

FCL *Capital*

1Q 2022

The Comedian

“Some event will come out of left field, and the market will go down, or the market will go up. Volatility will occur. Markets will continue to have these ups and downs. ... Basic corporate profits have grown about 8% a year historically. So, corporate profits double about every nine years. The stock market ought to double about every nine years. So I think — the market is about 3,800 today, or 3,700 — I'm pretty convinced the next 3,800 points will be up; it won't be down. The next 500 points, the next 600 points — I don't know which way they'll go. So, the market ought to double in the next eight or nine years. They'll double again in eight or nine years after that. Because profits go up 8% a year, and stocks will follow. That's all there is to it.”

(Peter Lynch, former Fidelity fund manager, in 1994)¹

For some of life's most consequential events, reality has a way of being even more improbable and laughable than fiction. “If this was a movie, no one would believe it”, you can hear people say. It is a fact of the fragile human condition that the events that shape destiny - like the moment someone meets their future spouse or the birth of an idea that creates a business that will change the world - usually happen by not much more than chance, destiny's capricious roll of the dice.

Only seven years ago, there was a comedy group called Kvartal 95, based in the unremarkable, forgotten and ugly Ukrainian steel town of Kryvyi Rih.

One of the productions of this small company was an unpretentious comedy show called “Servant of the People”. Starring as the show main character, was a man named Vasily Goloborodko, a middle school history teacher who, in the middle of a discussion and not knowing he was being filmed, rants about corrupt politicians out of touch with reality. The video goes viral and he, very improbably, becomes a national sensation, winning the election to become the country's president.

If that plot looks too out of touch with reality², too unbelievable to be taken as more than an unabashed comedy, well, the main actor in the series, Volodymyr Zelensky, not only also became a national sensation due to the popularity of the series and how its theme resonated with people, but also went on to win an election to become his country's president, only with more votes to spare than in the fictional series. Even more than that, over the past month he also became a global symbol of courage, resistance, and free will in the face of oppression, his face adorning t-shirts and social media posts across the globe.

¹ At the time we write this letter, April 2022, this comment is 28 years old. When he says, “the market”, Lynch is referring to the Dow Jones Industrial Average Index, which closed at 3,797 points the day he made that statement. If you compound that by an 8% annual growth rate over the last 27.5 years, which would get you to the present day, then you'd get 31,520 points. The Dow closed last Friday, April 1st, 2022, at 34,861, which is scarily close for such a long-term prediction. The S&P500 also had a very similar return over the same period.

² <https://youtu.be/HEvjsjvXQM4>

It would certainly be hard for a global investment house like ours to write about any other topic this quarter than the conflict in Ukraine, especially considering how much it affects many of our portfolio's investments.

We won't pretend to have any specific insights or geopolitical knowledge about the conflict: like everyone else we have been digesting the news every day and hoping for a peaceful outcome as soon as possible with the less loss of precious human life as possible.

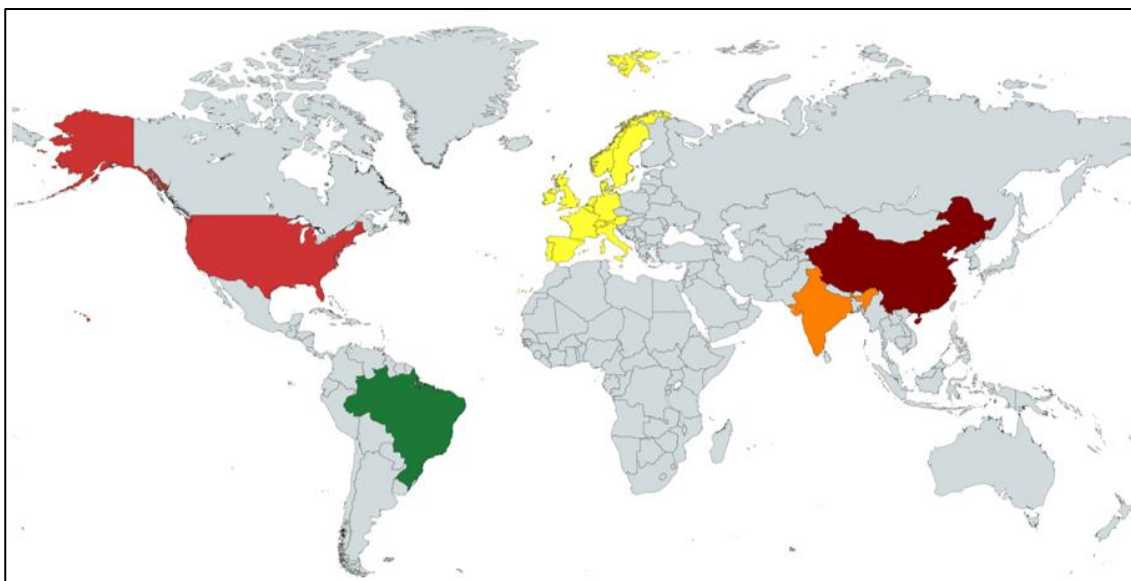
For the time being, the internal assessment of this house is that while our globally fragmented and diversified exposition prevents our FCL Opportunities fund from being the top performer in any single year - since our holdings are spread out across geographies with different index performances that cancel each other out - it also prevents our fund from suffering too much and to be overexposed to any single negative event. In other words, geographic diversification makes our fund more resilient.

Over the past few months, as soon as the first speculations about possible escalations between Russia and Ukraine were discussed back in November 2021, we decided to exit our position in Russia's VTB Bank, while our other Russia related position, the Danish brewer Carlsberg, was also exited not long before. The fact that our overall Russian exposure was exited with small profits, despite the circumstances, is related to our value investing discipline - margin of safety being one of the bedrocks of such trade.

	Carlsberg	VTB Bank
Internal Rate of Return	19,17%	-18,22%

In general, this house tries really hard to avoid the label "uninvestable" because due to our contrarian nature, it is often in the things that others don't dare to touch that we sometimes see hidden treasures and rewards. But in the case of 2022 Russia, be it because of international sanctions that don't make it feasible to invest in the country's equities, be it because of rule of law considerations, be it for ethical reasons, this house for the time being won't have any direct Russian exposure. This cements our transition from a BRICs equity fund that we started years ago to a more classic and diversified global equities fund.

Overall, we foresee that we will concentrate mainly in five markets: the USA, Brazil, Europe, China and India, with occasional opportunistic investments in other countries.



The geographies in which most of FCL's investments are and will be concentrated.

And what can we expect from those equity markets where both of our funds are positioned? Do we feel this is a promising time to invest? The scope of this letter will be an ample discussion on this topic, in light of the recent global geopolitical and financial events.

As shown in our most recent FCL Day³, our positions in emerging markets, especially China and Brazil, hurt the fund in 2021. Indeed, while our US and European holdings outperformed their respective indexes, our Brazilian and Chinese ones caused our aggregate performance in the past year to trail the MSCI All Country Index and most of the developed market indexes.

As is usually the case in finance, the cure for high prices is high prices and the cure for low prices is low prices. This house increasingly feels that, despite a very atypical first quarter, especially with the issue of war, the story of 2022 is still to be written and our best guess is that it is going to be a very different, indeed symmetrically opposite year than 2021, where there was a very strong first quarter followed by a weak year overall.

The theme of this letter will be slightly different than previous ones. Instead of a thesis focused on a specific security, we would like to talk about the markets we operate in, both in terms of ETFs and nonspecific exposure taken by our FCL Hedge fund as well as the general environment where the securities and stocks we select for our FCL Opportunities fund are located.

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³ <https://www.youtube.com/watch?v=E5hZnlqh3r0&t=208s>

Thesis: Equity Indexes

A journey through the different markets in which we are selecting our investments and why this house thinks emerging markets, especially China and Brazil, will turn for the better this year.

Starting by the two that harmed our performance in 2021:

China

In one of the most memorable passages from “The Godfather”, Michael Corleone, before heading out for a night packed with killings, resolutions and agreements, proclaims that “in one evening we are going to solve all of the family’s problems”.

Our team couldn’t help but think of this passage when watching the Chinese premier Liu He announcement this past march.

For every grievance the international financial community had about the Chinese stock market there was, often for the first time, an official position from the Chinese government.

Indeed, the announcement⁴ was unusual because it was so broad.

First, Mr. Liu said that the “rectifying” of Chinese tech platforms (read: regulatory crackdown) should end soon.

Then, there was a direct position on the issue of international listings and Chinese shell companies: China supports overseas listings and they are an important source of capital for Chinese entrepreneurs. It should be understood once again that China, in its own way, is opening itself to the global financial community.

Finally, he vowed the “government will release market supportive policies” and a lot more the market is still digesting. The result was one of the most action-packed weeks in all these years our team has spent watching Chinese and global markets.

The Golden Dragon Index, made of Chinese tech companies listed in New York, which was down some 60% over the past year, rose 32% the following day, before giving some gains following the recent geopolitical situation and the Federal Reserve’s rate hike discussions.

Of course, many things still need to get cleared before investors are properly able to assess the situation. First of all, the SEC has to agree with the Chinese government change of position and therefore declare that it will not delist the 270 or so Chinese companies from the New York markets. Moreover, a general improvement, albeit marginal between Chinese and American relations would surely help a lot.

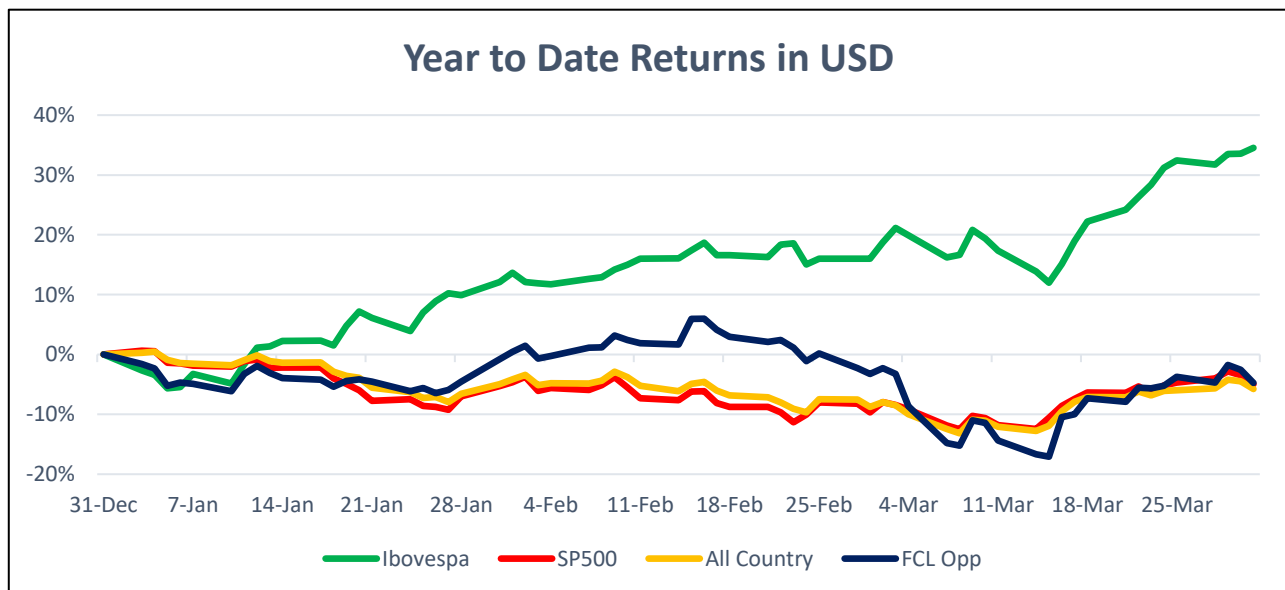
⁴ <https://www.ft.com/content/8d6d1394-c10a-45e2-bcc4-374439fd6760>

That being said, this house is very encouraged by the recent Chinese government change of tone, maybe scared by the possibility of a serious deceleration of growth in the Chinese economy this year, faced by multiple headwinds: a Covid surge and its own zero tolerance policies that impose draconian lockdowns and ruin the service economy; the problems facing its construction companies; the Ukraine War; the geopolitical situation with the USA; and its own “tech crackdown” that scared global investors away from Chinese shares.

We feel reassured (so far) by the Chinese behavior over these past few months, making amends to global investors and not interfering in the Ukraine War nor helping Russia to bypass sanctions in a meaningful way. After a very tough year we see all the ingredients for a turning point.

Brazil

Brazil was a complete outlier in the past quarter, with its stock index rising about 35% in US Dollar terms, helped by its distance from the Ukrainian conflict, its position as a commodities exporter and the relative calmness of its internal political situation given that both main candidates have already been tested by the market. It is not that investors like them, it's just that they at least know what to expect and although what they expect is not good, it is probably nothing they haven't experienced before.



Source: Bloomberg, FCL Capital

As for the future, we think Brazil might be not only one of the cheapest stock markets in the planet, but also one with the greatest medium-term perspectives – despite its first quarter performance, the Brazilian markets are trading at several standard deviations below its own usual multiples.



Source: FCL Day 2022 Presentation

We have been playing the Chinese and Brazilian markets in several ways.

Our Opportunities fund currently has around 20% of its portfolio in Chinese stocks (understood as China based companies that are listed either in Hong Kong or New York) and our FCL Hedge fund holds a more varied exposure through an ETF with many tech and financial names based in the country.

At the end of the first quarter, Brazil was, maybe for the first time in its five years history, our Opportunities fund largest single country exposure, comprising around 24% of the funds' portfolio. Our Brazilian exposure is through several different specific stocks, mostly focused in the domestic economy (as opposed to commodity plays), in sectors like education, healthcare and services.

Europe

If emerging markets had a very tough year, then Europe is not far behind. Despite being one of the planet's richest regions and home to many of the globe's most incredible companies, investors still see the European market as laggard, unpromising and unexciting while the US is seen as dynamic, promising and concentrated in growth sectors like technology. This has led to a mega decouple in terms of valuations and multiples (that always existed but was not that prominent) between those two markets over the past decade.

A final blow was obviously the Ukrainian conflict, the largest one in European soil since World War Two.

We think the market is overlooking Europe's strengths. As we maintained many times in this space, this house sees European luxury as the 2020s equivalent to US technology companies in the 2010s - undisputed global champions that will conquer more and more

parts of the globe but still trade at multiples that don't take this fact in consideration. Our FCL Opportunities fund holds a diverse set of securities focused on this macro trend.

But even if this call is wrong, a mere return to a more normal discount in European markets when compared to US ones, more in line with historical averages, would bring a significant relative rise to European stocks when compared to their US counterparts.

Trees don't grow to the sky and this house feels sooner or later we will see massive overperformance of the European, Brazilian and Chinese markets when compared to the US.

United States

As stated in this space numerous times before, despite still being undoubtedly the world's most dynamic and innovative economy, given its sky-high valuation and multiples of recent years, this house has found it hard to find investments in the US that fit our margin of safety criteria.

However this does not mean that we are completely out of the country, we still hold some significant investments there, specifically in mid-sized tech companies. More recently, with the tech rout of the last few months we are finally seeing very interesting US companies trading at more reasonable valuations.

Crypto

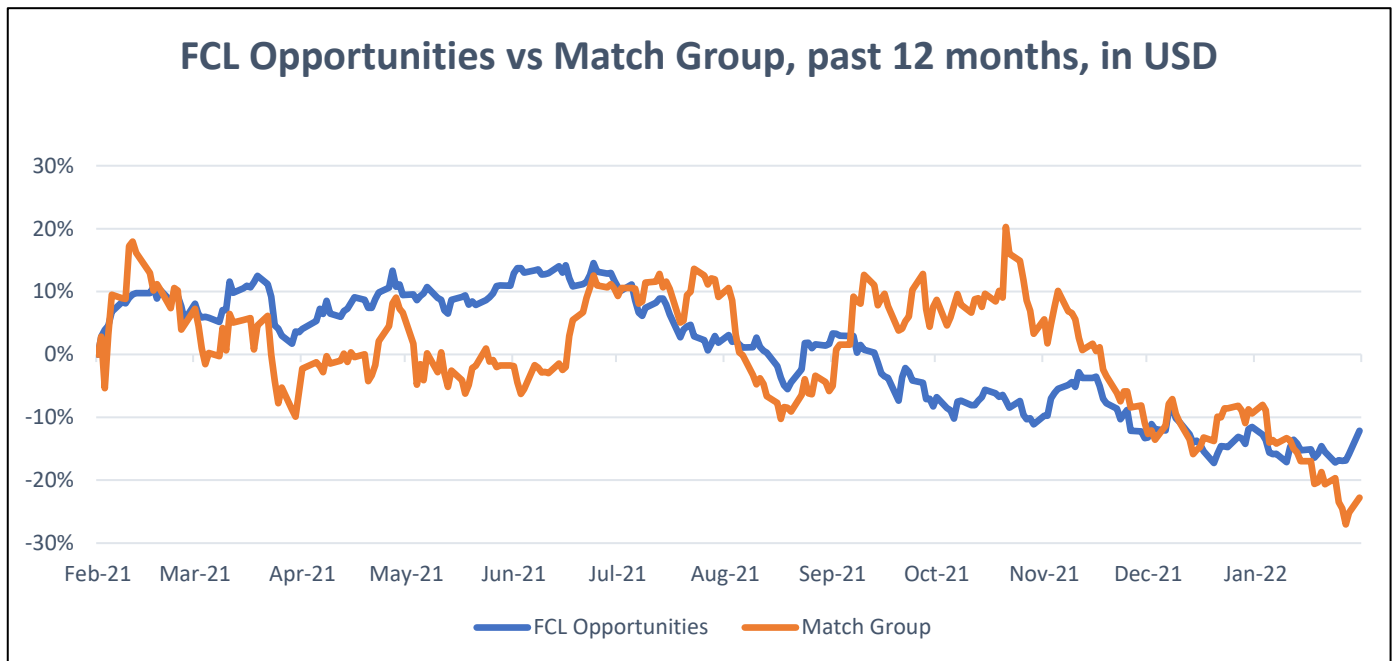
Finally, as our longtime investors know, we also hold direct and indirect positions in crypto, especially Bitcoin and Ethereum. If the current war proved one thing is that crypto is increasingly seen as a digital gold, a lifeline in times of stress and desperation, a reliable way to move one's wealth across geographies.

Bitcoin has not totally grown into its "digital gold" role yet, but it is getting there. It is not a purely "risk on" asset also, as its detractors would like to paint it. Over the past month for example, Bitcoin, despite having 3x the volatility of the Nasdaq, fell only 5%, against 12% of the technology index. Again, not yet a purely digital gold, an ultimate safe heaven, but being tested in such dire circumstances, this house can attest, it is slowly getting there.

Conclusion

Overall, as this house has been maintaining, our globally dispersed risk exposure is an important asset. It might prevent us of hitting the "bullseye" of being totally exposed to the market that rises the most in a given period. But, over the long term, the fund diversification will benefit our stock picking possibilities and decrease our risk exposure while increasing our long-term performance.

A case in point: the most frequent critique this house gets is our big exposure to China, admittedly a still emerging market that will therefore naturally carry the risks of one despite its giant importance to the global economy⁵. However, as an interesting intellectual exercise, with the carnage in growth equities around the world over the past 12 months, if during that period we had sold our Chinese stocks and invested 100% of our fund in a selected US company, for example Match.com, our most famous, profitable and celebrated investment, our fund performance would have been significantly worse off.



Source: Bloomberg, FCL Capital

In the first quarter the winds seem to have started to change, with emerging markets, especially Brazil, outperforming their developed peers for the first time in many years.

Overall this house will keep searching for the best risk adjusted long term opportunities in the diverse set of markets and companies we track.

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⁵ A fascinating dissonance which is a perennial theme of intellectual exploration for this house.

Performance

FCL Opportunities	
Year to Date, 2022, in BRL	-18,92%
Year to Date, 2022, in USD	-4,72%
12 Months, in BRL	-32,08%
12 Months, in USD	-19,29%
MSCI All Country Index, 12 Months, in USD	5,68%
Since Inception (30/01/2017), in BRL	111,72%
Since Inception (30/01/2017), in USD	39,17%
Avg Annual Return, since inception, in BRL	15,32%
Avg Annual Return, since inception, in USD	6,49%

FCL Hedge	
Year to Date, 2022, in BRL	-5,00%
Year to Date, 2022, as % of CDI	-205,36%
Since Inception (01/02/2017), in BRL	16,41%
Since Inception (01/02/2017), as % of CDI	47,14%

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

Position	Country	% Fund NAV
GoDaddy	USA	13,35%
Entain	UK	11,58%
Capri Holdings	USA	11,55%
Fleury	Brazil	10,27%
Yduqs	Brazil	8,96%

FCL Opportunities Portfolio Composition on March 31st, 2022:

Geographic Distribution	
Brazil	25,34%
USA	25,23%
Europe	24,17%
China	20,00%
India	1,07%

Portfolio Concentration	
Top 5	55,7%
Top 10	84,7%
Top 15	95,5%

Portfolio Composition by Sector	
Technology	35,16%
Consumer Discretionary	33,91%
Healthcare	10,27%
Education	8,96%
Industrials	4,49%
Financials	3,01%

Currency Exposure	
BRL	28,67%
USD	26,42%
HKD	14,78%
EUR	12,27%
GBP	11,58%
CNY	5,22%
INR	1,07%

On March 31st, 2022, FCL Hedge portfolio composition was:

FCL Hedge	
Stocks and ETFs	67,25%
Fixed Income	13,23%
Cash	19,52%

In the first quarter, when measured in BRL, the performance of our FCL Opportunities fund was -18.92%, impacted mainly by valuation effects when seen in the Brazilian currency. Given that we manage a global equity fund and some 75% of our holdings are outside Brazil, the rise of the Real against the Dollar impacts our holdings when measured in this currency.

In US dollars our Opportunities fund had a performance of -4.72% in the period, slightly beating the S&P500 and the MSCI All Country Index.

As for FCL Hedge, its performance in the first quarter was -5.00%, or -205.36% of the Brazilian CDI.

That being said, this house is very unsatisfied and upset with the past 12 months results, especially after a quarter when, before the beginning of the Ukrainian War, our fund was experiencing a period of strong outperformance when compared to global equity indexes.

A confluence of factors converged to bring terrible results for investors in global growth equities like this house. Indeed, the performance of most global equity benchmarks is far from being a fair barometer to the overall results in the markets, since their performance was strongly improved by a few large cap outperformers in selected sectors, like commodities, utilities, banks and large caps in general.

Stating only one example, the Russell 2000 US index that comprise small and medium US companies fell only 8% in the past 12 months, but if you take the median company listed in that same index, it fell more than 30%. Likewise, the absolute majority of companies listed on the Nasdaq or STOXX 600 indeed fell substantially more than the index itself, due to the overweight of large caps and the above-mentioned sectors. It is fair to say that the average growth stock in the US or Europe is down more than 50%,

with some good and profitable companies falling more than 70% in the past 12 months. In other words, a nightmare scenario for stock pickers.

To us, it seems clear that while there was overexcitement during the lockdown phase of the pandemic, even giving rise to “meme” stocks, now the markets clearly seem to be overcompensating on the other way around, like is so often the case.

So what are the reasons for the horrible performance of growth stocks and small cap stocks in general around the world?

1. Interest rates will increase and they particularly hurt growth stocks. The Fed has just started increasing rates and there is a lot more to come;
2. The past year brought a lot of turbulence and losses for investors in Chinese stocks like this house. Indeed, if we didn't have any investments in China, our performance in 2021 would have finished the year positive in the double digits (instead of a small loss like it did). First, there was the CCP's “tech crackdown” that started with the forced cancelation of Ant's IPO and had multiple events throughout the year. Then, a showdown between Chinese and US regulators regarding the listing of Chinese companies in New York exchanges⁶ and, finally, growing overall concerns about the future of US/China relations, with some western investors fearing a total parting of ways that could result, in a worst-case scenario, at an almost impossibility of making any investments in China;
3. The very poor performance of emerging markets and European stocks, due to a flight to quality, geopolitical uncertainties and recently, most crucially, the Ukraine War. In other words, in a volatile and unpredictable world, investors flew to quality and safety and, as a result, almost anything that was not a commodity stock, a very traditional “value” company or a US large capitalization company got slaughtered by the market.

That being said, this house feels that just like 2021 experienced a very happy first quarter followed by a turbulent rest of the year, 2022 might bring a symmetrically opposite fate.

What are the reasons for this optimism?

First, after the initial shock caused by the war in Europe passed, the past few weeks brought some signs of stabilization and even of a change of outperforming factors. For the first time in a while, emerging markets, especially Brazil but also, during some periods in the past few weeks, China, started to outperform their developed peers in intriguing ways.

It is of course still very early, baby steps. But we feel a change of winds regarding emerging markets might be coming and with that, the possibly of outperforming US equities.

⁶ <https://www.barrons.com/articles/alibaba-stock-china-delist-51647587701>

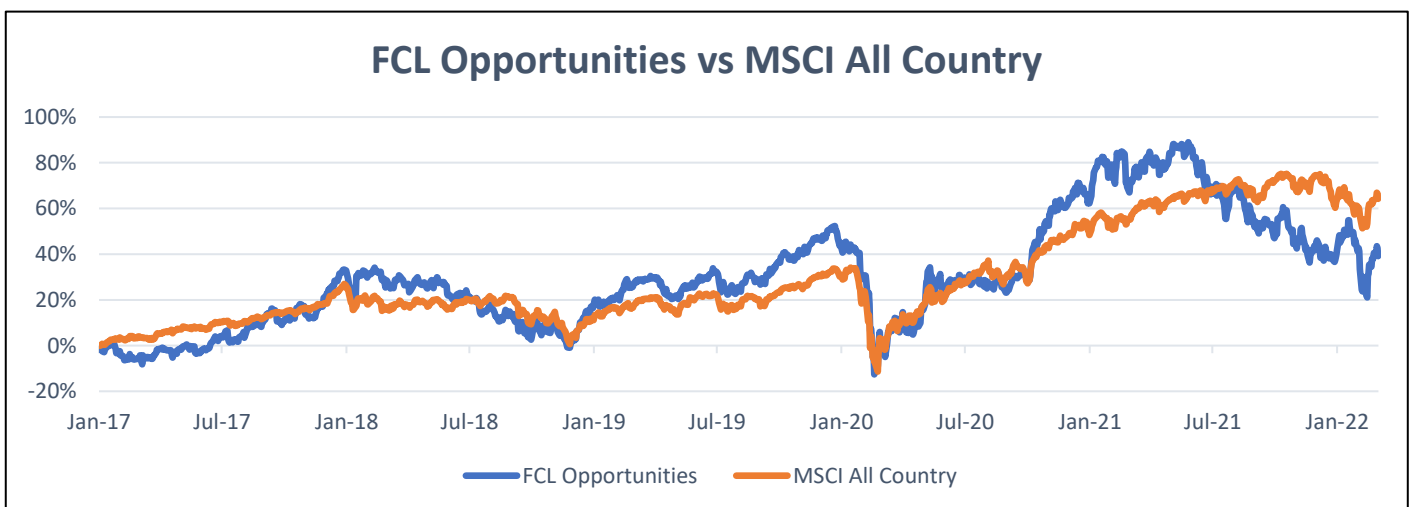
Second, regulators in China, perhaps scared by the growth slowdown the country is experiencing, started to behave differently. Not only did they start saying the right things, as seen in Liu He's pronouncement we mentioned above, they started doing the right things. Most consequentially, and potentially ending decades of standoff, they changed their country securities law to allow foreign auditors to conduct inspections inside China⁷. This is a crucial move and a necessary step for the 270+ US listed Chinese companies.

The market still maintains some skepticism regarding the possibility of these companies to remain listed in New York exchanges for a few reasons. Most importantly, US regulators still have to judge whether the changes the Chinese have done so far are enough, a tough assessment to make given the strong anti-Chinese sentiment deeply embedded in the US right now.

That being said, clearly the crackdown era seems to be mostly over and a new market supportive era by Chinese regulators might be starting. Hopefully the Chinese leadership realized the importance to the country's companies of having a well-developed and robust capital markets activity, be it onshore, in Hong Kong or abroad.

Finally, a final reason for our optimism is simply the fact, also mentioned in the first section of this letter, that global equity indexes, especially non-US ones, are trading near historically low multiples. As always, greed and fear take turns to rule the market and after a fear driven sell off we feel some bargain hunting might be available. Crucially, we see amazing growth companies trading at their cheapest valuations in many years.

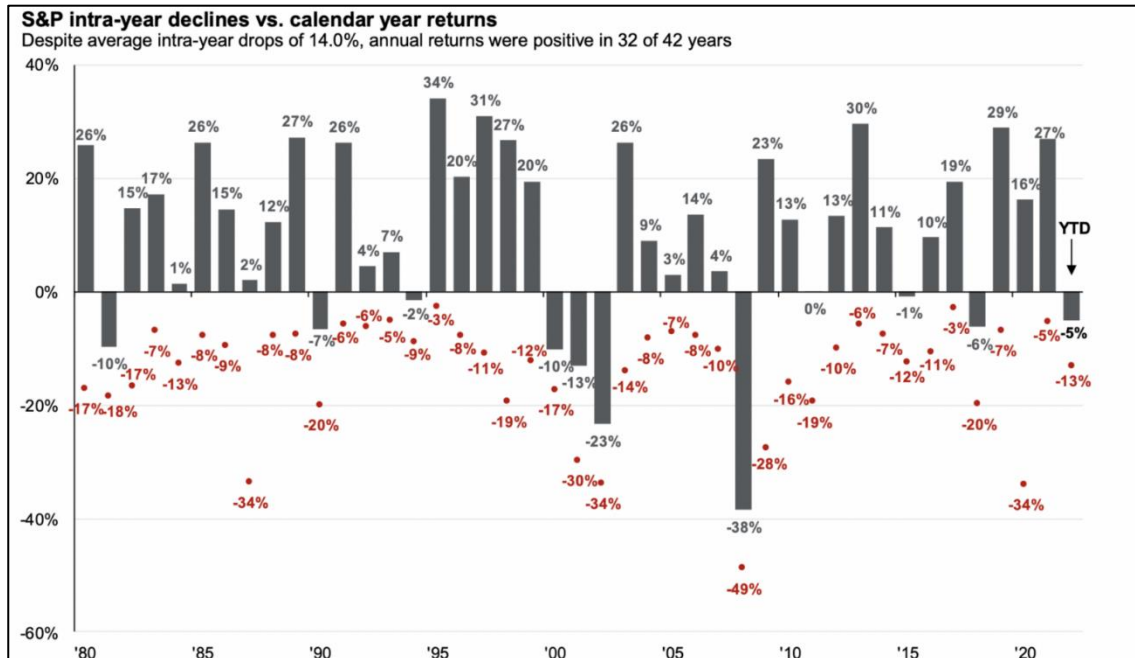
Since our launch in January 30th, 2017, our fund has for most of the time, with the exception of its first year, been ahead of the MSCI All Country Index. Due to our recent underperformance, especially because FCL Opportunities tends to invest with a heavier emphasis in emerging markets and in smaller cap companies, we are, for the first time in a while behind this unofficial benchmark. We feel confident and will work very hard to be ahead again soon. Crucially, we feel the factors that got us behind, like the perennial emerging markets underperformance, both in stock and in currency markets, might be finally turning.



Source: Bloomberg, FCL Capital

⁷ <https://finance.yahoo.com/news/china-removes-major-hurdle-allow-081622182.html>

As we said, we feel the story of 2022 is not yet written. In this fascinating chart below, we see the maximum drawdown in each given year and the subsequent year end performance for the S&P. In many years, as we can see, there were double digits drawdowns only for the year to end in profits. No one knows for sure, evidently, but our intuition is that 2022 could be one of these years.



Source: JP Morgan Asset Management “Guide to the market” Report

Finally a note of thanks to our investors, who remained loyal and confident throughout this past year’s underperformance. While we can’t control the market’s volatility and therefore our fund’s results, we promise, now and always, to focus on the variables we can control: our focus, discipline, perseverance and hard work. Our investors certainly deserve it and we will never let our guard down on this aspect. We love our work and know the story in stock investing is written in decades, not quarters or years. We feel happy to have found a group of investors that share this vision with whom we continue our mission to find and invest in the global opportunities of the 21st century.