BOGARI capital

BOGARI DIGEST 2008 - 2015

Excerpts From Our Reports – June 2015

As Bogari Capital enters a new phase in H2 2015, focusing our attention on investors located outside of Brazil, and aiming to provide a thorough understanding of our investment philosophy, we have curated a small collection of excerpts from our bi-monthly reports since our inception.

Going forward, our aim is to publish an English version of our report every quarter, starting with Q2 2015. These will deal with current themes and investment cases in our portfolios.

In the meantime, we hope you will enjoy the read, and would like to take the opportunity to encourage you to get in touch with us at contact@bogaricapital.com.br or on the phone +55 21 2249 1500 if you require any further details.

Guest Columnist on "Valor Economico"

August 8, 2009

Against The Flow: The Challenges of Long-Term Investing

Public equities are normally associated with a style of investing requiring long-term vision. However, it is common to observe that investors who keep shares for a long time are the exception rather than the rule. It is common to see investors buy and sell their holdings multiple times over a short time span. Studies in various markets indicate that the average holding period for a stock in an investors' portfolio has decreased in the last decade. We have attempted to understand the reasons, and have identified four factors.

The first factor comes down to human behavior. Regardless of the findings in the field of behavioural finance, it is intuitive to assume human beings are not equipped for inactivity. Keeping a stock in a portfolio for many years is not natural, all the more when we consider the immediatism and speed with which things happen in today's society. It is worth reminding that the stock will be negotiated daily during the period over which it will be held in the investor's portfolio, ticking up and down every day.

The second factor pertains to the large amount of information in circulation today. According to Richard Saul Wurman in his book "Information Anxiety", a daily edition of The New York Times contains more information than a common person of 17th century England would have seen in their whole life. The internet as a source of real-time information further exacerbates this trend. To a potential investor, this bombardment of information can be detrimental to formulating their own opinion.

The third factor is related to the way in which the stock market is currently structured. Stock brokers make money from activity, not inactivity. In other words, the greatest share of revenues from stockbroking firms comes from acting as a broker for the purchase and sale of stocks. Therefore, the focus of their marketing campaigns is centered on the act of buying and selling, shorter-term strategies, charts, etc. A client with less assets and more activity is better than a client with more assets and less activity. The stockbroking firms themselves help generate and distribute even more information to their clients through their reports, recommended portfolios, TV channels or online chats. All this flow generates a momentum favourable to trading.

Finally, a healthy aspect of Brazilian law has its own negative effect. The need to publish daily NAVs for regulated funds certainly brings robustness and greatly benefits the fund business. We would never make a case for any changes in that regard. We find the system as a whole to be very good. However, there is no denying the availability of daily NAVs and their constant updating create investor anxiety and propensity to immediatism, itself already a human trait.

Combining all the above-mentioned points with the convenience of trading stocks via online brokers, we believe it is only natural that the average investor has an ever-increasing short-term bias. If among professional investors this short-term bias is hard to control, it is a formidable task for the amateur investor.

Fortunately, to those who have a long term investment horizon, these are the behavioural differences which set the stage for opportunities to obtain enhanced performances. For long-term investors, the stock market exists to serve their objectives, and not to tempt them to take an action based on impulse. In our case, the stock market is just a marketplace where it is convenient to buy and sell shares in businesses. Therefore, we may keep a holding in our portfolio for as long as it suits us.

We do not believe in a single winning strategy. Long-term investments in public equity markets (buying adequate assets) is the strategy we know in depth, which is widely proven academically, and with which we have had excellent results over the last few years. Any strategy is valid, so long as it generates consistent returns.

The goal of this article is simply to draw attention to the current environment in which investors operate, so that they may prepare against short-term traps and control the activity level of their transactions.

On Risk

September/October, 2009

We regularly mention that we do not consider volatility to be a good measure of risk for our Fund. We would therefore like to discuss some ideas on the theme.

As we understand it, measuring risk through volatility makes sense when the investment can be liquidated at any time. In this case, it is important to know the "behavior profile" of the asset's price. The advantage of this measure is the convenience of calculating through historical information. The main downsides are the fact that the past is not necessarily a representation of the future, and the fact that the company's operational aspects are not taken into consideration.

Additionally, according to the theory, one must incur more risk to obtain an above-market performance. This theme has been widely debated in academic circles over recent decades, and we shall not delve any further. But, in theory, in order for our Fund to have a market-beating performance, we should have higher volatility. Our historic performance shows that clearly this theory does not hold true since our volatility this year is 14.2% versus the Bovespa's 31.9%, and our clearly superior performance.

As a consequence one might ask: "if volatility is not risk, then what is risk?" In order to answer this question, we need to highlight one of the principles of our investment philosophy: "In the long run (3 to 5 years), the negotiated price of a stock in the market converges towards the asset's intrinsic value".

In the private markets, where companies are not publicly negotiated, we may consider that the assets' prices correspond to their intrinsic values. Normally, buyers and sellers are rational, and buyers may perform due diligence on the target-company, increasing their knowledge of the asset.

Furthermore, in the private markets the risk of the investment tends to be that of the business' fundamentals. So long as the investor is patient, does not overpay for the asset, and if the latter generates value and has some growth, the probability of losing money is low. On the other hand, value-destroying assets are rarely sold for prices which do not reflect their realities.

In public markets, in the short term, risk may be reflected by its volatility. However, for long-term investments, risk tends to pertain to the business, as is the case in private markets. This is because in the long run the trading price converges towards the business' intrinsic value so that, should it deteriorate, the same should happen to its share price.

Therefore, to understand what sort of risk we are exposed to, it is necessary to understand the business model of the company and its capacity to create value over the next few years, much like is the case for private investments. To us, the risk of each share reflects the company's business risk.

So, how do we minimize this risk? Specifically, we minimize risk if we acquire a portfolio of assets at fair prices, presenting low probability of losing value over the following years. In a simplistic form, the main characteristics these businesses should present are: (i) tried and tested business model, (ii) suitable returns, (iii) some growth, and (iv) low indebtedness.

There are many reasons that lead a company to present those characteristics including the quality of its people (controlling shareholders and executives), competitive advantages, barriers of entry to their markets, etc.

Additionally, public equity investing presents some advantages over privately negotiated assets. First, we may purchase holdings in businesses which are irrationally cheap, as is generally the case during crises and in isolated cases at other times. Secondly, we have liquidity, which allows us to exit an investment when we wish, for rational prices or not. Thirdly, we have the option to exit the business if something goes wrong, which is not always the case in a private investment.

The challenge of working with this concept of risk lies in the complexity of translating it into numbers. As an example, we may try to define the inherent risk of an investment like Tempo Participações by answering the following question: What is the probability of the business losing value in the next three to five years?

Imagining the asset is worth R$5 per share, and assuming it to be trading at R$3.50, we have a safety margin of 30%. Ignoring our cost of capital, in the long run we would lose money if the asset were to devalue by 30%

Now, what is the probability of a reasonably stable business, generating cash, with good potential profits and no debt, losing over 30% of its value in three years? It is quite low, probably between 1-5%.

A reasonably diversified portfolio, composed of different assets, with low correlation between themselves, and possessing solid fundamentals tends to have a substantially lower risk than any individual asset. Likewise, risk as measured by volatility also decreases with diversification.

Therefore, when building our portfolio of investments, we are careful to acquire assets with good fundamentals, presenting the above characteristics, and in sufficient quantities to provide us with adequate diversification.

Despite the complexity of presenting a single number which represents the level of risk in our portfolio, we find solace in knowing its low operational risk is a result of our investment process, which indicates a diversified and value-generating portfolio over the long term.

On The Paradox of Price Corrections

March/April 2010

As many of you are aware, we sport no ambition to be traders, but rather long-term investors. Normally, in our investment cases we know what will happen to the companies and their shares, however we do not know when it will happen.

That is why we like to have time on our side. For that, we need to have: (i) adequate liabilities, i.e. long term investors; (ii) assets with a high probability of generating more value and growth over time; and (iii) the opportunity to buy these assets at a discount, or margin of safety, to protect ourselves from any unforeseen circumstances.

It is normal that while the company is in our portfolio, its share price will oscillate. Upward variations are usually not a problem, but downward price variations lead some to worry.

Over the months of March and April, some of our companies' share prices have dropped, negatively affecting the Fund's results.

We are not inclined to justify sporadic drops in the NAV due to a specific holding, but rather, are interested in presenting a different view of what the devaluation itself engenders. If, on one hand the devaluation causes momentary pain due to the perceived feeling of loss, on the other hand this devaluation should create an after-effect of comfort.

That is because when we re-analyze the investment case in a certain company, if nothing else has changed, the case is now stronger. As an example, if an asset was good at R$10, it is better at R$9, and better yet at R$8. As much as a 10% or 20% drop in price may be "painful", in the long run it is possible that the investor will end up better off, should he or she have additional capital to buy more of that same asset at reduced prices.

Some could argue that ideally, one should sell the asset at that higher price, and buy it again at the lower price. That way, we would have immediate gains with the sale, and cheaper repurchase. In theory the argument is correct, but in practice things are more complicated since future market moves are hard to predict. Additionally, as we have previously argued, we do not ambition to be traders and therefore do not take up short term positions, whether long or short.

In our strategy, within an interval of share price variation, we do not sell our positions and therefore accept market movements, however undesirable they may be. Past a certain value, we may buy or sell such assets. We sell our positions when their price reaches a level close to what we consider to be fair, and conversely, increase our position when there are exaggerated price drops which are not accompanied by a change in the company or its competitive environment which would justify this drop. The exception occurs when there is a great variation to the relative price between assets, as was the case in 2009. In this case, despite the fall, we sold stocks to buy others which were even cheaper.

Therefore, the price fluctuations of assets and, as a consequence those of the Fund's NAVs is normal and in many occasions beneficial to us. At this moment, as much as it may seem like a paradox, despite the devaluation of some of our assets, we are more comfortable with our portfolio than we were prior to the drop.

On Alignment

May/June 2010

Our investment philosophy has always been focused on assets which may generate good returns for our investors while maintaining very low operational risk. Since our aim is to have an investment vehicle which is safe and whose longevity will surpass 20 years, we limit our concentration to a single company, closely watch liquidity, and do not leverage our portfolio.

Despite having a relatively high historical performance, we seek consistency. Performance is but a consequence of our process as a whole, and not just due to isolated factors.

Our intransigence in maintaining the elements described above does have its consequences. The first being that we do not always have in our portfolio the most popular stocks in the market, and therefore some of our holdings may seem "exotic" at first. At least until their investment cases are vindicated. This was the case when we invested in Hering in 2006, when we outperformed with Helbor, Eztec and Parana Banco in 2009, and when we built a relevant holding in Tempo in 2010. However, we also like the popular stocks, at the right price. The global financial crisis, and last month's market corrections allowed us to buy Itau, Bradesco, Lojas Americanas and Banco do Brasil at great prices (in the latter case, we took the opportunity to buy the ordinary shares due to the large discount to preferred shares).

Having an unusual portfolio makes us sometimes to be considered different. Unfortunately, due to human nature, we tend to be unsettled by this. As 19th century German writer Marie von Ebner-Eschenbach said: "We are so vain that we even care for the opinion of those we don't care for".

The second consequence is a moderate pace of growth in terms of the size of the fund. We want to have long-term investors who understand what we do, and therefore we avoid investments from excessively concentrated client portfolios, or investments which may have a shorter-term bias than our own. We seek to grow at an adequate pace, minimizing the risks of having a portfolio we are not comfortable with, or losing sight of the reason why the firm was created. Our patience and consistency has brought us the honour of serving around 110 clients, who seem to believe in what we are doing.

We remind you that our greatest guarantee as we take in new investors is the fact that the partners at Bogari have the majority of their wealth invested in the Fund. Therefore, when we buy an asset, we are investing our own money, and therefore treat our clients' money literally as we would our own.

On Fund Classifications

January/February 2011

Bogari Value FIA has, for some time, been likened to a small-caps fund. This is not completely unfathomable considering our portfolio has always held smaller companies. However, we have always maintained that our objective is to buy good assets at adequate prices, regardless of any other characteristics. Moreover, we have often repeated that we tend to prefer larger companies to small ones, but, under normal conditions, larger companies tend to be more expensive due to their higher levels of liquidity, and for being well known in the markets.

However, over the last few months, larger companies have gotten more attractive than their smaller peers. We have started to take advantage of these opportunities, which drove our portfolio to present a relevant mix of large-cap holdings. Companies like Itau, Redecard, Petrobras and Telemar have become part of our portfolio.

The portfolio of companies we hold is just a consequence of our investment process. We seek to select assets with low probability of permanent capital loss, high probability of increased future cash flow generation, at adequate prices both in absolute and relative terms.

Our Fund should not be classified by the characteristics of its holdings, as we do not aim to focus on a particular type of company. Our sole commitment is with the strategy of delivering performance over the long term.

On Conviction

September/October 2011

As we see it, the usage of the word “conviction” by investors may be split in two different ways. The first occurs when talented investors employ the word in order to emphasize that, according to the best of their knowledge, there is a high probability of success in a certain investment. In our understanding, these investors are aware that the investment can go sour and are not using the word in its strict sense, but rather as a way to emphasize an extensive research process which is reflected in their assurance with the investment.

The second case is when those using the term truly believe in the end result of the investment. They use the word to generate a sense of security which does not really exist when selling their investment case to others. Quite probably, they are projecting their personal hopes on a single outcome. At this stage, the risks increase.

In our case, we do not like to use the word “conviction”, as we understand that its strict sense may convey a false sense of security, and therefore we do not condone it.

Conviction in Theory

Regardless of who uses the term, and in what situation, we must be careful with what we really think.

Studies show that, among the many biases in our brain, we tend to increase our sense of security as we become more familiarized with something. However, the rate at which we make correct choices does not increase as we enhance our understanding of a particular subject.

Mauboussin, in his excellent book *More Than You Know*, presents an experiment with punters on horse races. Initially, some information on the horses was given to them, and they were asked to assign the odds of each horse to win. As the quantity of information given to them was gradually increased, it was observed that the degree of confidence in their prognoses increased, while their accuracy did not.

Being more comfortable with a situation does not increase one’s chances of success. It is not simply the amount of information that matters, but also how effectively it is processed. Human beings, often involuntarily, look for more information in order to confirm their hypotheses, not to refute them.

Conviction in Practice

Throughout the years, we have had many opportunities to affirm that there is a non-negligible divergence between the reality of a company and how it is interpreted by the markets.

We have stated sometimes that the market’s degree of confidence in some aspects of companies’ businesses does not reflect what happens day to day. Moreover, we maintain that often the executives or the controlling shareholders themselves do not have a full grasp on what is happening inside their companies – often not by incompetence, but due to the sheer complexity of their businesses. Our past experience in the controlling group of some companies has taught us this reality.

This is one of the reasons why we do not concentrate excessively the holdings in our portfolio. We believe that no matter how well we know a company, something unexpected can always happen. Lest we forget Aracruz or Sadia[*].

[*] Those companies’ treasury departments were trading increasingly large positions in FX derivatives until a sudden devaluation of the BRL during the financial crisis in 2008 caused massive losses which nearly brought the collapse of those otherwise solid businesses and made them targets for takeovers.

Memoirs of a Niobium Salesman

January/February 2011

On March 2, 3 and 4 [of 2011, the financial daily] Valor Economico reported on the sale of 15% of CBBM (Brazilian Metals and Mining Company) to a group of Asian investors. According to the reports, the company was valued at U$13bn.

The group of buyers was formed by six companies: four of them Japanese, and two Korean, who had each bought a 2.5% stake. The new partners had the right to acquire a volume of niobium equivalent to their share of ownership in the company. This is a normal clause when a customer becomes a partner in a supplier of raw materials that are strategic to their operations.

To the few who took notice, the transaction was significant. We believe this was the reason that led the reporter to write about the subject during three straight days.

To the reader, the curious points are: how can this virtually unknown company be worth U$13bn, why would anyone pay so much to be a minority shareholder in a private Brazilian company, and what is niobium?

CBMM is relatively unknown, especially to those who are not in mining or steel-making. As a measure of the company's pedigree it is worth noting that it is owned by the Moreira Salles family - former controllers of Unibanco, and currently part of the controlling group of Itau-Unibanco, Brazil's largest privately-held banking group – with a nearly 100% stake in CBMM.. Today, the family owns about 9% of total shares of Itau, currently [Apr 2011] worth around R$15bn. As for CBMM, it was valued at close to R$21bn (U$13bn).

After speaking to some people on this subject, an interesting book was recommended to us, telling part of the company's history by its former Managing Director, José Alberto de Camargo. The book covers the period between 1975 to 2005, when he was at the reigns of CBMM.

Our interest in the story lies in understanding how the company came to be a market leader which, due to its price-setting capabilities in its product, also became extremely lucrative.

Niobium (formerly known as Columbium) is a metal which, when used in steel-making, produces stronger steel, also better suited to welding. The value proposition of niobium and its by-products is very compelling, as the addition of a small quantity – 400 grams per ton – is capable of bestowing the above characteristics on steel, making it better and more cost effective.

Niobium started being used in steel-making in the 1920s, however, the difficulty to obtain it and irregular stocks were a major barrier to its widespread use. The discovery and beginning of extraction of Brazilian and Canadian reserves have enabled widespread use.

CBMM's strategy to develop the market was very interesting. On one side, they started selling higher value-added products such as iron-niobium micro-alloys, and later super-alloys instead of pure niobium concentrate. Additionally, the disintermediation from trading companies and direct sale to end-users allowed the company to gain a better understanding of its clients' needs.

In order to generate credibility in a product produced in a country with scant industrial tradition like Brazil, CBMM created a logistics process guaranteeing order fulfillment in 72 hours. Clients were also able to define the type of packaging for the product. Additionally, the prices were fixed so as not to create undesired volatility and unpleasant surprises to its customers.

To stimulate demand and new uses, CBMM sponsored research into niobium applications throughout the world. It hired chemical engineers and also created an annual prize for the best publications on the theme.

Close relationships with the main steel-producing countries was fundamental. The company forged relations with the USSR and China during the Cold War era. Japan also began to be an important market for the company.

Gradually, the company developed the niobium market, guaranteeing a recurrent demand for its products. As the largest global producer of the metal (80%) and operating the world's richest niobium mine, CBMM was able to gradually increase its prices. The growth of China and the commodities boom were catalysts to this process.

The business model developed by the company was very well executed by José Alberto de Camargo. This allowed the company to generate profits of R$1.9bn, and its valuation to reach the levels paid by its buyers.

It is rewarding to see the materialization of the vision of a group of entrepreneurs who founded the company 69 years earlier, and of the Moreira Salles Family who acquired the project in 1965 and continued to develop it.

The peculiarity here lies in the fact that CBMM is a Brazilian company with global reach, an absolute leader in its market with a business model highly focused on innovation and technology. Brazilian companies with these characteristics are few and far between.

The Moreira Salles family have the merit of believing in, and continually supporting such a project. Many years later, its merits were rewarded by the recent transaction. What we can say is that businesses with these characteristics are the stuff of dreams for every investor, especially if bought at attractive prices.

On Government Intervention in the Electricity Sector

July/August 2012 and December 2013

December 2013

A little over a year ago, the Brazilian government published the now infamous MP579, whose objective was to define the renewal of the concessions of electricity transmission, generation and distribution expiring by 2017. The government's plan was to transfer part of the electricity cost reduction to society, as a result of lowered taxes for the sector, and the end of amortization of plants which had been in operation for many years, and therefore were paid off.

With the benefit of hindsight, we may concur that the process was disastrous, based on good intentions and terrible execution. And perhaps the greatest motivation for reducing the cost of electricity was in fact to force inflation under control.

However, not even this objective was achieved, as with the low level of the water reservoirs at the hydro power plants, it was necessary to dispatch the expensive gas-fueled power plants to avert the risk of electricity rationing. The cost reduction in energy generated excess demand precisely at the moment when no spare capacity was available. The final result was that electricity bills dropped less than expected, and this year and next we will have to pay the bill for this more expensive power coming on the grid.

September 2012

With regards to the public markets, what is almost unbelievable is that in spite of the uncertainties over the concession renewals, few analysts and investors believed that the most severe solution proposed by the government would actually be the chosen one. In the end, the least likely and highest impact scenario took place.

As we know, human beings tend to be optimistic and perpetuate the *status quo*, which in this case is represented by the renewal of the concessions at similar conditions to the original contract, as was usually the case.

Additionally, assets with good track records of paying dividends, and presenting low volatility in their accounts appear to be stable and low risk, which makes them popular investments.

By breaking with these expectations, the government caused a strong correction in the sector, simply because part of the economic value that was previously taken into account in valuation models of those companies – perhaps equivocally – no longer existed.

This is a clear illustration of the premise that risk is relative. From the point of view of share volatility and operational results, the risk of companies in the electric sector should be low. Such is the case that it is common market practice to assign a lower discount rate for these companies.

Additionally, consistent dividend payments by those firms lead some investors to believe such assets have an economic value above reality. The fact is that evaluating regulated companies seems like an easy task, but it is not. The reason being, that the logic of asset value is tied to regulations, and to definitions made by the conceding authorities, and not to any multiples, such as dividend yields.

On principle, we use the purchase price of a share as the main risk mitigator. In this case, we did not see a discount in the price of assets, as they already priced very low returns. In other words, the assets were expensive. It is possible that an expensive asset becomes even more expensive, or that it's operational performance is so good as to justify paying a premium. However, we do believe that in the majority of cases the risk is not worth bearing.

What we have seen in the case of the electric companies was that, since they were mostly priced above their real value, the change in expectations adjusted the prices in the market. For many investors, it is possible that this loss was a permanent one.