

São Paulo, January 24th 2014

Dear Shareholders,

In 2013 Mosaico FIA has appreciated 5.60%, while the Bovespa Index fell 15.50%. Since the fund's inception (July 2010) until the end of 2013 Mosaico FIA posted an average return of 23.7 % per year, while Ibovespa had an average annualized decrease of 5,6% during the same period.

2013 was a difficult year. For many market participants, it was a moment of disenchantment towards the prospects for our country. After three years of low growth and high inflation, it became clear that we live in an economy full of bottlenecks, and that the growth model followed during the last decade, based on increased consumption and public spending has run its course.

Perhaps the image that best summarized this disappointment was the cover of "The Economist" with the picture of the statue of Christ the Redeemer upside down on a collision course with Corcovado, the mount upon which it stands. The concerns raised in the Economist article are relevant. The list is extensive and involves: huge tax burden, poor management of public expenditure, lack of investment, the pension system deficit, bureaucracy, poor education, protectionism and, obviously, corrupt politicians.

All these problems are real and serious, but it is curious to remember that in 2009 the same publication had a cover story on Brazil in the opposite direction , showing the statue of Christ Redeemer rising to the skies like a rocket . That report praised the skill with which Brazil went by the international crisis of 2008, its economic stability since the 1990s and its natural resources.

Where does the truth lie amongst such dissonant points of views?

In our opinion the truth will not be found either looking up towards the sky, nor down in direction of a precipice. Brazil's problems worsened and became more evident in recent years, but our strengths have not disappeared.

Given that 2014 is an election year, it is extremely likely that there will be a continuation of what we have seen up to now in terms of economic policy. However, in 2015, the new president, whomever it may be, will be facing a crossroad. One option is to make a fiscal adjustment, however small, and have a slightly more friendly posture towards the private sector, to regain the confidence of markets and investments. If these small adjustments are not accompanied by structural reforms (e.g., defusing the time bomb that is our Social Security System) we will probably continue with mediocre growth. However, these small measures are already sufficient to avoid following the path taken by Argentina and Venezuela.

The other option is not to touch the unsustainable dynamic of public spending that we are currently facing, which will lead us to a risk of downgrades by the rating agencies, increasing interventionism in the country's economy, as well as increased populist policies.

This path tends to be a social and economic tragedy, but can be efficient enough to keep rulers in power.

Although possible, the second scenario seems unlikely. Today we live in a much better country than we lived 30 years ago. We fought hard and we paid dearly to have important institutional gains such as inflation control, fiscal responsibility, a reputation for enforcing contracts, free press, real democracy (with regular and free elections, as well as alternation of power), etc.. Therefore, after all these conquests, we have a lot to lose and it tends to make our governments more responsible and pragmatic. The recent auction concessions of toll roads and airports, and the increase in interest rates to curb inflation are signs of this pragmatism.

Perhaps the most pessimistic about our economy are right, and the future is no longer what it used to be. However, this does not necessarily mean that investment in Brazilian stocks will be poor. In 2013 the Greek stock market rose 35% in dollars while the Spanish index appreciated 33%, despite the serious problems of these countries. This apparent paradox is due to the fact that financial market tends to anticipate both the problems and the prospects of improvement.

In the Brazilian case the anticipation of problems is clear. Although Brazil's rating has not been downgraded so far, our bonds are already trading with a risk premium 80% higher than the average of its peers in Latin America. At the same time, the performance of the Bovespa index was the second worst among global stock indexes in 2013. Consequently, the average price/earnings ratio of the Brazilian market currently points to a discount of 40% vis-à-vis the US stocks market.

In light of the recent development of our stock market, we believe that it is easier to find investment opportunities today than in recent years. Since last July (when the Bovespa index reached its low for the year) we have invested approximately 20 % of our portfolio in new companies.

So after spending a few years commenting on our difficulty in finding new investment opportunities, we're finally changing our tune. Those who read us often must be wondering if we have consequently reduced our cash position, right? Actually, not so much. We still have 17% of our portfolio in cash while this value was 22% a year ago.

The new comers in our portfolio arrived at a good time, replacing some investment cases that were already becoming mature. On the other hand, the explanation for our relatively high cash position is an old Spanish saying: *"I do not believe in witches, but they certainly do exist!"*.

In other words, we do not believe in a scenario of serious crisis for Brazil, but want to be prepared to mitigate our problems if it happens. Besides the cash position, another line of defense in our portfolio are the exporters. We have about ¼ of our assets invested in companies that benefit from weaker Real.

In this sense, one of our largest positions is Fras-Le. Despite being unknown to many, due to its low liquidity in the market, Fras-Le is one of the world leaders of friction material (brake linings and brake blocks). Almost half of its revenue is generated abroad via exports or through its manufacturing plants in the U.S. and China. Furthermore, 75 % of its sales go to the aftermarket, which is much more stable and



profitable than direct supplies to OEMs. This stability can be proved in times of crisis, as in 2009, when Fras-Le's top line fell only 1% vis-à-vis 2008.

Fras-Le invests about 3% of its revenue in research and development. This has placed the company in the first row of innovation and generated countless awards for quality. Consequently, Fras-Le managed to maintain its market share virtually unchanged during the last 10 years in Brazil, even charging prices 10% higher than its competitors in the aftermarket.

We have been shareholders of Fras-Le for over three years, but kept a small stake in the company until last year. That's because it was going through a phase of intensive investments that included the expansion of overseas subsidiaries, SAP implementation and the acquisition of a producer of complementary products for brakes called Control. All these initiatives increased the company's execution risk and had an undermining effect in their short-term results. At the same time, the overvalued Real played against the competitiveness of Fras-Le's exports.

However, 2013 brought much tailwind for the company. At the same time that Fras-Le began to reap the rewards of the above initiatives, its profitability was driven up by the higher dollar. Due to the aforementioned, the company's operating profit will grow 40% in 2013. This favorable outlook encouraged us to increase our position to about 10% of the fund during the last semester.

In addition to the excellent operating performance, Fras-Le brought us more good news in the past year. The company announced two measures which we expected for a long time to improve their governance and liquidity: the unification of its share classes into a single class of voting shares, and the announcement of a share offer that, if successful, will greatly increase the company's trading volume in the stock market.

To conclude, we remain very excited about the prospects of our portfolio. We hold a series of profitable companies, that are very well managed, and which are priced at attractive levels. In addition, we continue with a positive outlook for Brazil in the long term, while we keep our mind open and our portfolio prepared for other scenarios. We would like to end this letter with a quote from Albert Einstein that translates very well this idea of mental flexibility:

"In an effort to understand reality, we are like a man trying to understand the mechanism of a closed watch. He sees the dial and pointers, hears their ticking but has no way to open the box. If this man is skilled, he can imagine a mechanism responsible for the facts observed but cannot be completely sure that his hypothesis is the only one possible."

We wish everyone a great 2014,

Mosaico Capital



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