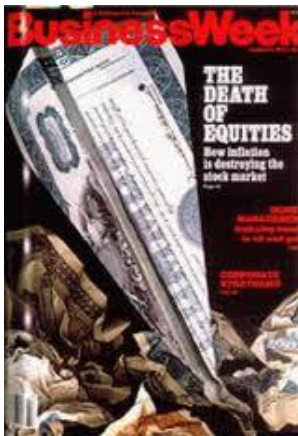


Cycles

"Stock prices have reached what looks like a permanently high plateau. I do not feel there will be soon if ever a 50 or 60 point break from present levels, such as they have predicted. I expect to see the stock market a good deal higher within a few months."

Dr. Irving Fisher, Professor of Economics at Yale University, one of the most important US economists of his day, speaking on October 17, 1929, a few weeks before the Great Crash.



"For better or worse, the U.S. economy probably has to regard the death of equities as a near-permanent condition."

The death of Equities - Business Week cover story, August 13th, 1979 cover business week magazine. The article's timing could not have been worse - over the next 20 years the market returned about 18 percent a year, the greatest bull market in history.

"Warren Buffett should say, 'I'm sorry.' How did he miss the silicon, wireless, DSL, cable, and biotech revolutions?"

Harry Newton, publisher of Technology Investor magazine, in 2000, a few days before Nasdaq Crash

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We never heard of anyone who got rich by following any advice contained in one of the “get rich” books, save, perhaps, for the authors of those books themselves. That being said, we are certain that new “get rich” books will make wonders for their authors and no one else’s pockets. Likewise, we all know that investors, amateurs and professional alike, make a series of rookie mistakes and will continue to make them for decades: they overtrade, because they feel good with the illusion of control. They behave in herds, because they feel safer this way. They assume that what has been happening in the recent past will keep happening very far in the future. And the most destructive of all for their financial futures: they maintain the illusion that they can time the market, avoiding it when it falls and getting back to it right before it rises. So it is not surprising that as a group investors lose money along the way.

Being a gregarious species, it is not such a surprise that financial markets are made of a series of packaged ideas and group thinking. New ideas, when brilliantly packaged, sell fast. If there’s one parallel between the investment world and the diets world is that people hate unpleasant truths. Following what Bernard Shaw once called the “triumph of hope over experience”, they keep looking for and dreaming about the next big idea, that will change their lives without the hassle of too much effort.

Year	Investment Fad	Ibovespa Level	Dow Jones Level
1978	Death of equities	-	805
1985	Conglomerates fever	-	1,546
1988	Japan will take the world	-	2,168
1994	Oh God, rates will rise	4,353	3,831
1999	The internet revolution	17,098	11,453
2000	Dot com crash	15,242	10,790
2002	Enron, rotten account	11,290	8,332
2007	House prices can never fall	63,884	13,261
2008	The world is ending! Sell everything and buy gold!	37,550	8,772

2009	Are we still alive?	68,587	10,430
2011	Will Europe end the World?	56,775	12,221

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1930's to 1940's: Smoking and The Master Cleanse	Lucky Strike Cigarette ad campaign ran an ad that said "Reach for a Lucky Instead of a Sweet."?
1950's: Praying for weight loss	"Pray Your Weight Away," which was published in 1957 was a best-selling book.
1960's: Cabbage Soup Diet and Support Groups	Overeaters Anonymous was formed in the early 60's as well as Weight Watchers in 1963. The Cabbage Soup Diet was also the most popular diet fad at that time.
1970's: Atkins Diet Revolution and Diet Pills	Dr. Atkins Diet Revolution in the 70's began the world's misguided hatred for carbs. Carbs' reputation has never quite recovered from this diet fad.
1980's: Scarsdale Diet	This two-week high-protein, low-carb and calorie diet touted that you could lose up to 20 pounds per week without any long-term deprivation of any vitamins or minerals.
1990's: Low-carb diet	Dr Atkins' diet resurfaced in the 1990's. Suddenly, everywhere you saw food that was promoted as low-carb and high in protein.

In Brazil, if we take the past 10 years of the Bovespa index, we went through the "*end is near*" phase in late 2002 (Ibovespa at 9.000 points, being the buying opportunity of a lifetime), the "*new market bubble*" in 2007 where anyone with a dubious business plan could raise a billion in IPO's, the "*future belongs to Brazil*" thesis in early 2008, the subsequent bear market, and last but not least, the funny phase we all live in 2013.

The new theory goes like this: the Ibovespa is not performing that well but hold on, dear reader, that's not the whole picture: there is not one stock index, but two! The first one, you should know, is made of the "old" Bovespa, with commodities exporters, government interference, inferior governance and suffering from a low-growth world. The "new" index, well, is basically made of ultra-expensive retail companies with no international exposure.

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It escapes our cognitive capacities to understand why should companies with exposure to an economy that grows substantially less than the world's economy as a whole be that much more expensive than companies placed in industries (and there are not many of them) where Brazil has a proven comparative advantage. And that is before we start the discussion about what we think of the overstretched Brazilian consumer and the country's equally overstretched economic model.

With this scenario in mind, over the past few months we have basically positioned ourselves to a world economy rebound, buying cyclical companies at bargain prices plus a few specific stories where we believe that through deep understanding we have found outstanding value. All while keeping an open eye for possible shorts in the retail, consumer and healthcare domestic sectors in Brazil.

Industry	Exposure
Foods	27.06%
Chemicals	22.04%
Fertilizers	21.53%
Metallurgy	19.60%
Logistics	8.69%
Real Estate	1.09%

FCL Equities Composition	
Long	104.95%
Short	(4.21%)
Cash	(1.04%)
Net Long	99.7%

So with so many mistakes being made by investors for so long, we would like to propose a few "immutable truths" (inspired by Buddhism's "noble truths") applied to the investment world:

Truth 1 - Over the long term, the returns of the average investor will converge to the yield of the underlying assets.

Mathematically speaking, there are just two possible ways a stock will rise: either it's earnings will rise or it's valuation (that is, the price / earnings multiple) will increase. Since valuation cannot increase or decrease *ad infinitum*, over the long term, logically, a

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stock will fluctuate around its earning's growth. The reverse logically applies in case of a decreasing stock price.

Warren Buffet famously once said that *"when people forget that with corporate earnings increasing by 6% a year, every time the stock market rises more than that they are signing for a failure"*. We doubt that he had anything related with the 6% early returns figure in his mind. Instead, he was applying the concept that stock returns gravitate around their earnings yield.

That being said, since this letter is about stock cycles, we would like to talk about the cycles we faced in the past two decades. As we all know, the 1990's was a remarkable decade. Stock indexes advanced more than 20% a year, both in the US and in Brazil. And making the mistake we discussed in the beginning of the letter, after this one single decade, analyst expectations for future market returns over the long term increased from 9% on aggregate in 1990 to some 11% in 2000. Of course they are now back to some 8% or even less.

But the real mistake is even worse than that. Since over the long term the stock market **has** to gravitate around it's earnings growth (valuation tends to go back to the mean through euphoria and panic phases), the truth is that the 1990's incredible returns (over 20% a year) and the 2000's dismal returns (less than zero in the US) were interlocked. Having risen much more than the earnings in the previous decade, the stock markets' valuation had to go back to reasonable levels in the following decade.

In the same way, after the 2007 euphoria, the Ibovespa index had to give back part of the 2002-2007 period gains. Likewise, long periods of subpar stock performance, like the 1930's and possibly the 2000's also contain the ingredients for future bull markets as they genuinely make stocks cheaper, adding to future gains.

So we can state a simple rule: every time a stock market rises more than its earnings growth, assuming no eternal change in its valuation, this rise is borrowing from future price appreciation. Likewise, every time a company or the stock market as a whole rises less or falls more than the earnings trend, it is aggregating in future price appreciation. The above mentioned principle is one of the reasons why we are quite optimistic about the Brazilian stock market and the future decade as a whole for financial markets.

Truth 2 - Over the medium term returns will greatly diverge from the mean thanks to different positions in the cycle.

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Having stated that prices should grow no more and no less than the earnings trend in the long run, we have to admit that, of course, prices can have huge deviation from this trend. One interesting thing about the stock market is that its returns are disproportional: a stock can be far away from its fair price for years and rise straight to the fair value in a few days.

Most stock returns are made in a few days. That's why timing the market is near impossible, if you "take vacations from the market", chances are that once you are confident enough to be invested, the best returns will have been already experienced. To achieve really outstanding results you have to be invested all the time. Especially when "*there is blood in the water*", as the saying goes.

The diversion from the mean is of course amplified by credit and business cycles. They matter a lot more than investors realize or care to admit. Adding to the list of investor mistakes, is insisting on chasing GDP growth. The financial industry gives huge headlines to GDP estimations and revisions. But in truth the business cycle and the credit cycle have a closer correlation to market returns.

The idea is really simple: if in *equilibrium*, the return on capital (the profits of businesses) should equal the cost of capital (their borrowing costs). If the return on capital is higher than the cost, there will be great demand for credit and an economic boom will ensue. If the return on capital is lower than the cost, there will be companies going out of business so demand for credit will decrease, making credit cheap once again.

This economic reality is of course amplified by investor's psychology as evidently shown by the much discussed "risk on - risk off" days. Investors' tendency to group assets in classes and believing they have the same attributes despite their micro factors is much stronger in times of stress.

Besides that, the old minskyan idea that a long period of calm and growth makes people believe that the good times will last forever naturally makes people to start to feel inclined to take more risk. So good times contain the seed of their own end and vice versa, as it entail the market's participants to extrapolate the present. So, in good times they leverage things up until everything blows up (2007) and in bad times they capitulate and run for the hills at any price, sowing once again the seed of the next bull market (as in 2009).

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So fluctuations can be huge as they often are but so far we can conclude that long term returns fluctuate around the earnings' growth trend and that deviations around this trend can be expected thanks to *herd behavior*, expectations, the credit and business cycles and so on.

Truth 3 - Investors could do better than that, but most won't.

The conclusion is obvious: since immemorial times, investors and dieters have been looking for a miracle. Something it makes them rich fast, and thin fast. Of course, in any field, beginners are expected to make rookies mistakes. Following self-interested advices and those who don't have "skin in the game" being just one of them. But in both industries, the problems run much deeper. The sad truth is that a series of practical and institutional constraints make the financial industry and it's professionals perform a lot worse than they could.

It was Keynes who once said that "*worldly wisdom teaches us that it is better for reputation to fail conventionally than to succeed unconventionally*", but why is that so? Let's say you just started your career in finance. If you work for a broker you'll be rewarded by how much your clients trade, not how well they do. On the other hand you are an asset manager, you'll likely see huge inflows if you have beaten your benchmark in the past year (or even in the past quarter) and huge outflows if the reverse is true.

Momentum, old and mysterious force that happens in finance, has been even getting stronger lately. In reality, it is quite simple: as the portfolios that have risen recently receive inflows, mere rebalance makes their managers buy additional shares of their favorite stocks, guaranteeing that in the short term what has recently raised keeps rising. Until it doesn't anymore.

And so we can conclude that the old agency problem - the issue with people representing the interest of investors not always having their own interests totally in line with their investors' - makes group thinking so powerful. It is not that (most) fund managers are inept, though some obviously are. It's just that assuming a frontally contrary position to the market can end a career in finance. Better to fail conventionally, as Keynes said.

Despite the fact that so many people track the greatest investors like Buffet, Soros, etc. (and this house is admittedly guilty in this practice) the real secret is not their geniality. What really makes the outstanding ones different than the crowd is the fact that it is

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their money at stake, bundled together with their investors' money. So the agency problem is practically solved. That is the reason why we usually respect fund managers that show this kind of fiduciary role, closing their vehicles for new investments, reducing the size of their funds, and so on. They are usually the ones to have a prominent performance.

And if the truth is that if the moment's idea is packaged and sold in a neat way, the suspicion is that what has been "hot" will usually perform abysmally in the future. That was the case for tech stocks in the NASDAQ and the rushed IPO's in Brazil alike.

The conclusion to our study of cycles is vast, but if we had to summarize it would be as follows:

1) Asset prices should be judged over the long term according to their earnings yield;

2) The power of cycles, the changing of expectations, the extrapolation of expectations to the distant future and consequently, reversion to the mean, are among the most extraordinary forces in the planet;

3) Business and credit cycles matter much more than investors seem to care or admit;

4) The power of incentives makes most financial professionals, terrible investors - better lose conventionally than do the unconventional thing and lose your job or your investors.

So one final question: everyone knows that if someone buys cheap, understands that earnings growth drives prices and doesn't buy fads, this person is supposed to make outstanding returns. Why no one really follows Buffet's investing style? We know tons of investors claim to be "value investors" and swear allegiance to Buffet's wisdom, but in reality very few people have seriously followed his style of very low turnover, concentrated bets, focus on absolute performance, and understanding of business cycles reversion to the mean.

The sad answer is a combination of *herd behavior* with the fact that unlike Buffet, managers have to show quarterly or monthly performances and would lose their investors with bets too far away from the mainstream. It takes someone really far away from the mainstream -as far away as Omaha, Nebraska, apparently- to not be trapped by short term performance focus, high trading to justify

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high fees and focus on what matters. Once again, the agency problems. If we take that perspective, maybe we can even think that more than his investment genius, his unique capital base and lack of pressure to show short term performance were Buffet's and Soros' real secret sauces. At least, in part.

This house believes, admittedly not very humbly, that it can follow the path of many good institutional investors that have avoided the conflicts of interest that arise in asset management. Since our first day, we have focused in long term performance, an aligned base of investors, a solid base of permanent capital, and attention to the power of incentives and a plan to close our fund once a certain capital threshold is reached. It is not trivial but it can be done, and if done properly it can be a tool for the returns we seek to achieve.

About FCL Capital

FCL Capital is an independent investment company, focused on portfolio management, free from conflicts of interest and multiple objectives that has for a mission the preservation and multiplication of its investors' capital, through a thorough financial analysis. Our goal is to generate absolute returns, staying solid and consistent through good and bad periods of the economic cycle.