FCL *Capital*

April | 2015

After a turbulent start of the year, April was a good month for our portfolio. Most of our positions performed well and our fund was up 9.01% (16.08% in US Dollar terms) for the month.

A few important changes happened to our portfolio so far this year. First, we ended our position in Direcional Engenharia (DIRR3:BZ). We still like the company and its management, believe in its competitive advantages, but with the current fiscal situation faced by the Brazilian government and the consequent questions regarding the scale and timing of the Minha Casa Minha Vida housing program, we decided to cut our losses than to just sit and hope for a more predictable scenario.

As we all know, one thing value investors hate is uncertainty, and while investing will always be a probabilistic activity, it is also true that to be able to properly estimate the value of a business we need some clarity regarding the future. We don't like binary situations.

While we still wish success for the company and have its management in high regard, it was our avoidance of situations where there was a lack of clarity that made us stay away from many mistakes in the past, like Kroton and OGX.

The fact is, faced with a completely new and unforeseen scenario, we are not sure the company's competitive advantages, like its scale in building low-cost housing projects and its industrial methods, will be of much advantage.

We hope so and do not rule out becoming shareholders once again in the future once the scenario becomes clearer but our reasoning is that holding its shares would be an unnecessary risk right now.

Also, beginning the internationalization process we talked about in our last letter, we slowly started two positions that are still relatively small in our portfolio: the airport retailer Dufry, based in Switzerland and Apple Computer, based in California.

We will talk about both investments and their rationales in much greater detail in future letters.

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After reviewing the first part of our letter, an eternal philosophical question remains: when we say our portfolio “did well” what does it really mean? Of course, it went up in nominal terms against the real, the local currency.

Returns, after all, have two components: the numerator, which is the nominal return of the portfolio itself, its appreciation or depreciation in value, and the denominator, in other words, against what the portfolio is being compared to (i.e.: the Brazilian currency, the American currency, a stock index, a national inflation rate, a commodity like gold or oil, and so on.)

Since FCL’s early days we have been telling our investors that unlike most Brazilian equity houses, we judge our own performance internally in US Dollars, and not Reais. We think this is a more appropriate measure since the USA is still the largest economy in nominal exchange terms and the most important one, with the US Dollar as the global reserve currency.

On the other hand, the Dollar is still a paper flat currency, and probably, when compared with, for example, the Swiss Franc, not even the soundest one.

So what is money in the end? If any return is only good or bad against something else does it mean that all returns an investor can achieve in the market are necessarily illusory, like a mirror image of something else but not a real thing? And if not, what is, after all, the central asset, the one against every other return and asset has to compare itself and so we can tell we had a positive or negative risk adjusted performance? This is the theme of this month’s letter.

Since ancient times, humanity has been looking for something against which it can compare and measure its wealth. The bad news is that governments around the world have had a terrible record of maintaining the purchasing power of their currencies over time.

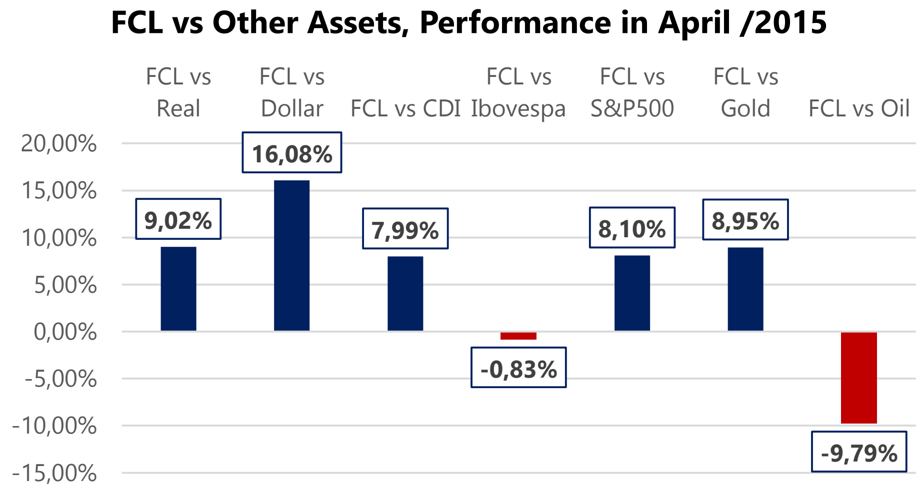
From ancient Rome, to the Weimar Republic in Germany before World War II, to the US Federal Reserve, to debt-ridden Latin American governments in the 80's, all have, to a greater or lesser extent, sought refuge in debasing their currencies when times get tough.

The important conclusion: since we are all vulnerable to governments influence when we have all our wealth tied in a 100% correlation to a single nation's currency, no single nation's currency could be the central asset we are looking for.

That being said, as long as the US Dollar maintains its outsized influence in the world´s financial markets and as long as we feel it at least resembles a modestly sound currency, it will remain the metric when we judge our performance internally. But that does not mean our future is tied to the US Dollar, we are an equity fund after all, and our companies have their results mostly in currencies that are not the dollar.

Since returns are usually measured in government currencies (like the Brazilian Real, the US Dollar, and so on), and since these currencies can go into trouble, be careful how investors measure their short-term and long-term performances. After all, they can be illusory. Certainly anyone invested in, say, the Zimbabwean stock market or Brazil's stock market during the early 90's made money at least in nominal, if not real, terms.

The chart below measures of FCL's performance this past month against several assets. Keep in mind that we are measuring the *same* performance that happened in this past month.



If national currencies can never be the central asset, does a central asset exist? Probably, if we look at mankind's history, the closer we can get to one is gold. We can search through centuries in almost every culture, every part of the globe, and since way before Christian times and people have always valued gold. The more you study gold's history and the more skeptical you become of national governments, the tendency is the more of a gold evangelist you become.

Interestingly, gold has many detractors and most point out to the fact that, well, gold has no intrinsic utility or value, besides the value that people judge gold has.

Warren Buffet famously said:

"[Gold] gets dug out of the ground in Africa, or someplace. Then we melt it down, dig another hole, bury it again and pay people to stand around guarding it. It has no utility. Anyone watching from Mars would be scratching their head."

"You could take all the gold that's ever been mined, and it would fill a cube 67 feet in each direction. For what it's worth at current gold prices, you could buy — not some — all of the farmland in the United States. Plus, you could buy 10 Exxon Mobil's (XOM), plus have $1 trillion of walking-around money. Or you could have a big cube of metal. Which would you take? Which is going to produce more value?"

We would like to take Buffet's argument on its head: Gold is a great candidate for being the central asset *precisely* because it has no utility. If it had, it could be measured against something and replaced. It could be fundamentally analyzed and therefore its fundamental - and not psychological factors - would influence its price.

Since it does not has any utility, and for some reason people have always wanted it, that's precisely the reason it is a great candidate. Gold just is. It has always been and possibly it will always be valued. End of story.

Also, gold works as a store of wealth much better than real estate: if you are a Jewish refugee trying to bribe your way out of Germany or Poland during the Second World War you could bribe the guards at the border (or maybe dig a hole, store your gold until you are back home years later), but you certainly couldn't take your real estate and carry it with you across the border. It is easily tradable, it is reasonably liquid.

Gold is portable, it keeps its value, and it has survived the test of time.

On the other hand, there are many problems with investing in gold. Mostly, no investor will ever have success if he ties most of its wealth to gold over the long term, as some New York fund managers painfully learnt after the financial crisis.

Since gold produces no income, it can be a great hedge against disaster - a good way of being short on risk - or a good storage of wealth when interest rates are very low. When they are not, the cost of carrying gold rises exponentially.

Moreover, there are indications that gold's exclusivity may be vanishing. Nowadays if you are a Russian oligarch or a Brazilian businessman desperate to take your wealth out of your country, there are many clever tactics, like Bitcoins or even buying art. Both of them have advantages and disadvantages but the point is that gold may be no longer be the only option for long-term viable storage of wealth.

In the end, almost everything in investing is either a two-edged sword, with pluses and minuses or a circular argument. Even gold has to be measured against something. It may come close, but even gold is no central asset.

So investors are still stuck in the labyrinth. They can measure their portfolio against gold, which is as good a measurement as any, just like us dollars, Reais, the Ibovespa index, and so on, but even then, since gold more likely than not won't produce decent returns (or maybe even positive inflation adjusted returns) in the next decades or so, they will still have to measure their gold holdings against something.

What about stock indexes? Since we are an equity fund it is obviously important to measure our performance against equity benchmarks. Investors should never forget to check if a manager can generate long-term alpha or not.

On the other hand, as long as this reasoning may work for an equity fund, the investors themselves who hold their portfolios probably don't have all of their wealth in any class of assets.

Even equity funds themselves may hold cash (like we do) when we are waiting for better investment opportunities. This means that, at least to some extent, we may be in and out of markets, at least in part. On a way, measuring performance exclusively against a stock index that can't do the same even for an active stock fund is kind of "cheating".

What about commodities like oil? Thinking of them as a possible central asset also doesn't make a lot of sense. We all put fuel in our tanks, or eat wheat or corn, but these purchases don't get anywhere close to 100% of our expenses, so our wealth shouldn't be completely tied to them, unless maybe you are trying to measure the performance of a specific oil or agricultural company.

What about Bitcoin? As libertarians, we would love to see the electronic currency's success, but Bitcoin, to say the very least, still has to endure the test of time and to gain broader acceptance.

What about inflation or fixed income securities? Also it wouldn't work. Most investors in this globalized world have both expenses and assets in more than one country, so, increasingly, inflated indexes won't measure the actual basket or personal expenses even for normal people that have assets and liabilities in multiple jurisdictions. Besides, a specific country than go burst (and they do from time to time). Finally, even if it's not the case, fixed income securities, over the very long-term, are not likely to produce decent returns if their investors have all of their wealth tied to it.

What about real estate? It is not portable, so you are tied to a specific place and the destiny of that single place. If Greece goes burst and you own real estate there you will fare a lot worse than if you own real estate in Manhattan. Also, it is not liquid, since every piece of land in unique.

What about productive assets, like an international portfolio of stocks and private companies? While you would likely have good long-term returns, you would be exposed to the global business cycle, and also, there are many assets, like bonds, that would outperform you during the downturns.

What about short-term investors? What about risk averse investors? It seems unfair to them to think of a possible central asset only in terms of being invested in productive long-term business when many people have short term assets and liabilities.

It is one of the ultimate questions in investing. And the search for the ultimate central asset continues.