FCL*Capital*

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Some dates we just never forget. Be it major world events (everyone knows where they were on September 11th, 2001) or for personal reasons: most of us can easily recall the day when their child was born or when they got married.

One of the dates this manager will always carry with him certainly doesn´t ring a bell for most people: January 12th, 2007. It was on this day, on a very cold and snowy morning in the Nebraskan town of Omaha that he met one of his idols and certainly the man that, apart from his family, had the most profound impact on him: Warren Buffet, also known as the most successful investor of all time.

This letter may be more personal than most we write in this space: it will be about our relationship with the founders of Berkshire Hathaway as an analogy for the relationship between financial markets (and all the things it contains, like stock prices that go up and down, news flow, and so forth) with real businesses. Businesses that were once still on the drawing board and were able to succeed.

A discussion about the dynamics between financial markets and the real economy. And about our relationship and admiration about the two guys that most clearly understood this relationship: Warren Buffet and Charles Munger.

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The real good stock investors (and they are few) usually go through three different stages in their investment style:

First, in what we will call the amateur phase (one that the vast majority of investors including many professionals will never leave behind) they concentrate their attention on the outputs the financial markets give them.

What do we call outputs? First and foremost, the stock prices. They feel cheerful when stocks (and their bonuses) are going up, depressed when they are coming down. Secondarily, they also follow the market volume closely, the news flow surrounding the companies they cover, and, let’s be fair, the research and educated opinions about the companies.

But if it were about this – stock research, volume charts, price actions, this house must admit: stock markets would never really make intuitive sense for us.

As some of you know, this manager was born a member of a third generation of a traditional, familiar and respected real estate company in Rio. Since he was a child everything he was able to observe: the careful decisions, the long-term plans, the cultivated trust, relationships and respect a company is able to gather, it would be in stark contrast with financial markets, if they were just about phase one. It would seem like stocks and companies are from two completely different worlds.

The real good investors are able to reach phase two: they understand that stocks are nothing more than pieces of companies. Someone founded those businesses (yes, even Mark Zuckerberg or Bill Gates once started with an idea) and through trials and errors, efforts and perseverance, some of those businesses reached the stock market (possibly the highest level an entrepreneur could dream about). So, though most measures listed companies are successful businesses (at least in size). But make no mistake: they are still businesses, just like the shoe shop or the local restaurant. And stocks are nothing more than legal claims on parts of those business (that´s why they are called shares).

For a good while when I joined the financial field I was a little embarrassed about my background: most people in finance, especially the ones that establish their own investment companies were usually traders in banks and brokerages. Here goes a typical headline: super successful chief trader on bank XYZ will now establish his own investment company!) We read those every day on Bloomberg.

This house doesn´t have this background. We came from the real side of things. We first saw thigs from behind the curtain to then establish our fund. No trading desk path for us.

For a while I though this was a major handicap. Now I think it is a major advantage. Only the real smart people are able to see though phase one. To really understand the businesses, and most importantly, the intersection of things, the business pulse, the way businesses operate beyond financial reports and stock charts. This house didn´t have to make that jump. We had to make the reverse way. We didn´t need to be smart to understand businesses, we only had to conquer the financial aspect with CFAs and MBAs. Counter intuitive but all things considered probably an easier path.

Coming from the ‘’real side’’, with a law degree and being from a family business, then an MBA and CFA later we still think how fortunate this background is. It certainly makes our perspective different. And to brag a little, as Coco Chanel once put it, ‘’in order to be irreplaceable one has to be unique’’.

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For months I had thought about which question to ask Warren Buffet. I would have, after all, only one question. I was one among many students, a member of the first class of financial students from Brazil admitted to this, that still is an annual special tradition: once a year Buffet spends a day with students from three different colleges offering his perspective about things, giving advice, and answering any questions we might have.

Just how valuable an opportunity like this is? Considering that he also auctions an annual dinner on eBay and the winning bid, typically a fund manager/fan is usually several million dollars and we could have it for basically free (only transportation to Omaha) that says it all.

So, there we were, the class from Stanford, the one from Harvard and the "Brazilian guys".

Many questions from other people, I felt, were wasted. Why bother with specifics when you have the world´s most amazing financial mind around? One wanted to know about specifics in the bond curve... duh… go ask Pimco.

I think he was initially uneasy: he put us in the back of the room. But after a while, impressed with a high level question from the Brazilian group, he let down his guard ''Brazil is big, and this has several implications. There will be huge winners in this group, that´s for sure''.

''Yes! Yes! That will be me! '' I wanted to stand up and scream to him, but obviously I just thought.

When it was finally my question the one to be asked, I could remember word for word the one I had thought long ago, still in Rio, six thousand miles away and brought in a piece of paper:

“Over the years you made your name buying companies with the most remarkable, enduring competitive advantages and they thrived. What is after all, YOUR competitive advantage, as an investor?

It is a question that, after reading thousands upon thousands of pages about him I could attest, no one had ever asked him.

He was close to our section in the audience.

‘’It is a good question, can you repeat while I walk back to the stage and think about an answer?”

(general laughter)

The question was repeated.

The answer he promptly gave is exactly the one I thought he would give. Because it is the simple truth.

“What is my personal competitive advantage as an investor? ‘’ he said.

Simple: ‘’I am rational’’.

This is, of course, simplifying things a lot. But simply being rational and having common sense can put you ahead. Berkshire never did anything complex or brilliant. It simply avoided being dumb. If the best thing was not buying a single share the whole year he wouldn't buy. Sounds easy. But how many were able to do it?

A second part of his humbleness is probably related that maybe he doesn´t know why he fared so well. A lot is said about outliers and the truth is that, even they don´t know exactly the reason for their extremely outstanding results.

Centenarians usually shrug when asked about their secret. Roger Federer recently after winning yet another grand slam let down a moment of self-amazement in his thank you speech, trophy in hand: ''You know, I am just a guy from Basel that thought about having a career as a professional tennis player... I didn´t really expect any of this''

And even Charlie Munger, warren buffet longtime partner:

"Actually, the thing I always wanted, the one I worked for, was a life of financial independence. I just overshot a lot'' (laughter)

That being said, we can count the many differentials warren buffet has over other investors.

The first one is that, quite literally, he was away from the crowd. Being in the backwater town of Omaha, Nebraska, and having most of his career in pre-internet years made him and Charlie Munger independent thinkers. There was simply not a lot of other people around interested in stocks and investments. Contrast that to where the action is: Wall Street and the city of London. You can hardly spend 5 minutes without a strong opinion about a specific stock that is going ''to the moon' or to ''zero''. As Buffett himself once said: ''to be a successful investor you need to be an independent thinker''.

But a second advantage comes straight from the first one: being away from the activity naturally made Buffet a long-term thinker. He engaged in what is now called the ''time arbitrage'', in other words, he realized stock markets may be fairly efficient in the short term but not super efficient in the long term. That´s where most obvious opportunities lie and where he focused his career.

A third advantage: the power of incentives. Buffett didn´t have benchmarks or short terms targets to meet and could focus on the big picture.

Fourth: disregard for conventions and sole focus on compounding and results. As Munger put it: we were just good at identifying all the bullshit and cutting it. Certainly, a manager that sits on his desk and does exactly nothing for a whole year would lose his job before Christmas. Buffett did it many times (probably the only professional investor ever to do it) and he turned out to be the world's greatest investor).

But to this house the final and least discussed thing about Warren Buffet´s edge is this: the best fund manager hasn´t been a fund manager for many decades. He is, technically speaking, the CEO of a public company that happens to engage in stock market and private markets investments and several other long-term activities including reinsurance.

This house thinks an even greater source of alpha than the time arbitrage opportunity is the investment structure arbitrage opportunity. We raised this subject many times in past letters: it is the investment world analogy of being a Ferrari driver against a small team driver in Formula 1: you have a better equipment.

Buffett never faced redemptions, daily NAVs and other problems and distractions many fund managers face. This, allied to his enormous talent, allowed him to flourish and outperform.

‘’I am rational’’ Buffet said. And it is indeed the thing that set him apart. The first ingredient was certainly his enormous talent. But how could he be so rational in a world where no one else can?

The answer lies in the structures and traditions of the investment world. The answer lies in the things that keep managers awake at night. Investors redemptions? Buffet never faced them. A short-term horizon? He had a permanent and unusual capital structure. Flexibility to look across investment horizons and asset classes? He was in charge of a holding company, not a fund.

‘’I am rational’’, Buffet said. Yes of course he is. His greater genius is not only investment skill, but molding a life, including his hometown, his investment vehicle, his incentives, that permitted him to distinguish himself in this way. In other words, he permitted himself to be rational.

As Charlie Munger remarked on the 50 years anniversary of Berkshire Hathaway in 2015, ‘’our holding company structure has been such a great success I am amazed there aren´t any people trying to copy us’’

‘’I know why there aren´t’’, Buffett said, ‘’because not many people want to get rich slowly’’.

So if the first step of an investor journey is watching stock prices, the second step is understanding the dynamics behind stocks and that stocks are really nothing more than parts of real world businesses, here comes the final part of an investor learning curve: you should think not in terms of stock prices, not even only in terms of individual companies, but you should think of you, your assets as a portfolio.

Even more important than owning a good business is understanding what are your exposures, what are the things that will make you make money, make you lose money (your factor allocation in the jargon that is currently in vogue) and even more important, how to limit your downside.

For example: this house thinks it has a beautiful and important mission for families and businessowners in Brazil: many of them despite being successful owners of their family business are incredibly under allocated in any other country or currency. In other words, despite their success their portfolio will still grow and thrive and shrink in value depending on the circumstances of a single economy and even worse, a very volatile one.

This problem is compounded by perverse incentives: when the business owner wants to allocate some of his capital to investments and to build a nest egg, legions of Brazilian banks and asset managers, in an industry that still ignores the world outside of the country will happily suggest lots of investment options for this businessperson to increase even more his personal allocation to the Brazilian economy.

This house has said many times in the past that the best way to look at its funds would be as a personal interest in an investment holding that carries minority and long-term positions in several promising global business. As for the third step: what is the portfolio? What is it you are getting? We believe our investors, including ourselves, the managers, are getting a diversified basket of promising companies of the 21st century: we hold more tech exposure, more BRICs exposure (both in our Chinese, Indian and Brazilian companies and in European and American companies that are heavily exposed to the BRICs) and at the same time a portfolio with a lower PE ratio than the S&P500 by a huge margin.

This is not to say we know our fund will surely outperform, especially in the short term. But back to Buffett: the longer the time frame the easier it is to see the arbitrage opportunity because no one will stop the fact that we are going to a world where technology and the BRIC countries are going to have a lot more prominence in our lives.

Warren Buffett and Charlie Munger certainly understood the power of perverse incentives better than most people. Among many brilliant quotes, their lack of patience for embellished financial reports (Munger: whenever I read ''Ebitda earnings I think ''bullshit earnings'' to Buffett´s disdain for access to sought after IPOs : ''I like things that are not being fought for. I like auctions with no buyers and where the sellers don´t want to inflate the price.''

After reading them for a decade now and a cursory glance of the news flow: the fascination with the so called FANG stocks (Facebook, Amazon, Netflix, Google) , the new avenues for profit for wall street (new ETFs that basically do the same thing, new ways to allocate subprime with different names) it´s hard to avoid the feeling that history doesn´t repeat itself but it does rhyme.

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This letter is not to lionize Warren buffet and Charlie Munger. For this house they are certainly major inspirations, but they are after all human beings and as human beings they make mistakes and have opinions and positions we disagree with.

Buffett supported the Iraq invasion. Charlie Munger is very public in his disdain for cryptocurrencies and blockchain, a position we find extremely close minded and pretentious. But since they were right in their call against the internet bubble and right on almost any of their calls over the past half a century, it is hard for any human being to avoid the feeling they are recognizing patterns and seeing it all over again. It is certainly hard for this house to be an independent thinker enough to completely disregard their opinions.

But even more important than being consistently right, there is something more in their story. From their grace in how they were available to share their insights and opinions, their lack of short term greed, their reputation that stands the test of time, and above all, from their wisdom that we find applicable to so many parts of our lives.

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A small final story about grace, and in a not public setting, when no one is around to see you or write about you: January 12th, 2007 was coming to an end. After three hours of a question and answer session with Warren Buffet in the headquarters of Berkshire Hathaway (something beyond my wildest dreams) and visits to two Berkshire companies, Nebraska Furniture Mart and Borsheims Jewelry, there was a lunch at Borat´s, Wanrren´s favorite steakhouse, completely paid by him for the roughly 150 students.

After that and a few souvenirs that were given to us, a final treat: each of us would have a few seconds to take a picture with him. That is for a kid who was aspiring for a career in finance, the ultimate selfie: you and the man.

We promptly formed a queue and were waiting anxiously for our turn.

Some took pictures whispering in his wear, like they were giving a stock tip. Some took dollar bills and wanted him to sign them.

Since it was the coldest day of the year, everyone had to improvise: we took the pictures inside of the restaurant, which was packed, full of mirrors and lights.

I gave him a hug and asked someone to shoot a pic of us.

After me, several dozen more students wanting their place with someone that, after all, has almost god like status in the worlds of business and finance.

The line gradually started to ease. Lunch was already being served and from there each university team and Buffett himself would go their separate ways.

To my horror, as I sat down for a celebratory lunch with a few colleagues, I realized my picture was completely wasted. This was 2007, before the iPhone was invented. With mirrors and lights no one would even be able to tell it was me and Warren Buffett in that picture. It was totally blurred.

That is ok, i tried to console myself. Just being here, being able to ask a question, visiting Berkshire, that´s more than I could have always asked for.

I glanced at Warren some 10 meters away from me, getting ready to sit down and have lunch himself in another table. The line was gone. He had made his duty. He had patiently posed with each of the 150 students.

Something clicked in me for some reason: I approached him again, knowing I shouldn’t.

“Would you mind taking another one with me?’’

Funny to think that the only thing I ever said to the world´s greatest financial mind was a request.

He could have said no. No one was looking. It was even a bit unfair: everyone only had one picture, it was my fault if I blew it. He had a right to have his damn lunch.

He immediately smiled: ‘’Sure, no problem at all’’!

And raised from his chair, posed again.

The second pic was still not perfect: those were pre-smartphone days.

But 11 years later there is still not a single day I haven´t looked at it in my living room.

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