

# FCL*Capital*

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## **Has the game of stock investing in Brazil been solved?**

In theory, we are supposed to buy stocks when they are cheap and sell then when they are expensive, trying to ignore the noise from the crowds. Maybe there is a reason the most successful investor ever lives in Omaha, far away from Wall Street.

Consequently, this also means that generally speaking, neglected stocks will tend to be cheaper and offer subsequently greater returns. There is comfort in being with the crowd, but this is usually a less lucrative path.

A puzzling anomaly has been bothering us, as value investors: it seems we are living in an age, at least when it comes to stock investing in Brazil, when consensus has been reached.

In video games, a game is usually “solved” when we reach the end and there is nothing else to learn from it. In investing, every value investor is told that consensus is something very dangerous and usually leads to crisis. <sup>1</sup>

We dedicate this monthly letter to one inquiry: has the game of stock investing in Brazil been solved?

Our first exercise<sup>2</sup> was to compile a table of the current major positions (according to the most recent CVM filings) of 10 of the largest and most respected equity houses in Brazil, from both Rio and Sao Paulo. In other words, our competitors.

Now for our top 5 positions as of late February: Minerva, Braskem, BTG Pactual, Metalurgica Gerdau, Log-In Logística.

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<sup>1</sup> As in “everyone knows that the housing market cannot fall in nominal terms” and so on.

<sup>2</sup> We excluded cash, which showed up frequently among the top 5 positions (another consensus position) and counted different share classes of the same company only once.

Competitor	Top 5 Positions
<b>A</b>	Itaúsa, Renner, AB Inbev, Cielo, BMF Bovespa
<b>B</b>	BR Foods, JSL, Restoque, Gerdau, Magnesita
<b>C</b>	Equatorial Energia, Cielo, Gerdau, Ultrapar, Itaúsa
<b>D</b>	Itaúsa, BB Seguridade, Cielo, Equatorial, Cosan
<b>E</b>	Equatorial, Via Varejo, Pão de Açúcar, Bradesco, Ambev
<b>F</b>	Itaú, Suzano Papel e Celulose, Cosan, Kroton, BR Foods
<b>G</b>	AB Inbev, Itaúsa, Qualicorp, Cielo, Kroton
<b>H</b>	BRF, Gerdau, Metalurgica Gerdau, Marisa, Tempo Participações
<b>I</b>	Itaú, Bradesco, Kroton, BB Seguridade, São Martinho
<b>J</b>	Bradesco, Cielo, Equatorial, Itaúsa, Cia Hering

A second exercise is related to cash. In fact, we suspect that if we included cash and short-term receivables among the positions, it would rival with Equatorial Energia and BRF as the single largest exposure among Brazilian equity managers. One of the 10 compiled competitors had a 33% exposure in cash, the exact limit a Brazilian equity fund is allowed to have.

The general exposure and asset allocation methods all seemed very similar from one house to the next. Exposure in the same sectors (large banks, a specific utility company, payment processors), high cash exposure and even a conviction in the same triggers, thesis and ideas, such as “we want companies able to perform in a low growth environment” and “we need something defensive and with high visibility”.

As we write this letter, some advice was being given by the top performing local manager this year and it was flashing in our Bloomberg Terminal: “the best strategy in the moment is to be extremely conservative and short term oriented” he said. Not surprisingly, when looking at his positions, he also had it all: Itaú, Bradesco, and so on.

At this house, because of our temperament, because of our size, possibilities and framework, we tend to avoid consensus and being contrarians as much as possible.

Obviously being contrarian for its own sake is not very smart, but when we talk with managers from Rio or São Paulo, the two financial

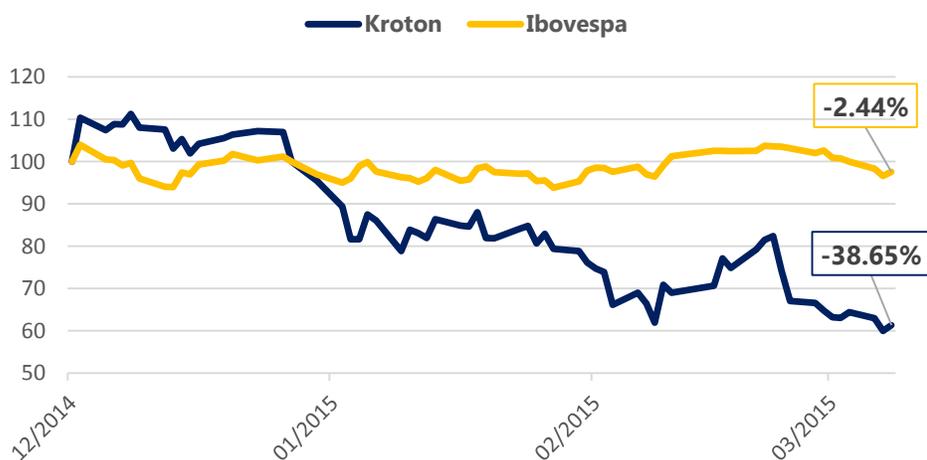
centers of the country, it seems a consensus has been reached. Does this bring opportunities or is just a natural consequence of the terrible economic environment we live in?

To answer this question, we think investors would gain some insights when analyzing the long-term performance of one of the “consensus” companies in their lists: Kroton<sup>3</sup>.

First, we need to give some credit to our competitors: it is hard to find a truly protected and predictable company in the Brazilian market. Kroton was indeed one reasonable bet (although too pricey for our taste) until the government suddenly decided to change, then un-change, then change again the FIES rules last month (which regulate student financing in Brazil).

Suddenly, one “predictable” company that was supposed to be “able to perform well and grow in a low growth economic environment” had its thesis destroyed.

## Kroton vs Ibovespa, 2015 Year to Date



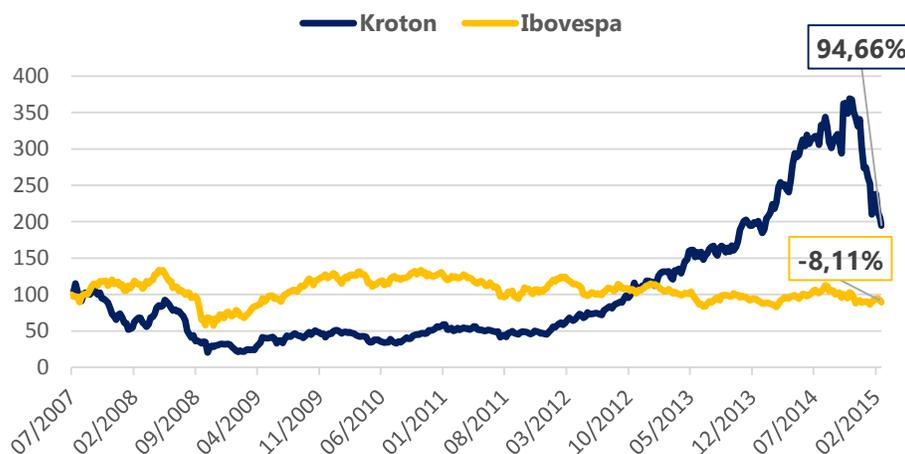
Once again, we are not claiming so far we would have done better than our competitors: we also can't foresee the future, especially because, to put it politely, we invest in a country that's not exactly

<sup>3</sup> Full disclosure: FCL never had long or short positions in the company.

Switzerland when it comes to predictability. We avoided the case because it looked expensive to us, but we did not possess any superior insight about a possible change of rules.

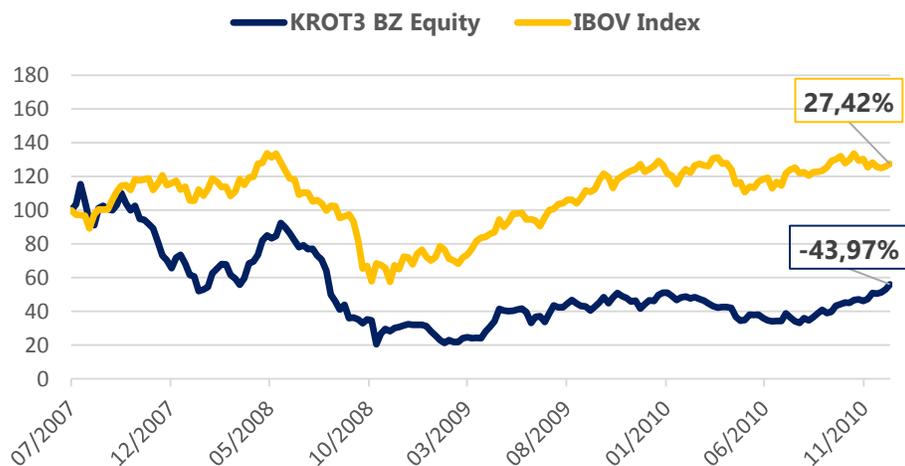
On the other hand, exactly because we do not possess superior insight, we avoid paying high multiples except in very specific circumstances. Going back to Kroton's historical stock price since its IPO, we think further insight could be gained:

## Kroton vs Ibovespa, Since IPO



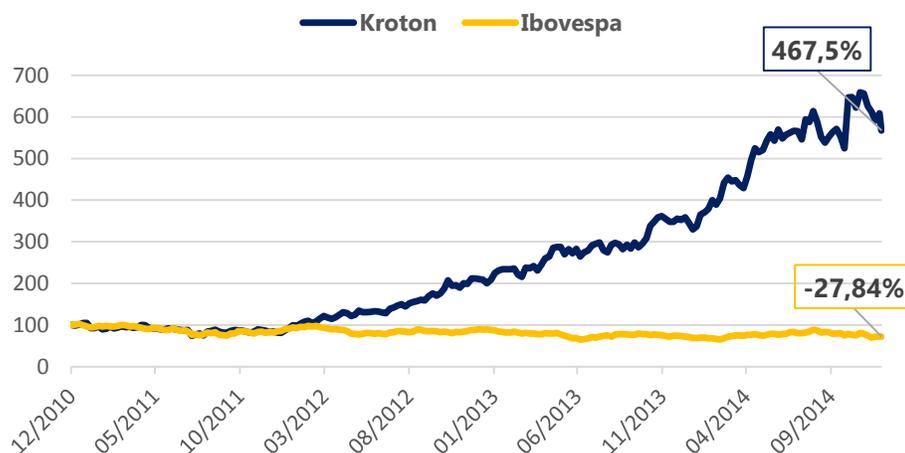
It may seem a very good stock performance, but look closer:

## Kroton vs Ibovespa, IPO - End of 2010



Kroton was one of the index worst performers in the 2007-2010 years, its stock falling 44% against a 27% rise of the Ibovespa index, when major doubts were raised against the company's management, business model, and even questions about the long-term profitability and viability of its sector.

## Kroton vs Ibovespa, 2011 - 2014



Then, starting in 2011, the tables turned completely; the shares appreciated 467% against a 28% decline of the Brazilian stock market, and Kroton was lauded as the anchor against a hostile government, the safety cushion when investing in Brazil's low growth economy.

Everything was going very smoothly until last month, when, the government seemed annoyed that someone was making too much money or simply realized that the financing program was getting too expensive and changed the rules of the game once again. Three different phases in eight years.

To some short-term investors this is evidence that there is a time to be in and out of specific companies and the market as a whole. We strongly disagree. No one foresees the future and can tell when cycles will turn.

Our recipe comes from a different perspective. We try hard to tell if the company is good or not, to visualize as hard as we can its future prospects (according to our limited knowledge and information) and

finally and very importantly, since we can be very wrong about everything, try not to pay too much for it.

Admittedly, there are advantages and disadvantages with our method. Since we just buy good companies at cheap prices, we do think our method tends to perform better over the long term.

On the other hand, since we do not try to find specific entry points<sup>4</sup> where to invest in a company and we spend a lot of time being against the consensus. For long periods, we can and do perform worse than the market.

No one gets too much hurt doing the same thing everyone else is doing. What is bad is being wrong AND alone<sup>5</sup>, which our investors should make no mistake, we will be from time to time. On the other hand, there are also few “multibaggers” in this more crowded path we try to avoid.

Which system is better? We do not think there is an answer for that. It depends on the specific abilities and virtues of the specific management team and very importantly, the specific mindset and alignment of its investors and limited partners

As some wall street veterans point out, your method is not what counts, what does count is that when doing what you are doing, you do have an edge over your competition.

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<sup>4</sup> When asked what is the single worst mistake equity investors make, we usually answer it is the search for the perfect entry point

<sup>5</sup> As one of our first investors put it brilliantly.