Brazil's hedge funds break through

Brazil's hedge fund industry is growing up. Two trends in particular stand out: foreign investors are seeking out local players through which to invest; and funds are evolving their strategies. Sudip Roy **reports from São Paulo**

IN OCTOBER, MIAMI hosted a conference entitled "Hedge Funds World LatAm 2005". Running over three days it gathered the brightest and best Latin American hedge fund managers to discuss the opportunities of investing in the region. A week later, another conference, "LatAm Hedge Funds 2005", took place, this time in Geneva, again attracting high-profile investors.

It would not be unusual for two events discussing the future of the US hedge fund industry to be arranged seven days apart. But for Latin America this was unprecedented, reflecting a growing interest in the sector there. The locations for the meetings were also significant. Latin American hedge funds are hitting the radar screens of foreign investors hunting for yield and therefore searching for the next big thing. Miami and Geneva are obvious homes of potential private investors.

Brazil is the main focus for these investors. Latin America's biggest economy accounts for the vast majority of the region's hedge funds. There are 109 Brazilian domiciled funds (which effectively can only invest in Brazil securities) according to data service provider Eurekahedge; another 97 are based offshore. These funds are producing healthy performances. Onshore funds are posting an average annualized return of 26.44%, while the figure for offshore vehicles is 17.78%.

In total these funds manage $23.7 billion, 75% of which is invested in offshore vehicles. The offshore funds face fewer regulations than their onshore counterparts. Onshore funds (which are open to local and foreign investors) can expose international investors to local interest rates and currency risks, whereas offshore funds are usually dollar-denominated. Both types have boomed over the past three years but the biggest growth has been in offshore funds. This year alone these have raised more than $8 billion, $600 million up on the previous year.

These figures will probably rise substantially over the next 12 to 18 months. Most Brazilian hedge funds have been approached by US and European private banks, high-net-worth individuals and fund of funds investors, which have been sniffing around São Paulo and Rio de Janeiro seeking investment opportunities.

When *Euromoney* visited one São Paulo hedge fund manager at the beginning of November he said he expected his offshore fund to receive more than $100 million from seven fund of funds vehicles from New York and London within the next couple of weeks. "These funds have already invested in Asia and in Latin America through global emerging markets funds but most don't have exposure to Latin America locally," he says. This is now changing. "We are getting five to 10 visits a month from international investors. A couple of years ago it used to be one a quarter," he adds.

Arminio Fraga: *Life for Brazilian hedge funds is no different to elsewhere*

Another local investor, Luiz Fernando Figueiredo, who established Mauá Investimentos in January, tells a similar story. Figueiredo is a former deputy governor at the central bank and a co-founder of Brazil's best-known hedge fund, Gávea Investimentos, which he started with his former central bank colleague Arminio Fraga, and Luis Fraga.

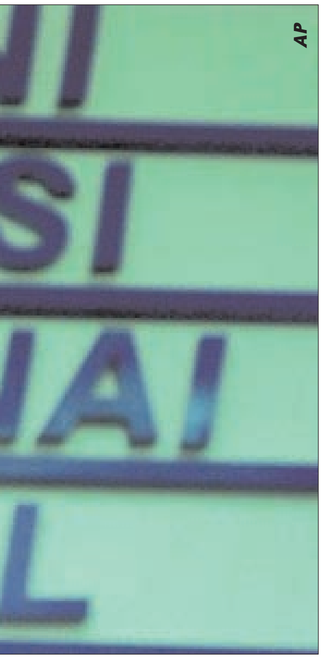
He says: "When I was at the central bank it was difficult to sell Brazil. Now we're seeing record foreign interest in the country, mostly from US and European funds of funds, though also even from pension funds and insurance companies."

Even hedge funds that are more reliant on local clients are reassessing their approach. Renato Abucham, a hedge fund manager with investment manager Claritas, says that his firm's biggest challenge is to build a global client base. "We're hoping to attract investors in the US, London and Geneva," he says, adding that the firm has received visits in São Paulo from foreign investors that it has never even contacted before.

Another local investment firm, Fama Investimentos, opened its offshore Brazil Fund to international investors in February. The fund's managers are roadshowing in London, Miami, New York, Paris and Zurich. So far the fund has $10 million of assets under management although the goal is to raise $200 million.

The long and the short

This growth in Brazil's hedge fund industry is helping to change its dynamics. The most important is in the evolution in investment strategies. The presence of more international investors is encouraging Brazil's hedge fund managers to adopt different styles. For offshore funds, for example, long/short equity is the most popular investment technique. American and European investors "have invested in diversified portfolios over the past 20 years so they understand the [hedge fund] concept. All they care about is track record," says Ricardo Quintero, a founding partner at Capitania Asset & Risk Management.



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International investors "have the right culture," says Mauá's Luiz Fernando Figueiredo. "They have experience of a 'typical' hedge fund. They are used to volatility."

The question is whether Brazil's local investors will follow their international counterparts' lead and adopt a more aggressive approach. Brazil's pension funds have a notoriously conservative outlook, conditioned largely by the country's volatile economic and political history. When hedge funds first sprouted in Brazil over 10 years ago, most onshore funds were macro- and multi-strategy driven. Today, these types of funds still dominate but more hedge fund managers are adopting such strategies as fixed-income arbitrage, relative value and especially long/short equity for onshore funds.

"Most funds are redefining their strategies and trying to take advantage of opportunities," says Jose Leopoldo Figueiredo, a director at Hedging Griffo, one of the pioneers of the Brazilian hedge fund industry. "Brazil has a very long history of investors making money in fixed income but now people are discovering value in equities."

The growing popularity of the long/short equity strategy is an important step in the development of the industry in Brazil. Too many macro funds are hedge funds in name only. In practice they take little risk and are really vanilla funds with a twist. Up to now, this has suited Brazil's pension funds, which have shown little appetite for volatility. Many hedge fund managers complain that these investors take an overly short-term view. "If a fund underperforms for two months in a row, it makes a manager risk averse," says Eduardo Munemori, co-founder of Constellation Asset Management.

Claritas's onshore macro fund, for example, suffered an outflow of R$600 million (US$272 million) in 2004 when the fund underperformed the benchmark by just 3% after its managers made the wrong bet on US interest rates. The severity of the punishment meted out by investors is particularly remarkable given that the fund had outperformed its benchmark by 8% in 2000, 12% in 2001, 19% in 2002 and 17% in 2003.

"The money outflow was a result of local investors not willing to lose a single point," says Claritas's Abucham. This year, he adds,

Mauá Investimentos

Named after the 19th-century Brazilian entrepreneur Ireneu Evangelista de Souza (the Baron of Mauá), Mauá Investimentos certainly has the pedigree to succeed.

Founded in January, the firm is the brainchild of Luiz Fernando Figueiredo, a former deputy governor at the central bank. He is also one of the co-founders, along with Arminio Fraga and Luis Fraga, of Gávea Investimentos, Brazil's best-known hedge fund. The Gávea link runs deep; 10 other Gávea executives joined Figueiredo at Mauá.

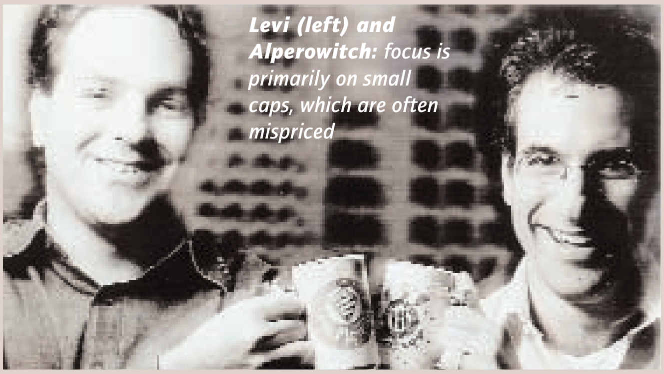
Figueiredo says his decision to leave Gávea 12 months ago was as much a lifestyle choice as anything else. Gávea's headquarters are in Rio de Janeiro but Figueiredo wanted to return to his home city of São Paulo. His split from the two Fragas is amicable – he will remain a partner at Gávea for another three years. In turn, Arminio and Luis will be partners in Mauá, also for three years.

Like Gávea, Mauá is a macro firm but whereas Gávea has one local portfolio and one that invests in global emerging markets, both of Maua's funds (one local, the other offshore) invest solely in Brazilian instruments.

In total Mauá manages $238 million. The firm runs several different investment strategies including fixed-income arbitrage and equity arbitrage, based on both value and event-driven analysis. The offshore fund tries to exploit differences between Brazilian asset prices in the onshore and international markets. Mauá relies on extensive research and thorough fundamental analysis. Investment decisions are taken on a consensual basis among three partners. The firm focuses on three kinds of risk – market risk, liquidity risk and cash risk. Mauá's risk management committee examines various stress scenarios, where all the extreme historical values and respective correlations are evaluated for different periods.

So far the firm's strategy appears to be working: the onshore fund is up 12% in dollar terms and the offshore fund is up 7% on an annualized basis.

Fama Investimentos



Levi (left) and Alperowitch: *focus is primarily on small caps, which are often mispriced*

Since its inception in 1993, Fama Investimentos has focused solely on Brazilian equities, primarily small-cap and mid-cap companies. A value investor, the firm relies entirely on fundamental analysis and places a lot of emphasis on equity research.

The firm runs both long only and absolute return funds for local and international investors. The offshore Brazil fund was originally established in October 2000 but it was only open to a couple of private investors for the first five years. Then last February it was opened to all accounts.

The fund is broken into three classes: valor class; equity value class and equity market neutral class. All are designed for international investors. The first two classes invest in Brazilian small-cap and mid-cap stocks, the difference being that the valor class is not hedged against devaluations of the Brazilian real, while the equity value class is. The equity market neutral class involves buying shares and shorting Bovespa index futures contracts, so neutralizing the Brazilian stock market risk. The fund does not leverage under any circumstances.

Fabio Alperowitch, who co-founded Fama with Mauricio Levi, says: "In Brazil there are lots of opportunities in small caps as companies tend to be mispriced." He cites the example of fashion retailer Guararapes. Fama bought the stock in 1997 for R$2.90. At the time the market was bearish because of the company's weak management and poor corporate governance. The company, though, turned its fortunes around and is now trading at R$56. "We are now divesting a small portion [of our shares]," says Alperowitch, "though our target price is R$100."

Given that Fama focuses primarily on small caps, it's relatively difficult for it to short stocks. "There are not many stocks available to short," says Alperowitch, who adds that weak liquidity can also be an issue.

As well as the offshore fund, Fama runs two long only and two absolute return funds locally.

money is returning to the fund. One problem is that clients can take out their money on a daily basis. In fact, Gávea, which was set up in 2003, was the first hedge fund to set a 90-day notice period for redemptions. Mauá has the same limit but most funds are overly vulnerable to the whims of their clients. Mauá's Luiz Fernando Figueiredo says that Brazil's hedge funds need to adopt at a minimum 30-day or 60-day redemption rules.

What Claritas's plight also shows is that performance matters above all else. It will take time for Brazilian pension funds, which have $120 billion of assets, to become more aggressive but if long/short equity strategies outperform macro funds they will be more willing to invest in them. This year macro funds have struggled (see graph). The only macro bet that has paid off is to be long real, short US dollar. This has given long/short equity and other investment styles a chance. "It has always paid to have big directional bets but when that changed managers began to look at other strategies," says Luiz Fernando Figueiredo. "It's a natural development of the market."

"Long/short equity is now in vogue," says Constellation's Munemori, who reckons Brazilian pension funds have an exposure to equities of about $30 billion through long only and hedge funds. "Everyone is looking for long/short opportunities, therefore supply is meeting demand."

Structural changes

Structural changes too are providing a boost to long/short equity funds. Improvements in corporate governance and liquidity mean that hedge fund managers can short individual stocks more easily than before. Greater transparency means that there are more shorting opportunities in the market. Companies and financial institutions are also looking more readily to the equity markets to raise cash, increasing the number of stocks listed. Over the past two years, there have been 24 initial and secondary offerings on the São Paulo stock exchange (Bovespa). Moreover, today there is less correlation between individual stocks and the overall index and so more opportunity to profit from shorting. "Two years ago it was difficult to find share prices that were falling in a rising stock market," says Munemori. "Now you can find stocks that significantly underperform or are falling in value, therefore you can make money on both the long and short sides."

Early equity funds simply shorted the index if they wanted to hedge their positions. "It's different now," says Munemori. "In the past, the main goal for equity hedge funds was to avoid systemic risk. Now the industry has evolved; managers are analysing specific company risks. This evolution has allowed new, younger, more sophisticated managers to succeed."

Florian Bartunek, Munemori's partner, says: "We've gone from a more volatile, macroeconomic-driven environment to one that is less volatile and more fundamentals driven." He adds: "Shorting to us is not a hedge but an important source of return."

Some pension funds are also beginning to lend stock to hedge funds, says Munemori. He reckons that Brazil has $3 billion of shorts outstanding. "Lending stocks can be an important source of income for pension funds," he says. Given that most pension funds have an average annual return target of inflation plus 6%, lending stocks at 5% to 6% can become a tidy little business for them.

In addition, the standard contract for stock lending in Brazil is 30 days, which means that the borrower has the freedom to use the stock as it sees fit for almost a month. In the US, by contrast, the lender can recall the stock at any time. One other advantage for short sellers in Brazil is that there is no uptick rule. In the US, for example, if a stock is trading at 25 when it's borrowed but then falls to 24, it cannot be shorted. In Brazil, there is no such constraint.

Still, there are limitations. "There aren't many stocks that you can borrow," says Gávea's Arminio Fraga, who before becoming central

PERFORMANCE OF BRAZIL ONSHORE FUNDS
2005 (AS AT END SEPT)

Source: Eurekahedge

bank governor in 1999 worked for George Soros. "The top 10 stocks are OK but there's more liquidity in currencies and fixed income. It's also much cheaper to short through ADRs."

Shorting can also be a laborious process for hedge fund managers, according to a recent report from Eurekahedge. "In Brazil, the shares are registered via the CBLC [the Clearing and Depository Corporation] in the name of the investor and not the broker," says the report. "As such, the process to short shares is dependent on the fund manager actively seeking shares and managing the operational aspects of renewing contracts and guaranteeing availability to avoid a squeeze."

The report concludes: "Fund managers need to employ significant resources and time to managing the process and building the relationship with the different brokers."

Another more general issue is that most investment managers are not keen to leverage their funds. Hedging Griffo, one of the most sophisticated players in Brazil, doesn't use leverage. "We always try to have a hedged position," says Jose Leopoldo Figueiredo. He reckons funds don't use leverage "because there is so much risk in the country anyway".

The biggest issue facing the industry, though, is the relatively high level of interest rates, which stand at 18.5%. "We used to say that our biggest competitor is the overnight rate not other funds," jokes Mauá's Luiz Fernando Figueiredo. But the point is well made. What incentive is there for pension funds to allocate money to hedge funds when they can make healthy returns through money market funds? And why should the country's banks get involved in the hedge fund business when they know that their vanilla funds will get plenty of demand? High interest rates, complain most hedge fund managers, are stifling the industry's growth. Others are more sanguine. Arminio Fraga, for one, reckons that the outlook is bright and that rates should come down over the forthcoming months, although the political and economic environment might become more volatile next year because of the presidential election. In any case, he adds, hedge funds have had to compete against much higher rates in the past. He says Brazil is no different to many other countries. "Life for a hedge fund in this environment is not that different from elsewhere."

Undoubtedly the potential is great. The economy appears to be on track, regulation is sound and market infrastructure is continually improving. Derivatives trading volumes are relatively healthy compared with other emerging markets. Individual equity options trading, for example, rose 23.1% in the first half of this year compared with the same period in 2004, according to the Futures Industry Association. Brazil's futures exchange (the BM&F), meanwhile, is the 11th most active derivatives exchange in the world, according to the FIA.

If the local pension funds can break out of their conservative mindset and learn to trust their hedge funds more, the industry's growth could be rapid. For international investors such doubts are already disappearing. n

Capitania Asset & Risk Management

The Capitania team: *arbitrage opportunities from out-of-line onshore and offshore pricing*

Capitania is one of a rare breed in Brazil's hedge fund community: a quant specialist, whose strategies include arbitrage and relative value. Amaury Junior, who previously worked for Bank of America and JPMorgan as a derivatives trader, founded the firm.

Capitania's initial mandate was to manage part of Bank of America's Brazil exposure, which comprised $300 million in cash instruments and $6 billion in exotic derivatives.

Today the firm manages money for a range of clients – its offshore hedge funds have $80 million of assets and its onshore hedge funds and private portfolios have $250 million. The funds invest across all Brazilian instruments including asset-backed securities, commodities and equities. The firm takes a long-term approach and focuses more on international investors than local.

Capitania also has an advisory division, which structures and executes financial risk management services for large corporations and financial institutions. Other advisory services include financial risk analysis and risk management policies and implementation guidelines.

On the fund management side, the firm seeks to profit from cyclical volatility in the emerging markets. It also tries to take advantage of any mispricings driven by different divisions of international banks trading Brazilian assets. Onshore and offshore pricing for the same asset is often out of line.

The firm has a barbell-like return profile: it seeks to perform well if Brazilian markets are either very strong or very weak. Supporting the firm's investment strategy are dedicated proprietary risk management systems and a fully built-out middle office and administrative infrastructure. "We are one of the few hedge funds to have developed our own back-office and risk management systems," says Arturo Profili, a partner at the firm.