

São Paulo, January 29th 2016

Dear shareholders,

In 2015 Mosaico FIA fell 16.16% while the Bovespa Index decreased by 13.31%. Since its inception (July, 2010) the average annual return of Mosaico FIA was 10.44%, while the Bovespa Index averaged an yield of -6.59% per year.

Last year we had the worst performance in the history of the fund and, for the first time since our inception, we had an annual return lower than that of the Bovespa Index. As the fund's major shareholder, I share the frustration of 2015's results.

### Mosaico FIA x Small Caps Index

	2010*	2011	2012	2013	2014	2015	Acumulado
Mosaico FIA (a)	38.7%	-0.20%	43.2%	5.6%	-1.9%	-16.2%	72.2%
Small Caps Index (SMLL) (b)	22.9%	-16.6%	28.7%	-15.2%	-17.0%	-22.4%	-27.9%
Difference (a-b)	15.8%	16.4%	14.5%	20.8%	15.1%	6.2%	100.1%

### Mosaico FIA x Bovespa Index

	2010*	2011	2012	2013	2014	2015	Acumulado
Mosaico FIA (a)	38.7%	-0.20%	43.2%	5.6%	-1.9%	-16.2%	72.2%
Bovespa Index (b)	10.1%	-18.1%	7.4%	-15.5%	-2.9%	-13.3%	-31.1%
Difference (a-b)	28.6%	17.9%	35.8%	21.1%	1.0%	-2.8%	103.3%

\* Fund's Inception: 07/12/2010. Source: Economática

To our defense it is worth saying that small caps have had a particularly difficult year. The small caps index fell 22.36%. Therefore, as in all previous years, our performance was better than that of the market in which we hold most of our investments.

The strongest drop in prices of smaller firms is common in times of crisis, mainly because in those periods investors want to be in positions that can be sold easily. This doesn't necessarily mean that the financial health of the small caps group is worse than that of the more liquid stocks.

We invest in smaller companies for two reasons: small caps tend to be cheaper than larger companies and there are fewer analysts covering this segment (which increases the chance of finding bargains).



Despite the bad year for smaller companies, our focus on this segment was determinant to achieving a better performance than that of the Bovespa Index over the last years.

On the other hand, the question is: what is the use of performing better than the stock market in a country where investing in stocks has been a bad business? In our case, for instance, despite the great advantage we have had since our inception in relation to the Bovespa Index, the accumulated return of Mosaico FIA amounted to 99% of the CDI accumulated return during the same period.

Finance books teach that you should demand a premium when investing in equities versus investing in fixed income securities, given the risks and volatility embedded in this kind of investment. This premise is linked to the meritocratic nature of capitalism, where competent entrepreneurs are rewarded, as well as the shares of the companies they run.

Unfortunately, however, in Brazil we live a distorted version of capitalism. Although our capitalism secures private property, we live in a business environment which is not very meritocratic. Our huge tax burden reflects a society addicted to counting on the government. Everyone wants to be taken care of, from the big businessman who wants cheap loans from BNDES to the small fishermen who want the government to guarantee their income after the fishing season has ended. Add to this our huge bureaucracy, our overprotective labor legislation, a lack of infrastructure and we have a framework in which entrepreneurship becomes an exercise in faith similar to the optimistic intuition of lottery bettors.

You must be thinking that nothing I'm talking about is new and that, even so, Mosaico has always had a positive look regarding Brazil's future and investing in the stock market. Our optimism comes from the realization that despite our problems, Brazil has evolved.

In the 1980s we were a nationalized economy, with hyperinflation, huge foreign debt, deep inequality, market reserve and we were in a fragile transition from a military government to a democracy. Brazil's picture today is much more beautiful: We have overcome hyperinflation, paid our foreign debt, distributed income, privatized some companies, opened up to imports a bit and consolidated our democracy.

In the past decade, these achievements, in addition to a very favorable foreign economic scenario, enabled the country to grow robustly. This created the feeling that the imbalance of the public accounts would not be so serious.

At the same time, during President Dilma's first term, we deepened profoundly our tax problems due to a type of development economics that mixed populism and ideology, taken to its ultimate consequences for the sake of re-election.

We at Mosaico did not remain inert to all of this. We gradually increased our cash position, which was close to zero in 2010, to an average level of 34%<sup>1</sup>, over the course of 2015.

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<sup>1</sup> Adjusted cash position includes, from August 2015 onwards, our holdings in Tempo Participações. At that time, funds managed by the Carlyle Group announced that they would make a tender offer to buy the company's controlling block and initiate a delisting process.



The truth is that Mosaico has always followed a bottom-up approach. This approach suggests that our portfolio should be built in such a way to select a number of good and cheap companies and that little importance should be given to macroeconomics. Warren Buffett, who is an inexhaustible source of wisdom and inspiration to us, suggests to American investors that they should take little interest in the economy, have faith in capitalism, and invest in the stock market.

What we found, the hard way, was that some of these principles do not fully apply to the Brazilian reality. First, as we have said earlier, capitalism here hasn't developed to its fullest form.

In addition, many Buffett investments are in companies that sell products whose demand changes little depending on the direction of the economy. A classic example is Coca-Cola. However, in the Brazilian stock market, there are few investment options in companies that, like Coca-Cola, are strong brands and produce basic consumer goods. And even among the few companies that would fall into this category, we see that the demand for its products is not so inelastic here in moments of crisis, since Brazilians' income is lower than that of their American peers.

A good example of this is M Dias Branco, leader in the production of biscuits and pasta in Brazil's northeast region and owner of the Adria brand. This company's inflation-adjusted revenue declined 8% in the first nine months of 2015 and its stock fell 26% last year.

Our economy's volatility becomes even clearer when we look at durable and capital goods. New cars sales, for instance, ended 2015 with a drop of 25.6%. Since 1970 there have been three annual falls of more than 25% in the licensing of new cars in Brazil. The largest of these occurred in 1981, with a 42% reduction. In the same period in the US, there was no year with a drop in vehicle sales of more than 25%; the worst moment was during 1974, with a retraction of 23%.

Therefore, we conclude that we should hereafter focus more on macroeconomic analysis. We continue to agree with the idea that the fair value of a company should be calculated based on profits at more normal times than those which we experienced last year. On the other hand, it has become clear that it is necessary to consider the period it takes for the company to return to posting normal results, in determining whether a stock is in fact cheap.

That said we believe that we will have three hard years for the economy ahead. We are reflecting this in many ways in our portfolio. Our adjusted cash position is at 45%<sup>2</sup> of the fund.

Currently, one-third of our cash position is in NTN-Bs (inflation-linked government bonds) in order to protect us against a looser stance from Brazil's Central Bank towards inflation.

In the stock portfolio we are increasing the weight of exporting and electric power companies, which have more stable revenues and margins. In addition, we are

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<sup>2</sup> Including our holdings in Tempo Participações which will be sold in the delisting offering.



parsimoniously buying more stock from companies that have been in the fund for some time and whose prices have fallen excessively.

We are also more engaged in the search for additional income from the shares we have in the portfolio. One strategy is lending a portion of our shares (BTC) to investors who want to sell them short. In addition, we started selling options for some existing stocks in our portfolio at strikes above current prices. In this process we receive income from selling the options and, in the event of a strong rise in stock prices, we have to sell these shares at the agreed strike price. It is worth saying that we would be selling, in any case, these shares once they hit the strike prices agreed.

All of these measures are intended to enable us to navigate more peacefully through the turbulent times of the next few years. However, we are running the risk of not taking full advantage of an eventual stock market rise, given our more defensive strategy. It is worth mentioning that the shares, in general, seem to be cheap in a scenario of Brazil getting back on track. One of the positive consequences of the economic crisis and government corruption scandals is the increasingly material chance of electing a government and congress more aligned with the stock market.

However, the economic and political challenges we face are huge, such as rising public debt and the need to vote unpopular measures (tax increases and unlikely spending cuts). In addition, three long years lay ahead before the next presidential election and its outcome remains uncertain. Finally, the international environment, which has helped us so much in the past decade, this time, raises concern, with China's economic growth slowing down and the US raising interest rates.

Therefore, we believe that our cautious stance makes sense for now, yet we remain alert to revisiting it, should circumstances change.

Perhaps our most skeptical readers are wondering if we will have the ability to anticipate any scenario shifts and capture all the benefits of a possible rise. We know that there is a certain audacity in our proposal. But the alternative to it would be too much confidence in the idea that corporate profits will return to the historical average. We won't go for a walk on thin ice, even if there is a pot of gold on the other side of the lake.

Despite our worried tone, the message we would like to convey to you is that we will persevere. The perception that Brazilian society has changed for the better is still valid even amidst the strong crisis we are experiencing. We are all struck by the solidity of our institutions as we see some of the country's most powerful figures accounting for justice. Besides that, fundamental questions about the state's sustainability, such as pension reform, can no longer be postponed and seem to be part of the agenda. And if this period of lean cows serves to banish populism and make Brazil more meritocratic, it will have been worth it.

We are grateful for trust you've placed in us and wish you an excellent year,



Roberto Knoepfelmacher.

Disclaimer

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