

FCL*Capital*

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Elections, Performance and Scenario - A Framework for the Next Few Years

Founded in 2007, FCL Capital is a very young company. Despite this fact, we cherish our rituals. One of them is to only comprehensively review and assess our performance in our annual letters, published every January, and not in our monthly letters. Mainly because as we always remind our investors, we maintain a very long-term perspective and therefore think it is counterproductive to discuss and analyze results all the time.

That being said, a few specific factors, like our underperformance during this year, and the recent Brazilian elections convinced us to open an exception and use this letter to discuss our recent performance and, more importantly, to analyze and assess our expectations for the next few years of the Brazilian economy and its markets.

As we stated in our last annual report, we entered 2014 with the following convictions about the Brazilian market in general:

- Brazil would continue to have a low growth rate;
- The economic policies were unlikely to change in the short-term;
- Two specific factors were hurting the Brazilian companies in the Bovespa's ability to compete and profit: a massively over-appreciated exchange rate and an environment of real wage gains combined with low growth, that was squeezing the companies' margins, especially industrials.

More importantly, we had the conviction that these two factors had to end, no matter the outcome of the Brazilian election.

We can say that along with the rest of the market, we had a tough year so far. In the first quarter, a terrible economic policy that put the country in stagflation¹ hurt our performance. Entering the second quarter, we missed the so called "electoral rally" because we hadn't changed our conviction that the exchange rate was

¹ A combination of low growth and high inflation, usually caused by lack of incentives or desire of companies to invest in increasing their production.

overvalued and that the best opportunities were not in the services sector or in the “electoral kit” (Petrobras, state banks, etc.), but in exporters and industrial companies that had their ability to compete hurt by cheap imports.

Most investors did not agree with us at first. Moreover, we do not think we are in the business of guessing who would win the elections and did not feel that we had a competitive advantage in this game. While some investors focused on this binary event, we kept our discipline and respected our mandate to look for great long-term opportunities even when short-term performance was being hurt.

The bad news is that it is still a tough year. With the nervous environment in the Brazilian market, many of our positions experienced a fall in their share price, mostly not based on fundamental reasons. The good news is that this reality started to revert itself in October. The tragic victory of the PT, working party to a fourth consecutive term, will bring more economic irrationality and authoritarianism, but our portfolio was well prepared for it.

Investors are finally realizing that the Brazilian economy should experience a significantly lower exchange rate. Our portfolio largely made of exporters and industrials outperformed heavily in the days following the election’s results. Since our conversion from an investment club into an investment fund, we are almost on par with our benchmark, while maintaining lower volatility and a very low correlation with the market and other Brazilian equity funds.

The second reason for industrials’ underperformance, a heated labor market, will also probably change. Unemployment cannot be kept low indefinitely unless in a high growth environment. This will be bad news for workers and for the economy as whole, but very good news for the companies that had had its margins squeezed by real wage gains without an economic environment where they could mark up their products and keep their margins.

During times of trouble, sometimes it helps to look at the long-term picture. Despite all its problems, Brazil is still a growing economy with maturing capital markets. More than that, its stock market had an amazing performance in the past 10 years.

Index Performance, Last 10 Years



The problem with the chart above is that it leaves too much room for imagination. Inevitably, the reader starts to think about how wonderful it would be to invest in March 2009 or how miserable someone who invested in late 2007 must be feeling. It is better to look at the annualized table for the past 10 years, after the good and bad moments.

Index Annualized Performance, Last 10 Years	
Ibovespa (Brazil)	8.91%
SPX (USA)	5.99%

Source: Bloomberg.

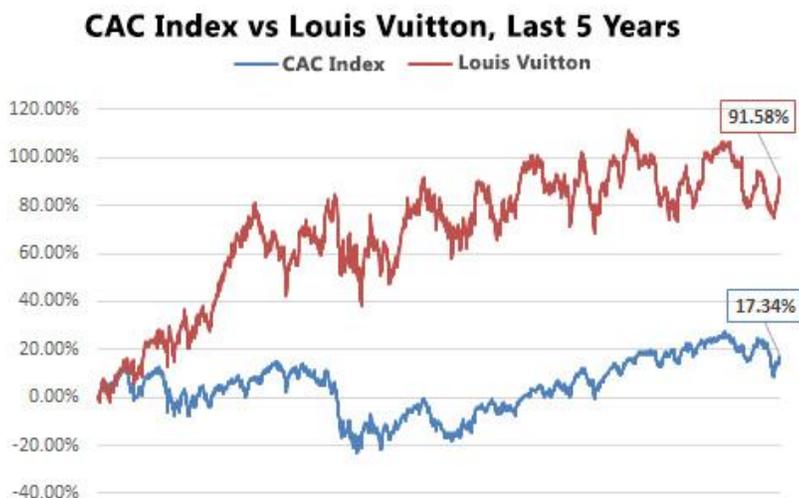
Looking at the next few years, our vision is that very good opportunities in the Ibovespa will continue to exist, and smart investors will be able to find great specific investment opportunities and ideas. There are many amazing companies in Brazil and nothing will change this fact.

Note that we are not claiming that the next few years will be great for Brazil or that the Brazilian economy will show fantastic growth rates. It will not. Many investors make this confusion between a national economy and its stock index, but the connection is not that straightforward.

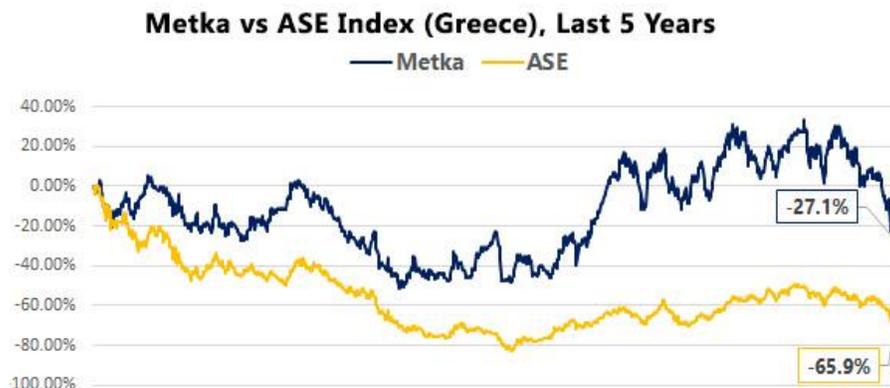
Companies nowadays are not locked or even necessarily dependent on a single country, many great companies make most of their sales outside their countries of origin and, in some cases, it is even not clear anymore which their main country is.

Besides, the stock market is a discounting machine, and frequently, times of low growth bring the best investment opportunities because of lower valuations, more attention to the downside, less tolerance for frauds or dodgy accounting and so forth.

Investors still look for this association, but they probably should analyze many companies in a different way. Should the LVMH group, the famous maker of Louis Vuitton handbags and many other luxury products get a low valuation because of the troubles in the French economy, when nowadays its main business is selling luxury goods to Asian customers?



Or, maybe in an even more extreme case, should the Greek industrial group Metka, that has 95% of its operations outside Greece be trading at nearly bankruptcy levels as it was at the high of the euro crisis?



Smarts investors realized they should not, and made a killing with these smart and (in retrospect) almost obvious trades. Likewise, it is very important for our investors to realize that it is perfectly possible to be bullish about specific Brazilian companies and bearish about the prospects of the Brazilian economy and vice versa.

It is not that we are gloomy about Dilma's victory and therefore think Brazil will face an imminent crisis and disaster. Brazil has many things going for it. It is a BRIC member, the second largest emerging market economy and has a population of 200 million people, mostly creative and tolerant. With all its flaws, it has an entrenched democracy, religious freedom, rule of law and a very pacifist culture that maintains the country completely absent from international conflicts of all kinds. In other words, it has lots of potential.

Unfortunately, we do think Brazil is in a long-term structural decline. It is stuck in a middle income trap, because of a lack of competitiveness which has many reasons, like a very much closed economy, red tape, high taxation, and, more importantly, terrible economic and political management, which is responsible for a gradual decline of Brazilians' economic and political freedoms.

Now the good news: since we can be bullish on specific Brazilian companies, and even the Brazilian stock market as a whole, without being bullish on Brazil as a country or as an economy, there will probably be many opportunities to make money in this vast country, as there certainly are now.

Even more than that, troubled countries usually carry some of the best opportunities because of the low valuations that investors seeing risk usually face. The level of your entry point in any investment is critical to your subsequent returns. If investors are supposed to "buy on the cannons, sell on the trumpets" then countries that have problems will usually be among the best opportunities.

We did a small study and found a group of four important democracies that experienced setbacks in the past few years: Brazil, Argentina, South Africa and Israel. Note that we did not include Venezuela or Bolivia in our research because quite frankly, Brazil cannot be compared to them - its size, importance, institutional maturity and depth of markets is simply on a whole different level compared to these South American neighbors, so that comparisons between Brazil and them really seem a bit unfair.

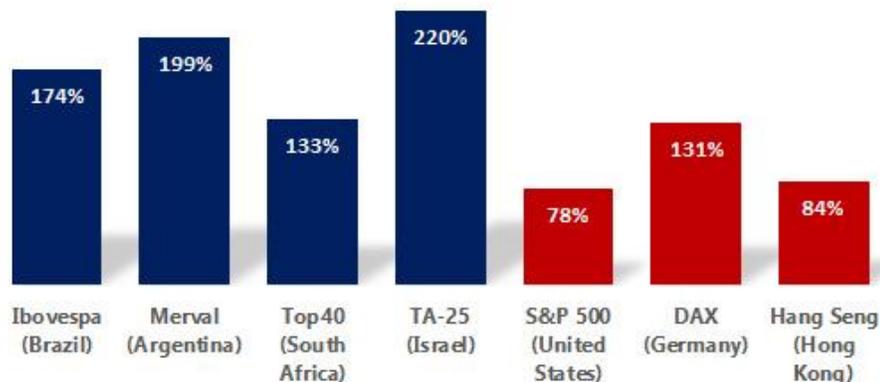
Argentina on the other hand, has a similar per capita level and an educated workforce, but populist policies and excessive fiscal spending without a responsible monetary policy were responsible for sending inflation spiraling out of control.

South Africa, under the rule of the ANC party, has been progressively walking away from the legacy of Nelson Mandela and adopting redistributionist and even Marxist policies that scare many investors while segregating its population.

Israel, by far the richest and better economically managed in this group, has a leadership that has been completely unable or unwilling (or both) to make peace with its neighbors, while gradually eroding freedoms of religion and expression.

In other words, any person would probably make a bet that these four markets underperformed in the past decade. Except that they did not. They outperformed the American, European and Chinese markets. In addition, they have lower P/E and price to book value multiples, as expected.

Non-Fantastic Four vs Developed Peers, Last 10 Years



Indexes' Price / Earnings	
Ibovespa (Brazil)	15.48
Merval (Argentina)	14.37
Top40 (South Africa)	17.39
TA100 (Israel)	16.97
SPX (USA)	17.66

Source: Bloomberg, October 2014.

Indexes' Price / Book Value	
Ibovespa (Brazil)	1.37
Merval (Argentina)	1.73
Top40 (South Africa)	2.30
TA100 (Israel)	1.43
SPX (USA)	2.69

Source: Bloomberg, October 2014.

Why did this happen?

First of all, convergence as an economic force has not ended. Since 1991, emerging markets experienced a GDP growth per capita of 2.4 points per year ahead of the USA, growing a lot faster during a few periods and slower in others.

More importantly, the market is a discounting machine. It is not buying something that is seeing as good, safe and valuable that will bring awesome returns. It is buying something that has a lot of value and few people can realize, while maintaining a strict risk discipline to avoid getting hurt after the inevitable mistakes.

Investors should obviously look for great companies. However, great companies are not necessarily located in great countries. It is possible to have the best of both worlds: investing in an amazing, world-class company while paying for the discounted valuation in a lower multiple, more inefficient market. That's the Holy Grail investors should look for.

Our conclusion is that while we had a tough year for several general and specific factors that are part of our business, we look for the next four years with no real reasons to expect our returns cannot match what we achieved in the past.

If you are miserable because of the reelection of an inept administration, we also are, but do not be too gloomy. An environment where people think things are just perfect brings complacency, lower risk aversion and, more importantly, sky-high valuations. Times and places with problems usually carry the best opportunities, since that is where we can find the overlooked raw diamonds.