

FCL*Capital*

January | 2015

The power of cycles produces some mind-boggling facts

In the course of our annual report published last month, we stated the case that our portfolio holdings had a great year in 2014 and probably saw, despite all well-known flaws in the Brazilian government and society, their combined intrinsic value rise, while their shares and consequently our fund's shares, collapsed.

Seen from a different angle, this also means that the divergence between the intrinsic and perceived value in our positions soared. That means, provided we are right on this, a higher future payoff for our fund. We always remember late 2007 and early 2008, when we judged that the market was overheated but did not act accordingly.

Having learnt our lesson, when the market tanked in late 2008 during the financial crisis, we did something we are still very proud of - we published a [special letter](#) noting our perception of a great investment opportunity at that time, as it turned out to be the case.

Through the years, one of the most important evolutions of this house's investment management has been a higher appreciation of the power of cycles. Everyone thought they were investment geniuses in 2007 and right now many people are worried they could "lose everything".

We cannot talk for anyone else, but FCL's portfolio right now contains zero derivatives, zero short positions, and, as always, no speculative or short-term investments. In other words, although it can certainly be frustrating to see our share price declining like it did in the past few months, our investors can rest assured that our overall risk is as controlled and monitored as ever. Indeed, it has been quite lower, when judged by our portfolio overall positions, in the past few months than it is usually the case.

So does this all mean that our investments faced zero problems in 2014? No, this would not be the truth. Among the factors that hurt our performance, we could name, among others:

1) Brazilian elections

Since the current Brazilian federal government put the country in a state of stagflation -increasing prices with no growth - besides blowing a hole in the country's fiscal situation, it is only natural that investors are expecting low growth in Brazil for the near future.

This fact in itself would not impact us as much since we hold a portfolio of exporters and international companies (with a few exceptions) but there are many spillover effects. We can observe an increase in costs of capital, in the discount rate applied to Brazilian companies and, crucially, higher risk aversion in the short term when it comes to any company domiciled in the country.

2) Petrobras corruption case

We had never had shares in Petrobras (except for short-selling positions) since the foundation of our fund, but this crisis produces the same effects we mentioned above: increase in aversion to Brazilian assets and overall costs of capital and discount rates for the Brazilian economy as a whole.

3) Energy crisis

One of our main theses is that the Brazilian exchange rate will face in the next few years a major devaluation. Since this is our belief, we searched for ways to profit from this change while maintaining our discipline and mandate of being a long biased, long term oriented equity-centric fund.

Among the major opportunities we found were companies we thought (and still think) will be among the major beneficiaries of this coming economic reality in Brazil: agribusiness companies (Minerva), industrials (Gerdau, Braskem) and exporters (Fibria). We are still very bullish about the long-term prospects of all these companies, as we explained in our annual report.

One adverse consequence of this policy, at least in the short term, is that we ended up holding a portfolio that is somewhat intensive in energy consumption.¹ A consequence is that our portfolio, especially the industrial companies, like Braskem and Gerdau, suffered heavily in the past few months because of the current uncertainty regarding the energy supply in Brazil.

Investors, as we know, have a tendency of not swimming against the current and worrying a lot about the short term, so the good news is that we think this adversity is already in the price.

In fact, even if the country faces an energy crisis worse than the market fears, we would argue this should not affect the prices too much. As any finance student can attest, a single year of cash flows, even if severely affected (which would not be the case for any of our companies) does not change the target price so much, since what counts are the discounted cash flows over time.

But as we all know, the market sometimes chooses to have a single worry in mind, and the energy crisis is in everyone's minds (including ours) currently.

4) High prices of cattle

A fourth reason for our recent underperformance is the high price of Brazilian cattle ready to be slaughtered, which hurts the margins of our largest holding, Minerva.

The cattle cycle is in itself a fascinating theme. When cattle prices are high, ranchers have an incentive to hold their female breeders, producing more calves that in about three years will be ready to be slaughtered. This reduces the numbers of slaughters in the short

¹ This habit of seeing our portfolio as one single big "holding" company is also a peculiar and traditional approach we like to maintain.

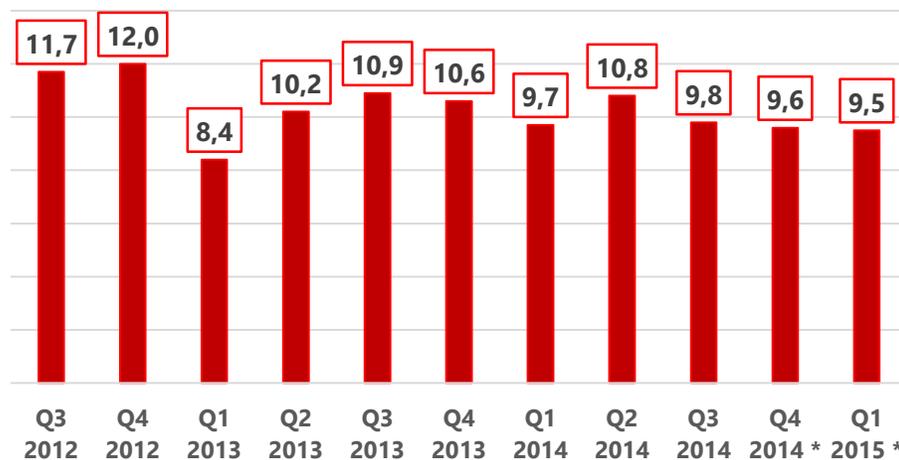
term (since females are being held); until more animals are ready at the same time to become food.

When this happens, ranchers then have an incentive to discard their female and male animals (since now there are more supply and consequently prices are low) and the cycle turns once again.

Cattle Price, Performance in Last 12 Months



Minerva, EBITDA Margin %



The fact is that supply is tight right now in the Brazilian cattle market, as it periodically is the case. Since our thesis about Minerva is very long term oriented and we plan to hold the company for many years to come, this does not concern us too much but it is true that in the short term it reduces the company margins

5) Oversupply of steel

Finally, there is the steel oversupply that is hurting Gerdau's margins. Gerdau is one of the best possible positions in the Bovespa if you believe (as we do) that Brazil will suffer a major currency devaluation in the next few years.

Simply put, the world is awash in too much steel, which obviously hurts the margins of steel companies.

Traditionally, a ton of long steel produced and sold by Gerdau in Brazil, can be sold at a roughly 15% premium to Turkish or Chinese bars (since an importer would have freight costs and so on).

Over the past year, as we stated in our annual report, Gerdau was the holding that hurt our performance the most, because on one hand the steel oversupply problem didn't get better, and on the other hand, the Brazilian currency did not devalue as much as we expected.

Now we have good reasons to believe both trends are turning: the Real's depreciation is gaining speed (which helps Gerdau to be able to increase its prices domestically in Brazilian Reals) and the oversupply problem may get better with China starting to deal with its overcapacity problems

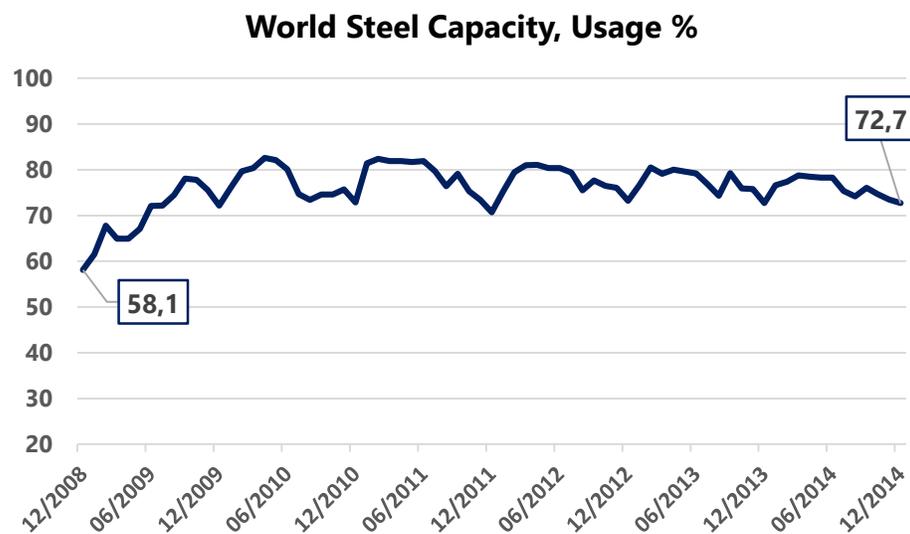
Chinese Steel, Price Per Ton



Turkish Steel, Price Per Ton



These reasons help explaining the bad market environment we faced in the past few months. That being said, as we all know, the market always searches for reasons and analysis, but during crisis, the time horizon of most investors (which is already short to start with in Brazil) diverges further from the listed company's founders, management (hopefully) and some long term oriented investors.



This next list shows some terrible stock performances of what, we think, are some pretty decent companies in the past 12 months.

Company	Last 12M Performance
Rossi Residencial	-78,77%
Mills	-78,46%
Saraiva	-73,74%
PDG	-71,46%
Magnesita	-64,09%
Unicasa	-59,07%
Log-In Logística	-57,36%
Imc Holdings	-54,97%
Profarma	-54,76%
Metalurgica Gerdau	-51,24%
Eucatex	-50,63%
Tereos	-49,36%

From the above list, we hold shares in Gerdau, Log In, and , starting this month, a small position in Mills, which we said we were not planning on buying, but the shares kept falling so much and so fast afterwards that we really saw an amazing opportunity where previously we didn't see any.

What strikes us the most about these companies is the short termism of many investors. Some of these companies, like Gerdau and Saraiva, are more than 100 years old. Saraiva, for example, was founded in 1914 and through the decades became an important publisher and retailer of books in Brazil, with a strong brand.

We personally do not love the business and don't hold any shares in the company. However, its shares fell almost three quarters in the past 12 months.

Is it really the case, we would love to ask, that the underlying intrinsic value of this centenarian business is worth only a quarter of what it was worth 12 months ago? Does anyone think the owners of the company really think that three quarters of their wealth and of their company is gone for good?

We don't really think so. The same goes for Gerdau, Tereos and some other companies listed above. Their shares prices fluctuated a lot for the worse, their operational performances and their intrinsic values not so much, and in some cases may have even risen

We have been stating often that volatility is the price to pay if you want to stand out from the crowd. It is impossible to beat the market in the long term without deviating from the average and if you do deviate from the average you will certainly have long periods of underperformance compared to the market.

This is the reason we always said that a possible fall from top to through of 40-50% can happen every decade or so in our fund. It will be painful but it will not harm our long-term goal of delivering superior average annual performance over the very long term.

Why is the equity market so volatile? The reason, in our opinion, is that over the past century equities were just a too damn good to be true business, delivering nominal returns of almost 10% a year when including dividends, far ahead of fixed income. It is a very good deal.

So what is the catch? Simple: you will endure painful volatility. You know that in the end, you will outperform fixed income, but you will suffer. That's the price to pay. Since many investors do not want to (or when push comes to shove, simply cannot) pay this price, equities remain a fabulous business if you are able to master the cycles.

In the context of the Brazilian reality, we think it is even more important to hold a concentrated long-term portfolio of good businesses, since the cost of capital is so high. Therefore, the frontier of risk versus return should be for most Brazilian equity investors above than the American or European ones in our minds (since you are competing with real returns in high single digits to start with).

Since this is a very specific mission, a select group of investors who think like us and understand what we are trying to accomplish is a necessary ingredient for our success and FCL has been fortunate to hold near permanent capital.

Cycles are therefore even more prominent in the context of an emerging and more inefficient market like Brazil than in its developed peers. As always, insiders are usually a good thermometer of the bullishness of any market: in 2007, several dozen companies rushed to do IPOs and sell their shares at the prices the market was paying.

Nowadays, we only hear about companies leaving the market and repurchasing their shares. On the other hand, practically no IPOs happened in the past year. It couldn't be any other way, after all insiders know their companies better than outsiders, especially short-term investors. They know better than anyone the difference between the price of their shares and the value of their companies.

Maybe this is the reason that every single great investor has had through his career, several periods of painful and multiyear underperformance, only to be proven right long after he was declared “wrong”² about the market. As Bill Ackman once said, *“investing is a business where you can look very silly for a meaningful period before you are proven right.”*

As often happens, we remember the tale of Mr. Market, the manic-depressive “partner” cited by Benjamin Graham in the classic book “The intelligent Investor”. Sometimes Mr. Market is euphoric, offering ridiculously high amounts of money to buy your interest in the business both of you own together.

On other occasions, he is really afraid and depressed, offering his share to you for very low prices. In both cases, it would probably be smart to take advantage of Mr. Market’s short sight. Most of the time, however, the wisest thing to do is do nothing and watch your business interest do the work for you. That is how we think about markets, with this take, narrated by graham six decades ago, always in mind.

² A famous example happened when a tech journalist declared, at the height of the dot.com euphoria that Warren Buffett should say “sorry” to his investors for having missed the boat.