FCL*Capital*

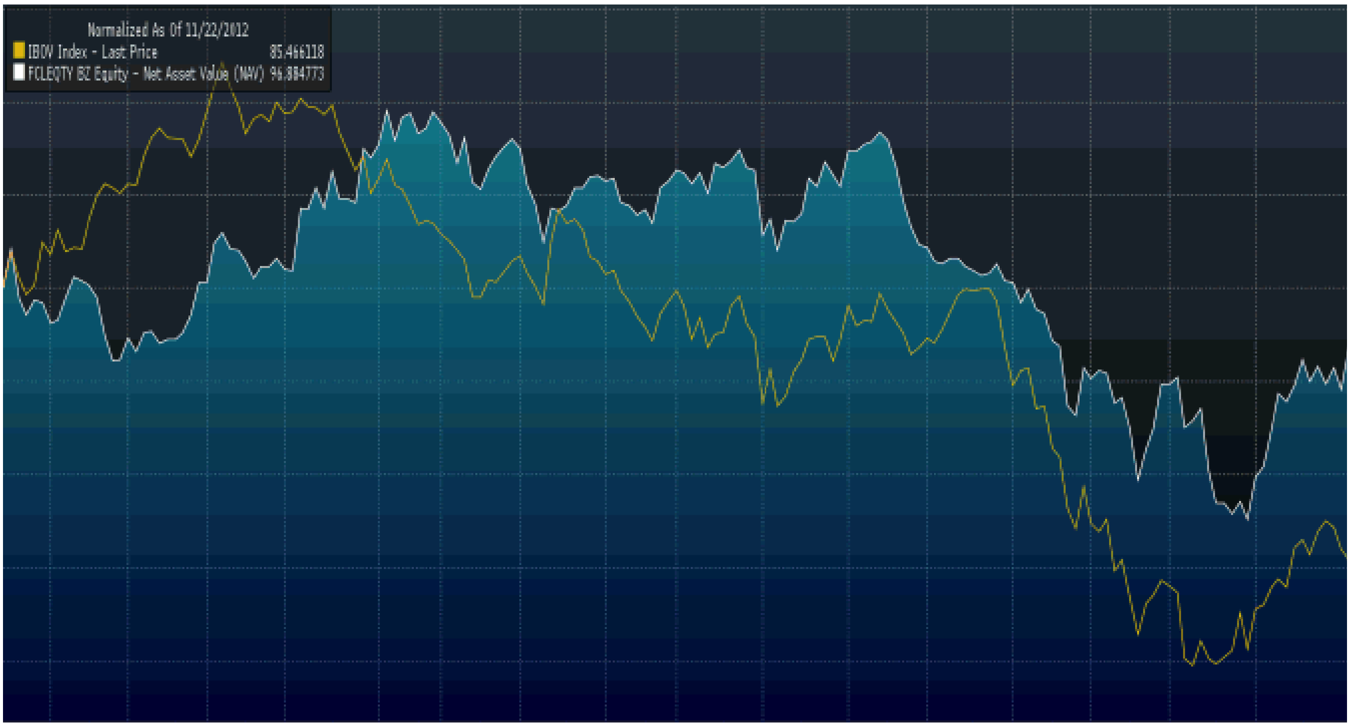
July 2013

www.fclcapital.com

Equity Performance (%)

Date	FCL Capital	Ibovespa	CDI
July	+2,21	+1,63	+0,70
Year-to-date	-3,44	-20,86	+4,15
Since 04/03/07*	+184,05	+4,20	+85,15
Since 11/22/12**	-3,11	-14,53	+4,88

(*) – Club was established (**) – Fund was established



Ibovespa vs FCL Capital since fund inception. Source: Bloomberg.

The Market and its Tribes

In the beginning there was chaos. The same metaphor used to describe universe's birth can be applied to the stock market. Obviously, there were always skilled traders, gifted with uncanny ability to understand things better and "guess" where prices were going.

In the really old days of the "wild west" stock market, the competitive advantages were different. Better information and the ability to manipulate it played a larger role. Gradually, more systematic approaches were born. The "market tribes" were slowly forming.

If we had to name the first person that really tried to systematize the stock market's behavior (probably one of the most inglorious tasks ever) and looked for the origins of the now widely used technical analysis we would have to study the story of a man named Charles Down. In a series of editorials on the Wall Street Journal at the turn of the 20th century, the famous “Down Theory” was published. The basic principles of the theory were:

- Everything known about any company is already discounted in its stock price.
- The market moves in trends- up, down or sideways.
- The trends have different phases where investors with different degrees of information act according to their knowledge.
- Market’s information cannot contradict itself.
- Volume is an important indicator of the strength of trends.
- The trend will continue until something comes up and brings it to an end.

And so, through the Down Theory, technical analysis, maybe the most widely tried method of “beating” the stock market was founded.

Other pioneers soon followed. In the 1930’s an important work by an American accountant called Ralph Elliott, named “Elliott Waves”, proposed that investors have a behavior that could be understood in cycles, and that this behavior derives from human psychology.

According to Elliott, if we could understand the cycle we were in, we could beat the stock market. Countless academic studies and market participants engaged in numerous trading strategies using these and several other technical analysis principles and theories.

***

Like all great ideas, the insights of the father of value investing, a British economist teaching in Columbia University New York called Benjamin Graham, were simple, probably widely used before him, but never before reunited and systematized.

The idea of Graham was to differentiate price and value - the first is what you pay for an asset, while the second is what the asset is really worth. The idea that they can diverge is intuitive but was never before fully explored. It is the capstone of value investing to this day.

Graham also proposed that the stock market can behave in crazy ways, pricing stocks very much above or below intrinsic value for some time because of human psychology, and motivated by the forces of greed and fear. But eventually, price and value would finally converge, and he advocated trying to access real value though several techniques - like market multiples and assessment of the underlying business of the company - and claimed that investors should look for a margin of safety, that is, the price discount of a business relative to its value.

A favorite allegory used by Graham was that of Mr. Market: an emotionally instable business partner that would be sometimes euphoric, offering you high amounts for shares of the business you own with him, and other times depressed, in which case it would probably be wise to buy from him additional shares of the business in question.

Gradually, Graham's eccentric ways of seeing financial markets started to gain popularity. He began teaching the course in 1928 and then in 1934 he finally published a book called Security Analysis which is still considered the "founding bible" of value investing. Several of his students from Columbia during the following years and decades would gain prominence as stock investors. In the year of 1949 a then 19 year old student from Nebraska would attend Graham's class for the first time. His name was Warren E. Buffet and he soon would become the most successful investor of all time.

***

A few decades after the value investing and the technical analysis tribes were founded, a Princeton student named John C. Boogle was very disappointed with the way stock markets were organized. He felt investment management was a huge business, but usually only for the managers, who charged high fees for their work. Even worse, most managers did a poor job of really delivering alpha, or value, through their stock selection.

His conclusion at the time was that it was nearly impossible for most investors to beat the market. And even if they did, they would have to do it for a wide margin to justify the high fees paid to brokers or investment managers.

So his proposal to create an index of securities that could be repeatable was quite radical at the time (1974), and through this construction the investor would have low fees, low trading costs and could replicate the market's performance. In other words, he didn't believe in investors' capacity of beating the average. Instead, he proposed we should accept to be on the average and at least avoid the high costs and delusions of trying to make "home runs".

John Boogle and the company he founded, called Vanguard, were without a doubt one of the most influential voices in the past century in the stock market. His ideas have inspired countless evolutions in markets, like the recent surge in ETF's and created a whole new phenomenon called passive investing.

So now we have talked about technical analysis, looking for trends and signals from market prices; value investors, looking for discrepancies between prices and values; and passive investors, trying to position themselves through an index.

Obviously there are many subdivisions and mixes in these tribes. Many investors are hard to classify and there are many sub tribes in each of these major tribes. And these three are still very far away from being all there is. But let's now focus a bit on what counts: the performance.

***

A lot of ink has been and will be spent on discussing the different approaches to the stock market. Evidence so far seems to prove that technical analysis really worked until around the 1950's, when it started to become very popular and then almost suddenly it stopped working. This really makes sense, because by definition, a strategy will only work if not too many people are using it. Otherwise it would converge to the mean - what Wall Street calls a "crowded trade".

Value investing also is a very difficult way to make money, as is every other way, of course. Evidence shows that few investors were able to consistently beat the market over long periods of time and that:

1) All of them underperformed the market for significant periods;

2) The few investors able to beat the market seemed to maintain their “magical ability” through good and bad periods.

At FCL, as our investors know, we adopt mainly a value investing philosophy, for a few reasons: the first one is that due to our background, value investing is what we know best and where we feel our insights could bring a sustainable competitive advantage over our competitors.

Also, it is something replicable and something we are able to understand and process. We don’t want only to make money for our investors. We also want to understand why we are making money, to make it something repeatable.

***

Over time, many other tribes, subdivisions and mixes between tribes obviously started to appear. There are the *quants*. They are almost totally absent in Brazil but they are the scientists of the financial world. Through their advanced computers and mathematical models, they try to gain an edge over everyone else. There are also the activists, who don’t necessarily target the best, cheapest companies but the ones where they feel they can change the behavior and unlock value.

They usually buy something like 5% to 10% of the company’s stock and agitate for change gaining seats and its board. Then after a while, if the plan goes well they sell it at a profit. There are many other lesser known tribes as well. Some investors are hard to define, resembling a response from the UFC fighter Vitor Belfort when asked why, being a *jiu-jitsu* fighter he had just knocked out an opponent with unbelievable boxing skills: *“Well, you can write that I am a jiu-jitsu fighter. In my heart I am. But the truth is, I am complete and will grab any available opportunity I can.”*

***

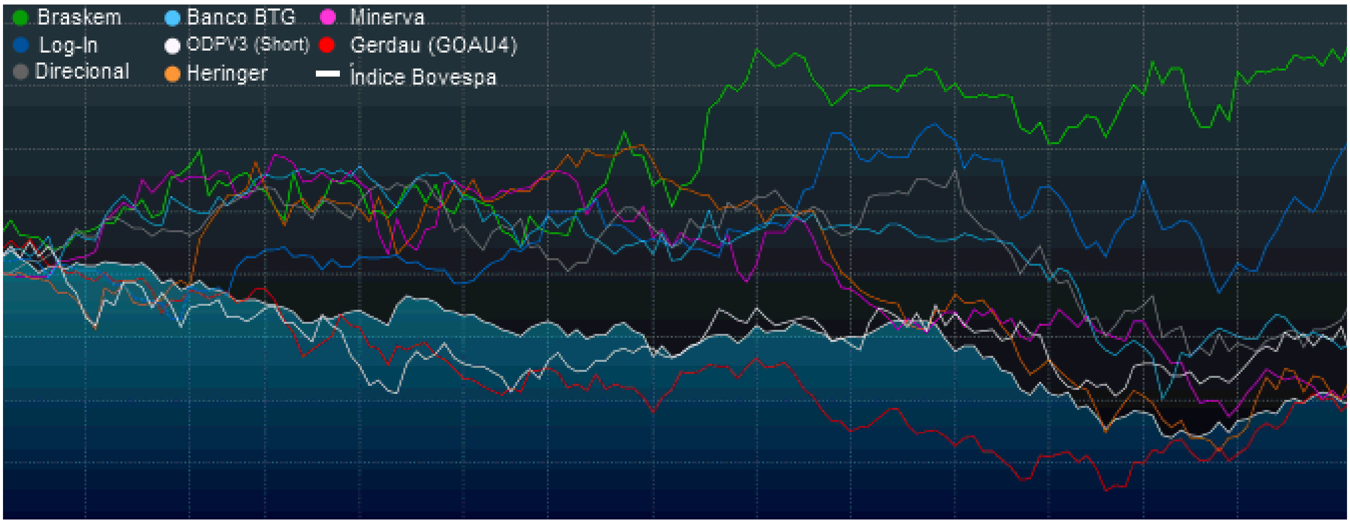
FCL Capital’s views of the market and how it applies its value investing strategy has evolved over time. Slowly, as our positions started to get bigger with the natural growth of our fund, we started to develop some mildly activist visions and positions, although we prefer to work with company’s managements rather than confronting them.

Also, we have been very attracted to the philosophy called “carry investing” lately. It is a very interesting concept and in many ways it is the ultimate and most radical degree of value investing. Think of the following situation: if you had to buy any stock in the Bovespa, which one would you pick? But there’s one big caveat: you will never be able to sell this stock again. You know beforehand that you are buying it for life. You shouldn’t choose something because its price is supposedly going up. You are becoming a partner in a business, this time for real. Would that change the way you approach the stock market?

Suddenly many investors’ positions look foolish. Liquidity can be, in very contradictory ways, a prison from where many investors never free themselves. So we took a hard assessment in our portfolio having this philosophy in mind. Warren Buffet once said himself: “don´t even think about owning a stock for fifteen days that you wouldn’t like to own for fifteen years. It just doesn’t make sense”. But here’s the thing about value investing: it is easier to talk about it then apply it.

***

We really believe to have built a portfolio that survives the hard test proposed by the carry investing philosophy (that's why it's called "carry", by the way). We think Minerva, Braskem and Gerdau are businesses we would feel comfortable to leave as inheritance for our children. They are in strong positions within their respective industries, their margins will improve, especially if the dollar keeps going up in the long term, and they will certainly be around for many years to come.



Performance o four stocks vs. Ibovespa in 2013.Source: Bloomberg.

We think Heringer was acquired quite cheaply and the rate of return of our investments depends on the quality of the businesses and on how cheaply or expensively it was acquired. In fact, the company is positioned in the only industry where Brazil really is a world champion. It helps a lot when we take a long term look. We think Log-In and BTG Pactual are also cases that carry a lot of promise for the long term and we would like to be Direcional management's partners for many years to come.

If we look at world class investors, maybe they are looking not so much for the highest possible return but for assets where they know will be good investments even if everything goes wrong. As evidenced by the hunt for the most valuable brands of capitalism, like Goldman Sachs, Heinz, Burger King and so on by the super investors Warren Buffet and Jorge Paulo Lemann.

They are probably letting higher rates of return in other ideas pass by in exchange for the fact that they are buying the ultimate franchises, which will certainly be here for centuries to come. They are buying the very foundations of the capitalist machine.

Likewise, on an immensely smaller level, we are mildly satisfied about how our portfolio performed so far this year. We know our investors had a tough year so far as our fund is still down this year. And although it is important to mention that our fund is comfortably in the top half of the investment funds in Brazil performance wise so far this year, we look forward for making up for these losses until the end of the year.

We almost haven't changed our positions in the last few months. If anything, their cases and their margin of safety became stronger. Log-In Logística just released, as we are writing this letter, a strong preview of its second quarter results. We are expecting the other results in the next few weeks. The thing about a good business is that its value (if not its price) goes up as time passes, while the value of a bad business (if not its price) goes down. Price and value slowly converge as time passes.

Gerdau (GOAU4) – Book Value per Share in the last 10 years. Fonte: Bloomberg.

Overall we think we are well positioned for a rebound in the stock market. Like all rebounds, a few key trading days will determine investor's success in reaping the gains and ending the year on positive territory.

Performance

FCL Equities Composition	
Long	102,06%
Short	(4,91%)
Cash	(2,85%)
Net Long	**94,30%**

FIA FCL Equities' performance was of +2,21% in July, comparing favorably against Ibovespa's +1,63% or CDI's +0,70% in the same period.

Year-to-date, our performance is still slightly negative, -3,44%, still favorably compared to Ibovespa's -20,86% slide, but losing to CDI's return of +4,15%.

Since FCL Capital investment club's inception, in April 3rd 2007, which later became FCL Equities FIA, established in November 22nd 2012, our performance has a compound return of +184,05% - an annual return of +17,86% - which compares favorably against Ibovespa's +4,20% or CDI's +85,15% in the same period.

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.

Investor Relations

Felipe Marcondes

felipe.marcondes@fclcapital.com

info@fclcapital.com

Avenida das Américas, 500 - Bloco 3

Sala 125

Rio de Janeiro / RJ - Brasil

CEP: 22640-100

Telefone: (55) (21) 3268-7918

www.fclcapital.com

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