FCL*Capital*

March | 2014

Seven Years of FCL Capital

With the end of the first quarter of 2014, FCL Capital celebrates seven years of existence, initially as an investment club operating with proprietary capital, and since November 2012 as a long biased equity fund.

During this period, the Brazilian Ibovespa Index experienced significant oscillations, but ended mostly flat (less than 10% up) and our shares, with lower volatility than the index, increased by more than 160%, or around 15% annualized.

Performance, FCL Capital vs Ibovespa			
Year	**FCL Capital**	**Ibovespa**	**FCL - Ibovespa**
2007	20.4%	38.0%	-17.6%
2008	-39.10%	-41.20%	2.1%
2009	224.90%	82.66%	142.2%
2010	29.54%	1.04%	28.5%
2011	-23.70%	-18.11%	-5.6%
2012	24.90%	7.40%	17.5%
2013	3.37%	-15.50%	18.9%
Total	**204.1%**	**11.3%**	**192.8%**

The scope of this letter will be to discuss and analyze the reasons for our significant underperformance in the first quarter of 2014 and the reasons why this has negligible impact for our long-term investors, who are focused on our fund shares' long-term appreciation.

Before we start to discuss our underperformance during the first quarter, a few usual reminders: short-term performance is meaningless to us and should be meaningless to our investors as well. We perceive drops in share prices as good opportunities to add cheap assets to our holdings. And most importantly, there are only 3 possible reasons why we would change our positions:

1. Other investors start to accept and incorporate our investment thesis for a particular company and the share price converges to our forecasted scenario. This is the "good scenario", when we can decrease our holdings at a profit;

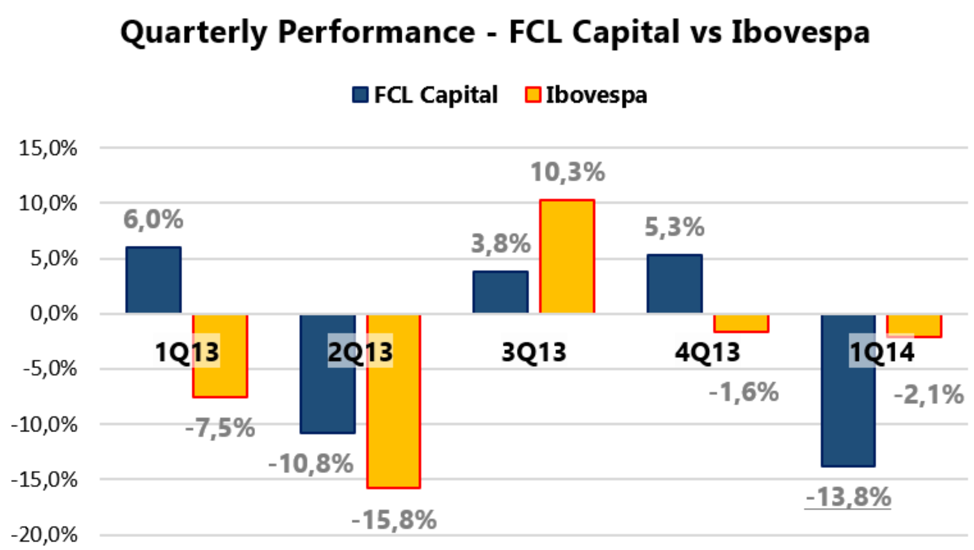
2. With time, we start to incorporate new information to our thesis and our degree of confidence or margin of safety starts to decrease, sometimes being completely destroyed. This is the "bad scenario". In a few outlying cases our theses proved to be mistaken, therefore we exited our position either at a loss or even at a profit when the market rises anyway (we don't count on luck, but it happens from time to time);

3. Neither of these things happen, but an even better investment opportunity appears and we want to use the cash that is tied up in another opportunity. It could be a reason for portfolio change if there is an even bigger degree of confidence in the risk/reward scenario or in the margin of safety. Usually we change marginally our portfolio holdings, decreasing slightly our exposition in stocks

that have outperformed and increasing in stocks that have been underperforming, therefore increasing our upside potential.

None of the above mentioned events occurred during the first quarter. Our turnover was practically nonexistent. Except for minor adjustments, our holdings remained as they were and no big events happened to any of our portfolio companies.

Nothing structural has really changed, but for reasons we will talk about ahead, the eminent Brazilian energy crisis has particularly hurt our portfolio, being mostly responsible for our underperformance during this quarter.



Starting in the middle of 2011, we began to formulate the following view of the market:

A series of actions by the Brazilian government, in contrast to what was happening in China, some of them conscious and some of them unnoticed byproducts, clearly dislocated the Brazilian economy to a model that is Heavy on consumption, but lacking in investment and competitiveness.

The country went through a series of governmental decisions that favored labor against capital and consumption against production, resulting in a clearly overvalued exchange rate, easier access to credit, real gains in minimum wages, very low unemployment, and so on.

The market as we all know moves in cycles. From 2002-2007, the stars were industrials and exporters, due to world's economic growth and China's rise. From 2007-2012, the few outperformers were mostly domestic companies focused on Brazilian personal consumption, like retailers and providers of consumer services.

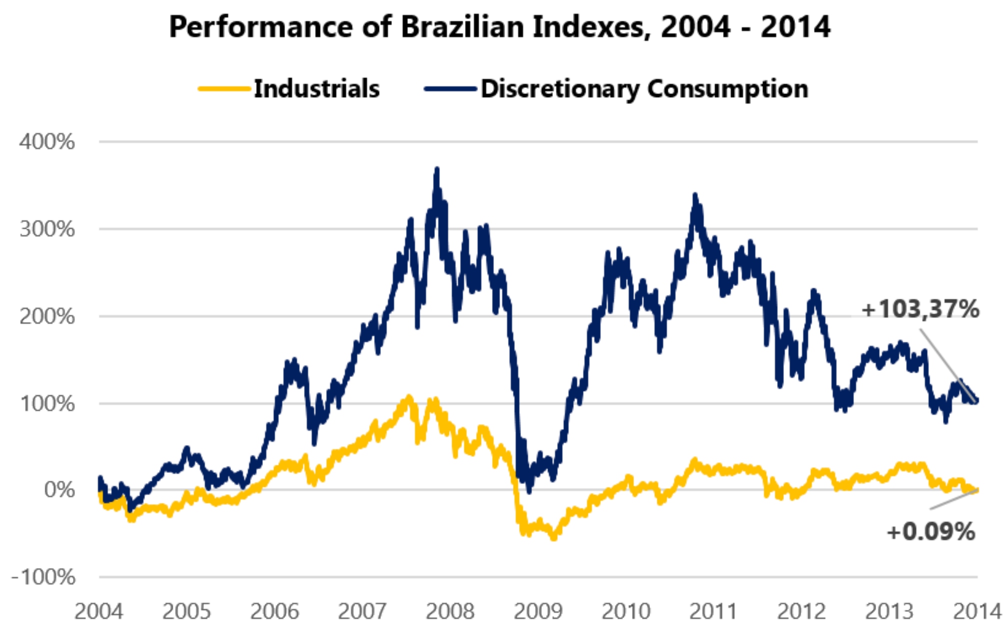
Our house has the contrarian view that the stars of the next cycle will once again be exporters and industrials. The two most relevant problems harming the Brazilian stock market were a very low unemployment rate (that hurts margins) and a terribly overvalued exchange rate, which hurts tradables in particular. We clearly saw the margins of almost every tradable sector being compressed, agriculture being the sole exception.

These two problems are being addressed. Our exchange rate has depreciated significantly and will probably continue to do so.

Analysts have yet to decide on their contradictory worries: they should either believe that 1.5% growth will be Brazil's "new normal", in which case year over year labor cost increases will start to decelerate or that Brazil will Grow faster than this threshold while maintaining a low unemployment rate?

One way or another it seems very clear to us that the significant opportunities right now are once again in tradables and exporters not in consumption and education, where most investors are looking.

We have used this space before to talk about what we called the "quality bubble" that we think is happening in the Brazilian markets, but a different phenomenon is also quite clear in our opinion.



Bovespa's discretionary consumption index soared in the last 10 years.

Given a dynamic of rising interest rates, depreciating exchange rates and a whole economic model that clearly found its limits, the outperformance of the so called "quality" consumer companies is very fragile. we think the winners will take advantage of this new dynamic in the Brazilian economy.

Therefore, in short, this is our assessment of the different sectors right now:

Industries Overview	
Industries	**Opinion**
Exporters & Industrials	**Very bullish**. There is always a time lag, but weaker labor market and exchange rates should start to benefit their margins.
Real Estate	**Bullish**. The market is notably bipolar when it comes to this industry. Current prices are very cheap for most stocks.
Domestic Consumption	**Bearish**. Families' expenditure levels, dependency of credit and leverage seems to have reached its limit.
Education	**Very bearish**. It is the only sector where insiders are happy with their share prices, raising a lot of money on Bovespa, particularly in secondary offerings. We are always afraid of aggressive long-term growth projections.

With this framework in mind, we entered 2014 very happy with our portfolio. The natural consequence of having a portfolio focused in industrials and exporters (Braskem, Gerdau, Minerva) is that an unforeseen shock of energy restriction will have a bigger impact than on, say, retailers or education companies. Therefore, our portfolio underperformed significantly because of our concentration on heavy energy users[1].

[1] Also, the absence in our portfolio of state companies, which we still think is a wise policy, did not allow us to get upside out of the government's recent slide in its approval ratings.

Overall, the possible energy crisis did not change a blip of our general assessment for the following reasons:

- Nothing structural has really changed. Even if there is rationing of energy, the impact would have a short duration. Our projections should adjust accordingly and our theses are not so fragile that a single year of (barely) different results would change much;

- In all honesty, we are probably holding our best portfolio ever. Our margin of safety and conviction have never been that high;

- We did many calculations and undusted the 2001 financial reports (Brazil's last energy crisis) and even that year, the damage was not that great. We really think investors are exaggerating. They were already nervous so this new factor is being used as a new excuse to sell.

Both Minerva and Gerdau have around 4% of its total costs related to energy consumption - amongst the highest in the Brazilian market - and Braskem has in energy around 2.3% of its total costs, therefore a quick analysis may scare investors away from our portfolio holdings (as it surely did). On the other hand, many facts mitigate this apparent dependency according to our analysis as follows:

1. The three companies have a reasonable and straightforward plan in place to deal with the situation if the worst happens;

2. All of their energy needs for this year are contracted;
3. Gerdau, in particular, has a state of the art program in self generation;
4. All these companies have experience dealing with the 2001 energy rationing;
5. Price rises and volume decreases should be less extreme than many investors fear (as they were in 2001), and their stock prices are already more than discounted for this scenario.

In any case, this is an atypical year and we should not be too scared about something that is a one-off event.

It is always a curious time for a manager when his convictions and his theses are marching forward while the market and its prices seem to be heading the other way. What we do is to keep our discipline. We will not fall prey to denial. Many times before, we were quick to admit that our thesis was just wrong, but in this case, we really feel that the story of 2014 is still to be told.

We do not know which kind of year this will be. We end the first quarter unsatisfied with our performance - no one likes to underperform and FCL has rarely been in this position in the past seven years[2] - but with increased conviction in our positions and the future upside of our portfolio. To buy low and sell high is the ticket to stock market outperformance. Everyone

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[2] Although there is only one single characteristic that unites 100% of all managers in the world that ever outperformed the markets: they all have faced significant and prolonged period of underperformance, sometimes lasting for many years.

knows that, but very few act on it. It is hard for most people to go against the flow.

We try to make sure our average investor does not get a smaller return than our fund itself, so we are being proactive about our assessment of the markets and when we think our investors should consider increasing exposure. We pride ourselves in having released a special letter at the height of the 2008 financial crisis, as it proved to be the best entry point ever in our fund.

Contrarianism is an important concept for us. It is an important part of our assessment of when we are bullish or bearish on the stock market and specific companies (our portfolio is made of uncommon positions as we are frequently told), but also on trying to separate signal from noise in how our positions are doing.

Sometimes despite a rising stock price, we start to realize that we are wrong in a thesis. Sometimes, like this past quarter, our share price and our stock holdings do terribly and we feel increased comfort in our positions at the lower prices. We would rather own them than the CDI or the Ibovespa index at this point.

We are fortunate to have an aligned investor base that understands what we are doing and aims for the long term. They are part of the reason behind our long-term outperformance. We thank them for their partnership and patience in adverse moments and truly believe that they will be eventually rewarded.