

**Interim letter to the co-investors of the BrightGate Focus Fund
1st half of 2023**

Madrid, July 5th, 2023

“There are more banks than bankers in the world.”

Morris Shapiro.

Dear co-investors,

I hope these festive months find you well and enjoy a well-deserved break over the coming weeks.

The Fund closed on 30 June with a NAV (institutional share class) of 1,347.5, representing a return of 17.8% over the six-month period, compared with 16.9% for the S&P500, 15.1% for the MSCI World and 5.4% for the BofA US High Yield Index (in all cases including reinvestment of dividends or coupons, but excluding the cost of currency hedging). Although the Fund does not follow any benchmark, I consider the three aforementioned indices to be a representative group of the asset universe (equities and high yield bonds) in which the strategy invests.

As I have mentioned in previous letters, the half-year results should be interpreted with caution. While I believe that the long-term performance of the Fund will be in line with the goals set at inception, short-term movements in NAV, both up and down, may be largely irrelevant.

The Fund has performed in line with the indices over the six-month period, although *I must stress that the gains did not come from the technology bubble or from those companies with weak business models* that fell sharply in 2022 and which, surprisingly, have rebounded dramatically in recent months without improving their future prospects in the slightest.

The US cyclical stocks in which we took a position a year ago have been largely responsible for the Fund's excellent performance over the period. A year ago at this time, all of these stocks had suffered severe corrections, partly because they were perceived by the market as Covid winners (their earnings would revert to the mean) and partly because all analysts and investors were anticipating a recession that would further dampen the earnings for all companies in the coming quarters.

Although the first part of the argument has turned out to be true, the most predicted economic recession in history has yet to materialise. *I want to point out again that the thesis of these companies* (a group that includes Allison Transmission, Green Brick Partners, Lithia Motors, THOR Industries and Patrick Industries) *did not depend on my (limited) ability to anticipate a recession*, but on their individual investment thesis. Although they all bear the pejorative label of "cyclical", they are leaders in their sectors (in some cases, niches), have strong balance sheets, very rational capital allocation programmes and attractive valuations.

One year on, we still have exposure to all of them and, again, the performance of their business over the next five years will not depend on whether the economic downturn eventually occurs; although their share prices may suffer in such an event, their management teams will continue to work towards achieving their long-term strategic objectives.

Before turning to the main portfolio movements over the half year, I would like to take the opportunity to share my thoughts on two issues that will be on the minds of many of our investors. First, the apparently healthy economic performance of the developed world, despite all the recent analysis to the contrary. And second, the high valuations of equity markets (especially the US one), despite the fact that monetary conditions, both interest rates and central bank balance sheets, are tighter than in 2021. As experimental economics shows us, while liquidity is a fundamental cause of bubble formation, a bubble can even in its absence form if a number of conditions are met, which we will explore below.

The (possible) inflationary impact of high interest rates on the economy, experimental economics, and bubbles in the laboratory

We are all wondering how it is possible that, after a year of warnings and predictions about the coming economic recession, it has not yet materialised. Given that this crisis has probably been the most predicted in history, it is natural that explanations abound as to why it has not happened. From the argument that monetary policy works with a lag, to others that the data are simply being fudged, to others that the sharp fall in oil (and other commodity) prices has had a positive impact on aggregate supply, all more or less agree that we simply need to wait a little longer. Needless to say, this conclusion is not very useful for investment decisions, as a recession is bound to come sooner or later.

I just wanted to put another argument on the table, which is far more plausible than the previous ones and which, in my opinion, is not receiving the attention it deserves. It is none other than the possibility that the interest rate hikes have not had the desired effect of cooling the economy, but precisely the opposite. The main proponent of this argument is the economist Warren Mosler, one of the founders of Modern Monetary Theory (MMT).

Mosler's argument is straightforward. Given high levels of government debt, higher interest rates create an additional revenue stream in the form of interest payments, some of which will eventually be consumed. From the government's point of view, higher interest payments have the effect of widening the government deficit. Such an increase in the deficit, coupled with the full employment situation in the US, not only has the effect of keeping economic activity high, *but also has a positive effect on inflation levels.*

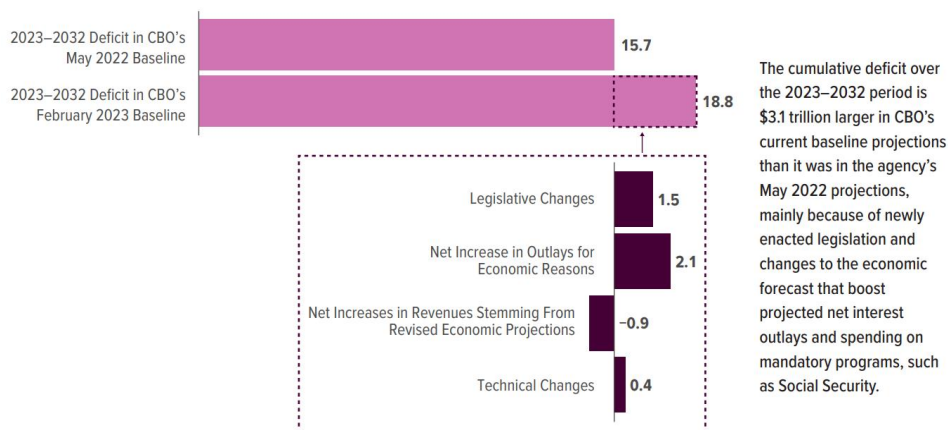
Yes, you read that right, according to Mosler, one of the reasons why inflation has been more persistent than initially thought is that interest rates are higher, despite the fact that supply chain issues have largely been resolved and energy-related commodity prices have reversed much of the gains they experienced in 2022.¹ Given the impact on public deficits, central banks (and conventional wisdom) have got it backwards, advocating rate hikes to slow the economy, when the opposite is true.

¹ Mosler explains in detail the transmission channels of higher interest rates on inflation and employment in this recent [podcast](#).

For Mosler, while there are individual winners (e.g., bond investors) and losers (e.g., someone buying a car and borrowing) in the economy from higher rates, the overall impact is positive. Most government debt is [held by the public](#) (around 77% of the total), so the potential to generate additional consumption is quite high. While Mosler explains that this is obviously an empirical question (some people will spend the money while others will simply hoard it), it is easy to imagine a channel (albeit a partial one) through which Fed rate hikes end up having a positive impact on inflation.

To understand the magnitude of the interest rate hike on the government deficit, it is interesting to chew on the following figures. The Congressional Budget Office (CBO) is the body responsible for drawing up scenarios for the coming years on the likely evolution of the US public deficit (and public debt). The rise in interest rates has had a major impact on the evolution of these scenarios. For example, in its May 2022 analysis, the CBO projected public deficits for 2023 of \$1 trillion, while in its latest update for 2023 this figure rises to \$1.4 trillion.

When we look beyond one year to but projections for the next decade (2022-2023), the results add up and the upward revisions become more pronounced. Over the next decade, the CBO expects cumulative deficits to be \$3.1 trillion higher than initially estimated. As the following graph from the report shows, not all of the increase is due to higher interest rates, but a large part is due to them:



Source: Congressional Budget Office (2023), [The Budget and Economic Outlook](#), p.68.

In this vein, Torsten Slok, Chief Economist at Apollo Global Management, [has graphically illustrated](#) the evolution of daily government interest payments over the past five years. While in 2019 this amount was \$1.0 billion per day, it has now almost doubled (\$1.8 billion).

A final and simple way of looking at it is that, given the current level of federal government debt relative to GDP ([around 120%](#) at the end of the first quarter, excluding local government debt), a 100 basis point increase in interest rates will have a permanent impact of around 100 basis points on the government deficit. Although, as mentioned above, this deficit does not have the same impact as a deficit resulting from handing out money to citizens, it cannot be zero either, given their different marginal propensities to consume.

In conclusion, I do not want to draw the misleading conclusion that because interest rates are high, then the probability of a recession in the coming quarters is zero. I simply want to give our investors an alternative (and, hopefully, more useful) way of thinking about the world. What *I am convinced of is that if these deficits are sustained over time and the Fed*

stays the course with its quantitative tightening programme, sooner or later asset valuations will suffer.

And all of this ties in with the next topic that I wanted to reflect on, which is none other than current valuations.

At the risk of sounding like a broken record, the valuations of most developed economy market equity indices (with the possible exception of the UK and a few other countries) remain at the highest levels in history, regardless of [which metric is used](#) (sales, gross margins, profits, Tobin's q) and which normalisation factor is applied (CAPE, last year's earnings, forward earnings, etc.). Historical experience shows that excessive valuations always lead to poor future returns, due to the simple fact of financial mathematics, which shows that one of the determinants of returns is the original purchase price.

What is most surprising, however, is not that valuations are in bubble territory, but that valuations are at the same level as in 2021 (which was already dramatically high), but with substantially higher interest rates. Clearly, the rise in interest rates has not had the effect that conventional financial theory would suggest. The other monetary variables through which central banks implement monetary policy, such as the size of their balance sheet, have also been more restrictive in relative terms compared to 2021 (although [disagreement](#) among analysts on this point), adding more unknowns as to what may be behind all this speculative process.

I would like to pause to analyse the role that investor psychology may be playing in this whole process. This is not a subject I like to talk about lightly, especially given my background as a macroeconomist (in macroeconomics we like to think that by modelling a few aggregate variables we can understand the behaviour of many other variables) and the fact that the effects of psychology on the economy are generally difficult to quantify.

On this last point, a branch of economics known as experimental economics, popularised by the economist Vernon Smith (who shared the 2002 Nobel Prize in Economics with Daniel Kahneman), has made great strides in recent decades in studying the formation of asset prices under laboratory conditions. For the purposes of this letter, I will only mention some of the findings of experimental economics on the formation of financial asset prices.

The classic experiment consists of gathering a group of participants, giving them an initial endowment of cash (say, dollars) and shares (not all receive the same ratio of cash to shares, but they do receive the same monetary value), and letting them buy and sell freely. The experiments last for fifteen rounds. At the beginning of each round, participants start trading their assets, and at the end of the round all the trades are tallied and the average price at which the trades occurred is calculated.

The key to understanding why such experiments are so illustrative is the way in which potential stock returns are determined. It is assumed that the stock pays a random dividend in each round, and that at the end of the fifteen rounds the stock has no residual value; in other words, the stock is only valuable in terms of the dividends it pays.² The most typical form usually adopted by those designing the experiment is to assume that the stock dividends follow the following probability function:

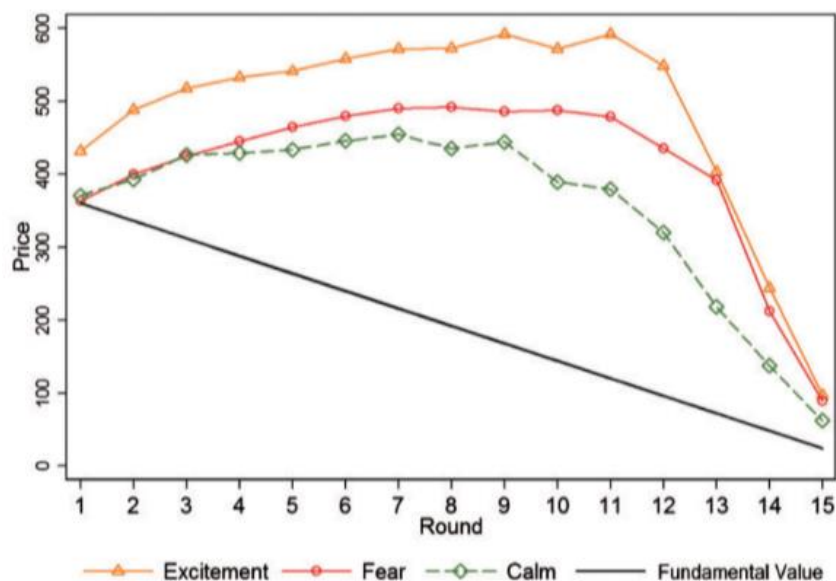
² In fact, as there are no interest rates or discount rates (the fifteen rounds are played back-to-back), the experiment is considerably simplified by relieving participants of the tedious task of discounting future dividends.

Dividend	Probability
0	25%
8	25%
28	25%
60	25%

That is, in each round, the expected dividend is \$24. It doesn't take a genius to work out that the intrinsic value of this simple stock at the start of the game should be $\$24 \times 15 = \360 , and that this value will drop monotonically over the rounds by the amount of the average dividend.

What is really interesting about these experiments is that *this simple setup leads participants to make erroneous valuations of the asset* – and by a huge margin.

For example, the graph below shows one such experiment, the results of which were published in 2016. The descending black line shows what the intrinsic value should be in each round of the game, while the other lines show the participants' current behaviour. The green line shows the bubble that would occur in a neutral emotional state for the participants. As the game progresses, the bubble swells more and more in terms relative to the intrinsic value of the stock, until in round 9 the average price participants are willing to pay is \$400, while the intrinsic value is around \$175, implying an overvaluation of 2.3 times!



Source: Andrade et al. (2016), Bubbling with Excitement: An Experiment, p.453.

The results are even more grotesque if at the beginning of the experiment the participants are subjected to tests that increase their level of euphoria (yellow line) or fear (red line). In these cases, the bubbles inflate further and take longer to adjust; in fact, they never quite adjust, since in the last round, for example, the average price at which trades are executed is around \$100, compared with an intrinsic value of \$24 (the expected value of a single dividend).

Curiously, even in a state of fear, participants are susceptible to being swept up in the collective euphoria – the fear of missing out effect in all its glory!

Experimental economics has conducted many such games in recent decades, using small variations in the initial setup of the experiment to determine the extent to which certain factors determine the behaviour of bubbles. Some of the main factors that have been documented to facilitate the emergence, size and intensity of a bubble are:

- The proportion of experienced versus inexperienced participants. Obviously, the more people participate in the experiment, the more accurate their stock valuations become.
- A more uncertain statistical distribution of the dividend.
- A statistical distribution of the dividend that includes the probability, albeit small, of outsize potential returns.
- Buying on margin is allowed.
- Interestingly, the possibility of short selling. Although short sellers tend to have a better understanding of the fundamental price of the stock in these experiments, they tend to start shorting very early, and then have to cover their losses at the peak of the bubble, which is thus prolonged over time.

The results of these experiments have profound implications for the functioning of markets in the real world because, as we have seen, bubbles can form even in simple environments. It is obviously difficult to know the extent to which any of these conditions are present in the real world, but I have no doubt that after a decade of easy money, financial market participants are clearly feeling exuberant.

I also believe that there are other factors behind the gains in equity indices so far this year. The proportion of people with little experience in the markets may be higher than ever (as evidenced by the rise of platforms such as Robin Hood and the retail investor), uncertainty is high (geopolitics, viruses, supply chains etc), the ability to buy and sell assets with highly skewed statistical distributions is also at high levels (as evidenced by the recent casino around the buy/sell of zero days to expiry options) and finally short sellers who have recently thrown in the towel by having to close out their positions.

Experimental economics can tell us why a bubble is forming, but unfortunately it cannot tell us how long it will last. In my view, and as I explain below, *the best way to protect ourselves from these events is simply to be invested in assets that are free of these dynamics and in which we have confidence that their intrinsic value will continue to rise over time.*

Main additions to the portfolio

During the first six months, the main additions to the portfolio were Asbury Automotive (ABG:US), Auto Partner (APR:PW) and Northeast Bank (NBN:US). Having outlined our investment thesis for the automotive distribution segment in previous letters, in this letter I will present a detailed investment thesis for the first bank I have added to the portfolio since the Fund's inception. Given the current opportunities across the spectrum of US financials created by fears of further banking panics, *I do not rule out increasing our exposure to the sector in the coming months, through both equity and fixed income instruments.*

Northeast Bank (NBN:US)

The recent failures of Silicon Valley Bank, Signature Bank, First Republic Bank and Credit Suisse have probably been the most significant events of the first half of 2023. The panic caused by the overnight collapse of these institutions has created interesting opportunities, especially in the US. In my view, the fears stem primarily from three main concerns. First, the possibility of further losses in government bond portfolios if interest rates continue to rise. The second is the financial health of loans backed by commercial real estate, as this segment has suffered from the work-from-home dynamic brought about by Covid, and many properties are expected to be unable to service the debt – especially in the office segment. The final concern is further runs on deposits, forcing banks to have to sell their assets at a discount and crystallise their losses.

While all these issues are eminently reasonable concerns, they are at the same time perfectly analysable with the information that banks are required to provide to their investors on a regular basis. In quarterly and annual reports, banks provide a detailed breakdown of their loan portfolios, losses in their bond portfolios and the types of deposits – and, in some cases, the share of deposits that fall below the \$250,000 threshold, the maximum amount covered by the US deposit insurance.

Many investors will argue that even with this information, banks are, in the end, a "black box", in the sense that while you have aggregate statistics on the loan portfolio, but you don't know the loans one by one. While there is some truth to this, I cannot help but feel some sympathy for the banking business because, in a way, the asset management business is similar, since mutual fund investors could raise the same argument against us, fund managers. When an institutional investor throws up his hands in the air and complains about the complexity of a bank, he does not realise that this is how his own investors sometimes feel the same way.

The bottom line is that *the most important aspect of looking at a bank is its corporate culture*. An excellent management team will have more rigorous underwriting standards than the competition, it will minimise losses in its bond portfolio, and it will build a strong deposit franchise that will allow it to fund itself at a lower cost.

In many cases, the letters written by the executives of these entities (as a personal letter writer, this is yet another reason for my sympathy) give an inside view of how they think on a day-to-day basis.

For example, the following excerpt comes from the letter Rene Jones, CEO of M&T Bank, wrote to his shareholders in February 2022. This is what Jones had to say about the unattractiveness of investing in government bonds at the time:

“A core operating tenet at M&T has always been to avoid reaching beyond our purpose and taking on too much risk, which can be in the form of credit risk from aggressive growth in loans or from fluctuations in interest rates. With a lack of loan demand during the year, many peers chose to invest a greater proportion of their excess cash into investment securities. It is notable that during the year, we chose to avoid following suit given the historically low rates of interest that did not seem to compensate us for the risk that rates might rise in the future. In essence, we decided it was better to hold our fire. A hypothetical \$10 billion

invested in a three-year U.S. Treasury bond yielding 16 basis points at the start of 2021 would have earned \$3 million in incremental interest income during the year; however, that would have been accompanied by a \$234 million decline in market value and thus a reduction in equity, as rates came off their lows. We made this conscious decision to avoid risking our shareholders' equity and, ultimately, we believe that they will appreciate that patience."

M&T is not only one of the largest regional banks in the US, but it also has one of the best track records of shareholder value creation since the 1980s, largely thanks to its extraordinary corporate culture, as can be seen from the extract above. Such a culture also transpires when one looks at the tenure of its top managers.

While Morris Shapiro's statement that there are more banks than bankers is true, M&T is not the only case of a well-run financial institution: in the United States it is possible to identify several financial firms with these characteristics, from banks to credit card companies to investment funds to auto lenders.

With this general introduction, we can now turn to the bank that has joined our portfolio in recent months. As I will argue, this institution more than meets all the criteria we have listed so far: rigorous credit process, no losses in its bond portfolio, no problems with potential deposit flight and one of the best management teams in North America.

Northeast Bank (NBN:US) is a US regional bank based in Maine. Although the bank was founded in 1872, its history was mediocre until a decade ago. During the Global Financial Crisis, the bank's financial situation was precarious, given the small scale of its operations and the losses it suffered on its loan portfolio.

It was in 2010 that the story relevant to us began. Rick Wayne, a banker with an extraordinary track record of creating shareholder value over the previous two decades, took control of NBN along with other investors to implement the same strategy he had pursued at Capital Crossing, his previous company: buying discounted commercial real estate loans from other banks in the secondary market.

To give an idea of the return Rick generated while at the helm of Capital Crossing, *the annualised rate of return he achieved from 1988 to 2007 was 23%, selling the bank to Lehman Brothers at the height of the housing bubble at a valuation of three times book value.* After his non-compete agreement with Lehman expired, Rick and his team went back into business with the acquisition of NBN.

Since 2010, Rick and his team have pursued the same strategy of buying commercial real estate loans at a discount and have also proven to be a very astute and opportunistic team when opportunities have arisen.

During the pandemic, the bank joined the Paycheck Protection Programme (PPP).³ Banks participating in the PPP acted as intermediaries between the government and small businesses, channelling loans and earning modest "correspondent fees" in the process. For most banks, the programme was cumbersome because of the paperwork involved and also

³ The PPP was an aid programme under which the US government gave low-interest loans to small businesses, which were not required to repay the loans in full as long as they were earmarked for a number of items – such as paying wages or rent.

carried some reputational risk – e.g., possible fraud by the company receiving the loan. In short, it was not worth the effort. For NBN, however, it was a once-in-a-lifetime opportunity, becoming *one of the most active banks nationwide in the programme*: in total, it brokered some \$14 billion, an incredible amount for such a small bank with \$1 trillion in assets at the time. Not only did NBN earn high correspondent fees for its size, but it was able to sell these loans at a profit afterwards. NBN's return on equity (ROE) was 35% in 2021 and 20% in 2022.

More recently, the opportunism of Rick and his team has been again demonstrated in the acquisition of heavily discounted loan portfolios late last year (which I explain below) and in the two unsuccessful bids he launched to acquire the assets of [Silicon Valley Bank](#) and [Signature Bank](#) (I'm not kidding).

The central part of the investment thesis is to understand why the business of buying loans in the secondary market is attractive, and then to understand why NBN, being legally a bank, can implement this business model on more favourable terms than if it had a different organisational structure – for example, a credit fund.

Firstly, NBN's underwriting philosophy when buying/originating a loan is simple and based on sound principles. NBN only considers loan portfolios where the underlying assets are cash generative, have no credit problems and have a strong repayment history. They never make loans backed by land or when the business is linked to construction or real estate development, as in their experience these are more difficult to value. One of the advantages of buying loans on the secondary market is that NBNs often have a better understanding of the quality of the underlying asset than the original lender, as the asset already has a credit history behind it.

Second, NBN's small size allows it to reach segments of the market with less access to funding, as large banks place little value on relationships with these smaller borrowers. At the end of the last quarter, NBN's loan portfolio was \$2.5 billion, spread over 4,656 loans, with an average loan size of \$539k. Other institutions, such as private credit funds, tend not to compete for small loans, preferring to acquire larger portfolios in one fell swoop. On the other hand, the small local banks against which NBN competes tend not to venture beyond their limited area of influence, avoiding buying loan portfolios where the collateral is highly diversified geographically.

Thirdly, although I have not yet mentioned it, NBN originates new loans as well as buying them on the secondary market. Having both activities under the same roof is another source of competitive advantage, as *the skills required to underwrite a loan are the same in both cases and, moreover, the two activities have very different profiles during an economic cycle*: in times of expansion, the opportunities for origination are greater than for acquisition, while in times of recession the reverse is true.

Finally, *the key element of NBN's strategy is its structure as a bank, a competitive advantage that I believe will be long-lasting* compared to credit funds with similar strategies. First, the cost of NBN's liabilities is lower than that of credit funds, as the latter have higher return expectations, allowing NBN to make better bids for creditworthy loans. Second, the reputational (and operational) risk of selling to a fund rather than a bank is important to banks (especially if the bank wants to maintain the future relationship with the customer). Finally, and most importantly, NBN's liabilities can grow quickly as opportunities arise through the issuance of certificates of deposit and its access to Federal

Home Loan Bank (FHLB) advances. Although these are more expensive sources of funding than a traditional deposit, the high-yielding assets that NBN acquires allow the interest margin to be higher than that of a traditional bank.

Conversely, if there are no investment opportunities available, NBN can return the advances to the FHLB and let its certificates of deposit mature, unlike a mutual fund, which has permanent capital and is under pressure to be always invested, regardless of market opportunities.

NBN's accordion-like balance sheet flexibility has been in action recently. In just nine months, NBN has grown its loan portfolio from \$1.3 billion to \$2.5 billion. Most of these acquisitions have occurred between November and December 2022, when Rick and his team took the opportunity to acquire high-quality commercial real estate loans that were purchased at a discount given the recent interest rate hikes. Currently, the average discount on the loan portfolio stands at 11.5%.

One of the most important red flags when looking at a bank is whether or not its asset growth has been rapid or not, as high asset growth could indicate a loosening of credit standards. However, despite the fact that NBN's asset growth has been rapid, I believe the credit quality will be very strong for a number of reasons. First, NBN's track record in this regard is outstanding, *with cumulative net charge-offs of only \$5.3m (!) from 2012 to 2022*. Second, the average LTV of the portfolio was 47% at the end of the last quarter. Finally, other portfolio statistics, such as the seasoning of the portfolio and the number of repayments that have occurred to date, are also very favourable.

In terms of valuation, it may be instructive to understand the bank's earnings power after the heavy acquisitions. Last quarter, earnings per share were \$1.7, which would be \$6.8 on an annualised basis. Given that I expect credit losses to be moderate going forward, I believe this figure is fairly representative of what the bank will earn going forward. At current prices, it would imply a P/E multiple of 6.2x.

Another way of looking at this is that the bank has a track record of 15 % ROEs and is trading at 1x book value. Depending on the rates of return demanded by investors, it would not be unreasonable to expect NBN to trade at twice book value in the future, a realistic estimate given its performance, future growth, and management team.

In any case, while these "short-term" valuations may be interesting, they do not allow us to see the forest for the trees, as these numbers do not consider the opportunities that will arise for Rick and his team over the coming years. Given the current macroeconomic environment, I am convinced that they will be manifold, either through additional purchases of loan portfolios, acquisitions of other banks or share buybacks – an option that Rick has used profusely in the past. I estimate IRRs of 15-20% on our investment over the next five years.

Main divestments in the first half

In line with the Fund's low turnover philosophy, we made only three divestments during the first half of the year: North Media, Naspers and LGI Homes. We closed the first one at a loss and the other two at a profit. In the case of North Media and LGI Homes, the main reason for selling was that the original investment thesis did not go as planned.

North Media's business has been severely impacted by the sharp rise in paper prices and by investments in the online real estate business. Both effects only have a short-term impact and should not be a reason to sell if one has a longer investment horizon. However, the capital allocation is far from optimal, as management has not taken the opportunity to buy back a substantial portion of the outstanding shares despite the falling price. Although the company has a stock portfolio that has created value over the long term, they have no role in the operation of North Media's business and, again, could have been sold to implement an ambitious buyback programme.

Finally, the sale of Naspers after a year and a half of investment was driven by the valuation of the shares and the investment opportunities now available to us. As a reminder, the Naspers investment was based solely on the opportunity to access the shares of Tencent, one of the highest barrier-to-entry businesses in the world, at a discount. Since our investment, Tencent shares have lost approximately 20% of their value while our Naspers shares have gained approximately 40%, closing a large part of the valuation gap.

Although Naspers shares continue to trade at a discount to Tencent's value and management is incentivised to reduce the discount (as evidenced by the simplification of cross-shareholdings between Naspers and Prosus that is about to take place), over time Naspers' valuation will become more dependent on the other businesses – *to which I do not want to have any exposure*, as I have no view on them. If Tencent shares continue to languish in the future, I would not rule out re-establishing a position in the company, but this time on a direct basis.

As always, I thank you for your trust and support, and I will be happy to answer any questions you may have.

Nullius in verba,

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