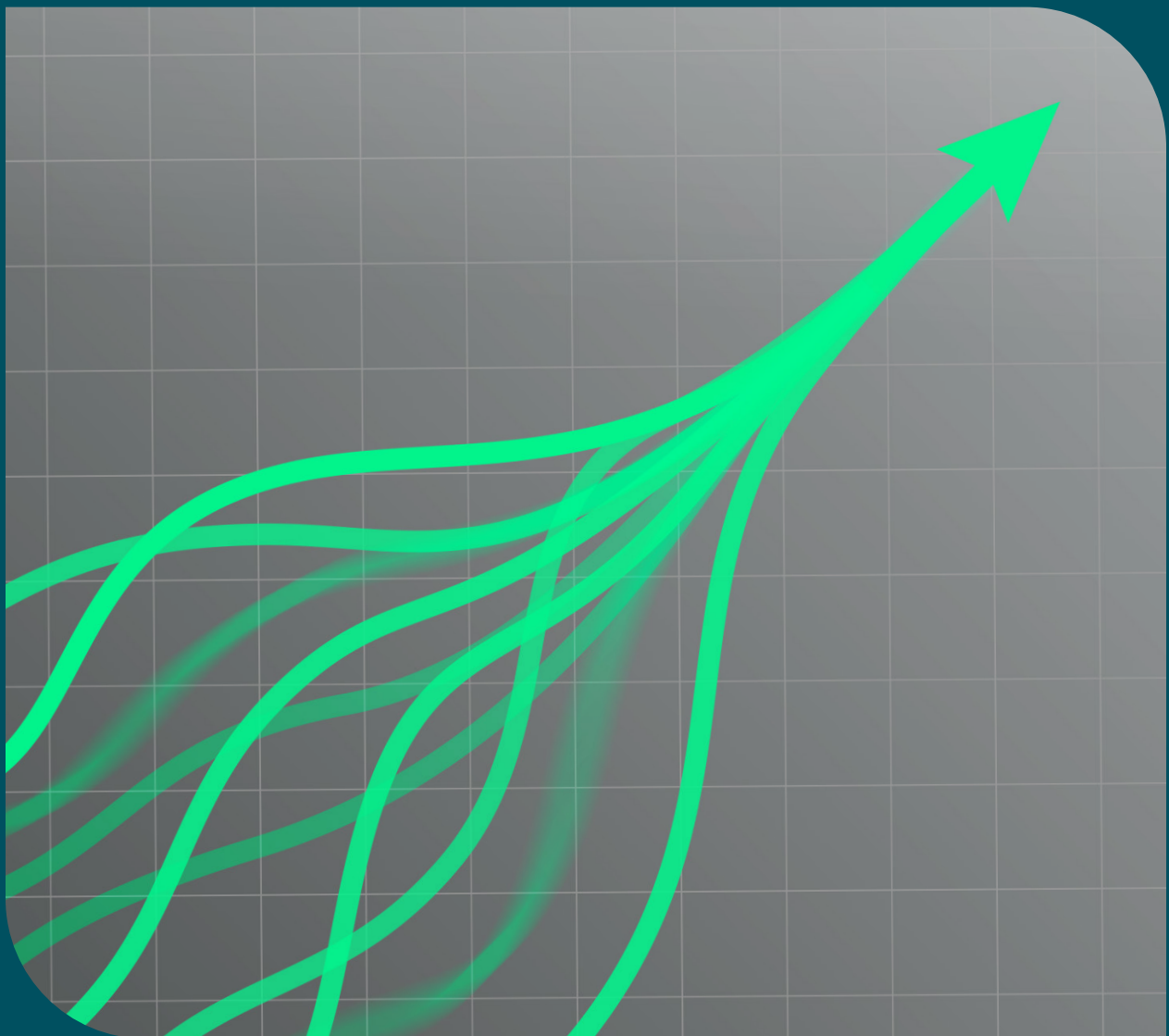


Fish where the fish are: The philosophy of quality.



Management Report

JAN-APR 2021

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2020 was an important test for every asset manager. It showed, once again, that without a robust investment philosophy, an investor will struggle to make good decisions in the midst of an acute crisis.

Recently, we came across an interview¹ with Chinese-American investor Li Lu, in which he describes the evolution of his investment strategy, with which we closely identify.

We are taking advantage of this recent calm in the storm to briefly tell his story, elucidate its similarities to ours, and explain the reasons which have led us to focus exclusively on high quality businesses.

Similar stories

Li Lu is Charlie Munger's go-to guy when it comes to investing in Asia. Founder and manager of Himalaya Capital, Li Lu is originally from China, but was educated in the mid-1990s at Columbia University, the home of value investing.

Li started investing according to Benjamin Graham's principles. He used to buy "dollars for fifty cents", i.e. companies that were cheap relative to their assets and immediate profits. He was indifferent to the nature of the business, as long as the discount was attractive.

Although he was fairly successful, Li gradually adapted his investment strategy to match the opportunities he identified.

First, he realized that he could better understand and find more share price discrepancies in small businesses. He decided to focus on this niche for a while, taking a hands on approach to the management of a few companies.

As his experience grew, he realized that the biggest returns came not from the cheapest businesses, but from those that generated the most value over time. No matter how big the discounts were, they were no match for the returns generated by the high-quality compounders.

Looking into these stories, Li noticed a pattern: these businesses achieved high returns on invested capital, were largely protected from competition, and had ample reinvestment opportunities. He also saw that it was possible to identify these characteristics over time, earning excellent returns even if there was no obvious discount at the time of purchase.

On the basis of these conclusions, Li expanded his scope to include companies of all sizes and regions – as long as they were extraordinary businesses.

Li's story is not unique. Munger, Buffett, and a series of other extraordinary investors have made a similar transition in their investment processes, moving from a preference for statistically cheap businesses to an obsession with exceptional ones.

Our story was no different. We started with the same traditional value investing principles pioneered by Graham, bringing to the Brazilian market the already successful method used by great investors in the American market.

It didn't take long for us to realize the importance of business and management quality. In the highly unstable environment of Brazil in the 1990's, opportunities in weak – but quantitatively cheap – businesses often resulted in unexpected value destruction. Only the strong businesses endured.

Our search for quality in a Brazil of state-owned and commodity focused enterprises also led us to small businesses, where, in some cases, we participated more actively with their management. As the local market developed, bringing better businesses to the stock market, we moved on to larger companies.

Gradually, we started studying businesses abroad, initially to complement our analysis of local companies. We closely followed the most exceptional businesses and management teams we could find. After a while, we came across some of the best investment opportunities we had ever seen, and soon decided to invest. As time went by, it became increasingly clear to us that the highest returns came from the companies that could compound their capital at high rates over very long periods.

The value dynamic

Discrepancies between price and value exist in any kind of company, from the best businesses to those on the brink of bankruptcy. As such, we are often asked why we devote our time exclusively to exceptional companies. We do this because of focus. We are certainly missing out on opportunities in ordinary companies, but we are convinced that the greatest value discrepancies are to be found in the best businesses.

Our preference for high-quality companies has many nuances, but can be summarized as follows: exceptional companies have qualitative characteristics that allow them to better protect their existing value and create new value over time. This value dynamic is the most important driver of long-term returns, but is recurrently underestimated by the market, which seeks more tangible and immediate discrepancies.

Any estimate of a company's intrinsic value depends on future cash flows, which in turn depend on assumptions that develop as the company and the competitive and economic environment change. The investor is always chasing a moving target.

For most companies, the growth in value is volatile and unpredictable. We have experienced several such situations. For instance, we once invested in apparent opportunities in the real estate development sector. We chose the most competent and reliable people we could find, studied their operations and portfolio in depth, and carefully estimated the rate at which the properties would sell. We were confident that we had found an attractive discrepancy between price and value. That is, until the economic cycle changed. Demand waned, contracts were scrapped, and the property values we had estimated plummeted.

What we have learned from this and countless other stories is that, no matter how good the analysis, most businesses are highly susceptible to unpredictable changes in value, which are predominant in dictating long-term returns.

A small number of exceptional businesses behave differently, though. They have a remarkable ability to withstand economic shocks and competitive attacks, operate in markets that present ample opportunities for innovation and reinvestment, and count on visionary managers that are capable of leading huge transformations. The value of these attributes is often not visible in the companies' current projections, but it exerts enormous influence on the growth of the business and, consequently, on investment returns.

A frequent example is Amazon. The company had been showing signs of these characteristics since it was a small online book retailer. Some pioneering investors identified such qualities early on, but even they could not imagine the unprecedented proportions the original business would take on – let alone that the company would invent a cloud computing business whose value would rival that of the e-commerce segment.

Amazon is undoubtedly a huge outlier, but it exemplifies a frequent phenomenon: exceptional businesses with exceptional people are able to compound their value consistently over much longer periods than what is typically implied by market prices.

The advantages of quality

Exceptional businesses present at least four major advantages:

1. Time is on your side: The long term only benefits the investor if the value of the business increases over time. The investor who spots a price discrepancy in an ordinary business hopes that the share price will promptly rise to the intrinsic value he has estimated. The more time passes, the longer they take to realize the forecast return, and the more exposed they are to uncontrollable risks. The investor in an exceptional business, on the other hand, may be almost indifferent to the stock price trajectory, since business value is increasing with time.

2. Knowledge also compounds: An investment in an ordinary business needs to be immediately replaced once the discrepancy between price and value is eliminated. An investor that is solely focused on exceptional companies can gradually acquire knowledge over time – reinforcing convictions that are likely to have a long shelf life rather than diluting his studies in countless short term cases.

3. Potential returns are higher: When a company is truly exceptional, the returns far exceed any share price discrepancy that can be found in an ordinary business. Companies such as Berkshire Hathaway, Google, Lojas Renner, Localiza, and so many others are examples that have compounded value year over year for decades, multiplying investors' capital tens or even hundreds of times. Those who correctly identified the potential of these businesses were highly rewarded.

4. There is less risk: Major capital losses occur mostly when the business suffers irreparable damage. Exceptional companies are, by definition, those best protected against competitors, disruptive technologies, poor governance, and other factors that can destroy value. A portfolio of exceptional companies can be both more concentrated and safer than a portfolio of ordinary companies.

"Fish where the fish are"

Many investors fully understand the advantages of the businesses we mentioned above. Still, most choose to follow a broader strategy, weighing up opportunities in all kinds of businesses. It is the so-called "there is a price for everything".

The problem is that it is impractical to analyze all the investment alternatives that exist. Every investor filters the universe he or she is going to analyze. Usually, the applied filter is geographic. Investors decide to become specialists in stocks from a certain region and commit to outperform the returns registered by the local index.

We have chosen to apply a different filter, based on the quality of the businesses. We understand that if our objective is to generate the best risk-adjusted returns, our filter should only be geographic if we believe that the best opportunities within our reach are restricted to Brazil. This is not the case.

There are many more exceptional companies in the world than we can possibly know about. Our effort is to systematically expand our scope and gather as much information about these businesses as possible in order to seize the best opportunities – ignoring geographical boundaries. For us, it makes no sense to invest time in ordinary companies until we have exhausted the opportunities to be found in exceptional ones.

The Price Factor

Just because we believe that exceptional businesses consistently generate value and represent the best opportunities does not mean we are indifferent to price. Any business, no matter how good, can reach an unjustifiable price.

Setting that price can be a major challenge. Companies with steep value generation curves naturally present a greater number of optionalities and therefore a wider distribution of possible outcomes. The market often identifies the potential of these businesses and prices them well in advance, building huge expectations.

The challenge is that these expectations do not always prove to be exaggerated. We have frequently underestimated the value creation of our investments. In Microsoft, for example, we captured a significant repricing in the company starting mid-2010, but divested at the end of 2016 because we thought the prices fairly reflected the value of the business. Further performance took us by surprise and we subsequently reinvested – at a higher price.

There is no formula for pricing a business's future growth in value. Investing is far from an exact science in this respect. Each case has unique characteristics that must be identified and pondered in order to generate superior decisions.

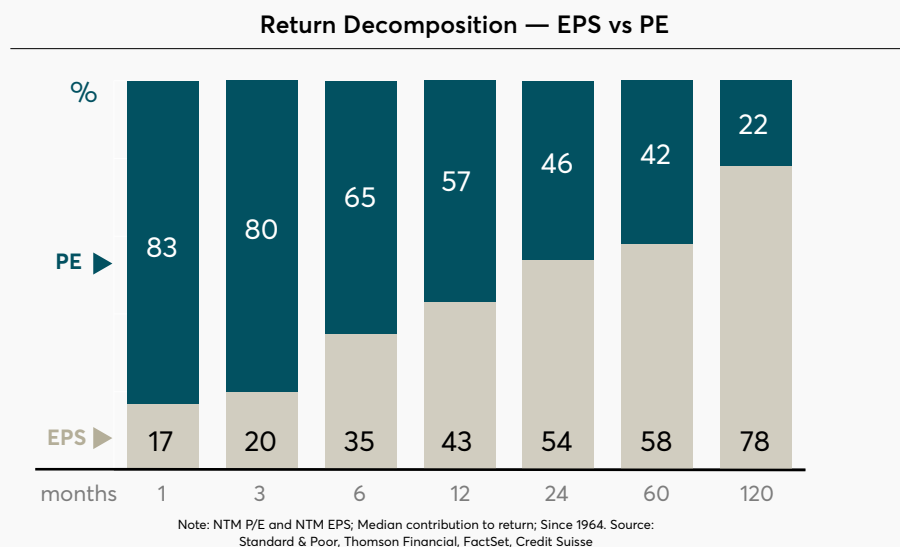
Hard as it may be, it is fundamental to be disciplined on price. Without it, the investor cannot truly understand the size of the opportunity, embedded expectations, and the risk he is running. At times, the investor will certainly miss out on part of the value generation, as was our case with Microsoft. On the other hand, he will avoid permanent losses in situations of real overpricing

Inescapable Arithmetic

Stock returns can be broken down into the growth in earnings per share and the change in the earnings multiple at which the stock trades. A recent Credit Suisse study analyzed the historical relevance of these factors in the U.S. market since 1964, comparing the median contribution of each factor to returns, according to time invested.

As time passed, the relevance of the multiple paid ("PE" in the chart above) decreased and the relevance of earnings per share ("EPS") growth increased. In other words, the contribution from changes in multiples was diluted over time, while earnings per share growth accumulated year on year.

The following table shows the annualized returns on an investment over a 5-year period, according to different earnings per share growth rates and multiple declines:



MULTIPLE COMPRESSION AFTER 5 YEARS

		0%	-10%	-20%	-30%	-50%
Annual earnings per share growth	10%	10%	7.7%	5.5%	2.4%	-4.2%
	15%	15%	12.6%	10.0%	7.1%	0.1%
	20%	20%	17.5%	14.8%	11.7%	4.5%

Note how in the case of a company that grows its earnings per share at a rate of 20% for 5 years, even with an expressive 30% multiple compressions, the investor still achieves an annualized return of 11.7%.

The dilutive impact of multiple compression, and consequent preponderance of earnings per share growth in returns, becomes increasingly clear as we stretch the calculations to a 10-year horizon, as the following table shows:

MULTIPLE COMPRESSION AFTER 10 YEARS

		0%	-10%	-20%	-30%	-50%
Annual earnings per share growth	10%	10%	8.8%	7.6%	6.1%	2.6%
	15%	15%	13.8%	12.5%	11.0%	7.3%
	20%	20%	18.7%	17.4%	15.8%	12.0%

Notice that the investor who eventually paid an outsized multiple on a company that was able to compound its earnings per share at a 20% rate, even after the drag caused by a 50% multiple compression, was able to take home a return of 12% per year.

The conclusion of this simple arithmetic is that, given a realistic entry multiple, the major determinant of long-term returns is earnings growth. Exceptional businesses fit this context as those that best allow us to create long-term conviction on future earning power.

Quality is not growth

It is important to separate the concept of a high-quality business able to compound in value from the concept of growth companies, typically characterized by high rates of revenue growth and optimistic valuations that are often difficult to understand.

Growth companies, nowadays most commonly technology platforms, have once again become popular in recent years thanks to their high stock returns. Such companies have experienced a period of strong growth, but the returns have also been marked by relevant multiple expansions. The anticipation of expectations is a recognition of both the potential of these businesses as well as the digital acceleration caused by the pandemic.

We understand that the business models of some of these companies are among the best ever created. Many of them grow without capital requirements, distribute their products at zero marginal cost, are able to quickly scale in huge markets, have global reach, recurring revenues, and enjoy substantial network effects that protect them against competitors. It is every entrepreneur's dream.

But high growth does not equate to high quality. Some of these companies are still much more vulnerable to competition than their valuations imply. Others don't have the right leaders, culture and incentive structure required for long-term value creation. And some have sold an unlikely pipe dream to investors and are attempting to aggressively buy their way to growth in the hope of one day achieving sustainable economics.

At the other end of the spectrum are the more traditional businesses, which grow less and trade at lower multiples. The fact that they aren't exuberant growers doesn't mean that they are not high-quality companies. Value curves are usually less steep in this category, but they can be much safer, a reflection of more mature and established businesses.

Some of our highest quality investments are in this category. Berkshire Hathaway, for example, is often earmarked as a dull company amid so many exciting growth stories. The businesses owned by the company are highly resilient and earn above-average returns on the huge capital invested, but that didn't stop its stock from trading near its book value last year, which equated to an implied multiple of about 7x the earnings of its private subsidiaries. So far, the stock has risen close to 25% this

year, and the 3 to 6-year annualized returns are in the 12% to 15% range. Our type of investment: attractive returns with an enormous margin of safety.

That doesn't mean we don't like growth companies. Netflix, for example, is a company that was burning cash until recently, reports modest profits, and trades at fairly high multiples. We believe this is not a reflection of a bad business with high expectations, but of a company that has been emphatically investing for over a decade in building a lasting competitive advantage that will prove insurmountable, and is now reaching an inflection point in the economics of the business. We foresee a very different financial reality for the company in 5 and 10 years, which should provide solid returns based on current prices.

There are even investments that we are unable to pigeonhole, such as Google and Facebook. Both companies are expected to grow in double digits for the next several years, have undeniably exceptional businesses, and possess huge optionalities, yet trade at very reasonable multiples, close to 20x earnings. Are they value or growth investments?

We are, therefore, entirely indifferent to categories such as growth and value, as well as any others that do not capture a clear distinction of attractiveness for investors – small and large, local and international, traditional and digital, and so many more.

The discipline dilemma

“Successful investing professionals are disciplined and consistent and they think a great deal about what they do and how they do it.”

– Benjamin Graham

At the core of a value investor's education is the concept of discipline. It was fundamental in the foundation of IP's values in 1988: Ethics, Transparency, Rationality, Discipline and Patience. To successfully navigate incessant market fluctuations, it is essential to keep a cool head and follow a well-established methodology. Changing approach in the midst of cycles is a recipe for disastrous investment decisions.

The problem is when discipline and consistency turn into dogma and stubbornness. It's when the value investor refuses to look for opportunities among fast growing,

high multiple companies, or when he refuses to learn about technology businesses because his idols overlooked them.

The secret to investor longevity is the ability to balance discipline with adaptability and healthy skepticism with continuous learning. Like Li Lu, we have come this far not only thanks to the diligence with which we apply our philosophy, but also because we have evolved in the face of the changing nature of the companies and opportunities available.

We will remain alert and open to further reassessing and refining our choices.

Miscellaneous

“

What's dangerous is not to evolve.”

— Jeff Bezos

“

The world wants you to be typical – in a thousand ways, it pulls at you. Don't let it happen”

— Jeff Bezos

“

I started out looking for cheap securities... Over time, I really fell in love with strong businesses. I morphed into finding strong businesses at bargain prices. I still have a streak in me that favors finding really cheap securities - I just can't help it. But over time, I've become more attracted to looking for great businesses that are inherently superior, more competitive, easier to predict, and with strong management teams.”

— Li Lu

“

I know of no better hedge against an uncertain world than owning a well-selected basket of common stocks in high quality businesses at deeply discounted prices (under normal circumstances) and ignoring the unknowable and the uncontrollable.”

— Li Lu

“

If you’re moving to Florida, would you call a realtor and say ‘give me the cheapest neighborhood’? [No, of course not.] Why do we do that in stocks?”

— Rajiv Jain

“

Our primary frontier of risk management isn’t wide diversification, but the quality of the individual businesses, their balance sheets and the people who run them.”

— Chuck Akre

“

When we think about companies, the overriding analytical consideration is the quality of the business and quality of management’s capital allocation decisions. The longer investors own shares the more their outcome is linked to these two metrics.”

— Nick Sleep

“

Quality counts. If you are a long term investor, it’s hard to find a more important factor as to what will power your ultimate investment returns. That said, quality is impossible to measure with precision because it often embodies more subjective qualitative factors than easily quantifiable measurements. Quality is also dynamic and changes over time.”

— Tom Gayner

“

Quality is forward looking. Today everyone talks about buying quality at sensible prices, but you have to be sure you're not overly anchored to backward-looking quality.”

— Rajiv Jain

“

Put simply, we can only expect quality to outperform, firstly, if ‘quality’ incorporates characteristics that should lead, if sustained, to superior long-term compounding of intrinsic value, and, secondly, if this superiority is not already captured in valuation.”

— Marathon Asset Management

“

If we are delighting customers, eliminating unnecessary costs and improving our products and services, we gain strength... On a daily basis, the effects are imperceptible; cumulatively, though, their consequences are enormous. When our long-term competitive position improves as a result of these almost unnoticeable actions, we describe the phenomenon as ‘widening the moat.’

— Warren Buffett

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In my view, widening the moat is more important than the width of the moat. Everyone is attacking a company's moat, so the question is not how wide it is, but whether it is widening at a faster pace than competitors are filling it up. Innovation is central to the idea of widening a moat.”

— Robert Vinall

“

A great company keeps working when you're not. A great company will eventually earn more and more and more while you're just sitting and doing nothing. And a mediocre company won't do that. So you're harnessing a long range force that will help you. It's very important. These mediocre companies, they by and large are going to cause a lot of agony and very modest profits. If you do fine, you've got to sell it and find another one. It's a lot of work. Whereas you just buy one great company, and if you get the right thing at the right price, you just sit there.”

— Charlie Munger

“

We have become more quality focused in our choice of companies to invest in. When I started investing we'd look at anything - a bank, a miner, a steel company - all sorts of things. Over the years I realised there's good companies and bad companies and I became more discerning about what was good and what was bad. I realised good is better. We've become much more quality conscious, focused on quality compounding. [We've become] less of an activist because good companies generally tend to be well run as well. We do less activism and let the quality of the companies do the work.”

— Chris Hohn

“

One lesson that has been very slow for me to learn but I get more and more appreciation for is it's far better to buy a good business at a fair price than a fair business at a good price. I started life as a bargain hunter and I'm still a bargain hunter and I've learned to appreciate that. The transition I've made is I don't want to buy pure bargains that much anymore. I'm more interested in moats that are at bargain prices, but it's probably another level of evolution to be able to buy moats which don't appear to be cheap but may in the end be wonderful. If I was talking to my younger self that's what I would tell him is to look for the great businesses. The Holy Grail from my perspective is that because there are 50,000 stocks, the market does give you every so often great moats at great prices.”

— Mohnish Pabrai

“

As students of the world's best companies we prepare our shopping list well in advance. When volatility strikes, we can act quickly having already spent years (in many cases) researching the companies we purchase. As French microbiologist Louis Pasteur once said, 'chance favors the prepared mind.'

— Jake Rosser

“

Over the long term, it's hard for a stock to earn a much better return than the business which underlies it. If the business earns 6% on capital over 40 years and you hold it for 40 years, you're not going to make much different than a 6% return even if you buy it at a huge discount. Conversely, if a business earns 18% on capital over 20 or 30 years, even if you pay an expensive looking price, you'll end up with a fine result. So the trick is getting into better businesses.”

— Charlie Munger

“

Price is the last thing we look at because we don't want to make a mistake in the business quality or the management quality. Because that is going to be the determinant of your success. If you think back to Coca-Cola trading at 45 times earnings or whatever in the 1960s, had you paid that 45x and just held onto it, your return would gravitate towards the ROE of the business the longer you held it. So over four decades you'd probably still be compounding in the high teens or low 20%s. So if we're going to make a mistake, I want to make a mistake on the price. I don't want to make a mistake on the quality.”

— Brian Bares

“

As students of the world's best companies we prepare our shopping list well in advance. When volatility strikes, we can act quickly having already spent years (in many cases) researching the companies we purchase. As French microbiologist Louis Pasteur once said, 'chance favors the prepared mind.’

— Jake Rosser

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