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The Journey of Stock Investing

Bill Gross, the famous bond manager who was in the headlines this past month for leaving the company he co-founded, Pimco, after four decades of an amazing career, is one of the few investment managers we really admire. He was on his way to being fired by his co-workers because, according to most accounts on the media, he is a terrible person to work with. That being said, he is a genius.

His market commentaries have been one of our favorite readings for several years now. Also, he is certainly one of the people who better understands the financial markets, specifically the fixed income markets around the world. Our favorite Bill Gross market commentary, written about three years ago, had an interesting metaphor that Brazilian investors in particular should really pay attention to, the famous story about the frog in the kettle:

"Put a frog in a kettle of boiling water and he'll jump out faster and further than any of those blue ribbon winners at the Calaveras County jumping frog contest. Put him in a pot at room temperature, however, slowly turn up the temperature to boiling, and you'll have frog legs for dinner. This latter, more unfortunate toad temporarily adapted to his external environment, which seemed like a practical thing to do, until – well, until he reached 212° at which point he was cooked."

What Gross meant, of course, was that fixed income investors sometimes are fooled by the illusion of the returns they think they are getting, but really are not. Anchorage, the attention we give to numbers that actually don't mean anything is a powerful force even among investment professionals. The confusion between nominal versus real returns adds to the illusion. Let's think about two investors, one with a fixed income portfolio and the other 100% invested in stocks.

What is the safest investment option? If you answered that it is the fixed income investment, you might be confusing risk with volatility. Things are almost paradoxical: how can the fixed income investor not lose money (in nominal terms) any single year, but end up with less money than the stock investor, who will suffer terrible swings in his portfolio? The answer is that fixed income investors

are usually “cooked” by the illusion of nominal, instead of real returns. If an investor with a secular horizon wants to enjoy above inflation consistent returns, he will need to differentiate volatility and risk.

Volatility means how broad is the spectrum of possible returns in a given year. Certainly, investing in stocks is more volatile than investing in fixed income securities because in any given year the stock market can go up or down by a lot and many different things can happen.

However, when it comes to risk, as defined by the chance of having a permanent loss of principal, stocks are not that risky. They are real assets, parts of companies, and when an investor puts his savings in stocks, he has a much better chance of beating inflation in the long run if compared to fixed income securities. Increasingly, this will also be the case for Brazil. This is the reason why we seriously doubt an investment program can be coherent and well thought if it does not have a significant portion in public or private equities.

The odd thing is that many characteristics about equity investing are still not known by most investors, even institutional ones. For example, it is fairly unlikely that you will lose money (permanent loss of principal) if you really are a long term investor.

What about the unfortunate ones who entered the market before the crash of 1929? Well, their 10 year annualized returns from 1929 to 1938 were 3.3% a year, really low, but not a tragedy. Obviously, they endured terrible swings along the way, but the ones who were there for the long term got out unharmed. That is why we differentiate volatility from permanent loss of principal. Investors should be able to understand and take advantage of volatility, but too often they confuse it with risk.

What about the Brazilian experience? We don't have too much good and reliable data from that far back, but we expect that the good times will soon be over for CDI investors - their impossible trifecta of returns, safety and liquidity in a single investment is an anomaly - and the CDI premium will gradually disappear as it is already slowly happening. That being said, if a hypothetical

investor bought the Ibovespa index on January 1st 2003, and remained invested to this day, he would have outperformed the CDI. Surely, quite a few Brazilian stock investors, including this house, did a lot better than the Ibovespa index in this period.

Going even further, the relatively long periods of negative returns in the stock markets, such as 2000-2009 for the Nasdaq or 2008-2013 for the Bovespa, had more to do with how good the previous periods were (it went up so much that these returns “stole” from the subsequent periods) than with how awful things actually were during these times. Symmetrically, cheap entry points, if you can recognize them, will probably bring higher than average returns for the investors with the stomach to have contrarian positions.

That being said, stock investing can test your patience, your confidence and how disciplined you are. Investors know they are supposed to buy low and sell high, but few are able to do it consistently. Many things in stock investing are symmetric.

Concentration, leverage and high conviction ideas will amplify your returns if you are right, but will make things much more painful if you are wrong. Deviation from the index will have the same effects and so on. Everything is a two edged sword, as pointed out by Howard Marks, another from our list of admired investors.

Counter intuitively, many things in the market are contradictory: the riskiest moments in the market are the moments when everyone is optimistic and risk aversion disappears. The safest moments to go “all in” are when panic is widespread and smart and brave investors could buy incredible bargains.

Many qualities are necessary to consistently beat the market, which is why very few people can really do it. One of them, certainly, is what Marks calls “second level thinking”. First level thinking goes like this: “the outlook is terrible. Dilma will win the election. Brazil is in a recession. Let’s sell everything!” Second level thinkers usually think in terms like: “The outlook is terrible, but everyone already knows this and prices are cheap enough, lets buy.” Or, on the other opposite end, someone who in 1990s said: “The outlook for tech stocks is great, but prices are stratospheric, let’s short them”.

Second level thinkers go deeper. Maybe this is what Keynes meant with his famous “beauty contest”¹ phrase.

The good news is that it is possible to enjoy market returns with a cheap index fund. Chances are that over the long term (a decade or more) you will do a lot better than if investing in the CDI or even buying a mutual stock fund. As discussed above, the “safety” of not having any volatility can lead to a decrease in purchasing power over the long term.

For those attempting to beat the market, there is a question as old as the markets themselves: to buy or to sell? Is the market expensive or cheap? We are convinced that this question in itself is one of the leading causes for the fact that so few investors make money consistently in the market.

First of all, not many people can “time the market”, being away during the down years and coming back just in time to enjoy the recovery. Many, if not all, would do a lot better to simply stay fully invested all the time, since nobody knows when the market will turn.

We hear many professionals saying “now it’s not the time to be invested” or “I will wait until things improve, I don’t want to try to catch a falling knife”. Obviously, what these investors really mean is that they don’t have any clue of what is going to happen.

Evidence shows that a few spectacular days are definitive to enjoy good returns in the long run. Lose them and your returns will be significantly lower. More importantly perhaps, and coming back to the “safety” discussion we’ve had in the beginning of this letter, comfort has a price: if you wait for things to get better, I would bet that the best opportunities to actually make money are taken by then. It is not that easy, if things already look better, assets should already be correctly priced.

¹ “It is not a case of choosing those [faces] that, to the best of one’s judgment, are really the prettiest, nor even those that average opinion genuinely thinks the prettiest. We have reached the third degree where we devote our intelligences to anticipating what average opinion expects the average opinion to be. And there are some, I believe, who practice the fourth, fifth and higher degrees.” (Keynes, General Theory of Employment Interest and Money, 1936).

We know this cycle will go on and on forever. Good times come and people become intoxicated by greed, after their friends and neighbors are making easy money in the market. Finally, the investor gives in and puts some money down. Obviously, the excesses can't go on forever and sooner or later something causes a market correction. Things are bad, the market is down. Years go by. People become convinced that the stock market will never be a good opportunity again. Stocks are for crazy people. Or at least, we should wait until things get better (by then the best bargains will be taken). Then, out of nowhere a rebound occurs, and the cycle goes on.²

This leaves a moderate investor, with no short term liabilities and no access to private equity, with only two reasonable options when investing for retirement: 1) a cheap index stock fund or 2) a stock mutual fund if he really trusts the manager will beat the market (very few will), since those are the only way to beat inflation over the long run.

The sad thing is that many small retail investors will keep trying to time the market, being invested when their friends and neighbors also are, and being away when no one wants to think about the stock market. In other words, I am fairly certain that unfortunately, the average person will have much worse returns in the stock market than even the average index fund.

We also want to discuss the myth that there is a "market" in itself. People don't invest in a market, apart from maybe the ones who are buying an index fund. They invest in specific companies, especially if they are like us and spend more time analyzing the micro than the macro. We did a study showing how well an investor would do in different markets in the past 10 years, depending on how skillful (and lucky) he was.

Starting with the US market, the world's largest and most important one, we looked for every company that kept being traded through the past 10 years, ending on July 31st 2014, and had a market cap above US\$ 600M.

² To put it in a more technical form, we could say the Shiller PE ratio tends to revert to the mean, although there is an intense debate about it. <http://equitablegrowth.org/2014/08/17/circumstances-worry-stock-market-high-honest-broker-week-august-16-2014/>

We found 1679 companies and divided them in quintiles. Let's suppose you were incredibly lucky, or a complete genius, and put all your money in the best performing stock over the past 10 years in the US market, the restaurant chain El Pollo Loco. You would have the unbelievable performance of 91.57% per year or, in other words, would, in the past 10 years, have multiplied your capital almost a thousand times. That's way better than Apple (44% per year) or Netflix (39% per year).

That being said, you wouldn't need to be so smart (or, let's face it, so lucky) to do very well in the US market in the past 10 years. Among the 1679 observations, if you picked observation 335, (between the first and second quintiles) you would have enjoyed returns of 16.09% per year, enough to multiply your capital almost five times in a decade.

The median observation, meaning half of all companies enjoyed better returns and half did worse in the past decade, still enjoyed a pretty reasonable return of 9.52% per year. The worst return among them all would of course almost leave you with no money at all: a terrible return of -61.01% and that's per year.

It is interesting to note that the median observation did a lot better than the S&P500 (5.68% per year) or even the Russel 2000 index (7.43%), an insight that leaves an observer with no other way but to conclude that a careful screening of good specific investment opportunities in stocks pays off in the long run.

US – Market Cap Greater Than 600M	
Sample	Yearly Return
#1 – El Pollo Loco	+91.57%
#335	+16.09%
#839 – Median	+9.52%
Bottom – YRC Worldwide	-61.04%
S&P 500 Index	5.68%
Russel 2000 Index	7.43%

Source: Bloomberg.

What about the Brazilian market? You could not find any stock over the last 10 years, amongst 207 listed companies, that performed better than Lojas Renner, which returned 68.65% per year, meaning an investor would multiply his capital 186 times if he bought shares of this company and then did nothing else for the next 10 years.

The observation between first and second quintiles brought a great return: 28.64% per year, much ahead of the Ibovespa and the CDI, and pretty much almost anything we could think of putting our money into. Funnily enough, these returns are after we compute the effects of the international crisis, the horrible past few years in the Brazilian market and so on. Patience is a hard and rewarding virtue.

Brazil – 207 Samples	
Sample	Yearly Return
#1 – Lojas Renner	+68.65%
#41	+28.64%
Median	+18.50%
Bottom	-34.03%
Ibovespa Index	9.55%
IBX Index	14.16%

Source: Bloomberg.

The journey of stock investing is a fascinating one. In our opinion what this tale tells us is that investors should spend a lot less time thinking about how well the market is going to behave (specifically, if they should or shouldn't be invested right now) and a lot more time thinking about products, industries and innovation. After all, a return of 91% per year is a lot better than a return of -61% and both happened in the same market, or 68% per year against -34% per year in Brazilian case.

Below, same data for Germany and Hong Kong:

Germany – Market Cap Greater Than 200M	
Sample	Yearly Return
#1 – Wirecard	+39.15%
#46 - Median	+20.18%
Bottom	-25.15%
DAX Index	9.31%

Hong Kong – Market Cap Greater Than 200M	
461 Samples	Yearly Return
#1 – Yestar International	+90,05%
#230 - Median	+13,06%
Bottom	-45,77%
Hang Seng Index	6,55%

Source: Bloomberg.

Our main job, first and foremost is to try to find which companies will be the ones to enjoy the best returns in the next decade of few decades. A search for the next big winners. It is a daunting task. We don't pretend we will always get things right and let's not forget, luck plays a huge part. But, we are convinced that we can have more winners than losers and certainly, no matter how well or how poorly the market does in the next decade, there will be huge winners. With hard work and a bit of luck, we might even be able to recognize a few of them.