EUREKAHEDGE

Overview of 2010 Key Trends in Latin American Hedge Funds

Eurekahedge
October 2010

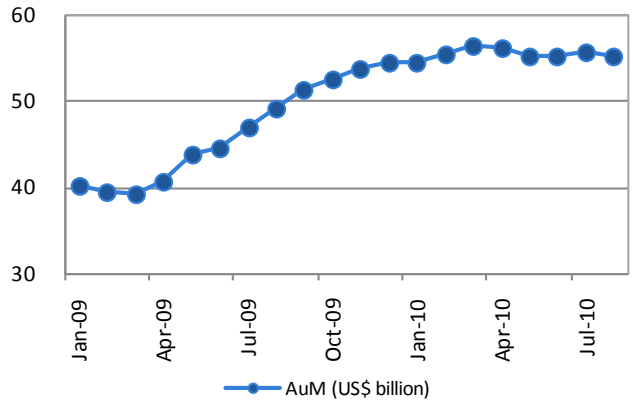
Introduction

2010 has seen the Latin American hedge fund industry emerge as one of the most dynamic sectors in the global hedge fund space. While performance and growth in most other hedge fund regions remained slow or registered marginal declines, Latin American hedge funds continued to provide consistent returns to their investors. The average Latin American manager has seen only two instances of marginally negative returns in the last 23 months. Figure 1a tracks the industry assets since January 2009.

The Eurekahedge Latin American Hedge Fund Index remained the best performing broad-region hedge fund index through most of this year, with its year-to-date August return standing at 3.97%. Furthermore, the net assets under management in regional hedge funds have grown to reach US$55.4 billion as at end-August 2010. This translates into a 41% increase in net assets in 18 months.

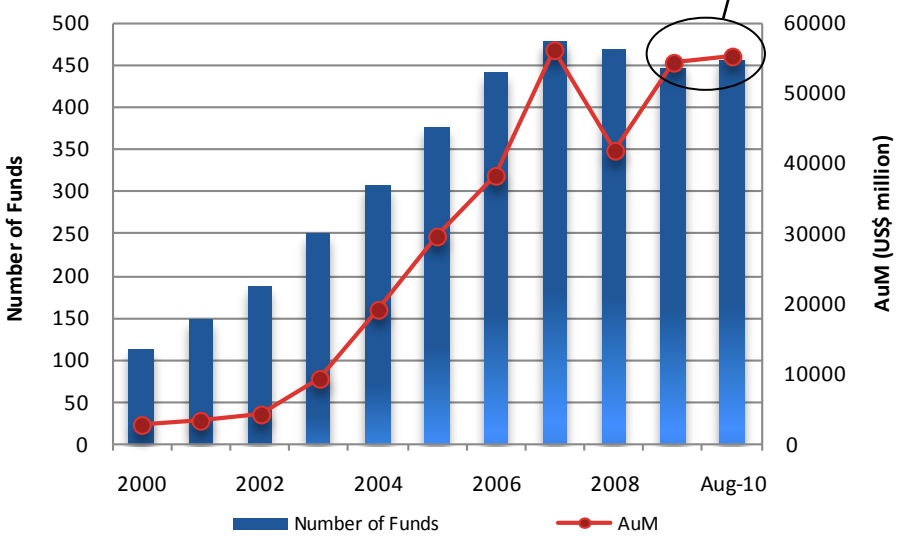
Figure 1b shows the growth in the Latin American hedge fund industry through the last decade. While the total number of funds in the region has grown nearly four times since 2000, the assets under management have increased by more than 20 times over the same period.

Figure 1a: Growth in Assets since January 2009



Source: Eurekahedge

Figure 1b: Industry Growth over the Years



Source: Eurekahedge

The growth in industry assets picked up incrementally after 2003, registering a three-fold increase from 2004 to 2007. This tremendous growth is underscored by the performance of the Eurekahedge Latin American Hedge Fund Index, which has gained 476.69% since its inception in December 1999, with an average annualised return of 17.70%, the highest amongst all major hedge fund regions.

Although Latin American hedge funds were also affected by the credit crunch and the financial crisis, managers delivered admirable downturn protection through this period with average losses of only 4.79% at a time when the average global hedge fund was down 10.87%. Although total assets decreased by 25% in 2008 and 1Q2009, due to record redemptions out of hedge funds, the industry has posted a remarkable recovery since then. In 2009 alone, Latin American managers posted a massive return of 28.02% while also attracting US$9.2 billion in the last three quarters of the year. Table 1 shows the asset flows and performance-based growth in the Latin American hedge fund industry since the start of 2008.

Table 1: Monthly Asset Flow in Latin American Hedge Funds

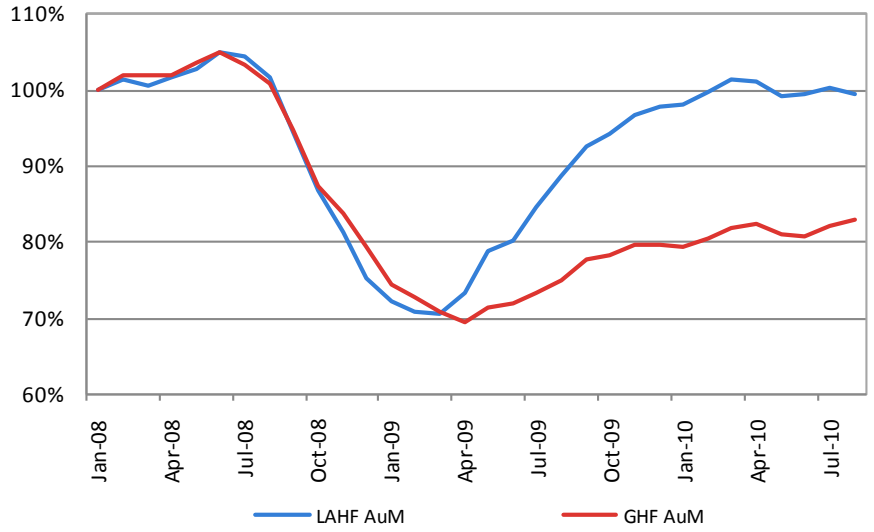
Month	Net Growth (Perf)	Net Flows	Assets at end
2007	**6.1**	**12.0**	**56.4**
Jan-08	-0.5	-0.3	55.6
Feb-08	1.4	-0.5	56.5
Mar-08	-1.0	0.5	56.0
Apr-08	0.7	-0.1	56.6
May-08	1.2	-0.6	57.1
Jun-08	0.2	1.1	58.4
Jul-08	-0.8	0.6	58.2
Aug-08	-0.8	-0.8	56.6
Sep-08	-1.9	-2.1	52.7
Oct-08	-1.5	-2.9	48.3
Nov-08	0.2	-3.2	45.3
Dec-08	0.3	-3.7	41.9
2008	**-2.5**	**-11.9**	**41.9**
Jan-09	0.5	-2.2	40.2
Feb-09	0.1	-0.9	39.4
Mar-09	0.2	-0.3	39.3
Apr-09	0.9	0.6	40.8
May-09	1.2	1.9	43.9
Jun-09	0.1	0.6	44.7
Jul-09	0.8	1.5	47
Aug-09	0.6	1.7	49.3
Sep-09	0.9	1.3	51.5
Oct-09	0.2	0.8	52.5
Nov-09	0.7	0.5	53.8
Dec-09	0.4	0.3	54.5
2009	**6.6**	**5.9**	**54.5**
Jan-10	0.1	0.1	54.6
Feb-10	0.1	0.8	55.5
Mar-10	0.6	0.3	56.4
Apr-10	0.2	-0.3	56.3
May-10	-0.5	-0.6	55.2
Jun-10	0.3	-0.2	55.3
Jul-10	0.6	-0.2	55.8
Aug-10	0.3	-0.7	55.4

Note: All figures are in US$ billion, unless otherwise stated.
Source: Eurekahedge

Copyright © Eurekahedge Pte Ltd 2010. All rights reserved.

Figure 2 illustrates the growth in Latin American hedge funds and global hedge funds due to asset flows since January 2008. Compared with global hedge funds, the rate of growth in Latin American funds has been nearly 20% greater as investors looked to diversify from traditional hedge fund regions in the wake of the financial crisis. In addition to increasing interest from global investors, local investors have also contributed significant capital to the industry.

Figure 2: Asset Flows to Latin American Hedge Funds vs Global Hedge Funds



Source: Eurekahedge

An important factor to consider when analysing the Latin American hedge fund industry is the difference between onshore and offshore hedge funds. Onshore Latin American hedge funds are mostly set-up in Brazil, which is the largest economy in the region, and denominated in Brazilian real. The reasons for a large local hedge fund market is that there are strict controls regulating the flow of capital in and out of the country, investors have to set-up special accounts, pay additional taxes, and all transactions have to go through the central bank. As such, investors look for real-denominated hedge funds, thereby creating a market for hedge fund managers.

Both onshore and offshore Latin American hedge funds have witnessed continuous growth over the last decade. The need to differentiate between onshore and offshore hedge funds arises from the fact that a majority of the onshore hedge funds are based in Brazil and denominated in the real, which has very high interest rates, thereby generating higher returns than offshore hedge funds, which are usually denominated in US dollars or other major currencies.

While offshore hedge funds make up a larger proportion of assets under management in Latin America, the growth rate of onshore hedge funds has been greater in recent times. Before the financial crisis, high-net-worth individuals in Latin America had a strong preference for offshore fund structures due to tax incentives; however, due to the increasing focus on greater regulations, onshore hedge funds have started to generate greater demand. Not only have onshore managers recovered all of their assets that were withdrawn in 2008, the current size of the industry is US$17.2 billion, which is near the all-time high.

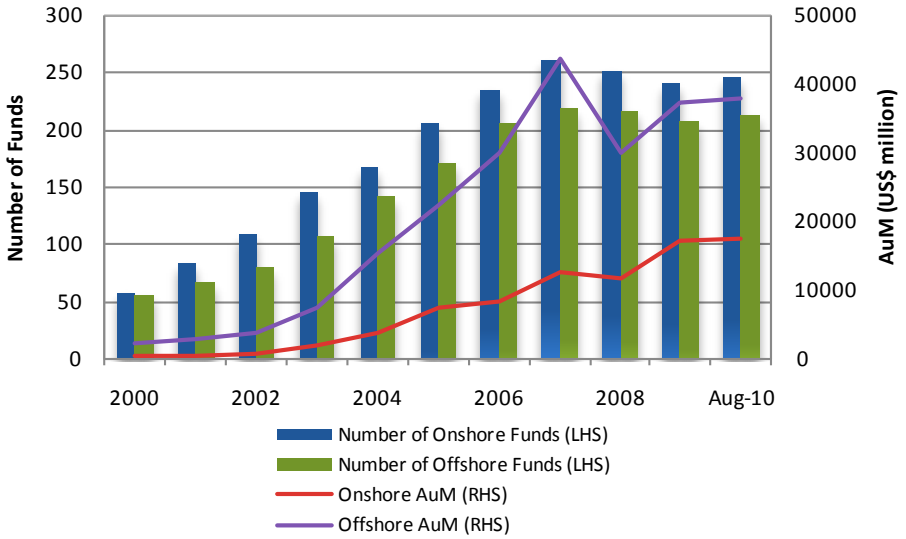
Onshore Hedge Fund Regulation

Despite Latin American hedge funds suffering some setbacks in 2008 primarily from negative net asset flows, positive performances in 2009 and 2010 have provided investors with renewed confidence that the Latin American hedge fund industry is built on a solid foundation. The Latin American onshore hedge fund market is largely dominated by Brazil, which not only hosts a number of service providers but also employs one of the most comprehensive regulatory framework in the world.

Hedge funds domiciled in Brazil are mandated to have daily redemption policies and are regulated by the *Comissão de Valores Mobiliários* (Securities and Exchange Commission of Brazil). Additionally, onshore hedge funds are required to disclose their holdings to regulators on a monthly basis while some hedge funds also provide weekly reports to independent risk managers. The regulators in Chile, Brazil and Mexico are also much stricter in terms of liquidity, risk exposure, mark-to-market and net asset value accounting than their counterparts in offshore market.

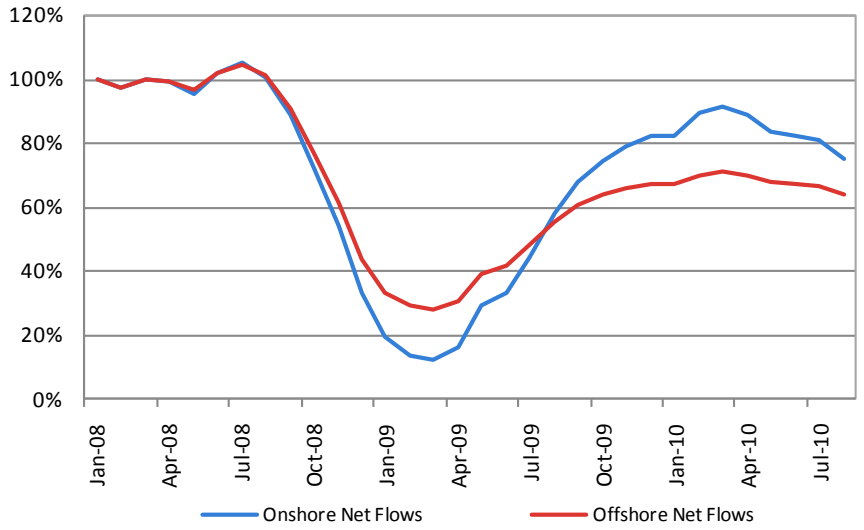
There has not been a single case of fraud in the region partly because regulations require independent (third-party) service providers and external risk assessment for domestic hedge funds. The confidence in the industry is demonstrated by the fact that in percentage terms, the net flows into onshore hedge fund vehicles have outpaced net flows into offshore hedge funds over the last eight months. Figures 3 and 4 show the comparative growth in onshore and offshore Latin American hedge funds.

Figure 3: Onshore and Offshore Industry Growth over the Years



Source: Eurekahedge

Figure 4: Net Flows into Onshore and Offshore Latin American Hedge Funds



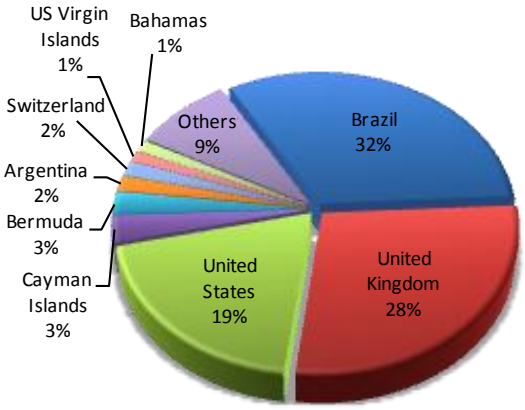
Source: Eurekahedge

Copyright © Eurekahedge Pte Ltd 2010. All rights reserved.

Head Office Location and Domiciles

While nearly 90% of onshore Latin American funds are based and domiciled in Brazil, the head office location of offshore Latin American funds shows a more global distribution. Most offshore managers are located in the United Kingdom and the United States, which collectively account for nearly 50% of funds. It should be noted that a similar breakdown in terms of assets under management shows that hedge funds located in the UK and the US manage almost 60% of the assets. This is primarily because of larger hedge fund investor base in these regions; however, there is now a greater diversity in the geographic location of Latin American hedge funds.

Figure 5: Head Office Location by Number of Offshore Funds

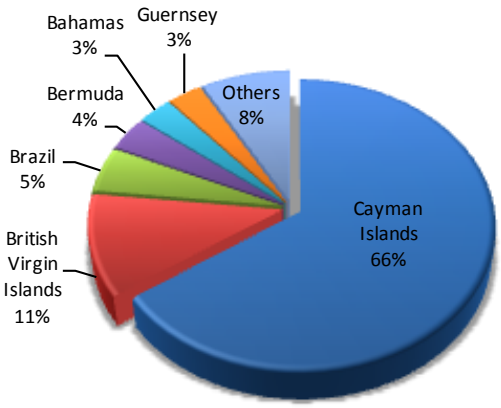


Source: Eurekahedge

A key point to note here is that Brazil is home to 32% of offshore funds, which are domiciled in offshore locations and primarily denominated in US dollars. Since Brazil itself is the largest economy in Latin America and managers tend to prefer geographical proximity to their investment regions in order to better monitor their portfolios, this is not a surprising development. Furthermore, Brazil also hosts a growing population of affluent individuals providing an investor base for managers, along with an increasing pool of talent and service providers.

In terms of fund domiciles, the offshore industry continues to be dominated by Cayman Islands-domiciled funds while Brazil, unsurprisingly, is the domicile of choice for more than 90% of onshore funds.

Figure 6: Domicile by Number of Funds

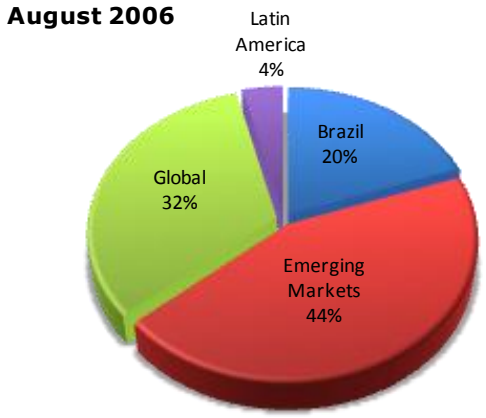


Source: Eurekahedge

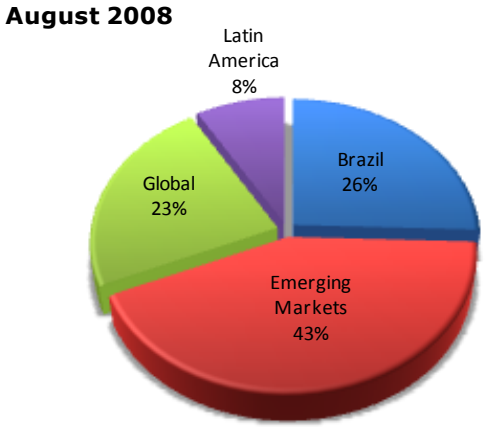
Geographic Mandates

Figures 7a-7c show the changes in the geographical mandate of Latin American hedge funds over the last five years. The figures include funds based in and investing in Latin America.

Figures 7a-7c: Geographic Mandates by Assets under Management



Source: Eurekahedge



Source: Eurekahedge

Source: Eurekahedge

The most prominent trend observed in the breakdown by geographical mandate is the increase in the assets of Brazil and Latin America focused funds. The two primary reasons for this are a) better performance of Latin American hedge funds over the last few years as compared with global hedge funds and b) greater allocations to region-/country-specific hedge funds.

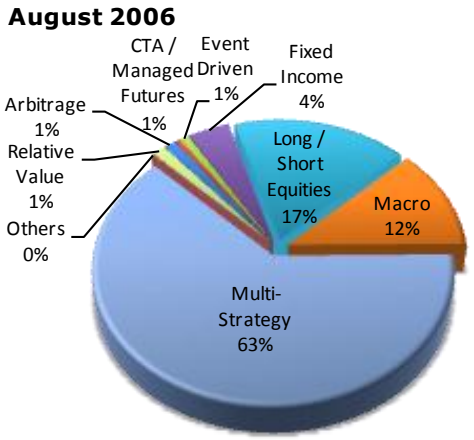
While global and emerging markets focused funds witnessed sharp losses in 2008, Latin American funds were down only 4.59% – as such, they did not suffer performance-based declines to the same extent. This further prompted investors who had earlier been allocating to the region through broad-mandated funds to invest directly into funds focused specifically on the region. Additionally, the recovery in Latin American markets in 2009 and 2010 has outpaced the global markets turnaround, hence, not only supporting performance but also building up investor interest in the region. As of end-September 2010, the MSCI Emerging Markets Latin America Index was up 123.26% since March 2009 while the MSCI World Index gained 57.04% over the same time period. Furthermore, the increasing population of high-net-worth individuals in Latin America has also provided regional managers with a new pool of investors who are familiar with the markets and prefer to invest in the region.

Copyright © Eurekahedge Pte Ltd 2010. All rights reserved.

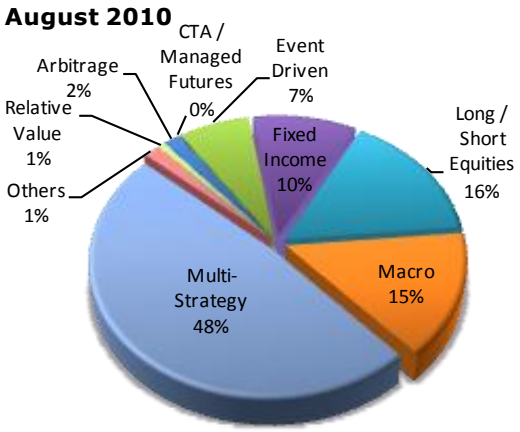
Strategic Mandates

The strategic mandate distribution of Latin American hedge funds also shows differing characteristics between onshore and offshore funds, and hence, their trends are discussed separately.

Figures 8a-8b: Onshore Strategic Mandates by Assets under Management



Source: Eurekahedge

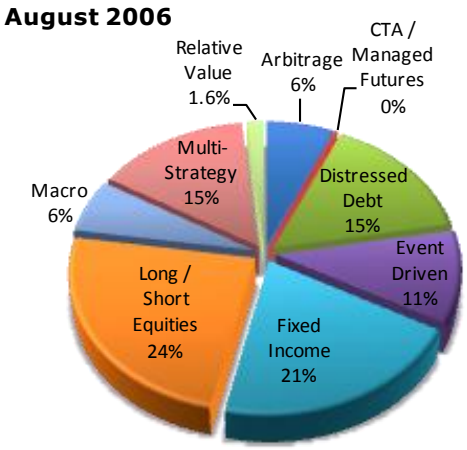


Source: Eurekahedge

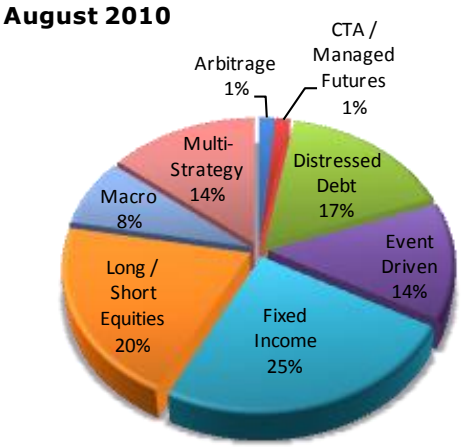
As shown in Figures 8a-8b, while multi-strategy investing remains the most popular mandate amongst onshore managers, the percentage of assets allocated to this strategy has fallen from 63% in 2006 to 48% in 2010. Two reasons for this change are a) due to increased risk aversion, investors re-allocated substantial capital to fixed income hedge funds during the financial crisis in 2008 – a move that proved beneficial as funds posted a return of 11.27% in 2008, and b) the hefty gains posted by event driven Latin American funds which resulted in greater growth in assets as opposed to other strategies.

Among the various offshore Latin American hedge fund strategies, fixed income, event driven and distressed debt have witnessed significant increases in their share of the total assets. While fixed income managers attracted significant capital from investors, event driven and distressed debt hedge funds increased their assets primarily from extraordinary performances in 2009 and 2010. Event driven hedge funds also witnessed capital inflows, driven by the growing interest in emerging markets and availability of new corporate activity opportunities.

Figures 9a-9b: Offshore Strategic Mandates by Assets under Management



Source: Eurekahedge

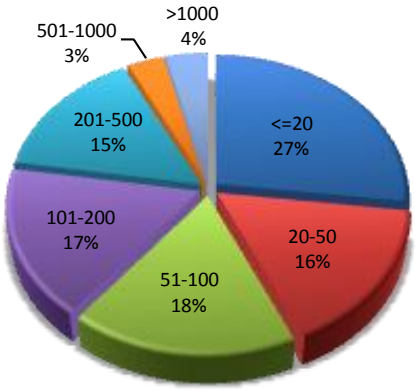


Source: Eurekahedge

Fund Sizes

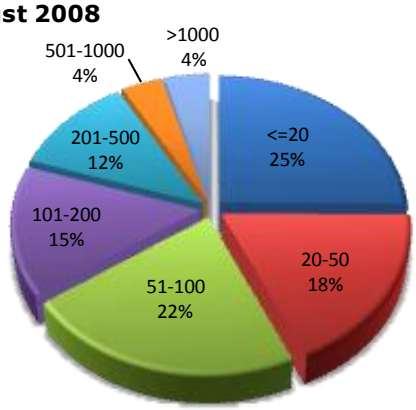
Figures 10a-10c: Fund Sizes

August 2006



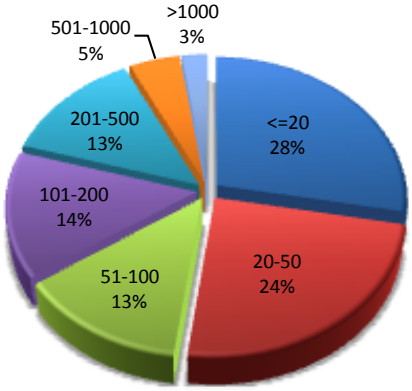
Source: Eurekahedge

August 2008



Source: Eurekahedge

August 2010



Source: Eurekahedge

The composition of the Latin American hedge fund sector in terms of fund sizes has varied according to the total industry assets. Although the current breakdown of funds is similar to that in 2006, the main difference is the 10% increase in small hedge funds managing less than US$50 million. This group represents those managers who witnessed significant withdrawals in 2008-2009 as well as hedge fund launches. Given that asset raising environment has not been favourable especially for small hedge funds, new managers have struggled to raise assets in the last 12 months.

Fees

Tables 2a and 2b show the changes in the fee structure of Latin American hedge funds as well as Asian and global hedge funds. While the trend of lower fees has been true across all regions in 2009-2010, Latin American funds have not made drastic changes to their fee structure. Although in 2009, Latin American start-up funds did lower their fees in line with investor demands, the average performance fees of funds launched in 2010 are back at 20%.

Copyright © Eurekahedge Pte Ltd 2010. All rights reserved.

Table 2a-2b: Average Fees of New Launches in Latin American, Asian and Global Hedge Funds

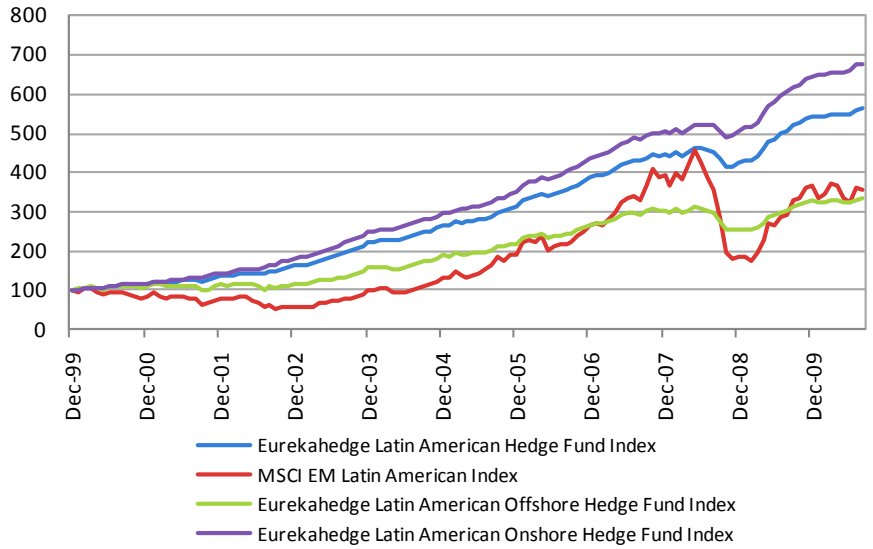
Management Fees (%)			
Year	LAHF	AHF	GHF
2005	1.80	1.73	1.71
2006	1.73	1.62	1.65
2007	1.89	1.84	1.74
2008	1.90	1.68	1.65
2009	1.62	1.66	1.64
2010	1.88	1.58	1.55

Performance Fees (%)			
Year	LAHF	AHF	GHF
2005	19.30	19.42	19.73
2006	19.27	18.78	19.02
2007	19.66	19.08	19.32
2008	20.47	18.86	18.84
2009	18.33	17.94	17.61
2010	20.00	19.22	18.95

Performance Review

After posting an excellent return of 28.02% in 2009, Latin American hedge funds have consistently been the best performers in 2010 among all broad hedge fund regions – the Eurekahedge Latin American Hedge Fund Index was up 3.97% YTD August. Figure 11 compares the performance of Latin American hedge funds with underlying markets, represented by the MSCI Emerging Markets Latin America Index.

Figure 11: Performance of Latin American Hedge Funds vs MSCI Latin American Index



Sources: Eurekahedge and MSCI

Over the last 10 years, Latin American hedge funds have delivered an annualised return of 17.70%, gaining 476.69% and outperforming underlying stock markets by 211%. Furthermore, the outperformance of hedge funds was exceptionally pronounced during the downturns of the last 10 years as managers used derivatives, short instruments and other hedging techniques to navigate through volatile financial markets. The Eurekahedge Latin American Hedge Fund Index posted gains of 14.9%, 17.3% and 20.1% in 2000, 2001 and 2002, respectively, while the MSCI Latin American Index sank by 18.4%, 4.3% and 24.8%, respectively, in those years. Additionally, the predominance of multi-strategy mandated funds means that managers also took positions in Latin American bonds and commodities outside of equities. This low correlation approach also helped Latin American funds surpass stock markets in the long run.

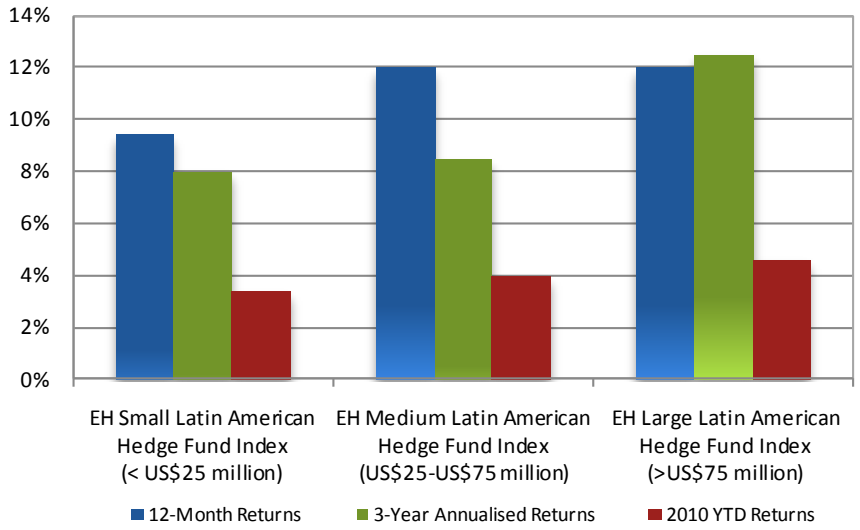
Within the Latin American hedge fund sector, onshore funds have delivered better performance than their offshore counterparts primarily due to the high interest rate of the Brazilian real. The Eurekahedge Onshore Latin American Hedge Fund Index has gained a massive 679% since its inception in December 1999 while the Eurekahedge Offshore Latin American Hedge Fund Index climbed 332% in the same period. Onshore funds have also delivered better returns in the shorter term, when compared with offshore Latin American hedge funds as shown in Table 3.

Table 3: Performance of Onshore and Offshore Latin American Hedge Funds

	EH Latin American Hedge Fund Index	EH Latin American Offshore Hedge Fund Index	EH Latin American Onshore Hedge Fund Index
12-Month Returns	11.40%	9.54%	12.20%
YTD 2010 Returns	3.97%	1.41%	5.07%
3- Year Annualised Returns	9.50%	4.25%	11.76%
3-Year Annualised Standard Deviation	6.60%	9.71%	5.45%

Performance by Fund Size

Figure 12: Performance of Latin American Hedge Funds across Fund Sizes



Source: Eurekahedge

The breakdown of Latin American hedge fund performance by fund size also shows some interesting trends. While funds across all size categories have delivered healthy returns in 2010, the larger funds have outperformed their smaller counterparts, gaining 4.58% on average. This trend also extends to the 12-month and the 3-year annualised returns figures, where large Latin American hedge funds have delivered higher returns than medium and small Latin American funds. Additionally, this outperformance has led to further inflows from investors; currently, the top 50 hedge funds in Latin America account for more than 70% of the industry assets.

Some of the reasons for these trends are given below:

a) Managers with a greater asset base are in a stronger position to get better deals from prime brokers (ie, negotiate for lower transaction costs), hence, helping future performance.
b) Redemption from a few investors will not force managers to liquidate potentially winning positions.
c) Financial magazines and media tend to report more on large hedge funds, providing greater exposure and free marketing.
d) Larger marketing budgets, hence, the ability to attract more capital.

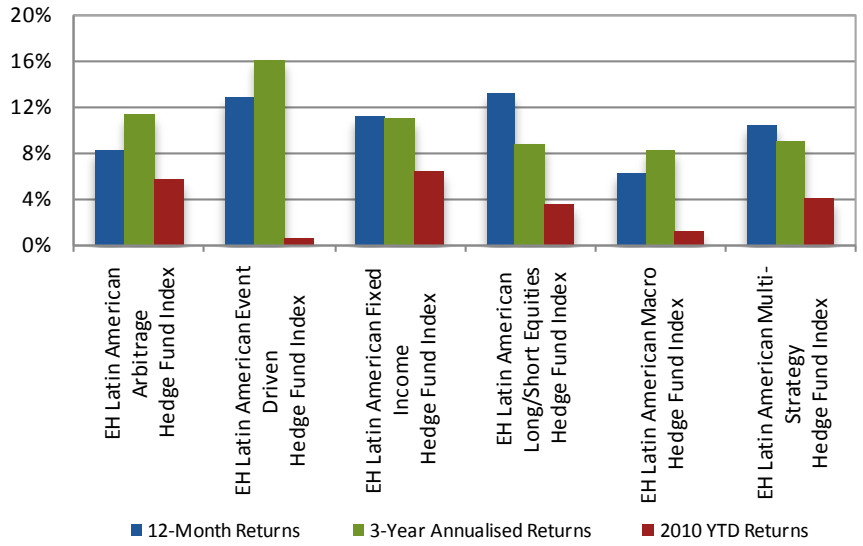
Copyright © Eurekahedge Pte Ltd 2010. All rights reserved.

Table 4: Performance of Latin American Hedge Funds across Fund Sizes

	EH Small Latin American Hedge Fund Index (<US$25 million)	EH Medium Latin American Hedge Fund Index (US$25-US$75 million)	EH Large Latin American Hedge Fund Index (>US$75 million)
1-Month Returns	9.42%	11.98%	11.98%
YTD 2010 Returns	3.35%	3.91%	4.58%
3-Year Annualised Returns	7.98%	8.46%	12.46%
3-Year Annualised Standard Deviation	5.08%	7.31%	6.67%

Strategy Performance

Figure 13: Performance of Latin American Hedge Funds across Strategic Mandates



Source: Eurekahedge

Latin American hedge funds across all strategic mandates look set to finish the year in positive territory, with all hedge fund strategy indices currently in the green. 2010 has seen the spotlight turn to fixed income hedge funds as they have racked up gains of 6.4% YTD August. Managers investing in high yielding emerging market debt, such as issues in Brazil, added substantial gains to their portfolios while arbitrage managers have also brought in profits of 5.63% through exploiting the various opportunities present in volatile market conditions.

In the 3-year measure, event driven hedge funds lead the way with an annualised return of 16.03% amid increased corporate activity in 2009 and 2010. Event driven managers have capitalised on a busy M&A environment over the last two years as the Latin American market saw US$164 billion worth of deals come onto the table in the first nine months of 2010. The value of the deals announced during the same three quarters last year was US$74 billion.

Table 5: Performance of Latin American Hedge Funds across Strategic Mandates

	EH Latin American Arbitrage Hedge Fund Index	EH Latin American Event Driven Hedge Fund Index	EH Latin American Fixed Income Hedge Fund Index	EH Latin American Long / Short Equities Hedge Fund Index	EH Latin American Macro Hedge Fund Index	EH Latin American Multi-Strategy Hedge Fund Index
12-Month Returns	8.32%	12.76%	11.15%	13.16%	6.24%	10.36%
YTD 2010 Returns	5.63%	0.50%	6.36%	3.55%	1.09%	4.03%
3-Year Annualised Returns	11.30%	16.03%	11.02%	8.85%	8.16%	9.04%
3-Year Annualised Standard Deviation	1.08%	12.08%	1.90%	10.38%	4.39%	5.71%

Conclusion

The Latin American hedge fund industry witnessed remarkable growth in the first seven years of the last decade before experiencing some rough times during the financial crisis. However, even during the downturn, regional managers still outperformed the underlying markets as well as hedge funds in other regions. Since then, the industry has posted an excellent recovery, with the average Latin American hedge fund up nearly 40% since November 2008.

The region's managers have also attracted significant assets over the last 18 months, bringing the current size of the Latin American hedge fund industry back to historical highs – US$56 billion. With an increasing base of local investors, strong economic fundamental and highly expected growth rate, the sector will continue to attract an increasing amount of capital going forward. Furthermore, with the emphasis on regulations post-financial crisis, the well-developed regulatory framework of the region's hedge fund industry will also be beneficial in attracting capital.

In terms of performance, Latin American managers have outperformed the underlying markets by more than 5% in annualised returns and going forward, we expect managers to deliver similar results. We also anticipate Latin American hedge funds to outperform other regions due to the excellent growth prospects in the underlying economies.

Copyright © Eurekahedge Pte Ltd 2010. All rights reserved.