ALASKA

ASSET MANAGEMENT

BIANNUAL LETTER

2S2016

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EQUITY STRATEGY

In the second semester of 2016, **Alaska Black FIC FIA - BDR Nível I** returned +46.93%, compared to +4.83% of IPCA+6% (*benchmark*), +6.77% of CDI and +16.89% of the Bovespa Index.

	2S16 (%)	2016 (%)	Since Inception (%)
Alaska Black	46.93%	129.21%	95.44%
Ibovespa	16.89%	38.93%	6.11%
IPCA+6% a.a.	4.83%	12.64%	87.68%
CDI	6.77%	14.00%	67.55%

The performance attribution for the semester, by sector, is shown below:

Strategy	2S16
Consumer Goods	19.60%
Hedge	12.98%
Petrochemical	8.15%
Pulp & Paper	5.83%
Costs	5.24%
Industrial	4.32%
Logistics	3.22%
Sanitation	1.94%
Cash	1.17%
Shopping	0.16%
Arbitrage	-1.39%
Real Estate	-1.60%
Technology	-2.20%
Total	**46.93%**

The fund ended the second semester of 2016 with the following characteristics:

1. Investments and Divestments: In the second half of the year, we divested from four companies, two of them in the shopping malls sector, one in logistics and the last in sanitation. We added seven companies: two in the technology sector, one in the consumer sector, one in the

petrochemical sector, and two companies primarily exporters. We ended the semester with 13 companies in the portfolio.

2. IRR: The expected internal rate of return on the portfolio of companies projected by us rose from 26.37% at the end of the 1st half of 2016 to 29.52% per year at the end of the 2nd half of 2016. This was only possible because we rotated the portfolio towards even more discounted assets.

3. Dividends: In the second half of this year, the fund received approximately R$ 1.236 million in earnings from companies (dividends and interest on equity).

4. Other Revenue: in the 2nd half of 2016, the fund had a positive result of around R$9.823 million in other income/expenses such as share rent, Arbitration/Hedge operations and cash compensation.

In the table below, we show how much the net income and revenues of the companies we invest in represent from the fund's net worth. As we see the fund as a holding company, we see today's portfolio versus the portfolio we had a year ago.

Accounts	2S15	2S16	Variation (%)
Net Revenue	194.27%	**164.88%**	**-15.1%**
Net Profit	2.06%	**3.89%**	**88.7%**

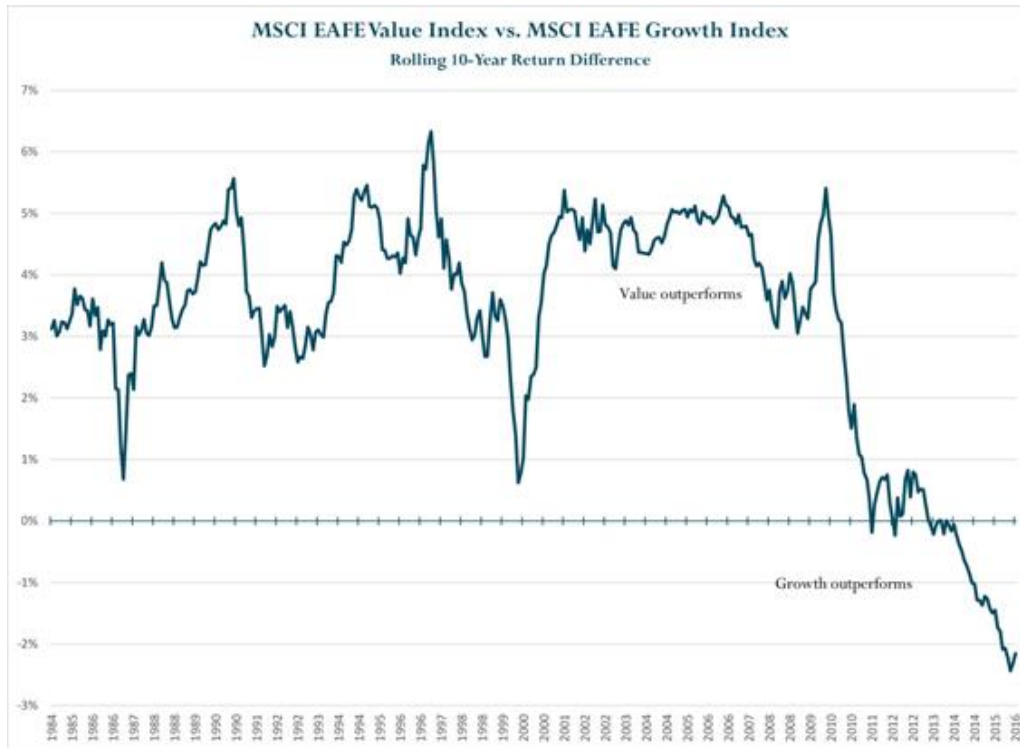
“History does not repeat itself, but it rhymes” - Mark Twain

Howard Marks is one of the best, and perhaps one of the most eloquent, American fund managers. Since he founded Oaktree Capital Management, he has produced, in addition to excellent returns, a series of open letters in which he comments on various topics relevant to the practice of investments. In one it states, "There are two rules we can always rely on: Rule #1: Most things will prove cyclical. Rule #2: Some of the greatest opportunities for gain and loss happen when people forget Rule #1." Market cyclicality is not a new subject for us, we have already mentioned in other letters how a great market cycle unfolds over the years, from the moment of deep depression to the height of euphoria. What we failed to address at the time is the fact that assets do not behave uniformly at these times. Stocks do not all rise together or fall in a coordinated way. Certain stocks, with similar characteristics, plummet quickly in times of crisis and then take off at the time of recovery, while others fall little in crises, however they don't go up as much when the good mood comes back in. One of our jobs is to know why this happens, and how is the best way to take advantage of this typical behavior of the stock market.

We learned through historical data that there is a category of stocks that stands out in relation to the others: the cheap (Quarterly Letter of the 4th Quarter of 2015). But this superiority develops over several years. At certain moments in history, the most expensive stocks (which have a higher growth expectation and/or lower internal discount rates) become even more expensive, and the cheaper ones (which price lower growth expectations and/or higher internal discount rates) become even cheaper, as in the late 1990s in the US.

However, there are good managers of the most varied styles. Seth Klarman, manager and author of the book "Margin of Safety: Risk-Averse Value Investing Strategies for the Thoughtful Investor" always invests in companies considered cheap (also called "value"), with a lot of discount to their equity values, for example. Phillip Fisher, another great investor and author of a number of books, has always looked for companies with great growth potential. Warren Buffett started his career looking for cheap companies, and after his association with Charlie Munger, he went on to invest mostly in companies that we can label as "high quality" or "growth" (high returns on invested capital, high barriers to entry, well-known brands, among others). Despite looking for considerably different characteristics, the three investors have achieved extraordinary success. This is due to the "skill" factor, which we will discuss in future letters.

Although it is possible to have a good long-term performance in all stock categories, we know that their returns can vary significantly in the shorter term. The chart below shows the relative performance over a 10-year rolling window between stocks classified as "growth" and "value" stocks since 1984:



Source: Morningstar

In recent years there has been a huge difference in performance between the two categories ("value" and "growth"), especially in the post-2008 crisis period, when shares of companies with more resilient and predictable results achieved better returns than those that were more dependent of the growth of the world economy. This was mainly due to the combination of two factors that favor companies with more predictable results: great macroeconomic uncertainty, which led to the search for "security", and low interest rates in the world, which favored the shares of companies known as "bond proxies", that is, companies that resemble fixed-income securities (interests fall, prices rise).

In Brazil it was no different, and the effects were further exacerbated by the deep institutional and economic crisis of recent years.

This leads to certain types of behaviors that deepen price distortion across asset categories.

In a crisis environment, the only certainty we have is that there will be a lot of uncertainty. The news will rarely be positive, experts will be pessimistic, and the mantra will be "this time is different". Yes, by definition it will always be different, otherwise there would be no crisis in the first place. The discourse of many funds changes from "delivering superior returns to clients" to "preserving capital at any cost". We are not against preserving capital, after all this is one of the necessary conditions for a good investment. What worries us a lot is "at any cost". This apparently well-intentioned phrase carries a huge cost to the investor, which greatly compromises long-term results.

Public data shows us that funds are increasingly similar in times of crisis. We realize that certain positions, in periods of uncertainty, are shared by a huge amount of funds, while others are practically forgotten by institutional investors.

During this period, the companies chosen by the "crowd" are not selected by chance. These companies are perceived as excellent and fit perfectly into the "high quality" label that we detailed above in the text. Because of this, they are extremely comfortable positions to have in a bad economic climate. No manager will be execrated for losing money investing in Ambev (just one example of a high-quality company), especially if dozens of other managers are too ("social proof", crowd safety, 4th Quarter 2015 Quarterly Letter).

As a company becomes unanimous in investment funds, its price begins to reflect more and more optimism, security or comfort in the market. In other words, a lower implied rate of return expected (Q3 2015 Quarterly Letter). On these occasions, the price can end up far exceeding its fair value and, therefore, it is almost impossible to

find a jewel on the stock exchange that is already present in the wallets of most market participants. Of course, choosing a portfolio of different companies is not enough to be successful. We can name countless companies that are forgotten by the market for good reasons and end up being true "traps". Being different can be painful, especially in environments of heightened pessimism (or optimism). For many investors, the fear of "making mistakes alone" makes many investments out of consensus unfeasible.

"The fact is there is no one kind of investment that is always best. If a particular industry or type of security becomes popular with investors, that popularity will always prove temporary and—when lost—may not return for many years." – Sir John Templeton.

Investing in the safety of the crowd brings comfort, for even biological reasons. Animals gather to minimize the chances of falling victim to predators, for example. However, in the financial market, it is necessary to see who actually benefits from the strategy of investing together with the consensus. In these cases, the greatest protégé is the manager, who "outsources" his responsibility for stockpicking to others of greater reputation. How to be criticized for losing money with a stock portfolio similar to those of the best managers in the country?

"Worldly wisdom teaches that it is better for reputation to fail conventionally than to succeed unconventionally." – John Maynard Keynes.

It is not an exclusive dynamic of the Brazilian market. Literature shows us that "herding", or "herding behavior", is present all over the world, being more intense in bad moments in the market. The reason for this has already been the subject of other letters, and justified by the works of Daniel Kahneman and Amos Tversky. The pain of loss is far greater than the joy of gain. This causes the

market incentive structure to favor group behavior (Quarterly Letter of the 4th Quarter of 2015). Studies show us that, in the long term, the effect of this behavior is negative for the profitability of funds. The big surprise is that both the funds copied and those that copy end up having their returns harmed after the herding. Being copied is something impossible to avoid, and it even works as proof of the competence of the managers in question. However, funds that tend to gather more have worse performance indicators (not just profitability) than those that do not.

In shorter timeframes, the strategy of everyone copying everyone "pays off". Funds do well during crises, they minimize losses on their shares or even post gains, clients are happy with the absence of big drops in shares and investments are easy to justify. With lesser uncertainty, however, it is almost impossible for portfolios with "unanimous" investments to keep up with the rest of the exchange. There are few, if any, additional buyers for these companies that many already have in their portfolios.

"If you buy the same securities everyone else is buying, you will have the same results as everyone else." – Sir John Templeton.

Of course, no crisis brings a light at the end of the tunnel that signals the time to change portfolios and invest in the most forgotten, cheaper stocks. However, we believe that our role is to try to maximize the long-term return on our clients' investments while minimizing risks.

"Time is the individual investor's last remaining edge on professionals. If you can think about the next five years while most are focused on the next five months, you have an advantage over everyone who tries to outperform based on sheer intellect." – Charlie Munger.

For that, we have to diverge from the majority when the numbers show signs of irrational behavior. It is almost impossible to buy an asset at the minimum, but it is important to know when the price starts to give us an excellent margin of safety. The great paradox is that the greatest possible margin of safety occurs at a time when stock volatility is at its peak and appetite at its lowest.

"The time when an asset is selling at its best bargain price is when most people are trying to sell. If you wait until you're through the tunnel and out into the sunshine, you'll have to pay a premium price." – Sir John Templeton.

"Finally, be aware that the market does not turn when market participants begin to see the light at the end of the tunnel. It turns when all looks black, but just a subtle shade less black than the day before." – Jeremy Grantham.

After several years of poor performance, the Brazilian stock market resurfaced in 2016. Those who spent the year looking for positive earnings or cash flows ended the year in surprise. We had already warned in the Letter for the 3rd Quarter and 4th Quarter of 2015 that asset price levels on the Brazilian stock exchange were too depressed. And it was this approach, in the best Walter Schloss style, that guided us in 2016.

Corporate profits can vary greatly according to economic cycles. It is a difficult metric to accurately predict. However, the value of assets, and therefore of the company, varies less and is easier to measure.

To better understand this approach, we propose an analogy between a listed company and a farm. Assigning value to a farm based on profit, or cash generation from its recent or current crops will end up generating some difficulties: (i) was the crop good or

bad?; (ii) did the weather hinder or help?; (iii) has the entire arable area of the farm been planted?; (iv) was the chosen culture adequate? (v) If corn were planted instead of soybeans, would the profit be different? Anyone who values a farm based on its current production can be very wrong.

Suppose there is a farm with productive land, well located, managed by excellent producers and agronomists. These producers, due to the economic crisis and lack of capital, planted only 25% of the arable area. To make matters worse, the weather got in the way with torrential rains, causing irreparable losses in production. Under these circumstances, the profit was only R$ 10 million. Investors looking exclusively for short-term quantitative data will assign this farm a value that will be a multiple of current earnings. Let's assume it's 10x profit, resulting in BRL 100 million of value for the farm, according to these investors. Is this approach the most correct? We believe not. It ignores the full future income potential of that farm, resulting in an undervalued valuation. This methodology could overestimate the same farm if conditions were different. In another scenario, with 100% of planted area, exceptionally favorable climate, at very high commodity prices, the farm could produce R$ 200 million in profit, and that does not mean it should be worth R$ 2 billion.

Several stocks at the end of 2015 fit into the farm analogy. Disappointing current numbers (profit and cash generation), due to low "planted area" (low capacity use), "unfavorable climate" (political environment) and scarce credit. Bad earnings but excellent assets. The market's preference for seeking short-term profits caused many assets to be depreciated, giving us the opportunity to buy them with a large margin of safety.

The big lesson of 2016 was:

“What we tried to do was to buy assets at a discount instead of buying earnings. Earnings can change quickly, but assets don’t.” – Walter Schloss.

And the following sentence is the most famous, simple and effective for every “value investor”, however, it is the most difficult to execute. For those who follow it to the letter, 2016 was an emblematic year:

“Be fearful when others are greedy and greedy when others are fearful.” – Warren Buffett

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