

“A margin of safety is necessary because valuation is an imprecise art, the future is unpredictable, and investors are human and do make mistakes. It is adherence to the concept of a margin of safety that best distinguishes value investors from all others, who are not as concerned about loss.”

Seth Klarman

In the previous letter, we intentionally introduced various topics in a superficial way to present an overview of how we think and invest. The idea is to use these letters to deepen issues relevant to our investment philosophy and how decisions are actually made. We intend to be able to fulfill this task in the best spirit of "if I were the partner looking from the outside, this is what I would like to know." Furthermore, we will eventually also discuss our understanding of the economic scenario, since the companies do not operate in a vacuum, but are affected by the macroeconomic environment (the less, the better, it is true). In addition to the intention for this letter to be an information channel, we also hope our partners feel free to send us suggestions and criticisms that may be of value for the conduction of the fund.

This time we will look at the margin of safety theme with a little more depth. Its importance for us lies less in the prominent role that it occupies within the Value philosophy, and more on how it is constantly present in our analysis and internal discussions regarding investments and the conduction of LIS.

The margin of safety concept, although being as old as the proper art of investing itself, was only formally introduced in the 1930s by Ben Graham and David Dodd, in their renowned book *Security Analysis*. To put it briefly, the authors argue that the secret of a sound investment is the very existence of the margin of safety, defined as the existence of a significant positive difference between the estimated value of an asset by a diligent investor and its market price. Thus, the investor would protect himself against the loss of capital in case of unfavorable future outcome and errors of estimation of the fair value.

The practice though, as often is the case, proves itself much more complex and intricate than theory suggests. The estimation of the fair value of a company is not a trivial task in the sense that it depends on the evaluation, often times subjective, of a series of quantitative and qualitative variables. The latter are sometimes difficult or even impossible to measure, but they are of no less importance in determining the fair value. For instance, governance issues cannot be worked in a spreadsheet, but represent a real problem in that they can lead to value erosion from minority shareholder's hands, and therefore lead to permanent losses of capital. Margin of safety, therefore, is far from being an absolute concept; on the contrary, it must be seen from different angles. At LIS, we work with margin of safety concept in two basic different ways, depending on the quality traits of the company at hand.

As a rule, under normal market conditions, good companies, those with strong barriers to entry, well-managed and oriented to shareholder value generation are usually overvalued by the market. Whereas companies we conveniently call “second-tier” - business models without obvious competitive advantages but low and controlled risks - may be priced much below the value that a private investor would be willing to pay or sometimes less than its asset replacement value.

We believe that good investment opportunities exist in both cases, but certainly each involves different types of risks and therefore require different approaches. Searching for margin of safety indistinctly may not be of much validity and worse still can lead to poor investment decisions. That is why we have developed different ways of assessing margin of safety, which we believe to be of

enormous value since the opportunities the market presents us with vary greatly in nature and quality depending on the economic cycle and the general mood of the market.

When we believe to be facing a company with strong qualitative attributes, which for us translates mainly into an attractive return on invested capital and resilient results during unfavorable times, we are more likely to pay a somewhat close price to its fair value if we understand chances are pretty good that the company will continue to compound value over time. In these cases, our analysis focuses deeply on understanding the qualitative factors behind its competitive advantages and especially how these factors should hold in the future so that the company may maintain its value generation course. In other words, we evaluate how sustainable these competitive advantages are. And there is no other way than to deeply look into the company and to keep a continuous and restless monitoring of the investment thesis. This is the kind of company which we are happy to partner with for many years.

On the other hand, we believe that there are good investment opportunities, with a large margin of safety, also in second-tier companies, as long as their market value is substantially below what we judge to be the fair value range. In these cases, our analysis focuses much more on valuation from a balance sheet perspective, as well as the assessment of potential value destruction arising from operating and financial losses.

Having the ability and flexibility to switch over between these two types of investment is very valuable for different reasons in our judgment. By broadening the possibilities for capital allocation, we increase the chances of finding good investments with a low probability of capital loss, which in itself is powerfully valuable in order to improve long-term returns. Also, the flexibility to balance the portfolio between investments of different natures allows us to take better advantage of the economic and market cycles, which are especially frequent and vigorous in Brazil.

Performance

Despite the short period since the fund's inception, a lot has happened from an microeconomic standpoint, i.e., from the companies we invested and all the others we monitor, as well as from the macroeconomic point, as Dilma Rousseff got impeached bringing hope for better times to the economy. The stock market, measured by the performance of the Ibovespa index, which works based on anticipation, went up foreseeing a more beneficial scenery, after a long period of overall declines since 2011.

It was in this context and the short span since the beginning of the fund that we initiated and concluded the investment in Grazziotin, having seized a good return. The company fits well and serves as an example of a company that, despite not having strong competitive advantages, has a number of positive risk mitigating factors and was extremely undervalued. These are crucial elements that created the margin of safety.

We already had acquaintance and followed the consistent and successful history of this southern retailer that for years has been delivering solid results and a totally debt-free balance sheet. Due to the gloomy environment of the markets in the first quarter of the year, we took advantage of the shares that were trading at very attractive discount levels and made the investment. Given the strong appreciation of the stock since then, we have disinvested as its price reached our fair value range.

As a final note, it is worth emphasizing that we continue to perfect our processes and grow more convinced of the importance of discipline and consistency in our role as capital allocators to generate

satisfactory long-term absolute returns. However, we will leave this subject to explore in our next letter.

Thank you in advance for having accompanied us so far and for your trust. We are at your disposal to answer any questions or to discuss more about the topics covered herein.

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