Report
DYNAMO 58
APR MAY JUN 2008

Halo

Successful investing is one of the most pragmatic and ambitious aspirations of the human spirit. The obstacles are huge and the mere description of the nature of the inherent difficulties underscores the enormity of the challenge. The act of investing: i) basically involves future events. By definition, it entails the uncertain and the imprecise; ii) presupposes the involvement and interaction of a host of matters, allied to the vast complexity deriving therefrom, and; iii) requires a disciplined will and a huge cognitive effort by the party in question.

The impact of climate change, the beginning of a war, a fire breaking out in an industrial plant, the untimely exodus of an important executive, the launch of a new technology, are but some of the uncertain events that are part and parcel of the investor's daily life, events that dramatically impact the results of his decisions. Furthermore, every purchase and sale presupposes a counterpart. The presence of the "other" requires insights regarding people's subjectivity and behavior. When the exchange is public, as in the case of securities traded in an organized market, we need inputs on market sociology, on the social psychology of the parties involved, and we also welcome any available contributions of mental models reflecting the typically complex nature of the respective interactive processes. And, thus, added to the uncertainty of natural events, is the imponderable nature of individual decisions and the equally unpredictable result of collective actions. Lastly, from an individual point of view, the decision to invest involves fear and greed, all of which require constant disciplining of the will. It can also be characterized as an introspective process, a reflection involving several thought faculties, bringing together the many compartments of our cognitive mechanisms. And it is in here, in this internal labyrinth, in this intense passage of synapses that so many of the sly ambushes lie in wait.

So, let us proceed. Based on fragmented statistical data, on wildly ambiguous information, we seek to identify the market's behavioral patterns and to build general asset price trends. Here we use the tool of induction. Parallel to this, we have aggregated macro-economic indicators, industry and sectorial dynamics, the underlying institutional environment, all of them raw materials for the selective filter of companies and of specific business models. Here, we put deductive reasoning to work. The act of investing is analytical since its elements are composed of, and formed by, a number of different parties (companies, businesses, markets) that must be broken down and ordered. It is synthetical because it seeks to identify connections and inter-relationships that aggregate the dispersed elements. It is technical because it is based on an organized objective knowledge base. It is art because it involves individual skills, personal experiences, and idiosyncratic talents.

This huge volume of simultaneous and not-simple tasks offers margins for processing errors. One of the most common errors of judgment was identified at the beginning of the last century by the American psychologist, Edward Thorndike. During World War I, Thorndike decided to examine how commanding officers evaluated their subordinates. In one of his studies, the psychologist asked these officers to rank their men by a number of criteria, such as intelligence, character, leadership qualities, etc. He was astonished by the result: a high cross correlation between positive and negative traits. In other words, the "best" soldiers were classified as superior in all respects. And the "inferior" individuals received low grades in all these categories. It was as though the more personable and better behaved soldiers were also the superior marksmen, cleaned their boots better, etc. Thorndike named this evidence the halo effect[1].

The halo effect is expressed and explained in many ways. Sometimes, it occurs as a typical breakdown of our way of thinking. In the basic mechanics of our reasoning lies a process of

1 *This episode is related in Phil Rosenzweig's excellent 2007 book: The Halo Effect...and the Eight Other Business Delusions That Deceive Managers, New York, Free Press, and was the inspiration behind the topic and title of this Letter.*

Our Performance

In this second quarter, Dynamo Cougar shares increased in value by 5.9%. Ibovespa increased by 7.3% and the IBX by 8.8%. The Fund reversed the first quarter's loss and closed the semester with an accumulated yield of 2.8%. During the first six months of the year, Ibovespa appreciated by 0.5% and the IBX by 1.7%. Over the last ten years, Dynamo Cougar has recorded a return of 24.1%pa in IGP-M and 32.7%pa in US dollars. During this same period, the Ibovespa appreciated by 9.5%pa over the IGP-M and 17.1%pa over the US dollar, and the IBX by 15.8%pa and 23.8%pa, respectively.

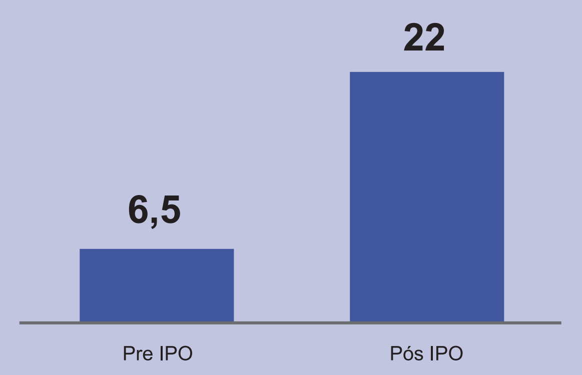
Stock markets sketched some optimism during the first two months of the quarter. Here in Brazil, the economic indicators left space for such appreciation in asset prices. In this second quarter, the GDP grew by 6.1%, in relation to the same period of last year, households consumption by 6.7%, investments, expressed in gross fixed capital formation, by association. The production of similarities occurs rapidly in our judgment, dominates the latter, but does not always accurately reflect the contingencies of the situations in question. In the above case, the associative format arises as a typical manifestation of people's tendency to form opinions on specific traits based on general impressions. Accordingly, the more evident impression (good looking) ranked in first place in the short-term memory storage, thereby influencing the subsequent processing of data and judgment of specific features (precision, dedication).

The halo effect has also been identified as a constant disposition in the human psychology. We tend to seek heuristic shortcuts to decipher hard-to-understand events. Our mind works relentlessly to reduce cognitive dissonance, seeking to make sense of, and find cohesion in, dispersed and less obvious phenomena. We seek accessible information that seems to us to be relevant and objective (good looking) and, based on this, make attributions on other more complex, vague, or ambiguous aspects (temperament, character, specific skills).

In social psychology, the halo effect is regarded as a manifestation of the so-called affect heuristic: the tendency to judge an individual's character based on his or her physical attributes. In studies of decisions on uncertainty, the halo effect appears as a heuristic bias variant, known as representativity. The representativity bias occurs when we attempt to assess an unknown event, such as a sample, for example, based on the degree to which its inherent, essential properties, are similar to the population's; or when the sample reflects significant aspects of the process by which it is generated.

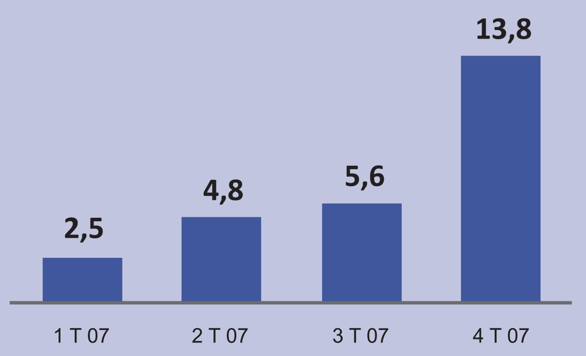
Thus, there are various versions of the halo effect and of its manifestations. It is enough that the most available information regarding a single cognitive or perceptive dimension, crosses over and taints all other aspects that should be part of an objective judgment. In our day-to-day analysis, the halo effect appears in all its many guises. The purpose of this Letter is simply to illustrate a few of these cases.

Table I
Total Annual Launches – Real Estate Developers – Public Cos (R$ Billion)



Source: Companies

Table II
Quaterly Lauches (R$ Billion)



Source: Companies

Sectorial Trap

One of the commonest errors committed in analytical processes is to confuse sectorial characteristics with investment opportunities. When a particular sector presents favorable conditions, an enormous urge arises to take part of these grand and heartening prospects. However, practical experience has shown that a good investment proposition reaches far beyond an attractive sectorial proposal.

The inherent danger here is that such dispositions are usually associated with a tendency to ignore any specific analyses of the companies and of their interaction in the competitive environment. The more evident general (sectorial) picture comes to prevail, dominates the judgment process, and influences investment decisions. Less obvious characteristics, such as the management's skills, the company's strategies for competitive differentiation, the incentive model of each individual company, the internal control tools, corporate cultures, etc., that require longer monitoring and a harder work to understand, become relegated to secondary status. And, thus the classic halo effect arises: specific choices been defined by generic impressions. Let us examine a few examples below.

The Real Estate Sector

Real estate development and construction sector is perhaps the best example of the dichotomy between promising sectorial prospects and successful investment theories. The recent enthusiasm with this sector lies in the unprecedented combination of some basic ingredients: economic stability, reductions in interest rates, increased credit availability, and enhanced long-term financing conditions, in addition to changes in judicial and institutional policy. Add this to the huge repressed demand for new homes (Brazil's housing deficit is calculated around of seven million units). Accordingly, the construction of new houses represented a degree of activity unknown since the nineteen seventies.

The investment community was quick to note these changes and began actively to seek means to take part in this new wave of growth. By taking advantage of the capital market's liquidity, realty companies went public in order to obtain funds for their very promising development projects. As a result, since 2005, twenty-one realty development companies have gone public in operations of approximately R$14 billion. And since the central topic was growth, almost all these neophytes brought with them highly aggressive business plans, without considering any relationship with the overall history of recent deliveries.

We know that an IPO represents a moment of inflection in any business project, but, under these circumstances, never had the disconnect between the past and the future been so great. After the initial public offers, the total volume of project launches amounted to R$22 billion, while, for the year before the respective offers, this amount totaled R$6.5 billion (table I). In other words, on average, each company multiplied its operations 3.5 times over, in no more than a year. A true spree of PSV[2]!

We believe that the real estate development business can be seen as a decision to allocate funds among a number of alternative projects based on a capital pool, a task analogous to management of an investment fund. Although the general concept is identical (housing units), the end products vary in the subtle differentiations of geographic locations, social and economic environments, and cultural idiosyncrasies. Accordingly, each project must be analyzed as a unique investment opportunity, with a different risk:return structure ratio. It would be a perilous simplification to treat all such ventures as mere clones of a modular industrial activity.

Accordingly, the proposition built into the prospects of companies of a dizzying scale of change over so brief a period of time, merits more critical judgment. However, the subject slipped by unnoted by the investors, who accepted the projects launched by these companies, depositing their expectations on the theory of sectorial virtue which was supposedly protected by the prospect of future growth. This climate of euphoria, allied to the necessity to meet up with the guidance's projections, merely created unprecedented situations, such as the excessive concentration of launches that occurred during the last two weeks of 2007 (Table II).

It so happened that the funds raised by the IPOs were insufficient to accommodate the volume of projected sales. Thus, either the investors dismissed the basic math or implicitly assumed that the capital market would remain permanently open for whichever company's future funding necessities. Moreover, these projects also assumed operating margins would remain identical to those of the past.

Recent cyclotimia of financials events have proven the effrontery of assuming that the capital market would be permanently accessible. And, now the effects of this absence are being felt: some companies showing cash scarcity symptoms and others now reviewing their projects. Furthermore, a wave of mergers and acquisitions is sweeping the market, where companies with insufficient fund availability seek the protection of larger and more capitalized organizations.

2 *PSV – potential sales value, is the value of the sales of the total amount of units launched in a certain real state project.*

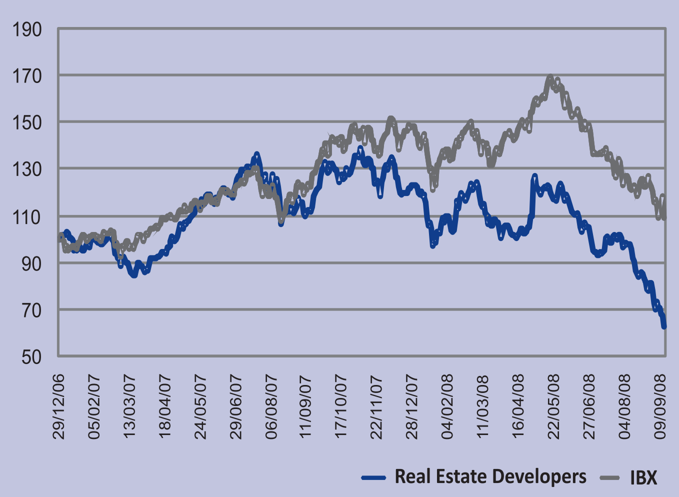
Our view on margins is that, in the past, they reflected both the higher opportunity cost of capital and the higher risk intrinsic to real estate development activities. With the improvements in these two conditions, we saw no reason why a more competitive environment could or would not succeed to arbitrate these returns. In fact, the IPO process itself contributed here since the greater number of capitalized players simply accelerated the competition among the chief products of this industry. It was no coincidence that the news on the increase in the costs of labor, construction materials, and site negotiations at record prices became a regular economic news item throughout last year.

Despite being somewhat overdue, investor recognition of the difficulties experienced by companies in adapting their business models to operate at higher scale levels ended up in a repricing of these assets in the stock exchange, that, on average, dropped by close to 60% ever since the peak of November 2007 (Graph I).

What is most intriguing here is the composition of the halo effect with the reversal of investor expectations. At first, the phenomenon involved confusing optimism about the macro-sectorial conditions as a determining indicator of corporate success. In other words, a deductive bias problem, where a generalized perception was attributed to a distinct and specific dimension. Now, we believe the opposite is happening, where investors extrapolate the specific difficulties experienced by some companies to the sectorial scenario – a typical error of induction.

What might happen is that, in a smaller group of companies, we could begin to see the appearance of the necessary managerial attributes, such as internal controls, qualified and experienced executives, capital discipline, to face the new sectorial scenario. This could result in such companies being negotiated with substantial discounts on their liquidation values, representing an interesting opportunity for diligent investors who successfully identify such assets.

Graph I – Real Estate Developers x IBX



Source: Economática, Cias.

The Electrical and Electronic Sector

Another typical example where sectorial characteristics can easily be confused with investment opportunities can be found in the electrical and electronic sector, specifically in the personal computer segment.

This segment has become extremely attractive for a combination of several reasons: increased credit availability, which has broadened the consumer market, foreign exchange appreciation enabling the import of Chinese components, a global drop in product prices, enhanced controls over pirated and counterfeit products, demographic factors allied to higher levels of education with increased Internet utilization, import barriers, in addition to tax incentives available to local assembly companies, and lower taxes.

Thanks to these facilities, in December 2006, Positivo Informática, the leading company in this sector, went public. The conjunction of these factors allowed for projections of double-digit growth of revenues and income, at the time of the initial offering.

Naturally, the company's considerable qualities were hailed at the time; its leadership position in the PC market, its brand recall, the qualifications of its sales team, its in-depth familiarity with the Brazilian retail market, and its omnipresent support services network. Since then, the company has taken full advantage of its favorable market position and has shown consistent growth. However, even it has begun to feel greater competitive pressure as revealed by an operating margin decrease, although it still retains its market share.

The point here is that the favorable sectorial winds have blown for all in this industry. The gray market, laying aside of the credit availability, ended up ceding space to other established companies, that, in Positivo's wake, also learned to take full advantage of the tax benefits and protections available to this sector. The firm, once accustomed to surfing the good waves alone, is now fighting off the competition. Sectorial superiority does not, of itself, guarantee a sustainable competitive edge. The market is unsure whether Positivo's size and good management are sufficient to assure that its business model will be protected and remain resilient.

Over the last few quarters, even given its increase in production scale and the appreciation of the Brazilian *real*, leading to a decrease in imported component costs, Positivo's gross margin barely grew. The company did not appropriate these benefits, which were passed directly to the consumer, thereby revealing that the franchising of the company did not result in the projected pricing power. Moreover, increased competition also resulted in increased sales and working capital expenses, which negatively impacted the company's EBITDA margin and its return on invested capital.

Positivo's shares are being traded at a drop of close to 60% of their IPO level, after having increased in value by 100%, when they hit their historic high. At this point, it became clear that the investors had extrapolated past returns to value the company without considering the competitive environment and the effect this would have on subsequent margins and returns. The company has already demonstrated business vision, good management capacity, in addition to a talent for making the most of market moments, and remained ahead of the competition when business showed robust expansion. Whether management will succeed in delivering the projected growth and sustain its margins and returns in a more adverse environment remains to be seen. If this occurs, the market will have once again fallen into the trap of judging the quality of a company by the external indicators of the financial reports, excessively penalizing share prices. If not, the resulting post-IPO euphoria will become yet another case of the halo effect deductive bias: when overall impressions (sectorial assumptions) govern specific choices (investment thesis).

The Telecom Sector

Another typical example of confusion between sectorial assertions and investment opportunities has also occurred in the Telecom sector. But here we have a reverse effect. This segment has long been marginalized, and thus left out of most analysts' "buy"-recommendations. The reasons are well known: i) the global trend to deregulation, leading to increased competition and favoring new market entrants to the detriment of the incumbents, ii) the perception that these companies have lower pricing and differentiation powers, iii) exposure to disruptive technological innovations, representing constant threats to the huge and necessary investments in R&D and in infrastructure, iv) negative psychological impacts on the investors impacted by the speculative Internet and Telecom bubbles at the beginning of the decade.

Added to the low sectorial multiples, inherited by the global negative view, telecom sector in Brazil also suffer from a perception of corporate risk built into some local companies' restructuring processes. Also, the fixed incumbent telephony system is presently seriously threatened by a significant customer migration to cellular phone systems. In turn, the latter are beset by fierce competition arising from the increased number of players fighting for customers that offer marginal returns not so promising. In other words, the profitable segment of the business is shrinking, and the growing one is not profitable. In this environment, the sector has become significantly less attractive to investors and the general mood is quite negative.

Once again, we must get down to details to understand the very significant differences involved. GVT is a new market arrival offering telephony, communication, and multimedia services in its concession areas. Thus it works in tune with local legislation which tends to foster a more competitive environment for the current incumbent "monopoly". Unlike in the US, where each round of technological innovation demanded major updates in infrastructure investments, leading to increased competitiveness in the supply of services, here, new comers offer an architecture of network and access in the state of the art with practically no competition whatsoever, since the fixed telephony network quality is very low. In practice, only GVT and Net are viable alternatives to the present incumbents and even their operating areas have little or no overlap. Moreover, it would seem that, among local incumbents, a certain monopoly culture prevails where there is considerable resistance to investing in the business, the marketing tactics are mostly holdovers from the past, and the concept to cultivate consumer services is not very spread.

Thus, GVT successfully garners a market wherever it sets up business. As its cutting edge network expands and consolidates, inevitably, the company erects significant obstacles to the entry of the competition. In addition to that, it is entitled to potentially explore others markets, with growing marginal returns, given the dilution of fixed costs typical in this business. The numbers speak for themselves: during this second quarter, GVT's net revenue increased by 36% over the same quarter last year, the EBITDA grew by 44% and the EBITDA margin reached 37.5%, 2.2 percentage points over 2T07. In a simple exercise the company uses to say that it spends R$1.2 thousand per subscriber, with a monthly return of R$135 and a 60% contribution margin. Assuming a churn rate of 12%, sales of 50% during the first year, and no terminal value for the equipment, the internal rate of return per subscriber would be somewhere in the region of 64%. We are aware of few investments with returns of this scale. In GVT's case, the fog of adverse sectorial statement masks an excellent investment proposition. Those who decide to remain global (G) and do not come down to the village (V) risk not perceiving the opportunities available in this telecom (T) company [3].

NB: In mid-September, GVT's chief shareholder announced an agreement which allow him to substantially increase his stake in the control of the company.

Steel: Flat x Long

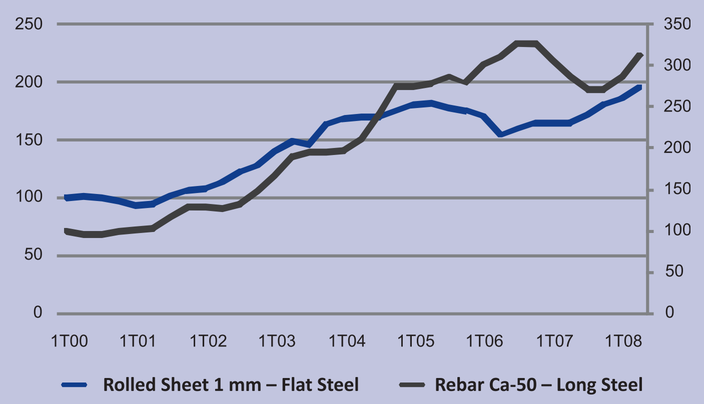
As a general rule, analysts view steel industry products as a commodity. Thus, the dynamics of this sector should be governed by the relative supply:demand ratio, by the level of utilization of capacity in the industry, by inventory levels, and by production costs. These are tradable products and the local markets are arbitrated based on the differential between production costs plus internalizing costs (transportation, tariff and non-tariff barriers, and exchange rates). The bulk of production is via blast furnace and production costs are conditional upon access to basic raw materials, i.e., metal commodities such as iron ore and coal.

We are aware that the above description applies perfectly to flat steel market, but that the Brazilian long steel market dynamics are completely different. We described the local peculiarities of this segment in Dynamo Report n. 48: a highly protected market, dominated by two producers, with little external threat. The highly pulverized supply and distribution chains ensure the producers considerable pricing power. The chief raw material utilized in the mini-mills is scrap iron, available locally from a vast range of small producers. Capacity expansion investments can be modular, with the investment of more modest volumes of capital and generating faster pay-backs than those deriving from blast furnace production. The end products have a wide variety of specifications, and are sold through hundreds of sales centers distributed throughout Brazil. The two segments' target-markets are also different: long steel basically goes to construction, infrastructure, and agricultural industries. Thus, the two segments have widely differing dynamics and features. But analysts treat them almost identically. Why? One possible explanation could be that, in analyzing commodities, the price-variable remains of utmost importance. And, in truth, historically, the behavior of steel flat and long prices is strikingly similar. (Graphs II and III)[4]. Thus, the two segments "came" to be regarded as having the same dynamic.

3 *GVT is the acronym for Global Village Telecom.*

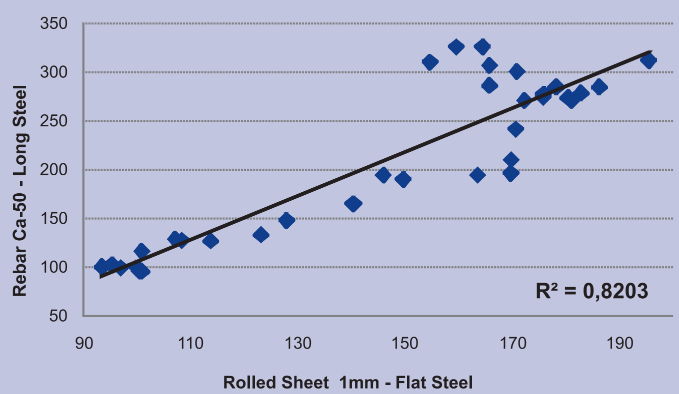
4 *Here, we utilized the rolled sheet (flat finishing) measuring 1 mm of 1.25 x 3,08 m, as proxy for the flat steel and the rebar (ribbed steel bar) c.a. 50 of 5/8 kg, as proxy for long steel, both sourced from by National System for Researching Construction Industry Costs and Indices, at the IBGE. In fact, the rebar is one of the main steel products utilized in the construction industry which, according to the IBS, in turn, consumed 52.1% of steel bars in Brazil in 2006.*

Graph II – Prices in Domestic Market Flat & Long Steel (base 100)



Source: IBGE (Sidra), prepared by Dynamo

Graph III – Prices Dispersion Domestic Market Flat and Long Steel (base 100)



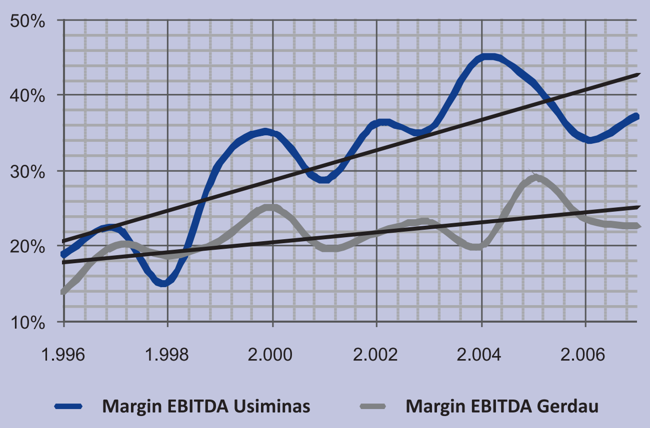
Source: IBGE (Sidra), prepared by Dynamo

The graphs suggest a significant parallel between flat and long products in the domestic market (R2 = 0.82). A similar profile can be found in the US (R2 = 0.87) and the European (R2 = 0.83) markets. However, if we look more closely and examine Brazilian companies' margins, we can identify the differences (Graphs IV and V).

In these graphs, if we take Gerdau as proxy for long steel and Usiminas for flat one, we see that the relationship between the operating margins is greatly reduced (R2 = 0.45) and that, similarly, the dispersal between them considerably greater[5]. Not surprisingly, with China's increased demand together with the movement towards consolidation of global supply, flat segment margins have expanded significantly over the last few years. But, what attracts our attention in this graph is the low historic volatility of the long segment. As we saw, in Brazil, this market is more protected and resilient, with a very much more stable margin dynamic, bearing little similarity to a typical commodity. In other words, this case clearly exemplifies a common error among analysts, one that results in the mistaken effect described: a generalized concept (steel is a commodity) indiscriminately applied with no specific differentiations (flat and long steel are also both commodities).

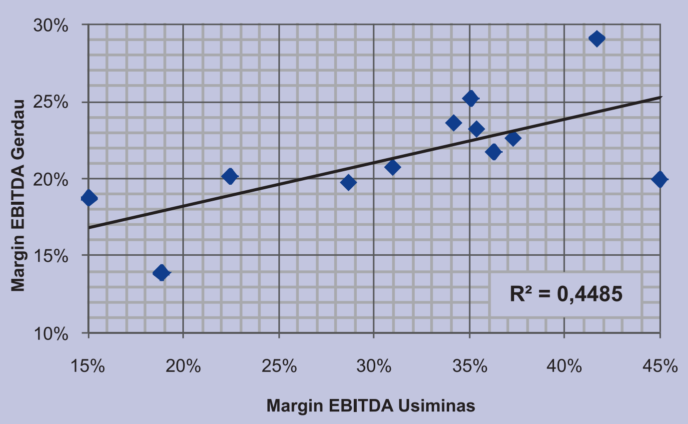
5 *Gerdau consolidated margin includes its domestic and overseas activities. This does not undermine our argument since management's performance is directed towards seeking increased consolidation of the supply chain, as happens here. Of course, with this, the volatility of overseas results also tends to fall. At present, the US operation meets 40% of its own scrap iron needs.*

Graph IV
Annual EBITDA Margin - Gerdau and Usiminas



Source: Gerdau, Usiminas, prepared by Dynamo

Graph V – Annual EBITDA Margin Dispersion - Gerdau and Usiminas



Source: Gerdau, Usiminas, prepared by Dynamo

Petrobras

The halo effect can also be reversed. In this event, the perception of a single feature regarded as undesirable will taint the entire judgment. A classic example in the corporate world is that of state-owned organizations. Here, the problem lies in the fact that the company is controlled by the Government. Strategic objectives that are not strictly part of the respective business, combined with a certain specificity of public management, become arguments sufficient to drown this type of company from any serious and selective investment process

Throughout Dynamo's existence, we have also been affected by this type of argument. Our golden investment rule is to identify distortions between price and value. Basically, we seek good and, preferably protected businesses, with good growth prospects and that are well managed. We also look out for important ancillary conditions that usually add substance to the respective investment theory. Chief among these are: i) understanding the company's long-term strategy, ii) verifying that the interests of shareholders and the executives are appropriately aligned, iii) identifying an interlocutor accountable to answer for management commitments. Generally speaking, these are not features of a state owned company. Control are generally defined and stable, but the exercising of power fluctuates under each change of electoral mandate. These companies are usually Government instruments and their operating activities tend to be subordinated to an agenda of interests not necessarily aligned with those of their minority shareholders. Senior executives can be here today and gone tomorrow. In this context, it would be well nigh impossible to attain the basic prerequisites for an investment meeting minimal safe conditions.

But, as we all know, there are exceptions to this rule. We have been studying the dimension of the opportunities inherent to oil exploration in Brazil. In particular, the activity of the so-called pre-salt cluster in the Santos Basin suggests a potential for prospecting resources that, if these are indeed confirmed, they would place Brazil among the world's major hydrocarbon producers. The investment potential is massive, implies major repercussions in this sector's economic activities, and could even contribute greatly to the country's development.

Based on the assumptions generally utilized by the industry to evaluate the potential of exploratory resources, our model of Petrobras indicates that only a small portion of this potential would be priced in today's market. In this context, if the existence of these resources and their production viability at costs compatible with the new oil price levels become a fact, this would cause an enormous discrepancy between price and intrinsic value for Petrobras. The company would qualify as a candidate for the attention of value investors such as us.

Let us examine the circumstances. Over the last years, Petrobras has regularly disclosed its five-year Business Plan. This document shows the company's chief strategic planning guidelines, mainly for its investment program. Although the Plan is adjusted annually, it is eagerly awaited by agents in the sector, and serve as the company's external reference and public commitment for all its stakeholders. This year, jointly with the Business Plan, Petrobras also disclosed a Strategic Plan going through to 2020, in which it defined its corporate principles, management objectives, and long-term operating targets.

It is a well known fact that Petrobras acts as a Government agent in managing Brazil's national energy policy. We also know that a small part of the company's capital is appropriated to 'structuring' projects that result in less than desirable returns. But, we also acknowledge some expediency in the present Government's management, insofar as this does not undermine the company's general interests. The price increase of refined products on May (to the detriment of federal tax collections), and the removal of the pre-salt blocks from the Ninth Round, at a time of significant competition for the signing bonus, may help illustrate this argument. Moreover, over time, Petrobras has developed internal bullet-proof mechanisms against political guidelines that could threaten the company's reputation for technical excellence. Even in the extreme event of alteration of regulatory policy or of the creation of a new company to manage the pre-salt resources, to date, there is no evidence that Petrobras could forfeit the exploration and production rights to its current concessions or be harmed in the competition for new areas.

In other words, in this case, in addition to an attractive valuation, the surrounding circumstances seem to have been satisfied, thereby qualifying Petrobras as a serious candidate in the race for space in selective investor portfolios. We continue to highlight any negative aspects identified, such as bad management control, unpleasant surprises in corporate expense, substantial operating cost increases, in addition to increased charges on special participation taxes in blocks that have already been put up for tender but have not yet been explored. Notwithstanding, our model still stands up to such challenges. Furthermore, we have improved our grassroots analysis: we discussed these matters with a great number of specialists in this segment, we visited a number of companies, those of Petrobras competitors, suppliers, and customers, both in Brazil and overseas. An almost entirely unanimous message arising from these conversations was the respect and even admiration in which Petrobras is held among the agents, who did not skimp on praise of the company's technical capacity and negotiating skills. Of course, many of these virtues were born under the aegis of the company's monopoly or quasi monopoly. Nevertheless, they are particularly important qualities at a time when a major portion of the company's future value is conditional upon its ability to meet several technological challenges and others relating to its management operating competence. In other words, the pre-salt opportunity (and here we refer not only to the Santos Basin cluster) could become so attractive that the status of public company could de downgraded to a faculty of second order of importance.

Our investigation, which we regard as still being incomplete and which will most certainly merit exclusive space in a future Letter, suggests that Petrobras is typically becoming the victim of a reverse halo effect. Its status as a an "of the Government and for the Government" company, with the negative perception brought about by such condition, tends to dominate an initial judgment, while simultaneously concealing its interesting features and blurring any objective and deeper analysis of the company's intrinsic value.

Our Performance

16.2%, and the operating profit of Ibovespa companies, by 15%. Dynamo Cougar followed these positive news on the fundamentals of the business environment in general, and thus, the majority of our investments performed well, particularly, Gerdau, GVT, Petrobras, and Drogasil.

Due to the delay in publishing this Report, we are writing in the context of a huge financial crisis, one certainly totally unfamiliar to the present generation. In this interconnected world, faraway financial flows do not bend to economic indicators nor to local corporate performances. At this specific time, Bovespa's historic high, reached in May, seems like a "remission" occurring just before the imminent bad news. But this is third quarter news. We shall cover this matter in our next Report.

Dynamo Cougar x IBX x Ibovespa
Performance up to june/2008 (in R$)

Period	Dynamo Cougar	IBX average	Ibovespa average
60 months	413,12%	491,97%	400,68%
36 months	152,44%	177,45%	158,07%
24 months	69,73%	83,27%	77,25%
12 months	6,41%	24,00%	19,49%
3 months	5,94%	8,79%	7,34%

NAV/Share on June 30th = R$ 199,870551336

Dynamo Cougar x Ibovespa x FGV-100
(Performance – Percentage Change in US$ dollars)

Period	DYNAMO COUGAR* Quarter	DYNAMO COUGAR* Year to Date	DYNAMO COUGAR* Since 01/09/93	FGV-100** Quarter	FGV-100** Year to Date	FGV-100** Since 01/09/93	IBOVESPA*** Quarter	IBOVESPA*** Year to Date	IBOVESPA*** Since 01/09/93
1993	-	38.78	38.78	-	9.07	9.07	-	11.12	11.12
1994	-	245.55	379.54	-	165.25	189.30	-	58.59	76.22
1995	-	-3.62	362.20	-	-35.06	87.87	-	-13.48	52.47
1996	-	53.56	609.75	-	6.62	100.30	-	53.19	133.57
1997	-	-6.20	565.50	-	-4.10	92.00	-	34.40	213.80
1998	-	-19.14	438.13	-	-31.49	31.54	-	-38.4	93.27
1999	-	104.64	1,001.24	-	116.46	184.73	-	69.49	227.58
2000	-	3.02	1,034.53	-	-2.63	177.23	-	-18.08	168.33
2001	-	-6.36	962.40	-	-8.84	152.71	-	-23.98	103.99
2002	-	-7.86	878.90	-	-24.15	91.67	-	-46.01	10.12
1stQuar/03	4.47	4.47	922.65	4.63	4.63	100.55	5.39	5.39	16.06
2ndQuar/03	27.29	32.98	1,201.73	38.16	44.55	177.07	34.33	41.58	55.91
3rdQuar/03	19.37	58.73	1,453.83	24.72	80.29	245.56	22.34	73.20	90.74
4thQuar/03	22.18	93.94	1,798.51	35.98	145.16	369.91	39.17	141.04	165.44
1stQuar/04	4.67	4.67	1,887.16	2.35	2.35	380.16	-1.40	-1.40	161.72
2ndQuar/04	-4.89	-0.45	1,790.04	-8.66	-6.51	339.30	-11.31	-12.56	132.11
3rdQuar/04	35.12	34.52	2,453.91	23.73	15.67	443.56	21.13	5.92	181.16
4thQuar/04	22.17	64.35	3,020.19	25.32	44.96	581.16	21.00	28.16	240.19
1stQuar/05	-1.69	-1.69	2,967.41	-1.66	-1.66	569.87	1.06	1.06	243.80
2ndQuar/05	5.41	3.62	3,133.23	2.98	1.27	589.80	7.51	8.65	269.60
3rdQuar/05	32.32	37.12	4,178.29	25.21	26.80	763.71	31.63	43.01	386.50
4thQuar/05	2.97	41.19	4,305.49	3.13	30.77	790.73	0.75	44.09	390.17
1stQuar/06	23.32	23.32	5,332.90	18.89	18.89	958.98	22.51	22.51	500.48
2ndQuar/06	-3.88	18.54	5,122.20	-4.58	13.44	910.48	-2.68	19.23	484.40
3rdQuar/06	5.68	25.27	5,418.57	2.64	16.44	937.17	-1.03	17.99	478.36
4thQuar/06	19.56	49.77	6,498.25	23.01	43.23	1,175.83	24.08	46.41	617.65
1stQuar/07	9.67	9.67	7,136.29	10.07	10.07	1,304.32	6.72	6.72	665.84
2ndQuar/07	29.34	41.85	9,259.40	28.84	41.81	1,709.26	27.19	35.73	874.08
3rdQuar/07	7.46	52.43	9,957.63	15.72	64.10	1,993.66	16.39	57.98	1,033.74
4thQuar/07	4.76	59.69	10,436.57	2.63	68.42	2,048.71	9.78	73.43	1,144.60
1stQuar/08	-1.74	-1.74	10,253.11	2.63	68.42	2,048.71	9.78	73.43	1,144.60
2ndQuar/08	16.40	14.37	11,950.74	11.55	16.11	2,394.95	17.94	13.16	1,308.33

Average Net Asset Value for Dynamo Cougar (Last 36 months): R$ 763,268,786.57

(*) 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.
(**) Index that includes 100 companies, but excludes banks and state-owned companies. (***) Ibovespa average.

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

www.dynamo.com.br

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DYNAMO

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