

FCL*Capital*

October | 2016

Location & Investing

For anyone wondering about where capitalism is going, counterintuitively, a good place to start is in Uffizi gallery in Firenze.

Outside, the beautiful and charming streets of what was once, centuries ago, one of the world's most important commercial hubs. Inside, art by masters like Da Vinci and Botticelli.

But while I was visiting and admiring the artworks years ago, like millions of tourists, one thing struck me: if we stop for a few minutes to read the story and description behind each artwork, we will learn that many, if not most of the pieces of art, were commissioned by an art patron, usually a merchant from Rome or Venice, that commissioned the work and supported the young artists in the name of fame, vanity and recognition of the society they lived in.

Just like New York City today, there was excess of capital and this affluence gave birth to a society that was inward looking and charitable to arts and other causes. A forward thinking place that was pushing the boundaries of what was possible at the time.

If present day hedge fund managers and private equity players finance new wings at the Lincoln Centers and the Metropolitan Museums of the world, it is a worth reminder that their affluence and their benevolence is really nothing new in this planet.

And there's more: Firenze and some other northern hubs were where the cool people, like artists and small entrepreneurs were. Rome and other southern cities were where the ``big money`` was established. The present day connection where New York bankers

and venture capitalists finance ideas that come from Silicon Valley in Northern California couldn't be clearer in my mind.

Is location, in this world of connectiveness still that important for present day investing? Has the world changed since renaissance days? This is the scope of this letter.

And the first answer: at first blush it did not. The hard fact is that the only thing that kept happening is the torch has passed from hand to hand since ancient roman days, but the structure of the game kept intact: from the Portuguese and their navigations, to the Spanish, to Italy in renaissance, to the Dutch, the British, to the Americans in the past 100 years, to (just possibly) the Chinese in the next 100, at each century there was a place where extraordinary results could be achieved and no other place could match. The only thing is that this place itself kept changing.

And the epicenter of capitalism in the early 21st century is still, indubitably, the United States Of America. If a country hosts 10 of the 10 largest public companies by market capitalization and 8 of the 10 richest individuals, its present day dominance is quite obvious.

But what about the future? Are there any present day clues that tell us not where the world is, but where the world is going? Guessing the past, after all, is quite an easy game.

Two quick insights stand out: the first is arbitrating the differences of opinion between insiders and outsiders and trying to figure out which group is ``right``.

Just a quick food for thought:

- Why is it that the further away you go from China, the more people are worried about the Chinese economy? Are foreigners better able to see the forest instead of the trees? Or are Chinese people better informed and able to see that China is not crashing after all and its future is bright?

- Why was it that while the world was still praising Brazil and The Economist put Christ the redeemer flying in its now infamous cover, Brazilians themselves were already despairing at the PT administration and realizing tough days were coming?

Zoom in and zoom out is therefore our first insight. Sometimes it is better to take a step in and look at what the insiders are thinking, sometimes it is wise to take a step back. Their difference of opinion and mindset is quite frequently a useful route to profits.

The second insight is trying to realize when companies and countries start to feel ``content`` and lower their guard.

It is a well established fact that a reliable predictor of tough recessions were when the tallest buildings, the ``white elephants`` were being erected. It is a long list, but we can give as examples:

- The construction of the Empire State building , that only ended after the 1929 crash.

¹ Source: Bloomberg

² Source: Forbes Magazine

³ The theme of ``zoom in`` and ``zoom out`` will be the subject of one of our upcoming letters

- Rio Olympics: the city won the right to become the host of the games in 2009 (the year before the famous Economist cover) and the games took place in 2016 amid the country's worst recession ever.

- Sochi Olympics in Moscow which followed a similar pattern to Rio's.

- Dubai: The emirate entered a financial crash while erecting unbelievable engineering structures

What does this pattern tell us? Possibly that once we see signs of triumph, of complacency, of self adoring congratulations, it is probably wise to be worried.

Obviously, common sense would tell us a great deal about the next century: gradually the shift of gravity should go from the West to the East, especially from the USA to China and, to a lesser extent, India and southeast Asia, since those places are where most of humanity lives and the sheer scale of current technology allows economic catch up and the passage of the leadership torch to happen faster than before. The magnitude of this transition, however, as well as its intensity, remains to be seen.

That being said, our investors should expect that our global Opportunities fund, that invests mostly in equities, should remain focused especially on American equities (since this is where most of the world's value still is), Brazilian equities (since this is where we have a competitive advantage) and, to a lesser extent, European equities (since they still carry promise) and to a still smaller extent, Asian equities (since there's where the future will be).

As always, the most rewarding opportunities are the ones not yet fully understood and written about. "In investing what is

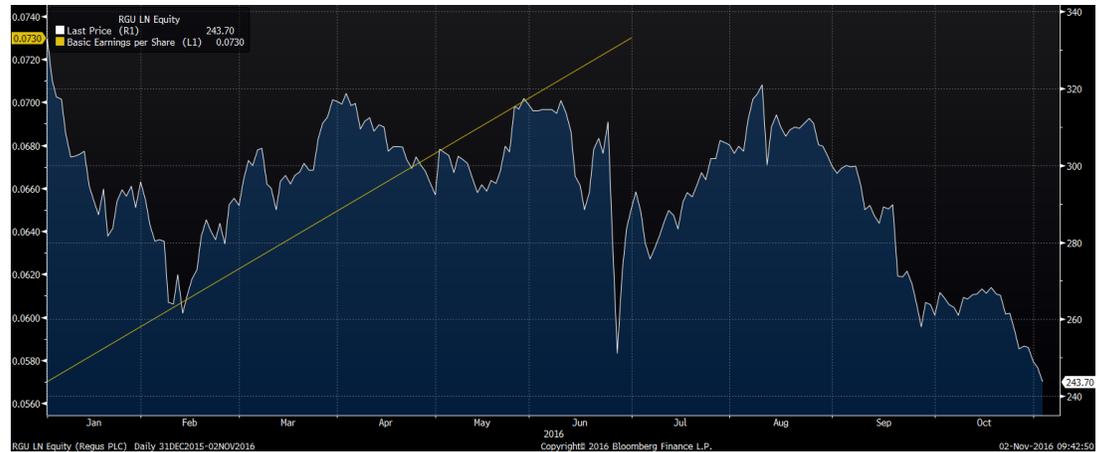
comfortable seldom is profitable”. And “what is understood needs not be discussed”

Now, looking back to the beginning of our letter, having seen through the prism of current geopolitical events, it seems almost laughable to think that location would no longer matter.

As we are writing this letter, in late 2016, Donald Trump is a serious contender to become the next president of the United States, possibly throwing the country, and consequently the world, in a spiral of uncertainty and populism.

Meanwhile, Brazil has not yet recovered from the worst recession in its history, thanks to the disastrous PT administration. Also, there’s Putin in Russia, the increasingly dictatorial Xi Jinping in China, Argentina’s first decent administration in decades. Everywhere you look, governments, countries and location still count a lot.

Meanwhile, Regus, a great company which was the theme of one of our past letters has been doing great operationally and surpassing our own projections when this house made its investment in the company, but has nonetheless been one of the greatest detractors of performance for our fund, subtracting more than 2 points of our Year to date performance, seeing its share plummet for one single reason: it is a British company amid the turmoil of Brexit.



Regus Earnings per share (left, in yellow) and price per share, right, in blue.

However, there are different aspects to look at in the location equation when investing. The first and most obvious one is to look at the pluses and minuses of the location of every company in the context of valuation and its future projections.

So, according to this logic, for example, Regus will suffer since it is located in Britain in 2016 (although most of its business is done outside the country) and Brazilian assets will rise thanks to Dilma Rousseff's removal from power.

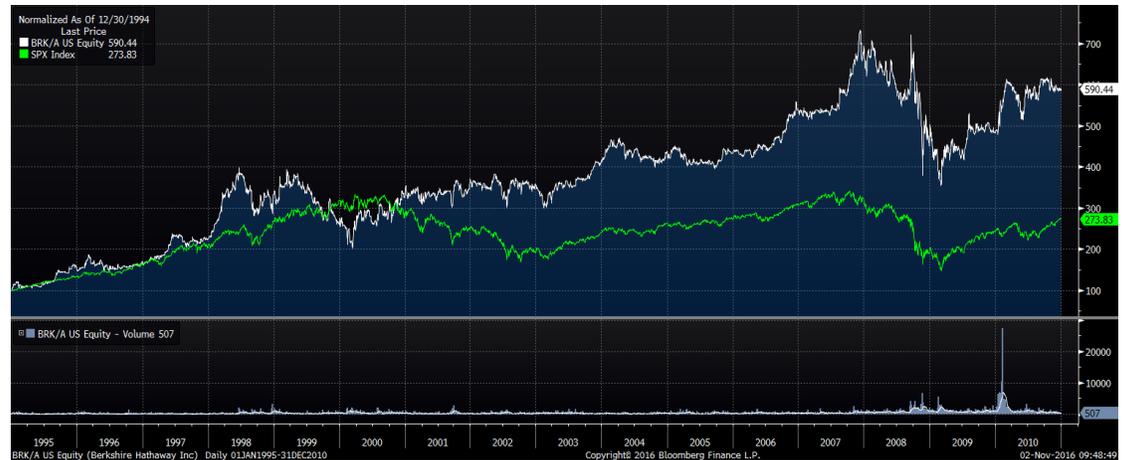
A second and deeper approach is to look at location in the context of competitive advantage. Every investor knows (or should know) that Warren Buffett is one of the largest investors of companies like Coca Cola and Proctor and Gamble. What is a lot more surprising is the giant portfolio of medium sized American companies Berkshire Hathaway bought along the years: regional trailer companies, local medium city newspapers and regional fast food franchises. What explains his interest in these so frankly non global and non aspirational businesses?

The answer is that Buffett is a defensive investor. So location in many of these cases is a barrier to entry. Medium sized cities only have enough room for a single local newspaper and these businesses usually are able to dictate prices and conditions since they have a loyal and sticky audience and face no competition. Likewise local manufacturing and fast food operation when well managed are closer to its customers and are able to fly under the radar of global competitors.

There is no more obvious example of Buffett's defensiveness than when asked about the endless possibilities of the internet, in the late 1990's Buffett replied that he saw the Internet more as a threat to his existing businesses than as an opportunity to make additional money.

In other words, he was not worried about guessing which one would be the next billion dollar internet idea. He was worried about his newspapers, his retail operations, his existing businesses.

The next day, following the interview, Berkshire's shares fell. To us, a testament of Buffett's genius is the fact that 15 years later retail, Newspapers and many other industries have to adapt to an increasingly online global audience.



Berkshire Hathaway VS S&P 500, 1995-2010

Still on the barrier of entry theme, there are linear as well as three-dimensional ways of thinking about problems and opportunities.

Brazil, for example, is a notoriously terrible place to do business: crazy taxes, endless red tape, and so on. Look at it the other way, however and it becomes obvious that this endless red tape becomes an entry barrier for competitors.

Once you are established and running a large business in Brazil, this difficult environment becomes a great protection. Obviously, it is terrible for the country. But it is good for the few businesses able to navigate through the jungle of doing business in the country. Successful examples of companies like Renner and Itau, that thrive in this climate and are way more successful than foreign competitors that tried to enter the country like Citigroup and Wal-Mart attest to this.



Past 12 months stock performances of Lojas Renner, Itau, Citigroup & Wal Mart

Also, obviously, location can bring unique attributes.

In our portfolio, both Minerva, thanks to Brazil's abundant water supply and world-class agribusiness and Fibria, close to the world's cheapest and fastest growing eucalyptus plantations, clearly wouldn't be the same companies if located anywhere else. Likewise for many companies around the globe. Business positioning after all is the art of searching for and finding what makes you unique.



Minerva & Fibria, Last 5 years share price in US\$ dollars

But the deeper, and in our opinion, most interesting prism to analyze location is though the old contradictions of investing.

It has been said in the past that everything in investing is a double edged sword: if you concentrate all you money in a single asset you will be a genius if things work out well or a poor man if they don't. Ditto if you use leverage. The more indexed and conservative you are the more mediocre your performance will certainly be, but pay attention, that can be a good thing!

Location in our opinion also works this way: if you are very certain that a certain country will have a change of government for the better, that a certain industry is turning itself around and so forth, that's where you should be located. On the other hand, global funds, diversified investors that spread their bets are by definition more "conservative": they are passing the giant rewards of concentrating their future but also protecting their assets.

Stated in other words: if you have strong opinions about a particular country or industry and are a very aggressive investor, it

may be wise to look nowhere else for some time. If you don't, you should worry more about the possible downfalls.

This house will alternate between these two extremes: we run a relatively concentrated portfolio of diversified assets. Depending on the time and situation, we will drift a bit to one end of the extreme but as a whole, we will err on the conservative side since we are stewards of our investor's money.

Also, in our search for unique attributes and where we should be, this house has decided to be clearer than ever in its "circle of competence" and where it should be located: Our global equities fund, which will soon be renamed "Opportunities", invests in 3 industries: basic resources & industrials, consumer services & industries and technology, and in five different markets: Brazil and LatAm, North America, Western Europe, China and India (although we are yet to make an investment in the last two and probably won't for the next few years).

This is what we would call, our raw material. The places where we will look for investing opportunities. Funnily enough, I had always thought that as we would grow and mature we would become less not more specialized but as the years pass, the importance of the competitive advantage, of knowing what you are doing and doing better than everyone else seems clearer.

Capitalism in the end is a system that rewards scarcity. It can be a software code no one else has. It can be the secret formula for making a soda. It can be superior, local knowledge to the most important connections and insights in the global economy. Scarcity in investing in the end is our ultimate quest, both in finding scarce value in our companies as in trying to create scarcity in our investing process.

This discussion is very timely for this house since on January 1st we are for the first time opening a very specific fund: one that aims to hedge and protect its investors assets doing a conservative and

rational cash management service and seeking to beat (but narrowly track) the Brazilian CDI index.

We feel it is a rational complementary service to our investors to offer this service and spin it off from our global stock fund, that invests mostly in public companies worldwide.

To summarize, it may come a time where location doesn't really matter. There are some indications we are heading this way. When the internet first came to the scene, many people predicted that that day had come. In a very paradoxical way, however, the world's greatest cities thrived with the internet instead of no longer mattering.

This happened because before making location irrelevant, the internet made the global workforce extremely mobile like never before. So the world's smartest people, unsurprisingly, increasingly decided to congregate and live in places like New York City, London and San Francisco.

But this was a first wave. It is also true, at the same time, that the difference between these three world class cities and the "middle pack", like Brazil or China is a lot smaller in many different ways than it was in the past. So the jury is still out to see how far we go in the "global village" debate.

⁴ We consider it a spin off since it was previously a cash management function of our global fund.

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

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

Auditoria



Custódia



Regulamentação



Administração



Advertência jurídica: Esta carta é publicada somente com o propósito de divulgação de informações almejando dar transparência aos nossos investidores e não deve ser entendida como uma oferta de venda do clube de investimentos FCL Capital ou de qualquer valor mobiliário nela citada. As opiniões e estimativas citadas nesta carta são considerações feitas até o momento da publicação e podem mudar sem nenhum anúncio ou aviso prévio. Performance passada não é garantia de performance futura. Fundos de investimentos não possuem garantia de seu administrador, do gestor, ou qualquer mecanismo de seguro de fundos. As performances exibidas são sempre líquidas de taxas de administração e performance, mas não do imposto de renda devido pelos cotistas. Para maiores informações favor acessar o Portal Educação Financeira da ANBIMA "Como Investir" (www.comoinvestir.com.br)