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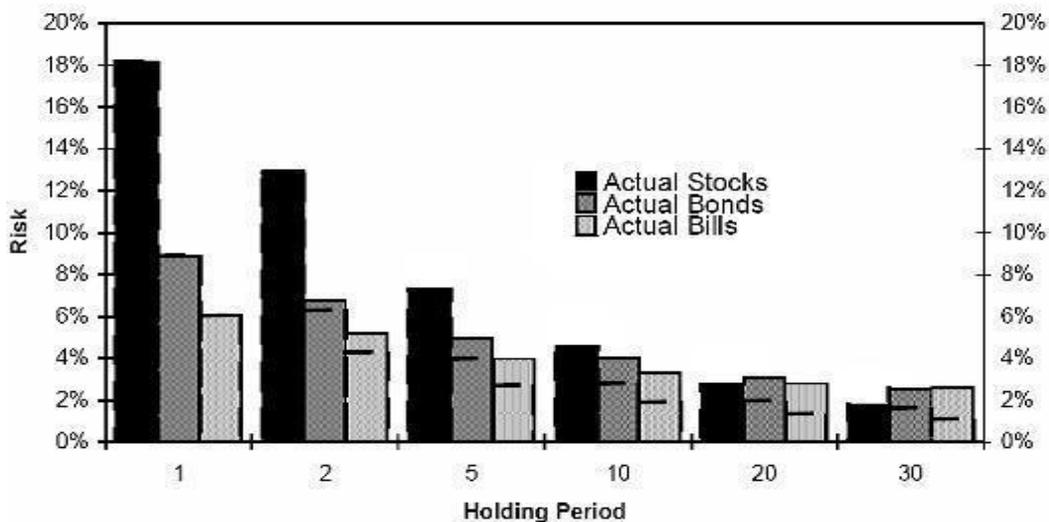
Correlation and the Liquidity Curse

Liquidity is a good thing. Everything else constant, the ability to sell an asset quickly, be it a house, a company or a stock, means that the risk of owning it is smaller than otherwise. Therefore, a rational investor should demand a smaller return than from an identical but less liquid asset. This much is unquestionable. However, as in many things, human interactions make the simple turn complex sometimes.

As our longtime readers know, we hold a deep admiration for Warren Buffet and Charles Munger, the investors behind Berkshire Hathaway. Berkshire's annual letters have long been mandatory reading for FCL's staff and there is an excerpt from their new annual report that we consider particularly useful in the current market turmoil in Brazil. Mr. Buffett tells the story about a farm he bought in 1986. He made reasonably simple calculations about the total cost, how corn prices would tend to go higher over time (although in unpredictable ways) and so on, estimating that he could expect average returns of over 10% a year, which proved correct.

The interesting fact is that certainly over these past decades the price of farmland in Midwestern USA zigged-zagged much more dramatically than Mr. Buffett somewhat predictable returns, and the price of the stocks of farm companies - pieces of companies that own properties just like this one - oscillated spectacularly. In the end, of course, the returns enjoyed by all three (farmland, stocks and Mr. Buffett's property) will be very similar - the quality of the assets you own naturally determine how well things will turn out - but the middle of the road will be different among these three alternatives.

The fact is that there is a great confusion, even among professional investors, between volatility and risk. Volatility is how much the value of your holdings can go up and down in the short term. Risk on the other hand, at least on our understanding, is the probability of the asset's value, the purchasing power it brings to its owner, decreasing in the long term. If the question is "what is more volatile: fixed income or stocks?" Of course, it is the second option. The possibility of the value of your stock holdings going down in nominal terms in any given year is much higher in the case of stocks than in fixed income. However, as Jeremy Siegel explained in his classic book "Stocks for the long Run", the less risky investment alternative for the long term, believe it or not, is stocks.



The chart above is from Jeremy Siegel's "Stocks for the Long Run". It measures the variability of the average return for each holding period. As shown, the longer the time span, the lower the variability, and for long holding periods, common stocks offer lower variability of returns than bonds. (Source: <http://retailinvestor.org/risk>)

Suppose you have bonds or other fixed income securities against the government of any country. As long as there is no default, you will have your money back. But here's the catch: if your personal portfolio is heavily concentrated in fixed income securities, over the long term the money will go up in nominal terms but will very possibly go down in purchase parity terms, because returns on fixed income are smaller than the inflation rate in any developed country. Nowadays, this is starting to be the case in Brazil as well.

This seems paradoxical, because fixed income investors will think they had positive returns every year, unlike a stock investor, but after a decade or two, he will have less money in purchase power terms than the stock investor who will face a bumpy road.

The "peace" that fixed income buys has a high price. Bill Gross, CEO of PIMCO and a man who understands fixed income as well as any other in the world, has a perfect metaphor: "If you throw a frog in a frying pan he will jump away saving his life. If on the other hand you throw a frog in warm water and very slowly start to heat it, he will not notice and die". So fixed income investors have to be very careful and not let the illusion of nominal returns - as opposed to real returns - guide their judgment and end up slowly cooking just like the frogs in Bill Gross' example.

Stocks are undeniably volatile. In the past, we talked about how sometimes liquidity lead people to hyperactivity, especially when they are nervous, and while it is a good thing, it can bizarrely lead people to do stupid things. The same is not true in other asset classes. Since people have no idea of how much the price of, say, real estate has gone up or down on any given day, they confuse illiquidity with safety and think that the price of real estate, unlike stocks, is stable.

Over a longer term, stocks have a huge advantage on any other financial asset¹: they are claims on productive assets. They are, in the end, parts of companies. Therefore, good companies are usually able to pass along rising costs to its customers, which makes stocks offer better real returns over the long term. In addition, a moderate annual inflation adds up and becomes an important issue in the long term. What's more, as Warren Buffett's farm example has shown, if an investor is careful to buy good pieces of business with sustainable competitive positions he will probably do well.

So why are stocks so volatile? Because investors do not want to lose money in the short term. Quite on the contrary, they want very much to make money in the short term, so opinions, macroeconomic facts and emotions make the value of the companies listed on the stock market oscillate a lot more than its fundamentals. This creates opportunities for long term value investors like us, which is why we urge investors to understand our strategy and acknowledge short term fluctuations as part of the game.

And so it has been since the dawn of stock markets: There are cycles. Sometimes people are euphoric (widespread fear of missing out) and sometimes scared (widespread fear of losing money). Howard Marks described perfectly the six phases of capital markets

1. A few smart investors start to believe that things will get better;
2. Most investors realize improvement is actually underway;
3. Everyone becomes sure things will only get better, forever - stocks make all-time highs;
4. A few smart investors realize that in the next few years things may actually get worse;
5. Most investors realize that things are getting worse;
6. Everyone becomes sure that things can only get worse forever - stocks at multi-year lows and become great buying opportunities.

¹ Even real estate is not a productive asset. It depreciates over the long term, unlike a company.

Which afterwards lead us to phase 1 again. In FCL, we are increasingly certain that the Brazilian market is somewhere between phases 6 and 1.

Sigmund Freud, in one of his most brilliant essays, discussed happiness. Happiness, he said, was necessarily a fleeting emotion: good things happen and then people become happy about it. After a while, however, this good news becomes a new starting point from which people want more. They are already incorporated, already a possession. In financial terms, we could say they start to be already in the price, which means additional good news are necessary to keep people constantly happy. After a while, it becomes increasingly impossible to surprise on the upside. The same goes on the other way around.

The consequence is that it's not so much what happens to you that determine happiness, it is the equation of reality minus expectations. If reality is better than expectations at any given point (and expectations move over time) then happiness will occur.

One could make a financial market parallel, and state that what matters in subsequent market performance is the starting point. Investors still think that good macroeconomic news will mean good market performance when there is widespread evidence that such relationship has never existed. Good economic news may be already in the price. A terrible piece of economic news that is better than what was expected, on the other hand, will make the market go up.

So people think about the future with different expectations in different times and these expectations determine the future of the market. Therefore, contrary to common sense, gloominess is the necessary ingredient for the stock market to go up in aggregate, and more importantly for us, for specific investment opportunities to arise. Mean reversion is possibly the most important force in nature as well in human emotions and being a contrarian is betting on mean reversion.

A few practical advices for investors in general and for ourselves as well: if you have money in the stock market, be it in an investment fund or otherwise, you should go up every morning look at the mirror and repeat: "Economic growth is not related to stock market returns."

The market is a discounting machine and it will discount a scenario that it sees ahead, correctly or not. It is amazing how fast things change, especially in emerging markets like Brazil. In 2007, we were the future. The salvation of a crumbling world economy. And because of that, and let's not forget, with the same political party in power, with an economic policy that, let's face it, was not that different from the current one, in the minds of international investors we deserved a huge premium to our developed stock market peers.

In 2014, on the other hand, the Brazilian market is trading at the cheapest multiples of the past decade or so, unless for a very brief moment at the most intense phase of the 2008 crisis. It means that in the minds of the international investment community, the Brazilian stock market deserves the same level of discount to the US market nowadays than in 2004, when the Novo Mercado had two companies and not 120, and it was rare to find a company listed here that had tag along rights.



Source: Bloomberg.

We really believe investors are putting an unjustified discount and therefore we are more optimistic about the Brazilian stock market than we've been for many years. Stories change to justify the current phase of euphoria or fear. In 2007, we deserved high multiples because we would grow more than developed markets, which turned out to be true, but interestingly, it stopped mattering. Now we deserve lower multiples because we have a bad economic policy (which was already true back then). Investors have always created a frame of rationalization to justify their emotions².

We are not saying that we believe Brazil's economy will grow rapidly in the future. What we say is that this is not a necessary condition, since there is no relationship between growth and market returns. Truth be told, actually there seems to be, according to the most recent academic evidence³ a relationship, albeit a negative one, probably because investors give a higher multiple to high growth countries - once again the matter of starting points.



²<http://video.ft.com/3127436212001/Emerging-opportunities/Markets>

³<http://www.economist.com/news/finance-and-economics/21596533-past-economic-growth-does-not-predict-future-stockmarket-returns-growth-paradox>

We believe however, that over the long term emerging markets offer the best investment opportunities for a very different reason: they are less efficient markets than its developed peers are.

There may be more: a low growth environment sometimes prevents competitors from entering new markets. Companies are more reluctant to expand and therefore use their cash wisely. The weaknesses are worked out. A low growth environment is not a terrible thing at all unless we are talking about a depression. Even then, it is amazing the percentage of fortunes and amazing companies that were created during the 1930s in the USA. What really hurts investment returns on the stock markets is the fear of lower growth by the investors, not lower growth itself.

Index Performance, 2010 - 2014 YTD



Correlation

Finally, we should also visit the topic off correlation. Once we realize that the market moves in cycles depending on its starting point, a new anomaly also deserves analysis. In the long term, obviously the returns on each stock will depend on how well each company will do - remember, stocks are parts of companies. Over the short term, investors, and we are including professional investors, have an annoying tendency to refer to the stock market as “the market”, meaning the index of each country.

Suppose we start a farm business. We buy a farm, then a second one, then a third and after a while, we list our company on the stock market. Obviously, there are many macroeconomic factors that will influence our business, such as the price of commodities like soy and corn, exchange rates in case we export or import, the cost of labor and so on. Why should our stock fall and rise every day almost in sync with the price of say, a miner or a retail company?

It should not and the reason it does is that investors read the same newspapers and tend to become optimistic or pessimistic at the same time. This is somewhat true in a more developed market like the US but is especially true in a market like Brazil. Over the long term of course, each business will have a different outcome and therefore its stock will respond, but over the short term, meaning, a day, a month and even a year to two, stocks will tend to move together.

Now things get interesting: The correlation, that is, the degree of how much stocks tend to move together

also changes over time. Usually during moments of very high fear, when investors just want to run for the hills, correlation skyrockets. So we read in the newspaper that “the market” went down. This may seem to be a bad thing, as our fund’s shares will probably fall, but this is what makes our business thrive in the long term: since investors just need to get out of “Brazilian stocks”, almost not mattering which one, this creates the opportunities for stock pickers like us to find discrepancies between price and value.

It is always a two edged sword. In moments of high correlation the market will be mostly going down, our shares will go down, hopefully less than the market, and it will be a very rich time for finding the investments that will explain our return in the future.

On the other hand, in normal times, correlation will start to go down, markets will go up, our shares will go up, hopefully more than the market, but there will probably be less obvious opportunities since less afraid investors will probably be able to distinguish a farm company from a retailer.

Starting points change, correlations between stocks rise and fall, the stock market goes up over the long term - it has to, because nominal GDP goes up over time and multiples cannot fall to less than zero - but it also swings dramatically. Because of that smart stock pickers are able to beat the market although, be advised, they are a rare breed. Periods of greed and fear (and everything in between) alternate their ruling and on and on goes the cycle.