Survival of the fittest and new strategic direction in 2009

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Lackluster performance and a change in the perception of the industry are making survival difficult for many Latin America hedge funds, at a time when many international investors are looking to diversify into opportunities in the Latam region and despite the fact that Latam funds lost less in 2008 than their emerging market counterparts in Asia, the Middle East and Africa, and Russia.

According to Chicago-based Hedge Fund Research, hedge funds investing in Latin America posted losses of 29.1 per cent for 2008, the smallest decline of any of the four major emerging markets regions. More than 100 funds focus on investing exclusively in Latin American markets, with an average fund size of just over USD 35 million per fund, the smallest average of the four emerging markets regions. These funds comprise more than five percent of total Emerging Markets hedge fund capital, up from three per cent in 2002.

Andres Azicri of Convex Management thinks that investment characteristics have worked against Latam funds: 'Most of the hedge funds in Latin America are based in Brazil. Some didn't perform very well during the crisis as they had a long bias. Compared to the average of the region, funds outside of Brazil performed better, being much more hedged rather than long bias. Still it was a very tough year as funds were faced with not only market risk but counter party risk, which was not minor'.

Convex Management is an Argentinean boutique, based in Buenos Aires and launched in May 2007 by Azicri and Marcelo Elbaum. Convex manages the Convex Fund, a Latin America-focused hedge fund.

Elsewhere in the Latam region, Brazilian funds have been hit hard by very strong redemptions and assets under management have fallen substantially, which is a trend that Otávio Vieira of Safdie Private Banking says is likely to get much worse before improving: 'In 2010 there will be perhaps 30-40 per cent of assets under management than there were in 2008, this is causing many funds to shut down, however those left standing will reap the benefits'.

Whilst obtaining adequate returns has been particularly difficult in the current environment, Mauricio Levi of Sao Paulo-based FAMA Investimentos believes there are reasons to remain positive: 'Macro has given some funds recent opportunities to make some money due to Brazilian interest rate behaviour. Brazil still has some macro events which make it possible for managers to show returns - high interest rates, a cheap stock market and other similar opportunities still exist'.

Since its inception in 1993, FAMA Investimentos has focused on Brazilian equities, primarily small-cap and mid-cap companies. The firm runs both long only and absolute return funds for local and international investors.

Levi warns that those trying to survive turbulent times will have to act quickly: 'We do expect to see still further funds being shut down in Brazil this year, unless managers are able to raise substantial assets in the very short term'.

Recent perception will have to be overcome to retain foreign investments. Large losses, the collapsing of business empires and financial scandals have badly shaken investor confidence worldwide and Mauricio Levi says hedge funds are now viewed differently, 'there is a little bit of a shift as how hedge funds are being perceived, as they were seen as 'risk free,' which has never been the case. Only now having witnessed recent events are perceptions catching up with reality'.

Levi feels that local Brazilian investors could shy away from fund managers until trust can be rebuilt, but that favourable factors should lure investors from outside the country. He says, 'Brazil has better behaviour than the rest of the world in terms of economic trends, in addition to a sophisticated market which still maintains opportunities in the form of mispriced assets - these factors give it a better outlook than the rest of the world'.

Levi feels that overseas investors may no longer be looking to Brazil as they associate its success as being linked with world commodity prices, however, he notes that the country's economy is more robust than many think, 'There is a misconception that Brazil is completely linked to commodities, and as commodities have dropped, that this will dramatically affect the country.'

Whether investment comes from domestic or international sources, fund managers are finding that clients are now seeking a different type of relationship. 'An important factor is transparency, and these days you have to be very communicative with investors,' says Azicri. Not only is the client -manager dynamic changing but there has also been a shift in the type of investments that now requirie very liquid trades and vehicles. This way investors can see where their money goes, as well as having easy access to it. Funds need both transparency and liquidity to survive in these times.

Even as the global hedge fund industry faces calls for greater scrutiny and regulation, the situation found in Latin America offers a contrast. Whilst many countries lack credible regulation, Brazil finds itself leading the way, according to Levi. He says, 'Regulation for hedge funds in Brazil is the best in the world. They need to follow exactly the same legislation as any other fund, with no black boxes. The Madoff situation, for example, would be impossible in Brazil, as all managers and funds need to be registered with the Comissao de Valores Mobiliarios, the Brazilian equivalent of the SEC. Even raising capital is regulated and occurs similarly as it would for a mutual fund'.

Brazil can offer assurances that its domestic hedge funds industry is being properly scrutinized, but Azicri says investors in unregulated funds need to be given options: 'The rest of Latin America is lacking regulation and given the current headlines we are seeing regarding hedge funds, it is unlikely regulators will spend any time moving forward with hedge fund regulation. For the time being it's a matter of establishing offshore, and then convincing local investors to invest in hedge funds which are not locally regulated'.

Some funds will be merely hoping to survive as the effect of the downturn continues to make conditions tough and volatile for the foreseeable future. In such a climate strategy is all important, and Azicri knows the direction he will follow: 'The macro approach, being very 'top-down' oriented, betting on local interest rates, especially downward. Central banks in Latin America will be very aggressive in lowering interest rates, much more than expected. Also on the currency side, local currencies will suffer, creating macro plays which should pay off this year, providing both good returns and liquidity.'

However, whilst Azicri has conviction about the macro approach, he advocates much greater caution when looking for cheap assets. He notes: 'The 'distressed' market is coming back, but is not ripe for the picking at this moment. The problem with the distressed market is the direct competition with the US and Europe, however it is only a matter of time before opportunities present themselves. Other than that, bottom-up strategies are not going to make any money, especially in the equity market, as correlation is very high between every asset class'.

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