



Picture: Buenos Aires

## New players enter the game – is Latin America ready for hedge funds ?

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**Equity markets in Latin America have performed strongly in recent years as a decade of reform and liberalisation has begun to yield results. Since January 1, 2001 the MSCI Latin America Index has risen by more than 200%, outperforming most other asset classes, including many other emerging markets indexes (Fig 1). Considerable improvements in the terms of trade for Latin America have played a large role, as has the notable improvement in the region's overall inflation and interest rate scenario. With military governments ceding control in the past two decades to elected civilian governments, the best results may be yet to come for this exciting equity asset class.**

We are particularly excited about the prospects for hedge funds now that they possess the tools and the fundamental catalysts needed to prosper. In a market traditionally dominated by money market funds, there is an important shift under way in the equity investment arena. Macroeconomic stability is likely to unleash a sustained wave of equity buying over the next few years in Brazil as institutional investment grows and equity weightings in Brazil's large investment management industry increase. Equity hedge funds offer enormous potential for capitalising on these structural changes.

### **Chile paves the way**

The evolution of the Chilean equity market over the last twenty years provides some important insights into the impact of structural change on equity market valuations. In 1990, the Chilean military ceded control to an appointed civilian government, which introduced wide-ranging reforms including the replacement of government social

security with new mandatory employee-funded pension schemes. Many state-owned companies were privatised, further removing the state from private enterprises. With the implementation of tight fiscal controls and policy incentives designed to boost export competitiveness, Chile began to enjoy both a balanced budget and sizeable trade surpluses. Local interest rates fell from 38% in 1982 to just 1.9% by 2004 (Fig 2).

In the late 1980s the stock market was further liberalized, culminating in the listing of Telecom Chile on the New York Stock Exchange in the early 1990s (Figure 3.). In subsequent years Chile slowly opened up its local stock market and fixed income market to foreign investors. The combined effects of more sophisticated capital markets, improved liquidity, falling inflation and declining real rates led to the creation of a vibrant equity market.

However, the Chilean experience has not been without its pitfalls. Corporate governance guidelines to regulate the behaviour of Chile's new generation of business leaders remain less stringent than those of developed markets. Pension funds in Chile are generally unwilling to confront poorly performing managements and are by design risk-averse. A chronic over-supply of capital to the equity market has led to complacency amongst business leaders and in many cases declining returns on capital. As a result, Chile's equity market has achieved only a fraction of its potential. Nevertheless, Latin America market participants, regulators and government officials have witnessed the remarkable changes in Chile and are striving to expand on the market's early success.

## Roadmap for Brazil

With a GDP of USD793b, Brazil is the largest economy in South America, well deserving of its title the 'Engine room of Latin America'. Brazil's investment management industry is also relatively large, with total system assets of USD568b as of October 2006. Brazil already enjoys having its own sophisticated financial market, including its own financial futures exchange, so the evolution towards hedge funds should prove easier than in those countries with lesser liquidity and hedging tools.

Given the improved macroeconomic environment and more stable political structure now in place, it is possible to envisage two major catalysts for improvement in the equity market in Brazil; first, the market should witness a steady increase, from a low base, in overall equity exposure. Second, there should be a trend of steady growth in Brazil's

own investment management industry, whose mutual funds and other vehicles are displacing pension funds as the key driver in the financial markets.

The macroeconomic picture in Brazil has improved dramatically in recent years, providing an important backdrop for the evolution of the equity market. In the mid 1990s, Brazil embarked on an ambitious program of economic reform and political liberalisation, culminating in the privatisation of key state-owned companies such as Telebras and Vale Rio Doce (Fig 4). However one key tenet of Brazil's economic policy was a semi-fixed exchange rate - effectively an inflation 'anchor' - a strategy that proved disastrous in Mexico and was soon to play out badly in Brazil as well. Spurred on by the Russian crisis and an almost perpetual series of lesser crises in Asia, Brazil's currency was forced to float freely, resulting in it halving in value between 1998 and 2002.

The inauguration of Lula in 2002 as President marked the low point in Brazil's recent economic history, but ironically the Presidency of Lula da Silva has proved to be extremely lucrative for fixed income and stock market investors in Brazil. Early 2003 saw interest rates peak at 26% and inflation spike to nearly 17% per annum as investors lost faith in Brazil's currency, which was rapidly losing its purchasing power (Fig 5.). Lula's administration was able to win over its critics by sticking to the terms of a draconian IMF austerity plan and by providing incentives designed to increase Brazil's share of global trade.

In subsequent quarters, Brazil's trade surplus began to swell as assertive trade policies, mixed with some good fortune, led to a sharp increase in the volume and dollar value of exports (Fig 6). With tight fiscal controls in place, Brazil's burgeoning current account surplus has slowly led

Figure 1 | MSCI Latin American index 1991-2006





to a marked improvement in Brazil's debt position. Net public debt as a percentage of GDP has fallen by over 10% since 2002, boosting confidence in Brazil's domestic bond market. New-found confidence in Brazil's own currency has also led to a recovery in the exchange rate, which is of major benefit in the fight against inflation. Consequently, Brazil is now in the best position it has been in decades to cut the real rate of interest, stimulate growth, and raise overall investment rates.

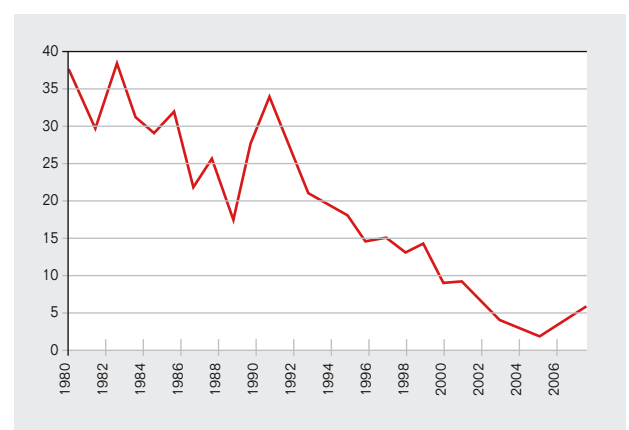
**Sea Changes in Brazil's asset management industry**

Traditionally, equity investment in Brazil has been dominated by the pension funds of state-owned companies such as Previ, Petros and Sistel. Their financial clout made many of the privatisations in Brazil in the 1990s possible and today many of these funds continue to hold large stakes in former state-owned companies. Riskier funding for capital investment in Brazil is possible through the lending and investment arms of the BNDES, Brazil's state-owned developmental investment bank. Persistent high real interest rates have meant that few pension funds have maintained high equity weightings, and investments have been for the most part limited to the export sector. Of the estimated USD147b assets held by Brazil's pension fund industry, about 29% is invested in equities, a number unlikely to

increase as strong returns in recent years have led to an over-funded condition for many funds. However, recent trends in Brazil would indicate that these traditional pension funds will soon be giving up their leadership in the equity markets to institutional investment managers, and in the not too distant future, to hedge funds.

The private fund management industry offers even greater prospects to drive stock market returns in the next decade. With over USD400b in assets under management, Brazil's institutional investment industry has its largest holdings allocated to short term fixed income investments. In the past ten months however, the average allocation to equities

**Figure 2 | Nominal annual monetary policy**



Source: Celfin

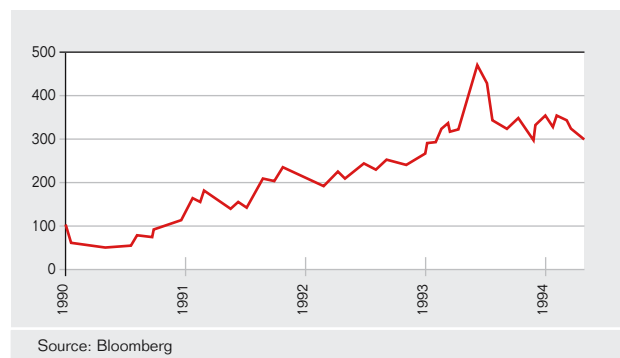
has risen from 11% to over 13.5%, generating over USD11b in net equity purchases. If private institutional managers were to boost their holdings to a weighting similar to that of the Brazilian pension funds, nearly USD60b would enter the Brazilian equity market by 2010. In emerging markets, local investment flows play an important role in determining the psychology of foreign investors – this type of catalyst amongst locals could lead to elevated foreign portfolio flows as well.

In early 2006 the Brazilian government relaxed certain parts of its complex tax code, easing restrictions on foreign investment in Brazilian government debt and real estate investment funds. Formerly subject to a 15% withholding tax on government debt profits, foreign investors from countries which have tax treaties with Brazil, as well as traditional pension fund investors outside of Brazil, can now buy government debt free of income tax. Likewise, profits relating to investments in real estate funds are also now free of taxes for eligible foreign investors. These moves provide important incentives for foreign investors to use lower cost funding offshore to purchase Brazilian assets, while at the same time providing the critical catalyst for longer term interest rates and property yields to converge towards the regional mean.

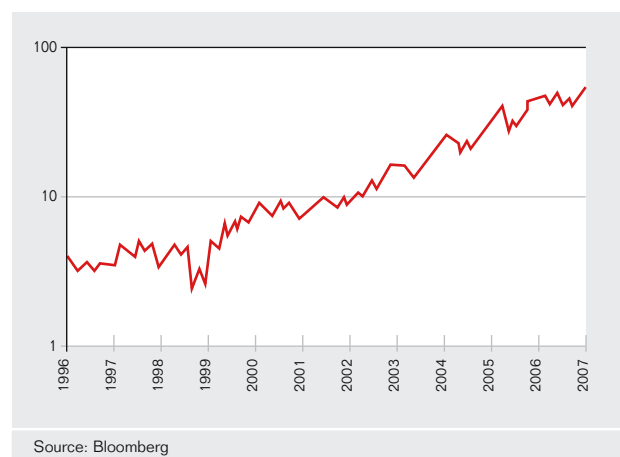
Capital markets have responded to the improved economic picture in Brazil by offering new investment instruments and derivatives contracts, while Initial Public Offerings ('IPOs') have multiplied. For example, there have been 51 IPOs in Brazil and other Latin Markets in 2006, raising over USD13b in funds. IPOs are a useful barometer for market sentiment, and the high level of activity in 2006 certainly points to a new confidence in Brazil and its neighbours. In early 2000 two popular exchange traded funds, I-Shares MSCI Brazil and I-Shares MSCI Mexico were introduced, allowing investors easier access to markets. I-Shares Brazil has ballooned in popularity and size with trading volumes expanding from roughly 300,000 shares a week in 2001, to somewhere over 20 million shares per week in 2006.

One interesting development for hedge funds has been that investment banks that provide custody for the I-Shares program have been able to create vital stock loan programs for those hedge funds and arbitrageurs looking to 'sell short' local Brazilian shares. Because of historic credit and legal problems in the interbank market in Brazil, stock lending for short sales has generally not been widely available. The growth of exchange traded funds has allowed for an offshore swaps market to develop under the auspices of the International Swaps Dealers Association ('ISDA') that has

**Figure 3 | Telecom Chile ADR rebased to 100 July 1990 - December 1994**

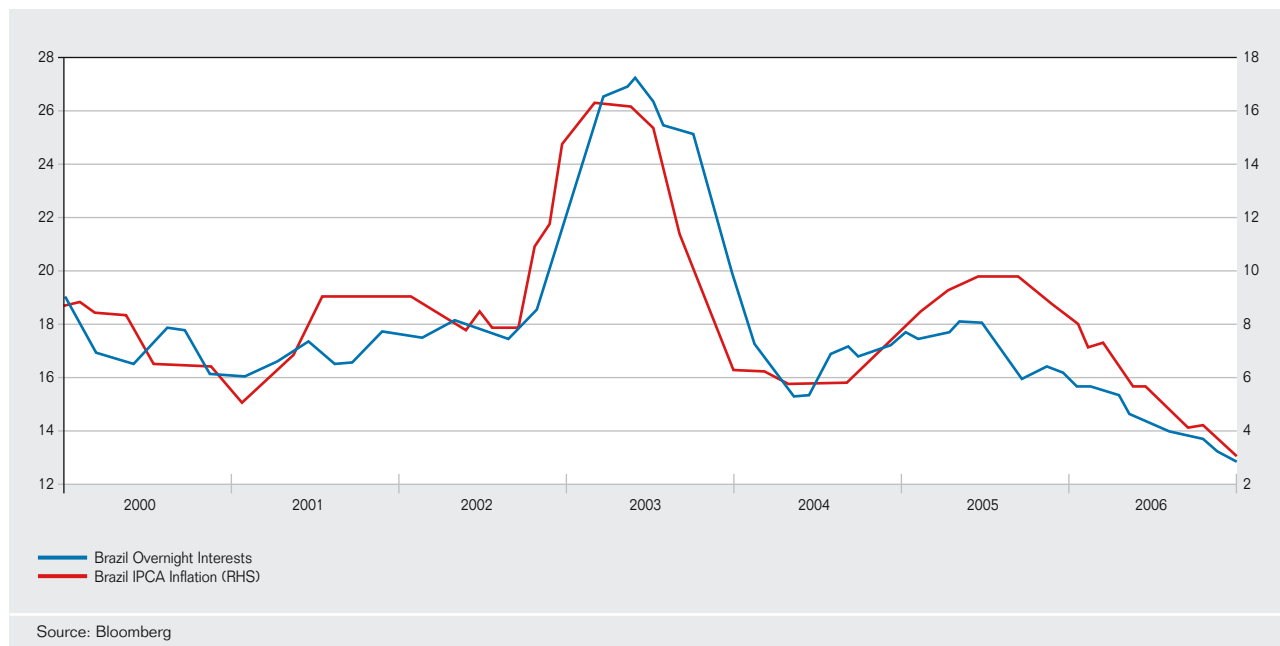


**Figure 4 | Cia. Vale do Rio Doce ADR**



taken the place of the more usual interbank securities lending market prevalent in the USA and Europe. Effective ability to sell short could transform the Brazilian equity market from a traditional 'long only' environment to one where other strategies, such as long-short equity hedge funds, might prosper. The availability of short selling can also help to add depth to the market and allow for more flexible approaches to option markets and option market making. Another innovation that could boost trading of Brazilian equities by risk-conscious hedge fund managers is the use of credit default swaps ('CDS'). The adoption of CDS in the equity trading environment has important implications for investment in sub-investment grade developing markets such as Brazil. With periods of financial or political instability fresh in investor memory, the use of credit default protection could prove popular amongst equity hedge fund managers. CDS have been around for years, largely used by arbitrageurs looking to offset specific unwanted exposures, but their wide-scale use by equity managers seeking to hedge out cataclysmic sovereign event risk could provide much needed 'disaster protection'.

Figure 5 | Brazil interest rates and inflation, January 2000 - November 2006



**Spreading Out. Implications for Mexico**

The Mexican equity market should also see some structural improvement in coming years as a result of the increased use of equities in pension funds. The most common platform for investment savings in Mexico is the AFORE, a mandatory contribution pension fund, typically managed by a bank or institutional investment manager. These funds have had extremely low weightings in equities in recent years, with exposures ranging from 0 to 1%. However recent changes to the legislation of AFORES now mean that it will become easier for them to add unprotected equity exposure. With nearly USD800m per month pouring into

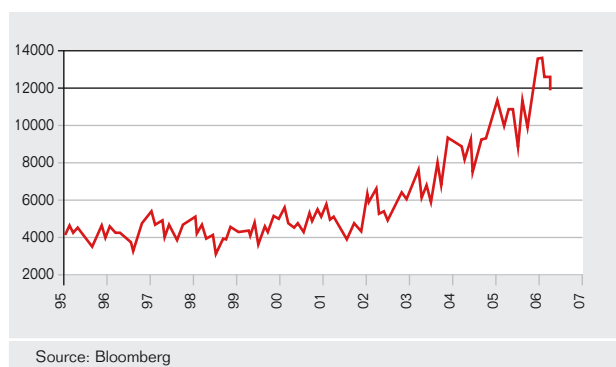
these funds, it is only a matter of time before we see an increase in equity exposure.

For hedge fund managers, the real opportunity in Mexico could be the broadening of the overall stock market, particularly if AFORE fund flows result in more IPOs and new equity placements by existing small and mid-cap shares. Short sales are a well-established practice in Mexico as book-entry record-keeping, legal structures and a vibrant interbank market have all allowed the practice to flourish. However, a key missing ingredient for Mexico remains the futures market for equity index, or lack thereof.

**Conclusion**

Following on from the success of Chile in the early 1990s, Latin America’s equity markets are set to enter a new period of growth and sophistication. Regardless of one’s opinion about the near term direction of individual markets, structural changes are likely to occur in Brazil and Mexico that should substantially improve the breadth and scale of the domestic equity markets. The introduction of equities to pension funds should improve overall liquidity conditions and generate important incentives for new equity listings. With new derivative products available and improved access to short sales, it is only a matter of time before hedge funds begin to play an important role in the region’s markets.

Figure 6 | OECB Brazil foreign Trade Exports FOB | July 1995 - November 2006 | in USDm



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