FCL*Capital*

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Random numbers, beauty contests and fishermen tales[1]

In 1998, the Financial Times offered to their subscribers a contest where the two best answers would gain a free business class ticket from London to New York City. It was an absurdly simple question: each participant just had to pick a random number from 1 to 100. The two closest answers to ⅔ (two thirds) of the average of answers of all participants would be granted the coveted business class tickets.

The contest was, of course, a rerun of Keynes immortal "beauty contest" phrase, saying that the stock market was such a fascinating machine because it worked like a beauty contest. You didn't really have to elect the girl you thought to be the most beautiful one, and not even the girl that you thought most people would think was the most beautiful one, but the girl you thought most people would think that most people would think was the most beautiful one... on and on in uncountable orders of magnitude.[2]

So what would that magical number be? Well, assuming participants would randomly guess any number from 1 to 100, logically, this being a normal curve the answers of both high and low numbers would cancel each other and the mean would tend to be around 50. But remember: you have to guess what number is closest to two thirds of the average number, so many people guessed the number 33 (⅔ x 50). But wait! You are probably not the first person to think of this, so why not pick the number 22, which is ⅔ the number 33? But hey, maybe some people got this far... so maybe a number like 15, which is closest to two thirds of 22? And so forth.

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[1] We enthusiastically recommend the Book "Superforecasting", one of the best on the subject we have read so far.

[2] We always thought interesting that Keynes never thought about securities you could carry to maturity in case of bonds, or to perpetuity, in the case of stocks.

Some people even pick the number 1 betting on an endless chain of diminishing numbers and since zero was not an option, this would be a bet on a logical end of the line outcome. In the end however, the correct number was something close to 13.

The two winners, it seems, were a very sophisticated mathematical trader, who probably spent uncountable hours thinking about all of these ramifications, and, it could not be any other way, someone who just guessed the number 13 "because he felt like it".

That´s exactly how it works in most human activities: a magical combination of some luck and some skill can do wonders.

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Let us face it: investing is a probabilistic human activity. There is no such thing as a sure thing in investing. Not even buying US treasury bonds and knowing "for sure" they will be paid in full. In fact, in the past couple of years, there were two instances when, in the middle of a huge game of brinkmanship between the US congress and Barack Obama, the world was scarily close to watching a full blown US default. The only reason this amazing occurrence did not shake the world markets too much is that a US sovereign default is in the realm of things that are so powerful and destructive. Like an asteroid potentially destroying earth, the inevitably of death and so on, that it is not even productive to think too much about it if they are really going to happen.

And so life went on.

Now, predicting reasonably the future is a necessary activity when engaging in an endeavor like investing. You are necessary positioning your and your investor's portfolio in the best and most resilient possible way to face undetermined and ultimately at least to some extent unpredictable events. Since investors are ultimately human beings, desperate for some meaning and understanding about an uncertain world, they tell themselves stories that we are going to call fishermen tales, to feel safe and justify their own actions to themselves as well as to other people.

Howard Marks once said that everything in investing is a two edged sword. This is a brilliant metaphor. For example, the only way to beat the market is to select securities, or pick a time to be in or out of the market, that is different from the market itself.

The other side of the coin is that since you will have a different exposure than the market than the market as a whole, the more different this exposure is the more chances you will have to beat the market eventually, if you are good or lucky. On the other hand, the more common will be the painful periods where you significantly underperform market.

Some people are amazed by why all of the world's best investors have in their lives endured terrible periods of underperformance. The answer is simple: since they have very different exposures than the market itself, which is the only possible way to beat the market. This will necessarily mean that in many painful periods this same fact will ensure they underperform.

Aside from being a two edged sword the market is cyclical and one of my favorite letters by this house so far concerns exactly the matter of cycles in the market.[3]

So how do investors deal with a market that is by its very nature unpredictable, uncertain, cyclical and a two edged sword? They fake certainty. In addition, they do it telling themselves and others fishermen tales.

Take, for example, the term BRICS. As if any acronym - and investors love acronyms - it was made for everyone to quickly

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[3] Our March 2013 letter: [Link]

understand something. In this case, the idea of convergence, that there were four countries that were not rich but had huge populations and landmass.

But to unite them in a single concept, and even worse, for their governments to embrace the idea and turn the club into a political organization, even “inviting” a new member that never really belonged in the club nor it should, is just crazy.

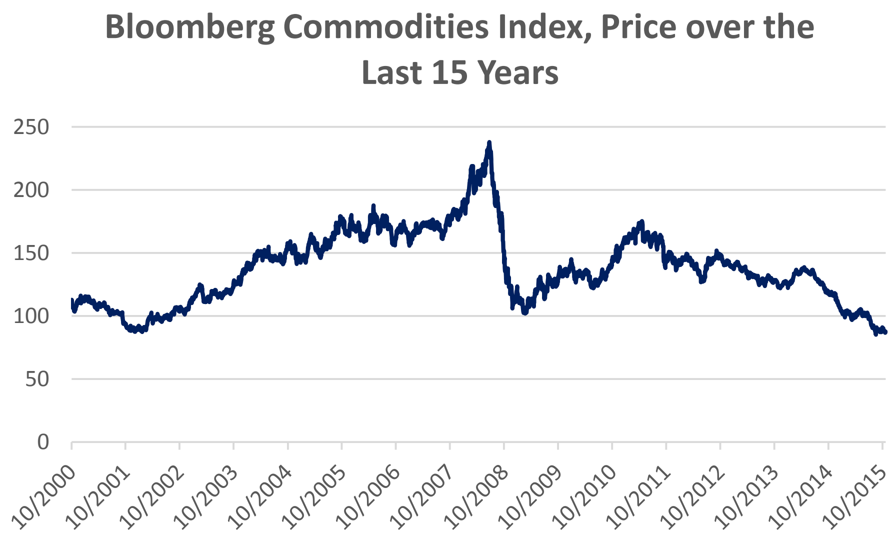
The BRICS contain two democracies and two dictatorships, each one with their own characteristics. Among the four, we would bet only China will go on to become a (mildly) developed country in the next few decades. India also has huge potential, being home to more than a billion people but has huge structural problems that don’t matter yet but probably will in a decade or two when the country reaches a level of development closer to the one Brazil enjoys today. Russia is still a giant gas station disguised as a country and Brazil will survive the current crisis but don’t count on it to become an economic superpower in this century because, sorry, it won’t.

Over the past 30 years the amount of acronyms and fishermen tales was astonishing. All of those were born for a reason: to understand something, for investors to feel safe inside an idea. The problem is, these tales and ideas generate herd behavior. Over the past, 10 years alone we went from “peak everything” in 2007, the idea that the Earth was running out of commodities and resources that made investors pile hundreds of billions in dollars in commodities indexes, to the current idea of the end of convergence and avoiding emerging markets at all costs because “the super cycle of commodities is over”.

Among the hundreds of ideas and stories used to sell financial products in the past few decades, the BRICS, the “new economy” of the internet stocks, “Japan is the future” (1980’s), shorting Japanese bonds to profit from Japan’s eminent collapse (2000’s), peak oil (2007), the shale revolution that is supposed to end America’s dependence on oil (2014), “frugality” companies for the recession

(2009), luxury products to thrive on global inequality (2013) and many, many others.

The interesting thing: sometimes stories and people´s mood changes and then asset prices and the world responds and changes accordingly, sometimes the world changes first and then the stories to explain the world (fishermen tales) change accordingly.



How to make sense of all of this?

A brilliant insight was given by Nicolas Nassim Taleb. Although we can never know the future for certain, a helpful indicator is to look symmetrically to the past: you want to know for how long a certain technology will still be around? For how long has it been around? The more something has been around; more it is likely to last. Suddenly we are back to the two edged sword and symmetrically of investing where we began this letter.

Why are we telling this tale? In part because we suspect once again investors are rushing with their stories when trying to understand Brazil. True, we share all the current desperation regarding the country´s current president and ruling party. Brazil is in the hands of inept kleptocrats. To borrow from Taleb, it's been just too short a period of time ago when the country was supposed to be the next economic superpower

If the current cycle had been going for decades, then we would also suspect it would take decades for the crisis to end. Since some of these same investors were so bullish just a few years back we suspect new fishermen tales will emerge to explain why Brazil will soon be a superpower and this won´t even be decades ahead.

Obviously, once again, nothing is guaranteed and investing is a probabilistic activity. Maybe Brazil will remain in this crisis for decades to come. Among many other reasons to discard this hypothesis, the crisis has been going on for too short a period for anyone to think of this as a base scenario. If assets prices were priced at sufficiently low level, even if this were true it would not change the possibility of a great buying opportunity.

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A final point has to be made about Braskem. It is the one investment we are most proud of in 2015 and one of the major reasons our fund is ahead of the benchmark this year. "Buy on the sound of cannons sell at the sound of trumpets", a wise man once said. We increased our position in the company after Dilma's reelection and at the height of the Lava Jato operation, where the company´s President of the Board was, very publicly, arrested and is currently being considered a key man for the investigation, potentially implicating in the possible arrest of former president Lula da Silva.

This is obviously, a situation any investor wants to avoid. Not to mention, even if it were not for this investigation that dominates the pages of newspapers in the country, Braskem is a cyclical industrial company; in a complicated industry that depends on growth of a very problematic economy, that is Brazil. So why did we increase our position?

Four reasons, according to our analysis:

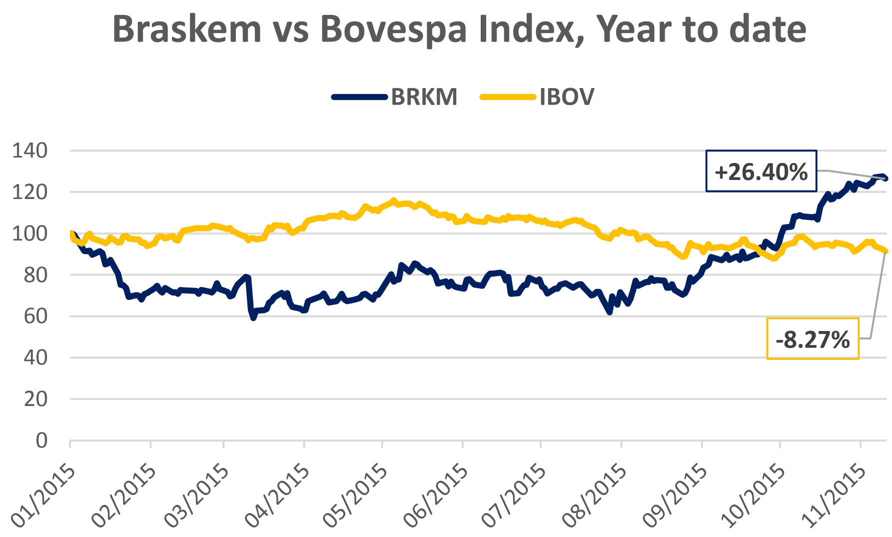
a. The company is, if anything , a victim and did not benefit itself of any wrongdoing;

b. Braskem enjoys huge and almost irreplaceable competitive advantages;

c. It is a fundamental company in the Brazilian economy. If it goes broke, Brazil stops. In fact, it is a huge monopoly and there´s no easy way to replace the company if it just disappeared from the face of the Earth tomorrow;

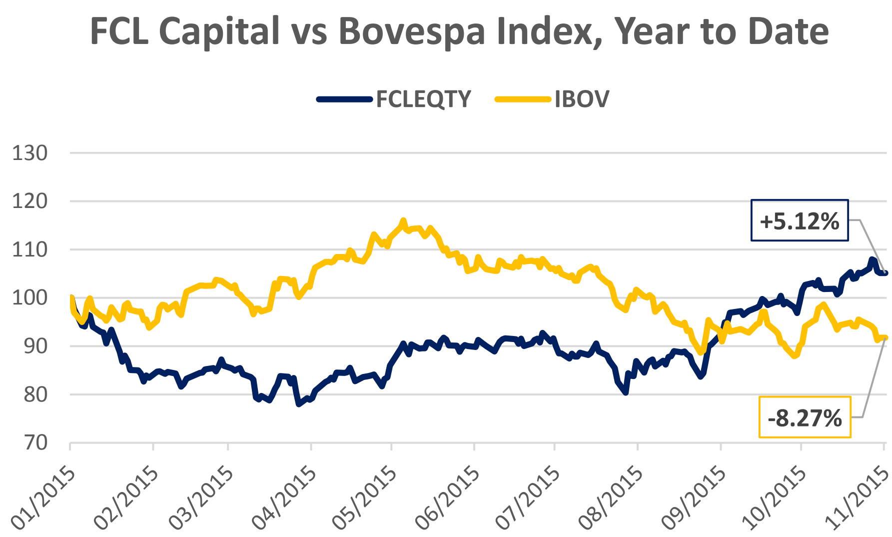
d. Every conceivable bad news was more than reflected in the price.

Once again, not an easy and typical position to hold, but one where we are very proud of our analysis.



AS it happens in many amazing investments, for a while we were almost shy of disclosing this investment to many of our peers and investors. There were many obvious reasons why investors wanted to avoid the stock. That was precisely the reason it was so cheap.

To borrow from another of our favorite investment phrases, in investing and in business, "what is comfortable, seldom is profitable". This was the case with our investment in Braskem.



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Relacionamento com Investidores

fcl@fclcapital.com

info@fclcapital.com

Avenida das Américas, 500 - Bloco 3

Sala 125

Rio de Janeiro / RJ - Brasil

CEP: 22640-100

Telefone: (55) (21) 3268-7918

www.fclcapital.com