

Value Investing in Latin America: Adaptability and Survivorship

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We at LIS Capital are value investors of the most traditional kind, always in search of overlooked companies, misunderstood business models and overestimated risks that generate opportunities for abnormal returns, achieved through diligent work and patience. Since we have been doing this together for quite a while, compounding knowledge and hopefully learning from our mistakes, we learned from experience to adapt and look for margin of safety using different techniques, anywhere in the range of Benjamin Graham's net-nets to fair-priced high-quality companies, developing quite a wide array of approaches to value investing.

With the trend of assets migrating to passive indexing, while active management becomes more and more specialized, we face an uphill battle. It's one we gladly fight, because, as it turns out, when investing in Latin/South American stock markets, as we do, such broad characteristics are of major importance. It is well documented how hard it is to make money consistently. It becomes even harder when you face a market as peculiar and challenging as ours. Just as in nature, we believe that being adaptable to your environment, while preserving the core pillars of value investing, is critical to long-term success.

There are several reasons why we judge our investing environment to be somewhat idiosyncratic. First, and foremost, Latin American markets are much smaller than the US or European stock markets. Summing the total listed companies in Brazil, Chile, Peru, Argentina and Colombia, we reach less than a thousand companies, or 20% of the total US listings. If we consider total market capitalization, it gets worse: those countries represent 5% of the total US market. And that is not even discounting the big oil companies, which are controlled by the state – one of our very rare “hard pass” rules when looking at investment opportunities. The variety of sectors represented in the stock market is also more restricted in Latin America, relatively speaking. Here, the top 3 sectors amount to, on average, 65% of the total market cap, against a 45% share in the US market. Governance and liquidity also play a role, as corporations are the exception to the rule in Latin America. Most commonly, companies have ownership groups that have varying levels of relationship with the stock market, with local regulations allowing quite a few loopholes that put unaware minority shareholders in danger. When the potential investing universe is this much smaller, stiff investment strategies might just not have enough oxygen to survive in the long run.

Secondly, Latin American stock markets are more volatile than their developed counterparts. That can be explained in part by the sensibility to foreign capital flux, but, most importantly, by the impact that local politics have in the economy, since, broadly speaking, our institutions are less mature. It starts by having some of the biggest companies being owned by the state, but the ramifications go deeper and become more problematic.

Populism is still a big factor in regional politics. It has led Argentina and Venezuela to extreme economic conditions. Nevertheless, it has been present all over the continent, albeit in subtler, and fortunately less destroying, ways. Ever-growing government interference in the economy, along with short-term horizons for public expenditure plans, create disruptions and frequent temporary illusions of greatness, commonly at the expense of future stability and sustainable growth. These cycles are frequent, and add volatility to the stock markets, which creates opportunities, both on the bear and the bull markets. This fact brings us to two insights: once again, a narrow framework for investing most likely will not be suitable for the different phases of the cycles. Second: being negligent with macroeconomic environment can be very harmful.

The recent developments in Brazil are a good example of that. During the long crisis that extended from early 2013 to this year and was largely originated by irresponsible fiscal expending policy, the high quality and more resilient companies, although arguably more expensive, fared way better throughout the dip. This year, though, while the whole stock market has been in an upward trend, as the economy shows signs of improvement, the outperformers are those somewhat not so sound companies, which were more impacted during the economic downturn. Political reforms that countered the unsustainable social welfare state of the past decade, such as the public spending cap, labor law flexibilization, and the still-pending pension reform, have moved the Brazilian economy outlook from potential collapse to slow recovery. It turns out, as it usually is, this was the perfect setting for a steep appreciation among companies trading at doom future scenarios. More likely, as economic recovery becomes less fragile, the type of companies that will be outperformers for the upcoming period will be very different from the ones who did so up to this point.

Now, the point is not to defend one investment strategy over the other nor to focus the investment method on chasing after the expected outperformers necessarily. We believe that to be able to avoid permanent capital losses and therefore sustain adequate results in Latin American markets, we must be comfortable enough transitioning and balancing from one strategy to the other, adapting to the ever-changing environment.

This is easier said than done. Screening, analyzing, and following through an investment in a low-multiple or a compounder company is very different. The mental requirements for each are also different: for low-multiple stocks, you might be looking for triggers or value traps, while in a compounder you will have to put much more attention into understanding the sustainability of competitive advantages that will allow the company to continue to compound value throughout time, for example. It is not a simple task to balance these apparent antagonistic mindsets. We admit that doing so inevitably adds more complexity to the investment method. While we have enough evidence and examples of traditional local managers who make us believe this approach adds value, we respect Charlie Munger's famous words: "It's not supposed to be easy. Anyone who finds it easy is stupid". For this reason, we value the importance of well-thought, disseminated and enforced processes that permeate the whole investment analysis and decision-making: all the way from selecting companies to analyze to balancing their portfolio sizing.

Processes are usually seen as a detractor to the geniality of money managers, taking away the art of active investing. We view them as a safety net for minimizing the frequency and the size of our mistakes. They are constructed in a way to minimize cognitive biases and protect us from what we don't know that we don't know – something to be tracked, particularly when you have a broader investment method. We follow Buffet's 1st rule as closely as we can, and processes are an important tool we use to safeguard us from ourselves in doing that. This is emphasized by having a collegiate decision-making system,

where personal biases are diluted, even more so since the team has known each other for many years.

So, when investing in Latin America, we find it mandatory to keep an open mind to value investing strategies that might work under different circumstances, as the regional markets are i) too restrictive to allow for specialization; and ii) constantly changing market circumstances create opportunities for diverse investment approaches. To minimize the downside risk of adding too much complexity, we see value in having processes that enforce rules of combat amidst all the noise, while protecting us from our own biases. Creating, fine-tuning, enforcing and following processes increases the amount of energy needed to invest by a considerable amount. We embrace that, as we would rather depend on transpiration and hard work than on inspiration and geniality.