Report

DYNAMO 74

2/4 2012

Philosophy of Patience

In the previous Report we classified into three categories the main reasons for a prevalence of short term orientation among capital market participants. We have seen that elements of a biological nature, derived from the human brain's architecture, drive us to short term decisions. This genetic disposition finds a good counterpart in the financial markets, in which one can find a multitude of immediate rewards.

Now, the idea is to continue to address the subject, but through different angles: first of all, we will comment on the vices and virtues that are inherent to a short term orientation. Then, we will list some measures that have been suggested on specialized discussion forums, to promote a greater long term commitment among market participants. Lastly, through some concrete examples, we will illustrate the issue and discuss its impacts over our daily activity as long term investors.

Justifications

The concepts of complexity and adaptive systems – addressed in previous Reports – imply that in order for the market to remain robust and efficient, investors with different profiles must interact independently. The capital markets' ecosystem requires a wide variety of species and short or very short term investors have an important role to play. In fact, our experience shows that the exaggerated responses by short term investors turn out to be the best investment opportunities for long term, patient investors. Moreover, short term strategies are important not only for the robustness of the system, but also for its liquidity. As the market's oxygen, liquidity is an essential ingredient to the proper working of the complex system of price formation. Even very long term investors use short term tactical trading moves to maximize the returns of their investments. Such strategy is only possible when there is enough market liquidity.

As an important component for the proper functioning of the markets, short term strategies can also be rational and successful. Good traders, long term survivors in an extremely competitive environment, are the best evidence that it is possible to achieve consistent results using this investment philosophy. Furthermore, as we have seen in the previous Report, concerns over short term results can be healthy, as it can exert a positive pressure for efficiency.

So why is there such mistrust with being focused on the short term? Some explanations:

i) Short term gains can occur in detriment of more sustainable long term profits. The here and now concept can be more certain, but it can come at the expense of obtaining a higher future reward. The present value of results that come from long term gains can be greater than immediate profits.

   In the corporate world, an excessive short term focus can imply long term risks for companies. Programs that target cost cutting and expense reductions that affect the training of personnel and executives, the R&D budget or management systems, can improve short term gains. However, these actions may create problems further down the road. Decisions to not execute a defensive acquisition (Brasil Telecom, GVT), to despise niche markets where new opportunities and threats come from (IBM, personal computer), to not promote important adaptations, to not respond as fast as the competitive environment requires (Kodak, digital imagery) and to not dedicate enough time to analyze strategic issues, can conspire against the sustainability and the growth of a business over the long term.

   Research papers on corporate strategy defend the thesis that a source of genuine competitive advantage would be the "the **cumulative** result of adhering to a set of consistent policies **over a period of time**".

(Dierickx and Cool, 1989, our emphasis). In other words, strategic attributes that can generate exceptional returns, only develop over time through a process of progressive concentration. Some examples: a continuous investment program in fixed assets, the gradual accumulation of specific knowledge, mutual confidence, corporate reputation, franchise development and distinctive organizational competences. Consequently, an excessive focus on the short term could interrupt a virtuous accumulation trajectory, defying the future sustainability of the business.

ii) Greater short term activism leads to greater costs. All else equal, the more intense the trading activity, the worst the results. In the 1945-1965 period, the average transaction cost of the 25 biggest American mutual funds was around 0.8% of their total net worth. Between 1983 and 2003, this same cost went up to 1%. At the same time, the total net worth of those funds went from US$0.7 billion in 1945 to US$2.5 trillions in 2004, a 3.6 thousand times increase (cfr Bogle 2005). It is also worth mentioning that, during this time period, technological advances managed to considerably lower the transaction costs. In other words, the increased turnover of the portfolio has been so high that it has diminished investors' returns, in a business that, theoretically, has high operational leverage.

iii) Short term orientation can create negative long term externalities for the company and for society. The markets' pressure for delivering results in the short term, in addition to the executives' will to defend their careers and paychecks, can generate an environment that isn't very cautious about issues whose repercussions will only appear in the future.

iv) Focusing on the short term can lead the investor to have a partial, compartmentalized and myopic view. Many subjects are only understood after looking at it from a wider angle. Investing is an activity that deals with probability and with complex issues. Statistically, a short term view forces one to rely on the trap of using limited statistical samples. Drawing the conclusion that the company is a good one, based on upbeat results of 3 consecutive quarters is almost the same as saying that a coin is tricked because it has shown the same side on the three first tosses. Longer statistical samples are required in order to draw assertive conclusions and this is only possible over a long time period. The short term analysis tends to overrate recent evidence, ignoring the rule of large numbers and the tendency of mean reversion, both typical attributes of repetitive events.

Complex phenomenons, as financial markets usually are, produce emerging characteristics that are different and superior to the integrating parts. Those can only be spotted when looking from a wider angle. In other words, focusing on the short term or on limited data prevents us from seeing the signs produced by the system. "There's a big seller on the screen, the stock price is going down, let's sell beforehand", would suggest an immediate analysis. In the meantime, the big seller disappears, the company announces another good contract and there goes our "technical" trader buying back the stock at a higher price.

Repairs

The excessive short term orientation of the capital markets has been widely addressed by different think tanks, an initiative that attempts to promote a long term perspective for market participants. "We believe that short-term objectives have eroded faith in corporations continuing to be the foundation of the American free enterprise system, which has been, in turn, the foundation of our economy. Restoring that faith critically requires restoring a long-term focus for boards, managers, and most particularly, shareholders—if not voluntarily, then by appropriate regulation."[1] Others have pointed "the tyranny of quarterly numbers as the principal reason for the perceived decline of the western economy" (crf. Repenning and Henderson, 2010).

In the United States, the shortening of the investing time frame by market participants is being aggravated by certain factors. These include: 1) the prevalence of a dispersed control structure; 2) the relevant participation of institutional investors, like hedge funds and mutual funds, many of them focusing on the short term. With this combination, there is a higher likelihood for the predominance of strategies that favor short term activism, as they dominate, even if temporarily, board appointments or shareholder meetings.

1 *The Aspen Institute (2009). As usual, the complete bibliographical references are available in our website: http://www.dynamo.com.br/narbibliog.asp*

As a result, long term investors feel threatened of being held hostage of this short term, opportunistic or even extractive agenda. Hence, the mobilization to try to rebalance the equilibrium of power, and the appeal, sometimes in an ideological tone.

For the sake of curiosity, we have listed below some of the suggestions being discussed by the think tanks:

- Alterations of the tax system applied to financial investments, stimulating more "patient" capital and discouraging trading activity. This could be done, for instance, through the use of tax rates that are adjusted down as the number of invested years increases;

- Political rights proportional to the investment duration, or a minimum time period required to be able to participate in some corporate acts;

- Augmenting the transparency requirements between players, so that conflict situations are avoided. For instance, when an activist votes in corporate events, and at the same time holds a short position in the stock. Or, in a takeover situation, when an investor can exercise his political rights in one company in order to maximize his economic interests in another;

- Preventing companies from providing quarterly profit guidance, or at least to adapt the periodicity of guidance to the company's business cycle and to its needs to access the stock market for capital. That way, smaller companies, with shorter product cycles, could continue to give short term guidance. More established companies, on the other hand, can endure more volatility of investors' mood and wouldn't need to give quarterly guidance;

- Executives' compensation packages should be drawn so that they capture not only the upside, but also the potential downside of their actions, aligning their interests with those of long term shareholders. Thus, basing the pay packages on long term metrics is advisable, with executives holding a "significant" amount of shares that vest in a time frame of three to five years. Similarly, the performance and the compensation of asset managers should also be designed according to long term metrics, and not on a quarterly basis. It is also expected from asset managers that an important part of their personal wealth is invested together with external investors in the funds they manage;

- The companies' communication and disclosure policies should be in accordance to their long term objectives. "Companies have the shareholders they deserve"[2]. Investor relation areas should make a genuine effort to find investors in accordance to the long term value creating ideas of the company. When speaking of Berkshire's communication strategy, Buffett (1983), as the controlling shareholder of a publicly-listed company, has stated that:

  "We feel that high quality ownership can be attracted and maintained if we consistently communicate our business and ownership philosophy - along with no other conflicting messages - and then let self selection follow its course (...). We try to attract investors who will understand our operations, attitudes and expectations. (And, fully as important, we try to dissuade those who won't.) We want those who think of themselves as business owners and invest in companies with the intention of staying a long time. And, we want those who keep their eyes focused on business results, not market prices."

Naturally, we should place these recommendations in a context of long term investors being threatened by short term activism in corporate decision forums. Therefore, some ideas may appear to us as controversial and too heterodox, as is the case with the proposal of political rights being proportional to the holding period of the investment. In Brazil, this wouldn't be as useful as most companies have a defined controlling shareholder, and this assures, in theory, the company's long term perspective. In any event, some of the suggestions are universal and should be considered by market participants, such as the long term alignment of compensation packages and a better communication strategy by the companies.

Implications

How does all of this affect us, as long term investors? As we have shown, one of the biggest advantages that we have at Dynamo is to be able to take advantage of market opportunities that are created by excessive reactions, by short term investors, to news/events that aren't very relevant to the company's long term fundamentals. In equity investments, this short term obsession prevents most of the players from seeing long term effects. In many cases,

2 *Business Roundtable Institute for Corporate ethics, CFA Institute, 2006.*

this determines the success or failure of an investment. Two examples to illustrate the point: in the first one, we will show how the myopic view of the short term investor prevents it from seeing long term risks. In the second one, we will show how opportunities can arise from this phenomenon.

Real estate is a case in point. It was the most predominant sector in our last IPO cycle. Driven by the convergence of positive indicators coming from the macro and micro scenarios, lower interest rates, credit abundance, greater juridical and institutional safety such as fiduciary alienation, better financing conditions for buyers, pent up demand as highlighted by the housing deficit, among others, demonstrate why the real estate sector had a honeymoon with the capital markets. In a two year period, no less than 23 companies have gone public, raising around R$19billion in primary resources in a total of 35 offerings. Since the investment thesis was based on a strong expected growth, each company raising capital promised a game-changing step-up. Having completed the offering, those companies tried to hold true to their promises by accelerating launches, as measured by the PSV (potential sales volume).

At first, the results measured by this criterion were largely satisfactory. However, this is a sector with a long business cycle, and the champagne used to celebrate today's launches can lead to an uncomfortable hangover when the delivery (or lack thereof) moment comes further down the road. As a matter of fact, after this thrilling start-up, what we have seen is a deterioration of conditions, forcing more aggressive *racers* to the guard rail. The scarcity of land, inflation of construction costs, geographical diversification without the proper management structure and the difficulties of an industry that has a convex curve in regards to economies of scale (in other words, from a certain point onwards, growth can cause diseconomies of scale), are all factors that conspired against the seemingly perfect conditions from the starting line.

What we find today are deteriorating margins, real estate inventories rising and some teams having to change drivers or going to the pits to refuel their capital base. Eleven companies have seen a 40% or greater depreciation in their stock price (compared to the peak value). Seven years after the first IPO of Bovespa's Novo Mercado, the future has already turned into a reality for this sector, bringing to some of them the perverse alchemy of the time that has elapsed, turning enthusiasm into agony.

There are rare exceptions of companies that managed to avoid the winner's curse that afflicted the real estate sector. Helbor was one of them; an *owner's company*, relying on the firm and competent presence of the controlling shareholder. Not only for the orientation in strategic decisions, but also on the day to day operation. This has helped Helbor not to be seduced by the siren´s song of the macro and sector forecasts. They continued to treat every project as unique, tailor-made, strictly observing a fiduciary duty agenda, in other words, with the same caution and diligence of a business owner. During the sector's euphoria, the company may not have celebrated as many launches as its competitors. Now, four and a half years after its IPO, Helbor shares with its shareholders the best performance of the sector.

In the real estate sector, an excessive short term focus didn't allow investors to see the long term risks inherent in those business propositions. Actually, to be more precise, the macro thesis for the Brazilian real estate sector was embedded with a long term premise: a reduction in the country's interest rates. However, as seen above, it is our nature to seek validation of our actions, to quantify the partial results of our choices and to reap immediate rewards. In this case, the PSV is the chosen metric to answer these inclinations. Hence, investors have been victims of a cognitive ambush: although a long term, macro vision was driving the investment thesis, investors fooled themselves by using a short term metric that isn't very indicative of the future performance of those companies.

Similarly, the excessive short term attention can prevent us from seeing future opportunities that only materialize in the long term. This is very common in long-duration projects. By definition, with a wider time frame, there are more chances of being struck by adverse events, and that generally bothers investors. Besides that, the level of risk intolerance rises when the environment is more uncertain, as the one that we are experiencing nowadays.

As seen on the previous Report, the hyperbolic discount virus is everywhere. If a company's value is measured through the discounted cash flow, this means that the "infected" investors are attributing a disproportionate and higher value to the first five years of cash flow, a lower value to the following five and an even smaller value to the "far-ended flow". Therefore, patient investors will probably find good opportunities in investment projects maturing over a long time frame.

Generally, the market views with some skepticism new projects having long business cycles. The same happens with expansions or acquisitions that require a long term time frame to capture synergies over time. The wider the time frame for the investment to mature, the bigger the chances of unforeseen or negative events to arise. Important variables, crucial for the investment's result, are very uncertain. Uncertainty grows over time. Investors are not comfortable with this prolonged risk exposure, with the possibility of a drastic change in the initial conditions and tend to vigorously discount investments of this nature. Therefore, it can be a good investment opportunity for long term investors when a company that is established, financially healthy and disciplined with its capital, announces a project of this kind. This was the case with Ambev, when it announced the acquisition of Quilmes in Argentina and Labatt in Canada. The same happened in the beginning of the decade when Gerdau started to make acquisitions in Canada and in the United States.

In the complex task of investing, nothing is monotonic. Hence, we can also look at the flip side: when news about an acquisition is well perceived by the market, but turns into a nightmare in the long term. This has happened to companies that went public recently, promising a growth strategy mainly based on acquisitions. In this case, each transaction is seen as a positive event for these "consolidators". The announcement of the deal itself has the power to catalyze, in the present, the expected future value of the transaction, confirming the markets' expectation of growth potential of this kind of business model. However, in some cases, time has shown the collateral effects of this strategy: exceedingly high entry valuations, difficulties in the integration of people, cultures and systems, negative surprises that weren't detected by the quick and shallow due diligence process, among others.

Similarly, transformational investment programs in pre-operating companies can also be good opportunities for long term investors. This happens because in the first few years (the ones that matter most to investors when attributing value) the company isn't generating any cash flow. As cash generation still is nothing but a distant hope, the market heavily discounts those stocks, especially during periods of high uncertainty and risk aversion. As time passes, confirming the company's commercial feasibility, management competence and the subsequent capacity of generating cash, there is a change in risk perception by investors. There is a change in assessment, an inflexion point, a reversion of the investor's preferences once the project is no longer seen as a cash drainer and remote long term value, but rather as a near term or effective cash generator. This is called an accelerated de-risking. As an example, this seems to have been the case with MPX in the last 2 years.

The social costs of a short term focus, that come in detriment to sustainable long term returns, are well known. An agenda of initiatives has been designed to prevent that the short term myopic view prevails in the universe of corporate and financial decisions. However, the markets have inherent properties that are associated with some dispositions rooted in our physiology, including our inclination towards short term thinking. Not to mention the incentives that lead to this strategy and the pressures of the business environment. Therefore, even if it seems logical to impose exogenous mechanisms to redirect the market, through regulation or governance, powerful internal forces contribute to maintain the status quo, in other words, the market's short term inclination. While the endgame is still unknown, as long term, patient and disciplined investors, Dynamo has an enormous advantage in this highly competitive market. A privilege for us as managers, a perspective of qualified return for our investors.

Rio de Janeiro, November 6th, 2012

DYNAMO COUGAR x IBX x IBOVESPA
Performance up to October/2012 (in R$)

Period	Dynamo Cougar	IBX	Ibovespa
60 months	87,6%	-4,0%	-12,6%
36 months	73,3%	5,6%	-7,3%
24 months	27,1%	-6,7%	-19,3%
12 months	22,5%	5,7%	-2,2%
Year to date	17,1%	5,3%	0,6%

NAV/Share on October 31st = R$ 380,162821554

DYNAMO COUGAR x FGV-100 x IBOVESPA
(Performance – Percentage Change in US$ dollars)

Period	DYNAMO COUGAR* Year	DYNAMO COUGAR* Since 01/09/93	FGV-100** Year	FGV-100** Since 01/09/93	IBOVESPA*** Year	IBOVESPA*** Since 01/09/93
1993	38,8%	38,8%	9,1%	9,1%	11,1%	11,1%
1994	245,6%	379,5%	165,3%	189,3%	58,6%	76,2%
1995	-3,6%	362,2%	-35,1%	87,9%	-13,5%	52,5%
1996	53,6%	609,8%	6,6%	100,3%	53,2%	133,6%
1997	-6,2%	565,5%	-4,1%	92,0%	34,4%	213,8%
1998	-19,1%	438,1%	-31,5%	31,5%	-38,4%	93,3%
1999	104,6%	1.001,2%	116,5%	184,7%	69,5%	227,6%
2000	3,0%	1.034,5%	-2,6%	177,2%	-18,1%	168,3%
2001	-6,4%	962,4%	-8,8%	152,7%	-24,0%	104,0%
2002	-7,9%	878,9%	-24,2%	91,7%	-46,0%	10,1%
2003	93,9%	1.798,5%	145,2%	369,9%	141,0%	165,4%
2004	64,4%	3.020,2%	45,0%	581,2%	28,2%	240,2%
2005	41,2%	4.305,5%	30,8%	790,7%	44,1%	390,2%
2006	49,8%	6.498,3%	43,2%	1.175,8%	46,4%	617,7%
2007	59,7%	10.436,6%	68,4%	2.048,7%	73,4%	1.144,6%
2008	-47,1%	5.470,1%	-50,1%	973,3%	-55,5%	453,7%
2009	143,7%	13.472,6%	151,9%	2.603,3%	144,0%	1.250,7%
2010	28,1%	17.282,0%	15,2%	3.013,2%	6,2%	1.334,5%
2011	-4,4%	16.514,5%	-20,6%	2.373,0%	-27,4%	941,7%

2012	DYNAMO COUGAR* Month	DYNAMO COUGAR* Year	FGV-100** Month	FGV-100** Year	IBOVESPA*** Month	IBOVESPA*** Year
JAN	12,0%	12,0%	15,5%	15,5%	19,9%	19,9%
FEV	8,6%	21,6%	7,1%	23,7%	6,2%	27,3%
MAR	-5,9%	15,1%	-4,0%	18,8%	-8,1%	17,0%
ABR	-3,5%	11,0%	-2,3%	16,0%	-7,7%	8,0%
MAI	-9,4%	0,6%	-18,2%	-5,1%	-17,5%	-10,9%
JUN	2,5%	3,1%	3,9%	-1,4%	-0,2%	-11,1%
JUN	2,5%	3,1%	3,9%	-1,4%	-0,2%	-11,1%
JUL	2,6%	5,8%	-1,1%	-2,5%	1,8%	-9,6%
AGO	1,7%	7,6%	-0,5%	-3,0%	2,6%	-7,4%
SET	0,8%	8,5%	6,7%	3,5%	4,0%	-3,7%
OUT	-0,3%	8,1%	0,5%	4,0%	-3,6%	-7,1%

Average Net Asset Value for Dynamo Cougar (Last 12 months): R$ 1.800.754.488

(*) 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 closing.

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

www.dynamo.com.br

DYNAMO

DYNAMO ADMINISTRAÇÃO DE RECURSOS LTDA.
Av. Ataulfo de Paiva, 1235 / 6º andar. Leblon. 22440-034. Rio. RJ. Brazil. Phone: (55 21) 2512-9394. Fax: (55 21) 2512-5720