Extracts from KKR Value Fund Letters

The following represents extracts from the KKR/Avoca Value Fund Letters, which were written between 2012 and 2015.

1. **Lessons Learned – A Framework for Investing;**
2. **The Nature of Options;**
3. **The Nature of Cash;**
4. **Leverage and the Lazy Man's Load;**
5. **Building Structural Advantages in Capital Allocation;**
6. **Building Wealth; and**
7. **"The Three R's": Rational, Resourceful and Resilient.**

Yours sincerely

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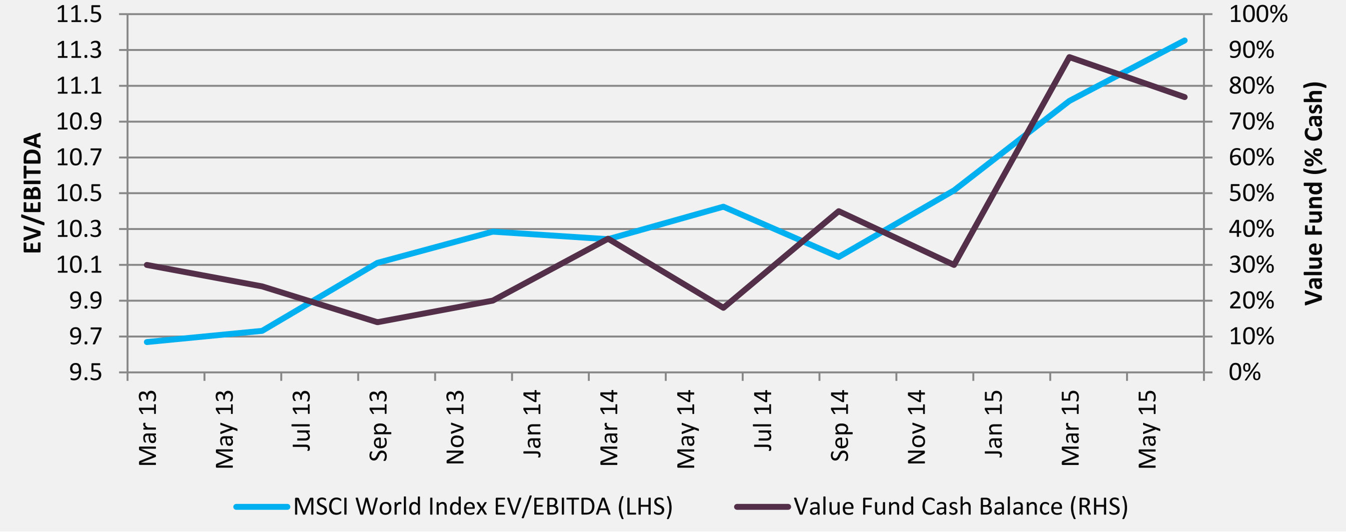
Lessons Learned –
A Framework for Investing

What we can say however is that the Fund's high cash levels reflected a risk sensitive approach to capital allocation and should give investors considerable comfort that we take our capital stewardship role seriously.

The chart below shows the average valuation levels in the MSCI Index (based on enterprise value as a multiple of EBITDA) versus the quarter end cash balance of the Fund.

Equity Valuation Multiples versus Value Fund Cash Balance



Source: Bloomberg, KKR analysis, to 30 June 2015

It has been a recurring theme since inception (as a re-reading of attached Appendix will attest) that we do not like putting capital at risk unless we feel that we are getting adequately compensated. Our exited IRRs on invested capital suggest that we were well compensated when we did take risk.

Lessons Learned – A framework for investing

We are not the first investors to learn these lessons. Everyone has their own philosophy which develops over time. Here are our current thoughts:

1. Sensible investing is a long term pursuit. Long term thinking should permeate all aspects of the business; from the nature of investor capital to the assessment of investment prospects.
2. Be honest in your ignorance. Avoid straying into areas that you don't or can't know.
3. Do your own work and do it well.
4. Use an investment checklist and continue to develop that checklist over time.
5. Assess new investments against the expected return from your existing portfolio which is your true opportunity cost of capital.
6. Focus your time on the areas that are most likely to offer outsized post tax real returns. The opportunity cost of time spent elsewhere is high.
7. Be explicit in the few key assumptions that are the largest drivers of the investment outcome. Test those assumptions with rational sceptics.
8. Cultivate an options mind-set. Understand the options that you are explicitly or implicitly getting or giving. Treasure the option value of holding cash. A fuller discussion on the nature of options is appended.
9. Be leery of leverage, direct or hidden. Understand its power and its pitfalls. If leverage is a big factor, be conscious of the binary nature of potential outcomes and size positions accordingly.
10. Understand probability based expected value and the broad shape of the distribution of possible outcomes.
11. Aggressively monitor your existing portfolio.
12. Fight the psychological tendency to 'lock in' gains by selling winners.
13. Continually ask where you might be wrong. Treat a non-negligible market loss as prima facie evidence that you are wrong and retest both your thesis and your process.
14. The market is there to serve you. Slow down and wait for compelling opportunities.
15. Strive to master the craft of rational capital allocation with a balanced blend of humility and ambition.

The Nature of Options

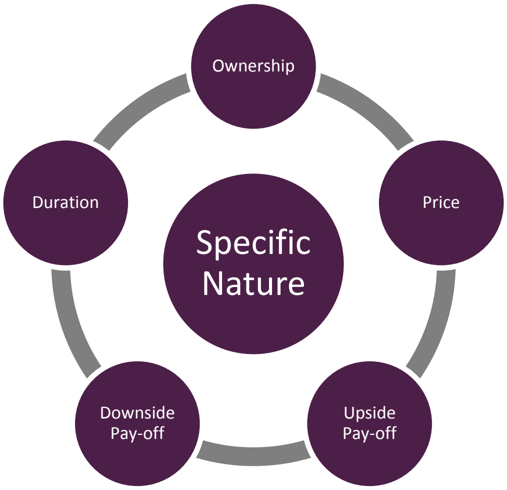
The Nature of Options

We talk a lot in everyday life about understanding our options, maximising our options, or keeping our options open. The worst (investment) fate for an investor or trader is to wipe out their capital. Staying in the game is critical, and an understanding of the nature of options is important to avoiding permanent loss of capital.

Investment lesson number 8 above suggests that we cultivate an options mind-set. Options are a complex topic. What follows is an exploration of the general nature of options (beyond the niche world of traded options). Examining investment decisions through an 'options lens' can help us become more rational and rounded investors.

The figure below outlines what we see as the key features to understand in assessing options.

Options: Key Features:



1. Specific Nature: To what exactly does the option relate? The option has to relate to something specific. In some cases this will be quite clear, e.g. the right to buy shares in Microsoft that are listed on a specified stock exchange. But what if someone gave you a gift of a call option on oil? To understand what you own, we need to be much more precise. Is it on West Texas or Brent? Does the option relate to physical oil (where we might have to take physical delivery) or does it relate to a financial contract? If it is a financial contract, can it be net-settled?

   We also need to understand the fundamental nature. Is it a right to buy (a call), to sell (a put), to extend, or to exchange etc.?

2. Who Owns the Option: The owner of the option (the buyer) is the party that is in control, and the one who gets to make the decision on whether to exercise. The option giver (the seller, or in 'options speak' called the 'writer') is a passive bystander (though the option writer can manage his exposure through hedging).

3. What is the Duration: The duration is the period during which the option can be exercised by its owner. All else being equal, option owners prefer long duration and option givers (writers) prefer short duration. You want to be in a situation where time is your friend.

4. What is the Option Price: The option price (premium) can be explicit and negotiated up-front (e.g. exchange traded options) or may be embedded and not precisely quantifiable where there is some optionality as part of a wider transaction (e.g. the right to prepay a fixed rate US home loan without penalty).

5. What is the Downside Pay-off Profile: **Understanding the downside potential pay-off profile is critical.** Never assume that some rare event will never happen. Extreme events happen more frequently than we think or wish. Is the downside known (e.g. buying an equity put or an equity call, where the downside equals the premium paid), capped (e.g. selling an equity put or selling an equity covered call) or potentially unlimited (e.g. selling/writing an un-covered equity call)?

6. What is the Upside Pay-off Profile: Is upside fixed (e.g. selling an equity put or an equity call), capped (e.g. buying an equity put), or unlimited (e.g. buying an equity call).

Once we understand the nature of an option we can get a basic sense of what an options value continuum might look like:

<u>Options Value Continuum:</u>

Valuable Option Characteristics:	**Dangerous Option Characteristics:**
- Uncapped upside	- Fixed & low upside
- Option bought	- Option sold
- Fixed and low / no cost downside	- Uncapped downside
Valuable Option Examples:	Dangerous Option Examples:
- Employee Incentive Stock Grants	- Selling poorly priced long dated catastrophe insurance
- High quality, un-levered business franchise bought at a fair or a low price	- Mezzanine lending to highly levered businesses
- Lifelong learning	- Playing multiple games of Russian roulette for small (or indeed large) rewards
- Holding cash ahead of a period of market dislocation	

To explore this further let's use an options lens to compare three different activities: lending, writing catastrophe insurance and buying equities.

	Lending	**Writing Cat Insurance**	**Buying Equities**
Downside:	Capped at the Loan Amount	Uncapped (unless re-insured or a specific cap is contracted)	Capped at the Investment Amount
Upside:	Capped	Fixed	Unlimited
Nature:	Selling a Put	Selling an un-covered call	Buying a call

The phrase 'picking up pennies in front of a steamroller' has been use to describe banking and insurance. The analogy is harsh but has more than a grain of truth. Floating rate lending without pre-payment penalties can look especially poor under an options lens. If things are going well for the company the lender gets repaid early, earning minimal income. If things go badly a 100% loss is a possibility. This is poor asymmetry.

Owning a large number of independent long-dated call options is a preferable way to build wealth.

<u>Checklist:</u> We are advocates of using an investment checklist which we periodically update to reflect new insight. We are adding the following questions under the heading of Options:

1. What explicit options are we buying or selling?
2. What implicit options are we buying or selling?
3. What is the shape of the pay-off profile?
4. Does the investment have traded options and if so do they offer either useful information or a more effective way to take/manage exposure?
5. Is our overall portfolio construction (including cash allocations) conducive to capitalising on periods of market dislocation?

Though the above discussion is focussed on investing, many of the lessons resonate with how to get the most from life more widely. The old adage "don't burn your bridges" is a wise one. Cultivating high quality relationships and friendships is a valuable options strategy.

The Nature of Cash

The Nature of Cash

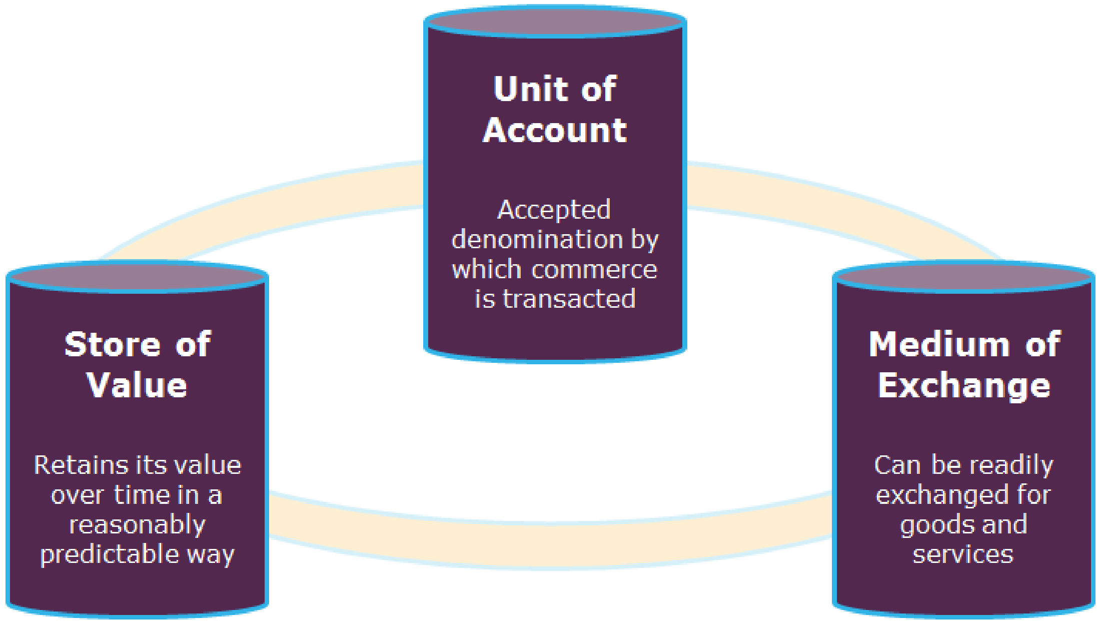
Cash is the Fund's largest holding so we thought it would be appropriate to consider; (i) the nature of cash, and (ii) its place in an investment portfolio.

When we talk about cash we are in fact talking about a deposit with a financial institution and our exploration might more appropriately be labelled as the nature of money. Cash (in the form of coins and bank-notes) represents a small fraction of the total money supply. The majority of what we call money is deposits held with financial institutions.

The Nature of Cash/Money

The classic definition of money might be as represented by the following diagram. Money is considered sound if it acts as a medium of exchange, a unit of account and a store of value.

Diagram One – **The Three Pillars of Sound Money**



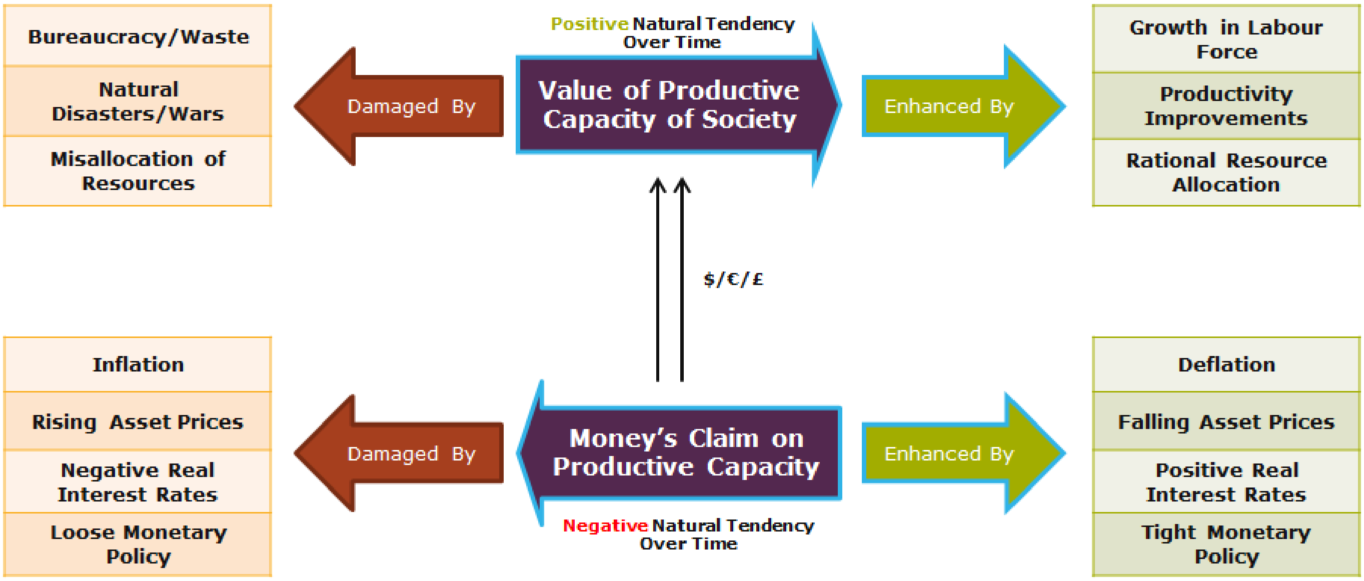
Money is not wealth but rather a claim on wealth. Ultimately money can be exchanged for goods and services or it can be used to buy productive capacity. If money couldn't be traded for goods or services it would have no utility. Money is, in essence, a deferred claim on productive capacity (e.g. the laying hen or the breeding stock) or on the fruits of productive capacity (e.g. the eggs). Productive capacity is the means to deliver the goods and services that people want.

Broadly speaking, productive capacity is increasing over time and normally it is better (from a long-term wealth accumulation perspective) to own productive capacity today than; (a) to consume today, or (b) to hold money for future consumption, or (c) to purchase productive capacity in the future.

The problem with holding money for a long period of time is that cracks can, and do, appear in the three pillars, especially in money's property as a store of value.

The schematic on the following page may help illustrate this dynamic.

Diagram Two– **Money as a Claim on Productive Capacity**



While there are many factors at play, over the medium to long term, productive capacity has a tendency to increase in value and money has a tendency to decrease in value (as it relates to moneys right to 'buy' a given amount of productive capacity). Normally, if you have a long term time horizon and you have sufficient liquid resources for current needs/possible emergencies, wealth is maximised through owning productive capacity, and not through holding cash.

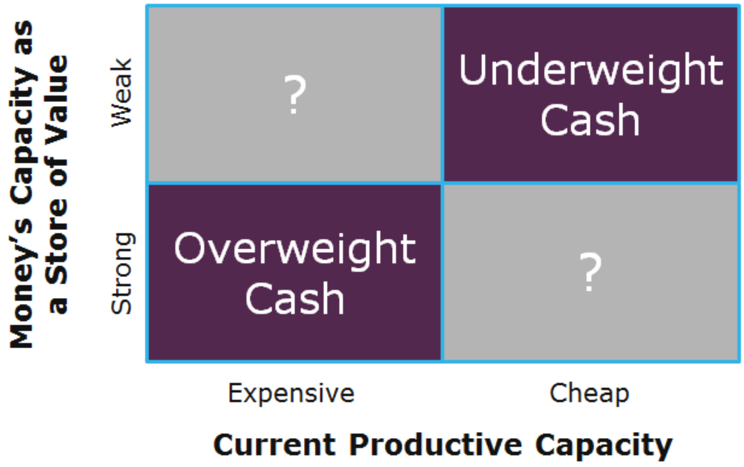
Cash in a Portfolio Context

Why would a portfolio manager (including this one) hold cash given the likely longer-term losing proposition (versus owning productive capacity)?

There are two lines of reasoning. One relates to what is essentially a timing call. We can think of cash as being akin to a variable claim on productive capacity and there will be times when that claim is more useful than others. The other reason for holding cash relates to the intrinsic optionality of cash.

Dealing with the variable claim first and building on our earlier schematic, there are times when it makes sense to hold more cash than normal, for example if asset prices are very expensive and cash/currency is not being inflated away or debased through excessive money printing (i.e. its properties as a store of value are sound).

Diagram Three– **The Cash Conundrum**



Aside from the timing call there are intrinsic reasons to hold some cash (once combined with a preparedness to hold no cash, or even to borrow, when the circumstances support full investment):

1. Optionality. Holding cash is a call option on future opportunity. Time has a habit of occasionally offering up exceptional opportunities and we only need a few to be able to capitalise on them. When the odds are especially favourable, having discipline and recognising such favourable odds is not enough, we must also have both the fortitude and liquidity to act.
2. Risk Management. Let's say for the say of simplicity that one could be 100% invested and earn a 6% market return or be 50% invested and earn 12% on the invested portion and nothing on the un-invested portion. Without getting into the weeds of the relative riskiness of the 6% or 12% investments (the 12% investment may in fact be less risky more often than people suspect), we would consider the 50% invested portfolio safer than the 100% invested portfolio.
3. Loss Asymmetry. Feeling the need to be always fully invested increases the risk of overpaying. Recovering the loss associated with overpaying for an asset is not directly proportional to the gain required to recover the loss. A 25% loss requires a 33% gain to get back to even. A 50% loss requires a doubling to break even. Investing is like playing a distorted game of snakes and ladders.

Outlook

We remain uncomfortable with broad market valuation levels (productive capacity is currently expensive). This environment is more conducive to trading around positions than it is for conviction long allocations. History tells us that this can change quickly. In the interim, we continue to strive to keep our discipline with the capital you have entrusted to us.

Thank you for your continued support. Our next holdings report will be in early October.

Yours sincerely,
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Leverage and the Lazy Man's Load

Leverage & the Lazy Man's Load

When I was a young boy my dad encouraged me to help with the manual labour around the garden of our house. Occasionally he would stop me as I pushed an overloaded wheel-barrow and point out that I was carrying a 'lazy man's load'. It took a toppling over of the wheel-barrow a few times for me to fully appreciate the lesson. An over-loaded wheel barrow is a lot like leverage; increased short term productivity at the risk of ruin.

Leverage is a topic we find ourselves returning to frequently and this probably won't be the last time. The trigger to revisit the topic this time has been us witnessing what recently happened at FXCM and what is currently playing out in the energy markets.

Shareholders may recall that FXCM was a KKR Value Fund portfolio holding last year. We bought FXCM as a likely beneficiary of rising FX volatility. When volatility rose in Q4, 2014, the expected higher cash generation didn't show through in the reported cash earnings of FXCM. The reasons for this apparent anomaly were not clear to us. On failing to understand why the cash-flow dynamics were not as we would have expected, we sold the position. That turned out to be a fortuitous sale, as earlier this year FXCM had to secure rescue financing when it suffered large losses. Those losses were as a result of the Swiss National Bank breaking its currency peg with the euro. This event (high FX volatility) should have been positive for FXCM, not life threatening. What happened? What happened is that FXCM's customers were highly leveraged, which meant that FXCM was *leveraged by association*, notwithstanding FXCM's so called agency only model.

Leverage magnifies results. Leverage can't make a bad investment good, but it can force an inopportune exit from an otherwise good investment. There are three obvious categories of leverage that most sensible investors will want to understand before allocating capital.

The first category is financial leverage or borrowing and we need to be sensitive to the amount, the terms and the availability. The second is operating leverage, the most common component of which is the level of fixed costs in a business. The third category is off balance sheet leverage (e.g. leases, pensions, derivatives, warranties, JV commitments).

Most of the time the sources of leverage are obvious, but there are times when even the most diligent investors get blind-sided. Examples of some of the less obvious sources of leverage are:

- Leveraged Customers or Leveraged Industry Structure. The FXCM example mentioned earlier is a good example. If your customers are highly leveraged, this makes them vulnerable, and by association you are vulnerable;
- Single or Concentrated Leverage Provider. The US for-profit education sector relies on Government guarantees to help students borrow for tuition fees. Certain exporters rely on one or more state subsidised credit insurers. This makes everyone in the sector vulnerable to changes in the credit policies of one or more providers without a satisfactory alternate source of funding;
- Working Capital Terms. If an industry suffers a shock through default of one player, it can drive some or all of the other participants to tighten credit terms thereby squeezing working capital; and
- Others. Cartel structures, long-term contracts (especially if index linked), large supplier or customer concentrations.

We are updating our investment checklist to look out for leverage under four categories; (i) financial, (ii) operational, (iii) off-balance sheet; and (iv) associated/hidden.

Building Structural Advantages in Capital Allocation

But, there is a problem with this thesis: Management is rarely incentivised to run off its business. The second problem is that the business is leveraged. Combining leverage with a commodity business is risky, and risk cuts both ways. An investment in Walter is really more in the nature of a call option and on that basis should be a much smaller position. I decided to reflect, exit and move on with a particular sensitivity to being more careful on position sizing the next time I get the opportunity to buy a cheap leveraged company (which are fine if sized accordingly and one can own a basket of such options).

Part III – Building Structural Advantages in Capital Allocation

When looking to invest in companies, we like to find sustainable structural competitive advantages and it got us thinking: *How does one create structural competitive advantages in the capital allocation business?*

We start with the premise that value stems from what is good for clients, and the obvious ingredient is long term investment performance. So the question might be reframed as: *What structural features (as distinct from capital allocation skills) can a capital allocator put in place that would help long term performance?* These are structural features that should be considered as competitive advantages and therefore lead to better returns for investors over time.

The exercise assumes one has competent capital allocation skills which of course is the key ingredient for long-term investment success. Capital allocation competence assumed, we turn to the structural features that in our view are competitive advantages:

1. Permanent Capital

In the hands of a competent capital allocator, having permanent capital is a tremendous competitive advantage. The best opportunities frequently occur when the typical investor behavioural bias is to redeem and head for the safe refuge of holding cash. This is why for example that average investor returns are significantly lower than the average mutual fund returns, i.e. investor level returns are worse than fund level returns due to poor timing decisions. Fund redemptions are high when prices fall, and fund subscriptions are high when prices rise, which is precisely the opposite of what a value oriented philosophy would suggest.

In 2009, some of the world's best capital allocators missed the opportunity of a lifetime, and by definition so did their investors, as redemption notices turned up when the rational behaviour would have been to stay invested, or to increase allocations to risk assets.

Having permanent capital allows capital allocators to:
a) At least maintain holdings/stay the course, or better, increase exposure, in times of market stress;
b) Focus on the long term when making investment decisions; and
c) Concentrate their time on investing.

2. Flexible Investment Mandate

The expected returns from asset classes are continuously changing. Having the ability to go where the value is makes strong sense. In the hands of a competent capital allocator (that knows their circle of competence), such flexibility is a clear structural advantage. To limit a mandate is analogous to boxing with one hand tied behind your back. For example, a mandate that prohibits investing in energy related securities might miss out on a key source of opportunity in 2015/2016.

3. Tax Efficacy

We covered this topic in last year's annual letter so won't repeat it here other than to re-iterate two key points:
- Tax is a significant drag on long-term returns; and
- We need to consider taxes at both the investment vehicle level and the investor level.

Tax is a specialist topic where professional advice should be taken, but as a general rule, it is structurally advantageous to have investment funds/firms that:
i. Allow gross roll-up, or capital accumulation at low tax rates; and
ii. Deliver their returns to investors in the form of capital gains rather than as income

4. Low Costs

An investment fund/firm that has low costs has a structural advantage. This is especially evident in low return environments. Fair asset management fees, low asset turnover and a simple fund/firm structure all help to keep costs in check.

5. Alignment of Interest

One may argue that this is more in the nature of good housekeeping than a structural/competitive advantage. Given the critical importance of incentives we suggest that investment firms where the managers have the vast majority of their wealth invested alongside outside investors is in fact a competitive advantage in that is addresses the agency problem and results in a more focussed investment effort.

6. Other Competitive Advantages

Some people argue that being away from the major financial centres is a competitive advantage. We don't have enough statistical evidence to tell. It at least seems clear that operating outside New York or London is not an impediment to investment performance.

Companies like Berkshire Hathaway, Fairfax and Markel have most if not all of the above structural advantages though the tax drag is arguably higher than if those companies were domiciled elsewhere. Leucadia (before its combination with Jefferies) had all of them (securing its tax efficacy by starting out with a corporation that had substantial tax loss carry forwards). While the KKR Value Fund has many of these structurally helpful features, it doesn't have permanent capital and the tax position is not ideal for certain Irish resident individual investors. We are examining whether there are sensible ways to address this and may come with some suggestions with our 2015 Annual Letter.

Part IV – Concluding Thoughts

Performance of +16.7% net of fees for 2014 is respectable but we will continue to strive to do better. Investment is a game of continuous improvement and with every year we should be learning more about our existing holdings and the wider opportunity set.

The Fund has had a cautious stance for the last two years, a period during which equity markets have risen substantially. This increases our degree of caution entering 2015. At the time of writing this letter, our cash levels have increased to over 50%. The second and third order effects of the substantial, and possibly sustained, fall in oil prices are material. Volatility is likely to go much higher and we expect our cash holdings to increase as we position the Fund for the inevitable opportunities that are likely to follow such disruption. We are also sensitive to the potential reversal of USD strength given the high degree of consensus suggesting continued USD strength.

We appreciate your continued support through the capital you have entrusted with us and will continue to work to earn your trust. We remain as committed as ever to helping our investors build wealth over time.

Yours sincerely,
Laurence Endersen

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Building Wealth

2013 Annual Shareholder Letter

Disposals during 2013				
Holding	Euro Cost	€ Proceeds Inc. Dividends	Euro Gain	IRR
BMW Preferred	€449,464	€566,265	26%	36%
Tetragon Financial Group	€977,529	€1,066,020	9%	22%
KKR & Co. L.P.	€1,333,453	€1,583,131	19%	41%

BMW Preferred was the very first position purchased by the Value Fund. We bought it on valuation grounds as the ordinary shares of BMW appeared cheap, but the preferred shares (which we have never seen mentioned in any of the investment banking research reports) were even cheaper, trading at a substantial discount to the ords. As the year progressed the ordinary shares rose in value and the preference discount narrowed. Car manufacturing is generally a commodity, low return on equity, business. Though BMW is an industry leader with strong positioning in the premium market we found the holding less compelling post a 26% gain.

Tetragon is a structured finance investor like Volta. We exited our position on concerns around re-investment risk and the expected future return to the Fund at the higher valuation. Since we exited our position the stock has fallen below our original cost and we have re-initiated a position in January 2014 which we will elaborate on in our Q1, 2014 Holdings Report.

We outlined our rationale for purchasing KKR in our Q2, 2013 Holdings Report. It was our highest conviction holding before we sold it. We have not lost our conviction. As most of you will be aware, KKR announced its intention to acquire Avoca Capital in Q4, 2013. It is KKR's policy for funds managed by it not to hold any interests in KKR itself so the Fund exited its position. Across all three disposals the IRRs are flattered by the short holding periods.

Part III – Building Wealth

The objective of the value fund is to build wealth over time. What follows might appear basic but sometimes it's best not to overcomplicate things. As someone once said to me, "there is only one cure for baldness and that's hair". We see three fundamental components to building wealth;

1. Own things that increase in value;
2. Avoid mistakes; and
3. Minimise other claims on the increase in value.

The first of these was addressed in our discussion of an ideal investment so we will focus on the other two..

Avoiding Mistakes

Mistakes are costly. The math of mistakes is miserable. Consider the following:

Two back to back years of 30% gains followed by a 30% loss gives a three year compounded return of 6%. The tortoise delivering a steady 10% per annum might be quite envious for two of those three years.

While making mistakes might be surest way to lose money, it is unfortunately not the only way. Virtually nothing is 100% predictable. You can be 95% sure of something and be battered by the one in twenty event. Everyone will get their fair share of chance events, good and bad, over time. We acknowledge the role of chance but we can't change it. So instead we focus on the things that are in our control, and minimising mistakes is in this category.

The two most common sources of mistakes are; (a) not knowing what you are doing and (b) leverage. The former speaks for itself, but is sometimes forgotten, especially in bull markets. The latter is more complicated because when it comes to building wealth, leverage can be wonderful.

In itself, leverage is neither good nor bad. It simply magnifies results. In both directions. The type of leverage matters. Bad leverage has one or more of the following features;

- You don't fully see it, for example hidden operating leverage or some cliff risk dynamics in a business model (related to not knowing what you are doing);
- Shorter in term than the assets that are being financed, either directly, or indirectly through conditions that can trigger demand for repayment or higher costs;
- Expensive.

In building wealth, leverage helps if you are in a hurry; but, if you want to build *and keep* wealth, it doesn't help to be in a hurry.

Some leverage is created more equal than other leverage. There are many examples where significant wealth has been built and kept using cheap term leverage. The 'float' in a profitable insurance business is a good example. Well located property bought at the right time in the cycle, financed long term at low fixed rates is a great way to build wealth.

In building our portfolio for the Value Fund we try to understand whether and where leverage is a factor, the nature of the leverage, and the magnified risk of loss if we are wrong in our assessment. A leveraged investment is in essence a *bigger* investment and if we get it wrong we will experience the bitter taste of the miserable math alluded to earlier.

Avoca Capital Holdings is regulated by the Central Bank of Ireland and subject to limited regulation by the Financial Conduct Authority. Details about the extent of our authorisation and regulation by the Financial Conduct Authority are available from us on request

2013 Annual Shareholder Letter

Minimise other claims

There are three thieves that conspire to erode our wealth. These are inflation, expenses and taxes.

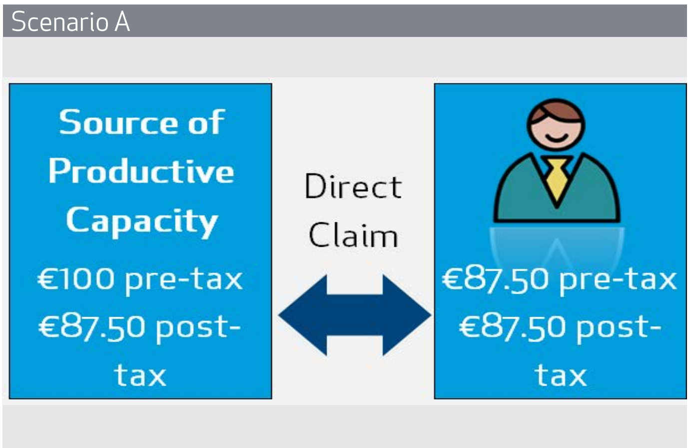
Inflation is the silent thief. The decade from 1973-82 inclusive saw average annual CPI inflation of 8.7% in the US, and peak inflation of 13.3% in 1979. That was simply daylight robbery for savers that felt like it was happening while you were asleep. Inflation remains subdued for now but it is a constant risk factor assessed in research of all of our investments.

The emergence of a $5 trillion passive investment industry represents retaliation to the thieving power of expenses. As a slight aside, one of the most amusing rationales I recently heard for passive investing was that it 'eliminated the risk of underperformance'.

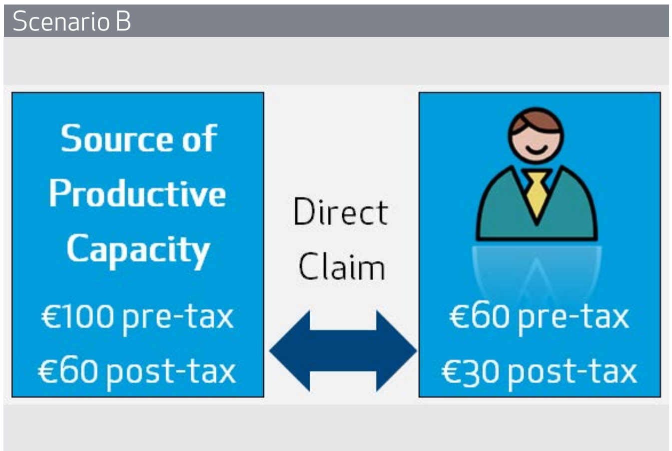
Most investors intuitively understand the performance drag caused by inflation and expenses. But when it comes to taxes far fewer investors have this intuitive understanding.

This is somewhat surprising because tax efficacy is an absolutely critical component when it comes to compounding wealth over the long term.

Consider the following two scenarios. In scenario A assume you are a tax exempt individual (perhaps through a retirement account) directly owning 100% of an Irish domiciled productive business that is taxed at 12.5%. The business earns €100 in pre-tax profits per year and fully distributes its earnings to you as owner. In this particular case you get to keep €87.50 as illustrated below.



For Scenario B assume the company is based in a high tax jurisdiction, paying 40% corporation tax, and you are a high marginal rate tax payer, paying 50%. The scenario B picture is not quite as pretty.



While this is a simplified example, it shows the importance of tax efficacy at both the source and tax efficacy in your hands. The difference is enormous. Some of the world's best compounders are fully aware of this dynamic and it explains why Berkshire Hathaway, Markel and Fairfax like to buy businesses outright as they have a more direct claim on the earnings, i.e. are closer to the source.

There are lots of other examples where being alive to hidden tax dynamics is important.

1. Knowing whether dividend or interest withholding tax is deducted from your income producing securities and if deducted whether it is recoverable. The taxes may be recoverable but the administrative task can be cumbersome and costly. In some countries withholding tax can snare a third or more of your income.
2. A preference for share buybacks over dividends if you are in a high income tax bracket.
3. The risk that Government tax policy can materially impact earnings, a particular risk for resource companies.
4. Companies may report overseas earnings gross of repatriation taxes. The foreign earnings are there, but you can't have them all.
5. Investment theory suggests that the value of a company should not be impacted by how leveraged it is. But this ignores the present value of the tax shield provided by interest deductibility.
6. While tax exemptions are preferred, tax deferrals are also valuable. The tax deferral is the economic equivalent of an interest free loan (i.e. good leverage). Over long periods the benefits of tax deferral can be substantial. Think of it as free gearing at the level of the tax that would otherwise have been due.

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7. For taxable individuals it is usually better to own long term compounders. Say you invest €1m in a stock and the stock goes to €2m. Assume 30% capital gains tax. If you sell that stock you will have €1.7m to reinvest. If you don't sell, you still have €2m working for you. The reinvestment candidate has a higher bar than your existing holding.

Simplified framework for building wealth: Buy compounding productive capacity as cheaply as possible and protect it against taxes and other expenses. If you must use leverage make sure it is long term, flexible and cheap (or preferably free). Avoid permanent losses of capital.

Part IV – Concluding Thoughts

The Fund had a solid start on an absolute basis, but was below par on a relative basis. This will happen to us occasionally, particularly in very strong years for equity markets such as the one we just had. We will not take undue risks with investor capital just to keep up with a calendarised benchmark. While the majority of the gains in 2013 came from familiar larger capitalised companies, given current valuations we will need to cast the net wider to find value in 2014. Wider doesn't mean any less cautious. We don't intend to fish in dangerous waters.

Readers may have noticed that we have not discussed the macro environment. The macro is what it is; context. Opportunities for us are found in the micro and our mantra remains macro for context and micro for conviction.

We appreciate your continued support through the capital you have entrusted with us and will continue to strive to earn your trust over time.

Yours sincerely,

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January 2014

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"The Three R's": Rational, Resourceful and Resilient

Q2 2013 Holdings

investor that is evolving into a more broad-based asset manager. Our reduced holding in Tetragon was informed by the more challenging re-investment environment that Tetragon faces. While Tetragon's existing legacy assets continue to produce substantial cash-flows it is proving challenging to re-invest those cash-flows at sufficiently attractive expected returns.

By contrast we believe that the future prospects for KKR are as strong as when we originally invested. We will share our investment thesis on KKR (and all our other holdings) as part of our annual review at the end of 2013, but the key tenets of the investment case are as follows:

- KKR is a global investment firm that has a market leading asset management franchise built upon over three decades of highly productive private equity experience;
- Long term market growth is supported by secular themes of increasing allocations to alternative assets, more challenging pension liability obligations, and institutions consolidating their investment allocations with larger tier one managers;
- Combination of long duration locked-in AUM and a significant permanent capital base;
- Investor friendly distribution policy;
- Proven ability to consistently and profitably grow;
- Management depth with world class capital allocation skills;
- A current valuation that, in our view, doesn't reflect the growth prospects, downside protection (diversified balance sheet), and resilience (long dated capital) of KKR's model.

We believe the KKR investment opportunity exists due to a combination of the relatively new nature of quoted alternative asset managers, a listed limited partnership structure, market valuation volatility and the likelihood of more penal taxation over time.

"Macro for Context, Micro for Conviction"

There seems to be immense focus on the macro environment in today's investment world. Perhaps it is because so many investors were wrong-footed by the financial crisis. The timing and magnitude of central banking easing/tightening themes dominate markets. The higher probability of rising interest rates is probably one of the most telegraphed macro risks the investment community has seen in some time. We know our significant limitations when it comes to macro forecasting. So, while we endeavour to understand the dynamics of the world in which we live, we see the macro environment as simply informing the investment context. We construct our portfolio from the bottom up, one investment at a time based on the specifics of each investment. Macro provides context, but micro provides the conviction. In each of our portfolio investments our first question is whether the investment offers sufficient value (i.e. a low risk of permanent loss and a better than reasonable prospect of a double digit annual return), and, as part of our assessment, we consider how the investment would behave under various macro scenarios. The core investment opportunity starts and ends with understanding the micro, within which we strive to stay alert to the macro sensitivity.

"The Three R's" – Rational, Resilient & Resourceful

In acting as fiduciaries of your and our capital we strive to be Rational, Resilient & Resourceful. If we can do a respectable job in each of these areas we believe that we will earn our keep.

First and foremost being **rational** is about avoiding costly mistakes. It is also about intellectual honesty, humility, seeking out disconfirming evidence, and a keen understanding of expected value. We continually ask ourselves why we are seeing a particular opportunity and what the market knows that we don't. We use an investment checklist in recognition of our human weaknesses and mental biases. There is an interesting new book written by William Thorndike called "Outsiders". It gives an account of a small number of CEO's that built phenomenal value for long term patient shareholders. The common thread amongst these extraordinary wealth builders was that they were all ultra-rational capital allocators. If there was nothing sensible to do they did nothing. If there was something really compelling to do they did it in size.

Being **resilient** is about ensuring we can stay in the game. In our first letter to our investors we referred to this resilience as being "durable by design". Having a shareholder base with a long-term time horizon, (or even better having access to permanent capital), is a fundamental tenet of being "durable by design". Institutional culture and reward systems are also critical elements of building a resilient investment approach. We are very deliberately endeavouring to be structurally organised in a way that develops and supports resilience.

Being **resourceful** is about working as intelligently as we can to uncover interesting investment opportunities. Great opportunities are rare. By definition they are difficult to find. Improving our resourcefulness is a permanent work in progress for us. We will continually experiment with ways to improve how we allocate the greatest amount of our time to the most promising opportunities.

Thank you for your continued support.

Yours sincerely,

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