Belgravia Capital SGIIC SA

Letter to investors

July 2019

Contents

Dear investors:

In this letter we analyse the performance of markets in the first half of the year. At Belgravia we continue to have a negative view of markets as a result of which we have fully hedged the portfolio over the last nine months and we hold an exceptionally high level of liquidity in the portfolios.

In April's letter we included a section explaining Belgravia's view of fundamental analysis, stating that we consider a value asset to be one whose price is lower than its present value.

Value is not incompatible with growth, and there can be value companies trading at high multiples. On this occasion we describe a style of investment which is the opposite of value: momentum.

To conclude, we would point out that we are finalising the details of the new compartment within the Luxembourg open-ended investment fund Belgravia Lux, which will have the same portfolio as Belgravia's other funds but with a minimum market exposure of 75%. This new compartment will complete the range of products which Belgravia has been offering its clients for the last 19 years.

	Belgravia Delta FI	Belgravia Epsilon FI	Q. I. Belgravia Lynx	Belgravia Lux Epsilon
ISIN	ES0114429006	ES0114353032 (CLASE R)	LU0691314768	LU1808857905 (CLASE R)
Patrimonio (millones EUR)	32	162	58	8
Estructura legal	Fondo de Inversión, UCITS	Fondo de Inversión, UCITS	SICAV, UCITS	SICAV, UCITS
Código Bloomberg	BELBALF SM Equity	BELEPSI SM Equity	AUBELXA LX Equity	BELLUER LX Equity
Rating Morningstar		★★★ Bronze	★★★ Bronze	
Categoría	Market neutral	Retorno absoluto		
Política de inversión	El fondo tiene un objetivo de rentabilidad anual no garantizada del 4% al 6%, con un enfoque *Equity Market Neutral,* que se corresponde con una volatilidad anualizada inferior a 8% y un R2 respecto al Stoxx 600 inferior a 0,15.	El Fondo/Sociedad tiene un objetivo de rentabilidad positiva con un ratio de Sharpe superior al del Stoxx 600, manteniendo la volatilidad inferior a dicho índice		

2010-2011 2015-2016 2015-2016 2016 2016 2017 2016 2016-2017

First half 2019

EQUITY EXPOSURE

We have maintained a very low exposure to equities since the beginning of the fourth quarter of 2018 as we believe we are at the end of the expansionary cycle, both monetary and economic.

On the monetary cycle, the message of the main central banks changed over the course of the first half of 2019 as a result of equity losses in the last quarter of 2018, worse than expected economic and corporate data and the heightening of trade tensions between the US and China in May. Accordingly, the FED has gone from a potential 25 basis point hike in the benchmark rate in 2019 to indications of a possible 50 basis point rate cut, and the ECB has left the door open to more monetary stimulus in order to comply with its mandate of close to 2% inflation.

The change to a more expansionary monetary policy has taken place faster than expected, evidencing the correlation in the last cycle between surplus liquidity and capital asset prices. However, we think the additional impact of this monetary policy will be small due to: i) current unemployment rates, close to lows in the US and northern Europe, which could lead to higher than desirable wage inflation, ii) current levels of interest rates which limit the scope for action, and iii) the high number of bond issues with negative yields.

On the economic side the slowdown is evident. In the first half of the year there were downgrades to GDP growth estimates in the main economies and leading indicators, such as the manufacturing PMI, below 50 (indicating contraction) in Europe and China. On the corporate side, earnings estimates for 2019 in Europe have fallen from 8% at the beginning of the year to 4% at present. In turn, the recovery expected for the second half of the year seems unlikely to occur and is being postponed until 2020.

In the first half of the year there were downgrades to GDP growth estimates in the main economies

In geopolitical terms the situation has not improved from the end of 2018. In the US-China trade conflict, tariffs have increased. In Europe and Japan uncertainty persists over the potential imposition of auto sector tariffs by the US.

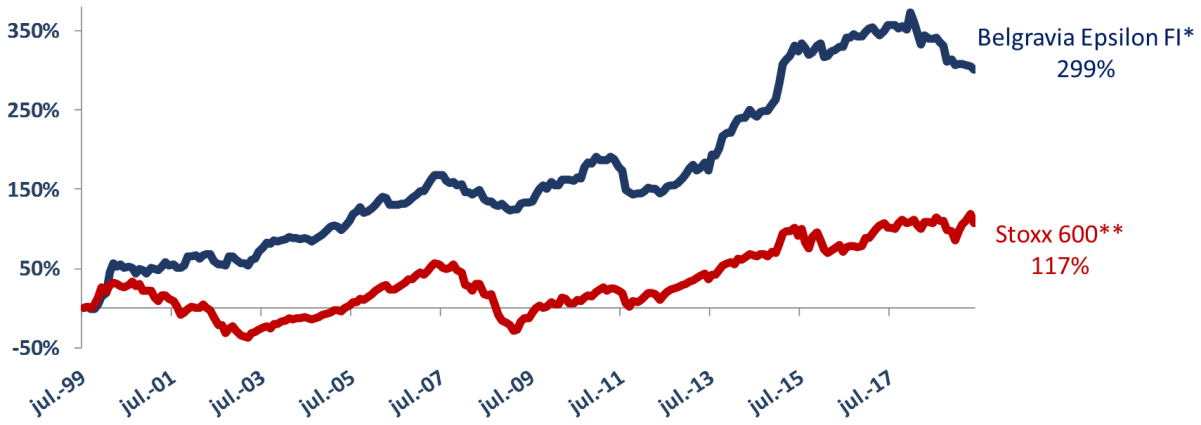
In the UK, Brexit has yet to be resolved and has caused the resignation of the prime minister. Finally, Italy remains in the European Commission's spotlight due to its potential failure to comply with fiscal targets.

Although central banks' policy has changed in the last quarter, we believe that at current valuation levels and with downgrades to both economic growth and corporate earnings estimates, our insignificant market risk is appropriate and our current liquidity position is "profitable" if prices fall. We expect price falls in coming months which would provide an opportunity to buy quality companies at more attractive prices.

In the first half of 2019, Belgravia Epsilon depreciated -2.01%, with an average net exposure to equities of 1.07%, against a positive evolution for European markets, with the Stoxx 600 appreciating 16.46%. US equities also performed positively, with the S&P 500 appreciating 18.18%, although the return in euros was 19.15%.

At the half year close, Belgravia Epsilon's net market exposure was 0.66%: i) 22.6% invested in European stocks and ii) 21.9% in short positions in Eurostoxx 50 futures to hedge market risk. The fund's liquidity was 77.4%.

Cumulative return of Belgravia Epsilon FI at 30th Jun 2019



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** From July 1999 to August 2004 the historical performance corresponds to Belgravia Beta SICAV, a company with the same investment policy which merged with Belgravia Epsilon FI in April 2017.** The Stoxx 600 series includes net dividends.*

EQUITY PORTFOLIO

Currently, the portfolio comprises 38 stocks which altogether represent a level of investment in equities of 22.6% of the fund's assets. Some 66% of this investment is in large cap stocks (over 5,000 million euros), with an approximate average weighting per position of 1% of the NAV, and 34% is invested in small and mid cap stocks (less than 5,000 million euros), with an approximate average weighting per position of 0.5% of the NAV.

The portfolio is constructed bottom-up, focusing on the individual merits of each company, without excessive bias from a sector viewpoint.

In the first half of 2019, the decline in bond yields favoured long duration equities: with higher growth and lower risk premium (higher quality) than average. Accordingly, among those stocks which have contributed positively to the portfolio in the first half of the year we would highlight those we classify as growth and quality: Assa Abloy, Philips, Mips, Siemens Gamesa and Reply.

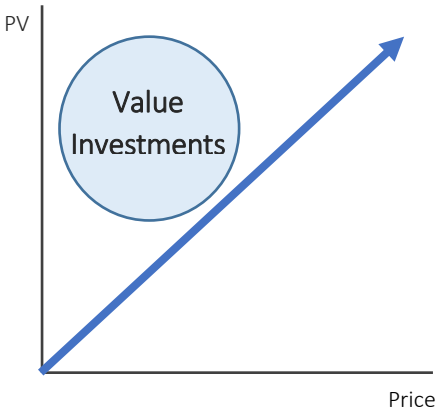
The following stocks have been added to the portfolio in the first half of the year: Assa Abloy, Carrefour, Cineworld, Convatec, EssilorLuxottica, Holmen, Kion, Merck KGaA, Pirelli, Prosegur Cash, Reckitt Benckiser, Ryanair and Telefónica.

Types of investment

VALUE INVESTMENT

In April's quarterly letter we defined value assets as those whose price is lower than their intrinsic value.

CHART 1



In turn, we defined the intrinsic value as the Present Value.

The PV of equities being:

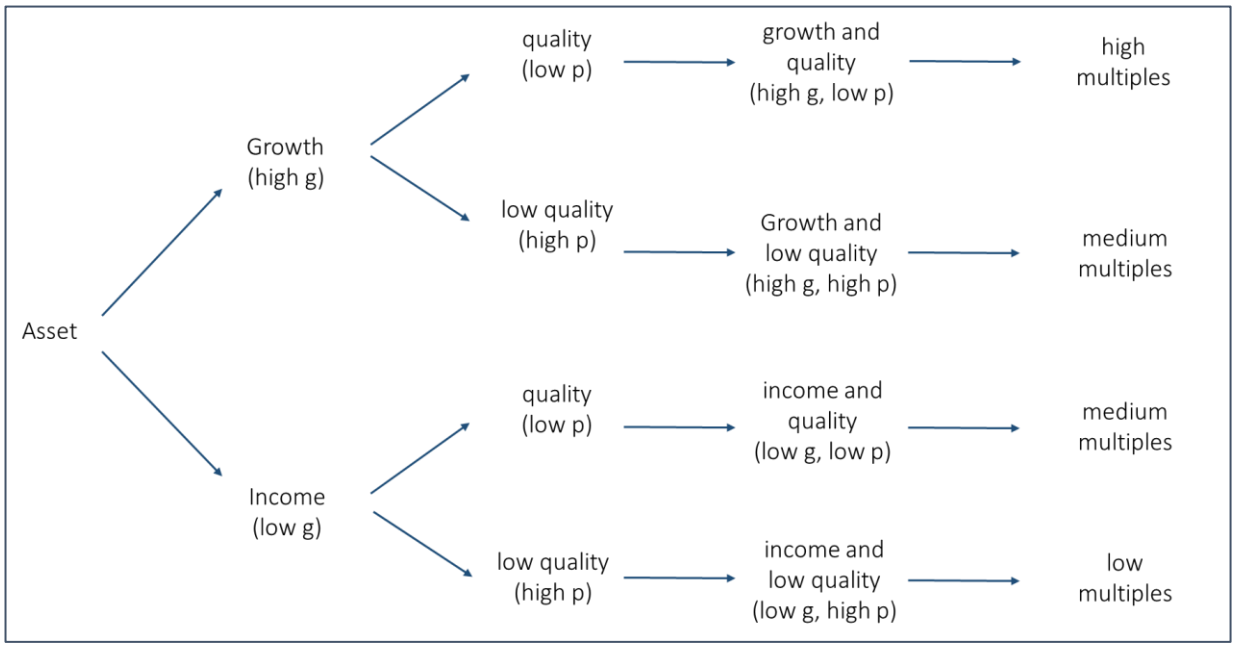
PV = D1 / (Rf+p-g) = (E1 x (1-RE)) / (Rf+p-g)

Where **PV** is the present or intrinsic value, **D1** the estimated dividend for period 1, **Rf** the risk-free rate, **p** the specific risk premium, **g** the dividend's long-term growth, **E1** the estimated earnings for period 1 and **RE** the earnings retention rate.

This is regardless of whether the investment trades at high or low valuation multiples (P/E, EV/EBIT, EV/EBITDA, etc.).

We established two investment classifications: growth vs. income and quality vs. non-quality, depending on whether the asset's variables in the PV calculation model (growth and risk premium) are high or low.

TABLE 1



These two classifications are independent of whether the investment is a value investment or not, as they depend exclusively on the intrinsic qualities of the asset and not on its price, which does, however, determine, in comparison with the present value, if the investment is a value one or not.

This led to four categories of assets according to the magnitude of their growth and risk premium, which imply higher valuation multiples the higher the growth and the smaller the risk premium.

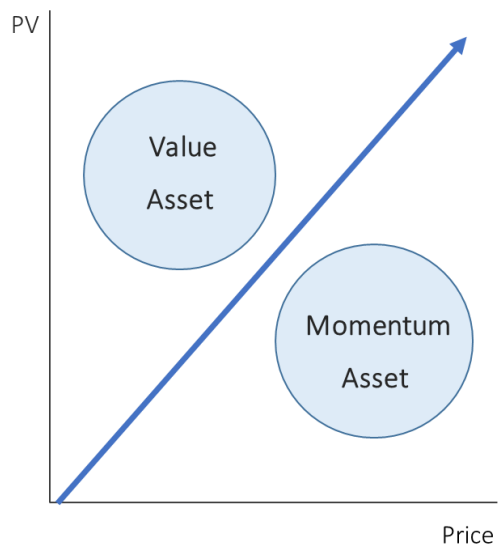
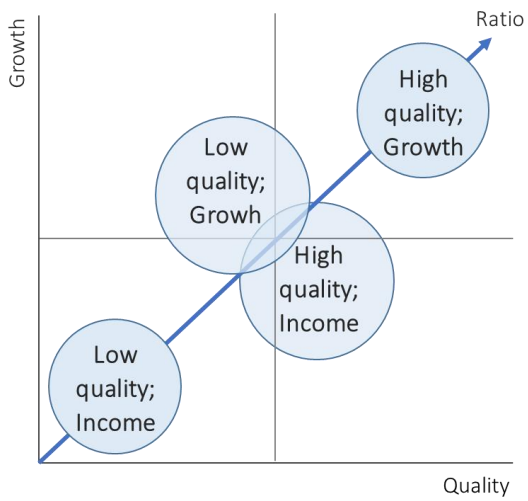


CHART 2



It is worthwhile asking why a financial asset, specifically a stock, would trade above its intrinsic value. The obvious answer is that, at least subjectively, the fact that it is trading above its intrinsic value does not mean the price cannot continue to rise, provided there are enough followers expecting further price rises. There are assets or shares that, whilst expensive (i.e. above their intrinsic value), can become even more so, before eventually converging towards their intrinsic value with a downturn in their price trend.

VALUE VS MOMENTUM

We define momentum assets as those which, as a result of a sustained increase in their price over time, are trading above their intrinsic or present value. Momentum investments are, then, the opposite of value investments which trade at a discount to their intrinsic or present value.

Momentum assets enjoy an uptrend in their growth expectations (g) and/or a downtrend in their risk premium (p)

CHART 3

In theoretical terms, with reference to the Present Value formula, momentum assets enjoy an uptrend in their growth expectations (g) and/or a downtrend in their risk premium (p). In other words, investors are prepared to pay a price premium over the intrinsic or present value because they expect the price to rise as a result of a future upgrade in growth or downgrade in the specific risk premium.

Market expectations for a future upgrade in growth or a downgrade in the risk premium are usually the result of the extrapolation to the future of historical trends in this respect. A company that repeatedly beats earnings expectations leads investors to upgrade future growth or to believe that expected growth will continue to be upgraded in the future. This causes a price increase which, in turn, fuels subsequent expectations of future upgrades to earnings growth. An interactive dependence is created between price and subjective growth expectations, which, while it continues to gain believers, is sufficient to maintain an uptrend in the price of the momentum investment even though it is trading at a premium to its intrinsic value.

Theoretically, in other words, in the Present Value formula, according to which the price of the asset directly depends on its Present Value, which in turns depends on the growth variable, g, we find in momentum assets that the increase in the price of the asset positively influences growth expectations or expectations for an upgrade of expected growth and so the perception of value within in the asset. This generates a mutual, often irrational, upwards influence between price and growth expectations which is characteristic of momentum assets. This trend is sustainable provided the flow of news and information regarding current and potential earnings generation keeps pace with the price, and the increase in the supply of the asset in response to this is sufficiently limited to not beat demand.

When the flow of news and information regarding the company's capacity to generate and grow earnings is unable to sustain the price uptrend, the investment stops being a momentum and the price begins to fall; or simply, the news become negative, sharply interrupting the uptrend in the price of the momentum asset; or the increase in the supply of the asset in response to the rise in price is sufficient to more than satisfy the increase in demand. Not surprisingly, momentum assets whose prices increase very sharply usually have a shorter life than those momentum assets whose prices increase more moderately.

This identification of momentum assets is equally valid for tulips in the Netherlands in the 17th century, the TMT sector at the end of the 1990s, the real estate sector in the middle of the first decade of this century and for fixed income at present.

A similar interpretation can be made of momentum assets that are based on expectations for downward revisions to their specific risk premiums. The reliability and recurrence shown by a company in the reporting of its earnings usually lead to an extrapolation to the future, even to perpetuity, of such an unsustainable trend, which generates expectations for further

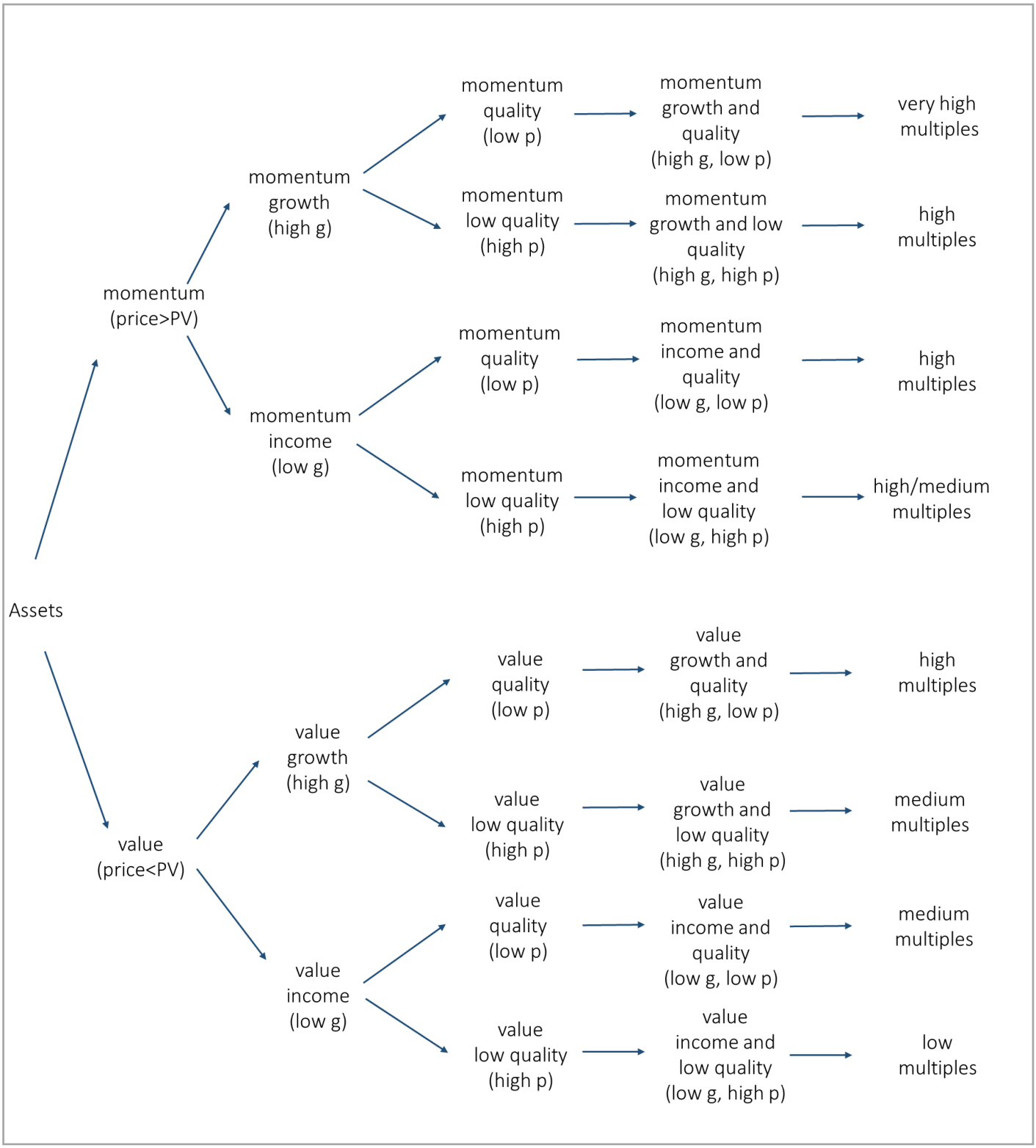
downward revisions to its risk premium and with it a further increase in the price above the intrinsic or present value of the asset.

We can also distinguish between two types of momentum assets: those in which growth is the main factor behind their high valuation and those in which it is the risk factor. The former are growth momentum assets and the latter quality momentum assets. Although scarce, income momentum assets and non-quality momentum assets do exist. The double classification on the basis of growth and quality variables that we established for value assets is equally valid for momentum assets, there also being among these growth and quality, income and quality, growth and non-quality and income and non- quality assets.

However, the growth factor is the one prevailing in most momentum assets, as could be expected, because the dispersion of the growth factor in the equities universe is much greater than that of the risk premium factor, which leads to its larger and more frequent propensity to excess. This explains the casual but not causal association of momentum assets with growth assets and with high multiples. This is somewhat similar to the casual but not causal association of value assets with assets with low multiples.

We can also distinguish between two types of momentum assets: those for which growth is the main factor of their high valuation and those for which it is the risk factor

TABLE 2


Assets
momentum (price>PV)
momentum growth (high g)
momentum quality (low p)
momentum growth and quality (high g, low p)
very high multiples
momentum low quality (high p)
momentum growth and low quality (high g, high p)
high multiples
momentum income (low g)
momentum quality (low p)
momentum income and quality (low g, low p)
high multiples
momentum low quality (high p)
momentum income and low quality (low g, high p)
high/medium multiples
value (price<PV)
value growth (high g)
value quality (low p)
value growth and quality (high g, low p)
high multiples
value low quality (high p)
value growth and low quality (high g, high p)
medium multiples
value income (low g)
value quality (low p)
value income and quality (low g, low p)
medium multiples
value low quality (high p)
value income and low quality (low g, high p)
low multiples

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