Constellation: Management Report 3Q13

Long Only Performance	Fund	Ibovespa in USD
YTD:	- 8.77%	- 20.98%
Last 12 months:	+ 1.53%	- 19.21%
Annualized Return since inception:	+ 20.66%	+ 6.20%

Long Short Performance	Fund
YTD:	- 6.48%
Last 12 months:	- 2.65%
Annualized Return since inception:	+ 8.75%

Dear Investors,

In our last letter (2Q13), we mentioned that the Brazilian Equity markets have been going through a bear market for longer than 2 years, with stocks trading close to 2009 lows. We went through a few reasons that might explain why the Brazilian Economy had such low credibility from a foreign investor perspective and why we believed our companies to be more resilient, in case the investment/business environment got worse.

What happened in this last quarter was actually the opposite, as the Ibovespa was up 10.55% and the MSCI +9.53% in USD. As usual, sharp short-term market moves tend to be unexpected. However, structural issues that we were concerned about in the beginning of the year are still out there, such as: lack of fiscal discipline from the Government, pressuring inflation; excess of Government intervention in businesses, reducing investment by companies.

All in all, what we saw was a significant rotation towards more cyclical companies exposed to the global Economy. The 9% depreciation of the BRL ytd favors these companies in terms of profitability and competitive gains; especially in sectors such as Pulp & Paper, Steel and Mining industries.

We understand that cyclical companies have different dynamics, fundamentals and valuations; and we do study them on an individual basis. We would never invest based solely on FX expectations; not to mention that in some of the cases, the BRL would have to continue to depreciate so that valuations are attractive, or else current multiple would not be justified.

Our portfolio continues to be of companies that should be profitable in an adverse Economy. Also, we have little exposure to cyclicals. This way, as expected, most of our holdings performed differently than the market. In the third quarter our Long Only fund was up 0.72%, vs. 10.55% of the Ibovespa in USD. Year-to-date and in the last 12 months, respectively, our Long Only fund is down -8.77% and +1.53% and the Ibovespa in USD is down -20.98% and -19.21%. This illustrates how our companies have navigated throughout this period, compared to the market.

The main contributors to this quarter's performance were: M. Dias Branco, Equatorial, Vale and Gerdau. Detractors were companies in Education and Financial Services. A position that had its size increased was Gerdau, as we believe this company can benefit both from the current BRL level, as well as in a less competitive scenario for long steel companies (construction and infrastructure).

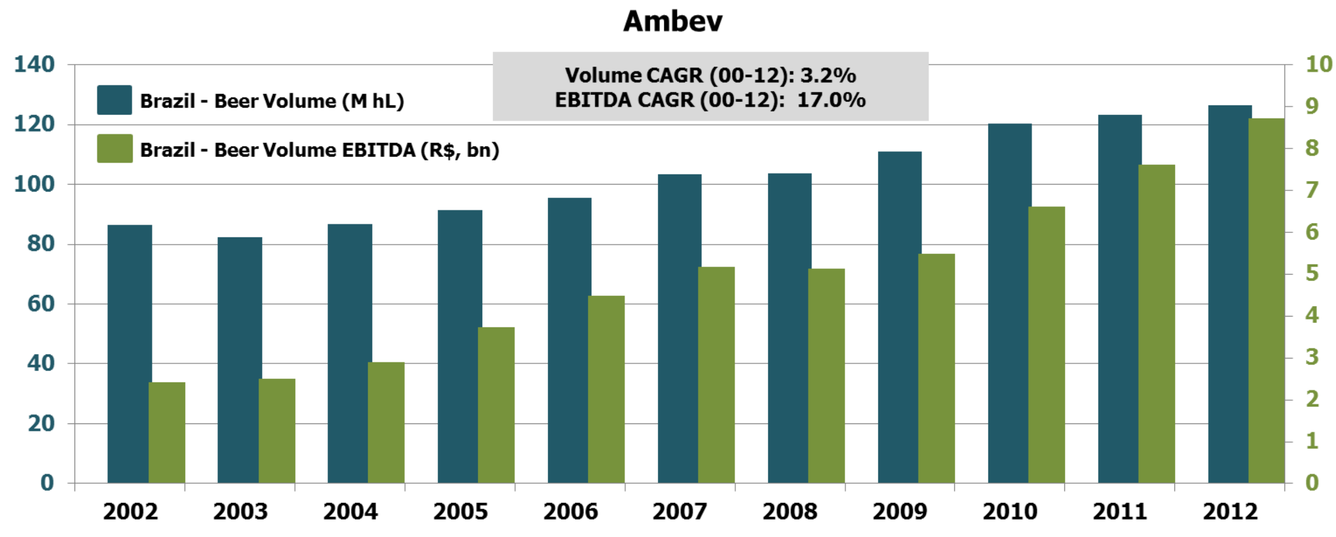
How our businesses are doing

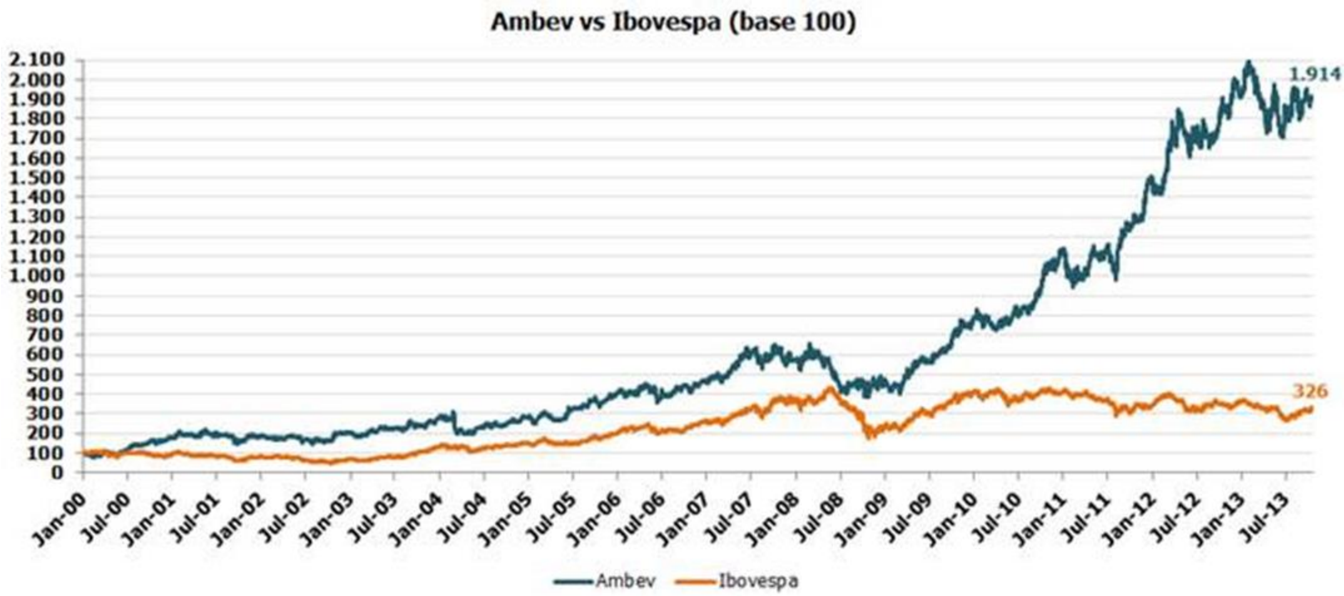
Even though Brazilian stocks' performance has been poor this year, our companies have been delivering strong results. In the first half of the year, our portfolio's net earnings per share grew on average 15% yoy. This demonstrates how the Economy's weak growth numbers did not affect all industries and companies. A complex and diversified Economy such as the Brazilian one allows us to find interesting stories that can compound good returns in the long-run even in shy growth scenarios.

What we do is evaluate our investment alternatives by separating what happens in the general (country) level from industries' particularities and from companies individually. This is crucial to understand if we are not being blind-sighted by our expectations based on the quality of businesses. As an example, throughout the years we have identified some patterns: many of the companies we invest in are in industries at initial consolidating phases and have regional or national leadership. What makes them special is not only the quality of their businesses or their competitive position, but their management teams' ability to run these good businesses and explore gains of scale and competitiveness possibilities. Good execution together with talented and aligned people is a rare asset. In fact, our experience in several businesses shows us that at this initial consolidating phase is when highest returns are generated. Sometimes, however, the management team loses focus on execution and let vanity speak louder. The challenge is to find good businesses, run by talented people willing to build competitive fortresses every day and who do not settle for little.

Throughout our history, we saw several companies that fit this description: Ambev, Totvs, Ultrapar, Gerdau and the ones we still hold, such as Lopes, Kroton, Aliansce and M. Dias. It is also interesting to look at Ambev's example in more detail given its long history of excellent execution.

We can see below how Ambev managed to sustain a 17% EBITDA growth per year in the last 12 years even in a timid growth market (3.2% CAGR from 2000 to 2012). This translates into 1,814% of value creation to shareholders, considering the change in stock price plus dividends in the period; compared to 226% from the index (a performance 8 times better). What we can infer from this example is that a well-positioned (competition) and well-managed (execution) company does not need to be in a fast-growing market to generate exceptional returns. Some could even say that fast growing markets help less-competent competitors.





The Ambev example helps us understand why in a weak year such as this, we still find relevant and mature companies delivering robust revenue and earnings growth. This is also the case of the largest food retailer in the country, which, in the last quarter, grew 10% Same Store Sales per year, while retail data keeps coming out weak.

Another example is our investment in Aliansce. Same Store Sales growth was 10% yoy and Same Store Rents growth was 11%, in the last quarter; while other large shopping mall companies show 6% to 8% growth numbers on average.

In sum, there are always good investment alternatives even in a slow-growing economy, as long as we have discipline to follow the proper process and can handle short-term volatility.

With this scenario in mind, we thought we should spend some time detailing an investment of ours that concentrates several of the above-mentioned topics: M. Dias Branco. The company has been generating excellent returns this year and we would like to give more details on the rationale behind the investment and why we believe this is a great example of value creation based on competitive positioning and execution.

M. Dias Branco

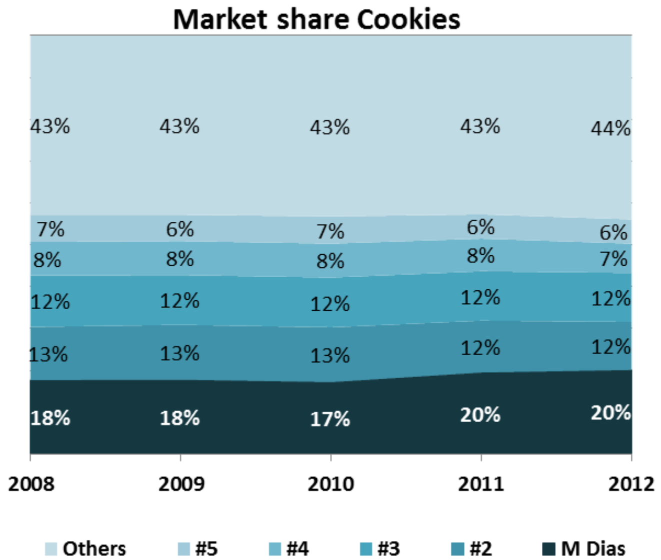
"The most important thing to me is figuring out how big a moat there is around the business. What I love, of course, is a big castle and a big moat with piranhas and crocodiles." - Warren E. Buffett.

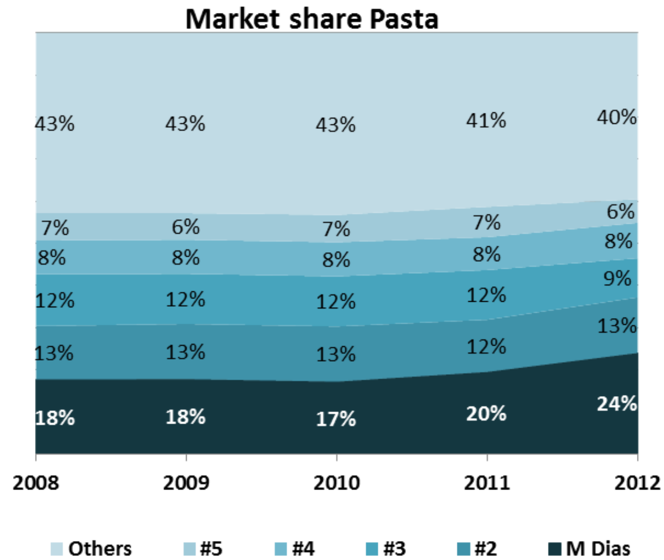
M. Dias Branco was founded in 1951 in Fortaleza, Ceará state, and its headquarters are still there. The company is the country leader in cookies and pasta. It is a BRL 11.5bn market cap company and the founding family still controls 74.5% of the capital. The later aspect helps to explain the 30-year experience of its 7 executive directors. This is why M. Dias Branco's management team is aligned, has owner mentality and has been expanding its business in a rigorous capital allocation standard.

In 2012, Brazilian pasta market revenue was BRL 6.2bn, being the third largest in volume in the World. In the same year, cookies market revenue was BRL 7bn, the second largest in volume in the World.

As you know, during our investment process, we dedicate a great amount of time in trying to understand barriers to entry and competitive advantages in a given industry. We try to identify three types of competitive advantages essentially: supply, demand and scale. In different levels, we see the three types present in M. Dias Branco.

Just by looking at the industry numbers we can see the presence of barriers to entry: stable market shares throughout the years, no relevant new entrants or exits or drastic positioning changes.





One of M. Dias' great competitive advantages is verticalization. The company produces 72% of the wheat it consumes and 86% of vegetable oil needed; its main cost components. Not only that, but it also has efficient mills integrated to pasta, margarine and cookies' mills.

The idea of the verticalization is to give the company the flexibility to alter certain inputs specifications if they need to and also the ability to have great control over the production process. Of course, however, every time the company makes a verticalization decision, we must consider if it also makes sense from a capital allocation point of view. In the case of M. Dias, we understand that flower mills, for example, are a great capital allocation decision *per se* with 17% average ROIC; that means that these mills are strategic to verticalization as well as a good capital allocation decision.

The industrial structure mentioned above shows the company's first competitive advantage – from the offer side: a hard-to-replicate efficient manufacturing structure which is also close to its consumers (such as the access to Aratu Port, in Bahia state, integrated with mills). M. Dias is therefore able to attend markets that represent 75% of its revenues (in the Northeast of Brazil) with a significantly more efficient cost structure than those of its competitors.

M. Dias is the country leader in pasta and cookies, with 24% and 20% market share, respectively. However this is not the type of information we use when identifying if there are competitive scale advantages in industry we study.

"Competitive advantages that lead to market dominance, either by a single company or by a small number of essentially equivalent firms, are much more likely to be found when the arena is local – bounded either geographically or in product space – than when it is large and scattered" – Bruce Greenwald[1].

It is possible to be a country leader even by being in second or third in certain regions. But that is not M. Dias' case. This company is a national leader as well as a leader in two of the five regions of the country (Northeast and South), and, more importantly, it totally dominates the Northeast.

Using an analogy with Anheuser-Busch Inbev, we can see that this company's and its competitors' market share in each country is crucial information in determining its profitability. We believe this is even more important than the overall market share.

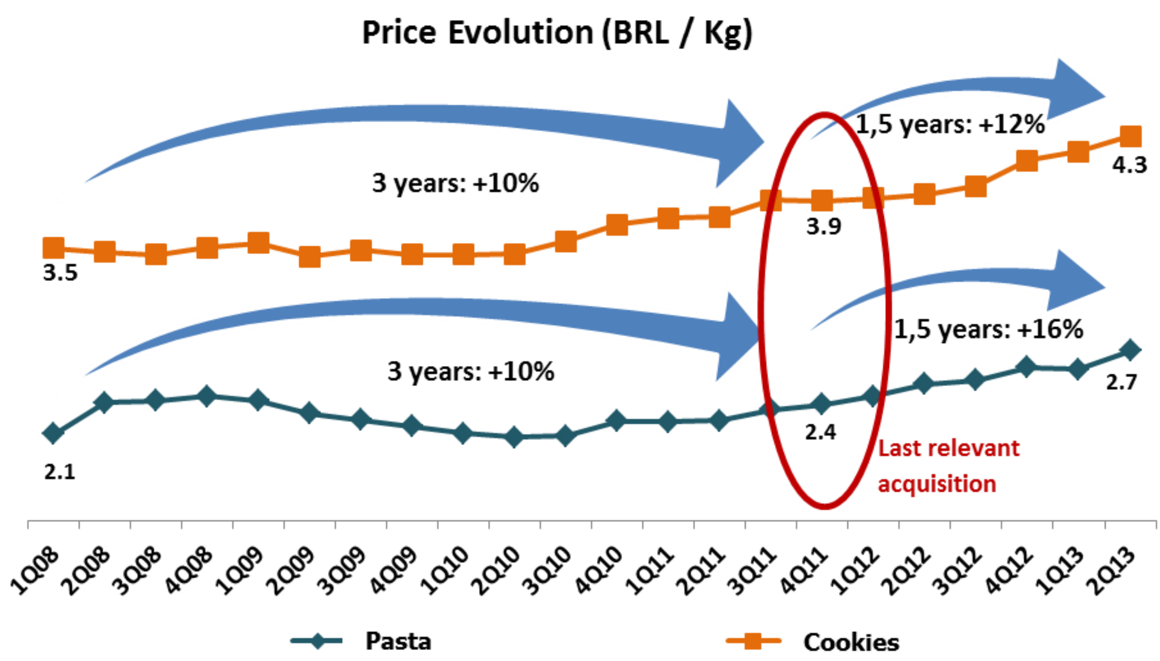
With the exception of the Northeast, in all other regions in Brazil the difference in market share between the leader and the second place is only 1.6 p.p. in cookies and 2.6 p.p. in pasta. In the Northeast, however, M. Dias has 55.8% of market share in cookies versus a merely 14.3% from the company in second place; in the pasta segment these numbers are 53.8% against 6.7% only. We are looking at a 41.5 market share points of advantage in cookies and 47.1 points in pasta (the same as 4x and 8x the size of the second largest player share). This shows how clear M. Dias competitive advantages are in terms of economies of scale.

"An elephant's first priority is to sustain what it has, which requires that it recognizes the sources and the limits of its competitive advantages… reinforces and protects existing advantages and to make those incremental investments that can extend them." – Bruce Greenwald[1].

The company managed to have such dominant positions as it has focused on region peculiarities, self-distribution and a careful consolidation process in the region. Since the IPO back in 2006, the company has acquired four companies, all of them in the Northeast. Since then, we have been working with a marginal ROIC of 18%, enabling a consistent and profitable growth. From 2006 to 2012, M. Dias has multiplied its revenues by 2.6x, and its EPS by 3.4x – results of great capital allocation.

The company can reach certain points of sales that its competitors cannot get to (such as mom and pap's food stores, which permit higher margins) due to several aspects: geographical location of M. Dias' mills, 21 distributions centers located in 9 different states of the Northeast and its in-house sales force with more than 250 vehicles around. This unique access to small retailers creates loyal customers and adds even more to the powerful combination of advantages from the demand side – customer captivity.

After a consolidation period and organic market share gains, the company has boosted its pricing power, especially in areas which it is already strong:



[1]Competition Demystified: A Radically Simplified Approach to Business Strategy by Bruce Greenwald

We see M. Dias gaining market share given expected innovations in its current business lines. And also by new business lines where synergies can be found, such as cake mix or toast. This would help the company grow more and yet leverage its competitive advantages.

This is indeed another example of a company that does not depend on demand growth to generate good returns. M. Dias has developed clear competitive advantages in a market with high barriers to entry in a way to capture profitability share from competitors. This is a great investment, especially in times when macroeconomic scenario is questionable. It has built a fortress with deep moats.

Constellation and our Team

We would like to share with you that, during the third quarter, two members of our team have become partners: Marcos Matsutani and Luciano Ferreira. We are extremely happy with their accomplishment and this comes as an acknowledgement of their commitment and good work; yet reinforcing our partnership culture.

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

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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.

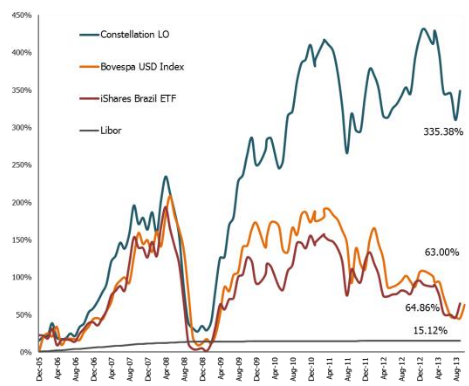
Share Appreciation (Net of all fees and audited by KPMG)

	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%	2.61%	-1.82%	10.47%	24.53%	377.23%
2013	5.52%	2.44%	-3.79%	3.44%	-6.10%	-10.33%	-0.05%	-7.95%	9.47%				-8.77%	335.38%

Exposure (Delta Adjusted)

Sector	% Long NAV
Education	21.45%
Services	19.93%
Fuel Distribution	12.85%
Financials	11.43%
Consumer Staples	7.65%
Utilities	6.79%
Metals & Mining	5.99%
Infrastructure	4.11%
Consumer Discretionary	3.61%
Homebuilders	1.45%
IBOV/Options	-2.24%
Total	**93.01%**
Exposure to the BRL	86.99%

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



Number of Positions

Stocks	28

Value per Share (net of all fees)

As of September 30th, 2013	496.9257

Sector Attribution

Outperformers	**% NAV**
Services	1.49%
Fuel Distribution	0.83%
Consumer Staples	0.64%
Underperformers	**% NAV**
Education	-0.39%
Homebuilders	-0.13%

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

Tenor	
1 Day	21.3%
1 Week	41.7%
1 Month	77.7%

Market Capitalization

>US$10 bn	12.7%
>US$ 1 bn and <US$10 bn	69.0%
<US$1 bn	11.3%
Total Equity Exposure	**93.0%**

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 of the Strategy:	US$ 925,613,094

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

Annualized Return	20.66%
Annualized Ibovespa USD Return	6.20%
Annualized Standard Deviation	33.20%
Ibovespa USD Annualized Standard Deviation	48.30%
# of Positive Months	59
# of Negative Months	35
Best Monthly Return	29.69%
Worst Monthly Return	-27.40%
ISIN:	KYG238261112

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The performance data is net of all fees, allocations and Expenses (and based on return of an investor participating in "new issue" securities). This performance data was (audited by KPMG/unaudited) and has been computed by the Investment Manager. Actual performance will also vary for individual investors depending upon, among others factors, the timing of investment and withdrawals (and the investor's eligibility status regarding receiving profits and losses from "new issues".) (the performance data includes reinvestment of dividends). Past performance is not indicative of future results.

The Ibovespa is a well-known stock market index which is included merely to show the general trend in the equity markets in the periods indicated and is not intended to imply that the Fund's account is comparable to the index either in composition or element of risk.

Any targets, estimates, averages or ranges or ranges set forth herein are non-binding guidelines and are subject to change at any time without notice to investors.

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Constellation Fund SPC Class B - Long Short

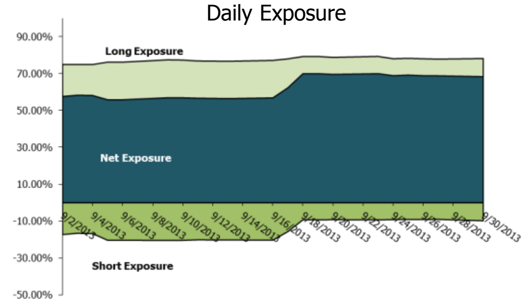
Fund Objective

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%	0.86%	-2.46%	5.80%	6.96%	164.75%
2013	3.04%	1.87%	-2.26%	2.13%	-3.98%	-5.91%	-0.13%	-6.29%	5.55%				-6.48%	147.60%

Daily Exposure



Total Portfolio P/L (Gross of Performance Fee)

	Jul13	Aug13	Sep13	2013
Longs	2.01%	(1.93)%	2.16%	0.37%
Shorts	(0.18)%	(0.92)%	(1.25)%	0.34%
FX/FX Options/Fixed Income	(1.75)%	(3.25)%	4.97%	(5.18)%
Equity /Index Options	(0.04)%	(0.02)%	(0.17)%	(0.43)%
Others Expenses	(0.17)%	(0.17)%	(0.16)%	(1.52)%
Total	**(0.13)%**	**(6.29)%**	**5.55%**	**(6.48)%**

Number of Equity Positions

Long	30
Short	5

Value per Share (Net of all Fees)

As of September 30th, 2013	**207.2950**

Sector Exposure (Delta Adjusted)

Sector	Long	Short	Gross	Net
Education	14.1%	0.0%	14.1%	14.1%
Services	13.4%	0.0%	13.4%	13.4%
Consumer Staples	11.0%	0.0%	11.0%	11.0%
Financials	10.4%	0.0%	10.4%	10.4%
Fuel Distribution	7.4%	0.0%	7.4%	7.4%
Metals & Mining	7.7%	-2.2%	9.9%	5.5%
Utilities	4.7%	0.0%	4.7%	4.7%
Consumer Discretionary	2.0%	0.0%	2.0%	2.0%
Infrastructure	2.9%	-1.1%	4.0%	1.9%
Energy	1.7%	0.0%	1.7%	1.7%
Healthcare	0.0%	-1.1%	1.1%	-1.1%
Homebuilders	2.7%	-4.7%	7.4%	-2.0%
ETFs/IBOV/Options	0.0%	-0.8%	0.8%	-0.8%
Total	**78.12%**	**-9.82%**	**87.94%**	**68.29%**
Exposure to the BRL				66.78%

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

Tenor	Long	Short
1 Day	61.3%	100.0%
1 Week	94.3%	100.0%
1 Month	100.0%	100.0%

Market Capitalization

	Long	Short
>US$10 bn	21.0%	2.9%
>US$ 1 bn and <US$10 bn	50.8%	6.9%
<US$1 bn	6.2%	0.0%
Total Equity Exposure	**78.0%**	**9.8%**

Main Characteristics

Inception Date*:	November 30, 2004.
Initial Investment:	US$100,000
Subsequent Investment:	US$50,000
Subscriptions:	Last Business Day of the month.
Redemptions:	Available series: monthly with 3 months prior notice.
Payments:	3 business days after the redemption day.
Advisory Fee:	2.0% per annum.
Performance Fee:	20% of the profit paid annually or upon redemption.
Net Asset Value:	Daily net of advisory fee.
AUM of the Strategy:	US$ 139,421,547

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

Annualized Return	8.75%
Annualized Standard Deviation	10.60%
Sharpe Ratio*	0.66%
# of Positive Months	62
# of Negative Months	44
Best Monthly Return	11.14%
Worst Monthly Return	-7.55%
ISIN:	KYG238261039

* Annualized T-Bill 90 daily return.