

WHY BOTHER?

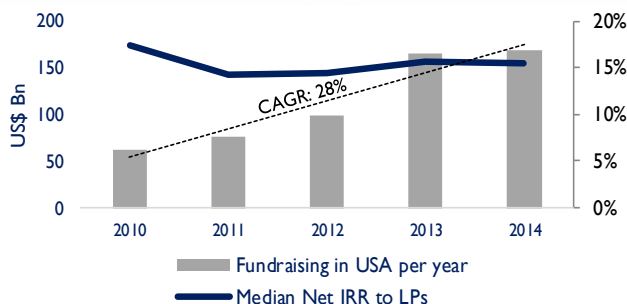
“A butterfly flaps its wings in the Amazonian jungle and, subsequently, a storm ravages half of Europe.”

This quote, by Edward Lorenz in Chaos Theory, has become a widespread meme and known by almost all in the investment world. Similarly, who would have imagined then that a mortgage subprime crisis in the US would lead to the blossoming of the PE industry in Western Europe and its demise in the Eastern side of the continent?

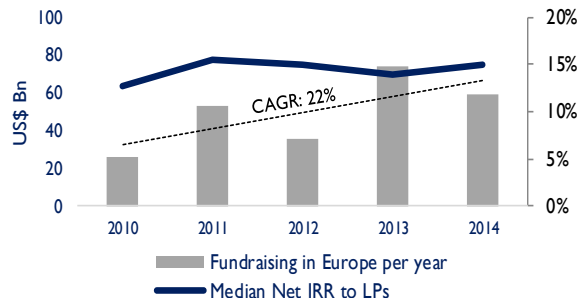
With developed economies going into the deepest recession since 1929, investors started flocking to emerging markets, which, at first, were relatively immune to the crisis. However, soon after, Central Banks put in place unconventional monetary policies in what became known as Quantitative Easing. QE has led to a period of low interest rates and the longest bull market ever in the US and Europe.

Asset price appreciation led to Private Equity performing well and low interest rates have led to an all-time high demand for the asset class from investors.

Fundraising and Returns of PE Funds in the USA¹



Fundraising and Returns of PE Funds in Europe²

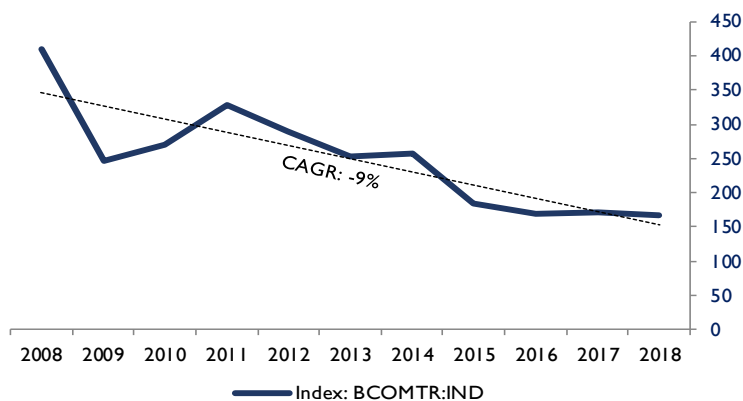


At the same time, Emerging Markets, with the exception of China, didn't perform as expected. Lower commodity prices, political instability and QE, amongst others, led to a weak cycle.

1 - Source: Pitchbook - 2018 Annual US PE Breakdown Report; Cambridge Associates – 2019 Q1 US PE Breakdown.

2 - Source: Pitchbook - 2018 Annual European PE Breakdown Report; Preqin - July 2019 Alternative Assets in Europe.

Evolution of Commodity Prices ³



Therefore, since early 2014 we've seen a trend from American and West European Investors which we have named: "Why Bother?"

Why bother investing in Emerging Markets if we have such good returns locally? Why bother covering another region of the planet (be it MENA, Eastern Europe, Africa) if we have enough diversification through our Asia exposure? Why bother looking at a particular market if it has had a troubled past? Why bother?

We will not delve into whether high returns in developed markets are sustainable, what percentage of it is due to QE, nor into the fact that past returns are not good predictors of future returns. The truth is that an overwhelmingly large trend has begun of concentrating global capital in a few locations.

"If only one man dies of hunger, that is a tragedy. If millions die, that's only statistics." ⁴

If only a single LP decided to concentrate its portfolio, this would have had limited impact. However, once a massive group flecks into a single direction, markets get distorted. The view that markets are generally efficient relies on the assumption that there are heterogeneous agents operating within the system. Once all agents behave the same way, bubbles happen.

Coincidentally, a similar trend emerged around 2014 with local Brazilian investors. Following the reelection of a leftwing president, markets panicked and nominal interest rates were increased to 14% p.a.. With high nominal interest rates, investors were asking: Why Bother? Why bother incurring in risk if we can achieve high returns with government bonds? Why bother investing in equities if a pension fund manager can meet its hurdle through government bonds?

3 – Source: Bloomberg

4 – Famous quote which was first attributed to Joseph Stalin in 1947.

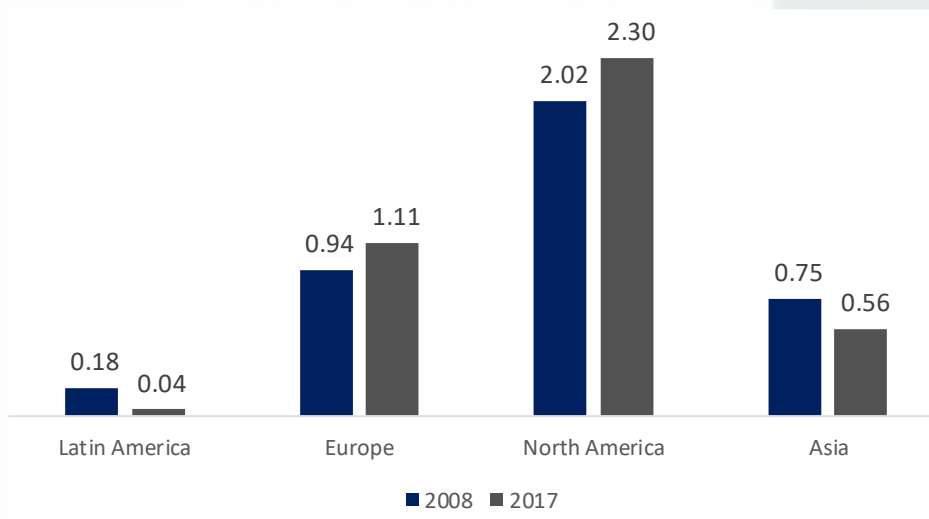
Again, we will not delve into the fact that, at the same time, inflation was at around 10% per year and capital gains are taxed at the nominal and not the real rate of return. Thus, real returns were only roughly about 1.7% after taxes.

The fact is that, at the same time that international LPs were redirecting their capital to developed markets, Brazilian investors were also de-risking their portfolios.

These twin trends led to a substantial shift in capital flow of Private Equity markets. To calculate the global PE investing trends, we created a ratio that is the result of the % of Global PE Fundraising per Region / % of Global GDP per Region. An index of 1 would mean there's no imbalance between the size of the economy and the amount of capital for PE investments it attracts. Results below 1 mean that the region receives less than its fair share of GDP and above 1, more than the fair share.

Latin America went from having an index of 0.18 to 0.04. It would need to increase its PE activity by 25 times in order to have a balanced ratio of PE activity to GDP.

% of Global PE Fundraising / % of Global GDP per Region Ratio⁵



We believe that the Why Bother mentality caused this distortion in the market.

5 – Source: World Bank; Preqin – 2018 Global PE & VC Report.

Price x Value

We all know there is a fundamental difference between Price and Value. Whereas Value measures the intrinsic worth of an asset, Price represents how much people are willing to pay for it. Successful investors aim to find assets whose prices are below their values.

It is easy, however, to fall prey to trophy asset curses. If something has immense value but prices already reflect it, any upside potential will most likely have already been baked in. As we've said in our 1Q18 letter: China, Healthcare and Tech command great value. Merge them together (a Chinese Health-Tech company) and boom (!), you've got superb value.

Having said that, if everyone else sees the same value that you do, prices will reflect this and little to no alpha should be achieved from such investment.

It is also easy to fall into value traps. Invest in something only because the price is low but not analyzing if the value of the asset is equally low. Buying cheap only pays off if you find something whose value is above the price paid.

Connecting the Dots

It is a consensus that the US and Chinese markets have more value than Latin America. The former is a powerhouse, with the most developed business infrastructure and pro-market culture in the planet. The latter has been the goldmine of growth over the last couple of decades.

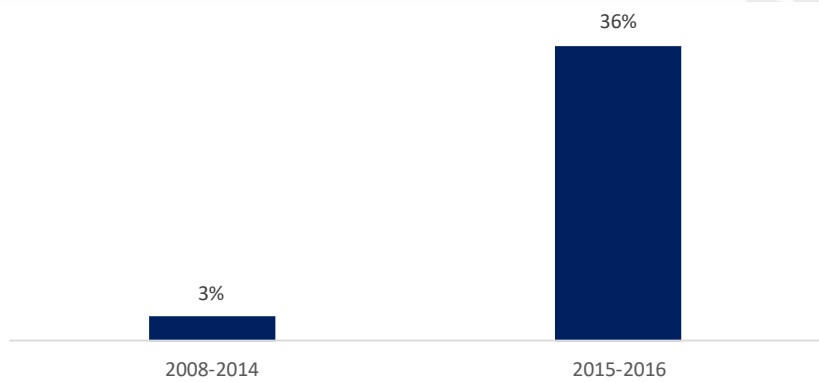
What is not a consensus is if prices are correctly reflecting the value differential. A riskier, lower growth asset that has its price correctly adjusted for it should, in theory, contain the same return potential than a more valuable asset. On the other hand, a lower quality asset whose price is much lower than its intrinsic value should have greater return potential than an overpriced high-quality asset.

The massive outflow of capital from Latin America since 2014 has led to one of the greatest Price x Value distortions we've ever seen; and, consequently, outsized returns for the few that remained investing.

Investments completed between 2008 and 2014 (when appetite for the region started to fade) have yielded in aggregate disappointing 3% p.a. in local currency. At the same time, deals done since 2015 have, on average, returned staggering 36%.

Not coincidentally, exactly when people began asking themselves "Why Bother?", market returns shot up:

Median IRR of Brazilian PE Funds per Vintage Year⁶



Once again, what matters is not only an asset's value, but the delta between this value and its current price. When market participants behave in unison, they don't allow for natural price corrections. Distortions start to appear. The massive trade-off of lower value Emerging Markets for higher value Developed markets led to a price distortion that has been there to be explored by the few left behind.

We believe this is a recurring pattern: Investors sell-off given their past performance experiences but fail to adjust their behavior due to future return prospects given the lower price points. US is hot due to the last decade of outperformance. EM is bad because it has not performed. Its very hard to create our judgments only by looking at forward expectations.

Why do you look at the speck of sawdust in your brother's eye and pay no attention to the plank in your own eye?⁷

It is easy for us to talk about other investors' potential shortcomings. However, we question ourselves: where have we at Spectra had our own "Why Bother(s)?" Which assets have we overlooked because the space was small? When did we pass on an opportunity only because recent returns had been bad?

This year marks the 10th anniversary since we began investing in the region's private markets. And with this, we naturally stopped to reflect on what we've done right and wrong.

Within the mistakes there were two kinds: investments we made which we shouldn't have (Type 1 error) and investments we didn't make but should have (Type 2).

6 – Source: Data from Spectra processed by Spectra, Inesper and ABVCAP.

7 – Source: Matthew 7:3 – 5.

We invested in a few managers/teams that turned out to be dogs. They were far less competent than we hoped for, and not well-aligned nor transparent. These investments cost us some money, on average 50-100% of the capital we allocated through these wrong decisions.

At the same time, we witnessed as the Brazilian VC Eco-System started to emerge around 2010. The first managers and founders were knocking at our doors explaining the merits of their theses. However, we asked: Why Bother? Why bother looking at VC when we have a much larger and proven Buyout asset class to focus on? Why bother looking at VC if it has proven to be an underperformer according to the [Kauffman Foundation seminal paper](#)? Why bother looking at the riskiest of the asset classes if our investors are not asking for it?

What a mistake it was! Venture Capital as an asset class has returned on average 38% in BRL for the 2011 to 2014 vintages in the region. Best performing funds (all on which we passed on) are set to deliver 10x+ to their LPs. Why bother has cost us much more than the bad investments we've made.

Looking forward, where are the areas we have been classifying in "Why Bother?" box? Which are the investment spaces that don't have immense value, but still, command some worth. What are the spaces that, due to herd thinking, have disproportionally low price tags?

We believe correctly answering these questions is key to maintaining a competitive edge in the market and to constantly find new pockets of inefficiencies.

Thank You



Rua Amauri, 255 – 4th Floor
01448-000 São Paulo SP Brazil



Phone: +55 11 3588-1177
Ricardo Kanitz: +55 11 98262-1199
Renato Abissamra: +55 11 98685-0410



ricardo.kanitz@spectrainvest.com
renato.abissamra@spectrainvest.com

