Part 1: Our View on Risk

The unstable political framework, the fiscal imbalance, the uneven progress of policy reforms and the doubts clouding the 2018 elections have all created a scenario of uncertainty. How many times do we see the following analysis when discussing the consequences of this scenario for investors? “Risk has declined since the beginning of 2016, but remains high. It is time to slightly increase allocation in moderate risk asset classes, such as multi-market funds (hedge funds). However, it is still too early for the Stock Market. When the social security reform and the 2018 election become clearer, investing in the Stock Market will pose less of a risk”. What is the problem with this type of rationale? From our point of view, this train of thought assesses the risk scenario without looking at its main variable - asset prices!

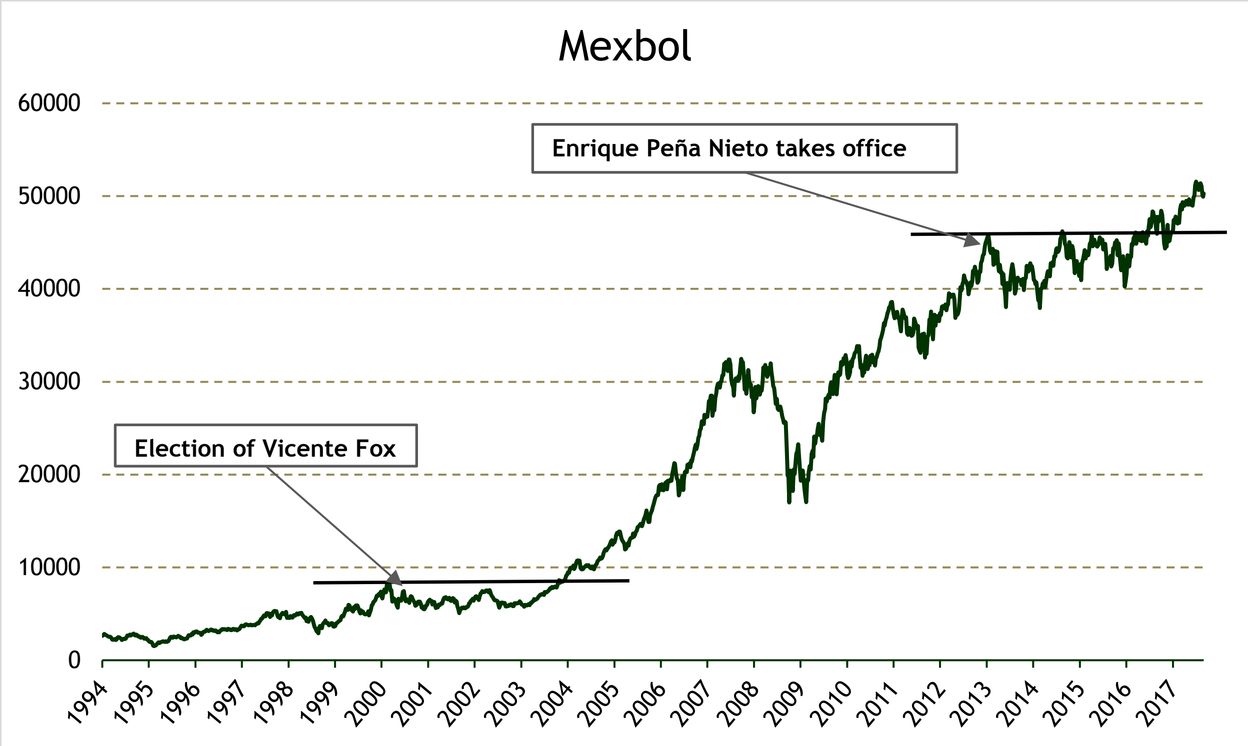
When we talk about “risk”, it is a concept can take many shapes and forms, evoking different insights from different people. In asset management, we are constantly exposed to a variety of risks that can, to some extent, affect the behavior of market players, including reputational risks, the risk of not meeting investor expectations, the risk of underperforming a particular benchmark or competitor, the risk of mismatching an investment horizon between strategy and investors, liquidity risks, and so on. Bearing all this in mind, the risk that worries us most is losing money over an acceptable horizon - which, in our case, is 3 to 5 years. Although investors have different investment horizons, if we had to simplify the definition of “risk”, it is basically the likelihood of losing money.

Within our investment horizon, we believe there are cheaper alternatives than investing in our funds if an investor wants exposure to the stock market’s directional risk and a return based on the long-term risk incurred. A passive fund charging lower fees serves this purpose well. Our work focuses on generating Alpha for our investors or, in other words, obtaining disproportional returns compared to the risks incurred. We believe that the 3 to 5 years horizon is more than sufficient to determine whether our decisions to invest in listed companies fulfilled their potential or not. In our view, an investment case that fails to produce the expected returns within this time frame is simply a wrong investment case to us.

Now, let’s focus on the current market situation. If Social Security reforms are approved and it becomes clear that the next president will be a candidate who supports the ongoing reforms (if they come to fruition), will investing in the Stock Market become more or less risky than it is now? It’s impossible to say because we only know current prices. Still, history provides several examples of how investors’ state of mind can influence their actions in similar scenarios. We have a good example right next door from Mexico's 2012 presidential elections. Like Brazil today, Mexico had - until then - been going through a long period of below-par growth compared with other emerging and Latin American economies, although it did not face as deep a recession as we did. There was a general consensus that, in order to grow the economy, Mexico needed deep structural reforms that would help increase productivity and drive GDP growth. These measures would have been hard to implement if the election had been won by a candidate with a populist agenda. This meant there was a lot of uncertainty around until President Enrique Pena Nieto won the election. He had introduced a bold reform agenda that included political, fiscal, educational, telecommunications and energy sector reforms. To put his plan into action, President Pena Nieto would have to face off against the interests of major organizations, such as the Teachers Union, and large monopolies, such as the telecommunications companies, as well as many in the political classes. In 2012, none of these reforms had been put in place and all investors had to guide them was a massively positive outlook for the future.

There are two interesting factor here. First, as far as the reforms were concerned, what happened in Mexico from 2012 on very closely matched the market's optimistic expectations. However, what no-one saw coming was the unexpected 50% slump in oil prices and that Pena Nieto would become the most unpopular President in Mexican history, after his involvement in several corruption scandals and a domestic crisis caused by the Iguala massacre. This combination of successful reforms with a series of unanticipated events, just like always happens in real-life, resulted in a level of growth that fell somewhat short of market expectations.

Second, during the first few days of 2013 after Pena Nieto's inauguration, when there was only hope, the Mexican stock market's Mexbol Index hit a 4-year peak that has only been consistently outperformed in 2017. Anyone investing at that time on a 3 to 5 years horizon was highly likely to lose money. In fact, this period of apparently reduced uncertainty posed the biggest risk to Mexico's equity investors in the last twenty years. The second highest risk window came during the first half of 2000, when Mexico was filled with hope after President Vicente Fox, a candidate who was member of the right-wing PAN party, was elected, ending left-wing PRI party's 80 year political dominance. The Mexican stock market would take almost four years to recover from that moment of euphoria.



Which lessons can the Mexican experience and many other similar episodes from the past teach us about the current situation?

We believe that if current hopes and aspirations coalesce into something more tangible before the 2018 Brazilian elections, it is quite likely that something similar will happen here. This means it is very likely that if a President with an economically conservative agenda is elected in 2018 (although nothing is certain right now), asset prices will have exceeded their "intrinsic value", in which case investments will face much bigger risks than they do today, when uncertainty is keeping feelings of euphoria under control. This does not mean that whoever invests after the 2018 elections will lose money, which was the case in Mexico. As far as investment cycles are concerned, history has some very good road signs for us but never explicitly says which path to take. We believe the Mexican experience of 2012 is a practical example of how we should handle risk modulation in a scenario of reduced uncertainty and rising euphoria.

When apparent "uncertainties" diminish and the future seems more certain, investors are filled with hope and let their imaginations run free; they start to believe in a new, more positive and permanent state of affairs, forgetting the cyclical nature of practically all variables that affect the outlook for returns. This state of mind is driven by feelings such as envy and greed, which may not be particularly edifying, but still have a significant influence on almost everybody's behavior. It is tough to see your friends or competitors earning money while you're missing out! This type of situation encourages people to take a rosier view of a less risky future, which is reflected by asset prices that continue climbing to levels well above their "intrinsic" value. This is a truly high-risk environment that makes it likelier we will lose money. Nothing goes up forever, so at some point in time, what went up must come down. During the downturn, another irrational feeling that affects us all - a disproportional aversion to loss - dominates our actions, dragging asset prices down too far. This cycle repeats. It is as though investor mood swings reflect the movement of a pendulum as it moves from one extreme to another, from depression (prices < intrinsic value), to euphoria (prices > intrinsic value) and then back to depression, with little time spent in equilibrium (prices = intrinsic value). The stronger this movement is toward either extreme, the sharper the pendulum swings back.

This behavior is well known and highly predictable, but there are at least two aspects of this that will complicate an investor's life. First, despite this pendulum-like movement, the market is not a true pendulum because the length of time it spends moving away from the point of equilibrium is completely unknown. A complete cycle could last months or even years. This means that prices can spend years, or a large share of an investors' life, above assets' "intrinsic value", which may also distorts the way we build memories of balanced parameters. Another complication is that buying an asset below its intrinsic value is easier to talk about than it is to actually do. For example, an asset's "intrinsic value" is linked to several fundamentals (management, competitive differentials, barriers to entry, etc.) that dictate a company's capacity to generate future cash flows for shareholders. However, in the real world where the future is uncertain, predicting a company's ability to generate future cash flows in the distant future is far from an exact science. Economist John Kenneth Galbraith used to say that there are two types of people who make these predictions - those who don't know, and those who don't know they don't know. We always want to be in the first group and do what we do aware that we have no clear-cut answers and that the future is a distribution of several possible scenarios with different probabilities for coming to fruition rather than a single scenario.

Even for people who believe they are consistently able to accurately predict the future, it is no easy task. In an academic paper from 1984, economists Stanley Fischer and Robert Merton offered an insightful look into how investment decisions and capital costs for companies vary as a function of changing stock prices. They said there is an ongoing interaction which means stock "price" fluctuations can change a company's fundamentals and its "intrinsic value".

Given this level of complexity, many stock market investors choose to give little weight to fundamental analysis and simply follow asset price “trends”. As discussed previously, the cycle of investors’ expectations from depression to euphoria can lead prices to continue moving away from an asset’s “intrinsic value” for a long period of time, something we usually refer to as momentum. There are many famous investors who build successful careers based entirely on identifying and capturing this phenomenon. From our standpoint, the biggest problem with this approach to investing is that it can be extremely risk-complacent when prices have far outstripped asset fundamentals.

Although we admit this is a complex and imprecise exercise, at Equitas we focus our energy and attention on trying to understand companies’ fundamentals. We believe that focusing our efforts on analyzing a limited subset of companies, whose fundamentals we can understand better than the average investor - what Warren Buffett calls the “circle of competence” - reduces the inaccuracy of our “intrinsic value” estimates. We believe that by focusing on a circle of competence, we can also increase our chances of identifying momentum and technical issues that are not linked to fundamentals and could have a short-term impact on stock prices.

Where are risks currently at?

Despite our efforts to understand the fundamentals of publicly listed companies, we believe that the ability to generate exceptional long-term risk-adjusted returns necessarily hinges on understanding the broader context within which companies operate. In other words, the economic environment. As described in our January 2017 letter looking at the various cycles we are exposed to, we believe that the Brazilian economy has reached an inflection point for a number of short-term and long-term cycles. We also described the massive potential at most of Brazil’s publicly listed companies to accelerate profits based on a blend of economic acceleration, operational leverage and a favorable competitive environment. We saw the first sign of this during the first quarter of this year when we noted average revenues, EBITDA and net profit reported by companies in our portfolio grew 2%, 7% and 19%, respectively, year on year. In the second quarter of 2017, these figures increased significantly to 7%, 23% and 75%, respectively. We believe this trend towards significantly higher profits should continue for a number of years. This is the main reason why we described that point in time, in our May 2017 letter, as an “alignment of the stars” for equities in Brazil. On the other hand, the factors that shaped this “alignment” are now understood by a much larger number of investors, leading to a strong asset price appreciation (the Ibovespa has gained 21% since our last letter in May 2017).

Well-known investor Howard Marks (founder of Oaktree Capital) descries a bull market as having three phases:

One - When a few visionaries start to believe that things will improve;

Two - When most investors realize that an improvement is happening;

Three - When everyone is convinced things will always be better.

From this standpoint, if we analyze the Brazilian market on its own, isolated from the rest of the world, it seems to us we are clearly in the second phase. This means that right now, as the conditions and outlooks we have already observed continue to improve, we are in an environment that offers reasonable returns while risks remain fairly well balanced. As political and economic uncertainty diminishes, we could find ourselves in the higher-risk third phase as 2018 progresses, like Mexico did in 2000 and 2012.

As our main concern is to protect capital, we do not have the luxury of taking a simplistic view of risk by analyzing the domestic environment outside the global context. A significant part of the Brazilian stock market's appreciation over the past 18 months has clearly been driven by international appetite for risk, which has benefitted emerging markets. Although this has been good for us, we believe it also poses one of the biggest risks we now face. While the Brazilian market is in the second phase of its bull market, international markets are apparently some way ahead of us and are deep into the third phase. The combination of political uncertainty, extremely low interest rates, synchronized growth and unusually low inflation in key economies has created an environment where people are hunting for returns and are overly willing to take risks. Howard Marks himself tackled this theme in his last two letters to stakeholders, entitled “There They Go Again... Again” and “Yet Again?”.

Despite the difficulty of predicting the future to find out if the optimistic outlook reflected by foreign asset prices is justified or not, we can see evidence investors are highly likely to take risks, which historically suggests this is a time for caution. There are plenty of indications of risk complacency: (I) high yield bonds are providing extremely low returns, consistent with historic yields of high grade bonds. (ii) expected returns from US stocks are probably close to their lowest point historically. Cyclically adjusted P/E ratios (Shiller P/E) at a threshold that was only exceeded in 1929 and 2000 (two bubbles). The market cap of US companies as a percentage of GDP, a metric commonly referenced by Warren Buffett, at its historical peak of 145% against an average of 100% from 1995-2017; (Iii) the VIX, the average implied volatility on the options market which indicates expectations of future volatility, is at historically low levels; (Iv) the valuation of the “FAANGs” (Facebook, Amazon, Apple, Netflix and

Google), which is so astronomically high it seems to indicate that investors are convinced they possess the key to the future, despite representing an industry where the only constant is change; (V) the enormous volume of capital being raised by private equity funds; and (vi) Bitcoin and other digital currencies (which may not be bubbles, but act exactly as if they are), are just some indicators that the international markets are going through a period of gluttony.

A common characteristic during periods of excess that lead to economic bubbles is people trying to rationalize atypical events. There will always be some new factor, often linked to technological progress, that will make the future seem unlike anything in the past and that justifies new patterns of thought where typically cyclical variables take on a veneer of permanence. In our view, the current discussion on how demographic shifts and globalized means of production will lead to a lasting change in the historical relationship between growth standards and inflation in key economies, is more of an attempt to rationalize these atypical conditions, rather than an indication that economic cycles have been abolished.

How should we navigate this scenario?

As asset prices are the biggest risk factor, we remain very confident of our portfolio's risk-adjusted return outlook, even if we are keeping a weather eye on the atypical external environment and the significant level of risk complacency. Our portfolio contains many companies that should benefit from the increase in domestic consumption, Brazil's economic recovery and any future decrease in political uncertainty. To protect this portfolio from seemingly improbable events that, in the event they do occur, could cause permanent capital losses, we have taken advantage of this low volatility environment to purchase cheaper insurance.

PS: In our May document, we discussed the political crisis caused by the Federal Attorney General's accusations against President Michel Temer. We warned about the risk that steps taken by leading representatives from the Federal Attorney General and the Judiciary could lead to a breakdown in legitimacy and the terrible example of State-sponsored impunity set by the Batista brothers' plea bargain agreement. We concluded that: "This game is still being played and we need a big turnaround or Brazil will lose out". The game is not over yet, but Brazil is currently showing signs of quite a turnaround...

EQUITAS

Equitas Selection FIC FIA vs Ibovespa vs IBX vs CDI

	Absolute Return (R$)				Annualized Return (R$)			
	Equitas Selection	Ibovespa	IBX	CDI	Equitas Selection	Ibovespa	IBX	CDI
Starting on (06/07/2010)	277.3%	14.1%	51.2%	110.9%	20.4%	1.9%	6.0%	11.0%
36 months	56.9%	15.6%	17.2%	43.7%	16.2%	4.9%	5.4%	12.8%
24 months	86.0%	51.9%	50.8%	27.9%	36.5%	23.3%	22.8%	13.1%
12 months	28.8%	22.3%	22.5%	12.1%				
Year (2017)	36.7%	17.6%	18.7%	7.4%				

Baseline date: 8/31/2017

Average PE - Last 12 months - Equitas Selection FIC FIA (R$ thousand): 66,303
Current PE - 31/08/2017 - Equitas Selection FIC FIA (R$ thousand): 132,963

Equitas Investment Fund Management Services Ltda.

Tel: 11 3049 3954 Fax: 11 3049 3305
fundos@equitas.com.br
www.equitas.com.br