

## How to Separate the Wheat from the Chaff (*Overview of Our Investment Process*) February 2025

### Dear Investors,

Each market cycle presents a different challenge for equity investing. When markets are rising and sentiment is euphoric, the risk is to follow the prevailing optimism and overpay for stocks. This is especially true because perceptions of what is expensive or cheap tend to adjust slowly when prices rise over an extended period. A stock that is merely less expensive can easily be mistaken for a true bargain. Today, however, this is not the challenge we are facing.

Brazilian equities have been trading at low valuations for quite some time. Few would disagree with this statement, yet most investors still prefer to stay on the sidelines, concerned about how long it may take for the market to recover. We take a different view. We believe that it is not possible to reliably predict turning points in market trends, and we therefore prefer to keep our funds fully invested in equities at this time. That said, the decision to allocate capital to equities is less important than selecting which companies to invest in. This brings us to the central question: how do we decide what to buy in downturns?

Looking purely at current prices and comparing them to historical averages, many stocks appear attractive. However, the macroeconomic environment that has driven widespread pessimism also creates real risks for businesses in Brazil. The challenge today is to identify high-quality businesses whose shares have declined along with the broader market, but that will remain resilient in an adverse environment and continue to deliver solid results—or are well positioned to capture the eventual recovery, which will come sooner or later.

There is no deterministic answer to this question. Each investor develops their own practices, even when following similar investment philosophies. In what follows, we outline the general principles behind the methods we use to select our investment theses.

### Screening Investment Ideas

Searching for attractive investment opportunities is, at its core, a process of prospecting. We need to move a lot of rocks to find a small amount of gold. The sources of ideas are diverse: screening for companies that meet certain quantitative criteria, news flow, conversations with market participants, significant insider purchases (by executives, board members, or controlling shareholders), and industry cycles we have followed over the years. However, there is no quick or easy way to identify good opportunities. When we begin analyzing any given business, we already know that the probability of ultimately investing in it is low. It is far more likely to be rock than gold.

The efficiency of this process depends heavily on quickly discarding poor opportunities. Shortly after identifying a potentially interesting business, we look for any major red flags. If one is found, the idea can be set aside without spending time analyzing its positive aspects. There is always the possibility that we are discarding a less obvious but attractive opportunity. However, it would be highly inefficient to spend the time required to achieve near certainty that every idea that appears unattractive is indeed so. Our goal is to allocate our limited time to studying what appears most promising.

At the same time, we are mindful of continuously expanding our knowledge of companies and industries over the years. Occasionally, we come across interesting businesses that are somewhat expensive or facing a

temporary issue that appears solvable. In such cases, the thesis may not be actionable immediately, but it may still be worthwhile to study the business so that we are prepared to act quickly if it becomes an attractive opportunity in the future.

There is a meaningful degree of subjectivity in this screening process—enough that intellectual curiosity plays an important role in how we allocate our time. The profession is part practical, part academic. The pragmatism of seeking efficiency in the investment process coexists with a degree of creative flexibility, which is essential for intellectual development and for identifying investment theses that are not yet visible to the broader market.

In practice, implementation is more straightforward than it may seem. Each of us has the autonomy to source ideas in our own way until identifying an opportunity with a reasonable hypothesis of being attractive. We discuss each idea in weekly meetings, and those that appear promising move on to the next stage.

### **Intermediate Analysis**

Each industry has its own dynamics, which we seek to understand before assessing any specific company. The quality of the business category is as important as the quality of the company itself. In general, average companies operating in very attractive industries tend to deliver better results than excellent companies in structurally poor ones.

This stage of analysis is largely qualitative and grounded in microeconomic principles. We look for industries that address essential and enduring societal needs. Less aggressive competitive environments increase the likelihood of strong returns. Pricing power is desirable, as it allows companies to pass through cost fluctuations. Cyclical businesses are not necessarily unattractive, but highly erratic and volatile cycles can be problematic. Regulatory dependence is also a risk, given the unpredictability of political intervention. In short, the list of relevant factors is extensive. The key questions we seek to answer are: what makes a business good, and what could ultimately undermine it?

The main challenge at this stage is using time efficiently—prioritizing the factors that are both easier to assess and most impactful to the business. There is no strict rule for how to do this. The process is inherently heuristic, meaning that many decisions are made quickly and almost instinctively, based on experience and knowledge accumulated over years of analyzing companies.

Once we understand the industry dynamics, we turn our focus to the company and assess whether its core fundamentals are attractive. We aim to invest in businesses that are consistently profitable, have demonstrated resilience through macroeconomic crises, and hold a strong competitive position within their industries.

If the business appears attractive, we proceed to form an initial view of its intrinsic value. Estimating a company's value with high precision is time-consuming, but developing a rough valuation range is relatively quick and sufficient to assess whether the current share price is likely to be attractive.

These qualitative and quantitative analyses are then compiled and presented for discussion with the entire investment team. Based on this discussion, we decide whether the thesis merits advancing to the final stage, which requires significantly greater time commitment.

### **Detailed Analysis**

The investment theses we choose to analyze in depth already exhibit a reasonably high level of quality. The scenario in which the business succeeds and generates an attractive return is usually clear, but we do not

yet have a well-formed view on the likelihood of that scenario materializing. There is a natural tendency to focus only on the desired outcome and seek arguments that reinforce it (confirmation bias). This is dangerous, as a compelling upside case does not, by itself, make a good investment—what matters is the likelihood that the company’s plans are not derailed by risk factors.

Mapping and deeply understanding the risks inherent to the business is the most complex stage of the analysis process. There is an academic view that the risk of investing in a stock can be measured by its price volatility, but we believe this approach is overly simplistic and insufficient. Business risk cannot be reduced to a single quantitative metric, as it encompasses the full range of possible future scenarios in which the company could suffer permanent impairment.

At this stage, process efficiency becomes secondary. Our objective is to minimize the risk of error, even if that entails redundant analyses, exploratory lines of thought, and extended philosophical discussions. We may spend months studying a company until we reach the level of understanding we consider adequate to make a decision—or conclude that such a level is unattainable and abandon the opportunity, recognizing the limits of our knowledge.

As we deepen our analysis, we actively search for weaknesses in the thesis. Risks are always present, and we aim to ensure that none of them go unnoticed. After identifying them, we focus on those that could have a material impact on the company’s intrinsic value and assess the probability of each one materializing. This process involves multiple analyses, discussions, and reflections until we arrive at a stable view on whether the overall risk level is acceptable.

It is also critical to thoroughly analyze the competitive environment in which the company operates, with particular focus on its competitive advantages relative to peers and the sustainability of those advantages (the well-known “moat”). Companies with a strong competitive position tend to have a much easier path—they attract top talent, access capital at lower cost, and withstand pressure in negotiations with suppliers and customers. This is precisely what we seek: to invest in companies that are unlikely to face significant difficulties.

In parallel with the qualitative analysis, we work to estimate the intrinsic value of the business. This involves building financial models with cash flow projections, simulating multiple scenarios, identifying the variables that most affect results, and refining our understanding of how these variables may evolve over time. While the calculations themselves are precise, the outcome is far from exact. What we ultimately obtain is a range of possible future values, distributed around a central estimate that we use as our reference point. The dispersion around this central estimate is also important, as an attractive entry price is one that lies below the estimated values in the vast majority of simulated scenarios. The gap between this attractive price and the central estimate is what we refer to as the margin of safety.

In general, the entire investment team becomes involved in the analysis and discussion of theses that reach this final stage. This may not be strictly necessary, but it is almost inevitable. The most compelling ideas naturally generate greater interest, and the willingness to engage is reinforced by the fact that we all have a significant portion of our personal capital invested alongside our clients in our equity funds.

## **Investment Decision**

At the end of the evaluation process, there are three key questions we must answer: (i) do we want to own shares of the company? (ii) what is the maximum price we are willing to pay? and (iii) what portfolio weight should the position have?

The logic behind the first two questions is similar to that of purchasing any product. Whether you decide to buy depends primarily on whether the product meets your minimum quality standards. The maximum price

depends on how much value you assign to the product relative to its quality. What makes investment decisions more complex is that assessing quality and value is significantly more demanding, the amount of capital involved is substantial, and there are thousands of other investors attempting to make better decisions than yours. You can only buy what someone else is willing to sell, and one side is wrong on price.

Determining the appropriate portfolio weight is a more specific challenge in investing. We consider three elements: the relationship between potential upside and downside, the absolute amount of capital we are willing to expose to each company's risks, and our level of conviction in the investment thesis. The guiding principle is to maximize the upside-to-downside ratio while maintaining prudent risk control.

Our decision-making process also includes a few formal steps to ensure discipline. Once the analysis is complete, we conduct an extended, structured review of the thesis. At this stage, everyone is already well informed about the business and multiple informal discussions have taken place. Even so, we see value in dedicating several additional hours to a focused and comprehensive review.

Following this, we prepare a memorandum summarizing the key aspects of the business, the most relevant risks, our valuation view, and our recommended course of action. The entire team reviews the document and provides feedback. When necessary, additional discussion sessions are held. Finally, we produce a final version of the memorandum, including the investment decision—whether to invest, at what price, and up to what portfolio weight.

We are not proponents of unnecessary bureaucracy, but in stages where the cost of error is high, having structured protocols helps mitigate the natural tendency to overlook details when the overall impression is positive. The discipline of writing down the full reasoning process also improves decision quality. Writing enhances logical thinking, much like working through calculations on paper strengthens mathematical reasoning. As an added benefit, maintaining written records of our analysis and decisions allows us to review past choices and identify areas for improvement.

We believe that sound investment decisions depend on capable people applying robust methods. We focus on the quality of decisions, as the outcome of any individual investment is a poor measure of an investor's skill. Rational and prudent investments can generate negative returns, while flawed decisions may occasionally produce strong results due to randomness. Over the long term, however, we believe that consistent performance depends far more on skill and discipline than on luck.

It is worth noting that our stock selection process is intentionally simple in its structure. Over time, we refine specific aspects of our daily work, but there are no hidden complexities. Many goals in life can be achieved through simple, well-known methods when executed with discipline. These are the types of practices we value: simple and effective.