Brazil takes off

Strong performance draws assets back to hedge funds, but how long can it last? / By John Rumsey

Brazil is flying high again—financial markets are soaring and the hedge fund industry is following suit. After big losses in 2008, Brazilian hedge funds have posted double-digit returns on average this year, and assets are flowing back into the retail-focused market at a fast clip. Thing is, investors in Brazil have experienced big swings before. And six months into this most recent rally, they're wondering how long it will last.

In August, assets in Brazil's hedge funds jumped by R$8 billion ($4.37 billion), after leaping R$14.7 billion ($8.03 billion) in July. Those gains put total hedge fund assets at R$299.4 billion ($164 billion), 6.4% higher than 12 months ago, according to the National Association of Investment Banks, whose data includes all multimarket funds, known as multimercados, which often invest heavily in government debt and are managed conservatively by the large commercial banks.

The strong asset flows reflect this year's deep cuts in the Central Bank of Brazil's Selic interest rate, from 13.75% to 8.75%, which has rendered yields on fixed-income instruments less attractive and has led to a dizzying run-up in Brazil's financial markets. The Bovespa Index had gained a bit more than 50% year-to-date as of September 8, while the currency was up 27% against the U.S. dollar.

The equity rally reflects the faster-than-expected recovery of Brazil's economy, evidenced by strong industrial production and growing employment, says Luis d'Amato, head of institutional sales at Credit Suisse Hedging-Griffo, which with $17.8 billion is one of the country's largest hedge fund managers. Brazil's gross domestic product is expected to grow by 4% in 2010, a figure far beyond most developed countries' dreams.

But strong inflows don't tell the whole story. Almost none of Brazil's long/short equity funds are above their May 2008 high-water marks, while only about half of all macro funds are above, according to Henry Gonzalez, chief investment officer of Fram Capital. And, according to M Square, which measures a large swathe of hedge fund assets outside the retail bank sector, Brazil's hedge fund assets have actually declined in the trailing months to August 14—by 21.9% to R$34 billion.

Some Brazilian managers are now understandably wary of what could come after such rich performance. Fram's Gonzalez turned cautious in June. Although he thinks Brazil's strength as a sovereign credit is not yet being recognized, he notes that price-to-earnings multiples in the stock market are high and seem to be anticipating a return to "The Great Moderation," a term coined earlier this decade by Harvard economist James Stock to describe the perceived end of volatility in banking systems. In Gonzalez's view, valuations of both stocks and the real carry more risk than expected return. D'Amato is also cautious: his firm Hedging Griffo has a neutral stance on equities.

Another bearish sign: Harvard Management, which runs Harvard University's $26 billion endowment, sold back the 12.5% stake it took in 2007 in Gávea, stewarded by former Central Bank governor Arminio Fraga. (Harvard's endowment has its own problems, having lost 27% for the 12 months that ended June 2009, far more than the broader market.)

// There's been a shift in mindset. Foreign investors can't ignore Brazil anymore // *Arthur Mizne*

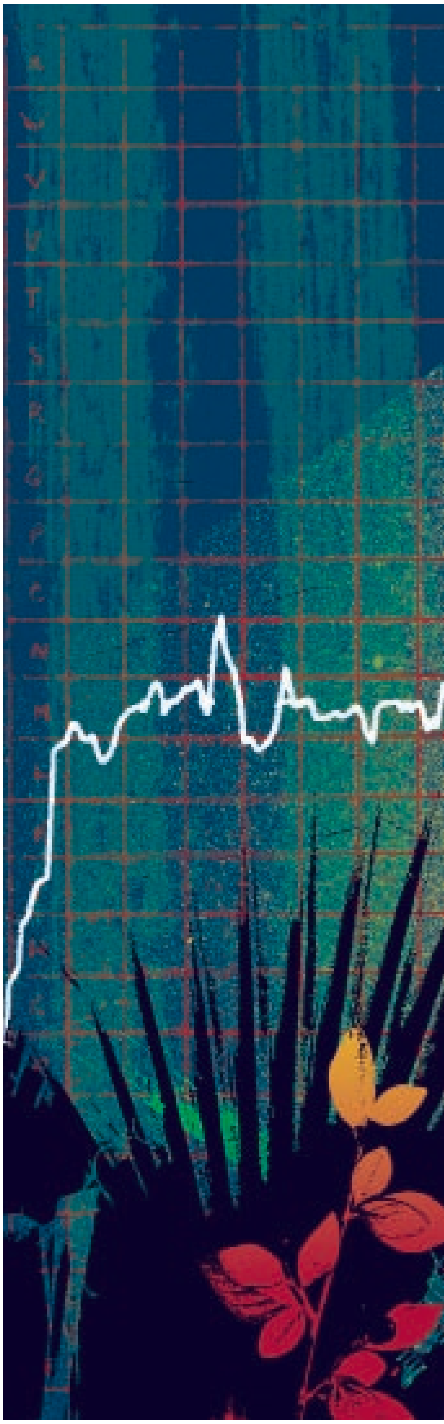
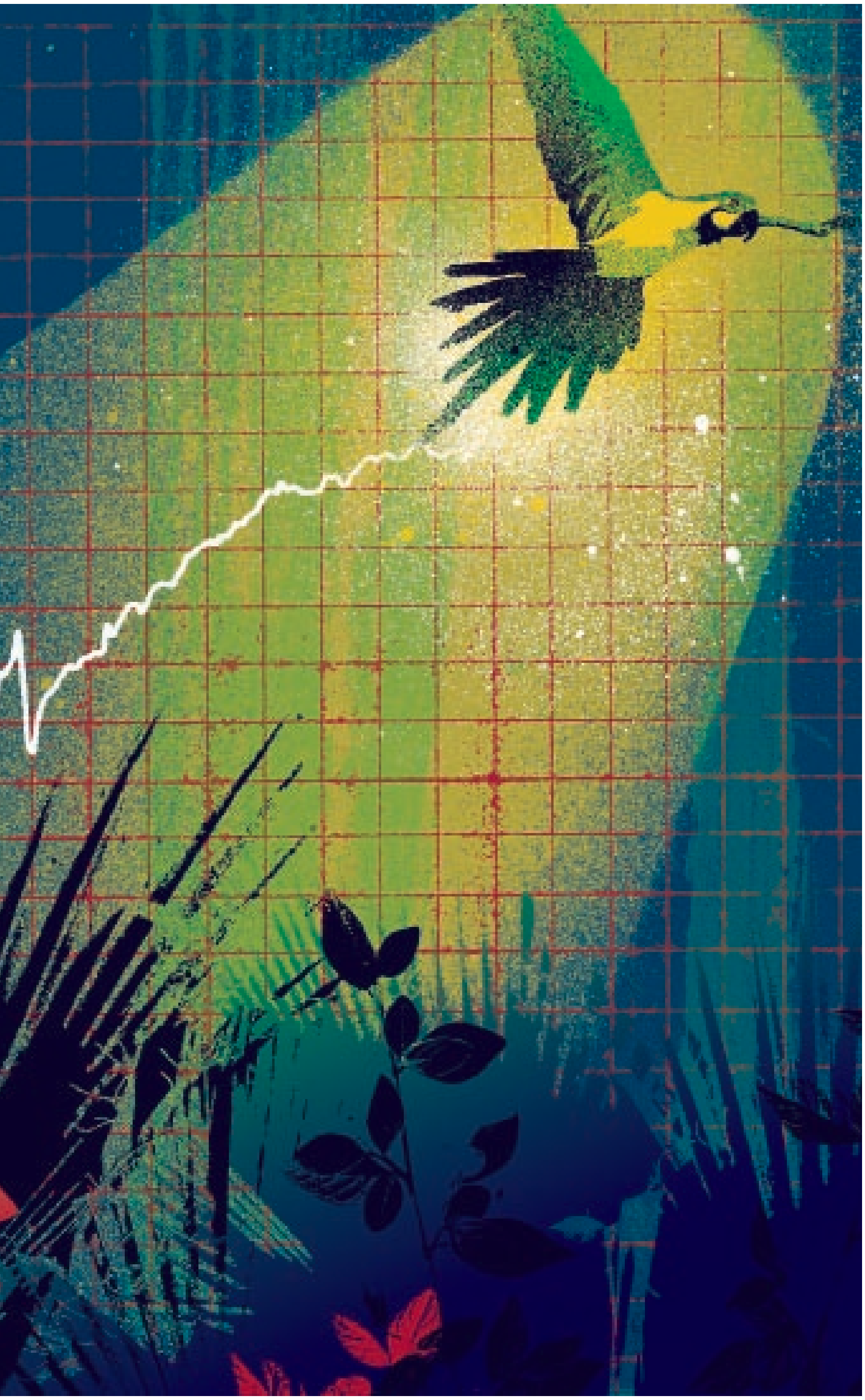


ILLUSTRATION BY SHONAGH RAE

As the markets climbed this summer, however, still other retail and foreign investors regained confidence in Brazil's on- and offshore markets, says Arthur Mizne, partner at M Square, a São Paulo consultant and fund manager. "There's been a shift in mindset. Foreign investors can't ignore Brazil anymore." A long/short equity fund managed by Ashmore Capital, the Brazilian arm of London's $25 billion Ashmore Investment Management, has pulled in $20 million from foreign institutions (and $30



million in total) since the vehicle's January 2 launch—all without active marketing, says Eduardo Lopes, Ashmore Brazil's chief executive. Since inception, the fund has gained 80%, 15 percentage points more than the MSCI Brazil Index. Onshore funds typically attract new assets more quickly than offshore ones as Brazilian investors react quickly to performance updates.

Brazil offers U.S. and European investors diversification, thanks to a growing internal consumer market and a relatively sound fiscal position. It is also a commodity export play. One U.S. fund of funds manager with more than $2 billion in assets allocates all of its Latin America equity exposure to Brazil. The investor notes that Brazil has been one of his portfolio's best performing asset classes this year.

Foreign investors are generally seeking equity funds with full exposure to the Brazilian real, which has relatively little correlation with the U.S. dollar, yen and euro, Mizne says. He sees most interest from U.S. and European family offices, which typically move quickly in and out of hedge funds. In the past two months, two U.S. family offices and one large U.S. pension fund made their first-ever trips to Brazil, according to the fund of funds manager. U.S. funds of funds are kicking Brazil's tires but are not yet ready to commit.

This year's fund inflows have underpinned a substantial reversal in the outflows that began in the second half of 2008. As the fund of funds manager says: "It was brutal. There was massive destruction in the domestic industry with investors either migrating to long-only investments or keeping to high-yielding deposits."

Nearly all hedge fund managers were affected. Investors in Credit Suisse Hedging-Griffo's Green Fund redeemed 10% of their assets between August 2008 and January 2009 as the flagship strategy lost 17.49% for the full year. This year through August has been much better: Green returned 60.21% and is closed again to new allocations.

Brazilian funds are particularly susceptible to redemptions because they have short lockup periods, typically 30 to 90 days, which were often loosened in the crisis. Credit Suisse reduced the lockup on some funds from 90 to 30 days, according to Dany Rappaport, founder of wealth management adviser InvestPort in São Paulo. The R$2.9 billion GAP Asset Management of Rio de Janeiro slashed the period from 60 to 30 days on select funds.

Providing greater liquidity for investors is quite the opposite tack that many U.S. and European funds took last year. The different outcome in Brazil is a function of the country's unusual hedge fund regulation scheme. In Brazil, hedge funds are regulated like mutual funds, which are mostly for retail investors. Onshore, managers must publish daily net asset values and file monthly reports to the Comissão de Valores Mobiliários (CVM), Brazil's equivalent to the Securities and Exchange Commission. If a fund is unable to meet the demand for redemptions, the manager submits a plan to the CVM, and the administrator calls a shareholder meeting to vote on the vehicle's fate. They can either close the fund or pass its assets on to another manager to run, though such an extreme outcome has been rare.

Hedge fund investors in Brazil are becoming more educated about the market, but their knowledge started at a base level, says Rappaport, explaining that investors were quick to redeem as losses mounted. "My job is to try to get clients not to pull money out in a crisis, but they were afraid," he notes.

In 2008, many macro strategies underperformed Brazil's benchmark CDI rate, the average of overnight lending costs among banks. According to Arsenal Investimentos, macro funds gained 6.33% on average against the the CDI's 12.38% gain. Macro funds thus received a disproportionately higher number of redemption requests because they are usually measured against fixed-income benchmarks. (Long/short strategies, which are benchmarked against equity indices, did not underperform so badly on a relative basis.) The great beneficiary was fixed-income and long-only equity strategies. For example, Hedging-Griffo's fixed-income funds grew fivefold in the past two years, to about $2.5 billion from $500 million.

That's not to say long/short equity funds did well. As a whole, these funds failed to protect on the downside, producing just 40% of CDI. Hedging Griffo's long/short equity strategy lost 26.4% in 2008 and has hemorraghed $86 million in assets over the past 12 months to manage a mere $30 million. The vehicle has recovered some this year, having gained 36%.

In recognition of this poor performance, Hedging-Griffo recalibrated its long/short strategy. Historically, the fund ran with a 200% gross exposure and a net long exposure running between 10% and 20%, says D'Amato. This year, the fund is operating with a much lower gross exposure of around 60%, with net exposure close to zero. Because of its lower gross exposure, the fund has more cash to invest in Brazil's sovereign bonds, which offer a good carry. For the year through August, the vehicle had gained 31.48%.

One of Brazil's top performers last year was relative newcomer Fram Capital. The Amundsen fund gained 32.58% in 2008 and is up 6.5% this year through August. The fund benefited from an early recognition that the Brazilian markets, which proved resistant in this year's second quarter, would be affected by the global crisis and that the appreciation of the real would reverse, says Gonzalez.

As Brazil's financial markets rebound and develop further, particularly with respect to securitization, several new hedge fund strategies are in the works. For example, long/short equity funds are seeing a renewal of interest with an emphasis on pair trading, says Rappaport.

Hedging Griffo is pushing into Brazil's frontier markets, including the addition of a fund that invests in Brazil's mortgage-backed securities market through instruments called certificados de recebíveis imobiliários (CRIs). Mizne sees a surge of hedge fund interest in convertible bonds issued by blue-chip companies, for these instruments are yielding a juicy 110% to 115% of the CDI. Structured notes, typically on currency and equity options, are also popular. Lopes expects hedge funds to explore credit and hard currency corporate debt. Meanwhile, Fram Capital already runs a quant fund and intends to add another next year.

There is much to play for in Brazil. The savings market is close to $700 billion, of which 95% is managed by banks. That pool of assets will continue to trickle into independent hedge funds as rates come down—and if funds can produce more consistent performance. But hedge funds are still a cottage industry in Brazil, highly fragmented, and dominated by star managers, such as Fraga and Luis Stuhlberger of Hedging-Griffo. Before the industry sees meaningful inflows, hedge funds must learn to cater to more precisely defined mandates. Managers also need to implement stronger internal oversight, including a wider system of checks and balances between portfolio managers and risk controls, says Gonzalez. The trick is to pay for all that.

And there's the rub. If markets flatline from here on out, fixed-income investments will begin to look more appealing and the evolution to a more diversified, alpha-driven market will be further delayed. AR

Strict regulation benefits Brazil

B Brazil's robust regulatory framework, and the structure behind its hedge fund industry, allowed Brazil's funds to withstand last year's financial earthquake better than most, according to a commentary posted on the AR Website by four hedge fund practitioners. Marcos Toledo, chief operating officer of M Square; Luis Vicente D'Amato, partner at Credit Suisse Hedging-Griffo; Enio Shinohara, partner at Claritas, and Felipe Prata, a partner at Nest Investimentos, point out that transparency and risk control have been fundamental prerequisites for any institution operating in Brazil since the turbulent environment of the 1980s and 1990s, in which the equity fund industry was formed. "We hold the view that increased regulation and supervision in the worldwide markets is a trend that is here to stay," the authors write.
For more, please go to www.absolutereturn-alpha.com.