"ALL POWER CORRUPTS, BUT POWERPOINT CORRUPTS ABSOLUTELY"[1]

Picture Warren Buffett and Charlie Munger leaving dinner in Omaha in the 1970's. As they step out of the restaurant, they bump into Marty McFly leaning against his Delorean, offering a ride to the future, more specifically to 2014. During the trip, Warren unwillingly spills a can of Cherry Coke on the car's circuits. After a strong flash of light, while Munger is dropped off in Wall Street, Buffett ends up in Rio de Janeiro's Leblon neighborhood. Still disoriented, he steps into a restaurant packed with khaki-pants-wearing young professionals and, upon starting a conversation, finds out they are asset managers. Buffett's eyes sparkle, especially when one of them cites the Oracle of Omaha as the main inspiration of the neighborhood. One week later, Marty McFly manages to fix the Delorean and rescues the two elders-to-be. When Warren and Charlie reunite, they immediately start talking about their experiences and reach an unexpected conclusion: who would have guessed that in 2014 there would be more value investors in Rio de Janeiro than on Wall Street!

In Brazil, the growth in the number of equity funds has by far exceeded the number of companies available for investments. In their quest for some differentiation, it is natural that analysts excitedly seek to amass as much information as possible on the companies and industries present in the market. This attitude, which we have already dubbed as an "informational treasure hunt", seems to have turned into a full-blown competition, with a greater emphasis placed on *perspiration* rather than on *inspiration*.

This accumulation of information, when combined with the feeling of hard work, can lead to a state of excessive confidence. In this process, the ability to reflect tends to be renounced in favor of the construction of a story that is orderly, clean, and coherent. The process of constructing an "investment case", inherited from Harvard Business School and investment bankers, transforms the research process into a Hollywood-like-script, with a beginning, middle and end. In order to show diligence, even the risks are pointed out as necessary components of the plot, although softened as though they were part of a distant planet or completely under control. Rumsfeld's dictum is widely ignored: "(...) there are things that we now know we don't know. But there are also unknown unknowns. There are things we do not know we don't know."[2]

Given that reality is awash with incomplete information, we prefer knowledge to be built organically, often through unimagined paths. In our opinion, one should not seek supposed equilibria through linear and finite processes, but instead concede that the research process is complex, adaptive and occurs in conditions that are essentially "out-of-equilibrium"[3]. In many cases the generation of new ideas or a differentiated perception of risk results from dedicating time to themes that are hardly related to the specific case at hand. However, the construction of this "intangible asset" is usually discouraged in a metric-obsessed industry, where the demonstration of effort and knowledge of details is more appreciated than the real comprehension of the risks inherent to investing in a company.

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[1] Malcolm Gladwell's adaptation to the famous quote attributed to Lord Acton, 19th century British politician and historian: "Power tends to corrupt, and absolute power corrupts absolutely."

[2] Donald Rumsfeld

[3] Here, we borrowed and adapted terms and ideas from Complexity Science's literature, whereby a "complex adaptive system" is defined as a "macroscopic order" emerging from the interactions of similar and interconnected micro-structures. Such systems are essentially dynamic and their interaction with the external environment differs from what would be the interaction of the mere sum of the parts that compose them. In turn, "complex adaptive systems" are molded and adapted in "far-from-equilibrium" conditions, on the so-called "edge of chaos"

Strength, knowledge & wood

Once upon a time, an experienced lumberjack was challenged by a young man. The competition drew the attention of everyone in the area. The consensus belief was that the "old man" did not stand a chance against the great physical advantage of the challenger. Right from the outset the young man took on the task with great energy and focus, cutting trees like never before, certain that he would be the winner. From time to time, he looked to the side and smiled as he saw his "lazy" opponent sitting with the axe on his lap. In the end, everyone was taken aback. The old woodcutter had won by a significant margin. Puzzled and disconsolate, the young man exclaimed:

- This makes no sense! How can you have cut more trees than me? I worked non-stop and at several times saw you resting!

- You are mistaken – the winner replied – I was not resting... I was just sharpening my axe.

"WHENEVER A THEORY APPEARS TO YOU AS THE ONLY POSSIBLE ONE, TAKE THIS AS A SIGN THAT YOU HAVE NEITHER UNDERSTOOD THE THEORY NOR THE PROBLEM WHICH IT WAS INTENDED TO SOLVE"[4]

Similar to our lack of belief in a pre-determined script while evaluating companies, we also consider agnosticism in capital allocation a necessary precondition to building a long track record of superior returns. The philosophical pillars of value investing such as margin of safety, discipline, patience and the capacity to maintain a long-term view, should not be forgotten. However, these very concepts can be applied to different asset classes.

In practice, this idea is received with a lot of resistance primarily due to the institutional arrangement most allocators and investors are part of. Funds are rigidly pigeonholed in accordance with their managers' specialties, and any deviation from the designated strategy is considered heretical. Thus, the funds' need to adapt to the fundamentally cyclical nature of the market is not respected.

A superficial assessment of Warren Buffett would define him as a monothematic investor. However, a deeper look at his track record reveals a much more complex and interesting style of investing. While Buffett is currently famous for being an investor focused on quality companies, during the beginning of his career in the 1950s and 1960s, he bought Graham-style "cigar butts"[5]. In the 1980s, he practiced "risk arbitrage"[6] on the back of the LBO[7] wave, and in the following decade built positions in global currencies. Still during this period, while championing investments in stocks due to fear of runaway inflation, he also invested in long-term bonds. From the 2008 crisis on, he surprised the market by buying convertible preferred shares of Goldman Sachs and Bank of America. The list goes on...

Naturally, the investment in shares of companies (public and private) accounts for the greatest contribution to Buffett's returns. However, by dynamically allocating capital to other asset classes, defined by Buffett himself as something close to "cash-parking", he avoided committing fatal mistakes such as investing in stocks at sub-optimal returns. In his 1988 letter, commenting on his arbitrage activities during that period, Buffett opened by saying: "(...) We prefer, of course, to make major long-term commitments, but we often have more cash than good ideas. At such times, arbitrage sometimes promises much greater returns than Treasury Bills and, equally important, cools any temptation we may have to relax our standards for long-term investments."[8]

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[4] Karl Popper, British philosopher

[5] Term utilized by value investors to describe the shares of low quality, heavily discounted companies, which trade at a fraction of their net working capital. The inability to pass inflation on to consumers and the low returns on capital employed mean that investments in such shares will result in poor returns to shareholders if held for long periods. However, given the cheap valuation, if certain catalysts occur (such as the return of part of the capital by means of aggressive buybacks or distributions of extraordinary dividends) the investment may yield interesting returns. Hence the term "cigar butt": If one commits to such businesses for long periods of time, they will most probably turn out to be horrible investments. But they can always bring a satisfactory "last puff", such as that at the end of a cigar

[6] "Risk arbitrage" here deals solely with equity transactions made in advance of relevant corporate events (mergers and acquisitions)

[7] Leveraged Buyouts: Highly leveraged purchase of control of a company

[8] Extended quote from the 1988 Berkshire Hathaway letter, "Arbitrage" section: "In past reports we have told you that our insurance subsidiaries sometimes engage in arbitrage as an alternative to holding short-term cash equivalents. We prefer, of course, to make major long-term commitments, but we often have more cash than good ideas. At such times, arbitrage sometimes promises much greater returns than Treasury Bills and, equally important, cools any temptation we may have to relax our standards for long-term investments. (Charlie's sign off after we've talked about an arbitrage commitment is usually: 'Okay, at least it will keep you out of bars.')"

As a counterpoint to a flexible investment mandate, some funds and investors with near-monothematic strategies in listed companies in Brazil had exceptional returns in the past 15-20 years, a length of time that is almost unexceptionable. However, it must be noted that within this period, Brazil saw a sharp decline in long-term interest rates. In the past 20 years, the CDI (overnight interbank deposit rate) returned approximately 11.5% per annum, in dollar terms[9]. If the possibility of investing in the NTN-B (the Brazilian long-term/fixed-rate government security linked to inflation) existed at the beginning of this period, one could probably have fetched a similar return to many of these funds.

This does not amount to any type of demerit. Exposing oneself to long duration assets during a paleolithic period, in terms of governance for both companies and the government, while still reaching the finish line alive, represents enormous success. Avoiding the traps that led to the permanent destruction of capital during the crises that occurred during this period was certainly a difficult task.

However, trying to replicate a strategy with historical long-term success, albeit tempting, may not be the best alternative. Our basic premise is the fact that specific investment processes that lead to good results in a determined period should not be repeated without thought. Many of the return idiosyncrasies between certain asset classes, or tranches of the capital structure, stem exactly from the rarity of flexible mandates. For example, the bonds of some Brazilian construction companies recently traded at a 20% Yield to Maturity (YTM), while banks negotiated at twice their book value. Without delving into banks' profit retention rates and the marginal returns on such profits, the relevant exposure of their credit portfolios to large Brazilian companies and consequently, to the possibility of systemic default, indicates that one of them should be wrong. In fact, as one of Brazil's most successful investment managers says: "Equity analysts are from Mars, fixed income analysts are from Venus."

"SELF-INTEREST GOT OUT OF HAND. IT CREATED A BOTTOM-LINE SOCIETY IN WHICH SUCCESS IS MEASURED IN MONETARY TERMS. DOLLARS BECAME THE COIN OF THE NEW REALM. UNCHECKED MARKET FORCES OVERWHELMED TRADITIONAL STANDARDS OF PROFESSIONAL CONDUCT, DEVELOPED OVER CENTURIES"[10]

Notwithstanding a few exceptional investors, the quest for a more flexible mandate demands a team with a considerable number of people. Despite the multiplication of knowledge, the difficulty in obtaining good long-term returns by means of a collective effort is extremely underestimated. The potential for friction and deviations is incalculable and unfortunately quite a common route. If it is already difficult to admit mistakes, change opinions and express these changes in the portfolio in an individual manner, carrying out such tasks as a group is even more complex.

Similarly, in addition to the importance of a team comprised of people with different skills and personalities, it is vital that the group act cooperatively and, above all, comprehend that results can only be evaluated across several years. That is a difficult task, given the ease with which each individual tends to overstate the importance of his or her competencies; feeling entitled to be rewarded semi-annually instead of after several decades.

That is why we are skeptical with regards to strictly quantitative and supposedly measurable rules of compensation. Multi-million dollar bonuses originating from individual contributions measured in the short term (very often due simply to the market's cyclicality) tend to generate more friction than benefits[11]. When one deals with other people's money, the work

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[9] From 12/31/1994 to 12/31/2014. Source: Bloomberg

[10] John Bogle, founder of Vanguard. The following link presents the original article, "A Crisis of Ethic Proportions": http://www.wsj.com/articles/SB124027114694536997

[11] Michael Sandell, in his book "What Money Can't Buy," discusses how the sense of collective reciprocity is corrupted when every relationship is based strictly on economic terms. Blood donation is a classic example: in the British system, where donations were not paid, the quantity and quality of blood exceeded by a wide margin the blood donated in the U.S., where until recently donations were paid for. The financial payment generated perverse incentives for ineligible donors to lie about their background just to receive the promised compensation. Besides, the prevalence of the market-oriented logic utilized weakened the selfless motivation of donors uninterested in payments. Providing a fiduciary service such as allocating other people's capital also seems to us, in the first place, an essentially moral activity. Any attempt to "align" such an activity in an extremely "pecuniary" way can be very dangerous. In the following link follows more data on paid vs. non-paid blood donation: http://www.who.int/bloodsafety/publications/9789241599696_eng.pdf

relationship must be guided, essentially, by ethical principles. By creating a strictly market-related relationship for our profession, one ends up having a hard time attracting individuals led by these values. For example, why work arduously if the fund is below the high water mark and an eventual bonus seems far away? It is better to change jobs than to worry about recovering the investor's money.

We have built our team slowly and organically, designing the partnership with the aim of easing adherence to the aforementioned values. Any marginal benefit from a larger team set up hastily would be entirely outweighed by a less interconnected party. The capacity to criticize postures, make decisions collectively, discuss ideas based on arguments and not on hierarchy and debate concepts openly without the fear of admitting mistakes would be lost. The maintenance of these features, which seem simple in form but are in fact complex to execute, is our main long-term institutional challenge.

RESULTS, PART I: "RUN, RABBIT RUN / DIG THAT HOLE, FORGET THE SUN / AND WHEN AT LAST THE WORK IS DONE / DON'T SIT DOWN IT'S TIME TO DIG ANOTHER ONE"[12]

Since Atmos' inception[13] through December 31, 2014, - a period just over five years, - the fund had an annualized nominal return in Brazilian reais of 19.3%, or 12.5% in real terms. The table below summarizes key absolute and relative performance indicators.

	2009*	2010	2011	2012	2013	2014	Performance	Per Year	Volatility	Drawdown
Atmos Ações	11,95%	24,23%	6,42%	31,61%	15,39%	11,58%	**150,80%**	**19,30%**	**10,87%**	**(13,99%)**
Ibovespa	2,83%	1,05%	(18,11%)	7,40%	(15,50%)	(2,91%)	**(25,02%)**	**(5,38%)**	**22,67%**	**(38,40%)**
BM&FBovespa Small Cap	9,76%	22,74%	(16,63%)	28,66%	(15,21%)	(16,95%)	**1,76%**	**0,34%**	**18,10%**	**(34,93%)**
CDI	1,72%	9,73%	11,59%	8,41%	8,05%	10,80%	**61,66%**	**9,66%**	-	-
NTN-B 2045	5,19%	27,40%	12,26%	40,83%	(23,33%)	18,15%	**91,90%**	**13,33%**	**13,30%**	**(30,75%)**

* From fund's inception on 10/15/2009

Although the numbers above paint a positive picture, this period is not sufficiently long for congratulatory remarks. Cycles usually work as levers of good results and it takes only one significant mistake to spoil the long term compounding of returns. "The game isn't over until it's over", or in our case, when capital is returned to investors.

Over the last few years, Brazil went through a turbulent period, disproportionately affecting lower-quality companies that could not pass inflation on to consumers and that customarily suffer relevant impacts in their businesses in more difficult times. In addition, the commodities industry was heavily impacted by unwise capital allocation decisions and China's slowdown. Simply avoiding these two sub-groups would have been enough to highlight our returns when compared to the performance of the Ibovespa, or even that of the Small Caps index. However, our aversion to projects, M&A stories with eye-catching synergies, operationally leveraged industries and government-dependent businesses, also contributed significantly to our relative performance, given the enormous destruction of value these companies underwent during this period.

We believe it is more important to concentrate one's study on risk assessment and on the potential for loss in adverse scenarios than to try to estimate the potential for gain under optimistic circumstances. Although we have no prejudice toward investing in riskier investment cases, we limit not only the size of the position but also the number of investments of this kind. This discipline has largely steered us away from the examples mentioned above. The chart below illustrates this issue, as it demonstrates the diversification of positive contributions to our returns and the low number of losses in the fund's performance. "I think part of the popularity of Berkshire Hathaway is that we look like people who have found a trick. It's not brilliance. It's just avoiding stupidity."[14]

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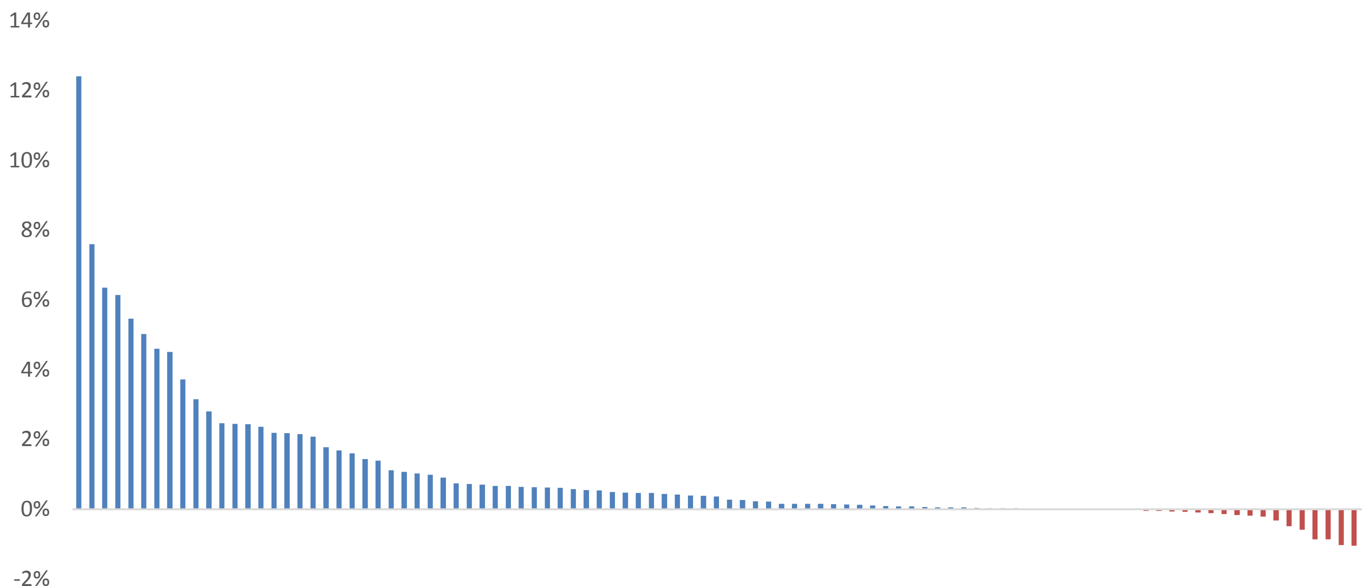
[12] Quote from the song "Breathe" by the British band Pink Floyd
[13] Beginning of Atmos Ações on 10/15/2009
[14] Charlie Munger



Gross performance attribution by company - from 10/15/2009 to 12/31/2014

RESULTS, PART II: "LIVING IS EASY WITH EYES CLOSED, MISUNDERSTANDING ALL YOU SEE"[15]

The need to constantly avoiding traps, combined with a market that has been "anemic" in new companies, has pushed us towards other asset classes. In this movement, we do not seek to produce extraordinary results but rather to decrease the portfolio's risk and capitalize on relevant payoff discrepancies when compared to our main activity of investing in Brazilian stocks.

From 2012 on, we started to invest in global companies[16]. In 2014, we invested in inflation-linked government securities and allocated part of our cash position in US dollars. We consider the cash position an option to allocate capital in the future with less risk of permanent impairments. In this manner, having part of the cash parked in "hard currency" with low inflation offers greater protection when compared to keeping it in local currency. Speculation is to invest cash in reais at a level that is far from long-term equilibrium, simply because of the high interest rates the country presents, instead of giving up the high rates in order to protect capital. This whole process always targets decreasing the risk of considerable losses to the fund.

Every comparison between investments depends on the price paid, but in theory (omitting the fact that in Latin America reality can sometimes be more creative than fiction): (i) investing in stable companies in a fragile institutional framework is riskier than investing in stable companies in developed countries; (ii) investing in a company's bonds is less risky than buying its stock[17]; (iii) allocating capital directly in dollars is less risky than investing in commodity companies with the expectation that a sharp currency devaluation will improve its operating margins; and (iv) investing in fixed-income securities linked to inflation is less risky than investing in regulated companies that have inflation-pegged revenues, but which might eventually be subject to breaches of contract and changes in the legal framework. Equity managers who have rigid mandates but can identify opportunities outside their specific asset class end up forced to use stocks as the only investment vehicle with which to express all of their opinions. However, as exposed, this leads to a risk-return relationship that is far less favorable to the long-term investor.

[15] Quote from "Strawberry Fields Forever" by the British band The Beatles

[16] The rationale behind this decision is discussed deeply in our 9th letter: "The 'focus trap' and international investment"

[17] Although we are generalizing for all cases, this specific case deserves a caveat. For high-quality companies with wide capacity to pass on price increases, when there is a relevant risk of runaway inflation, equities are much safer than bonds (and especially much safer than fixed-rate notes with very long durations)

We enjoy the freedom to seek alternatives outside of our main activity, which is investing in stocks, and the ability to use direct instruments when they are available. Recently, we carried out our first investment in corporate bonds. We are attracted by notes issued abroad by some Brazilian companies, whose implicit returns seem more interesting than more junior options within the capital structure. We think it is pivotal that this process always be marked by a certain gradualism and pre-established limits. However, in a country like Brazil, which is strapped for quality companies, this intellectual growth-process may prove necessary to our survival and ability to deliver good returns in the long run.

We do not want to sound repetitive, but all investment alternatives that we look at are relative to investment opportunities in Brazilian equities, and we have no intention to try to time the market. As a result, the fund's volatility should continue to be equivalent to that of a traditional equity fund. At the end of the day, our rationale regarding greater investment management flexibility derives from a simple idea: as you add the "opportunity cost" to the portfolio, a theoretical relationship starts to be represented in practice. Here is what Warren Buffett had to say on the matter in his 2014 letter to shareholders: "(...) a broad range of options always sharpens decision-making."

The table below shows how the most important contribution to the fund's performance came predominantly from investments in Brazilian equities, even in the most recent period. However, as we have stressed in this letter, the flexibility to allocate capital in other asset classes will remain an important tool to improve the fund's risk profile and prevent us from relaxing our demanded long-term investment standards.

Atmos Ações' Performance Attribution	2009*	2010	2011	2012	2013	2014	2015**
Brazilian Equities	12,64%	23,33%	6,52%	28,55%	11,28%	7,95%	7,48%
Cash (CDI)	0,42%	2,61%	3,14%	2,32%	1,54%	0,79%	0,53%
Index Hedge	(0,28%)	(0,77%)	(0,18%)	(0,05%)	(0,10%)	2,01%	(0,07%)
Currency Hedge	-	(0,13%)	(0,29%)	(0,01%)	0,11%	(0,62%)	2,10%
Global Equities	-	-	-	0,45%	4,29%	2,66%	1,77%
Government Long-term Bonds	-	-	-	-	-	0,99%	0,07%
Corporate Bonds	-	-	-	-	-	-	0,06%

Atmos Ações' gross performance attribution per year in Brazilian reais. We calculate it as the sum of all assets' daily attributions, and therefore the effects of compounding aren't taken into account

* From fund's inception on 10/15/2009

**On this table we are displaying, as an exception, 2015's first quarter (from 01/02/2015 to 03/31/2015) to demonstrate the importance of different asset classes in the beginning of the year