# Vinci Partners Listed Equities Mosaico Fund – Quarterly Letter 1Q 2020







# **Vinci Partners Listed Equities**

Mosaico Fund - Quarterly Letter

1Q 2020

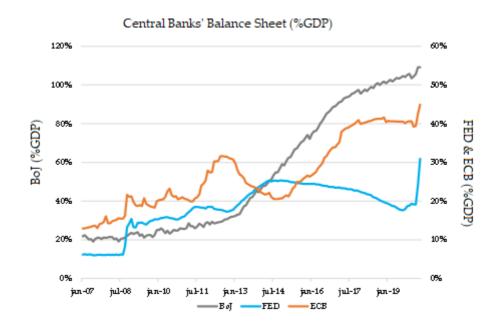
Dear investors,

In the first quarter of 2020, Vinci Mosaico fund fell 34.3% while the Ibovespa lost 36.9%. Since its inception back in July 2010, the fund has had an average annualized return of 15.2% versus 1.5% of the Ibovespa.

As we all know, this was not an ordinary quarter. The global economy, which started off the year with an auspicious outlook, entered in induced coma in March. Most of the non-essential activities were temporarily shut down as a result of the social distance measures necessary to stop the advance of the pandemic.

The fear of the harmful effects this hibernation would bring to the economy has put markets in an all-time high panic mode. In early March, the S&P 500 index fell 23.8% in just 15 days, having one of its largest pullbacks in such interval since its creation.

The responses of governments and central banks around the world were also unprecedented. Armed with the tools that saved the global financial system in the aftermath of the 2008 crisis, central banks around the world lowered interest rates and repurchased bonds in an amazing scale, free from the taboo that this injection of liquidity could cause hyperinflation. At the same time, governments have opened up their vaults, making aid programs much larger than the post-Lehman fiscal stimulus, to support the most vulnerable people and businesses during the extended quarantine.



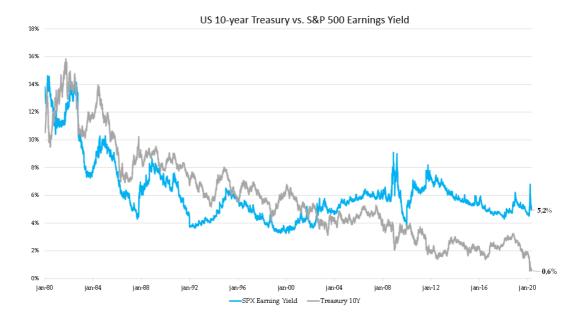
Source: FED, ECB, BoJ





These measures, together with the gradual containment of the pandemic, have brought an important relief to the markets. Even with the IMF predicting that the world will have its biggest recession this year since the great depression of the 1930s (3% drop in global GDP), the stock markets of developed countries are currently at a level close to that of the beginning of 2019, when there was no idea that a pandemic would hit the world.

An important explanation for this paradox is what's happening with the long-term interest rates of the world's main economies. Take the US 10-year Treasury as an example, where the annual return fell from 1.9% at the beginning of the year to a meager 0.6% today (much less than the US inflation target of 2% p.y.). In this context, stocks become a viable option despite the significant drop in profits that this crisis will cause.



Source: Bloomberg, Vinci Partners

On the other hand, it seems intriguing that interest rates in developed countries are so low at the same time that these governments' indebtedness is growing enormously with bailouts. There are two good explanations for this.

Firstly, the quarantines are expected to cause many bankruptcies and job losses, creating a great idleness in the economy. Consequently, inflation is expected to remain low for the next few years and there will be no need to raise interest rates to contain it.





In addition, the crisis is forcing people to save more, either because of the consumption restrictions imposed by the social distancing or fear of losing their jobs<sup>1</sup>. For the same reasons, many new investments are also being shelved. This pause in capex means that, at the margin, there is more savings than options to invest the money This inflates the price of current assets, lowering their returns.

There are still many doubts on how the global economy will recover. One of the main certainties available is that at least until the end of this year there will not be a vaccine approved by the main regulatory agencies and distributed on a large scale. In other words, we will have to deal with some degree of social distancing for a long period of time in order to mitigate the effects of a possible second wave.

It is true that there are now unlimited resources, both in terms of capital and people, to search for treatments for SARS COV 2<sup>2</sup>. Some of the antivirals currently being tested are likely to prove effective against COVID-19. These antivirals, combined with the use of masks, the increase in the ability to carry out tests and to track people who have been in contact with infected ones may lead us to a buffer solution until the vaccine brings the long-awaited immunity to the population. But many of us won't go to amusement parks, gyms and football stadiums until a vaccine is finally in use.

In addition to the precautions we'll still have to take, the world will be different when we emerge from this induced coma. Unfortunately, many businesses will not reopen at the end of the quarantine. And with them, millions of jobs will be lost.

However, not all of the pandemic legacy will be cursed. An important outcome of the quarantines will be the acceleration in the process of digitalization of the economy. The most intuitive example in this field is the increase in e-commerce spending and home-office, which result in important efficiency and cost gains. In addition, the huge investments that have been made in research and medical infrastructure should bring benefits that go far beyond combating COVID 19<sup>3</sup>.

China's experience may give us some clues as to what to expect in the reopening of Western economies. Having been the initial focus of the disease, China beat the first phase of the epidemic in late February. In March there was already a strong economic recovery, but it started to evolve at a slower pace throughout April<sup>4</sup>. The recovery was also not uniform across sectors. While steel production returned to pre-COVID levels, driven by infrastructure works, the retail and tourism sectors are still running at very low levels.

The impact of the pandemic will also be uneven across countries. Emerging countries' stock markets experienced, on average, a sharper deterioration compared to their developed peers.

 $<sup>^{\</sup>rm 1}$  Source: Paul Krugman's article for the New York Times: Notes on the Coronacoma.

<sup>&</sup>lt;sup>2</sup> Excerpt inspired by the excellent live: "XP recebe Luis Stuhlberger e Luiz Parreiras, da Verde Asset Management": <a href="https://www.youtube.com/watch?v=2lH9OUiUk28">https://www.youtube.com/watch?v=2lH9OUiUk28</a>.

<sup>&</sup>lt;sup>3</sup> Excerpt inspired by the brilliant live "XP Private recebe Martin Escobari, co-presidente da General Atlantic": <a href="https://www.youtube.com/watch?v=MybxX-Ugioo&t=562s">https://www.youtube.com/watch?v=MybxX-Ugioo&t=562s</a>.

<sup>&</sup>lt;sup>4</sup> Source: China staggers out of lockdown, Andrew Batson, Gavekal Dagonomics.





# Vinci Partners Listed Equities

Mosaico Fund - Quarterly Letter

1Q 2020

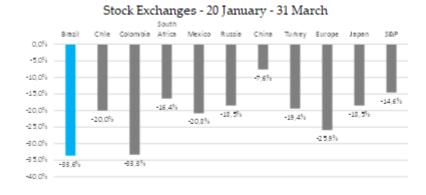
The main explanation for this is that long-term interest rates in many emerging countries have risen, as oppose to what happened in developed economies, reflecting the greater confidence investors have in more stable countries, with a better credit track-record.

With regards to Brazil, we were relatively well prepared to deal with the crisis from a healthcare point of view. The number of ICU beds per million inhabitants in Brazil is greater than in many developed countries, despite being very unevenly distributed between the public and private network and also in regional terms<sup>5</sup>. In addition, we took advantage of the fact that the disease was slow to arrive here and started mild quarantines in the main Brazilian cities earlier than in Europe and the USA.

Our public health system (SUS) and our income distribution programs, with all their limitations, have been effective in bringing, even to the poorest, medical and financial assistances. A good example was the R\$ 600 emergency aid that has already been delivered to 45 million people<sup>6</sup> (that could reach close to 60 million people), taking advantage of the Bolsa Família program registration.

On the other hand, the enormous difficulties in maintaining social distancing in an emerging country<sup>7</sup> are causing the Brazilian healthcare system to dangerously approach its limit.

In addition, the country embarked on a political crisis just when it had to face enormous humanitarian and economic challenges imposed by the coronavirus. This instability is expected to disrupt the prominent reform agenda which was under way, affecting our growth outlook. Consequently, the Brazilian stock exchange is the worst performer among the main emerging markets so far this year.



Source: Bloomberg, Vinci Partners

<sup>&</sup>lt;sup>5</sup> Source: Conselho Federal de Medicina.

<sup>&</sup>lt;sup>6</sup> Source: Ministério da Cidadania.

<sup>&</sup>lt;sup>7</sup> About 6% of the brazilian population lives in slums, according to Wikipedia.





The most recent projections point to a drop of about 5% in the Brazilian GDP this year<sup>8</sup>. The downturn of the economy, combined with the strengthened government's support programs during the crisis, will result in a big increase of the public debt during 2020, which should reach close to 90% of GDP. However, if we resist the temptation to perpetuate the 2020 extraordinary public spending due to the pandemic, we will soon return to a declining path of the debt / GDP ratio, thanks to the 2019 pension reform<sup>9</sup>.

Given the dramatic change in the scenario, we had to make important adjustments to our portfolio. The period from the end of February to the end of March recorded the greatest portfolio turnover in the history of the fund. Even with countless uncertainties about the future and how much of it is already reflected in current prices, the following points guided our investment decisions:

Less growth, more risk: the current scenario strongly impacts investment cases in which the performance of the economy and the value of perpetuity are very relevant assumptions. Following this logic, we sold our positions in Duratex, Oi and Tegma. We also sold our holdings in Azul and CVC for the same reasons, which were exacerbated by the violent effects of the pandemic in the aviation and tourism sectors.

We believe that right now the ideal company should have the following characteristics: stable demand, competitive advantages, low indebtedness, high cash generation and attractive valuation. In our opinion, Vale, which has become the largest holding of the portfolio, has all of these attributes and an additional advantage, which we describe below:

**Geographical diversification:** due to the uncertainties about the outlook of the Brazilian economy, it seemed prudent to increase our exposure to exporters. Vale has China as its main sales destination, where demand for iron ore is expected to remain stable due to investments in infrastructure, which is part of the measures to stimulate the economic activity.

Our position in Suzano also has the export angle as one of its main attributes. In addition, the company has benefited from the increased demand for pulp due to the intensification of hygiene habits arising from the fight against COVID 19.

**Regulated businesses, greater predictability:** This sector remains the one in which we have our greatest exposure, through electric utilities, sewage and telecom companies. Its indispensable characteristic and the presence of a strong regulation to guarantee the economic and financial equilibrium of the concession contracts makes its returns more stable.

Even so, these utilities will not be unscathed either. Energy distributors, for example, will have to manage a strong increase in defaults and a drop in demand. However, the government and

<sup>&</sup>lt;sup>8</sup> In April, the IMF revised its projection for Brazilian GDP growth in 2020 to -5,3.

<sup>&</sup>lt;sup>9</sup> Projections from the Economic Department of Vinci Partners.



# Vinci Partners Listed Equities Mosaico Fund – Quarterly Letter

1Q 2020

the regulatory agency are working on solutions to ensure that companies do not run out of cash and pass on to the consumers over the next five years most of their revenue loss.

**Corporate Darwinism:** Market competition finds parallels in the survival of species, and this crisis can be seen as a type of ice age, which puts the least resilient and adaptable at risk of extinction.

On the other hand, healthier and better managed companies in many sectors will have an important opportunity to consolidate their markets and reduce competition as a result.

An example on this issue is the banking sector, where incumbents have been attacked in numerous fronts by different types of fintechs and by a regulatory agenda based on market competition, which should remain on hold for the time being.

The crisis is likely to dampen risk appetite and loss indulgence in the venture capital funds universe.

On the other hand, large banks will be able to take advantage of the forced adaptation of their clientele to digital service and strongly accelerate the closing of branches and costs cuts.

We do not intend to say that large banks will benefit from the pandemic. In fact, they are likely to experience the strongest delinquency in their recent history. But their solid capital ratios should withstand the shock. And as their multiples are close to historical lows, it seems that these possible competitive benefits are not reflected in their prices. Therefore, we have increased our exposure to the sector in recent months.

Several other companies in the portfolio will emerge from this crisis stronger than their competitors. We will discuss some of the them shortly.

Concentration in companies that we know well: It has never been more imperative for a company's management to have a flawless execution as it is being the case in this crisis. Preservation of cash, strict cost control, adaptation to digital channels, care for the health of its employees and customers are some of the most important issues on the corporate agenda.

On our side, as equity fund managers, this is not a time for experiment. As a result, we are increasing exposure to companies in which we have great confidence in management and who we have known for years. This is particularly important for sectors that are not protected by the mantle of regulation or the countercyclicality of exports.

In this context, three companies in the portfolio stand out: Unidas (car rental), Tenda (low-income homebuilding) and Yduqs (higher education). We're sure that these three companies will be greatly affected by the quarantine and the recession. However, the trio is among the leaders and the most competent players in sectors that are facing strong consolidation. They have low leverage, their managements have a strong sense of ownership and their share prices seem very attractive to us.



# Vinci Partners Listed Equities Mosaico Fund – Quarterly Letter

1Q 2020

**Cash position, option value:** Invested cash has never returned so little in Brazil. But given the great uncertainty in the current scenario, cash has a strategic role in mitigating any downward pressure, besides giving us a strong and liquid currency to take advantage of any opportunities. Currently, our cash position stands at approximately 7%.

Despite the worrying tone of this letter, we would like to wrap up with a note of optimism. We are experiencing a serious crisis in Brazil, but it's just one of the several crises that we've gone through. Nevertheless, despite the low growth in the last decades, we've had very important institutional achievements such as the return of democracy, the control of inflation, a better income distribution and, more recently, the fight against corruption. As much as we've taken some false steps, our society has proved to be mature and responsible at decisive moments, such as last year ahead of the approval of the pension reform. It shouldn't be any different this time around. This too shall pass!<sup>10</sup>

Best regards,

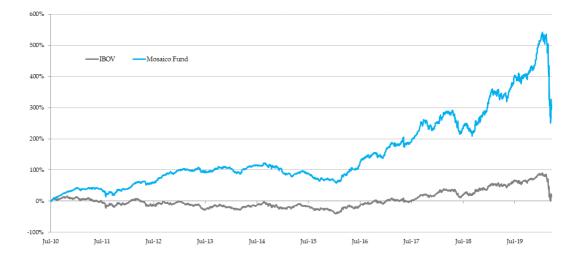
**Vinci Partners** 

<sup>&</sup>lt;sup>10</sup> Allusion to a well-known Persian legend that reflects the transitory and ephemeral nature of human condition. <a href="https://en.wikipedia.org/wiki/This">https://en.wikipedia.org/wiki/This</a> too shall pass





	jan/20	feb/20	mar/20						2020 YTD*	ITD*
Mosaico Fund	1,7%	-5,4%	-31,7%						-34,3%	295,49
Ibovespa	-1,6%	-8,4%	-29,9%						-36,9%	16,0%
*since inception in July 1	2th 2010									
	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Mosaico Fund	38,7%	-0,2%	43,2%	5,6%	-1,9%	-16,2%	44,9%	40,6%	14,8%	49,5%
Thorrooma	10.19/	10 10/	7 40/	1 5 5 0/	2.09/	12 20/	29 09/	26.09/	15.00/	21 60/







# Vinci Partners Listed Equities Mosaico Fund – Quarterly Letter

1Q 2020

### **LEGAL NOTICES**

This material is purely informative, has not been audited and is for the exclusive use of its recipient. The information contained in this document shall not be disclosed to third parties or reproduced without Vinci's prior and express consent. The information contained in this document is materially accurate up to the date it refers to. This material is not intended to be complete, nor does Vinci undertake any commitment to update the information contained herein. Past profitability is no guarantee of future results. This letter constitutes an opinion of Vinci's analysts and managers, but should not be interpreted as a recommendation, legal or of any other nature, by Vinci, and does not take into account the particular situation of any person. Any projections, conjuncture assessments or market estimates indicated in this material are based on certain premises, reflect the views of Vinci analysts and managers and have not been independently verified and therefore should not be interpreted as an indication of the actual events that will occur. Other events that have not been taken into account may occur and have a significant impact on the market and, consequently, on investments. Vinci analysts and managers use information from sources known for its reliability and good faith, but this does not represent or endorse the accuracy or reliability of any of this information and Vinci is not responsible for the content of that information. The use of the information contained herein will be given solely at the risk and risk of your user. Before making any decision on its investments, Vinci recommends that the interested party consult his own legal advisor.



Rio de Janeiro 55 21 2159 6000 Av. Bartolomeu Mitre, 336 Leblon - 22431-002 São Paulo 55 11 3572 3700 Av. Brigadeiro Faria Lima, 2.277 14º andar - Jd. Paulistano - 01452-000 Recife 55 81 3204 6811 Av. República do Libano, 251 - Sala 301 Torre A - Pina - 51110-160 Nova York 1 646 559 8000 780 Third Avenue, 25th Floor 10017