Report
DYNAMO 100
4/4 2018

Continuation

In this Report, which marks Dynamo's 25th anniversary, we continue to reflect on our first memories. We move forward to take in the highlights of Dynamo Reports 17 to 32, which recorded the major events from years five through eight of our history. At the end, we've provided an index with all of the titles and topics of Reports 33 to 100.

In Dynamo Report 17, *Chaos Theory and the Asian Crisis*, from the 4th quarter of 1997, we addressed the alarming spread of the financial crisis that began in the so-called Asian Tigers and swept across globalized markets. To borrow a metaphor from chaos theory, butterflies had flapped their wings on the other side of the world and set off hurricanes elsewhere. In Brazil, the government reacted by once again hiking the basic interest rate. Fiscal Policy remained to be called. Our recommendation back then is frustratingly appropriate today: "*Until structural changes (especially tax and pension reforms) are approved, we'll remain vulnerable to the next flock of Asian butterflies... But if those reforms are approved in the second semester of 1998, say, and if the external scenario stays in a similar position to late 1997, we can say that in the long term, the October crisis will have been a net positive for Brazil – in the sense that it yanked the government out of its comfortable paralysis.*"

On the capital markets, the crisis set off an unbridled sell-off, which was explained away as a strategic move to adjust global portfolios (with no consideration whatsoever as to the respective companies' fundamentals). The less liquid small cap stocks wound up taking an even harder hit, and for the first time, Cougar would close behind the Ibovespa. We maintained the serenity of long-term investors, and took advantage of the situation to increase our stake in companies we thought highly of, and which had fallen significantly: Renner, Saraiva, Lojas Americanas and the two Ipirangas, Distribuidora (DPPI) e Petróleo (CBPI). Coincidentally, just as most investors were bewildered with the free-falling prices, we were able to recount the successful conclusion of an unusual sort of project for a fundamentalist investor, a long-term process in which Dynamo played an important part. This was the corporate restructuring of Indústrias Villares (IVI), which led to the extinction of the "founding shares" and to the distribution of the entirety of its shares in Elevadores Atlas to all of its shareholders. Atlas, which would become the Fund's largest position, thus emerged as the first true corporation in our capital market.

With macroeconomic stability and with a promising internal market, Brazil became a target for expansion-driven multinational corporations, which led to a wave of consolidation across several local industries. We devoted Report 18, *Changes of Control of Publicly Traded Companies in Brazil* to what happens to minority shareholders when such companies change hands. There are challenges from the get-go, starting with a lack of transparency around the offers' notices. Buyers often failed to disclose their intentions vis-à-vis the other shareholders, or their management goals for the company, much less get into the potential conflicts of interest.

Our 16-case sample showed that even in light of an excessive premium (at an average of 250%) – in theory a demonstration of total confidence by the new partners – performance for preferred shares continued to languish. In fact, the mediocre performance of preferred shares was a reflection of the complete asymmetry between common shareholders in the controlling block and the other shareholders. By that time, we knew from experience that the larger the control premium, the more incentive the new partners would have to average down their purchase price through the other shares. It was common to spot crafty provisions, hidden results, and once in a while we'd find a management contract in favor of the controlling shareholders, based on a percentage of the company's revenues. In our experience with companies, under these circumstances executives would take on the odd position of emphasizing difficulties, sketching out gloomy prospects, and look to deflate their correspondents' expectations. Internally, we started referring to this surrealist mode as a "de-listing road show" campaign.

"Evolutionary theory first appeared in the field of biology but became multidisciplinary with the use of the concept of survival in competitive environments to explain the formation of complex social structures such as companies, political parties and organizations." That's how we opened Report 15, *If Darwin Were a Company Analyst*. Companies, too, are inserted into a competitive environment that "*tests the quality of such design, eliminating the ones of poor quality, and perfectioning the better ones."* Those designs, which serve as physical records of evolution, can be subjected to reverse engineering. A good analyst's role, then, would mean analyzing these innovative elements that may lead to business success.

Mental models are fundamental ingredients in any investor's analytical toolkit. We'll return to them in future Reports. Here, we used the analogy to address the design of stock option plans, which were novelties at the time. Good governance entails constantly working to align interests. An instrument that allows "*the company to share its capital ownership with its employees, granting them significant financial rewards when they show a superior performance*" is an invaluable asset. We recommended a few elements, such as long-term packages with vesting periods before allowing the sale of shares; requiring the exercise of the options to be financed from annual bonuses; and a conversion price with a "*discount over the market price which may vary between 5 and 20% in order to grant an extra incentive for the employees to exercise their options*."

As the situation abroad became even grimmer, Cougar would see its worst drawdown to date in the third quarter of 1998, when the fund fell 31.8% (along with the Ibovespa, which dropped 34.5%). The collapse of LTCM was an emblematic demise, exposing the fragility of extremely leveraged strategies and making it clear to the Nobel Prize winners at its head that in severe crises, markets synchronize and historical correlations go down the drain. From then on, the market began unanimously predicting that credit would shrink and the economy would slow down across the board. In Brazil, the obvious recommendation was to stick with the comfortable protection of the CDI (the interbank overnight rate). In Dynamo Report 20, *Consensus and Rationality*, we recalled that at those valuations, with an average portfolio P/E of 3.5x, our fundamentalist common sense would recommend that we should increase the Fund's exposure – despite the market consensus pointing towards fixed income protection. Indeed, Cougar would bounce back to positive returns for the next six quarters for a gain of 148.8%, or a net appreciation from that terrible trimester of 69.7%.

The courage called for by our contrarian stance would be justified early on next quarter, when the Fund recovered 14.2% of its value while the Ibovespa stayed put. We took Dynamo Report 21, from the last quarter of that year, to remind our shareholders that 1998 had been particularly challenging for investors. The Russian moratorium had sparked widespread panic, coming as a surprise to both smart-money investors who were testing hitherto unseen levels of leverage and major international banks operating at the "limit of irresponsibility." The liquidity crunch would soon sweep over emerging countries.

Cougar saw negative returns of 12.5% for the year, while the Ibovespa plunged 33.4%. Against this turbulent market backdrop, two important corporate events would mark our portfolio, and it was to this that we devoted Report 21: *New Paradigms, New Problems*. Yet another instance of our preference for topics that relate to analyzing companies and involve our ability to actively manage our investments.

The first was the public offering by JC Penney to acquire control of Renner. The structure of the offer as posed to preferred shareholders contained conditions that made it extremely unfair, such as higher prices for first sellers and a limit on the number of shares they would acquire. In other words, shareholders were supposed to run off and sell; if they didn't, they would be faced with a 20% discount or zero liquidity. The offer didn't reveal the price to be paid to the controlling block, nor did it provide any information about how JC Penney intended to run the company. We manifested this to the relevant authorities and reached out to a group of shareholders in an unprecedented mobilization. The regulatory agencies acted quickly: Bovespa suspended negotiations and CVM canceled the offering. JC Penney came in with a new offer and improved conditions, but even so, we decided not to tender our shares. Indeed, later on we would be able to sell our position at a better price.

The second case was Eternit, a company we'd been following for quite some time. At the time, technical studies found no evidence that chrysotile asbestos, the form used by the company, produced the harmful effects seen in Europe and the United States, where amphibole asbestos had been used indiscriminately. Eternit's mine was considered a model operation and had received ISO 14001 certification. The company had accumulated significant cash reserves, and our recommendation was in the direction of optimizing their capital structure. We assembled a large group of shareholders and presented an alternative to management's proposal at the General Shareholders' Meeting. The group turned out to hold a majority of votes, making this perhaps the first genuine Extraordinary General Shareholders' Meeting we were notified of. The extraordinary dividend represented a yield of 25%. From then on, Eternit would start paying out dividends regularly, bringing a large number of individuals into its shareholder base. This broader distribution of capital brought liquidity and never-before-seen valuations for the company's shares.

After a long discussion over fixed vs. floating exchange rates, pegged currencies, heterodox (or downright bizarre) experiments such as the "exogenous diagonal band," Brazil ultimately opted for a free floating currency, and the immediate result was an abrupt devaluation of the Real. In that context, Report 22, *The Real Value of Companies in Brazil*, analyzed the effects of the devaluation on the intrinsic value of Brazilian companies. We examined two different categories, items affecting companies' underlying value as in the balance sheet, and items affecting earnings power. Analyzing the balance sheet is a more straightforward task. The impact on earnings power over time is more important and more challenging to estimate, since one has to infer the real effective devaluation for each company – in other words, where the interaction between the exchange rate and inflation will come to rest after an initial overshooting, vis-à-vis the company's ability to pass through domestic inflation. Since currency depreciation tends to favor inflation, and some pass-through is always possible, we concluded that devaluation inevitably boosts companies' value in the local currency, to some extent.[1] We used our investment in Fosfértil to illustrate how difficult it was for investors to access the value of companies in light of major exchange-rate shifts. Though it wasn't an exporter – it was the only local producer of an imported good – Fosfértil priced its products in dollars. Back then, our calculations of the effect of devaluation on the company's bottom line led us to a P/E of 3.2x for 1999. A bargain, clouded from view amidst the mental confusion brought on by sharp adjustments in relative currency value.

Dynamo Report 23 would open a long series of reflections on corporate structure and governance matters. As long-term investors hardened by nearly six years of active militancy, we were convinced that if Brazil did indeed harbor the noble aim of enjoying the unequivocal benefits of a thriving capital market, the foundations for minority shareholder protection would have to be laid down. The absence of a legal framework was an invitation to opportunism, and without regulatory attention, preferred shareholders were easy prey for the controlling block. From shock to shock, like a behaviorist basic survival strategy the safe path of liquidity was invariably chosen. Low involvement and widespread disinterest in discussions of corporate structure were the natural corollary of this unbalanced ecosystem.

Our work was based on two principles that, for us at least, were crystal-clear: (i) to ensure that already-guaranteed rights would be respected, looking to restore the portion of value that was due to non-controlling shareholders but which they were not always able to claim; (ii) equipped with the vast empirical evidence from countries with more developed capital markets, to insist that fairness in corporate relations would inevitably lead to better pricing for the company and thus gains for all shareholders. If our work based on premise (i) came to be interpreted as a conflicting, redistributive agenda, part (ii) disarmed that narrow reading, indicating that we were working toward a higher purpose and providing systematic benefits for all involved. We were determined to mount a proactive defense of our shareholders' interests and the rights to which they were entitled, with the conviction that this was the basis for sustainable value creation for everyone involved in the corporation.

Report 23, *Broken Window Theory*, ventures into a parallel to illustrate the situation of minority shareholders in Brazil, recalling that New York City's drastic crime reduction stemmed from harsh policing of minor infractions such as graffiti and public drinking. A specialized unit within the city police came to the conclusion that permissive attitudes ultimately paved the way for the development of more serious crimes. In an apartment building, one broken window may stand as an invitation for others to be broken, leading to the degrading of the building as a whole. Similarly, if police ignored minor lawbreakers, they might inadvertently be letting major crime proliferate. We extended the analogy to the way that minority shareholders were too often treated in Brazil. *"The widespread use of ingenious methods that clearly contradicted the spirit of a public corporation place our capital markets in a situation that is as desolate as some of the darkest streets in the Bronx."*

We saw meaningful progress in CVM's recent willingness to take a firmer hand with these sorts of opportunistic behavior, as we'd seen previously with Renner. Instruction 299 would follow soon thereafter, regulating the

1 *Of course, this reasoning doesn't apply to companies with a foreign currency cost base and local currency revenues.*

disclosure of information when control is being negotiated or when company insiders are changing their stake, as well as delimiting the rules for voluntary public offerings to acquire company shares.

That same quarter saw the successful acquisition of Elevadores Atlas by Schindler. At that point, Atlas was the Fund's largest investment, and generated an excellent return. It was sold for close to R$720 million, and Cougar had begun investing in Indústria Villares (IVI) back in 1995 when the company had a market value of just R$40 million. IVI promoted a financial restructuring, eliminated the company's "founding shares" , and established a modern ownership structure with only one class of shares, becoming the first true corporation in Brazil, in addition to distributing dividends compatible with the stable, lucrative nature of the business. The outcome of this short story of huge capital market success also came about in the best possible way. Without any legal obligation to do so, Schindler decided to extend the offer it had made to a group of shareholders that together comprised the majority of its capital to the remaining shareholders, with a discount of just 11%. Of course, this was the result of this group's negotiations on behalf of the rest. Indeed, the price extended to the second group represented a premium of about 37% over the share's historical high, and of nearly 100% over the average price in the 90 days prior to the sale.

Dynamo Report 24, *Understanding the Fiscal Board*, examines this important entity for exercising participation and oversight of companies, guaranteed by law to voting or non-voting minority shareholders. In light of our vast experience – Dynamo has exercised this right of representation whenever possible – the Report describes the mechanisms for claiming seats, shareholders' responsibilities in the nominations to the board, the rules that govern the composition of the FB, its specific powers as a collective body , and the rights and responsibilities of board members. The Report is didactic, as the title itself suggests, and the idea was to share our know-how and encourage other investors to take a more participatory approach to corporate engagement. We knew that the more people got involved, the sooner we might arrive at that long-harbored ideal equilibrium in governance. Of course, since we strove to pursue healthy relations, we also warned against the dangers of inappropriate behavior. FB members should be guided solely by the company's interests, and should never use their position to seek personal benefits or advantages for the shareholder who elected them. "*The FB member that uses this blackmail strategy is a predator of the FB.s reputation, which is the reason why they must be rapidly exterminated.*"

In Dynamo Report 25, *The Prisoner's Dilemma and Brazilian Corporate Law*, we returned to the touchy topic of tender offers for de-listings. The controlling shareholders' move to take the company private poses a classic dilemma to the remaining shareholders inherent to collective action, just as in the prisoner's dilemma: "*the best decision for each investor is to sell quickly regardless of price, as not only he may get a better price, but the stock will lose liquidity as the float shrinks substantially. However, the best collective decision is not to sell until the bidder offers a fair price.*" Brazilian legislation, designed for a growing capital market, was unprepared for this insurmountable conflict of interests, the end product of which is the peculiar spectacle we described above as a "de-listing road show." Hence the importance of effective regulatory action to curtail this imbalance in advantages.

Back then, a bill by Congressman Emerson Kapaz aimed at enhancing the Brazilian corporate law was starting to move through Congress. We took advantage of the Report to make our opinions on the main points of the reform known. This isn't the time or place to go into a detailed rehashing of all the elements of the bill and our respective contributions. We'd like to dwell on just two, as an illustration of our attentive participation in the process, as reflected in effective and at times subtle suggestions in a productive discussion, which led to an important period of institutional development for Brazil's capital markets.

One point of particular debate had to do with preferred shares. We recognized that preferred shares had historically played a key role in the growth of family-owned companies with no other long-term funding options available in the country. At the same time they contributed to preserve the interests of a "reference shareholder", the one with a genuine strategic approach. As we saw it, it would be important to update the role of preferred shares, making them better aligned with corporate interests. To that end, we suggested that preferred shares issued after the change in the law should be entitled to "*a priority dividend of 6% per annum over the company's book value*." The natural consequence of placing preferred shares first in the dividend line would lead to greater discipline in investments. This was our move against the problem of empire-building, all too common in companies with huge corporate leverage(pyramidal corporate structure), where the controlling shareholder has a diluted economic interest.

Another of our contributions had to do with redemption rights during de-listing offerings, where the Kapaz bill suggested as a minimum price the book value or economic value. Since we knew that in good companies the latter is invariably higher, we suggested, in a slight adjustment to the language of the proposal, that the larger of the two should be used. We closed out the Report by dwelling on the good example set by Ultrapar, which had recently gone public and was about to publicly announce voluntary tag-along rights for minority shareholders in their bylaws. To our eyes, the company possessed all three of the factors we looked for in our investments: *(i) a sound business; (ii) run by people who are highly competent and honest; and (iii) with a corporate structure that aligns the interests of executives, controlling and minority shareholders*. Indeed, this would prove an extraordinarily virtuous combination, judging from Ultrapar's long subsequent trajectory of earnings growth and stock price appreciation.

As always in our fourth-quarter Reports, we presented a brief overview of the previous year. In 1999, Cougar saw gains of 203% in Reais and 105% in dollars. Little more than a year later, nothing could be farther from the dire prospects that analysts and economists had been predicting in the wake of the Russian crisis. Once again, we touched on the advantages of guiding our investment decisions by the more reliable compass of companies' fundamentals and not letting ourselves be swayed by macroeconomic "fortune--telling". We concluded with a note on the phenomenon of the internet, which had fired up the American market and affected the prices of certain shares in Brazil. *"We have been studying the theme for quite a while and although we still have some difficulty understanding the rationale that justify the valuations, there is no doubt in our minds that the impact of the spread of the internet will be nothing short of revolutionary."* Indeed, since then we believe that we've arrived at a more sophisticated understanding of technological matters, the reach of connectivity, the unique dynamics of network effects, and businesses organized as platforms or ecosystems. On the other hand, we recognized we're still involved in ongoing discussions, and some doubts remain as to the rationale behind these companies' valuations.

In Dynamo Report 26, *Controlling Premium in Brazil: Why, How, and to Whom?*, we circled back for a look at *"the mystery of our market's (negatively) record-setting controlling premia"*. This time, we sought out solid allies at Harvard and Chicago to back us up. Recently published, high-quality studies with evidence from a number of countries suggested that the regulatory and legal frameworks in a given society shapes the value of private benefits of control, ultimately determining the equilibrium (or not) of ownership structures. In other words, Brazil's gargantuan controlling premia could be explained by the existence of a small group of shareholders able to take a sum generated by the corporation as a whole and channel it to their own benefit. As permissiveness abounded; we even listed *"a vast repertoire of legal and illegal tropical ways to expropriate minority shareholders."*

As for the practical consequences of this perverse asymmetry, we addressed two. The first, the fact that changes of control tend to push minority investors and controlling shareholders into a zero-sum game. In light of a tender offer, the lower the price of the minority shareholders' stocks, the better for the controlling block. That was when we found ourselves in *"the weird position of convincing executives that their company is actually doing much better than they are trying to convince us."* The second manifested itself in *"the preference from minority investors for higher dividends as opposed to the investment compulsion of the controlling shareholder."* Better an immediate, egalitarian distribution of the company's results than an uncertain decision that may be driven by the unspoken aim of bulking up the asset base now so as to sweeten the controlling premium farther down the road.

This explains an apparent paradox in our governance agenda back then. As long-term investors, we were looking for companies with the potential for consistent returns over time as they reinvested profits into their ongoing activities. This was always a guiding principle for us and a perfect match for good companies where everyone was on the same page – meaning that a decision to (re)invest went towards a higher return for all shareholders, not just to bulk up the asset base or funnel power to a minority. On the other hand, we also often found companies with unbalanced capital structures and excessive cash reserves. In these cases, distributing dividends brought evident benefits in terms of greater fiscal efficiency, and we of course made our wishes known on that score. The experience showed that when a controlling block aggressively resisted these logical, legitimate demands, there was probably some side agenda at work. In this sense, the call for dividends also helped reveal the extent to which interests were aligned among shareholders.

On the subject of convergence of interests, we closed out the Report by describing Ultrapar's corporate structuring where the Company decided to ensure equal treatment for all shareholders should control be transferred (tag-along rights), a move that, as we observed, "*set a new paradigm*."

The debate over reforming Brazilian corporate law was steaming ahead. Of course, conflicting interests clashed, and representatives from a group of publicly listed companies warned against the changes, alleging that they might lead to de-listings en masse – and hence shrink our slim capital market even further. We dedicated Dynamo Report 27, *The False Dilemma*, to arguing just the opposite. Weighing the examples set by other countries, gathered from high-quality empirical studies, we saw that reality was marching to the beat of a different drum. The robust development of capital markets depended precisely on a regulatory framework able to guarantee greater protection to minority shareholders. We pointed out that the wave of de-listings happening in Brazil just then was not related to a fear of a more egalitarian corporate law on the horizon. Rather, we were seeing the natural thinning of a generation of companies whose decision to go public had been artificially driven by tax incentives, and not a genuine desire to do so.

We went on to lay out a few contributions to major points in the discussion of the corporate law reform. First, the importance of setting a minimum price for de-listing offers, in an attempt to adjust for the immediate imbalance that comes into play, with the controlling shareholder monopolizing the initiatives and the relevant information. The second had to do with the control premium. We often heard arguments that control premiums were justified by the controlling shareholders' full-time dedication to the company's activities, as well as the fact that they often serve as guarantors for its loans. To our eyes, neither point made sense. Time spent on the company ought to be accounted for in an employment contract, separating out the ownership function from the labor function. As for the guarantees, this was just another company expense; and the guarantors ought to be remunerated at market rates, as if they were banks themselves. Finally, we argued that despite a few shortfalls in terms of its treatment of preferred shares, the bill represented significant progress, including the return of tag-along rights for all common shares and the definition of economic value as the exclusive price criterion for de-listing offers. We concluded as follows: *"The great evolution of our capital markets will come when controlling shareholders realize, by themselves or compulsorily because of the new law, that their private benefits of control are smaller than the gains generated by the potential reduction in the cost of capital of their companies. Only then will Brazilian companies advance in the direction of more democratic structures of capital, instead of the oligarchical structures that currently prevail in Brazil."* It was August of 2000. Auspicious developments were around the corner, and would come to validate stubbornly held aspirations.

In Dynamo Report 28, *De-Listings: Markets, Monopolies and Regulation*, we described the regulatory advances introduced by Instructions 229 and 299, recently consolidated by Instruction 345, which the CVM hoped would lend greater balance to the de-listing process. Such an important decision about the company's future would now have to be approved by a majority of all shareholders in a general meeting. Moreover, even those who voted against the move would be given up to six months to sell their shares. Finally, one last normative improvement stipulated that the proponent declare whether they intended to cancel the company's registration of public listing at a later date. These adjustments were able to seal off opportunistic loopholes that allowed for controllers to exert monopolistic power over the de-listing process.

In parallel, although the final wording of the Corporate Law reform bill hadn't been settled on yet, the broad discussion over the need to improve protection for minority shareholders had already wrought major consequences. Among those, we highlighted: i) the creation of the Bovespa's Novo Mercado, establishing a unique status for companies with higher standards of governance; ii) incentives introduced into pension fund rules to drive allocation in companies with good governance; iii) and BNDES' (the state-owned development bank) adoption of a governance criterion as part of the process of granting financing and participating in investment projects.

"The lack of a court specialized in corporate matters is a major obstacle to any significant advance in the institutional environment. The virtual absence of jurisprudence on corporate issues is a direct consequence of such fact as it leads to few suits being brought to the courts and even fewer being taken through all the instances for a final decision." With that in mind, we were drawn to examine the sale of Banco Real to ABN-AMRO – which, after being hit with a civil suit, was forced to grant tag along rights to the minority shareholder who had brought the case. We devoted Dynamo Report 29, *Tag Along: A Real Case*, to an account of this symbolic event.

To put it briefly, the sale of the bank was preceded by a maneuver whereby the controlling shareholder had split his operational holdings, looking to nab the entirety of a hefty control premium. The complaint alleged that minority shareholders in those intermediate companies were wronged. The judge agreed, recognized that the controller had abused his power, and ruled that the controlling premium belonged to all of the shareholders in the holdings. We took this opportunity to recall a similar case, involving Cia Hering, with the split and later sale of Ceval Participações. The topic of controlled, publicly listed companies was relevant and a cause for concern, since our portfolio included a number of investments potentially subject to the same kind of action, including Itaúsa/Banco Itaú, Ipiranga Distribuidora (DPPI)/ Ipiranga Petróleo (CBPI), and Alpargatas/Santista Textil.

In our comments on our performance, we closed out 2000 with a note on our relative performance: Cougar had gone up 12.6% even as the Ibovespa fell 10.5%. Ambev, Caemi and Eternit were the biggest contributors to that rise. For the coming year, we were enthusiastic about the potential of the companies we'd invested in. The stable macro environment promised that we might see a historic drop in interest rates, and hence the long-awaited historical migration of capital from fixed-income securities to equities. Unfortunately, that time hadn't yet come. Soon thereafter, we'd be faced with dire prospects overseas, most dramatically with the critical economic situation in Argentina, as well as growing concerns about the electoral scenario and an unprecedented energy crisis in Brazil that led to rationing. The Selic rate, which had opened 2000 at 19%, would halt its slide in February of 2001 at 15.25%, climbing back to 19% by mid-year.

The year 2001 would bring two important pieces of news for capital markets: the inauguration of the Bovespa's Novo Mercado – "*an the eldorado for investors looking for clear and fair rules on corporate matters*" – and the approval of Resolution 2829 by the CMN (National Monetary Council), establishing investment rules for pension funds. It's true, we were still waiting to see a success story in our market involving a company with pristine governance, to confirm our hypothesis that a more equitable structure will bring benefits to all participants. Even so, given these partial advances, we wondered where we should turn next. And we suggested a path in Dynamo Report 30, *Dispersion of Capital Ownership*. The reality of dispersed capital, allowing for the arbitraging of control in the market, seemed seductive. "*When ownership is not concentrated, the market value of companies will reflect the average of the investors' expectations about the future of their businesses.*" Corporate negligence and operational inefficiency would be exposed, reflected in depressed share prices, which might in turn draw in parties interested in proposing changes. That way, shareholders would no longer be perennial hostages of a single management agenda.[2]

And how to go about transitioning from a concentrated ownership structure to a dispersed model? Having surveyed comparative studies, we picked out three suggestions: i) reinforcing regulatory and monitoring structures so as to cut down on controllers' ability to reap private benefits from ownership; ii) allowing the equity market to become the primary source for funding long-term growth – in this case, the better priced the share, the lower the company's capital costs; iii) analyzing the role of the inheritance tax as an additional incentive toward the fragmentation of control and professionalization of family-owned companies. By way of illustration, we circled back to Eternit. The company's decision to establish a rule for automatically distributing dividends above a minimum cash level attracted a flock of individual investors. This genuine dispersion of capital ultimately brought greater liquidity and helped boost the company's shares significantly.[3]

2 *Back then, besieged by the maneuvers of inept controllers, we harbored an almost romantic notion of the virtues of dispersing the control of shares. Later on, when we came face to face with the reality of corporation in Brazil, we would realize that this model of capital organization also calls for shareholders to play a vigilant, active role.*

3 *Eternit was running a quite profitable, stable business, and attracted investors looking for sustainable dividends. The issue of asbestos would soon become more severe, as the substance was eventually banned and the company filed for bankruptcy protection. By that time, we had sold our stake.*

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

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

NAV/Share on March 29 = R$ 936,988885800

Our capital market was still struggling to affirm its identity and fulfill its destiny as a mechanism for competitive long-term financing for participants, and thus as an instrument meant to drive the country's economic development. In this context, it was only natural for us to look kindly, and even admiringly, on other countries' successful experiences. We began aiming at the Anglo-Saxon model, as a benchmark – hence the frequent parallels. In Report 31, *The Forgotten Illiquidity Premium: Long Live the CDI*, we were back to the analogies. This time, we wanted to examine the different strategic paths taken by institutional investors in both countries.

In the United States, institutional investors, led by certain universities' endowment funds, embarked on a successful attempt at diversification, incorporating less liquid instruments into their portfolios whenever the returns promised to be greater. This move was driven by the fact that in more traditional categories – where there is, at least theoretically, lower risk and higher liquidity – returns are more heavily arbitraged. As long-term investors equipped with advanced analytical tools (their own, or those provided by third parties), it made all the sense in the world for these institutions to seek better returns from less liquid markets or assets.

In Brazil, institutional investors – pension funds chief among them – behaved quite differently. They had a bumpy track record as non-voting minority shareholders, and when they moved into the controlling block, they faced serious governance issues. Meanwhile, our risk-free interest rate remained stubbornly generous. The combination of a negative experience with stocks and the undeniable charm of the CDI (the interbank rate) led to a trend toward allocation in fixed income that proved difficult to shake. Hence, we closed out the Report with another mention of CMN Resolution 2829, encouraging foundations to "*eventually shift from liquidity to good corporate governance and quality long term investments*."

After two more years of adjustments and debates, Brazil's new Corporate Law was finally passed on October 31st, 2001. Dynamo was an eager participant in the discussions. We knew that this was a unique moment, the conception of an institutional compass that would guide the interactions of market participants from then on. This was an intense, focused time. We brought with us eight years' experience as militant investors, as well as an inexhaustible willingness to fill in the gaps in our legal knowledge so that we could better dialogue with corporate lawyers. Report 32, *The New Corporate Law: Advances, Absences, and Problems*, provided a summary of our main impressions and contributions. The text is dense and lengthy, divided into four major sections: "*Major Advances*," "*Supporting Actors*," "*Absences*," and "*Potential Problems*." A sketch of our conclusion appears at the very start: "*We are utterly convinced that this new law, which many consider to be the possible law, is very positive for our capital markets. However, we must express our frustration over the confusing process of political negotiation to get this law passed, which froze the version approved by Congress and produced a final text of legal quality below our expectations. For this reason, it should be emphasized the importance and urgency of its regulation by the CVM, as will become clear along this Report.*"

Our "*Major Advances*" included: i) the return of tag along rights for common shares, albeit at a 20% discount; ii) the introduction of the concept of a "fair price" for de--listing buyouts; iii) the strengthening of the CVM, including a provision for it to become self-financed; and iv) the potential for arbitration clauses in case of shareholder conflicts. Under "*Absences*," we listed: i) the wasted opportunity to improve the quality of preferred shares, since the law provided for the right to a 10% higher dividend, effectively canceling out two substantially better alternatives, namely tag-along rights in the same conditions as for ordinary shares or a priority dividend of 6% of book value; ii) another missed opportunity to improve the way in which shareholders deal with conflicts of interests (article 115). We had suggested that preferred shareholders be allowed to vote on matters of conflicts of interest, which would subsequently be approved by the CVM; iii) the election of a third member of the fiscal board by a majority of all shareholders; and iv) the obligation to peg the exercise of redemption rights to economic value.

It's been said that experience is the name we give to our mistakes. Self-critical reflection is part of Dynamo's DNA, an element of our culture, seen countless times in these early Reports. Longevity *cum* self-criticism can give rise to an auspicious alchemy when it comes to investing, an activity not short on critical decisions. Reflecting on our mistakes, going back to the drawing board, incorporating lessons, improving processes, refining analogies, and heading on to the next case better-informed and better-prepared: such is the Sisyphean path of the investor. The more time in the field and the less turnover, the more consistently one can expect this method to perform.

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

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

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

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

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

(**) Ibovespa closing.

We believed that our shareholders and friends would also be interested in the playful exercise of taking the symbolic mark of our hundredth Report to wring out the memory of our beginnings, putting together a potpourri of highlights from those first eight years. We came away with the conviction that the purpose and *principles* that guided our trajectory were there from the start. At the same time, the ever-shifting environment called on us to constantly adapt. Out of respect for our readers' time, we've distilled the remaining Reports down into a thematic index. Hopefully an illustration of our dedication to develop specific knowledge, hone existing processes and methods, refine our mental models, decipher hostile environments, and comprehend silent transformations.

Often, we were too early. Sometimes we were too late. On a few occasions, we were nearsighted and failed to make out distant trends; on others, we were farsighted and underestimated turbulence close at hand. Trusting in experience, we were precipitated in our inductive leaps. Overly cautious, we were slow to arrive at a logical conclusion. When too analytical, we fragmented our knowledge into shards of information. When excessively synthetical, we overlooked the eloquence of details. Between stumbles and steps forward, hindrances and triumphs, we've made it thus far thanks to our shareholders' unmitigated trust. With the same energy as the early days, and with a healthy supply of experience on our side, we now set out to *continue* this journey of the next twenty-five years.

Rio de Janeiro, April 2, 2019.

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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