Report

DYNAMO 60

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In our last Report we briefly narrated the path of investment banks, from their very beginnings as commercial houses in the seventeenth century to the decision to go public during the last quartile of the twentieth century. We saw that the advance of technological needs, the codification of tasks, and the financial capital needed to confront that new competitive environment thrust the banks towards the capital market. As they abandoned the traditional partnership model, the banks discarded the structure that had seamlessly promoted the transmission of tacit knowledge along their corporations and, at the same time, that preserved the integrity of the foundation on which their entrepreneurship had been based: the reputational capital.

Our intention now is to check the effects of this decision. This will enable us to describe our investments in the financial sector, the focus of this Report. By clarifying the differences between the basic structures of banks here and overseas, we believe we can justify important positions of our portfolio in this sector, even in the current worldwide atmosphere of shattered confidence in this particular area of business. Lastly, we shall conclude with a practical observation on the importance that, here at Dynamo, we ascribe to some aspects described in our last two Reports.

Effects

The transition from a private company to a public one involves a number of significant challenges. The case of banks was no different. For a number of reasons, it is hard to inculcate into a corporation that type of tacit human knowledge described in our last Report. Firstly, because binding the virtues and skills of a traditional capitalist banker to the reputation of a public company is a particularly taxing undertaking. To successfully motivate these big talents to place their skills at the service of the company, as they use to do in a partnership structure, represents a huge challenge for any incentive package. Furthermore, the change to a reality of a public company alters corporate governance structures: when the executives are no longer the owners, the pressure of internal peer group monitoring wanes. Moreover, the more the company grows, the more codified the performance metrics become, which tend to replace the informal method of evaluations, usual among partnerships. Frequently, performance packages based on impersonal algorithms trample on less obvious cultural aspects, and tend to undermine the cooperative and collegiate behavior so typical of partnerships. And this is how, together, large-scale operations, mechanical management practices, and widespread ownership become a major challenge to businesses that are dependent on tacit human capital.

By going public, investment banks then find themselves face to face internally with the classic governance problems of dispersed control: monitoring the executives, the reality of a company with no "owner", and the difficulty to design an incentive system which could achieve to balance the demand for short-term results with the preservation of the respective bank's long-term interests.

The challenge is exacerbated given that, in the banking business, reputation is a paramount ingredient to corporate suc-

Our Performance

In this fourth quarter, Dynamo Cougar shares decreased in value by 15.9%. *Ibovespa* dropped by 21.7% and the *IBX* by 25.9%. The Fund reported an accumulated negative result for year of 30.2%. *Ibovespa* accumulated losses of 41.3% and the *IBX* by 41.9%. Over the last ten years, Dynamo Cougar has recorded a return of 21.6%^{pa} in *IGP-M* and 26.3%^{pa} in US dollars. During this same period, the *Ibovespa* appreciated by 7.0%^{pa} over the *IGP-M*, 11.1%^{pa} over the US dollar and the *IBX* by 13.3%^{pa} and 17.7%^{pa}, respectively. Since it started up activities in September 1993, the Fund has earned 24.6%^{pa} in *IGP-M* and 29.9%^{pa} in US dollars, while the *Ibovespa* increased in value by 7.2%^{pa} and 11.8%^{pa}, respectively on the same basis.

The quarter saw further impacts of the global financial crisis, particularly, in October. Daily, stock exchanges recorded record losses. The violent deleverage process continued to suffocate the credit market. Governments and central banks worldwide launched packages to stimulate the economies and bailout domestic financial systems. Still in November, economic indicators began to feel the financial crisis hit: drop cess. It was for this very reason that the family control model of the early investment banks was set to associate the name of the institution with the preservation of customers interest. Cleary, that arrangement satisfactorily met the reputation need of the business. No sooner does this link weaken, when senior executives cease to be the owners of the company, when internal controls nod off, when the imperatives of competitiveness expose customers to an array of risky, or even questionable transactions, the conditions for unpleasant surprises are presented.

In fact, the incentive mechanisms of overseas investment banks extrapolated the canons of compensation in financial services. While the media aimed their critical missiles at hedge funds and their 20% performance fees, investment banks pay out 50% of revenues as compensation, in extremely levered structures and ignoring the high watermark concept[1]. Moreover, hedge funds operate on a partnership basis, where the personal reputation of the manager is permanently subject to proof. And this does not even consider the investment of one's own money, practice of alignment of interests very common among hedge fund managers, which does not occur to the same degree of intensity between banks executives.

In a recent article in Portfolio Magazine (*December 2008 Issue*), Michael Lewis, author of *Liar's Poker,* lights up the above arguments. He intersperses his analytical narrative in respect of the causes of the current crisis, the "end" of Wall Street, with a conversation with John Gutfreund, CEO of Salomon Brothers at the time when the bank went public[2]. The quote is long but apposite.

John Gutfreund did violence to the Wall Street order – and got himself dubbed the King of Wall Street – when he turned Salomon Brothers from a private partnership into Wall Street's first public corporation. He ignored the outrage of Salomon's retired partners. ("I was disgusted by his materialism", William Salomon, the son of the firm's founder, who had made Gutfreund CEO only after he'd promised never to sell the firm, had told me). (…) He and the other partners not only made a quick killing; they transferred the ultimate financial risk from themselves to their shareholders. It didn't, in the end, make a great deal of sense for the shareholders. (A share of Salomon Brothers purchased when I arrived on the trading floor, in 1986, at a then market price of $42, would be worth 2.26 shares of Citigroup today – market value: $27). But it made fantastic sense for the investment banks.

From that moment, though, the Wall Street firm became a black box. The shareholders who financed the risks had no real understanding of what the risk takers were doing, and as the risk-taking grew ever more complex, their understanding diminished. The moment Salomon Brothers demonstrated the potential gains to be had by the investment bank as public corporation, the psychological foundations of Wall Street shifted from trust to blind faith.

No investment bank owned by its employees would have levered itself 35 to 1 or bought and held $50 billion in mezzanine CDO's. I doubt any partnership would have sought to game the rating agencies or leap into bed with loan sharks or even allow mezzanine CDO's to be sold to its customers. The hoped-for short-term gain would not have justified the long-term hit.

No partnership, for that, matter, would have hired me or anyone remotely like me. Was there ever any correlation between the ability to get in and out of Princeton and a talent for taking financial risk?

Now I asked Gutfreund about his biggest decision. "Yes", he said. "They – the heads of the other Wall Street firms – all said what an awful thing it was to go public and how could you do such a thing. But when the temptation arose, they all gave in to it". He agreed that the main effect of turning a partnership into a corporation was to transfer the financial risk to the shareholders. "When things go wrong, it´s their problem"…

1 *Under the high watermark system, performance is only due when the fund attains the highest NAV. In other words, under this system, investors do not pay performance at times when the return on the fund is below the hurdle.*

2 *In addition to Michael Lewis' Liar's Poker, another book on the story of Salomon Brothers is Margin Mayer's Nightmare on Wall Street – Salomon Brothers and the Corruption of the Marketplace, (1993). There is no little irony contained in Mayer's remark that, in English, the name Gutfreund means "good friend". The frontispiece bears a passage that clearly illustrates the present context: "And when the firm manipulated the government bond market in a U$10 billion scandal, they destroyed not only careers but the reputation of their house in a business where reputation is everything".*

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in consumer confidence, generalized economic deceleration, investment cancelations, and growing unemployment rates. This is the third act of the classic description of negative cycles: from a drop in asset prices, we go through credit tightness, to finally arrive at real economy slowdown. Dozens of quality analyses have been written about this crisis and these specialists' astute comments have much more to contribute to the matter, since we, meanwhile, maintain our focus on the day-to-day of the companies.

The fact that, during this quarter, the Ibovespa recorded a result six percentage points lower than ours or, in relative terms, 35% lower, is no consolation. Not even for the year, where this difference exceeded ten percentage points. Our monitoring of the Fund's historic drawdown shows that, at the peak of this crisis, i.e., on October 27, 2008, Dynamo Cougar's share prices dropped by 49.9%, very similar to the magnitude of that of the 1998 Russian crisis, when the Fund's maximum loss reached 47.2%. In this context, the situation is not so unprecedented. One of these good analyses we mentioned above, associated the economic cycles with Tolstoy's imagery on family happiness: just as in periods of prosperity all families are happy in a similar fashion, however, as recession times, each family is miserable

Defects

The ordinary, the commonplace, is usually straightforward. It is the atypical that demands more arguments. And this was why we needed such a long detour, begun in our last Report, to try and find explanations for current problems that defy logic: How could the investment banks expose their proprietary desks and their customers' money to such risky deals, to such low quality assets? How, in so short a period of time, could the banks destroy their apparently solid franchises, that were built up along so many decades?

In historic perspective, we saw that the loss of importance of reputational capital and the absence of internal controls, allied to the disappearance of the partnership structure, set the stage for such permissive behavior. From then on, excessive leverage, unrestrained securitization, and the indiscriminate use of exotic derivatives materialized as the product of this lenient environment.

In defense of the banks, it could be argued that customers and shareholders could not be exempted for responsibility to monitor their own investments and that it is part of fiduciary duty of CFOs to acknowledge the payoffs inherent to these derivatives transactions. Indubitably, the business as usual argument has its points, and we cannot allow ourselves to fall into the simplistic Manichean trap of splitting the players into the good guys and the bad ones. On the other hand, the relationship between banks and their customers, carefully built over several decades, has always been based on reputation. It would be almost impossible for outsiders to recognize the exact moment when this reputational capital began to be extinguished.

Nor are we in any way alleging the superiority of defined control over widespread ownership when we defend partnerships rather than corporations. Those of you who have been following our Reports are aware of the care we have taken in dealing with this matter of ownership structure, a regular topic in our in-house discussions. We recently revisited the theme in our Report No. 52, "*Dispersed and Concentrated Ownership – A Topic Revisited*", where we updated our thoughts and technical bibliography on the subject. On behalf of our own experience, there we stated that "Despite intense theoretical discussion and empirical studies, to date, no definitive conclusion has been reached in respect of the superiority of one system over another". In fact, for years now, we have fluctuated between the two alternatives. On the one hand, there is a certain preference for dispersion when, as minority shareholders, we felt the difficulties of a system with minimal legal protection, scarce liquidity, and hermetically sealed control blocks enjoying the private benefits of control. On the other hand, we also appreciated the vigilance of a diligent controlling shareholder, the "eye of the owner", a quality which began to gain more recognition at the time when companies with widespread ownership structure became increasingly involved in corporate scandals in the beginning of the decade (Enron, WorldCom, Global Crossing, Tyco, etc.). In this particular case, that of financial services, where reputation is of paramount importance, the empirical pendulum leans us towards the concentrated ownership system.

Deflect: Itaú-Unibanco

We said that this crisis is basically a financial one. The financial system shrinks, traditional institutions fall by the wayside, and the sector now seeks to found its proper size in global GDP. In this scenario, it seems positively brazen to say that two important investments of our funds are precisely in the banking sector: Itaú(sa) and Unibanco, now together under the same structure. Such seemingly incongruity merits explanation. We shall use this opportunity to explain the basis for our optimism in respect of this new company.

Basically, two ideas pervade our analysis: i) the view that the fundamentals of business here are robust and the structure of the domestic banking industry differs in many important ways from the organization model of the sector in other countries, particularly, the US[3]; ii) the perception that the merger represents an unique opportunity for the new company, both in terms of growth potential and of maximization of the current assets and costs base.

3 *In this case, the path to modernity seems to be inverted, justifying the appearance of typical national differences, almost as we could hear in the economy echos from the Brazilian Week of Modern Art of 1922.*

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in their own individual way. In this particular context, the crisis brings unique challenges and uncertainties, since the basic ingredients are also unparalleled: the complexity of globally linked financial markets, the magnitude of an unprecedented de-leverage process, the diversity of players with an array of strategies, incentives, mandates, and expectations, all of them interacting in an environment dominated by insecurity, stress, and fear. We have enormous difficulty in making any kind of projection on the outcome of this combination of such vague elements. Instead of dedicating ourselves to the adventure of forecasts on markets and economies, we would rather focus our energies on analyzing business and keep very close to the companies. In this context, the difference from the major drawdown of 1998 is that we can count on a bit more of experience over these ten years, and must remind ourselves of that fair definition that 'experience is the name we give to our own mistakes'.

We are aware that our investors allocate a portion of their savings here to Dynamo in order to maintain long-term exposure to equity market, through an investment approach based on value investing. Our duty is to extract/prospect for the best investment options available, joining efforts, experience, methods, and discipline. We truly believe that this combination, Itaú-Unibanco can be regarded as a multiple franchise company. In other words, a number of business segments with their own dynamics operating under a single umbrella, thereby enabling optimum use of the available synergy and scale gains. Unlike most other overseas markets, with very distinct segmentation of players along the financial services chain, Brazilian commercial bank operations are verticalized and integrated and offer a wide range of different products. With interests aligned among stockholders, excellent growth prospects, management of high quality, and an attractive valuation, this merger reinforces the franchise, increases share in important markets, and further expand the group's advantages of scale against its competition.

Examples always help in making a point. Brazilian banks have a verticalized presence in the credit card market. They dominate the market from the time of the actual transaction is made by the customer in a store to the issue of the cards themselves. This means that, at every credit card purchase made, a rapidly expanding market in Brazil, the banks retain practically all the fees on such transaction. This is a business that requires little amount of capital and presents high returns. In truth, the returns are even greater than what is accounted, since part of the reported cost base is related to the acquisition of new customers. At Unibanco, close to one-third of its profits derived from this segment. In addition to its extremely efficient sourcing and processing structure, Unibanco also has a regional credit card brand with approximately ten million users. With the merger, the credit card segment will be an import source of synergy and an interesting growth driver for Itaú-Unibanco over the next few years.

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over time, can produce outstanding risk/return results. So much so that we have always invested, and will continue to invest, our own resources in our funds. Historically, Dynamo Cougar has always been invested more than 90% of its net worth. The reason for this is that, over all these years, we have identified investment opportunities whose compound pay-offs, over time, exceeded the alternative return of a risk-free security. Throughout 2008, we identified good reasons to be invested in a select group of Brazilian companies. Dynamo Cougar's main positions should disclose excellent results in this fourth quarter and will probably continue to present robust growth rates into 2009. These are well managed and capitalized companies that do not require external funding to finance their activities. Their businesses are protected, resilient and grow organically. In this sense, the fund's exposure closely to historical levels seemed to be reasonable.

Here, we are beginning to feel the crisis via the channels of expectations, of relative prices (terms of trade), and naturally, of the higher cost of capital. Opinion polls and industrial soundings reveal less confident consumers and more cautious entrepreneurs. The reflex was December's significant drop in local industrial production of 14.5% over the same period in last year.

Interestingly, the market seems not to price properly this potential on the bank's valuation. A leading Brazilian card payment company, listed in *Bovespa*, *Redecard* is traded at an earnings multiple (P/E) of approximately 16x. Taking this as a reference, according to our estimates, we would have a market value of R$30 billion for this business area, based on its contribution to the combined results of the banks. If this is indeed the case, the other operations of the new Itaú-Unibanco would be valued at a P/E ratio of 6.5x for 2009. Accordingly, either the remainder of the Bank's operations is very undervalued, or the real value of the credit card business is not accurately considered in the Bank valuation. The impression is that this rationale could be extended to other areas of the Bank, had we other references of listed companies. In other words, with this integrated and verticalized operation, the real value of each segment becomes less evident, although we have good indications enabling us to believe that the value of the whole is significantly greater than the sum of its parts.

Another example of the immediate impact of the potential gain arising from the merger would be an improved allocation of capital of Unibanco's assets portfolio. As a smaller player and with a more expensive and shorter term funding cost, before the merger, Unibanco was obliged to maintain higher cash reserves, in addition to having a credit portfolio biased towards large corporate customers and lower maturity assets. Now that it is included in Itaú's portfolio, we can expect its cash reserves and a portion of its loans to large companies to be allocated to more profitable areas, thereby increasing the total return on its loan portfolio. On the other hand, Unibanco has a far more robust operation in the insurance segment, particularly since its acquisition of 50% of its AIG joint-venture. Here, it is Itaú that has the greater potential for improvement and use of scale gains.

Itaú-Unibanco hold close to 20% of the Brazilian banking market, with even stronger positions in profitable and high growth sectors, such as credit cards (35% of market share and 15% of profits), loans to the automotive sector (35% of market share and 12% of profits)[4], in addition to asset management, and private pension plans. In practice, this market share could be even greater. Two government banks, Banco do Brasil and Caixa Econômica Federal, jointly hold one quarter of the banking industry, with significant compulsory focus on the agricultural and real estate sectors, respectively. These federal banks, with their subsidized funds and high costs, tend to pursue very different objectives from those of the private players, and are less competitive in less regulated markets. If we adjust the market to the reality of competition among private capital banks only, in practice, Itaú-Unibanco holds close to 30% of the market.

The new structure of Itaú-Unibanco has a high potential for achieving scale gains in a number of areas, from cost structure to the credit approval process. Since the company will have a vast customer base – 15 million current accounts, 50 million credit cards, and agreements with four of Brazil's six

4 *Dynamo estimates for both sectors.*

largest retailers – this capacity to access individual credit profiles enables much faster and more efficient credit approvals. This leads to increased speed and lower processing and credit score definition costs, whereby the Bank would be the first choice among many intensive consumer credit businesses, particularly, retail stores. The trend is for this robust market position to lead to higher margins, thereby producing an obvious positive feed-back mechanism. This, in turn, leads to greater growth in the emerging profitable sectors, such as, for example, loans to the automotive sector, where Itaú dominates and shows high profitability.

Funding is an especially valuable business area, with great potential for optimization of returns. Unlike the US financial model where banks compete with several other players in the race for managing individual, institutional, and corporate savings, in Brazil, local banks strongly dominate the channels to access third-party resources. The possibility of offering the entire array of financial products to customers is a key competitive advantage: it increases the scale of operations, broadens the capacity to raise funds, all of which lead to a desirable diversity and control in the funding structure.

Balance sheet risks in the Brazilian financial sector are considerably lower than overseas. Traditionally, local banks are less leveraged. The Basel index published in the fourth quarter for the joint Itaú-Unibanco operation was 16.1%, far higher than the recommended standards. The levels of provisions against potential losses are also very high. This is because, historically, banks have always operated in a highly volatile environment, with a complete absence of incentives to maximize short-term results; on the contrary, in fact. This represents a buffer against changes of mood in the credit environment. The quality of domestic banks' loan portfolios is also better. This could be due to the fact that growth opportunities are still significant in the more traditional markets, or possibly due to lack of time, or even inattention. But the fact remains that our banks have practically been unaffected by the confusion created by the exotic instruments[5]. Similarly, the duration of local portfolios is shorter, since we are not widely exposed to the real estate market, where loan repayment schedules are much longer. Another major difference is the fact that Brazil's secondary market is still just beginning; securitization mechanisms are hesitant and financial transactions basically take place in organized markets. The madness of the over the counter markets, the blind spot of overseas regulations, barely exists in Brazil. In theory, this represents limitations in domestic banks' potential activities. On the other hand, it provides increased protection to investors, as they are freed from the risks of these low visibility transactions.

The environment also helped. The post-*PROER* (Program for Fostering the Restructuring of the National Financial System) financial system learned to live with incontrovertibly austere regulations. Here, the monitoring jurisdictions between *BACEN* (Brazilian Central Bank) and the *CVM* appear to be clearly defined. We have no areas of ill-defined regulations as it seems to occur in the USA. Furthermore, under the respective rules, the net worth of officers and board members of financial institutions are blocked in cases of litigation, losses arising from negligent management, or filings for bankruptcy. This rule is retroactive for up to five years as of the close of the respective board member's/director's term of office and remains in force throughout the entire course of the judicial inquiry that, in Brazil, can take many years. There is no doubt that, since they impose greater discipline on management, our domestic institutional rules in this area provide greater protection to minority shareholders of banks, something that clearly is not the case in the US. In addition, it brings a sort of barrier to entry to new comers, by imposing additional penalties over unsuccessful entrepreneurs.

For some considerable time, we have been hearing the argument that the return on equity of Brazilian banks is excessively high. Relative analyses between countries place local banks in an uncomfortable position above the standard returns curve. This suggests a permanent downside threat as a result of the universal law of convergence to the mean. This premise disregards the considerable differences between the bases of competitiveness and organization of Brazil's financial and banking sector. Returns in Brazil have to be structurally higher than the average, since the market is relatively more concentrated and the transactional part of the business, least capital intensive, is significant, as opposed to the typical spread business, which is, as a rule, more subject to arbitrage. Furthermore, the static comparison of these metrics of return does not include features such as market positioning, busi-

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This scenario demands unremitting monitoring since both expectations and realities have changed at an unprecedented speed. For example, several companies have confessed difficulties in preparing their own budgets, so huge are the uncertainties and lack of visibility. As we said earlier, our main positions promise to report strong results for the last quarter, and continue to release positive signals at this start of the year, maintaining relatively aggressive targets for 2009. In truth, companies that together represent 30% of our portfolio have already published their annual financial statements. We noted that the EBITDA growth in the fourth quarter (qoq), weighted by the size of these investments in the Fund portfolio, was 26%. Confidence in the strong fundamentals and good operating performance of these companies goes hand-in-hand with a perception of a chaotic and uncertain external environment. And this could still lead to significant share price volatility. On the other hand, since many of these investments performed poorly in this recent movement of indiscriminate price liquidations, at present, the good perspectives of these businesses *vis-à-vis* their valuations seem a touch unbalanced.

5 *Recent exceptions have been corporate derivatives in FX transactions. More commonly known overseas, they were brought in by foreign banks. Although this is not a widely used practice among domestic companies, it caused significant havoc in companies such as Sadia, Aracruz, and Votorantim.*

ness mix, the quality and transparency of assets, the conservative style of management, all of which represent quality differences in relation to our peers overseas.

The merger involves challenges and requires special attention focus, one of them being the cultural transformation. The co-existence, for a determined period of time, of two equally deep-rooted and different corporate cultures tends to produce a certain degree of uncertainty regarding the time required for absorption and the actual nature of the cultural identity arising from the process. Moreover, Banco Itaú is in the process of changing part of its management, since a number of its senior executives are approaching retirement. The recently announced management structure includes several Unibanco executives. Even the Bank's own CEO, Roberto Setúbal, recognizes the need for more decentralization and renewing among the senior management team, as can be seen from the following extract from a recent interview:

"The only thing our competitors cannot copy is our company's culture – and it is here that we can form a sustainable competitive edge. Presently, we are reviewing our culture in a "top down" project, which started with our senior executive level and is currently at the second and third levels. This project is partially related to leadership style, but with a focus on the ongoing improvement of day-to-day activities. We have had some impressive results regarding the way our people work together. This project involves people, most especially those at an intermediary level, to enable them to develop increased responsibility, initiative, and leadership skills. If this works, I believe we shall gain not only a competitive edge, but several smaller advantages spread throughout our lines of business, and at all levels of our organization. Over time, this could become a single and extremely powerful quality, and one that would be very hard to replicate[6].

We have great confidence in the ability of the current executives to handle this transition smoothly, but, given the risk involved and the manifest importance of the success of this episode for the performance of the new company, we have intensified our attention to this matter.

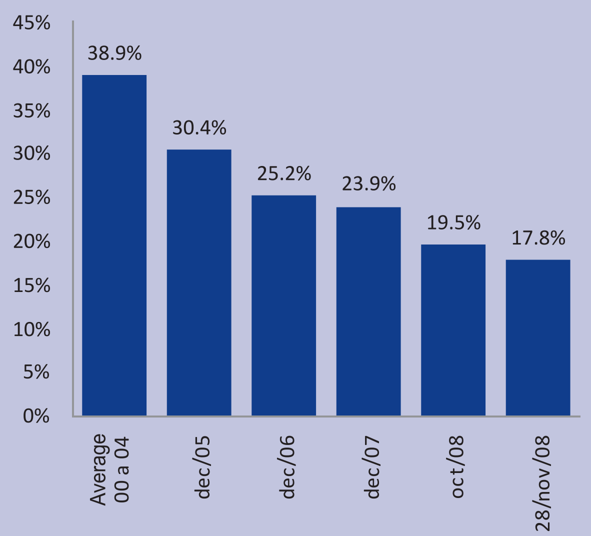
When the merger was announced, our main investment in the sector was already Itaúsa, the holding company of the Setúbal and Villela families, that controls Banco Itaú, in addition to investments in the industrial sector. Itaúsa has been in our portfolio, to a greater or lesser degree, since 1997. Over the years, our experience has been that the market circumstantially offers excellent opportunities for investing in Banco Itaú taking advantage of Itaúsa's holding company discount. Precisely about this matter, we made the following comment in our Report No. 20 (3Q1998): "Our experience with holding companies (best example of which is Indústrias Villares) shows that even more important is to analyze the behavior of the company vis-à-vis the discount of its shares. If the company is complacent and blames the market imperfections for the situation, this is a sign that the fair discount may be higher than usual. On the other hand, if the company is pro-active, and assumes the discount to be its own problem, taking concrete measures to reduce it, this is a very positive sign and, overtime, the discount may even be eliminated with all shareholders benefiting from the process. We believe Itaúsa to fall into this last category".

Since then, Itaúsa management's approach has confirmed our impression. A number of measures were taken: the launch of the investor relations website, regular meetings with analysts, dividend reinvestment practices, improved disclosure, and, particularly, a consistent and timely share repurchase policy. The figures speak for themselves: since 1998 through last September, Itaúsa received a total amount of R$5.8 billion in dividends. Close to R$4.7 billion, net of capital increases, were passed on to their shareholders. The company also repurchased and canceled the equivalent of almost R$1.6 billion in shares, equal to 5.5% of the outstanding shares.

In fact, Itaúsa´s discount has been dropping over time, as can be observed in the table below. Nevertheless, the current discount represents an excellent opportunity for exposure to the new Itaú-Unibanco, since, as described above, Itaúsa is expected to continue offering a higher dividend yield.

The strategic value of Itaúsa investments is another important aspect. Again, in our Letter No. 20, we commented: "Naturally, if the holding company owns strategic positions that cannot be emulated (most notably, controlling stakes), it is possible that it shares trade at a premium to its parts. However, the question still remains as to whether the owner of such controlling stake is only the controlling group of the holding itself or all of its shareholders".

Chart I
Itaúsa- Historical Discount (%)



Source: Itaúsa

6 *Roberto Setúbal, interview to The McKinsey Quarterly – Special Edition 2007: Creating a New Agenda to Latin America, pgs 121-129.*

At the time of the merger, when the Moreira Salles family, which controlled Unibanco, migrated to the new company's joint control vehicle (IU), Itaúsa received more shares than it was due by the established relative valuation. In counterpart, the Moreira Salles family received a lower economic interest. This meant that Itaúsa and, consequently, all its shareholders received a premium for dividing the control of the new company. This premium, in the form of shares, increased Itaúsa's stake in the new bank by 6.8%, with no corresponding cash disbursement, and thereby immediately reducing the historical discount[7]. Interestingly and, to our surprise, this episode went unnoticed by the analysts who commented the deal.

It has been some considerable time since Itaú and Unibanco went public, but they also retained the chief virtues of their original partnerships, which, as we have seen, proved to be very appropriate to the financial services business. Thus, both Itaú and Unibanco, and now, also, Itaú-Unibanco, are arranged in a defined control structure, where the controlling families hold the top executive positions. The two banks have always been noted for their strong corporate culture. They are also widely acknowledged for their conservative management policy and for their efforts to cultivate long-term relationships with their customers and shareholders, in other words, for the great importance they attribute to preserving their reputational capital. In this context, the behavior of our domestic banks differs vastly from the reality of their international peers.

Reflect

Just before we end this Report, a brief note is required on the topic of reputational capital, in reference to our own company. In our view, the partnership structure is the best arrangement for Dynamo, where tacit knowledge prevails and reputation is quite simply our greatest asset. In our Report No. 39, that ludic self-analysis exercise that was part of the celebration of Cougar's tenth anniversary, we saw that the manner in which we structured our company (partnership) adjusted perfectly to the corporate culture of Dynamo. This fine-tuning shows how satisfied we are with our story and our complete lack of interest in testing any other kind of corporate arrangement for our company.

Recently, the global financial crisis gave us an example of how important it is to be up-to-date with one's own good name. Over the last few months, we have witnessed a huge rush of redemption requests on funds here in Brazil and overseas. Not even managers with a first class track record were unaffected. Funds with long redemption and grace periods, some involving side pocket, lock-ups, and gate clauses, mechanisms that reduce investor mobility – and maybe, indeed, because of this – experienced substantial redemptions. When crisis strikes, at the very first sign of any uncertainty, the hitherto trusted protections fail to deliver.

However, here at Dynamo Cougar for example, with our significantly more "unprotected" structure of redemption schedule of twelve days (D+12) only, to date, we have had practically no redemptions. In fact, in response to some investors' requests, we opened the Fund to investments and ended up receiving a good volume of new money. It appears to us that, in this time of uncertainty and challenges, the combination of low redemption/ positive flow of new money (fair amount of subscriptions) seems to uphold the value perceived by investors of the characteristics that we admit we nurture for reasons of principle and not merely for the mere economic calculations of the 'business'. In Dynamo's partnership model, control and management are indistinguishable, inseparable. Moreover, the people who control and manage also invest a significant portion of their net worth. These three roles are equally important. This equilibrium between the individuals involved results in maximum security for other investors, since the funds are always managed with no distortion of asymmetry of interests. For example, this harmony is reflected in the fact that it is not one of our goals to number among the 'best' managers in the rankings of conventional publications, nor do we attempt to compete in performance comparisons against market indices. This attitude usually conceals a hypertrophy of objectives of managers against the ones of investors'. Our focus is to seek the best investments within the range of the mandate we understand we receive from ours investors, independently of any result that this may represent to us as managers.

Perhaps it is excess vanity to attempt to see in the mirror of one's own virtues what we should attribute to our shareholders. After all, it is they who, in the midst of the mist, make the decision on their portfolio allocations, and, in this case, continue to identify good medium and long-term perspectives for the companies in which we invest together.

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

Period	Dynamo Cougar	IBX average	Ibovespa average
60 months	137.32%	107.95%	68.71%
36 months	26.23%	17.18%	12.77%
24 months	-7.73%	-13.79%	-15.67%
12 months	-30.25%	-41.89%	-41.31%
3 months	-15.88%	-21.52%	-21.69%

NAV/Share on December 31sd = R$ 135.624369261

7 *In the merger, the number of shares of Banco Itaú held by Itaúsa increased by 8.3%, arising from the shares issued by Banco Itaú as a partial payment for Itaúsa's investment in Itaú Europe, and due to the premium obtained on the formation of the IU Holding Company.*

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

Period	DYNAMO COUGAR*			FGV-100**			IBOVESPA***		
	Quarter	Year to Date	Since 01/09/93	Quarter	Year to Date	Since 01/09/93	Quarter	Year to Date	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	4.09	4.09	2,136.62	-4.06	-4.06	1,094.11
2ndQuar/08	16.40	14.37	11,950.74	11.55	16.11	2,394.95	17.94	13.16	1,308.33
3rdQuar/08	-32.92	-23.28	7,983.42	-23.37	-26.01	1,480.89	-38.71	-30.65	763.15
4thQuar/08	-31.09	-47.14	5,470.06	-17.58	-50.05	973.34	-35.86	-55.52	453.66

Average Net Asset Value for Dynamo Cougar (Last 36 months): R$ 802,035,992.42

(*) 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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