Brazil: window opens for international managers

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Welcome

Brazil is the world’s eighth largest asset management market with upwards of $800 billion of invested assets. Hitherto, the great bulk of that money has been tied up in the country’s domestic bond and equity markets. In this issue of Spotlight we look at prospects for a shift of direction in Brazilian investment flows and the opportunities now presented for international asset managers seeking to penetrate this big market.

In the past two years, Brazil has witnessed two major regulatory changes which, for the first time, have paved the way for registered investment funds, high net worth investors and, above all, pension funds to invest abroad. As a consequence, the need to establish a presence in Brazil has assumed greater priority among international asset managers.

While a steady stream of US, European and, increasingly, Asian firms are setting up shop in Rio and San Paulo, the signs are they will need to be patient. For the time being, high domestic interest rates make Brazil’s bond markets an attractive, low-risk haven for local investors, big and small – a situation that looks unlikely to change in the near future.

We also take a look at moves the Brazilian authorities are making to expand and internationalise their own capital markets and capture at least a proportion of the anticipated outflows.

Pension funds hold the key

In recent years, Brazil has been viewed by international asset managers primarily as an investment destination. Strong growth, a steady improvement in credit standing and an appreciation in the real – all have underpinned Brazil’s status as member of the elite ‘BRIC’ club of emerging countries. After a relatively resilient economic performance in 2008/9, Brazil reported net portfolio investment of $13.5 billion in 2009.

Now, however, Brazil is beginning to look like an exciting fund market in its own right. The reason? Local investors are starting to take advantage of new-won freedoms to invest overseas.

Regulatory changes in the past couple of years have allowed first authorised investment funds and high net worth individuals and then pension funds to invest a proportion of their assets abroad. At the top end of the private investor market, the so-called ‘super-qualified investors’, individuals can now invest 100%
of their money into an international fund – but there is a high minimum investment of R$1m (US$560,000). This new market for sophisticated investors represents a major opportunity for international firms. Few domestic asset managers can genuinely claim to offer expertise in international markets.

What has got the asset management industry really excited, however, is the move announced a year ago to permit local pension funds to allocate 10% of their assets to offshore markets. That may not sound like much but, since pension funds account for around half of all investment assets in Brazil, it amounts to a potential outflow of $40 billion to $50 billion.

**Master-feeder Structures Essential**

Numerous international fund managers have descended on Rio and more are looking to enter the market. However, there are hurdles to jump. Offshore funds cannot be sold in Brazil so asset managers are obliged to use master-feeder structures – using locally domiciled ‘international investment funds’ as their feeders. Asset managers must also register locally and are required to maintain a substantial presence in Brazil. It does not help that, historically, around 80% of local distribution has been controlled by banks.

The market is highly regulated, with firms obliged to provide data to the regulator on a daily basis. To minimize the initial investment, many firms are turning to third-party administrators. With a presence in Brazil that stretches back 95 years, and an established position in the local fund administration market, Citi has been actively helping international fund managers enter the market and create local feeder funds.

Perhaps the biggest competition for international funds stems not from local fund managers but from the yields available in the domestic bond markets – and the returns achieved there in the past six or seven years. Brazil’s dollar bonds have been among the best performing securities in the world as Brazil has transformed itself over that period from developing nation into economic superstar. The yield premium for holding the country’s debt has fallen sharply.

That explains why half of total assets under management in Brazil are still invested in government bonds. It also explains why foreign holdings of Brazil’s domestic debt have risen from almost zero to around 9% of the total stock in just four years.

Despite the strong growth in the economy over much of the past decade, domestic real bonds still offer double-digit returns. That reflects the ongoing battle with inflation being waged by Brazil’s central bank. In the second quarter of this year – a time when central banks in the US and Europe were continuing to hold rates down at the lowest levels in history – Brazil’s benchmark Selic rate was raised twice.

The effect of that? No other country has real rates as high as Brazil’s. At a time when competing BRICs such as China and India are offering international investors in their government bond markets yields of less than 5%, Brazil is offering yields of between 10% and 12%.
Is Brazil Another Chile?
Taking the long view, however, Brazilian interest rates must fall. In recognition of that fact, institutional investors are already starting to look for different instruments and different markets. The hope is that Brazil will mirror what has already happened in Chile following a progressive relaxation of the overseas investment rules over the course of the 1990s.

Over time, the relaxation moves have had a pronounced effect on the growth of the local funds market and the direction of investment flows. Chile accounted for 120 new fund registrations in 2009 and close on half of local investment in the country now finds its way into offshore assets. All the major asset managers are selling into the Chilean market. While Chilean pension funds have been slow to take advantage of their freedom to invest up to 12% of their portfolios in foreign securities, many are now looking at increasing their international holdings.

It is already a mark of how far the Brazilian market has come that it is no longer just the top names from the US and Europe - be it asset managers or investors - that are looking to enter the local market. Asian names now figure prominently in the mix, among them Mirae Asset Management, the big Korean asset manager. Prior to its setting up locally, Mirae already had an allocation to the country managed out of London. Two years ago it moved the operation to Brazil.

Dual Attraction to a Brazil Presence
That achieved two goals for Mirae - improving its ability to penetrate the Brazilian market and enabling it to sell its Brazilian expertise back home in Asia. Other international firms are looking to adopt a similar strategy. The attraction of a Brazilian operation is twofold. Not only does it allow a firm to compete locally, tapping the anticipated outflow as demand for international investment expands, but it also ensures the manager is well positioned to capitalise on growing international demand for Brazilian equities. On a ten-year view, Brazil's economy is set to become one of the world's largest. That is expected to oblige institutional investors in OECD countries to review their allocations to the Brazilian market. Most are currently tiny.

Recent newcomers have hired locally to build the domestic expertise and market intelligence they need. Cost is clearly an issue here and the Brazilian regulator insists that firms establish a full presence in the local marketplace if they are to be allowed to distribute locally. For a number of firms, the solution is to piggy-back Citi's existing investment in people and systems and outsource their local administration requirements. An alliance with Citi delivers the very best in back office and distribution support while minimising a firm's up-front investment in the country.

Brazil may be a 'slow burn', but it offers immense potential as a funds market on a three- to five-year view. The development of local expertise will also prove rewarding in a larger context as international investors increasingly turn their attention to Brazil's economic growth potential. The key is to enter the market in a cost-effective manner. With its long history in the country and its highly developed local securities services expertise, Citi is ideally positioned to help international asset managers make their Brazilian aspirations a reality.
Local Market has Big Ambitions

As the Brazilian authorities progressively open up the international markets to domestic investors, so they are endeavouring to bring more of the international capital markets to Brazil.

In March, the Brazilian Federation of Banks, FEBRABAN, got together with the financial and capital markets association, ANBIMA, and the stock and futures markets operator, BM&F Bovespa, to form a new association called Brazil Investment and Business – or BRAiN for short. The purpose of the new initiative is to strengthen Brazil's position as a regional investment and business hub and to accelerate the internationalisation of Brazil's financial sector and capital markets.

As part of the new approach, local exchanges are promoting the creation of Brazilian Depositary Receipts (BDRs). Investment in a BDR counts as an investment abroad and Brazilian exchanges are looking to capture some of the dealing from the outflow expected following the recent regulatory changes.

Telefonica, the Spanish telecoms company, and Dufry Group, a Swiss retailer, were among the first to list local BDRs – both as a result of M&A activity. Citi has been closely involved in opening up the new market, winning the mandate to bring ten US unsponsored BDRs, which started trading in September 2010.

The authorities have also been encouraging the creation of exchange-traded funds (ETFs). ETFs are seen as a critical element of the strategy to improve the local markets. To date, iShares has led the way with six ETFs launched in the past two years. Citi acts as administrator to all six.

The development of the BDR market and the creation of ETFs are both aimed at expanding local liquidity and increasing the range of instruments traded locally. The ultimate goal is to transform the Brazilian market into a worldwide securities hub. With its strong local presence, Citi is playing its part in this initiative.