FCL*Capital*

April 2018

The endless quest

Every profession has its inspiring muse. For the professional athlete, it is the gold medal, for the tennis player a grand slam trophy, for the literary writer, a Nobel, for the actor, an Oscar or golden globe award.

For the investment profession, the inspiring muse is a five-letter word that is much discussed but not so much understood: alpha.

Why do a selected few investors beat the markets while most don´t? Why are there a selected few among us, like David Tepper or Warren Buffett, that were able to, over decades, leave market indexes and almost everyone else on the dust? Their hability to generate alpha is the reason.

As every investor should know, risk and returns are correlated when it comes to investing: the more risk you incur, the higher your returns (but also your volatility) tends to be.

Alpha on the other hand is the risk adjusted return. A higher return not explained by higher risk. It is, simply put, investment skill. If two fund managers incur in the same level of risk and one of them has, over time, better returns, alpha should be the explanation.

Alpha is therefore, like black holes or dark energy, almost a magic of science: we can measure it, so we know it must exist. And the search for alpha is the goal of every active fund manager. If you give up the dream of finding alpha, then it is better to just leave all your money in an index fund and enjoy your life at the beach.

Our letter this month will be about this house´s approach to finding alpha, our permanent search for this element, our process, and our best shot at trying to explain to our investors why we think we can deliver alpha when so many fund houses are not able to.

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First of all, we are going to be blunt: alpha is private information. And we mean it, always and everywhere. But don´t mean “private” in the illegal sense. We just mean that to achieve alpha (an admittedly very hard task) an investor needs to either:

a. Know or find out something very few people know.
b. Be able to understand or process the information in a way that few people are able to, even if many people also know it.
c. Be able to act on information that very few people are able or willing to act on, even if many know the same thing and understand it.

Let´s look at each of those things:

1. Private Information on private markets (Private equity, Crypto currencies, etc.)

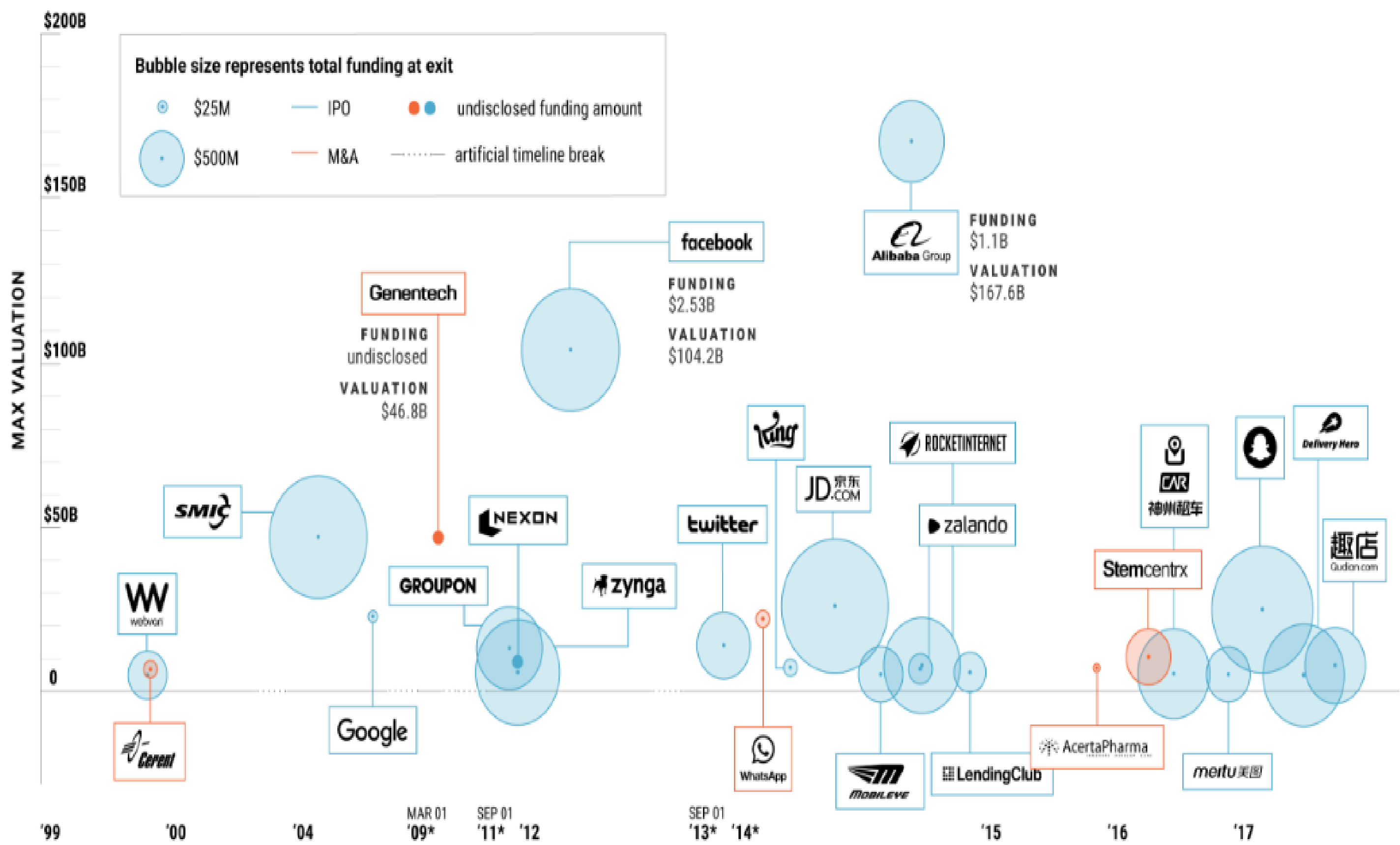
Starting where alpha is most abundant, most people accept that in non-public non-traded markets, it is possible to find remarkable investment opportunities if you have the right connections, if you are in the right place at the right time or if you are a gifted entrepreneur.

Think about remarkable companies like Apple and Microsoft and the brilliance of their founders. Or maybe even more remarkably about the elite Venture Capital firms in California: over decades they stablished their reputations as the go to places for ambitious entrepreneurs with their advices and connections and the cycle reinforced itself. The best new entrepreneurs wanted to partner with them and their funds kept generating above average returns. The result is an amazing track record of incredible companies and amazing returns that is still going strong to this day.[1]

Why is it easier to find alpha in non-traded markets then in, say, investing in stocks or currencies? Simply because information is slower, unreliable, more difficult to get. Everyone who pays a Bloomberg terminal can get a quote and find a lot of information about any trade stock that trades anywhere in the world. But if you happen to live in, say, Indonesia, and there is an amazing opportunity there, there is a greater chance this opportunity will not be taken advantage of by the time a smart businessperson acts. In investment jargon, the opportunity takes longer to be arbitraged away.

1 Although the crypto revolution may endanger their business model.

Top 25 VC- Backed Exits of all time



* Some years are abbreviated for legibility
** Genentech and Alibaba are technically not first exits but are generally accepted as reference first exits
Source: CBINSIGHTS

2. Private information on specific corners of the market (aka ‘’semi private markets) (emerging markets, small caps stocks, etc)

So, if our investors concur that it is possible to find alpha in private companies, private investment opportunities, and private equity in general, let´s move closer to the day to day alpha search this house labors on: what we call semi private markets.

While it is true that public markets generally have higher level of information and higher liquidity than private markets, not all public markets are created equal.

As we said before in this space, one of the reasons this house focuses on small caps and emerging markets is that those markets are, to use the jargon, “less efficient”.

Take the Brazilian markets. Many of the smaller Brazilian companies listed on the stock exchange only release their statements in Portuguese. Besides, most of their regular investor meetings, company visits and conferences also tend to be in Brazil. Clearly, non-Brazilian investors are at a major disadvantage. The same can be said of small cap companies listed on the Shanghai and Shenzhen exchanges for china, small cap Japanese companies, and so forth.

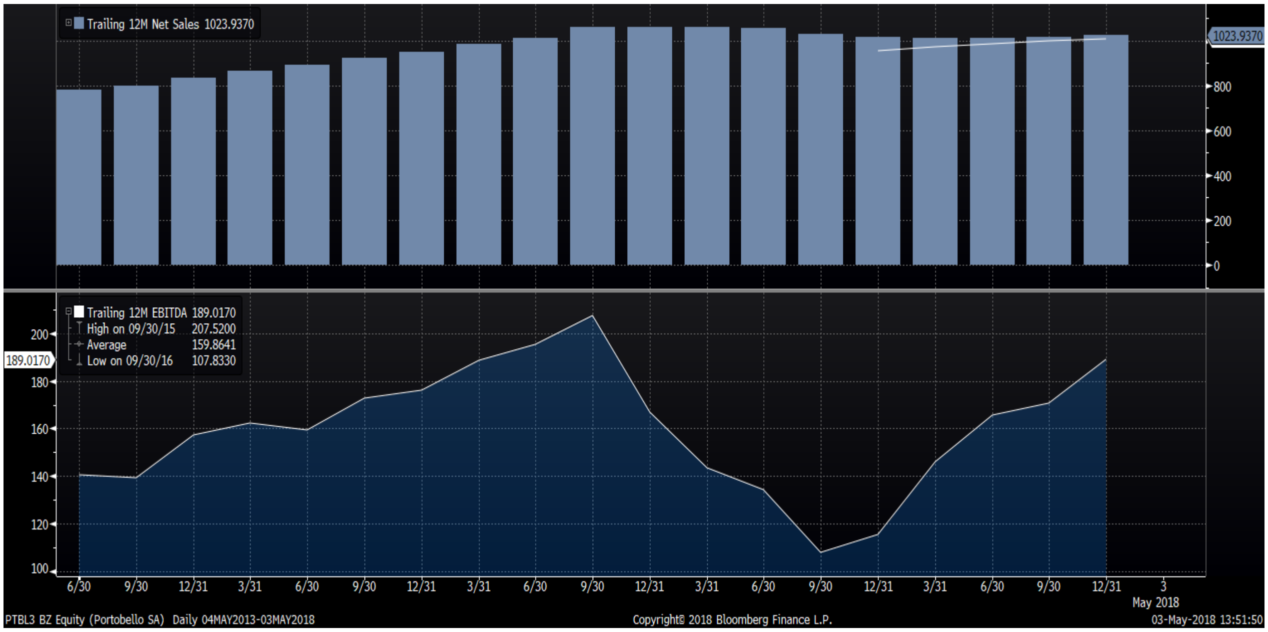
But there is more. When we take a small cap company, say a company valued at $300 million on the Brazilian stock exchange, even if an astute analyst at a big investment firm, one that manages, say, 50 billion USD, could spot and understand the opportunity, he couldn’t act on it because the opportunity would be simply too small for his company to be able to allocate on it and profit from it.

As Warren Buffett himself once remarked, “size is the enemy of outperformance”.

So, to summarize, alpha can certainly be found on the private markets, but it can also be found of specific “corners” of the public market, the niches, where not many people are able to go. It can be because of size, nationality, specific characteristics, anywhere you can understand things better than your competitors. Anywhere you can know something most people don´t.

Many of this house´s past investment ideas where attempts to explore semi private information in this way. Let´s suppose we had a specific opinion on the price of oil (a market this house admittedly does not have an edge on): well, it takes a lot of courage to believe you know something that is incorporated in the price of an asset that trades billions of dollars daily and that has investors across the globe trying to understand it.

Now let´s take our investment in Portobello, a small cap Brazilian company. It´s stock barely trades a million dollars on a good day. It´s financial reports are mostly in Portuguese. Its stores are all located in Brazil. After a few months of field work and digging the company reports, we judged we had a good understanding of the business. We judged we had “semi private” information. We think this route is a lot more credible.



Trailing 12 months Portobello Net sales and Ebitda (source: Bloomberg)

Finally, it is possible to find alpha if you have exceptional alignment with your investor base, they understand what you try to do and tolerate fluctuations because they know that to have outperformance you necessarily have to have periods of underperformance. Also, it is possible if you have a fund structure that allows for longer term opportunities, lower turnover and a flexible mandate that allows you to exploit discrepancies.

Bizarrely, we even think a good sign of a talented investor might be found if someone has endured severe underperformance for some time. It means this person or team is willing at least to deviate violently from the consensus, knowing that doing that is the only way to find alpha in the long run.

As we often put it to our investors, we believe the future of the investment profession belongs to the niche, to the ones that do things differently, the bizarre investment strategies, the "misfits" as Steve jobs would have said.

It is there, in those specific, hidden corners, that is still possible to find alpha.

3. Private analysis on public information

The last and in our opinion most fascinating place where alpha can be found is not in private markets or even in the hidden corners of the market, but anywhere, even in the blue chips, in the S&P500 or anywhere else.

Because the last source of alpha comes not from knowing something no one else knows or being able to act on something no one else is able to, but processing information in a superior way, or even more importantly, being *willing* to act in a way no one else is willing to.

As Keynes once put it, ‘’it is better for a reputation to fail conventionally than to succeed unconventionally.'

Career risk has always been one of the great limitators of performance in the investment world. And psychology teaches every investor how hard it is to hold lone wolf positions, to stand apart from the crowd, to invest in an unconventional way or with an ultra long-term focus when everyone on wall street is focused on the next quarter.

There is money to be made by being able to understand the same information better. And there is money to be made by being able to stand apart from the crowd, to face career and reputational risk and do things your own way.

Why are there obvious unexploited opportunities? It can be because of career risk: at the depth of the financial crisis, many people knew the market would come roaring back since everything was so cheap. But humans are not a rational species: everyone was afraid, everyone was losing their jobs and almost no one was brave enough to say: “I will be the first to take the risk”. The same process happens in reverse order in bull markets when bears are laughed at.

Opportunities can also arise from simple noise: why bother with a 10 year horizon marvelous opportunity when you are worried about your bonus next quarter? Why bother with researching something very unconventional when you sit in the middle of wall street and go to lunch every day with the same kinds of people, talking about the same stocks and same subjects. Most people don´t put the extra effort of being really “on the ground”.

Very frequently, this house is questioned about our unusual structure and apparent lack of resources: very few analysts, centralized decision making, and an idea based instead of sector based analytical structure, etc.

While we certainly wouldn’t dare to compare ourselves, it is fascinating to note that the very few investors in history that really had outstanding results were the ones with a very similar process than ours. And also, the ones who were able to shut out all the distractions, all the noise, and process information differently.

How come the most successful investor of all time sat alone in a 10 square meter room in rural Omaha, Nebraska and outperformed the big wall street banks with their army of traders, reports and noise for decades?

How come the man who defined what it is to be a hedge fund manager, George Soros, decided with his partner Jim Rogers on purpose to have their offices in the opposite corner of Manhattan from the big banks so not to “expose themselves” with what everyone else was thinking?

Even in Brazil, amazing stories like Tempo Capital, armed with a secretary and a subpar computer were able to stand away from the crowd.

As was once said, insanity is doing things over and over again and expecting different, outstanding results.

This house is proud to have its own approach, admittedly with many flaws and disadvantages, but one we think shuts down the most of unhealthy distractions and preoccupation to our only and sacred goal of finding alpha for our investors.

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So, to sum it up, while we wholeheartedly admit that beating the market, for any investor including this house is an incredibly difficult task, we also think it is a possible one. There is inefficiency in the market to profit from.

And what makes the market inefficient?

We gave three different routes for alpha and we think each of those routes has a different reason to exist.

On the first reason, “private information”, it is simply the inability of most market participants to get the information they need.

It is important to note, alpha search is a dynamic process. Information gets ever more efficient and it is the job of any investor to keep “outcompeting” the market in terms of having better, faster, or unique information.

On the second reason, “semi private information”, it is the fact that even though participants know they need to know, they can´t act on that information. For this one the competitive advantage lies more in the structure surrounding your investment process than in how “good” you are.

As for the final reason, it is the fact that even though participants could act, they won´t. And why this inefficiency, that seems to be the easiest of the three listed to be solved and arbitraged away, is not?

We think the market is simply too correlated. Not on the macro sense but correlated as a whole.

Venture capital firms are similar to each other – most of them sit on Silicon Valley and talk to the same entrepreneurs

Macro firms spend their days looking at the same trends and with their members having lunch with each other in posh restaurants in London or New York (or, in the Brazilian context, in Leblon or Faria Lima) and eventually switching one firm for another.

Even more broadly, the market is too westernized, have too narrow a frame of what a good business should be, is too addicted to managing money instead of chasing returns (a corporate version of career risk) and especially, its participants are too afraid to straw away from consensus thinking. Let´s face it: we are a bunch of people with offices in similar places armed with Bloomberg Terminals.

And even more broadly, investors seem to be similar with one another. Similar backgrounds, similar geographic locations, similar reputational risks and friendships.

It is no wonder that decades of empirical research have shown that contrary to the odds, small entrepreneurial investment firms outperform the big ones. Even more astonishingly, an interesting amount of “lone wolves” were able to outperform.

But even with this reality, every big asset management company brags that is has X analysts, that it has X billions under management. Well, those things should be seen as handicaps because evidence shows that those are not the top performing companies over the long run. And even more, allocators should not prioritize those firms. But they do, and a big institutional firm is certainly a ticked box for most allocators. They too have their career risk to be careful about and just like no one gets fired for “buying IBM”, no one gets fired for allocating money in the Blackstones and Bridgewaters of the world.

This is understandable: we are a social species. If you are an investor, it is hard to be confident enough to disagree with everyone. If you are an allocator, it is hard to be the first one to take a shot at an up and coming manager that could either be your star performer or an embarrassment for you. And so, the circle goes, and people keep expecting different results doing the same thing.

At this house we try to attack market inefficiency head on: we are not afraid to be unconventional. And we know this will cost us dearly in terms of how big we can get. We are not very “institutional”, to put it kindly. But due to personal taste and circumstances it is the path we decided to take.

The good news for our investors is that over time we only became more radical about the basic promise of our foundation: a house dedicated to alpha and not asset gathering. If you need proof just remember we split our fund in two, losing investors and increasing our costs to be able to adopt our sought-after strategy of allocating all our capital in international BRIC related opportunities like our main fund is now able to do. A year later, we couldn’t be happier that this is the decision we made. And we think our results speak for us.

So, what would be the road ahead for us?

This house certainly will never be the largest and probably not even the best, but we will be happy to be one of the most profitable.

Every investment company is unique. FCL is certainly unique in its own ways. We think we found a niche – a blue ocean if you will – in less crowded global opportunities that are overlooked by most investors because they are either:

a. Iliquid
b. Small
c. Too international in nature
d. Unconventional
e. Poorly understood and too complicated
f. Have too long a time frame

Our mission for the next few years and decades will be to explore those opportunities for our investors.

Even more importantly, thinking about the future, we feel that even though we will never compare with some investment houses out there in terms of resources, personnel, and yes, assets under management, our numbers show that we can compete and even outcompete in the game of long term risk adjusted returns – in the game of alpha. That is the game we decided to play.

FCL Team

Sobre a FCL Capital

A FCL Capital é uma gestora de recursos sediada no Rio de Janeiro, cujo objetivo é maximizar o retorno de seus investidores. A FCL tem como nicho principal, mas não exclusivo, investimentos em empresas abertas, listadas em bolsa de valores (posições compradas e vendidas nos mercados acionários). Para saber mais sobre nosso trabalho, entre em contato conosco ou acesse nosso website: **www.fclcapital.com**.

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

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