



M. M. WARBURG BANK SCHWEIZ



WARBURG INVEST LUXEMBOURG

WARBURG VALUE FUND

ISIN LU0208289271 (Class B)

MANAGER COMMENTARY 1st quarter 2018**REVIEW**

The Fund's net asset value (B-shares) fell by 6.60% during 1Q18. Since inception (12/23/04) through 03/31/18, the Fund has compounded at an annual net return rate of 9.46%.

During the reporting period we sold one holding: the price of Brazilian paper manufacturer Fibria Celulose S.A. approached our conservative estimate of intrinsic value. On the buy side, we initiated a new position in a globally active, UK-based provider of power and rental solutions. Overall the cash balance remains low at less than 1% of AuM.

Sure enough, after a long phase of low volatility in the financial markets, it returned with a vengeance during the reporting period: price swings on bourses the world over spiked heavily, initially sparked by a notable uptick in long-term sovereign debt yields in hard-currency economies, followed by a mix of geopolitical tensions, concerns about international trade relations and lastly, data protection issues and regulatory angst engulfing the social media and big-tech space.

While the latter three issues may be viewed as garden-variety preoccupations in the markets' ongoing quest to climb the proverbial "wall-of-worry", the former may be tougher to digest for the investment community. After all, because so much time has passed most of today's market participants have not experienced the late 1970s and early 1980s, when interest rates for a host of reasons were substantially higher and played a much more impacting and disciplining role than in the current low-rate environment.

OUTLOOK, THOUGHTS AND ISSUES*The Fund in the context of a rising yield environment*

In the past we have written many times about how a potentially higher interest rate environment could affect the Fund's portfolio. We have always maintained, as we reiterate today, that we needn't be overly concerned about rising yield levels and that we would even look forward to such a more normalized interest rate scenario. In this report we are going to delineate the most important factors that will help to shield the portfolio from the arguably negative influence rising interest rates exert on equities.

First, let's look at the portfolio's sectoral positioning and its sensitivity to rising rates. The Fund is invested to roughly two-thirds in so-called "economically-sensitive" areas such as industrials, materials and energy, as well as discretionary services such as transportation logistics and media. If it is true, as currently argued by most economists, that the firming up of rates is due to a strong macro environment, then that should benefit the P&Ls of our economically sensitive portfolio holdings, which in turn will dampen or cancel out the adverse effect of higher rates.

On the other hand, we do have quite a heavy exposure, roughly one-fifth of the portfolio, in so-called "interest-rate-sensitive" areas such as utilities and telecom services. These industries are driven by their heavy reliance on recurring debt issuance, supposedly hampering their return after financing costs are taken into account. Although this may be true in the very short-term, these types of businesses usually are able to pass along higher financing costs to the customer over time, albeit with a certain time lag. Hence for us as long-term investors, rising rates from the perspective of utilities and other regulated, asset-heavy firms is not something that we unduly worry about.

But we may also look at interest rate risk at the portfolio level in another way. Put in simple terms, the multi-decade trend of falling interest rates, culminating in a prolonged low-rate setting after the sub-prime and the peripheral debt crisis in the US and Europe, respectively, led to two valuation "sub-worlds" in the equities markets: one of (1) "growth"—encompassing high-tech, new media, healthcare as well as high free-cash flow generators such as consumer staples, the so-called "bond-proxies"—and one of (2) "value"—cyclical industries with erratic profit margins and high capital needs, often disparagingly and wrongly called "low-quality" stocks by market commentators. Coupled with the ever growing trend toward the indexation of investment programs, the valuation parameters in the "growth" world has risen spectacularly, while the "value" camp has remained stuck in neglected territory. The result has been a significant and persistent valuation gap between those two sub-worlds.

We are convinced that this stark disparity will be disturbed and at least partially unwounded as soon as a more normal scenario in the yield curve profile emerges where interest rates, composed of real interest rates plus inflationary expectations, will be priced more adequately than in the memorable past. We are equally convinced that if such more normalized financial market conditions were to materialize in which valuation perceptions between "growth" and "value" became more equitable, the fund would be in an exceptionally strong position to benefit.

Granted, we have been waiting for conditions to become more normal for a long time, requiring enormous discipline and patience in the process on the part of both portfolio management and fund investor. Having said that, considering the more-than-robust past results in an environment that has not played well for our approach and expecting a more hospitable environment for our investment positioning in the future, we look forward to continued strong compound return generation for the fund, indeed.

Gregor Trachsel
Portfolio Manager



THE INVESTMENT APPROACH

We buy equities that trade at significant discounts to our estimate of intrinsic value, where we define intrinsic value as the company's worth to a strategic buyer / long-term owner able to exert full control over the business. We sell (1) when the price catches up to intrinsic value, (2) if we realize that we made a mistake in our analysis or that our assumptions underlying the investment case no longer hold true, or (3) if we find a better alternative to an existing portfolio position.

Our investment process is exclusively designed to evaluate the business, operating and financial risk taken by the firms we analyse. In contrast to the vast majority of other investment funds, *we do not attempt at all* to estimate or anticipate risks that are beyond the realm of corporate finance, such as the general movements in the equity, fixed-income and currency markets. Typically, to make it worthwhile to purchase and hold a particular equity position, our valuation analysis must indicate a potential doubling in price over the ensuing five years. Our objective for the Fund is, *over time*, to achieve compound annual returns after all fees of ca. 10% in EUR-terms.

DISCLAIMER

The WARBURG VALUE FUND has been established under Part I of the Luxembourg law of 20 December 2002 on undertakings for collective investment. From now on the fund is subject to Part I of the Law of 17 December 2010 and complies with the changed provisions set forth by the directive of the Council of the European Communities no 2009/65/EG of 13 July 2009.

The fund is registered for distribution in Luxembourg, Germany, Austria and Switzerland. It is not admitted for distribution in the U.S. The prospectus with the Management Regulations, the Key Investor Information Document (KIID) and the annual and semi-annual reports of the Fund are available free of charge at the investment company (Warburg Invest Luxembourg S.A., 2 Place François-Joseph Dargent in L-1413 Luxembourg) or from the Paying- and Representation Agents (M.M.Warburg Bank Luxembourg S.A., 2 Place François-Joseph Dargent in L-1413 Luxembourg, M.M.Warburg & CO KGaA, Ferdinandstr. 75 in D-20095 Hamburg, Erste Bank der österreichischen Sparkassen AG, Graben 21 in A-1010 Vienna or M.M.Warburg Bank (Schweiz) AG, Parkring 12 in CH-8027 Zurich).

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