Constellation: Management Report 3Q12

Long Only Performance	Fund	Ibovespa in USD
YTD:	+ 11.89%	- 4.09%
Last 12 months:	+ 20.93%	+ 5.06%
Annualized Return since inception:	+ 23.70%	+ 10.53%

Long Short Performance	Fund
YTD:	+ 2.76%
Last 12 months:	+ 2.23%
Annualized Return since inception:	+ 9.95%

Dear Investor,

History seems to be repeating itself. Global markets' price action in the third quarter of 2012 and in the beginning of the year had a very similar behavior: a significant search for Beta resulted in great appreciation of the S&P and Emerging Markets' stocks (with the exception of China as investors now anticipate a more significant slowdown for the country). As in the first quarter of the year, massive flows were responsible for a general appreciation of assets, and different types of quality companies felt it.

We have also experienced this phenomenon here in Brazil. Companies that have delivered weaker numbers as their exports or domestic sales' margins have come out lower, due to weak growth numbers and a close-to-flat Industrial Production, have also followed the high-beta rally. Government intervention in several fronts with the goal to help companies that have suffered from lower competitiveness, together with lower global interest rates, enabled even not-so-special companies to see their stock prices perform well.

This seems to be the same case as in the beginning of this year, when only good news appeared to be priced in several companies, even in some of ours. At the time, we reduced our exposure to near 70% (using our Long Only fund as an example). And as several quality companies had their stock prices pushed down in the second quarter of 2012, we took the chance to increase our exposure to close to 100%. As of the end of the third quarter, we have a lower exposure again, given valuation levels of some of our investments (which we have partially reduced). Differently than in the beginning of the year, the Brazilian Economy is now starting to pick up again, partly due to governmental measures but also because of an increase in the purchase power of individuals given a much lower domestic interest rate.

As inflation seems to be under control, as mentioned in our previous letter, we believe the next few quarters should be good for companies and the stage is set for good businesses to benefit from a stronger demand and gain back competitiveness levels. Therefore, this time our cash level should be less than it was 6 months ago as we want to be ready for opportunities that could arise from companies already in our portfolio, as well as those which we have just been monitoring. We would like to point out that, this year particularly, we have changed our cash level more than usual, given the high volatility of prices and valuations.

Long Only strategy: Performance and Exposure

Our funds kept on delivering good performance this year: our Long Only fund is up 7.01% this quarter and 11.89% ytd when compared to 7.97% and -4.09% of the Ibovespa in USD, respectively.

As previously mentioned, both the good momentum of Brazilian markets as well as positive results delivered by our companies had to do with the good performance. The largest contributors were: (i) two companies in Education (Kroton and Abril), that even running different sets of businesses, have benefitted from their competitive advantages, grew their market share in their segments and increased profitability; (ii) recent and still small investments in Real Estate, such as MRV; (iii) a BVMF position which we have added to the portfolio with a large margin of safety, as concerns related to competition risk seem exaggerated to us. In fact, one of the topics to be discussed in this letter involves our business quality concept – that has a lot to do with barriers to entry and competitive advantages of each company.

The largest detractors of the fund in this past quarter were: (i) CEMIG (Utilities), given changes in renovating concessions announced by the Government (which we will get into more details herein); and (ii) our investment in DASA (Medical Diagnosis), the company's new model has been taking longer to be implemented than firstly anticipated, therefore some investors are now questioning the profitability of the business.

Last quarter we were close to fully invested. This time, as mentioned above, we have around 15% in cash. However, we are more optimistic with the potential of the Brazilian Economy and the current environment for our companies.

Long Short strategy: Performance and Exposure

The Long Short fund was up 2.93% in the quarter and 2.76% ytd. As you probably heard us mention before, the long side of the Long Short fund is almost identical to the Long Only fund, but weightings are different given the short book. Basically what differs both strategies are the shorts and the net exposure.

As per the exposure, just like in the Long Only strategy, we have also reduced our net exposure: from above 70% at one point to 61% (39% beta adjusted), as of the end of the quarter. Our gross exposure was at 82% as of 3Q12.

In terms of contributors, from the long side we see the same names from the Long Only pop up. As for the short side, contributors were a short in another Medical Diagnosis company (which pretty much offset the loss in the DASA long position); and one in OGX.

As per detractors, the longs that were detrimental to our performance came from Utilities; and in the short side from Auto-parts Industrials and Pulp & Paper.

Our "good-quality company concept": competitive positioning and barriers to entry

We are frequently asked by our investors about our search for quality. Sometimes it means paying some premium (especially for those looking at short-term multiples). High-quality companies give us the conviction we need in terms of future profitability: this happens when our research indicates that there is market to be conquered or margins to be increased. One of the most significant quality indicators is the company's competitive positioning and true barriers to entry to its business.

In this sense, we thought it would be interesting to discuss in more detail how we identify a company that truly has competitive advantages.

Initially we try to understand which factors could mean a real barrier to entry: especially those coming from the supply and demand side and economies of scale.

Competitive advantages from the supply side happen when a company gets to deliver the same product to its clients at a lower cost. MDias Branco (an investment we have in Food – Biscuits, Crackers, Whole Wheat products) is a good example. The company's asset structure is set in a way that its costs are drastically reduced (mills, ports and plants are all close to each other) – an unquestionable competitive advantage, making it one of the most profitable companies in the sector, which, by the way, is usually a low-margin industry. This isolated fact provides a margin of around 20-25% larger to that of its competitors.

Barriers to entry coming from the demand side exist not only due to product and brand differentiation, but also to customers' habit and high switching costs of changing to a new supplier. MDias Branco also checks this other box, with its differentiated in-house distribution that allows it to reach even smaller and more distant retailers, especially in the Northeast – making it hard for new entrants to penetrate this market with such low prices.

Economies of scale are another type of competitive advantage. This is something that we believe should be analyzed on the micro and not macro level. Lopes (our Real Estate Broker), for instance, is a leader in São Paulo, Rio de Janeiro and Brasília, the 3 largest markets in Brazil – this actually means a lot more than being a leader in the country as a whole.

Back to the crackers' market: with the exception of the Northeast of Brazil, the largest gap between the leader and the second player is merely 1.6 percentage points (pp) - in the Northeast, however, MDias has 53.2%, which is 48.8pp more than the second largest share which has only 7.4%.

It is important to analyze the evolution of market shares of companies and try to identify possible patterns. A stable market share to us means that there are significant barriers to entry in a certain market, and this is another aspect we look for in a company. Localiza, for example, is the leader since 1980 in auto rentals and, since 2005, it has had a market share larger than the sum of the 2nd, 3rd and 4th players – therefore there are true barriers to entry into the industry.

On top of that, we give special attention to the evolution of the ROIC of companies throughout the years. Companies that have a distinctive competitive position and strong barriers to entry have higher ROIC both compared to its competitors as well as in absolute terms. We see Localiza's spread between ROIC and capital cost at least 10x larger than that of its main competitors. Once again barriers to entry can be clearly identified in this business.

We just wanted to provide a little more color on our "good-quality company concept", a concept many times mentioned in our presentations and which is crucial to our decision making process.

Government intervention in the Utility sector and the impact to our portfolio

Given recent Government announcements related to the power generation and transmission industry and the repercussion to stock prices of companies, we thought we should spend some time discussing this topic. Currently, we are invested in Cemig and Taesa.

In regards to Taesa (a company dedicated to power transmission exclusively), there are no concessions to expire in the near future (closest one in 2030 only), therefore there should be little or no impact there. Taesa's stock price, in fact, has barely suffered and it is now close to its highs. The company we will discuss in greater detail is, therefore, Cemig.

Between 2015 and 2017 several generation plants and transmission lines concessions, from private and state-owned companies, are due to expire. This represents approximately 20% of generation and 80% of transmission capacity of the country.

On September 11th, the Government announced new terms for concession renewals. Two topics were big surprises and caught the market empty-handed: (i) the expected return of concessions to be renewed would be extremely low – close to zero; (ii) new concession terms (less favorable ones) were extended to some plants that were supposed to be automatically renewed.

In regards to the first topic, final compensation numbers are not yet defined (they should be finalized and released in November) and we believe the Government and the companies will soon find some common ground. Compensation should not be that high, once a big portion of investments to power plants have already depreciated, yet we believe the terms should somehow improve. If that does not happen, companies will not be willing to renew their concessions but will still get cash flows until expiration (2 to 3 years). This outcome is actually possible; and companies have considered this possibility. If more favorable terms come along, we expect a positive impact to Cemig of 7% better than our base case scenario – considering the current stock price level and a lower expected intrinsic value already.

The second topic, however, has a relevant political component. Three of Cemig's power plants that should have their concessions automatically renewed represent 37% of the company's capacity and approximately 18% of the total EBITDA. Automatic renewals were entirely expected and priced in (as a note, in April of this year one of Eletrobras' power plants was renewed with similar terms from before). To everyone's surprise, these three Cemig power plants were included in the package with new and less favorable terms. If there is a revision and these plants are indeed excluded from the new terms, we anticipate a 23% appreciation of Cemig's intrinsic value.

The new rules were elaborated in Provisional Measure format. This measure had 431 amendments (that must be evaluated and voted by the Congress) and they are currently at the negotiation phase. Companies' executives and controlling shareholders are doing everything they politically can and seem cautiously optimistic with the possible outcome. We can say we have the same impression given our constant interaction with the companies, Government and regulators: there is a reasonable chance final terms will indeed turn out to be better.

We believe our Cemig investment has a large margin of safety and a good potential return. In our most conservative base case scenario (considering no automatic renewals), the company is trading at 10x 2013 earnings, has a dividend yield of 9.5% and a DCF upside of 33% (fixed discount rate of 13.5%). In a more optimist scenario, the DCF upside should be 80%, with a dividend yield of 13% for 2013. Please note final agreements are to be reached in the coming weeks.

We thought we should discuss three questions we are often asked:

(i) Is this event in Utilities another proof of an interventionist Government?
We do not believe so. These concessions were about to expire and new proposals were expected anyway. The new terms were definitely too harsh – much more than expected. And we also think negotiations were poorly handled. As discussions are still going on, we believe the best approach is to wait until final terms are agreed upon.

(ii) Has the Government broken any rules?
Once again, no. Everything that has been done by the Government is admitted by the law.

(iii) Should investors be concerned with other companies that are exposed to other concession renewals such as: ports, roads, sewage, etc?
As we mentioned before, the Government has been more strict and proposing tight rates of returns (well, interest rates in Brazil have never been this low…). Yet all has been inside the legal framework.

In our opinion the Government has not broken any contracts and has, in fact, got more right than wrong. However, communication has been extremely poor and that creates noise for sure, especially among international investors.

The final power regulation model will translate into lower power tariffs: 16.2% less for residential customers and up to 28% less for industrial/commercial customers. On average this means a 20% reduction, where 13% comes from concessions that are expiring and 7% from sector specific tax reductions. This is excellent news to the Brazilian Economy in general, inflation and several companies in our portfolio: companies that have surely benefitted from several of these pro-competition measures implemented by the Government in the last few months.

We value your relationship and the trust you have placed in us by investing in Constellation. Our investor relations team will be glad to answer any further questions.

Sincerely,
Constellation Team

Constellation ASSET MANAGEMENT

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Constellation Fund SPC Equities Class – Long Only

Fund Objective

The fund's objective is to provide sophisticated investors with superior risk-adjusted returns by investing in stocks at the Brazilian Stock market through a rigorous research driven "bottom-up" fundamental approach, while carefully attempting to control portfolio risk and transaction costs. The fund does not intend to track market indices and is generally invested 80% to 105% of the NAV. Leverage is rarely used and we attempt to avoid excessive concentration.

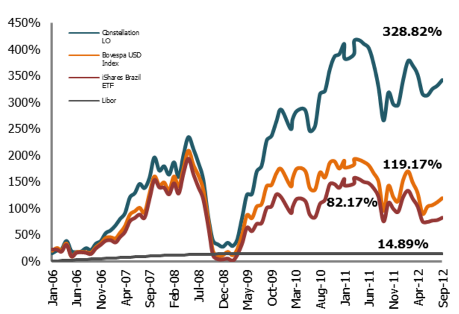
Share Appreciation (Net of all fees and audited by KPMG)

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD	Since Incep.
2005												2.45%	2.45%	2.45%
2006	12.28%	4.59%	1.81%	12.98%	-13.71%	-1.74%	0.87%	5.37%	-2.81%	9.94%	3.77%	10.64%	49.33%	52.99%
2007	3.43%	6.07%	7.08%	6.20%	15.43%	3.71%	7.66%	-3.21%	8.31%	14.71%	-8.38%	3.03%	82.52%	179.22%
2008	-5.66%	8.81%	-9.70%	16.76%	10.62%	-6.76%	-8.13%	-13.70%	-27.40%	-24.95%	-5.06%	-3.36%	-55.75%	23.55%
2009	5.88%	-4.40%	9.14%	29.69%	23.55%	0.65%	18.58%	4.21%	16.85%	2.64%	8.23%	6.14%	203.31%	274.75%
2010	-9.52%	5.32%	4.32%	0.30%	-10.20%	2.60%	16.98%	1.52%	9.54%	5.25%	1.07%	3.91%	32.09%	395.01%
2011	-5.48%	1.73%	5.06%	0.36%	-1.39%	-1.62%	-5.92%	-9.51%	-14.43%	14.36%	-5.27%	-0.24%	-22.57%	283.28%
2012	11.85%	8.14%	-1.81%	-3.72%	-7.99%	-0.62%	2.85%	1.50%	2.50%				11.89%	328.82%

Sector Exposure (Delta Adjusted)

Sector	% Long NAV
Education	14.83%
Infrastructure	13.27%
Utilities	11.97%
Services	10.37%
Financials	8.76%
Homebuilders	8.60%
Fuel Distribution	6.56%
Consumer Discretionary	4.01%
Metals & Mining	4.00%
Consumer Staples	1.72%
Healthcare	1.12%
Energy	0.00%
Industrials	0.00%
Total	**85.20%**

Constellation (net of fees) ***vs.* Ibovespa *vs.* ETF**



Value per Share (net of all fees)

As of September 28th, 2012	**489.4181**

Stock´s Sector Contribution

Outperformers	**% NAV**
Financials	0.87%
Financials	0.87%
Fuel Distribution	0.65%
Underperformers	**% NAV**
Utilities	-2.68%
Utilities	-0.20%
Homebuilders	-0.06%

Number of Positions

Stocks	24
Investment Cases	16

Overall Strategy Liquidity (1/3 of Average Daily Traded Volume)

Tenor	
1 Day	28.5%
1 Week	48.7%
1 Month	77.5%

Market Capitalization

>US$10 bn	11.9%
>US$ 1 bn and <US$10 bn	67.6%
<US$1 bn	5.7%
Total Equity Exposure	**85.2%**

Main Characteristics

Inception Date*:	November 30, 2005.
Initial Investment:	US$ 100,000
Subsequent Investment:	US$ 50,000
Subscriptions:	Last Business Day of the month.
Redemptions:	Available series: monthly with 3 months prior notice.
Payments:	Three business days after the redemption day.
Advisory Fee:	1.0% per annum.
Incentive Allocation:	10% of the profit paid annually or upon redemption.
Net Asset Value:	Daily net of advisory fee.
AUM per Strategy:	US$ 652,466,760

* Equities Class

Risk x Return Profile (Since Inception – Net of all Fees)

Annualized Return	23.70%
Annualized Ibovespa USD Return	10.53%
Annualized Standard Deviation	34.96%
Ibovespa USD Annualized Standard Deviation	42.14%
# of Positive Months	53
# of Negative Months	29
Best Monthly Return	29.69%
Worst Monthly Return	-27.40%
ISIN:	KYG238261112
* Risk free rate is T-Bill 90 return.	

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Constellation Fund SPC Class B - Long Short

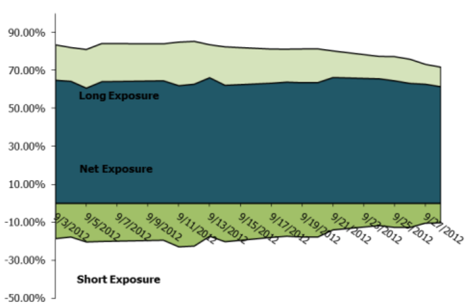
Fund Objective

The fund's objective is to provide sophisticated investors with superior risk-adjusted returns in any market environment. To achieve the objective, the fund employs a classic long/short equity strategy by investing in stocks at the Brazilian Stock Exchange, while carefully attempting to control portfolio risk and transaction costs. Our stock selection is based on rigorous research driven "bottom-up" fundamental analysis.

Share Appreciation net of all fees (* Performance of Long Short Class A until Nov 04, Class B onwards.)

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD	Since Incep.
2002 *												2.27%	2.27%	2.3%
2003 *	0.97%	1.00%	1.11%	1.65%	-0.29%	0.68%	0.25%	3.10%	2.92%	1.45%	4.71%	1.60%	20.81%	23.6%
2004 *	3.52%	0.22%	0.26%	-1.99%	-0.79%	0.58%	0.68%	3.38%	2.70%	0.67%	-0.09%	8.37%	18.52%	46.4%
2005	6.13%	4.90%	-3.81%	-2.86%	0.50%	1.15%	-1.49%	1.26%	9.20%	-2.11%	4.48%	2.51%	20.76%	76.8%
2006	6.61%	1.20%	-0.38%	8.68%	-3.72%	-1.03%	0.57%	3.67%	-1.85%	0.89%	0.53%	3.42%	19.46%	111.2%
2007	0.85%	3.13%	2.76%	0.87%	5.00%	-0.28%	2.90%	-2.10%	2.54%	3.43%	-4.58%	2.70%	18.18%	149.6%
2008	-1.77%	-0.57%	-3.92%	1.47%	2.45%	-2.11%	-2.67%	-4.32%	-5.36%	-7.55%	-1.10%	-2.39%	-24.88%	87.5%
2009	-0.15%	-1.01%	2.03%	3.69%	4.19%	0.32%	6.20%	1.11%	7.73%	2.45%	2.34%	2.40%	35.75%	154.5%
2010	-2.83%	1.74%	0.93%	-0.04%	-3.60%	0.75%	6.23%	0.95%	3.23%	1.35%	0.75%	1.12%	10.74%	181.9%
2011	-1.56%	0.03%	1.78%	-0.19%	-0.94%	-2.22%	-2.08%	-3.28%	-3.82%	1.66%	-1.61%	-0.54%	-12.19%	147.52%
2012	3.12%	2.66%	-0.62%	-2.03%	-2.57%	-0.59%	2.33%	0.01%	0.58%				2.76%	154.36%

Daily Exposure



Total Portfolio P/L (Gross of Performance Fee)

	Jul12	Aug12	Sep12	2012
Longs	3.67%	0.61%	2.02%	10.12%
Shorts	(0.45)%	(1.01)%	(1.24)%	(2.58)%
FX/FX Options/Fixed Income	(0.66)%	0.64%	0.10%	(2.74)%
Equity /Index Options	(0.06)%	(0.05)%	(0.12)%	(0.11)%
Others Expenses	(0.17)%	(0.18)%	(0.18)%	(1.54)%
Total	2.33%	0.01%	0.58%	2.76%

Number of Equity Positions

Long	30
Short	8

Value per Share (Net of all Fees)

As of September 28th, 2012	**212.9485**

Sector Exposure (Delta Adjusted)

Sector	Long	Short	Gross	Net
Utilities	9.12%	0.00%	9.12%	9.12%
Education	8.37%	0.00%	8.37%	8.37%
Infrastructure	7.21%	0.00%	7.21%	7.21%
Financials	7.07%	-0.88%	7.95%	6.19%
Services	6.08%	0.00%	6.08%	6.08%
Consumer Discretionary	5.58%	-0.44%	6.02%	5.15%
Homebuilders	4.86%	0.00%	4.86%	4.86%
Fuel Distribution	4.16%	0.00%	4.16%	4.16%
Consumer Staples	2.60%	0.00%	2.60%	2.60%
Metals & Mining	1.76%	-0.91%	2.67%	0.86%
Healthcare	0.75%	-0.56%	1.31%	0.18%
Industrials	0.00%	-0.52%	0.52%	-0.52%
Energy	0.32%	-1.97%	2.29%	-1.66%
Pulp & Paper	0.00%	-2.95%	2.95%	-2.95%
ETFs/IBOV	13.80%	0.00%	13.80%	13.80%
Options	0.00%	-2.10%	2.10%	-2.10%
Total	**71.69%**	**-10.33%**	**82.02%**	**61.36%**

Overall Strategy liquidity (1/3 of Daily Average Traded Volume)

Tenor	Long	Short
1 Day	61.4%	90.7%
1 Week	88.4%	100.0%
1 Month	100.0%	100.0%

Market Capitalization

	Long	Short
>US$10 bn	22.2%	5.5%
>US$ 1 bn and <US$10 bn	46.1%	4.8%
<US$1 bn	3.4%	0.0%
Total Equity Exposure	71.7%	10.3%

Main Characteristics

Inception Date*:	November 30, 2004.
Initial Investment:	US$100,000
Subsequent Investment:	US$50,000
Subscriptions:	Last Business Day of the month.
Redemptions:	Available series: monthly with 3 months prior notice.
Payments:	3 business days after the redemption day.
Advisory Fee:	2.0% per annum.
Performance Fee:	20% of the profit paid annually or upon redemption.
Net Asset Value:	Daily net of advisory fee.
AUM per Strategy:	US$ 164,191,246

Risk x Return Profile** (Since Inception – Net of all Fees)

Annualized Return	9.95%
Annualized Standard Deviation	10.55%
Sharpe Ratio*	0.78%
# of Positive Months	56
# of Negative Months	39
Best Monthly Return	11.14%
Worst Monthly Return	-7.55%
ISIN:	KYG238261039

* Annualized T-Bill 90 daily return.