Pedal to the metal!

In occasional letters, like this one, we try to provide our investors with insights into our investment philosophy. Because some issues are so complex or we are unable to summarize them, some of our letters have been quite long. This time, we are making life much easier for our readers. The title of the letter says everything about our current view of the economy and the position of our portfolio.

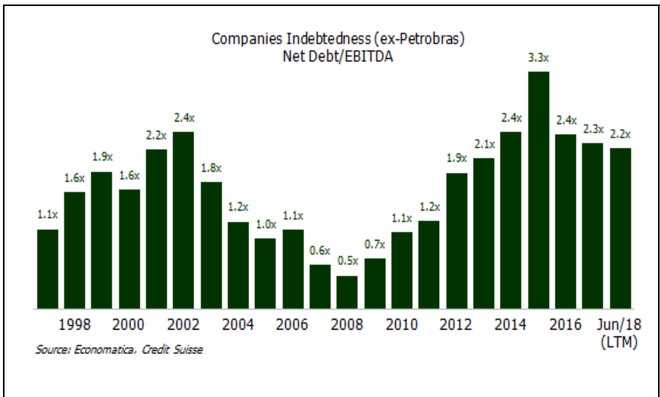
Our approach to investing offers two ways of achieving risk-adjusted performance to outperform the market in the long term. The first is through stock-picking and selecting a robust basket of stocks to establish a balanced portfolio over time. The second is understanding and adapting to the cycles we are exposed to. As each of these paths has its own limitations, we believe efficient fund management should blend both approaches.

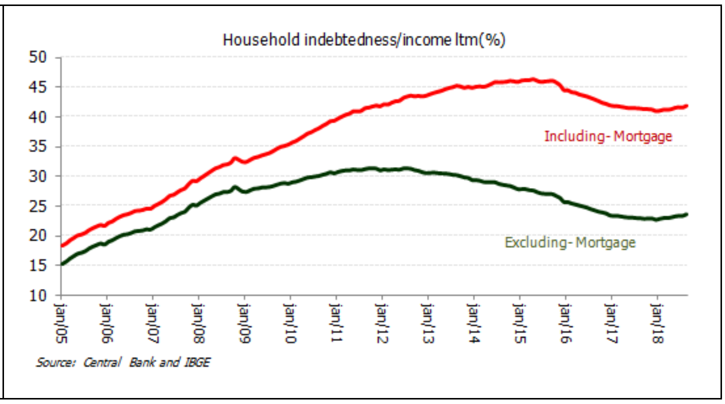
We believe that in order to have an edge in our stock-picking process, we need to specialize in a particular circle of competence and develop in-depth analyses. This involves a lot of work, but the goal is simply to make choices based on better risk assessment and try to minimize errors inherent to the decision-making process. The experience we have accumulated is very helpful when we are trying to understand and adapt to different cycles. However, this wealth of experience and our in-depth analyses do not eliminate or reduce the risks posed by the assets we select. The future paths that determine the outcomes of our investments are full of uncertainties and are affected by a wide variety of random events. This means that even with the benefit of the deepest analyses, the most extensive experience or even superhuman intelligence, a good investor knows he or she will never have a crystal ball capable of predicting the future. The best we can do is try and use probability in our favor to increase your chances of success.

Having got that initial disclaimer out of the way, we believe there is a high likelihood the stars are coming into alignment for Brazil's stock market. A combination of (i) valuations that are still discounted against other emerging markets, close the their ten-year average (depressed by 5 years of Dilma); and (ii) the current point in the cycle, give us an enormous safety margin for investing in Brazilian stocks today. In truth, Brazil is already two years into a Bull Market, just not on a straight-line trajectory. We have been through a very noisy election that shook up the markets. Having turned that page, we believe markets will resume a consistent upward trend.

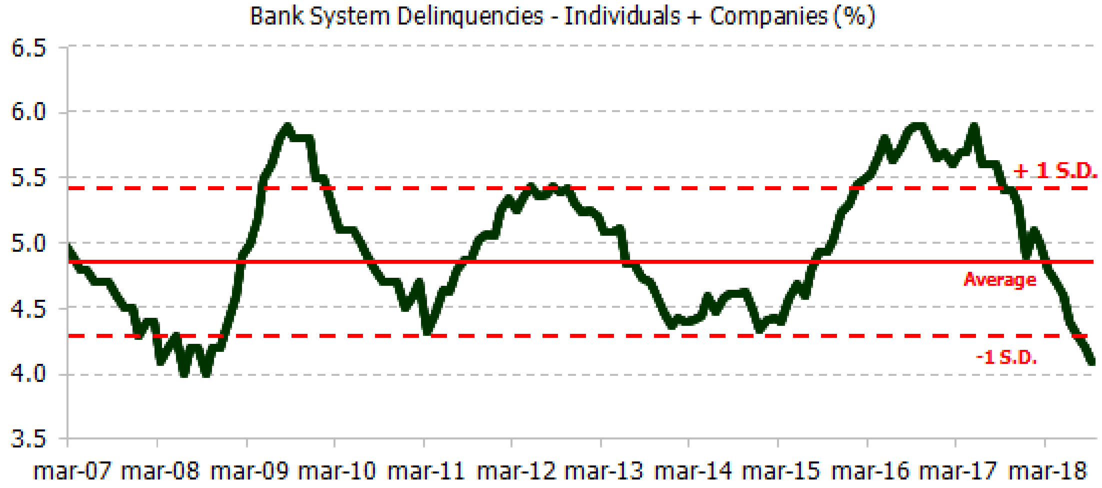
Cycles

Since our letter to investors in January 2017 - “On Cycles and Equitas” - we have frequently talked about the possibility of favorable cycles overlapping one another in the current economic landscape. The 2016 impeachment signaled a turnaround in the political cycle. We emerged from a long and extremely costly period of leftist populism to embark on a path offering fewer distortions, leading towards greater fiscal equilibrium and less State interference and involvement in the economy. Prior to last week’s elections, the jury was still out on this turnaround but the left’s defeat at the polls clearly ended any risk of a short-term upset. The economic cycle also hit an inflection point in 2016. Despite the modest recovery in economic activity, we saw corporate profits rebound strongly throughout 2017. Although revenue growth was unspectacular, companies in general reported rising operating margins as a result of cost-cutting efforts and efficiency drives that businesses were forced to pursue after years of economic depression caused by Dilma’s administration. Headline interest rates were cut, leading to a drop in financial costs which, alongside rising operational earnings, resulted in strong growth for companies’ net profits. This growth continued in 2018. In 2Q 2018, the companies in our portfolio (not including Eletrobras) reported Revenue, EBITDA and Net Profit growth of 13%, 23% and 90% respectively. We believe that net profits will continue to grow more than 20% for a number of years, even if we only see a modest rebound in economic growth. As results and cash generation improve, companies have reduced their financial leverage and families have followed suit by limiting consumption.





As companies and consumers have deleveraged, banks have taken a more conservative position during this turnaround, reporting a significant improvement in the quality of their credit portfolios and improved balance sheets. Bank credit portfolio defaults are close to historic lows!



Source: Central Bank

Deleveraging and the sharp drop in defaults have created very favorable conditions for the start of a new credit cycle, which could be a significant boost for economy activity. All the market was missing to embark on this path was “confidence". Electoral uncertainties were holding back supply and demand for credit. Now the elections are behind us, we believe the market will react positively.

But what about the uncertainties?

There are plenty of them, on both the domestic and international fronts. Domestically, despite positive signals from the president-elect and his team, there is a lot of work to do on reforms and there will be plenty of resistance from our corporations and interest groups. The president’s convictions and his team’s ability to coordinate will come under scrutiny. This makes it difficult to predict how successful the new administration will be in its efforts to reach fiscal balance and move ahead with a productive agenda. In any event, the course has been set and we are going in the right direction. Internationally, rising US interest rates, the possibility of the US-China trade war intensifying and crises in Euro zone countries (e.g. Italy) are just some of the issues that could have an impact on the Brazilian stock market’s performance.

The good news is that these uncertainties have not only been “mapped”, they have been appearing on the front pages of the newspapers almost every day. As we said in our September 2017 letter - Our view of Risk - risk and uncertainty are two different things. In our view, the risk that most concerns us is the risk of losing money over our investment horizon. The likelihood of this occurring is directly linked with the prices we pay for the stocks we buy. This means that a blue sky scenario (i.e., one with apparently few uncertainties), when prices rise too far on the back of excessive investor confidence, is one we would classify as high risk. In these cases, black swan events (highly unlikely yet significant occurrences that have not been properly mapped) have a major impact on asset prices and increase the probability of permanent loss of capital. That being said, we believe the current scenario is very healthy as asset prices have been restrained by the many mapped uncertainties we face, which have, to an extent, been over-reported. Many local media outlets reacted hysterically to Bolsonaro's victory, hyping any disagreements in the newly-elected president's team. Some outlets have tried to create the impression that these missteps are clear signs of an inability to govern and even incompetence, which creates noise and makes it difficult for the international media to understand Brazil's current situation. If the new administration's biggest sins are the communication problems of a team that has not had time to gel - working for a president who was elected just a week ago - we could well be in for a great government.

Where will capital flows come from?

Our work focuses on understanding and analyzing fundamentals, but we are frequently asked where we believe the capital flows that will boost Brazilian stock prices will come from. Unfortunately, we haven't the faintest idea what the short-term marginal impact will be from capital flows among the various market players. We do not know whether the marginal demand that will impact asset prices will initially come from foreign funds (that focus on Brazil and emerging or global markets), local investment funds, pension funds (an alternative I think we can ignore) or individual investors. We will leave this analysis to our treasury colleagues, who may have a more informed view of the characteristics underpinning these additional short-term stock-buying inflows, as well as astrologers and tarot readers. What we can do is look back, noting that Brazil's stock market has reacted positively in recent weeks despite the fact that other emerging market bourses fell into negative territory; stocks were mainly bought by local fund managers, with foreign investors as their main counterparties. In other words, local fund managers, who have a better view of domestic events and are better positioned to assess them, appear to have taken the lead and increased their exposure to Brazilian stocks.

Although we do not have much idea how short-term dynamics will unfold, we can clearly see where demand for Brazilian stocks could come from in the medium and long terms. The answer is: from everywhere! Brazilian stocks have always represented a ridiculously small proportion of foreign investors’ portfolio, but in recent years it has become completely insignificant. Sadly, everyone has lost interest in us over the past few years. It has been tough getting on the radar of US and European investors who do not focus on Latin America. In fact, interest in Latin America among these investors over the past few years has basically focused on getting travel tips about the best itineraries in Patagonia. In other words, if we can push ahead with reforms to the point where we can rekindle interest in Brazil, we could attract a lot of capital from these investors.

But overall, we believe demand from local investors shows most potential. Stocks represent a very low percentage of local investors’ portfolios compared with both developed and emerging markets. Today, an individual who invests 15-20% of its funds in stocks is considered as aggressive. Stocks frequently represent less than 10% of local investors’ portfolios. According to the 2018 edition of Capgemini's annual World Wealth Report, on average, stocks represent 40% of portfolios in developed markets (excluding property) and more than 30% in emerging markets. In those countries, 70-80% of young savers’ portfolios are often made up of stocks. Brazil is an anomaly because it has lived through at least 25 years of extremely high interest rates. Generations of investors, investment advisors and consultants were trained to look for capital gains from post-fixed, short-term fixed income investments, often with daily liquidity and backed by the Brazilian Treasury. In “normal” markets, financial instruments with these characteristics offer negative real returns and some offered negative nominal returns during the post-2008 crisis cycle. In recent decades, the trade-off in Brazil from riskier and longer term investments has always been less attractive.

For the first time, we believe real interest rates could settle at levels closer to these seen in civilized economies. If this is indeed the cases, domestic investors will be forced to take risks and lengthen their investment horizons, which means making significant changes to the make-up of their portfolios and focusing much more on equities. Brazil’s real interest rates have been low since 2017, which means a change in investment approaches becomes ever more likely following the elections. However, as this implies a cultural change, investment portfolios will not change overnight and we could see marginal demand for local stocks for many years to come.

Conclusion

We believe this is a one-of-a-kind situation in our careers and could be a memorable time for Brazilian equities. This cycle is likely to be disproportionately beneficial for state-owned companies and sectors linked with families' discretionary spending, which were the hardest hit by the recent economic crisis. This will be the backdrop against which we plan to position our portfolio. Pedal to the metal!

Equitas Selection FIC FIA vs Ibovespa vs IBX vs CDI

	Return (BRL)				Annualized Return (BRL)			
	Equitas Selection	Ibovespa	IBX	CDI	Equitas Selection	Ibovespa	IBX	CDI
Since Inception (July 6, 2010)	354.3%	40.9%	85.0%	127.6%	20.0%	4.2%	7.7%	10.4%
Last 36 months	125.9%	90.6%	87.9%	35.0%	31.3%	24.1%	23.5%	10.6%
Last 24 months	52.0%	34.7%	34.5%	18.4%	23.3%	16.1%	16.0%	8.8%
Last 12 months	15.3%	17.6%	17.0%	6.6%				
YTD (2018)	18.4%	14.4%	13.9%	5.4%				

Base Date: October 31, 2018

Average NAV - LTM - Equitas Selection FIC FIA (R$ thousands): 240,598

Fund NAV - October 31, 2018 - Equitas Selection FIC FIA (R$ thousands): 288,821

Equitas AUM - October 31, 2018 (R$ thousands): 427,065

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