

FCL *Capital*

2Q 2023

Performance:

FCL Opportunities	
Year to Date, 2023, in BRL	-4,15%
Year to Date, 2023, in USD	5,83%
12 Months, in BRL	-0,35%
12 Months, in USD	9,40%
MSCI All Country Index, 12 Months, in USD	14,36%
Since Inception (30/01/2017), in BRL	82,46%
Since Inception (30/01/2017), in USD	18,77%
Avg Annual Return, since inception, in BRL	9,80%
Avg Annual Return, since inception, in USD	2,71%

At the end of the quarter, FCL Opportunities top 5 positions were:

Position	Country	% Fund NAV
Uber	US	11,7%
Moncler	Italy	11,1%
Go Daddy	US	10,6%
Entain	UK	10,4%
IHS	Nigeria	8,4%

FCL Opportunities Portfolio Composition on June 30st, 2023:

Portfolio Composition by Sector	
Consumer Discretionary	40,8%
Technology	32,7%
Healthcare	10,9%
Telecom Services	8,4%
Financials	8,4%

Currency Exposure	
USD	40,5%
EUR	19,5%
BRL	12,9%
GBP	10,4%
CNY	8,2%
HKD	6,4%
INR	2,1%

Geographic Distribution	
USA	31,8%
Europe	29,9%
China	14,6%
Brazil	10,9%
Others	10,5%

Portfolio Concentration	
Top 5	52,2%
Top 10	87,5%
Top 15	97,6%

FCL Opportunities had a positive performance of 5.83% in US dollar terms in the first half of 2023. In the past 12 months, the fund's US dollar performance was a positive 9.4%.

On the other hand, when measured in Brazilian reais the fund's performance has been weak: -4.15% in the first semester and basically flat in the past 12 months, -0.35%.

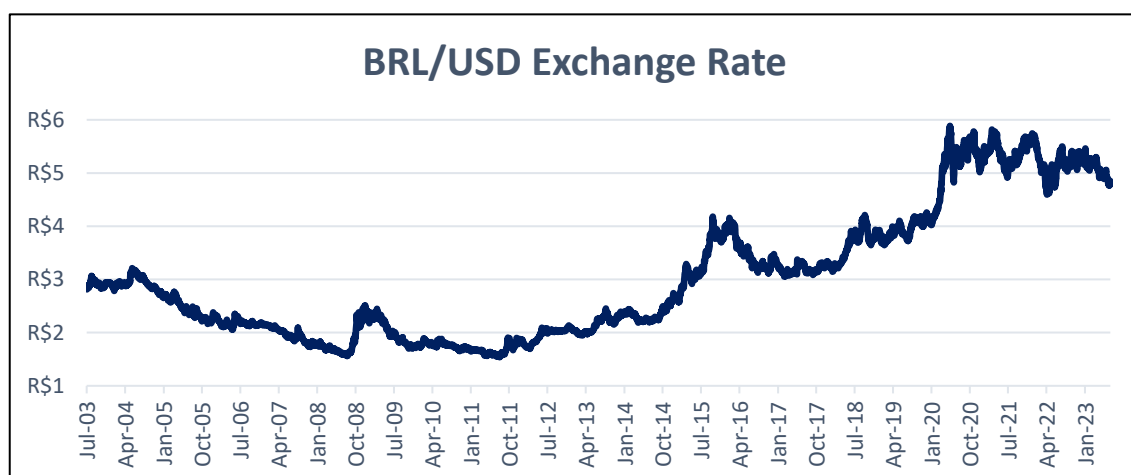
The relatively weak performance in BRL happened because of the significant rise of this currency when compared to the USD and other international currencies over the past months. Since the beginning of the year, the Brazilian currency has risen 12% against the USD dollar.

As this house has discussed many times in this space, we see temporary differences and volatility in our performance when measured in different currencies as extremely natural occurrences.

In fact, since our fund's inception, the exact opposite phenomenon has basically been the norm: the fund's performance in BRL has historically been helped by the depreciation of the Brazilian currency against developed market currencies. We expect that over the long term this will continue to be the case.

Since Brazil's average inflation tends to be higher than that of the US and Europe, Purchase Power Parity theory practically guarantees that the BRL will continue to depreciate against the US dollar and the Euro over the long run, naturally with periods of strong appreciation when past excesses are corrected, exactly like we've been seeing over the past few months.

As we said many times in the past, we judge compounded annual performance over the long term to be the most appropriate measure to assess our fund's performance, since over the shorter term noises and fluctuations like the one discussed above will occur.



Source: Bloomberg, FCL Capital

In any case, and regardless of which currency we are analyzing the fund in, we are satisfied with the way that our FCL Opportunities fund has been gradually recovering

from its lows in mid-2022 and, more importantly, we are very happy with the operating results of the companies we invest in. The first semester of 2022 was tough for our fund and stock investors in general, but in the past twelve months our fund has at least shown stabilization, if not yet regaining all of the lost territory.

As for FCL Opportunities' portfolio, as usual for this house, there were few changes through this past quarter. The main change was the sale of two small investments that we had in Brazil. However, even with these sales, the strong performance of Brazilian assets in the period meant that our overall exposure to the country barely changed.

This excellent performance of Brazilian assets, together with the strong appreciation of the Nigerian company IHS, has made our exposure to emerging countries rise from 31% of net worth at the beginning of the year to 36% currently. However, when we calculate the origin of the revenues of the companies that we have in our portfolio, we observe that our effective exposure to emerging countries is actually close to 47%, exactly as desired.

Geographic Distribution of Invested Capital			
by legal headquarters		by revenue	
USA	32,6%	USA	29,2%
Europe	30,6%	Asia	25,7%
Asia	17,1%	Europe	23,8%
Brazil	11,1%	Brazil	13,3%
Africa	8,6%	Africa	7,9%

For the coming months, we are prepared for the beginning of the earnings season in which we will assess the operating performance of our investees and remain attentive to new opportunities that may arise.

Portfolio Changes and Emerging Markets Suffering

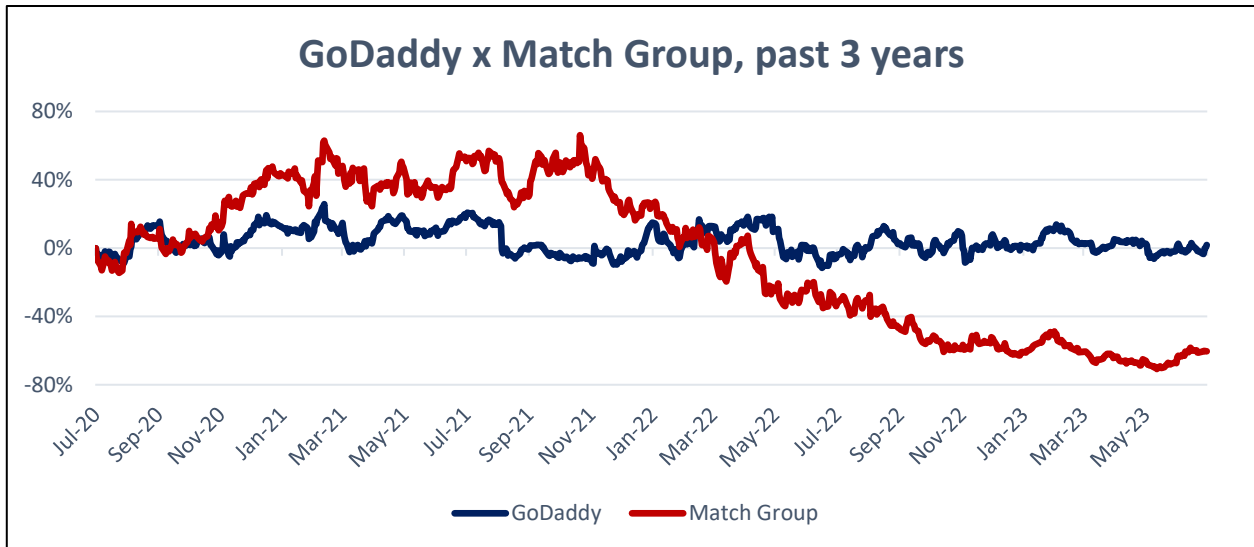
As we've explained in the past, FCL Opportunities has performed very well in its stock picking capabilities over the past few years. Our holdings consistently outperformed their respective regional benchmarks, be it on our US investments or in China or in Brazil.

We were also able to protect our fund from some of the worst losses that global growth companies have endured.

For example: In mid-2021, at the height of the tech bubble, we exited one of our most important and profitable investments ever, Match Group¹ and basically used to proceeds to increase our exposure to GoDaddy. Since then, even though GoDaddy has been facing some tough times, with its shares basically flat since we first bought it, the investment fared much better than Match Group, which saw a correction of more than 60% in the period.

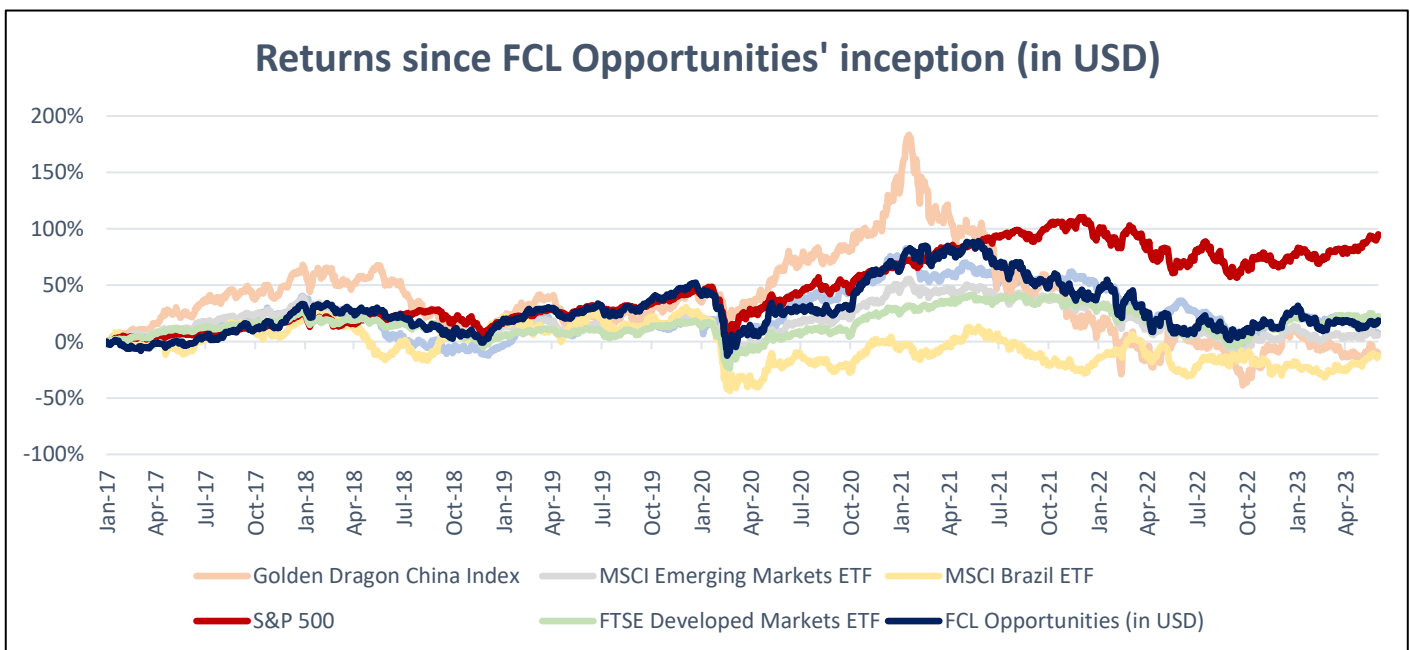
¹ For more on our past investment in Match Group, you can check our participation in episode 21 of the Stock Pickers podcast.

Link: <https://open.spotify.com/episode/2nj1kFk9QP2hZCrkb5rRQF?si=2m9uTK3HRgeBGfrHidBUIw>



Source: Bloomberg, FCL Capital

Having said all that, we are certainly not satisfied with the performance our FCL Opportunities fund has shown in the past 36 months and are working hard to regain our high water marks. We do believe that we are in a relatively low point and the future will be better than the past. Why is that so? Because the past few years have been particularly tough for a strategy like ours, with a heavy emphasis in emerging market growth companies.



Source: Bloomberg, FCL Capital

To summarize, since our fund is focused on finding and exploiting the most promising unconventional opportunities in overlooked corners of the global stock markets, periods of large cap and developed markets outperformance, like the past few years, usually make our fund underperform while periods of emerging markets and small caps outperformance, like we believe the next decade will be, are when this house specially shines.

Marina Abramovich and the Trash Bin

One of the most famous and dramatic performers of our time, Marina Abramovich is known for a number of scary and unconventional art shows like “The Artist is Present”. In this show, she would just sit still for several weeks in front of the audience and anyone could sit close to her for as long as they wanted just not being allowed to talk or touch her. Just witnessing her presence. Most people couldn’t bear the heaviness of the experience and would usually leave after a few minutes.



“The Artist is Present”, May 2010

In one recent interview she recalls sitting for hours in front of people and asking them to write their ideas, whatever they wanted or felt at the time. And then to give her their papers and throw the bad or useless ideas in a trash can near the table. After a few months of this exercise, she went straight to the garbage bin and never even bothered to read the papers that were given to her. Why? Because it is always the discarded ideas, the bizarre ones, the ones we are too ashamed to show the world that are truly inspiring.

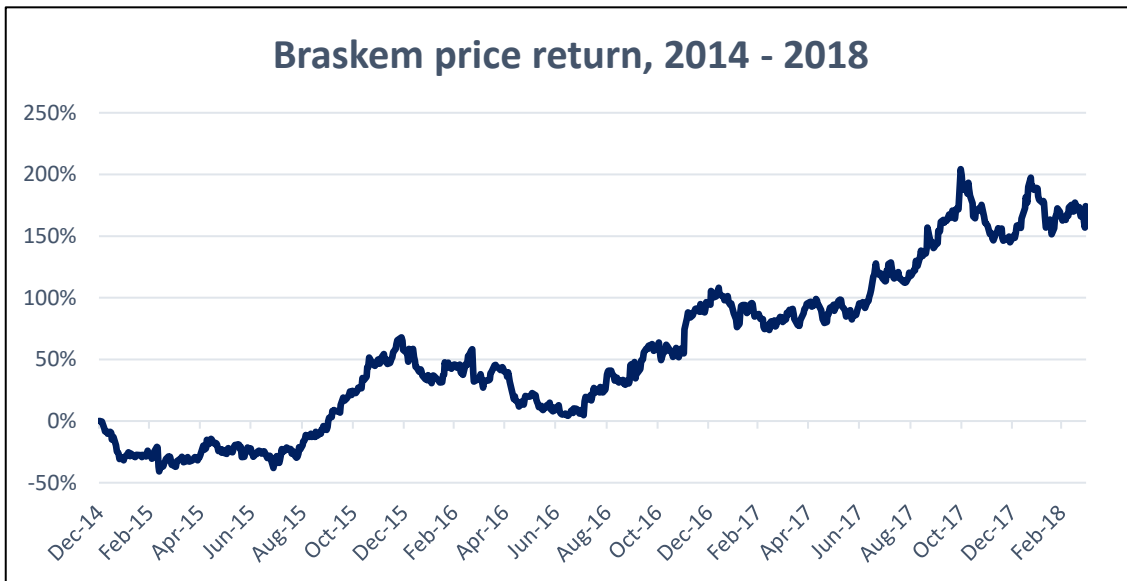
As we read this recent interview we couldn’t help but draw a parallel with the investment management profession. Frequently your best idea is the one you just can’t put in practice because it is too bold, too unorthodox, too unusual. It will bring you ridicule and humiliation.

For this house one of our most profitable ideas ever was buying Braskem when it was basically an untouchable and uninvestable stock, in the midst of the Car Wash scandal. Of course this scared us, but we just felt that even though we were as afraid as anyone, we had to act and buy at those ridiculous prices. We understood the situation, the risks, the company, the business. We thought about worst case scenarios and saw an opportunity.²

Looking back years later, it was a very tough an unnatural thing to do but we just felt we had to act. We understood the company and its dilemmas. We judged it would survive.

² For more on our past Braskem thesis you can access our writeup on Sumzero, published in February 2016. Link: <https://sumzero.com/pro/research/ideas/11595>

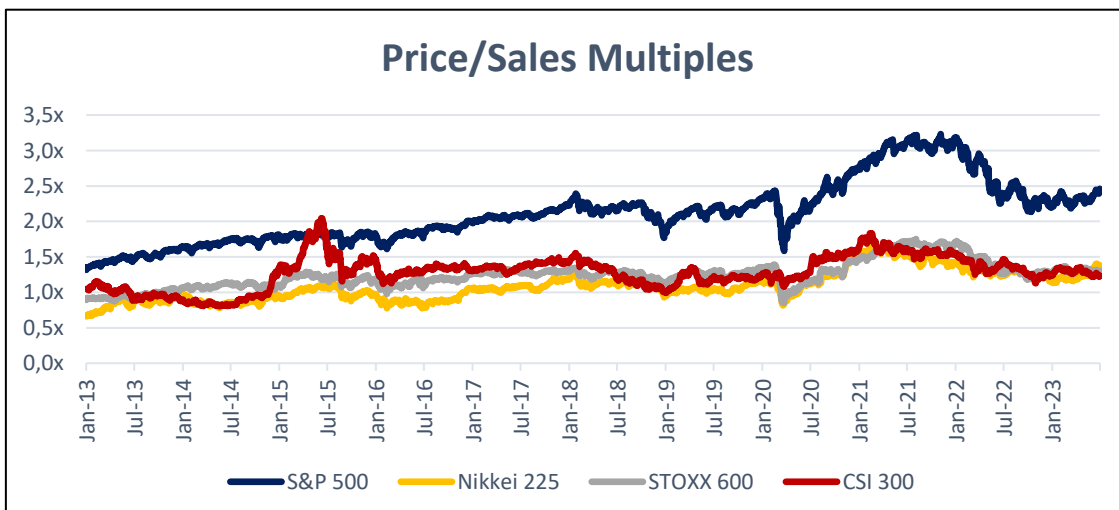
But at the same time, no self-respecting investment house would admit publicly of buying such a stock in such a horrible situation. Certainly, if the investment turned out to be unprofitable, it would have been very embarrassing, to say the least.



Source: Bloomberg, FCL Capital

If there is one untouchable and uninvestable idea right now, one that might be embarrassing to reveal in one's portfolio, it is definitely emerging markets in general and China in particular.

In fact, China's stock market has been officially declared "uninvestible"³ by a large number of investment luminaries and one of the world's most important banks.⁴ China right now is an idea thrown at the trash bin. Few would suggest it out loud, afraid of being ridiculed. "Buying Chinese stocks?! Don't you get it? Are you crazy?"



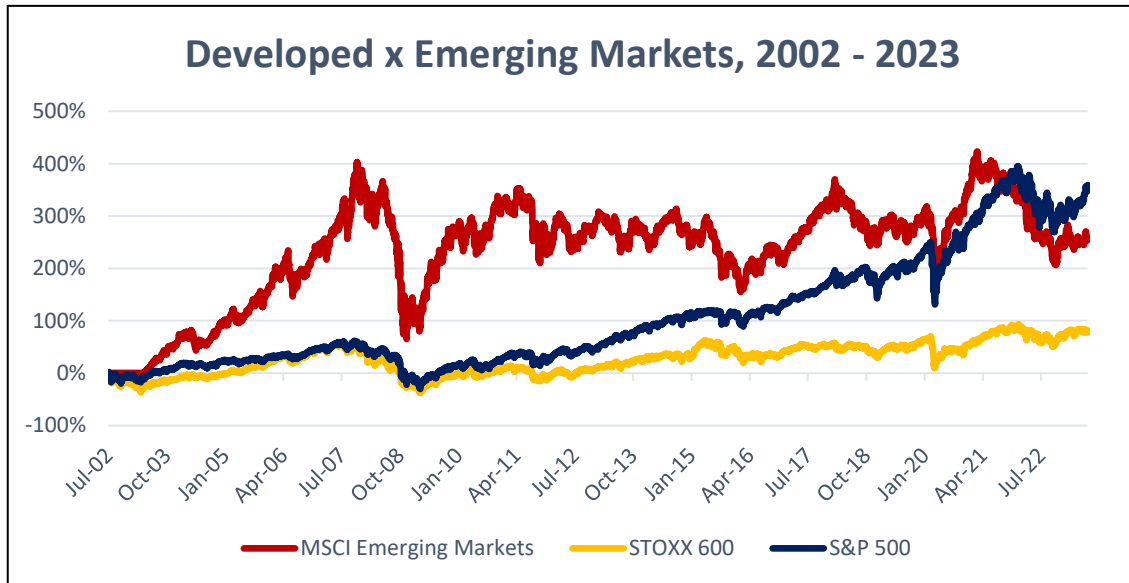
Source: Bloomberg, FCL Capital

³ Fittingly enough, the "uninvestible" call might have marked the exact low point of the Chinese stock market that has since recovered some (but not even close to all) losses.

⁴ <https://www.ft.com/content/55c7702a-7c45-4521-85e8-95cb9ed14b26>

The fact is that periods of outperformance steal future performance from assets and the contrary is also true. China and Emerging Markets in general just had a decade of massive underperformance and this cost a great deal to our fund, which has the mandate to uncover opportunities across the planet, particularly companies located in or related to emerging markets.

But all is not lost, if we take a long term perspective we can see that periods of drastic falls in valuation and massive underperformance are usually followed by extreme bull markets and vice-versa.



Source: Bloomberg, FCL Capital

We can't promise, of course, but this house does feel that the next decade might bring a different and opposite story. An occasion to search through papers in the trash bin and rehearsal some old ideas.

Thesis: Hypera

One of the advantages of a flexible and global investment mandate is the luxury of seeking alpha where this house sees the most opportunity and promise. This broad universe of possibilities allows us to focus on the few specific countries and sectors where this house sees a combination of upside, an inviting valuation and where we judge to have a competitive advantage on understanding and exploring the risk reward opportunities before us.

Over the past few years we've made numerous investments across global financial markets, among them⁵:

- The consumer and technological sectors in China;
- The banking sector in India;
- The retail and consumer sectors in the US;
- The luxury industry and gaming industry in Europe.⁶

In this letter we will give an update about a sector we've been invested in, in different forms, since the beginning of our FCL Opportunities fund: the Brazilian healthcare sector.

Comprising around 11% of our fund's exposure, healthcare is currently the only sector we are invested in Brazil. Interestingly, Brazil is also the only country where we have healthcare investments.

To put it in other terms, this house believes not only that healthcare is the most promising long term opportunity in Brazil's stock market but also that Brazil has the most promising healthcare industry on global stock markets.

And why do we see such a bright future for healthcare in Brazil?

To sum it up, Brazil is getting older faster than any other country, alongside China and a few other places. Today, one in ten Brazilians is over 65 years old and by 2060 that number will have risen to one in four.

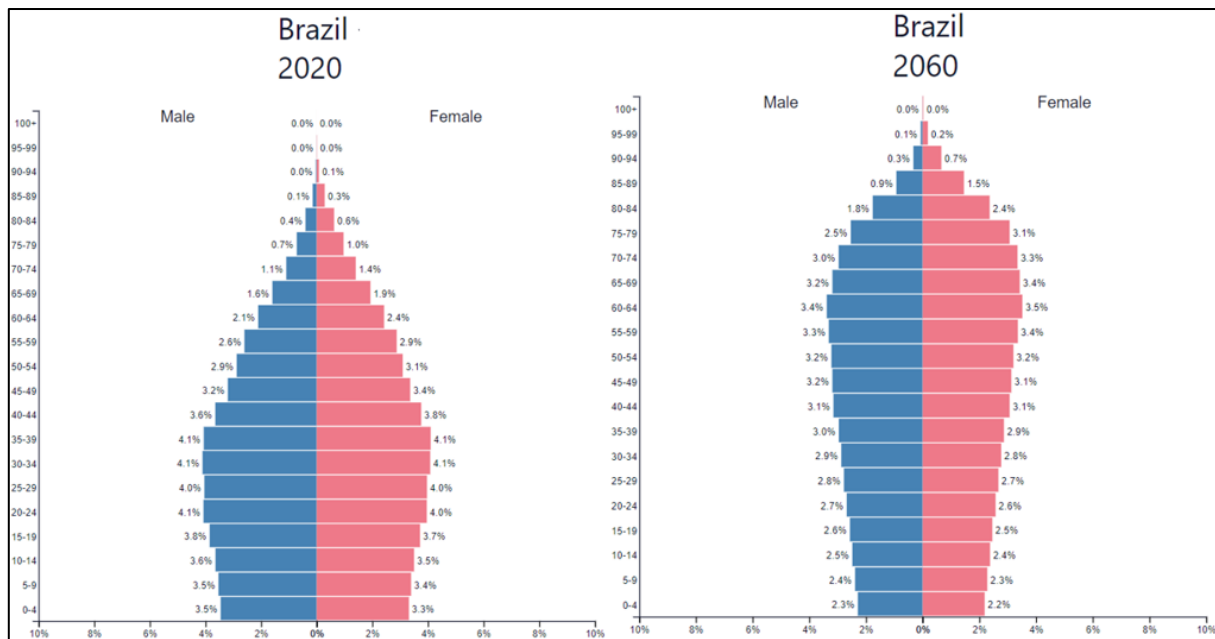
At the same time, Brazil, as it is an emerging market, is also expected to get wealthier over time.

The sweet spot for healthcare consumption and for demand of healthcare services all over the world is exactly a place that is getting older and wealthier, precisely like Brazil currently is.

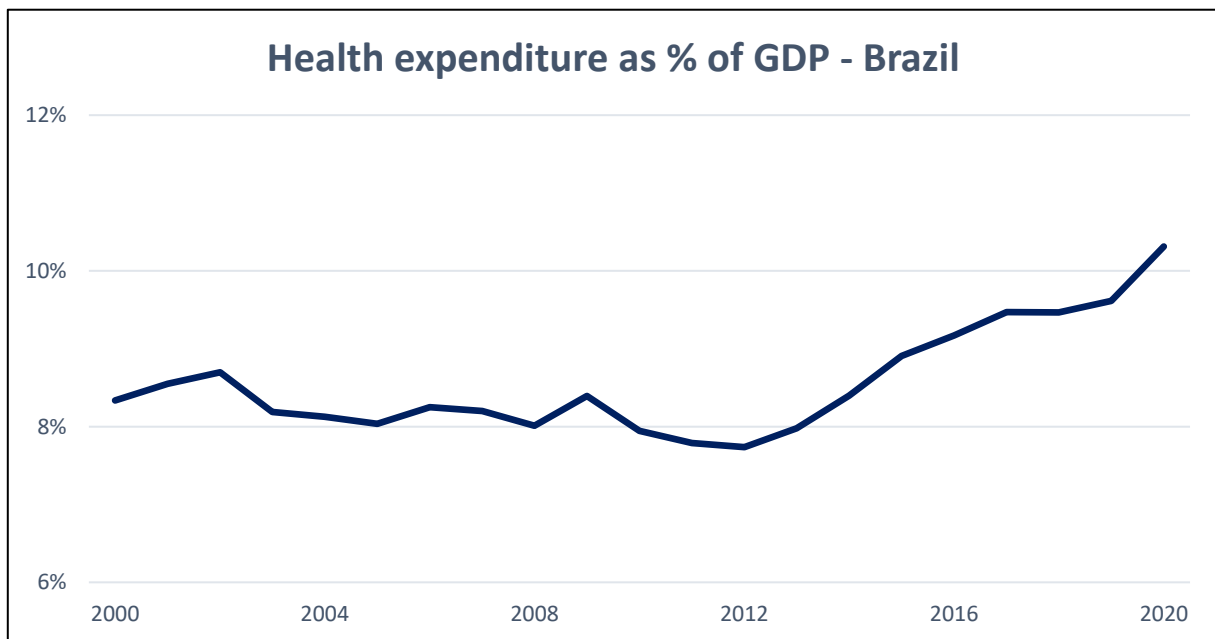
⁵ To learn more about our macro theses and our approach to finding new investments, we encourage you to check our Institutional Presentation:

https://www.fclcapital.com/files/ugd/8d6b17_ce6c20ff4b8542fc8985f83f6195342c.pdf

⁶ For more on our European Luxury thesis, check our 3Q 2020 Letter: https://84471c97-e192-4d57-a61f-283398a4101f.usrfiles.com/ugd/8d6b17_f79825c9b9d64789899b325e810dbf8b.pdf



Source: <https://www.populationpyramid.net/>, FCL Capital



Source: World Bank database, FCL Capital

Inside Brazil's healthcare ecosystem, our preference is for relatively asset light providers focused in one specific niche, an opinion admittedly contrarian to the local stock market sell side coverage, which overwhelmingly favors integrated providers.⁷

We think pure play providers focused on specific parts of the healthcare value chain will have higher margins and, crucially, higher ROICs over the longer term since we see a lot

⁷ For example, healthcare plans that also run their own hospitals.

of diseconomies of scale and inefficiencies among many of the listed healthcare companies in Brazil.⁸

Finally, apart from pure play companies, we also tend to prefer players exposed to relatively lightly regulated parts of the healthcare chain like labs and over the counter/generic drug makers as opposed to hospitals and medical insurance providers.

Brazil is an emerging market with unpredictable regulations and a tough business environment. Populism is rampant. Therefore, it is very plausible (and even expected) in election years to see Brazilian politicians running on a platform to nullify health insurance plan increases.

However, no politician will ever rail against a lab provider or an over the counter pharmaceutical company. These are more protected from any possible regulatory onslaught because they are a far smaller or indirect cost to consumers. No votes will be won by promising cheaper Engov.⁹

Many of the world's billionaires certainly have fascinating personalities. In our opinion one of the most interesting and at the same time unknown one is named João Alvez de Queiroz Filho.

He is certainly one of the most publicity shy billionaires out there, which made our research about him much more difficult. To give an idea, to this day he doesn't have public pictures. Forbes magazine, for example, leaves a blank space when it mentions him in its famous "billionaires list".¹⁰

Back in 1969, Queiroz Filho together with his father founded a local housecleaning products business called Arisco, which he went on to sell decades later for USD 500 million. While many businessmen focus on a given product attributes, it seems that Queiroz Filho genius was solely to create simple but powerful brands that resonate well with consumers, that are on top their minds.

A few years after selling Arisco, Queiroz Filho founded another consumption and brands group, called Hypermarcas (Hyperbrands). Then, in 2016, Coty, a French multinational, bought the personal goods and consumption brands from Hypermarcas for another USD 1 billion.

The unsold part left inside Hypermarcas was a collection of prescription and nonprescription drugs business, focused on what the company calls "power brands", basically everyday medicines for ailments like headache and flu. This part of the group was then called Hypera Pharma and nowadays simply Hypera.

⁸ This letter should ideally be read in conjunction with FCL Capital's newly released podcast episode about our investments in the Brazilian healthcare sector. Link:

<https://open.spotify.com/episode/6YUcgQt5D1440HLjEeIMtU?si=f6eb57fe85ec45ff>

⁹ Brazil's most famous hangover medicine.

¹⁰ <https://www.forbes.com/profile/joao-alves-de-queiroz-filho/?sh=2ed4e6437bb1>



Some of the “power brands” in Hypera’s portfolio.

The company itself will not argue with the fact that, scientifically speaking, its business is quite simple. Its products mostly comprise of generic drugs with formulas that have long been in public domain, some dermocosmetics and a relatively small prescription based business.

As opposed to most pharmaceutical companies, Hypera’s competitive advantage doesn’t come from an intensive R&D expenditure for acquiring valuable patents (that will someday inevitably expire).

Instead, Hypera turns this logic on itself by being a creator and owner of incredibly powerful brands, that just so happened to sell medicines. In other words, a brands company disguised as a pharma company.

Hypera owns several brands that any Brazilian can easily identify such as Apracur and Benegrip (over the counter medicines for flu), Buscopan (for stomach aches), Engov (used for hangovers and especially beloved in the land of carnival), Epocler (for the liver), Estomazil (stomach pain) and Neosaldina (Brazil’s most used headache painkiller).

Those are far from the most advanced, cutting edge, hyper expensive patented medicines. They resemble everyday personal items, exactly like Queiroz Filho had been doing for decades with his non-medical ventures. All those brands dominate Brazil’s list of top selling medicines year after year.¹¹

¹¹ <https://www.inovafarma.com.br/blog/medicamentos-mais-vendidos-em-farmacias/>

OTC leader with a leading position in the main categories

	MARKET (R\$)	Hypera pharma	KEY BRANDS
Pain	3.8bi	1.1bi (29% ¹) #2	Neosaldina Doralgina Lisador Miorrelax Alivium Doril
Flu and Respiratory	4.6bi	0.9bi (20% ¹) #1	BENEGRIP Rinosoro Coristina d
Gastrointestinal	3.5bi	0.6bi (17% ¹) #1	ENGOV ESTOMAZIL Epocler gastrol Eparema Tamarine
VMS	5.9bi	0.4bi (7% ¹) #3	vitaminas neo química VITASAY Addera D₃ BIOTONICA FONTOURA
Antispasmodics	0.4bi	0.3bi (81% ¹) #1	Buscopan

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Note: According to IQVIA, considers the market for over-the-counter (OTC) products. ¹Market-Share.

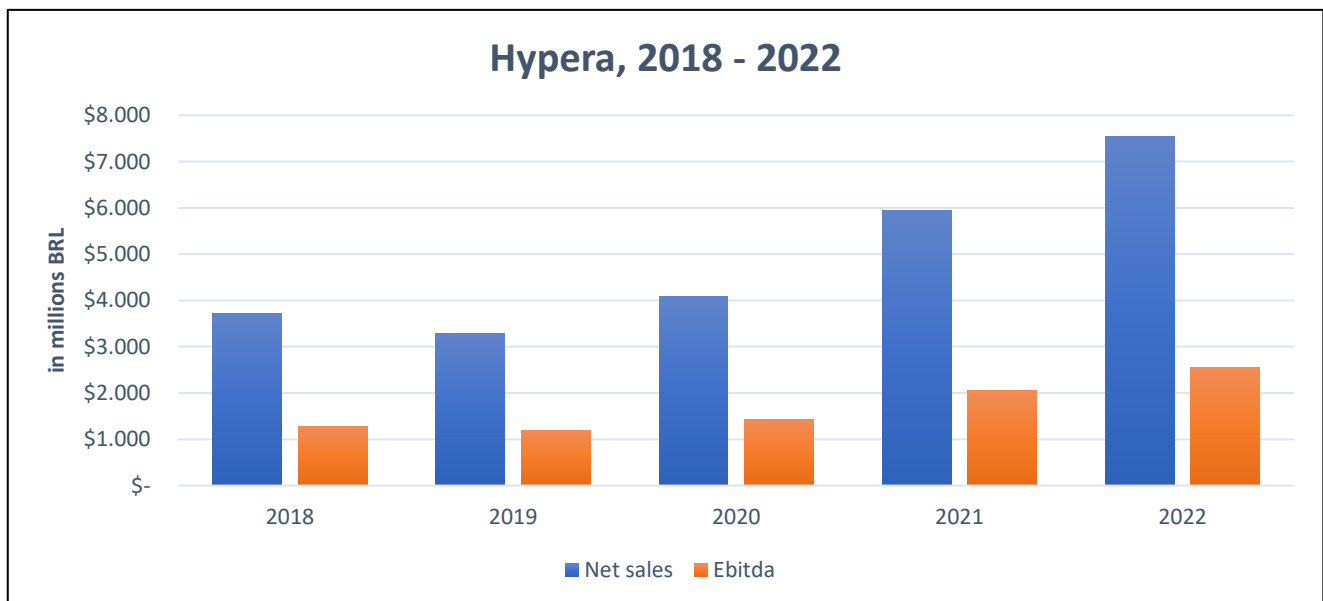


Source: Hypera's Institutional Presentation

A quick glance at Hypera's margins and growth profile puts it at an elite table of global lab companies and what makes the company an anomaly is that, unlike its peers, Hypera's R&D expenses are considerably lower than what would be expected.

(TTM)	Hypera	Pfizer	GSK
Ebitda Margin	33,7%	43,7%	33,1%
R&D as % of sales*	7,1%	12,5%	19,2%

*including capitalized costs



Source: Hypera financial statements, FCL Capital

Last but not least, Hypera not only grows faster than most of its peers, but its growth is smoother since it is not subject to patent expirations and cutting edge competition from international biotech companies.

Instead, to this house, Hypera's moat seems a lot more powerful: the strength and loyalty of its millions of consumers towards their many brands.

	EV/Ebitda (24e)	Free Cash Flow Yield (24e)	Past 3-year Sales Growth
Hypera	10,3x	6,0%	31,8%
Pfizer	8,8x	8,5%	34,9%
GSK	6,6x	10,4%	-4,6%
Bachem	23,2x	n/a	19,2%

*2024 Bloomberg consensus

As seen above, considering its strengths and growth profile, Hypera remains intriguingly cheap when compared to most of its global peers. Among the reasons, we speculate the following:

1. The fact that it is only traded in Brazil with Portuguese financial reports;
2. It is poorly understood by the market since, as we've seen, its business model is quite different from most other pharma companies;
3. As consequence items (1) and (2), global investors may judge it as a simple company with no moats (since it has relatively few patents) and thus misunderstand its true competitive advantage.

About the last point, this house thinks this logic should be turned on its head: Hypera's focus on brands makes its business more stable, more profitable and with more formidable moats than most of its global rivals, and the company should deserve a premium on its valuation and not a discount like it currently does.

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It's a Winner Takes All World

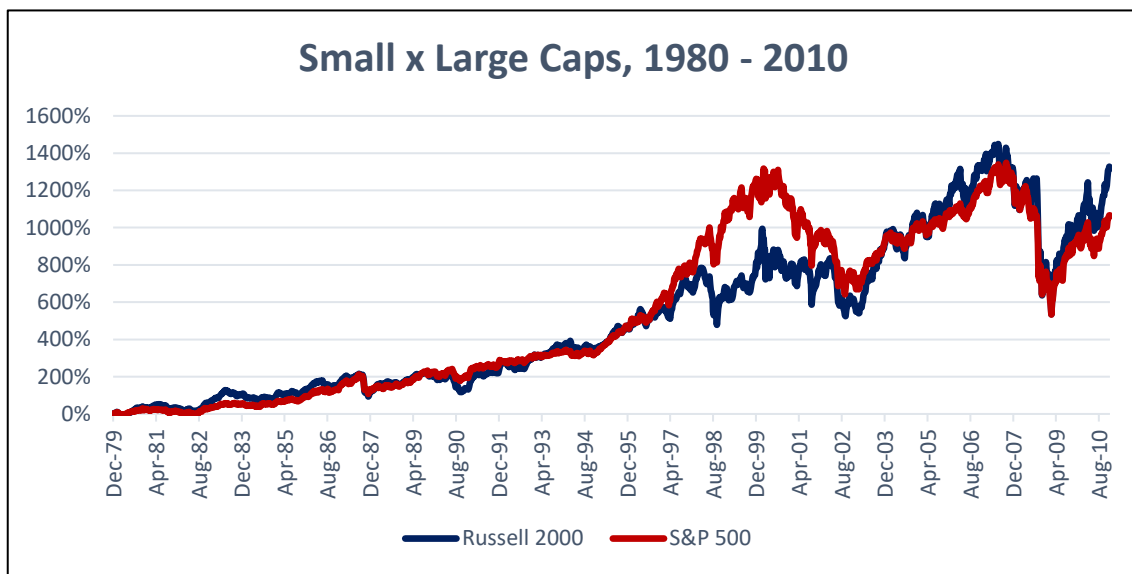
"Underdogs win all the time. Why, then, are we shocked every time a David beats a Goliath? Why do we automatically assume that someone who is smaller or poorer or less skilled is necessarily at a disadvantage?"

- From "David and Goliath" by Malcom Gladwell

It has long been widely acknowledged, ever since financial markets first came to life, that smaller companies as a group tend to outperform larger ones. Most serious financial analysts will still, to this day, maintain that over very long periods (meaning decades) that will probably continue to be the case.

The reason for this is straightforward: the law of large numbers. If you already dominate your market, you will, by definition, only grow as fast as the industry you are in. And as Clayton Christensen proved in his classic book “The Innovator’s Dilemma” large incumbents are usually in a terrible position to continue to innovate and will frequently get disrupted by innovators.

Well, that’s precisely how the world has functioned for the past two centuries.



Source: Bloomberg, FCL Capital

Until, suddenly, that stopped being the case.

Over the past decade, the US economy has experienced what has been dubbed as the narrowest bull market in history: only a handful of very large tech companies (Meta, Apple, Alphabet, Microsoft, Amazon, Netflix and a few others) had spectacular performances, carrying the index up with them due to their large weight. If you were not invested in at least one of them, among the thousands and thousands of US listed companies to choose from, it is very likely that you underperformed the market.

The index reliance on these companies is far above what we’ve seen historically.

S&P 500 Top 10 Holdings									
1980		1985		1990		1995			
IBM	4.3%	IBM	6.4%	IBM	3.0%	General Electric	2.6%		
AT&T	3.9%	Exxon	2.7%	Exxon	2.9%	AT&T	2.3%		
Exxon	3.8%	General Electric	2.2%	General Electric	2.3%	Exxon	2.2%		
Standard Oil (IN)	2.5%	AT&T	1.8%	Phillip Morris	2.2%	Coke	2.0%		
Schlumberger	2.4%	General Motors	1.5%	Royal Dutch	1.9%	Merck	1.8%		
Shell Oil	1.9%	Royal Dutch	1.1%	Bristol-Myers	1.6%	Royal Dutch	1.7%		
Mobil	1.9%	DuPont	1.1%	Merck	1.6%	Philip Morris	1.6%		
Standard Oil (CA)	1.8%	Amaco	1.1%	Wal-Mart	1.6%	Procter & Gamble	1.2%		
Atlantic Richfield	1.6%	Bell South	1.0%	AT&T	1.5%	Johnson & Johnson	1.2%		
General Electric	1.5%	Sears	0.9%	Coke	1.4%	Microsoft	1.1%		
Top 10 Holdings	25.6%	Top 10 Holdings	19.8%	Top 10 Holdings	20.0%	Top 10 Holdings	17.7%		
2000		2005		2010		2015			
General Electric	4.1%	General Electric	3.2%	Exxon	3.1%	Apple	3.0%		
Exxon	2.6%	Exxon	3.0%	Apple	2.5%	Google	2.8%		
Pfizer	2.5%	Microsoft	2.4%	Microsoft	2.0%	Microsoft	2.3%		
Citigroup	2.5%	Citigroup	2.1%	Berkshire Hathaway	1.7%	Berkshire Hathaway	1.7%		
Cisco	2.4%	Procter & Gamble	1.7%	General Electric	1.6%	Exxon	1.7%		
Wal-Mart	2.0%	Wal-Mart	1.7%	Wal-Mart	1.6%	Amazon	1.6%		
Microsoft	2.0%	Bank of America	1.6%	Google	1.6%	General Electric	1.6%		
AIG	2.0%	Johnson & Johnson	1.6%	Chevron	1.5%	Facebook	1.5%		
Merck	1.9%	AIG	1.5%	IBM	1.5%	Johnson & Johnson	1.5%		
Intel	1.7%	Pfizer	1.5%	Procter & Gamble	1.5%	Wells Fargo	1.4%		
Top 10 Holdings	23.5%	Top 10 Holdings	20.4%	Top 10 Holdings	18.6%	Top 10 Holdings	19.1%		
2020		2023							
Apple	4.8%	Apple	7.2%						
Microsoft	4.7%	Microsoft	6.5%						
Amazon	4.2%	Google	3.5%						
Google	3.1%	Amazon	2.8%						
Facebook	2.1%	Nvidia	1.9%						
Berkshire Hathaway	1.4%	Berkshire Hathaway	1.7%						
Visa	1.3%	Facebook	1.5%						
Johnson & Johnson	1.2%	Exxon	1.4%						
Wal-Mart	1.1%	UnitedHealth	1.3%						
JP Morgan	0.9%	Tesla	1.2%						
Top 10 Holdings	24.8%	Top 10 Holdings	29.2%						

Source: <https://awealthofcommonsense.com/2023/05/concentration-in-the-stock-market-2/>

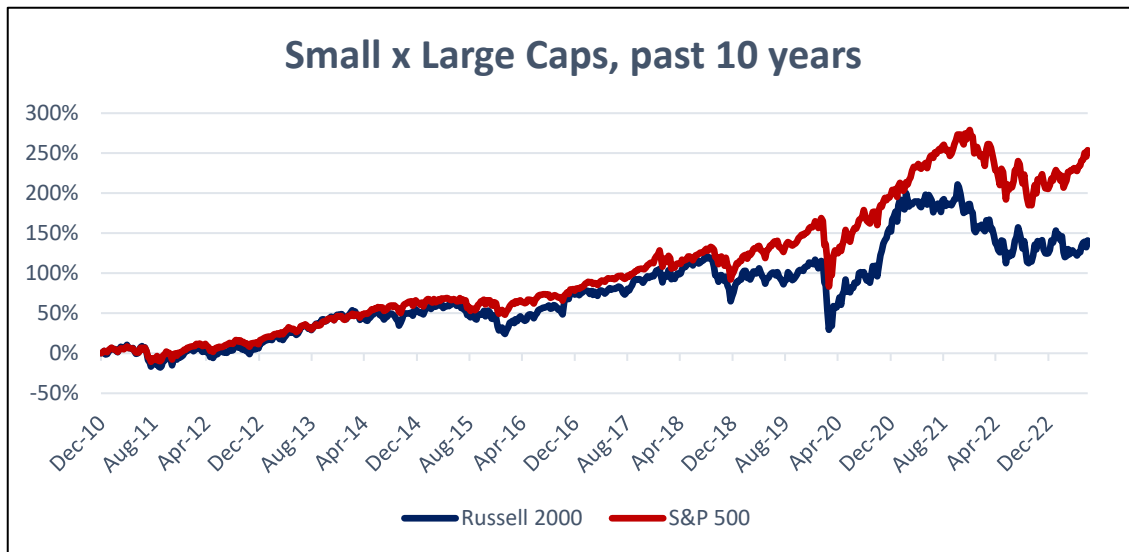
And that's just the beginning, in this century a few seemly unconnected events came together to form a new equilibrium:

- The ongoing "latinization" of the US economy, from a high investment low returns environment to an oligopolistic, low investment, high returns one, characterized by a handful of major companies dominating their respective sectors.¹²
- The creation of a lax regulation environment that allowed the formation of several cartels, oligopolies and monopolies, particularly in the nascent tech industry in the US.¹³
- The advent of the digital economy that brought network effects and their moats to a whole new level.
- The diffusion of the speed information and this generation of incumbents seemingly getting better at defending their positions.

¹² The Herfindahl-Hirschman index, one of the most widely used measures of market competition intensity has shown a dramatic decrease in competition in US markets in recent decades <https://www.oecd.org/daf/competition/methodologies-to-measure-market-competition-2021.pdf>

¹³ It is beyond the scope of this letter and the scope of this house as an investment company to judge if this is good or bad phenomenon, we will only stick to the facts and evolution of the economic process in this study.

If we add all those factor, it sure does seem that Goliath has learned a few new tricks. As a result, some observers are already coming to the conclusion that the world just doesn't work the same way as it did back in the 20th century.



Source: Bloomberg, FCL Capital

Since this house has made several investments over its life both in leaders of their respective industries such as Uber in urban mobility, PayPal in online payments, and HelloFresh in meal kit delivery, along with disruptive challengers like Pinduoduo and Anta that are trying to shake up the status quo, this letter aims to explore a fundamental question: are we currently living in a winner takes all world?

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At first blush, this whole discussion might seem bizarre. It has never been easier to start a new company.

The tech revolution that created so many new business models, the work from home revolution that allowed small companies to recruit people from everywhere around the globe and to operate very cheaply without a central structure, the cloud computing revolution that allowed companies to rent their digital infrastructure and operate at a fraction of the costs they would have incurred in the past.

Amidst all those fundamental changes, one would expect a boom in entrepreneurship and a decline in giant corporations' power. However, in one of the many paradoxes of the internet, the exact opposite is happening, the story of the 21st century is so far, if not a "winner takes all" world, at least a "winner takes most" situation.

Why is it so? No one seems to have a direct and clear answer. It might be a combination of many factors. In a very intriguing podcast conversation¹⁴ aptly called “The lagging performance of small caps” one host raised the intriguing possibility that in this new world with an abundance of information, players and choices “the table stakes to just be in the game have simply risen, likely suffocating small caps”¹⁵. We also observe this phenomenon in the IPO stage, where smaller companies have a harder time than before accessing the capital markets, which now prefers larger deals and capital raisings.

A separate theory is that with the rise of intangible assets as a greater proportion of the economy and the advent of the software and information revolution, smaller players simply aren’t able to occupy inefficient niches and have breather room like they did before.¹⁶

Finally, a third and equally plausible theory suggests that this could be yet another passing phase or trend that as almost everything in life and markets will surely pass, paving the way for a whole new era of huge small cap outperformance.

The fact is that, for now, the winner takes all effect can be seen almost anywhere: increasingly we have one dominant global financial center, New York, together with preponderant regional hubs; one dominant currency; and even within cities, most people will be able to tell with ease the dominant neighborhoods that stand out as the center of culture, commerce or nightlife.

At the sector level, we see one clearly dominant company in almost every industry and very rarely that position being threatened. What is even more puzzling, in almost all of these cases, the dominance is increasing, with the leader pulling further apart from the rest of the pack and not the other way around as used to be the case. In other words, now the Goliaths, for a change, are beating the Davids really bad.

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Price x Volume

An interesting consequence of a world with lower competitive intensity is the move from volume to price.

In a high competition environment, firms will charge lower mark ups in order to defend their market share. As for a low competition environment, firms will actually pursue higher mark ups to defend their margins and their profits.

One of the many reasons for the post pandemic inflationary outburst the global economy experienced in the past couple of years is, in this house’s opinion, the lower competitive intensity when compared to the past, allowing firms to maintain their margins and to raise prices.

¹⁴ Episode link: <https://open.spotify.com/episode/50uUUBRz5wbQS5kl2t4e2X>

¹⁵ This is obviously a poker analogy. Table stakes are what players pay prior to the game simply to be part of a tournament. Separate rooms with higher betting players have higher table stakes.

¹⁶ <https://awealthofcommonsense.com/2018/09/is-software-eating-value-investing/>

And why are firms able to get away with it? A more oligopolistic market structure? Higher table stakes choking newcomers? A relatively less economically sensitive consumer still able to afford items thanks to pandemic savings¹⁷? A less innovative economy that benefits the incumbents? The “excuse” of the pandemic and supply chain disruptions that allowed companies to get away with price increases (Pepsi potentially being a prime example)¹⁸? Or maybe all of the above?

Now concerning our portfolio investments, we ask the question: Is the winner truly taking all?

Case Study 1: Uber x Lyft

As our regular readers and investors know, Uber is currently one of this house’s major positions. Its case study is a fascinating story of incumbents trumping over newcomers and startups.¹⁹

Gradually, under the leadership of Dara Khosrowshahi, Uber has been able to gradually lock in its customers and drivers and amplify its longstanding market share advantage against its major competitor, Lyft.

Over the past year, with the obvious competitive disadvantage it is facing, Lyft has been in turmoil, its leadership team under constant change culminating in the appointment of a new CEO earlier this year. His first move on the job was to ax 1,200 jobs in an effort to cut the company costs and just stay afloat.²⁰

Apart from Lyft, the situation is even more dramatic, with local competitors getting burst, regulators finally caving in and accepting Uber as an urban mobility solution and even local taxi unions giving up the fight and having its fleet join Uber, a move that would be utterly unconceivable just a few years ago.²¹

In other words, competitors, regulators and rivals are gradually bending and accepting the inevitable.

An interesting leader paradox this house became increasingly convinced of: as painful as bear markets are (and everything that is not large cap tech is still in bear market territory) it is exactly in those moments, when excess venture capital funding dries up, when SPAC IPOs are not in fashion anymore and people suddenly remember that money has a cost that market leaders can dig up their moats and solidify their leadership.

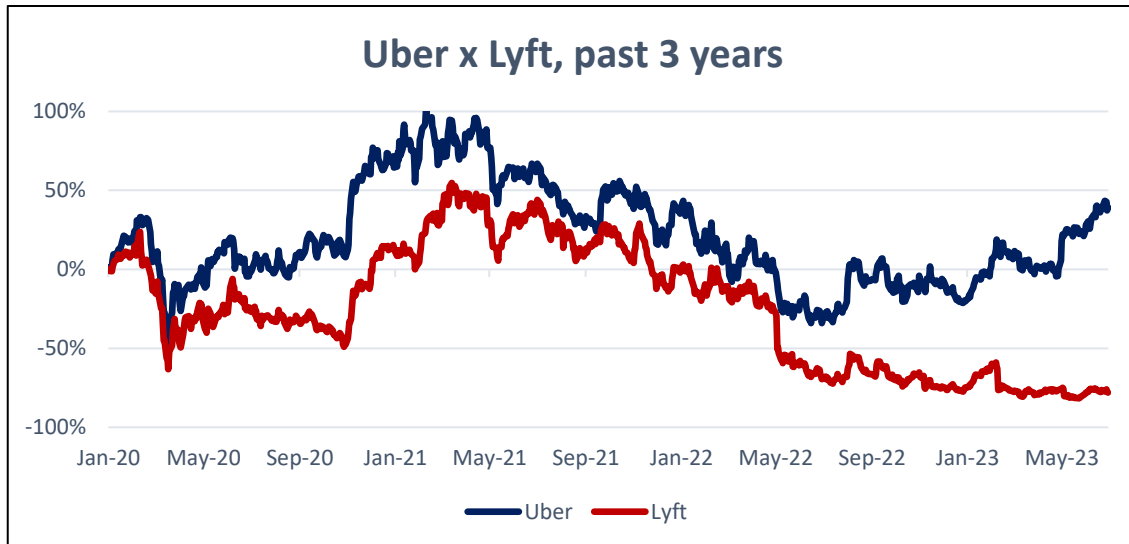
¹⁷ <https://www.ft.com/content/32129c50-cb8a-4179-adc7-d78f41fb91d4>

¹⁸ <https://ritholtz.com/2023/04/price-over-volume/>

¹⁹ A lot more about our Uber thesis can be found in our 3Q2022 letter and episode 6 of our podcast series.

²⁰ <https://www.cnbc.com/2023/04/21/lyfts-new-ceo-begins-tenure-with-layoffs-reported-cutting-1200-jobs.html>

²¹ <https://www.reuters.com/business/autos-transportation/uber-executive-says-european-taxis-joining-platform-2023-05-29/>
<https://www.nytimes.com/2022/03/24/business/uber-new-york-taxis.html>

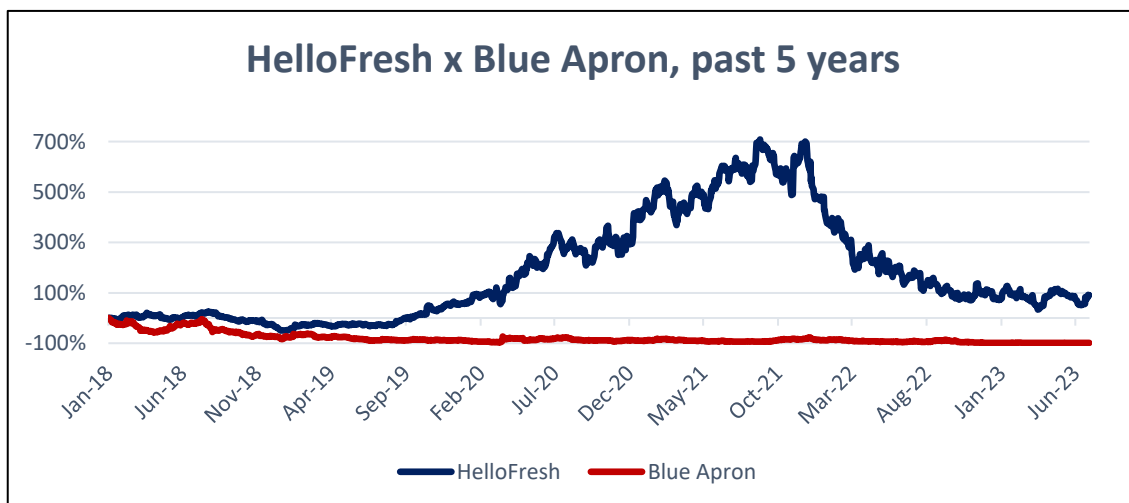


Source: Bloomberg, FCL Capital

Case Study 2: HelloFresh

HelloFresh is another one of this house's investments that was able to solidify its leadership position thanks to the recent bear market and increase in cost of capital.

First, its only real credible competitor in the US, Blue Apron, went practically bankrupt.



Source: Bloomberg, FCL Capital

Apart from Blue Apron, the only upstart company that could pose a serious threat to HelloFresh's dominance is Gousto, an ambitious UK startup company.

The thing is that burning money to compete with HelloFresh during the free money pandemic era was easy. However, when things suddenly changed with the current bear market, Gousto's backers got tired of the incessant cash burning and the company announced its new plans to halt any expansion to new markets outside the UK, at least

until it becomes profitable. It recently raised a relatively modest £50 million in a significant down round from previous valuations.²²

As in the last case study, we see a leader suffering in volatile times, but using that same challenging environment in its favor to pull well ahead of competitors.

Considering both those cases, we are once again led to ask: is the podcast host's intuition correct? Have the table stakes to even start playing the game really risen?

Case Study 3: Amazon vs Shein/Temu

This house is also watching with interest a third fascinating corporate battle only this time we are siding with the newcomers, the disruptors as opposed to the incumbent.

Over the past year we discussed a few times our investment in the Chinese retail website Pinduoduo. While Pinduoduo itself faces its own battles in its home turf against formidable companies like Alibaba, JD and ByteDance in the hyper competitive Chinese e-commerce market, we also watch with fascination a couple of Chinese upstarts take on the mighty Amazon in American soil.

Shein is well known to the Brazilian and western public thanks to its irresistible prices and quick delivery. A more recent upstart that has risen like a rocket over the past year, first in the US market and now also in Canada, Australia and Europe is Temu, a company owned by Pinduoduo that is in large part inspired by Shein's success.

Will the Chinese challengers be able to conquer the American market dominated over the past three decades by Amazon? It is one of the big questions of our time and one we are monitoring with close attention.

Overall, however, not many stories of disruptors displacing leaders happened lately. The leaders mostly seem comfortable and entrenched with a couple of fascinating exceptions: the rise of Tik Tok against Meta, becoming arguably the most important social network in the US²³ and the fall of Bud Light in the beer industry thanks to a huge backlash against a recent disastrous marketing campaign.²⁴

How will the Chinese challengers fare? They certainly have incredible capabilities like a fast and ample source of suppliers from China and incredibly efficient logistics, allowing them to make goods reach the US market very cheaply. On the other hand, Amazon is undoubtedly a formidable adversary to say the least and it is fair to assume that, at least in the US, legislators might still step in to avoid Amazon being displaced by Chinese companies in their home soil.

²²<https://www.thegrocer.co.uk/fundraising/gousto-taps-investors-for-additional-50m-amid-volatile-market-conditions/676023.article>

²³ Despite all time high anti-China sentiment in the US and numerous politicians attempting to block the app.

²⁴ <https://www.nytimes.com/2023/06/14/business/bud-light-lgbtq-backlash.html>

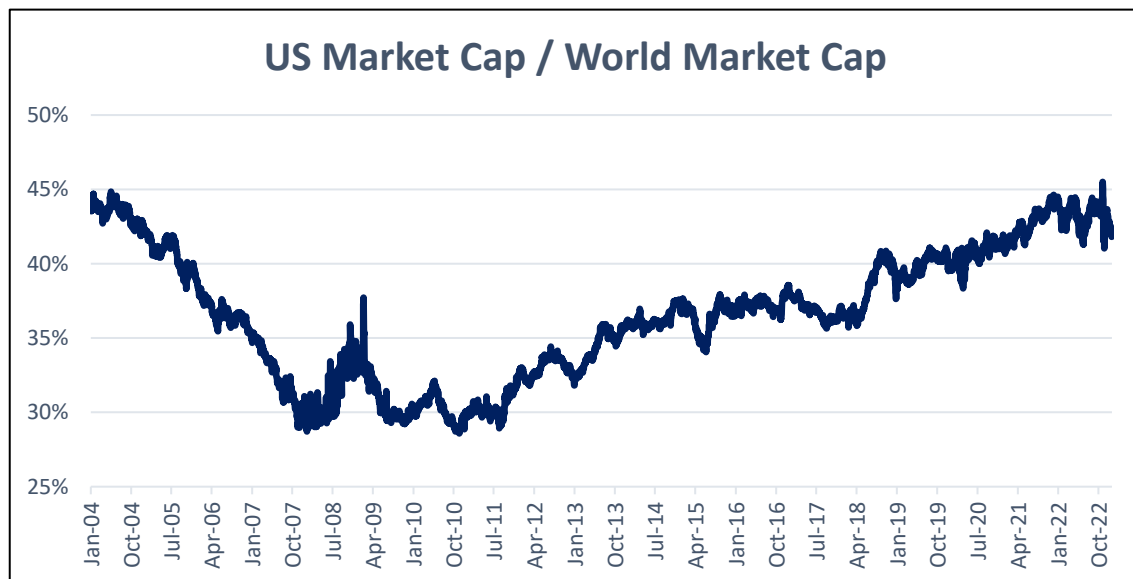
Case Study 4: Financial Markets - USA vs Rest of the World

Zooming out a bit, we decided to compare not only companies but entire markets themselves. As we all know, over the past century, the US market, especially New York City, is the undisputed home of financial markets and global finance. As it is the leader, how is its dominance faring?

We decided to compare markets by the percentage of their respective market capitalization to the world total.

The US market started the 21st century as 46% of total global market capitalization, at the height of emerging market euphoria and US pessimism in 2011 this percentage fell to 29% and now it has risen back to 36%.

Brazil started the century as 0.6% of total market cap, reached a high of 3.5% of the world's total in early 2012 and now has fallen back to 0.8%.



Source: Bloomberg, FCL Capital

Many caveats need to be made about this study. First, total market capitalization is not the only relevant metric to analyze a financial market's importance. London, for example, despite its low percentage in global capitalization is surely the world's second most important financial center and in several important metrics still the first, being the global leader in areas like insurance and global currency exchange.

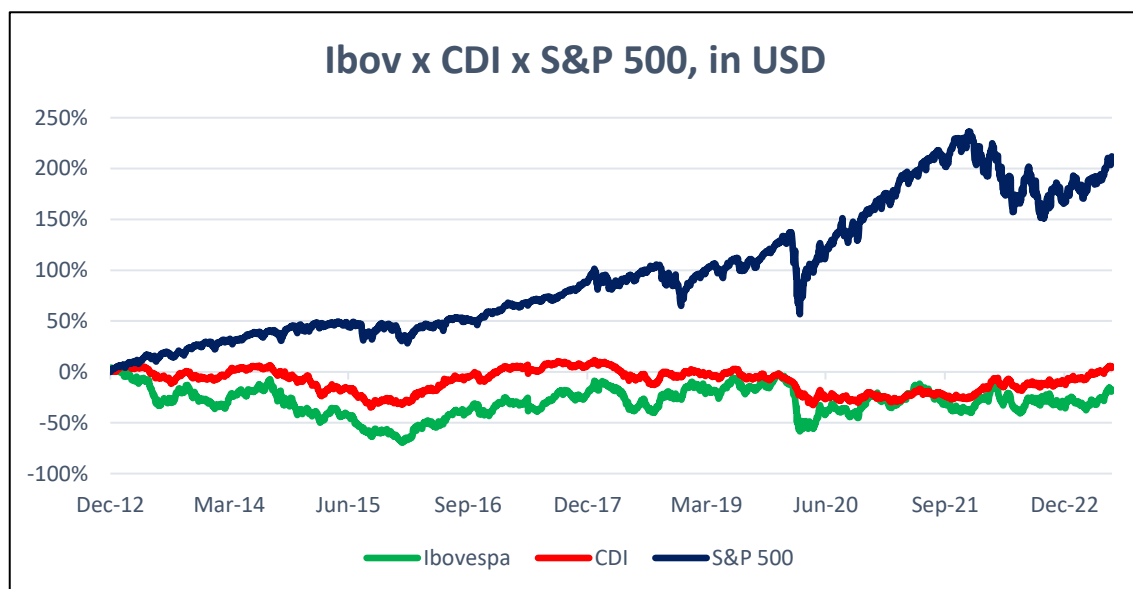
As for the future, this house would bet that a few up and coming emerging financial centers might have fundamental importance in the coming decades: the three city states of Hong Kong, Singapore and Dubai, and maybe also the cities of Shanghai and Mumbai in the twin Asian giants of China and India.

That being said, New York's dominance already lasts well over a century²⁵ which again shows that while "change is the only constant" as the ancient Greeks put it, it is also true that the world sometimes moves slowly, history rhymes and leaders can stay leaders for a long time.

The US dominance, home bias and the case for international diversification

With the current rise in the Brazilian real against the US dollar and the bull market in the Ibovespa index, many of our Brazil-based investors have been asking us whether the case for international diversification remains intact.

A simple long term 10-year comparison in USD between the Brazilian CDI, the Ibovespa index and the S&P 500 should quickly lay this question to rest.



Source: Bloomberg, FCL Capital

A separate question: if the US dominance is so entrenched, why bother venturing in more exotic markets like China, Brazil and even Europe, why not to only invest in the US?

It is important to note that although markets go through long cycles, the US is not the only country with incredible companies.

Over the past 30 years, US markets have outperformed international ones handily, but all of this outperformance is derived from the 2013-2022 tech rally. It is easy to forget now, but performance in the 20-year period of 1993-2013 was basically even between the two. When we consider a wider range, from 1970 to 2013, US and international markets had a virtually equal performance: 9.7% against 9.6% annually compounded.

²⁵ For more on the history of finance and New York's role in it, access our "200 years under the buttonwood tree" 2Q 2021 Letter. Link: https://84471c97-e192-4d57-a61f-283398a4101f.usrfiles.com/ugd/8d6b17_f85fe96800b44c45bc1ad8a35086d3f3.pdf

And contrary to general believe, even the past decade of American vast outperformance has mostly happened because of an increase in the premium paid for US companies (i.e. higher valuation multiples) and not from American companies increasing their earnings faster than their world peers.

Since this house is mostly interested in specific companies as opposed to markets as a whole, we decided to perform a simple exercise and track every liquid company above a certain market cap that kept trading over the past 10 years and had a total annual return above 25% yearly in USD (an admittedly incredible return).

Despite the undoubted dominance of the US market, responsible for 40% of the global market cap, we found that there were 273 companies fitting that incredible high bar on June 30th, 2023. Of those, 62 American (23%)²⁶, 49 from India (18%), 47 from China (17%), 4 from Brazil (1%) and a lot more from other places, from Argentina to Vietnam.

Clearly, the US has no monopoly on long term compounders.

And this shouldn't come as a surprise. Emerging markets generally have less covered companies ready to be discovered, the hidden diamonds. The ones you don't wake up and read about in the Financial Times every day (except maybe for a handful of large cap prominent ones). Indeed an incredible fertile ground for stock pickers like this house.

To sum it up, international diversification is always necessary and have many different components: first it lowers the portfolio risk for any investor, since it makes the portfolio less exposed to the vicissitudes of a single market. Further, as financial theory shows, it lowers volatility and increases the expected returns of a portfolio. International diversification is indeed one of the last remaining free lunches most investors haven't taken advantage of yet.

So what is the future for small caps?

Looking ahead, we still think smaller companies might as a group outperform their larger peers over time, through periods of relative under and overperformance.

Entrepreneurship is still alive and many people with brilliant ideas will keep challenging the status quo. To suppose that the current crop of large companies will dominate forever is to suppose that "this time is different", certainly the most dangerous phrase in finance.

Recessions and bear markets in particular have a formidable role: on the macro level they are agents of purification, allowing the economy to focus its resources on the most useful solutions. On the sector level they make less efficient companies go broke and consequently they are a blessing in disguise for the leaders, the best companies.

And this house is in good company. Munger and Buffett themselves said many times that if they were young and starting with relatively little money they would focus on small caps, because "clearly you run into companies that are less followed as they get smaller and there's more chances for inefficiencies when you're dealing with something where

²⁶ And that's already considering the incredible US bull market of the past decade.

you can only buy \$100,000 in a month as rather than \$100 million” – Buffett, and also quoting Munger: “if I had to start small today I’d look for the small ones [companies] with a durable advantage that might become big in the future.”

With these words we don’t claim the debate as settled, but the good thing for investors is that they don’t need to put mental silos in the investment process. This house has invested in many large caps in its still short history, from Vale to PayPal, but to us, the holy grail, the big dream, will always be to pick the obscure and unknown (company or market) and see it one day rise to prominence.

That’s the vision we live for.