

### **Hedge-Fund Boom in Latin America: an Eldorado that isn't as new as one might think, but remains highly promising**

After Asia, South America now appears to be the Promised Land for investors seeking absolute and decorrelated returns. Whereas a regional approach was deemed too restrictive several years ago, specialisation seems to be the most appropriate investment perspective in Emerging Markets today. Hence, hedge funds now grow and multiply in this region characterised by favourable economic conditions and where years of reforms and growth have begun to pay off.

2006 should turn out to be an exceptional year: although returns may not meet the record levels of recent years, for the first time the region is proving to be resilient in the face of global economic turbulence, enabling local managers to fully exploit the opportunities presented by a local market that manages to attract and maintain a healthy level of liquidity.

#### **Although hedge funds have long ceased to be a novelty here, the industry is thriving**

Today, European and North-American Funds-of-Funds have set their sights on hedge fund managers from Rio to Buenos Aires. It is worth pointing out that the concept of absolute return is no novelty in this market, and certain hedge funds have already established honourable track records since the late 1990s. The new feature today is the internationalisation of hedge fund demand.

The region's hedge funds experienced a first wave of success in the late 1990s, as they were championed by a number of wealthy local families, seeking to exploit regional markets' extreme volatility and keen to protect their gains in recurring market debacles. These pioneers mostly launched multi-strategy and Global Macro funds and didn't necessarily limit investments to their home region; on occasion, they exploited opportunities in other Emerging Markets as well as in the G3 area.

The second catalyst to hedge fund growth in Latin America was the combination of state defaults in Ecuador and Argentina in 2000, as well as the economic slump in Brazil and the region at large in 2002, in the context of an international liquidity crisis. Opportunities for Distressed and Event-Driven strategies thus multiplied in the region, which experienced a very substantial capital inflow from "global" Emerging Market fund managers reallocating assets away from the Far East.

Since 2004, new managers and new strategies have developed in South America; in particular, Long/Short Equity strategies have owed their success to the newfound buoyancy of regional equity markets that benefited from a strong

liquidity expansion, numerous IPOs and healthy consolidation trends in several sectors, notably telecommunications.

#### **A variety of strategies around one common denominator: volatility**

Volatility is a hedge fund manager's best ally in Emerging Markets, as trading opportunities emerge directly from extreme market swings as well as market collapses. South American managers are used to working in an environment where volatility averages 30% to 40%, i.e. twice the level of volatility in North American markets under quiet trading conditions. Certain hedge fund specialists have specifically built their reputations on the ability to generate very strong returns in periods of severe market downturn, with the scope for gains being more limited in times of market euphoria. Other managers, less at ease with the concept of short sales, prefer to wait for opportunities in Distressed Securities strategies; indeed, such opportunities are never very far from arising in the region and offer sufficiently generous returns to offset less lucrative years.

There are few essential differences between Latin American hedge fund managers and their counterparts in London or Hong-Kong. Most have learned the trade on the proprietary desks of leading local or international banks. However, there are also some personalities, like Armínio Fraga (manager of Gávea Investimentos), whose curriculum is particular: indeed, Fraga started fund-managing with George Soros before spending several years at the helm of Brazil's Central Bank. The specific asset class being traded, and systemic volatility are the two distinctive elements in a Latin American hedge fund manager's day-to-day business: these factors also motivate him to always be prepared in the event of a drastic turn in market conditions.

On the South American continent, Brazil obviously represents the leading financial market: this country alone makes up approximately 50% of the regional MSCI Index. Brazil is unique among Emerging Markets in that it harbours a substantial demand on the part of domestic institutions, be it for foreign and local-currency debt, on and offshore forex trading, equities (local companies and ADRs), futures, interest-rate derivatives or commodities. In terms of hedge funds, Brazil is also the region's leader: according to Eurekahedge, the country harbours nearly 95% of total South American assets, yet less than 3% of world assets. Hedge fund strategies are thus authorised in Brazil, under the oversight of the CVM, Brazil's Financial Market Authority, which sees in these funds a means to enhance the local market's flexibility and efficiency. Certain alternative strategies are not in use, such as Convertible Bond Arbitrage, whereas

sophisticated country specific strategies have evolved, such as arbitrage on ethanol-backed securities. The outlook for Long/Short Equity strategies is rather limited owing to the high cost of securities borrowing, yet this barrier also secures superior returns to those who know how to find securities lenders at the local level.

**Brazil: a virtuous cycle offering a historic opportunity**

Whereas Asia is traditionally an equity market, Latin America is historically associated to debt trading. Conditions on the continent, however, are in the process of changing drastically, for all of South America's larger countries are seizing the opportunity presented by historic balance-of-payments surpluses to buy back their debt. As foreign debt tapers off and credit spreads remain near all time lows, managers have switched their focus to local currency debt and equity markets. Whereas traditional Brady and Eurobond markets are centred in London and New York, local bond markets are mainly led by regional specialists owing to relatively high barriers to entry.

Today, local Brazilian markets benefit from a unique opportunity, recognised even by managers who are notoriously cautious about the country. Despite upcoming presidential elections and international uncertainty as to future world growth and liquidity, Brazil is not about to re-enact the meltdown of 2002. Indeed, for the first time, the country's fundamentals are sufficiently sound to enable the central bank to continue loosening its monetary policy, against the current global uptrend in interest rates. Nominal Brazilian interest rates have thus recently fallen under the 15% mark compared to almost 20% a year ago, and the market already expects this trend to continue, reflecting a marked slowdown in inflation, which has fallen below 4%.

This expected interest-rate fall should continue attracting capital into Brazilian markets, thus offering a liquidity that will favour local hedge funds in coming months despite a rather pessimistic international outlook. The scope for strong returns therefore remains intact, and the time for a market reversal is still far from ripe. Nevertheless, in this promising context, one must be able to select those managers who will be able to fully profit from it, something not necessarily given to all investors.

Florence Duculot  
Portfolio Manager, E.I.M. S.A.