

FCL*Capital*

December 2013

www.fclcapital.com

“In investing, what is comfortable is rarely profitable.”
(Robert Arnott)

FCL Capital - Performance	
Year of 2013	+3.37%
Since the fund started (11/21/12)	+3.73%
Since the club started (04/03/07)	+204.12%
Last 5 years, Annualized	+32.91% per year
Since the fund started (11/21/12), Annualized	+3.36% per year
Since the club started (04/03/07), Annualized	+17.87% per year

It is a source of great joy for FCL Capital to have spent another year with the trust and confidence of our investors and to deliver another year of positive performance, even facing adverse markets as Brazilian equity investors have faced over these past three years.

In the past, we used our annual report for sharing ideas and talking about the general trends of our business¹, while leaving the most specific investment related reports for our monthly letters. This year, we decided to make a general assessment of our first years in our annual report.

After almost 6 years as an investment club and a full year as an equity fund, we believe that for the first time our investors have a reasonable time frame to judge our performance, because as time goes by, the compounded annual return becomes less dependent merely on the result of pure chance.

We divided this annual report in 3 parts: in the first one we make a summary of our accumulated performance versus the Ibovespa index and the CDI along the years, discussing the reasons for our outperformance throughout these years. In the second part we make a review of a few significant investments made in these early years and finally, in the final part, we briefly discuss strategy and the future, detailing what we believe are our competitive advantages and therefore, our main sources of alpha.

We wish you all a great year ahead and thank you for your partnership over this past year.

Sincerely,

FCL Team

¹ We specifically recommend the excellent “The world in” series, by the Economist Intelligence Unit.

Part 1 - Performance During Our Early Years

1.1) 2007

We opened the FCL Capital investment club on April 3rd, 2007, amid what was possibly the strongest bull market in the Brazilian equity market's history. Looking back, we judge that timing was a bit unfortunate. A product like ours would almost by definition underperform the market amid so much euphoria, since we invest based on a long-term outlook of the best individual opportunities we can find in the market, have cash almost as a strategic asset, rarely are fully invested, and so on.

During a bull market, momentum and sub-quality stocks are usually the best performers.

On our May 2007 letter, we called attention to what we called excessive euphoria in the Brazilian stock market at that time:

"It is no secret that the Brazilian stock market is heated. Not that this will change our strategy or that there is any doubt that an investor with good stock selection will over time achieve adequate long-term returns. But, certainly in the short term, there seems to be a consensus in most good Brazilian investment houses that obvious investment opportunities in the market are becoming increasingly rare. Greater flow of resources to the same assets generates an increase in asset prices, great for sellers of stocks, but bad for buyers like us"

(Excerpt from FCL Capital's May, 2007 Monthly Letter)

We spent most of that year invested in some long-term positions, one of which we still hold in late 2013, and we were able to achieve a good absolute return (our primary focus), but, as expected, underperforming the equity benchmark.

Accumulated Overperformance, 2007	
FCL Capital x Ibovespa	-17.59%
FCL Capital x CDI	+12.00%

1.2) 2008

During late 2007 and early 2008, some very important investments for our club were bought or sold, like GVT, Estacio and Alpargatas. We were generally very optimistic about a few specific ideas in our portfolio but pessimistic with the valuations most companies were trading at on the stock exchange.

Interestingly, when the international crisis happened in mid-2008, our underperformance compared to the Ibovespa started to disappear, having vanished for good in the next year.

Overall, 2008 was a very important year for us. Thanks to the firesale prices we found in the second half of this year, we were able for the first time ever to become fully invested, with good companies at unbelievable prices and then we turned to countercyclical bullish.

Thanks to the buying we did in 2008, 2009 is still our best year so far. This shows how naive it is to judge a strategy like ours through a short-term perspective. The negative performance of 2008 is the other side of the coin of the fantastic performance of 2009. One wouldn't happen without the other. That is why our

business has an inherently long-term nature.

But, apart from the best buying we ever did, we carry another reason to be proud from 2008: we took the time to write a special letter then, dated from October 20th 2008, at the very height of the international crisis, saying that it was a special time where we saw fantastic opportunities, and invited our investors to increase their exposure in our club at the time. Whoever invested then, obtained compounded annualized return of over 30% to this date.

Accumulated Overperformance, 2007-2008	
FCL Capital x Ibovespa	-7.80%
FCL Capital x CDI	-48.52%

1.3) 2009

Like we said above, our “fantastic” performance of 2009 would not have happened if it wasn’t for the depreciated prices of 2008. It amazes us that few investors who try to forecast market returns realize what to us is one of the great rules of investing: future return is usually a consequence of the starting point.

For example, many people bring the fact that the 2000’s were the worst decade for stock returns in the US, even worse than the 1920’s. What few bother to remember is that the 1990’s were the best decade ever, bringing the valuations to sky high levels. The previous period’s outperformance or underperformance is very frequently the seed of the subsequent period reversal.

But it gets even farther than that. Usually, after a long period of outperformance investors get very bullish, predicting that the good times are about to become even better, while after miserable periods, expectations get so low that it becomes very easy to surprise the market positively.

It seems almost obvious that with the advent of amazing investment tools, real time information and so on, being contrarian to “emotional trading” should have been arbitrated away by now. Interestingly, if anything, it is becoming easier to generate outperformance this way. Ever fewer investors are able to put in place a sensible long-term strategy, with their capital bases ever more volatile.

That being said, the 2008-2009 period was indeed great for us. A few of our old thesis all of a sudden converged to what we deemed as their intrinsic value, including Estacio (acquired by the private equity firm GP Investments at a great premium), Marisa (with its multiples converging to their competitors’ as our thesis had argued they eventually would) and so on.

Starting this year, we had exhibited accumulated over performance compared to both the Ibovespa and the CDI, a fact that remains true to this day.

Accumulated Overperformance, 2007-2009	
FCL Capital x Ibovespa	+90.02%
FCL Capital x CDI	+104.31%

1.4) 2010

During 2010 a few important developments took place. First and foremost, it was the year where we think

we reached maturity as long-term investors and finally got our strategy and framework to the point it is today. Starting from this year, we think we really knew what we wanted and how to look for it.

Also, during this year our portfolio started to look like it does today. With relevant positions in companies like Braskem, Minerva and Gerdau, while the differences were mostly due to positions which we would love to keep owning but have proved to be investment value traps (like CSU) or where the value converged to our thesis (like tarpon or GVT).

Accumulated Overperformance, 2007-2010	
FCL Capital x Ibovespa	+156.60%
FCL Capital x CDI	+161.58%

1.5) 2011

It was the only full year where we underperformed the Brazilian stock market². Overall, due to a confluence of a few factors:

- 1) An underperformance of value stocks compared to growth and momentum stocks in the Brazilian market during the year;
- 2) Momentary underperformance due to technical/not fundamental factors in some long-term positions, like Minerva and Braskem, which we still hold today with great IRR's;
- 3) One "value trap" that proved to be a mistaken thesis, CSU Cardsystem (CARD3:BZ) which we have exited then.

Accumulated Overperformance, 2007-2011	
FCL Capital x Ibovespa	+111.07%
FCL Capital x CDI	+71.40%

1.6) 2012

During the year of 2012, the two main problems of the Brazilian stock market - an overvalued exchange rate and the increasing cost of labor - started to emerge. Overall, Minerva was the great outperformer, generating returns of over 100% against a flat benchmark over the year. The company was the main reason for our outperformance during 2012, where FCL had a return of 22.86%³ compared to -0.09% of the Ibovespa.

Accumulated Overperformance, 2007-2012	
FCL Capital x Ibovespa	+162.15%
FCL Capital x CDI	+116.44%

² Not considering 2007, since we only had nine months of operation in our first year.

³ During the year of 2012, our investment club was converted into an equity fund. We consolidate the returns of both vehicles here, since the club was succeeded by the fund.

1.7) 2013

During 2013 we haven't changed our philosophy or strategy. In the first half of the year we have added a few individual positions to our fund, that still haven't reached maturity, like Direcional, Log-In and BTG Pactual, while reducing, marginally, positions that kept increasing in price and converging to their intrinsic value, like Minerva, Braskem & Gerdau.

It is interesting to note that in the timeframe of this study, the Brazilian main equity index, Ibovespa, has underperformed the fixed income benchmark, the CDI. In our judgment, this may indicate that the next few years may bring a substantial overperformance of equities over the CDI; Once again, the starting point is very often a crucial indicator of subsequent performance.

Braskem was the leader in our portfolio this past year, having appreciated 64.06% in 2013, being among the top five stocks overall in the Brazilian stock market. In 2013, our performance was of 3.37% comparing favorably against (15.49%) of the Ibovespa index. In the past five years, consolidating our investment club with the fund, our annual performance on December 31st 2013 was of 32.91% and since April 3rd 2007 our accumulated performance is 204.12% against 11.28% of the Ibovespa and 92.01% of the Brazilian CDI or annualized return of 17.87%, against 1.60% (Ibovespa) and 10.15% (CDI)

Accumulated Overperformance, 2007-2013	
FCL Capital x Ibovespa	+192.84%
FCL Capital x CDI	+112.11%
CDI x Ibovespa	+80.73%

Part 2 - Cases

2.1) Marisa

Since its foundation in 1948 in the southeast region of Brazil, Marisa has been a leading brand for middle income female consumers interested in finding everyday fashion.

It finally made its IPO in early 2007, mostly because they were worried about competitors expanding and raising capital in the market, not due to true knowledge of what being a public company meant and the realization that it was the right strategy for them.

The offer was mildly disappointing, with the price being fixed below the lowest estimated range, but over time, the discount to their greatest competitor, Renner, only got wider.

As a family-ran company, some practices and metrics were not the best in the business and according to most measures, Marisa was a good but not outstanding company, unlike Renner.

However, that was not the main reason for the subsequent crash in the company's share prices. After spending several decades as a 100% owned family company, it was a shock for the executives to be questioned, to have to participate in regular conference calls, to open up their plans and numbers and so on. The consequence: share prices nosedived.

That was when the company started to get our attention. After some contact with the executives of the company, conversations with people with deep knowledge of the Brazilian retail sector, observing some

new initiatives and a few good hires by the company, we formed our main thesis, which had a few factors:

a) Over time, the company would learn to be more transparent and act as a public company. Not because of altruism, but because doing so was in the family's best interest, since they still had most shares and their net worth could increase exponentially. Learning to become an open company is almost trivial and the market seemed too focused on this almost cosmetic factor instead of paying attention to operational metrics, where the company already was top tier.

b) The simple fact that becoming a public company would have in itself a positive effect on the company's operating practices and most metrics could converge or even surpass Renner's since the company was more trusted and commanded more brand loyalty from its customers than their main competitor.

c) Over time, the small operational gap and huge valuation gap between Renner and Marisa could, if not disappear, at least converge somewhat and that would already make a very promising investment opportunity overlooked by the market.

Marisa vs Renner – Same Store Sales (SSS) Increase						
	2007	2008	2009	2010	2011	2012
Marisa	14.4%	5.7%	3.4%	13.2%	7.3%	10.1%
Renner	8.5%	2.7%	1.4%	10.3%	7.2%	8.8%

Marisa vs Renner – Sales (R\$ millions) per 1.000 m ²						
	2007	2008	2009	2010	2011	2012
Marisa	5.80	5.92	5.83	6.09	7.30	7.58
Renner	8.60	8.51	8.47	8.98	9.10	9.58

Asset Performance , 04/2008 - 08/2009



2.2) Estacio

Estacio is for us one of the best examples of the cyclicity in attention by equity investors in terms of sector.

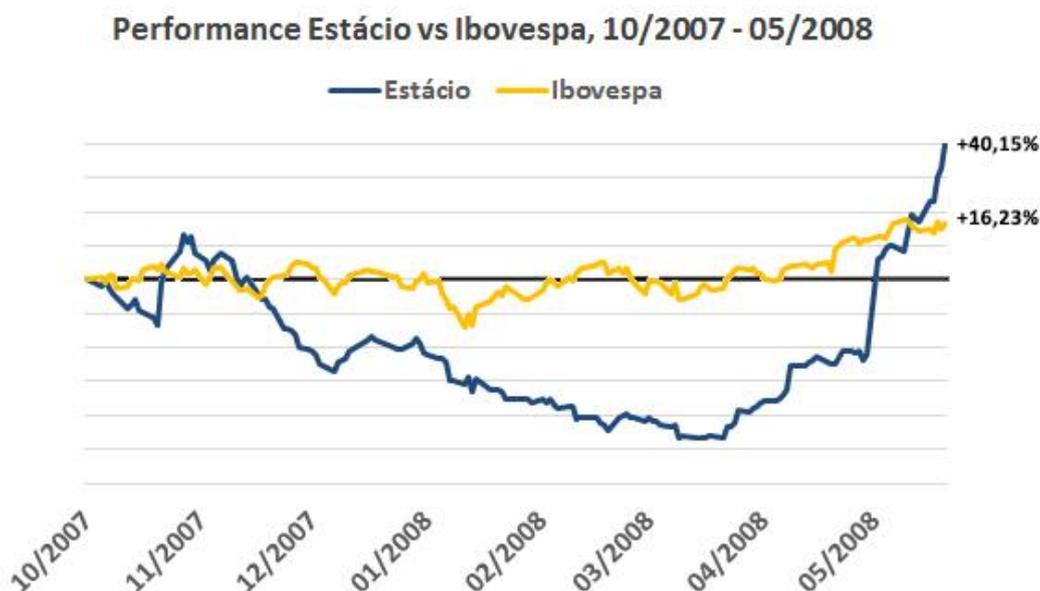
Established in 1970 as a humble law school in a poor district in Rio de Janeiro, it was the first private sector post-secondary school to really adopt a business structure aiming to consolidate the fragmented Brazilian market years before its competitors.

Nowadays, the education sector is one of the best performing in the Brazilian stock index, and some consider Anhanguera and Kroton blue chips. Back in late 2007, when we made our first investment in Estacio, many investors had an ongoing concern about the long-term feasibility of the model.

This is a very significant investment for us, because it was our first ever significant grassroots work, contacting teachers, alumni, directors and competitors of Estacio and finding significant information like:

- a) A recurring revenue, high margin, replicable model;
- b) Estacio was buying small private institutions to consolidate the market at a higher price per student than it was itself being traded in the stock exchange. Why should a small institution deserve a higher multiple per student than the leader?
- c) A low CAPEX, high free cash flow business;
- d) A distant and neglecting sell side.

About six month after we initiated a position in Estacio, GP Investimentos, one of Brazil's leading private equity firms, purchased Estacio at a high premium and we decided to exit our position;



2.3) CSU Cardsystem: A value trap

Many investors ask us about what investment mistakes we made along the years. We think this is an intelligent question because through mistakes they can see our framework, our reasoning and access if we made good mistakes (as defined by those that were not the result of lack of workup and allowed us to grow as investors) and bad mistakes. The greatest one we made so far was with CSU (CARD3:BZ).

Basically, CSU is the leading independent processor of electronic payments in Brazil. It is the kind of

company that has thousands of clients despite the fact that people do not know they are clients of CSU. It has good, honest management and adequate vision of where it should be in the market.

Historically, Brazil had a duopoly of credit card acquiring, Cielo and Redecard, the two companies responsible for the transactions between the retailers and the card brands. Cielo was the sole acquirer of the Visa Brand while Redecard was responsible for Martercard acquiring.



While acquiring is obviously the largest industry with the highest margins - after all it is based on a monopoly - even after the new regulations from antitrust authorities starting in 2010 it remained a great business, we formed a thesis, perhaps one of the most well researched we ever did, that over time the value chain in this industry would start to flow from the acquirers to the processors like CSU.

There were a few reasons that led us to believe in the thesis. The most important is that this pattern happened in most open and well-developed markets: with the opening of acquiring functions for new companies, there were dozens or even hundred acquirers while the processing function became increasingly consolidated.

The result is that in these markets there are even bigger processor companies than acquirers. Indeed, companies like Global Payments or First Data are bigger in the US, for example, than the similar to Cielo or Redecard. We didn't expect that much in Brazil, but we certainly expected that as the leader in processing, CSU would have a great future ahead, while acquirers like Cielo could struggle with new regulations and antitrust authorities.

Nevertheless, one single huge difference was not in our analysis, and in the end made all the difference: Brazil's huge banking concentration. Many of CSU's main clients are card divisions of regional and/or medium banks and with intense speed many of those continued throughout the years to be bought by one of Brazil's main banks. Over time, the gates for entering this sector in the country became ever closer to closed.

At the same time, Cielo and Redecard were able to find great accommodations with retailers and continued to command higher loyalty and margins than we expected. Alone, it does not necessarily affects CSU

directly, but contributes to maintain a closed market for new entrants in the Brazilian card business.

Overall it was an idea where we betted that Brazil's reality would converge to what is experienced in most of the world and because of local idiosyncrasies, it just didn't happen.

CSU Cardsystem Investment, Multiples		
	In	Out
EV / EBITDA	5.26	3.96
Price / Earnings	17.51	9.17
Dividend Yield	0	7.05

Performance CSU vs Ibovespa, 08/2009 - 03/2012



2.4) Global Village Telecom - GVT

Back in 2007, GVT had combined a few things we love in a stock:

- A great company that happens to be in an overlooked or, in this case, hated industry;
- A company that is badly understood, has lazy or inept sell side and therefore trades at similar multiples of peers that are not really their competitors or don't even belong in its industry;
- A business with significant and sustainable competitive advantages.

With reason, investors hate the telecom industry in Brazil, due to factors such as:

- Too many regulations, too little differentiation;
- Low brand and customer loyalty;
- High CAPEX, absent free cash flow and so on.

With all that said, GVT traded at similar multiples as its competitors, despite:

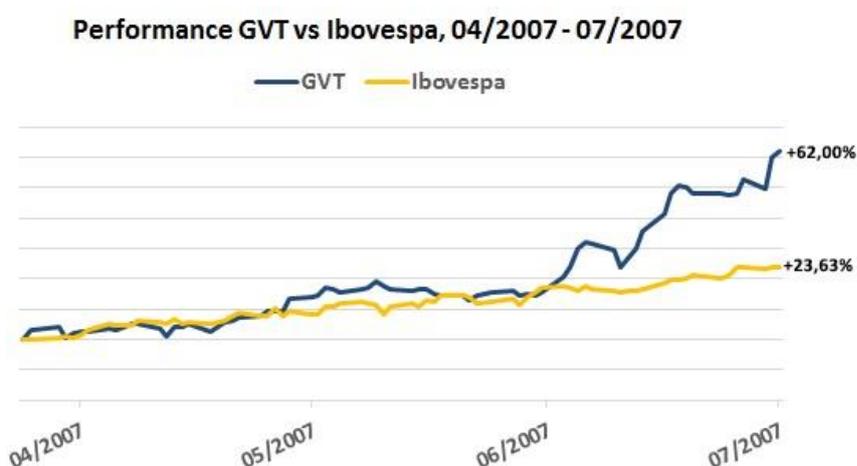
- Being the only telecom company listed in Novo Mercado at the same time that was not really interested in trying to screw its investors more each day;

b) It was not really a regular telecom business. It was a niche, very specific player. It provided landlines (and not mobile lines) for businesses and heavy users, that cared less about price and more about superior quality and reliability;

c) It was from a different generation so it did not have to upgrade its equipment, which was the envy of the industry. This also meant it would not face a huge CAPEX program ahead;

d) It was simply the best in class. The only smart business model in the industry, the best management, a niche player far away from the overall sector problems, and despite this it traded at similar multiples than the other phone companies in Brazil.

We remained invested for less than we forecasted as it has been the case a few times over the years. A strategic player, in this case Vivendi, the French conglomerate, acquired the whole company and consequently our investment. Overall, we believe this is our greatest IRR so far because of this.



2.5) Odontoprev

When it comes to shorting stocks, FCL takes an unusual approach, quite different from most investment houses that therefore deserve further explanation:

a) We don't "have to have" any short exposure at all, reserving this tool for situations where we judge to have found significantly overvalued stocks according to our value based long-term framework;

b) We usually don't arbitrate pairs or use other combined strategies. We just look for discrepancies between price and value both on the short and on the long side of our portfolio. We try to generate alpha on both sides of our portfolio and if we don't find attractive investment opportunities, we just hold cash;

c) Due to this approach, our short portfolio, when it exists at all, may contain positions we hold for years as long our thesis is still standing and we judge price has not converged to value.

Such was the case with Odontoprev. We saw in Odontoprev an honest and able management, that deserves praise for creating a brand new and promising industry in Brazil (dental plans) and even deserved to be traded at decent multiples. At the right price it is even a company we could be long on. However, there were strong reasons for us to see the company as a compelling short opportunity:

a) An unbelievable hype. The company was very competent in promoting the stock, and increasingly adopted short term focus and metrics, with a strange obsession in beating the quarterly consensus. Analysts kept raising their target prices as the stock kept soaring;

b) A case of low hanging fruit. Odontoprev brought the dental healthcare plan industry to Brazil so it was a natural and deserving leader. However, the years have passed and every medical insurance company realized that they were missing an incredible opportunity. And worse, they could take advantage of synergies between dental and medical plans, they could subsidize to a certain extent the later and more.

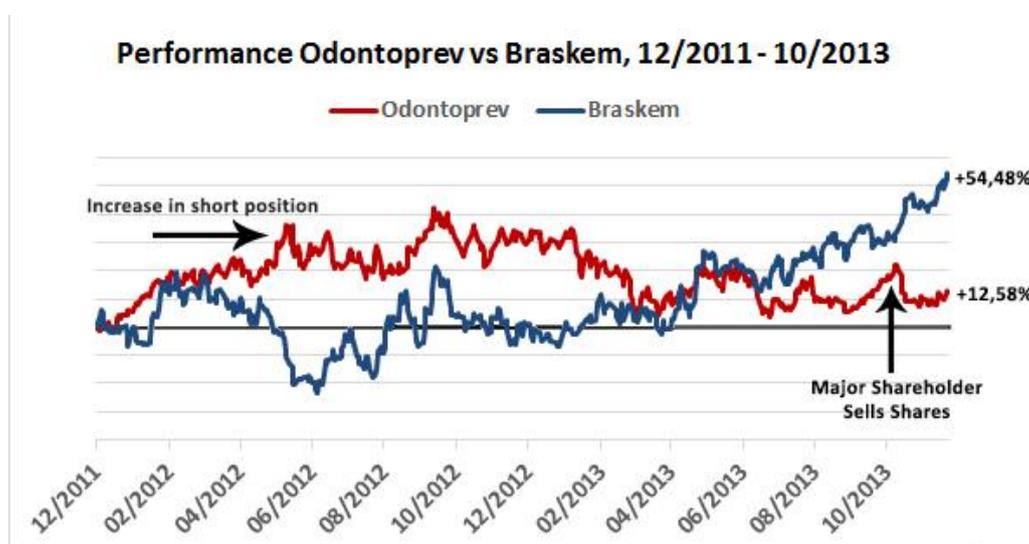
Increasingly, management itself recognized that the best days of growth and profitability were over. Margins started to suffer. Growth started to slow and will certainly only get worse. The stock however kept going up and multiples priced the company for perfection, (estimated EV/EBITDA of 17 and P/E of 25 for 2014!) like the best days for the company are still ahead.

Odontoprev – Increase in clients over year					
2007	2008	2009	2010	2011	2012
31.84%	41.62%	69.69%	19.25%	11.15%	8.00%

c) Due to the quality bubble we talked about in our last letter (everything already generating yield deserving high multiples), analysts stopped caring about the long-term perspectives for the company and increasingly focused on distribution of dividends in the next quarter. This made the stock price reach absurd levels and we decided to short the stock because eventually long-term would arrive.

Short Investment in Odontoprev, Multiples	
EV / EBITDA	24.5
Price / Earnings	32.35
Price to Sales	6.0

Long-term arrived sooner rather than later: the controller shareholder decided to sell his stake **without any premium on the market**, something I had never seen in my life, and essentially exited his position. The stock nosedived and we were able to close our short position at a good profit. Overall, we kept rolling our short position for over two years and did not really care after each quarter of “beaten consensus” and hype by the sell side. Eventually, long-term arrived.



2.6) Minerva

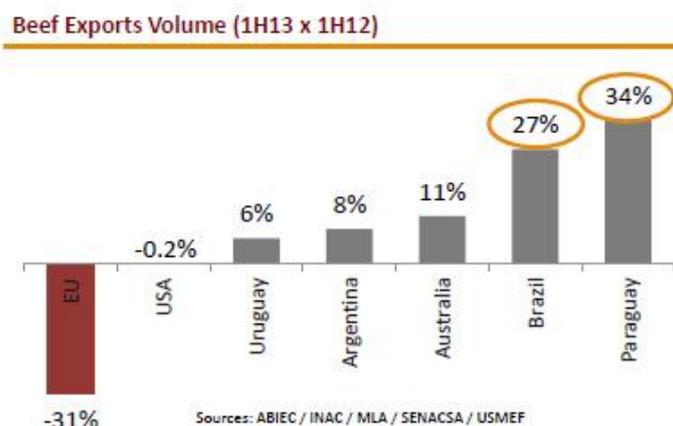
It is easy to tell that hard commodities, like steel, timber, coal and especially iron ore, were the main beneficiaries of the Chinese boom in the past decade. The levels of urbanization the country has been experiencing are simply unprecedented. It is going through in one generation what Europe took 200 years to achieve: moving hundreds of millions of people from the farm to the cities. All of this of course, demands Iron Ore, steel, and other materials.

Increasingly, we see the Chinese leadership aware that this model based solely on urbanization and investment is mostly over. The low hanging fruit has been harvested. And they have no other alternative than raise consumption that is being suppressed by facts like an undervalued currency, low interest rates and wasteful investment.

This leads us to believe that in the next decade, when China will still experience significant but a different growth, the winners will not be the same ones as in the past. We are not claiming with this that Minerva will someday be as big a company as Vale. Still, its long-term prospects are certainly amazing.

Historically, Russia has been the main importer of Brazilian beef. Increasingly though, Hong Kong is growing and already fighting for the first place. Although the headlines tell us that Brazilian beef is still restricted in mainland china, it is a secret to no one that Hong Kong is frequently used as a trading hub. So Minerva is already exporting indirectly to china in great quantities and this is only poised to increase with time.

At the same time, it is ever clearer that no region can really compete with South America in meat production: abundance of water (a huge cost differential in this business) vast and relatively cheap land (ditto), scale, capital, knowledge, and a much more favorable climate. Without the terrible dry periods that often happen in Australia and Midwest US, not to mention the total absence of competitiveness from Europe, makes this region the obvious future leader



Minerva is the most efficient, best run company in one of the most promising industries in the world. It has huge competitive advantages, it is consolidating fast, it trades at cheap multiples (estimated 5.5 EV/EBITDA for 2014), it has decreasing leverage, free cash flow, and most analysts are completely lost and worried about the short term fluctuation in the cattle cycle and price.

We think many are losing the big picture. When we are asked about which company we would love to hold for decades we usually name Minerva. We started our investment in 2010, and after a 200% increase in price, we had to marginally decrease our exposure for our investors not to incur in excessive risk.

With the moderate increase in cattle prices this year, which has a short-term impact on the company's margins, the shares did not have a great year and we were able to increase our exposure once again. It is one more time this house's largest position at the time we write this letter.

Minerva, Operational Data					
	2009	2010	2011	2012	2013 (E)
Revenue	2,602	3,408	3,977	4,380	5,299
EBITDA	187	246	328	469	548
EBITDA Margin	7.18%	7.21%	8.24%	10.72%	10.34%

Performance Minerva vs Ibovespa, 03/2010 - 12/2013



Part 3 - The Alpha Paradox - A Brief Description of Our Alpha

As we said many times before, as value investors we do not subscribe to the efficient market hypothesis. We would agree that we participate in a market that tends to efficiency (i.e.: once profitable opportunities become obvious, they are arbitrated away) as opposed to an efficient market (where there is no possibility of long-term sustainable positive alpha).

Many capital allocators would agree with us. Still, it is only natural for fund of funds' managers, endowments and so on to look for companies that can deliver systematized, repeatable and understandable overperformance when looking for active managers. In others words, any fund manager that cannot state clearly, why and how he will be able to deliver risk adjusted positive returns is probably in trouble.

On the other hand, here comes, in our opinion, the paradox: since we live in a market that tends to efficiency (as opposed to efficient), any strategy that is too explainable and replicable will also be arbitrated away. How do we reconcile that? And what do we think, after all, that FCL's edge is?

Before we enter a discussion about alpha, a few caveats must be raised: most of the investors we admire, like Peter Lynch and Warren Buffett, have never really thought of performance as scientifically decomposed in "alpha" and "beta" terms. Mostly, they care about "the math to work" (as in Lynch's case) or in "margin of safety" and in buying good companies with long-term advantages (Buffett). How much their stocks would go up with the market over time and how much would be overperformance was, at best, an afterthought.

We subscribe to this tradition of looking for absolute and not relative returns. So, for the rest of this section, when we mention alpha, and our search and discussion of alpha, we really mean what we think is our “edge” or our competitive advantage as investors, and not really our ability to beat a relative benchmark. The purpose of this section is to give a glimpse to our investors about the future.

Having in section 1 discussed our performance over the years and in section 2 dissected our most significant cases, in section 3 we will open our framework and try to state how we think we will keep having an edge and keep delivering good risk adjusted performance through new investment cases. In other words, section 3 is about our method.

Investing, as we all know, has become an increasingly professionalized activity, since at least the 1970s in G7 countries like the US or the UK, and at least since the 1990s in emerging markets like Brazil. Due to this factor, many investors raise the point that alpha has become increasingly hard to find, since no corner of the financial markets is now completely unexplored anymore. There are a few reasons why many investors believe that generating alpha (or maintaining an edge, if you prefer) will be harder in the future than in the past:

- First and foremost, there is simply more capital chasing the same investment ideas than ever before in mankind’s history;
- Not only that, but the average skill of the players has steadily increased over time. There are more CFAs awarded in the past ten years than ever existed before. In any competitive sport, be it tennis, baseball or basketball, when the payers’ average ability gets higher, the ability of a single player or a few players to outperform gets smaller⁴. Will the same occur in investing? We don’t think so, for reasons we explain below;
- There is an unprecedented amount of technology and real time information in the markets.

So why don’t we subscribe to the view that alpha will be harder to find in the future than it has been in the past?

There are a number of reasons, the most important of them all being the fact that investors in our opinion are at least as prone to the same mistakes and biases they have been incurring in since the dawn of the stock markets centuries ago.

We are not claiming that there are no outstandingly smart people in this field or corners of the markets where it is really hard to have an edge. But overall, as long as investors’ process, think and analyze the same information differently there will always be room for alpha generating strategies in the market.

No matter how many Bloomberg terminals, fast-trading strategies and so on the market has, the beauty about investing is that investors are not really competing in the same game. They get to choose the roads they will be travelling to try to generate performance. The real alpha, in our opinion, is not really in the next millisecond to be gained or even in a new algorithm with better/faster information. It is in how humans can react differently to the same information.

⁴ My favorite example is the USA basketball “dream team” from the 1992 Olympics. Subsequent US teams were usually still the best in the world, but due to the spread generated by the best practises that globalizatiion brings, were no longer capable of obliterating adversaries with victories of 50-60 points of difference on average.

Historically, we have been able to beat the market and generate performance for our investors in three main ways and we think this will continue to be the case in the future. The way we see it, this house has three main “edges”, or competitive advantages:

3.1) Concentrating on the less efficient niches of the market

One of the great things about being a Brazil-based investor is that you get the best of both worlds: Brazilian market is not underdeveloped to the point where you do not even operate in a proper market, unlike parts of Africa or Asia. At the same time, it is not efficient to the point where the competition is in the efficiency frontier, like the US or Europe. We are just in the right spot. Opportunities that probably would not appear in the US or UK are still abundant here.

We will never know for certain, but we don't think Minerva would be selling at eight times next year's earnings if it was an American company. We doubt that BTG would be trading at a similar price to book value than Goldman if both were as deeply analyzed.

Overall, emerging markets are interesting not because they will grow faster or anything like that (the correlation between macro growth and stock market returns is anything but trivial), but, emerging markets offer the simplest, best opportunities for stock investors since the market is way less efficient.

Being in Brazil is only a very small part of our niche. We also tend to concentrate in ideas that even in Brazil are overlooked. We are usually concentrated in smaller cap companies since we don't need to be in ultra-liquid stocks, so the ingredients we usually love are:

- Inexistent and or neglectful sell side. Either because it is a small cap company, it is not properly understood or due to the long-term nature of the business. In this case, the sell side does not usually really care about promoting the company;
- Behavioral biases. We usually look for sectors that are “not in vogue” where investors are not really seeing the big picture or, our favorite, companies which were unduly packaged and considered of the same group of a set of companies that the single company should not really be considered part of.

3.2) Being able to take advantage of other firms' limitations of time, sector, concentration and knowledge

Since we are highly unusual in our structure: with a more concentrated portfolio, longer term horizon and longer term capital base orientation than most of the industry, we are able to exploit many opportunities not because of superior skill or brilliance but because our format allows us, like:

- Smaller and/or more illiquid companies;
- Good companies that are currently underperforming due to technical reasons or other reasons not related to fundamentals. Since we can be long-term oriented we are able to try to catch a falling knife, as in the market dictum, and do that all the time;
- Since we run a concentrated portfolio, we can have a higher degree of average knowledge of each company and a higher conviction degree than most managers.

3.3) A proprietary capital mentality

Most investors have an agency problem. They would like to act as rational investors, but face a constraint: they need to cut losses now, or generate performance for their bonus the next semester, and as much as they would love to keep their investor base happy, when faced with this choice most not completely altruistic human beings would set for their own neck instead.

Although they intellectually may know that incredible opportunities may lie on the long-term horizon, they really can't explore them. It is obvious that in financial markets the long-term is less efficient than the short term. Therefore, we try to explore one of our main advantages, which is having an aligned investors' base that lets us pursue a long-term time horizon.

Exploring the long-term is not something trivial. This house is also, after all, an agent for its investors. So how do we reconcile being an agent with exploring limitations of other agents? By making a rational choice of having a smaller and consequentially more stable capital base than could be the case.

We don't use empty words when we tell our investors that they are one of our main sources of competitive advantage. We really believe that having long-term investors in our base, and consequentially being able to have a proprietary capital mentality and exploring the agency problem of others investors is one of our main edges.

There are many advantages of our stable and long-term capital base such as:

- Being able to have relatively few, concentrated and long-term high conviction positions, unlike most of the market;
- Being able to be a contrarian. Without the agency problem, we are able to be positive when others are fearful and fearful when others are greedy, since we don't have a benchmark to beat in the next quarter. Many people discuss the "genius" behind people like George Soros and Warren Buffet (and this house is guilty of this sin), but if I had to point to one single source of edge they have it would not really be brilliance, but the competitive advantage of a stable capital base.

Why is Buffett so much better than most fund managers? Well, in our opinion, first and foremost, because he is not a fund manager. He has the most stable form of capital of all: a real company to manage. Is it extraordinary how overlooked this fact is.

3.4) The Big Picture

Having discussed sources 1, 2 and 3, it is time for our final and perhaps more ingrained source of edge. It is being able, due to our culture, people, abilities and history, to look at the big picture and manage emotions and sentiments better than most.

Once again, we do not claim that we are brilliant geniuses with a "right" to beat the market just because we call ourselves value long-term investors. But being an unusual company in a few ways, we do believe we can navigate the markets fluctuations better than many:

- Unlike many investment houses, our partners did not come from trading desks in investment banks. Although we certainly lose a lot from that, we also bring a unique background to the table. We have an owner-long-term approach to the companies and think we can access competitors, the industry and the

macro picture in a way that many investors that never really worked in any environment but in front of a Bloomberg screen could.

- As many others who follow the Dodd-Graham value investment tradition, we are adept of being counter-cyclically greedy and ok with ups and downs as long as the downside is manageable and the investments are rigorously made according to our philosophy in a manner that keeps care and integrity. We will keep this as a priority.

- One of the unique things about FCL is that it really started as a way to invest our own capital. We formed an investment club in 2007 and over time, with family and friends and then new people wanting to get in we professionalized our activities. Of course this meant that our growth was slower and our capital base more stable. Most importantly, it meant we started, and to a large extent still are, managing our own money.

Ray Dalio once said that being a contrarian, which is itself hard enough, and at the same time being right when everybody else is wrong is the only way to beat the market. We know that there are many brilliant people out there and maintaining discipline and the culture as a company grows is not trivial.

Being young, loving what we do and having no plans to do anything else for the next several decades makes us believe we can maintain this proprietary capital mentality while looking for pockets of inefficiency like the ones that allowed us to overperform so far.

The big picture is that in the end each company and investor is unique in its history, principles and so on. Warren Buffett once said that "in value investing you either get it right away or you never get it". We once again agree with him.

We pride ourselves in having a different background and looking at the market from a different perspective than most investors and believe that over time we will be able to keep exploring and developing our edge in search for this little paradoxical thing that every investor looks for, but never really is able to explain: in the middle of so much competition and opinions, the quest for a permanent edge.