BESTINVER
Asset Management

03

Quarterly Insight

No. 3, October 2008

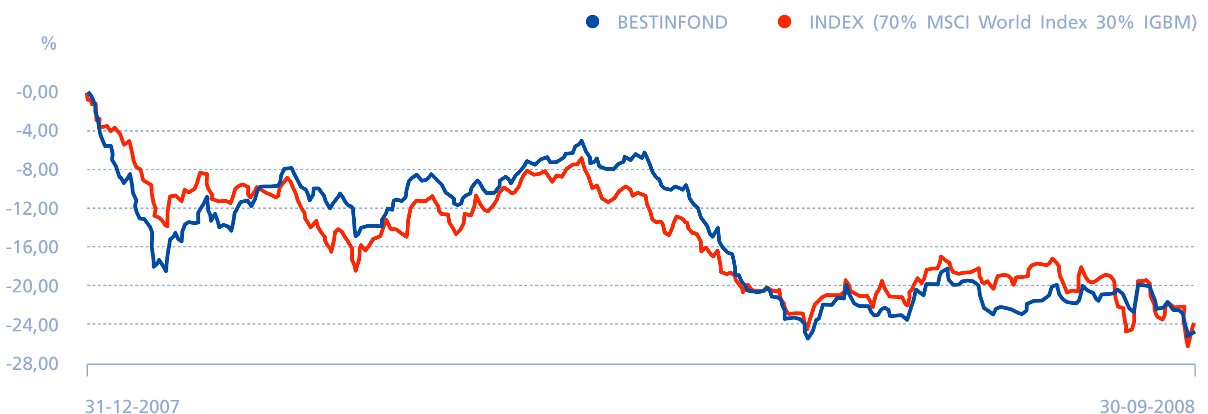
una compañía acciona

BESTINVER
Asset Management

- In the third quarter of 2008 we have seen Wall Street firms collapse and global stock markets reach **new annual lows.** Ironically, European stock markets (where our companies are listed) have recorded far higher cumulative losses over the year than the US market, epicentre of the current financial crisis.

- Our investment strategy (reflected in our Bestinfond mutual fund and our Bestinver Global pension fund) has generated a negative yield during the year of 24.9%, compared to a 24.25% decline on its benchmark (70% MSCI World Index and 30% IGBM). The chart below shows how **performance has been close to its benchmark** throughout 2008.

BESTINFOND **Fund´s Trend 2008**



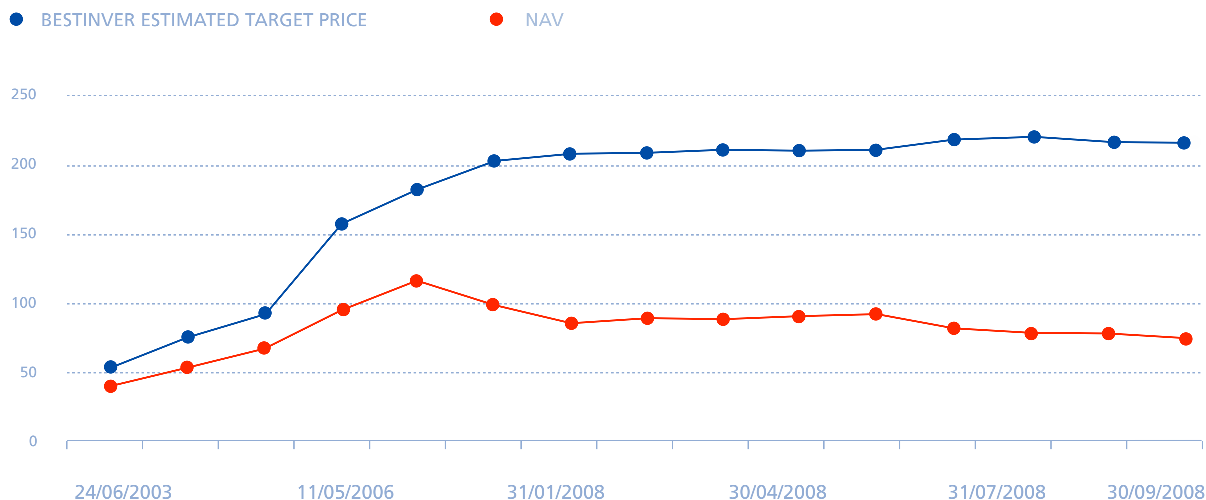
▸ Bestinfond invests in 70% international equities and 30% Iberian equities.

CUMULATIVE YIELD: -24.92%

- Despite the falls by stock markets where we are invested, over the quarter we managed to **maintain Bestinfond's target price** virtually intact, with substantial upside of 189%.

BESTINFOND

Trend gap between target value and NAV.



- Bestinfond invests in 70% international equities and 30% Iberian equities.
  Information is published monthly in the Client Zone of our website: www.bestinver.com

BESTINFOND	30-jun-08	30-sep-08	Chg %
Target Price (€ /sh)	213,5	213,0	-0,23%
NAV(€ /sh)	81,8	73,8	-9,79%
Upside	161%	189%	
P/E (2009 estimated FCF)	5,7 x	5,2 x	

x 10)
x 10)

$ 750
$ 500
$ 250

1,500
300

The Current Environment

Recent events have had a significant impact on many financial institutions in Western Europe and, particularly, in the US. This crisis derives from the same source as previous ones: over-indebtedness of financial systems underwritten by the tacit or explicit support of their home governments. As we have repeatedly said, such excesses always end badly and with negative consequences for most of the parties involved.

However, we must reiterate that, although in the short term it seems that Bestinver's funds have been caught up in the present situation, **long term the impact will be minimum,** as we can profit from the current turmoil. There are several reasons for this:

- **We eliminated exposure to the banking sector several years ago and it remains zero.** Clearly, this was no coincidence but rather because we anticipated the bursting of the credit bubble. Also, financial institutions are hard to analyse from the outside and we remain committed to our policy of investing in companies where the analysis is straightforward allowing us to assign value with little risk of error.

- **90% of our companies have minimum or non-existent debt.** They do not depend on credit to operate their business and some are cash positive (indeed some have very significant cash piles relative to their total valuation). Those portfolio companies that do have higher debt enjoy a relatively relaxed maturity schedule.

- **Our invested companies have clients spread across the world** and can redirect sales to more favourable markets (China, Brazil, etc.). For instance, the three biggest positions in our international portfolio (BMW, Ciba and Clariant) make 25% of their sales in the US, 50% in Europe and 25% in the rest of the world.

- As we said in January, the **most negative impact on our funds is due to the lack of liquidity of some fellow investors in these firms.** The deleveraging that has been underway since the summer has forced these co-investors to sell stakes at any price in a bid to raise cash. This is a temporary phenomenon, that always resolves itself and will ultimately demonstrate the massive value in our investments. An update of this value is available every month on our website and it has maintained a steady uptrend since the start of the crisis, despite our trimming of several company valuations.

- We would recall that **global growth in 2008 will be approximately 3%.** This might slow down in 2009 but should remain positive thanks to the vigorous boost from continental China's economy. China's growth is based on sustainable factors such as savings (savings rates are above 25%) and labour productivity (productivity is improving at faster than 5-6% a year), both factors that have become scarce in some western countries. We must emphasise that despite the constant bombing of bad news coming from Western economies, many countries are developing on positive terms, without piling up debt. Since 1990 we have seen a gradual shift in the global economy. The combination of strong economic growth, trade liberalisation, universal internet access, rising commodity prices and capital inflows to emerging markets has led to a situation where these countries are now more interdependent between themselves and less reliant on the developed world to buy their exports. The four BRIC countries alone now contribute with a 15% of the global GDP, increasing their share of the world economy at a pace unimaginable just a few years back. The role being developed by China on this matter is key. Chinese consumers are starting, in real terms, to make a bigger contribution to global growth than Americans are. The Chinese middle and upper classes now comprise 180 million people.

- The **excessive rally in commodities, which had such a pronounced short-term impact on some of the funds' companies, is starting to go the opposite way.** This should also bring welcome relief to western consumers who can soon expect to see the effect on their purchasing power. In our previous edition, we noted that high oil prices were having a serious effect on western fuel consumption. Crude prices have now dropped to nearly 40% below their peak. We cannot say where the trend will go from here, but the speed at which prices were rising was unsustainable.

The financial crises: where to invest money when the financial system is collapsing

When this happens the government concerned has only one option: to issue more money, depreciating its currency value and generating inflation. This makes it easier to pay off the burden of debt. In such circumstances fixed-income investors lose value in proportion to the gravity of the crisis. The worse the situation, the more money/inflation will be needed to resolve it.

The sole course open to savers looking to preserve their purchasing power in such grave times is to invest in real assets: houses, offices, furniture, factories, etc. as these provide a real service to society and will continue to do so for the next 10 years. As a result they would still have value even in the extreme case that the currency becomes totally worthless (as in Germany in the 1920s) when the fixed-income investor would lose all their savings. The problem with real assets is that they are hard to acquire quickly (nor is it easy to store houses, land, offices, furniture, etc.). Fortunately, there is a way to make this easier: the stock market. Shares are stakes in real assets (factories, buildings, patents, etc.), which while they may temporarily lose some value at the start of the crisis ultimately adjust to the new situation, even after the financial system shrinks or disappears.

In our last quarterly edition we mentioned the examples of Germany and Argentina. Let's look more closely at the recent collapse of the Argentinean financial system. Analysing the breakdown of the system it is clear that investors holding Argentine government bonds in 2001 lost 70% of their savings and did not recover it later. In contrast, investors in equities initially lost 60% the same year but their investments not only recovered rapidly but increased nine-fold in just five years. The Argentine government bond continues to trade at approximately the same price as when the crisis first hit.

ARGENTINE GOVERNMENT BOND

Performance 2000-2008

ARGENTINE STOCK MARKET (Merval)

Performance 2000-2008

This leads us to the conclusion that:

- If the financial system continues to function, investing in equities will allow us to profit as the situation improves.

- If the financial system collapses, this investment in equities will defend the purchasing power of our savings (unlike any type of fixed-income investment).

Our view is that we will probably not see the end of the crisis until prices in the US Real Estate market cease to fall. In some regions, prices are already down by close to 50%, suggesting that the end is not far off. The great advantage of the US economy is its massive flexibility. In less than 18 months it is making a huge adjustment that will allow it to approach the next few years on a much sounder footing. We genuinely believe that in the long term the effects will be positive.

In any event, we insist that, strange as it may seem, **equities are the best asset to preserve wealth when the financial system is collapsing,** and therefore with patience and a cool head we can expect to obtain rewards in the medium term.

Differences from the 1929 crash and Japan's Lost Decade (1990-2000)

The current crisis bears little similarity with either the Depression that followed the 1929 crash or the Japanese crisis of 1990-2000. In the 1930s, the US prevented the adjustment mechanism from working. Falling product prices were not matched by cuts in wages (the government stepped in to prevent this), driving a massive number of firms into bankruptcy. Fortunately, it seems that this time round the error will not be repeated and this should allow the Real Estate sector to find an appropriate price (it is already 20% below highs).

In Japan too, attempts were made to delay the adjustment process by seeking to hide the problem. But the overvaluation of assets, both Real Estate and equities (then trading on a P/E of 60x), was so severe that prices were inexorably eroded.

We recommend that investors who wish to learn more on this subject turn to the economists from the "Austrian School", including Hayek, Von Mises, Rothbard and Huerta de Soto. Their works not only give a clear explanation of economic crises but, in the case of Hayek, anticipated what happened in 1929.

Our Funds

The sharp falls in share prices over recent quarters mean that there is now **not a single equities manager in Europe who can claim a positive yield on its fund for the year.** But of all the different investment styles, "Value Investing" has generated the worst results in 2007 and 2008. According to Nomura Securities, in the last 12 months those shares in the US Russell-1000 index with the cheapest multiples have posted year-on-year falls of close to 70%. But perhaps the most surprising point is the conclusion of a report by investment manager Brandes on 600 US and 150 European managers, which shows that the funds that can boast the best 10-year performances are currently underperforming the market heavily.

The last time Bestinfond recorded a performance similar to now was in 1998 and 1999, when it underperformed the market by 8.16% and 27.12% respectively. Then, we were able to invest at bargain prices which yielded very satisfactory returns over the next 10 years. Today we are doing the same, adding to our position in solid companies that are clearly undervalued.

Once again this quarter, Bestinver's management team has been making additional subscriptions to the funds.

- http://www.bestinver.com/equipo.aspx

Our International Portfolio

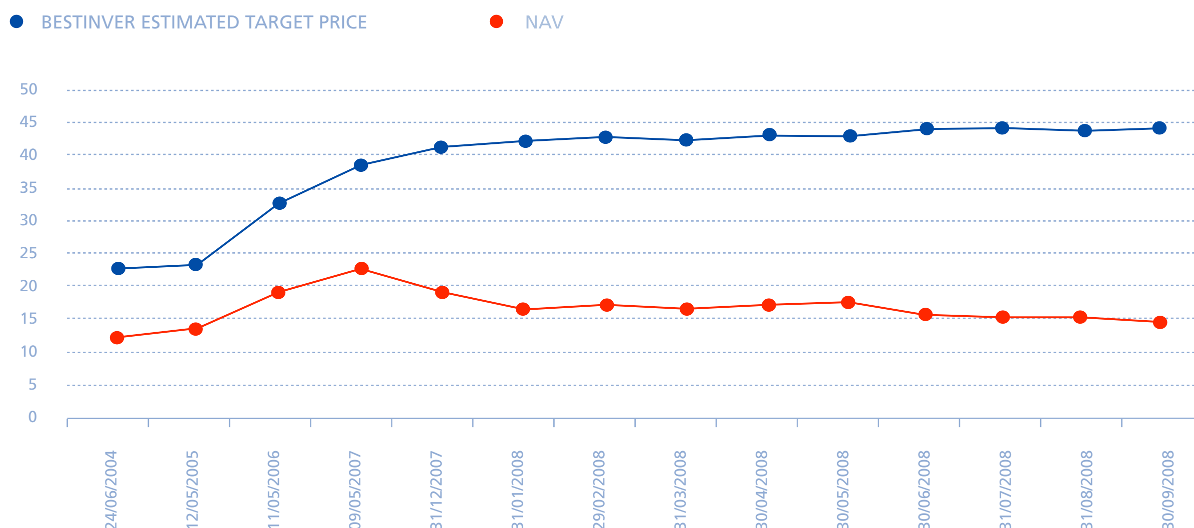
Over the quarter our international portfolio generated a negative yield of 9.1%, returning a negative yield of 25.3% over the year, compared to a -22.5% performance by its MSCI benchmark. In the long run, the fund continues to outperform the index, by an annual average of 7.0% and 11.8% for the last 5 and 10 years, respectively.

As we said, the portfolio's performance has been dragged down in the short run by the "bear" markets, even though **it has no exposure to the main problem areas.** Exposure to the banking and Real Estate sectors is zero and 87.2% of the companies held have **low debt,** with 15.5% of these having a positive net cash position. In some cases this represents a very significant portion of their valuation. Of the remaining 12.8% of the portfolio invested in more heavily geared companies, nearly all have a relatively easy repayment schedule.

During the quarter, in light of the latest downgrades to forecasts for global economic growth, we reduced the valuation of 17 of our companies, raising it in just five cases. That said, it is important to differentiate between a temporary reduction in valuation due to inclement economic circumstances and a permanent loss of value. Of these 17 companies, only four suffered a permanent impairment to their value. The other 13 of the 17 downgrades reflected temporary circumstances and were really an exercise in prudent management given the economic situation, which will be reversed as soon as the outlook improves. All four of those whose values were permanently marked down continue to offer tremendously attractive upside. Overall, we managed to keep the value of the portfolio stable.

BESTINVER INTERNACIONAL

Trend gap between target value and NAV.



▶ Information is published monthly in the Client Zone of our website: www.bestinver.es

BESTINVER INTERNACIONAL	30-jun-08	30-sep-08	Chg %
Target Price (€ /sh)	44,3	44,1	-0,49%
NAV (€ /sh)	15,6	14,2	-9,09%
Upside	184%	211%	
P/E (2009 estimated FCF)	5,3 x	4,8 x	

Once again, we should return here to the case of BMW. During the quarter BMW cut its intermediate profit targets for 2008-10, partly owed to the adverse economic environment, likely to impact sales, but chiefly to the tough climate for raw materials prices and the strong euro. However, it maintained its three-year target of an 8-12% operating margin. Just as we are now moving into a bad phase, when profits will be below normal, so there will be good phases when profits will be unusually high. The key point is that since the economy started to slow down, BMW's position versus its competitors, one of the fundamental long-term

factors that ultimately determines value, not only remains undamaged but has continued to improve, as is clear from its ongoing gains in market share. Also, since it announced its profit warning:

- Some of the external conditions have already improved significantly, with raw materials prices falling significantly and a 10% rise in the dollar. Nor can we rule out a possible intensification of this trend. True, sales could be somewhat lower due to the crisis.

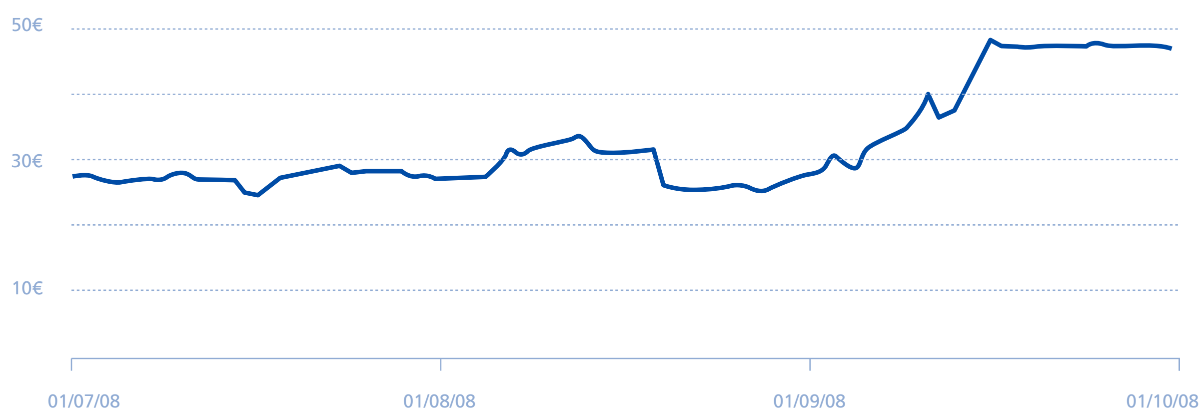
- Our valuation does not assume that BMW reaches its targets. Rather, we are basing our figures on more conservative operating profits. Another example of the safety cushion that we build into our investments.

In last quarter's edition we highlighted the massive undervaluation of BMW. Factors such as a temporarily unfavourable situation, among others, explain why the market is offering unexpected investment opportunities. The chart below shows how the company's share price is close to its level of 10 years ago, despite doubling its unit sales of vehicles and multiplying profits six-fold.

BMW **Performance of the last ten years.**

The single most striking event affecting the international portfolio last quarter was the takeover offer that we received from German multinational BASF for Ciba, which was the fund's second-biggest position before the offer was made. Coincidentally, in our last quarterly letter we had cited the steady strengthening of our stake in Ciba as the share fell as an example of value creation. We said at the time that the catalyst for generating positive returns could come in various ways (including a takeover bid) and at any time.

CIBA — Performance of the last three months.



Nonetheless, the offer of CHF 50 per share, a 32% premium over the previous day's share price and 100% above its annual lows, was still well below our valuation of CHF 110 per share. As a result, we decided not to subscribe to the offer. BASF opportunistically took advantage of market circumstances to launch an offer priced well below the target's value. It is also interesting to note that another of the main holdings in our international portfolio is the Swiss company Clariant, one of the few specialist chemicals firms not to belong to one of the sector's large diversified groups. This suggests there may be a good chance for Clariant of finding itself in a similar situation to Ciba and a dozen other chemicals specialists that have been bought out in the last few years.

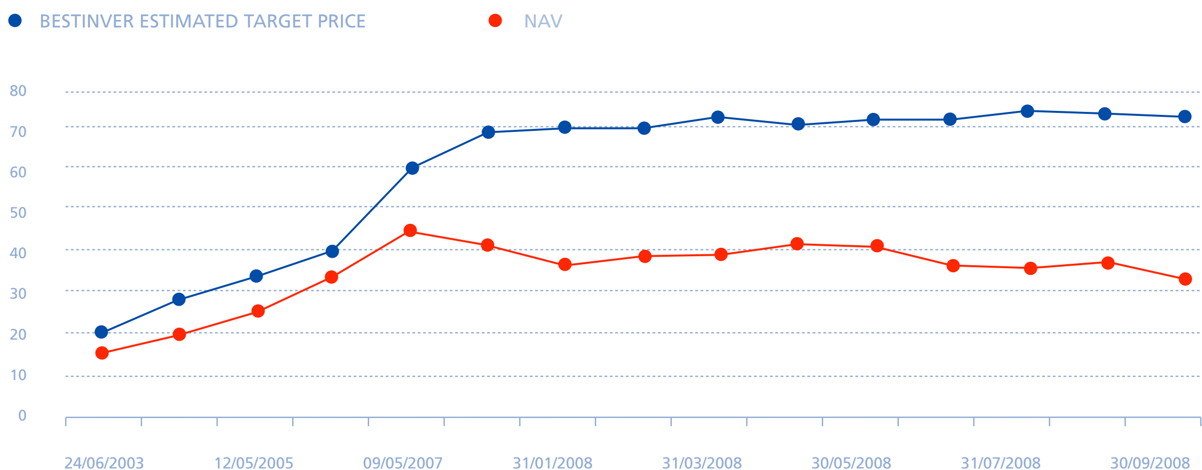
The estimated P/E of the fund is currently 4.8x, giving an upside of 211%.

Our Iberian Portfolio

Over the quarter our Iberian portfolio generated a negative yield of 12% and has returned a negative performance of 23% over the year, compared to -28.4% by its IGBM benchmark. The Ibex Small Cap index has fallen by 41.23% year-to-date. In the long run, the fund continues to outperform the index, by 4.2% and 9.0% for the last five and 10 years, respectively. Note that, since Spain's economy entered its last upturn phase five years ago, our outperformance of the index has been, while still satisfactory, well below what we achieved over the full 10-year cycle. Given that we now find ourselves at the start of a downturn in the cycle, **we expect our outperformance of the index to significantly increase.**

In the third quarter we cut our valuations on seven companies, and raised it on none. These downgrades were more temporary than permanent in character, largely motivated by the unfavourable global environment. Despite the downward revisions we were again able to keep the value of the portfolio stable.

BESTINVER BOLSA **Trend gap between target value and NAV.**



▸ Information is published monthly in the Client Zone of our website: www.bestinver.es

BESTINVER BOLSA	30-jun-08	30-sep-08	Chg %
Target Price (€ /sh)	72,8	72,3	-0,60%
NAV (€ /sh)	36,9	32,4	-11,98%
Upside	97%	123%	
P/E (2009 estimated FCF)	7,6 x	6,7 x	

Our priority for the Iberian portfolio, as we have been emphasising for some time, is to avoid exposure to cyclical businesses in Spain, investing instead in businesses active beyond Spain's borders, exporters and Portuguese firms which together make up 71% of the current portfolio. Of those businesses whose market is in Spain (i.e. the other 29%) most are in **sectors that are by nature barely cyclical** such as food, beverages and tobacco, insurance, utilities, civil engineering and infrastructure, or which depend on global variables such as energy and metals. Only a residual part, therefore, remains exposed to cyclical businesses based in Spain. We should mention here, though, that even in these latter companies, we believe that the wide safety margin provided by the attractive prices at which we invested, reduces our risk of a permanent loss of value to near zero. Of course, exposure to the Spanish banking and real estate sectors is, and has been for a long time, virtually non-existent.

One interesting event this quarter was Gas Natural's takeover of Unión Fenosa, in which we were invested via Corporación Financiera Alba. We valued Unión Fenosa at €16.6 per share, well above the €11 around which it was trading before the bid was announced, but below the €18.3 offered by Gas Natural. This is another instance of our valuations proving accurate. Remember that the clear undervaluation of Unión Fenosa at €11 took place in a well-understood sector enjoying clear visibility, with a recent benchmark provided by Endesa. It seems reasonable to assume that such opportunities are increasingly common and substantial among small companies overlooked by the market.

CORPORACIÓN FINANCIERA ALBA

Performance of the last twelve months.

The Iberian fund's biggest investment, implemented through a number of Spanish and Portuguese companies, is in the pulp and paper sector, with a weighting of slightly over 20%. This is a global sector, whose underlying raw material has in general been bypassed by the recent bubble in commodity prices. Our picks in this sector rank among the global industry's most competitive companies and are trading at heavily undervalued prices. We believe that this is one good example among many that justify our highly positive expectations for the future performance of the Iberian portfolio, regardless of what happens to the Spanish economy.

The estimated P/E of the portfolio is currently 6.7x, with upside of 123%.

Bestinver Hedge Value Fund

Our “hedge” portfolio performed broadly in line with the market over the quarter, yielding a negative 6.9% (compared to -5.4% by the market, based on the MSCI World index). As noted in our previous quarterly newsletter, Bestinver´s Hedge Value Fund is **concentrated on our strongest investment ideas.** Given that our best ideas often stem from falls in the share price of sound companies, it can happen that the very inclusion of such opportunities in the fund drags down its short-term performance.

It is interesting to note, too, that the negative quarterly performance occurred even though Ciba, which gained 61% over the period, was one of our main positions. This was because the other fund positions, which we stress again represent our best ideas, actually underperformed the market. As a result we can now invest at levels of extreme undervaluation, situations that arise only very rarely and generally only at times such as the current market panic.

At the moment our “hedge” fund is trading on an estimated P/E of 4.3x, implying an upside of 246%.

Conclusion

Over the last 11 years we have faced a string of negative scenarios. First, there was the financial crisis of 1997 which triggered a significant drop in the Real Estate markets of Southeast Asia and the stock markets worldwide. This was followed by the Russian default in 1998 and the collapse of the hedge fund LTCM the same year. Shortly afterwards, in March 2000, came the dotcom crisis, which was then exacerbated by the 9/11 terrorist attacks. At the end of the same year we saw the collapse of Enron, throwing the global audit industry into crisis. Finally, over the last year we have seen the bursting of Real Estate booms in countries such as the US, UK, Ireland and Spain. **Despite all these negative scenarios our international and Iberian portfolios have offered our investors annual average yields of 8.5% and 14.9% respectively since 1998 with flat global markets.**

Of course, we would not wish to seem overly bullish about our portfolio and are well aware of the seriousness of the credit crunch and its unpredictable nature. But we want to make a clear distinction between the stock market prices of our companies and the intrinsic value of the businesses in which we are invested. Every so often, the market throws up this type of opportunities and what marks out the managers that beat the market over the long term, such as ourselves, from those that do not, is precisely the ability to take advantage of moments of crisis such as the current one.

For those investors who feel “tempted” to disinvest now in order to buy back in later, we would highlight two key points: First, the stock market does not price in the present, but the future. The securities market anticipates the outlook for companies and when the news on the global economy is at its gloomiest our funds will have been rising for months. Second, yields are asymmetric in their distribution: the 30 best trading days each year account for 90% of yield, so it is not worth missing out on any of these “bull” sessions.

BESTINVER
Asset Management

una compañía acciona

- This document has been prepared by Bestinver Gestión, S.A. SGIIC for information purposes only and can be in no way considered an offer to participate in its investment funds. The information contained herein was compiled by Bestinver Gestión, S.A. SGIIC from sources it believes are reliable. However, while appropriate measures have been taken to verify its accuracy, Bestinver Gestión, S.A. SGIIC in no way guarantees that it is accurate, complete or up to date.

- All opinions and estimates included on this document reflect the best judgment of Bestinver Gestión, S.A. SGIIC as of the date they refer to and may be changed without prior notification. All opinions issued herein are general in nature and do not take into consideration individual specific investment objectives or financial circumstances.

- Under no circumstances can Bestinver Gestión, S.A. SGIIC, its managers, employees or authorised personnel be held responsible for any damage resulting, directly or indirectly, from the use of the information contained within this document. Information regarding past returns does not in any way constitute a promise or guarantee as to future performance.

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

- Text written by Fernando Bernad Marrase (Bestinver fund manager).

- All of the Bestinver mutual funds are co-managed by the three fund managers: Francisco García Paramés, Álvaro Guzmán de Lázaro, and Fernando Bernad Marrase.

- The current quarterly newsletter as well as the old ones can be found on our website. (www.bestinver.com)

- **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.

03

BESTINVER
Asset Management

BESTINVER, S.A.

C/ Juan de Mena, 8 - 1º Dcha.
28014 MADRID

bestinver@bestinver.es
Tel: (34) 91 595 91 50/00
Fax: (34) 91 595 91 20/21
www.bestinver.es