The Hard Side of Value Investing

January 2023

Dear investors,

We closed 2022 with a return of -12.0% for the year, compared with +4.7% for the IBOV and -15.1% for the SMLL (small-cap index). The cumulative return since the fund's inception, approximately 9.5 years ago, is 1,163%, representing an average annual return of 30.7% p.a. (vs. 9.2% p.a. for the IBOV):

	Annual		Since Inception	
	Ártica LT FIA	Ibovespa	Ártica LT FIA	Ibovespa
2013	**20.2%**	8.2%	**20.2%**	8.2%
2014	**16.0%**	-2.9%	**39.4%**	5.0%
2015	**-19.7%**	-13.3%	**12.0%**	-8.9%
2016	**50.3%**	38.9%	**68.3%**	26.5%
2017	**151.7%**	26.9%	**323.7%**	60.5%
2018	**98.8%**	15.0%	**742.3%**	84.6%
2019	**33.1%**	31.6%	**1,021.5%**	142.9%
2020	**7.1%**	2.9%	**1,101.6%**	150.0%
2021	**19.4%**	-11.9%	**1,335.2%**	120.2%
2022	**-12.0%**	+4.7%	**1,163.3%**	130.5%

During this period, we maintained our traditional strategy: identifying companies with resilient businesses and strong historical profitability, and buying their shares when the price was attractive. We began our buying season in the last quarter of 2021, when some stocks had reached a price level that already seemed attractive to us, and we continued making gradual purchases up to the present moment.

Knowing today the price trajectory of the stocks we chose to hold in the portfolio, we started buying approximately three quarters earlier than would have been ideal. It does not seem to us that we overpaid for any of our positions, but we would undoubtedly have been better off waiting and buying the same stocks at even lower prices than what we initially paid.

Missing the perfect moment is one of the eternal burdens of investors. Since it is impossible to predict short-term stock price movements, it is expected that the execution of purchases and sales will always be suboptimal. Even knowing this, it is always uncomfortable to calculate how much better the execution could have been.

On that candid note, in this letter we will discuss the challenges of investing according to a truly fundamentalist, long-term philosophy, and what we believe is required to do it successfully.

Macroeconomic uncertainty

When we read today's headlines, things can seem worrying at first glance. In Brazil, the new government has shown little concern for fiscal responsibility, increasing spending beyond the expenditure ceiling without clear offsetting revenue measures which could result in a rise in the public debt-to-GDP ratio, already at quite an elevated level for an emerging market country. Globally, the major economies are showing signs of slowdown, driven by tighter monetary policies from central banks following years of near-zero interest rates. In addition, international economic relations are being reassessed in the wake of geopolitical conflicts around the world, which could lead to a reorganization of supply chains that prioritizes political stability and predictability over economic efficiency and productivity.

Yet we have been through far worse periods, and even so, equities delivered strong gains in the periods that followed. Newspapers are full of explanations about what is happening in the economy, but understanding the logic of the past is far easier than predicting the future. We are quite skeptical about the possibility of forecasting macroeconomic movements, especially given the number of random factors that affect the economy over time. No one foresaw the pandemic or the Russia-Ukraine war two of the main sources of today's macroeconomic problems.

As a rule, economists label these events as non-recurring and explain that their projections would have materialized had these extremely rare occurrences not taken place. But the question is not how often a pandemic or a geopolitically significant war occurs, but rather how often any kind of unforeseeable event with meaningful economic impact takes place.

Random factors can be both bad and good. Sometimes a new technology emerges that enormously boosts productivity in a given sector. In other cases, a weather event results in a country having an excellent harvest while others suffer very poor agricultural output. The country with abundant crops may benefit from GDP growth, a favorable trade balance, and currency appreciation through no merit other than being in the place where it rained just enough. This alone illustrates the difficulty of working with macroeconomic projections. For additional evidence, in our February 2022 letter we analyzed the accuracy of macroeconomic variable forecasts in the Expectations System compiled by the Central Bank of Brazil. In short, it falls far short of impressive.

How to deal with uncertainty

Being aware of unpredictability is better than harboring the illusion that the future is foreseeable. If you had to choose a vehicle for a 100km race over unknown terrain, you would be better off choosing a horse which can travel anywhere than a Ferrari, which only works on pavement. Depending on the track, you might not finish first, but you will finish the race.

The essence of an investment selection strategy is the same: without knowing what we will have to navigate, the best decision is to favor investments in companies capable of continuing to operate across a wide range of possible scenarios. This requires that their businesses either be adaptable to different macroeconomic environments or operate in naturally stable market segments.

Drawing from our own portfolio, Multi is an adaptable business: its expertise lies in importing finished products or components (particularly from China), assembling and distributing them in Brazil, and it is reasonably agnostic about which products those are. The company today handles more than 7,000 items, with a portfolio profile quite different from what it was 5 years ago. Our thesis depends more on Multi's competence in continuing to execute its cycle of selecting, importing, and selling new products than on the specific performance of the company's current product lineup.

Whirlpool, manufacturer of the Brastemp and Consul white goods brands, is an example of a business operating in a stable market. The white goods sector evolves very slowly from a technological standpoint (consider how much your refrigerator has changed in the last 10 years), where brand is a highly important factor in consumer purchasing decisions and cost efficiency depends heavily on scale. As a result, few companies dominate this sector worldwide, and we have seen no major changes in the organization of this industry over recent decades.

The hard side of this strategy is that businesses with this profile will not always deliver the best performance relative to other possible investments. In 2022, several commodity-linked companies outperformed our portfolio, but we resisted investing in those sectors because the risk associated with future commodity price declines seemed significant to us. In our imaginary race, if the first 50km were paved road, you would hate yourself for having chosen the horse and would only feel vindicated when a river appeared in the course.

Although our two examples did not have their best year in 2022, they are solid businesses that continue to generate profits even in this difficult environment and are well positioned to expand their results when the economic backdrop recovers. That improvement will certainly come, even if we do not know exactly when, since the cyclical nature of the economy is well understood. The question you may be asking yourself is: why hold or buy stocks during a down cycle, rather than waiting for the crisis to pass? Excellent question.

The pain of buying in a downturn

We like to buy stocks at prices significantly below what we believe they are worth. This is only possible during down cycles, amid bad news and widespread market pessimism, when some investors lose confidence in companies and decide to sell their shares at any price. No one is willing to sell us shares at steep discounts when the macroeconomic environment is positive, the company is posting excellent results, and market sentiment is buoyant. Buying very cheaply requires facing negative scenarios head-on.

Some argue that the trick is to wait for the market to start recovering before buying but this advice is about as useful as the recommendation to buy low and sell high. It would obviously be a good tactic, if it were possible to know exactly where we are in the economic cycle today and if no one else in the market had the same awareness. In real life, the opportunities to buy at very depressed prices disappear once macroeconomic uncertainty clears. It is precisely this problem determining the exact timing of economic cycles that makes us long-term investors.

It is easier to estimate with some precision how much it will rain over the next 5 years, based on historical rainfall averages over time, than to reliably forecast how much it will rain in a specific week several months from now. Similarly, it is easier to estimate that a company should generate a certain level of results over 5 years than to correctly predict its results for a specific quarter. For this reason, our investment theses assume we will remain positioned for a long period, making it likely that we will navigate through both favorable and unfavorable macro environments. With the expectation of riding out the full cycle, it is far more advantageous to buy during periods of stress, when prices are lower, and to have the patience to wait for conditions to improve. It sounds simple, but it is harder than it appears.

Resilience through declines

It is rare to be lucky enough to buy at the exact moment when the price trend is reversing, such that the stock only rises after your purchase. When buying in the midst of crises, it is more common to watch the stock continue declining for some time. This demands both analytical skill and a healthy dose of psychological resilience.

On the analytical side, doing solid work to assess the true value of the company you have invested in is what gives you the conviction to stay positioned in a thesis. If you know something is worth around 100, you bought it for 70, and you see the price fall to 50, you may regret not having waited longer to buy it all at 50 but you have the comfort of knowing that 70 was still a good price (this example summarizes our current situation). Without that reference point for true value, investing would become an agonizing game of chance.

Even with that analysis in hand, staying invested means watching prices fall day after day, amid a flood of negative news and countless voices saying this is one of the worst crises in history and there may be no recovery because “this time is different.” Not being shaken by emotional excess and remaining purely rational during these periods is a test of discipline and temperament. One must step back from the day-to-day and look backward, to understand how history has unfolded through other crises. The reasonable expectation tends to be far less extreme than what newspaper headlines proclaim: there is always something different about each situation, but the same economic cycle dynamics have been observed countless times. As Mark Twain said, “History doesn’t repeat itself, but it rhymes.”

This practice becomes easier with time. Today, after nearly 10 years of investing through Ártica Long Term, we tend to embrace periods of crisis precisely because they are the moments when we can invest in new theses at deeply depressed prices.

The urge to act

Executing a fundamentalist, long-term investment strategy is also difficult because our instincts are wired to react quickly to each new stimulus in the environment, not to navigate through a cycle that unfolds slowly over many years.

In times of turbulence, the temptation is to move too much. A large number of investors nervously reshuffle their portfolios in response to every new headline. Constantly repositioning can even appear diligent, since incorporating new information into analysis is part of the job but not every day brings something that will genuinely affect the long-term outcome of a thesis. In most cases, the impact of news is overestimated and unnecessary moves are made, rendering the investment strategy incoherent and increasing transaction costs.

Doing nothing is not easy when it runs against our impulses. Calmly waiting for market turbulence to pass watching the desperation and frantic movement of the market requires a form of self-control analogous to that needed for dieting. Losing weight is theoretically simple and requires no action: just stop eating. The hard part is sitting still while hungry.

The way to counter instinctive impulses is to trust in pure rationality. We know that a country’s economy depends on such a vast array of agents, has such complex governance, and is affected by so many random events that it is not easy to deliberately steer it in any given direction for better or for worse. Short of the major events that occur from time to time, things tend to change slowly. There is therefore a certain dissonance in abruptly changing one’s view of the future at every turn.

Scarcity of feedback

Another difficulty experienced by long-term investors is the small number of feedback signals they will receive over the years about their own investment theses. Unlike learning to play a musical instrument where every mistake is immediately apparent and another attempt can be made right away an investment thesis can take years to prove itself right or wrong. A fundamentalist investor will typically execute only a few dozen theses in an entire career. As a result, the opportunity for empirical learning is quite limited, making trial and error a poor method for learning to invest.

Investing well requires an almost academic life of continuous study and a conviction derived from accumulated knowledge and rationality which is different from the conviction we have when executing something we have done hundreds of times and seen produce the same result repeatedly. It is necessary to maintain this “academic conviction” so as not to let the instinctive side prevail at critical moments, and to be capable of continuing to act in a rational and consistent manner. Napoleon Bonaparte said that military genius was the capacity to behave in an ordinary way while everyone around you was losing their head. We believe this same logic applies to the world of investing.

Outlook for Ártica Long Term FIA

We purchased the majority of the shares we currently hold over the past 5 quarters, moving against the broader market. We are aware of the current macroeconomic risks (we explored some of them in our last 3 letters) but, having bought our shares at such low prices, we have good return prospects even if the economic environment takes several years to recover.

Since there is still considerable uncertainty regarding the new government particularly the impact its policies will have on the interest rate curve it is not clear whether we will see any recovery over the course of 2023. However, Brazil has gravitated toward centrist policies for several decades now, so we continue to treat this as our base case. The public’s own reaction to unorthodox government moves tends to steer it toward a more moderate course of action.

In any case, we will remain attentive to the evolution of the country’s economy, monitoring whether the deterioration forecast by so many will actually materialize without allowing ourselves to be influenced by the political extremism that has persisted since the presidential campaign period.

We remain confident in the quality of the companies we hold in our portfolio today and in the return potential they carry. As our greatest act of conviction, we made a substantial volume of new capital contributions of our own to Ártica Long Term throughout 2022, joined by several people who have been investing with us for some time and some new investors whom we had the pleasure of welcoming. While numerous equity funds experienced massive waves of redemptions, Ártica Long Term closed the year with approximately BRL 70 million in net inflows.