# THE IMPACT OF FX VOLATILITY

Buying high and selling low is seldomly on investor's "How To" tips on becoming successful.

However, unfortunately, that is what frequently happens. We know that we should be greedy when others are fearful and be fearful when others are greedy to use Warren Buffet's expression but, by definition, we tend to do what others are doing. Our limbic system (that controls emotions) has a much greater power over our decision making that we'd like to admit.

Because of this, there is a myriad of studies (Why Average Investors Earn Below Average Market Returns) showing that fund returns are much higher than investor returns. On liquid assets, LPs tend to get in close to the peaks and leave at the troughs. Reasons for this go from the fact that smaller funds tend to outperform larger ones and, thus, as the fund gets bigger its returns dwindle. But, at the same time, there are many more LPs when the fund is big then when it is small. Our herd mentality, confirmation bias are some of the explanations why we opt to get out when others are doing the same rather than when we should really be selling.

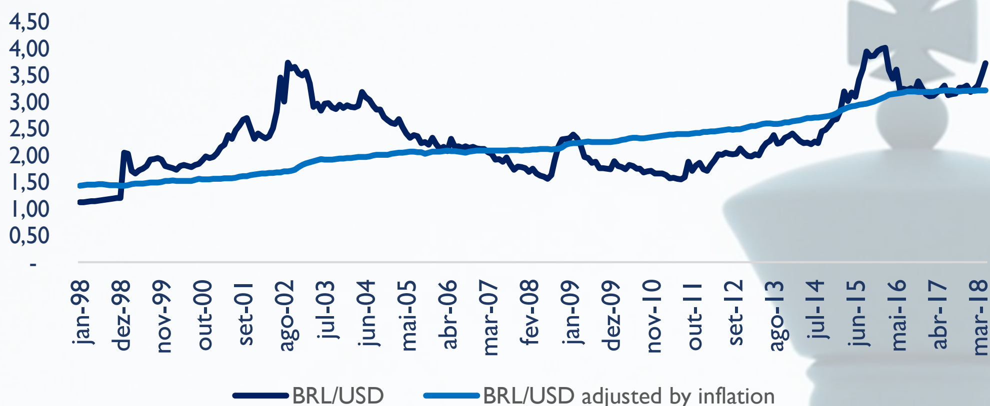
The illiquidity of Private Equity is often mentioned as a deterrent for the Investment in the asset class. However, it can be beneficial to investors as it prevents LPs from selling low*. GPs tend to have greater difficulty to sell their assets during troughs. A study conducted by the Spectra-Insper partnership showed that there is a 5-fold increase of a deal being sold if it is going through a hot market condition than if it is going through a cold market condition (Spectra-Insper Study). Getting your money back during the peak of the cycle increases your chance that, when a downturn begins, the LP will not have fully reinvested that cash, thus, being able to have a better entry point on their re-invested capital.

This phenomenon of selling high is not only true to market valuations, but also to the FX price point. We have seen that the number of exits is much lower when local currency (BRL for our example) is undervalued compared to the USD, than when the FX is overvalued.

To do so, we have calculated the FX adjusted by the inflation differential since 1998 and compared to the nominal FX. First of all, it is interesting to note that over the long run, FX tends to adjust to its intrinsic value, obviously with a lot of volatility in between.

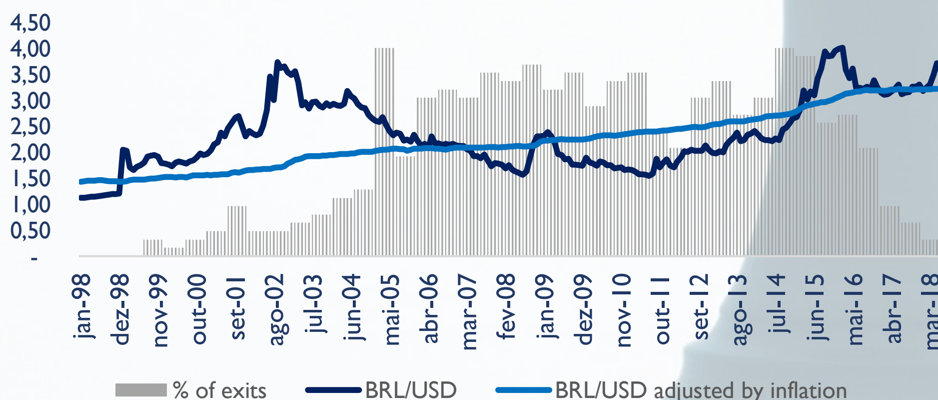
* For the sake of this letter, I will not go into the liquidity that secondaries provide.

## Nominal and inflation adjusted BRL / USD FX




The next step was plotting market exits and checking if they were sold during periods of over or under valuation relative to the intrinsic real value of the FX.

## Exits distribution versus BRL / USD FX and inflation adjusted FX

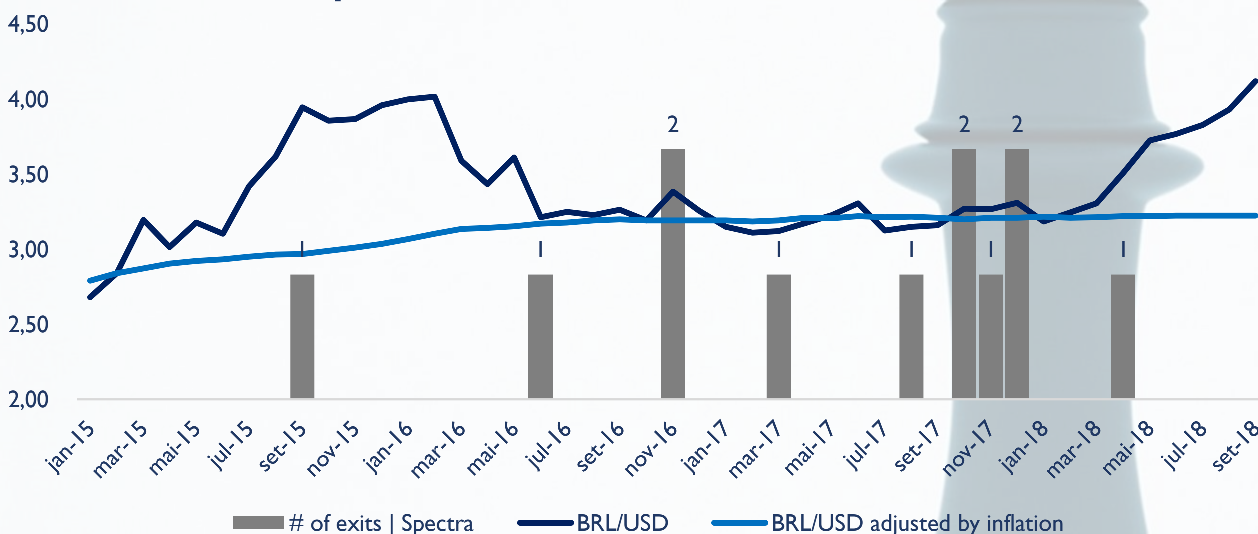



What we have seen is that, despite the fact that over this sample period we had almost even periods of over and under valuations, 58% of exits happened when the BRL was overvalued relative to the USD. This finding ties into an earlier study conducted by the Spectra-Insper initiative that has shown that the impact of FX on realized deals has been of circa 0.4% IRR differential (Spectra-Insper Study).

*Spectra-Insper Database 2018 and Ipeadata.

We take from this that, because of the illiquidity of Private Equity, there is much greater volatility (and thus risk) on the interim NAVs that managers report, than on actual cashflows. LPs complain a lot about the interim NAVs. However, this volatility has little practical impact on their ultimate returns. The main problem might be on a potential bias it creates when making new investment decisions.

Turning into Spectra's portfolio, we have seen it has been conforming to the ideas above. As a disclaimer, our portfolio is still quite young with an average age of 1,9 years. Moreover only 13% has more than 4 years (including realized deals). As we'd expect, the vast majority of the exits occurred when currency was not undervalued:




Our portfolio has shown a far greater exit ratio during 2017 when the market conditions were favorable and has had a reduced exit rate in 2018 due to economic and political uncertainties.

As we gear towards turbulent times, we have only one certainty in mind: cycles will continue existing and, as long as we remain patient and disciplined, their impact on realized returns shall be far lesser than on the stress and anxiety they create.

*Spectra's database and ipeadata

SPECTRA INVESTMENTS

# Thank You

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