Clusters

"We could be in instant contact with each other, wherever we may be, where we can contact our friends anywhere on earth, even if we don't know their actual physical location. It will be possible in that age, perhaps only 50 years from now, for a man to conduct his business from Tahiti or Bali just as well as he could from London…. Almost any executive skill, any administrative skill, even any physical skill, could be made independent of distance. I am perfectly serious when I suggest that one day we may have brain surgeons in Edinburgh operating on patients in New Zealand.
When that time comes, the whole world would've shrunk to a point and the traditional role of the city as the meeting place for men would've ceased to make any sense. In fact, men will no longer commute - they will communicate, they won't have to travel for business anymore, they'll only travel for pleasure."

(Arthur C Clarke, futurist, in 1964) #

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As a 13 year old, I started to develop a rather strange habit: I started to read every compilation I could find of the world's richest people, first in the Forbes magazine and then as my pathology got worse in any business publication where I could find one of those lists. One of the joys of becoming an asset manager was to be able to connect the dots: it was an exciting new world where I somehow could have contact with the Gateses, Buffetts and Slims of this world, if not in person, at least interacting with their companies. I could understand that those men don't live in a vacuum: it is their companies, the businesses they have built and the interactions with other men, the ones who analyze their businesses that count.

After some time, I had practically the whole list memorized. I knew their names, where they were from and their companies. As I was getting better at it, and this was before I even started to read newspapers or business magazines, things got interesting: I started to realize that I could pretty much tell how a billionaire became a billionaire just by finding out where he was from: someone from San Francisco bay area was certainly from a technological background. Someone from LA almost surely had made his fortune in the entertainment industry. Someone from New York and London was involved in finance. Someone from continental Europe almost certainly was an heir (not the founder of the business behind their fortune) of a business from high fashion or luxury in general. And this insight worked 90% of the time and if you buy on of the new lists, it will still work.

I kept wondering how that was possible. Billionaires, of course, are an extreme occurrence. They are outliers. And contrary to what most people think, they are not a natural consequence of capitalism. Rather, they are a bug, a virus in the system. It is part of capitalism's nature to have new competitors coming in every time someone is spotted making money, creating a business that goes right. Accordingly, every time people realize that a certain idea is ruined, it is quickly abandoned.

Capitalism has a natural way to make sure everyone's outcomes plot around the mean: if things are going too badly, people will no longer compete with your business, profession, or activity, and if things are going great, new competitors will come in and future results won't be nearly as good as the prior ones. Think of shopping centers in Brazil today, or internet retailing in the US. Or even about professions, that also follow this pattern. So in this sense billionaires are anomalies of the system. For some reason at

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their time and place they overcame competition, contrary forces and everything else, achieving results so far from the mean.

So what are the set of circumstances that make some activities, and the ones involved with them, to achieve unique results depending on where they are? And most importantly, how this framework affects our investments in different business?

Contrary to what Arthur Clarke predicted in 1964, the world is still arranged in cities. In fact, a growing percentage of humanity lives in them. And even more astoundingly, the power of clusters is, if anything, increasing with the advent of the internet and development of communications. Firstly, the definition: cluster is the act of a business segment to group together in the same geographical location. It does sound counterintuitive at first. Why would competitors that sometimes even hate each other, be near each other, in this vast globe? But it does make sense. And cluster theory is a natural development of the old Ricardian comparative advantage notion. It was further expanded by countless others, notably Malcolm Gladwell with his book Outliers. For a vast mosaic of reasons: government, culture, necessity, information and many others, a certain time and place becomes the exact ingredient for a certain activity to be conducted in a superior way than anywhere else.

And the more a stock analyst thinks about the market, even to this day, the more he is playing with the notion of comparative advantage and clusters: an example would be the cheer around Iron Ore and Vale in Brazil. In FCL's case, our search for comparative advantage culminated with our investments in Minerva, with its vast abundance of water and land like no other competitor abroad would have, Heringer, for being indispensable for the world's most efficient farms like a fertilizer company in no other country could claim and many other businesses that this house has invested in. The search for the killer idea, the outlier, is necessarily the search for an irreplaceable comparative advantage.

Where are the world's clusters? Where are the businesses and circumstances that are not matched anywhere else?

Practically everywhere: be in the ivory business in Italy three centuries ago or in watchmaking in Switzerland. In finance, the two main clusters in the world are naturally organized around the streets of New York (especially in Manhattan between the 40th and the 60th, with mini clusters in Greenwich Connecticut and

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Long Island) and London (preferably in the posh Belgravia or Knightsbridge districts), with smaller financial clusters also present in cities like Hong Kong, Singapore, Zurich and so on. In Brazil, our nascent financial community has already managed to form its clusters: in Faria Lima, if the firm is from Sao Paulo or in Leblon if it is from Rio de Janeiro.

And why is that so? Why is it not usual to find a financial firm based anywhere else? There are many reasons. In most businesses, there is a strong synergy when you are near your competitors: in finance´s case the traders have lunch together, discuss their ideas with their peers, use the same services and providers, receive visits from the same clients, consume the same things, share insights and ideas. The farmers may buy fertilizer in bulk. Embraer could certainly not exist if not for the amazing cluster in São Jose dos Campos, with so many suppliers, ITA, IME, and so on.

We should accept cluster as part of life. For the time being we, as humanity, will continue to live in cities. And there is the irony of ironies: the one industry that was supposed to end clusters' existence after millennia since the first appeared has created a cluster of its own. In fact, if you have ambitions of creating an internet company that can change the world, like Facebook, Google or Apple, it's better to do it in Silicon Valley, a region in northern California, 50 miles away from San Francisco. The above mentioned companies are not disperse around the globe. They are all a few miles apart from each other. Why? Once again, an engineer from say HP, another local company, can be useful in the next startup. Stanford University is also not far away and with time, a few entrepreneurs who became billionaires founding tech companies, turned into venture capitalists themselves financing, sometimes for money, sometimes just for altruism, the next kid with a grand idea in his head. And so the ecosystem exploded.

Examples of Clusters	
Fashion	New York, Paris, London, Milan
Finance (World)	New York, London, Hong Kong, Singapore
Finance (Brazil)	Faria Lima in São Paulo; Leblon, Centro and Barra da Tijuca in Rio de Janeiro
Technology	Sillicon Valley
Tobacco	Southeast Asia
Chemicals	Germany, North Europe
Agrobusiness	Brazil

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With that introduction, we can discuss one of our past year´s investments. Taurus is a traditional company, based in the south of brazil but having the USA as its biggest market. It is an arms manufacturer. It can sound anachronistic to invest in an arms business. And indeed, the optionality characteristics we see in this position don´t allow us to ever have a substantial stake in this company. If things go very wrong with this investment it won´t hurt our investors too much. But with that said, we can see that Taurus is situated in a time and place that has the potential for a business outlier.

America, as we all know, is a significantly more affluent, less urban country and has a significantly more spread out population. Also, crucially, it is a nation more suspicious about government activity than almost any other, particularly continental Europe. It is even hard to understand in most places why would someone buy a weapon. Personally, I certainly don´t think buying one is a good idea. In America however, there are more weapons than people and its gun culture is so ingrained that all the talk of a restriction in the past few weeks has led to a gigantic explosion in demand for exactly the kind of weapons involved in the Newtown massacre.

Much to our taste, the investment is full of behavioral biases: the business seems immoral to many people. Even the private equity company that owned the maker of the weapons used in the massacre quickly decided to sell the business. Additionally, if you don´t live under a rock you surely know that president Obama is discussing restrictions to the sales of automatic guns in the USA, and that would supposedly hurt the business.

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So Taurus has some characteristics that are unique in the Bovespa today: a very good business, with experienced management, selling for very very cheap multiples, with a resilient demand, predictable sales and margins. It is also heavily discounted because of its size that guarantees that most of its investors are located in Brazil, most of which don´t really understand the unique cluster where it is located. Like it or not, the right to bear arms is part of the American psyche. Any possible restriction, even if it happens, won´t affect the business at all (it will probably help it).

FCL's investments situated in significant clusters	
Minerva	World's cheapest water and land, unique cattle cycle.
Heringer	Most efficient grain producers in the world.
Taurus	Unique culture that brings resilient demand.
Tereos	World's most efficient and relevant sugar exporter.

Of course we shouldn't try to read too much into cluster's theory. Europe, after three decades without experiencing the creation of a new company that became one of world's largest 500, saw the rise of the group Inditex (parent company of the Zara clothing stores), curiously in low growth and high debt Spain, with its high cost of labor and low competitively. Likewise, the world's most successful investor ever is a man from Omaha, Nebraska. Also, some of London's most prominent fund managers are emigrating to contemplate life on the shores of the lakes of Switzerland, in part because they are starting to realize that outstanding investors are supposed to be apart from the crowd and its permanent noise and opinions.

This house is also located outside of Rio's financial cluster, among the shopping malls of Barra da Tijuca, and we feel great about it. So while it's true that geographic, circumstances, time and place are a huge part of the mosaic that builds great companies and enduring competitive advantages, sometimes the killer idea , the game changer comes from nowhere.

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About FCL Capital

FCL Capital is an independent investment company, focused on portfolio management, free from conflicts of interest and multiple objectives that has for a mission the preservation and multiplication of its investors' capital, through a thorough financial analysis. Our goal is to generate absolute returns, staying solid and consistent through good and bad periods of the economic cycle.