Amid economic turmoil, Latin American still shines

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Little more than a year ago, hedge funds in Latin America were riding a boom that made the region one of the most sought-after investment markets in the world. The biggest market for alternative investment managers, Brazil, was part of the BRIC quartet of emerging markets perceived as offering the biggest opportunities for growth over the coming decade.

Both in Brazil and across the region, the vigorous growth of both the hedge fund industry and the economy as a whole was underpinned by vastly improved economic socio-political fundamentals, including greater political stability, increasing budget discipline and lower inflation, as well as increased demand and higher prices for agricultural and mineral commodities.

But the past year has been a tricky one for Latin American hedge fund managers from the point of view of performance and asset levels. Latin American managers suffered performance losses of nearly 30 per cent in 2008, according to Hedge Fund Research, albeit the smallest decline of any emerging markets region, although other estimates put last year's losses as low as 17 per cent.

Meanwhile assets under management declined by somewhere between 24 and 28 per cent, with the bulk of the outflows coming from redemptions by international investors in offshore funds. Onshore hedge funds - a staple in particular of the Brazilian market, where long-only equity funds have traditionally suffered from lack of competitiveness in an environment characterised by high inflation and interest rates - appear to have done better both in terms of performance and in keeping the confidence of investors.

Assessing the industry's total size has always been as much art as science, since many emerging market funds have in recent years been heavily skewed toward Latin America (Brazil alone is home to more than 7 per cent of all emerging market hedge managers, according to HFR).

According to Otávio de Magalhães Coutinho Vieira, director of investments at Safdié Private Banking, part of a group with long-established roots in the region, there are currently around 120 offshore funds focused on Latin America. Other estimates put the total number of funds as high as 150. HFR says the region represents 9.8 per cent of all emerging market hedge funds and 5.3 per cent of their total assets.

Some industry members fear the number of managers and funds in the market will inevitably decrease as a result of the depredations of the past year, which followed at least eight consecutive years of double-digit returns. Undoubtedly the region's hedge funds have suffered from increased nervousness among investors toward all areas perceived to offer heightened risks, in part because of a past history of economic, political and currency instability, but there is a widespread belief that the industry is built on solid foundations, especially the onshore industry which tends to be subject to similar regulation to traditional funds.

'Brazilian, Chilean and Mexican regulations are much stricter in terms of transparency, risk exposure, mark to market and net asset value assessment than the offshore industry,' Vieira says. 'Furthermore, there has been not a single case of fraud, as regulators in the region require independent service providers and external risk assessment.'

He also notes that so far, Latin America's banking and financial systems appear to have been significantly less affected by toxic assets and deteriorating loan quality than their counterparts in North America and Europe. While offshore investors have been influenced by problems in their home markets, local investors have been reassured that domestic institutions, once regarded as particularly fragile, are now much more solidly based.

Vieira also argues that once the dust has settled, Latin America will also benefit from the attractive range of investment opportunities open to hedge funds, including a wide array of domestic stock markets and listed companies. At the same time, interest rates particularly in Brazil remain significantly higher than across the OECD countries as a whole, even though the government had largely brought inflation under control even before last year's sudden downturn in commodity prices, and its once-monstrous debt mountain has been significantly reduced. The award of investment-grade status to Brazil by Standard & Poor's in April last year was a reflection of how far the country has moved down the path of fiscal discipline.

Panama has traditionally played an important role as a financial gateway to Latin America for offshore investors, but the British Virgin Islands is also becoming an increasingly important hub for fund business. An example is the establishment in the BVI last year of ACE Fund Services as part of the group of financial services companies belonging to Panamanian law firm Patton, Moreno & Asvat and its trust company affiliate, Assets Trust & Corporate Services.

The office is headed by managing director Mara Alido Spencer, who has spent a decade in the BVI in the fund structuring and administration sector. 'Latin America is in an excellent position to develop its fund business domestically and internationally,' she says. 'In recent years Argentina, Brazil and Mexico have taken advantage of blossoming opportunities in their markets and economies to appeal to local and international investors alike.'

Alido says that interest in the region has been swelled by years of solid investment performance. 'Latin American managers have raised both their profile and credibility as a result of solid returns to their investors,' she argues. 'The stabilisation of markets and regulation of stock exchanges in the region has played a crucial role in the development of fund business. The use of offshore funds has enabled managers to raise their profile by exposing them to a global audience of international investors.'

While industry members acknowledge that hedge funds face tougher times this year as international investor sentiment remains skittish, the underlying fundamentals of the region should help managers to provide continuing above-average performance into the future. And the rigorous regulatory structures in most significant investment management centres chimes perfectly with the new drive toward increased oversight of the industry, including the use of third-party service providers, manifest in the US and Europe. While managers elsewhere may require time to adjust to the new requirements, for Latin America's hedge fund managers it will be simply business as usual.

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