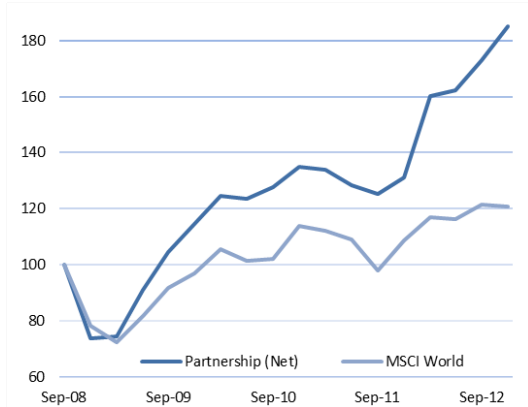
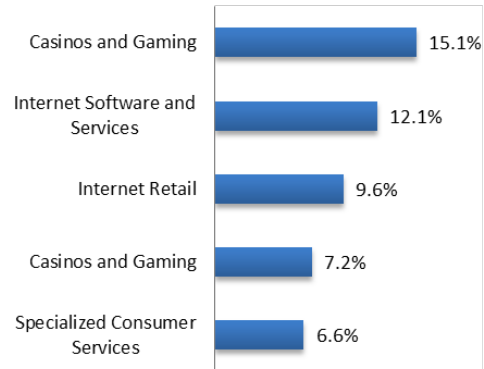


Performance			EUR <sup>1</sup>	Index
<b>Inception Date:</b>	01 October 2008	<b>Quarter</b>	6.9%	-0.6%
<b>Portfolio Style:</b>	Value / Total Return	<b>Since inception (annualized)</b>	15.6%	4.5%
<b>Manager:</b>	Robert Leitz	<b>Since inception (cumulative)</b>	85.0%	20.7%

**Performance in EUR**



**Top 5 Positions**



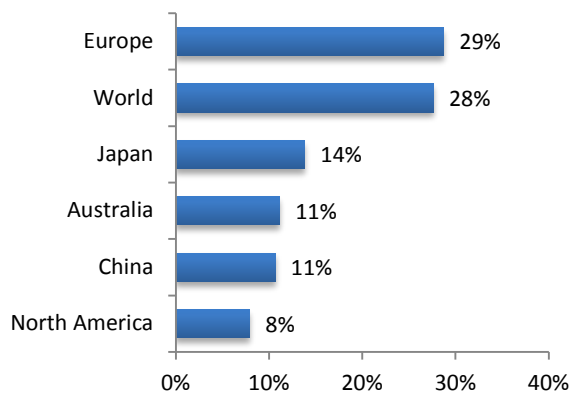
### Market Review

In the fourth quarter of 2012, global equity markets were slightly higher in US dollar terms but largely flat in euro terms, as the euro temporarily strengthened against the dollar. Concerns about stalled “fiscal cliff” negotiations and a possible recession in the Eurozone weighed on markets for much of the quarter, although an accord on the US fiscal cliff was reached shortly after quarter-end. Markets were buoyed somewhat by improving economic data out of China and, to a lesser extent, the US. In Japan, the decisive victory of the Liberal Democratic Party (LDP) led markets to expect further monetary stimulus measures as well as aggressive policies to weaken the yen.

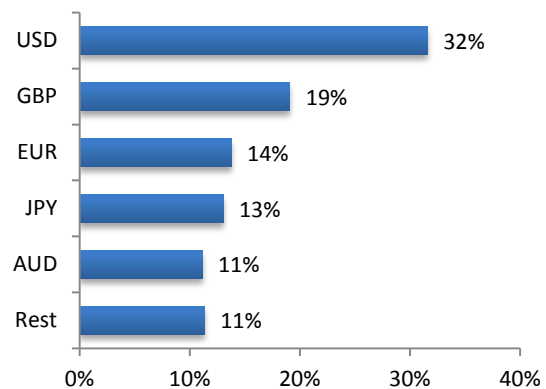
### Portfolio Review

While most positions saw higher market valuations in 2012, three investments significantly drove performance: an Australian gaming firm, a UK gaming firm and an Israeli software company. Given that several stocks rose significantly in 2012, I chose to book profits in a few of these “big winners” while looking for more attractive opportunities. As a result, there may be more portfolio reshuffling in the beginning of 2013, and I might also hold cash until I find truly compelling opportunities. Experience has shown that the ability to hold cash and patiently wait for a great market opportunity is far more valuable and has led to much higher returns than immediately jumping on the next available investment, especially when it does not appear all that attractive.

**Geographic Breakdown by Revenue Market**



**Geographic Breakdown by Listing Currency**



<sup>1</sup>Net returns: no leverage, after all costs (no management fee, 25% performance fee for returns greater than 4% p.a., high watermark)

## QUARTERLY REVIEW

For the quarter ended December 31, 2012, the portfolio returned net +6.9% in EUR (+9.0% in USD). In 2012, the portfolio returned net +41.1% in EUR (+45.9% in USD). Since inception on October 1, 2008, the core portfolio has generated net cumulative returns of +85.0% in EUR (+77.3% in USD) and annualized net returns of +15.6% in EUR (+14.4% in USD). At Iolite, we consider unleveraged long-term absolute performance far more important than relative performance against a benchmark.

To set expectations: while I am extremely pleased with the portfolio's performance in 2012 and continue to have what I believe are good investment ideas, I do not expect to repeat these stellar gains anytime soon.

Most positions saw higher market valuations in 2012, but three investments in particular significantly drove performance: an Australian gaming firm, a UK gaming firm and an Israeli software company. All three investments benefited from improved operating performance, improved capital allocation and improved market perception. The portfolio's returns could actually have been much higher had I not consistently realized profits to keep exposure to any of those three winning positions at a maximum level of around 10% and to recycle funds from positions with risen valuations to those with lower market valuations.

### **Deciding when to sell is at least as difficult as deciding when to buy**

The question every portfolio manager should ask himself every morning is: "If I were to start from scratch, would I buy the same portfolio again?" If there were better opportunities in the market, a rational investor would sell his holdings and put his funds into those opportunities. I believe the majority of fund managers do not act this way for various reasons, such as ownership bias - the human tendency to get emotional about possessions.

It is difficult to remain emotionally detached from one's investments. One of my key recognitions in 2012 has been just how important and difficult it is to decide when to sell. Most people talk about why and when they bought a stock, but few talk about why and when they sold it.

Let's look at the Australian gaming firm. When I bought the position in early 2012, it was an easy purchase: the company was trading at just 4x free cash flow, had no debt, and future earnings were destined to rise as the company had just disposed of a loss-making business unit. Management also indicated strong business momentum. By mid-2012, earnings had improved, the share price had tripled and the company was now trading at 6-7x current earnings. I considered this a fair valuation for a very small business in a highly regulated industry. By October, third-quarter earnings had come in better than expected and management had announced plans to expand internationally. Institutional money managers had increasingly become interested in the stock and the company was now trading at 8x free cash flow, or 5x my original purchasing price. Given the fantastic performance of the company and stock, it was hard not to fall in love with the stock and my own brilliance for having picked it in January 2012.

The question was where to go from there. On the one hand, it was possible to argue for a strong bull case: the company could continue its phenomenal growth momentum, especially given the international expansion plans, and a company with strong growth potential trading at 8x present free cash flow is not particularly expensive. On the other hand, buried in one quarterly report,

management had indicated a possible decline in short-term earnings due to higher growth expenditure. Gaming remains a heavily regulated industry with high structural uncertainties, and the stock's margin of safety had declined with its increased market multiples. While I do not try to predict the market, a sudden earnings decline of a company whose stock has seen a 500% increase in market price over just 12 months can easily lead to a temporary selloff.

I decided to heavily sell down the position in the first quarter of 2013 to recycle the funds into cheaper and more attractive opportunities. Only time will tell if this was the right decision. In any case, it was a great ride, and I am happy with the gains I was able to realize by selling the stock.

### Misconceptions about risk & return

I was asked about the risk-return characteristics of my portfolio. Many people I speak to (especially those that are particularly risk-averse) think I am taking on high risks because my portfolio has beaten the market by a significant margin over the last few years. They typically prefer to invest in so-called "safe" index funds, diversified mutual funds, real estate, or treasuries.

My answer might come as a surprise: I believe my portfolio is less risky than a broadly diversified market portfolio and offers much higher potential returns. Sounds too good to be true? Well, it gets better: I also happen to believe that the common perception of risk and return – where higher returns require higher risks (the risk premium) – taught at universities and in marketing literature is just plain wrong and misleading. Here's why.

1. Price and the margin of safety: in my view, risk and return are mainly defined by the price paid for the fair value of an underlying asset. The less you pay for an asset, the higher the margin of safety and the higher the potential returns. If you can buy a portfolio of businesses for much less than what they are intrinsically worth, you will be much better off than somebody who just buys the market as a whole from both a risk and return perspective. The exception to this statement would be a period in which the whole market is trading significantly below fair value - it then becomes important to pick those stocks that are cheapest on a relative basis in order to have a favorable risk-return profile compared to the market.
2. Leverage and speculative portfolio construction: many investors, driven by the common perception of risk and return, take on excessive risks to achieve outstanding returns (e.g. by taking on leverage or pursuing speculative opportunities). I believe those people vastly underestimate survivorship bias (we often focus on the few winners in a large crowd with many losers) and fail to factor in the damage of a possible blow-up of their portfolios. For example, speculation in a few positions could wipe out a stellar four-year track record through losses in year 5 (see table below).

Risk/Return Sensitivities						
Year	Portfolio 1 "Dull 5%"		Portfolio 2 "Speculative 10%"		Portfolio 3 "Leveraged 20%"	
	Return	Assets	Return	Assets	Return	Assets
0		100,000		100,000		100,000
1	5%	105,000	10%	110,000	20%	120,000
2	5%	110,250	10%	121,000	20%	144,000
3	5%	115,763	10%	133,100	20%	172,800
4	5%	121,551	10%	146,410	20%	207,360
5	5%	127,628	-15%	124,449	-40%	124,416

To all those who think holding a basket of high-risk portfolios will outperform the market as a few major winners smooth out the losses of the others: I am skeptical. To all those gambling on high bonuses in years 1-4: the times to easily move on to a new fund are gone. To all investors wanting to retire rich: preserving capital over the long-term is more important than stellar but risky short-term gains.

3. Portfolio diversification: I believe the common perception that diversification reduces risk is somewhat dangerous, because there are times when whole asset classes or individual securities are obviously mispriced and could be avoided. Just shunning those asset classes can easily lead to market-beating returns. For example, in my mind, one of the greatest bubbles of all times is currently occurring in government bonds of developed nations (US, UK, EU and Japan). If those countries were companies, we would talk about negative earnings, negative free cash flows, huge pension deficits, extreme levels of leverage, unfavorable demographics, outdated products and structurally uncompetitive business units - all while inflation and interest rates are likely to increase from current record-low levels over the next 5-10 years. Now ask yourself, would you lend money to those businesses at a fixed rate of 2% for 20 years? It is incomprehensible to me why individuals, insurance companies and banks continue to buy government bonds at real negative returns of economies in a state of weakening fiscal stability. There is no safety in government debt, and it should be very easy to beat the market over the next 5-10 years by avoiding the pitfall that is the debt issued by the US, UK, EU and Japan.

## Outlook

From a macro perspective, I believe anything is possible in 2013. Extremely loose monetary policies around the world could lead to a massive surge in inflation and push markets upwards. It is also possible that weakening developed-market currencies along with high inflation in China could lead to a resurrection of Western real economies. The *Atlantic Monthly* just featured an interesting article on a growing trend of US businesses to move production and development back home after they were moved to Asia just a few years ago. In addition, the shale-gas boom might lead to a drastic decline in energy prices and establish US energy independence for a few decades to come.

However, real economies around the world remain fragile and dependent on very loose monetary policies, our banks are less stable than ever before (earnings and balance sheets might rise due to low interest rates, but those are low-quality earnings without adequate cash flows backing them), and geopolitical risks remain high (tensions in the Middle East, including Iran; the UK might vote to leave the EU, etc.). In my next quarterly letter I will elaborate on how record low yields have led to a tremendous decline in the quality of earnings and the balance sheets of banks and insurance companies, and the dangers of a low-yield environment to asset prices and the real economy.

From my perspective, as a bottom-up stock investor, after the strong gains we saw in 2012 and the first weeks of 2013, it is more difficult for me to find attractive investments (investments with high return and low risk characteristics). While I have found investments that could generate satisfying returns in the medium to long term, they are expensive enough to be subject to mark-to-market risk in case of a possible downturn. Since I will have to replace a few of the "big winners" of 2012, there may be more portfolio reshuffling in the beginning of 2013, and I might also hold more cash until I

find truly compelling opportunities. Experience has shown that the ability to hold cash and patiently wait for a great market opportunity is far more valuable and has led to much higher returns than immediately jumping on the next available investment, especially when it does not appear all that attractive.

I am happy to answer your questions and see assets grow.  
Please spread the word!

Robert Leitz

## CLOSED POSITIONS

Position	Sector/Industry	Listing Currency	Absolute Return	IRR
<b>Zhongpin</b>	Packaged Foods and Meats	USD	18.9%	21.0%
<p>The company engages in processing and distribution of meat and food products primarily in China, with a focus on pork products. When I initiated the position in 2011, the stock had traded down with the overall Chinese market and amid fears that most publicly listed Chinese companies were fraud cases. In contrast, I thought this was a solid business with a great asset base (slaughter houses, retail outlets, and a large supply chain/distribution network). Zhonpin's shareholders include very large and well-known fund managers, which, to me, was an added positive. The company had heavily invested in new production facilities, and the earnings from those new facilities had not come through at the time of purchase. Considering future earnings, I thought the stock was undervalued. In addition, buyout rumors provided a floor to the stock's pricing level.</p> <p>Over time I slightly changed my opinion of the company: a) it is a low-margin business and its moat might be smaller than originally thought, b) it has grown very quickly, particularly through debt and equity issuance, not free-cash-flow generation, c) I tend to discount China risk higher now than I did back in 2011. Given my increasingly negative perception of the business's risks as well as the higher market valuation, I decided to realize profits and turn to other, more attractive opportunities with a higher margin of safety.</p>				
<b>China Nepstar Chain Drugstore</b>	Drug Retail	USD	-33.2%	-22.6%
<p>The company owns and operates a retail drugstore chain that sells a range of pharmaceutical and other healthcare products in China. In most countries, drugstores are very strong businesses and have been among the great growth stories of the last two decades (national regulation permitting). At the time of purchase in 2011, the company had significant cash reserves from past capital increases and used those reserves to grow the business, buy back shares and pay cash dividends. Overall, I considered the market price in 2011 an attractive opportunity to get into a promising growth story with a decent margin of safety given the company's cash reserves.</p> <p>I sold the stock for various reasons: a) at 1% of AUM it was negligible, b) the business' profitability declined even though store count and revenues increased (partly due to changes in the regulatory environment), c) tangible book value declined sharply between 2010 and 2012, and d) I tend to discount China risk higher now than I did back in 2011.</p>				

## PERFORMANCE & BENCHMARKING

%

	in EUR			
	Portfolio Net <sup>2</sup>		MSCI World DM	
	quarter	cum	quarter	cum
Q4 08	-26.2	-26.2	-21.6	-21.6
Q1 09	0.7	-25.5	-7.8	-27.7
Q2 09	22.6	-8.9	13.0	-18.3
Q3 09	14.7	4.5	12.2	-8.4
Q4 09	9.5	14.5	5.9	-2.9
Q1 10	8.8	24.5	8.9	5.7
Q2 10	-0.7	23.6	-4.2	1.3
Q3 10	3.2	27.6	1.0	2.3
Q4 10	5.7	34.8	11.4	13.9
Q1 11	-0.5	34.1	-1.5	12.2
Q2 11	-4.3	28.3	-2.8	9.1
Q3 11	-2.3	25.4	-10.0	-1.9
Q4 11	4.6	31.1	10.7	8.6
Q1 12	22.1	60.1	7.8	17.1
Q2 12	1.2	62.1	-0.8	16.2
Q3 12	6.8	73.1	4.5	21.4
Q4 12	6.9	85.0	-0.6	20.7

	in USD			
	Portfolio Net		MSCI World DM	
	quarter	cum	quarter	cum
Q4 08	-26.3	-26.3	-22.2	-22.2
Q1 09	-4.6	-29.7	-12.5	-31.9
Q2 09	29.9	-8.7	19.7	-18.5
Q3 09	18.4	8.1	16.9	-4.7
Q4 09	7.8	16.5	3.7	-1.2
Q1 10	4.1	21.2	2.7	1.5
Q2 10	-10.1	8.9	-13.3	-11.9
Q3 10	15.5	26.1	13.7	0.1
Q4 10	3.3	30.3	8.1	8.3
Q1 11	4.3	35.8	4.3	12.9
Q2 11	-1.9	33.3	-0.3	12.6
Q3 11	-9.9	20.0	-17.1	-6.6
Q4 11	1.2	21.5	7.1	0.0
Q1 12	27.5	54.9	10.9	11.0
Q2 12	-3.8	49.0	-5.8	4.5
Q3 12	9.1	62.6	6.1	10.9
Q4 12	9.0	77.3	2.1	13.2

1-Year  
Annualized  
Total

	41.1	11.1
	15.6	4.5
	85.0	20.7

	45.9	13.2
	14.4	3.0
	77.3	13.2

<sup>2</sup> Net returns: no leverage, after all costs (no management fee, 25% performance fee for returns greater than 4% p.a., high watermark)

## 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 will always be 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 2-5% of assets annually. At iolite, the maximum fixed fee that you would pay is 1%.

### 2. **No performance fees without sustainable capital gains.**

We only charge a performance fee for annual returns greater 4% (including a high watermark).

### 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.