

FCL*Capital*

October 2018

If someday, dear investor, you feel that life has a funny way of disregarding facts and the world keeps maintaining nonsensical beliefs, spare a thought for a man named George Price.

He was one of the most brilliant minds of the 20th century, and a literally genius that time forgot, and history decided not to give due credit for.

Born in the US, after being involved with the Manhattan project, Price moved to London to work at a laboratory in the second half of the 20th century where he was deeply involved in not one, but three incredible scientific milestones: first, a breakthrough thesis on kin selection with a new Price equation¹ that vindicated group selection²; a remarkable evolution in Darwin's theories, second, introducing the concept of the evolutionarily stable strategy³ (ESS), a central concept in game theory⁴; and third, formalizing Fisher's fundamental theorem of natural selection⁵. In sum, he was one of the torch bearers carrying forward Darwin's work in the 1900s while giving humanity major advancements in biology, ecology and even economics.

As in many brilliant minds, that was when his internal conflicts started: in 1970 Price became an ardently religious person. He converted to Christianity and started spending countless hours studying the bible, specially the new testament.

It did not escape his brilliant mind that his religious beliefs started to collide frontally with the natural evolution theories for which he was known for. The world had this annoying tendency of not working in the way that he, with his morals and beliefs, thought it should work.

1 https://en.wikipedia.org/wiki/Price_equation

2 https://en.wikipedia.org/wiki/Group_selection

3 https://en.wikipedia.org/wiki/Evolutionarily_stable_strategy

4 https://en.wikipedia.org/wiki/Game_theory

5 https://en.wikipedia.org/wiki/Fisher%27s_fundamental_theorem_of_natural_selection

Later, also interested in behavioral economics, he developed a mathematical theory of kindness and selflessness, and was basically forced to conclude that selflessness doesn't really exist: every human deep down when he does something kind expects something from the universe in return.

"The best the natural process can do is a kind of second-hand kindness, a selflessness which is not really selfless but rather very much selfish" (George Price).

Trying to disprove his own selflessness theory, he started to live a remarkably selfless life: he would share his house with random beggars, sometimes sharing it with dozens of people at the same time and eventually having to live on a squat. He gave all his money to charity. But still, the truth about humanity made him increasingly depressed.

As the years went by, he became sad and isolated because of his findings. The more he studied evolution the more it became clearer to him that his beloved god, if he really existed, seemed at best to be an absent one. The more he studied selflessness he realized there is no such thing in the human species

In January 6th, 1975 in his laboratory he took a pair of scissors and cut his carotid artery, ending his own life.

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Although obviously in a much less extreme way, George Price has been in the mind of this house's team for this past month. Few times before we felt, like he surely did, such a wide dichotomy between: theory – or in

other words, what reality should be – and practice – the way reality unfolds before our eyes to our own amazement.

The stock markets worldwide just had their worst month since 2012.



Returns in USD for October: FCL Opportunities: -5,65%, S&P500: - 7,28%, MSCI World: -7,60%

The interesting thing, even this performance is far away from uniform: over this past year, the overvalued large cap US market is outperforming while the depressed and bargain priced emerging market stocks—especially Chinese ones – keep making new lows. It shouldn't be this way. Theory dictates that faster growing companies should have higher multiples. And China's GDP composition shows that even a full-scale trade war couldn't knock China from its growth path.

So how can theory and practice diverge in such a way that makes reality make no sense in the short term?

That's one of the painful things of being long term value investors: it can take time for the world to become rational again. And you never know

exactly when it is going to happen. That is why we always repeat the mantra that an aligned and long-term oriented investor's base is one of this house's real long term advantages.

And since this is admittedly a painful strategy, why do we take part in it? Simply put, because it is the only proven way of beating the market.

The good news is that, while we can never promise returns, we feel the market seems to have reached a bottom. We also feel this is the best entry point so far since we opened our fund in early 2017: we have a better portfolio of companies being traded at wider discounts than when we first opened up shop.

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Confirmation bias?

Let's take one step back: since we are empiricists – is it true that the markets shouldn't be behaving the way they are? Are we negating reality? Are we just wrong and trying to blame irrational market participants? It is a fair question.

In a fantastic paper called "Why facts don't change our minds" ⁶ author James Clear argues that since humans love to feel part of groups, whenever facts shock with our identity and therefore our allegiance to the things we do, say and especially the people we cling to – it is identity not facts that will survive.

⁶ <https://jamesclear.com/why-facts-dont-change-minds>

So, is it the reason? Is this house guilty of not seeing the truth?

Since we publish monthly letters with our public positions in companies we invest in, is it hard for us to admit we made mistakes or are we trying to bend the facts?

While we are certainly human and not immune to those kinds of mistakes, we don't think this is the case at the time we write this letter (late 2018).

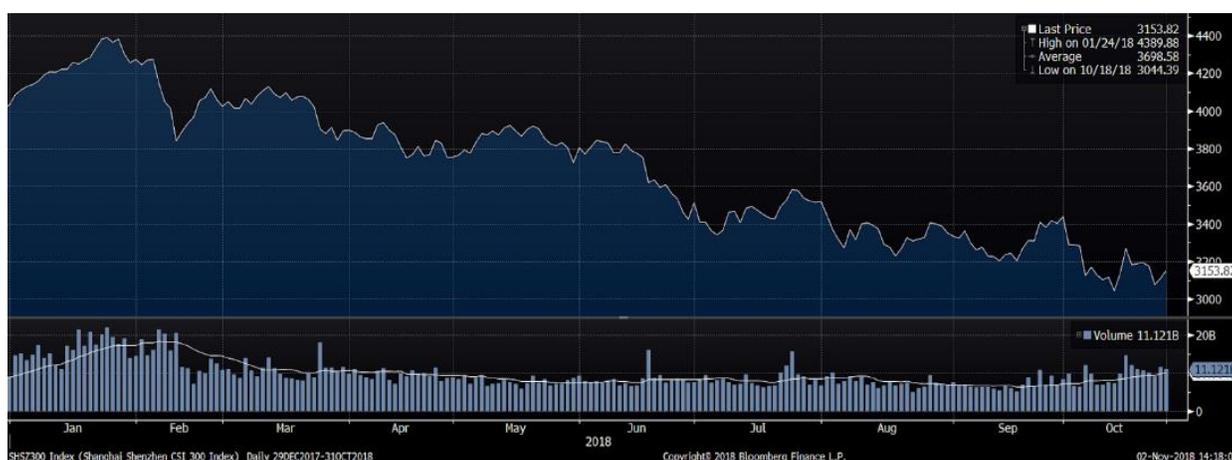
A few charts from companies we have investments on might make you judge for yourself. Bellow a table of revenues, Ebitda (a measure of cash generation) and stock prices for the two worst losers in our portfolio this year, YY and Vipshop. Both Chinese internet companies (and interestingly, both belonging to probably the most immune sector in china to a trade war).

YY	2016	2017	2018 (Cons)
Revenue	¥8.204,00	¥11.594,00	¥15.563,00
Ebitda	¥1.959,00	¥2.902,00	¥3.030,00
Stock Price	\$40,58	\$113,06	\$63,90

Vipshop	2016	2017	2018 (Cons)
Revenue	¥56.591,00	¥72.912,00	¥86.460,00
Ebitda	¥3.730,00	¥3.804,00	¥3.264,00
Stock Price	\$11,07	\$11,72	\$4,86

It seems clear it was not the operational results that dragged the companies' stock prices lower. It was some other exogenous factor. They are doing just fine: increasing their revenues and cash generation like they should.

So why the underperformance? Clearly a look at the Chinese market as a whole shows the reason: it is the market that fell off a cliff, not our companies. They were just dragged along with the market.



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The million-dollar question – the timing factor.

In the dawn of the new millennium, in the year of 1998, several investors were convinced the Nasdaq stock exchange of tech companies was selling at irrational valuations.

Many companies were being traded at hundreds of times their annual revenues. Some had no sales at all and were worth billions of dollars.

Some didn't seem to have viable business models that would even survive. But their founders were paper billionaires on the cover of business magazines.

Some intrepid hedge fund managers decided that enough was enough. They began shorting the Nasdaq in 1997 (back in those days hedge funds tended to be smaller than they are now).

Almost immediately, the tech darlings of the time kept going up and they started losing money. The year went by and the brave "short Nasdaq" group increased their combined position in 1998. They were being ridiculed and their performance suffered. Other fund managers and tech executives would publicly report daily how dumb they were.

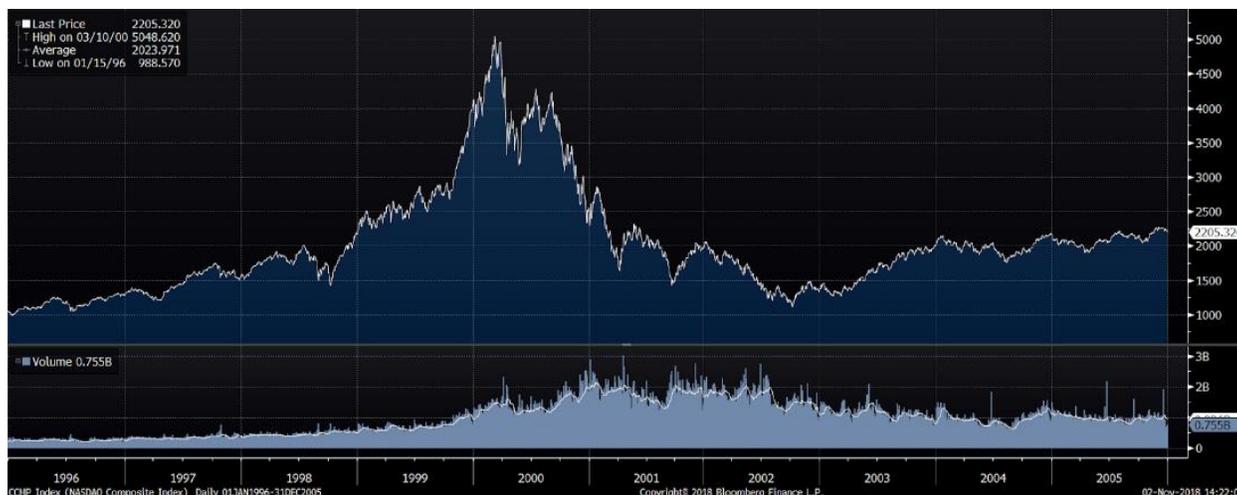
The predictable path for fund managers followed: investors redemptions, poor performance, public humiliation. Chief executives of tech companies laughing at them for being burnt.

Some managers decided to go all in the following year. They knew the market was in a bubble. It was a matter of time. They increased the short positions essentially betting their firms that the market would fall off a cliff.

The market indeed seemed to wobble in the first half of 1999 and the managers started to seem prescient. But then, something incredible happened: the market recovered its incredible optimism and ended the year in all-time highs. Many fund managers from the "short Nasdaq" group essentially went broke and closed their firms.

As we now know, their fundamental thesis was essentially right: in April 2000 the Nasdaq began to wobble again, it started to seem clear that the

market was trading at irrational valuations and the Nasdaq eventually declined 80% from its highs in the next few years.



Nasdaq: 1995 - 2005

This brings us to the timing factor – as important as being right is when you are right.

For this house the most curious aspect of the timing factor is the fact that what separates genius to stupidity is simply the same action taken at a different time leads to a completely different path.

One of this manager’s favorite market adages is “what the wise man does in the beginning the fool does in the end”.

And not only in financial markets. In a fantastic TED talk venture capitalist Bill Gross argues that timing is the single reason some startups fail while other very similar ones go on to reach billion-dollar valuations.⁷

⁷ https://www.ted.com/talks/bill_gross_the_single_biggest_reason_why_startups_succeed

Indeed, an amazing list that was widely circulated in the financial press in the early 2000s was “the 15 most bizarre internet stock companies that failed”. Predictably, the purpose was to make fun of the companies that went under.

But fast forward 20 years. As venture capital firm A16 notes, many of those “bizarre” ideas resurfaced in new versions. Uber, YouTube, Spotify, and even Pets.com. Maybe the poster child of that era is, if we think about it, a pretty good idea. Once again, it was timing that set their fate. They were not bad ideas. They were a bit too early.

But timing brings some valuable lessons: since we can never predict when things will start working and behaving normally again, risk control, never betting the house and openness to being proven wrong should always be the motto of any investor that wants to stay in the game for long.

Over the past 20 months both of our funds delivered, we think, pretty solid performance, despite this past month.



FCL Opportunities accumulated returns in BRL since inception in 30/01/2018

To recap, the mission of FCL Opportunities is delivering long term, dollar based, compounded performance that is superior to any other global stock fund. Our strategy for that is focusing in long term transformations in the BRIC economies and the companies related to them.

Our FCL Hedge fund is focused on being exposed to the best Brazilian ideas while offering very strict risk control and with the objective of surpassing the Brazilian CDI while not incurring too much risk.

This house's goal is for our Opportunities fund to have long term dollar returns of at least 20% annually, admittedly with some down years being compensated by some outstanding years. That's part of the plan. And to this point we have no reason to think we can't reach our goals. Seeing over the long term, October was just a tiny blip and it is predictable that bad months like this will occur.

As Howard Marks is fond of saying, the market moves like a pendulum: sometimes people are too euphoric and fear missing out on the latest investment opportunity, sometimes they are completely scared and can't act even when opportunity presents. Those should be the times when investors should go "all in". It is when opportunities abound. "Buy when there is blood on the streets" a smart value investor once said.

This house would add, the market not only moves in circles but at every point people are ready to give some rationalization and explaining to why the market is behaving the way it is. Surely, we think, such a thought would puzzle George Price: he knew that people don't know all the facts. We just make up flawed explanations to reality as we go along, to pretend we understand things perfectly and are in control.

As it happens the only way to beat the market is to be away from the consensus. If an investor does everything according to consensus inevitably, he would get market returns. But since being away from the

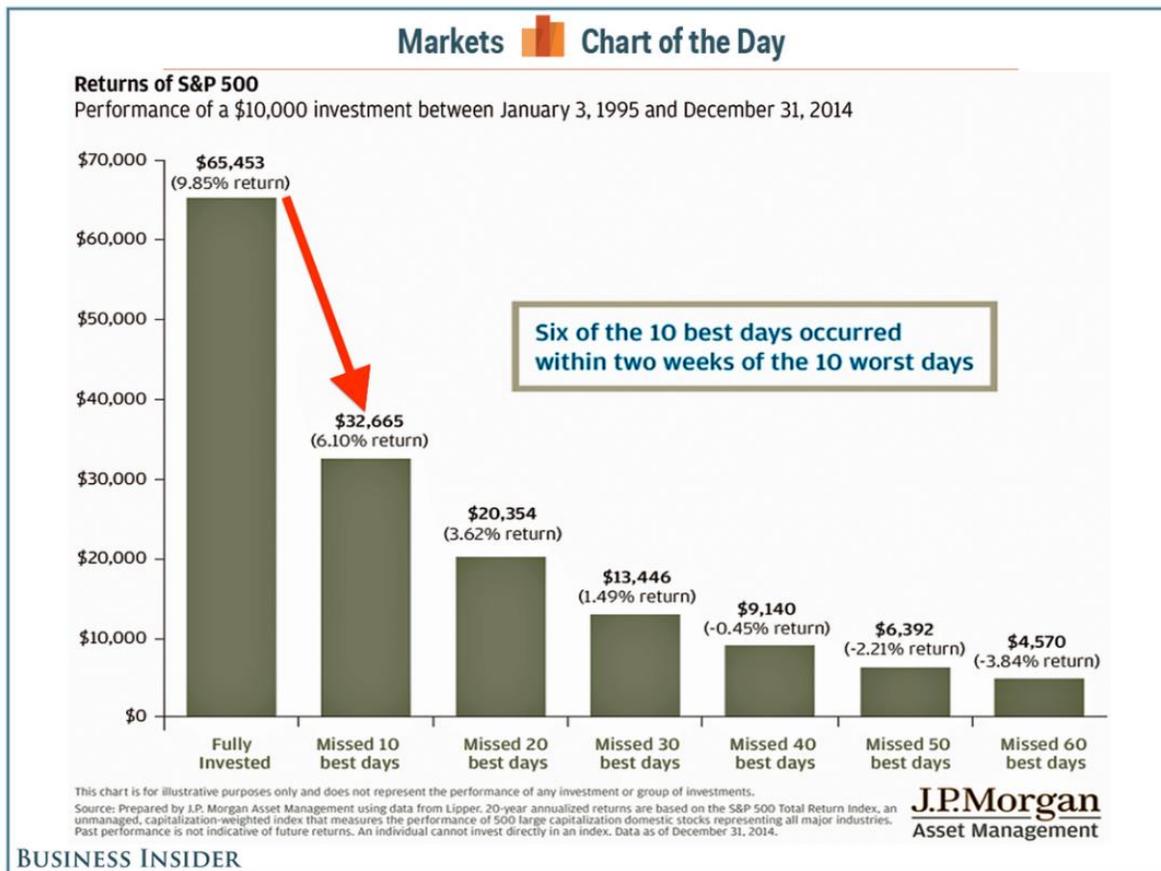
consensus is the only road to alpha, inevitably, this road will be paved with many periods of underperformance. It is almost like a law: you can only be able to beat the market if you are able to endure the suffering of some underperformance periods. Interestingly, while the long term average performance of the S&P500 is around 10% per year, as Buffett notes, in very few individual years the market performance is close to this average. Usually it goes up or down a lot.

And how hard is it for most people to be away from the consensus? Very hard it turns out, including for professional investors.

Every day we tune in on Bloomberg and there will be experts assuring that the market is going up or down the way it is because of this or that event.

This house doesn't pay too much attention to those explanations. We try to be scientific in our approach. As written on the walls of Google's headquarters, "data, not opinions". Our inputs are balance sheets, company reports, and projections of the business we invest in. We try to leave emotions at the door when we check in for work.

Not easy for sure. And an approach that seems more painful than just staying out during bad times. But over the long term more profitable. As academic studies have shown, since no one can know for sure when the market will turn, the best thing is to be invested at all times in stocks. Just not being invested in the best 10 days of the market during a 20-year period, would dramatically lower long term returns. And usually those best golden days are exactly the ones when the market is at a bottom and turns.



In other words: if you hold on for a while just to wait the market turn, it means you will lose the best days of the market and lower your long-term performance. When it is possible to realize the market is turning, almost by definition it is already too late.

So, the most rational thing is to stay invested stay diligent and redouble our research efforts. And our investors can be sure, now and ever, that this is exactly what we will keep doing.

We thank our investors for their support during positive and negative periods and are as confident as ever our product will deliver some very satisfactory long-term risk adjusted returns. Some storms might rock the ship a bit but onwards we sail on.

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.

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

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