Atmos CAPITAL

"BECOME INDEPENDENT OF THE GOOD OPINION OF OTHERS"[1]

Ambev, the most successful Brazilian corporation of the past few decades, was unabashedly built on copying existing models and using international benchmarks. Today, ironically, the company is the target of an unbridled search for its own imitation. Any variation of its management model seems almost heretical.

One of the most remarkable features of the company, which stems from a model used at most investment banks, is the utilization of an operational meritocracy. People are assessed by clearly identifiable targets and rise within the company as these are met.

However, reflection is necessary even when copying something. If on one hand the theoretical concept of meritocracy seems unquestionable, its implementation is by no means simple. Many fail after not realizing that the brewing business has features that facilitate this type of management. This is a resilient business, with high margins in most parts of the world and low volatility. These factors allow a greater capacity to measure results, with some assertiveness, in short periods.

When interpreting a story, the trend is to stick to a restricted number of measurable variables and assign them a higher weight. Ambev is the result of years of development of a slowly built and almost irreplicable culture, and its meritocratic management method is just one of the factors behind its great success. The elements that constitute a culture do not fit in an equation, and can't be methodically assessed. "Not everything that counts can be counted, and not everything that can be counted counts."[2]

"CULTURE EATS STRATEGY FOR BREAKFAST"[3]

Currently, any departure from a "modern" management model seems to indicate that the business is outdated. Aggressive meritocracy, zero-based budgeting, target setting, stock option plans, and the icing on the cake, hiring former Ambev employees, seem to be the only path to success for Brazilian companies.

A classic target for the use of the "Ambev 101" playbook are family-owned companies. The possibility of being an agent that inducts change to these businesses is very tempting. For those who attempt this game, meteoric careers are available as well as the possibility of quick and large rewards. On the other hand, that which is good for the individual who improves results in the short run may not necessarily be good for the company or its shareholders with longer-term investment horizons. If anything, five years is a long time in the life of an executive, but is hardly significant for the intrinsic value of a business.

[1] Abraham Harold Maslow, U.S.-born psychologist
[2] Some sources attribute this sentence to William Bruce Cameron, U.S.-born sociologist. The quote first appeared in his 1963 paper, "Informal Sociology: A Casual Introduction to Sociological Thinking"
[3] Peter Drucker, management guru

Schlitz

In 1933, as Prohibition came to an end in the U.S., Schlitz became the best-selling beer in the country. It remained the leader for almost 20 years through constant innovation in packaging, marketing strategy and distribution. From the beginning of the 1950s Budweiser started to share the market's leadership with Schlitz, taking over the position in 1957 after a strike at Schlitz.

In 1970, with production at its capacity limit, Schlitz sought a quick rise in profitability and changed its production process: it reduced the brewing time, increasing capacity without making new investments and, at the same time, replaced some ingredients with lower-quality equivalents.

These measures boosted short-term results and the company beat its previous sales record in 1974. However, consumers slowly noticed the drop in quality and abandoned the brand. Schlitz was sold in the 1980s for a fraction of its market value during its golden era and fell into oblivion.

At the most successful family-owned companies, the partners hold a long-term view of the business. These companies are built around the personality of an entrepreneur and their culture reflects his features. Amid this environment, in each generation one of the members of the family usually presents himself as a sort of “cultural bastion.” Wal-Mart is an emblematic case where a specific culture is maintained through the leadership of Sam Walton's heirs in the board of directors. Even Warren Buffett, who shows great aversion to any type of nepotism, nominated his son Howard for the position of chairman of the board of directors of Berkshire Hathaway after his death.

The desire of perpetuation often works as a powerful instrument for the company's own continuity, even if, in some situations, the trade-off can be a reduction in short-term efficiency. The attempt to break abruptly with these features may irremediably destabilize the essence of the business[4].

“ONE TRICK PONY”

Upon acquiring the control of a company, financial investors often concentrate on two sources of value creation: optimization of the capital structure and search for operational gains. Even though these investors often manage to obtain good returns, we hardly see them building a successful case with permanent operational gains.

Building a culture when the objective of the shareholder is to exit the business, preferably as soon as possible, is no easy task.

Sometimes the wisdom pertaining to what is possible to achieve in a short period of time is found in the least expected of places, such as in an ad for a car repair shop: “Here we do three types of work: good, cheap and fast. Our client can only pick two. If it is good and cheap, it won’t be fast, if it is cheap and fast it won't be good, if it is fast and good, it won’t be cheap!” The process of implementing a good culture is hard: the necessary work is never cheap, and certainly not fast.

Making matters even more complex, in many cases of “corporate engineering” a series of acquisitions are made with the objective of increasing the size of the business quickly en route to an IPO or follow-on offering. Normally, the obvious line of argumentation utilized to give credibility to such transactions is that of margin gains accruing from economies of scale. All this M&A activity in immature companies reminds us of the analogy of the individual who tries to change the tire of a VW Beetle running at 200 km/h. If the objective is reached, the case will be published in the Guinness Book of World Records. However, the chance of collapse at some point before the finish line is huge. We can't help and remember the famous cliché phrase: “They did not know it was impossible, so they did… *La Merde*!”[5]

Many people may not remember this, but it took Brahma (the predecessor of Ambev) almost 10 years to make its first major acquisition. Plenty of time to form a culture and a competent team of executives aligned with the construction of the business.

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[4] *“A system which is efficient in the static sense at every point in time can be inferior to a system which is never efficient in this sense, because the reason for its static inefficiency can be the driver for its long-term performance.”* – Schumpeter (1942)

[5] Atmos adaptation to the famous quote attributed to Mark Twain and Jean Cocteau

Only at this stage of maturity does the constant search for organic growth or expansion via acquisitions start to act positively, clearing the way for new talents to keep developing their careers and to be challenged frequently. The virtuous cycle starts to act. Normally, the game is lost when one attempts to accelerate this process.

There is a certain utopia that it is possible to attract a leader (or a group of executives) only with appealing compensation packages and an alignment built contractually to avoid all obstacles. However, we find countless examples of smart, well educated, and financially aligned people who led their respective businesses to ruin by ignoring (intentionally or not) low probability events in the short term[6].

Our feeling is that a disproportionate amount of time is spent thinking about alignment strategies and *ex-post* targets, while the *ex-ante* cultural selection of people (even though it sounds “soft”) is much more relevant.

“INVERT, ALWAYS INVERT”[7]

Rules of thumb, as alluring as they are, usually work in a reduced number of cases.

Presently, the top examples of success worldwide feature a management model totally different from the current Brazilian corporate “template”. Although it has existed since the late 1970s, the model utilized by most technology companies has gained notoriety more recently as the sector has become ripe and more relevant to the global economy.

The lack of corporate rigidity in these businesses is impressive. This does not mean an absence of rules, controls and targets, but that the model of hierarchical relationship changes. It seems that the *quasi*-military legacy of control and fear is exhausted, migrating to an environment where the commitment is moral. A tutor is no longer necessary, and by transferring the responsibility to the individual, each employee becomes a despot of himself[8].

Candle Problem

Karl Duncker proposed a classic experiment in behavioral psychology in the 1940s. The problem, known as the “Candle Problem”, was quite simple: it consisted in sticking a lit candle on a corkboard without letting wax drop on the table below. To this end, in addition to the candle, participants were handed a small box full of pins and a matchbox. The solution was not trivial and some creativity was necessary for seeing in the “pin box” a second function: it could also serve as a support for the candle after it had been stuck on the wall with the pins.

This problem was adapted throughout the years, and one of its tests was polemical and quite conflicting with the motivational premises of the time: two groups were challenged to execute the task, and in one of them the participants were financially rewarded if they finished first. The experiment, repeated countless times in different situations, showed consistent and counter-intuitive results. The financially rewarded group, on average, presented lower performance when compared to the unrewarded group.[9]

Amid this new business environment, compensation is far from the only attraction and retention variable. This generation, with some contempt for traditional environments, seeks, above all, freedom, autonomy and the possibility of a significant career in terms of accomplishments.

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[6] It is interesting to note that precisely the two CEOs of the U.S. banks that were hardest hit by the 2008 crisis (Richard “Dick” Fuld of Lehman Brothers and James “Jimmy” Cayne of Bear Stearns) had much of their net worth in stocks of their respective banks

[7] Carl Gustav Jacob Jacobi, German mathematician

[8] We recommend the reading of a presentation on Netflix's culture. January article of Harvard Business Review: http://hbr.org/2014/01/how-netflix-reinvented-hr/ar/1

[9] Dan Ariely, Uri Gneezy, George Lowenstein, and Nina Mazar, who specialize in Behavioral Finance, summarized the results of the problem in a 2009 paper (“Large Stakes and Big Mistakes”, The Review of Economic Studies) in the following way: “(...) tasks that involve only physical effort are likely to benefit from increased incentives, while for tasks that include a cognitive component, such as adding numbers, there seems to be a level of incentive beyond which further increases can have detrimental effects on performance.”

"EVERYTHING SHOULD BE AS SIMPLE AS IT CAN BE, BUT NOT SIMPLER"[10]

The asset management business is highly cyclical. Measuring a fund's performance, as well as that of the team, within the bounds of a Gregorian calendar is a hard task. This is a complex environment for the utilization of a simple meritocratic model. The initial temptation is to aggressively pay those who, apparently, contributed more to the year's return. Even without meddling into the relevant issue that short periods are very prone to randomness, this form of compensation can generate a series of different distortions.

For example, paying based on the tangible result of one year may end up adversely selecting individuals more prone to risk. The cooperative environment among the team members tends to disappear, paving the way for aggressive and individualistic behavior. This simple practice makes the discussion biased and poor from a reflexive standpoint. The analyst's objective stops being a search for truth and the discussion becomes a battle to book positions in the portfolio. The capacity to admit mistakes is deconstructed.

In this industry, the game of the individual paid in the short term based on metrics is misaligned in its inception. If the result is positive, some hierarchical steps are climbed, while those who fail try to hide behind "market irrationality". In the worst scenario, jobs are changed, leaving the scar on the clients' skin.

An alternative is to acknowledge the difficulty to measure results and bring adaptations to the traditional meritocratic model. The concern becomes exclusively the evaluation of the investment processes, in detriment of measurable results. However, although well intentioned, this attempt may bring by yet other complexities. It is common to witness the beginning of a frenzied search for hardly relevant marginal information by part of analysts, in an attempt to try to demonstrate knowledge. In addition to the lost time, this amount of information with low marginal utility may end up perversely influencing the capacity to reflect.

The big question that poses itself is how do we adapt to all these problems in search of an ideal model. The immediate answer is very simple: an ideal model does not exist. Our impression is that working with a small team, sharing long-term goals and having different personalities with very similar core-values is a good path. In choosing people who find in asset management a fertile environment for discussion, for democratically studying and admitting mistakes, who respect different styles and the diversity of ideas, who take pleasure in what they do, and above all do not see compensation as the only reason to work, culture gets built almost on autopilot.

In these first four years some steps of this long journey were taken. The team has been growing slowly, respecting our belief that this effort has a natural limit. Currently our team is composed of 11 people, nine of whom dedicated to the fund's management. At the end of 2013, two of our colleagues became partners.

[10] Albert Einstein

PERSPECTIVES FOR 2014

"PRESSURE IS SOMETHING YOU FEEL WHEN YOU DON'T KNOW WHAT THE HELL YOU'RE DOING"[11]

The mistakes committed mainly in PT's (Workers' Party) second term resulted in deep bottlenecks choking growth in Brazil. Simple indicators such as the amount of reserves, primary surplus and current account deficit financed by FDI – Foreign Direct Investment – belied an unsustainable model. But while we grew based on the expansion of government spending, rising wages, income redistribution and credit growth, the market stopped pressing the government for more consistent policies. The control of public spending, structural reforms, new public concessions and the much feared privatizations were placed on the back burner.

At this moment, the story seems different. Even a government that holds a deep disbelief for the liberal template cannot ignore the pressure of the market. The executive branch had to give away marginally against its will. Interest rates that previously "could never rise past 10%", now near 11%. Concurrently, public concessions started to leave the drawing board and loans from government-owned banks slowed down.

It won't be easy to recover such a long period without reforms and investment. Regardless of who the next president will be, he will be forced to carry out difficult adjustments. It is likely that it will take the country a few years to re-encounter a more robust growth path. On the other hand, asset prices in Brazil have already started to reflect not just this scenario of slower growth, but some probability of lack of fiscal control and a significant rise in inflation. The sharp drop in prices of stocks linked to the local market in the past several months was the beginning of a correction of the previous excess of optimism.

Today it is already possible to buy good businesses at reasonable prices. We are seeking to concentrate the fund's positions on these assets and to decrease the exposure to lower quality businesses. As we conduct this rebalancing we have slowly increased our exposure, although we still maintain a significant share of the portfolio in cash and global stocks.

Although we remain cautious, we believe that even PT can alter its course of action with a strong pressure from the market. As mentioned previously, the policies and decision-making process have improved marginally, albeit not enough to speed up growth. A sluggish government is certainly better than an idle government.

[11] Peyton Manning, U.S. football player, currently a quarterback for the Denver Broncos