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Economic stability puts Latin hedge fund opportunities in the spotlight

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It may have taken the new-found enthusiasm of North American and European investors for the BRIC quartet of emerging markets to highlight the investment case for Latin America in general, but Brazil and its neighbours are no longer the undiscovered secret of the investment world. Governments demonstrating a new willingness to buckle down to economic discipline combined with soaring prices for commodities have helped to propel the region into the global spotlight, especially as Western countries grapple with the risk of recession.

With little fanfare, Latin American hedge fund managers have been quietly delivering outsize returns for most of this decade, even as their counterparts in Asia have hogged most of the limelight. According to the Latin American Hedge Fund Index produced by Eurekahedge, an alternative investment research and advisory firm based in Singapore, funds covering the region have averaged an annualised return of just over 20 per cent over the eight years to the end of 2007.

Over that period the index has experienced just 14 losing months out of 96, the worst being a drawdown of 1.90 per cent in April 2000, while annual returns have ranged from 14.76 per cent last year to 33.88 per cent in 2003. In January this year, when the global hedge fund industry is believed to have recorded an average loss of between 3 and 4 per cent, Latin American managers were down by less than 1 per cent, according to provisional Eurekahedge figures.

Investors may have only recently caught on to the potential of Latin American managers, but big international institutions have already started to take notice. In December 2006 Credit Suisse agreed to pay USD294m for a majority stake (50 per cent plus one share) in Hedging-Griffo, a São Paulo-based wealth and asset manager that at the time had USD7.6bn in hedge fund, private equity and traditional assets; combined with Credit Suisse's existing Brazilian business, the combined firm now manages more than USD20bn.

Last month Bank of New York Mellon completed the acquisition (for an undisclosed sum) of ARX Capital Management, a manager established in Rio de Janeiro in 2001 which has more than USD2.8bn in 20 onshore and offshore hedge and traditional funds following multistrategy, long/short and long-only investment strategies. The Brazilian firm's chief executive, Alberto Tovar, is now running BNY Mellon's combined Brazilian asset management business.

Rio-based manager Gávea Investimentos, which manages some USD5.5bn, half of it in domestic and offshore hedge funds, has sold a 12.5 per cent stake to Harvard Management Company for an undisclosed sum. The coming year is likely to see more approaches for some

of the more prominent Latin American managers, most of which are based in Brazil and whose principals learned their trade on the proprietary trading desks of international investment banks or in traditional asset management businesses.

The industry also boasts luminaries such as Arminio Fraga Neto, who was a managing director of Soros Fund Management in New York between 1993 and 1998, focusing on emerging markets, and founded Gávea Investimentos in 2003. In between Fraga, as governor of the Central Bank of Brazil, is widely credited with having braked the country's galloping inflation and restored its fiscal credibility in international markets.

The stabilisation of monetary and economic policy in Brazil, under presidents Fernando Henrique Cardoso and the present incumbent, Luiz Inácio Lula da Silva, has been the critical factor in creating an environment in which hedge fund managers have been able to flourish - although developments that have boosted the value of the country's commodities, including rising global food prices and soaring demand for raw materials from the industrialising countries of Asia, have also helped.

'Brazil's economy has improved considerably since the late 1990s,' says Otávio de Magalhães Coutinho Vieira, director of asset management and head of fund advisory services with private banking firm Safdié Group in Brazil. 'We now have a balance of payments and fiscal surplus, while core inflation has stable for the past three years. Macroeconomic conditions are in good shape: the public sector is a net external creditor and the ratio of internal debt to GDP is now about 45 per cent and decreasing. It looks a good story to investors.'

Getting the economic fundamentals right has helped to create the liquidity that is fuelling the growth of the hedge fund industry, Vieira says. 'We are seeing a wave of IPOs and liquidity coming into derivatives, and these inflows are improving conditions for the asset management industry, enabling managers to diversify and find new opportunities in the market,' he says. 'In terms of the equity market, it means companies now have the conditions to make plans in an organised fashion. The macroeconomic conditions have helped both asset managers and the real economy.'

Balkir Zihnali, a senior portfolio manager with Santander Group fund of hedge funds manager Optimal Investment Services, argues that the creation of an environment that encourages more companies to go public is vital. 'The more material hedge funds can operate with the better, in increasing the range of long and short opportunities,' he says.

However, Zihnali insists that the Optimal Latin America Fund does not try to compete with active long-only mangers or exchange-traded funds, but looks to underlying managers capable of exploiting market inefficiencies and volatility in the region - and for all the economic and financial stabilisation achieved over the past decade, he says, those inefficiencies are still a long way from being ironed out.

'The more inefficiencies there are, the better for us,' he says. 'For example, take the performance differential between small and mid-cap companies in Brazil with large caps. Because long-only managers have focused on the stocks with the highest liquidity, they've been pushing up the largest cap stocks by 50 to 70 per cent. A lot of these companies are actually cyclical stocks that are trading peak multiples on peak earnings.

'By contrast, there are small-cap companies in Brazil that have cash on the balance sheet and are cash-flow positive, but whose price has not performed so well. When that corrects, our managers could make money at a time when the major indices will be coming down quite sharply. In emerging markets, the fear and greed cycle is always pushing valuations to ridiculous places, and when there's a panic people throw the baby out with the bathwater. Managers that are hedged will not suffer the bulk of the downside and are in a position of strength for buying from players with weaker hands.'

It is too soon to discount the possibility of Latin America being affected by the cascading problems sparked by the US sub-prime meltdown last year and the resulting credit crunch, and a dip in Latin American stock markets at the end of last year increased nervousness among investors. Nevertheless, there is reason to believe that the region, and certainly Brazil in particular, may shine in comparison with North America, and perhaps Europe and Asia, over the coming months.

Latin American investment markets bounced back quickly after the initial shocks of last July and August, Vieira says, and the nature of the economic environment has meant that the credit-linked strategies seen particularly in North America did not attract much interest from managers in the region. 'In August we saw huge downturns in equity markets, but they recovered very fast,' he says.

'The majority of Brazilian managers don't spent much time researching credit or putting it in their books, because there are so many other types of opportunity, and credit has not been a worthwhile area because the equity market has been bullish for so long. Only a few portfolios include bonds or corporate credit, and they don't tend to have CDO-type strategies - it's rare to see anything linked to structured credit.'

Commodities are the big draw for investors from Asia, Zihnali says, where much of the interest in the Optimal Latin America Fund is coming from. 'Investors there clearly understand what Asia needs and who has those resources,' he says. 'Asia needs lots of soft commodities such as soybeans, wheat and other agricultural products, because it has a growing population, they need to build infrastructure, which involves iron and steel, and they need oil, timber and pulp. These natural resources are huge for Brazil and the region in general.'

However, the risk of contagion is likely to make the downside protection offered by hedge fund strategies particularly appealing to investors from outside the region, according to Javier Echave, an Optimal vice-president based in New York who monitors alternative managers in the Americas. 'Investor appetite has been impressive from Europe and other OECD markets, both on the alternative and traditional sides,' he says.

'After the past two years, everyone needs some emerging markets exposure in their portfolio. But no-one is sure whether these markets will keep growing, or whether they will be affected by whatever happens in the US. Exposure to Latin American countries through funds of hedge funds offers the full upside but also peace of mind because these managers can not only protect investors' money but profit from the downside too.'

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