AFFINIUM

Disciplina + Humildad + Rigor ⇒ Verdad

3rd Quarter Letter of Affinium International FI

October 11, 2021

We are as blind as Tiresias, yet nowhere near as prophetic.

Dear Fund Investor:

During the 3rd quarter the fund NAV fell -1.54%, with the month of September result -3.33%.

The monthly results since the fund commenced operations on 31 March 2021 are as follows:

—Table 1—

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	2021
NAV	-	-	99.4939	101.533	103.734	102.458	103.762	104.364	100.885	-	-	-	
Net Total Return NTR	-	-	-	2.05%	2.17%	-1.23%	1.27%	0.58%	-3.33%	-	-	-	1.40%
Cumulative NTR	-	-	-	2.05%	4.26%	2.98%	4.29%	4.90%	1.40%	-	-	-	

Clearly the negative months of June and September stand out. So, what affected the portfolio?

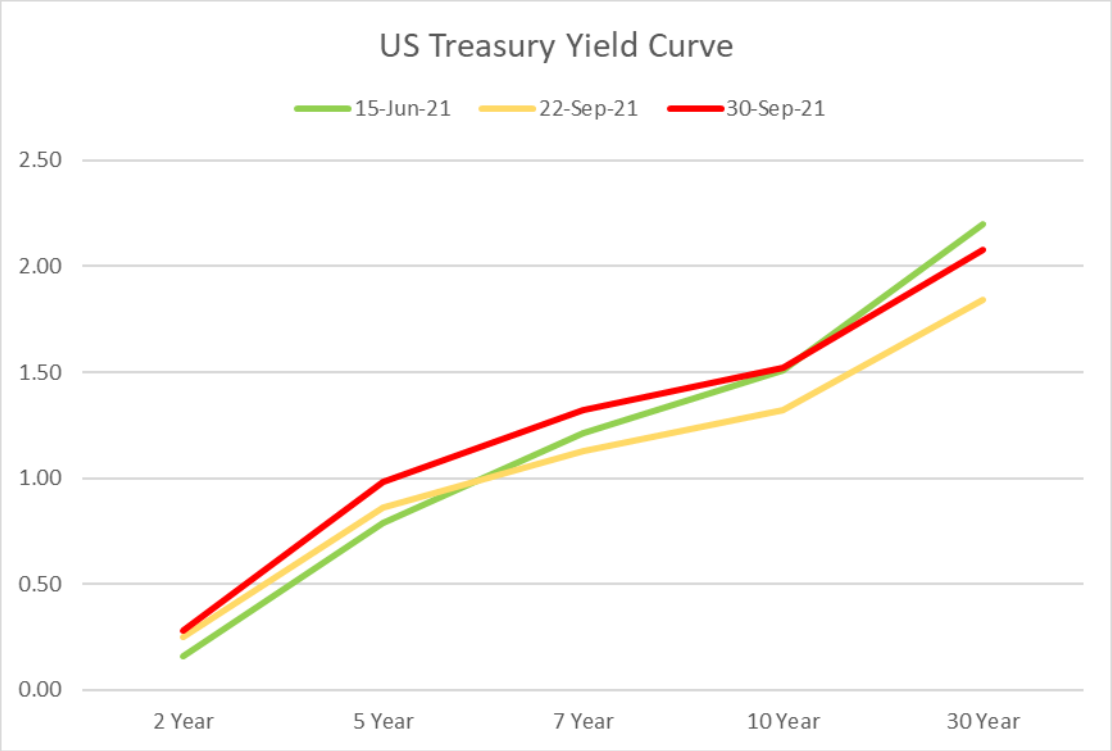
Reviewing our notes from June, on the 16th the Federal Reserve published an updated dot plot now showing two expected increases in the Fed Funds Rate by the end of 2023. This caused market participants to prepare for the Fed tapering the Chinese Flu emergency measures as well as attempting to estimate the timing of the first rise in the Fed Funds Rate since 2018.

In the days before the Fed's dot plot publication, Gold market participants started to anticipate the possibility of these events and the Gold price started to fall again from its most recent high of approximately $1900 on 1st June to $1750 by 30th June -7.9%.

In addition, bond market participants acted similarly from the 11th to 15th June during the days before the Fed's dot plot publication. However, after the Fed 16th June publication whereas we saw yields rise at the short end of the curve —1 Month to 5 Years— we saw yields fall at the longer end of the curve —30 Years— as can be seen in Chart 1. From the 15th June to the 30th September, you can see that yields on 2Y, 5Y and 7Y have all moved higher, whereas the 10Y hasn't changed and the 30Y has in fact fallen. This is commonly referred to as a flattening of the yield curve. It is important to appreciate that bonds are pure

breed mathematical animals; when the current bond you hold rises in yield you experience a price loss as a consequence that your bond pays less coupon than a new bond with a now higher yield. So, market participants must be compensated for the lower yield in your bond to incentivize them to be indifferent to purchasing your bond or the new bond with a higher yield. In our portfolio we maintain as closely as possible the same maturities and therefore we sell our existing bonds and buy the new bond. This means we will now receive the higher yield and as such start to recover the loss in price suffered from selling the previous bond with the lower yield. We will elaborate on this aspect of bonds in another letter in the future.

—Chart 1—



In conclusion for June, as the portfolio is invested in the shorter end —whose yields rose whilst longer end yields fell— the negative bond returns together with the fall in the price of Gold caused the majority of the June loss. On the positive side, Stocks —with the exception of Emerging Market (EM) Stocks— and Real Estate rose somewhat during June, thus providing some compensation.

Turning to September, Gold yet again fell back down from $1814 on 31st August to $1731 by 30th September -4.6% as participants again started anticipating Fed tapering and any potential eventual first rise in the Fed Funds Rate since 2018. And it came on 22nd September when Chairman Powell hinted that tapering could easily be announced before the end of 2021 and end by the middle of 2022.

This time around both shorter term yields rose as did longer term yields. Nevertheless, the previous discrepancy did not fully recover as the 30Y yield is still lower on 30th September at 2.08% than on 15th June at 2.20% and the 10Y has barely changed with the remainder of the yield curve higher. Thus, the portfolio is still at a temporary relative disadvantage to longer term bonds and we believe this divergence will be recovered over the market cycle.

Stocks also fell during September with USA -4.75%, Europe -3% and EM -3.97% we believe principally due to sentiment regarding contagion of the Chinese property developer Evergrande having technically defaulted on some bonds as well as other Chinese developers experiencing their own bond problems. We believe this China tempest in a teapot, the exceptional run-up in stocks of >100% since the lows of the March 2020 sell off, the anticipation of the Fed tapering, the estimated timing of the first Fed Funds Rate increase and recent weak economic data are together causing participants in stocks to take a breather to allow some of these uncertainties to clear before committing further capital or buying any more dips. We will comment further on EM stocks and in particular China in a future letter.

Real Estate also fell in September -5.5% after experiencing a sharp run-up of 4% in August and it is our opinion that this is due again to uncertainty over the coming taper, the estimated time of the first Fed Fund Rate increase and the rise in bond yields. We believe real estate could continue to suffer into the taper but will recover if the first Fed Funds Rate increase is not expected until late 2023 or beyond. As always, much will depend on the evolution of the economy to which we are essentially blind although we may enjoy opining about its course for intellectual stimulation.

In addition to the four portfolio assets, our risk reduction techniques were able to reduce some losses by 20% in September. By way of an example with no relation to our portfolio, if a loss were -10% the final losses were reduced to only -8% by risk reduction techniques. We use such techniques following a strict framework and process to avoid falling into the trap of market timing. This means we are fully aware these might not coincide with every single shock to the markets, but as we have shown you in our memo dated 25th June 2021 titled *"Puede mejorarse el Buy&Hold?"* on page 7, if we are able to reduce losses of only one of the shocks over time or alternatively a decent percentage of the losses of several shocks over time, the Total Return (TR) would be several multiples that of the buy & hold TR.

Another important concept we have mentioned in our memo titled *"El Drawdown…"* is the perspective of drawdown versus losses and previous run-ups. Referring to Table 1 above showing monthly net total returns and net cumulative total return, you should see the June monthly return as -1.23% and the net cumulative return falling from 4.26% at the end of May to 2.98% at the end of June. This is in stark contrast to the run-up of some 4% experienced between beginning of May until the first week of June and the subsequent intra-month drawdown of a similar -4% immediately after the run-up until the middle of June. Solely focusing on the drawdown in isolation without considering any previous run-up and the net cumulative total return before and after the drawdown can lead to devastating myopia. The same can be witnessed in the previous run-up into the first week of September and the subsequent drawdown intra-month until the end of September. The cumulative net total return reached a high of 4.26% at the end of May and then fell -1.28% to end June at 2.98% and the net cumulative total return reached a new high of 4.9% at the end of August and then fell by -3.5% to settle at 1.4% at the end of September. Contrast that with the drawdowns of approximately -3% in June and -4% in September and that even so, since the Fund began operations, the net cumulative total return is still 1.4%. Additionally, consider that in September the individual portfolio assets fell between -4% to -5% —except for bonds.

We do not deny the importance of drawdowns, rather they should always be put into perspective. The size of drawdowns in isolation are useful for a first-time investor in any fund

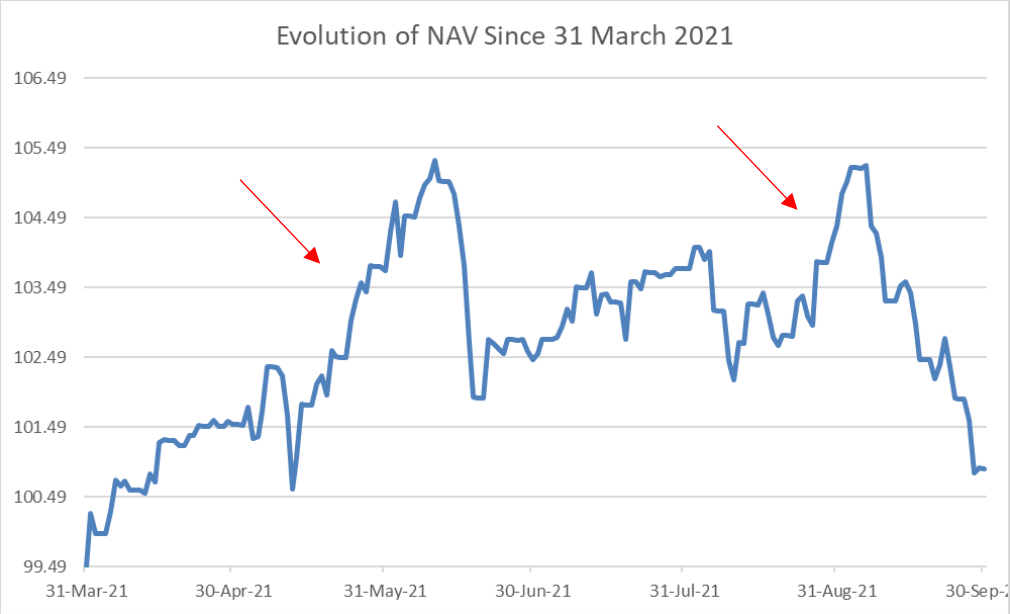
who wishes to invest one lump sum rather than some form of scaling-in. Such an investor needs to consider what potential loss could be experienced immediately after having invested the lump sum. Once sufficient time has passed since each investor entered the fund, the drawdowns lose importance —as long as they are contained of course. What matters over time are the cumulative gains and monthly losses. What we mean by this by way of example is, if you had been invested in a fund for a longer period, say looking back to 2019, and the fund made 20% in 2019, 8% in 2020 and so far in 2021 you are making a further 2%, any recent drawdowns should not concern you as your cumulative net return is some +32% over what has been a relatively short period of time of 2.75 years. With such perspective, neither the monthly losses of June and September 2021 nor their intra-month drawdowns are terribly significant in relative terms. Of course, this perspective is more difficult for a new investor investing in a fund for the first time especially just before or during any recent drawdown who has only 6 months knowledge of the historical performance. As more time passes and gains are obtained and accumulated, the perspective we are indicating comes further and further into play for all fund investors.

Zooming in further on the current drawdowns since the Fund started operations on 31 March 2021 until 30 September, another perspective is also useful: that of individual portfolio asset price levels from their highs during the same period. In the US Stocks are down -5.2%, Europe -4.3%, EM -9.9%, Real Estate is down -8%, Gold is down -9.3%. In Bond land, yields have risen from their lows by the following absolute amount of yield: 2Y +0.17%, 5Y +0.37%, 7Y +0.39%, 10Y +0.36% and 30Y +0.28%. In turn the relative increase in yields is as follows: 2Y +121%, 5Y +57%, 7Y +41%, 10Y +30% and 30Y +15%. As can be again seen, the shorter end of the yield curve -2Y to 7Y- have increased in yield by a much higher proportion than the longer end of the yield curve 30Y. Glancing at the individual price falls from the highs of the three individual 'risk' assets in the portfolio —Stocks, Real Estate and Gold— a drawdown at the portfolio level of -4.14% in September is substantially lower than the individual drawdowns of the three risk assets and very coherent with the portfolio's ex-ante construction. Finally, do not lose sight of the fact that despite all these price falls the portfolio is still positive at +1.45 Net TR as of 30 September. Of course, the portfolio construction and risk reduction techniques designed to mitigate outsized *("desproporcionada")* losses, is only one leg our portfolio's construction. The other leg —of equal importance— is how the portfolio behaves when most or all individual portfolio assets are rising from their price lows and making new highs.

Although it is crucial to analyze the behavior of a portfolio during periods of losses, it is equally important to analyze periods of gains to complete attempts to understand any portfolio and how it should behave. With this in mind we turn our attention to the months of April, May, July and August. What we expect to see during periods portfolio assets are rising in price is that the portfolio makes more than satisfactory gains. Of course, it will not keep pace with stock market gains during such ebullient times. Our portfolio is designed to make more than satisfactory gains during periods of euphoria and lose substantially less than the stock market during periods of extreme fear with the subsequent outsized losses of broad stocks. This is what we refer to as our constant search for asymmetry. Although the Fund has a short life of only 6 months, there are signals that this equally critical leg of the portfolio construction is behaving correctly by looking at the positive gains made during the months of April, May, July due to the substantial run-ups from 31 March to 10 June and again towards the end of August until the first week of September —see Chart 2.

April saw a total net gain of 2.05% and was the first full month of operations. Stocks in the US led the way with gains of 5.4%, Europe 2.1% and EM 2.5%, all contributing to the portfolio. Real Estate was the lead portfolio asset with gains of 8%. Bond yields fell slightly across the curve in April providing some low positive gains and Gold made gains of 5%. So, the conclusion is that the portfolio makes more than satisfactory gains when all assets rise. What would be extremely worrying is if the portfolio did not make good gains when all assets were rising so much.

—Chart 2—



In May portfolio assets continued their march higher albeit with market participants in some assets needing a gentle reminder investing is not a sprint rather a marathon —Gold participants clearly did not receive any such reminder. Real Estate gained 1%, in Stocks US 0.44%, Europe 2.6%, EM 0.4%, Gold 7% and Bond yields ever so slightly falling across the curve. So, again all portfolio assets gaining in general with one outlier gain contributing most to the portfolio total gain of 2.17%. Yet again when portfolio assets make decent sized gains the portfolio capitalizes them —to a lesser extent of course but more than satisfactorily.

During July, Gold, Real Estate, Stocks were all up with the exception of EM caused by the Chinese government starting to show its true colors in public and bond yields were somewhat lower across the curve.

By contrast August was positive but a fairly mixed bag across assets; Bonds yields rose but not to the heights of June, Gold was virtually flat, Real Estate spiked higher towards the end of August and into the first week of September. Stocks in the USA and Europe rose whilst EM took another leg lower but recovered to end August almost flat. However, another short-sharp portfolio run-up started in the last days of August and peaked during the first week of September. Again, showing that when portfolio assets rise in price the portfolio is able to garner a good proportion of these gains and in themselves satisfactory. The first leg of the portfolio is demonstrating that it is alive and kicking.

Finally, a quick note to those of you who are not aware of the performance of the portfolio in previous months and calendar years before the Fund's launch; we are restricted by the financial regulations from publishing past results before the Fund started operations. However, we can at the very least state that had the Fund started operations on 31 December 2020 the total return year to date (YTD) as at 30 September 2021 would be a little higher at approximately +2.6%

This concludes our review of portfolio performance in the 3rd Quarter and since Fund operations began on 31 March 2021. However, we would like to encourage you as a Fund investor to not hesitate in the slightest to contact us with your questions, comments or suggestions. We work for you, ourselves and nobody else.

For the remainder of this quarterly letter, we would like to share our vision of markets with you, from the past, the present and the future. We hear you exclaim, "But you don't know the future, you can't predict it and you can't truly understand the past!" Absolutely right, but that doesn't mean we shouldn't try to think why events might have occurred in the past, where we are in the present, what might happen in the future and how such events could affect our portfolio. If not only for intellectual exercise, such a process can assist us in trying to understand market participants' behavior and their effect on our own portfolio's behavior. Of course, we are essentially blind and not at all prophetic, but we firmly believe, come what may, we have a sufficient mix of assets that will allow us to bring a satisfactory catch safely back to port even though we won't be makers of the market.

* * *

Markets

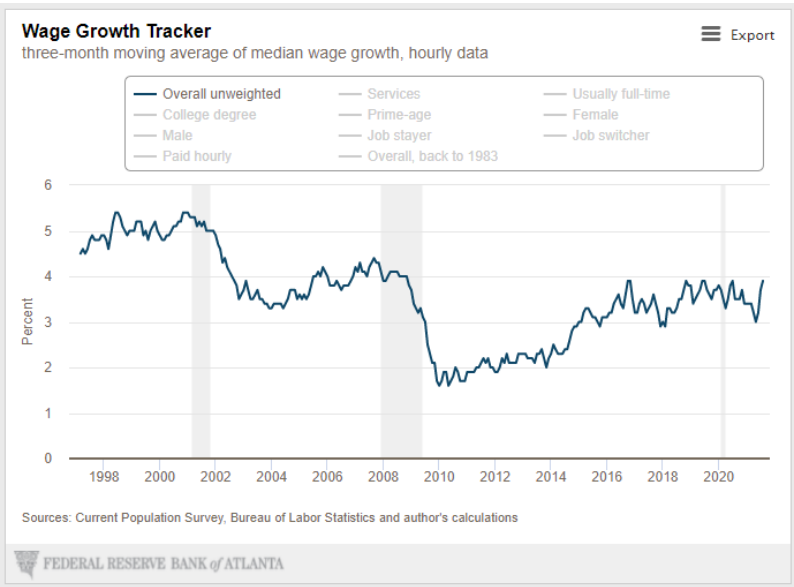
"If you do not know where you come from, then you don't know where you are, and if you don't know where you are, then you don't know where you're going. And if you don't know where you're going, you're probably going wrong."

—the late Sir Terence David John Pratchett OBE R.I.P.

We believe that to know where we are going, we need to go back to historical events of 2008 and its aftermath, not to mention the regime that came into play from 1980 with the period referred to as globalization —exporting manufacturing to China. It is not our intention to bore you with the reasons why central banks around the world flooded the financial system with the now infamous QE —the jury is still out on whether QE was a successful measure. However, due to political short-termism and necessity at the time, the consequences of not acting would have been much worse —in the short term— than doing nothing at all. Think of a seriously ill patient on the intensive care bed requiring life support of every measure and you would have a pretty accurate picture of the state of the financial system at the end of 2008.

Around the years of 2010 and 2011, every financial commentator was screaming about inflation. It was to our amazement that participants believed the patient could rise from the intensive care bed, pull off all the life support machines and start to sprint let alone run a marathon. With bank loans failing to back everyday borrowers, companies taking advantage of low corporate bond yields to simply buy-back their own stock, wage growth halving between 2008-2010 and barely rising above 2% between 2010-2014 —see Chart 3— it is not difficult to ascertain why higher inflation had not appeared as feared back in 2010/2011.

—Chart 3—



Further, at the beginning of 2021 bank loans at the biggest US banks as a share of their total assets fell to just 46% —a record low. The economy was growing at its fastest rate in history at the end of 2020. Yes, a large money supply plus a fairly high velocity of money can and will bring higher inflation, but we believe that is still a way away.

Since then, higher inflation has appeared but, in our view, this is not because the US economy is full of optimism, rather buyers are panicking due to supply problems, stratospheric transportation costs and now much higher energy costs —for example oil, electricity and natural gas. Does this mean this higher inflation is indeed transitory or sticky or likely to exponentially increase into hyperinflation as many were predicting in January and February 2021? Only time will tell, but we believe that without an increase in bank loans, higher wage growth and of course economic growth above at least 2.5%, inflation is likely to be transitory. The hyperinflation of the late 1970's took at least a decade to materialize since its seeds were first sown.

Nevertheless, we believe the regime that was in place since 1980 will reverse and we will enter a generally rising rates environment with higher inflation than we have been used to since 1980. As the deflationary factors of globalization and exporting manufacturing to China —with cheaper costs/higher profits— are to a greater or lesser extent reversed and many processes and dependencies brought back home or closer to home, prices will generally face upward pressure. However, this doesn't mean that market cycles will cease to exist, rather that portfolio assets and some of their relationships will be reversed on their heads. Bonds will face headwinds and with higher discount rates stocks will also face reductions on the valuation of their future earnings.

Turning back to central banks, their QE and setting the cost of money —via interest rates, they and their political cohorts are somewhat in a pickle. The governments are reliant on the level of interest rates to finance their spending programs and of course on QE to maintain ready buyers of their bond emissions. Our view is that central banks and especially the Fed had been trying to reduce QE and its balance sheet between 2013 and 2018. More importantly the Fed was desperate to return the Fed Funds Rate back to more normal levels or at least have it return to a higher level from which to be able to cut when needed. This would allow QE to be less relied upon and we would be back to monetary policy 1.0 and without monetary policy 2.0, 3.0 etc.

So, what happened last time? The first taper began in December 2013 and ended with a final purchase of $15billion in October 2014 —turned out not to be final. Market participants then focused on the first interest rate increase since 2007 announced by Yellen in 2014 as starting the following year —2015. Indeed, the first interest rate increase came in December 2015 and the Fed's plan was finally in play. However, the next rate increase didn't come until December 2016 —data dependent and slowly as she goes. This should have been no surprise as the Fed had to tread very carefully so as not to push the economy too much. In that outcome, not only interest rates would have to fall to zero again but possibly the launch of another QE.

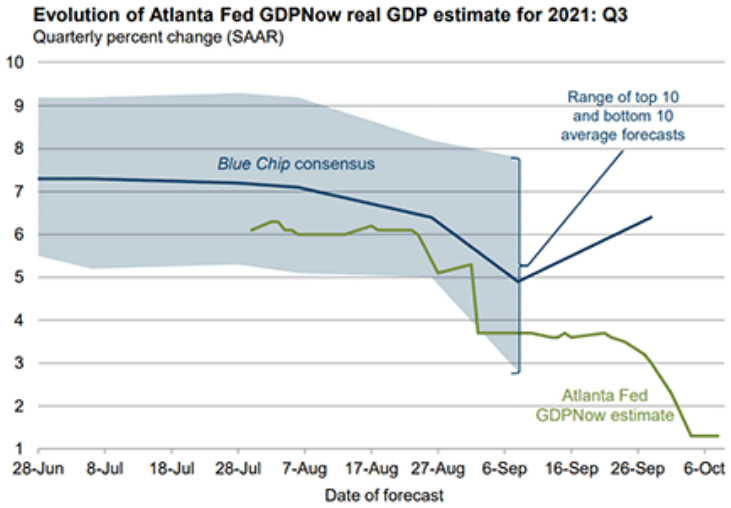
Unfortunately, Yellen was substituted by Powell and the Fed continued raising rates to 2.4% with the last rise in December 2018. We can understand their desire to try and return rates back up to some form of normality and to never rely on QE again for the distant future. Rates were then reduced in 2019 but stopped at about 1.5%. Naturally, the Fed didn't want

to reduce down to zero again and attempted to see if the economy could grow with 1.5% Fed Funds. Why? Because if the economy could grow with stable inflation, then the Fed would be able to raise rates next time from a higher starting point than zero and thus could probably raise rates to a higher level than in 2018 and return monetary policy to some form of normality without needing the politically incorrect QE with all the financial distortion that causes -in the intensive care it is the goal of the doctors to return the patient to some form of normality without having to depend on life support measures.

But such is destiny, and the Chinese Flu would appear out of nowhere —or maybe timing was of the essence— and the Fed's plans were ruined as not only did rates have to fall back to zero but an even bigger QE than during the whole period since the 2008 financial crisis had to be re-started. We were back to the intensive care bed and back on full life support again. Oh, to be a fly on the wall at the Eccles Building!

So, we are back at the monetary policy process that was attempted from 2013-2018 believing in a mid-cycle to end-cycle transition. But are we really in mid cycle? If we are then how long will the mid cycle last? Will we ever reach the end cycle phase? What if this is in fact still early cycle? Whatever the case may be, at this moment in time the situation is complicated by higher inflation (transitory?) and lower real GDP growth as shown by the real time Atlanta Fed GDPNow and the declining GDP forecasts in the FOMC's latest economic projections releases —see Chart 4.

—Chart 4—

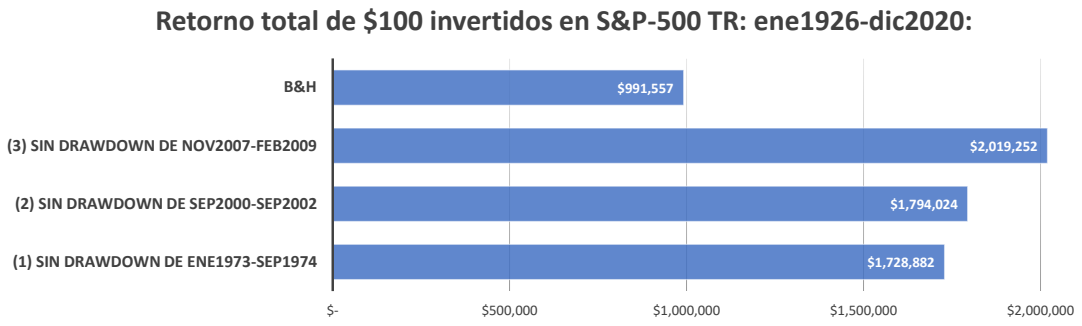


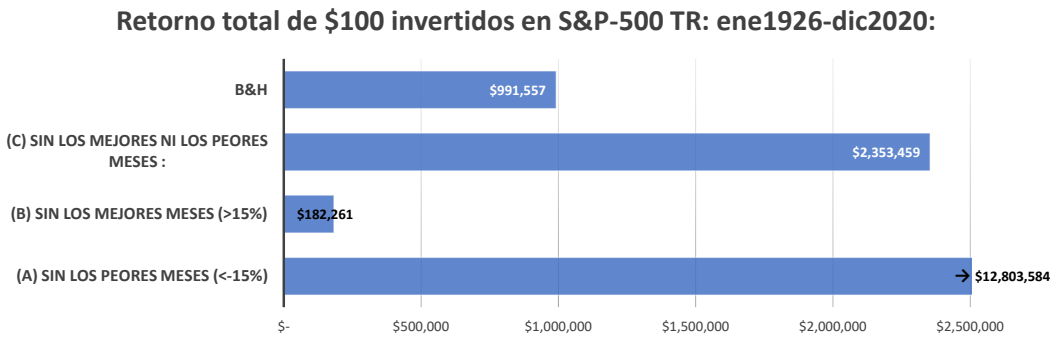
Back in 2013 when the taper commenced, inflation was much lower than 2021 and annual real GDP growth was higher at about 4.3%. Then at the end of 2015 —the first interest rate increase— inflation was still moderate and real GDP growth had fallen to 2.7%, but increased to 3.5% at the end of 2016 —the second interest rate increase— and peaked at 4.8% in 2017. These figures are in remarkable contrast to now at the end of 2021 and the Fed is about to start the taper yet has made clear any interest rate increases will be based on a wholly different set of factors.

We constantly ask ourselves all sorts of questions —as you would expect us to—; What if the Fed stops the taper before it finishes? What if they successfully complete the taper but the economy cannot tolerate any increases in interest rates. What happens if inflation stays

at these levels or increases even higher? What if another exogenous event (Chinese Flu) shocks the markets and economy again? etc. Our reply to all of these questions and scenarios is we simply have no idea which is going to play out. All we know is that any of them may happen and one or more of them will happen, but we have not the remotest idea when they will happen.

Nevertheless, we can and should have a framework within which we can construct portfolios according to strict criteria and can form a rigid repeatable investment process. It is and never will be perfect, but if we can put ourselves into a position that if we are right albeit without market timing and with some luck, we may reduce the chances of outsized losses and therefore need only gain moderate amounts of market returns thereafter to compound at a more than satisfactory rate. We take this opportunity to remind you of two curious charts from one of our recent memos:





Coming full circle, we are blind and nowhere near prophetic. We can be certain that events will occur, but we possess no certainty as to when they will happen. QE may end, but interest rates may not rise as expected or may rise much later than expected. QE may need to be re-started again. Inflation could persist or go higher and then interest rates may have to be increased even though growth is weak. QE may end and then interest rates follow by rising and growth improves higher or at the very least growth continues despite the interest rate increases. We cannot know which will play out or precisely how.

At Affinium, we are confident in our portfolio construction, strict framework and resulting repeatable process, such that whatever scenario plays out, we have the right mix of assets to survive the market cycle storms and to then go on and garner more than satisfactory market

returns in the good harvest times. That is the essence in the design of our portfolio and will remain so.

Yours faithfully,

Marcos Perez & Sharash Alexander

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