Report
DYNAMO 99
3/4 2018

Beginnings and Principles

In 2018, Dynamo turned 25. This Report and the next are dedicated to two Pedros who have been with us from the very start and are the rocks upon which our history was built. Pedro Eberle, our founding partner, whose profound knowledge of the equities market sparked the ignition on this dynamo. Pedro Damasceno, our lifelong partner, will always be with us in perpetual moto of affection and memories.

On December 31st, Cougar concluded its 4th month of operations, with quite satisfactory results. Starting with this Report, we, the managers of the Fund, will seek to update our investors on at least a quarterly basis with a brief summary of Cougar's performance, as well as our view of the market.

That was how we opened our "Cougar Report #1," dated January 7th, 1994.

The promise in that pioneering paragraph – to provide updates approximately every three months to our shareholders – has brought us to this hundredth Dynamo Report. In retrospect, these reports have served as a faithful record of our investment/asset management work over the years. With that in mind, encouraged by investors and friends, we've decided to devote this edition and the next to a look back at the beginnings, leafing through the records of our first steps.

We'll start out with a brief recap of what was happening in Brazil in the '90s, in order to put Dynamo's early days into context. We then present a summary of the main arguments from Reports 1 through 16, which cover our first four years. The following Report takes in the next four years, working off Reports 17 to 32. Our comments today play a supporting role, something like a movie-theater usher – shining a light and allowing readers to take a seat and enjoy the original texts, reproduced here in italics. At the end, Reports 33 through 100 are displayed in a single table, structured as a thematic index that will lend some order to this vast array of information.

Let's start with a brief summary of Dynamo's debut. It was September 1993. After six failed attempts at stabilizing Brazil's currency in under a decade, annual inflation had swelled to 1,730%. The Finance Minister was the fifth appointee to take on the job that year. Facing impeachment, the president had resigned less than halfway through his term. The vice president was eventually confirmed to replace him, but relations between the executive and legislative branches were marked by widespread distrust and low governability. In the foreign policy arena, the country struggled in the shadow of the 1987 moratorium. The ongoing negotiations over Brady bonds would only be concluded in the next year. We didn't even have a country risk rating, since the agencies would only officially set up shop in the second half of the 1990s. Meanwhile, foreign financial investors had been active around here since CMN Resolution 1832/91 – then known as Annex IV (to Resolution 1287/87), which allowed for the free movement of short-term financial assets – after which we became all too familiar with the fickle nature of external capital flows.

When it came to the capital markets, activity was still scarce. Historically low savings rates in Brazil, along with the absence of a culture of investment in securities, had called for inorganic measures that might encourage the development of the market. Under the Government

Economic Action Plan (PAEG, in Portuguese), the 1960s brought the laying of institutional foundations, essentially fiscal incentives, which allowed savers to invest a part of their income taxes due in equity funds/debentures, and companies would receive tax waivers upon going public. These artificial shortcuts would take their toll, as we'll see, and bring serious unintended consequences: a generation of distracted investors and disengaged companies.

Though we already had a solid legal apparatus, thanks to the Brazilian Corporate Law (*Lei das S.A.*) and the creation of the Securities and Exchange Commission (CVM), both dating from 1976, participants' relatively low engagement hobbled the development of jurisprudence. Good law withered without praxis to sustain it. The equities segment was viewed with particular suspicion. Events such as the early '70s bubble and the "Nahas Case" in 1989 were still vivid enough to warrant caution in an environment where the imbalance between "professionals" and "amateurs" would inevitably deal a blow to the pockets of the latter group. Better fall back on the safe rents of the overnight rates.

In short: in the political arena, we were steeping in uncertainty under a weak transitional government, Congress having just forced the resignation of the first president to be democratically elected in thirty years. As for the economy, we were at the mercy of chronic inflation and skeptical of the country's ability to break free of it. Though we'd established automatic protection mechanisms through broad indexing, it was only natural that, given the context, the business environment would become seriously atrophied and entrepreneurs and investors would adopt a blinkered view. The result was that our stock market became dominated by speculation, with increasing foreign involvement, revealing a hard preference for liquidity over any consideration of the value of a given asset.

In this context, Dynamo was founded on the following idea: why not put part of your finances that are currently being administered by major financial institutions (understood to have solid track records and sterling reputations), into a new equity fund managed by individuals who have just formed an independent partnership, guided by the notion that with discipline, diligence, and analyses focusing solely on the intrinsic value of companies, it would be possible to build a stock portfolio with less liquidity, but which would provide consistent real returns in the medium/long term? Wait, what?

As with the prevailing aphorism that investment returns tend to be proportional to the risks, the end-to-end return for Dynamo Cougar's initial shareholders over these 25 years (17,237.7% in dollars, or 22.9% p.a.) is an ex post demonstration of just how unusual the above proposal seemed back then. Like today's start-ups, Dynamo was born of a purpose. It wasn't a very original one, but bringing it to Brazil just then made it seem downright exotic. Only visionaries – by which we mean close friends – would agree to take it on. To those fearless adventurers, and to all those who joined us along the way, our deepest and everlasting gratitude.

The Reports from those early years might be considered our founding documents. There, we find the pillars of our philosophy and investment strategy. They reveal Dynamo's identity, the vicissitudes of our analytical work, the way we view and interact with companies, envision portfolios and position ourselves on the capital market. In light of the knowledge we have today, these observations might seem redundant. But if we go back in time, we can see just how pioneering they were. That's why we've gathered them together and present them now for our readers' enjoyment.

In Cougar Report 1, introducing our first table of relative outperformance, we were careful to emphasize that *our main priority* was *the real appreciation of shares, and not outperforming the Ibovespa or other equity funds*. By that, we meant that we were looking for companies with solid fundamentals, preferably those off the market's radar, with good operating leverage, but which weren't solely dependent on the national macroeconomic situation. In other words, our approach would basically be the same as that of a bottom-up investor.

We also looked for situations of potential for what we called "capital structure arbitrage" (de-listings, failures to observe rights set forth in company bylaws, etc.) that might call for us to intervene more actively in our investments. We could have hardly imagined back then that, with these early mechanisms, we were in effect conducting "corporate governance" avant la lettre.

The search for fundamental value and capital structure arbitrage/active management are two elements that can only be combined in the context of medium- and long-term investments. This key statement can be found in Report 2, which illustrates cases of distortions between price and value: i) the fact that Brahma's market value was nearly double that of Antarctica, when "*that difference could not be justified by fundamental factors*"; ii) the issue of book value adjustments for the calculation of minimum dividends for class A stocks in Siderúrgica Tubarão; iii) the discussion around a fair price for Parmalat's offer to delist Lacesa.

There was no evidence in our market that investment strategies with this sort of approach might prove successful. Moreover, even if they did come, results could well take their time. At this stage, the Reports played an important educational role. They reminded our shareholders that patience would be a fundamental ingredient in attaining our goals, and that we shouldn't let ourselves be swayed by short-term results. This recommendation was not to be taken lightly. By Report 3, it was 1994 and the stock market wobbled at every electoral poll. By July, when the Report came out, the Workers' Party (*Partido do Trabalhador – PT*) looked as though it had a decent chance. The Ibovespa's annual volatility had shot up to around 65%. One of Dynamo's key characteristics, concern with capital protection, came to the fore. This was how we summed up the dilemma at hand: *Since we are not specialists in correctly predicting extremely short-term changes across the market as a whole (nor do we harbor that ambition), we find it less than prudent to constantly dismantle and rebuild our portfolio in the absence of any strong conviction. And even when that is the case, we prefer to hedge only part of the portfolio, since our stocks are only distantly correlated to the index and our profitability can take a major hit from a wrong step. In short, we prefer to bet on our ability to discover great companies at attractive prices, rather than trying to predict short-term market movements."*

While the market twisted in the macropolitical winds, we kept on seeking out opportunities on the micro environment of companies and our capital market. As all this was going on, in Report 3, we described an episode that perfectly illustrates the feeling that we were headed in a promising direction. In that quarter, we saw gains of 900% in dollars from the acquisition of warrants from Lojas Americanas. The bonuses were practically illiquid; surprisingly enough, Cougar managed to acquire the stake "*after we took advantage of a transaction carried out practically undercover during the lunch break in Rio de Janeiro stock market*." In a still not arbitraged market, focus and discipline would be handsomely rewarded.

By Report 4, Fernando Henrique Cardoso had just been given his first term in the first round of that year's elections. We noted that with the market quickly appreciating, the Fund would probably "underperform, *since our focus is outside the blue chip stocks*." Even so, Cougar saw a robust performance, especially for two assets with low liquidity that had been in the portfolio for months: Lacta and Cemepe. These results allowed us to once again compliment the virtue of discipline. "*This factor merely reinforces the point that if our investment strategy is to succeed, it will require significant patience and a much longer-term vision than the majority of market participants are willing to allow for.*" Cemepe – formerly *Companhia Marcopolo de Participações* – was yet another example of a little-known company, a holding company through which we were able to buy Caraíba Metais, with revenues of $300 million, for practically nothing. That's right. Now and then we'd find classic investment opportunities, à la Graham, such as companies going for less than their net working capital, or holding companies going for less than the sum of the market cap of their subsidiaries. We closed out Report #4 by describing our enthusiasm over a promising new investment: Lojas Renner. Interesting results, excellent growth prospects, and P/E for '94 of around 5x...

Since our investment approach was both new and very specific, from the start we wondered what the potential size of the opportunities before us might be, and what was the limit of capital we could manage without causing the performance of the Fund to suffer. In Report 5, we revealed what would prove to be a precocious concern. Back then we were managing $30 million, and we concluded that under current market conditions and given the redemption rule of only D+4, we would hit maximum capacity at around $50-60 million. Setting aside the merits of the calculations themselves – fortunately, Brazil's capital market has progressed by leaps and bounds since then – it's interesting to notice how Dynamo has always been genuinely preoccupied with performance, and not maximizing assets under management.

In addition to adjusting the volume of assets to the potential range of opportunities for our investment strategy, another permanent concern was the emergence of a structural imbalance between the fund's assets and liabilities. We bought low-liquidity stocks that promised to mature in the medium to long term, even though the liquidity rule for mutual funds stood at D+4. Hence our care in bringing to the Fund's base investors who truly understood the potential – and the limitations – of our philosophy. This also explains the pedagogical function of the Reports as a channel of communication, allowing us to repeat that we must be neither seduced by gains nor shattered by short-term losses. And so, during a market downswing in the first quarter of '95 – when the Ibovespa slumped 30.7% in reais and Cougar fell 10.4% – we confessed in Report 6: "*A great concern for us during this last quarter was the possibility of redemptions. We are glad to inform that the level of net redemption during the quarter was very low (3.5% of the Fund) This fact reinforces our confidence that our shareholders do share the same investment philosophy as we do.*"

We took advantage of that ambiguous moment of market correction, perhaps sparked by fears of contamination from the Mexican crisis, to reinforce the main contours of our strategy: "*Our approach can best be summarized as research driven [and] value oriented. We try to analyze companies using the same parameters as someone that would be buying the entire business. If we feel a company is grossly undervalued under this criteria, we will make an investment in it regardless of market timing as we think the market capitalization will eventually reflect its real business value (in fact, the market often overreacts).*" In a market where "*most fund managers prefer an approach in which it is more important to understand the evolution of the shares than that of the company,*" we pressed ahead with our more labor-intensive strategy, moving away from the herd, seeking out higher ground in search of better grazing.[1] And to shore up our argument, we went on to say that we'd taken advantage of the market correction to buy more shares in Lojas Americanas and Souza Cruz, at "*reasonable*" prices that did not seem to discount any future growth and shares in Bradesco "*at prices that account for the drop in inflation [and so revenues from floating], but which fail to account for the explosive growth of the insurance and credit card businesses.*" We concluded on a high note, optimistic about a portfolio that reflected an average expected P/E for 1995 of 7x, with multiple companies with lower liquidity with P/Es below 5x and a dividend yield of over 10%.

At this point, we're in July of 1995. The Plano Real is a year old, and the old dream of currency stabilization has finally come to pass. Pent-up demand would burst forth in the robust expansion of domestic consumption and imports, facilitated by an appreciated exchange rate. On the capital markets, the scare of the recent correction, high volatility, and the passage of constitutional reforms came to put a premium on liquidity once again, and stocks in state-owned companies apparently on the verge of being privatized saw excellent performance. In this context, Report 7 marked the beginning of our thematic titles, with a suggestive choice: *The Tuna Can and the Stock Market*.

Essentially, the report was dedicated to explaining why we didn't share the market's enthusiasm around the potential privatizations of Telebrás and Eletrobrás. It wouldn't make sense to sell the holdings, since the government's share was low (24% and 48%, respectively), and a sale would mean swapping a public monopoly for a private one. Nor did it make sense to sell the subsidiaries, since under the legislation at the time, the profits had to be used to acquire the national treasury's privatization bonds (NTN-P), the economics of which were frankly unappetizing. Since these companies had minority shareholders, we foresaw an avalanche of complaints. Given these inconsistencies (which we've summarized here for brevity's sake, but the argument went into greater detail), we were skeptical of the market's collective buoyancy in regards to these two entities. Then we remembered the joke about the can of tuna that's bought and resold repeatedly, at ever-increasing prices. Finally, one of the buyers decides to open it up and finds, to his surprise, that the tuna has gone bad. Upon hearing his complaint, the seller responds: "*What difference does it make? That tuna's not for eating, it's just for trading*."

In addition to our incorrigible habit of examining cans before buying them, we occasionally went so far as to suggest improvements to the manufacturer. In this case, we believed that the format best suited to the interests of the government and the market would be "*to sell the concessions services through public auctions*"[2]

We concluded the Report with a paragraph about a new investment: Nitrocarbono. Solid potential for substituting glass, privileged access to the main raw

1 *This Report alluded to the metaphor used by investor Ralph Wanger, whose* A Zebra in Lion Country *would become a classic of value investing, focusing on small caps stock.*

2 *This suggestion was based on the rules of the game as they stood then. As we'll see in a bit, the government resorted to an underhand move and eventually opted for a framework whereby the holding was divided up and twelve subsidiaries were auctioned off (3 fixed telephony companies, 8 mobile telephone companies, and one long-distance operator).*

ingredient, paraxylene, and an attractive valuation, of P/E around 5x. Good fundamentals, but the investment would prove disastrous: a classic value trap. Ironically, the tuna would go bad later on down the road, becoming one of the (thankfully few) counter-examples of our strict quality control.

In Report 8, *Sleeping with the enemy*, we marked the Fund's second anniversary with an excellent accumulated performance of 322% in dollars, against 52.7% for the Ibovespa and 131% for the FGV-100.[3] For the first time, we touched on a topic that would return in subsequent editions, emphasizing the fundamental effects of the differences between structures of corporate control in the United States and Brazil. In the U.S., conflicts arise between executives and shareholders; here, they arise between controlling and minority shareholders. The shareholding dispersion that characterizes the American market ultimately dilutes the pressure on companies. The result was that executives began favoring initiatives that increased their influence, to the detriment of shareholders' returns. It was only as the junk bond market grew that investors were able to take up financial arms and assert themselves, demanding that value creation for all shareholders be restored as the top priority in company decision-making.

As we observed the differences between the two markets, we wrote: "*Shareholder policy is one of the main aspects of our research process. Ultimately, what we try to understand is whether our interests are coincident, different or conflicting with the majority shareholder. Unfortunately, in too many cases, our conclusion has been that buying shares in the company will be like sleeping with the enemy.*" We drew up a suggested checklist of factors that would help settle the question: dividend policy, share buybacks, majority shareholder with non-voting shares, executive and employee compensation, access to executives, understanding of and ability to grasp investors as collaborators, and the degree of aggressiveness of the "marketing" of shares. We concluded with an observation that was half-aspiration, half-reality, and which would become a mantra in our future interactions with companies: "*The scenario has been improving in Brazil recently. With the overall level of the stock market being much higher than during the 80's, controlling shareholders that are fair to other shareholders can be rewarded by the market with a higher valuation for their companies, the consequence of which is the increase of the owner's net worth. The higher market capitalization brings another important, albeit often overlooked, benefit for companies, which is the reduction of their cost of capital. Over the past few years, many companies changed their shareholder policies and their market values increased considerably.*"

As we closed out Report 8, we recounted a peculiar fact. "*It has been one year since the election of Mr. Fernando Henrique Cardoso. Trying to analyze the market during this period, we imagined the following story. Twelve months ago, an investor had access to today's newspapers and found out that: (i) the dollar was trading around R$ 0,95; (ii) inflation was below 1% per month; (iii) GDP had grown around 5% for the year; (iv) foreign reserves were close to US$ 50 billion; and (v) constitutional reforms were mostly approved. The only information missing was the situation of the stock market. What would such investor have done? He would probably have bought shares in the Brazilian stock market and lost money as the Ibovespa is down 25.3% and the FGV-100 is down 12.8% since the election.*" This argument became an inescapable reminder to our shareholders of "*how difficult it is to invest based only on market timing or macro analysis.*"

Report 9 – henceforth baptized Dynamo Report, and no longer Cougar Report – was entitled "*The First Year of the Rest of Our Lives?*" and began with an interesting reflection on the effects of the end of the long cycle of inflation on companies' day-to-day management practices. Several price changes distorted consumers' sense of relative value. Inside companies, management mistakes were easily camouflaged through automatic readjustments. Stabilization meant that slip-ups in working capital became much more visible. "*Broadly speaking, we saw the resurgence of other management elements which had taken a backseat, such as strategic planning, brand awareness, product positioning, and human resources, regained considerable importance especially over financial management.*" The end of inflation reshaped the competition between companies, making quality

3 The FGV-100 was a stock index calculated by the Fundação Getúlio Vargas, including the hundred largest private non-financial companies on Brazil's major stock markets, classified by "excellence" and "liquidity," where "excellence" was defined basically by indicators of "scale" (size) and "performance." Compared to Ibovespa, this methodology generated a portfolio closer to our investment style.

management absolutely crucial.[4] In all likelihood, stock portfolios which were able to reflect this performed better. In 1995, Cougar dropped only 3.6% in dollars, while the FGV-100 plummeted 35.2%.

Not satisfied with our absolute performance, we took the opportunity to reflect on our mistakes. This would be the case in multiple subsequent reports; self-examination is an integral part of the culture at Dynamo. Back then, we wrote: "*We were also too slow in perceiving the severe downturn of the economy that began in the second quarter of 1995 and its impact on some of our investments. In a way, we had the same attitude of irrational and unfounded optimism of the managers of these companies, instead of dealing objectively with the problem. Finally, we did not take advantage of the steep fall of the market in March when we could have purchased shares of some excellent companies at very attractive prices. Without trying to justify our mistakes, it has to be noted that we were then keeping an amount of cash that was above average in order to face possible redemptions which actually never happened. If our Fund had a longer redemption profile maybe we could have been more aggressive.*"

We concluded with two additional comments. The first laid out two reasons for our optimism around a new investment: Ericsson, one of the few private companies in the telecommunications sector on the stock market that had both interesting capex potential in the Telebrás system and an attractive valuation, going for below its net working capital. By that point, opportunities like that were vanishing. Funnily enough, when writing about which system – CDMA or TDMA – ought to prevail in Brazil, we argued that "*in Europe, Ericsson is synonymous with mobile phones, almost as much as Gillete is synonymous with razors*." We had yet to be acquainted with Motorola, Blackberry, smartphones, and The Dollar Shave, among other surprises that the inventive spirit of capitalist competition would produce as time went on.

Our second comment had to do with "*our skepticism towards state-owned companies, as we find that minority shareholders will not necessarily profit when privatization happens.*" This time, our warning came with the dangerous precedent opened by PROER, the program designed to restructure the financial sector; it allowed companies to treat non-controlling voting shareholders differently from controlling shareholders when control of a company is sold.[5] In other words, this meant that the government's interests – the government being the controlling shareholder – outweighed the balance between shareholders. That was why, within the same industry, we found ourselves enthusiastic about an equipment manufacturer and bearish on investments in telecommunications companies themselves. No contradiction – just an illustration of the concept that bottom-up investors may take a number of forking paths within the scope of a single sector or situation. This was also yet another example of us going against the market consensus, which was still privileging size and liquidity.

Value investors throughout the world dedicate themselves to scrutinizing the origin of a company's fundamental value. In a market with scant legal protections, with controlling groups prevailing in companies' ownership structures, we are confronted with a second set of tasks, equally challenging and equally relevant: analyzing how that value is distributed. Value which is created and kept in cash – or, worse, diverted through tunneling practices by controlling shareholders won't be worth much to minority shareholders. In Dynamo Report 10, *The Key to Unlock the Safe*, we started to address this very issue. After all, what use is a safe full of gold if we don't have the key to open it?

With this image in mind, we ran down a few positive examples of companies that distribute their results equitably. Our portfolio included Brahma and Souza Cruz, which handed out extraordinary dividends, and Monteiro Aranha, which shared the wealth by reducing capital and distributing non-voting shares in Klabin to all its shareholders. Across the market, we saw a significant rise in announcements of share repurchase programs. We also presented a few negative cases: Siderúrgica Tubarão was still refusing to incorporate book value adjustments/

4 *It would be impossible not to draw a parallel to the digital reconfiguration we're witnessing today. While the changes being wrought today have even deeper and farther-reaching consequences for companies' futures, this episode from the past can at least give us a clue: once again, the solution rests on quality management and the ability to adapt to this new competitive landscape.*

5 *This was the government's rash repeal of Article 254 of Brazilian corporate law. Our fears would come true farther down the road, and the government did, indeed, use the mechanism to capture exorbitant payouts when selling control of the split-up subsidiaries of Telebrás. What followed was a predictable epilogue: debt-ridden controlling interests trying to reach an average price at the expense of minority shareholders, mainly through brazenly lopsided corporate restructuring.*

corrections into its dividend calculations and had just announced a stock option plan with several design problems, including a strike price with a steep discount from the market price. But the case of Lacta took that year's award for corporate belligerence. Just a year before, Endipa, the holding that controls the company, had bought 50% of Visconti (the long-time Panettone maker) and had recently decided to sell it to Lacta, "*Endipa sold its participation in Visconti to Lacta for a price apparently four times higher than it had paid, and the valuation endorsing [that] price was signed by a software company!*"... Even twenty years later, as we find ourselves in the era of the Internet of Things, this particular connection still seems like a bit of a stretch.

The next Report, *(Un)Popular Stocks*, lingered on another topic close to value investors' hearts: the possibility of building positions in companies long forgotten, fallen out of fashion, or seemingly out of step with the market's overall vision. "*We have never invested in stocks based on their popularity. In fact, up to now, a good portion of our return has come from investments in companies with great fundamentals but that were going through bad times, and, as such, were forgotten. Not that we like to be contrarians just for the intellectual pleasure it provides; we only do so after a thorough analysis which gives us a strong conviction. Neither do we sell stocks just because they have gained popularity. Our investments in Lojas Renner and Brahma, very popular in the capital markets today, are a proof of that.*"

From there, we went on to describe our investment in the Banco de Crédito Nacional (National Credit Bank, or BCN), which was hardly an obvious proposition at a time when the Brazilian financial system faced tremendous uncertainty, as manifested in the ongoing interventions into the Banco Econômico and the Banco Nacional. That uncertainty was baked into the valuation: when we started buying our stake, BCN was going for a P/E of 1.6x, price-to-book of 25% and a dividend yield of 16%. The bank had seen consistent results (albeit with a focus on treasury and foreign exchange), with a conservative loan loss provision that was among the highest in the sector, had an active buyback policy, a solid working culture and an executive team that we judged "*competent, competitive and committed [to] the long-term performance of the bank.*" With this array of strengths, the bank was attractive enough for an investor with our mindset to climb aboard, setting out in search of value even in the face of a hostile external outlook.

Dynamo Report 12 closes out the Fund's third year and establishes a proper two-part structure: a central section where we go into greater depth on a given issue, and a separate piece where we provide details about our quarterly performance. Within a structure that favored longer and deeper narratives, the first topic couldn't have been more appropriate: *Learning with Warren Buffet*.

By that point, Buffett had a 31-year track record at Berkshire Hathaway (BH) and had conquered both fame and fortune, jostling with Bill Gates for first place on *Forbes'* list of the richest people on the planet. But his investment principles had yet to become widely known in Brazil (only one of his books had been translated into Portuguese back then). We took advantage of the opportunity to give a brief summary of his biography, in addition to Berkshire's beginnings as a holding company, and the portfolio's biggest stakes in publicly held companies at the time. Above all, though, we devoted the report to the principles that define Buffett's approach to investing.

Having done that, we asked ourselves what companies in Brazil might be worthy of the Berkshire seal. At the time, our best guesses were: Bradesco, Brahma, Coteminas, Globex, Itaú, Lojas Renner, and Pão de Açúcar. We closed out the Report with an aspirational parallel:

"*It should be clear at this point that Dynamo's strategy is, to a large degree, inspired by Warren Buffet. Obviously, it is difficult to compare the Buffet model with a Brazilian asset management company whose investment*

Dynamo Cougar x IBX x Ibovespa
Performance up to March 2019 (in R$)

Period	Dynamo Cougar	IBX	Ibovespa
60 months	120,9%	90,2%	89,3%
36 months	65,4%	91,9%	90,6%
24 months	40,5%	47,9%	46,8%
12 months	18,8%	12,7%	11,8%
Year to date	12,3%	8,6%	8,6%

NAV/Share on March 29 = R$ 936,988885800 *vehicles are mutual funds that invest in non-voting shares of listed companies. Learning from Buffet, at Dynamo, we try to emphasize the following aspects: (i) long term investment horizon; (ii) extensive knowledge of companies; (iii) interaction with management in an effort to participate in the process of creating value to existing share- holders; and (iv) no concerns with the economy or short term market fluctuations.*

It would be extremely pretentious and almost unacceptable to make any comparisons between Dynamo's and BH's results. However, there is a characteristic of Buffet that we fully share and believe to possess in the same intensity. We take a great pleasure from our work and are convinced we will remain in this business for a very long time. Like Buffet, we also think that our investment philosophy reflects our own personalities and matches perfectly with our personal life style. We believe that when this harmony is reached, the chances of achieving superior results are vastly enhanced."

In Dynamo Report 13, *Modern Times*, we noted two trends toward structural change in the Brazilian economy and wondered whether companies should be adapting to this new scenario. The first was the transformation that had been brought by the new macroeconomic situation. Until then, *"in a economy with double-digit monthly inflation, sky-high real interest rates, unavailable long-term credit and a volatile level of activity,"* hanging on to significant short-term cash reserves was a sign of prudence. With inflation under control, interest rates falling, BNDES taking a more active role as a long-term creditor and competition heating up between businesses, the conservative strategy of high cash reserves had to be weighed against the goal of pursuing better rates of return for shareholders. With that in mind, distributing excess capital and allowing for some financial leverage might make sense.[6]

The second observation was that, with Brazil's commercial opening, macro stability and the expansion of the domestic market, the country would become an effective target of strategies for international corporate expansion. A few typically globalized industries were captured by the wave of consolidation, such as the auto parts sector. We warned that the local reality of extreme fragmentation in certain sectors where scale and operating leverage matter, especially retail and commerce, might be in its final days. Later on, we would understand that regulatory, fiscal, and logistical idiosyncrasies would significantly prolong the lifespan of competent local incumbents. Even so, our suggestion that companies take heed of "modern times" would prove paradoxically timeless.

In Dynamo Report 14, entitled "Risk and Rationality," we presented a few problems where people, forced to make decisions in situations of uncertainty, wind up flouting rational logic. The experiments were drawn from Peter Bernstein's classic book *Against the Gods – The Remarkable Story of Risk*. Risk itself is a crucial topic for us at Dynamo because it speaks to the essence of our situation as fundamentalist investors. We acquire unarbitraged shares in the belief that they will be arbitraged someday. The market – alternately irrational, distracted, short-sighted, confused, rash, and moody – will eventually recognize the persuasiveness of the assets' intrinsic value and move in that direction. Thus, we'll find ourselves returning to the topic in subsequent Reports.

On a practical note, Report 14 also recalled Bernstein's argument that this apparent lack of rationality might also explain the relative unpopularity of index funds in the United States. Though only a minority of actively managed funds were able to beat the index in the medium or long term, passive funds had just 20% market share. We saw the same phenomenon in Brazil. In our own monitoring of other equity funds, over the preceding three years, only Cougar had been able to beat the Ibovespa.[7]

We closed out the Report by reinforcing our non-parametric view of risk in our investments:

6 *Unfortunately, the long-awaited consistent drop in short and long-term interest rates would be interrupted shortly thereafter amidst fears of contagion from the 1997 Asian crisis.*

7 *The tide would turn, and today index funds represent the majority of equity funds in the United States. A belated triumph of rationality? Perhaps so. Good managers at active funds are starting to speak out and arguing that the trend may have swung too far in the opposite direction. After all, active investors, with their countless arbitrage strategies, are the ones determining the index composition. If they became a small minority, that fundamental diversity would be lost and the indices would come to mirror that atrophy. Of course, all this would likely produce ripe opportunities for active, diligent investors, assets would flow back toward actively managed funds and the pendulum would come to equilibrium once again. Interestingly enough, what was considered irrationality back then (a small minority of passive funds) wouldn't be seen as such now; and what is seen as rational today (a majority of passive funds) may not be seen as such in the future.*

"How do we see Dynamo in this context? In the first place, our understanding of risk is simpler. We think that the real risk to stock investors is in the balance sheet and in the management of the company in which one invests. The better we know the company, the smaller the risk of a surprise in the long term. If, on one hand, it is difficult to forecast what will happen to the markets in which the companies operate, on the other hand, it is not so hard do identify excellent companies. And that is just the kind of company, with high quality management and adequate capital structure, that will be able to deal with the future, whichever it may be, in the most efficient way, keeping, or even increasing, its comparative advantages. For that reason, we value so much the culture of a company and the quality of its management, aspects that are too often overlooked as they are not quantifiable and sometimes difficult to evaluate.

Second, as the number of sophisticated investors that dedicate their best talents to follow the non-state-owned companies in Brazil is still relatively small, it is reasonable to assume that their stock prices are further from their fair values than those of state-owned companies.

And finally, we always attempt to act like true partners of the companies in which we invest. Collaborating with management is one of our key objectives as we consider ourselves to be co-responsible in the process of creating value to shareholders. If we achieve this goal, our risk is even further reduced."

This was mid-1997, as the American market found itself on a long and sustained upswing. Alan Greenspan, then leading the Fed, had already warned of the dangers of "irrational exuberance." In Dynamo Report 15, *Rational Exuberance*, we pointed out that American companies had seen downright exuberant results in recent years, and that despite the considerable rise in the stock market, profits were indeed record-breaking. In other words, in light of major increases in productivity, improvements in companies' fundamentals and structural developments of capital markets, exuberance was actually quite rational.

The progress in the capital markets confirmed shareholders' regained empowerment, as corporate decisions came to privilege value creation and return on invested capital. This shift to a more rational use of capital was shaped by a variety of instruments: selling non-operating assets, cutting back on working capital, optimizing use of physical capacity, inventories, and workforce, and executive compensation packages tied to operational performance, among other things. The globalization of markets would bring the efficiency wave to Brazilian shores, posing a risk to any local companies which might stubbornly turn their backs on these important improvements. We wrapped up the Report by alerting to an ever-present danger in the business environment: the trend towards the preservation of the status quo. "*It is very difficult, however, for successful Brazilian companies to accept this cultural change. The issues we have been talking about (such as greater leverage, stock buy-backs and stock-option plans for executives) may sound academic to most companies operating in Brazil today. But when a competitor starts selling the same product at a lower price, and achieve[s] a better return on equity by allocating capital more rationally, these concepts will become reality. Companies which act proactively will certainly create more value for their shareholders.*"

We took advantage of Dynamo Report 16, *Four Years of Cougar-Dynamo*, to take stock of the fund's performance over a period where our return in dollars had been 66.9% p.a., as opposed to 26.2% p.a. for the FGV-100 and 35.5% p.a. for the Ibovespa. Major contributions over that period in question came from Lojas Renner, Lojas Americanas, Indústrias Villares, and Ericsson. In the case of the latter, we *"got the fundamentals right, but the timing wrong. We sold our stake much earlier than we should have, given an erroneous view of the company's margin"* – influenced, truth be told, by the company's executives themselves. This taught us the lesson that although we seek to know companies as well as the people leading them, their opinions shouldn't always underpin our decision to invest or divest. Once again, we took the opportunity to analyze our own missteps.

"As for our biggest mistakes, we prefer to avoid naming names. But as we reflect on them, we can identify two recurring attitudes: (i) investments in petrochemical companies and (ii) investments in weak companies at times when we thought that stock prices were too low... In the former case, our expectations as to the price cycle were completely wrong-headed (did anyone guess it right?), but the fact is that we also stumbled when evaluating the quality of management at some of the companies in which we invested, especially in terms of strategic planning and corporate management. As for the second source of mistakes, we've been working to avoid that sort of temptation.

DYNAMO COUGAR x IBOVESPA
(Performance – Percentage Change in US$ dollars)

Period	DYNAMO COUGAR* Year	DYNAMO COUGAR* Since Sep 1, 1993	IBOVESPA** Year	IBOVESPA** Since Sep 1, 1993
1993	38.8%	38.8%	7.7%	7.7%
1994	245.6%	379.5%	62.6%	75.1%
1995	-3.6%	362.2%	-14.0%	50.5%
1996	53.6%	609.8%	53.2%	130.6%
1997	-6.2%	565.5%	34.7%	210.6%
1998	-19.1%	438.1%	-38.5%	91.0%
1999	104.6%	1,001.2%	70.2%	224.9%
2000	3.0%	1,034.5%	-18.3%	165.4%
2001	-6.4%	962.4%	-25.0%	99.0%
2002	-7.9%	878.9%	-45.5%	8.5%
2003	93.9%	1,798.5%	141.3%	161.8%
2004	64.4%	3,020.2%	28.2%	235.7%
2005	41.2%	4,305.5%	44.8%	386.1%
2006	49.8%	6,498.3%	45.5%	607.5%
2007	59.7%	10,436.6%	73.4%	1,126.8%
2008	-47.1%	5,470.1%	-55.4%	446.5%
2009	143.7%	13,472.6%	145.2%	1,239.9%
2010	28.1%	17,282.0%	5.6%	1,331.8%
2011	-4.4%	16,514.5%	-27.3%	929.1%
2012	14.0%	18,844.6%	-1.4%	914.5%
2013	-7.3%	17,456.8%	-26.3%	647.9%
2014	-6.0%	16,401.5%	-14.4%	540.4%
2015	-23.3%	12,560.8%	-41.0%	277.6%
2016	42.4%	17,926.4%	66.5%	528.6%
2017	25.8%	22,574.0%	25.0%	685.6%
2018	-8.9%	20,567.8%	-1.8%	671.5%

2019	DYNAMO COUGAR* Month	DYNAMO COUGAR* Year	IBOVESPA** Month	IBOVESPA** Year
JAN	17.2%	17.2%	17.6%	17.6%
FEB	-1.7%	15.2%	-4.1%	12.7%
MAR	-3.1%	11.7%	-4.2%	8.0%

Average Net Asset Value for Dynamo Cougar
(Last 12 months): R$ 3.201.478.218

(*) The Dynamo Cougar Fund figures are audited by Price Waterhouse and Coopers and returns net of all costs and fees, except for Adjustment of Performance Fee, if due.

(**) Ibovespa closing.

Given the low valuations in most private companies, it hasn't been easy, but we've already learned that there's a big difference between a low stock price and a cheap stock price."

Elsewhere in Report 16, we delved into the reasons that led us to be particularly interested in retail in Brazil, and where we'd built a major portfolio of investments in Renner, Americanas, Saraiva, Globex, and Panvel. In a sector with excellent growth prospects and major operating leverage, the quality of management made all the difference. Looking at the composition of shopping centers in the United States, we were bullish on the growth of anchor stores and specialized shops in Brazil, which was in line with Renner's expansion strategy in São Paulo. Not a trivial decision for a small southern chain to take on the competitive São Paulo market. Confident in the company's ability to follow through, we trusted that Renner would be able to charm higher-income audiences/clients. Little did we know that seventeen years and 67 Reports later, we'd be able to provide a detailed account of what had become a long and lucrative journey.[8]

As always, out of respect for our readers' time, we'll draw the first part of these recollections to a close here. We hope that it was enjoyable for you to read as it was gratifying for us to revisit our beginnings and principles.

Rio de Janeiro, April 2, 2019.

8 *Namely, Dynamo Report 83,* Renner: The Geometry of Retail *and 84,* Renner: The Path of the Palindrome, *from January 2015.*

Please visit our website if you would like to compare the performance of Dynamo funds to other indices:

www.dynamo.com.br

DYNAMO

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