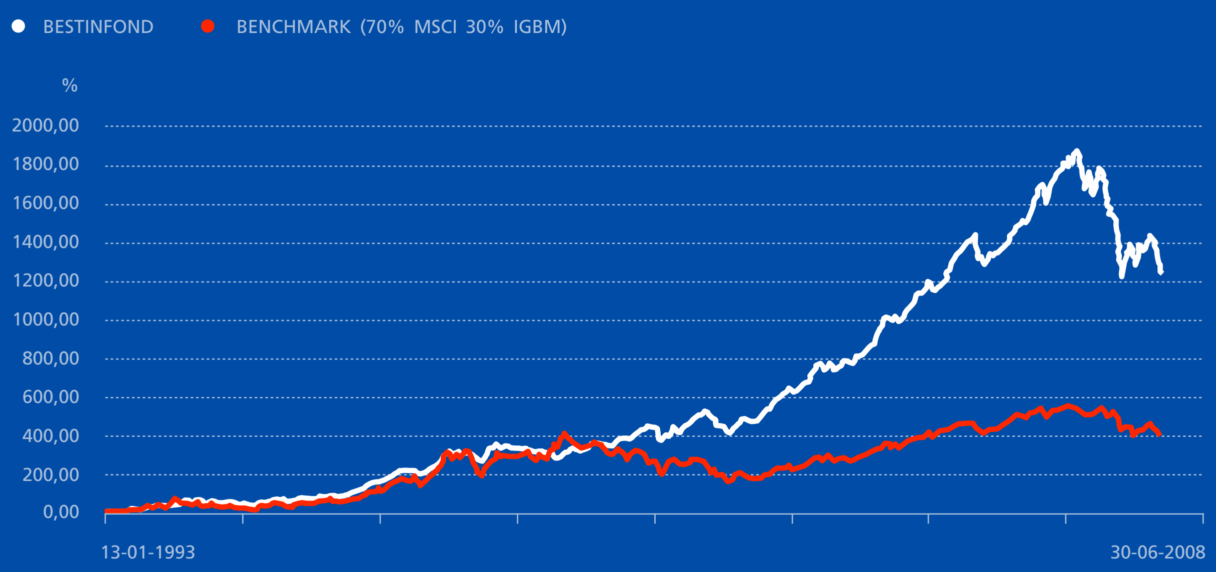
In any event, the average annual yields for the last 15, 10 and five years of 17.4%, 12.6% and 15.9%, respectively, remain highly attractive and have outperformed the benchmark index over all these periods.

PERIOD (13-01-1993 / 30-06-2008)

Bestinfond vs. its benchmark (since launch of fund).



"...short-term movements in equities are not the result of rational analysis of the information..."

Nevertheless, we continued to create value over the quarter. Bestinfond's upside at the end of June is 161%: NAV fell 6.5% while our valuation increased 3%. This, despite revising downward the value of 17 stocks in the Iberian portfolio and 36 in the international portfolio. At Bestinver we do not attempt to make macro-economic forecasts, but we have scaled back our forecasts for growth in companies' valuations.

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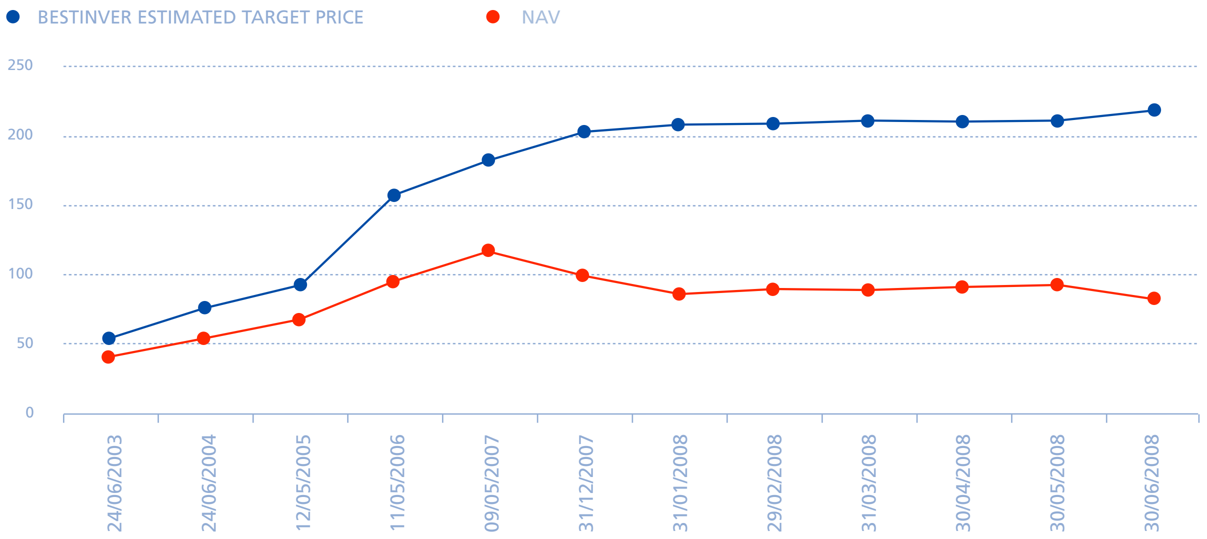
BESTINFOND

Difference between target price and NAV.



BESTINFOND	31-dic-07	30-jun-08	Chg %
Trget Price (€ /sh)	198,5	213,5	7,57%
NAV (€ /sh)	98,2	81,8	-16,78%
Upside	102%	161%	
P/E (2009 estimated FCF)	7,4 x	5,7 x	

We shall comment in greater detail on the international and Iberian portfolios below. For the moment though, it is worth noting that short-term movements in equities are not the result of rational analysis of the information and data coming onto the market which is then efficiently reflected by rises and falls in share prices. Far from it. It is at times of uncertainty like the present that markets suffer their greatest volatility and react in extreme and exaggerated ways. As the legendary investor Benjamin Graham said, the market is a manic-depressive that veers between episodes of euphoria and depression. One of the premises and key principles of Value Investing is to take advantage of such extreme reactions, buying sound businesses at tremendously attractive prices, which could probably not be obtained in a private deal, where a rational and informed owner would negotiate on equal terms with an equally rational and well-informed buyer.

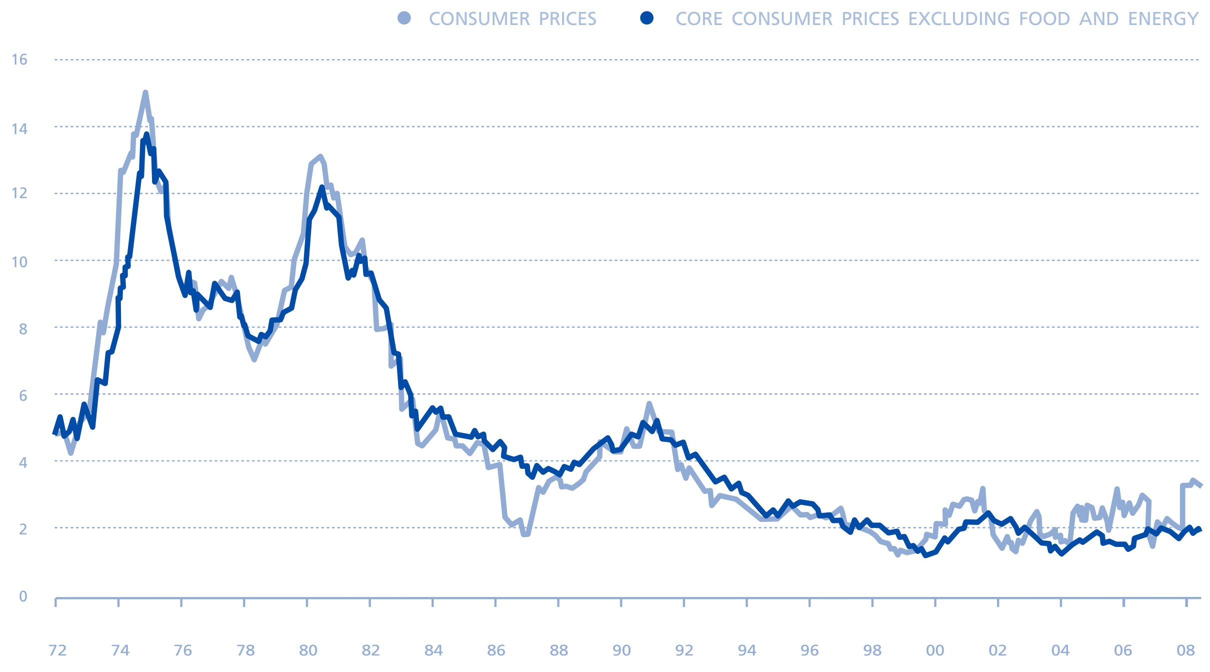
The fiercely volatile and irrational stock market performance over the last few months is clearly illustrated by the near 20% fall in global equities between January and March, which was then virtually reversed during rallies of between 15% and 25% by mid-May, only for markets to slump again over the following month and a half. There are also plenty of examples of stocks that, without any foundation in news or even rumours, have fallen and bounced back by over 5% in successive days' trading. This volatility has had a substantial short-term impact on our funds, which have also experienced big fluctuations over the period. Remember that our investment strategy does not seek to minimise volatility. In fact, we seek to take advantage of volatility to invest for the long term, which means that in the short term there is no alternative but to "grin and bear it". As Warren Buffet says, *"look at market fluctuations as your friend rather than your enemy, profit from folly rather than participate in it"*. From our point of view, risk is not volatility, but the possibility of a permanent loss of value in our investments.

Analysing the macroeconomic "fundamentals" that underlie the current negative sentiment and market uncertainty, we find that economies are slowing. However, as we said in our last report, our working scenario is based on global growth of 3-4.5% and even after recent adjustments the current forecast is still for growth of around 4%. Although the US, the EU-15 and Japan are expected to grow by 1%, 1.7% and 2% respectively, the impact on global growth will be largely offset by solid expectations elsewhere in the world, in markets such as Asia, Latin America, Eastern Europe and the Middle East. We would note that China is still projected to grow by 10%. Even if growth did slip to 1-2%, it would have no significant impact on our valuations, although some adjustments would be necessary.

Another recent cause of concern has been the latest uptick in inflation. Global prices have been on the rise, most notably the price of crude which has risen to over US$140 per barrel from around US$20 a few years ago. It is important, however, to note that the current anticipated inflation of 4-5% in the US and Europe can be absorbed within the normal functioning of the economy. In fact, inflation in OECD countries over the last 200 years has averaged 4%. Past episodes of stagflation, such as that of 1974-76, have been marked by double-digit inflation.

OECD Consumer Prices (YoY %)

Inflation in OECD countries since the 1970s oil crisis.



Another fundamental feature of the current spike in inflation is that it is mainly concentrated on oil and food (although also impacting other factors of production such as metals and some services that are seeing demand rise steeply). For the moment however, this is not feeding through to core inflation. In general, the current environment makes it harder for inflation in particular factors of production, prompted by supply shocks, to spill over into more general inflation. First, because oil and food make up a dwindling share of the total economy, even after the recent price rises. And second because the current situation is very different from the 1970s as the labour factor of production is far more mobile than it was then due to labour market reforms in many countries and globalisation in general. Other phenomena have also helped eliminate the rigidity that leads to an inflationary spiral, including the liberalisation of prices in other sectors and industries, privatisations, the growth of communications, and the explicit mandate of central banks to combat inflationary processes.

"...at Bestinver we are "agnostic" as to future trends in inflation, exchange rates, interest rates and other macro-economic variables..."

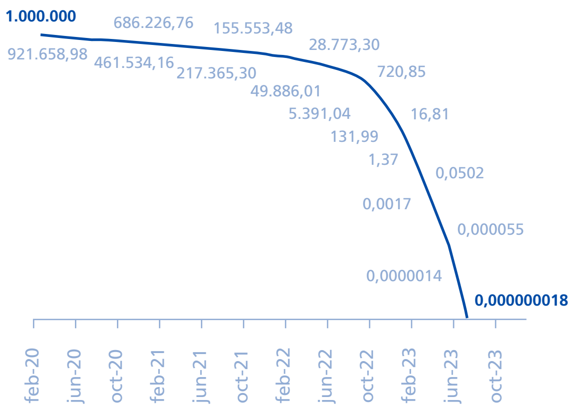
Remember that at Bestinver we are "agnostic" as to future trends in inflation, exchange rates, interest rates and other macro-economic variables and therefore none of our investment decisions rely on forecasts for these factors. That said, to take one example, analysts believe that at current levels of US$140 per barrel, the oil price is starting to have an appreciable impact on demand for fuel and energy. This, coupled with the rise, albeit slow, in the supply of crude and other substitute sources of energy will mean that the market will find a new equilibrium point, probably below the current one. If this does not happen it will mean the economy has been able to absorb the rise in prices.

But what happens if an inflation spiral does eventually take hold? In these circumstances, as we have often explained at Bestinver, the best place to safeguard the purchasing power of assets is in equities. For clear examples of this, look at what happened in Germany in the 1920s and Argentina after its 2002 devaluation. This makes sense, as companies that produce goods or provide a service that is valuable to society ultimately pass on the inflationary processes to the prices of their goods and services. Otherwise, production would stall. Money left in a current account (cash) depreciates by definition in periods of inflation. Fixed-income securities, whose value is contractually set in nominal terms also lose value.

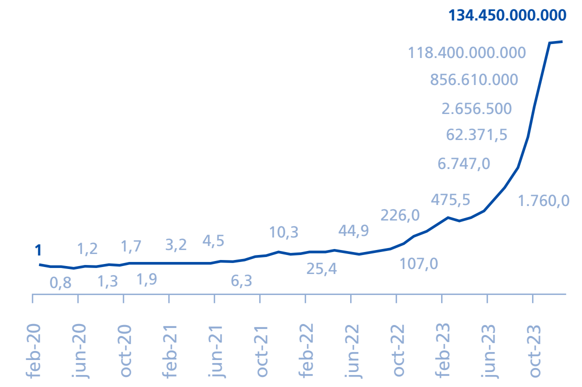
Argentinean government bonds
2000 – 2007

Argentinean stock market index (Merval)
2000-2007

Inflation in Germany (1920 – 1924)

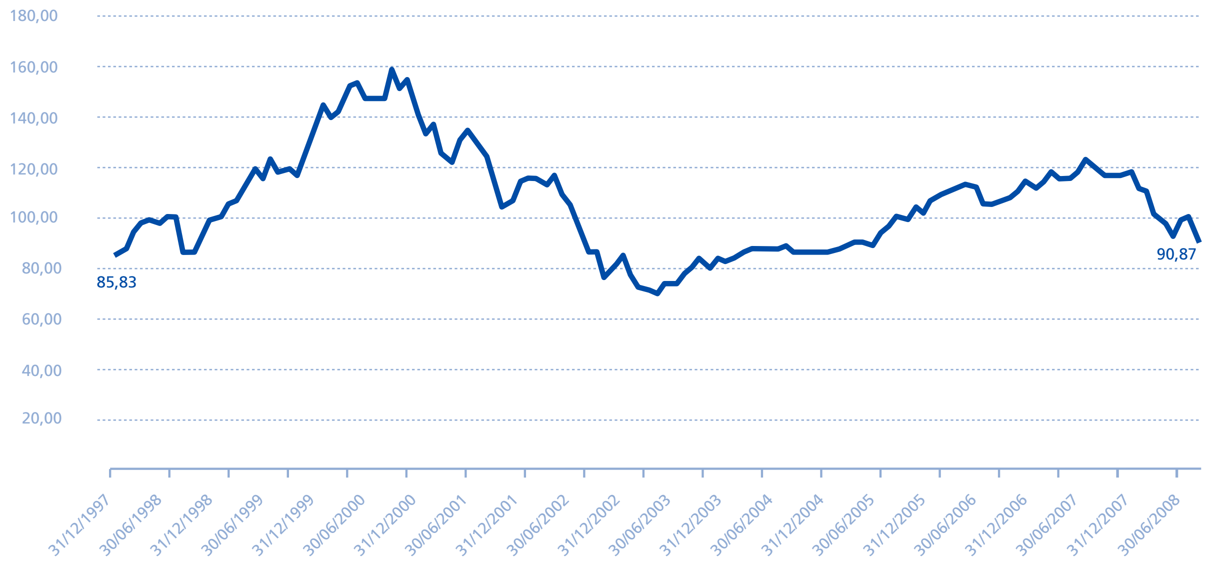


German Stock Market (1920 – 1924)



In conclusion, we believe that the forecast levels of global growth and inflation remain reasonable and, in any case, we would stress that the best asset class for hedging inflation is equities. As we said at the start, global stock markets over the last 10 years have failed to fully price in the growth of the world's economies (although in 1998 they were probably overvalued) and could start to break out of their current stagnation at any moment. For our part, we will be looking to outperform this market trend.

MSCI since 1998



Our Funds

The performance of our two main portfolios in 2008, the Iberian - reflected in the Bestinver Bolsa fund - and the international - reflected in the Bestinver Internacional fund - has been somewhat unequal. Bestinver Bolsa has fallen by a cumulative 12% to the end of June, vs. a 21% fall by the IGBM: an outperformance of 9%. Bestinver Internacional generated negative yields of 17% vs. an 18% fall by the MSCI World. It would be wrong, however, to lay too much weight on the superior performance by our Iberian portfolio over the half-year. Any analysis based on short investment periods, such as a half-year or a year, is prone to error. Compare, for instance, this latest half-year with 1999 when Bestinver Internacional achieved yields 6.3% better than the MSCI while Bestinver Bolsa underperformed the IGBM by -27.2%, its worst ever relative showing. In fact, since its launch in 1998, Bestinver Internacional has a better track record of outperformance, 8.6% annually vs. 7.6% for our Spanish portfolio since inception in 1993. The problem is that global stock markets recorded a flat performance over these ten years.

	BESTINVER	INDEX	RELATIVE PERFORMANCE
Iberian Equities: annual average performance since 1993	19,61 %	12,00 %	7,61 %
Global equities: annual average performance since 1998	9,13 %	0,48 %	8,65 %

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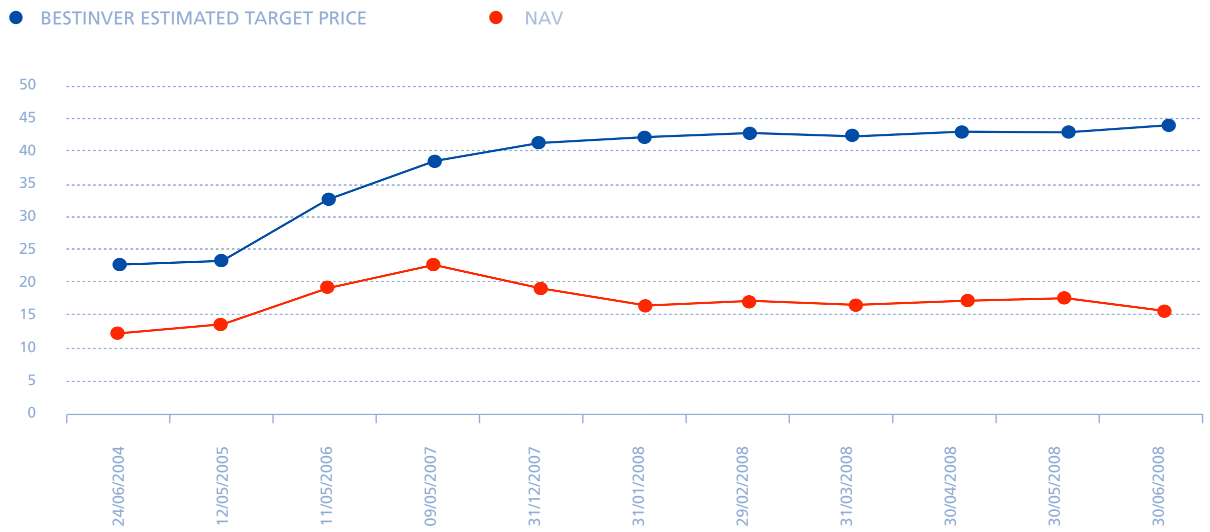
Our International Portfolio

Our international portfolio has upside of 184%. Over the quarter we revised our target price of 36 companies downward (the average downgrade was less than 10%), and five companies upward, seeking to be extremely conservative. Nonetheless, despite the 5% fall in NAV, the estimated value of the fund has increased over the quarter by 4%.

BESTINVER INTERNACIONAL

Difference between target price and NAV.



BESTINVER INTERNACIONAL	31-dic-07	30-jun-08	Chg %
Trget Price (€ /sh)	41,2	44,3	7,48%
NAV (€ /sh)	18,9	15,6	-17,83%
Upside	117%	184%	
P/E (2009 estimated FCF)	6,9 x	5,3 x	

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Now you may ask, how can the fund's NAV fall by 6% and yet its estimated value rise by 4%? This is possible because of an appropriate rotation of the portfolio, selling companies with less upside and investing in others with greater upside. For instance, we received takeover bids for three of the companies in which we were invested in Q1 and another three in Q2, including an improved offer on one of the Q1 bids. As a result, behind the 5% underlying fall there was a process of gradually divesting stocks that had made gains rather than falling, and reinvesting in others that had fallen by substantially more than 5%, creating an opportunity for those willing to invest for the long term to buy into good companies at exceptional prices.

Another way in which the fund's estimated value increased was by the creation of value within companies in which we are invested. For instance, BMW announced growth in vehicle sales of nearly 5% in the first six months of 2008, despite the global economic environment. As a result, irrespective of what happened to the share price, BMW is creating value through the mere passage of time. At the moment the company's market value is €15.5 billion and it has €13 billion in net cash and finance. In other words, we are paying around €2.5 billion for one of the world's best car makes, a company that generates €3 billion in cash flow every year. This means that BMW is currently trading at a P/E of 0.8x, which is effectively as though we were getting it for free. Although unusual, at times the market can offer this type of opportunity, which we at Bestinver always try to seize (even if it means short-term pain).

One specific example of how we create value by rotating the portfolio is the sale of Corporate Express and investment in Ciba.

We have been invested in Corporate Express for years. Its shares slumped to a low of €3.18 in January 2008. During the fall we gradually added to our holding in the company until it made up 3.5% of our international portfolio. In mid-February, US multinational Staples launched a takeover bid for Corporate Express at €7.25 per share, more than double its low of a few weeks previously, which it later increased on two successive occasions in the last quarter, first to €8 and finally to €9.25, the price at which we sold the last of our position.

One of the companies in which we reinvested our gains on Corporate Express was the Swiss company Ciba. Ciba shares began the year trading at CHF 50 and ended the last quarter below CHF 30. As it declined over the half-year we gradually added to our investment in the stock and it now forms one of the main positions in our international portfolio. Ciba makes high value-added chemicals which it sells worldwide. It has for decades been market leader in most of the segments where it competes and earns fairly stable margins. It currently trades at 4x its estimated free cash flow, even without assuming it achieves all the cost savings and productivity improvements that it has planned. Possible catalysts for the stock's revival include a takeover bid, the steady release of solid quarterly results, etc. This investment has helped boost the total upside in our international portfolio and we are confident it will generate substantial gains for our investors.

It is interesting to note that on 10 July, Warren Buffet and Dow Chemical submitted a bid for Rohm and Haas –a US company similar to Ciba-, with multiples, which if applied to Ciba, would give a share price of CHF110 per share. This is in line with our valuation of the company, which we have lowered from CHF113 (and which we highlighted during our Client Conferences in February) to CHF110 which is included in our funds' target price. This confirms that our valuations are realistic, even conservative, despite being substantially higher than current prices.

Corporate Express Share Price.

Ciba Share Price.

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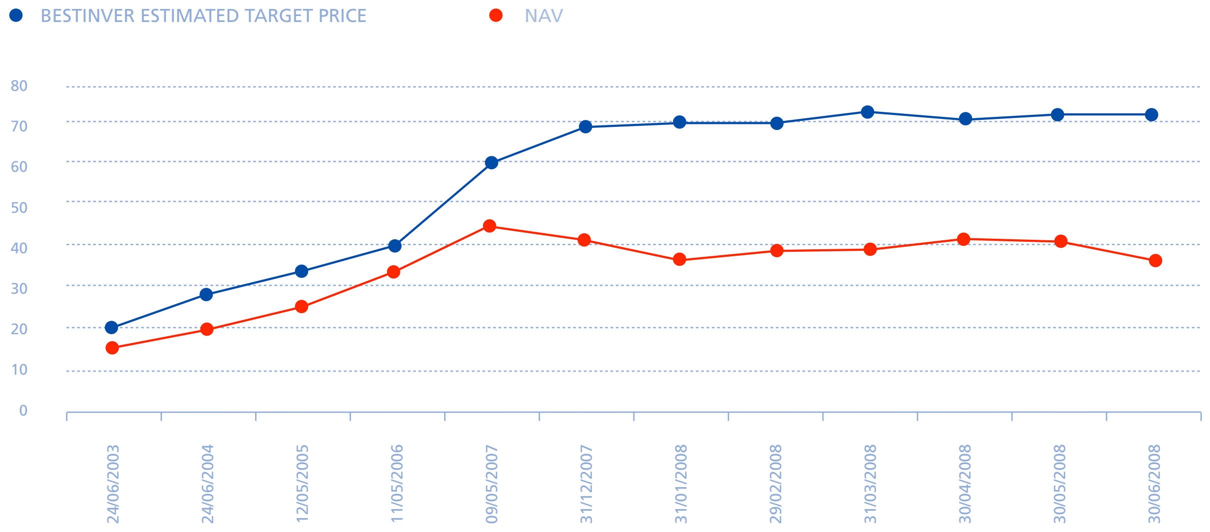
Our Iberian Portfolio

Our Iberian portfolio has upside potential of 97%. Over the quarter we have revised our valuation on 17 companies downward (average downgrades are less than 9%) and our valuation of two upward. This conservative approach means that the target price has remained stable over the quarter.

Our strategy of eliminating exposure to Spanish domestic demand in cyclical sectors was successful in 2008. The portfolio outperformed its index by 9% in the year to end-June.

BESTINVER BOLSA

Difference between target price and NAV.



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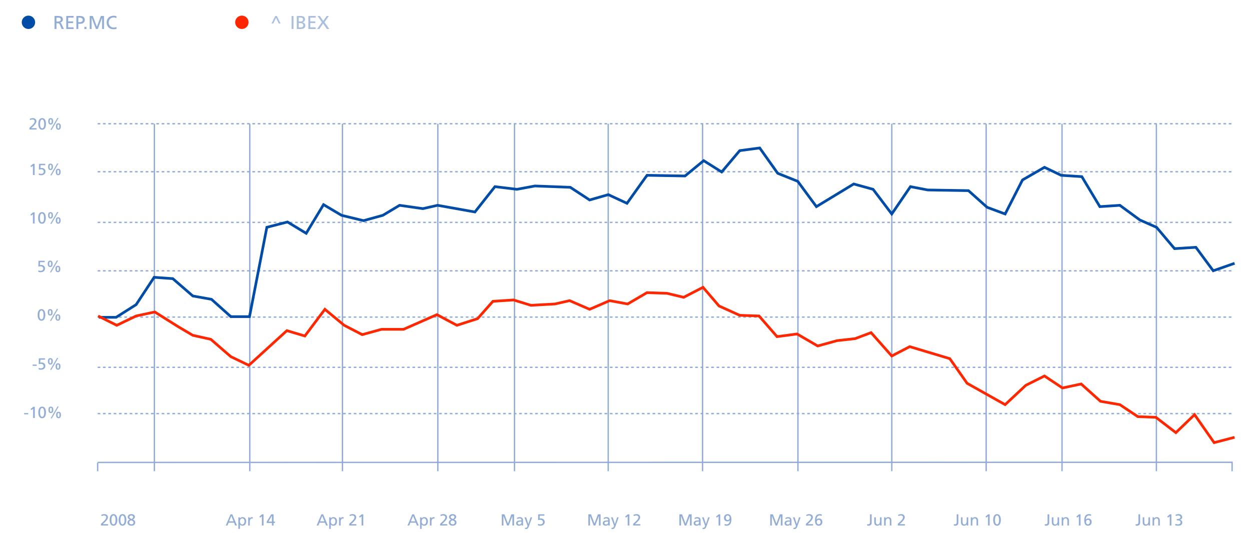
BESTINVER BOLSA	31-dic-07	30-jun-08	Chg %
Target Price (€ /sh)	69,6	72,8	4,56%
NAV (€ /sh)	42,2	36,9	-12,58%
Upside	65%	97%	
P/E (2009 estimated FCF)	9,1 x	7,6 x	

Our strategy remains firmly focused on avoiding exposure to cyclical sectors in Spain, by concentrating holdings on companies whose business is largely in exports or international (which at the end of June made up nearly 60% of the portfolio's estimated value) or, in all other cases, on companies doing business in Spain but with scant exposure to the cycle, and in Portuguese stocks (which were weighted at nearly 20% of the Iberian portfolio at the end of the first half-year). There are some businesses that ride out crises largely unscathed or actually perform "anti-cyclically", such as car and credit insurance, to which we are exposed via Mapfre and Catalana Occident, or fast food chains, in which we have positions via Ibersol, a Burger King franchise operator whose sales growth has actually accelerated since the crisis hit. Paradoxically, the market has failed to make the distinction and Ibersol shares have been heavily marked down, an opportunity that we have seized by adding to our investment.

One instance of how we managed to beat the IGBM over the six months is our investment in Repsol YPF. The share price has fallen to below €20, its January low. We have taken advantage of the decline to buy and Repsol YPF now makes up 9% of our Iberian portfolio. At €20 per share, our fair value for the company gives upside of more than 100%. In Q2, Repsol YPF announced highly promising results from its deep-water exploration operations off the Brazilian coast, with the potential to have a significant impact on its value. The share price hit €27.5 in the last quarter, a 40% rise from its lows, and is now trading at close to €25 with a performance that far outstrips that of the IGBM. At Bestinver we are aware that

Repsol's exploratory blocks in the Santos basin have significant hidden value, which has not been included in our valuation of the company. This is just one instance of a common event in Value Investing, which is the unlocking of some hidden value that is not always priced in as it is deemed to be uncertain, but which is known to be a potential source of additional gains or, if you prefer, an extra cushion of value for the investment.

Repsol YPF share price and the IBEX - 35



"Bestinver Hedge Value Fund is a portfolio concentrated on our strongest investment ideas."

Bestinver Hedge Value Fund is constituted as a free mutual fund under the Spanish hedge fund law on fondos de inversión libre. Its investment philosophy is, however, the same as that of our other mutual funds. Where it differs is that it is more concentrated, invested in just 25 stocks with the largest 10 positions making up nearly 72% of its total value. The fund can also take on debt to leverage its investments, within certain constraints, although at the time of writing it has no leverage.

Bestinver Hedge Value Fund is, then, a portfolio concentrated on our strongest investment ideas. That said, at times of high volatility, great uncertainty and sharp market falls such as we are now seeing, the fund may perform negatively in the short term. Since our best investment ideas come from steep price falls in the shares of large corporates as long as the market continues to throw up such exceptional investment opportunities and we continue to incorporate them into the fund, we may continue to see short-term negative performance.

Short-term performance aside, the fund has an estimated P/E of 4.7x, giving it upside of 246%.

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Conclusion

"Our funds, trading at 6x earnings (Bestinfond), offer an excellent long-term investment opportunity. "

Global stock markets are living through turbulent times, with sharp falls and high volatility. In our view, the economies, and the financial systems of some countries in particular, are shaking off the excesses of recent years caused by overly accommodative monetary policy introduced to ease the necessary transition after the bursting of the tech bubble of the 1990s. However, the world's major stock markets go into this crisis in a markedly different position from that of the turn of this century. Then, the main indices were trading at multiples of over 25x estimated earnings. The Nasdaq at one point even touched 150x. Today, the S&P 500 is trading at less than 15 times earnings and European indices are at 1-11x. At Bestinver we have taken advantage of recent falls to create value. Our funds, trading at 6x earnings (Bestinfond), offer an excellent long-term investment opportunity. For clients prepared to ride out the current stock market volatility we would like to note that we are currently "sowing" and the long-term returns we reap will make up for the difficult times that have hit fund yields over the last year.

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- All Bestinver returns are expressed in local currency, as net after expenses and commissions.

- Text written by Fernando Bernad (Fund Manager).

- **Upside:** The fund's scope for revaluation in the opinion of Bestinver fund managers, calculated as the difference between current P/E and target P/E. It is not about the earnings of the fund in a particular period, as, although the fund may be achieving a particular level of return, the goal of the fund managers is to increase this potential, or, at least, to keep it constant.

- **P/E:** Price of free cash-flow at which the fund is trading, based on the P/E estimated by Bestinver's fund managers for each company (includes adjustments such as debt, changes in the cycle, exchange rates, etc.)

- **Price:** The net asset value of the shares in the fund. For the international stock market, the net asset value of the B. Internacional fund is used; whilst for the Iberian stock market, the net asset value of the B. Bolsa fund is used.

- Target **Price:** The net asset value that shares in a fund could reach based on the intrinsic value, in the opinion of Bestinver's fund managers, of all the stocks in the portfolio.