

FCL*Capital*

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www.fclcapital.com

Different models of cash flow

One of the approaches we like to take when assessing our investment portfolio is to treat our fund as if it was a big company. This is useful over time because it lets us compare not only our invested companies with their peers but also our own portfolio with how it was in the past, in order to answer questions like:

- Does it hold more or less cash than it did historically?
- Is the portfolio cheaper or more expensive according to multiples like EV/EBITDA, P/E, replacement ratios and so on?

Treating our fund like one huge investment helps our long-term view and helps figuring out how comfortable we are to fulfill our only purpose, which is to generate high compounded annual return to our investors over long periods of time.

One question that a few investors have raised is about the lower level of average dividend yield in our portfolio right now. Since our foundation in 2007, probably due to our value framework, we tended to hold a significant number of stocks that had high dividend yield ratios, although this is not an end in itself. It is always important to remember that what matters is present value, not the way the cash flow is paid, be it through capital appreciation or distribution of the company's earnings.

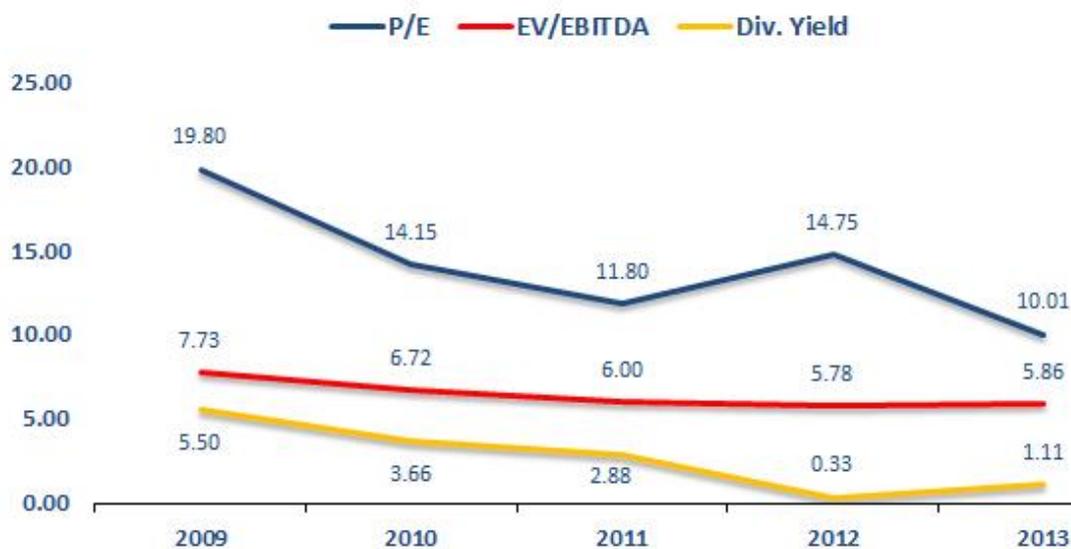
That being said, our temperament and framework has historically kept us away from projects where investors are demanded to pay upfront for a possible future realization of the business potential. This way of thinking may have prevented us from enjoying some good investment opportunities where we judged we didn't have a sufficient degree of knowledge and competitive advantage to control uncertainty, but also has spared us of many unpleasant surprises.

All other variables constant, however, we would prefer to share the capital appreciation of a fast growing company that is still in its expansion phase (and therefore not significantly distributing earnings) than to buy completely mature "cash cows" where we feel market tends to be more efficient since the margin for mistakes is smaller.

With this framework in mind, we were able to buy over the years a few businesses where we saw huge opportunities ahead while the valuations made sense to us and many times made it possible for us to enjoy significant dividend yields at the same time. For a few reasons we are going to explore in this letter, this is not the case anymore.

While we are glad to say that we have a high level of confidence in our current portfolio, which combines huge growth potential with cheap valuations, if our strategy works, the cash flow will be appropriated in an entirely different manner, with dividends not being as significant as they were in the past. In other words, our portfolio currently holds in our opinion as much quality for low prices as it ever has, but not nearly as much dividend yield.

FCL Portfolio - Evolution of Multiples



At year end, except for 2013, utilizing forward multiples and excluding extraordinary items, cash and positions consisting less than 5% of the fund's portfolio.

We are always trying to learn from our mistakes in order to get better as investors, that being said, our approach has not really changed much over the years. We like to invest in ideas that can bring asymmetrical payoff (we don't like to invest in ideas where if everything goes right we get a small payoff), with cheap valuations and a careful assessment of the risks associated to the investment.

One particularity of being based in Brazil is that it is easier to spot market inefficiencies than it is in developed markets. As any value investor, almost by definition we don't subscribe to the "efficient market" hypothesis, but there's no doubt that the Brazilian equity market is way LESS efficient than, say, the US' market.

A good example comes from a conference call I recently had with one of the very few analysts that has an open coverage of Log-In Logística, one of our portfolio investments. As I was reading the analyst's research reports I was getting ready mentally to discuss how and why I disagreed with most of his views and was significantly more optimistic about the company than he was.

When the conference call finally started, however, he confessed that the target price still had not been changed since the departure of the previous analyst in charge of Log-In at this particular brokerage firm. He had been responsible for Log-In's coverage for "only a few months" he said, and had "not particularly looked in depth" at this company.

We have always tried to exploit the competitive advantage we get from emphasizing in companies with lazy and/or not interested sell side coverage, that are not well understood and have a payoff time that the market, with its short term focus in general, feels is too long and therefore doesn't have an incentive to promote and so on, while generally trying to stay away from hollow good intentions, projects or loved companies¹.

¹ BR foods, probably the most loved company nowadays among brazilian asset managers is a good example of an investment idea where we don't share nearly the same optimism as much of the market.

We are not contrarians because it is “cool” to be a contrarian. We have this approach because it allows us to outperform the market with fewer resources than many of our larger competitors. That is why even though we don’t believe in the macro versus micro distinction (macro and micro are in the end one), we will always emphasize in the so called micro.

I once read a well-researched case for going long palladium against platinum for example. It all made sense: palladium is used in converter catalysts in cars that burn gasoline (used in fast growing Asia and North America) while platinum is mostly used in diesel engines (Europe), and even there many applications are starting to use palladium.

So palladium is essentially gaining market share. Moreover, the supply/demand figure pointed to a strong long/short opportunity. But we never made this trade, not only because it is far away from our core competence and mission. Also because of a logical assessment of the situation. We thought: “how many guys are certainly looking at this very moment at palladium and platinum prices in front of their Bloomberg terminals in lots of places in the world?”. Thousands for sure, located wherever, Japan, New York, Thailand, you name it. But how many people really understand Log-In better than we do, apart from the insiders? Without false modesty I would say, very few.

So our contrarian ways lead us, at the moment, to have an unusually non dividend paying portfolio. We all know that in moments of euphoria the market loves everything, but especially the most promising stories with the possibilities of huge paybacks. At the same time, in periods of high uncertainty like the one we are currently experiencing, especially in emerging markets, a high discount is applied to more variable and/or more distant cash flows, even with huge net present values.

In others words, world stock markets are, right now, in our view, attributing a huge premium to any stock that behaves more like a bond.



Source: *The Economist* (June 15th, 2013)

How this “quality bubble” came to life is a long debate but we think there are two main reasons

1) It is a scary world with low yields out there

The 2008 financial crisis is still alive in the minds of many investors, so it is natural to assume the risk appetite may not come back fast. Therefore, investors rushed to anything that generates yield, unfortunately though, yields for fixed income products are at historical lows.

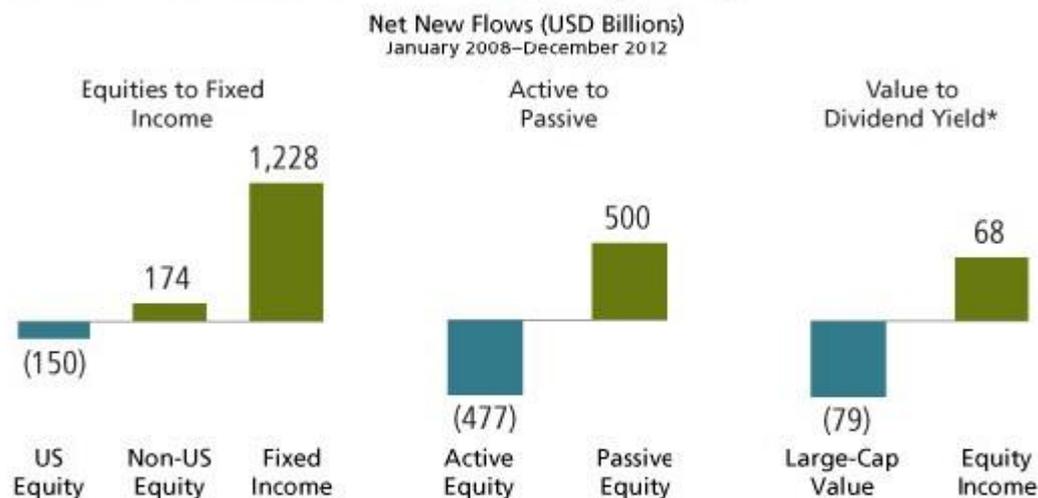
One consequence was that anything that seemed uncorrelated to the stock market, like the art market or real estate funds, experienced a huge increase in investors’ demand. Also, since some of those investors had to have exposure to the stock markets, there was a clear outperformance for anything more “bond-like” with two characteristics: not too risky and generates yields that bonds could not generate.

2) The market always had and always will have fads

From the “nifty fifty’s” of the 1960s, to the “conglomerates mania” of the 1970s and the tech boom of the 1990s, investors proved again and again that they are human beings with herd behavior. After a huge crisis that is still unfolding, it is only logical to assume that the next trend will be to invest in companies with conservative balance-sheets.

It is important to say that there are many good things about investing in conservative companies. We have never invested in over leveraged, distress-like equities. But at a certain price, investments in conservative companies start to become aggressive investments due to the valuations some investors are paying. We think we may be approaching this level.

Investment Flows Have Reflected Lingering Anxiety



As of December 31, 2012
 Historical analysis does not guarantee future results.
 Includes US domiciled mutual funds and ETFs; excludes closed-end funds, sector and specialty equity funds.
 *Based on Lipper categories; large cap value includes US, international and global large cap value;
 equity income includes US, international and global equity income.
 Source: Lipper, Strategic Insight and AllianceBernstein

Source: Institutional Investor Magazine.

Deep Value Protects Against Rising Bond Yields



As of March 31, 2013

*Using the hedged returns in USD based on the Bernstein global large-cap universe of stocks, sorted monthly by price to book value and beta, measuring the difference in returns between the cheapest quintile of stocks (Q1) and universe average and the lowest beta and universe average from January 1, 1971, to February 28, 2013.

Source: Barclays, Bloomberg, Center for Research in Security Prices, MSCI and AllianceBernstein

Source: Institutional Investor Magazine.

Also, let's not forget, quality may mean different things to different investors. And a high dividend yield is not in itself a seal of high quality

If history is any guide, hyped classes of companies, be they conglomerates from the 1970s, tech stocks from the 90s or dividend paying companies now, may disappoint in the future when the valuations are adjusted and new fads emerge to take the place of the old ones.

As any distortion in the market, fundamentals usually reverse to the mean and prices eventually converge to the fundamentals. We think that while some pessimism is justified, (and still concentrating on the micro instead of the macro where we don't have a competitive advantage) our call is that investors' pessimism with the stock markets in general, and emerging stock markets in particular, may have gone too far, with a complete reassessment of how investors think about returns, a decreasing focus on active equity strategies and clear exaggerations in their pessimism about long term equity returns.

In the past couple of years, we have focused in companies where we could see opportunities while having a high degree of understanding and foreseeability when it came to their future cash flows, while at the same time paying a low price for them since in many cases they had a longer payback period with their cash flows still being heavily invested in consolidation (as is the case with Minerva), expansion (Braskem) or even their business had not reached maturity (Log In, Heringer).

We are very happy with our portfolio and think we bought great companies, which we would like to hold for years at attractive prices, in part due to the snub they suffered for not being mature, bond-like, dividend-paying companies.

The market is a discounting machine. Sometimes it breaks down one way or the other, discounting too much or too little depending on trends, efficiency, depth, fear, greed, and several other factors. While making lots of mistakes as any investor would, we try to arbitrate and take advantage of the temporary break downs in the market discounting machine.