

RAIDERS OF THE LOST ARK

Traditionally, there is a big appeal in positioning one's self as a typical "value investor", a real-world treasure-hunter. Who wouldn't like to hand over capital to a modern-day Indiana Jones, mandated to search the markets for "under-valued companies, with little coverage and misunderstood by the general public"? This kind of investment-approach was very successful in Brazil during the last decade, while the country did not attract relevant sums of long-term capital and, as a consequence, quite a few "jewels" were left untouched for a long period of time.

During the last few years, most local and foreign investors have scavenged the Brazilian markets for businesses with very similar characteristics. Well managed companies, with sound corporate governance principles, high growth prospects, marginal returns above the cost of capital, large barriers to entry, elevated pricing-power, and if not enough, negotiating with a significant discount to intrinsic value. Indeed, the overall speech sounds very attractive and catchy, but has "someone already negotiated with the Russians"?¹ If everyone is looking for similar characteristics in the same place, finding a good investment opportunity will not be an easy task.

In today's market there is a big trade-off between trying to "treasure-hunt" and pay a premium for quality. And, except for the khaki-colored pants that compose our traditional working uniform, we do not have the calling of a modern-day Indiana.

"IF THE FACTS DON'T FIT THE THEORY, CHANGE THE FACTS"²

Aside from periods of higher market uncertainty, quality companies are usually traded at higher multiples. On the other hand, lower quality companies usually trade at lower multiples, although the relative discount to their higher quality peers does not mean investments in such companies are less risky. When a negative scenario materializes, lower quality companies suffer significant impacts, thus lowering the probability of exceptional returns being obtained over the long-run. It follows that, concentrating one's portfolio in this kind of business, even if for a short period of time, exposes it to the risk of a permanent loss of capital.

It might be tempting to keep the fund 100% allocated in cash and cash equivalents, waiting for some sort of cataclysm to invest in high quality businesses with a somewhat higher margin of safety. However, letting go of at least some level of exposure to real assets might prove to be quite expensive in case the next big crisis takes a long time to occur.

This leads us to portfolio allocation – a significant part of our holdings are currently concentrated in higher quality companies and we know we are paying somewhat of a premium for such. Risk is added through smaller positions in lower quality businesses that we believe constitute high expected-value short-term bets. Finally, we keep a reasonably sized cash position, in order to limit the fund's potential losses in adverse scenarios.

¹ Brazilian Football player Mané Garrincha, questioning coach Feola, before the match against the extinct Soviet Union, at the 1958 Worldcup.

² Albert Einstein

At this point we are confronted with two questions that we discuss a lot internally, namely: (i) Currently, how much of a premium are we willing to accept to pay for excellent businesses, and (ii) How do we protect ourselves from the natural inertia that arises from the “buy-and-hold” strategy that is so widespread among long-term investors?

With relation to the first item, even though it’s not exactly prudent to anchor ourselves in a specific number, we generally find it acceptable to invest in companies with a somewhat steady operational free cash-flow generation and credible growth potential, that do not trade at P/E multiples much higher than 20x. Brazil seems to be converging with the rest of the world to lower real rates of return in fixed-income, which subsequently affects the returns required by equity investors. The problem with this scenario is that stock price increases of the magnitude of 10% ,20% ,30%, unaccompanied by significant changes in results, make a lot of difference, disproportionately increasing the investment’s loss potential. It’s hard to sleep at night, when one pays a 25x multiple, independent of business quality.

We need to find alternatives, which takes us to the discussion of the second item. This one, a little more complex, will be divided into two sub-sections: (a) Rebalancing, and (b) The need to get rid of inertia.

- (a) Rebalancing – Long-term Investing vs. Long-term investment strategy

There is a certain market consensus that when a good company is found for a reasonable price, the investment ought to be maintained for a long period of time. Large price swings, both on the upside and the downside, should be ignored. On the other hand, it is also a consensus position that no company is good enough to the extent that its market capitalization can be completely ignored. These ideas seem to us to be quite contradictory.

To illustrate, let us imagine an investor that, having diligently studied a company, decides that performing an investment at R\$10 per share (bearish scenario) constitutes a good margin of safety. At the same time, this investor decides he’ll only sell his position if the company reaches a price around R\$20 per share (bullish scenario). This situation is comfortable given that the company’s stock will hardly trade, in the short-medium run, below the acquisition target-price or above the selling target-price, for a long period of time. The strategy of requiring a certain margin of safety when it’s time to buy, but not maintaining the same degree of conservativeness or precaution when it’s time to sell, generates a certain “cognitive ease”, but hardly characterizes as an optimal solution from a risk management perspective.

The innate human aversion to losses explains a good measure of the financially unsound behavior illustrated above. Scientists working in the field of Behavioral Finance have demonstrated through a series of experiments in the last few decades that humans have an innate difficulty to altering status-quo positions. As an example let us imagine that a person holds a pre-paid ticket to a series of concerts – in such a case, he/she will feel almost obliged to attend the whole season, even if conflicting events arise. However, if the season tickets had been offered gratuitously, this same person would hardly have any trouble giving up on going to at least some of the concerts³. This situation is analogous to that which goes on in the investment world – investors seem to have an inherent reluctance to changing investments that haven’t yet performed as expected, even if greater opportunities are identified elsewhere.

³ Thaler Richard H., “Toward a positive theory of Consumer Choice”, Journal of Economic Behavior and Organization (1980)

In our view, trying to protect oneself from committing mistakes utilizing an absolute investment framework for each asset may not be the best way to manage one's portfolio. Aside from not guaranteeing success in any sort of way, this apparently comfortable situation may hamper the process of searching for new opportunities and, worse than that, diminish the manager's capacity to assess the relative valuation between assets.

A very important characteristic of our management strategy consists in the constant rebalancing of the fund's positions when significant price movements occur without any particularly relevant marginal information. In this manner, we are able to keep the portfolio concentrated in higher quality companies, while still avoiding to pay excessive mark-ups for such. Independent of how sound and robust the research process may be, the world is certainly not free of uncertainties, and frequently the ex-post reality proves us that our ex-ante theses were quite wrong. We cannot guarantee that our process will generate a better result for the fund, but in our view, it will at least diminish the probability of our incurring in a significant loss of capital throughout the "investment route". After all, "the bigger they are, the harder they fall".⁴

- (b) Inertia – "In theory, there is no difference between theory and practice, in practice there is"⁵

The "value investing" process, allied with the long-term investment philosophy is an arduous journey which requires a lot of time studying and interacting with a multitude of different actors. Being methodical and disciplined is a good start, but still far from a guarantee of success. At the end of the journey, a conclusion is reached that must be expressed within the portfolio. Having the capacity of changing one's mind when necessary seems to us one of the greatest challenges constantly facing investors.

An additional piece of information, however easily obtained and devoid of the analytical rigor previously employed, shouldn't be underestimated and can completely alter the investment thesis. At this point human nature tends to increase people's reluctance to changing opinions, either because more emphasis is ascribed to information obtained through theoretically more robust processes, or because we don't want to believe that a tremendous amount of work and time were "wasted". Unfortunately, the relevance of the information is not linearly correlated with the effort invested in the discovery. We shouldn't underestimate our natural inertia to changing opinion.

This is one of the reasons we do not sympathize with the word "conviction". An investment that receives such a stamp gains a rigidity that does not please us, possibly creating enormous amounts of resistance to changes that are crucial within the investment process.

"SHOULD YOUR YIELD APPEAR TOO SMALL, BE THANKFUL I DON'T TAKE IT ALL, 'CAUSE I'M THE TAXMAN"⁶

In the United States, savers have been losing capital slowly with negative real returns of -0.6%p.a. in 10-yr. treasury notes. Under this scenario, American blue chip stocks have performed reasonably well, even with low growth prospects and high tail-risks in the event of a rupture occurring in the Euro-zone. These companies generally present stable cash-flows with a yield around 7%p.a., which seems quite attractive in a world where 0% interest-rates have become the norm.

⁴ "Barbados" Joe Walcott

⁵ Yogi Berra

⁶ From the original: "Should five per cent appear too small, be thankful I don't take it all, 'cause I'm the Taxman" – The Beatles

Brazil is also converging to reward its few savers at a much lower real interest-rate: consumer leverage is reaching its limits, the utilization of so-called “macroprudential” monetary-measures isn’t considered taboo anymore, the whole world faces lower growth rates, and China in particular, is decelerating. The peculiarity in the Brazilian case is that capital allocation within the country is still very much directed towards the rear-view scenario where easily available real returns could be obtained through the purchase of government bonds. This is quite different from other comparable parts of the world, where investors are already much more exposed to equities.

This scenario can provide for a paradigm shift in the local markets and it’s currently possible to observe companies with a stable free cash-flow generation, that distribute a good amount of earnings in the form of dividends, trading at P/E multiples of 25x, even without much further growth potential. They have truly become the “last cold coca-cola in the desert”. Other companies that are more exposed to domestic markets are also trading at levels very near what seems to be their respective fair values, having gone up by more than 30% this year, even with results coming in quite lower than what was expected by the market in the end of 2011.

Allocating capital has never been an easy task, but nowadays the challenges loom even higher. In a world with low growth rates and filled with tail risks of big structural ruptures, going down the quality ladder in the search for investment alternatives seems very risky. As has already been mentioned, we believe that this kind of strategy will hardly generate consistent returns over the long-run. It would be even more imprudent to allocate relevant sums of capital in this kind of business under such an uncertain environment.

The last ten years of the Brazilian stock exchange have been marked by a significant institutional change in the country and an excellent commodity cycle, both of which have given support to a big rally in stocks as an asset class. In the last three years the performance has been somewhat shyer. It’s possible that the recent drop is merely a consequence of the previous years’ exuberance, but in a general sense, what we observe is a more challenging economic scenario exposing failures of lower quality business models. In Brazil, where companies face relatively high cost inflation, a simple deceleration in the rhythm of price increase can bring by quite adverse impacts on margins.

In this fashion, we continue concentrating our investments in higher quality companies that are also solid generators of operational free cash-flow. However, the recent increase in the premium paid for such has left the portfolio more succint to losses in case we’re wrong. To soften this effect, we are keeping a fair amount of the portfolio invested in cash, and we're a little more active in rebalancing our positions.

In a world where capital preservation is a big challenge, we shouldn’t underestimate the challenge of generating positive real rates of return for our investors.