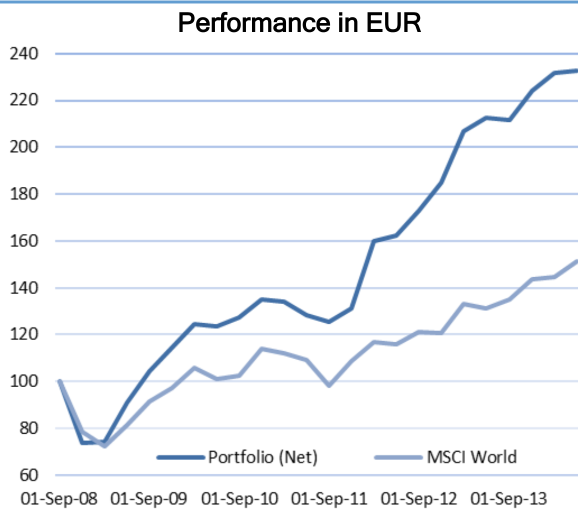
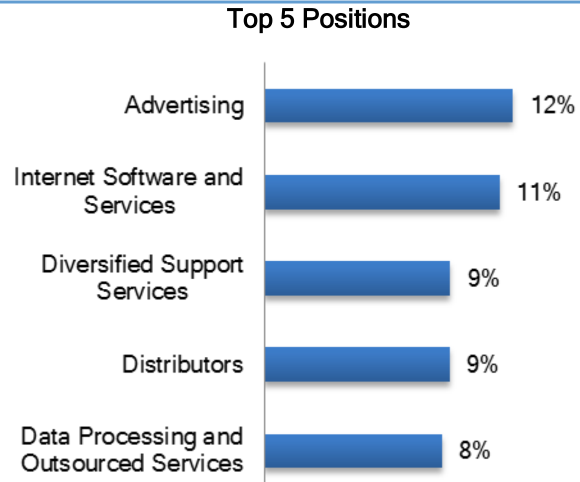
iolite CORE PORTFOLIO Q2 2014

Performance			EUR[1]	Index
Inception Date:	01 October 2008	**Quarter**	0.5%	4.7%
Portfolio Style:	Value / Total Return	**Year-to-Date**	3.8%	5.4%
Manager:	Robert Leitz	**Since inception (annualized)**	15.8%	7.5%
		Since inception (cumulative)	132.6%	51.5%

Performance in EUR



Top 5 Positions



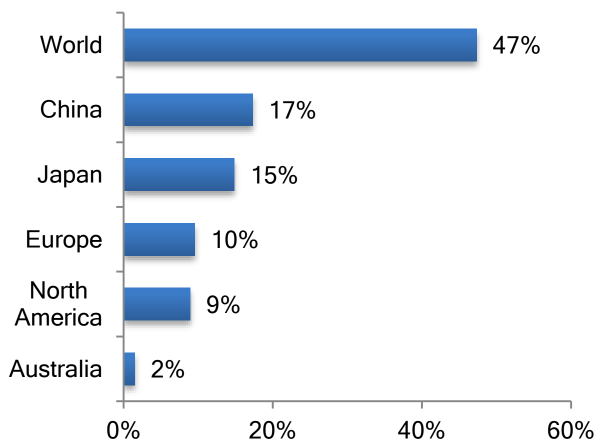
Market Review

Global equities made gains in the second quarter, supported by ongoing accommodative monetary policy from central banks. Geopolitical tensions were in focus amid an escalation of conflict in Iraq. Eurozone equities were supported by the European Central Bank's announcement of measures to stimulate growth and fend off the risk of deflation. The measures included a cut to interest rates and the introduction of a negative deposit rate. UK equities edged higher, though markets were unsettled by suggestions that an interest rate rise could happen sooner than expected. German markets shrugged off a forced capital increase at Deutsche Bank that diluted existing shareholders by a third. In Japan, macroeconomic data was mixed following a planned increase in the consumption tax. Emerging markets outperformed developed market peers. Emerging Asia was the strongest region, led by gains in India, where optimism about the country's growth and reform prospects was buoyed following the election victory of Narendra Modi.

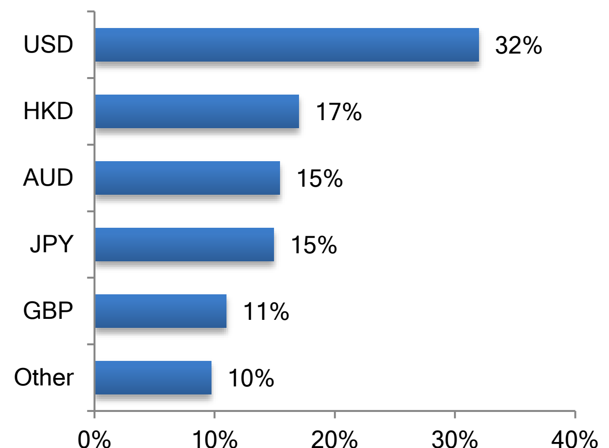
Portfolio Review

With a quarterly net performance of 0.5%, the portfolio only grew marginally in value and underperformed the index by 420bps. I added a new position in Australia.

Geographic Breakdown by Revenue Market



Geographic Breakdown by Listing Currency



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

QUARTERLY REVIEW

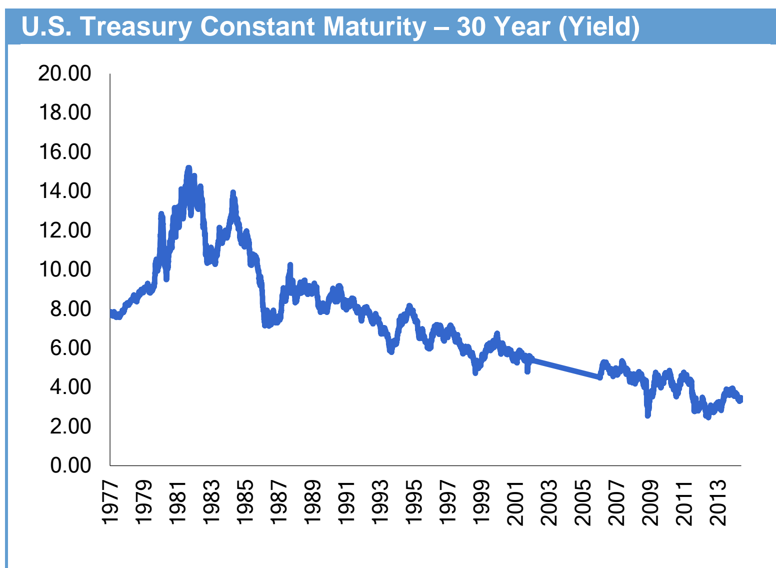
For the quarter ended June 30, 2014, the portfolio returned +0.5% in EUR (-0.1% in USD), net of all fees. Since inception on October 1, 2008, the core portfolio has generated net cumulative returns of +132.6% in EUR (+129.4% in USD) and annualized net returns of 15.8% in EUR (+15.5% in USD). I consider unleveraged long-term absolute performance far more important than relative performance against a benchmark.

Macroeconomic Environment

"For, he reasons pointedly / That which must not, can not be." (Christian Morgenstern)

[Humans tend to question apparent facts, not their own theory. This syndrome of blindness, ideological fixation and false premises is a recurring pattern in human behavioral history.]

One of my financially most memorable moments happened shortly after my 21st birthday. I was handed over the keys to a savings account my grandparents had set up on my birth – along with a piggy bank in their living room. Every once in a while, they would put a few Deutschmarks into the piggy bank and eventually deposit them in my savings account. They did this until around the time I entered elementary school. The keys to my savings account came in the form of a little booklet that showed balances and interest payments. This booklet hadn't been updated since the last deposit was made (at around the time I turned 6) and when I entered the bank, the clerk put the booklet into a noisy needle printer to update its entries. And the printer rattled on while it printed interest, interest on interest, and interest on interest on interest. When it finally stopped, the balance was more than twice the last shown balance and was obviously much more than I was expecting. The annualized return must have been between 5-6% when official inflation ranged between 2-3%. I was in awe of the miracle that is compounded interest.



Statistical highlights 1981-2013

	30-Year US Treasury Yield (%)	Official US Inflation Rate (%)
High	15.2	13.6
Low	2.5	(0.3)
Average	7.2	3.2
Median	6.8	3.0

Those days are long gone. In June, the European Central Bank (ECB) launched a range of measures to boost European economies - including lowering its key benchmark interest rate from 0.25% to a record low of 0.15% and imposing a negative interest rate on deposits, by cutting bank deposit rates from 0% to negative (!) 0.1% in a bid to encourage banks to lend to businesses, rather than holding

on to money. I think this is an act of desperation (some might say financial martyrdom). How bad must the situation be, how strong the political pressure, that the ECB is trying to artificially prop up the European economy so forcefully? Note that the ECB is not alone. The Japanese, English and American central banks are doing pretty much the same. In fact, the Bank of Japan, after years in a zero-interest environment, just took the next leap by announcing equity purchases to drive up share prices and prop up inflation.

It's difficult to say when rates will reverse to the mean but it seems impossible that they could get any lower from here. In my mind, we are experiencing the most recent peak in what has been a 30-year policy-driven bull market of fixed income investments in the developed world. I also believe we have long entered bubble territory and that we vastly underestimate the impact of falling interest rates on the global economy over the last 30 years. We attribute skill and growth were there is none, just ever-cheapening credit and paper gains based on falling yields - these are some examples:

- Consumption benefited as people felt wealthier, credit became cheaper and it was easy for the political system to transfer capital from the working population to retirees and special interest groups
- Emerging markets benefited from inflated global demand and availability of capital as overstated earnings in the first world were being invested in the third world
- The financial sector benefited from inflated product demand, inflated asset values and inflated earnings as well as declining costs of leverage
- Real estate markets benefited from inflated asset values as leverage became more readily available and cheaper
- Most industries benefited from inflated global demand and declining costs of leverage as well as improved availability of capital

Frugal savers are at a disadvantage and unnecessarily put at risk. If, over the last decade, you invested into government or corporate bonds, returns were mostly driven by paper gains based on ever-falling interest rates, not cash proceeds. It is a "Last Fool's" game (somebody willing to pay an even higher price than the last buyer) – similar to an excessive run-up in a company's stock price. Many of these paper gains will be eliminated once yields turn and investors who don't get out at the right time will face dire consequences. For example, a 30-year, 3.8% government bond falls 25% in price if market yields increase by just 170 basis points to 5.5%.

It's not just savers that are being cheated, it's a whole system cheating itself. We are witnessing a gigantic bubble of self-reinforcing effects (Charlie Munger calls this a Lollapalooza Effect and George Soros calls it Reflexivity) that sets all the wrong incentives and that drives market participants to take headless actions. For example, the zero interest environment is driving several Swiss and German citizens (a frugal and risk-averse crowd) to increasingly invest into "Betongold" (concrete gold – i.e. real estate) given its perceived "safety". Well, buying a house at 30 times annual rental income with 95% leverage can be a profitable investment, but it is definitely not without risk. Especially not if these buyers are mostly using variable interest mortgages to fund their purchases. In Switzerland, properties are typically bought without the intention to amortize loans (interest = rent) and interest rates on variable loans currently hover at around 1-2%. In such a market, priced to perfection, if interest rates

double to more normal levels of 3-4%, the nominal price of houses is at risk to decline by more than 20% in my opinion.

Portfolio Update

The core portfolio achieved a positive return of 0.5% in the quarter. As a value investor, I am not concerned about short-term performance and I consider the market to be a source of opportunity, not a rational measure of economic activity. Being able to find new ideas is much more important to me, and investment ideas I have.

Global markets have seen a long run-up in prices after the financial crisis in 2008 and it has become more difficult to find bargains in this market. While I don't find global equity markets particularly expensive, especially not on a relative basis to fixed income markets, I do believe there are rising pockets of overvaluation. As of the last twelve months, many fellow asset managers had a better hand in profiting from the perceived "flight to quality" (i.e. liquidity-driven multiple arbitrage of blue chip stocks such as Nestle or Roche), from cyclical investments (e.g. automakers) or from investments in beaten-down financial stocks. I just couldn't convince myself to buy or hold these stocks at recent market valuations. For example: I don't consider Nestle a bargain at 2x revenue and 20x owner earnings, and I consider Amazon to be outright expensive at 250x EBIT (despite being an Amazon-shopaholic myself).

I continue to find investment theses that work based on asset values, existing operating cash flows or asymmetrical risk/reward opportunities (e.g. 20% downside and 200% upside) and that are not dependent on the Last Fool's game. For example, the portfolio is fully invested but its underlying stocks are trading at a weighted cash to market capitalization of around 30%. In other words – based on the underlying stocks, the portfolio is around 30% in cash. I consider the cash reserves of the portfolio's holdings a significant margin of safety and an option to generate growth through acquisitions or share buybacks.

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

Robert

PERFORMANCE & BENCHMARKING

%	in EUR (net of fees)						in USD (net of fees)					
	Q1	Q2	Q2	Q4	Year	Index	Q1	Q2	Q2	Q4	Year	Index
2008 (Q4)	-	-	-	-26.2	**-26.2**	**-21.6**	-	-	-	-26.3	**-26.3**	**-22.2**
2009	0.7	22.6	14.7	9.5	**55.0**	**23.8**	-4.6	29.9	18.4	7.8	**58.0**	**27.0**
2010	8.8	-0.7	3.2	5.7	**17.8**	**17.4**	4.1	-10.1	15.8	3.3	**11.8**	**9.6**
2011	-0.5	-4.3	-2.3	4.6	**-2.7**	**-4.7**	4.3	-1.9	-9.9	1.2	**-6.7**	**-7.6**
2012	22.1	1.2	6.8	6.9	**41.1**	**11.1**	27.5	-3.8	9.1	9.0	**45.9**	**13.2**
2013	11.7	2.8	-0.3	5.8	**21.2**	**19.1**	9.2	4.0	3.3	6.7	**25.2**	**24.1**
2014 (YTD)	3.3	0.5			**3.8**	**5.4**	3.4	-0.1			**3.3**	**5.0**

	EUR Year	EUR Index	USD Year	USD Index
Last 12M	**9.5**	**15.5**	**13.9**	**21.6**
Annualized	**15.8**	**7.5**	**15.5**	**7.0**
Total	**132.6**	**51.5**	**129.4**	**47.4**

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 3-5% of assets annually – unrelated to performance. 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.