FCL Capital

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1) Investment outlook

Different circumstances in different times lead us to choose the subject of our monthly letters. Sometimes it is a subject which we love or have strong opinions about. Sometimes it is demand driven, our investors ask us to do it. In the case of this month's monthly letter's subject, property funds, the subject almost choose itself.

The past few years have seen an explosion of this type of investment product in Brazil for both good and bad reasons, as we will see shortly. In finance, property funds are a broad investment class where funds, usually in a closed end structure, invest the proceed in assets backed by some kind of property: art, wine, gold, stamps, but in this letter we will limit our scope to the biggest and most common type of property fund, real estate private equity funds.

There is a long history of institutional investment in real estate, both through direct ownership of property and through pooled investment funds. Initially, institutional real estate investments were directed to the core real estate in the major world markets, like London and New York, but gradually, market conditions led to the emergence of opportunistic funds focused in one specific aspect of the real estate market: commercial, prime locations, emerging markets, sub prime properties, etc.

In Brazil, "fundos imobiliários", which means "real estate funds" were oficially introduced by law in 1993. There are many good things about the current boom in real estate funds in Brazil. The basic assumption of the industry's bulls, that with a lower interest rate investors will need to look for more sophisticated products in order to achieve higher yields is totally sound and have been advocated by this house many times in the past.

Additionally, we can find assurance in the fact that we are talking about an industry that was not invented in Brazil, property funds exist and flourish everywhere in the world. The biggest private equity managers in the world, KKR, Blackstone group, Apollo, Carlyle, among others, all have real estate funds operating as we write this letter.

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And it could not be different: as interest rates remain extraordinarily low in developed markets, the search for higher yield, the same search Brazilian investors are starting to experience in a much more dramatic way, takes place. So property funds are perfectly suited for sophisticated investors that want yield and adequate returns without incurring in too much volatility and risk. They know after all that their investment is backed by a property, limiting the downside.

Therefore, it is a valid and traditional industry and based on sound reasons, but nonetheless, we are very worried about its rapid growth in Brazil. We don't say this for egoistical reasons or for competition's sake, our funds serve a different kind of investors and we don't rule out launching a property fund someday anyway, but we are starting to feel more and more like we did in 2007 regarding the stock markets. Feeling like many investors are making a big mistake.

Below we try to systematize our reasons for this feeling. There are basically three big factors, we will call them yellow flags, behind our worries. Many investors actually in "fundos imobiliários" may not know what they are doing and may encounter big trouble ahead:

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1- They don't know what they are buying

First and foremost, investors need to understand that property funds are not and can never be a substitute for a fixed income fund. If you are feeling miserable because you can't take any risk and Brazilian fixed income is not what it used to be- well, sorry, the best thing you can do is stick to your less attractive fixed income portfolio.

Property funds are a sub category of private equity funds. These beasts are the top of sophistication and complexity in the investment universe. They offer no guaranties of liquidity. This means the following: if for some reason you suddenly need money, you can sell your government bonds and get money almost instantly. In a property fund there's a pre-determined period, usually 5 to 8 years and most likely you won't be able to redeem your shares and get your money before that.

It is true that some funds have what we call a secondary market, a reasonably liquid market for selling your shares to someone else in order to get your money back before it is time, but such markets don't exist for most property funds and even for the ones that it does, in times of stress, liquidity could very well dry up. So, let's face it, property funds are for sophisticated investors, pension plans, investment managers or high net worth individuals. Investor with no need for withdraws in the near future.

It is a temerity in our view to see this products being sold to moms and pops, by the same people that sold them stocks back in 2007. These buyers are the most vulnerable public and don't understand that they are buying something completely different from a fixed income fund. We also cannot forget, it is easy to make a sales pitch for anything that resembles real estate in Brazil. Our inflationary past, our (still) underdeveloped financial system and our Portuguese heritage makes it a bit too easy to misinterpret and mix real estate with security and "stocks" with risk.

Funny enough, I have encountered more than once Brazilian investors in love with a real estate portfolio that happens to belong to a listed company, the stocks of which they would never in their dreams have the audacity to buy. It doesn't make much sense.

2- They don't understand the performance that is attracting them

With the explosion of property funds in Brazil it became very

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common to encounter a performance table of the industry; we have received it many times in the past year without even soliciting one. It shows the top performing funds in this category in Brazil.

Many funds have performance of over +20% YTD, it really seems incredible in the context of a single digit fixed income yield. Problem is, investors are not reading the performance correctly, probably because of the yellow flag number 1, and think they are dealing with a sustainable, replicable performance. There are three possible sources of return for a real estate fund:

-The yield received by the fund for the rental or sale of the property;

-An increase in value of the fund's share due to a boom in the secondary market;

-Proceeds received in the fund's liquidation.

Let's imagine a hypothetical fund. Let's imagine the fund had been operating for a couple of years with three years left until the portfolio is liquidated. In this scenario, reason C is still far away. The fund we are imagining is in the same situation as the vast majority of real estate funds in Brazil. Let's also imagine the following reasonable assumptions:

-The fund's net asset value is R$ 100 million and the fund's shares trade at net asset value;

-The fund pays R$ 5 million in rentals to its investors per year.

Simple math tells us that the fund's investors have around 5% yearly return in dividends.

Now let's assume that, as many Brazilian funds this year, the market likes the fund's shares. And from net asset value they now trade at 1.5 times their original net asset value. The market value is now R$ 150 million. But here's the catch: the dividends received through rentals are still R$ 5 million (it is the same portfolio after all, only the fund's shares increased in value in the secondary market).

At first, the investors love the 50% upside for sure. But now, new investors will receive a dividend yield of (5 million/150 million = 3,33%/year). Now, even though the fund's share increased in value, the future dividend yield will be smaller in percentage terms.

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Obviously, this also works the other way around: investors can look for bargains: funds that had a decrease in its shares' value, prompting a higher prospective yield. But once again we ran into the previous problem: a sophisticated product for sophisticated investors.

Now, let's run a table of some property funds returns in Brazil in 2012:

Fundo[1]	Dvd Yield 12R	YTD
A	4,0%	25,00%
B	5,6%	43,75%
C	5,5%	11,23%
D	5,6%	14,04%
E	4,3%	20,31%
F	5,9%	4,17%
G	3,0%	25,33%
H	5,0%	34,56%
I	5,0%	22,73%
J	5,2%	5,98%
K	4,9%	19,46%
L	3,3%	37,32%
M	3,8%	38,95%

Some funds apparently show a fantastic performance, some of them topping 20% in 2012 alone. What is usually left unsaid is that almost all of this performance is due to an increase in the price of the fund's shares. It is easy to understand why: interest rates have fallen really fast in Brazil this year, so the discount applied to future rental has decreased, prompting a fast rise in value, but this is not recurring performance. There is no indication that it will happen again.

To get an idea of what the future holds, we should focus on the rental income: returns look a lot less stellar once we do that. In the same sampling, the top fund returned only 5.9%. To sum it up, the increase in value per share shouldn't be seen as replicable performance. And this fact has been overlooked by many Brazilian investors, that don't have the knowledge and experience necessary to analyze these products.

3- The circumstances might change drastically

[1] The funds in this table and the performances are all real. YTD information ends on 28/09/2012, source: Empiricus research.

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Once we understand yellow flags 1 and 2, it is easy to think of a third one. Property funds are a totally legitimate asset class, but mostly suited for investors that can endure illiquidity for long period of time and that understand what they are buying. Additionally, it is a type of structure where returns can depend greatly on the secondary markets' opinions, just like stocks.

So there is a long set of risks that property investors are exposed to and may not be aware of. Some of the risks are related to: international search for yield, risk appetite, interest rates, macro factors, and so on. It is really simplistic to look only at the underlying property, unless you really want to carry the fund until its portfolio liquidation, which doesn't seem to be the case for most Brazilian investors at all.

If interest rates start to be raised again in developed markets, and sooner or later they certainly will, the secondary value of many fund's shares could be affected, showing risks that resemble more the ones affecting equities than fixed income investments.

A great idea, ahead of its time.

We respect property funds. If properly understood they can add value and yield to a portfolio without too much volatility. But they shouldn't be viewed as a holy grail of risk-free returns. Such things belong to the realm of fiction, investors should convince themselves once and for all that those funds shouldn't be viewed as "fixed income 2.0 - investor's paradise".

2) Performance

2.1) FCL Capital Investment club

On November 21st 2012, the FCL Capital investment Club had its last day of existence. Since inception in April 3rd 2007 until the club was converted into the fund FCL Equities FIA, its total return was of 189.36% in BRL, comparing favorably with a performance of 21.50% of the Ibovespa Index and 76.47% of the Brazilian CDI in the same period.

The club's annualized performance was of 20.67% in Brazilian reais and 20.0% in US dollars, again comparing favorably with the performance of the Brazilian CDI, the Ibovespa and S&P500 indexes during the same period.

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One thing we are especially proud of: our returns were consistent throughout the club's existence: In the past 12 months (until November 21st) our return in reais was of 25.16% against -1.11% of the Ibovespa and 8.60% of the CDI. In the past 24 months it was down 1.11% against -16.93% of the Ibovespa Index. In the past 36 months it returned 29.90% against -16.11% of the Ibovespa Index.

2.2) FCL Equities FIA

According to the rules issued by CVM # 409 for Advertising Investment Funds (with changes introduced by the instructions 411, 413, 450, 456 and 465).

Article 75. Any disclosure of information on the results of the fund can only be done by any means, after a grace period of 6 (six) months from the date of first issuance of shares.

The fund started on 22/11/2012, therefore we will begin disclosing information relating to the share value and performance, in this place, on 23/05/2013. Thank you for understanding.

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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.