In this third ATMOS QUARTERLY LETTER, we will discuss (i) the fund's performance since its inception, considering that the fund has just reached a little over one year of existence, (ii) the importance and difficulty of remaining loyal to an investment discipline and (iii) perspectives for 2011.

2010 Results

In 2010 the fund's profitability reached 24.2% in comparison to 12.2% of our performance benchmark (IPCA + 6%) and 1.0% of Ibovespa. Since the beginning of Atmos' management in October 2009, the fund accumulates an appreciation of 39.1% net of all costs in comparison to 14.7% of our benchmark and 3.9% of the Ibovespa. (All aforementioned return figures are measured in Brazilian Reais).

Since the fund's track-record is still short, we believe that any quantitative assessment would be inadequate. We prefer to focus on certain qualitative observations related to our investment process that, contrary to past profitability, will be important for our future performance.

We started 2010 with a cautious stance which was reflected in the fund's high cash postion. At that moment, although we believed that companies would deliver exceptional results, market prices were not sufficiently attractive to merit the investment of our entire portfolio with an adequate margin of safety. It should be pointed out that our cash position is not determined by our opinion of market behavior over time, but on our assessment of how much we have to lose in more pessimistic scenarios.

This attitude did not change significantly during the year. The cash portion of the portfolio varied between 25%-33% during 2010. In addition, we spent approximately 1% of the portfolio in insurances to protect the portfolio in the case of a strong drop in the market, which did not happen.

We do not believe that a high cash position and protections are enough to state that a portfolio is very risk averse. The perception of increased security frequently leads people to run greater risks. In a research study conducted in Munich in the 1980s, part of a taxi fleet was equipped with an "anti-lock braking system" (ABS) . The rest of the fleet continued with their regular braking system. The two groups, similar in all other aspects, were kept under secret observation for three years. Contrary to expectations, the group equipped with the ABS suffered a greater number of serious accidents. More confident, the drivers started driving more aggressively.

To avoid this type of behavior, in addition to the high cash percentage and protection measures, we concentrated our positions in assets that presented more stable cash flow generation and that could remain relatively immune to cycles. Assets considered risky, but with a high potential of appreciation, are also a part of our portfolio, but always have their size limited by the risk incurred.

Looking back, the fact that we operated the entire year with a high cash position and permanently purchased protections cost us a few percentage points in profitability for the year. However, these are percentage points that we feel very comfortable having left behind.

As was stated in our first report, "The combination of being partners of good businesses, but also having cash to avoid excessive losses at moments of large optimism, will allow us to take advantage of eventual market-swings to increase the fund's exposure when the margin of safety is larger. This will be fundamental to the fund's objective of obtaining a good absolute long-term return."

Another point we would like to emphasize is our constant preoccupation concerning the fund's liquidity. Despite the fact that the total amount of assets under our supervision is still relatively small, we have always maintained a portfolio concentrated in companies with at least reasonable liquidity. The exposure to companies that negotiate less than R$1Mn remained under 5% of our portfolio on average. This is a characteristic we consider important, because we attribute a relevant weight to the possibility of admitting mistakes, changing our minds and at the same time being able to express these changes in opinion in the portfolio.

The obsession to beat the market

Usually, when an investor succeeds in predicting the market's short term moves, he/she rapidly attributes the result to his/her management ability. If the result is not what he/she expected, they take refuge behind the argument that the market is irrational, focused on short-term results, inefficient, rigged, a "voting machine", and so forth. In this case, the market constantly reminds us that the long-term is nothing more than the sum of short-term periods.

Therefore, to achieve consistent returns, is it necessary to be more right than wrong in the short-term? In our view, not necessarily. It is obvious that being frequently right makes the investor happy. When somebody is making money he or she becomes a much more pleasant husband or wife, tells great jokes to his/her friends and, above all, becomes more confident in his/her ability to beat the market. The problem is that just a few bad days can destroy all the returns built over very long periods. For managers that do not mind changing their jobs, these are just a few days of bad mood. For the fund's investors, it can mean a severe savings destruction.

Then, is going against the consensus always the best strategy? We also think not. At certain periods of time, the overall consensus is right. In Brazil, investing in the Real, in the stock market and in interest-rates were consensus positions during the last 5 years that generated excellent results. Furthermore, being frequently wrong in the short term can discourage the manager, decreasing his/her confidence and decision-making prowess.

To invest is not simple, nor is there a simple recipe for success. In addition to the complexity of analyzing various micro and macro factors, we must still face difficulties along the way that hinder our ability to maintain our discipline and rationality at all times.

In our evaluation, the differential of a good investor consists in the ability to recognize his/her mistakes – regardless of the market's movements – changing his/her mind when the fundamentals change and, above all, maintaining his/her conviction when prices are moving in a direction opposite to that which was expected. To simply try to "go with the flow" is like changing traffic lanes. The chance of getting to one's destination faster is purely random. The only certainty is that the chances of crashing the car are greater.

At the end of the day, our ability to obtain long-term returns above the market average – made up of intelligent and informed people – will depend less on superior analytical skills and more on a structure aligned with the clients, with the right incentives, where everyone is rowing in the same direction and everyone has a similar perception of risk. These are all key factors required to maintain the investment discipline and philosophy consistent over time.

Perspectives for 2011

At the beginning of 2010, we believed that Brazilian companies would present exceptional results throughout the year, due to a combination of heated demand and idle capacity, resulting in expressive operational leverage. For most companies it was not only a year of a strong growth in revenues, but also of an expressive expansion in margins.

For 2011, we believe that the internal market scenario indicates greater uncertainty. Brazil's good performance during the 2008 crisis has generated the conviction that the country can grow consistently at, at least, 4% a year. However, despite the strong growth in 2010, we must remember that Brazil did not grow at all in 2009. With growth below 4% during the 2009-10 biennium, the economy once again presents inflationary pressures, even with the extremely low world inflation and appreciation of the Real.

This new higher inflation scenario has a relevant impact on the real economy. In 2011, we will probably see cost pressures arising from several vectors that were already present at the end of 2010 including, but not limited to: increasing prices of commodities, lack of a qualified workforce, collapse in logistics and pressure of managed prices due to the rise of the IGP-M. In order to control inflation, the adjustment via interest rates, spending cuts or by means of so-called macro-prudential measures should potentially be strong enough to prevent the economy from growing more than 4%.

In other words, although the general consensus indicates the contrary, the probability of margin contractions is not negligible. With a more challenging environment and aggressive projections for 2011, consumer stocks are being negotiated near the historic maximums in terms of market multiples, leaving little space for disappointment.

Brazil has become one of the most popular investment destinations in the international market. The price of any product reflects the balance between supply and demand. Stocks are no different. If on the one hand, we had a large demand for domestic market assets in 2010, the supply of new stocks remained limited for quite some time due to Petrobras' stock offering. In 2011, we expect a different scenario, more akin to 2007, with the realization of several public offerings directed toward the domestic market. In the stock market, the adjustment of supply is slower than that of demand. After all, it takes time to construct investment plans and prepare a company to go public. But as long as businessmen continue to have the opportunity to sell their businesses at high prices and bankers continue to collect their *fees*, the number of offerings will keep growing. Thus, the argument that stocks can keep rising indefinitely based solely on flow relies too much on one specific side of the equation.

Having this scenario as a background, we are facing great difficulties to find consumption companies that present a good risk-return ratio. The results may remain positive, but the expectations are even higher, as are the implicit multiples. We continue to maintain certain selective positions, but none representing more than 5% of the fund. The largest of the fund's positions are concentrated in the financial sector, which is currently out of 'fashion' due to the risks of so-called macro-prudential measures and the increase in competition. In this sector, we have found first line companies with excellent growth perspectives still being negotiated at attractive prices.

For now, we continue with 30% in cash and protections, waiting for the opportunity to increase the fund's exposure. We are currently unable to forecast whether the market will suffer any significant correction in 2011 or not, but these events usually occur without warning. With our current portfolio and with the chance to take advantage of eventual opportunities, we believe that the fund is very well positioned to deliver a good long-term return for its shareholders.

An excellent 2011 to everyone,
Atmos Capital