

INVESTING IN STOCKS FOR THE LONG TERM (PART 2)

June, 2020

Dear investors,

Given the turbulent environment in which we are living, we have dedicated our recent letters to providing a historical perspective on investing in stocks.

We have already written two letters on the subject: the first addressed investing in times of crisis, and the second compared the historical returns of stocks vs. fixed income in several countries.

In this letter, we explore the subject further and present an analysis focused on the Brazilian market.

We often hear news and analysts' comments criticizing investments in Brazil. The problems cited are well known: political instability, fiscal deficits, historically high inflation (although it has been under control in recent years), decades of low economic growth, among others.

Despite all of these problems, the Brazilian stock market has an excellent track record of returns. From the creation of the Ibovespa in Jan/1968 to May/2020 (in the middle of the Covid-19 crisis), the Ibovespa returned 161 times its value in dollars (equivalent to an annual rate of 10.2% per year), compared with 148 times for the S&P 500 (10.0% per year) over the same period. The Brazilian index's return is higher than that of the US index even when we include 2020, which has been a terrible year for the Ibovespa (a return of -43% vs. -5% for the S&P 500, both in dollars).

These results appear in Chart 1 below, which shows an Ibovespa track record marked by downturns followed by periods of extraordinary appreciation.

Chart 1 - Historical return of the Ibovespa vs. the S&P 500 in dollars¹



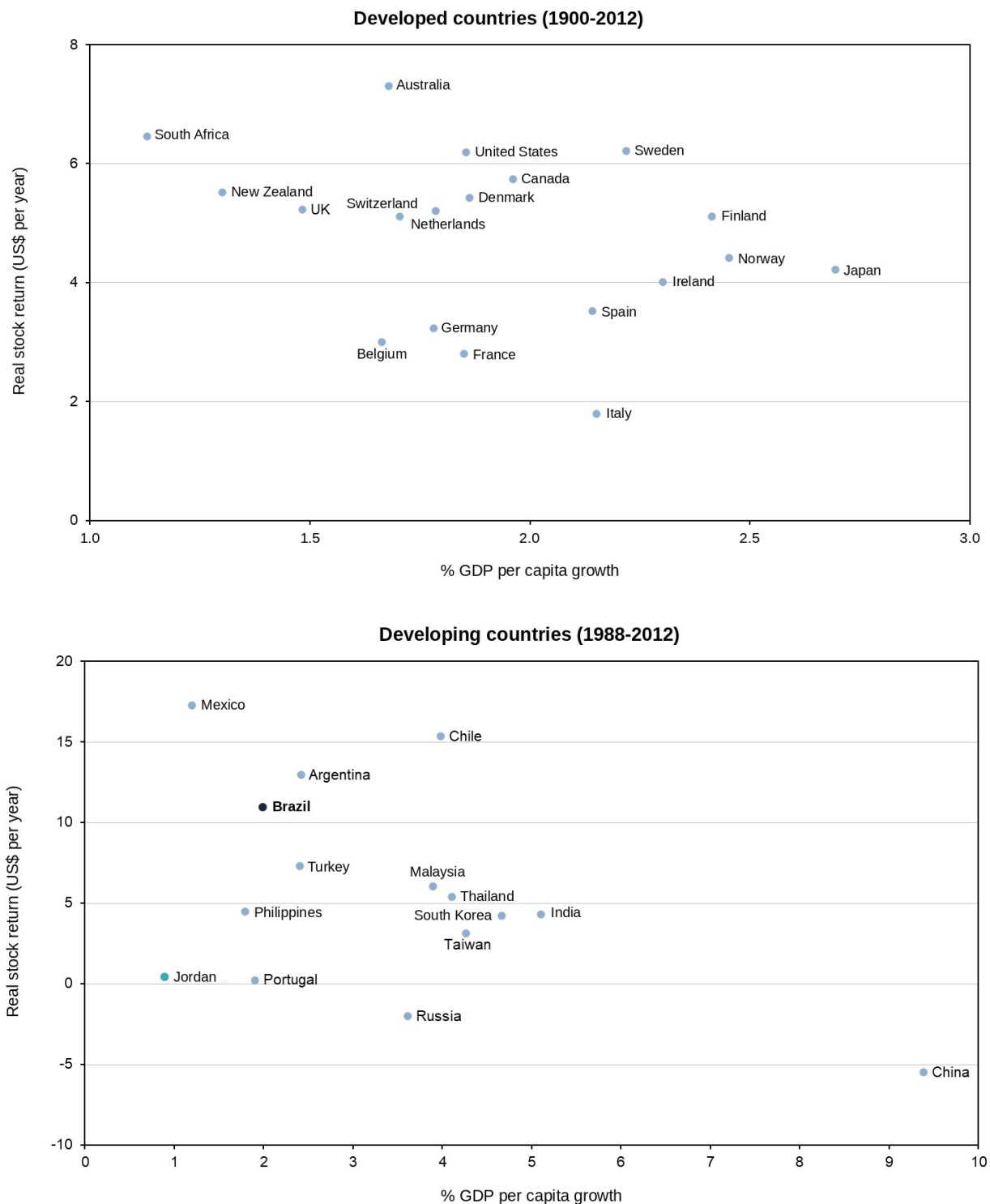
This result seems counterintuitive, particularly when we consider our turbulent political and economic history. Since the index was created in 1968, Brazil has lived through a military dictatorship and two impeachments, has had 7 different currencies and has gone through countless economic crises. During this period, the country certainly grew below its economic potential, so how can this result be explained?

Contrary to popular opinion, a specific country's economic growth bears little relation to the performance of its stock market, especially considering that we live in a globalized economy in which global economic growth is what matters most. Data from 34 countries collected over a period of 112 years (1900-2012) for developed countries and 24 years (1988-2012) for developing countries show a surprising result: a low correlation between economic growth and stock market appreciation.

Brazil, for example, is one of the countries with the best returns over this period, despite weak economic growth.

¹ Source: Ártica analysis; data presented for the period between Jan/68 (inception of the Ibovespa) and May/20; S&P considering dividend reinvestment (SP500TR), whose data are presented annually between 1968-88 and monthly from 1988 onward

Chart 2 - Stock returns vs. economic growth²



Why does this happen?

There are three hypotheses to explain this trend:

1. In the globalized world in which we live, the stock indexes of many countries have a significant presence of multinationals or exporters whose results are more closely tied to the performance of the global economy than to the local one.

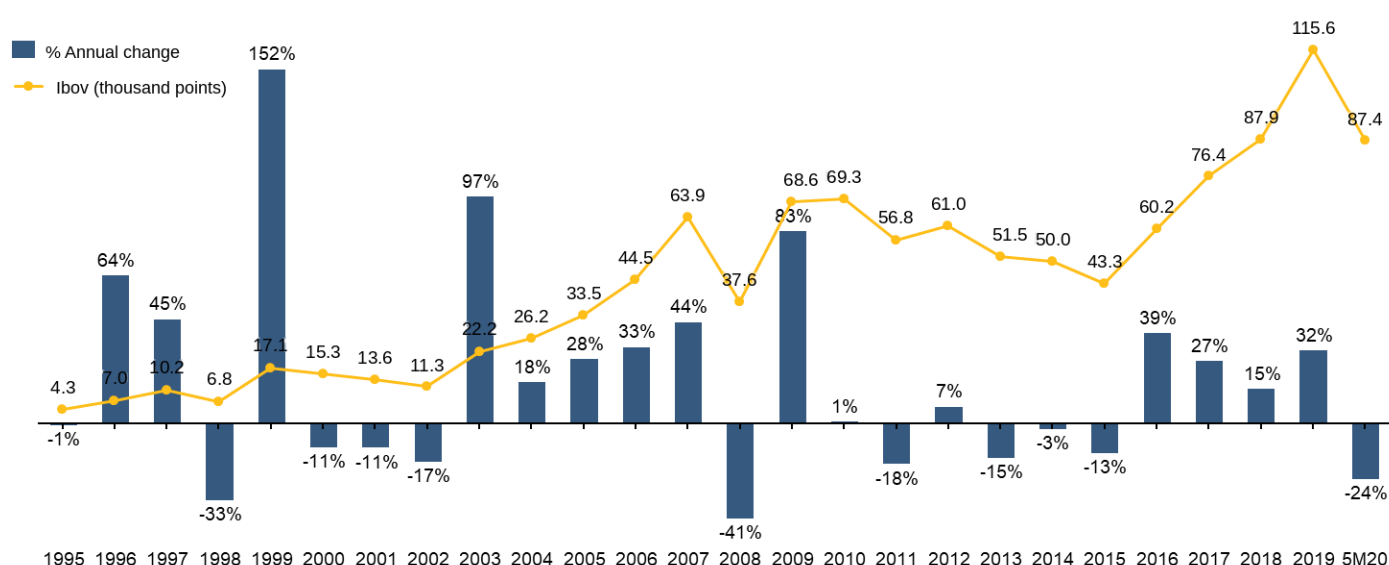
² Source: Stocks for the Long Run, Jeremy J. Siegel (2014)

In the case of Brazil, 37% of the Ibovespa index is made up of companies linked to commodities (Petrobras, Vale, Suzano, Klabin), industrial exporters (Embraer, Weg) or companies with significant international subsidiaries (Ambev, JBS, Natura, Gerdau).

2. In many countries, the capital market is underdeveloped and there is a limited number of companies whose shares are traded on the respective exchanges. These companies do not necessarily reflect the overall performance of the economy. In addition, because of their size, these companies generally have significant competitive advantages over their smaller competitors and are able to achieve above-average returns on invested capital, which contributes to higher stock market returns.
3. As with individual stocks, higher growth does not necessarily translate into higher returns because, in many cases, expectations are already built into share prices through higher multiples.

It is worth reflecting here on the importance of the long term when investing in stocks. Despite its excellent historical performance, the Ibovespa is an index with a history of high volatility, in which years of sharp declines were followed by years of exceptional gains. This can be seen in Chart 1 and is also illustrated by the following chart:

Chart 3 – Annual and cumulative return of the Ibovespa, in reais (1995-2020)³



An investor who had sold his shares in 2002, disappointed with the market's performance, would have missed a great opportunity for the gains that came between 2003 and 2007. The same happened in 2008 and 2015 – who knows, might this be the case in 2020?

Knowing how volatile the Ibovespa is, investors might ask whether a “*time the market*” investment strategy would make sense – that is, investing in stocks when the market is down and selling when the market is up. Although it makes theoretical sense, the problem with this strategy is that no one knows which direction the market will go, whether it will rise or fall, and waiting for the ideal moment to get in can create an enormous opportunity cost.

³ Source: Ártica analysis

Research conducted in the United States comparing market analysts' forecasts of S&P 500 appreciation with what actually happened shows large discrepancies in almost every year. Some examples: in 2008, the forecast was for a 16% gain; what happened: a 37% decline. In 2013, the forecast was for a meager 3% gain; the result: a 32% gain.

The point here is not to criticize analysts' work, but rather to show that, in the short term, the stock market is unpredictable. For this reason, we believe that the best strategy is to always stay invested and thus enjoy the long-term benefits that stocks provide.

ARCÁDIA FIA – MAY 31, 2020

Historical cumulative return⁴

Indicators:

Current net assets:

R\$72.8 million

12-month average net assets:

R\$62.6 million

Cumulative return:

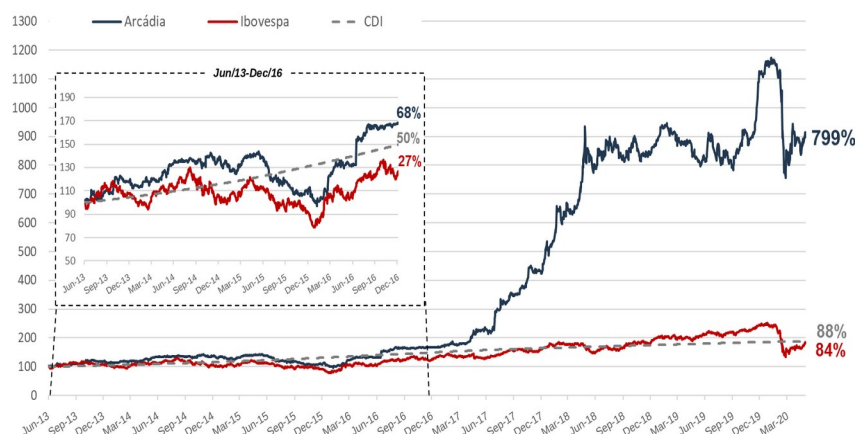
798.8%

12-month return:

8.7%

36-month return:

295.8%



	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Year		Since inception	
													Arcádia	Ibov	Arcádia	Ibov
2013	-	-	-	-	-	2.2%	6.7%	(5.2%)	8.8%	8.3%	(1.0%)	(0.3%)	20.2%	8.2%	20.2%	8.2%
2014	(4.5%)	2.9%	2.2%	(0.9%)	4.2%	7.7%	1.2%	0.9%	(1.2%)	(1.2%)	6.2%	(1.7%)	16.0%	-2.9%	39.4%	5.0%
2015	(4.4%)	(3.6%)	3.4%	5.1%	1.3%	(4.2%)	(10.6%)	(2.9%)	0.2%	(8.7%)	0.5%	3.5%	-19.7%	-13.3%	12.0%	-8.9%
2016	(9.7%)	2.8%	20.9%	4.7%	1.8%	(0.7%)	16.1%	7.8%	(0.3%)	(1.0%)	1.6%	0.6%	50.3%	38.9%	68.3%	26.5%
2017	2.0%	3.7%	1.4%	2.6%	20.4%	1.7%	27.9%	9.4%	8.7%	8.9%	14.1%	(1.2%)	151.7%	26.9%	323.7%	60.5%
2018	22.1%	23.9%	0.8%	2.4%	29.7%	(8.4%)	7.9%	5.1%	(7.8%)	6.5%	(4.7%)	0.9%	98.8%	15.0%	742.3%	84.6%
2019	10.7%	(1.7%)	(3.4%)	(1.2%)	(5.7%)	(1.5%)	3.6%	1.0%	(7.8%)	14.0%	0.5%	25.0%	33.1%	31.6%	1,021.5%	142.9%
2020	2.7%	(4.2%)	(24.8%)	8.0%	0.2%	-	-	-	-	-	-	-	-19.9%	-24.4%	798.8%	83.6%

⁴ Arcádia began on June 27, 2013 as an “investment club” and, on September 27, 2019, it was converted into an “equity investment fund.” Returns shown from inception as a club on June 27, 2013 through May 31, 2020