

São Paulo, January 10th 2017

"They say the darkest hour is right before the dawn" – Bob Dylan

Dear Shareholders,

In 2016 Mosaico FIA appreciated 44.85%, while the Bovespa Index rose 38.94%. Since its inception (July, 2010) until the end of 2016 Mosaico FIA posted an average annual return of 15.2%, while Bovespa Index posted an average annualized decrease of 0.7% during the same period.

Who could imagine a year ago that, in face of the country's worst economic crisis ever recorded, we would have the highest Bovespa Index rise in 7 years and that our fund would have its best annual performance since its inception?

In fact, the year of 2016 was filled with unpredictable events such as President Dilma's impeachment, the UK's decision to leave the European Union ("Brexit") and Trump's election.

The author Nassim Taleb coined an expression for these extreme occurrences, which brutally change our perception and which, *a posteriori*, seem predictable and obvious. He calls them "Black Swans." Before the discovery of Australia, it was believed that it was only possible to have white swans, since until that moment there was no record of swans of any other color. The black birds found in Oceania serve to teach us that a possibility cannot be discarded simply because it has not yet occurred.

According to Taleb, black swans are more frequent than we think (think, for instance, of the 9/11 attack or the Lehman Brothers crisis), which emphasizes the weight of chance in our lives and the low accuracy of projections.

In this regard, our frequent readers should remember the worried tone of our last letter. Our portfolio reflected this concern with an adjusted cash position¹ of approximately 45%. On the other hand, we knew of our limitations in predicting the future and that many stocks would be cheap if our economy got back on track (something that seemed to be relegated to 2019). So we set out to change our minds if circumstances changed. In March, as the chance for a change in government became palpable, we reversed part of our conservatism. Even so, we maintained an average adjusted cash position of 37% of the fund throughout the year.

Our good performance was mainly due to some great successes in the stock portfolio (such as our holdings in Sanepar, Tegma and CVC) and the absence of negative contributions. We were pleased that our stock selection provided an interesting return at the same time that our conservative cash position has brought us safely through the sea of uncertainties we faced in 2016.

¹ By "Adjusted cash position" we are referring to our holdings in repos, NTN's and shares of companies in process of public offering, despite the fact that the last two items mentioned present higher risks and volatility above our standard cash holdings.



It is worth mentioning the case of Sanepar, a water and sewerage company in the state of Paraná. This was one of the highest rises on Bovespa in the year (+ 267%) and the main contributor to our performance, accounting for about 1/5 of our return in 2016. We started a small position in the company about two years ago and we saw its shares suffer from the 2015 water crisis (although the Paraná state was left unharmed due to its abundant water resources). At the same time, the company's average tariff rose by 20% in 2016, regaining part of its past gap and cost increases. The combination of bullish revenue and depressed stocks kept Sanepar's Price/Earnings ratio at only 2.5x at the start of the year - one of the lowest multiples I've seen in my career. Consequently, we doubled our position to 4% of the fund in March.

From then on, two other events boosted Sanepar's performance: (i) further developments in the company's tariff review process, which should ensure that the company's large investments will be properly remunerated and (ii) a long-awaited share offering that has tripled its shares daily trading liquidity².

The past year was also very positive on other fronts. In September I joined Sanepar's supervisory board, position I also hold in Tegma since 2015. To be present in these boards has been a very enriching experience, deepening our knowledge of these companies' businesses and of the corporate gears.

In addition, we became much more active in BTC (as lenders) and in the sale of stock options. We acquired a lot of know-how about these activities, which improved our returns by about 1%. It seems little, but having an average return of 16% a.a. in 20 years, instead of 15% a.a., makes us 19% richer in the end.

In addition, we managed our cash positions more intelligently, intensifying the purchase of NTN-Bs and shares in the process of public offering³. As we closely monitored the NTN market, we developed a better sense of the opportunity cost of stocks. We could see that many shares' cash flow projections, at current prices, point to very close (or even lower) rates of return of that of public securities. This is something that does not make sense, in our view, given the greater risk embedded in profit projections. Consequently, we currently have about 20% of the fund invested in NTNs.

Finally, we reinforced our team with the arrival of Pedro Wehbe. Pedro graduated in Mechatronics Engineering from University of São Paulo and, prior to joining Mosaico, worked at IFC and RB Capital. Pedro has played an important role in the execution of these new strategies and in equity research.

With 2016 ended, what can we expect for the coming year? From what we have discussed earlier on the power of chance, we must only conjecture. This is even truer this year, when the black swans elected in 2016 will try to lay their eggs.

² In December 2016, both a primary and secondary offerings took place, in which the company raised BRL 250 mm; the government of Paraná State, Andrade Gutierrez and FI Caixa GP-PR sold their holdings, amounting to a total of BRL 1,500 mm. In 2014 a tentative offering took place, which was aborted due to the market's unfavorable conditions at the time.

³ The public offerings, which we refer to, are tag-along public offerings (triggered by change in the company's controlling block, which, in this case, is followed by the extension of the buyer's offer to all minority shareholders) and also delisting offerings (when a company becomes privately held).

Trump's agenda is particularly uncertain. The market has responded well to possible tax cuts and deregulation in the US. On the other hand, the US elected president campaign pledges entail risks of a trade war, geopolitical conflicts and environmental neglect.

In addition, the anti-establishment and anti-globalization sentiments are not restricted to the USA. It is worth remembering the unusual decision of the British to leave the European Union and the Italians who forced the departure of their prime minister, once he blocked a constitutional reform. There will be elections in the major European economies in 2017 and the risk of populist contagion is material.

Behind the dissatisfaction of American and European voters is the increase in income inequality. The average American wage has been stagnant for 30 years; The 1.5 per cent increase in per capita income in this period was essentially concentrated in the richest 1 per cent. Europeans are afflicted by mass unemployment stemming from the austerity measures implemented to contain the Euro crisis and have the challenge of dealing with the migratory waves from the Middle East and North Africa in a context of growing terrorism. Add to this the development of new technologies (such as artificial intelligence) that put many traditional jobs in check.

This background is a fertile ground for simplistic ideas such as the demonization of globalization and of production chains, which have provided a great symbiosis between China and the US, being one of the main drivers of the world's two largest economies growth in recent years.

Here in Brazil, on the other hand, we have the chance to adopt a positive agenda. If we can approve the pension reform without much change compared to the text that was sent to Congress, we will have taken a decisive step towards public spending sustainability. Obviously, we are not talking about an easy task, given the unpopular nature of this measure and the possible political instability resulting from the further involvement of politicians and businessmen in "Operation Car Wash" plea bargains. On the other hand, the deep recession we have experienced has taken the taboo connotation out of this reform while the government has had surprising loyalty so far in Congress, despite its low popularity.

However, it is hard to imagine that the country will post robust growth in the coming years. Between 1980 and 2015, Brazil's average GDP growth was 2.5% per year. And a large part of this growth came from an increase in the working age population, which rose by 2.1% per year. In the next 10 years, the working age population is expected to grow only 0.7% per year. In addition to that, government, which is the least dynamic part of the economy, has consistently been increasing its stake in the country's spending over the past 20 years, so we come to the conclusion that it will be quite challenging to repeat our historical growth.

The root of our weak growth is the low productivity of the Brazilian economy. This is a problem with several causes, among which are (i) low quality of education (mainly secondary education), (ii) bureaucracy, (iii) closed economy and (iv) large concentration of small and uncompetitive companies which survive as zombies under



the government's mantle of subsidy⁴. The government is timidly beginning to propose measures to attack such problems, such as high school reform and Central Bank measures to cheapen credit, but there is much to be done and we should not expect transformational changes.

Consequently, it seems to us more plausible to believe that interest rates in Brazil will become lower than to bet on a vigorous resumption of growth. This thinking guides our investing rationale in companies we define as "defenders"; among them are regulated companies (such as Sanepar and Transmissão Paulista) in addition to NTNs. At the other end of the spectrum we have our "center-forwards": companies whose businesses are quite sensitive to the economic cycle, such as Tegma (vehicles) and Eztec (real estate). The sales decline in these companies was so deep that the mere stabilization of the economy is expected to bring them robust growth.

We complemented our stock portfolio with a diversified collection of profitable, well-managed businesses that, in our opinion, trade at attractive valuations. We estimate an average ROE for our stock portfolio in 2017 of 18% and Price/Earnings ratio of 12.5x.

That being said, the message we would like to convey is that we have the portfolio prepared for different scenarios and our minds open to change. After all, as John Maynard Keynes said: *"When the facts change, I change my mind. What do you do, sir?"*

We wish you an excellent 2017,

Roberto Knoepfelmacher.

⁴ Marcos Lisboa and José Alexandre Scheinkman spoke brilliantly about this topic in a recent Folha de São Paulo article entitled "The Moonings to the Brazilian Economic Growth".
<http://www1.folha.uol.com.br/ilustrissima/2016/12/1841866-as-amarras-para-o-crescimento-da-economia-brasileira.shtml>



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