Interior. Brøndums annexe. Ca. 1920. Detail.
Anna Ancher, one of the Skagen painters.
The picture is owned by the Skagens Museum.

SKAGEN Tellus

2 January 2011

Portfolio manager Torgeir Høien

SKAGEN funds

What is SKAGEN Tellus?

- SKAGEN Tellus, established at the end of September 2006, is an actively managed global bond fund with a very broad macro mandate that invests in securities and currencies considered to give our unit holders the best risk adjusted return.
- The fund, which has euro as a reference currency, is only invested in sovereign bonds. The portfolio consists of both developed and emerging market bonds.
- Based on proprietary research and extensive analytical coverage of global markets, we seek to find bonds and currencies that are mispriced in global markets.
- The fund is managed by Torgeir Høien, who has been a portfolio manager with SKAGEN Funds since 2005.

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The numbers in a nutshell

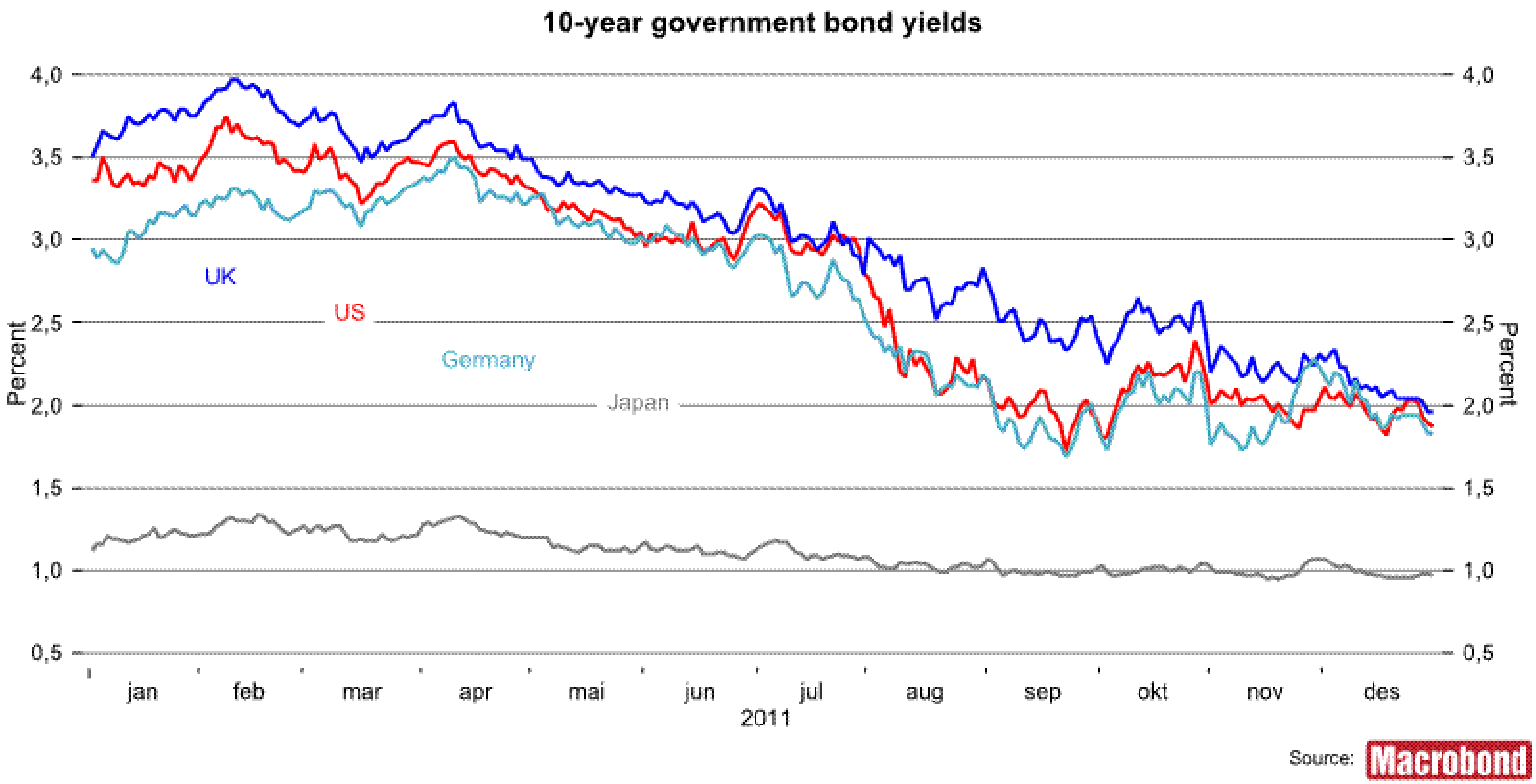
- SKAGEN Tellus' net asset value increased 2.8 percent in December as measured in EUR.
- The benchmark index* gained 3.9 percent last month, also measured in EUR.
- In 2011 SKAGEN Tellus was down 0.7 percent, while the benchmark was up 7.8 percent.
- At the end of December the fund's net yield was 2.4 percent and the portfolio's average duration was 3.0 years.
- Since inception in September 2006 the fund has had an annualized return of 5.6 percent, while the index has delivered an annual return of 6.6 percent.
- Volatility as measured by standard deviation has been 7.4 percent for the fund since its inception. years. The benchmark had a standard deviation of 8.7 percent in the same period.
- The fund's Sharpe ratio has been 0.4, versus 0.46 for the benchmark index since the fund's inception. The Information Ratio for the fund has been -0.1

* The benchmark index is Barclays' Global Treasury Index, 3-5 Years Duration.

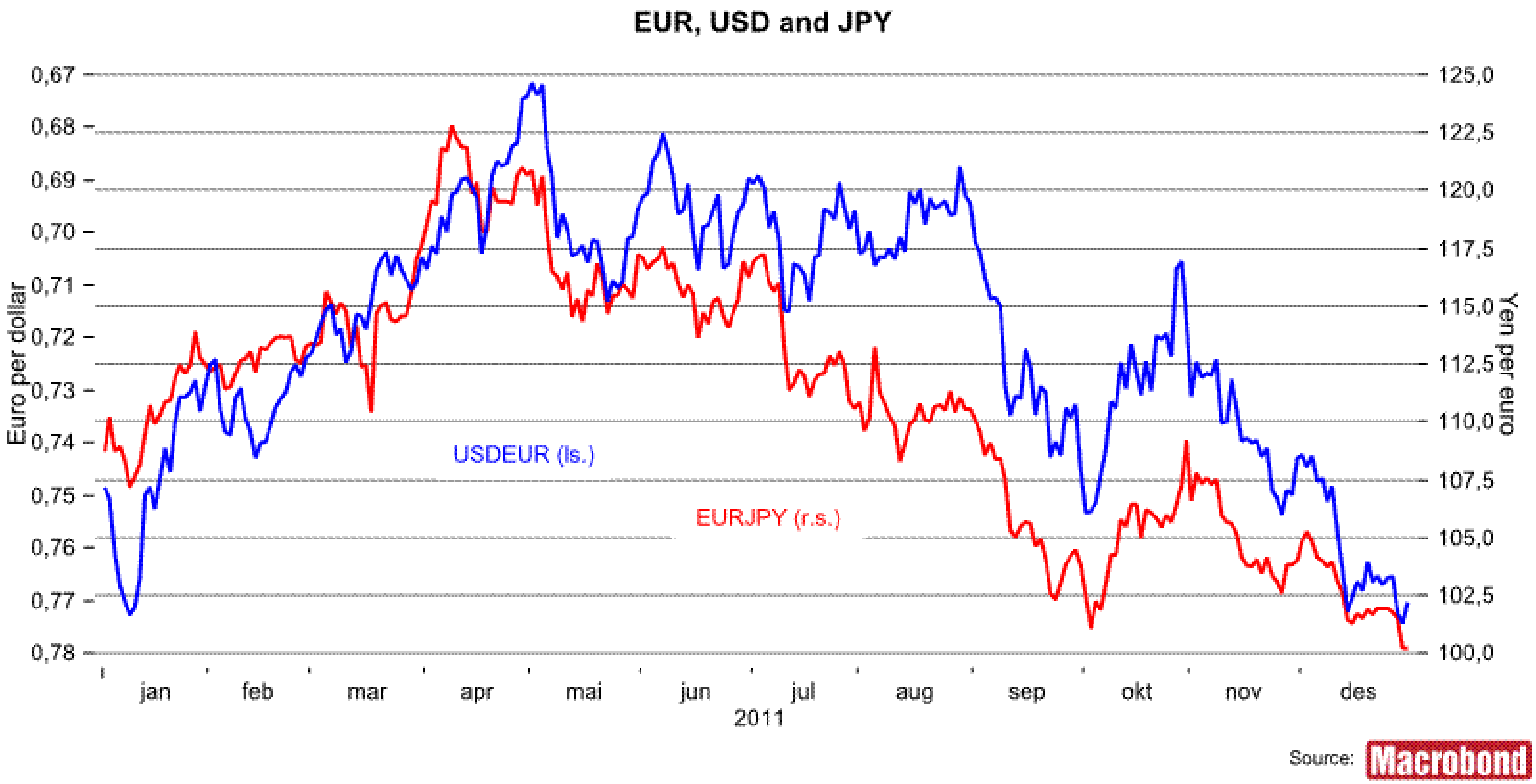
How did we get it so wrong?

- SKAGEN Tellus, to our and our clients' disappointment, vastly underperformed the fund's benchmark index in 2011. How come?
- At the end of the second half of 2011 we cut the duration of the fund, by scaling back our duration in advanced market sovereign bonds. This proved to be a mistake, as yields plunged and ended at record lows in some markets. As bond prices surge when interest rates drop, this pushed up the benchmark index and we were unable to join the bond party.
- We chose to reduce duration because we thought that the prospects for advanced economies would be better than turned out to be the case. Although leading indicators fell much more sharply than the hard numbers, economic growth came in slightly lower during the second half of 2011 than we had expected. Also, we worried about the state of public finances in many advanced nations. But as the Eurozone debt crisis unfolded – accelerating faster in the second half of last year than we had anticipated – shaky public finances in Japan, the US and the UK did not impact their sovereign debts' status as safe havens.
- Moreover, the Japanese yen, which has a substantial weight in the benchmark index, gained about 10 percent versus the euro in 2011, and we did not hold any yen-denominated bonds in our portfolio. In our view Japanese public finances are out on a limb, and it is only a matter of time before we see a major uptick in yields in combination with higher inflation and a depreciation of the yen. This did not happen in 2011, however, and we lost by not seeking out the same Asian safe haven as many other investors did.
- 2011 was the second year since SKAGEN Tellus' inception that we have lost out to the benchmark index. The previous year was 2008.
- There is no doubt that navigating in sovereign bonds and currency markets has been a difficult task since the financial crisis began in 2007. And while we do not expect plain sailing in 2012, we do expect that hard-won experience will enable us to navigate the waters better this year than in 2011. Our aim is to give our unit holders a decent return on their capital and to make up for lost ground relative to the benchmark index.

What we missed out on



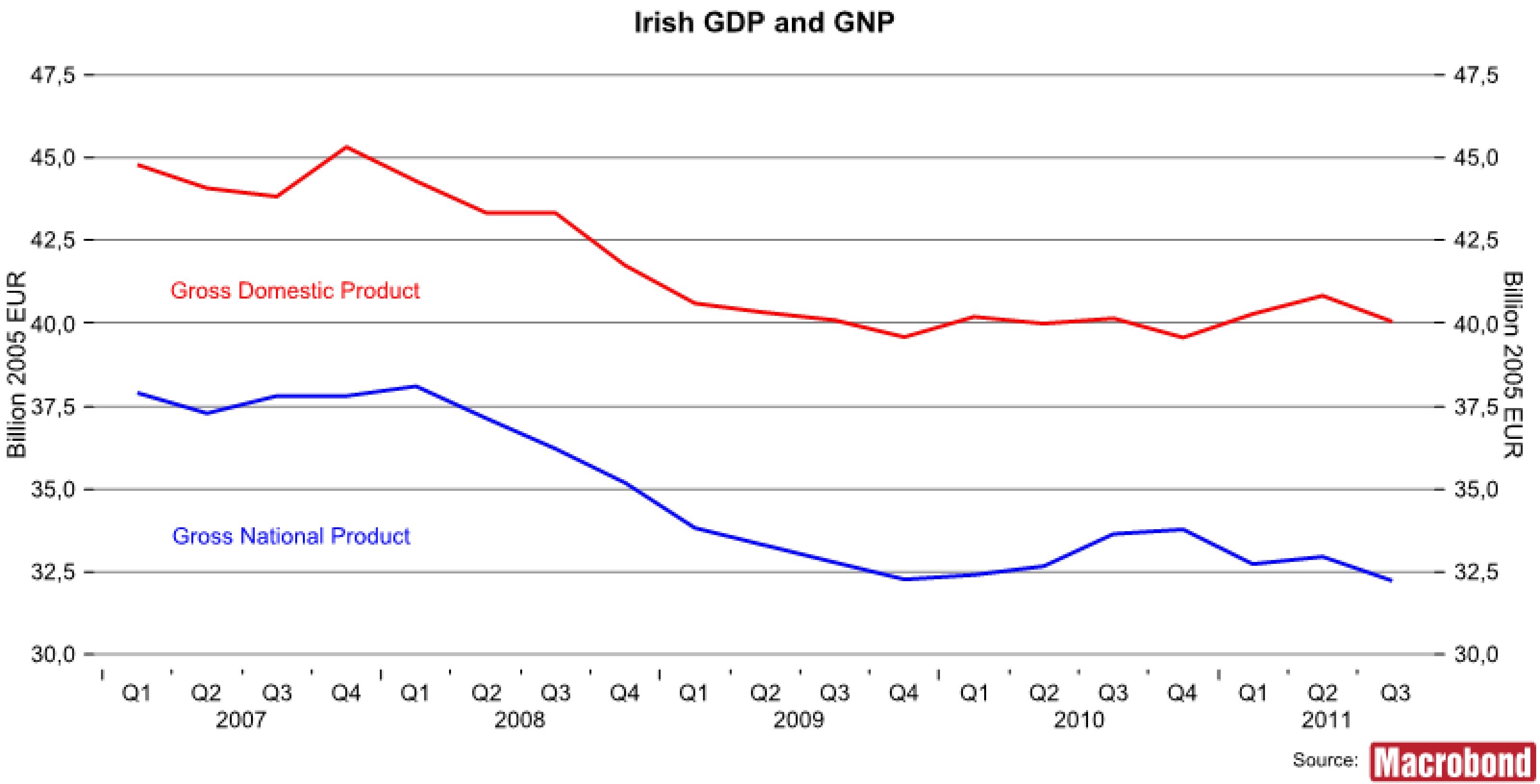
The three major currencies in 2011



Portfolio changes in December

- We only made one major change to the portfolio in December.
- The one major change was to sell our holding of a long-term Irish sovereign bond, which at the start of the month accounted for 4.9 percent of the portfolio. We decided to sell our position based on a rapid deterioration of the Irish economy in the second half of 2011 and a bleaker outlook for 2012. The negative growth rate for Q3 was quite stark, and when measured by the amount of value added by labour and capital owned by Irish citizens, i.e. Gross National Product, the economy is now almost back to where it was after the recession in 2009. (See chart overleaf).
- Ireland started last year on the right footing, but the small open economy fared worse as the outlook for the global economy weakened. Weaker growth means less room for higher government revenues and therefore a stronger credit risk for the Irish state. Ireland is in “bail-out” programs, but meagre growth and less rapid adjustment of the fiscal stance, mean that the risk of “private sector involvement”, i.e. a haircut imposed upon private holders of Irish sovereign debt, is greater. The EU has said that Greece is a special case, and that haircuts will not be applicable to other cases, but we are far from sure that this will continue to be the case as the crisis unfolds.
- The ECB’s new round of long-term financing of Eurozone banks is helping some of the sovereigns since the banks use ECB funds to finance purchases of sovereign debt. But the ECB’s program is tailored more for Italy and Spain than for the original peripherals, and it also is set to have the largest impact on relative short-term debt.
- We also sold off a small position in a Russian sovereign bond due to higher political risk and an expected slowdown of the Russian economy in combination with worsening terms of trade. We used the proceeds from these two sales to finance a proportional increase in the fund’s other investments.

The Irish economy since 2007



Our major bets going into 2012

- According to our calculations the euro is overvalued relative to the US dollar. Hence we are overweight in dollar and underweight in euro relative to the benchmark index. We still think that the Japanese yen – to say nothing of Japanese bond prices – is overvalued, and we are not exposed to yen-denominated instruments.

- Within Europe our only long position is in Slovakia, where the fund holds a bond that matures in 2020. Slovakia's public finances are solid, with net public debt at 25 percent of GDP and a primary deficit of 1.9 percent of GDP in 2012 as estimated by the IMF. Slovakian banks also have little exposure to the periphery of the Eurozone.

- We continue to find most value in long-term emerging market bonds. In fact, we think that 2012 will see a convergence between developed markets' and emerging markets' sovereign bonds. The point is that many emerging markets now finance their public sector using bonds issued in domestic currency. And both their debt levels and deficits are often more "advanced" than in most advanced economies. Domestic currency bonds coupled with independent central banks that target a low and stable inflation rate, vastly reduce long-term interest and currency volatility.

- Of course, it is important to distinguish between the various emerging markets. In our view the most value, both with respect to bond prices and the potential for currency appreciation, can be found in South Africa, Poland, Brazil, Mexico, Colombia and Turkey. According to our calculations the Taiwanese dollar is the world's most undervalued currency. Thus we continue to be invested at the short end of the Taiwanese yield curve.

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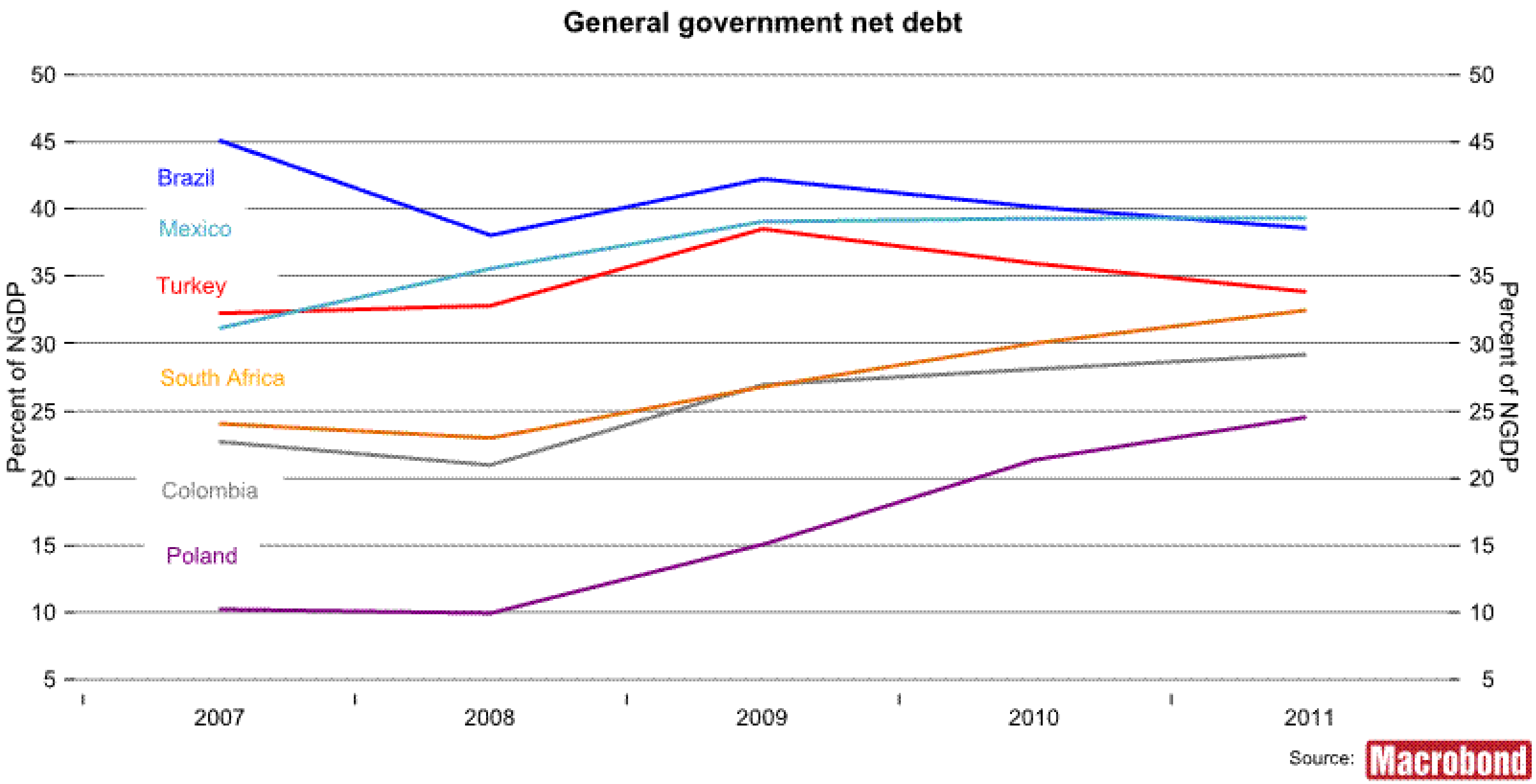
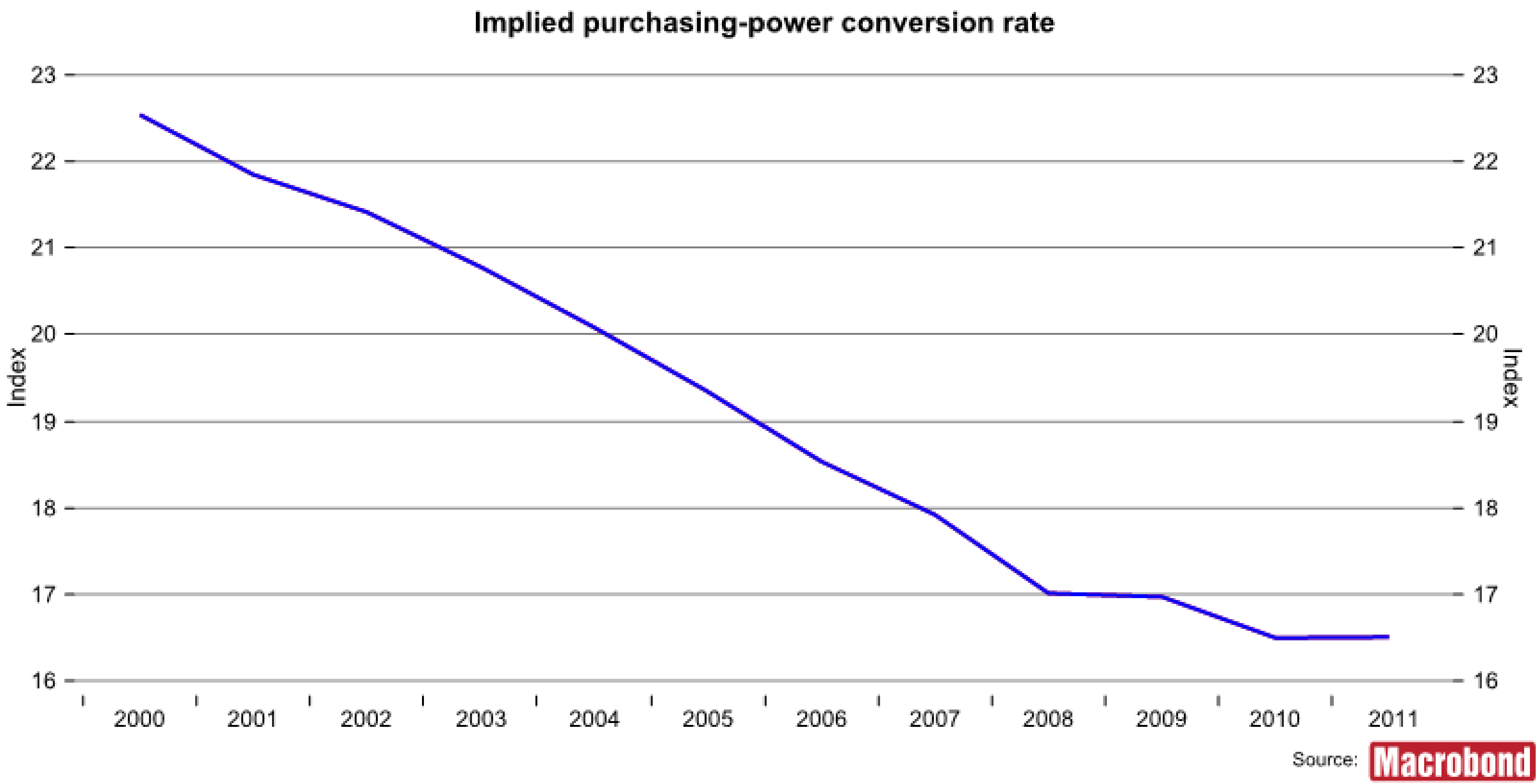
Some emerging markets' public finances are on a solid footing



Why the Taiwanese dollar is undervalued



Portfolio as of 30 December 2011 – page 1 of 2

Paper	Maturity	Yield	S&P-rating	Share
UK Government	2011	0.4%	AAA	7.0%
Finnish Government	2012	0.1%	AAA	6.1%
US Government	2011	0.1%	AA+	5.6%
Norwegian Government	2012	2.1%	AAA	5.6%
Taiwanese Government	2012	0.7%	AA-	5.6%
Canadian Government	2011	0.8%	AAA	5.5%
Slovakian Government	2020	5.4%	A+	5.5%
EBRD (CNY)	2015	1.9%	AAA	5.3%
South-African Government	2036	9.1%	A	5.2%
Hong Kong Government	2012	0.2%	AAA	5.0%

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Portfolio as of 30 December 2011 – page 2 of 2

Paper	Maturity	Yield	S&P-rating	Share
Polish Government	2021	5.6%	A	4,9%
Australian Government	2012	4.1%	AAA	4.7%
Lithuanian Government (USD)	2020	6.0%	BBB	4.5%
Brazilian Government	2028	8.8%	A-	4.3%
Mexican Government	2036	8.1%	A-	4.0%
Swedish Government	2012	1.6%	AAA	3.8%
Colombian Government	2021	5.2%	BBB+	3.6%
US Government	2013	0.2%	AA	3.4%
Turkish Government	2020	10.0%	BB+	3.2%
Swedish Government	2012	2.0%	AAA	2.9%
Net cash (mostly USD)				4.4%

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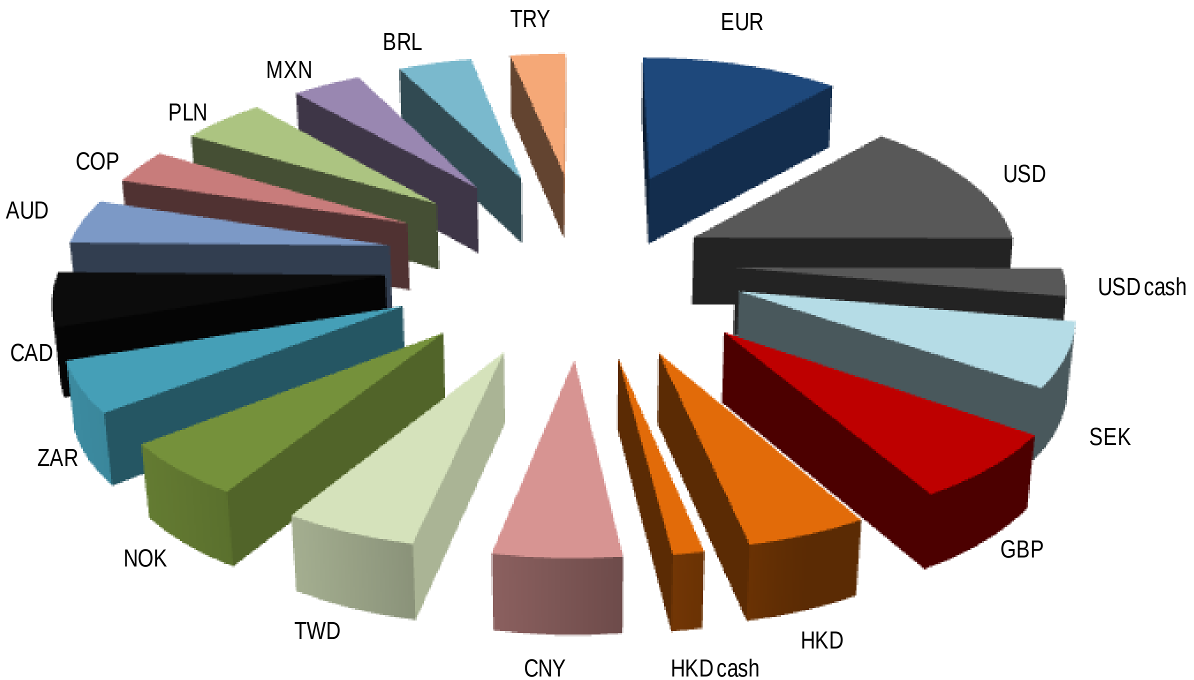
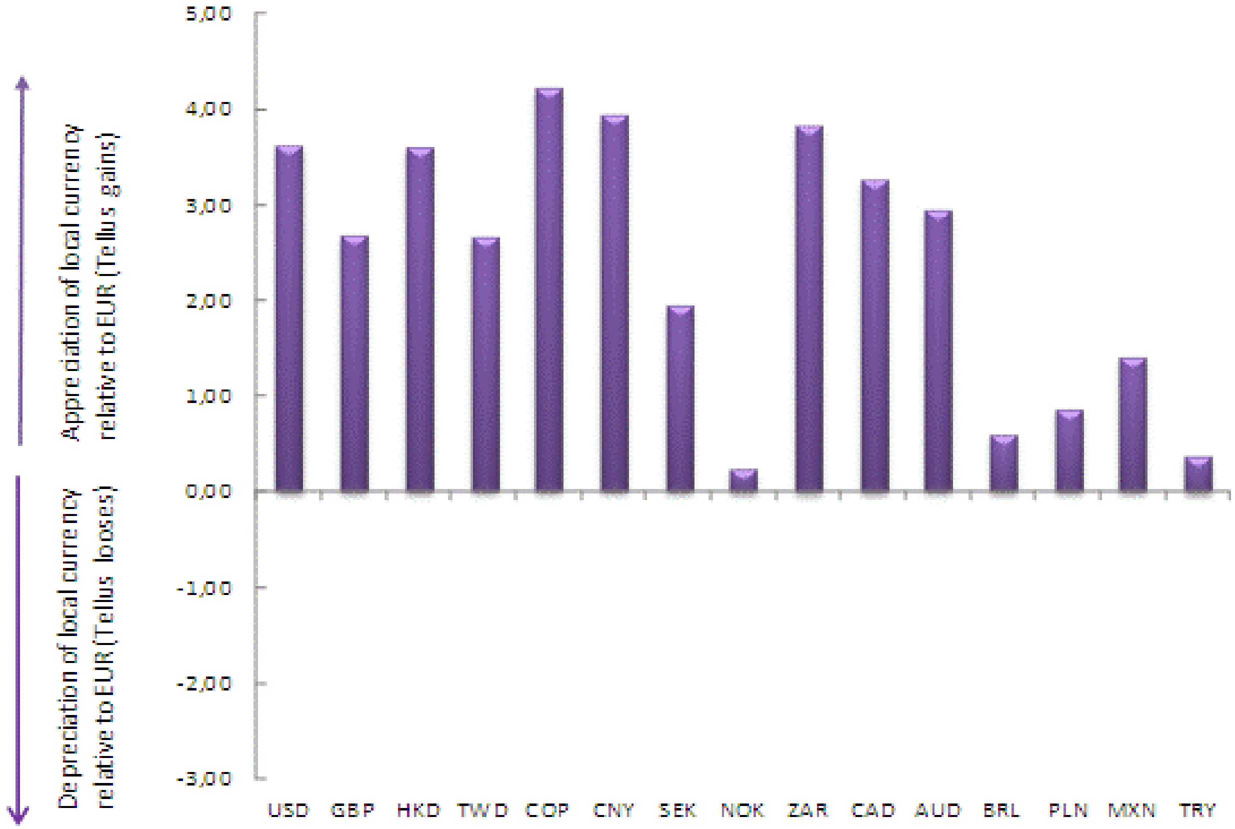
The currency composition of the fund on 30 December



Currency gains and losses relative to EUR in December



Working target for the next 36 months

- Although it has increased lately, we still have quite a low yield in the fund. As of 30 December the yield was 2.4 percent.

- We have set a rather modest target for the next 36 months. Though short-term interest will begin to normalise in the major economies in this period, we expect the process to be gradual. As our overall duration is low, due to low duration in our developed market investments, a rise in short-term interest rates will quite quickly translate into higher returns in the fund.

- We do expect capital gains where we have entered the long end of the yield curve. As explained above, these positions are mostly centred on emerging markets. Also, we should be able to cash in on our currency positions. In sum we target an annual return of 5 percent per year over the next 36 months.

- It should be noted that SKAGEN Tellus, as a global bond fund, does take substantial risk. Hence the fund's NAV will be volatile and there may be periods of negative return, as has been the case in 2011. Investors are advised to have an investment horizon of at least one year or more.

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For more information

- Please refer to:
  - Our latest Market report
  - Follow our macroeconomic analysis Economy at a Glance
  - Information on SKAGEN Tellus on our web pages

The yield refers to the current yield that the fund receives for its interest rate holdings measured as a percentage of the fund's value. The yield is net of the fund's management fee. The fund's future returns will be a function of the current yield that the fund receives, capital gains and losses from the fund's holdings in bonds and certificates, as well as any gains and losses from currency exposure linked to foreign holdings. Also, the yield on inflation protected securities does not incorporate expected inflation. The fund's future returns must be expected to differ from the fund's yield.

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