

FCL *Capital*

1Q 2021

The misfits (a 4-year celebration)

“Two roads diverged on a wood
And I - I took the one less travelled by
And that has made all the difference”
(From “The Road Not Taken”, by Robert Frost)

On May 14th, 2018, this investment manager was gathered alongside many other members of the global investment elite in Hong Kong for the annual CFA Institute Global Conference.

The CFA Institute is possibly the planet’s most recognized and respected nonprofit financial association and the annual event used to be (in pre-covid times at least) an opportunity to see and maybe even exchange a few words with many of the global financial industry luminaries.

As its guest speaker for this particular conference, the CFA Institute was able to pull something extraordinary, Steve Eisman agreed to speak, in a very rare public appearance.

Although not a household name like, say, George Soros, Ray Dalio or Warren Buffett, Eisman is not a less extraordinary character, he was able to pull what is quite possibly the most daring, genius and profitable financial trade in history: he was the man who, while being the manager of a very small and obscure hedge fund, shorted the subprime industry at the top of the real estate bubble in 2008. All the while being laughed at by the few people who knew what he was doing. Even so, Steve ended up making billions of dollars for his fund’s investors in the process.

The whole saga was immortalized in the 2015 film “*The Big Short*”, directed by Adam McKay, where Eisman and some of the very few other misfit investors that dared to think the unthinkable and bet on the impossible were portrayed.

So, this manager could feel and see that the excitement and anticipation in that Hong Kong hall, where the global financial industry was gathered, was palpable. It would be a rare chance to see Eisman himself explain the trade, expose his current convictions, and discuss his investment thinking.

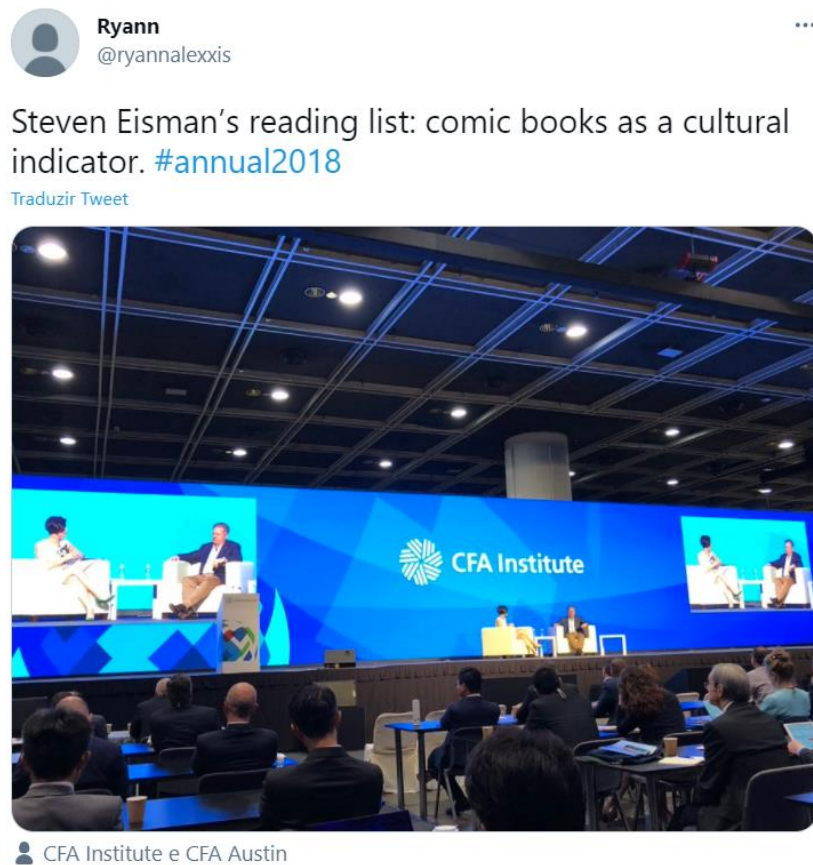
What followed was completely bizarre. A very shy, floor-looking, and trembling Steve Eisman approached the stage. Even from afar you could tell by the way he looked at other people that he had Asperge’s.

As he approached the microphone what were his first words? Some commentary of the current level of bond yields? No. Some thoughts on private equity? Nope.

“In all my life I’ve read comic books” said Eisman. “I’ve been reading them since I was 10 and they keep telling me the direction of future events, like the current election of

Donald Trump. They are very prescient about the general climate of society, the change of times, they read the general mood.”

The crowd seemed confused, a little embarrassed by a commentary so out of context, so far away from, well, financial orthodoxy.



Steve Eisman at the 2018 CFA Global Conference

But then again, if he were a normal investor, with an orthodox mindset, he wouldn't have shorted subprime in 2008. As everyone knows, the story of the misunderstood genius is a cliché for a reason.

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If there ever was a global tourist attraction that was completely undesired by its own local population and government, it certainly was transit system bus 142 dumped on a national park close to Stampede Trail in Alaska, also known as the “Magic Bus”.

It was there where a 24-year-old student called Chris Mccandless lived for the last four months of his life and where his body was eventually found back in 1992.

Mccandless was certainly someone who never fit in. Just fresh from university he felt that he didn't want to follow his father's wish for him to become a lawyer. He began to drift

apart from his family, except for occasional contacts by mail with his sister. He began to live a nomadic lifestyle, spending only a few weeks at a time in a single place and working a series of odd jobs in the process.

As the seasons were changing, he felt that even that was too claustrophobic and decided to decamp, alone and without any appropriate gear or experience, to spend one year as a hermit in Alaska.

There, while living completely isolated from anyone else, he eventually died either of starvation or poisoning¹ in the school bus he had found in the woods and had made his home, away from civilization.

It would be the crazy and atypical story of a foolish 24-year-old if not for an article that first appeared in Outside magazine back in 1993, then because of an award-winning movie directed by Sean Penn and with a soundtrack by Eddie Vedder² called “Into the Wild”.

Gradually and then suddenly, it was not another typical story. The magical bus started to be visited by people from all over the world, despite being in an inhospitable, dangerous, and inaccessible part of Alaska. People from everywhere somehow felt they could relate to the longing and sense of drift and despair that McCandless had.



“The Magic Bus”

¹ https://en.wikipedia.org/wiki/Chris_McCandless

² <https://youtu.be/ouANEo2w0Pg>

After years having to endure people doing pilgrimages to the Magic Bus in Alaska to see where Mccandless had spent his last days, Alaska state authorities finally decided to remove the bus, due to people constantly needing rescue and even dying in their journey to the “magic bus”.

“Why do these strange thirsts grip me” asked once in a poem Clarice Lispector, Brazil’s most revered essayist. Throughout her life she suffered from a distant and loveless marriage and a series of constant movings that left her searching for a sense of belonging. This was the inspiration for her poems which covered topics about life, suffering and, especially, loneliness.

Lispector was never really presented as a “Brazilian writer”, in the sense that her works have no regionalisms, typical of Brazilian literature. Instead, she wrote about universal feelings, the ones that anyone, no matter who or where, can relate to.

Loneliness³, as the one felt by Lispector, and psychedelics, as experienced by countless writers and rock stars, are possibly, this house would argue, the two largest gateways to unique thoughts.

If craziness is, as Einstein puts it, doing the same things over and over again and expecting different results, loneliness and psychedelics (alcohol included) are two gateways to unique thoughts be they good or bad, genius or tragedy.

That explains why a disproportionate amount of artistic talent is shown by gay people, a group that unfortunately still today must endure a disproportionate amount of loneliness. That’s also why Bob Marley and the Wailers⁴ sought inspiration in forbidden plants and Led Zeppelin in forbidden lab drugs.

In our first letter, back in August 2012, we said we would strive to be a different kind of investment company, more interested in figuring out our own unique approach to investments than in raising capital. Even so, we certainly hoped to find at least a few investors along the way to join us in our journey for undiscovered and asymmetric opportunities.

In other words, our investment philosophy is not for everybody and we wish it to remain that way. Instead of molding ourselves to provide what investors were seeking, we vowed to look for investors in line with our unique search for unconventional ideas. It was

³<https://www.theatlantic.com/health/archive/2017/03/the-virtues-of-isolation/521100/>

⁴<https://www.labroots.com/trending/cannabis-sciences/13574/connection-rastafarianism-marijuana#:~:text=In%20fact%2C%20Bob%20Marley%20did,him%20to%20access%20his%20creativity>

definitely a bold statement for newcomers, but then again, we had nothing to lose so we could be daring.

At first, needless to say, only family and close friends were in the boat.

As we celebrate eight years of existence and four years since our Opportunities fund was launched, the theme of this letter will serve as an internal reflection for our team:

How can we, in this extremely regulated and institutional industry, keep the counterculture that has brought us so far? How to maintain the daring ethos that inspired our original ideas and were responsible for our fund's performance, while at the same time institutionalize and grow?

How can we have state of the art back office, analysis, security, but also remain misfits and keep an eye out for the magical, the unconventional?

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At first, the fringe looks an ugly and unpromising place, but then, it suddenly becomes interesting. At first, Steve Wozniak and Steve Jobs were just some nerds in a Californian garage, but then they created Apple and changed the world. At first, UFC was an outlaw human cockfighting ring, but then it became a billion-dollar franchise. At first, Cryptocurrencies were a hobby designed by a few curious people, but then it gave way to the biggest revolution in finance ever seen since the Dutch first started trading shares of the VOC in the 17th century. Only misfits, the ones that get laughed at, are capable of coming up with something so out of the box, so game changing.

In what is arguably its most beautiful passage, the Bible (or the Torah depending on one's religion) tells the story of David and Goliath. It is a tale about overcoming disadvantages. How could a small boy beat a giant?

The real insight is that when you are in such a disadvantage, as David was, you reconfigure the game. Sure, a regular combat would never be a real contest, but how about surprising the giant? How about changing the rules?

Likewise, each investor is unique, comes from a specific point in geography and time and has seen things that no one else has in the exact same way. Everyone has unique insights. The key is, like David, to use your own unique advantages in your favor.

This house was founded by people with very little prior experience in financial circles. Over time we had to overcome at least part of the obstacles that this handicap brought, like lack of contacts and pedigree. On the other hand, we had some advantages that time spent solely on financial desks might not provide, such as unique insights into the real economy.

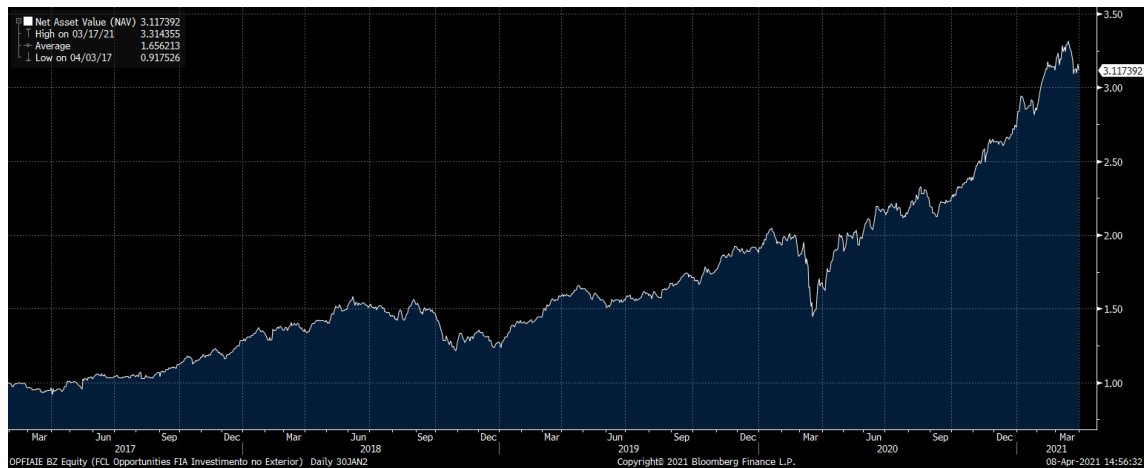
All in all, if you are looking for something truly remarkable, we would advise to always look for countercultural places where there is a small but intense and diehard following. There you might find the new UFCs, the new cryptos, the new Nirvanas of the world.

Certainly not in mainstream circles, because once something is institutionalized, it becomes understood, it becomes tamed, or, to use a financial term, it goes into the price. It is in those small niches, we suspect, that many of our future investment ideas might come from.

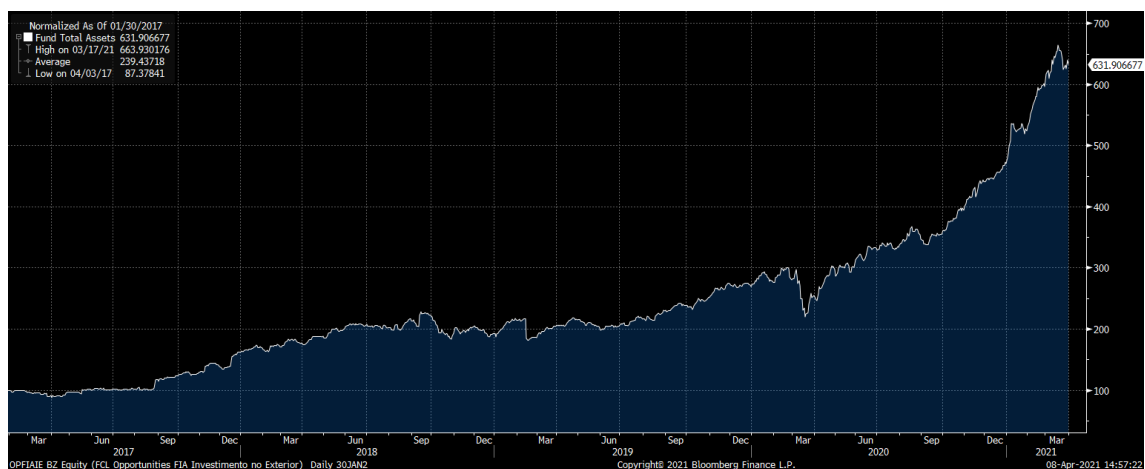
Before investors and spreadsheets, when there are only a few nuts doing something intense and clearly believing in something crazy, that's when people might want to take a look. From outcasts and hermits to crypto enthusiasts tweeting "When Lambo", to startup founders, to the Chinese peasants who are currently giving birth to some of the companies that will rule the century.

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A lot has happened since we opened our Opportunities fund four years ago, on January 30th, 2017.



FCL Opportunities performance since Inception in January 2017. Base: 1



FCL Opportunities assets under management since inception. Base: 100

We are very proud of the financial performance our investors have achieved. Very proud indeed to have found a group of investors that share our vision and mindset about looking for unconventional Opportunities in a global 21st century framework and proud of what we might still accomplish together.

In some ways we surpassed even our own expectations, but we still think that the best breed of Opportunities and insights still lies ahead. The more we learn about global finance, the more we figure out that there is much more to unfold.

Looking back to our August 2012 letter we said: *“Our mission is to be a very long term, aggressive, value obsessed, contrarian investor. So obviously we need a client base that thinks like us: low turnover, a focus on the big picture, deep understanding of the facts as opposed to the noise and disregard of what everyone else is thinking. We will always see ourselves first as investors and just then as asset managers”*.

In other words, we promised to be, in a way, misfits. And if this house had to credit just one factor for the success we achieved so far, it would have to be this mentality. Many well-intentioned people told us that opening a global, qualified investors only fund in Brazil, let alone one from a new manager, was crazy. At the time, not even conventional global funds by big, traditional managers had gained traction in the country. Also, Brazilians were, we were told, biased to short-term thinking and would never have the patience for our kind of thesis and investments.

We take this letter to look back and celebrate our anniversary and also to thank each one of our investors who entrusted us with their capital, patience and energy. If we have one promise to all of you is this: then and now and forever, we vow to remain unconventional in many ways.

Finally, our current reflection is: how can we grow while, at least in corporate terms, remaining hermits, with a contrarian way of thinking, away from the noise of the crowds, with our own unique culture and mindset?

It is not trivial, but this house is convinced it is something achievable.

Obviously, just as any other financial company, we will always seek the highest levels of fiduciary duty, responsibility and compliance. However, complementary to that, this house’s manifesto is clear: we will always seek the unconventional, because we are convinced that there is where the real alpha lies.

A global mindset, a concentrated portfolio and a very specific and disciplined mandate, while at the same time trying to look across asset classes. Or, as we like to say, understanding the forest instead of its trees, while also keeping an eye out for some diamonds along the way.

All in all, we will always be looking for something that is either brand new or something already ordinary, but that needs to be seen with an entirely new perspective. We will always keep pushing frontiers. Always daring. Always misfits.

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Thesis: Vale

Style drift, when one investment manager invests in thesis or ideas away from his specific mandate, has a bad reputation in finance and with good reason.

As believers in the Mungerian concept of “circle of competence”, being disciplined and loyal to one’s strengths and style when it comes to investing, this house is humble enough to realize that doing only one thing at a high level is already hard enough. And even when one is playing at his own strengths, good performance is far from assured in this business.

Having meant everything we said in the previous section, the thesis we are going to present in this letter has been in our fund for the past year and is quite far from usual for us.

While not necessarily “away from our mandate”, since our bylaws allows us to invest in any public traded stock, Vale is certainly away from our inner circle of competence. Exactly for this reason, because we are admittedly tourists in this case, we felt we had to double check everything.

We spend most of our days looking for the champions of the 21st century while trying not to overpay for them. Since the start of our fund, our focus has been the winners of the future, specifically medium sized companies that have, in some way, exposure to the BRIC’s and its markets.

Vale, on the other hand, is a blue-chip company that is covered by every major investment bank in the word. Its market cap is around \$100 billion US dollars, way above the usual range of \$200 million - \$25 billion US dollars for the companies we usually invest in. And, as it is a commodity business, it is certainly not a champion of tomorrow in the traditional sense. On the contrary, it is possibly the most classic value idea in this house’s portfolio right now.

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To start discussing our investment in Vale we first need to zoom out and discuss the past few years and the current context of the company. And, as everyone knows, the current context is very troubling indeed.

Vale is a giant mining company engaged in the production of several minerals. However, its fortunes have always been most intensely aligned with one product in particular - Iron Ore.

Alongside two other companies: Britain’s BHP and Australia’s Rio Tinto, the trio is responsible for the vast majority of the international trade in Iron Ore. The bulk of it goes to feed China’s massive steel production, since Chinese Iron Ore is of low quality, expensive, and simply not sufficient to satiate the country’s demand. This trend should continue for the next few decades as China continues its industrialization and urbanization, trends that are shaping the century in many ways.

Despite being a globally admired company, Vale has clearly shown serious governance problems in the past, to put it mildly.

On November 5th, 2015, in what became known as the “Mariana Dam disaster”⁵, a dam in the Samarco Mariana Mining Complex suffered a catastrophic failure resulting in a flooding that devastated the downstream villages of Bento Rodrigues and Paracatu de Baixo, killing 19 people. Samarco is a joint-owned subsidiary of Vale.

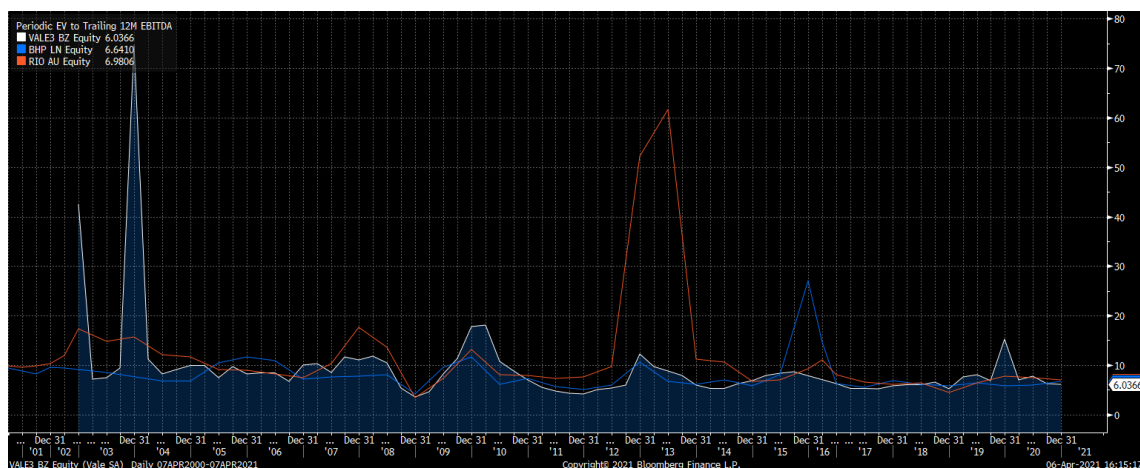
Then, on January 25th, 2019, an even worse tragedy happened: a tailings dam operated by Vale at the Córrego do Feijão Iron Ore mine, close to Brumadinho, Minas Gerais, collapsed⁶. As a result, 270 people died, with the total human and legal costs still being tallied.

There was widespread consensus that the company has been neglectful in the management of its enormous structures and there were evident corporate governance flaws in accounting for all the possible environmental and social risks in its operations.

At the same time, the global financial market was entering a period of fascination with growth tech companies and away from everything that, like mining companies, deals with atoms and not just bytes. This trend was especially felt in emerging market companies, an asset class that after being in vogue in the first decade of this century, lagged behind for the past ten years.

This double setback - Vale’s internal *Via Crucis* and the global finance’s disdain for the mining industry - has resulted in what this house thinks is a historical mispricing anomaly.

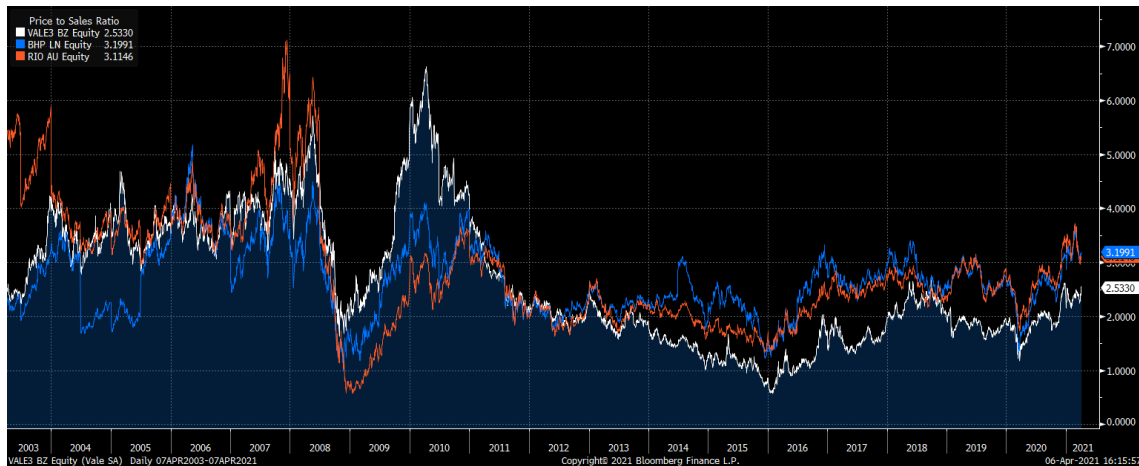
Even though Iron Ore will probably remain one of the most profitable parts of the global mining industrial complex for, at least, the next two or three decades, the trio of giants is trading at some of their lowest multiples in this century.



Vale, Rio Tinto and BHP - EV/EBITDA Multiples

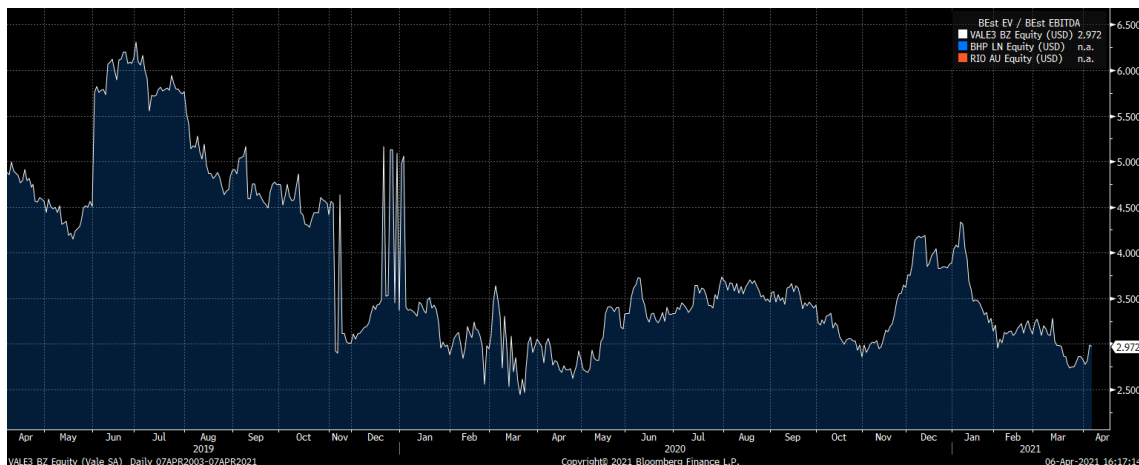
⁵ https://en.wikipedia.org/wiki/Mariana_dam_disaster

⁶ https://en.wikipedia.org/wiki/Brumadinho_dam_disaster



Vale, Rio Tinto and BHP - Price to Sales Ratio

In the case of Vale, however, the decrease in multiples is even more extreme, with the company facing a huge valuation gap even compared with its two rivals.



Vale's EV to expected 12-month EBITDA, historical series

It is beyond the scope of this thesis to enter a lengthy discussion about the growth vs. value investing frameworks, but it is clear that industries like finance, commodities and indeed, mining, have, in the past decade, suffered with relative disdain by global investors, enamored with developed markets growth stocks in general and tech stocks in particular.



S&P500 Growth Index (blue) vs. Emerging Markets Value (white), for the past 10 years.

To sum it up, Vale is a star in an overlooked but highly profitable industry, in a sector that will continue to be crucial for the global economy for the next 30 - 40 years. And on top of that, it faced almost life-threatening governance and ESG issues that made it highly toxic, to the point that even investors inside the mining industry discarded it when compared to rivals.

The result is some astonishing multiples for a world class company: normalized free cash flow yield close to 20%, according to 2021 consensus, and price earnings ratio of just 6x.

Now let us discuss each of the reasons behind Vale's bizarre valuation:

- a. The global mining industry is not currently "in vogue"

Fact: It is widely discussed in financial media that in early 2021 global investors started a rotation from super expensive tech and growth names in favor of value companies that were left behind in the recent rally and are still considerably cheap. Although we cannot be certain this movement will last, this house thinks the next decade will bring above average return for commodities and industrial names, especially in emerging markets, due to years of underinvestment and low current valuations.

- b. Vale's specific governance issues

Fact: After a very traumatic near death experience a revolution is taking place inside Vale. Its whole executive board has changed, including its recently appointed CEO, Eduardo Bartolomeo, who has been very clear and direct that improving the company's governance, its security standards and its ESG behavior is the number one priority.

Of course, the transformation of a company's culture doesn't happen overnight, but this house believes Vale will be once again investable by the global community once investors realize that the serious flaws that gave birth to the recent tragedy are being effectively addressed.

c. Possible legal and financial setbacks

Fact: Previous to the release of this letter, on February 2021, Vale agreed to a 37 billion reais (7 billion US dollars) settlement with Brazilian authorities over the reimbursement for the environmental and human cost of the Brumadinho tragedy. Even though the settlement does not include individual damages, it was the largest such agreement in Latin America's history and it's likely to reflect most of Vale's financial obligations. This will possibly mean an important catalyst for Vale's shares to start to converge back to its rivals' multiples, since it removes an important tail risk for the company. As it is often said in finance, the devil is better than uncertainty.

There are of course risks in our thesis, as there always are. Iron Ore could face a serious price decrease. China's growth, urbanization and consequently its steel and Iron Ore appetite could decrease. And most crucial of all, Vale could face a new tragedy like the one in Brumadinho.

This house judges these risks unlikely or implausible.

First, China should continue to see an average of a million people per month moving from rural areas to its cities, totaling almost 400 million people by 2050. This unprecedented urbanization will continue to generate demand for more buildings, bridges, and roads, consequently, a lot of steel will be needed. To cover this huge demand, the country already produces over half of the planet's steel and since Iron Ore is used for its production, Vale, BHP, and Rio Tinto should continue to rely on China for the bulk of its exports.

Second, the world has changed in crucial ways and so has Vale. The company knows it simply cannot afford more disasters and the tradeoff between speed and efficiency on one hand and security on the other has clearly moved towards the latter. In the future, the company should be more conservative in its production methods and more careful with its ESG standards. In other words, we will see a more robust production model. That's, after all, what all its stakeholders are demanding.

Finally, as the world turns and with it its mood, tastes, and fashion, we should not only see a convergence of Vale multiples with the multiples of its two major peers (which in itself would mean a share price increase of some 70% for Vale, not counting its annual dividends) but the trio, with the rest of the global mining industry and the global value sector, should also see a reinvigorated investors' enthusiasm in this next decade, unlike what happened in the last.

All in all, this house believes we are entering a positive era for commodities, emerging markets and value stocks as opposed to an almost single-handed focus on tech, US markets and growth. As it has always been, reversion to the mean is a powerful force in financial markets.

With this framework in mind, this house started investing in Vale's shares around the fourth quarter of 2019 and to this date we still hold part of our stake.

The shares have appreciated meaningfully in the past year representing one of our fund's highest Internal Rate of Returns in 2020:



Vale's share performance, since October 2019

To summarize, Vale, although far from this house's usual type of investment, just seems like too good an opportunity to pass up.

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Performance

FCL Opportunities	
Year to Date, 2021, in BRL	14,09%
Year to Date, 2021, in USD	5,16%
MSCI All Country Index, YTD, 2021, in USD	4,88%
Since Inception (30/01/2017), in BRL	211,74%
Since Inception (30/01/2017), in USD	72,42%
Avg Annual Return, since inception, in BRL	31,20%
Avg Annual Return, since inception, in USD	13,93%

FCL Hedge	
Year to Date, 2021, in BRL	1,83%
Year to Date, 2021, as % of CDI	376,63%
Since Inception (01/02/2017), in BRL	41,84%
Since Inception (01/02/2017), as % of CDI	156,98%

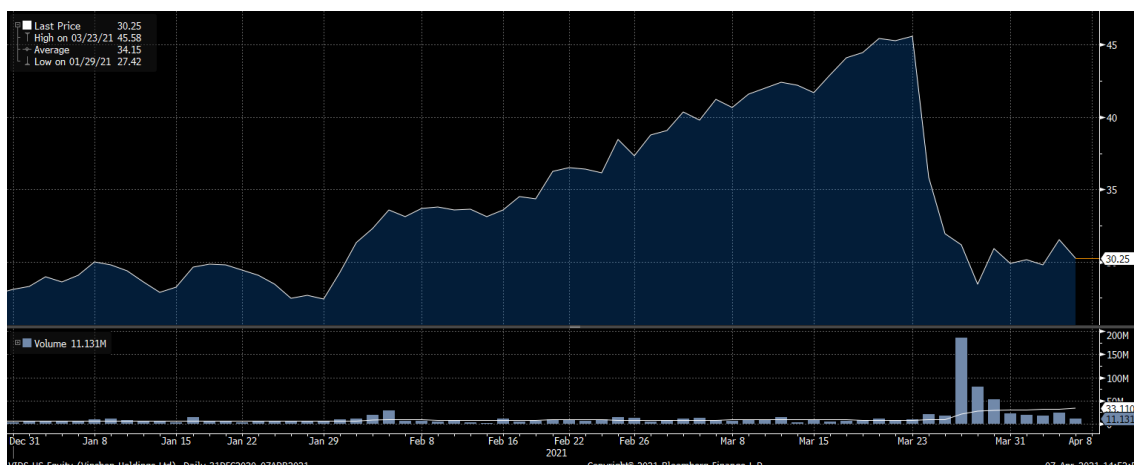
In the first quarter of 2021, FCL Opportunities, this house's flagship fund and main investment vehicle, appreciated 14,09% in BRL (+5,16% in USD). Since our inception on January 30th, 2017, our shares appreciated by 211,74% in BRL (+72,42% in USD), showing an average annual return of 31,20% in BRL (13,93% in USD)

Our FCL Hedge also showed very satisfactory result of +1,83% or the equivalent of 376,63% of the Brazilian CDI in the first quarter of the year.

Had it not been for the blowup of a very important investment vehicle in New York City called Archegos Capital Management, our performance would have been even stronger.

To sum it up, Archegos had very levered positions in high-risk strategies. When the price of one of its positions began to tumble, a sizable margin call could not be met, triggering similar demands for cash from other banks and, as a result, the fund had to be tragically liquidated. Since Vipshop, by coincidence one of FCL Opportunities' main positions, was also one of the companies in Archegos' portfolio, some major banks organized a forced block trade sale of its shares to liquidate all of the fund's position.

For this reason, although there were no fundamental changes to the company's long-term prospects, Vipshop shares suffered heavily in March, costing our Opportunities fund a few precious percentage points of performance in the quarter.



Vipshop – Year to Date

Needless to say, this house remains very committed to our investment in Vipshop and has taken advantage of the recent price drop to increase our stake in the company. We think a forced sale with no fundamental relation with the company itself is usually a good opportunity for long term investors like this house to add to their positions.

At the end of the first quarter, FCL Opportunities top 5 positions were:

Position	Country	% Fund NAV
Entain	UK	12,31%
BRF	Brazil	10,09%
Capri Holdings	USA	9,69%
Yduqs	Brazil	8,97%
Vipshop	China	8,16%

As for FCL Hedge, the portfolio composition on March 31st, 2021 was:

FCL Hedge	
Stocks and ETFs	68,01%
Cash and Fixed Income	19,49%
Other Positions	12,50%

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Throughout the quarter, the global investment community discussed the impact of a possible rise in the US long term 10-year treasury rate. A higher interest rate will mean higher discount rate for stocks, especially growth tech names that have most of its projected cash flows far into the future, some of them not even profitable yet.

Since November of last year, when news of a Covid-19 vaccine first emerged, a “rotation” has taken place from growth and tech in developed markets towards names that should benefit when the full reopening occurs.

This house judges that our portfolio, comprised of long-term winners in the new economy, is well prepared to withstand any possible friction to come, as the first quarter of this year has attested.

All in all, we remain convinced that this decade, the 2020s, will bring above average returns for emerging markets, especially value companies in sectors like commodities and industrials. Companies best able to capitalize on the expansion of wealth in China, such as Chinese tech and consumer names and European fashion houses, should also benefit. This house is particularly excited with the latter, which might be a sector containing deep parallels with US tech companies in the 2010s: unrivalled in their prominence and ready to expand their consumer base and conquer the world.

There are basically 4 major themes our Opportunities fund is currently exploring:

- Chinese tech and consumer names - “the champions of the future”;
Positions: Anta, Vipshop, YY, among others.
- European fashion houses, best able to capitalize on the increasing Asian wealth;
Positions: Moncler and Capri.
- Brazilian names able to surf the Asian industrialization wave, like commodities exporters;
Positions: Vale, BRF, Suzano.
- Brazilian companies able to solve some of the country’s chronic deficiencies and needs;
Position: Yduqs and Fleury

As always, we thank our investors for their trust and commitment and hope to see you all soon.