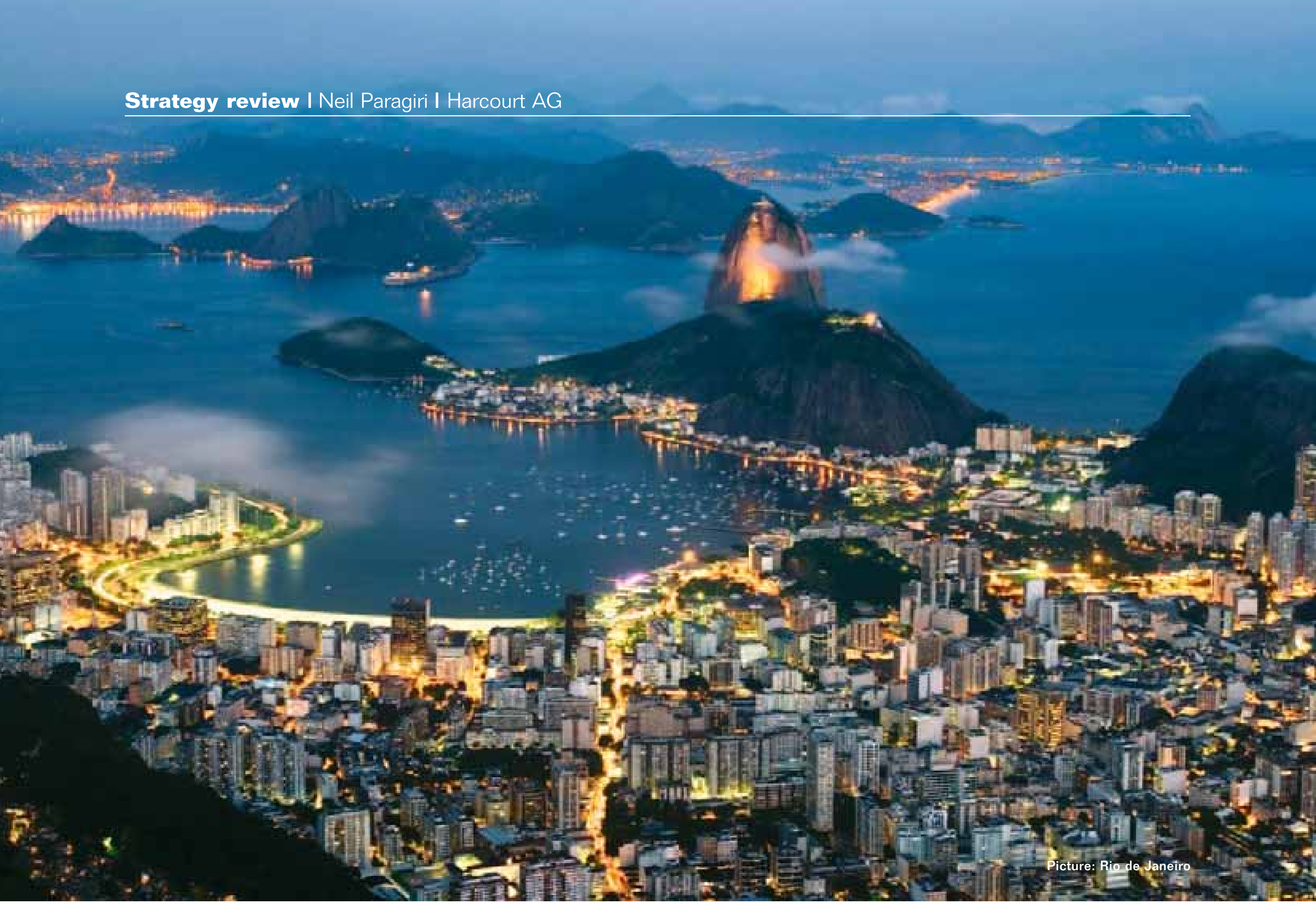


Picture: Rio de Janeiro

Latin America – Is it the next hedge fund investment opportunity?

By Neil Paragiri I Harcourt AG

Over the past several years, our industry has witnessed the migration of hedge fund flows starting with the United States, then expanding to Europe and in the past two years moving to Asia. Why? Because the US has become a much more efficient and crowded market for hedge fund investing. A plethora of funds chase the same or fewer arbitrage opportunities. To a large extent, this increasingly applies to Europe as well. Moreover, significant inflows have gone into Asia for the past 2 to 3 years, somewhat crowding out that market. Where does that leave the investors who are seeking new horizons and new frontiers? For the US investors, they do not have to look too far from their backyard and for others just a bit farther. A diverse set of emerging economies, known collectively as Latin America, is evolving into providing interesting hedge fund investment opportunities.

There is a prevailing perception of Latin America as being largely commodity driven, laden with debt and heavily dependent on the growth of US economy. This is debatable. Over the past decade, there have been significant structural changes in Latin American economies. With the exception of Mexico (due to NAFTA) and Venezuela (heavily dependent on oil exports to the US), other Latin American countries are becoming far less dependent on the US economy (Figure 1). Also, Latin American countries have managed to reduce their debt levels considerably (Figure 2). They have seen substantial foreign reserve increases across the board, and have enjoyed relatively low inflation (Figure 3) by historical standards. Consequently, most of them today have built current account surpluses (Figure 4).

These are as a result of a culmination of global growth, companies becoming more efficient, better governmental policies and improved governance, just to name a few. The sovereign debt of some of these counties is expected to attain investment grade ratings in the next few years. Unlike in the past, where Latin America's economic growth was largely dependent on commodities and agriculture, the economic growth these days is more derived from other sources such as domestic consumption, industrial exports, consumer credit (housing and consumer finance), exports to China, India and other Asian economies. However, the GDP growth in Latin America is relatively moderate and does not reflect what one would expect in successful growing emerging market economies – particularly for a large economy like Brazil (Figure 5). Notwithstanding, correlation with commodity prices, development of large Asian economies, continued expansion of US economy, regional politics and governmental policies will remain some of key risk factors in the foreseeable future until these countries become efficient self-sustaining economic engines in their own rights. There is not a complete de-coupling of Latin America from the US yet because even recently in early January 2007, the inflationary expectations in the US and falling oil prices lead to a pronounced drop in most of the Latin American equity markets. Could China impact Latin America more than the US in the future? One could argue that a slowdown in China could have more adverse impact to Latin America in the future than the US.

And we should not forget India, a country that can create even greater demand for what Latin America has to offer going forward. What if India continues to grow for years to come? Could it dampen the impact of a slowdown in the US or even China? Nevertheless, the long-run scenario is that the demand for commodities and exports of Latin America is expected to be sustainable for the foreseeable future.

Hedge funds in Latin America

Given the backdrop of the above economic scenario, Latin America may prove to be an ideal environment for the local hedge fund industry where significant inefficiencies and volatilities continue are in abundance for the skilled arbitrageurs and experienced stock pickers. By some counts, there are approximately over 300 hedge funds focusing on Latin American markets, managing more than USD40b in aggregate. Although these figures are relatively small when compared to the hedge fund industry as a whole, the hedge fund industry in Latin America has grown over 50% in the past 2 years.

There are various ways for hedge fund investors to take hedge fund exposure to Latin America. For instance, some global macro managers have built expertise investing in the Latin American markets. Likewise, CTA (Commodity Trading Advisors) funds have been trading currencies, fixed income and equities in emerging markets; the same goes for fixed income managers who are specializing emerging market debt and distressed securities. However, investors will find that often these managers' exposure to Latin American markets is more limited and also opportunistic because of their global trading nature and for diversification reasons. Likewise, institutional investors have generally shied away from Latin

Figure 1 I Latin American exports to the US

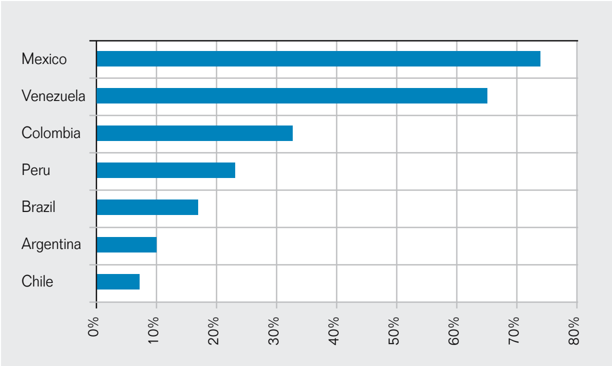


Figure 2 I Latin American debt levels

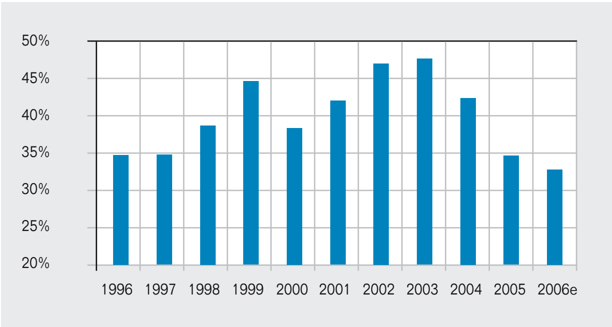


Figure 3 I Latin American inflation

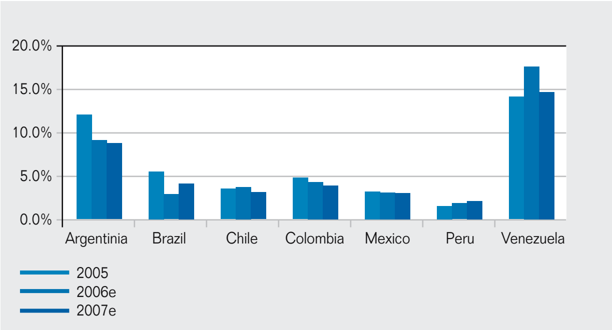
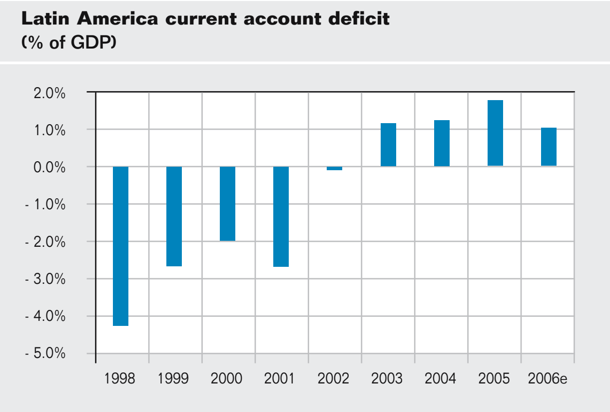


Figure 4 | Latin American current account deficit



America because of the perceived volatility of the emerging markets, for which there are many examples in the past. It goes without saying that local hedge funds have not been on the institutional radar screens either.

However, we today believe that Latin America is evolving into a legitimate hedge fund market much like Asia a few years back.

A good way to access Latin American hedge fund markets is through a combination of global managers who have a substantial dedicated exposure to these markets as well as utilizing local managers who have developed country expertise. Although some might argue that being local may be disadvantageous for understanding global changes, it is our experience that the local hedge fund managers are keenly aware of how global events can impact their investment activities. To put it another way: how many investors will invest with a hedge fund manager based in Asia trading US markets?

As the local Latin American managers have experienced tail events at least once every year, they have by and large become better at navigating through major drawdowns during a crisis. Furthermore, for most asset classes, local knowledge constitutes a competitive edge. Because of their frequently limited size, several securities may not even be on the radar screen of global hedge funds.

Figure 5 | Latin American GDP Growth

Real GDP Growth	2004	2005	2006	2007e
Argentina	9.0%	9.2%	8.6%	5.9%
Brazil	4.9%	2.3%	2.9%	3.0%
Chile	6.2%	6.3%	4.8%	5.3%
Colombia	4.9%	5.2%	5.2%	4.5%
Mexico	4.2%	3.0%	4.3%	3.6%
Peru	5.5%	6.4%	6.4%	6.0%
Venezuela	17.9%	9.3%	8.1%	5.0%
Region	5.6%	3.8%	4.3%	3.7%

Source: UBS

Another area where local knowledge plays an important role is in selecting small and mid cap stocks - these companies are not often followed by analysts even at the local financial institutions. Yet, they provide attractive investment opportunities for the local hedge funds.

A vast majority of local funds are based in Brazil and a large number of those funds are on-shore, catering to local investors. Besides Brazil, there are a handful of funds based in Argentina. Very recently, hedge funds are being setup and planned in Chile and Peru. Quite interestingly, hedge funds are virtually non-existent in Mexico. In part due to its proximity to the United States, the hedge fund managers who invest in Mexico are often based in Florida or New York. Besides the local managers, there is a vast pool of hedge funds based in the US and UK focusing on Latin America.

The range of strategies pursued by these funds is broad. A significant proportion of the managers are split between macro, multi-strategy and long/short equity strategies. Other available strategies include fixed income arbitrage, relative value equity, emerging market debt, and even asset based lending.

Historically, Latin American hedge fund returns have far exceeded diversified global hedge indices (Figure 6). Since the beginning of 2001, the Latin American hedge fund Index has enormously outperformed any other geographical hedge fund indices. However, the investors should be aware of the higher volatility and the risks associated with emerging markets. It is worth discussing how Brazil and Argentina provide some interesting local hedge fund investment opportunities.

Brazil

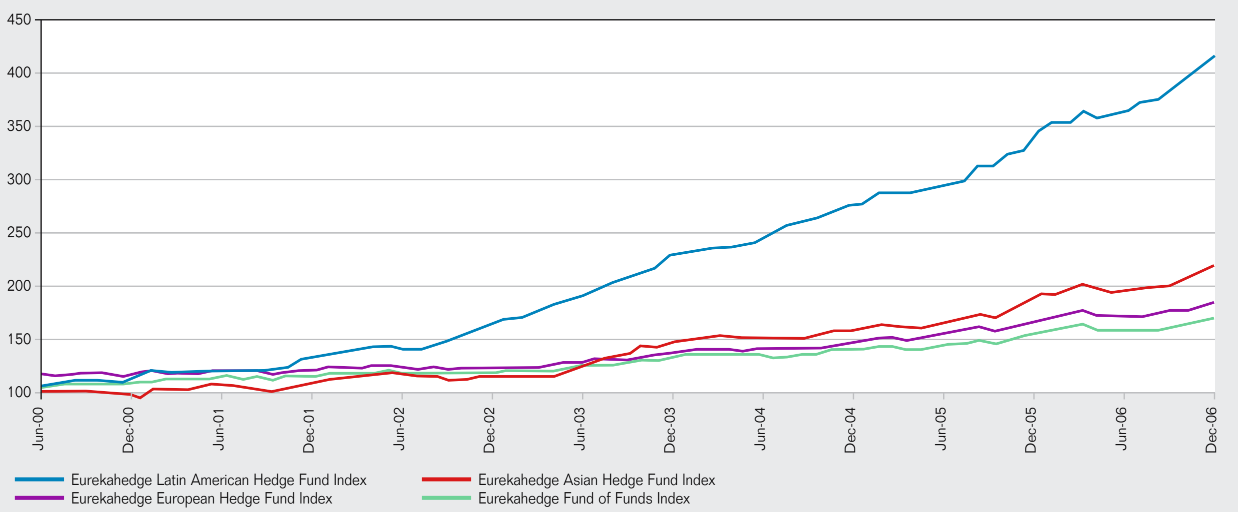
Brazil has been in the forefront of the Latin American hedge fund industry in terms of talent of the hedge fund managers, availability of financial instruments, and improved liquidity. Brazil's hedge fund industry has been in existence since the mid '90s. Initially catering mainly for local investors, recently these managers have become more active in soliciting off-shore capital. By Harcourt's estimate, there are approximately 60 hedge funds in Brazil with off-shore structures for the non-Brazilian investors today. We expect this number to grow significantly in the coming years.

The Brazilian on-shore funds are highly regulated. The funds are required to provide daily liquidity, be registered with Comissão de Valores Mobiliários (CVM), Brazil's local SEC), and provide a high level of transparency with the

portfolio holdings reported by CVM with one-month lag.
Brazil is the largest of the economies in Latin America. In the past few years, there have been remarkable structural changes that make it an attractive market for the hedge funds. With improving dollar reserves (currently at USD86b), Brazil can continue to better manage its liabilities in the coming years. Brazil also has an improving current account benefiting from the global demand for its commodities. At 13.5%, the local CDI rates are still high although the Central Bank has been actively lowering rates. At inflation around 3%, the real rates are still at high levels of 10% although significantly lower from the historic levels.
While globally, central banks are continuing to increase interest rates, Brazil is one of the few countries where lower interest rates are expected in the near future (assuming that inflation continues to be benign). This could result in improvements in the consumer finance and mortgage lending areas.
Brazil is a relatively young country. Some 50 to 60 million consumers are in their 20's, it being very attractive population segment associated with a high rate of personal consumption.
Another area of potential growth is in asset based lending. Hedge funds are beginning to offer financing services in the areas of agriculture and consumer finance.
The equity markets in Brazil are also going through significant changes. More and more companies are adopting what is called "Nuevo Mercado" (new economy) listings. Historically, investing in Brazilian equity markets presented interesting challenges. Most of the companies issued shares with voting

rights and non-voting rights and the voting shares were always held by a few owners. Nowadays, some of the local hedge funds have begun to play activist roles by challenging the voting share holders to adopt better business models and

Figure 6 I Hedge fund performance Asia, Europe, Latin America



Source: Eurekahedge

encouraging companies to more aggressively follow the tenets of shareholder value creation. There is also increased liquidity in the Brazilian market in the recent years with more ADRs and increased shorting opportunities.

The Brazilian hedge fund industry is largely dominated by multi-strategy (macro) and long/short equity funds. There are, however, more choices to investors including fixed income arbitrage, event-driven, and market neutral funds. Multi-strategy managers tend to have substantial exposure to equities, trade Brazilian Real against USD, and trade a limited number of fixed income instruments.

It is important to highlight is that Brazilian hedge fund managers today almost exclusively trade Brazilian markets only with a few exception. For this reason, what an investor can expect from a Brazilian manager is pure Brazilian exposure.

Argentina

The economic growth of Argentina, coming out of its default, continues to be strong with GDP growth of 9% in 2006 and 7% expected growth in 2007. The country has gone through important changes since the default.

As shown in Figure 5, Argentina's economy has recently been one of the strongest economies in Latin America. In 2005, its current account surplus was 1.6%. The trade surplus of USD11b was mainly supported by high real exchange rate and sustained prices of commodities.

The country still has several structural and regulatory reforms to be completed (including the utilities sector), and also has one of the of the highest inflation rates in Latin America. The inflation is somewhat contained by price controls. As the

government eases those, the inflationary pressure would have a dramatic impact on the economy. After the default, Argentinean companies have substantially improved their balance sheets and debt servicing capabilities.
The equity market is also showing signs of revival, although there is a lack of liquidity and limited shorting capabilities (except ADRs). The way for an investor to take exposure to Argentina is largely through the fixed income market in restructuring, sovereign debt, and corporate hold-outs. As the presidential election in Argentina is to take place by the end of 2007, investors need to be mindful of the policies the new government is likely to carry out in terms of price controls on energy, dealing with hold-out sovereign debts and its ability to control inflation.
There are currently a limited number of hedge funds in Argentina. By Harcourt's estimate, there are only 8 local hedge funds today. A few of those invest outside of Argentina to diversify their exposure but similar to Brazilian managers, their expertise lies within Argentina. Argentinean focused funds attempt to take advantage of the recovery and as equity market conditions improve, we expect these funds will continue to evolve taking more equity exposure.
In conclusion, we believe Argentina also provides an interesting hedge fund investment opportunity and we expect to see more hedge funds in Argentina in the coming years. Argentina was indeed a very dominant economy in Latin America a few years ago and there is a lot of hedge fund talent and experience that can be harvested in this country.

Other countries

Other countries such as Chile, Peru and Colombia all are increasingly becoming important economies in the region as their markets become more open, thereby providing interesting opportunities for foreign investors.
For instance, Chile has be one of the best managed Latin American economies for a long-time and continues to enjoy a stable political environment. However, Chile's growth is very much dependent on copper prices and the demand for copper in the global markets. Chile is actively taking measures to avoid such dependence.
Colombia was a relatively closed economy to foreign investors and the re-elected President Uribe has made marked improvements in terms of security and also signed a comprehensive free trade agreement last year with the United States, opening the door for an increase in bi-lateral trade.
Peru has experienced substantial growth as a result of commodity boom and remains vulnerable if the commodity prices fall.

Political risks

There are numerous risks worth discussing; but one stands out: the political environment.
The leftist government policies in Venezuela, Bolivia and to a lesser extent in Brazil could have a profound impact on the economic growth of this region. When President Lula da Silvia was elected for the first-time, there was a great deal of uncertainty on Brazil's economic future due to his socialist policy platform. He has proven to be more moderate than most people had expected.
Recently, Mexico's president Felipe Calderón was narrowly elected whose candidacy was fiercely opposed by his leftist opponent Andrés Manuel López Obrador who continues to challenge any sweeping market reform agenda.
At one end of the spectrum, Venezuela's president Chavez has been publicly promoting a heavily socialist agenda. Even at the time of this writing, President Chavez announced his plans to nationalize Venezuela's largest phone company, CA Nacional Telefones de Venezuela and also take greater control of the oil industry. Such postures which may be real or anecdotal may keep foreign investors and institutions shying away from Venezuela.

Conclusion

What can one possibly draw from all these assessments about Latin America? Will the boom result in sustainable returns?
The answer largely depends on the time horizon taken by investors, and by their ability to identify hedge fund managers who can successfully generate alpha by taking advantage of the long-term improving fundamentals of these economies. At the same time, both hedge funds as well as their investors need to be mindful of short-term volatility and systemic shokks. We encourage investors to take a long-term perspective in order to achieve high rates of returns, and to accept short-term market volatilities.
Diversified portfolio allocation is quite important for investing in Latin America. Such a portfolio should consist of local and global hedge fund managers with vast experience trading in local markets and countries, different strategies and those managers who have experienced various market crises. As the liquidity and the shorting capabilities in these markets improves, we expect to see more managers establishing hedge funds and are determined to play a role in the development of this emerging hedge fund market.