

FCL*Capital*

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The problem with asymmetric payoffs

It is very difficult to beat the market consistently. You have to disagree with the consensus which is easy on its own, but doing so and being right at the same time is trickier. Not only that, even if you are right while the consensus is wrong, there's an additional problem which will be the theme of this letter, which is the uncertainty regarding the timing of the payoffs.

There are different routes to attempt to beat the market. In its classic form, value investing consists of selecting predictable, cash flow positive companies traded in the market for a discount to its estimated intrinsic value. This is a style created by the late Benjamin Graham in the first half of the 20th century, further developed by his many disciples, the most famous of which is Warren Buffett.

At this house, we follow the Benjamin Graham tradition, but over time, we added a specific twist, further specializing in a specific subsector of value investing: we like to surf long-term trends that present asymmetric opportunities with potentially huge payoffs.

This is not merely an academic distinction. While both strategies try to beat the market by selecting superior companies, below their intrinsic value, the timing of the payoffs and their potential returns set them apart.

	Traditional Value Investing	Asymmetric Opportunities
Expected Performance	Slightly positive, slow and steady	Positive-Neutral
Potential Payoffs	Reasonable	Huge

Until we further progress, a few caveats: We believe very deeply in “slow & steady” when it comes to investing. A huge number of our investments over the years have been rooted in this framework and this continues to be the case, as shown in our position in Apple, a couple of months back. Moreover, there is compelling evidence that when it comes to stock investing, slow and steady usually beats erratic and inconsistent.

Nevertheless, we think there at least two reasons investors should not blindly choose simply the safest and most boring stocks right now. The first is that we think there has been too much focus in the Brazilian asset management industry in buying “disguised bonds” while investing in stocks.

In other words, every company lauded as “safe” and “resilient” became an obvious trade in the limited number of possibilities that the Brazilian and Latin American stock markets present. As experience shows, usually when something is unanimously regarded as “predictable” and “a safe bet”, it often turns out to be exactly the opposite.

The second relates to our fiduciary duty as stock investors and stewards of the money that is entrusted upon us by our investors. Interest rates are very high in Brazil so obviously the cost of capital has to be a concern. This does not mean that we are not looking to the long term, but it means that every positions has to bring a sufficiently big potential upside to justify the huge cost of capital stock investors have in Brazil.

Many positions currently favored by some “leading” managers in Brazil right now just do not cut it for us.¹ Our

¹ An interesting episode happened earlier this year in one of the few Value Investing Events held in Rio. After a thesis was presented, with limited upside according to the very manager who was proposing it but for a company deemed “safe”, the first question from the audience was

fiduciary duty tells us we should look either for potentially lucrative opportunities or, which would also be more honest, invest in fixed income, as we do, to a small extent, in our fund right now.

In bad times and long bear markets, like the one emerging markets are currently experiencing, our strategy will usually underperform the “disguised fixed income” one. On the other hand, when greed replaces fear, or a special trigger goes off, investing in asymmetrical opportunities will more than compensate for the lost time.

We know this may sound like a plea for patience for our investors. The last few years have been very hard for emerging market investors. However, intellectually, we are as confident as ever that after the adjustments we are currently applying to our strategy-especially the end of the overdependence in the Brazilian markets- our long-term returns should be back at where they were before.

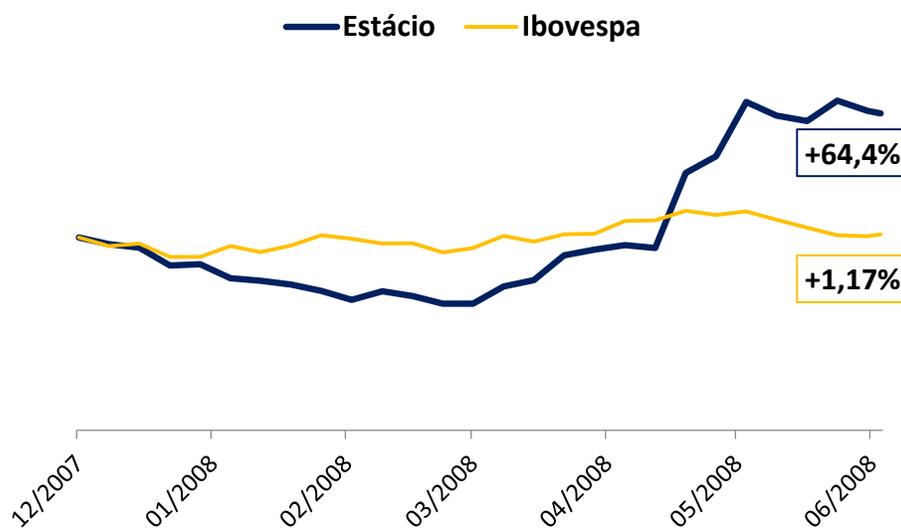
To summarize, we could present a few cases when we were underperforming and a special trigger gave our positions the exponential return we were after

A) Estácio vs. Bovespa

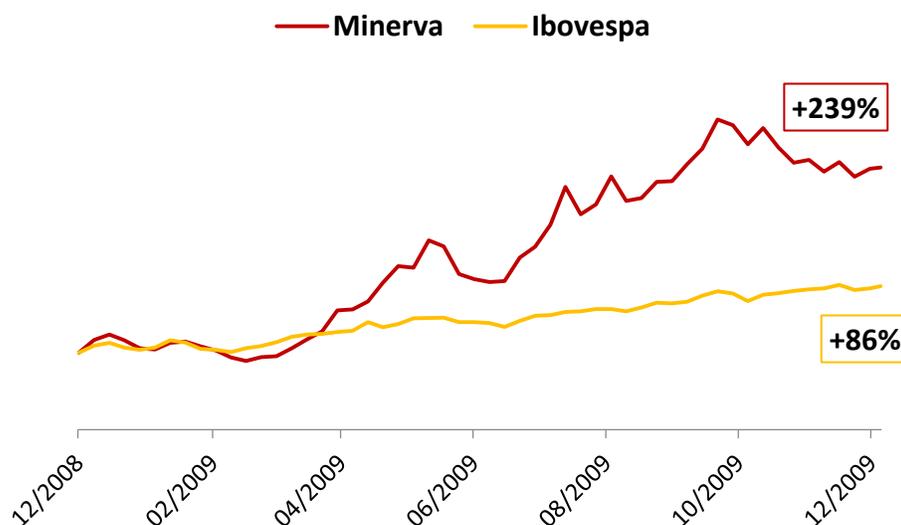
Estácio was underperforming the broader market in 2007. The consensus was that education was not a profitable or safe industry, the exact opposite of the consensus that was in vogue last year. As the company was free cash flow positive and trading very cheaply, GP , a large private equity firm in Brazil, bought the control of the group, giving us the

“good, but is this more attractive than fixed income”? Consternation from the manager followed, and a lot of soul searching by the audience in the next 20 minutes.

return we were expecting to be realized over a number of years.



B) Minerva vs Ibovespa in 2009



Minerva was already the best-managed meatpacking company back in 2009 when we started our position. The market was very focused in non-cash levels of profitability and leverage, and the recent financial crisis and currency

devaluation in Brazil had the consequence of putting the company's debt levels above some covenants. We, on the other hand, focused in the operational level, and the following year had exponential returns in one of the best positions of our fund so far.

We do not think the opportunities regarding stock investing in Brazil are dead, even with the current cost of capital – its investment managers in the country that will have to change their framework and adapt, but most are not prepared to do so.

They need more “Minervas” to forget about their “Cielos” or “Souza Cruzes”. Slow and steady is the best strategy for most of the time, but to be a contrarian ready to face the current interest rate environment in the country it is necessary a concentration in the few outstanding potential opportunities. We believe there are still a few of them out there.