NORMANDIA
INVESTIMENTOS

LETTER TO INVESTORS
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Normandia: the idea, the name, and the reason for investing

"Well done is better than well said"
Benjamin Franklin

The first contact is always more difficult for those who take the initiative of introducing themselves. However, we believe that just mentioning our name is not enough to evoke the meanings that made us choose this designation, so maybe the analogy behind this choice and some lessons learned from history can help us in this process.

At the end of 2013, we started conversations and preliminary meetings that resulted in the creation of **Normandia Investimentos**. Each meeting would bring us closer to our final corporate strategy. We would frequently use examples and metaphors from World War II, a subject that coincidentally all partners were knowledgeable about and interested in. The choice of the company's name stemmed from one of these debates about D-Day, the first day of the Allied invasion of Normandy that eventually led to the end of World War II. Since then, the name *Normandia* represents to us the aspirations of that operation: a hard and purposeful mission, with planned aspects and practical problems that emerged in the crossing.

Much like our purpose of creating an investment company, crossing the English Channel was not a new objective. In the long history of war between France and England, the operation had been considered many times. Needless to say that a lot of study was necessary for the successful outcome. They needed to know the terrain, to study the tides, to learn more about the risk involved. The Allied Expeditionary Air Force carried out over 3,200 photo-reconnaissance missions until the beginning of the invasion. A wide array of competencies were shipped. From marine engineering and development of amphibious assault carriers specifically for the theater of operations to oceanography, cartography, soil study, among others. This strategy teaches us that assessing risk involves a systemic and multidisciplinary approach.

As mentioned before, many were the hardships faced during the crossing on D-Day. The environment, the weather conditions, the region's typically rough sea and - maybe the most important - the *unknown*... Just to mention one example, during planning, when the mission was known as *Overlord* in the allied high command, two brave volunteers crossed the channel on a dinghy to collect soil samples and help to define routes for tanks and armored vehicles. It is interesting to think about the positive effect of field experience. Of broadening the area of contact with the problem.

Another aspect can be used as relevant analogy for the investment activity: the decision-making process of commanders. It is known that the Germans were commanded by Erwin Rommel, an extremely vertical general in the chain of command. On the other side, however, General Dwight D. Eisenhower was always willing to listen to each person involved in the operations under his command, and often did so. He confessed to having doubts as to what to do and showed quite a bit of candor. He exhaustively reviewed his plans, frequently adapting details to new information brought by soldiers. The Battle of Normandy was, to a certain extent, a clash between different models of learning. We identify ourselves with General Eisenhower's method and, for that reason, we avoid excessive segregation of the process of analysis and decision-making in our activities.

Broadly speaking, we consider that reflecting upon our convictions is an essential part of who we are. We started our company with the goal of building an environment for investment in stocks, predominantly Brazilian, that would favor compound return, patience, and detachment from job positions and ideologies. The central point of the way we invest is reflecting on the extension and the quality of what we know.

Returning to our history analogies, it is known that the German commander Rommel based his plans on a rigid doctrine, trying to guess in which beach his landing would happen and concentrating his resources according to bets made with high conviction. In the meantime, his enemy thought that more important than getting the beach right was to have a way out, if he got it wrong in the first place. This is also crucial in our routine as investors. Given that the process of analysis and evaluation of companies is imprecise in its nature, we always prefer to work with sensitivity analysis and alternative scenarios.

One point we like to remind ourselves about is that there was no *silver bullet* or a quick solution to win the battle. People, discipline, and execution, obviously aligned with an organized and planned support structure, led them to victory. In our investing activity, *there is no recipe*. We believe that the probability of good returns increases according to the philosophy you choose, but nothing can be achieved without good execution, discipline and good judgment. And here, unfortunately, the analogy is imperfect. In investment, and especially when the goal is to generate consistent returns, the war never ends.

Talking a bit more about philosophy and investment practice, we will analyze in the next few pages the actual decisions made by one of the most iconic names in the field. Using some practical examples, we intend to express our opinion about themes and issues that we believe are critical to the way we invest. We do not intend to use the past as a guide to the future, but just as analytic material and a sort of bridge to lead us into reflection.

Benjamin Graham and his practice as an investor

"Charlie says as you get older you tolerate more and more in your old friends and less and less in your new friends"
Warren Buffett

We will now guide the reader through a less explored dimension of Benjamin Graham's life. Author of classics such as *The Intelligent Investor* and *Security Analysis* and considered as the father of *Value Investing*, Graham divided his professional life between his activity as a professor of investment at the University of Columbia, the actual practice as investor, and some experience as an Economics theorist. He is also known for having played a central part as Warren Buffett's mentor. Buffett often recognizes that his contact with Graham was fundamental to his success.

In our time, maybe influenced by the 2008 crisis, Graham became a sort of entry in investment dictionaries. It is hard to find an equity fund brochure, or a management letter, that is not filled with his most famous concepts. Sometimes they mention the distinction between speculation and investment, other times intrinsic value and safety margin. If we brought together some equity managers in a room, maybe it would be possible to play bingo with a card containing these expressions.

Nevertheless, what attracts our attention the most in the history of this famous investor is a rich facet unknown to greater audiences. We believe that the traces left by his concrete decisions may be even more valuable than his written texts.

Benjamin was born in London in May 9th, 1894. His family moved to New York when he was only one year old. After a difficult childhood (his father died at the young age of 35), he graduates from Columbia and gets his first job at *Newburger, Henderson & Loeb,* as a liquidation assistant at the bond desk.

We can say that Ben started his capital market activities on the sell side. His tasks were many, including, among others, writing short investment recommendations on a daily report offered to clients. In his daily interactions with the front line, he starts to doubt the decision-making model of some clients. This seems to have made him consider what were their fears and behaviors. He already shows some inclination toward studying the mind of the shareholder, the way they think.

In 1915, the top management of the *Guggenheim Exploration Holding Company*, (before you ask, yes, it is the same family as in the Guggenheim Foundation and Museum) decides to terminate all investees also listed in the stock market. At that time these subsidiaries represented interest in many copper mines. The plan of the Board of Directors was to return the money to the holding's shareholders. Graham, at the time, perceives an arbitrage between the market value of the parties and the holding and recommends a long & short. This recommendation, it seems, significantly changed his equity, via bonus, and his reputation as analyst.

Excited about the *Guggenheim* arbitrage, he systematically starts to repeat the same type of operation. He gets US$ 10,000 in funding from a friend and sets up a sort of managed portfolio. After the USA entered war in 1917, the portfolio suffers with the lack of asset price reference, and more and more margin over the same position starts to be required. His friend asks for surrender, but accepts to receive the money in monthly installments of US$60. After some time, effort, and counting on the recovery of price reference, Ben manages to grant liquidity to his first investor. The fall may have left a scar. After that, we do not find another phase in his life when his portfolio had been so committed to arbitrage. It is likely that he learned an important lesson about portfolio liquidity management.

At the same time, the market goes into a *Bull Market* frenzy. A trendy stock starts to become the preferred topic of conversation among *brokers*. It was called *Consolidated Textil*. In addition to common stocks, the company had a convertible preferred stock with a 7% coupon that, at the time Graham studied it, was being sold at its face value in the market. One of the partners in the brokerage house recommended a huge amount of common stocks to clients at US$ 70 per stock. Graham warned that the convertible would have the same return at a lower risk. This was so because it was possible to short sell the stocks and buy the preferred stock. Result: the stock price fell from US$ 70 to US$ 20.

Maybe here he has showed attention to the level of subordination and arbitrage that may disturb analysts who are excessively focused on one single instrument. At **Normandia** we believe that paying attention to the risks and opportunities stemming from the subordination level, even considering the limitations of instruments in the Brazilian market, is a central point in the *Value Investing philosophy.* Considering this perspective as limited to common stocks (very usual nowadays, especially in Brazil) seems to disregard a great virtue of this school we so much admire.

As to Graham, after some more years writing recommendations, other lessons seem to have been learned. Optimistic about the *Milwaukee & St. Paul Railroad bonds*, he decides to discuss his viewpoint with *Robert J Marony*, financial director of the company. At a meeting, Marony refuses to agree with Ben's optimistic view, but wins his trust and later becomes investor and director of the Graham & Newman Corp. Here we can see how people can make a difference in business. In his books, Graham seems not to mention this point, maybe because he understands that the ability to read people cannot be taught in manuals. Aligned with this perspective, at **Normandia** we dedicate special attention to this point, especially because we are in a country with low capital dispersion and a huge overlapping of control and management of companies.

Going back to Benjamin's steps, we see that, amidst the euphoria of the beginning of the 1920's, he invested in two companies and withdrew his position a few days after they went public. The first one was the *Ertel Oil Company*, bought before the event for US$ 3 and sold at US$ 8 a few weeks after going public. The other one, *Savold Tires*, was bought at US$ 10 and sold at US $ 37. Even though this may seem to be against his principles, maybe here he has shown a great deal of discipline. This was almost a *day trade*, which apparently is incompatible with Graham's philosophy, but maybe there is nothing more loyal to *Value Investing* than selling a stock when price convergence happens faster than initially predicted.

In 1925, Benjamin Graham opens the *Graham & Newman Corp*, in partnership with Jerome Newman. The company started with a capital of US$ 450,000 and formally started Ben's career as third-party resource manager, at the age of 31. In the same year, he started to study eight pipeline companies who were part of *Standard Oil.* He found that they carried large amounts of railroad bonds, that exceeded their own market value. One of them, *Northern Pipeline*, was traded at US$ 65 and carried US$ 95 per stock in net assets, among which the previously mentioned bonds. Graham inconspicuously buys 2,000 stocks of the company, from the existing 40,000. These acquisitions make him the largest shareholder after the Rockefeler Foundation, which held 23%.

Later the investor schedules a meeting with the president of *Northern Pipeline* and explains in detail the problems of carrying these bonds. During the meeting he suggests that at least US$ 90 per stock be paid as dividends. The president's response could clearly be the same nowadays, in a hypothetical conversation with a Brazilian company in the same situation. Graham was told that the oil sector was more complex than he was able to understand and that hidden forces affected this decision. He tried then, unsuccessfully, to approve his extraordinary dividend proposal in the next shareholders meeting in January 1927.

In the next year, after collecting votes by proxy equivalent to 38% of shares, he met with a representative of the *Rockefeler Fundation* who told him that, for political reasons, the foundation did not intervene in the investees. In the next shareholders meeting, Ben managed to become the first elected board member who was not directly connected to *Standard Oil*. His agenda was clear, he did not seem to be there for the adulation of the position. In the next weeks, he made the company pay a dividend of US$ 70 per share. The market saw the repressed value in the company and the stock price skyrocketed to US$ 100. Lo and behold, an activist similar to the ones found today! Without being named so, without *Twitter*, *Facebook* or media, he seems to have acted like Carl Icahn (American manager of Icahn Capital L.P, famous for his activist strategy) does nowadays.

We had access to the management letters from the period between 1946 and 1958. His letters were not very clarifying due to their colder accounting nature. Some brief conclusions, however, can be inferred. The sum of the assets at market value almost always was very close to the portfolio's Net equity. This means that he had almost no liability or leveraging. The amount deposited as guarantee and the *long* and *short* balances suggest that he may had experimented with *short selling.* But this is just a conjecture of ours.

He also remained loyal to a few sectors almost all the time. Especially R*ailroad*, *utilities* and insurance. His choice to remain in cash seems to be pretty consistent during this period, remaining almost always between 0% and 15% of the total assets. During this time, Graham does less and less arbitrage as compared to portfolio. It is not known if this stems from lack of opportunity or from some more conceptual decision.

At a hearing in the United States Senate in 1955, we find more revealing passages. The representatives summoned Graham in order to investigate the relationship between price and value of stocks and how it was linked to speculative bubbles, but they ended up changing the subject to the history of the *Graham & Newman Corp*. At some point they inquire about cases in which the company had allegedly taken control over listed companies. Graham clarifies that he only changed *management* about 4 times in more than 400 investments he had made, but also seems to hint that he was not against the idea.

Still in the Senate, he is questioned about the general level of market prices. Careful as usual, he states that he sees some signs of exaggeration in the relationship between stock prices and profit. He explains that what worried him was not exactly the situation at the time of his testimony, but the ensuing cycle of attraction of more and more capital. Graham here may have predicted, many decades in advance, George Soros' concept of reflexivity. Asked about how he was investing in that year, he answers that he was migrating from purely discounted stocks to special situations of corporate change and specific corporate events, where he considered to be less exposed to market risk.

This point seems to clearly state his concern with directing his attention to more attractive opportunities. He seems to be aware of the trap of insisting on some stocks, even with the compression of returns. He also seems to be concerned about using the safety margin concept to steer his recon flight when searching for new opportunities. We believe that nothing can be more *Value Investing* than giving up the excessive focus on a few assets if they do not represent opportunities. Even more so when hand in hand with critical thinking about the cycle of competence.

It would be interesting to mention that his interest in macroeconomics was deeper than people imagine, leading him to participate in the Bretton Woods conference, where he presented a proposal to create a world reserve currency. It could not have been different since he invested in a context of redesign of the world economic system, typical of the post-World War II. Here yet another misunderstanding is clarified. There is no conflict between knowing about subjects such as this and his philosophy.

Finally, Graham continued to work at the *Graham & Newman Corp* until he closed the company, retired and moved with his family to California in 1956. Warren Buffett still worked there for a while before he met Charlie Munger. The compound return of the portfolio managed by Benjamin cannot be accurately calculated. But even with the 1929 crisis in the middle of his career, some estimates mention something like a 20% compound annual return.

Looking at this background, what stands out is that the strategies adopted by Graham sought to match adjusting to the existing environment and strong principles. Even though he went through various economic situations and invested by means of a wide array of instruments, Benjamin Graham remained loyal to focusing on intrinsic value and to understanding companies in detail. He had, therefore, a rich life with plenty of experience, marked by a constant search for knowledge, self-analysis and great dedication to what he did. At **Normandia,** we learned from his practice and mainly with the more central and unchanging concepts found in his books.

We hope that we were able to introduce ourselves properly in this first letter. Our goal is to write a letter like this every six months, in March and September, and discuss many different subjects that we consider relevant.

Thank you for trusting us,

Normandia Investimentos