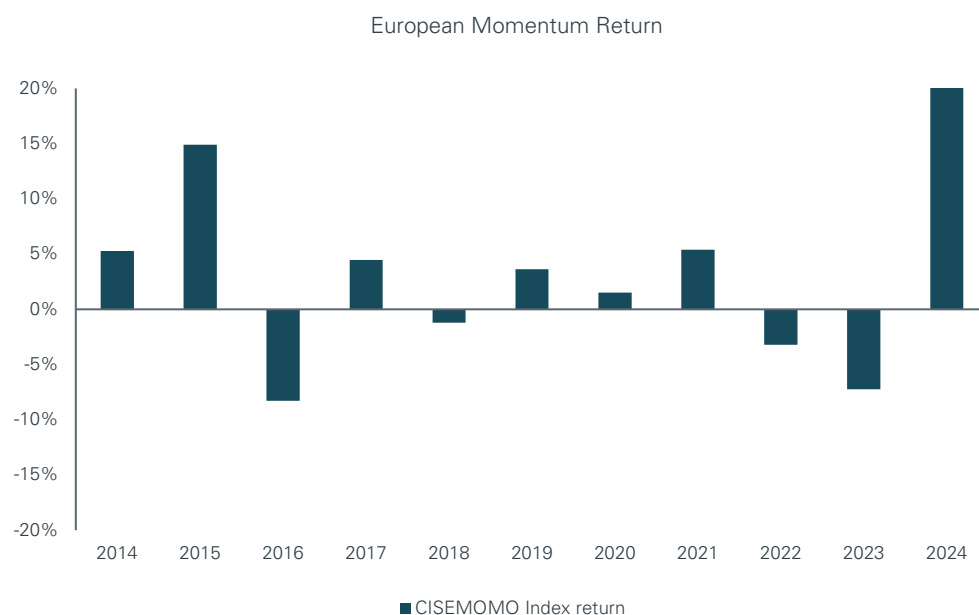


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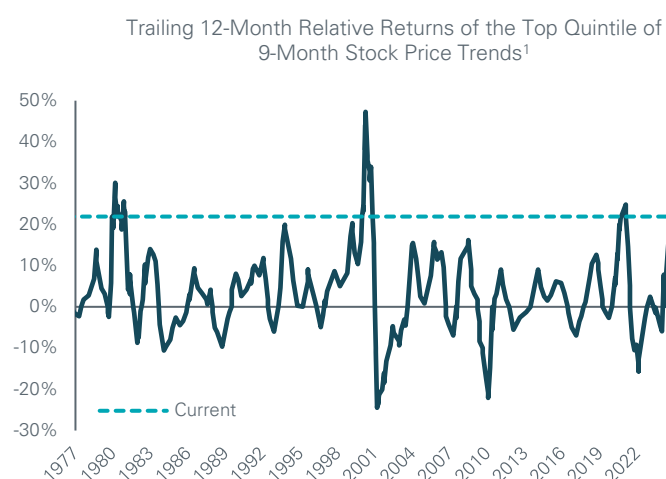
Fourth Quarter Letter 2024

Introduction

The funds lagged equity benchmarks, a disappointing result. The largest drivers of equity returns came from price and earnings momentum; our valuation predicated approach was unhelpful against this backdrop. The scale of momentum outperformance was pronounced by historical standards:

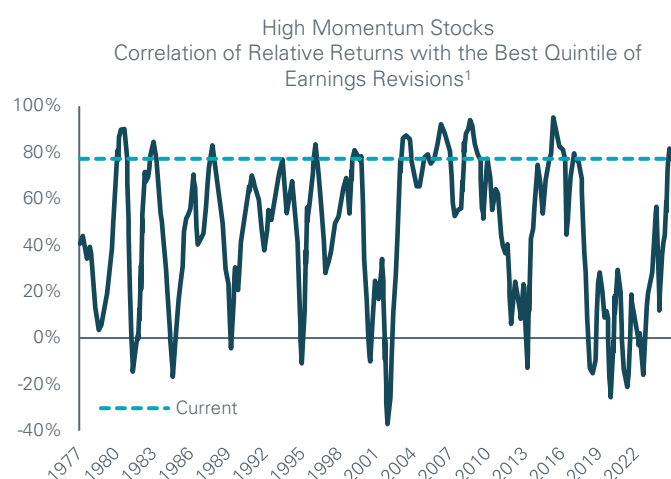


Source: Bloomberg



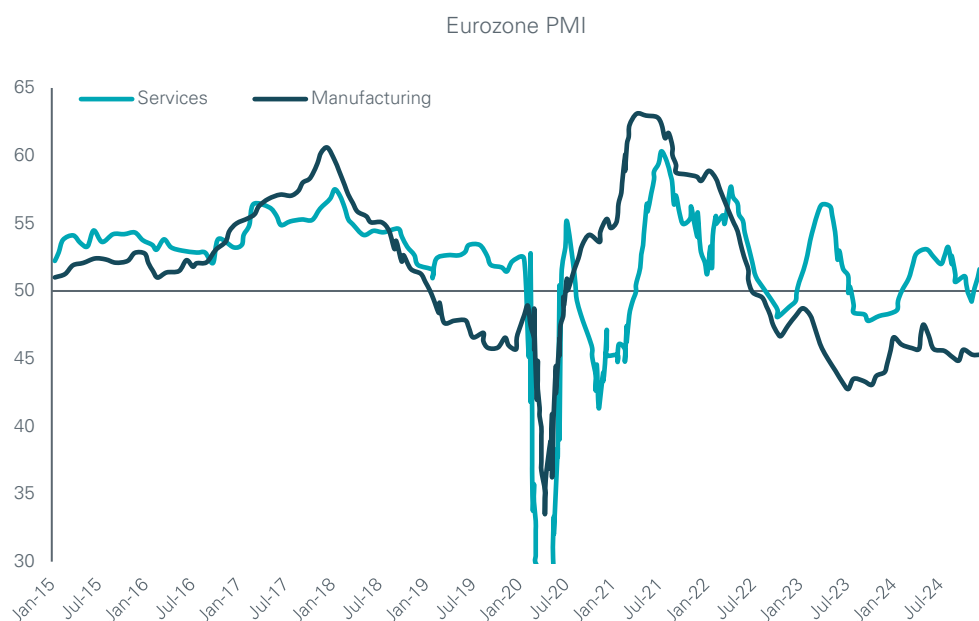
¹Large-capitalisation stocks, capitalisation-weighted data smoothed on a trailing 3-month basis, 1953 through mid-December 2024.

Source: National Bureau of Economic Research, Empirical Research Partners



¹Large-capitalisation stocks in the top quintile of 9-month stock price momentum, capitalisation-weighted data measured over the trailing 12 months and smoothed on a trailing 3-month basis, 1977 through mid-December 2024. Source: Empirical Research Partners

In particular, cyclical stocks behaved as if near term pressures were persistent. Typically, cyclical equities see the multiple expand into downgrades: indeed they usually start to outperform coterminously with the downgrade cycle. In 2024, however, they followed earnings as if those were embedded in terminal values. Moving in lockstep implies that near term conditions will persist into perpetuity; this is doubly puzzling given depressed starting levels of economic activity:

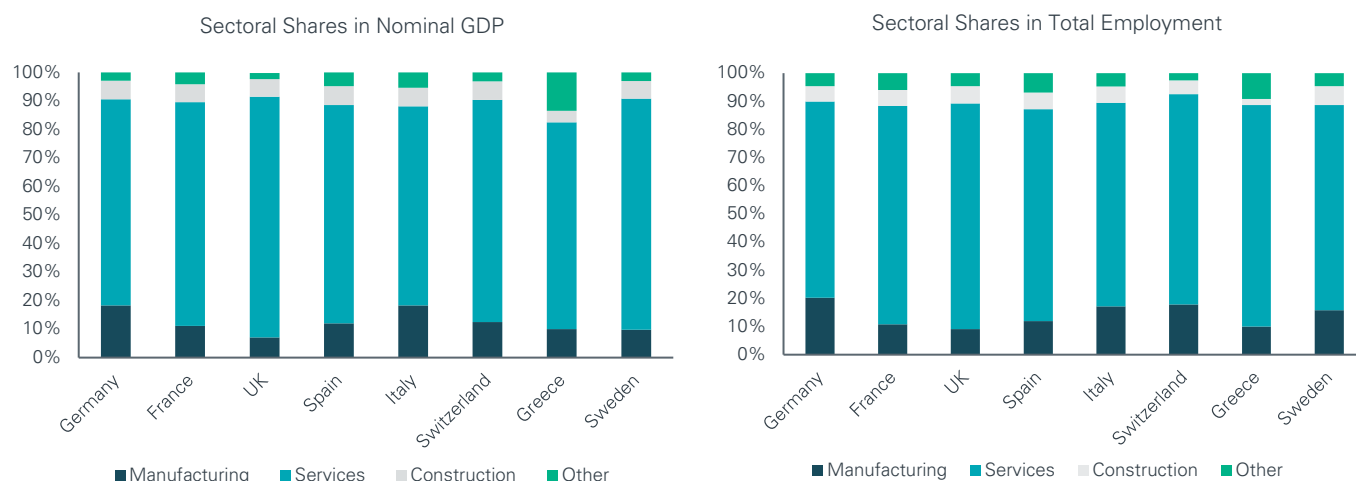


Source: WIND, Bloomberg, Datastream, Indeed.com, BNP Paribas Exane estimates

We have been caught offside by this lack of discounting, in particular in mid-cap assets where investor disinterest is most pronounced. In truth we think this is the most likely explanatory factor: Europe is so reviled as a domicile that the normal investing patterns are not applying. Digging a little deeper into the proximate causes of the lack of valuation support and resultant earnings momentum and terminal value opportunity, we see a few potential drivers worth considering:

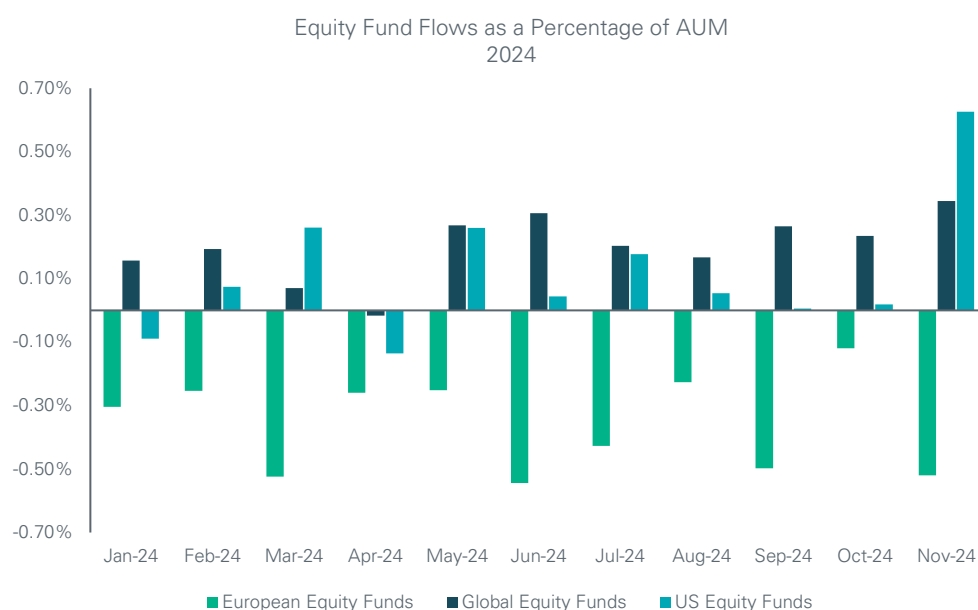
- i) The length of the downcycle in manufacturing (30 months at this stage) and the oddity of the post Covid economic environment lead investors to believe it to be structural, and hence price near term earnings moves into terminal multiples. This has been an extraordinary period in Europe, with simultaneous hits from a war, the largest real income squeeze since the 1970's, rising interest rates, Chinese economic pressures (both demand falling and export supply rising) and a massive post-Covid inventory destocking all combining to dampen demand. Investor timeframes are short, and the conclusion is that cyclical conditions are in fact structural; hence narratives around de-industrialisation and so forth. We address reasons for optimism later in this section – many of these impacts are moving from headwinds to tailwinds – but their longevity strains investor patience, a limited commodity at the best of times. It is also worth pointing out that even domestically Europe is not a homogenous entity: the core may be struggling but most of the periphery has been growing healthily. Given that a decade ago economies like Spain, Portugal and Greece were deemed to be in terminal and structural decline – and their equities uninvestable – the fact that they have grown throughout the recent period offers some comfort.
- ii) A fear that the Trump administration's declared tariff policies augur worse to come for European economies (ignoring the associated implication that domicile and equity exposures are identical). The impact of tariffs is a complex question and we attempted to address it shortly after the election in a short video: [The Potential Impact of Trump Tariffs](#). On an aggregate economic level they are clearly unhelpful; in the long run especially for the country enacting them. Nearer term the effect on listed equities is more complex and depends on a number of factors: gross margins, margins in local distribution channels, pricing power and substitutes to name a few. We do not believe – other than demand pressures from a simple tax on US consumption – our portfolio to be particularly impacted. A number of countervailing factors seem likely, most significantly FX, which to date would actually drive upgrades. The threat of a hostile US administration is also forcing Europe to change: most obviously the

collapse of the German government because of instability in the coalition around fiscal policy. The deeper aims of the Trump administration, with savings gluts and Chinese overproduction/suppression of real wages, could lead to positive global rebalancing; fiscal change in the European core is an essential part of this. We are sceptical that tariffs are an efficient tool to achieve these complex long run aims, however. Additionally, most economies – even manufacturing oriented trading nations – are more domestic than often assumed:



Source: Goldman Sachs

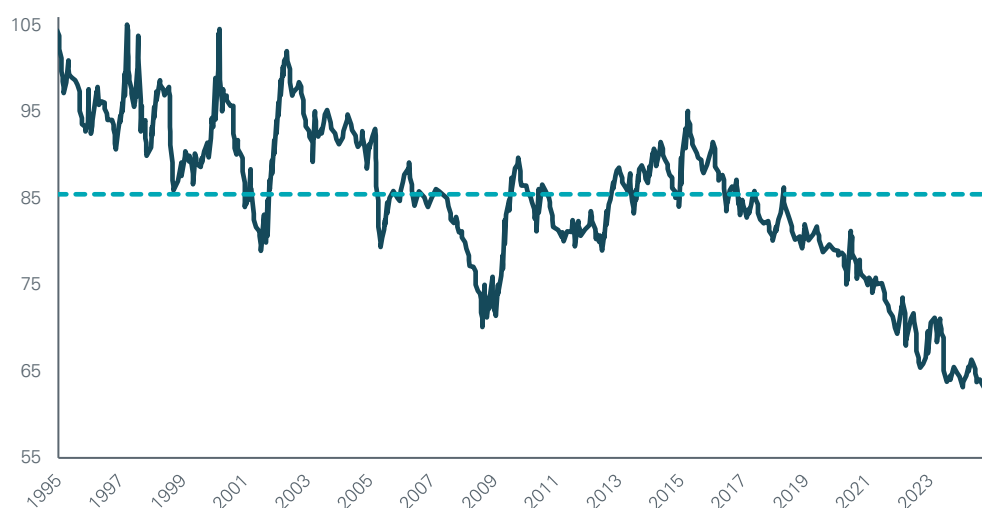
- iii) A changing market structure could be an explanation. Active management continues to suffer material outflows, especially in Europe. Index oriented products, short term and levered investors are gaining share – perhaps a disinterest in mid-caps and valuation is simply about the rise of participants who are indifferent to or unable to capitalise on long duration, valuation oriented strategies.



Source: Citigroup

Whatever the investor rationalisation, this is clearly a top-down and domicile driven pressure on multiples. With only c.40% of the European equity market's sales sourced domestically, even bearishness around local demand does not properly explain the valuation gap or focus on earnings momentum. A postcode discount remains true even in entirely global businesses in a duopoly: Boeing trades at a material premium on EV/S to Airbus despite higher leverage, product issues and a decade plus future disadvantage in production of the growth part of aircraft fleet demand. In fact, it may be structurally compromised in an incredibly long duration industry; the premium is entirely about a US listing. Current conditions are reminiscent of 2000, but with a geographic rather than sectorally led driver of disinterest. The New Economy era was characterised by ebullience in the internet sector, but the oft forgotten corollary was low valuations everywhere else in the so-called Old Economy. Similarly today European equities trade at distressed multiples – on depressed earnings base in a depressed cycle – because investor belief in US hegemony causes them to be dismissed.

Europe Relative to the US
12m Forward P/E Ratio



Source: Citigroup

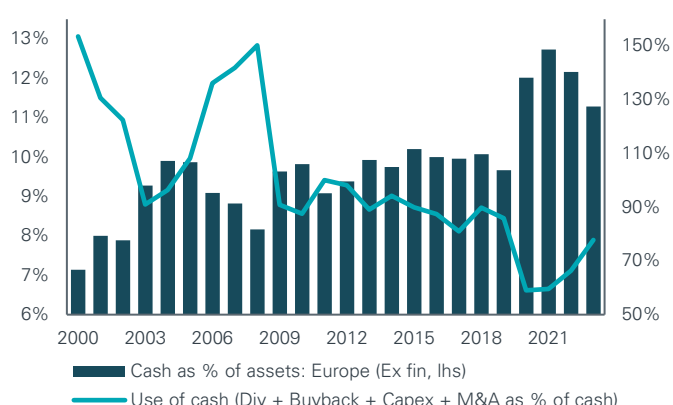
The question is what can turn such sentiment, and we would outline a few potential drivers. One element that is in management's control is capital deployment. The combination of low multiples, high returns on equity and low balance sheet leverage affords the ability for capital return; in particular buybacks. These mechanistically affect earnings momentum, and given today's valuations are highly appealing. High returns on capital at low PE multiples would make such balance sheet deployment accretive and more than simple financial engineering.

MSCI Europe Share Count
Rolling 3-year CAGR



Source: LSEG Data & Analytics, Barclays Research

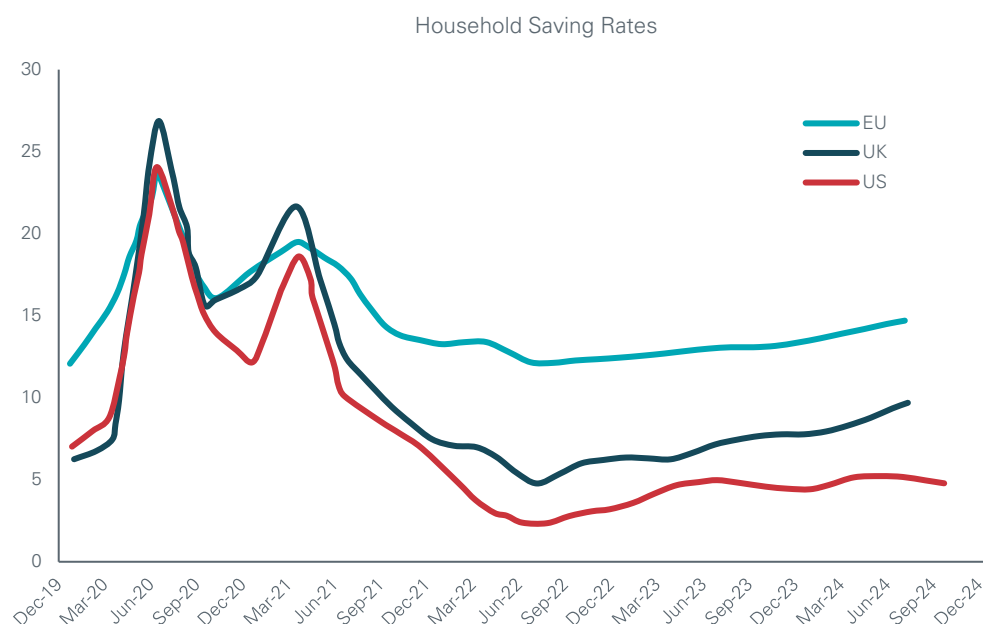
Cash and Use of Cash
MSCI Europe Balance Sheets



Source: LSEG Data & Analytics, IBES, Barclays Research

If corporates are loathe to enact capital returns, they may well have the decision taken out of their hands. Given the high quality industrial assets available at low multiples – and the gulf in valuations versus both private market transactions and US listed companies – we would expect more takeovers if such low valuations persist. Finally, and perhaps most importantly, many of the pressures on the economic cycle that have impeded top-lines in Europe are in the process of reversing:

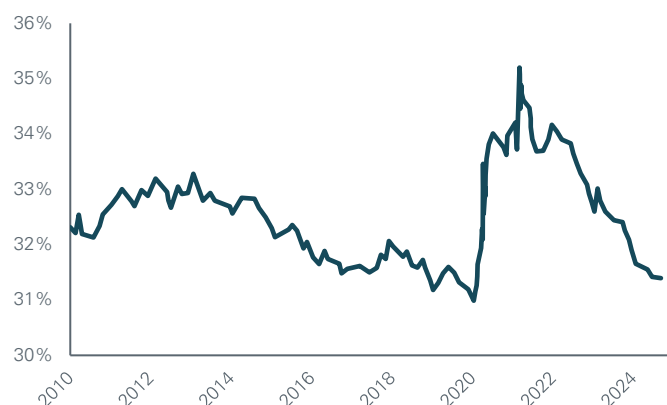
- i) Having suffered the largest squeeze in real wages since the 1970's as a function of the war's impact on gas and electricity prices, real wages in Europe are growing again. Crucially, they are also doing so against an unspent savings build accumulated during Covid, in direct contrast to the US:



Source: Datastream, BNP Paribas Exane estimates

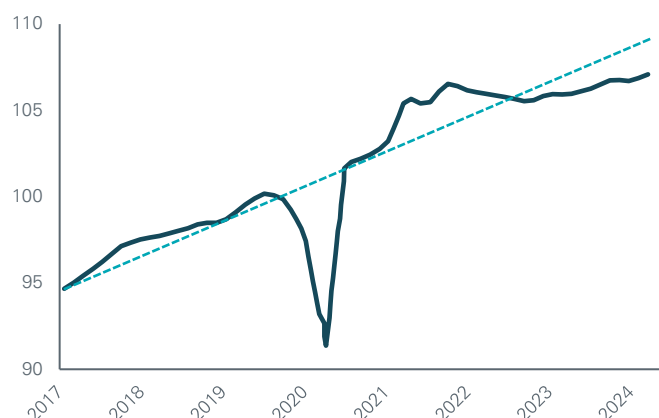
- ii) Fiscal policy has been restrictive and may be about to loosen, both secularly and in response to Trump and defence. [Draghi's paper](#) on EU competitiveness and German electoral shifts are significant. Meanwhile the US has been running huge deficits and pump priming
- iii) China appears to have faced up to the depth of its issues and is attempting to craft a policy response
- iv) Rates are falling: with 70% of European funding through bank loans, this is immediately impactful (again in contrast to the US). The ECB raised rates into a near recession and massive consumer squeeze; this is reversing and is important for economic activity, especially construction and inventory funding
- v) The inventory destock post Covid has been massive and goods/services demand has largely normalised

Personal Consumption Expenditure (PCE) Goods
as a Percentage of Total PCE



Source: Datastream, Bloomberg, BNP Paribas Exane estimates

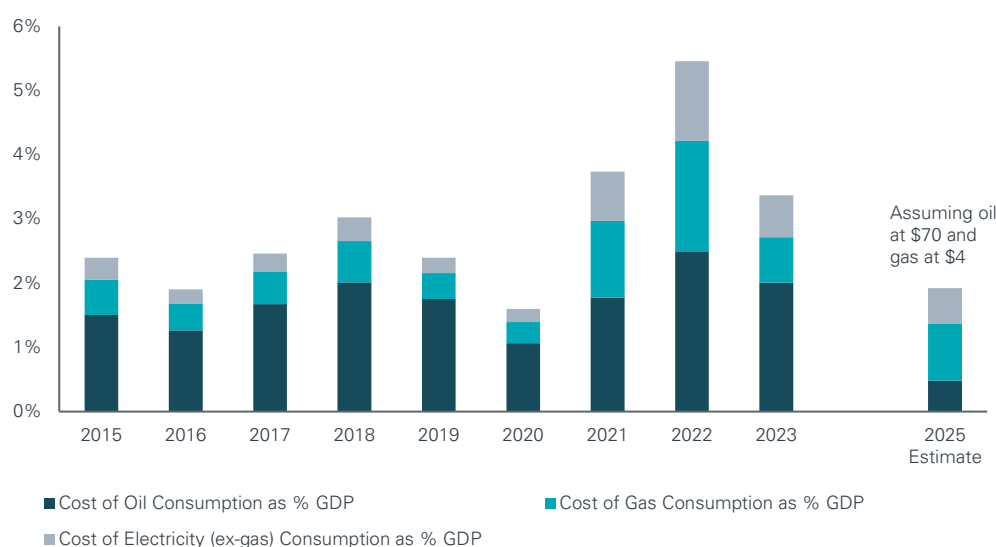
OECD Goods Consumption, pre-Covid = 100



Source: OECD, TS Lombard

- vi) Trump may enact tariffs, but he may also expedite the end to an awful war in Ukraine that has destroyed both industrial sentiment and appetite for European equities
- vii) Gas supply has been hugely impacted by the war but even assuming there is no resolution, market forces are beginning to respond. The best cure for high prices being high prices, the LNG fleet is due to see massive additions: during the period through to 2028 c.30% of incremental capacity is forecast to be coming onstream. Energy price inflation has been a key driver of consumer pressure in Europe as well as the de-industrialisation and structural narrative around Germany in particular. The purchase of large amounts of US gas would also help both energy security and the Trump administration's deal based narratives around global trade.

Cost of Energy in Europe as a Percentage of GDP



Source: Citigroup

One stock that illustrates the hold that earnings momentum has had over equity returns in 2024 is Zalando, the European market leader in online clothing in both B2C and B2B. We have discussed the investment in prior letters, but the key drivers of the opportunity are worth re-iterating. A demand boom during Covid and subsequent bust in

online delivery sent the shares soaring and collapsing, drove active customer numbers up and down, and crushed margins because the company (and their competitors) over-ordered inventory and had to clear it through discounting into a weak consumer environment. We saw their underlying dominance as extending through this period of pain, and a potential capital cycle opportunity emerging at low multiples. The industry competitors were not generating cash, Zalando was gaining share in a weak market, had the balance sheet strength to wait out the weak online demand environment, and through cycle the industry should have structural growth characteristics. Meanwhile the equity market – in common with other cyclical assets – simply de-rated the stock alongside earnings momentum. We bought shares earlier in the year below €17. As the topline environment turned for the better – inventory levels and active customer levels normalised from the Covid bullwhip – earnings turned and the stock followed. Today the shares are €30, and almost nothing has changed in the structural prospects for the industry or company on any timeframe longer than a year or so. Only the curve of earnings upgrades matters, and the terminal multiple contracts or expands according to the momentum there; longer term competitive conditions are irrelevant for the moment.

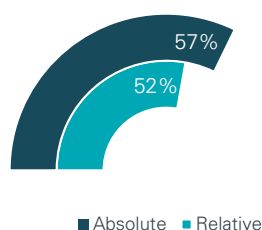
As a result of a focus on earnings and price momentum – and near total investor disinterest in European domiciled equities – the opportunity set is most analogous to that we last found in 2000. The distinction is that then it was mediated by sector, and today it is focused on domicile. Equities listed in Europe where near term operating momentum is weak trade at very depressed multiples, despite pressured levels of demand; stocks seem to trade either trough on trough or peak on peak. Multiples have followed earnings over a short timeframe rather than competitive advantage, returns on capital, management quality or the long-term level of demand. As a consequence – and particularly in the mid-cap space – the question is how to align the portfolio most efficiently with such a fertile opportunity set without making it a single factor bet on negative near term operating momentum versus long run quality.

Review of the Year

The fund had a poor year relative on the long side, underperforming the STOXX Europe 600 Index¹ by c.5%. This negative alpha was largely incurred in January and February, when we failed to keep up with buoyant markets. Much of the source of negative return was factorial; as described in the introduction, market regimes that reward earnings momentum over valuation are unlikely to be favourable to our approach. This thematic was pervasive but intersects with other sources of relative pressure that are worth detailing. Firstly, our positioning was too mid-cap orientated. The European mid-cap index² rose c.5% versus a large-cap return³ of c.9%. This effect was even more pronounced in cyclical sectors: a good proxy would be the DAX which rose nearly 19% versus an MDAX return over the year of -5.7%. Our substantial overweight in mid-caps was a drag; this in turn is difficult to disentangle from valuation as a factor, given the relative cheapness of mid-caps.

Secondly, valuation failing as an anchor meant that skewness was deeply negative. Our hit ratios – whilst low compared to our historically achieved averages – were favourable:

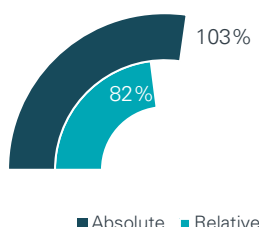
Long Hit Rate - 2024¹



¹ Relative to STOXX Europe 600 Net TR EUR (SXXR), ² STOXX Europe MID 200 Net TR EUR (MCXR), ³ STOXX Europe LARGE 200 Net TR EUR (LCXR). Source: Lancaster IM

However companies that missed earnings from a starting point of low valuations saw no ballast from starting multiples, and underperformed drastically. This is the converse of positive index drivers in a momentum market, and meant that skewness was negative:

Long Slugging Rate - 2024¹



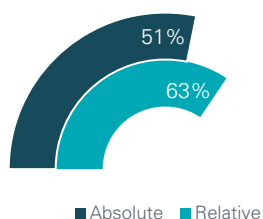
¹ Relative to STOXX Europe 600 Net TR EUR (SXXR). Source: Lancaster IM, Morgan Stanley Fund Services

When cyclicity, negative earnings momentum and the mid-cap factor combined, positions were extremely costly irrespective of valuation starting point: Signify and Spectris are especially pertinent examples. Whilst we rely on valuation more than earnings progression to judge timing, we are of course cognisant of near-term earnings as a risk. This cycle has been tough to forecast relative to prior ones: historical patterns have been less applicable as war and Covid distorted both demand and supply. In this context, it has been harder to predict whether we are early on estimates momentum, and the market has been unforgiving of such mistakes. Valuation has not helped cushion downside asymmetry. We are stylistically early on cyclical names, but in such an environment this has been costly. Similarly, multiples have not offered protection in a momentum market to investments where we over-estimated management's capacity for successful execution (Ubisoft).

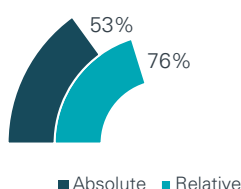
Essentially – whilst hit ratios were acceptable – the balance of outsized losers and winners was out of line with historic averages and hurt fund returns relative.

On the short side of the portfolio we had slightly negative alpha. The composition was not dissimilar to the long side, with hit ratios acceptable, but skewness costly:

Short Hit Rate - 2024¹



Short Slugging Rate - 2024¹



¹ Relative to STOXX Europe 600 Net TR EUR (SXXR). Source: Lancaster IM, Morgan Stanley Fund Services

However, although the composition of returns may be similar in type to the long side, the underlying driver is somewhat distinct. In this case country allocation was problematic; our shorts had alpha against the domestic indices, but being short US stocks against a European benchmark was problematic.

This may simply be recency bias; US markets were exceptionally strong last year, and a rising tide lifted all boats. However, we also believe it to have potential ramifications for our process prospectively. One of the attractions of shorting US stocks has been that the excellent disclosure standards mean that quantitative approaches are more

time efficient, both in screening for and in working through ideas. With a recent addition to the analyst team on the short side, we have more ability to process individual European names where the workflow analytically is complex because of the opacity of accounting. This should mean less of a country mismatch between longs and shorts in exposure terms. We do not mean to imply any diminution in our belief in our ability to continue to generate alpha in both geographies; simply that we can pursue more ideas closer to home, even if the IRR to time of those is less attractive. Prospectively the name count should rise and the relative exposure to US shorts seems likely to fall.

Portfolio Strategy

Given the wide opportunity set resultant from investor disinterest in Europe's equity markets detailed above, the challenge in portfolio construction is how to best express this. The under-valuations on offer may be widespread, but their extent is directly related to the fragility of near-term prospects and perceived (rather than real) vulnerability to tariffs in particular. Mid-cap, cyclical, and high operating leverage equities trade at the lowest multiples, irrespective of long-run growth and return credentials. However, assembling a best in class of these alone leaves the portfolio hostage, particularly to economic factors. As a result, we have attempted to diversify by end markets and company type to the degree possible; and lean on idiosyncratic catalysts to shorten the portfolio's duration and mitigate against a single factor bet, however attractive. Additionally, we have continued to keep the somewhat flatter sizing in place since the beginning of 2022: this insulates against sharp share price movements, extends our hold period, and respects both the number of opportunities and their mid-cap and cyclical character.

One common thematic in our investments has been that sales weakness has driven share price declines; but that underlying margins have held up better than anticipated, given this pressure on demand. Essentially companies are cutting costs and offering operating efficiencies, meaning that despite absolute outcomes being disappointing, margin progression has been better than in similar downcycles. We believe that such changes in internal cost structures augur well for a prolonged period of earnings surprise as and when the demand cycle turns positive – or indeed even flattens out.

We initiated a new position in the quarter in **Howden Joinery**, the UK kitchen manufacturer. Howden is – perhaps surprisingly – a high return business, dominant in a category that doesn't immediately sound attractive. The company has consistently generated a ROIC in excess of 50% going back over 15 years. Founded in 1995, it has adopted a different route to market to existing competitors, focusing on selling to the tradesperson rather than the end consumer. The industry norm had been to operate showrooms and sell to the homeowner directly. This differentiated route to market – alongside scale, local management incentives and production integration – explains their high returns on capital.

Buying a kitchen is a highly expensive, long-term investment for the average consumer. 95% of Howden's business is renovation, 5% new build. With average kitchen lives being 20-25 years, a consumer only makes the decision a couple of times in their lives. Meanwhile the average tradesman installs 25 per year. The consumer is therefore inclined to listen to the tradesperson, and Howden drives its business model towards what matters to the latter. The tradesperson is compensated on a per job basis, so time and labour efficiency are key. Howden makes this simple both via product design and depot density; the company operates 850 depots across the UK. Given the average kitchen has 140 components, availability is vital.

In addition to the pricing advantage of having an end payor who finds it hard to compare true pricing and relies on a channel advisor, Howden further obscures costs via a unique confidential pricing model. Every tradesperson must have an account with Howden to transact, and the price is negotiated with the local depot manager on a kitchen-by-kitchen basis. As kitchens have become more complex, a multi decade shift from DIY to trade installation has also provided a tailwind to Howden's topline.

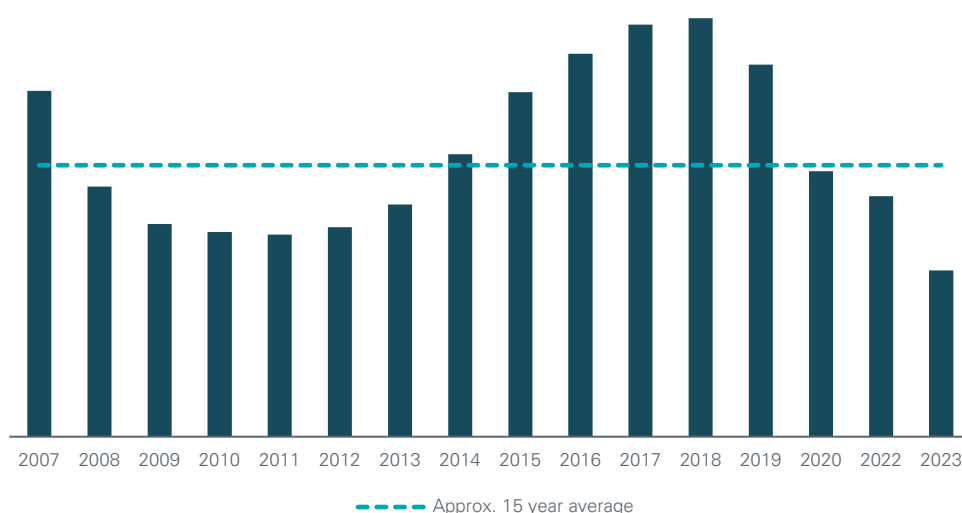
Depot managers – and the responsibility afforded to them in a decentralised model – represent the next pillar of Howden’s success. Whilst the company operates nationally, the tradesperson channel means that this remains a local business. From the company’s foundation onwards, customer facing depots have been decentralised, with local managers given complete P&L responsibility. They are directly incentivised, receiving 5% of gross depot profitability. This alignment means successful managers can earn way in excess of industry averages, allowing retention of the best talent. There is also a clear incentive for front line staff to offer feedback on, and drive innovation in, product design.

Whilst the customer facing elements of the business are local, Howden leverage the benefits of scale in production through a centralised manufacturing, procurement, and supply chain. Today, 35% of product is manufactured internally with a target to get to 50% in a few years. As they dominate the industry vertical with nearly 30% market share in kitchens, the resulting procurement benefits versus other competitors are considerable. Asset turns are also higher given a streamlined, focused supply chain set up to address one niche market.

Competitors have tried to copy the model to compete away excess returns but found it hard even when the company was a great deal smaller. As recounted in Howden’s founder’s book – Matthew Ingle’s amusingly entitled if somewhat dry “Kitchen or Sink” – Travis Perkins bid for the company in 2004. When the bid was turned down, Travis Perkins – themselves a large builders merchant – opened a copycat offering. Despite significant funding this division – Benchmarx – never achieved close to Howden’s volume per depot. 20 years later they have around 3% market share – roughly a tenth of Howden – and have discontinued the opening of new store space.

Howden has consistently taken share in the UK kitchen market since its founding 30 years ago. While share gains accelerated in the post Covid period, pulled forward demand and rising interest rates has resulted in top line being flat in recent years, masking the progress the company has been making. As a result, the equity has de-rated, against the backdrop of an underlying kitchen market that is currently at multi-decade volume lows:

Estimated UK Kitchen Market Volumes



Source: Howden Joinery 1H24 Results Presentation, Slide 62. Management estimates based on: JKMR, Mintel, ONS, Companies House, annual reports, supplier intel, government sources 2020 and 2021 average is shown to smooth the volatility in sales of COVID-19 pandemic

From today’s depressed conditions we think the company can double top line over the next decade, implying a c.7% revenue CAGR, based on:

- i) Underlying market growth in line with UK household formation
- ii) A recovery to mid-cycle volumes in the UK
- iii) Continued share gains – the industry is still highly fragmented, with independents making up 40% of the market
- iv) Product extension into similarly produced offerings down the same distribution channel (e.g., joinery, bedrooms etc)

They also have a fledgling French operation that is currently loss making but is guided to break even in 2026; we view this as a free option. In conclusion, we see the company as a highly dominant, well managed franchise in an unglamorous area whose high return credentials have been forgotten in a moribund post Covid top-line environment. With £340m of net cash on the balance sheet and France marked at zero, Howden is on 11x 2025 EV/EBIT. Given that current UK kitchen volumes are well below GFC lows, the risk reward is compelling for a through cycle compounder.

On the short side of the portfolio we have initiated a position in a **Scandinavian commercial real estate business**. We believe asset quality to be poor and earnings materially overstated; meanwhile leverage is worse than initially apparent. Our concerns are compounded by poor governance, with related party transactions, JV income and poor board independence.

The company appears to be understating vacancy rates. At first glance these seem in line with historic averages; but including terminated leases yet to be vacated they are at the highest level since 2019. Rising rent receivables also show pressure on the underlying cash flows. Year on year to the latest quarter's rent receivables increased from 18.5% of rental income to 24.4%; such an escalation in unpaid rent may speak to tenant distress. Meanwhile an increasing reliance on low quality JV profits to make up earnings shortfalls is troubling; and related party JVs contributed 25% of earnings at the last full balance sheet date, versus only 7% in 2021. Even within this earnings stream quality is falling: to the 9 month stage of 2024 receivables accounted for 50% of JV (and 11% of total group) profits versus a negligible amount in the prior year.

Finally not only are operating earnings degrading in quality, but the balance sheet is weaker than it appears. On a reported basis the LTV is amongst the lowest in the Scandinavian peer group; but when adjusted for D shares and JV debt it is one of the highest. Any further cyclical degradation could see significant pressure from leverage.

Conclusion

Returns to cyclical European equities, in particular mid-caps, have been torrid. A pronounced and prolonged economic downcycle has led investors to conclude that cyclical conditions are structural, a thesis only reinforced by prospective policy choices in the US. However many of the economic headwinds are fading, and large swathes of equities are at historically depressed valuations on depressed earnings. Domicile is not economic exposure; many companies are global leaders in their industries. Corporates are cutting costs which serves to reinforce operating leverage should the cycle attenuate. Momentum markets have meant companies trade either trough on trough or peak on peak; at today's valuations the runway should earnings momentum turn is long, both in underlying cash flows and the multiples ascribed to those. Europe has challenges, but equity markets discount a geographic version of the New Economy's sector driven distortions. Timing any shift in sentiment is exceptionally difficult, but the long term rewards to a valuation driven strategy in a neglected asset class have the potential to be secular in scope.

Contact Details

Lancaster Investment Management
Yalding House, 152-156 Great Portland Street
London, W1W 6AJ

Rory Hayward
rory.hayward@lancasterIM.co.uk
+44 20 7842 1050

Lucy Purslow
lucy.purslow@lancasterIM.co.uk
+44 20 7842 1048

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