FCL*Capital*

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Permanence & convexity

In our permanent search for alpha, we are constantly building, at FCL Capital, a framework for accessing and understanding our investment ideas. What are the ingredients that make a winning or losing long-term investment decision? We, as everyone else, are only starting to understand the market reality, but we feel by now that if there was a secret mojo, a *yin and yang* equivalent to stock investing, we would say it is the two forces of **permanence** and **convexity,** and how they relate to some of our investment ideas.

Part I – Permanence: The staying power factor

As the name implies, permanence refers to the predictability that a given outcome will stay the same way in the future. Much has been written about the unpredictability of capitalism but any stock analyst has, as part of his job, to search for clues on how the future will be.

First of all, it is a good thing that money is always changing hands and the success of the past (especially when it comes to the success of one or more generations of a family) will not necessarily translate into the success of the next generation. As much as the “rich dad, noble son, poor grandson” syndrome is much discussed, it is actually a good thing from a macro perspective.

The reality however, is that there was never as much mobility as many think (some surnames in Europe seem to have above average incomes that extend for over 300 years) and besides, a new smart global elite is emerging, who puts their children in Ivy League schools, buys them The Economist signatures since early ages and put them in mandarin classes.

Once again, from a macro perspective (if not from a micro point of view) the advent of this enlightened global elite is a terrible occurrence. These people may have finally conquered the system when it comes to maintaining their families in the top spots for longer than ever.

When it comes to companies, our job is to find the best performing ones, which will continue to have remarkable performances in the future. Is it possible to do so? Will the post-Steve Jobs Apple continue to amaze? Will Coca-Cola be the most drank soda in 100 years?

The sad answer is that unlike the situation of families, the performance of companies seems more volatile and difficult to predict than personal finances. Most companies with above average ROE tend to return to their respective sector averages.

Much is still being learned about the science of the staying on the top[1], but our suspicion is that at least part of the answer comes from buying a business that the investor “will never want to sell” as Warren Buffett once said. This helps the investor to avoid the temptation of attempting to “time” the market, buying an asset that he thinks will outperform for a certain period and selling in the opposite situation. When someone is comfortable with a business, a “partner mentality” kicks in and the real staying power shows up.

Instead of trying to time the market, investors should look for companies that have real and sustainable comparative advantages. This “secret recipe” is still being understood, maybe it is part of the legacy of their founders, part of their respective position, their brands[2]. A company with enough uniqueness will usually guarantee its place in the sun for many years to come.

(1) The book “Built to Last” by Jim Collins is perhaps the first attempt of answering that question.
(2) Possibly the reason the super investors Jorge Paulo Lemann and Warren Buffett just bought Heinz is that they see its brand a great predictor of their staying power in the future.

TOP 10 ROIC % 2003-2007		TOP 10 ROIC % 2008-2012	
Souza Cruz	39,63	Estácio	119,53
Embraer	38,24	Lojas Renner	62,51
Metal Leve	30,61	Natura	58,31
Itausa	27,30	AES Tietê	36,27
Fosfertil	23,23	Valid	35,17
Ferbasa	19,83	**Souza Cruz**	31,50
Saraiva	19,18	**Petrobras**	27,16
Tractebel	17,50	**Tractebel**	26,54
Petrobras	16,76	Cia Concessões	22,83
Ambev	16,64	Paraná Banco	21,39

**- Annualized, very low volume stocks ignored.*

ROIC % 2008 à 2012 of companies no longer in TOP 10: Saraiva 20,89 - Metal Leve 19,83 – Ambev 12,50 – Embraer 6,76 – Ferbasa 4,11 – Itasa -37,29 – Fosfertil is no longer being traded.

TOP 10 Returns % 2003-2007		TOP 10 Returns % 2008-2012	
Plascar	174,63	Cia Hering	68,83
Lojas Renner	117,45	Raia Drogasil	39,26
Iochpe Maxxion	116,99	Arteris	36,50
Mangels	92,70	Marcopolo	35,95
Usiminas	92,10	Marisa	34,37
IdeiasNet	85,53	Souza Cruz	34,32
Rossi	85,22	Natura	34,30
Tam	83,22	Odontoprev	33,54
Romi	80,02	Ambev	32,44
CSN	76,98	Sanepar	32,44

**- Annualized, very low volume stocks ignored.*

Return % 2008-2012 of companies no longer in TOP 10: Plascar -46,67 – Lojas Renner 20,85 – Iochpe Maxxion 10,56 – Mangels -31,75 – Usiminas -11,63 – IdeiasNet -26,18 – Rossi -25,66 – Romi -24,83 – CSN -10,26 – TAM is no longer being traded. **No company stayed in the TOP 10.**

TOP 10 Returns % Brazil 2003-2012		TOP 10 Returns % USA 2003-2012	
Lojas Renner	62,09	Monster Beverages	69,16
Iochpe Maxxion	54,88	Green Mountain Coffee	49,83
Cia Concessões	52,12	Apple	48,57
Cia Hering	47,27	Southern Copper	38,03
Alpargatas	44,19	Southwestern Energy	34,97
Lojas Americanas	38,86	Tesoro Corp	34,06
Marcopolo	35,53	Netflix	33,71
Metal Leve	35,32	Cummings	31,48
Randon Part	34,99	Seugene Corp	31,10
Klabin	34,54	Guess Inc.	31,01

Part 2 – Convexity: The power of nonlinear payoffs

If permanence is the power of maintaining a situation, convexity, on the other hand, is the power of the non-linear payoff. Permanence is playing defense while convexity is playing offense. Many people subconsciously recognize this when they play the lottery or in Vegas. The maximum (and highly probable) outcome is a small loss, which is "already in the price", while the highly unlikely but fantastic payoff in case things turn out nicely represents an almost infinite upside.

In real life, we see people subtly understanding and trying to manipulate the power of convexity in ways favorable to them. An aspiring band with no money but a suitcase full of dreams that arrive in the US or UK, the actress that heads to California, if American, or to Rio, if Brazilian, the elites of Brazil that put their children in interexchange programs to "see what is out there", and of course, the investors. Many of them retail investor without market experience, trying their lucks with "penny stocks". In all of these cases, the agents know that the highest payoff is very far away from being a certainty, but they can try to "manipulate" luck by taking a chance.

At FCL Capital, our offense game has gone through many stages and it is now quite systematic in a few aspects. Our biggest position for the past couple of years was previously what we call an "option in the form of a stock". Minerva was highly disregarded for its high level of leverage and adverse sector characteristics. We spent months going back and forward in its balance sheet and concluded that a new cattle cycle, its process of deleveraging and its cheap multiples would mean with almost certainty that its stock would have to be repriced, as happened. In other words, it was a very cheap "option".

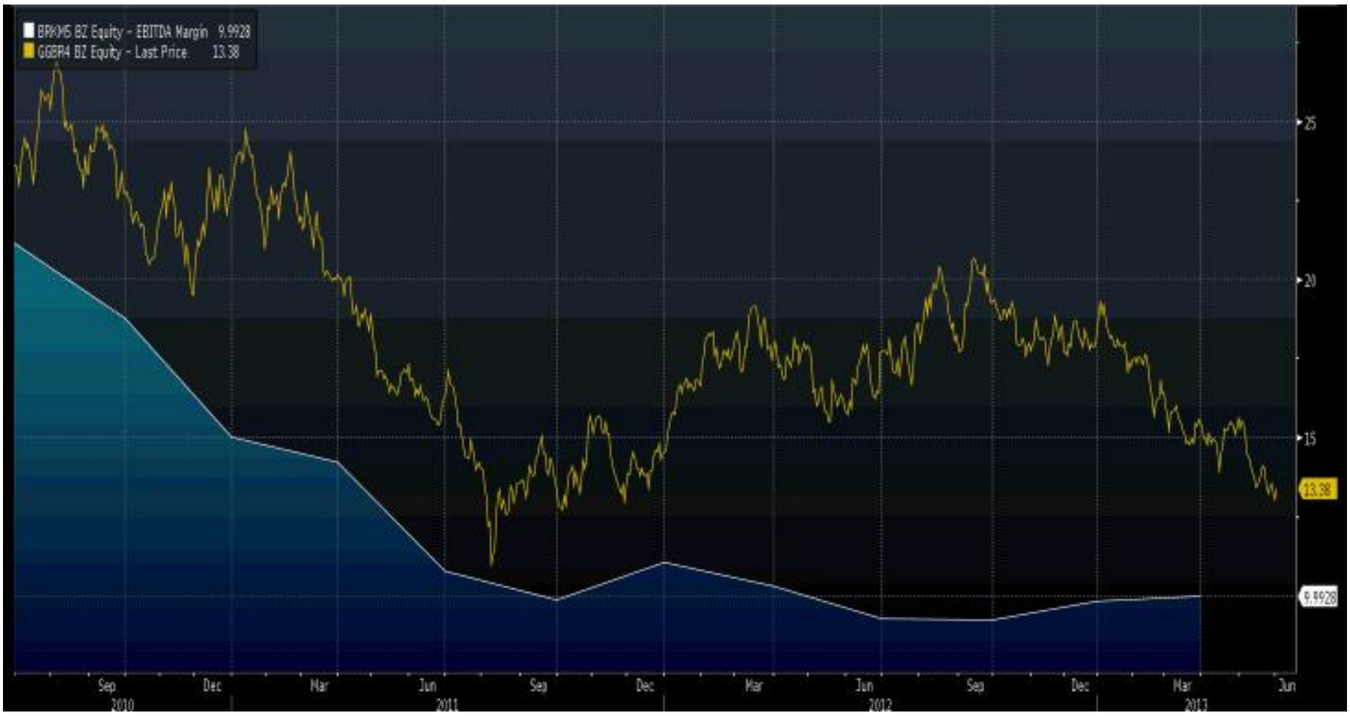
Minerva's Performance (ticker: BEEF3) in the last 3 years. Source: Financial Times.

Nowadays, our search for cheap options in the market marches forward. Meanwhile we maintain a large part of our previous position in Minerva, due to the market being slow to acknowledge that there are still a few realities associated with this case not priced in. Some of these are the competitive position of South American cattle markets in comparison to its competitors, and the ongoing repricing of the Brazilian real that will improve its margins. We also built positions in two large and established companies, bigger and better well know than the average FCL Capital's investment.

Braskem & Gerdau are admittedly two businesses in highly cyclical industries. The first one is

Brazil's major petrochemical company, discussed a few times in our past letters. The second one is a Brazilian industrial champion, in a problematic industry plagued by China's overcapacity and the dark clouds hovering the world's economy. We are not claiming to have all the answers to these above-mentioned problems, but we do claim that these problems are already present in the current stock prices.

That is where our asymmetric payoff, our search for convexity leads us: if the world economy does not improve and lifts all the boats, we still have two great dividend paying and investment grade companies, purchased at cheap multiples. In this case, we will probably lose a little bit of money, since both business depend highly on the world economy (although Braskem's unique position in Brazil´s petrochemical industry and Gerdau advantage of being able to benefit from the US reemergence as a manufacturing base will certainly mitigate that losses). On the other hand, if the world economy and the Brazilian stock market improves, they will benefit greatly.



EBITDA Margin in the last 3 years for Braskem and Gerdau. Source: Bloomberg.

Some simplistic assumptions like a reflection of both companies EBITDA margins and the consequent improvement of its multiples lead us to potentially very high internal rates of return. If both companies' margins return to their long-term average on the back of an improving world economy, while its multiples also return to what has been their norm, the payoffs could be astronomical. A small limited loss in case things go bad and a very high gain in case you have some luck: that's the Holy Grail investors are always looking for and that's what we judge to have found in both of these companies.

Performance

From January 1st until May 31th FCL Equities fund had an accumulated performance of -0.02%, comparing favorably against -12.21% of the Ibovespa index, our benchmark, and disfavorably against 2,81% of the brazilian CDI.

Since the inception of our first product, FCL Capital investment club, on April 3rd 2007 and aggregating this performance with our fund, that started on November 22nd 2012, our compositive performance is 194,14%, once again comparing favorably against 15,59%of the Ibovespa index and 82,77%of the brazilian CDI.

Our compounded annual performance, our most important internal metric, ended the month of May at 19,07% since the inception of our investment club and 3,33% since the inception of our investment fund.

FCL Equities Composition	
Long	103.91%
Short	(4.70%)
Cash	(2.28%)
Net Long	**96.93%**

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.

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Auditor

KPMG

Custodian

Bradesco

Regulation

ANBIMA — A presente instituição aderiu ao Código ANBIMA de Regulação e Melhores Práticas para os Fundos de Investimento.

Administration and Distribution

BNY MELLON