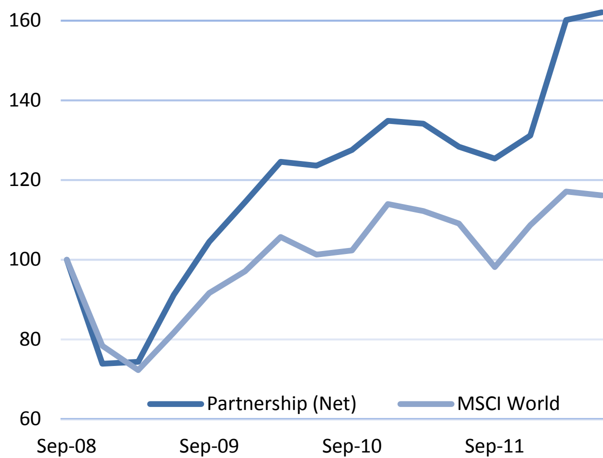
iolite

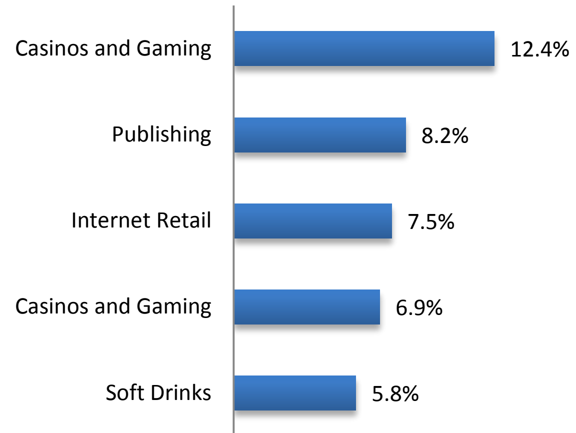
CORE PORTFOLIO Q2 2012

Performance			EUR[1]	Index
Inception Date:	01 October 2008	**Quarter**	1.2%	-0.8%
Portfolio Style:	Value / Total Return	**Since inception (annualized)**	13.7%	4.1%
Manager:	Robert Leitz	**Since inception (cumulative)**	62.1%	16.2%

Performance in EUR



Top 5 Positions



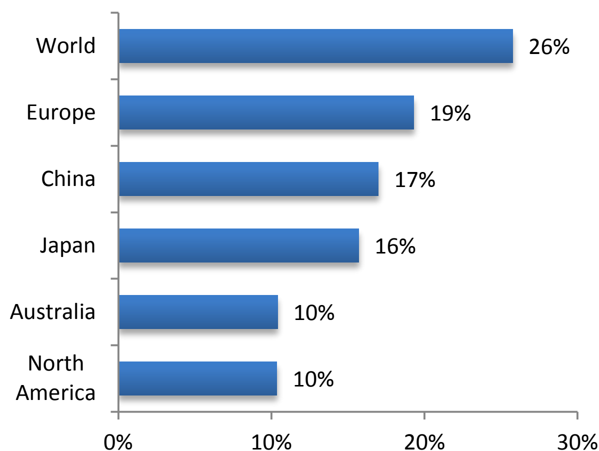
Market Review

- Stock markets around the globe stumbled in the second quarter, primarily due to sovereign debt concerns in Europe and signs of slowing economic growth in the U.S. and major emerging markets.
- International stock markets suffered the greatest damage during the quarter, affected by a rise in risk aversion as Europe's economy continued to stall and interest rates for Spanish and Italian government bonds rose to levels that would make it difficult to finance their national debt.
- Investors seeking a safe haven from the volatility of equity markets poured money into U.S. Treasury securities.

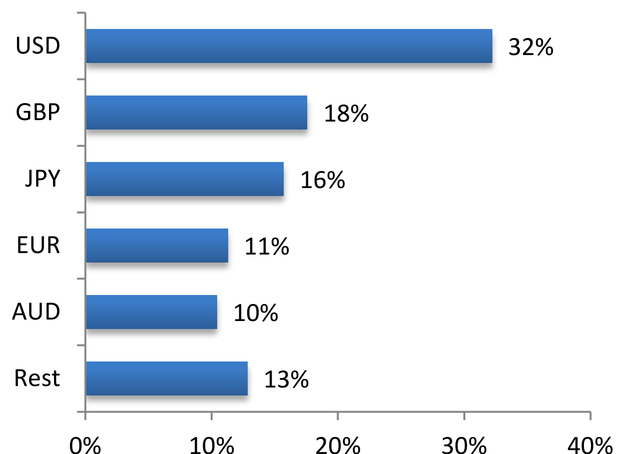
Portfolio Review

- We did not exit a single position, although we scaled down our position in a gaming firm. We used these proceeds, as well as an injection of new funds, to buy two new sizable opportunities.
- No position contributed significantly relative to others.

Geographic Breakdown by Revenue Markets



Geographic Breakdown by Listing Currency



[1] Net returns: after all costs and fees (no management fee, 25% performance fee for returns greater than 4% p.a.)

QUARTERLY REVIEW

For the quarter ended June 30, 2012, the portfolio returned net +1.2% in EUR (-3.8% in USD). Since inception on October 1, 2008, the portfolio has generated net cumulative returns of +62.1% in EUR (+49.0% in USD) and annualized net returns of +13.7% in EUR (+11.2% in USD). At iolite, we consider long-term absolute performance far more important than relative performance against a benchmark.

In the second quarter of 2012, most market participants focused on Europe and anticipated a collapse of Europe as we know it. The US media, in particular, was quick to point out the many flaws of "socialist", "fragmented" and "incapable" European governments. We read that German austerity was driving struggling Mediterranean countries further into depression and thus pushing Europe closer to the brink of collapse (if not – in a rather strong dose of scare-mongering – all-out war). Please allow me to make a few comments regarding the situation in Europe.

You cannot solve a problem of too much debt with more debt, forever.

A nation's wealth is defined by its productive capacity and efficiency, not by its ability to print money. While it may be possible to temporarily defer crises through monetary and fiscal stimuli (which is what many US and Mediterranean politicians are fighting for), it is impossible to print your way out of a mess of enormous budget and trade deficits, aging societies, massive off-balance sheet liabilities (like Social Security and Medicare), and the loss of relative power to emerging nations such as China. Current calls for loose monetary policies are often based on lessons from the Great Depression. Some important market players like Ben Bernanke and George Soros have continued to call for more fiscal and monetary stimuli, arguing that deflation might create a vicious downward spiral with falling wages, rising unemployment and - ultimately - unrest in the general population. However, it is important to remember that such rhetoric coincides with an election year - by promoting the "easy way" (printing money), politicians are likely just trying to buy votes, investors are just talking their books, and Ben Bernanke is just supporting those that support him. Inflation is a heavy tax on the prudent, and while it does benefit the leveraged long player, it seriously hurts conservative savers and the common man. In the words of Jim Rogers: "If printing money would solve all problems, Zimbabwe would be the richest nation on earth." In other words - if you live beyond your means, taking on more debt might buy you months or years but will ultimately result in ruin.

The United States, the United Kingdom, Eurozone, Japan: all in the same boat.

Recent press and market focus has been on Europe. However, almost all developed nations are facing the same structural flaws and challenges. The US - like the UK, Eurozone and Japan - is running tremendous budget and trade deficits, facing enormous off-balance sheet liabilities, and its public sector and infrastructure are falling apart. The United States is widely seen as a homogenous country, but it is a monetary union of 50 states, which have stark structural differences among them (e.g. California and New Mexico). If you think about it, California should be the Germany of the US – an economic powerhouse and the engine of growth and prosperity for the rest of the continent. However, California is getting closer to becoming a failing state: the Golden State's finances are a mess, and an increasing number of municipalities are declaring bankruptcies. If the home of such wonderful companies as Apple, CISCO, Google or Facebook does not have the means to pay for

quality roads or education (thousands of teachers have been let go in the last few years) – who will foot the bill and bail out the rest of the country when the time comes? I am not saying that Europe is better off than the US, but I am saying that the US is not better off than most other developed nations.

Treasuries of developed nations (US, UK, Euroland, Japan): the biggest bubble ever.

We are facing record low interest rates in almost all developed societies. A few weeks ago, German treasuries were sold for negative nominal yields. In effect, instead of the government paying savers yields on government bonds, savers are paying the government to keep their hard-earned money. Even more interesting, current low treasury yields don't correspond with shaky and worsening public finances. In a world of extremely loose monetary policies, unsustainable budget and trade deficits, as well as increasingly indebted nations, the costs of borrowing should increase to compensate investors for the higher risk. I dread the day when treasuries will start defaulting or inflation will pick up substantially and all those hard-working conservative savers will realize sharp losses in their investments in treasuries, either directly or indirectly (e.g. pension funds, shares in financial institutions).

In the current environment, I stick to long-only highly selective equity investments. An investment in a stable business for less than 10 times free cash flow is likely to generate 10% annual returns. If inflation would pick up or the company would grow, buy back shares or increase debt to pay a special dividend, those annual returns would likely be greater than 10%. And in case of deflation, the 10% free cash flow yield should still compare favorably to treasury yields of 1-3%. Please also see the attached case study on Japan.

Despite volatile market prices, I still consider many of the portfolio's holdings attractively valued. I have also been able to find new investment opportunities.

I am happy to answer your questions and see assets grow.

Please spread the word!

Robert Leitz

PERFORMANCE & BENCHMARKING

%	in EUR				in USD			
	Portfolio Net[2,3]		MSCI World DM		Portfolio Net		MSCI World DM	
	quarter	cum	quarter	cum	quarter	cum	quarter	cum
Q4 08	-26.2	-26.2	-21.6	-21.6	-26.3	-26.3	-22.2	-22.2
Q1 09	0.7	-25.5	-7.8	-27.7	-4.6	-29.7	-12.5	-31.9
Q2 09	22.6	-8.9	13.0	-18.3	29.9	-8.7	19.7	-18.5
Q3 09	14.7	4.5	12.2	-8.4	18.4	8.1	16.9	-4.7
Q4 09	9.5	14.5	5.9	-2.9	7.8	16.5	3.7	-1.2
Q1 10	8.8	24.5	8.9	5.7	4.1	21.2	2.7	1.5
Q2 10	-0.7	23.6	-4.2	1.3	-10.1	8.9	-13.3	-11.9
Q3 10	3.2	27.6	1.0	2.3	15.5	26.1	13.7	0.1
Q4 10	5.7	34.8	11.4	13.9	3.3	30.3	8.1	8.3
Q1 11	-0.5	34.1	-1.5	12.2	4.3	35.8	4.3	12.9
Q2 11	-4.3	28.3	-2.8	9.1	-1.9	33.3	-0.3	12.6
Q3 11	-2.3	25.4	-10.0	-1.9	-9.9	20.0	-17.1	-6.6
Q4 11	4.6	31.1	10.7	8.6	1.2	21.5	7.1	0.0
Q1 12	22.1	60.1	7.8	17.1	27.5	54.9	10.9	11.0
Q2 12	1.2	62.1	-0.8	16.2	-3.8	49.0	-5.8	4.5

	EUR Portfolio Net	EUR MSCI World DM	USD Portfolio Net	USD MSCI World DM
1-Year	26.3	6.5	11.8	-7.2
Annualized	13.7	4.1	11.2	1.2
Total	62.1	16.2	49.0	4.5

[2] Net returns: after all costs and fees (no management fee, 25% performance fee for returns greater 4% p.a.)
[3] Q4 09 – Q4 11 restated

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Investment Approach

“Price is what you pay, value is what you get.” [Charlie Munger]

“You will not be right simply because a large number of people momentarily agree with you. You will not be right simply because important people agree with you. You will be right, over the course of many transactions, if your hypotheses are correct, your facts are correct, and your reasoning is correct.” [Warren Buffett]

A share represents a fractional ownership of an underlying business and a bond is a loan to a business. Therefore, in the medium to long term, the performance of shares and bonds correlate with those of the underlying businesses.

I see myself as a value investor. That is, I invest in what I consider undervalued securities instead of betting on the development of the market as a whole. I buy securities if the market price is below my fair value estimate. I do not believe in timing the market as this would be speculation. Neither do I believe in overweighting certain countries or industries simply to beat a certain index. I avoid leverage and try to minimize complexity (such as derivatives or complex capital structures) in order to provide better protection from permanent capital loss.

My goal is to generate sustainable market-beating absolute returns with a few select value investments. It is difficult or near impossible to exactly predict when these undervalued securities will reach fair value - in some cases the progression could be very fast, but in many cases it could take years. Therefore, investors need to be patient and should have a long-term horizon. In my mind, a track record of at least three years is required to draw conclusions about the qualities of a portfolio manager. Financial markets are very volatile and what may appear to be a trend, even over a couple of years, can sometimes be misleading.

Key Benefits to Clients

1. **Low/no management fees.** It is not unheard of in the fund management industry for investors to be charged 2-4% of their assets for the privilege of having their assets managed by some bank employee. At iolite, the maximum fixed fee that you would pay is 1%.
2. **No performance fees without sustainable capital gains.** iolite only makes money if the client makes money and only charges a performance fee if the portfolio exceeds the last high plus a 4% hurdle.
3. **Client portfolios are modeled after the portfolio manager’s personal account.** At iolite, we eat our own cooking.
4. **No leverage, no margin loans, no complexity.** At iolite, we try to keep things simple and stick to time-tested value investing strategies.

CASE STUDY – JAPAN

"Investment philosophy is the clear understanding that by owning shares of stocks he owns businesses, not pieces of paper." [Warren Buffett]

I typically run screens to search global databases for investment opportunities. And currently, two markets stick out, with very low valuations: China and Japan. The story in both markets is very different. Most Chinese equities that are trading at very low valuations are most likely due to suspicion of fraudulent activities at the underlying companies. In contrast, I think the low valuations of Japanese equities have very little to do with underlying fundamentals and much more the result of a 20-year bear market, investor fatigue and the current preference of Japanese individuals and companies to buy Japanese treasuries. Many people have – so far unsuccessfully – tried to call the bottom of the Japanese market. While I can't say when the market will ultimately bottom out, I can say that I am now seeing some really extraordinary opportunities. It is possible that in a few years' time we will look back at Japan in 2012 as one of the greatest – and safest – investment opportunities in the last 50 years.

Let's look at three rather randomly chosen examples from my screens. All figures in the tables are in euros.

a) **Jewelry business:** engages in the manufacture, wholesale, and retail sale of jewelry in Japan. The company operates 180 specialty jewelry retail stores.

Free cash flow (10-year average)	15m
Balance sheet:	
o Cash	350m
o Investments	0m
o Working capital	170m (diamonds and precious metals)
o Debt	0m
Market capitalization	380m

b) **Funeral company:** provides wedding and funeral services in Tokyo.

Free cash flow (10-year average)	8m
Balance sheet:	
o Cash	50m
o Investments	100m
o Working capital	0m
o Debt	0m
Market capitalization	60m

c) **Cosmetics company:** engages in the manufacture and marketing of cosmetics, pharmaceuticals, and nutritional supplements. It distributes its products through direct sales, retail, and business-to-business channels.

Free cash flow (10-year average)	40m
Balance sheet:	
o Cash	350m
o Investments	0m
o Working capital	100m
o Debt	0m
Market capitalization	320m

What do all of these examples have in common? Even though the companies operate in different industries, they have proven to be very stable and cash-generative over the last ten years, have very strong balance sheets with no debt and an excess of tangible assets over market capitalization. All three businesses decided to pile up the cash they generated over the last few years (often buying Japanese treasuries) instead of paying dividends, buying back stock or investing in growth.

So, what is the possible downside to an investor buying shares of these companies?

a) Cash: the value of the companies' cash holdings might significantly falter in case of:
   i. A depreciation of the Japanese yen against the investor's home currency
   ii. Rising domestic inflation (Japan's printing presses have been heating up for years)
   iii. Value-destructive acquisitions or other value-destroying management actions
b) Information: for the non-Japanese speaker, information on companies and industries is limited. The lack of local knowledge and good documentation lead to higher overall investment risk.
c) Timing: it is unknown when the market will recognize the true value of these companies, and an investor with impatient capital might easily run out of steam.

I consider these risks are outweighed by the extremely low price you are paying for the companies. If the yen depreciates, economic growth would improve, driving earnings growth. Even a devaluation of up to 30% for the yen or Japanese treasuries would still result in outstanding returns. In addition, any returns would not be tied to the use of leverage or a speculative outcome.

Overall, I think there are two ways to play the Japan story: a basket trade for the passive investor and the activist play.

1) A basket trade, buying a handful of securities instead of just one or two, should help reduce a portfolio's volatility and prevent excessive losses from betting on the wrong horse (fraud cases, unforeseen business declines, etc.). This is the approach I am currently pursuing.
2) However, an activist investor should be able to generate even better returns because he would help unlock the value potential earlier and better. Each of the companies listed above has a

market capitalization of less than EUR 400m, and – from a purely stock buyout perspective – one should not require much capital to gain a seat on the board of one of these companies. In all three cases, buybacks or cash dividends should lead to unleveraged annual returns of greater than 25% over a five-year time period. That means tripling an investor’s money in just five years. All it takes is a little time for local due diligence and EUR 20 million or so to start.

Please call me if you are interested in raising an activist Japanese small-caps fund to tackle this historic opportunity.