Americanas and the SUR: Risk or Noise?

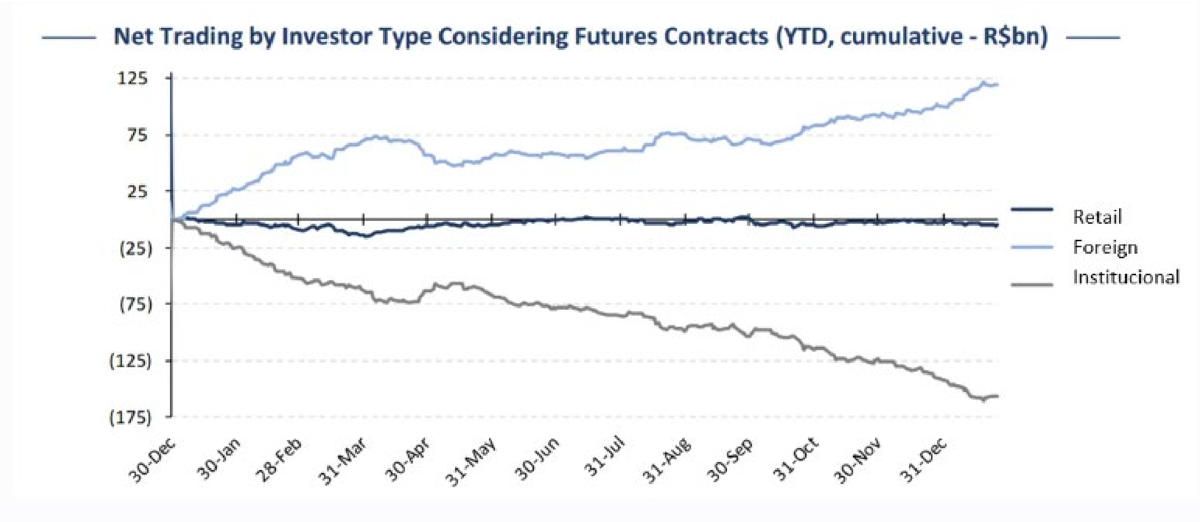
February 2023

Dear investors,

One of the proverbs repeated many times by Charlie Munger, Warren Buffett's partner at Berkshire Hathaway who turned 99 this month, is that "to a man with a hammer, every problem looks like a nail." In his characteristically laconic style, it is a critique of the tendency to view the world in overly simplistic terms, trying to explain everything through very narrow ideas rather than seeking to understand the nuances and complexities of each situation.

With all the turbulence Brazil has been going through, the investing public has been closely tracking every new development, however minor, in economics and politics. We were no exception. We dedicated more time than usual to these topics in recent months. However, we have the impression that newspaper headlines have been receiving more weight than they should in the decisions of Brazilian investors. News events have become the market's "hammers", treated as relevant factors in estimates about the likely economic future even when they are highly speculative or of very limited impact.

Meanwhile, foreign investors purchased approximately BRL 120 billion in Brazilian equities over the past 12 months, sold by local investors. In other words, foreigners are "betting" that the future of our economy will be better than Brazilians themselves believe. Only one side can be right.



Source: BTG (Brazil: Follow the Money)

There is an important detail: the selling by Brazilian institutional investors was not driven purely by their managers' views. Equity and multi-strategy funds experienced BRL 146 billion in redemptions during this period, which forces managers to sell in order to return money to their investors. This selling activity therefore reflects the allocation decisions of Brazil's retail investor base, which is particularly susceptible to the "man with a hammer" syndrome, as these investors devote far less time than professional investors to in-depth economic analysis.

To illustrate how some recent events may have had a greater impact than warranted, we will comment on two cases that drew significant attention last month: the accounting scandal at

Lojas Americanas and the new government's announcement of its intention to create a common currency with Argentina, the SUR.

The Americanas scandal

From time to time, a major fraud case comes to light in the markets. In 2020, it was IRB Brasil. This month, it was Americanas, which, as best as can be determined at this point, failed to record BRL 20 billion in debt on its balance sheets. The case received so much media coverage, with numerous articles explaining what happened and speculating about the company's possible future, that we will assume some prior knowledge and simply share our own observations.

The amount of hidden debt is so large that the company has no chance of survival without a new capital injection. But from a purely pragmatic standpoint, the situation is: tragic for Americanas' shareholders, who saw their investments wiped out overnight; damaging for the company's creditors and suppliers, who will not receive everything owed to them; irrelevant for most of the market, which had no connection to Americanas; and beneficial for competing retailers, who will be able to capture a significant share of the market previously held by Americanas.

The largest of these four groups is the one made up of those who are indifferent or little affected. The accounting hole was enormous for the company, which was worth BRL 10 billion on the stock exchange, but not particularly significant for the market as a whole, where the total set of listed companies is today worth approximately BRL 4.2 trillion. Nevertheless, the topic gained such prominence in financial markets that it even raised the general cost of private credit operations. Banks and credit fund managers suddenly became more conscious of this type of risk (which always existed) and began overestimating its relevance when calculating appropriate interest rates for each loan. There is a completely different episode that well illustrates this kind of exaggerated reaction to a newly materialized risk.

On September 11, 2001, two planes were hijacked by terrorists and flown into the World Trade Center towers in the United States. In the aftermath, the number of air passengers in the United States suddenly fell by more than 30% compared to the months prior. With the memory of the terrorist attack fresh in their minds, fear of flying surged and countless people decided to replace air travel with road travel, a decision that is entirely understandable from a psychological standpoint, but completely irrational. The risk of death in air travel is far lower than in road travel (currently around 18 times lower for commercial aircraft). As a result, the decision to drive, driven by the recent memory of the attack, killed thousands and thousands of people around the world. A tragedy far more silent than that of the people in the buildings that were struck, but just as lethal.

In our last letter, we discussed the difficulty of maintaining rationality even when it points in a different direction from what feels intuitive. It would certainly have been uncomfortable to board a flight while seeing images of the planes involved in the terrorist attack on the front page of every newspaper, but it would still have been the rational decision. One of the most important skills an investor can cultivate is the ability to act in accordance with what makes sense, rather than in the way that is psychologically most comfortable.

One final observation about Americanas before moving on: avoiding an investment in the company did not require detecting the fraud, something very difficult to do from the outside. It was enough to notice that the company had posted losses in 9 of the last 10 years and had relied on successive capital injections to remain solvent. These are not the traits of a good business.

The SUR fantasy

On his first diplomatic trip to Argentina, the new president announced the possible creation of a common currency to facilitate commercial transactions in Latin America, with the suggested name of SUR. The episode caused some initial stir, but reverberated far less in the market than the Americanas case, we suspect because a broad consensus of specialists concluded the plan was unlikely to leave the drawing board. In our own analysis of how a project of this nature might evolve, we sought to understand at what stage Mercosur stood relative to the history of the European Union.

In 1957, the European Economic Community (EEC) was established: the economic bloc that preceded the European Union and was born already enshrining free trade and labor movement among its member states. Thirteen years later (1970), a group was created to draft a plan for monetary unification among member countries, whose implementation was initially frustrated by the complexity of aligning multiple currencies amid exchange rate instability. Only nine years after that (1979) did the European Currency Unit (ECU) emerge, a book-entry currency used for financial transactions between countries in the bloc. The ECU evolved into the Euro 20 years later (1999), and the adoption of the Euro as a circulating currency took a further three years (2002).

If we equate the recent announcement of an intention to explore the creation of the SUR with the formation of the European study group in 1970, and follow the same timeline from that point, the SUR would be born in 2032 as something akin to what the ECU was and would become a common circulating currency in 2055. Even with genuine political will now, there are so many complexities and obstacles that it would be virtually impossible to implement something like this within a single presidential term. It would therefore require the support of consecutive governments in both countries for it to ever materialize. It may never happen.

This brief historical overview is already sufficient to dispel concerns about any short-term impact from this project. Given the flood of criticism the idea received, it is possible that the new government will not even want to spend political capital pursuing it further.

The world loves novelty

The risk of following economic and political events too eagerly is gradually losing sight of the bigger picture. In the desire to account for every new development, one can start to forget about the structural factors that evolve slowly but have greater impact.

In our letter published in November, we discussed the positive impact that the trend toward decentralizing production chains, currently very dependent on Asian countries, could have on Brazil’s economic development. Along the same lines, the plan to decarbonize the economy could make Brazil’s energy matrix, which is far cleaner than average, an attractive proposition for new investment in our country. These factors will remain valid over many years, but tend to be forgotten by the general public, giving way to the latest news, however less significant it may be compared to older developments.

Although news events affect stock prices in the short term, long-term price movements are far more correlated with the financial results generated by each company. It therefore requires a constant effort to remain cool-headed and skeptical in the face of current topics, separating what can truly cause a lasting impact from what is merely noise. Particularly when it comes to political agendas, where the noise-to-signal ratio is high.

What do the buyers see?

Looking at the Brazilian landscape from a distance with a broader perspective and less attention to every political storm, our dramas are part of the country's normal reality: Brazil is always going through controversies and scandals. The specifics of the current drama are of little relevance to long-term outlooks. The most likely scenario is that Brazil will continue with the low economic growth it has been delivering for recent decades, a result of confusing legislation, enormous productivity challenges, and an inefficient state.

While this is not a particularly encouraging prognosis, this base scenario is already reflected in current average market price levels. This is precisely why real interest rates are higher and valuation multiples for Brazilian companies are lower than in developed economies. What is motivating the investors buying now, foreign or otherwise, is certainly the current price level, which is well below the averages that already account for our persistently tepid economy. It is a discount that compensates for a significant degree of macroeconomic and political risk.

We have been saying that prices are low for several months now, and the fact that we have yet to see a trend reversal in the market may frustrate those who are more impatient. It is always worth reiterating that the timing of any reversal is unpredictable and may take many more months. We invest with the long term always in mind, not because we enjoy making money slowly, but because we believe it is the safest and most reliable approach available.