Report

DYNAMO 59

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Metamorphosis

The world is plunged in the worst financial crisis since the Depression of 1929. Social phenomena of global impact as such are not used to be covered by one single explanation. This case was no different. Reliable analyses have already identified the possible causes of the current global credit crunch: electoral purposes of governments to artificially sanction already overstretched realty markets, excessive easing of central banks resulting in excess of liquidity throughout the system, negligence of regulatory bodies, deviations in the design of incentives among market participants, lenience of risk agencies, and, as ever, the spicy flavor of such an immoderate ambition. An array of political, economic, cultural, and institutional factors allied to the baser instincts of human nature have resulted in an unprecedented destruction of wealth.

In essence, this is a financial crisis. Each and every ingredient thereof has, in some way, filtered through the financial system. In this case, a specific agent nurtured relationships with each of these factors: the investment banks. Mortgages originated in the real estate segment were attractively packaged and spread over by the investment banks as securities throughout the market. The liquidity produced by low interest rates was multiplied in highly leveraged balance sheets. Regulators were not able to keep up with the inventiveness of these new financial products nor watch the non-conventional trade floors, new playgrounds where the investment banks went out to have fun. The crisis also opened the gates to highly questionable compensation practices and incentive models, though assiduous they were among investment banks' packages. It was no coincidence that these same banks reported the worst losses. Traditional institutions such as Bear Stearns, Lehman Brothers, and Merrill Lynch toppled along the way.

Excessive leverage, unrestrained securitization, and toxic derivatives, the "financial weapons of mass destruction" rapidly reached the economic headlines as the villains of the piece. Although they might be accused as guilty, they are still 'merely' tools of execution, and products of their environment. One may guess that a prior transformation within the system would have led to a generalized unprecedented behavior and equally exotic arrangements. We tried to understand this metamorphosis. As is our custom and, indeed, reflex action, we went back to basics. We analyzed the origins of the investment banks, checked each one's history and growth. We trod remote trails where we sought clearer clues that might explain the source of certain decisions that instigated this global financial chaos. This is certainly also a limited and partial approach, but one less deeply examined by most analysts. As the path grew

Our Performance

In this third quarter, Dynamo Cougar shares decreased in value by 19.3%. *Ibovespa* dropped by 26.3% and the *IBX* by 26.4%. Thus, the Fund reported an accumulated negative result for these nine months of 17.1%. *Ibovespa* accumulated losses of 25.1% and *IBX* by 25.9%. Over the last ten years, Dynamo Cougar has recorded a return of 25.8`^{pa} in *IGP-M* and 32.78%^{pa} in US dollars. During this same period, the *Ibovespa* appreciated by 9.9%^{pa} over the *IGP-M* and 16.1%^{pa} over the US dollar and the *IBX* by 16.5%^{pa} and 23.1%^{pa}, respectively.

In September, the global financial crisis intensified and mushroomed. First, Fannie Mae and Freddie Mac rang warning bells, followed by the FED's refusal to respond to Lehman Brothers SOS. Then it was the turn of longer, we divided the task into two Reports. In this one, we describe the investment banks' course. In the next one, we shall give some practical insights into the topics discussed in the context of our funds and of Dynamo itself.

Roots

The securities market of the eighteenth century was dominated by a handful of investment companies, such as the Rothschilds, the Barings, and the Browns. Prior to becoming leading financiers, these Houses started up activities in the area of inter-Atlantic trade in the seventeenth century, when they imported commodities to Europe, particularly, Britain, and exported manufactured goods to the US. There was little international trade legislation at the time and disputes were settled completely arbitrarily in court. The execution of credit in court was an especially challenging task.

Operating under these conditions was an ongoing challenge. Not just due to the many different jurisdictions involved but also because the distances between the parties inevitably limited communications. If the parties involved should had to rely on existing legal enforcement measures, it would be almost impossible for them to close a single deal. Accordingly, these "Atlantic merchants"1 drew up alternative contracting methods, based on specific institutional agreements and private regulations. These were chiefly based on: i) the in-depth knowledge of the parties involved, ii) a close-knit, long-term relationship based on trust and mutual encouragement for cooperation, and iii) the threat of exclusion if any of these mutually agreed conventions were infringed. In this way, they would gather a vast amount of information on their clients and markets. This led to the creation of a worthy relationships network, built on a solid commercial and operational credibility base.

In this environment, where it was hard to execute loan agreements, obviously, these traders would use their reputations and superior knowledge to loan money to their clients. And thus it was. Throughout the nineteenth century, the transport and communications systems evolved, as did the judicial and institutional environment of international trade. Accordingly, these Houses sought alternative business to use their good names and knowledge. The solution was the financial markets. And, so, by the close of the century, a goodly portion of the profits of these ex-traders/neo-financiers already derived from cash advances to commercial companies and from foreign exchange transactions. The Commercial Houses had transformed themselves into Investment Banks.

Thanks to the enormous distance between the parties involved in these transactions and the dispersion of information available, at first, the role of these intermediaries was essential to commercial counterparties. All this knowledge was accumulated in family business arrangements, and was often concentrated in the patriarchal owner who placed his personal stamp on company transactions. When the main activity went from mere intermediation in commercial transactions to issuing securities, similarly, the investment banks' reputations became associated with the success of the transactions they offered their clients.

1 The term used by Morrison, A. and Wilhelm, Jr., W. in *Investment Banking, Institutions, Politics and Law* (2007), Oxford University Press, from which we borrowed several of the arguments used in this Report.

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AIG, the biggest insurance company in the US, to admit losses in credit default swap market and suffer a liquidity crisis. The de-leverage process advanced speedily and interbank market credits dried up in many parts of the world. Equity markets collapsed in a coordinated way, in a process of general liquidation of assets. In this environment, businesses fundamentals lost importance, dominated as they were by continuous sale flows. As share prices dropped, margin calls increased, feeding-back new sales, in a pro-cyclical process.

Here in Brazil, share prices accompanied this rhythm. Big caps suffered as a liquid investment vehicle in times of crisis. Small caps suffered from a lack of liquidity, since fund manager had to sell at any price to face increasing redemptions. Equity market indices dropped synchronized. In nominal terms, Dynamo Cougar recorded its worst quarterly performance since the 1998 Russian crisis. Of its ten lead positions, five dropped close to 30% during the quarter. In some of these investments, we

At the time, information on these companies and on the quality of their executives was notoriously unreliable, dispersed, and scarce. Moreover, shareholders' power to monitor and control management was practically nil. Here, the banks played a fundamental long-term stakeholder role. The Morgan case was the most well-known. The House pioneered a activist role, being present at the board meetings of its investee companies, and having the power to contract and dismiss executive officers. Thanks to its reputation as a diligent financial intermediary, Morgan's presence was the signal to investors that the respective company would be managed with energy and competence. The investment could also lead to additional benefits, such as privileged access to a financial capital pool, in addition to protection from competitive threats from other companies under the banker's oligarchic influence. This explained the companies' considerable interest in numbering investment banks among their shareholders.

There is evidence that Morgan's involvement did indeed add value. In a comparative study, De Long (1990)2 estimates that, based on a sample of twenty companies in a number of different segments, the presence of a partner of J.P. Morgan and Co. on the board of directors added up to 30% in value on the return on shares from 1910-1912. This perception was also essential to sustain the bankers' long-term business, since it assured their deal flow capacity, in addition to maintaining their pricing power, through the ability to charge fees above market averages.

Tacit Knowledge, Partnership, and Reputation

Investment bank business at the time was dependent on the banker/capitalist's particular brand of personal, experimental, intuitive, and non-transferable knowledge. This knowledge was exercised and acquired over many years through management of relationships networks, deal flows, selection and management of trading strategies, and a wide range of consulting activities, such as mergers, acquisitions, and restructuring operations.

All financial transactions are based on some degree of confidence in the intermediary role. But, in securities issues, the asymmetry of information between the issuer and the buyer of the security is far greater. This is the chief reason why confidence in the intermediary institution's reputation is paramount. Without this, the entrepreneur will have insufficient comfort to offer and expose his business to the market. On the other hand, investors would enjoy little safety in buying an asset about which they know far less than the seller. Frequently, it becomes impossible to establish an equitable balance between the needs of the parties involved. Investors demand more information, in order to better price the asset and to minimize analysis risks, entrepreneurs intend to access funds without providing strategic and proprietary information. In this case, it is the intermediary's name that accommodates differing expectations and minimizes the transaction discount.

This proprietary knowledge, this tacit human capital, unquestionably, was the most valuable asset for the investment banks. However, by definition, this

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witnessed the uncontrolled sale of one or two foreign investment funds that were obliged to liquidate their portfolios. In other cases, companies that had initially held out, eventually became the victims of their own success, and became the preferred target of sales, booking relatively lower losses.

There were few major changes to the Fund's portfolio. Natura and Pão de Açúcar stood out and thanks to their relatively better performances, gained positions in the portfolio passively. During the quarter, Natura increased by 14.9% and Pão de Açúcar dropped by 'only' 3.3%. An assortment of common reasons was responsible for this. Both companies have traditionally more resilient products, had suffered prices adjustments earlier, and have stronger shareholder bases.

We remain watchful, combing for opportunities in a market dominated by fear and uncertainty. However, the worst could be yet to come.

2 De Long, J. (1990) *Did J.P. Morgan´s Men Add Value?* Harvard University, Department of Economics.

form of idiosyncratic intelligence cannot be stored, documented, or transferred for traditional training purposes. This type of experience can only be absorbed by exposure to the mentoring tasks carried out in the person by the banker himself. In other words, two problems arose for these organizations: i) What incentive did a senior partner (banker) have to pass on hard earned knowledge to someone who could then take his place? ii) How, after this, could the junior partner be persuaded not to leave the company? If we could easily establish property rights over an investment banker's human capital, these would cease to be problems. Alas, this is not the case. The fact that it is impossible for property rights to rule implicit knowledge contributions ensures that this type of knowledge can´t be transferred from generation to generation via formal agreements.

The standard solution to this transfer of implicit knowledge problem has always occurred via iliquid and, to a degree, discretionary, stakes. When equity participations are iliquid, the senior partner guarantees long-term commitment from the junior partner, while potentially and simultaneously ensuring a final buyer for his stake, thereby reducing the opportunity cost of the mentoring task. In other words, the fittest structure to deal with matters involving tacit knowledge is a partnership. It is no coincidence that this is the predominating arrangement to be found among financial boutiques, law offices, and consulting firms.

However, it is also extremely difficult for a company to prove ex ante whether or not it has the desirable implicit skills to offer to its clients. In such a case, another basic ingredient comes into play – the company's reputation. Investment banks depend basically on their good names for generating greater returns, i.e., attract clients and charge high fees for their services. It is precisely because the equity in an iliquid company is tied up, that the partners primary interest is to protect their reputation. The most efficient manner in which to ensure this is via a strict process of promoting new partners. Thus, the senior partners will tend to train their younger successors as a recipe for preserving the company's reputation (its chief asset) as well as the value of their investments. Thus, once again the partnership structure successfully creates a system whereby tacit human capital may be transferred. The partnership agreement achieves this goal by offering its partners an iliquid stake in the firm's reputation. In turn, they unofficially undertake to train these new partners in order to safeguard the firm's reputation in addition to guaranteeing a market for their investments.

Moreover, the iliquidity of the equity stakes demands a higher mutual commitment among the partners that manifests itself through continuous monitoring the firm. This is reflected in an increased attention to any free rider behavior and by peer group pressure. It is no coincidence that most investment bank recruitment of potential partners takes place precisely at the senior partners' social position level.

Thus, a partnership's structure is highly fitted to handle business involving typically tacit tasks, skills, and knowledge. It was thanks to this arrangement that the investment banks were established in the eighteenth century and carried on developing throughout the nineteenth century, when they played a vital role in financial capitalism and in the economic development of the US. It is not by chance that almost all of them bear the name of their founders. Up until 1960, this type of structure remained practically unchanged. A family, blocked control structure prevailed. The banks restricted their activities to their areas of expertise and offered their clients carefully selected transactions duly sustained by the reassurance of their reputation. The financial capital of these partnerships was limited and their partners identified strongly with their respective Houses. Turnovers were extremely low and the chief asset of these banks was the respect with which they were regarded by their clients and peers. It was precisely the fact that it was well nigh impossible to replicate this reputational capital carefully built over time, that became the main obstacle to entering the business, which, in the long run, ensured that they were highly profitable.

The Route to Going Public

It was at this time that two forces conspired to transform the US banking system's business environment. This had a profound impact on the internal organization of retail banks and, shortly thereafter, on investment banks.

Firstly, there was the impact of the information technology revolution on the banking sector. The ensuing swift explosion of computer use had a massive impact on administrative task routines and led to an exponential increase in the volume of trades. This movement coincided also with the increase share of institutional investors and mutual funds in the total volume of transactions, thanks to the improvement in trading and back office activities (settlement, custody). The banks that first invested in technology reaped huge benefits, as in the case of Merrill Lynch, which obtained a significant edge in the retail brokerage market and in the underwriting sector throughout the nineteen sixties.

Very shortly then, personal computers arrived at the front office. Every account manager was able to control a far greater number of clients. Electronic spreadsheets provided analysts with an instant calculation tool, valuation and asset pricing tasks were standardized, and trading strategies were coded into replicable algorithms. Additionally, this mixed group of techniques became organized into a formal learning process. In other words, what was previously learned in a lengthy process of personal tutoring suddenly became available in 'financial engineering' textbooks or in business administration classrooms. Skills that previously had only been acquired through a long drawn-out process of internal exposure to corporate culture were now widely available. In a way, the human element of investment bank activities became transformed into a commodity, as did the concept that investment banks should be 'deal factories'.

These crucial changes led to the downgrading of the importance of the capitalist banker. His experience-based knowledge and tacit human capital began to lose ground, and the relative weight of the investment banker reputation decreased radically. This occurred mainly in markets where activities were more coded, such as the retail services, the secondary trading market, and, even to a certain extent, the asset management. Consequently, the obstacles to entering these markets lessened, competitiveness intensified, and profit margins were squeezed.

Then the banks found themselves obliged to increase the size of their businesses in order to increase their competitiveness. They targeted to gain economies of scale brought by the automation of processes and the codification of activities, and began testing new market niches. For this, they needed funds and the capital market became a feasible financing option.

The result of these changes was that investment banks whose preference was to operate in the securities market discovered that the value of their reputation had devalued drastically. Morrison and Wilhelm (2007) argued that banks aware of this could be motivated to liquidate their reputations while they lasted, and to direct clients towards less profitable deals, as seems to have been the case with Bankers Trust.

The fame remains that this combination of forces, the advance of technological needs and capital requirements essential to counter the new competitive environment, forced first the retail and then the wholesale banks in the direction of the capital market. The so-called 'back office crisis' between 1967 and 1970 clearly highlighted the fact that retail bank survival was conditional upon more automated business operations. In 1971, with NYSE authorization, sixteen retail banks went public. The nineteen eighties saw the investment banks take this same route. Goldman Sachs in 1999 and Lazard Frères in 2005 were the last partnerships to go public.

With the road duly paved, we are now in a position, in our next Report, to examine the the consequences for investment banks to going public and to decreasing their reputation. In the light of this narrative, we take the opportunity to analyze our investment in Brazil's financial services sector (Itaú and Unibanco) and shall conclude with a few practical considerations on the vital importance that reputation represents to us at Dynamo.

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

Period	Dynamo Cougar	IBX average	Ibovespa average
60 months	240,99%	259,94%	196,62%
36 months	62,76%	61,19%	52,84%
24 months	28,97%	34,85%	31,40%
12 months	-16,33%	-19,77%	-20,74%
3 months	-19,34%	-26,35%	-26,30%

NAV/Share on September 30th = R$ 161,222059931

Dynamo Cougar x FGV-100 x Ibovespa
(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
1st Quar/03	4.47	4.47	922.65	4.63	4.63	100.55	5.39	5.39	16.06
2nd Quar/03	27.29	32.98	1,201.73	38.16	44.55	177.07	34.33	41.58	55.91
3rd Quar/03	19.37	58.73	1,453.83	24.72	80.29	245.56	22.34	73.20	90.74
4th Quar/03	22.18	93.94	1,798.51	35.98	145.16	369.91	39.17	141.04	165.44
1st Quar/04	4.67	4.67	1,887.16	2.35	2.35	380.16	-1.40	-1.40	161.72
2nd Quar/04	-4.89	-0.45	1,790.04	-8.66	-6.51	339.30	-11.31	-12.56	132.11
3rd Quar/04	35.12	34.52	2,453.91	23.73	15.67	443.56	21.13	5.92	181.16
4th Quar/04	22.17	64.35	3,020.19	25.32	44.96	581.16	21.00	28.16	240.19
1st Quar/05	-1.69	-1.69	2,967.41	-1.66	-1.66	569.87	1.06	1.06	243.80
2nd Quar/05	5.41	3.62	3,133.23	2.98	1.27	589.80	7.51	8.65	269.60
3rd Quar/05	32.32	37.12	4,178.29	25.21	26.80	763.71	31.63	43.01	386.50
4th Quar/05	2.97	41.19	4,305.49	3.13	30.77	790.73	0.75	44.09	390.17
1st Quar/06	23.32	23.32	5,332.90	18.89	18.89	958.98	22.51	22.51	500.48
2nd Quar/06	-3.88	18.54	5,122.20	-4.58	13.44	910.48	-2.68	19.23	484.40
3rd Quar/06	5.68	25.27	5,418.57	2.64	16.44	937.17	-1.03	17.99	478.36
4th Quar/06	19.56	49.77	6,498.25	23.01	43.23	1,175.83	24.08	46.41	617.65
1st Quar/07	9.67	9.67	7,136.29	10.07	10.07	1,304.32	6.72	6.72	665.84
2nd Quar/07	29.34	41.85	9,259.40	28.84	41.81	1,709.26	27.19	35.73	874.08
3rd Quar/07	7.46	52.43	9,957.63	15.72	64.10	1,993.66	16.39	57.98	1,033.74
4th Quar/07	4.76	59.69	10,436.57	2.63	68.42	2,048.71	9.78	73.43	1,144.60
1st Quar/08	-1.74	-1.74	10,253.11	4.09	4.09	2,136.62	-4.06	-4.06	1,094.11
2nd Quar/08	16.40	14.37	11,950.74	11.55	16.11	2,394.95	17.94	13.16	1,308.33
3rd Quar/08	-32.92	-23.28	7,983.42	-23.37	-26.01	1,480.89	-38.71	-30.65	763.15

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.

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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