

FCL *Capital*

2Q 2024

Japan trip report

Japan is in so many ways a fascinating place. For centuries, it lived in “splendid isolation” to the outside world, a policy imposed by the Tokuhawa Sogunate in the 17th century where, apart from the very occasional trade contact with a few Portuguese and Dutch merchant ships, Japanese people living in their island lived a very much hermetic and isolated experience from everyone else.

Those centuries clearly left a long-term impact in countless good and bad ways that is still felt, from its unique and amazing culture and cuisine to the low English proficiency that sets Japan apart from other rich world countries.

Once poised to take over the US economy as the world’s largest in the late 1980s a few things combined and conspired to take the world in a different direction: while Japanese companies excel in electronics, hardware machinery and heavy industry, the changing winds of the 1990s brought the advent of the internet and the rise of the service economy, where US companies are unmatched. Meanwhile, the country’s size and demography meant that the scale and internal market in Japan would never match the world’s three largest economic blocs today: China, the US and the European Union.

The country also faced a long series of self-imposed problems, from its real estate bubble to anachronistic lending practices by its banks to a risk averse culture that made it hard for Japanese companies that excelled in the late part of the 20th century to compete against more modern rivals in the 21st century.

After three decades of stagnation, it seems once again the winds of change are blowing. One of major complaints by the international financial community, the clear lack of corporate governance by major Japanese corporations, historically interested in insider dealings and cross shareholdings with like-minded established Japanese conglomerates and lacking transparency¹ and alignment with minority shareholders has gone through a revolution in the past decade.

Some developments that were unthinkable not long ago, like English financial reports and conference calls, shareholders meetings, Japanese bosses open to engagement and consequently some high-profile western investors like Dan Loeb and Warren Buffett announcing major investments in Japan almost don’t raise an eyebrow anymore.

To this house, Japan has always been placed in the “too hard” basket. On one hand the country didn’t sit at the core of our expertise and (more activities like our investments in China, the US or Europe while at the other hand it was also not as familiar as Brazil, with its distance and lack of English materials leaving us to largely ignore the country, apart from a few sparse investments like Nintendo, that has already entered our FCL Opportunities twice (more on the company later) and has always been a world class company.

¹ Gradually, Japanese society is realizing the old ways of doing business, dominated by conservative conglomerates and a “job for life” mentality in a big corporation no longer is fit for the 21st century. Corporate reforms and shareholder friendly initiatives are becoming the norm.

Over the past year a few things conspired to make us progressively more curious about Japan, from the clear improvement in corporate governance, to the new, more energetic macroeconomic direction the country is embarking, to a new generation of Japanese CEOs that clearly want to engage with the world. Over the past year we have been researching about not one, but two possible Japanese portfolio investments for our FCL Opportunities fund, about which we will disclose in time, while also actively searching for more opportunities.

This past month of May we embarked on a two-week trip to Japan and while also appreciating the country's strange and amazing uniqueness - from its amazing restaurants to a Sumo tournament - also took the time to visit many companies, talk to other investors, allocators, policy makers and CFOs to try to advance our framework and understanding of the Japanese economy.

This is, admittedly, an ongoing and unfinished effort. This quarterly letter is the result of our trip and our impressions so far. We hope our readers enjoy it, whether they agree with our insights or not.

It is accepted wisdom that Japan is declining relative to the rest of the world. There are many possible ways to measure this. Its economy is probably still the second most sophisticated in the world (although there is not a universal definition of "sophistication", Japan's economy is composed of high tech and high value-added companies, which have a lot of R&D investments, while also having a very important stock exchange, high technological content and so on). Apart from the USA, this house would be hard pressed to state another economy of more than 100 million people that has so many high-end companies. It is the country of Toyota, Nintendo, Sony Honda, Panasonic, Mitsubishi, Softbank and so many other companies at the forefront of the global economy.

But in at least one aspect, it might still be number 1: Although again, there's not a single definition of "what is the world's richest country" we can enumerate at least four straightforward criteria (there are many other possible ones).

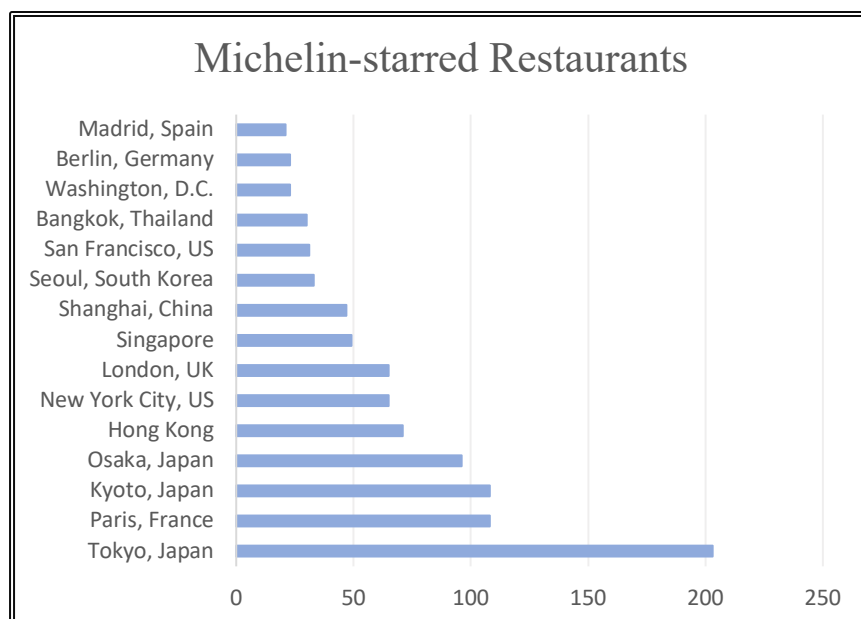
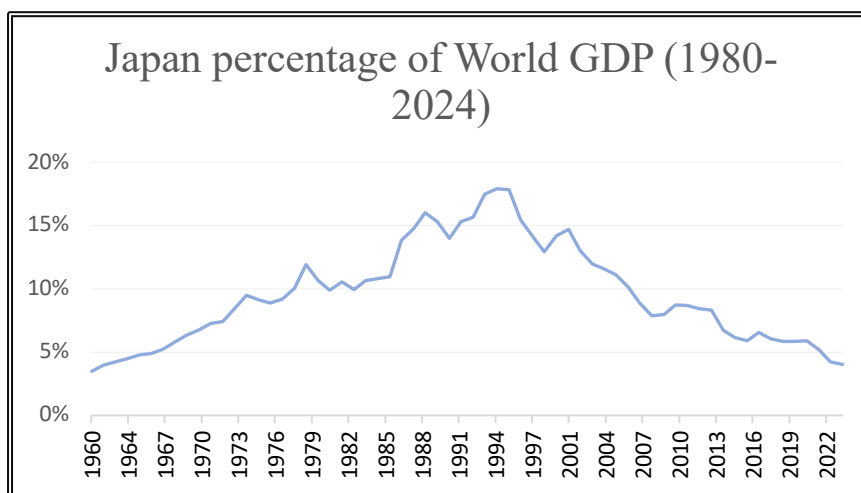
If you consider the world's richest country as the one where people enjoy the highest GDP per capita the title (except for some tiny nations like Monaco and Luxembourg) might go to Norway.

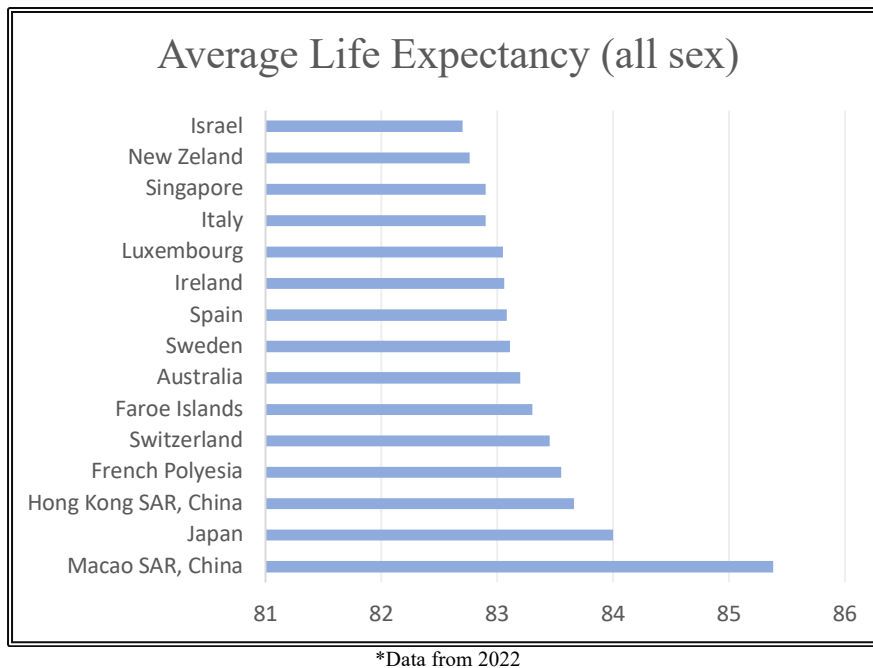
But Norway is a high tax Scandinavian society. If you care about which place people have more money in the bank, instead of producing more, then the title goes to Switzerland, where more than a third of its habitants is a dollar millionaire.

But having money in the bank is not all. Where in the world people can consume more goods and services? With its incredibly sophisticated financial markets and availability of credit, abundant natural resources and plot sizes, mind blowing offer of services and products, the USA stands apart: the houses are larger, there are simply more business ideas, options for consumption and bargains than anywhere else.

But what if instead we don't focus on quantity as much as on quality? What if we consider the world's wealthiest country the one where, to put it simply, its habitants live a better life? They live longer, have better food and more Michelin starred restaurants, they have an unmatched transportation and train system, incredible department stores and healthcare? Then Japan is probably still the wealthiest country.

As countless of first time visitors to Tokyo state when first observing the city's incredible selection of restaurants, its hyper safe and punctual trains, the social capital that make people wait for the green light to cross even narrow streets when there's obviously no car nearby, its cleanliness that makes cities like New York or Paris (let's not even mention emerging economies) look like third world places, after a few days in Tokyo witnessing all that they usually all exclaim "well, if this is decline, then I guess you can sign me in..."





Japan is certainly hard for a foreigner to grasp. No matter how clean, organized and safe its cities are, the incredible number of written and unwritten norms and customs combined with the huge language barrier makes Japan a place that takes time to understand.

When the manager of this house, on a hot June afternoon, decided to get a bottle of water while walking for a business meeting, he stopped in a street vending machine². After seeing countless bottles for sale, he finally spotted a white one on the top self where it was written “water” with lots of Japanese characters. After selecting it, a huge surprise came when he noticed it was, instead, “milk water” a mix of regular water and cold milk that apparently is very common and popular in Japan. And it was a product of Suntory, a company that we will discuss in more detail below.

One of our first objects of inquiry was the ecosystem of convenience stores in Japan. First, some local context: in Japan, convenience stores are more important than they are elsewhere. They are a little bit of everything: mini supermarket, pick up point for dinner food, postal station and more. Traditionally, two chains dominate the market: the local branch of 7 Eleven ([TYO: 3382](#)), which is a separate public company listed in Tokyo, and a local chain called Family Mart.

We tried but couldn’t meet with the managers of both companies for logistical reasons, but we did numerous channel checks at different times of the day, making more than 10 visits to 7 Eleven Stores in different parts of the country. Overall, we came very close to make an investment in 7 Eleven Japan in late 2023 but a sudden price moves away from our target composed with our concerns for the general demographic picture of the country that forbids us to bid at high multiples resulted in the fact that the investment never happened (so far).

² Street vending machines are ubiquitous in the streets of Japan, you can see them almost in every block and they sell everything imaginable, from instant coffee to water, from live animals to instant noodles.

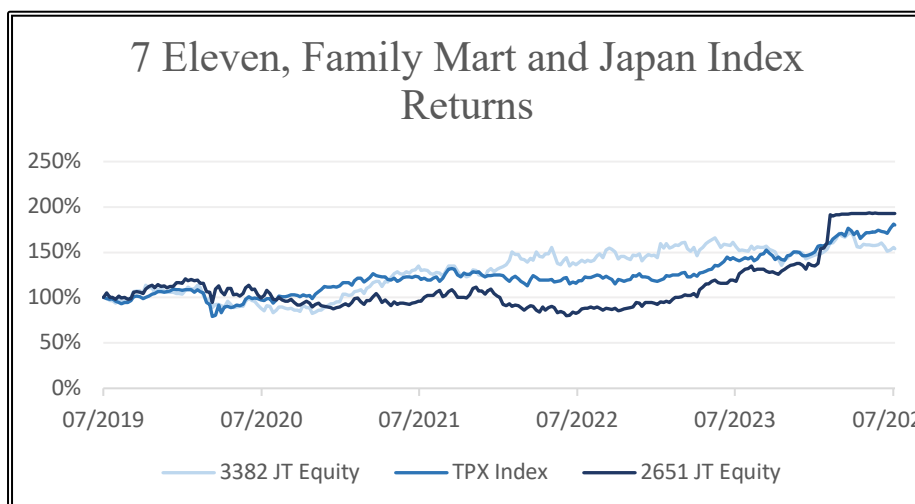
FCL Capital

In Thousand JPY	Seven & i Holdings (3382.T) LTM
Sales	9,850,470,000.00
Gross Profit	1,789,550,000.00
<i>Gross Margin</i>	18.17%
Net Income	368,880,000.00
<i>CAGR</i>	-4.0%
Market Cap.	5,122,000,000.00
<i>P/E</i>	13.89
Free Cash Flow	673,010,000.00
<i>FCFY</i>	13.14%
Enterprise Value	7,366,065,000.00
EBITDA	1,054,950,000.00
<i>EV/EBITDA</i>	6.98





*This photo was taken to highlight how the demographic crisis in Japan is affecting certain services, in this case, cashier work.



Japan is also a very important destination for the global luxury industry. Overall, around 10% of global luxury sales go to Japan which is amazing considering the country is home to only 125 million people. Moncler, which our long-time readers know is one of our fund's largest positions, is well represented in the country. In the trending Ginza district, we visited Moncler's prominent flagship store which, even in summer, was clearly busy.

One philosophical thought we asked ourselves was why such an equalitarian society, where one rarely sees displays of wealth (and also not of any hint of poverty) has such a strong taste for global luxury. One theory we have is that, deep down, this consumption is related to Japanese perfectionism: they are a minimalist and perfectionist society and are used to the best, in food, clothing, accessories and more. Casually accepting low quality is not something the Japanese do.



*Moncler Store in Ginza, Tokyo

We visited several companies and had productive discussions with fellow fund managers living in the country. One particular rabbit hole we got into was the Japanese heavy industry, machinery and utility sector, with companies like Mitsubishi Heavy industries ([8058:TYO](#)) and Hitachi machinery ([6501:TYO](#)). If there is one particularity, they are secular, dividend paying conglomerates, globally competitive and with diversified revenues.

If there is one thing that is almost certain to still be around decades in the future is these companies. As one Japanese fund manager told us during our trip, “if you think the world is gonna end, this is the place to be: the most boring and safe sector in the most boring and safe country”.

We think this is too harsh a judgement. The cheap multiples combined with conservative management, improvements in corporate governance where for the first time ever management teams are talking about share buybacks and dividends and annual investors meetings make us think that the country hold some interesting value opportunities hidden in these sectors and conglomerates.

In one outstanding event, Hitachi Construction machinery (6501:TYO) recently announced that for the first time, it would have not only sales targets but also, ROIC (return on invested capital) and Cash Flow targets, something unthinkable for a Japanese secular company that is part of a conglomerate until a short while ago. This announcement is now in the company investor relations webpage in, wait for it-plain English for every shareholder to read³.

³ <https://www.hitachicm.com/global/en/corporate/mid-term-management-plan/>

Hitachi (6051:TYO)	
In JPY	LTM
P/E	9.16%
DY	3.31%
FCFY	2.83%

Mitsubishi (8058:TYO)	
In JPY	LTM
P/E	30.95%
DY	0.98%
FCFY	2.48%



Suntory

Suntory ([2587:TYO](#)) might be one of the most famous Japanese companies. Its roots trace back to 1899 when a wine and liquor importer decided to produce a Japanese product more suited to Japanese tastes.

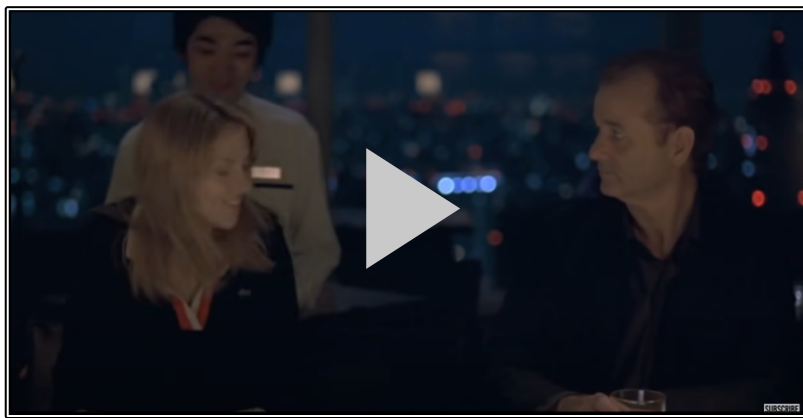
During its first decades Suntory tried its luck with several different products like Port Wine and Liquors but it was only in 1937 and 1963 respectively that it launched the two products which today the company is most associated with: whiskey and beer.

The Japanese beer market is huge, and to touch again on the topic of Japanese perfectionism, gradually Japanese whiskey has become one of the most respected if not the most respected in the world alongside whiskey's spiritual birthplace of Scotland. Japanese whiskey brands receive innumerable international awards and some bottles are sold for thousands of dollars in international auction houses.

In one of the all-time most famous movie scenes, in *Lost In Translation*, the actor Bill Murray, playing a middle aged famed actor that is in Tokyo to shoot a Japanese whiskey commercial, meets the character played by actress Scarlett Johanson in the New York Bar, a rooftop bar at the top of the Park Hyatt Tokyo Hotel while jazz is playing and the amazing Tokyo skyline is seen from the windows.

The film deals with the feelings of strangeness, loneliness and not fitting in, as seen from the eyes of two westerners in this land of beautiful but different customs and language.

“I came here to film a whiskey commercial. The good news is that the whiskey works”, said Murray⁴.



The scene was obviously recreated by countless visitors to Tokyo including this manager. In real life Suntory has long been an obsession for us. Hard to put in a single bucket because it has some elements of companies like Ambev while also competing with Diageo in the more premium whiskey segment. Also, exports are becoming a more important part of its sales mix, which on the one hand is good because of the limitations of the Japanese market while on the other hand brings some complexity due to the Yen/Dollar exchange rate.

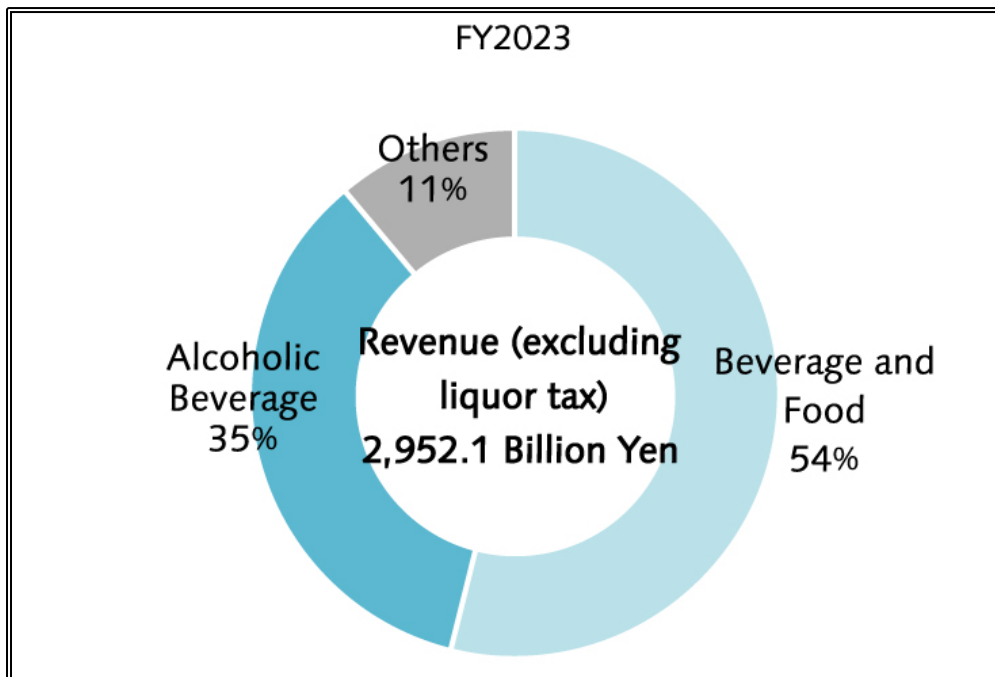
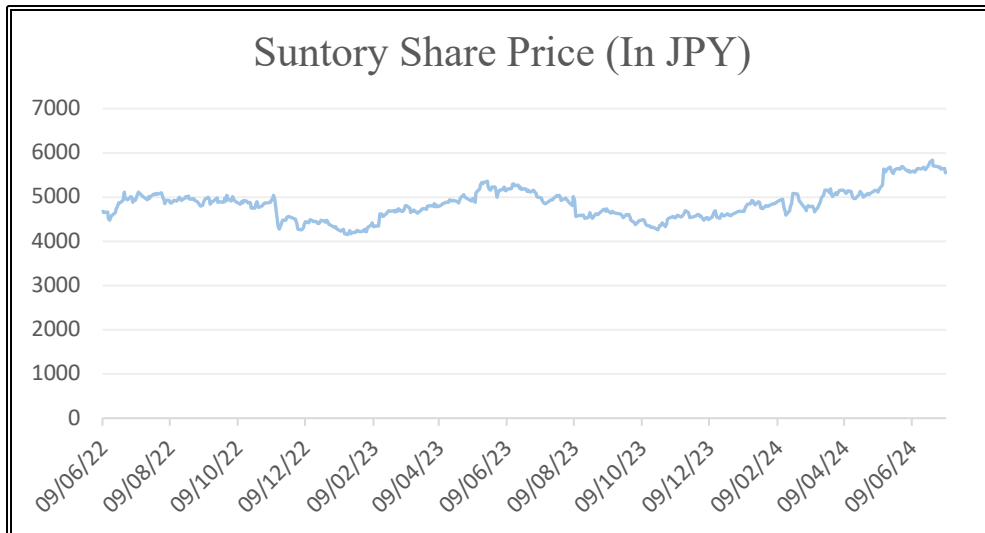
⁴ Interestingly, the Suntory whiskey that Murray came to advertise in the movie is Hibiki 17 years which was discontinued in 2008 because Suntory couldn't keep with the demand of the product, instead opting for the more affordable 12 years product.



*All Suntory brands

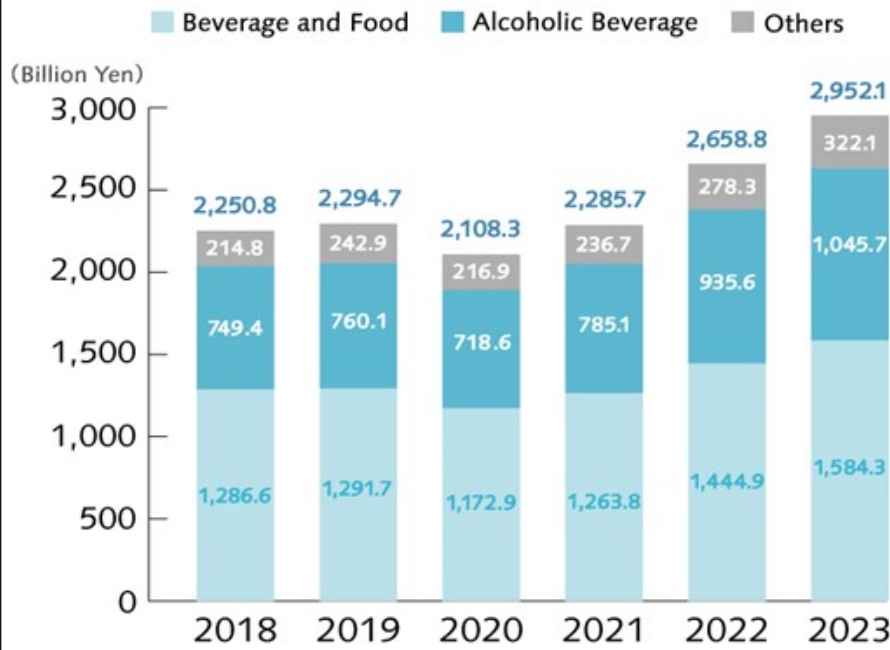
Suntory has many of the attributes of the world's greatest consumer and drinks companies like Inbev, Moutai and Heineken, during our trip and over the past few weeks we took our time to dig deeper into the company's internalization and mid-term growth plans.

In Thousand JPY	Suntory (2587.T) LTM
Sales	1,626,162,000.00
Gross Profit	604,938,000.00
<i>Gross Margin</i>	<i>37.20%</i>
Net Income	88,410,000.00
<i>CAGR</i>	<i>10.5%</i>
Market Cap.	1,741,000,000.00
<i>P/E</i>	<i>19.69</i>
Free Cash Flow	673,010,000.00
<i>FCFY</i>	<i>38.66%</i>
Enterprise Value	1,642,012,000.00
EBITDA	288,019,000.00
<i>EV/EBITDA</i>	<i>5.70</i>



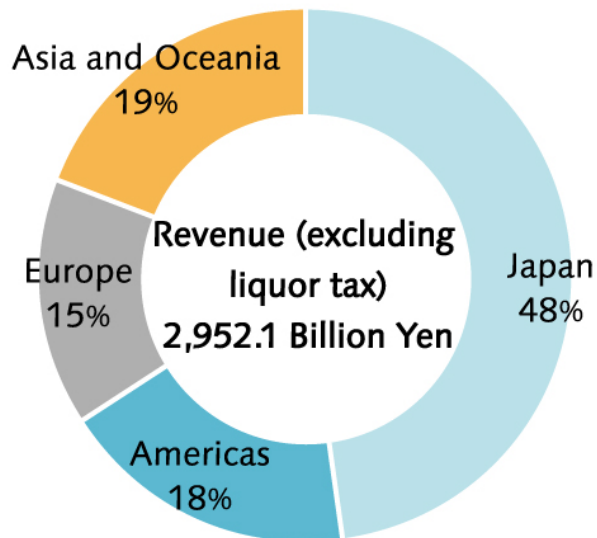
*Beverage and Food: Non-alcoholic beverages, health drinks, processed food, other products
 Alcoholic beverages: Spirits, beer, wine and other alcoholic beverages
 Others: Health food, ice cream, restaurants, flowers, Operations in China and other operations
 *Consolidated Revenue

Suntory Sources of Revenue

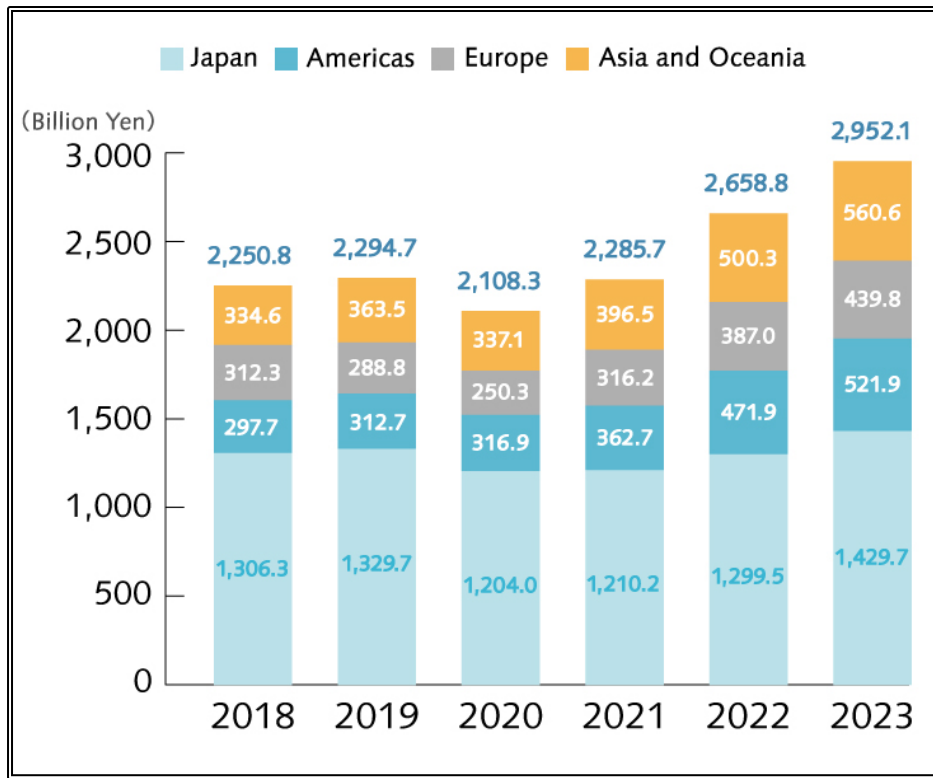


*Consolidated Revenue

FY2023



*Consolidated Revenue



*Consolidated Revenue

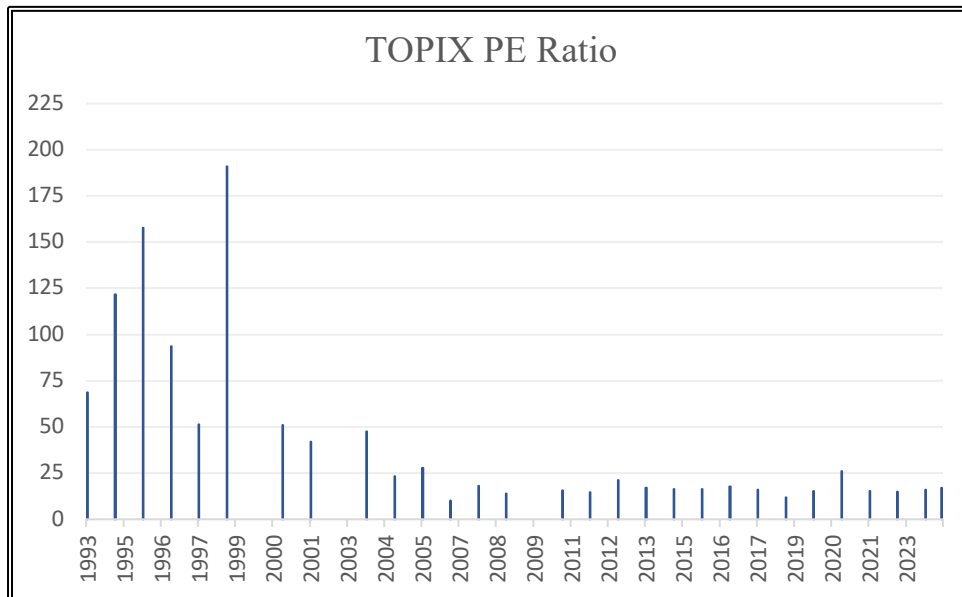
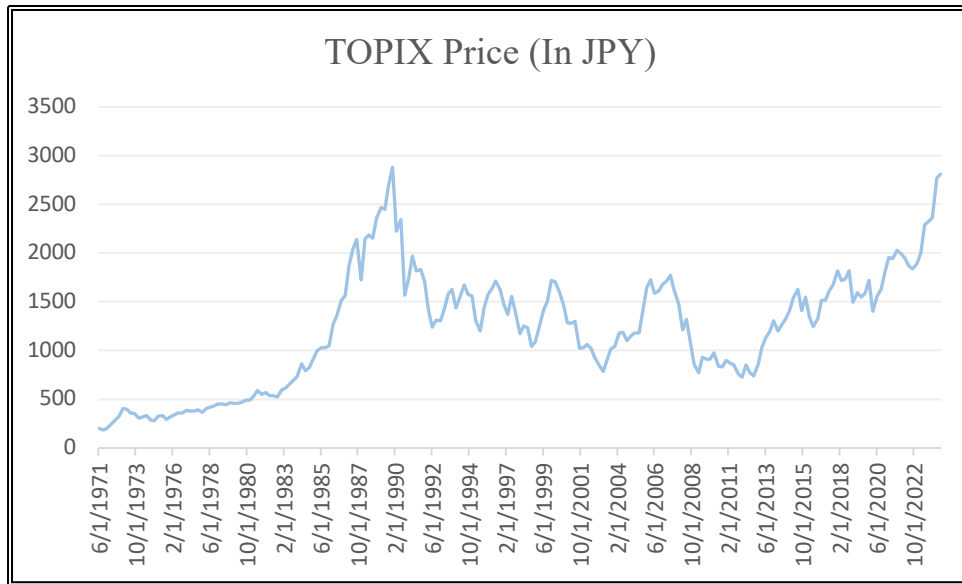
In USD	Mkt Cap	EV/EBITDA	P/FCF	CAGR	DY	P/E
SUNTORY (2587:TYO)	10863.72	7.00	25.53	10.58%	1.68%	19.76
HEINEKEN (HEIA:NA)	55359.83	10.78	24.85	15.97%	1.93%	21.70
DIAGEO (DGE:LN)	71450.74	13.80	25.47	13.48%	3.22%	18.12
MOUTAI (600519:CH)	245408.51	N/A	26.21	15.42%	3.52%	22.87

Japan soft power

A word about Japan's soft power: the country is clearly in fashion not only to global investment managers but to the planet. And it's easy to see why: Japan has countless unique attributes and in Tokyo which is certainly one of the world's greatest cities. The number of international tourists boomed in the past five years, exceeding 3 million in 2023⁵:

The only word of caution this house would add is that investors are humans and humans are very susceptible to hype and cycles. If the current trend of soft power continues, we suspect the days of low PE multiples for the TOPIX index might be numbered.

⁵ <https://www.tourism.jp/en/tourism-database/stats/#:~:text=According%20to%20Japan%20National%20Tourism,2%20months%20in%20a%20row.>





Nintendo

Last but not least a special section about a company that twice has entered our FCL Opportunities portfolio: Nintendo ([7974:TYO](#)).

To call Nintendo one of the most fascinating companies in the world would be an understatement.

Founded in Japan's historical capital of Kyoto in 1889, Nintendo reinvented itself innumerable times. Its founder was a local salesman and craftsman called Fusajiro Yamauchi⁶, it originally made Hanafuda cards (a traditional type of Japanese playing card).

During the 1950s and 1960s the Yamauchi family even made a deal with Disney, where the American company signed a deal for its characters to be used in its playing cards.

Then in the 70s, Nintendo ventured in toys and, crucially, then in electronic toys and arcades (Japan being after all the home of the famous pachinko stores and karaoke's, with arcades to this day having a crucial place in Japanese social culture).

In 1981 a big hit came when a Nintendo engineer from Kyoto, called Shigeru Miyamoto developed an arcade game called Donkey Kong.

As surprising as any of its games, the world changing event, the most iconic character that the genius of Shigeru Miyamoto would create had first appeared in Donkey Kong as a unimportant villain and would later have its own game: an Italian plumber that, as people from all corners of earth now know, had to save a princess while collecting stars, passing through plumbing's and eating mushrooms: Mario.



Mario first came to life in Japanese arcades but it reached the peak of its popularity when Nintendo decided to bet on the nascent home entertainment industry and, in many countries, Nintendo would give as part of a package, the Super Mario Bros game when people bought the Famicom Entertainment System (as the first Nintendo video console was known in Japan) or the Nintendo Entertainment System (as the console was known in the USA and Europe).

⁶ Until very recently the Yamauchi family were the reference shareholders. And to this day, Nintendo's headquarters is in Kyoto, unlike the majority of Japanese large companies, which have their headquarters in Tokyo.

Mario would go on to become the most important character of the explosion of Japanese home entertainment systems in the world, starring countless games, from the Super Mario Bros series to Mario Kart (a live version of which can be tried in the streets of Tokyo and to which this manager conservatively declined the opportunity) to starring in movies and cartoons.

It is hard to overstate the popularity of Mario around the world. When doing the Nintendo peregrination in Kyoto, not only to the company's original headquarters and its current one to meet the company's management but also to stores and points of interest, it gets hard not to compare the company with another family entertainment colossus across the pacific: Disney.

Both companies have loyal fans and children that cross the world to be able to see and interact with their beloved characters. They want a picture with Mario and friends, they cry when they see Mario live and scream in joy with their families much the same way children have done it for so many decades in the Disney theme parks and cruises.

In fact, it is reported that Disney's management team went once in despair when a national survey back in 1990 found that at that particular time Mario was more popular among American children than Mickey⁷.



Original Nintendo Headquarters

⁷<https://en.wikipedia.org/wiki/Mario#:~:text=In%201990%2C%20a%20national%20survey,American%20children%20than%20Mickey%20Mouse.>



Nintendo 19th Century Hanafuda Cards

In Thousand JPY	Nintendo (7974.T) LTM
Sales	1,671,870,000.00
Gross Profit	954,340,000.00
<i>Gross Margin</i>	<i>57.08%</i>
Net Income	490,640,000.00
<i>CAGR</i>	<i>4.38%</i>
Market Cap.	11,416,780,000.00
<i>P/E</i>	<i>23.27</i>
Free Cash Flow	445,970,000.00
<i>FCFY</i>	<i>3.91%</i>
Enterprise Value	9,171,450,000.00
EBITDA	546,800,000.00
<i>EV/EBITDA</i>	<i>16.77</i>

All of that would be amazing by itself. But as it happens Nintendo also sits at an intersection of several themes this house is particularly interested in.

It is obvious, not only after our interactions with management and fellow Nintendo fans but even to a casual observer that is not particularly interested in business and is visiting Kyoto that Nintendo sits on a very rarefied league of companies that can command devotion around the world. The main reason sell side analysts give Nintendo a relatively low multiple is well known to the financial community: the console cycle.

The thinking goes like this: Nintendo might be amazing, but its revenues are ultimately tied to how many consoles and games it will sell and those numbers are tied to the release of its entertainment systems. Right now, for example, it has been many years since their last console, the super popular Nintendo Switch, came to market and the simple fact is that most people that wanted or could buy one already did.

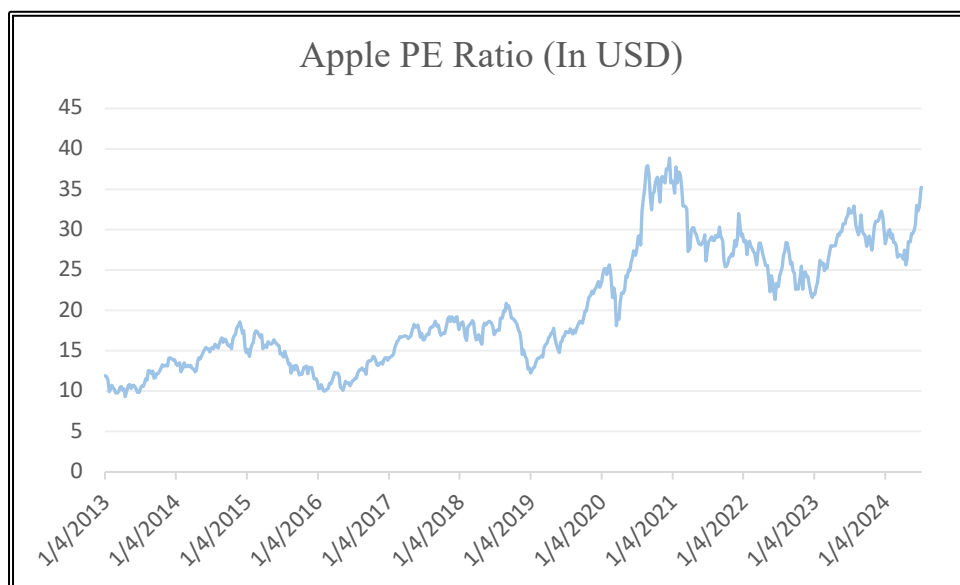
When researching Nintendo, another company came to our thoughts: Apple.

Back in 2015 the general wisdom of Wall Street was that Apple would never have a multiple near the level of companies like Salesforce or Google because it was a hardware company, that couldn't grow as fast or have such a large cash flow as software companies that had bigger moats.

In the words of David Tepper an investor we greatly admire, from a CNBC interview back in 2015:

"[But] it's always going to have a lower multiple" he argued, "because it is still a device company that, even though people think it can't be replaced, still something can come along."

Tepper was wrong. Not only Apple was not replaced, but its multiples gradually converged to the multiples of high-quality software companies.



Could Nintendo be in 2024 what Apple was in 2015? Nintendo is also a “device company” And just like Apple then, its hardware cycle might be breaking for the first time Nintendo is starting to get rid of the console cycle, that is showing signs of exhaustion in the internet age and launched Nintendo Direct where it is selling Netflix style access to its games.



It is still early days and Nintendo’s management has always been halfhearted about the efforts. But some Nintendo longtime observers already speculate that if the console cycle breaks and if Nintendo is able to rent its huge game catalog online it will cease to be a “device company” and its revenues will be more predictable, margins will widen and its multiples might very well double⁸.

In one of his first days in Tokyo your manager took part in what is probably the most famous tourist attraction in Tokyo: the Shibuya crossing.

To the uninitiated it is nothing more than going to the world’s busiest street intersection in Shibuya district and crossing to the other side. Among all of the planet’s marvels and places for sightseeing, this might seem like one of the silliest. It does have the beauty and history of say, the Coliseum or the Eiffel tower or Christ the redeemer.

There were people dressed as anime characters, crossing the street side by side with locals in suits rushing back from work or running to catch the train.

⁸ The search for companies with hidden assets inside is an old theme for this house. Marvel comics, which was once worth less than \$ 100 million despite having franchises like Spider man and X-men that were worth multiple times that was a watershed case for us. More recently Playboy enterprises ([PLBY:US](#)) a historical leader in adult entertainment that is still not able to monetize its brand might be an interesting case, among others.



Shibuya crossing

But at the same time, among all of the planet's tourist attractions it seemed one of the most symbolic: no big gestures, just being part of that giant mass of humanity (it seems that in a single green light some three thousand people cross to the other side of the street at rush hour) Simply being part of the city's landscape and crossing the street. Just doing something banal in one of the world's greatest cities. Even if for just a few seconds, just belonging.

Performance

FCL Opportunities		FCL Opportunities		FCL Opportunities	
Returns		Geographic Distribution	% AUM	Sector Distribution	% AUM
Year To Date (BRL)	-0.56%	China	36.50%	Consumer Discretionary	37.05%
Year To Date (USD)	11.79%	EUA	24.45%	Technology	15.29%
12 Months (BRL)	6.09%	Europa	12.63%	Financials	11.24%
12 Months (USD)	7.85%	Brasil	5.93%	Communication Services	9.16%
Since Inception (BRL)	89.32%	India	8.86%	Industrials	8.89%
Since Inception (USD)	7.85%	World	5.47%	ETFS:	5.47%
Annualized Rate of return (BRL)	8.63%			Healthcare	3.54%
Annualized Rate of return (USD)	1.01%			Staple	3.18%

FCL Opportunities		FCL Opportunities		FCL Opportunities	
Top 5 Concentration	% AUM	Exchange Exposure	% AUM	Portfolio Concentration	% AUM
Pinduoduo	15.41%	USD	56.58%	Top 5	61.24%
Uber	15.29%	HKD	21.08%	Top 10	89.04%
Anta	12.19%	EUR	12.63%	Top 15	93.83%
Moncler	9.45%	BRL	3.54%		
BYD	8.89%				

FCL Opportunities shares increased 6,21% in the second quarter of 2024 (-4,5% in US dollars). Over the past 12 months our shares increased by 5,27% (-9,07% in US dollars) and since our inception on January 30th, 2017, our shares increased 92,82% in Brazilian reais, a compounded annual return of 9,26%.

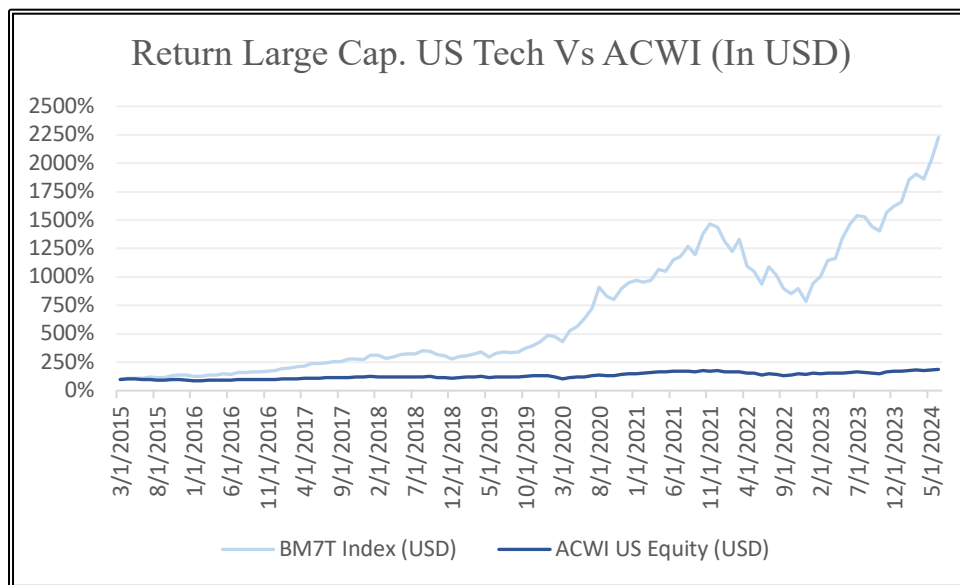
As the US dollar skyrocketed against the Brazilian currency, the fund's return when measured in this currency were respectively -4,5%, -9,07% in the quarter and past 12 months and +7,89% since inception.

Overall, we think our global strategy defended our investor's portfolio well against the local currency's devaluation.

Price discovery

As everyone knows, active management tries to identify securities' mispricing's and profit from those. Maybe no period in the history of financial markets has been crueler for active managers to beat their respective indexes. Virtually no global active fund managers beat their stock benchmarks, especially the S&P500⁹.

Why is that so? One of the major reasons is that over the past 10 years, large cap. US tech companies, in other words, the very largest companies in the largest and most liquid market, beat everyone else and left pretty much anything else in the dust.



Why is that important? Because in a capitalization weighted index, where the largest companies have the largest weight, when exactly these large cap. companies are the best performers, you carry the index upwards against lower performing small and mid-capitalization companies.

In other words, if a manager picks anything besides the obvious, any lower capitalization stock, any other international market, his performance almost surely suffered. The consequence is that very few managers beat the benchmark.

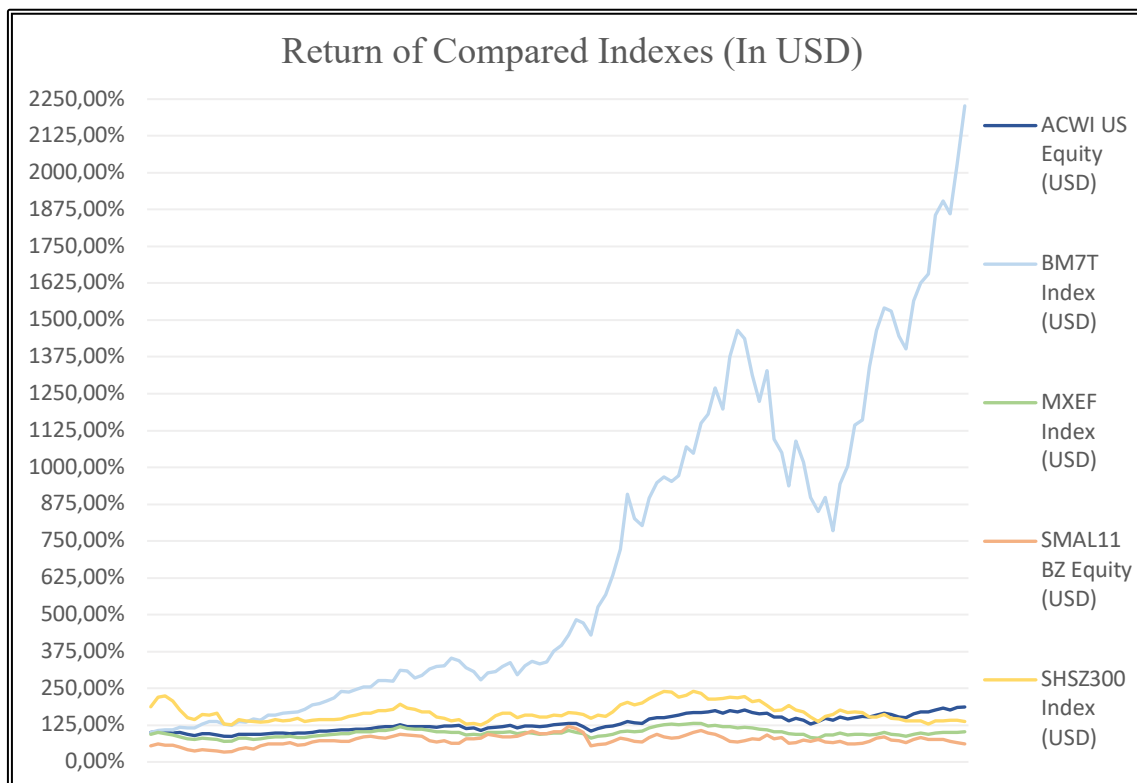
The market always has anomalies and they usually go away with time. Over this space we discussed over the years many of these anomalies, from the nifty fifties to the tech bubble. The current anomalies are AI companies, large technology stocks and the US markets in general, in a complete disregard against almost any other major market¹⁰.

⁹ And this has certainly contributed even more and accelerated the ongoing rise.

¹⁰ With the interesting exception of Japan, a market we discuss in this letter.

Let's run again the past 10 years of the S&P500, that had its fantastic performance carried by the likes of NVidia, Microsoft, Apple and Google and compare with the Russell2000, which is comprised of US small and medium stocks. Observe that almost half of the dollar return of the past 10 years would have gone away. And this is the best performing large market of this decade.

Now let's suppose this hypothetical stock picker chose to invest in emerging market stocks, which were, after all, the winners of the 2000s. He would be lucky to show a positive dollar return in the past 10 years. And this before accounting for the fact that even in these markets, large companies outperformed smaller ones.



Some people think this will go on forever. And we discussed here, some smart investors think simply that “the table stakes have risen” to be able to compete in today’s intangible and tech economy.

But as everyone knows, if there is one really dangerous phrase in the market is that “this time is different”. Cycles might last a long time - as Japan’s 30-year bear market attests - but they almost invariably change and if something can’t go on forever it won’t.

This house would bet that we will still see days of emerging market outperformance, of bright days for the Brazilian, Chinese and global stock exchanges and, crucially for stock pickers and reverting to the long-term norm, of small caps outperformance against their large cap peers.

We don't know when these things will happen, obviously, and no one knows. But we can't help but marvel at the capacity of investors to take the present and extrapolate it into the distant future as if today's reality is eternal.

In one insightful recent podcast interview¹¹, an anonymous market commentator that goes by the pseudonym of modest proposal, argued that for investors observing the current NVidia/ AI frenzy, studying mid 2000s craziness in commodities markets might bring lessons. Then and now, there was a new demand shock: back then the insertion of the Chinese economy into the global economic system that made commodities demand skyrocket. Now, the demand for chips useful for large language models, a market in which NVidia excels. Just like miners, from Brazil's Vale to Australia's Rio Tinto just couldn't produce enough iron ore then, NVidia today can't produce chips fast enough.

Investors thought that commodities prices would keep grinding higher forever. Goldman Sachs famously said that commodities had entered a "super cycle", something bigger and longer lasting than a cycle.

Fast forward to the present day and of course investors are also busy extrapolating the present situation into the very distant future. It is hard for this house to come up with any plausible assumptions about chips demand that would justify current NVidia prices. But we might, of course, be wrong. In any case our fiduciary duty wouldn't allow us to invest in something which we judge as having no margin of safety.

In markets as in life, the "only permanent thing is change" as Heraclitus wrote 2500 years ago. History doesn't repeat but it does rhyme and with change astute investors learn to recognize some patterns and usual behaviors. As always psychology is an interesting ally when trying to understand an uncertain world.

How will the current AI frenzy play out? Will NVidia have the same fate as Vale and other commodity producers or will a new, real super cycle appear? Although we don't know the answer our bet in this case is in permanence: a cycle of greed in one corner of the market will sooner or later end while the cycles of fear we see in emerging markets and small caps will someday give birth to a new narrative that transforms fear into greed and the cycles will keep changing, and on and on for as long as the markets last.

As always, we thank you for the trust you put in us,

FCL Team.

¹¹<https://open.spotify.com/episode/0OJF1BuCiO2oFAyPAA4G5R?si=w70a9LmiRNKLigR8x7aAnA&%3Bt=1648&nd=1&dlsi=314217d3b8cf4b09>