# FCL*Capital*

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**Three Argentinians in a bar in 2000**

It is December 2000. Plaza Rosada in Buenos Aires is bursting with daily protests. Three wealthy Argentinian friends meet to drink a few glasses of wine, have some parillada and complain about the country's ills. As it is common in this corner of the globe, Argentina has many attractions - an amazing culture, good food and wine, some of the best-looking people on the planet and the beauty of Patagonia. But, as it is even more common in this corner of earth, it has some of the worst populism and dumbest economic policies that could be conceived by mankind.

For the past three years, starting in 1998, Argentina has experienced a terrible economic recession. The world economy is in a fragile state and Brazil, the country's largest trading partner, has specific problems of its own, but most of the damage is self-inflicted. Throughout the 20th century, continuous red tape and fiscal profligacy combined with disregard for inflation led to a complicated business environment. The low productivity growth and, especially, low confidence in the country's domestic currency led the country's previous administration to effectively dollarize the economy, a move held in high regard by the population, if not by exporters and industrialists.

The three friends are businessman worried about their life savings. Daily protests against the government and the general direction of the country are starting to gather strength. Some more nervous people are already emigrating abroad. Talk on the street is that the administration of Fernando de La Rua may not reach the end of its term.

So the first friend says: "I am really worried about the country's economic situation. I'm going to put all my money in fixed income and sleep well".

The second friend replies: "I'm also worried, but I don't trust this government. They may devalue the exchange rate. They may impose capital controls. I am going to put all my money in real estate, buying a few houses and apartments in the Recoleta region. I think my money will be safer this way".

The third friend says: "I believe in Argentina's economic future. I'm going to put all my money in stocks".

14 years have passed and now we have the benefit of hindsight. How have each friend fared?

We now know that terrible things just followed these three friends imaginary conversation. After years of recession and weeks of heavy protests, President Fernando de La Rua resigned on the 20th of December, 2001. A series of presidents, some of them lasting only days in office, tried to solve the country's ills.

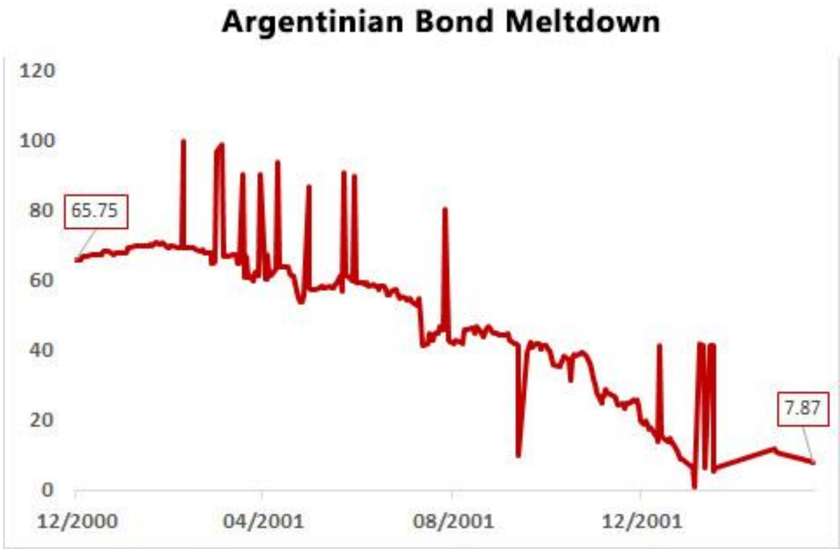
Without any other alternative, on the 26th of December, 2001, Argentina defaulted on U$ 93 billion of its debts, the world's largest sovereign default of all time at the time. Foreign investment has dried. The currency exchange rate, formerly fixed 1-to-1 against the US dollar, was floated, and the peso devalued to nearly 4-to-1, producing a sudden rise in inflation and a fall in real GDP of 11% in 2002.

Eventually, the country offered in June 2004 a proposal of restructuring on its defaulted obligations, amounting to a cut of 75% in the net present value of its debt. Some creditors, which were later dubbed the "holdouts", did not accept the terms and sued the Argentinian government to be fully paid. In time, a group of so called "vulture funds", led by Elliott Management's Paul Singer, bought some of the holdout claims and are actively battling the Argentinian government. This would alone make a very interesting monthly letter, but for today let's go back to the three Argentinian friends in our story.

So how well would the first friend, who was scared about the outlook and decided to put his life's saving in fixed income would have fared?

Terribly of course. He didn't foresee the country's default. Even assuming that only 53% of his holdings were restructured (the average share that was restructured at the time), the 75% haircut in 2005 would have meant that to this day he probably wouldn't have recouped his losses. Not to mention the trauma of seeing, in a single day, all the money that he thought was in safe deposit accounts gone.

And that's before counting all the terrible inflation Argentina has experienced in the past 13 years. As we discussed in our past letters, investors usually make a lot of confusion between real and nominal returns. So the outcome for the fixed income investor in Argentina, after the worst default in history, is that he lost money in nominal and in real terms. In US dollars, his life savings practically vanished.

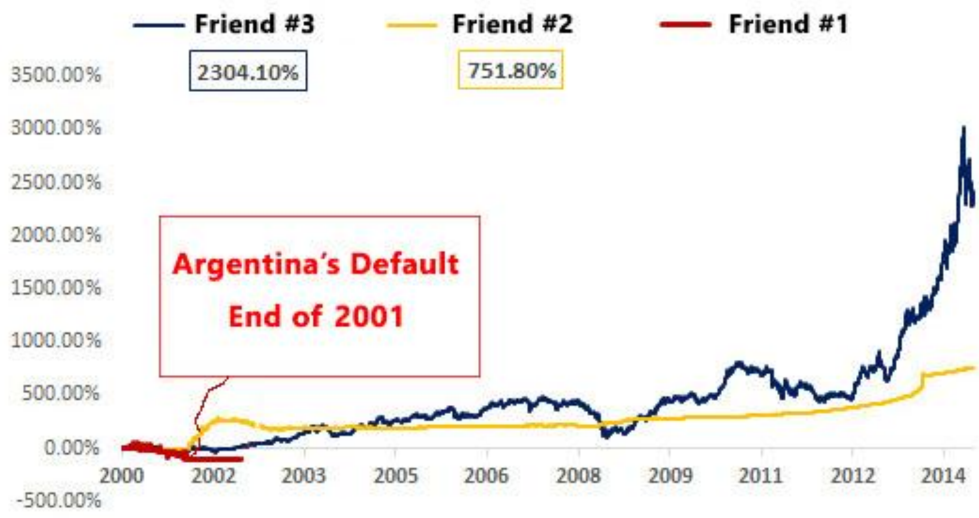



Now let's turn our attention to the second friend. He was rightly worried about a possible default, or capital controls in the country, and decided to put everything in real estate.

Real estate is not usually a very efficient form of investment for the average person. A series of cultural preferences and developments made the Iberians, from whom Argentinians and Brazilians descend, to simply love to put money in real estate. It has never really been a very efficient way to allocate capital.

There are capital gains, all sorts of costs that investors usually don't put in the equation, like broker costs, fees, taxes, vacancy and opportunity costs, and so on, but let's be very charitable and suppose investor number 2 was able to keep up with the US dollar's rise against the peso with his real estate investments in Argentina.

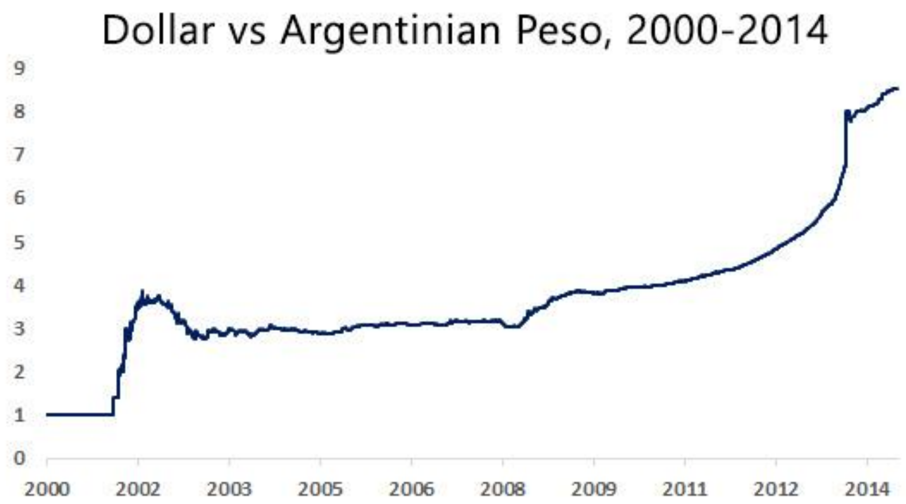
Putting it in other words, this also means that he had no real return. He has exactly the same money as he had 14 years ago, although with more pesos. But, on the other hand, a disaster did not happen, unlike for investor number 1. He didn't move forward, stood still, but unlike the first investor he didn't fall.




Finally, there's the third investor. At first look, he is the one who should have fared the worst. He was certainly wrong the most about his country's economic outlook. And, as a matter of fact, for a while he really was the one facing the worst results.

From the start of 2001 until mid-2002, with the messy economic situation and foreign investors exiting the country, the Merval Index exchange lost 80% of its value. Think about it for a while: From the comfort of someone who put all his money in fixed income, probably investor number 1 would have called investor 3 to tell him how foolish he was to be invested in stocks during that time. He was reduced to only a fifth of his life savings!

Then, very slowly, things started to improve. By mid-2003 he was back to half of his initial investment in the stock market. By 2005, five years after investing, he was back to his initial investment and quickly turned it into a profit. By 2008 things were looking rosy and he was riding a 60% profit when the international financial crisis hit and he ended the year at a 25% loss in dollar terms from his initial investment once again. Then, he slowly recouped his losses and after 14 years, he sits at the top of a 180% gain in us dollar terms. A much better result than that of his friend who invested in real estate, not to mention the friend who invested in fixed income only to face returns that were smaller than inflation even without factoring the country's horrible default on its debts.



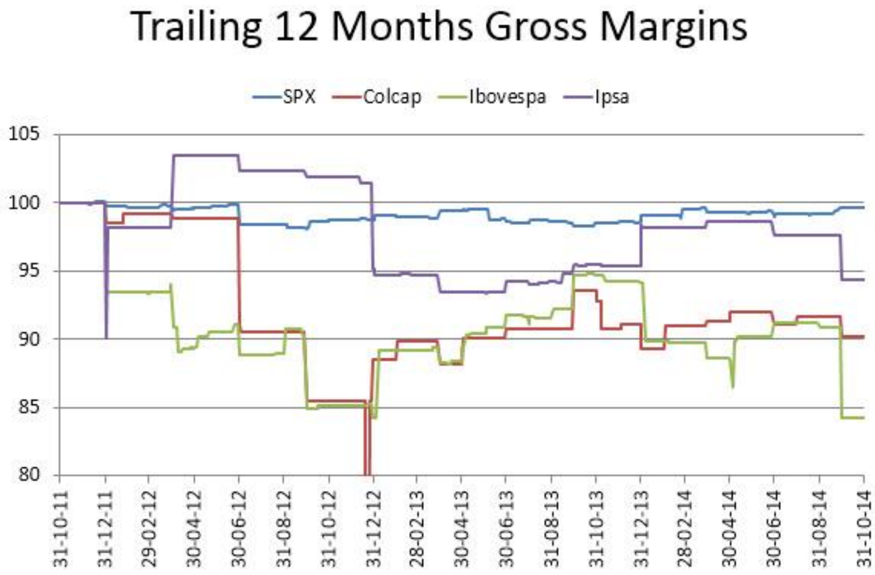

So, what can we learn from this story? At least five main points come to our mind:

**1. Over the long term, to state the obvious, stocks do outperform**. There are many reasons why. First of all, it wouldn't make any sense for it not to be the case. Why would anyone care to invest in stocks if they didn't tend to outperform. Stocks are part of companies, and companies are not stock quotations, but a collection of real assets with real people on leadership and carrying real incentives. Assuming a company has decent leadership, management is expected to do the right things most of the time. If times are tough they will cut the costs. If there are opportunities, management is expected to exploit them. So, over the long term, when perceptions change from worst to something less bad, stocks outperform.

**2. There's no relationship between stock performance and GDP growth.** Everyone knows that stocks outperform over the long term. What many investors don't know is that there's not an exact time when they're expected to do so. Many people think that when the good news comes it is time to buy stocks, but this is wrong. When good news comes, most people in the market are already feeling better and that positive outlook is already in the price.

What moves stock prices over the very long term are the companies' earnings - but, over the short term, as in a year or two, are changes in expectations. So the ideal time to buy is just before good news start to happen.

**3. As important as growth are the companies' margins.** This one may also be counterintuitive but, sometimes, lower growth is just what the market needs. We think one of the main factors behind Brazil's and most Latin American countries' underperformance in the past few years is the shock in costs that the continent's companies had to absorb. Unemployment levels fell way below their natural rate, while, fuelled by the commodities boom and the FED's quantitative easing, the region's currencies appreciated to levels way above what the fundamentals would suggest. This is especially the case for Brazil, so the consequence was a steady fall in margins. Maybe, margin recovery is just as important right now for the companies in the Bovespa than top line growth.




**4.** We are not claiming that Brazil will also experience a default, but we think this story is a useful reminder that **fixed income investments (like all other kinds of investments) have risks[1].**

[1] *These risks are perceived differently depending on the recent memory of a certain set of investors. For example, Argentineans have a natural tendency of trying to get their money out of the country as soon as possible due to Argentina's recent "Corralito", while Brazilians don't trust the financial system and love to buy real estate due to the "Confisco" they faced in 1990 during Collor's administration.*

The main point of this parable is to say that volatility is not the same as risk. Which investment is most volatile: fixed income, real estate or equities? Obviously the later. Certainly, investor number 3 endured price variations each day that were way more violent than his two friends. However, which investment class is riskier over the long term? (Meaning: carries a higher chance of a permanent loss of principal) We are not so sure on the answer.

**5. Finally, most investors would do well not to try to time the market.** We have said this countless times, but we will say once again. It saddens us to know that many mutual fund equity investors will have lower returns than the fund itself. And why does it happen? Simply because investors in most mutual stock funds decide to invest exactly after the stock market went up a lot, and, specifically, decide to redeem their money exactly after the worst losses in the market.

Study after study shows that when the stock market goes up, investors put more money in it. And when it goes down, they pull money out. The problem with trying to "time" the market like this is that investors usually come to the market after the biggest rises and tend to get out at the lowest points or close to them.

The most striking example we know is the famous Magellan Fund from Fidelity, that during the Peter Lynch years (1977-1990) was able to show the outstanding performance of 29% per year, but during that time the average investor from the fund actually lost money![2] And this is not unique; this phenomenon also happens frequently in Brazilian equity funds.

In this regard, FCL clearly stands out from the crowd. It helps that we have such a small base of loyal investors, who, like us, are in for the very long term and are committed to what we are trying to achieve throughout the economic and investing cycles. As we said before, this is a huge competitive advantage for us.

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[2] http://www.tuveinvestments.com/documents/Disipline-Akeytosuccessinbusinessandinvesting.pdf

Be greedy when others are fearful and fearful when others are greedy. The most wisdom fuelled, but also the hardest to practice words when it comes to investing.