



Artwork by Danielle Fonseca - PIPA Prize 2016 Nominee
"The Furious Craftsman II" from the series "The Hammer with no Master", 2015, action for a photograph, 42x29.7cm, edition 1/5.

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RESEARCH AND ANALYSIS

RESEARCH AND ANALYSIS

ABOUT OUR COVER

The photographic work by Danielle Fonseca "The Furious Craftsman II" from the series "The Hammer with No Master" from 2015 made us think that even the most harmonious systems, like a piano, sometimes get out of order and need some serious fixing. That's precisely how we feel in regards to the Capitalist/Democratic system.

A BIT ON THE LONG SIDE (PUN INTENDED)

Whenever we start writing our quarterly report, we intend to make it shorter than our past average. We know our readers are busy people and everybody's day only has 24 hours. But, in the end, we fail miserably. Since we have a goal that's measurable, why do we "fail"?

We offer a few reasons/excuses:

The first one is that writing this report forces us to organize, constantly revisit and reevaluate our thoughts. Of course we could do that and keep it in our files. However, we find the responsibility that comes with writing something and sharing it with people you admire and respect to be quite helpful and sharpening. You'd better be ready to discuss the topics, and take opportunities to practice intellectual honesty and humbleness to convince otherwise or be proven dead wrong. As we developed this interesting group of readers, we receive invaluable feedback, questions and recommendations after each report, and we hope this community keeps expanding.

Furthermore, we see it as a matter of coherence and fairness. Since the thing we value most in companies is knowing how key members of the team think, what their values are and how they evolve and act over time, we find it only fair that we provide our readers with the best possible shot to do the same with us. For that we try to provide answers (and musings) on topics that either we identify as relevant or that have emerged in recent conversations.

IS IT ART?

One issue that has emerged with increasing frequency is algo-trading/black-box funds v. traditionally managed funds.

Given the advances in processing power, storage and link speed, there's no doubt that systems are getting faster and more capable by the day. As we get to the point of self-driving cars, Amazon's Echo assistant, computer chess champions, it's only natural that the question arises: is investment management Art or is it something that can, and ultimately will, be automated?

In most cases involving these transitional situations, we think it depends on the time horizon and if we're talking about a market share change or complete domination. If we're talking about the time frame that will (eventually) allow us to upload our consciences into a "dry body", leaving our "wet bodies" and all its deficiencies behind, that seems quite plausible¹.

¹ The first mention of this situation we can remember was by Ray Kurzweil in his "The Singularity is Near" book from 2006.

Nevertheless, this seems to be a while away, even if you believe true Artificial Intelligence will be attained.

The situation, as we see it today, is quite mixed. There are a few cases of (very) successful "black-box" investors, just as there are those of old human investors. And disasters abound on both sides.

Taking a slightly more fundamental approach to the issue, based on what we've been discussing with some people we respect and who are more enthusiastic about algo-trading, the key arguments go like this:

1. Systems don't succumb to emotions, which is the major driver for failure in human managers. True, but there are people like Bjorn "Iceberg" Borg and Ivan Lendl in tennis, or Buffet and Munger that, as they say, are wired differently. This commands lots of proven experience and common sense.
2. Systems can process a lot more information than individuals, much faster. Therefore, it's only a matter of "treating", inputting data, processing it and refining the algorithms. Also true, but we see two major obstacles here. First there's the easy part which entails accessing relevant data: public, objective and codified data like regulatory filings, trades, management CVs, interviews, presentations, tweets, etc.

Yet what about the "meta information" like body language, talking to and evaluating the quality and motivations of managers? What about good

private investors that follow the industry for decades and don't publish anything but you meet at a party, or people who know people in the companies and notice their state of mind, how committed they are, **what the true corporate culture is** (usually quite different from what the annual reports or a corporate presentation wants to make you believe). Proprietary research like counting shopping bags in the streets and malls, informal comments from competitors, suppliers, clients, and former employees about a range of issues like lifestyle change signals of key personnel or quality of young trainees? Or young people and new private companies that are in the proverbial garage creating the next "new, new thing?"²

How do we measure those soft variables?³ The quants argue that all this information is reflected in trades and somehow they get the signal from there and that the systems are dynamic, constantly being tweaked and adjusted. Hmm. Possibly, but it sounds like quite a stretch to us...

On the other hand, as systems get more complex and sophisticated, we see three key problems:

1. As some friends in the IT business (and experience) keep reminding us, there is no bug-free system and the more complex the system, the greater likelihood that more bugs can exist in latent form in different parts, only to hatch when it's node

² Why do they think we go to things like Developers Conferences, WebSummit, etc...

³ Yes, we know about neural networks and actually have been studying the subject since college, i.e. almost 40 years

is activated. As the saying goes: "the devil is in the details..."

2. Again, as systems evolve, they get more expensive and will need scale to dilute its costs. So, if successful, they can either turn into victims of their own success or lack the liquidity to execute its strategies. This is compounded by the fact that the number of investors and investment houses committing to algo-trading is increasing. If they're big and "right" at a given point, what happens? Who will be the losers?
3. Markets are chaotic. Going back to our hard sciences background, we remember there are two types of chaos:

Type One does not react to predictions about it, i.e. there's no feedback loop. The best example is the weather, which despite all its complexity, predictions and precautions taken by us, its outcome remains unchanged (unless one really takes Murphy's Law seriously or if one considers the rare case where clouds are bombarded to force rain in critically dry areas).

Type Two DOES react to predictions, because the predictors are part of the system and their acts become variables. These are "closed loops" or interactive systems, and therefore aren't suitable for predictive models. It suffices to say that the weather doesn't mind if someone predicts rain or sunshine, but markets are adversarial games and we really can't

figure what would be worse: two big systems with opposing or congruent views...

In sum, we think there are many people way smarter than us and that we respect who are delving into this challenge and it is possible that they find a solution. However, in practical terms, if anything we can tell the kids in the back seat that we're "not there yet". This is a "zero margin for error" business and despite all efforts against it, airplanes still fall from the skies, hospitals still kill patients due to system and/or human mistakes in operating the systems and many other mission-critical endeavours fail. One should never forget that one of the risks of making too many things too fast is that there's no time for adjustments. Maybe one of the biggest advantages of being humans in this case (at least for some) might be to know their limits, keep a margin of safety in terms of position sizing, trading frequency and complexity, and **be fearful of what can go wrong**. Computers, like us, will have to get philosophical and know that they don't know what they don't know. We don't exclude the possibility of a HAL9000⁴ kind of trading system arising...



⁴ HAL is an acronym to Heuristically programmed ALgorithmic computer, a character in Arthur Clarke's "2001, a Space Odyssey." According to the Wikipedia entry, "In the film the artificial intelligence is shown to triumph easily. However, as time progresses, HAL begins to malfunction in subtle ways and, as a result, the decision is made to shut down HAL in order to prevent more serious malfunctions."

We know one thing for sure: if/when we get to the point where systems can consistently and reliably be good investors, that will be the least of our concerns. After all, if some of them can precisely predict the market (a type-two chaotic system), many more things will change and the market's existence itself will make no sense. We might even keep challenging them just for the fun of it, like kids playing a game.

In practical terms, for now, we'd rather stick to our system and processes and monitor the developments. We definitely believe some will be successful for a period of time, but since any string of numbers multiplied by zero equals zero, and we can see why many things will go wrong for a while on the algo side before eventually they get it right, we'll keep our mantra that "to finish first, first you have to finish". Rest assured we believe someday we'll be disrupted and we don't expect anyone to shed a tear for us. We'll find something else to do if we're still around then (in the "alive" sense of the expression).

ON CREATIVITY

Taking a cue from the previous topic, we found a great opportunity to highlight some points in the excellent "Creativity, Inc", by Ed Catmull, one of the best books we ever read when it comes to managing creatives. Catmull was one of the founders, alongside Ed Lasseter, who fulfilled more of the "artist's" role, and Steve Jobs, main investor and mentor, of wildly

successful animation studio Pixar, later acquired by Disney.

His ideas and experiences are so much more relevant since he not only used them to build Pixar, but also to reboot Disney Animation, by effectively changing its culture and, as a consequence, its processes and results. No small feat considering that Pixar was not only much smaller and younger than venerable Disney, but was in fact acquired by it, the house that invented animation. An "acquihire" that Walmart would kill for.

The decision to invest time on the book came from different drivers:

The first one was to study the case of something that went very well. Their "hit" ratio is unheard of (defined as blockbusters/films produced), and managing creative types is certainly one of the hardest parts of what we do. Also, we like to study both highly successful cases and major disasters.

The second one was the aforementioned fact that we see many similarities with our business, and as most things get commoditized, the ability to manage creatives will become more and more important. So that's an important tool for our toolbox.

Lastly because Disney is a company we admire in terms of assets and Bob Iger is a great manager, but succession is currently a riddle that has been a yellow flag. We're old enough to remember

what happened when the late Frank Wells, the "grounded" part of the Eisner-Wells duo that ran Disney, tragically died in a helicopter crash. Eisner got ahead of himself, tried bringing in his friend Michael Ovitz to help, which in turn only led to more confusion and an epic Board war with Disney's successor (Roy) which kept the company limping for years. We're especially weary of media companies, because despite all its attractive economics, it seems to attract egotists who turn out to be poor manager and big spenders (of shareholder capital).⁵

We tried to convey some of the most relevant points from our perspective here. Still we strongly encourage everyone with some passing interest in corporate culture, corporate strategy or management to read the whole book⁶.

The fact that Mr Catmull has the soul of an artist but the education of an engineer certainly is a relevant part of his book's success and of what attracted us to him. The other reason is the fact that they started small and with some values we consider highly determinant for future success⁷.

The book is not that big, and it's conveniently divided into five parts. The first one approaches how Pixar got started, which is nice and fun but relatively "sparse". A few sentences we choose to highlight:

"George Lucas [who incubated the idea of computer-generated movies in Lucasfilm] ... created his own island, a community that embraced films and computers but pledges allegiance to neither of the prevailing cultures that defines those businesses. The resulting environment felt as protected as an academic institution⁸ - an idea that would stay with me and help shape what I would later try to build at Pixar. **Experimentation was highly valued, but the urgency of a for-profit enterprise was definitely in the air.**"

"[Steve Jobs] pushed and prodded and poked... His aim didn't seem to be to absorb the intricacies of our technology as much as to hone his own argument, to temper it by sparring with us."

"After we signed our names, [on the deal where we bought Pixar from LucasFilms] Steve [Jobs] pulled Alvy and me aside, put his arms around us and said, 'whatever happens, we have to be loyal to each other'".

"Figuring out how to build a sustainable creative culture - one that didn't just pay lip service to the importance of things like honesty, excellence, communication, originality and self-assessment but really committed to them, no matter how uncomfortable that became - wasn't a singular

⁵ If someone has some thoughts they can share with us on Bob Iger's succession, we'd be very interested in hearing it.

⁶ <https://www.amazon.co.uk/Creativity-Inc-Overcoming-Unseen-Inspiration/dp/0593070097/>

⁷ We never forget what we heard from Sir Michael Moritz back in the 90s. It went like this: "The first 100 days are disproportionately important for companies. That's when they're still small, everyone knows everyone and the guys making the decision of re-using clips and the two sides of the paper is the one that soon will be deciding if it's ok for people to fly First Class and later on to build a new headquarter."

⁸ Which we think accurately describes both IP and PIPA.

assignment. It was a day-in-day-out, full-time job. And one that I wanted to do."

"How could we enable the talents of these people, keep them happy, and not let the inevitable complexities that come with any collaborative endeavour undo us along the way?"

"My hope was to make this culture so vigorous that it would survive when Pixar's founding members were long gone, enabling the company to continue producing original films that make money, yes, but also contributed positively to the world."

In chapter three, as he looks at Peter Deming's, Toyota's, and Sony's ways of operating their businesses, it gets more practical and quite similar to what we always hear from our very successful friends at Danaher.

"The responsibility to find and fix problems should be assigned to **every** employee, from the most senior manager to the lowest person on the production line... Deming's approach - and Toyota's, too - gave **ownership of and responsibility** for a product's quality to the people who were most involved in its creation. Instead of merely repeating an action, workers could suggest changes, call out problems, and - this next element seemed particularly important to me - **feel the pride** that came when they helped fix what was broken. This resulted in continuous improvement, driving out flaws and improving

quality. In other words, the Japanese assembly line became a place where workers' engagement strengthened the resulting product."

Again, this should be much easier for us to implement both at PIPA Global and the PIPA Institute, given our deliberately small size. However, it is something we should always keep in mind and periodically check if we're actually following. It should go without saying that this is the golden standard we look for in companies we like to think of as good investments. This reiterates the importance of hiring, motivating and retaining special people, passionate perfectionists, obsessive learners, capable of judgement (good old common sense). Things that, at least for now, are removed from what can be put into algorithms.

Finally, central to our always-cautious opinion regarding the decision to whether or not concentrate investments:

"A few years ago, when Toyota stumbled - initially failing to acknowledge serious problems with their braking systems, which led to rare public embarrassment - I remember being struck that a company as smart as Toyota could act in a way that ran so counter to one of its deepest cultural values. Whatever these forces are that make people do dumb things, they are powerful, they are often invisible, and they lurk even in the best of environments."⁹

⁹ One doesn't have to look any further than the Sokol imbroglio at Berkshire, which was more relevant since he was seen by many as shortlisted to succeed Buffett..

MENTAL MODELS

Stick & Carrot

Anyone who knows us or has read anything we've written understands we consider incentives and alignment of interests one of the most important factors when evaluating a company (the others being competence, business model quality and of course, price). However, there are many caveats concerning how incentives and punishments are structured.

One clear example we like to keep in mind is "Merda d'artista - Artist's Shit", a 1961 artwork by Italian artist Piero Manzoni. Although the official story is that at the time the piece was created, Manzoni was producing works that explored the relationship between art production and human production (Artist's Breath ("Fiato d'artista"), a series of balloons filled with his own breath, being an example) one of the legends about the piece is that his gallerist was pressuring him to increase production in order to meet heated demand for his works. Things would've gotten to a point where it was said that people would buy any shit made by him. Manzoni quickly solved the problem. The work consists of 90 tin cans, each filled with 30 grams of faeces, and measuring 4.8 by 6.5 centimetres (1.9 in × 2.6 in), with a label in Italian, English, French and German stating:



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So much for unintended consequences.

Incentives are one side of the coin and punishment is the other. We find ourselves wishing for more well-tailored arrangements and developments on the incentive side as we're quite frustrated with most punishment systems.

It seems to us that governments in general, after having dug themselves into ever-deeper holes and having the power to do so, have become prone to taking the easiest and most profitable way out; i.e. harrasing and fining successful companies left and right. The "Regulatititis" global epidemics (if not an intentionally spread disease) enables them, as does all the talk of wealth concentration. This leads to what seems to us as quite the unfair situation, where shareholders end

¹⁰ Artist's Shit - Contents 30 gr net - Freshly preserved - Produced and tinned in May 1961

up being punished twice or more. They lose what went through the frauds, they pay inflated bonuses and most, if not all, of the fines. That's beyond unfair; it's a menace that risks destroying the whole system. As is always the case when things are taken to an extreme against fundamental moral values of the prevalent system, a crisis should follow. Either the processes or the system will have to change.

We couldn't take that out of our minds as we browsed through the brilliant "You say you want a Revolution" exhibition at the V&A Museum. The exhibition illustrates all the changes precipitated between 1966 and 1969 when people got fed up with anachronistic rules and governments and spoke out against racial discrimination, the Vietnam War, as well as the memorable protests from Prague to Paris to Woodstock, and that was BEFORE the internet¹¹. It is worth noting that "they set the agenda that is at the heart of the current fierce struggle between Western liberal values and fundamentalism of all sorts: the rights of the individual and their relationship to the 'State'". Looking backwards, it seems the pendulum has swung to one extreme and back. So there's hope, but it's time to keep our seat-belts buckled. Please see the Miscellaneous section below for some highlights of the texts in the catalog¹².

On August 19 of this year, the FT reported that Ben-Artzi, who exposed false accounting in Deutsche

Bank, declined share of payout after executives went unpunished (his shares would be worth over USD 8 million).

"Deutsche did not commit this wrongdoing. Deutsche was the victim. **To be precise, the bank's shareholders and its rank-and-file employees who are now losing their jobs in droves are the primary victims.** Meanwhile, top executives retired with multimillion-dollar bonuses based on the misrepresentation of the bank's balance sheet".

In the same positive vein and one day prior, Theresa May, British Prime Minister, announced a proposal to punish the promoter of tax avoidance schemes. Talk about using the "stick."

A Treasury consultation paper has proposed the idea of extending the penalties for avoidance schemes disallowed by Her Majesty's Revenue & Customs to those who advise on them. Under the new regime, accountants, lawyers and consultants that peddle or assist these schemes could end up paying a fine of up to 100% of the money that would have been lost to the taxpayer.

Unfortunately those are still the exceptions to the rule and there's much more to improve before we get into a more fair situation.

¹¹ The exhibition goes until February 26, 2017. In our humble opinion everyone older than 18 should go. It's one of the most engaging and thorough history lessons over that recent and relevant period that still relates very closely to current issues. More info here: <http://www.vam.ac.uk/exhibitions/you-say-you-want-a-revolution-records-and-rebels-1966-70>

¹² <https://www.amazon.co.uk/You-Say-Want-Revolution-1966-1970/dp/1851778918/>

On the subject of sticks, we've developed a quite cynical view that governments find it much easier to fine big banks than to tax them. Regulation complexity and public impressions also favour the alternative of punishing banks with fines. As a test to our thesis we conducted a quick research, which might not be perfectly accurate given that some agreements and tax returns are not public. It does however give an idea of what we're talking about. In the three years from 2012 to 2014 the ten big banks we chose arbitrarily,¹³ because they were top of mind for us, paid around USD 123 billion in fines in the US alone, whereas cash taxes paid by the same banks in that same period was about USD 84 billion. Not a fun time to be a big bank in the US and a gentle reminder of the heavy hand of government. Sometimes big is not beautiful. Everything in life is cyclical and involves tradeoff. Once again, shareholders were penalized for management's sins. We have a hard time accepting that as fair.

COMPANIES

As one of our wisest and smartest friends says, there's no place to hide. From Coca-Cola to Kellogg's, from TV networks to IBM, all traditional brands face a huge challenge as the rate of change accelerates and new generations substitute previous ones in terms of consuming. In Buffett's parlance, the moats are becoming rarer and shallower. We think the ultimate moat would be the capacity to combine creativity with execution, in the right amounts.

In our opinion, every business is a cigar butt. Some are longer, some burn faster. What we look for are managers that agree with this vision and keep making and/or buying new cigars so that we can satisfy our addiction for compounding.

AMAZON

The company keeps innovating on all fronts, and we keep poking at it.

They recently launched Fresh in London. Here are some of our first impressions:

- The whole platform is quite superior to Ocado's (which we would consider short material, if not for the ultra-high short interest, and which we're still puzzled as to why WMT preferred to spend more on Jet.com). Extremely user-friendly, specially for those used to Amazon's "look and feel" (hundreds of millions, a nice network effect and scale advantage).
- They seem to be including local brands, from bakeries to butchers, which to us can help diminish the idea that Amazon is a big warehouse and all produce comes from the same or a handful of suppliers. Thus becoming more appealing to people who want diversification as well as to millennials who value local/organic/artesanal.
- We placed our order by 11:00 am. Delivery happened at 18:00 sharp, as scheduled. Delivery

¹³ Bank of America (biggest fine payer), HSBC, JPM Chase, Wells Fargo (biggest taxpayer in the period), UBS, Barclays, Credit Suisse, Citigroup, Deutsche Bank, Morgan Stanley and Goldman Sachs.

windows were plentiful but caution would make us assume that part of it might be attributable to the fact it's still in the early days. However, AMZN's execution track record deserves some credit as well...

- In sharp contrast to Ocado, that has refrigerated vans, they use dry ice. Still not clear if it's cheaper or a "phasing up" thing. But it was summer and a hot one at that. Products arrived in perfect condition. Given the average temperature in London and the acquisition, maintenance and fuel costs of a refrigerated van, we tend to believe the dry ice solution might prove successful. Even as they scale up and could eventually bring refrigerated vans to cost parity per volume, it's a fact that the dry ice solution **allows AMZN to mix up fresh and other products, increasing the intraday frequency of deliveries, leading to even greater customer convenience, Amazon's True North.**

When we think of it, it's hard not to feel sorry for the Ocados and Best Buys of the world, who are trying to compete having to scale their routes, and don't have integrated accounts nor AWS inhouse. Life can be tough for some and sweet for others.

In order to avoid making this a "one point extrapolation" in commenting the fact with some friends from New York and San Francisco, we got the same feedback.

Another front we've been investigating is Amazon's B2B segment (AmazonSupply, launched in 2012, and Amazon Business, its evolution, launched in 2015). As usual, we've poked from many different angles. We spoke to a former CEO of a great company whose execution track record has always impressed us and whom we have in the highest regard.

As we raised our concerns and befuddlement with Amazon's execution track record, which never ceases to amaze us to the point of fear, he replied that he's also quite impressed and a fan.

Given his background, his closest and most relevant experience with the company has been in the B2B segment, he suggested we dig a bit more on the topic which, if successful, could be a "needle mover" for Amazon. Bare in mind that he thinks the dynamics v. Grainger and Fastenal are more challenging, despite ending his remarks with the caveat that "it's hard to bet against Bezos".

We then went back to check on Grainger and Fastenal. From Grainger, we basically got that:

- Amazon is a "very good customer" of theirs, among their top customers. They use Grainger's vending machines in their Distribution Centres.
- Their complexity of inventory challenges are a great fit for Grainger.
- The fact that Amazon Supply got taken down

and sent back inside Amazon Business indicates that they are not investing full-force on the MRO distribution industry, selling products online instead.

- This is the sort of competitor they are used to facing, but two things keep them at bay:

1) Most of them don't stock their products, they source. So not only they can't compete with the prices but also can't deliver as fast as Grainger;

2) They don't offer broadline services and the customer relationship that Grainger does.

- When we asked if there was any concern about Amazon's notorious willingness to slash prices to sell more, their Senior Manager of Investor Relations mentioned that in 2012, Grainger was taking the AMZN threat very seriously and they ran a study on over 40 thousand SKUs to compare with AMZN and had around 99% of price parity between them.

And from Fastenal:

- It is difficult for one of their clients to go to Amazon Supply because they don't have the service side of the story.

- Client-sales relationship is very important in this business.

Bernstein, which is a research house we find among the best (valuations and recommendations notwithstanding) recently wrote the following on Amazon's effort in B2B:

"Take, for example, the market for facilities maintenance and related products. This segment corresponds to USD 126 billion in annual spending in the US alone, with another USD 83 billion in Europe and Japan, according to Grainger. **The market is extremely fragmented in this segment** and in several others targeted by Amazon Business. Grainger has 6% share in the US market in the facilities maintenance and related products market, and the majority of the market is served by small, local providers. Succeeding in this market is far from trivial as it requires investment selection, pricing, sales approach, and capabilities (e.g., Grainger has 3,500 sales reps), and logistics capabilities supporting same or next-day delivery. **Challenging as this may seem, the market fragmentation, Amazon's scale, existing logistic infrastructure, willingness to invest and track record in creating large new businesses, including AWS, lead us to believe that this could be a sizeable, real opportunity in the medium term.**"

We also looked at the company's recent filings to see what we could get on the subject. As usual, not much.

2Q15 - Quarterly Earnings

Amazon announced Amazon Business, a new business-to-business marketplace that offers hundreds of millions of products.¹⁴

April 2015 interview for Forbes

"Amazon Business has hundreds of millions of products for sale — already many times what's on offer on AmazonSupply," said Prentis Wilson, Amazon's wholesale czar. Wilson said the new marketplace was born out of consultation with business customers of all sizes, from churches to multi-billion-dollar corporations. "We continued to hear that they wanted an Amazon shopping experience when they were buying for work," he said¹⁵.

3Q15 - Quarterly Earnings

Amazon continues to expand its international categories with the launch of the Business, Industrial, and Scientific Supplies store for Japan, UK, Germany, France, Italy, and Spain with hundreds of thousands of items available for businesses

4Q15 - Quarterly Earnings

Only eight months after launch, Amazon Business, a marketplace with features and benefits tailored to businesses, serves more than 200,000 businesses ranging from small businesses to Fortune 500 companies.

1Q16 - Quarterly Earnings

Amazon Business, a B2B offering that includes features and benefits tailored to businesses, now serves more than 300,000 businesses ranging from small to Fortune 500 companies.

2Q16 - Quarterly Earnings

Amazon Business now serves more than 400,000 businesses and generated more than USD 1 billion in sales in its first year. Amazon Business has more than 30,000 third-party sellers who fulfill over half of Amazon Business orders.

We then reached out to some friends that have been the "masters of e-commerce" in Brazil since the late 90's. Having made more than their fair share of money a while ago, they've been investing in the segment in a very diligent and informed way since they have the great advantage of having actually ran Brazil's biggest e-commerce operations, no small feat considering all the challenges it entails due to the country's dismal infrastructure. As a result, they've built an enviable global network of contacts in the industry. The fact that they're benchmark-and-number obsessed only contributes to the weight we give their opinions.

To start, it goes without saying that they consider AMZN the golden standard in e-commerce. They classified it very simply for us: their core business is

¹⁴ <https://www.internetretailer.com/2015/04/27/say-hello-amazon-business-good-bye-amazonsupply>
<http://www.ft.com/cms/s/0/08cbb4da-eda5-11e4-987e-00144feab7de.html#axzz4Knpev3dq>
<http://www.cpcstrategy.com/blog/2016/03/amazon-b2b/>

¹⁵ <http://www.forbes.com/sites/clareoconnor/2015/04/28/amazon-launches-amazon-business-marketplace-will-close-amazonsupply/#596aa31e66d2>

customer service, which leads to focus on execution, reflected on metric-analysis paranoia and kaizen-style execution, always optimizing and simplifying processes.

Another point on which we agreed is that AMZN is less focused on attracting all PhDs of the world, like some other "usual suspects". It's much more of an execution company and we all have the impression that having too many creative types would end up being detractors to the business. Of course we understand that AMZN doesn't have to use all their individual businesses to build a successful beach-head and that once that's established...

Furthermore, the old "friend or foe" framework is completely outdated, since companies now compete on certain fronts and are partners in others. As we've established, we have noticed that the B2B segment hasn't been mentioned much by Bezos & Co. It could be a strategy or simply that it's not a priority at the moment. We would be interested in knowing your take on the subject.

At the end of the day, we think the whole AMZN B2B issue is a matter of opportunity cost. Is this segment the most attractive one to invest time and capital now vis-a-vis other lines of business and international expansion? Do they have the right "owner" for the project?

The New York Times recently reported that "Amazon Is Quietly Eliminating List Prices"¹⁶, which we found

quite insightful. Some highlights with which we fully agree:

Amazon wants to be so deeply embedded in a customer's life that buying happens as naturally as breathing, and nearly as often.

Amazon doesn't have to seduce customers with a deal because they're going to buy anyway.

Amazon is a data-driven company with very few sacred cows.

Amazon has always focused on driving revenue while disregarding profits. That had many implications: it was driven to try new things; it could undercut any competitor who focused on price; it could literally buy customer loyalty.

In Amazon's third decade, with its complete domination of the e-commerce landscape, there are signs it is beginning to emphasize the value each customer brings.

If Amazon brings the milk and music into your house, not to mention videos, e-books and the devices to consume them on, as well as a hot dinner and just about any other object you could want, that presents a pricing challenge of a different sort. Untangling what those deals are worth — as opposed to what they cost — is probably impossible.

"Twenty years ago, we were hesitant to trust online

¹⁶ http://www.nytimes.com/2016/07/04/business/amazon-is-quietly-eliminating-list-prices.html?_r=0

companies with our credit card information," Mr. Compeau observed. "Now we're being asked to trust them completely."

Last but not least, it's always important to remember that although within actuarial terms, the risk of not having Buffett around is higher, so much of the value we see in AMZN depends on Bezos. Despite the success of AWS under Andy Jessy's steering, Bezos is still quite involved in the all-important function of selecting and killing projects, a.k.a capital allocation.

WELLS FARGO

Needless to say, the highly publicized recent news on Wells Fargo "opening of fake accounts" surprised us. Not that we live under the illusion that big organizations can be anything close to seamless perfection, but one of our mantras is that good companies generally come up with good surprises, and the same logic applies to bad companies.

For those who haven't been following these events, so far it appears that since lots of middle managers' variable compensation was linked to the number of new accounts opened. This resulted in a few million fake accounts being opened. If anything, this is another example of how incentives can backfire.

Although we tend to believe the issue was hugely amplified by Democratic media spin doctors to cover Hillary's problems and hurt "fat Republican pigs", it's one more proof that mammoth institutions are

impossible to keep clean. As Goldman Sachs CEO famously said, "every 20,000 person city has a prison." WFC says it has dismissed 5,300 miscreant staff over the issue.

We don't know how biased we are given our admiration of the company, but this whole thing seems to be much to do about too little. We keep wondering how much it's one more way of government extracting fines or some plot by competitors (New York institutions do not enjoy the fact that Wells Fargo is the biggest US bank by market capitalization and has (had?) the best reputation, by far). If any proof of that was needed, one needs to look no further than the mocking piece published by no other than The New Yorker Magazine¹⁷ in the appropriately named "Daily Shouts" column.

The key takeaway is the old point of incentives leading to exacerbated behaviour. Its focus is treating itself as a retail operation, therefore much more protected from the Investment Banking and Treasury wheeling and dealing. And it acts this way making most of its money out of services and interest-rate spreads.

One of the great opportunities the bank has been exploring over the last few years is the huge discrepancy between its number of banking clients and its number of credit cards users.

Of course, one has to pause now that one knows that a few millions of those accounts and cross-selling were fraudulent. There's no question the bank's reputation

¹⁷ <http://www.newyorker.com/humor/daily-shouts/from-wells-fargo-re-closing-the-accounts-we-secretly-opened-for-you>

will suffer. On the other hand, considering the competition and with the info available, we expect, for the time being, the worst case scenario would be for WFC to become just like the others. Still, we're far from sitting idle and hoping for the best. We've been poking left and right within our network, from bankers to former regulators to marketers, and trying to develop a more informed opinion.

Current "scandal" notwithstanding, top management quality is exceptional. It's worth remembering that it was the ONLY major US bank that didn't need help from the government (although it reluctantly took some TARP money to avoid making the others look too weak).

With its huge deposit base, when interest rates go up (yes, we believe they eventually will) the gains to be made will be quite significant. Reputational risk is something that all big companies are exposed to and experience shows us that many manage to handle it relatively well, like J&J (Tylenol), American Express (Salad Oil), Toyota, VW, etc. Episodes like this one are never good news but something one has to be prepared for and work hard to put behind. For investors it might even prove to be an opportunity.

To sum it up, we list below the possible consequences in crescent order of likelihood of occurrence and impact on the company:

1. Management's time and energy gets diverted.
This goes without saying and is bad enough. One needs to only remember the impact of the antitrust investigation and process against Microsoft to see

how bad it can get. However, WFC's dominance doesn't even come close to MSFT's back then and, compared to the sins of other major banks, this one looks like a "peccadillo", so we expect it to go away faster. Of course that's part of the job, but as Munger says: the best way to get out of trouble, is to stay out of trouble in the first place.

2. WFC's image as the most ethical, best managed and productive big bank legitimately comes into question. No doubt about it. Only time will tell the consequences. We're optimists that this can turn out to be a small cautionary blip over time.
3. The issue represents a much wider problem with the bank's culture and controls. On the practical side, we've been trying to assess this aspect, through contacts with former senior bank executives and central bankers; i.e. is it possible that this was something that is acceptable and one that will from time to time "fall through the cracks" as certainly happens many times in all big companies? If so, it shouldn't leave a legitimate negative mark on WFC's culture and controls scorecard.
4. Given the huge blow administered by the media and politicians just as we reach quite an important election, can the issue lead the bank to over-react, and on top of the time lost to managing the crisis, become stiffened and lose productivity and competitiveness? That wouldn't surprise us, and is the aspect that would lead us to lower our expectations regarding the company.

WESTERN UNION

Despite all new entrants in the payments business, the company chugs on, generating tons of free cash flow. The key competitive advantage continues to be the lack of necessity of bank accounts at both ends and its unrivaled global reach.

Finally someone gave M-Pesa a run for their money. Well, sort of. Users of mVisa will still need a bank account. In that regard, WU still reigns supreme. Of course we should be aware that nothing is stable, specially nowadays, but we believe this dog still has a few bites to it, courtesy of the Regulaititis epidemics we mention above.

The FT reported that:

Visa has partnered with four banks in Kenya to launch a mobile phone payments platform that will mount the first credible challenge to the country's dominant M-Pesa system.

The mVisa service allows people to send money to each other's accounts without first loading a digital wallet, as well as pay for goods and services without a point of sale machine regardless of which mobile provider is being used.

Kenya is one of the most attractive markets for mobile money because of the success of M-Pesa,

launched by Safaricom, which is 40% owned by Vodafone, nine years ago.

The total value of M-Pesa transactions in Safaricom's last financial year was USD 52 billion and the company's earnings from the service in 2015/16 was more than USD 400 million.

but

"The primary goal is to enable businesses and individuals to make digital payments directly from your bank account and on a system that's interoperable between banks and mobile networks."

However, the new system faces an uphill battle in drawing customers away from M-Pesa, which has been a runaway success for making payments and transferring money over a mobile phone in a country where many people lack a bank account.

mVisa is largely aimed at people with bank accounts, although prepaid cards are available. M-Pesa users, in contrast, only need a mobile phone. Mobile phone penetration in Kenya is almost 90 per cent, while the number of people with bank accounts is less than half that.

Since we believe that, unfortunately, the Regulaititis epidemics still has legs to go, WU looks like a good (if not cynical) way to profit from it.

USD Million	2012	2013	2014	2015	jun 2016
Enterprise Value	10.039	11.607	11.277	10.908	12.118
Free Cash Flow	1.092	1.008	940	927	946

ABI INBEV AND SABMILLER

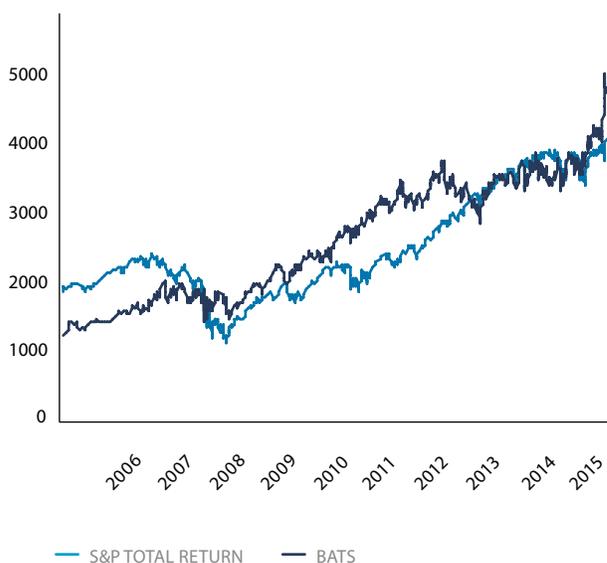
Despite some expected resistance from minority SABMiller shareholders that were offered cash and took the Brexit-induced GBP hit, the deal goes on after ABI threw in a few more chips. Since the deal got vast coverage from the media and sell-side reports, we'll save you time and just focus on key points regarding the deal.

The first one is that a note published on the Monday following the acceptance of the sweetened offer by the Board, it became evident that some people were still surprised by the fact that only one person from SABMiller's top management was maintained. The key takeaway for us is that those people still don't understand that when ABI or Danaher say they focus on keeping their culture, **they mean it. That's their core business competence.** We tend to think that's good news. One needs different perspectives in order to make money.

The second one is that it's self evident that ABI is not only closer, but maybe close enough to be so big so that size becomes an issue, both growth and acquisition-wise. Contrary to DHR or TMO, ABI products are consumer-facing and much more unified/less splittable businesses, which inevitably puts them closer to the "big winners losers love to hate" category. On the other hand, most people don't have any idea that many of the brands belong to the

same company (just like luxury holdings LVMH and Richemont). Plus, as disproportionately big taxpayers, they have the government on their side. A look at the returns posted over the last decade by big tobacco companies, which have to deal with much worse issues, also shows that there's room for optimism.

S&P TOTAL RETURN VS. BATS



The beauty of it is we can see its cause. As the market gets mature and players consolidate, marketing expenses not only get diluted but might be trimmed down. A rational, long-term oriented team will have at its disposal the alternatives of paying dividends and/or increasing buybacks so that the cash can be deployed in other alternatives, hopefully some that will benefit from their strengths in capital allocation.

PERSPECTIVES

Regulation & Sizing

In our last report we discussed our impressions on why average productivity isn't growing despite the fact that companies we like are showing "productivity exuberance". One friend was kind enough to highlight to us that one more reason for this could be the "Regulatitis" most governments are experimenting with.

It happened on a day we were having coffee in a London library coffee shop. After my friend ordered a nut cake, the waitress, quite ashamed, told us she was obligated to inform us that nut cakes contain... nuts... Obviously this is only a tiny anecdotal evidence. Quite more relevant is this text from the GE annual report:

"What is unique in this cycle is the difficult relationship between business and government, the worst I have ever seen. Technology, productivity and globalization have been the driving forces during my business career. In business, if you don't lead these changes, you get fired; in politics, if you don't fight them, you can't get elected.

In the US, we want exports but seem to hate trade and exporters; globally, governments love small businesses but then regulate them to death."

Being big is one solution, for one can then dilute all the costs of complying over a huge revenue base. On the other hand, too-big of an organization also has their historic problems, they get hard to manage, "loved to hate" and increasingly difficult to grow (which becomes a problem in terms of attracting talent, once you've abandoned the "boutique" or the free-agent business models).

Examples of too-big-to-manage are abound. US carmakers used to be the golden standard in terms of well-managed multinational companies¹⁸. Today, they are a tiny shadow of their former selves, face competition from startup Tesla and have a cloudy future due to asset optimization trends like Uber. As pointed out in a recent article¹⁹ sent to us by a friend:

"By 2025, owning a car will go the way of the DVD... Between car payments, insurance, gas and repairs, car ownership costs the average American family nearly USD 9,000 each year... The car has actually become more like a USD 9,000 ball and chain that gets dragged through our daily life".

Next time you walk outside, pay really close attention to the space around you. Look at how much land is devoted to cars — and nothing else," says Zimmer. "Most of us have grown up in cities built around the automobile, but imagine for a minute, what our world could look like if we found a way to take most of these cars off the road. It would be a world with less traffic and less pollution."

¹⁸ For those interested in corporate "archeology" we recommend "My Years with General Motors", by Alfred Sloan

¹⁹ <http://www.cnbc.com/2016/09/19/lyft-co-founder-by-2025-owning-a-car-will-go-the-way-of-the-dvd.html>

Walmart seems to be going in the same direction. In its specific case, we believe the main issues it suffers from are:

- Leadership questions, which gets amplified as it faces a historic technology change and competes with one of the most brilliant leaders of our lifetime which is still in his prime (no pun intended) years.
- The amount of physical assets with fixed costs, decreasing productivity and lack of alternative use.

Even "darling" Berkshire Hathaway suffers from size (and makes no secret of it). Buffett is always complaining about how difficult it has gotten to "move the needle". At least we see many managerial "opportunities" there simply because Buffett's capital originating and investing skills has made it sufficient for them to be run well enough. Also, we are led to believe that succession and leadership issues will be better addressed than in Walmart's case, if nothing less because they have been so obvious for so long in BRK's case, while at WMT size was seen unilaterally as an advantage and led them to believe they were unbeatable.

As mentioned above ABInBev and soon-to-include SABMiller fall in the category of being so well managed that they practically took over the whole "beer world". In practical terms, it's hard to imagine them being allowed to make one more acquisition that could move the needle (Russia, China and India,

maybe?). Misters Lemann, Telles and Sicupira have had the geniality and foresight of fractionating their interests, so Kraft Heinz and Burger King share some investors and, most importantly, the same corporate culture. However, their efficiency is so far above the competition's that they'll hit the same "problem" of being too big very soon. Some people speculate if they might somehow succeed Buffett at Berkshire. Well, that at the very least would give them a little more room to "play". And possibly the first USD 1 trillion dollar combo, albeit completely segregated in terms of corporate structures.

Buybacks are also an interesting alternative to be considered. Taking a long-term view, we wouldn't mind it if companies that find non-economic or regulatory difficulty to grow would either pay dividends or buyback shares. There are price and fiscal considerations, but companies like ABI should probably be underleveraged again soon and if the credit markets continue to offer the possibility of raising long term capital at a cost that is much lower than the company's return, we see it as an attractive alternative to distribute cash and invite them back to repeat the game plan with other companies. Just "shooting from the hip", we can name great businesses with similar attributes that could benefit from a shake-up by committed owners like them: Nestlé, Coca-Cola, Mondelez, P&G and the list goes on and on.

Danaher and Thermo Fisher are both already USD 60 billion companies, and Danaher opted to split itself

into Danaher and Fortive. Many factors went into it, but certainly keeping things at a more manageable scale and in a way that facilitates new acquisitions was a factor. Just as in the case of our friends at ABI, once you create a culture that delivers a continuous stream of great motivated people, who think and act like owners, it's paramount that you develop opportunities for the best of them to run their own show.

Maybe the most extreme negative example are Global Banks²⁰, which combine the difficulties of managing hundreds of thousands of people under heavy and diverse regulation and being a historically hated industry.

Itaú already has an immense market share in the Brazilian financial markets, and just like Admiral in the UK, it's not a truly global company. They will find it harder and harder to grow in their home markets. One could say that's an opportunity, but in tightly regulated markets with strong incumbents, that's proven to be quite a challenge.

So what is there to do in practical terms? Prioritize companies that have "cracked the management code" and have shown to spread their culture among different vehicles, like ABI, KHC, DHR, FTV, CFX and on the rare breed that are managing to grow at breakneck speed, despite their sizes, like AMZN, GOOG and FB. Unfortunately, the last two come with governance issues that lead us to believe a much bigger discount should be attached.

Going back to the beginning, we think the lifespan of the algo-traders will be quite short, for once/if they get it right, they will swallow the market and that's going to be the end of it.

We'll also take this opportunity to reaffirm our intention to keep our size relatively small as in we, people, know in our minds what we're doing, know the agreements, know the people we're dealing with and can work seamlessly from mobile phones in a park, coffee shop, even from our paper notebooks. We do try to take the maximum benefits from technologies, but we always make a point that we can keep functioning if our computers and/or internet connections go bananas, as they sometimes do.

Despite all our efforts to the contrary, it's very difficult to be original. As it should be clear, we try to be very deliberate information gatherers, filters and value-attributors, being it written, gestural or spoken. As we mentioned in some points throughout this report, some very smart and wise people we've been fortunate to get to know through life are generous enough to share some opinions with us. We can't thank them enough. Please keep in mind that if you have access to this report, and you have something to add, which many times takes the form of a question or disagreement, please don't hesitate to reach out.

Most people we have been talking to are skeptical about economies, the markets and the system as a whole. Taking a cue from our Regulatititis phobia,

²⁰ Old Safra in his immense wisdom and experience was known to be very specific to his sons: we're Jews and bankers. Never ever let yourselves be the biggest bank in any country.

the fact that the US and the EU seem to be engaged in a "cold war" using regulation (or the threat of it) against each other's "business champions" adds to the recurring reminder of the memorable Pink Floyd album "The Delicate Sound of Thunder".

With Ms Clinton joining Ms Merkel and Ms May, the three main occidental nations are about to be run by women. Let's hope that history repeats itself on a macro scale and women fix up the mess made by men (and please consider Brazil's recently impeached Dilma Rousseff the exception to the rule). If they fail, we only see one alternative: technology, as in [ctrl-alt-del].

Just to make it clear: we're no atavic pessimists. But we do strive to avoid a trap highlighted (again) by Mr Catmull:

"When downsides coexist with upsides, as they often do, people are reluctant to explore what's bugging them, for fear of being labeled complainers. I also realized that this kind of thing, if left unaddressed, could fester and destroy."

It's just that we think one of the most important things in investing is to get the risk/reward ratio approximately right. Human nature and all that derives from it is cyclical. There's a time to be greedy and a time to be fearful. What would make us happy? A 33% decrease in asset prices would be a nice start. As the

image on this report's cover, the keyboard needs to be disassembled, cleaned and reassembled.

To point out efforts in what we consider the right direction and end on a positive note, during the quarter we had the pleasure to talk to Ms Ngaire Woods, Dean of the Oxford Blavatnik School of Business²¹. Her wisdom, energy level, commitment and enthusiasm towards improving government practices, and the fact that people with her attributes dedicate their life to the cause, is really something that gives us hope.

An abstract of her interview to the FT²²:

"This is not a school of public affairs. And it's not a school about why governments fail. It's a school about what works; how do we learn from it; how do we build on it; how do we educate the next generation of leaders to use science, engineering and to be more effective."

"If you let yourself get down listening to the negatives, the risks, the naysayers, you'd never get anything done at Oxford. But if you focus on the positive, everything is possible. I like to marshal people around what works."

Among the troves of interesting facts, evidences, research cases²³ and data she offered us, we'd like to highlight one. While in countries like the US or Brazil, more than 10,000 people in the top level of Federal Government "churn" with each government change,

²¹ <http://www.bsg.ox.ac.uk/people/ngaire-woods>

²² <http://www.ft.com/cms/s/2/4ce23df8-7136-11e2-9b5c-00144feab49a.html?siteedition=intl>

²³ https://www.amazon.co.uk/gp/product/0333776453/ref=oh_aui_detailpage_o06_s00?ie=UTF8&pssc=1
https://www.amazon.co.uk/gp/product/0198295669/ref=oh_aui_detailpage_o05_s00?ie=UTF8&pssc=1
https://www.amazon.co.uk/gp/product/069113961X/ref=oh_aui_detailpage_o04_s00?ie=UTF8&pssc=1
https://www.amazon.co.uk/gp/product/0801444241/ref=oh_aui_detailpage_o03_s00?ie=UTF8&pssc=1

in Denmark, the golden-standard benchmark in public governance, only about 10 (ten) do. Of course Denmark is much smaller (population = 5.6 million vs 324 million in the US and 206 million in Brazil), but there are **two orders of magnitude difference in the ratios**. That's absolutely an eye opener, a blinking red light in the panel, or to put it bluntly, a slap on the face. Definitely something that deserves lots of attention. Again, we have our friends to thank for the introduction.

We think continuity is grossly underrated²⁴. Repeating things, even the ones that are working, eventually gets boring for some people, and day-dreaming and looking for "moon-shoots" is addictive to others. If on the one hand experimentation and innovation is paramount, on the other better execution comes from repetition and continued improvements.

Experience has led us to believe two things are key:

- To repeat, expand and continually improve what works on a wholesale scale and experiment deliberately and continually on a small scale, always measuring and evaluating. Again old "friends" like Lojas Renner, Danaher and Amazon are clear examples.
- Some people thrive on executing and others on creating/innovating. In order to have a great company, **you need both and in the "right"**

proportion.²⁵ And since we already dedicated a relevant part of this report to Mr Catmull's ideas (Good Uncle Buffet deserved some rest):

"Getting the team right is the necessary precursor to getting ideas right... Even the smartest people can form an ineffective team if they are mismatched."

²⁴ That's why we keep repeating Munger's phrase that "to finish first, first you have to finish".

²⁵ Citing again Mr Catmull, he mentions of the job of Production Managers: "[They] are the people who keep track of the endless details that ensure that a movie is delivered on time and on budget". Good ideas are a dollar a dozen. At the end of the day, companies must **execute**.

RANDOM BITS

Pension plans beware: "The number of people in Britain reaching the age of 100 has quadrupled in the past 30 years and is likely to quadruple again by 2035."

— **Financial Times**

FAA Expects 600,000 Commercial Drones In The Air Within A Year: "We are in 'one of the most dramatic periods of change in the history of transportation'"

— **Transportation Secretary Anthony Foxx**

According to Barclays' latest research, commodities saw investment inflows of USD 54 billion between January and August, an all-time high for the first eight months of the year. If the current trend continues, 2016 will mark the first year of net inflows into commodities for the first time in four years. Gold has been by far the single most popular commodity investment in 2016, with flows into physically backed exchange traded products climbing to a net USD 27 billion. This comes after three consecutive years of net outflows from gold ETPs and is already far ahead of the previous record set in 2009.

— **Financial Times**

Over the past 10 years, banks globally have underperformed the rest of the market by about 50%, according to MSCI.

— **John Auters**

Although a different (and larger) period of time and smaller geography, an interesting number to compare with the fines and taxes paid by our arbitrary list mentioned above in the "Stick and Carrot" section:

"Eurozone's banks raised more than EUR 250 billion from 2007 to 2014."

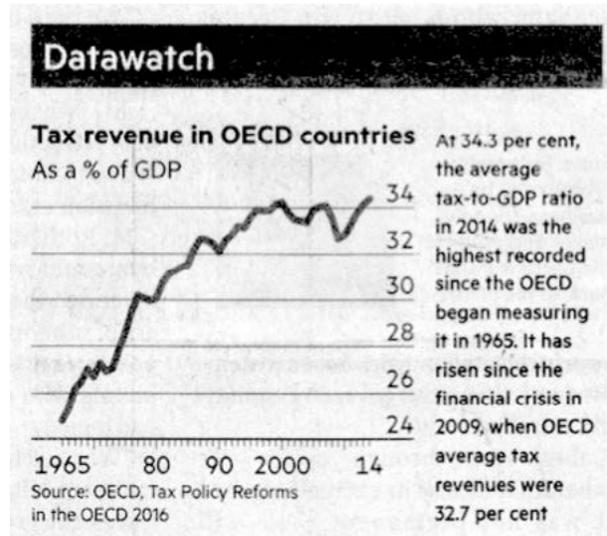
— **Financial Times**

"The average tax-to-GDP ratio in 2014 was the highest recorded since the OECD began measuring tax burdens in 1965. The average tax-to-GDP ratio reached 34.4%, a 0.2 percentage point increase from its 2013 level. It has risen steadily since the financial crisis in 2009, when the OECD average tax revenues were just 32.7 per cent of GDP."

— **Financial Times - and people still wonder why there's no productivity gains...**

- Only six countries, including the UK, Sweden and Norway, bucked this trend.
- Denmark was the country with the highest tax-to-GDP ratio of 50.9%, followed by France at 45.2%. The countries with the lowest tax burdens were Mexico at 19.5%, Chile at 19.8%, Korea at 24.6% and the US which had a tax-to-GDP ratio of 26% in 2014.

By the end of September, the FT published the following chart on its first page . As we always like to remind our readers, we're not economists ourselves, but we could imagine a model where this data goes some way in explaining the "productivity conundrum".



The September 29 Lex section of the FT reported that so far this year, nine out of 76 US initial public offerings have a dual class system, according to Dealogic. We can understand some situations where this feature is even a necessity. But we have seen much more where they were something that led us to apply a discount to what we consider a fair business value. That's an issue always at the top of our check-list...

MISCELLANEOUS

"The most insightful lesson I derived from The School of Athens is that the great thinkers are there not for us to respect unquestioningly, but rather for us to question respectfully"

— **Hanoi Student who won the prize for best art text 2016**

Some other thoughts by Mr Catmull that we found pertinent to our context:

- This one applies to the issue of algo-trading discussed in the "Is it Art" topic above: "What had drawn me to science, all those years ago, was the search for understanding. Human interaction is far more complex than relativity or string theory, of course, but that only made it more interesting and important; it constantly challenged my presumptions."
- "To me... [it] should be obvious: Ideas come from people. Therefore, people are more important than ideas"
- "You need to show your people that you meant it when you said that while efficiency was a goal, quality was *the* goal."

- "Words like quality and *excellence* are misapplied so relentlessly that they border on meaningless. Managers scour books and magazines looking for greater understanding but settle instead for adopting a new terminology, thinking that using fresh words will bring them closer to their goals. When someone comes with a phrase that sticks, it becomes a meme, which migrates around even as it disconnects from its original meaning. To ensure quality, then, *excellence* must be an *earned* word, attributed by others to us, not proclaimed by us about ourselves.
- "The conundrum is how to become mature, how to take on responsibility and become reliable while at the same time preserving your childlike wonder."

From the Brilliant "You say you want a Revolution" exhibition at the V&A, we can gather some data points that reinforce the rate of change:

- "Until 1977 a married woman had to have her husband's permission if she wanted to take a job or open a bank account in Germany."
- "In 1965, homosexuality was illegal in the UK and a woman had to be married to get the pill."

- "LSD was legal"
- "In a world without mobile phones or personal computing, music provided the connectivity for the late 1960s, linking similarly minded people thousands of miles apart with ideas, words, humour, images and, above all, a sense of community."
- "On Friday 28 April, Boxer Muhammad Ali (for those too young to know, one of history's top athletes and public personalities) refuses, as a conscientious objector, to be conscripted to fight in Vietnam. He had earlier declared, 'I ain't got no quarrel with them Viet Cong - no Viet Cong ever called me nigger'. 'No I am not going 10,000 miles to help murder, kill and burn other people to simply help continue the domination of white slave masters over dark people!' He was sentenced to five years in prison and was stripped of his world heavyweight boxing title.
- Interracial marriage in the USA has been fully legal in all states since 1967.
- Blowing up all projections are the 15% of all marriages that are interracial..
- "On Friday, 27 November 1967, French President de Gaulle vetoes UK entry into the Common Market" (one of our favourites).

"Europe may have to abandon the Euro to save Europe and the European project" - Joseph Stiglitz, Nobel Laureate in Economics

At present, large banks are allowed to use their own internal models to calculate risk-weighted assets — a crucial measure for determining the amount of capital they are required to hold. Yet over time, banks' RWA as a proportion of total assets have been drifting down. There is a strong suspicion that this is not just due to making safer loans. - FT Europe must address its banks' enduring malaise - There is a suspicion that institutions have been gaming the rules.

"A map of the world that does not include Utopia is not worth even glancing at, for it leaves out the one country at which Humanity is always landing. And when Humanity lands there, it looks out, and, seeing a better country, sets sail. Progress is the realisation of Utopias."
— **Oscar Wilde**

"Tax is the price we pay to live in a civilized society" - Theresa May, British PM. (Of course, as in everything that involves price, it depends on how much for what...)

And since there's no way that we can talk about government without taking some notes from Lady Margaret Thatcher:

- Successful entrepreneurship is ultimately a matter of flair. But there is also a fund of practical knowledge to be acquired and, of course, the right legal and financial framework has to be provided for productive a enterprise to develop.
- Singapore's success shows us that:
 - A country's wealth need not depend on natural resources, it may even ultimately benefit from their absence.
 - The greatest resource of all is Man.
 - What government has to do is to set the framework for human talent to flourish.
- "You only have to wade through a metric measure or two of European prose, culled from its directives, circulars, reports, communiqués or what pass as debates in its 'parliament', and you will quickly understand that Europe is, in truth, synonymous with bureaucracy"
- Europe in anything other than the geographical sense is a wholly artificial construct. It makes no sense at all to lump together Beethoven and Debussy, Voltaire and Burke, Vermeer and Picasso, Notre Dame and St Paul's, boiled beef and bouillabaisse, and portray them as elements of a 'European' musical, philosophical, artistic, architectural or gastronomic reality. If Europe charms us, as it has so often charmed me, it is precisely because of its contrasts and contradictions, not its coherence and continuity.

- Let us never forget this fundamental truth: the State has no source of money other than money which people earn themselves. If the State wishes to spend more it can do so only by borrowing your savings or by taxing you more. It is no good thinking that someone else will pay – that ‘someone else’ is you. There is no such thing as public money; there is only taxpayers’ money.

- And our favourite: "Constitutions have to be written on hearts, not just paper."

"Like a child counting the years in notches marking their height, I will increasingly count mine by the number of social networks that I don't understand"

— *Lisa Pollock, 35 years old FT columnist*

"Every single point in History is a crossroad. A single travelled road leads from the past to the present, but myriad paths fork off into the future. Some of those paths are wider, smoother and better marked, and thus more likely to be taken, but sometimes history - or the people who make history - takes unexpected turns... History cannot be explained deterministically and it cannot be predicted because it is chaotic"

— *Yuval Noah Harari*

Then you better start swimmin' or you'll sink like a stone, For the times, they are a'changing
— *Bob Dylan*

"People should fear getting famous like pigs fear fattening up (for the slaughter)"
— *Pedro Bodin de Moraes*

"You don't need a weatherman to tell you which way the wind is blowing."
— *Bob Dylan, 1965*

"Change only happens in a crisis, and then actions that are undertaken depend on the ideas that are just lying around"

— **Milton Friedman**

From the brilliant, highly instigating and amazing in its foreseeing accuracy in most aspects "Snow Crash"²⁶, by Neal Stephenson. A dystopian novel published in 1992.

"The B & C people would also like me to point out that many of you who have excess US currency to get rid of have been trying to kill two birds with one stone by using old billion dollar bills as bathroom tissue. While creative, this approach has two drawbacks:

- 1) It clogs the plumbing, and
- 2) It constitutes defacement of US currency, which is a federal crime.

DON'T DO IT!"

Expanding on the famous Plank's sentence. Science and culture advances one funeral at a time. Human nature over millennia. In investing, we try to have both timeframes in mind, for we believe one applies to businesses and the other to markets.

²⁶ https://www.amazon.co.uk/Snow-Crash-Neal-Stephenson/dp/0241953189/ref=tmm_pap_swatch_0?encoding=UTF8&qid=1474666032&sr=1-1-spell

PIPA PRIZE

PIPA PRIZE

THE POWER OF CELEBRATING ACCOMPLISHMENTS AND GOOD EXAMPLES

PIPA Prize was created when we returned from England to Brazil back in the late 2000. The spark was noticing the contrast of our kids' friends in the UK and those in Brazil. Those that had talent for the Arts in the UK saw pursuing a career in their area of competence and passion as natural. So did their families. On the other hand, most our kids friends back in Brazil that were artistic minded, were scared of even raising the possibility with their parents. That's when we decided to put together a little effort, money and some concepts we believed and associated with good results to create the PIPA Prize.

Some key guidelines in that regard was to create a tangible benefit (hence a concentrated prize for the main winner), an international artistic residence (in order to try to provide "escape velocity from an art scene still isolated) and the widest possible recognition, as we deeply believe that one of the key problems in Brazil is mostly lauding the not so good examples and ignoring or even punishing the good ones.

We never cease to get touched by the fact that still today, every year there are countless events in the UK celebrating 1st war heroes. The Royal Mint, for example, does a fantastic job of celebrating accomplishments by British people. From writers to scientist, from

warriors to athletes. And many are commemorative issues only, that sell by the thousands. Definitely it's not all about money. The comparison even with the special editions made in Brazil to celebrate the World Cup and now the Olympics only highlight the abysmal different value attached to accomplishments. One effect is that people like us, immigrants, quickly get more connected and proud here than where we happened to be born. That's a "club I like to engage". One only has to see the migration flows to see the power of incentives.

Getting back to our obsession with incentives. One need goals, idols, examples, the immense pleasure derived from accomplishing something and being recognized for it.

Of course we understand that one has a personal and private pleasure of doing something good. That's probably more pronounced with artists. But in a capitalist society, you need that others acknowledge and value what you do, your work.

In terms of scope PIPA was designed to award artists with a recent and relevant trajectory and not only to recognize what they have accomplished so far, but also hopefully boost them to an higher orbit. It was not designed to discover new artists. Hopefully those will be inspired by PIPA's winners.

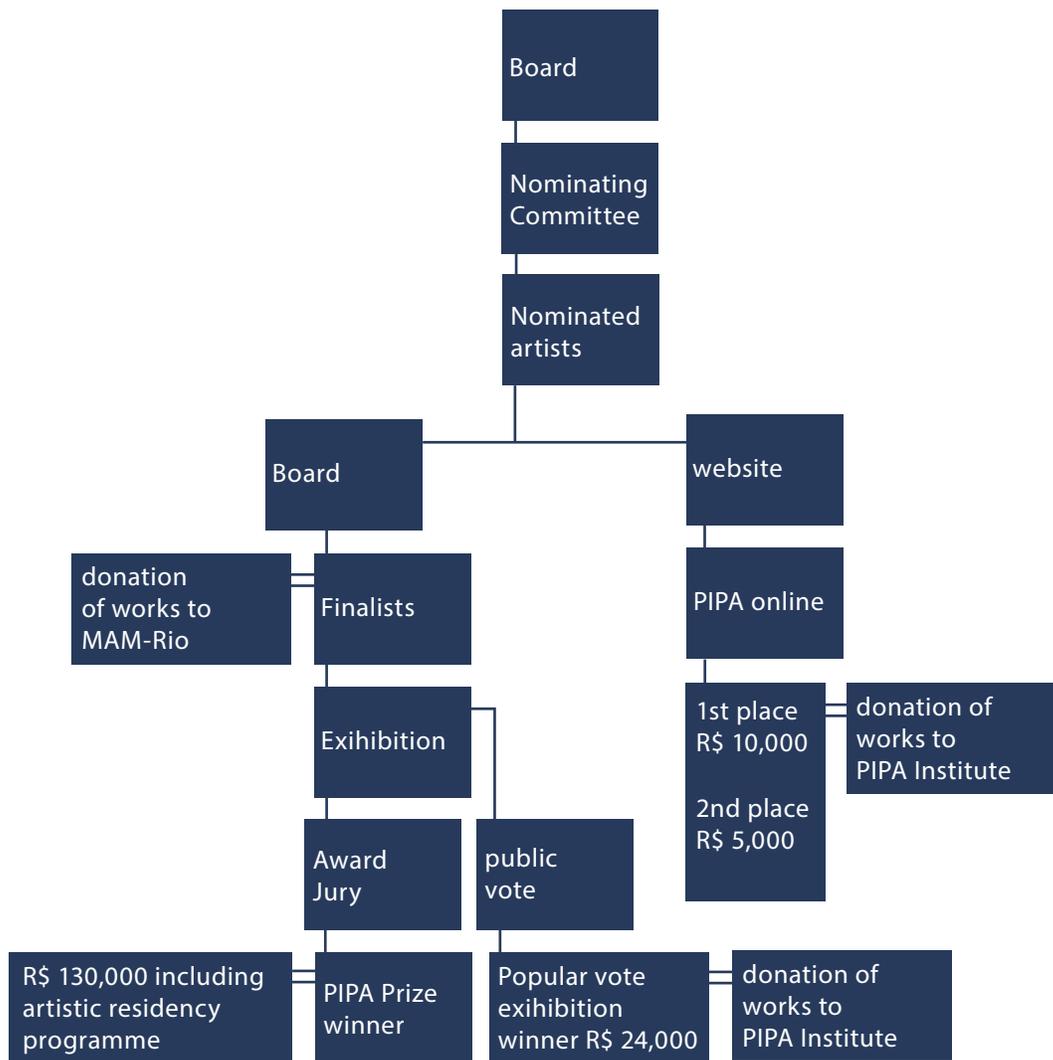
Throughout the years we noticed that the Award became something bigger than that. In one hand

it highlights the new generation that most of the Brazilian contemporary art "insiders" already know, follow and praise. On the other hand, via its catalogue, website and social media pages it presents to a wider audience artists still only known by their closer circle. All that led us to adopt the tagline we heard more than a few times as we (relentlessly) searched for feedback that PIPA has become "the window into the Brazilian contemporary art."

To have access to these artists, each year we invite art experts from all the regions of the country to be members of the Nominating Committee.

This year we included both in the catalogue and at the exhibition a fluxogram to make easier to understand how the Prize's process works.

PIPA Prize process



On top of the pleasure we derive from the project through the opportunity to meet and learn from people of a huge spectrum of "walks of life", the Prize also functions as a Research & Development in terms of processes, incentive mechanisms and new/social media.

By adopting a relatively formal and deliberately functional approach to the execution side of the project, we believe not only we make it more likely that key performance objectives are attained, but also by focusing on the use of common free or cheap tools and a strong processes documentation, we might be able to help other NGOs by giving them access to our "blueprints".

PIPA Prize 2016 - Finalists and exhibition

The four finalists for the main category of the Prize, are showing their works until November 13th, at the Museum of Modern Art of Rio de Janeiro (MAM-Rio).

This year **Clara Ianni**, **Gustavo Speridião**, **Luiza Baldan** and **Paulo Nazareth** give to the exhibition a strong political character.

"They are four artists with strong assertive poetics, diversified and high political intensity. In a country, and world, convulsed by political crises and challenges, what is expected of art, at least, is a commitment and involvement with the current situation.", comments Luiz Camillo Osorio, Curator of PIPA Institute.

Clara Ianni, whose research for a doctorate in Visual Arts at USP is focused on the relationship between art and politics, shows the video installation "Circle" (2014-2016).

"Circle" features a documentary video of a demonstration against the Football World Cup, in the streets of São Paulo in 2014, where the police use the Hamburg's Cauldron technique. The strategy is to control a demonstration by training police circular cords that move and push the crowd in order to confine it to a certain area. *"The idea of the work is to make us think about the shape of the circle and its various applications"*, says Ianni. The artist replicates this circle on the museum's ground which connects the Hamburg circle to the tapes on the floor of the museums that indicate the minimum approach distance to see a work of art.

More details on her works can be found at: <http://www.pipaprize.com/pag/clara-ianni/>

Gustavo Speridião probably is the artist in which the political footprint is more explicit. He is showing the installation-painting "Fora" (2013), a 6.5-meter canvas clipped on the wall, in which he fills the pictorial plan painting words as if it was a political demonstration banner or a notebook with political notes. Speridião highlights on the painting: *"Tears, blood, sweat, and nankin - speaking of the work process, the material is basically this"*.

"Everyone has a very political profile. Perhaps in Baldan's work is where this approach is less obvious, but it can be found on the way she explores the architecture", says Osorio.

More details on his work can be found at: <http://www.pipaprize.com/pag/artists/gustavo-speridiao/>

Luiza Baldan presents the video installation "Perabé" (2014-2015) a contemporary narrative of the artist relationship with the cities that she has lived. *"São Paulo was the first city where I lived, for a short time that is not on the coast and I realized how much I miss the sea in my relationship with the city".* It is a collection of photographs and a text written by the artist, read in four different voices through four separate sound channels that adds to the immersive qualities of the work.

According to Baldan, *"Paulo Nazareth's work looks completely different from mine, but it has this thing of wandering and displacement. You somehow build things up from what you pick up and find along the way".*

More details on her work can be found at: <http://www.pipaprize.com/pag/artists/luiza-baldan/>

Paulo Nazareth who has traveled long distances on foot, from the village of Caiova to New York, from Miami to Mumbai, among several curious destinations, showcases the series "Produtos de genocídio"/"Products of Genocide" (2015-2016),

an installation composed of ready-made objects, silkscreens, prints and a video. The series reflects on the extermination of indigenous populations and the appropriation of elements of their culture as consumer goods.

Nazareth observes: *"I don't know how our works are going to dialogue, but we are already talking as we are living the same moment in time. Each one of us has a story and a different way to face life and this current historical moment".*

More details on his work can be found at: <http://www.pipaprize.com/pag/paulo-nazareth/>

PIPA Prize website

At PIPA Prize website you can find profile pages including video interviews of the 335 nominated artists over the seven editions of the prize. You can also check a cultural agenda with exhibitions and events related to nominees and the Prize's collaborators.

In the best Kaizen spirit we admire so much we're always looking for ways to improve. This year we introduced a column with critic texts and interviews with the finalists by Luiz Camillo Osorio, curator of PIPA Institute.

Below you can read an excerpt from the text he written in August. The full text is at www.pipaprize.com in English and at www.premiopia.com in Portuguese.

The Spectacles, the absurd and helplessness in contemporary art

By Luiz Camillo Osorio

The San Francisco Museum of Modern Art (SFMOMA) recently opened its doors to the public. Inevitably, given that it is a modern art museum in the capital of the new technologies, the scale, ambition and figures involved are astonishing.

Nothing, however, attracted more attention during the museum's opening period than the unexpected "performance" by two young, unknown (until then) boys from the neighbouring city of San Jose, who were visiting one day during the first weeks. One of them took off his spectacles, cap and jacket, and positioned them in various places around the galleries, as if they were "works of art". The first item, the spectacles, caused a frisson. People gathered round to observe them close up, to discuss and photograph them. The trap had been set. This is art, art is this... We're all fools, capable of being taken in by a childish prank! In parentheses, it's worth noting that the cap and jacket did not attract any interest. No one stopped or even photographed them.

They might have seemed, to a suggestible audience, to be about being-in-a-museum—and that audience could have included me. Suggestibility, undaunted by fear of proving foolish, is essential to art love." This art love, however, goes hand in hand, for better or worse, with notions of appropriate behaviour associated, in museums, with a fear of intellectual and social exclusion.

You have to pretend to understand in order not to be left out of the club of the included in the art world. This pose, however, does not allow for genuflection or the surrender to shock, or the expression of delight in the face of strangeness. The initiated is no fool; he is cool. Surprise can make fools of us all. That's what makes those glasses interesting. The photo that circulated showed surprise – and this is good and rare, independently of the prank. If this is the case, then it was worth it. Perhaps those boys' 15 minutes of fame served to show that it is still possible to genuflect in a museum, to be absurd, to be enchanted in a world of total, sophisticated disenchantment. And that art can be everywhere and nowhere. I prefer to side with those who are still able to be surprised, even if they make fools of themselves, and want to justify the unjustifiable.

PIPA Online 2016

Last but not least, in what has already become a traditional PIPA category, PIPA Online happened during the third quarter.

Originally imagined as a way to bring a younger generation closer to the art scene, it has established itself as relevant way to amplify the benefits to all participating artist via network effect. As each artist bring people to PIPA's site to their works, texts and video interviews, the other participants also benefit from wider exposure. The process has a self-reinforcing nature where 1+1 = much more than 2.

This year three indigenous artists were nominated

and two of them happened to be the two most voted artists at the online prize²⁷.

The 10 artists that went into the second round received almost 10,700 votes.

Jaider Esbell, a Makushi, from the Roraima State, in Amazonia, was the winner receiving 3789 votes at the end of the 2nd round and was awarded R\$10 thousand. His literature and artworks, including poetry, photography and videos, have taken him to an avant-garde position in the state.

More details on his work can be found at: <http://www.pipaprize.com/pag/jaider-esbell/>

Arissana Pataxó, from the Pataxó ethnicity, lives in Santa Cruz de Cabrália, Bahia. She was the runner-up with 3686 votes and was awarded R\$5 thousand. Arissana has a degree in Fine Arts, develops her artistic production in various techniques, and approaches the indigenous thematic as part of the contemporary world.

More details on her work can be found at: <http://www.pipaprize.com/pag/arissana-pataxo/>

PIPA MISCELLANEOUS

- Going back to Ed Catmull's book mentioned above, the sentence that opens Chapter 3 "A defining goal" struck a chord with us as we look back 7 years ago:

²⁷ To participate in the second round Artists have to receive a minimum of 500 votes in the 1st round to participate in the second and defining round. Out of the 63 participating artists, 10 were classified for the 2nd round.

- "There is nothing quite like ignorance combined with a driving need to succeed to force rapid learning".
- IN the same book he provides a good example of what we mean by providing incentives that go beyond the immediatly financial:
 - "I wish I could bottle how it felt to come into work during those first heady days after Toy Story came out. People seemed to walk a little taller, they were so proud of what we'd done"
 - "I don't make movies to make money. I make money to make movies". - *Walt Disney*
 - 'In neither music nor art have I a real style, craft or technique. I just plummet through, on either a wave of euphoria or mind-splintering dejection. This can often all be held together by a bloody-minded determination to create something that was not there before." - *David Bowie at Frida Kahlo Museum, Mexico City, October 1997.*

PIPA
PRÊMIO □ PRIZE

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