

# FCL*Capital*

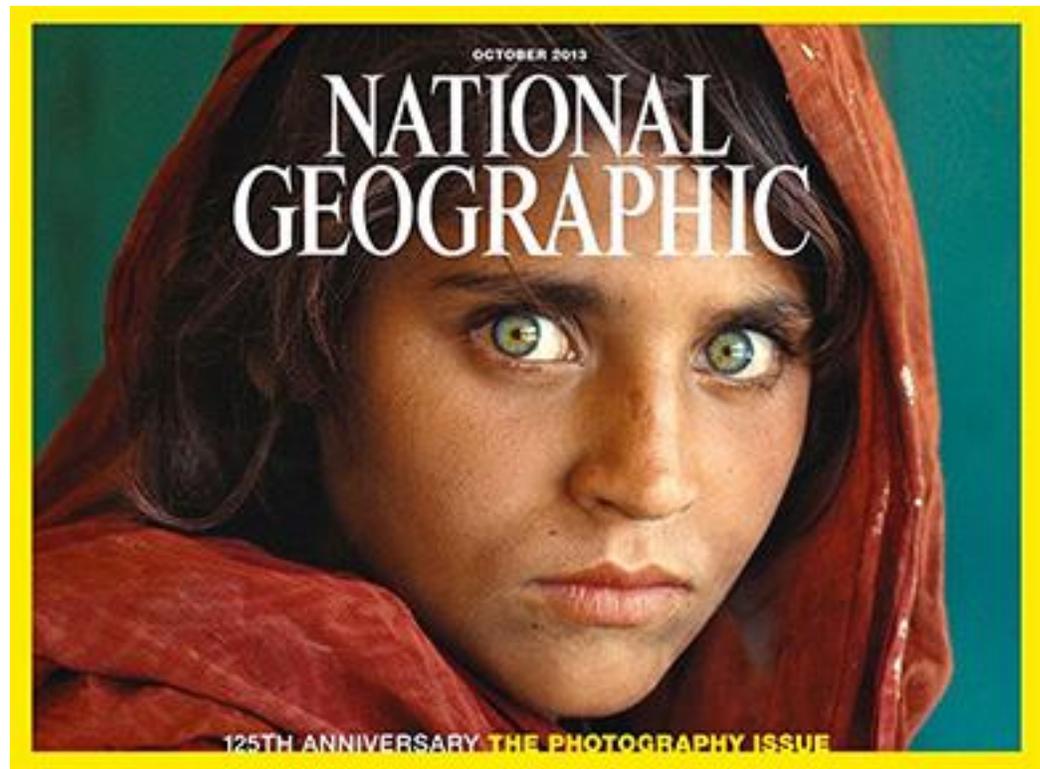
August | 2015

## A saga told in two classic covers

Some images and covers can capture the word's imagination. Sometimes we realize almost instantly, sometimes it takes a while to realize we are facing a masterpiece, an image that will change or symbolize how we as humanity view things.

Quite a few pictures have documented the world we live. From the famous Times Square kiss photographed during the "victory day" in New York City to the works of Cartier Bresson.

However, probably the most iconic cover, and one of the most amazing pictures ever taken, was the stunning June 1985 cover of the National Geographic magazine where the photographer Steve McCurry, while wandering in Afghanistan to study the Soviet occupation, stumbled upon and photographed a shy girl wearing a veil in a refugee camp.



The subject of this letter will also be an iconic cover that would go on to become one of the most famous ones in recent years of The Economist magazine, the publication that is, according to many including the partners of this house, the best magazine in the world.

The November 14 2009 issue of the Economist with the statue of Christ the Redeemer taking off, and the subsequent September 2013 issue with the same statue crashing down and asking “Has Brazil blown it?”



It is hard not to be emotional regarding this issue. It is not secret to our investors that we publicly said in this very space before that we think Brazil is governed by a populist, leftist, incompetent and corrupt administration.

However, this will not be the focus of this letter. As our investors know, we do not care so much about cycles, be they negative or positive. Instead, after reading, rereading, taking notes and studying both pieces published by The Economist, we will try to discuss with our investors how we assess the long-term potentialities and weaknesses of the country, and where we think Brazilian markets are heading.

In other words, what we think the next few decade will bring for Brazil, after the PT Party (hopefully) has left power.

To begin with, the vision about Brazil tends to be, for a number of reasons, binary. As The Economist notes in its 2009 piece, when Goldman Sachs first coined the “BRIC” term back in 2001, many people wondered how a country that had a growth rate as skimpy as the bikinis it is famous for could be included. Then everyone joined in euphoria and praise, and now, in a typical s curve, back to dismay

Not only foreigners are to blame. Brazilians are emotional by their very nature. In every rational and objective way , be it GDP Per capita, connectivity, property rights and so on, Brazil is somewhere in the middle of the pack, the typical “Grade C student”, certainly not Switzerland but also not Somalia. The problem is, sometimes, it seems when we talk to a Brazilian, noting this would be the most offensive thing. We are supposed to conclude that Brazil is either the next superpower, the country of the future, or... the worst place on Earth. Probably the one thing that would leave a Brazilian offended is the truth: Brazil is a regular, grade C student and probably will always be.

As the magazine notes, in some ways Brazil even outclasses the other BRICS: unlike China or Russia, it is a democratic country with a completely free press, despite some attempts by the ruling party to silence it. It has independent courts. Unlike India, it is not desperately poor, and is in complete peace with its neighbors, sitting in a great time zone between the USA and Europe.<sup>1</sup>

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<sup>1</sup> South Africa was included in the club later by politicians and for all purposes should never be treated as a true BRIC. If a country in Africa should be included, that should certainly be Nigeria because of its far greater potential.

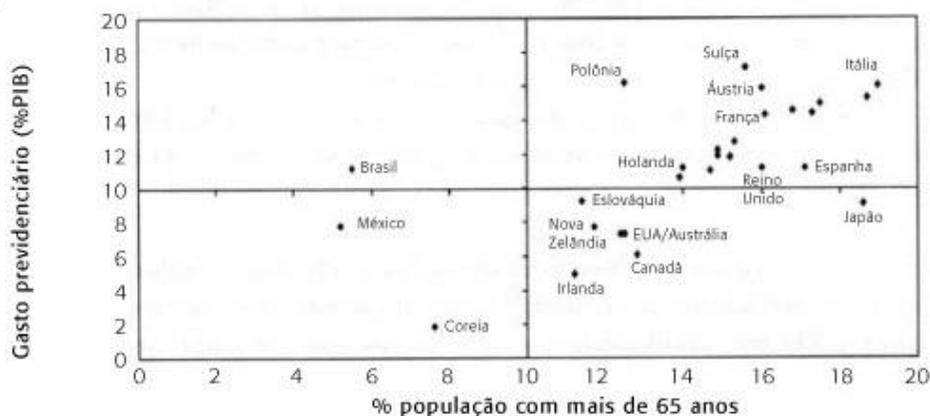
Brazil has been for so long a laggard that it was not difficult for the current ruling party to sell a misguided image of a country on the verge of becoming a superpower. In effect, one of the most cherished myths supported by the Latin American left is that the only reason this hasn't happened yet is because some evil outside forces are preventing it.

The Pré-Sal debacle is symbolic: it was supposed to be a “second discovery of the country” as former president Lula has said. Instead, the sad truth is, if oil stays below \$ 45 a barrel, the economic value of the whole Pré-Sal is close to zero.

To the magazine's credit, many of the country weakness were already dully noted back in the optimistic report in 2009: expenses growing faster than revenues and chronic corruption. We would add some of our own: a symptomatic tendency by individuals to appropriate chunks of the state for them, be them businessmen with their ties and subsidized loans from the government, the middle class, (with their public universities and sclerotic pension system) or the low-income segment with their transfer schemes.

In every democracy there is a natural tendency of avoiding short-term pain in favor of long-term gains. In Brazil, this notion is almost on a class of its own in its complete incapacity to reform its pension system, its tax system, and its labor laws, to weaken its corrupt state and to bring more openness when it comes to trade and regulation.

### Pension System Spending by Country



Source: Giambiagi

To sum it up, we think the main point is, people tend to see Brazil too much in a glass half full-glass half empty scenario. The truth is always more complicated and the country lives with its strengths and weaknesses at the same time. We will remain when in our best almost a tropical USA and when in our worst, the country of industrial policy, “clientelism” and “national champions” who are the dear friends of the government.

More than anything, Brazil has an amazing potential. Indeed, if a Martian came to Earth tomorrow, he would probably judge that Brazil has the fourth greatest potential of any country on Earth. Only five countries are at the same time continent sized (which brings scale, natural resources and lowers costs) and have a population of more than 100 million people: the four BRICS and the United States of America.

Considering that the USA, China and India, with much bigger populations are certainly destined to be, by far, the three largest economies in the world for the remaining of the 21st century, Brazil ought to be, if it delivers at least partially on its potential, the fourth largest economy. It enjoys better

demographics and has more scale and potential than Japan, Germany, France and Russia.

In fact, even after the recent currency's slide, the country's largest company by market capitalization, Ambev, is worth more than U\$ 80 billion dollars. This fact in itself should be a reminder of how relevant the country is: not many markets are capable of producing companies of a caliber comparable to Ambev or Itaú. Certainly, you cannot compare Brazil to, say, Colombia or Argentina.

So why this country is stuck in this mess? As we are saying, many of the country's wounds are old. But if corruption, statism and clientelism are certainly not new in Brazil, the PT party certainly deepened these troubles, increasing expenses way beyond what was responsible and thinking the good times would roll on, rewarding its friends and not caring about predictability, rule of law, easiness of doing business.

Countries with over 5.000.000 KM <sup>2</sup> in territory	Intersection	Countries with over 100 million population
Canada Australia	Brazil Rússia India China United States	Indonesia Pakistan Nigeria Bangladesh México



Brazil is, in this beginning of 21st century, not by chance, a mirror image of China: too much consumption, too little investment. It could not be any other way; the future is not something too important in Latin America in general. *“Interest rates are high, things are uncertain, let’s live for today”*, the region’s governments certainly think. The problem is that eventually the future does arrive.

### Brazilian Budget Deficit



Source Bloomberg

In the short and medium term, the country’s direct problem is fiscal. Over the past 12 months, the country’s downgrade has gone from a dire possibility to an almost certainty and finance minister Joaquim Levy is increasingly showing signs of giving up the fight.

We do not envy him. He has to convince a messy coalition of Marxists and clientelist coronels of leaving their instincts behind and voting for budget cuts that would make the country healthy again over the long-term, especially if the government is able to approve a pension system reform, but

over the short-term they could lose votes. In addition, as we know, the future is uninteresting in Brazil. Let us live for today!

When China gave its first signs of trouble five years ago, the government's natural response was to revert to its statist mindset: credit subsidies to chosen industries and companies, protectionism, avoidance of free trade, new regulations, murky agreements and understandings with executives not to fire anyone, and so on.

Above all, a frequent change of rules that completely misunderstands how predictability is important for a private company. Almost every single morning former minister Mantega would be calling a press conference to announce a new change of rules, with such a dizzying frequency that we started calling Brazil the "anti-Switzerland". If the alpine country is so safe and predictable to be called "boring", Brazil is certainly its total opposite.

Medium income country, like Brazil, are certainly in a tricky place. Very poor countries, when they change just a few basic things, can quickly develop. For example, for many African countries today, or for China three decades ago, moving people from the countryside to the cities, allowing private enterprise, and so on, was more than enough to usher a new era.

When countries approach the middle-income level, however, this will not be enough anymore. Productivity starts to matter, and for this to keep improving a new set of things has to emerge, like decent infrastructure, improving education, a good work ethic, sound rules, sensible and moderate taxes and regulations, a healthy business environment, and so on.

On all these counts, Brazil still has a lot of work to do, and what is more worrying, the government, too much focused on the short term, does not care or does not want to attack any of these problems.

The good news is that the tide eventually will rise again. If Brazil was a stock it would certainly be a buy; a strong competitor that just needs a change in administration. It is a shame the Carls Icahns of the world cannot buy the whole country and force a change. It will have to come from inside. On the other hand, the soft infrastructure is in place: a free press and executives that are increasingly aware and vocal about these problems.

The country, like many other emerging markets, and unlike the 1990s, has a floating currency regime, which is certainly the main reason it is not in deep crisis, the first buffer is a sinking currency, not a payment crisis. When it comes to the external sector at least, the middle class will have to learn within its means and forget about vacations in Florida.

Moreover, for investors, an important reminder: there's no correlation between GDP growth and stock market returns, or even better, there's a negative one because once the economy is booming, the valuations of listed companies probably already reflect that.

We think this is a great time to buy Brazilian stocks. In fact, with the terrible fiscal situation of the country, we would even argue that, as was shown at the turn of the century in Argentina, counter intuitively, investing in Brazilian stocks, especially exporters like this house has been doing, is a safer place to store your money than government bonds that could eventually default like LCAs and NTNBs.

Finally, an honest consideration: if we had a strictly global mandate to pick stocks with no emphasis on any single

country and were located in, say, New York or London, we would probably be looking at emerging markets now.

The S&P500 has been doing well for the past five years in an amazing divergence with emerging markets and its multiples are high even before considering that 48% of the earnings of the companies in the index are from abroad, in Euros or other currencies that have severely depreciated against the dollar.

**Difference between Ibovespa and SPX, Last 5 years**



Meanwhile, companies like Fibria and Braskem, both in our portfolio, have almost all of their earnings and cash generation power tied to the US currency, and even in Brazilian real their valuations suffered terribly with the Brazilian stock market plunge. If we dollarize their multiples adjusting for the American currency, their valuations are close to their lowest levels ever.

Trailing EV/EBITDA comparison in Reais and Dólares		
Fibria	In R\$: 11,37	In US\$: 8,07
Braskem	In R\$: 4,04	In US\$: 3,23

The interesting thing about having success in markets is that the most basic aspect of this activity is the need to think objectively and independently. Over the first half of the year our portfolio suffered severely because of our decision to concentrate our fund in shares of exporters that would maintain their earning power in case of a severe depreciation of the Brazilian currency.

The market, on the other hand, punished us and rewarded the shares of companies deemed “safe”, meaning with predictable short-term earnings stability in real. Now, suddenly, these companies are suffering and our portfolio is being rewarded and performing wonderfully. We even got a few calls from investors asking how we could produce such stellar returns amid the market’s carnage in August while being fully investing.

The short answer is that we were not fools before because of our previous underperformance, and we are not geniuses now because of our recent success. Investing is a marathon and in the end, the only thing that matters is how diligent you are, how well thought are your convictions and, above everything else, if since the beginning if you were right or wrong

Performance over the past 6 months	
FCL Capital	+7,16%
Ibovespa	-9,61%
CDI	+6,49%

**Addendum:** Dear investor, this letter was concluded on September 8th 2015, right before two extraordinary events that would probably alter its text: the shocking picture of a Syrian boy named Aylan drowned at the Turkish beach of Bedrum and the information that the ratings agency Standard & Poor's put the Brazilian sovereign credit note on speculative grade.

It is worth mentioning, the following day after this event; our portfolio went up in Brazilian real and slightly down in US dollar terms due to the Brazilian currency's depreciation. This is a fresh reassurance that we are on the right path in our strategy of focusing our exposition in Brazilian exporting companies or companies that earn revenues in strong currencies.

We chose to leave all this letter discussions, including the ones about covers and pictures that changed history and about the imminence of a Brazilian downgrade intact since those were our reasoning at the time of the confection of this letter.

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