Hedge funds in Latin America

The flavour of the month

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The hedge fund phenomenon that started in the early 1990s in the industrialised countries, especially the United States, has finally arrived in Latin America. As staff reporter Gregg Greenberg mentioned last August: “even though it’s winter in South America, Latin American funds are anything but cool”.

In fact, the industry, which at the end of 1998 comprised less than 50 hedge funds, has grown to more than 200 (including both offshore and onshore funds). These funds are managed from different places such as Brazil (Sao Paulo and Rio de Janeiro), the United States (New York, San Francisco and Chicago), the United Kingdom (London) and Argentina (Buenos Aires). They trade assets located throughout the Latin American continent as well as the United States, Europe and even fellow emerging markets.

Together with the growth in hedge fund activity, we have also seen an important increase in the number of property/real estate funds (either with the purpose of investing in Latin American countries or for pooling funds from Latin American investors or functionaries). They trade assets located throughout the Latin American continent as well as the United States, mainly Florida and Texas) and private equity funds. The reasons for the above growth are:

(i) the closure of various of the more traditional investment banks (which at the same time forced talented money managers to set up their own companies and left investors with fewer investment options);

(ii) a decrease in interest rates;

(iii) a market need for more flexible, higher yielding and speculative investments;

(iv) the lack of investor confidence in the traditional financial institutions that followed the major financial crises in the area (Mexico 1994, Brazil 1997 and Argentina 2001); and

(v) the fact that, after years of inflation, currency devaluations, etc., investors in Latin America seem to be more willing to speculate on hedge funds than investors located in other regions of the world.

In addition to these reasons, some of the countries in the region, such as Mexico, benefited from the new investment opportunities arising out of economic reform, privatisation, lowered trade barriers, and rapid economic growth. Others, like Chile, have enacted new pension laws that place greater emphasis on the role of private investment in retirement savings.

Hedge Funds

A hedge fund is an open-ended investment company that pools money from shareholders (investors) and invests in a diversified portfolio of securities with an aggressive approach. Unlike closed-end funds, open-ended funds are obliged to redeem shares at the request of the shareholder. When a shareholder redeems shares, he or she receives the net asset value of those shares, which equals the value of the fund’s net assets divided by the number of shares outstanding at the relevant redemption day.

An investment manager determines the composition of the fund’s investment portfolio in accordance with the fund’s investment objectives and strategy as set out in the fund offering documents. Differing from more traditional mutual funds, hedge funds:

(i) are less regulated;

(ii) use more sophisticated investment strategies (leverage, short selling, etc.);

(iii) do not allow for daily redemptions; and

(iv) have higher minimum investment requirements.

Hedge funds are typically organised as corporations rather than as a partnership or other vehicle. They are managed by the directors (very often they are corporate directors provided by the administrator) and in most cases the fund does not have other officers. The interests offered by the fund to its investors are usually shares of common stock, usually penny par, but sold at an initial offering price of USD 100 or USD 1,000 per share.

As corporations, the funds are governed by their bylaws. Other than the bylaws, the main documents of the fund are its offering memorandum and the corresponding subscription agreement, as well as the agreements to be executed with its investment manager, its administrator and other service providers (banks, brokers, custodians, etc.). The investment manager will control all the investment management functions (essentially the selection of the investments to be made by the fund) whereas the administrator will be responsible for the calculation of the net asset value and the net asset value per share, as well as the processing of subscription and redemption requests. The administrator will also have general corporate functions such as providing periodic reports to investors and maintaining books and other corporate records.

As consideration for the services provided to the fund, the administrator generally charges a fee calculated with reference to basis points on the fund’s net asset value with an annual minimum. The manager charges a fixed management fee also calculated with reference to the net asset value of the fund plus an incentive or performance fee that is generally subject to a high water mark. If a fund applies a high water mark, the manager is only entitled to a performance fee on the new net appreciation since the last change and no payments are made until the fund compensates its shareholders for previous losses on the same period. The payment of the incentive fee may also be subject to a hurdle rate or a threshold rate.

Globally speaking, the more common strategies utilised by a hedge fund are: equities (36%), arbitrage (20%), event-driven (13%), macro (12%), distressed securities (5%) and sector (4%). Hedge funds with Latin American investors or functionaries tend to be more conservative. In fact, more than 50% of them have a multi-strategy approach. From the remaining 48%, the most common strategies are long/short equities, distressed debt and fixed income.

Property Funds

This category includes funds that follow one or more of the following investment strategies:

- Distress & Foreclosure Properties
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The fund acquires residential properties from auctions or purchases distress properties from other sources such as liquidators, administrators, receivers, realtors & mortgage brokers. After a property is purchased, the fund carries out refurbishments and lists it for immediate sale.
The Securities Commission in Brazil, for example, has passed new rules on the organisation and management of private equity funds through the creation of the “Fundo de Investimento em Participações”. The structure of this Fund is very flexible and allows investments in shares, debentures, warrants and convertible bonds issued by private and public companies.

Mexico is another country which has recently shown an interest in creating a more attractive regulatory framework for private equity funds. In fact, its government has just appointed one of the largest and most prestigious law firms in Mexico to draft specific legislation. Until now, venture capital investors in Mexico have been active in the following sectors: real estate, tourism and exports.

The situation in Chile is very similar to that described in Mexico. In this case it was not only the Chilean government who appointed a leading law firm to draft legislation but also the Inter-American Development Bank. This project is now being reviewed by the Chilean Parliament. Additionally, Chile is about to add a special type of corporation to its Corporate Act in order to make it easier for venture capitalists to invest in the country. The new vehicle will be similar to a Sociedad Anónima but it will have special rules as to corporate governance which will make it more attractive to investors.

Argentina, on the other hand, has introduced important restrictions on foreign investors, especially in respect of the registration of foreign entities in order to conduct business in the country and to purchase shares in local companies. From a legal perspective, the main features of venture capital funds are as follows:

(i) they close after the offering period so that no additional investors are accepted;
(ii) they have a fixed term (from five to seven years);
(iii) their directors adopt a “hands-on” approach in respect of the day-to-day operations of the portfolio companies; and
(iv) the investment is generally being made in instalments or contributions, which may cause a problem in jurisdictions where shares can only be issued fully paid.

Offshore vs. Onshore Funds

All the funds mentioned in the previous sections can be organised as onshore or offshore entities. The reasons why a sponsor/manager may want to set up a fund offshore instead of offshore are essentially:

(i) setting up an onshore fund is less expensive; and
(ii) neither the fund nor its officers or investors will have problems vis-à-vis blacklists drawn up by local regulators (especially in countries such as Mexico, Argentina or Brazil).

The incentives that offshore jurisdictions generally offer are:

(a) tax advantages;
(b) use of innovative legislation or institutions not available in a particular onshore jurisdiction;
(c) avoidance of over-regulation; and/or
(d) confidentiality.

The main domiciles for offshore funds, sponsored by Latin American investment managers, are the Cayman Islands and the British Virgin Islands. Other common jurisdictions (not often used by Latin American funds) are Bermuda, Bahamas, Ireland, Netherlands Antilles and the Channel Islands.

As of today, the countries in the region that more commonly use offshore vehicles are Argentina, Mexico, Brazil and Venezuela. More conservative countries, such as Chile, are not yet as keen to use these vehicles. Surprisingly, however, Chile is one of the countries in Latin America with more liberal regulations towards companies incorporated in low-tax jurisdictions.

So far, most of the investment funds in Latin America are “stand alone” funds. We expect that in the near future, offshore vehicles and new legislation is enacted in the different countries within the region, more “side-by-side” or “master-feeder” structures will be seen. We also expect fund managers to adopt riskier investment programmes (as of today few hedge funds we have seen use leverage).

Before all that, however, most investment funds in Latin America will have to establish a track record, provide solid returns and show that they are more trustworthy than the traditional financial institutions.

ENDNOTES


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