

**Anniversaries make you healthier. Statistics show that those who celebrate more anniversaries live longer...**

Atmos Ações turned three years old in October 2012. Up until now we have hardly commented on returns or performance in our letters. In our view, a minimal amount of time is required for this type of information to start becoming valid, principally due to the influence wielded by exogenous factors on short-term movements.

During the fund’s initial years, we concentrated our letter on themes that we deem relevant for the construction of our investment processes. Our goal was aimed at enabling investors to qualitatively assess the consistency of our work. We always imagined that the third anniversary would be a better moment to start any type of quantitative reflection.

The current scenario seems interesting for the fund. It outperformed the Ibovespa and the maximum drawdown<sup>1</sup> was about half of that seen for the index. Alongside this favorable relative performance, we posted positive returns every year.

On the other hand, one might say that the Ibovespa had a somewhat timid performance in the period. The BM&F Bovespa Small Cap<sup>2</sup> index, for instance, delivered far better results than those presented by the leading Brazilian stock market indicator. Although we also outperformed this particular index, the difference was narrower.

	Return	Volatility	Drawdown
Atmos Ações	94.79%	10.75%	-13.99%
Ibovespa	-8.62%	22.69%	-33.33%
BM&F Bovespa Small Cap	44.50%	19.78%	-27.26%

From the fund’s inception on 10/15/2009 to 12/31/2012

Perhaps most intriguing would be to compare the performance of Atmos Ações with that of NTN-B’s (the Brazilian version of TIPS)<sup>3</sup>. Unfortunately, this comparison isn’t favorable to us. The longer-maturity NTN-B’s (over 20 years) returned over 100% in the period, as a result of the compression in real interest rates in Brazil. It is not very encouraging to imagine that if we had spent this period “laying on the beach” we could have generated a higher return for our clients, incurring in (at least apparently) less risk of a permanent loss of capital.

However, comparing our performance with the *ex post* return of the best performing asset doesn’t seem like a particularly fair analysis. During all of this time, we had a relevant portion of the portfolio - an average of 30% - in cash, in instruments that yield floating rates (CDI), which were not benefited by the compression in real interest rates. Furthermore, not every stock in the Brazilian exchange was favored by the recent drop in interest rates, and this effect was structurally negative for some businesses such as banks and insurance companies.

**“It turns out that you can’t extrapolate the results of base pairs to whole strands of DNA.”<sup>4</sup>**

In countries that have a mature funds industry (as defined by a longer series of data to analyze), the statistics are largely unfavorable to the average return of funds. Among several other reasons is the fact that management and performance fees are relevant through time when compared to the capacity of the average manager to generate index-beating results.

<sup>1</sup> The drawdown of a series of shares/prices represents the percent decline between the maximum value and the minimum subsequent value of the series, measured in a determined period of time

<sup>2</sup> The BM&FBOVESPA Small Cap is an index composed by companies with a smaller market capitalization. Different from the Ibovespa, it is concentrated in companies linked to the internal market in sectors such as consumption, construction, education and utilities

<sup>3</sup> Fixed-rate government securities pegged to inflation

<sup>4</sup> Bern Kohler, American biochemist

Curiously, during the past three years the average return of equity funds in Brazil was quite superior to that of most comparable market indices, with those funds that seek absolute returns posting some of the best results.

A closer look at this category of funds shows certain similarities in their general discourse. Typical value investment concepts such as the search for a margin of safety, knowledge garnered through multiple sources of information, focus on companies with a stable cash flow, amongst others, are themes dealt with exhaustively, almost like religious dogmas.

#### *The Superinvestors of Graham-and-Doddsville<sup>5</sup>*

In the 1980s, when invited for a lecture to celebrate the 50th anniversary of the classic text by Graham & Dodd about margin of safety, Warren Buffett challenged the Efficient Market Hypothesis, highly praised in academic circles at that moment.

To this end, he selected funds from some of his Graham classmates, which built their performance based on the teachings amassed in the 1950s. These investors managed for a very long period (20-30 years) to beat the S&P consistently. If it were only one investor with extraordinary gains, or a group of investors basically following the portfolio of a leading investor, it would be more likely to attribute the superior results to chance. But the group in question was independent, had heterogeneous processes and portfolios, some of the managers within the group hardly talked to one other, and obtained extraordinary results under distinct market conditions. Buffett called these investors “the superinvestors of Graham&Doddsville”.

As a result, could it be said that there is a superior DNA of Brazilian independent managers who benefit from a differentiated philosophy and investment processes? In order to achieve this comparatively extraordinary performance, would it suffice to have smart people grouped in an office, with some knowledge of the philosophical underpinnings of a value-oriented approach to investments, detailed spreadsheets and checklists of meetings?

**“(…) We are quite adept at telling stories about patterns, whether they exist or not.”<sup>6</sup>**

Evaluating this group based solely on its good performance and on an apparent robustness of processes could possibly lead to a misleading conclusion that Dr. Daniel Kahneman<sup>7</sup>, based on his own experience, coined as the “Illusion of Validity”.

The expression was created after an experiment run by the Israeli army, which consisted in placing a group of soldiers, unknown to one another, to perform tasks in order to be judged by aspects such as leadership, intelligence and reaction to stress. To avoid any type of pre-judgment, the group was observed without the judges having any awareness of the soldiers’ ranks within the army.

In the end, the candidates received individual grades and summaries were made containing the impressions of each soldier. The evaluators had no difficulty in finding the stars, whose qualities were clearer compared to the others. This apparent ease brought a high degree of confidence in the selection of soldiers who would move on to official training.

However, by comparing the initial conclusions with the feedback received during the soldiers’ careers, the evidence was largely contradictory. The skill to foresee the future performance of each soldier based on the initial assessment was negligible.

It is curious that even with the results proving to be disconnected from reality, trust in such remained unshaken and the tests kept being implemented.

<sup>5</sup> [http://www4.gsb.columbia.edu/null?&exclusive=filemgr.download&file\\_id=522](http://www4.gsb.columbia.edu/null?&exclusive=filemgr.download&file_id=522)

<sup>6</sup> Michael Shermer, founder of Skeptics Society and editorial chief of “Skeptic” magazine

<sup>7</sup> Renowned Israeli psychologist, Nobel prize in Economics in 2002 and one of the founding fathers of behavioral finance

We find it very difficult to evaluate a manager in quantitative terms if this same manager hasn't experienced a wide-ranging diversity of market conditions<sup>8</sup>. The scenario of the past three years didn't provide these conditions. In this period, the big theme was the growth in domestic consumption and the decline in interest rates, with the result of a large expansion of the multiples of stocks linked to the national economy. Simultaneously, many companies were benefited by the reduction in the cost of capital and by the narrowing of the risk premium in Brazil. Lastly, the global need for yield was the cherry on the cake, elevating the most operationally-admired companies, with good governance, to a "Holy Grail" status.

It is also important to note that the government helped to increase the wedge in the performance of the assets mentioned above and the major components of the index. We can mention two relevant examples in the Ibovespa: (i) Petrobras, with the deterioration of its investment plan in the past few years and its deplorable use as an instrument of economic policy and (ii) the electrical-utilities industry, which was proven to be subject to quite aggressive initiatives by the government when it comes to the renewal and renegotiation of concessions.

The past three years were very positive for the companies usually held by funds with a mandate for absolute returns. The natural tendency is to assume that this type of fund is a "differentiated species", capable of generating returns consistently above the major benchmarks. At this point in the cycle, the danger might be exactly to believe in this premise.

We must be cautious not to end up as the evaluators of the Israeli army. A good return in the past few years combined with apparently robust investment processes do not validate past decisions, and do not ensure that optimal long-run capital allocation decisions will be carried out in the future.

In analyzing long periods, limiting fatal mistakes tends to be much more important than being frequently (albeit not always) right. We should not forget the examples of investors who were capable of generating long and impeccable track records, but in the end threw it all away in one single year of significant errors.

In our activity, paranoia, insecurity and the notion that success will never be fully achieved are essential conditions for survival over the long term. We cannot run the risk of seeing only what we want to see at the expense of reality.

**"Deep down you may still be that same great kid you used to be. But it's not who you are underneath, it's what you do that defines you."**<sup>9</sup>

The capacity to create and maintain a culture concerned with capital preservation should be a key factor towards avoiding big mistakes. In this sense, our ability to retain the people who have already become part of the project and share our values will be our greatest challenge. Investment research is continuous, gradual and time intensive, which increases the importance of preserving both the individual and collective memories. So far, we are happy with the work that has been done. All the partners that started out in the fund remain at Atmos, and this year we upgraded another member of the team to the partnership.

The team's orientation must always be the cooperative game towards common objectives, with no space for specific positions of "stardom". As a result, we seek to prevent personal interests from influencing decisions of portfolio management, encouraging an ego-free environment, with ample openness for debate.

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<sup>8</sup> In Brazil, to make matters worse, there are few companies with stable cash flow and significant liquidity trading in the local market (different from the examples given by Buffett pertaining to "Graham-Doddsville"), making the portfolios of funds with similar mandates relatively similar

<sup>9</sup> Rachel Dawes, *Batman Begins* (2005)

Meanwhile, in order to maintain the research team focused on fundamentals and avoid emotional judgment, our emphasis will always be on processes instead of results, allowing mistakes to be understood as an indispensable tool for the improvement of investment decision-making. These features, in our opinion, preserve the capacity to work rationally and at the same time help sustain the team.

However, only after weathering adverse market situations, which pertain to every long walk, will it be possible to judge more clearly our capacity to preserve our principles. Afterall, "everybody has a plan 'till they get punched in the mouth"<sup>10</sup>

## Perspectives for 2013

In our last letter, we wrote about the perception that in a world of low real interest rates, paying a little more for cash-generating quality companies looked like an interesting investment. In an effort to soothe losses in adverse scenarios, we had a relevant portion of the fund allocated in cash and a little more activity in rebalancing the portfolio.

Six months later, following a steep rise in the premia being paid for the more attractive quality companies with apparently growing results, and amid an environment of worsening growth perspectives and worsening inflation in Brazil, it is harder to maintain this strategy. The macro environment and the atypical capital flows have contributed to make the task of allocating capital even harder. We live in a world hungry for assets with yield and inflation protection.

The current portfolio expresses some of this sentiment. The fund has never been so diversified, and despite the fact that the core positions in the portfolio continue being good businesses, we have increased our exposure to businesses where the "government risk" seems to already have been incorporated to stock prices and to more stable/cash-generating companies with little growth implicit in prices paid. Moreover, our cash position continues very near to its upper limit of 30% of the total assets under management.

At this moment, we believe it is more important to protect the portfolio than to attempt to become some sort of upside-seeking hero. We are willing to wait for more interesting opportunities in order to start advancing yet again.

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<sup>10</sup>Mike Tyson in response to a reporter, when asked about the strategy of his opponent