BOGARI capital

BOGARI VALUE

Investor Letter 1 – July 2008

Bogari Value FIA is a fund investing in companies whose shares are traded in the public equity markets in Brazil. The Fund focuses on long term investment opportunities based on identifying distortions between an asset's value, and its trading price.

Our aim is to double our clients' capital every 3 years, which should occur over long periods, and always prioritizing permanent capital preservation*. The Fund may acquire shares of companies of any size and liquidity. Bogari Value FIA is managed by Flavio Sznajder, Senior Partner of Bogari Capital, and member of the Board of Contax Participações, with wide-ranging experience in long-term investments - both liquid and illiquid.

This is the first report of Bogari Value, first fund opened to external clients of Bogari Capital. Therefore, a brief explanation of who we are is in order, as well as explaining what we aim to achieve, and the adequate profile of our investor base.

Who We Are

Bogari Capital is an independent asset management company. The firm was founded following our partners' extensive experience in long-term investments, both liquid and illiquid; active participation in various entities in direct link with Boards of Administration; and active management of various companies. This experience has created some unusual competitive advantages over most Brazilian asset managers:

- Deep knowledge of companies' operational aspects;
- Awareness of the dynamics of relationships between the controlling shareholders, minority shareholders, and the markets;
- Comprehensive knowledge of Brazilian corporate law;
- As long-term investors, we can benefit from investing in companies of all sizes and liquidity profiles.

Our values are integrity, clarity, quality, objectivity, meritocracy, and long-term thinking, both in the investments we make, as well as in the relationships we forge with clients, shareholders, and staff.

We are aligned in such way that a significant share of the partners' wealth is invested alongside our clients in the same vehicle.

What We Aim To Do

Our objective is to provide our clients with long-term investment opportunities based on identifying distortions between an asset's value, and its trading price – we are value investors. Furthermore, we have an independent investment philosophy, as we do not follow the market in our decisions.

Using investment strategies rooted in value, we seek to generate consistent returns over the long term, with a constant focus on capital preservation*.

Our investment philosophy is based on:

- Being conservative – we always opt to acquire assets which are substantially below their intrinsic value, thus increasing the potential for profits and reducing the probability of losses;
- Seeking the highest level of liquidity and legal protection available, without a premium;
- As co-investors, we defend our interests in the companies we invest in;
- We are long-term investors, with the patience required to wait for price and value to converge.

Our risk management process is based on the premise that risk is the "possibility of a permanent loss" and not just asset volatility. Despite disliking volatility, we know how to live with it, and ultimately how to benefit from it. We mitigate our investments' risks by:

- Having long-term liabilities, i.e. our clients' assets must have time horizons matching those of our investments;
- Acquiring assets with substantial discounts over their intrinsic values;
- Having deep knowledge of the assets we acquire;
- Adequately diversifying the portfolio, but not excessively so;
- Constantly monitoring the fundamentals and periodically reevaluating the investment cases;
- Disposing of expensive assets, or those which have not behaved according to our expectations.

General Concepts

Various studies have identified different parameters associated with better performance generation over the long term, such as: (i) portfolios of cheaper stocks (i.e. smaller multiples, or value stocks) perform better than portfolios laden with expensive stocks; and (ii) portfolios of stocks in smaller companies (smaller market cap) perform better than those with larger companies. Additionally, it is possible to demonstrate that over the long term, stock prices and intrinsic value converge.

Prior to investigating the themes above in greater detail, it is worth mentioning that, contrary to what it may seem, our intention is not necessarily to invest in small and/or illiquid companies. We simply seek to advocate the advantages of not restricting oneself to pre-selecting assets based on those variables. All things being equal, we prefer liquid to illiquid, and larger companies to smaller ones. However, we prefer even more to have adequate returns by maintaining a focus on capital preservation.

We are free to take up the positions with the best risk-return ratio as we are not encumbered by liquidity, company or sector sizes. Having this "advantage" leads us to believe that we are more likely to achieve our long-term objectives. When any company is excluded from the investable universe, one's potential gains are now restricted to that new, smaller universe.

Normally, buying cheap stocks requires personality, since one often finds oneself going against the flow. The more expensive stocks are dearer due to a simple matter of demand.

Reasons Why a Company's Stock May Be Cheap

Stocks can become cheap due to reasons affecting its offering on the market – (i) operational reasons, or (ii) perceived difficulties in the sector; or demand – (iii) liquidity or size. Behind each of these reasons lies a great investment opportunity.

The crisis we are going through reflects the mismatch between supply and demand. Many foreign investors are liquidating positions in different markets due to operational reasons – whichever these may be – in order to reduce exposure and meet their investors' redemption requests. As a consequence, they push the markets down by selling large amounts of stocks. As demand is not sufficient, prices are in turn pushed downwards. These are the best times to buy stocks, since the company has not suffered any changes whatsoever in the real world.

When there is a problem with a company or its sector, one must understand whether or not those adversities are permanent. If the higher probability scenarios imply value destruction, the asset price may be justified. However, should we be dealing with a temporary issue, this is likely to be a good opportunity to invest in that company.

As for liquidity, it represents the velocity in which one can buy or sell an asset. Undoubtedly, it is preferable to have a liquid asset to an illiquid one. We could even say liquidity is an option for converting an asset into cash in the short term. For this reason, it is natural that the more liquid stocks carry a premium over their less liquid peers. Implicitly, one is paying for the cash optionality.

Investors sometimes overstate the importance of liquidity in their strategy. Simply speaking, very large or short-term oriented portfolios with higher turnover must have liquid assets. On the other hand, smaller, low turnover, long-term portfolios need not necessarily hold highly liquid assets.

In our case, we may buy either very liquid, or less liquid assets, due to our investment horizon. This characteristic enables us to simply select the cheapest stocks with best potential for appreciation. This is an advantage because our experience shows that very cheap stocks lose liquidity because their market value is smaller, and also more shareholders are reluctant to sell the stock at a discount.

However, an asset's liquidity may change over time since, as the stock price gets closer to its intrinsic value – and thus more expensive – its liquidity increases (as much as it may seem like a paradox!). Additionally, when investing over the long term, the relevant liquidity encompasses the whole period. For example, instead of taking advantage of the daily liquidity, we can benefit from monthly liquidity, as we can sell the asset over a longer period.

Finally, the market cap may also be a cause for an asset's low price. Investors have limited resources for analyzing companies, thus restricting the number of companies in their portfolios. This means that large investors target companies over a certain market cap. As a result, smaller companies see less demand for their stocks, leaving them cheaper on average.

Investing in smaller companies requires somewhat closer attention with regards to risk assessment and possibility of permanent loss of capital. Larger companies tend to have more robust and focused businesses, with higher survivorship, while smaller companies are still stabilizing and defining their business models. Larger companies also have better access to capital, consolidated management and control structures, scale, and bargaining power. On the other hand, smaller companies tend to have higher growth rates, and operate in more promising markets.

In these companies, the figure of the entrepreneur is fundamental. Such companies are more personified than their larger peers, which are more structured and institutionalized. When we do business with a smaller company, we deal with the "owner" (almost literally), which is why their competence and honesty, among others, are so important. Making a long-term investment with a bad partner is almost always a recipe for disaster.

The Concept of Risk

We evaluate our biggest risk as a function of the probability of permanent loss of capital, unlike most of the market which is based on asset volatility. Why do we have a different view?

We believe that volatility makes sense in shorter-term investments, since the need to sell an asset may arise during adverse market conditions. When we purchase shares of a real asset for the long term, we have the flexibility to sell at the most appropriate point in time. Should the market price at that moment not suit us, we can wait for a more opportune time. Therefore, in theory, we do not expect volatility to significantly affect our results.

In order that this flexibility holds true, we need two factors: (i) that the assets managed by us are long-term, allowing us not to be forced sellers at unsuitable times; and (ii) that the acquired asset creates value over time, so that the more we wait, the more the asset will be worth.

During the process of convergence between price and value, the shares in the portfolio keep on being traded. Often – as it is currently the case – their values will suffer strong drops in the markets. These negative variations do not necessarily translate into a decrease in the asset's intrinsic value. Moreover, shareholders who will have held on to their shares will not have suffered any ill effects, psychological ones notwithstanding. It is undoubtedly a great challenge to keep calm during strong drops in the markets - but it remains just that, if the asset retains its intrinsic value.

Permanent capital loss is the result of a drop in the value of shares due to a deterioration of its intrinsic value. In this case, one would need to liquidate their shares in order to avoid further losses. A price drop with no real cause is merely asset volatility, and selling at that stage would not be necessary if the allocated capital is long term.

Other than the long-term factors, our strategy is not that novel. We merely intend to apply, with discipline, that which many already know, various studies prove, and few actually follow.

What We Aim To Do

In order to successfully apply our methodology, it is imperative that, on average, we have funding with adequate time horizons. It is futile to have a long-term strategy with short-term funding. This situation would lead to a mismatch when returning capital to our clients since we would not be able to adequately sell the assets in the portfolio in the short term. Low liquidity of assets in a portfolio can lead to serious issues, if one is forced to sell them indiscriminately.

Consequently, it is fundamental to understand what our ideal clients' characteristics would be. Below we list some of the main ones:

- Must know and understand our strategy, feeling comfortable with its execution;
- Plan the use of their assets over the long term. To that end, has alternative sources of liquid assets which may be tapped at shorter notice, if necessary. Our Fund should be classed as one of their less liquid assets, and therefore only up to 20-40% of their total assets should be kept with us;
- Understand that we are investing in companies, buying shares of businesses, as if one were investing in a restaurant, or a small shop.

Ideally, we should seek funding with time horizons equivalent to those which have similar performance targets. Private equity investments usually have 7-10 years' timescales and normally one may not withdraw their investment midway.

We understand that having a product with private equity-like performance, safety, and higher liquidity may be interesting to our clients.

However, defining a redemption schedule is fundamental, as we do not wish to harm some investors to benefit others who failed to understand, or got their investment objectives wrong.

We are therefore in the final stages of changing the Fund's redemption rules. We plan to change two aspects: redemption cut-off dates, and redemption notices.

On the first point, redemption requests may be placed on the 10th of each month.

After putting much thought on the question of redemption notices, we have decided on a model which will be beneficial to our long-term investors. We still leave the "emergency exit" open for those who may, for some reason, require their cash in the short term, ahead of the normal notice period.

Our proposed redemption notice will be:

Redemption Notice	Exit Fee
T+90	10%
T+180	0%

Over the next few days we shall call for a Shareholders Assembly in order to implement these changes†.

Over our upcoming reports, we shall be exposing some of our investment cases, and other themes relevant to our business. For further clarifications, please feel free to get in touch on +55 21 2249 1500 or contato@bogaricapital.com.br

* This is not a "capital guaranteed" product.

† Due to the global financial crisis taking hold soon after this report was published, the proposal for changes to redemption notices were dropped.