



Dear Investor Friends,

Your Sextant funds have posted very negative performance since the start of the year. Even though sharp declines and long periods of underperformance are unfortunately inevitable in the life of a conviction portfolio, we are very sorry about this. The whole Amiral Gestion team is still heavily invested in the Sextant funds, and of course we do not find this situation very pleasant either. But we have already experienced this in managing the Sextant funds and on many occasions before. The declines restore our margins of safety, offer new opportunities, and prepare the rises of tomorrow.

Mistakes in 2008

Following six years of outperformance, in which we had often held our ground well in declines thanks to great caution (a lot of cash, investment in companies with little or no debt and very low valuation multiples), our funds have amplified the market decline. Of course the market may be mistaken about the true value of our companies. It has been mistaken many times, mistreating some of our favourite investments which in the end performed magnificently in the long term. However, we must admit that we made some costly mistakes:

- We were very worried by the rise in energy prices and for the first time we had decided to hedge our portfolios as of 2007. By choosing short-dated products, in the end we lost patience and were no longer covered at the most critical moment. Our greatest regret is to have under-estimated the impact of the credit crisis which has caused a quite exceptional plunge in the markets. Of course we are not the only ones, a banking crisis on such a scale is very fortunately still a highly unlikely event statistically, but in future we shall have to make greater allowance for the occurrence of such events to avoid suffering such steep declines again by improving our hedging management.
- At the start of the year we came back too soon into certain small and mid caps whose valuation had already partially collapsed. In a bear market, when liquidity problems oblige funds to pull out of paper that nobody any longer wants, everything is possible, even the absurd. We have experienced this on very many occasions over the past twenty years or so. Great patience is therefore essential. And understanding that the best hedging instrument is a good cash position.
- The oil sector attracted our attention as early as 2004, when oil shares were heavily undervalued in light of their growth prospects and the inevitable rise in oil prices. In 2007 and 2008 we added to these positions given the continuing rise in energy prices. We knew that this sector was very volatile. But we had not envisaged such rapid upward and downward movements. When the oil price was at US\$140 last summer,



oil shares were valued on an implied price per barrel of between \$90 and \$100, which seemed to us a very fine margin of safety. But we made a big mistake by forgetting that if the barrel fell to \$90, the differential relative to this famous implied price per barrel would still be in relatively the same proportions. Today, oil companies' valuations are based on an oil price of between \$50 and \$60 per barrel, having collapsed during the summer. What is far more surprising is that oil service shares have followed the same path, even though their cash flows are ensured, in some cases for the next four to five years, by contract. We clearly lacked foresight and caution. We should have anticipated this risk, well knowing the volatility of energy prices.

Is it the end of the world?

In the near term, before all throwing ourselves out the window, we should nevertheless look for some light on the horizon. And there is light. Firstly, there is complete panic. Fear has gripped all investors, who no longer even dare to leave their money in the bank. We are therefore undoubtedly not far from a market low. Usually, share markets bottom out well before the depths of an economic crisis, because they anticipate. I don't know anyone who is optimistic, and experience shows that this is generally a good sign. Secondly, I think one should not under-estimate the great desire of our friends in the emerging countries to consume and live better. They have large financial reserves, that they will be able to invest to develop their economies. The Chinese and Indians have to build airports, public transport systems, schools and hospitals, and thousands of high-rise office and residential buildings. The citizens of the Gulf are going to build new towns, buy and develop new farmlands in Africa, build a bridge between the Yemen and Djibouti to prepare to develop these regions and make them more accessible, build universities because in the end their women will be entitled to education just like everyone.

It is certain, too, that things will quieten down on the credit markets. Without trust in the banks and without short-term loans to allow businesses to function, the economy would inevitably collapse. Monetary authorities and governments cannot allow such a situation, and they have the means of providing remedies that have largely been adopted already. It seems to me absolutely inconceivable that banks' clients will lose their assets. If people think so, it's because stress is at its peak, and the bottom is near. There are also technical situations that are easy to understand and will be only temporary: there are a large number of funds that are obliged to sell at any price to cope with heavy redemptions and the need to reduce their leverage. When they can no longer obtain credit, those that were borrowing for arbitrage operations are obliged to unwind their positions. There is therefore a very high probability that equities are at prices that are very interesting for the long term.

In short, there's hope!



There is also Warren Buffett who is buying left, right and centre. Forty billion dollars since the start of the year (Goldman Sachs, General Electric, etc.), that's no small amount. Buffett is probably the most patient investor we know. He doesn't always buy at the bottom, generally that's impossible, but in the long term he has seldom been mistaken.

Our equity portfolio

This is where our greatest hope and our confidence in the future lies.

Oil shares have truly collapsed and are valued at an implied oil price of less than \$60 per barrel. Now, although consumption is falling in the West, this is not the case worldwide. And production is at best stagnant. The natural overall decline of the world's oil fields is estimated at between 2% and 5% per year. Which means that an extra 1.5 to 4 million barrels per day must be brought into production each year simply to stabilize global production. Now, below \$80, the profitability of a large number of new projects will become uncertain and they will be abandoned. Oil-field depletion is not slowing down with the recession and, one after another, producers are announcing production declines. Mexico's decline, for example, is accelerating sooner than expected. Russia, whose experts were expecting a continual increase over several years, has, on the contrary, seen its production begin to decline this year. Russia is the leading producer in the world, with 10 million barrels per day, and while its production declined by only 0.4% in September relative to last year, its exports fell more heavily to 5.14 million barrels per day, i.e. a 10% drop! The country is the second largest oil exporter in the world, but it is also a country in which energy consumption is increasing sharply. Like in all the OPEC countries.

Of course, the market decline has hit every sector. And for many shares we are approaching valuation levels at which we have fantastic margins of safety which suggest to us that a loss in the long term is very unlikely. Over 70% of our companies have highly positive net cash positions.

Fred Olsen Energy is a Norwegian company which owns platforms for deepwater drilling, at depths between 500 and over 3000 metres. It is in deep water that oil is found at present, off the coasts of Brazil and Africa. To explore and develop the fields, it is essential to have these platforms, which are costly, at between 700 and 800 million US dollars, and take a very long time to build, between three and four years. Demand from oil companies far exceeds supply, and as a result the profits of the fortunate platform owners are booming. The world leader in this field is **Transocean**, in which we have long been shareholders. But with the recent correction in oil share prices, the valuation of **Fred Olsen** has become curious: although the orders backlog represents more than three years' turnover, the market capitalization represents hardly more than three times cash flows for the coming years. In other words, the market assigns no residual value to Fred Olsen's fleet as of 2012, whereas **Transocean** has already signed contracts at record prices for the same type of platforms up until 2016! We are



relatively confident regarding the use of these cash flows, because **Fred Olsen** is a very cautious company and, unless an exceptional opportunity arises, they will probably be paid to shareholders in the form of share buybacks and dividends. Of course, the fall in oil prices could be worrying for the demand for drilling platforms. However, to calculate the return on the contracts that they sign for such platforms, oil companies apply oil prices that are still far below the current price, at most US\$70 per barrel. This explains why **Fred Olsen** has recently signed contracts for such platforms at record levels despite the collapse in oil prices.

Google, of which we have spoken to you regularly, is far less expensive than at the time of its IPO in 2004... on a PE of 17X current earnings and with 30% profit growth. Have you tried to imagine your life on Internet without Google?

Gameloft is a survivor in the mobile video game industry. It has 20 million euros in cash holdings at a time when its competitors are going bankrupt one after another, and also when the market is at last going to explode, due to the iPhone revolution. At Apple, they say that the iPhone is the best mobile game platform in the world and it also allows you to telephone. Its sales have little to fear from the recession and gamers should appreciate being able to download games of Nintendo DS quality for 10 US dollars instead of 40.

1000mercis.com is also flush with cash, about 15 million euros at year-end compared with a market cap of 55 million, thanks to remarkable patience in using the funds raised at the time of the IPO. Stripping out its cash, the company is valued at about 6 times earnings for an annual growth rate of over 40% since its creation.

We currently hold some companies that are no doubt less remarkable and less well known, whose valuations are intriguing and on which we have upside potential of more than 300%. The most interesting thing is that, with portfolio rotation, we can sell shares on low valuations to buy others that are a giveaway. We are buying shares on valuations of less than 3X earnings or 2X operating profit, or even ... below their cash at bank just as in 2002. It is true that you can't trust banks, but all the same... We recently bought shares in an oil company whose market capitalization is equal to its cash and which produces oil at a cost price, excluding depreciation, of \$20 per barrel!

Target 500

Of course, we shall do everything possible and work ever harder to right the boat and regain the peaks for our funds: 500 on "PEA" and 180 on "Autour du Monde". We shall continue to invest in our management team: there are now ten of us analysts and managers. We must admit that we do not have the slightest idea of the short-term performance of our funds. When



panic sets in, anything becomes possible. But shares are at knockdown prices. For those who have the courage to buy in the thick of the turmoil (generally a good time to buy), we are eliminating entry fees for a period of six months, to attenuate the effects of volatility.

Despite our mistakes, we consider that the fall of our Sextant funds has been greatly amplified by a crisis of confidence that has never been seen in at least several decades, if not a century. We believe that the end of the liquidity crisis and the restoration of confidence will lead to a revaluation of our investments.

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