

# FCL*Capital*

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Learning doesn't come easily. Increasingly, psychologists find out that "talent" however loosely defined, is kind of overrated. "Grit" on the other hand, or simply, will power, passion and perseverance is a far greater predictor of winners and losers.

As Bernardo Rezende, Brazil's national team's volleyball coach said in a monumental phrase in his memoirs book, "every time i face a choice between a monstrous talent and a medium one, but full of grit and willpower, i end up realizing that the second kind always prevails in the end. Every single time"<sup>1</sup>.

To sum it up, as many said before, "sucess is a lousy teacher". But since life is too short and would be too painful to provide learning solely through one's own missteps, it is always best, when possible, to learn a bit from other people's mistakes as well.

We dedicate this letter to our greatest insights, discoveries, lessons, surprises and mistakes in the past decade. Most of these insights were achieved through trial and error, some of them while watching fellow investors and finally, some, through painful mistakes. We hope you enjoy our list and feel free to write us with any insights you think are important to you as an investor or businessmen that we might have left out!

What follows is our personal guide to what we think the future of investing will look like.

## **-Second level thinking**

The first idea is one that is (thankfully) becoming increasingly popular in the investing world but still a foreign concept to most investors.

One of its early proponents is a recurring appearance in our letters: Oaktree's chairman Howard Marks.

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<sup>1</sup> Loosely translated from Bernardo Rezende biographical book, "Turning sweat into Gold" written after Brazil's gold medal conquest in Athens, 2004.

Basically, second level thinking proposes that what really matters is not really what you think will happen, but the deviation from what reality will be to the average expectations.

If “everyone” is buying stocks of a specific country or industry or company because “everyone knows” they can only go up, it may be wise to sell. And vice versa.

There is a reason this house lists “contrarianism” as one of its core principles: no company is so good that its share price and expectations don’t even matter. Also, no company is so bad that there is no price at which it may be wise to buy its shares.

There is the always forgotten difference between good and bad companies (or real estate, bonds, etc) and good and bad investments in those same assets. They are **not** one and the same thing.

Prices are an information. They are an instrument in the search for the truth. And this searched for truth is the company’s exact and true intrinsic value.

One of the most obvious examples of second level thinking: Valor Economico newspaper recently compiled an index of companies investigated in Brazil in the “Lava Jato” trials for corruption. Obviously, as a group these are companies any investor should be very, very careful before jumping in. A bad outcome in this investigation can be a fatal blow.

One of the companies in this “index” is, by the way, Braskem, one of this house major positions for the past few years.

It turns out, quite surprisingly to some, that this index outperformed the Brazilian benchmark in the past year. Not only that, but Braskem has been a star performer in the Bovespa and our portfolio.

How is that possible if these companies face such a large handicap? How could we advocated investing in (let alone profited from) a company whose Chairman had been implicated in Brazil’s most high profile corruption case ever?

The answer is second level thinking: what matters to the share price is not reality per se, but the deviation between expectations and outcome. Everyone "knew" it would be crazy to buy Braskem's shares. That's why its shares were trading at levels that made Braskem a no brainer. Almost nothing could happen that would make its shares not appreciate significantly. It was in fact, as we publicly advocated in our investment pitch to Sumzero<sup>2</sup>, one of the cheapest and most promising large cap stocks in the world by almost every metric.



Braskem: Up 63% in the past 12 months despite terrible news flow.

If everyone bets that a given horse will win the race, even if he does, this will probably be a mediocre investment at best. The simple fact: there are good and bad assets ( be they copanies, land, art or whatever) and good and bad investments and these two groups are not identical.

**Investing according to amateur investors : returns = ( and depending on) an improving reality**

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<sup>2</sup> FCL Investment Thesys to sumzero website, march 2016

## **Investing according to smart second level thinkers : returns = reality - expectations**

The formulas above sum up the difference of investing between the eyes of investors that have or have not second level thinking.

As we develop a cursory interest for investing, we all have a natural tendency for first level thinking: "i love this company, its stock must be a buy!", or " the economy is heading for a recession, better to sell stocks!".In fact, the vast majority of investing professionals are still trapped in first level thinking.We can read this kind of advice every day in financial press.

Second level thinking is different.It starts from expectations themselves. It requires an unnatural way of thinking. " Is the recession that is coming already fully reflected in stock prices? Not fully reflected? Or more than reflected?

Note that in second level thinking we start by the positioning of market participants and not by what we think will happen. And how do we know what the market is thinking? Simple, we look for the most relevant information in a capitalist economy: prices

Once we have prices ( be they prices of stocks, bonds, real estate and so on) we know what everyone as a collective is thinking.And then we can explore this information comparing our own judgement with the judgement of the market.

Beware: second level thinking is extremely difficult. It is an extreme form of value investing, it is unnatural, it is hard to do.But to learn second level thinking has been one of the greatest insights and toughest challenges and tasks this house faces every day.

## **-Disregard for external opinions and noise**

At FCL we like to operate the same way Nietzsche liked to write his books: "with windows closed".

Why such an eccentric positioning?

It is widely accepted that one of the most important traits of value investors is the ability and capacity to think with your own head. While we undoubtedly agree about the importance of fact checking, knowledge gathering, information search in an uncertain world, at the same time, there is a point that you have to process all this excess of information that modern age provides us.

And here is the thing: in a world where every professional has a Bloomberg terminal and instant web search, what differentiates investors is not anymore the access to information—that was indeed once the case decades ago— but how we process and deal with the information we all have.

Last year we dedicated one of our monthly letters to the importance of place, and the fact the world's most successful investor lives in peaceful Omaha, thousands of miles away from New York City or London. This is not just a coincidence. Isolation brings clarity and conviction.

But there's even more: even if a firm prides itself with a culture of search for knowledge and independency, we suspect a collegiate structure to decide about investment allocation can be harmful. Groups tend to produce average and average is the enemy if you are trying to do something so hard as to beat the market. Indeed, recent research has been clear that sole managers beat collegiate structures in terms of investment performance.

The future of investing won't be of supercomputers and robots, as many think. Indeed, precisely because those things are coming, the future will be of lone wolves and small time garage investors beating the pros, who no longer will have the information advantage and that will have huge institutions that forbid them to be nimble.

How can lone wolves beat the market: by looking for overlooked corners ( like Michael Burry famously did in the subprime crisis), by attempting to facts that are overlooked at the financial dinner tables: companies in industries with shrinking supply instead of increasing demand, companies that are small enough not to appear on the pages of the Wall Street Journal frequently, companies that don't do roadshows in the biggest financial centers.

That's why we think the future of asset management belongs to lone wolves who completely disregard and don't even have access to external opinions and the everyday noise of Wall Street.

### **-Ideas count for nothing**

Investing requires a few contradictions: you have to be smart, but also to be fast when proved wrong. You have to passionately fact checking- always , every day. Chances are that your most beloved ideas are just dead wrong.

Also, even if you love your ideas, execution and timing are more important than you might want to admit: just ask the value managers who went burst shorting the nasdaq nack in 1999 when it was going to the strathosphere. Just ask every entrepreneur who had exactly the same idea that Mark Zuckenbergr or Larry Page did ( hey, Friendster has been around since 2001, Altavista since 1994).

Indeed, one of the funniest things about entrepreneurs is the overemphasis they put on their ideas: they try to keep it a secret when the opposite approach: telling just about everyone about it, to stress it and try to improve it and see if it still stands would be better. If you have an amazing business idea, a note to you: your idea is worth nothing. Outstanding execution is potentially worth billions.

And last but not least, investing is increasingly a job where little details can cause an earthquake: that long forgotten footnote, that discredited industry analyst who is the only bull ( or bear) in a particular country or industry, those crazy and excentric investment managers...you will find thousands of dead ends to find a pot of gold hidden somewhere.

## **-Create your own competitive advantage**

Everyone is especially good and smart at something. Start from your knowledge base, your own personal moat.

In the case of this house, we are obviously tilted towards emerging markets ( but without disregarding developed ones completely) and focus on three core industries where we think we have personal moats and competitive advantage ( in terms of knowledge , relationships and expertise) : consumer industries and services, basic industries and commodities producers and finally, technology.

Build your own mosaic of knowledge, your personal moat, and start from there.

**-Bloomberg terminals and financial models distract us: in the end its all a game of figuring out which businesses will thrive and which will not and not overpaying for the first group**

**-With al that being said, the future is too uncertain and unpredictable, so buy cheap, buy value**

Don't overpay. Trust us, no thing is a no brainer, nothing is a sure thing. Don't overestimate your own capacity of predicting the future.



## **Our way:**

An ultra lean, tech enabled operation with a small but passionate team that dedicates its time to invest in its own unconventional way and looks for the overlooked corners in investing ( and trust us, there are still many overlooked assets if you are bold and have a global mindset)

## **Finally: where we do think we did most of own own mistakes in the past decade?**

In retrospect, we probably overimphasized a few things and wrongly downplayed the importance of others. We certainly also had home runs.

There were circumstances where after much research we came to a conclusion that although correct turned out to be irrelevant because something else that we had not foreseen or didnt give any importance to changed the whole story. We do think this is a frequent value investor mistake and one where we are trying to smarten up to.

With that being said, a personal reminder: we are still beginners in our first decade of investing. We hope to learn with our mistakes and become better investors over time.

## Sobre a FCL Capital

A FCL Capital é uma gestora de recursos sediada no Rio de Janeiro, cujo objetivo é maximizar o retorno de seus investidores. A FCL tem como nicho principal, mas não exclusivo, investimentos em empresas abertas, listadas em bolsa de valores (posições compradas e vendidas nos mercados acionários). Para saber mais sobre nosso trabalho, entre em contato conosco ou acesse nosso website: [www.fclcapital.com](http://www.fclcapital.com).

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