Atmos CAPITAL

“CHAINS OF HABIT ARE TOO LIGHT TO BE FELT UNTIL THEY ARE TOO HEAVY TO BE BROKEN”[1]

When working with the aid of a map the chances of arriving at the wrong location are small. That object supposedly serves as a guarantee that the correct destination will be reached. The natural and immediate reaction is to focus on the charted course, thus increasing the odds of a good execution. The risk is to execute perfectly the wrong task.

On January 5, 2013, Sabine Moreau left her home in Solre-sur-Sambre in order to pick up a friend at the Brussels train station. It was supposed to be a short 80km ride, but it ended up being a long journey. Without questioning her GPS, Sabine crossed six countries, read traffic signs in multiple languages and stopped several times to rest and refuel her car. In the end, she arrived 1,300km away from her destination, in Croatia. She said: “I saw all the traffic signs. First in French, then German and finally in Croatian. But I did not ask myself any questions. I was just distracted, so I kept my foot on the accelerator. I only noticed that there was something wrong when suddenly I arrived at Zagreb and realized I was no longer in Belgium.”[2]

In a world awash with information, many activities demand concentration, then training and repeating exhaustively the same task. Often, this seems to be the only way to evolve and reach one's goals through time. In the investment realm, this type of obsession can lead to significant gains at specific moments, but we are doubtful whether it constitutes the best way of generating consistent, long-term results.

The collapse of the so-called Nifty-Fifty companies in the U.S. stock market marked a watershed in the past century, coming to show yet again that trusting a map blindly, although very comfortable, can lead to undesired destinations.

Nifty-Fifty

Nifty-Fifty was an informal term used to describe the favorite stocks of institutional investors in the 1960s. These stocks represented companies that had fantastic track records, stable cash flows and substantial dividend growth since World War II. As time went by, these companies' expected results became ever more optimistic, and it seemed obvious to many that the prices of the securities representing the Nifty-Fifty group could only go up. Investors were comfortable buying these stocks at increasingly high multiples, which surged to 30, 40, 50... times earnings. The possibility of quickly multiplying one’s net worth made the U.S. middle class move its savings toward the fledgling mutual funds industry. During this period, these funds' total assets under management grew from US$2.5 billion at the beginning of the cycle to about US$56 billion at the peak of the cycle (these figures are not adjusted for inflation to today's values).

In the mid-1970s, when it seemed like nothing could go wrong, this trend was bucked. As the Nifty-Fifty's shares sharply tumbled, junk bonds, which had been all but forgotten, initiated a historical rally. The stocks of the surviving Nifty-Fifty group took almost a quarter of a century to go back to their original prices, a time frame that might be considered too long even for the most patient of investors.

The original theory that top-quality companies would eventually turn out to be good investments regardless of the price paid for such businesses showed once again that exuberant extrapolations ad infinitum generally end badly.

1 Warren E. Buffett

2 http://www.telegraph.co.uk/news/worldnews/europe/belgium/9798779/GPS-failure-leaves-Belgian-woman-in-Zagreb-two-days-later.html

An excessive focus on one particular investment theme ends up contributing to speculative imbalances. The assets that featured good returns in the past attract more capital, which further raises their prices. Furthermore, the specialists, by definition, preclude themselves from searching for opportunities outside of their specific research-niche, and even if a manager acknowledges the existence of better alternatives in other markets, it is difficult to overcome one's own sales pitch to the original investor base. More often than not, managers commit to the (perhaps unattainable) task of successfully repeating the same strategy.

Changing habits and routines is one of the main difficulties of human beings: "Inertia is the strongest force in the universe"[3]. However, for those seeking consistent long-term results, reflecting on how to protect from what might be considered a “focus trap” is absolutely indispensable.

“A GENERALIST TREATS WHAT HE THINKS YOU HAVE. A SPECIALIST THINKS YOU HAVE WHAT HE TREATS”[4]

In theory, the possibility of rebalancing among asset classes allows an investor to better capitalize on market cycles. The trade-off is that the investment universe becomes almost infinite in size.

In the past few years, we have been continually discussing how to increase our scope without compromising the team's alignment and how the fund’s day-to-day management is conducted. Defining a circle of competence and sticking to it is always the easiest solution, but the incapacity to expand it may bring disproportionate risks in the long run, not to mention the problems that might accrue from having to alter the traced path exactly in the moment when change is inevitable.

It has been a while since we started dedicating part of our research to international companies. In some way or another, a large chunk of local businesses are affected by the large multinationals. Besides, in countries such as the United States, a host of industries and companies have already been through situations that are similar to those going on in modern-day Brazil. Analyzing the competitive dynamics of Brazilian companies without sifting diligently through what is happening around the world would be like trying to play chess on a backgammon board.

The transition from the purely analytical model described above toward effectively investing in international companies was natural. The final push came from a regulatory change that allowed local funds to allocate part of their portfolios in assets outside Brazil.

The exposure to these assets is still very low and the contribution thus far is hardly relevant to the fund’s accumulated performance. We have expanded our circle of competence, concentrating the research primarily on large global consumer staples companies, all of which feature common characteristic: well-known brands, strong competitive advantages, stable cash generation and globally diversified revenue. Most of them have relevant operations in Brazil, or are somehow linked to Brazilian companies.

There is a belief that residing in the same location as the invested company makes up a relevant informational advantage. We are a little skeptical about this piece of popular investment wisdom. For example, currently less than 25% of the operating income at Coca-Cola comes from the United States. It is not clear whether an investor in New York will have an edge over another in Rio de Janeiro, London or even in the interior of China. Another case is that of AB-Inbev, which is based in Belgium and headquartered in New York. It is mainly managed by Brazilian executives who came from Ambev, whose trajectories we have been following for a long time.

Undoubtedly, the detailed research process that seeks multiple sources of information is important in the investment process, but it is not a necessary ticket toward success. The idea that participating in an information treasure hunt raises the likelihood of achieving good results in proportion to the expended effort may be merely illusory. The conviction generated by this sensation might even be dangerous. Understanding the culture, track record and in what part of the business-cycle a company is, seems to us more important than any marginal information. Lastly, our goal is to generate good absolute returns, rather than to beat the performance of the international market or any other stock-market index. In this sense, the simple opportunity of diversifying the fund’s allocation over to markets

3 Anonymous

4 Anonymous

where we believe that the probability of incurring in a permanent loss of capital is smaller, can be an important tool to improve long-term returns.

"WE THINK THAT THE INEVITABLE WILL OCCURR AND WE END UP FACING THE UNEXPECTED"[5]

During the past four years the outlook for Brazil took a drastic negative turn, albeit the companies pegged to domestic consumption having performed extremely well. Moreover, unfortunately, the country had not use its previous bonanza to do some of its long overdue institutional homework.

The 2008 world economic meltdown removed any embarrassment the government might have had in the past to seek alternatives to the more orthodox economic model that had been in force up to that moment, and we ended up seeing a turn toward a "structuralist economics" framework. The changes worked for some time and the apparent success fed the fantasy that the government could play the leading role in inducing growth.

The model favoring consumption growth seems to have reached its limit. In order for the country to return to a prosperous path gaining productivity is imperative. This new step demands sacrifices and costly political decisions in the short run. This is not trivial for any government and history shows that these only change direction once they have clearly hit a wall.

As in all Darwinian processes, the most radical of technocrats have been selected for the country's most important positions. The amount of questionable policies that have been implemented since, seem like scenes straight out of a tongue-in-cheek comedy: changes in the bidding model for oil fields, an industrial policy of "national champions" led by BNDES, an explosion in public credit, concession auctions focused on the electoral-picture with no concern with actual delivery, creative accounting for fiscal accounts, disregard for the inflation target, educational credit focused on quantity without commitment to quality, and a lot more.

A government that makes bad decisions increases significantly the dispersion of scenarios, and therefore, protecting the fund from significant losses has been a big challenge. A few years of good results were enough for the Brazilian "Nifty-Twenty" to trade at extremely high multiples. The recent reversal in the prices of these assets seems to be merely a correction of past excesses.

Nowadays, a negative perception of the Brazilian economy and of Brazilian institutions is almost unanimous. Although it has become common investment-management practice to diverge from the consensus, this was not a good strategy while the country was improving, and we do not see grounds for it being any different now. This way, the possibility of allocating capital outside Brazil seems like a very worthy alternative.

On the other hand, the long-term potential of the country remains intact and when the negative scenario seems inevitable, the unexpected might happen.

5 Fernando Henrique Cardoso