

# Latin Americans eye offshore investments

Distributing and marketing hedge funds in Latin America

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International hedge funds have found it difficult to gain a foothold in the Latin American market which continues to be dominated by domestic hedge funds. However, recent regulatory changes could offer a route into this hugely promising market for offshore hedge funds.

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Hedge fund managers trying to raise capital in a difficult economic environment could do worse than to look at the vibrant markets of Latin America. These have emerged from the financial crisis in much better shape than most would have expected.

The sheer amount of wealth in Latin America makes a compelling case for targeting investors in the region. The World Wealth Report 2009 compiled by Merrill Lynch and Capgemini estimated the combined wealth of high net worth individuals (HNWI) in Latin America at \$5.8 trillion.

This places Latin America well ahead of the Middle East where HNWI control \$1.4 trillion and within reach of Asia-Pacific where HNWI have accumulated \$7.4 trillion in wealth.

The Merrill Lynch/Capgemini report found wealthy individuals and families in Latin America did a much better job of protecting their capital during the financial crisis than

those in other parts of the world. The combined wealth of HNWI in Latin America was down just 6% in 2008 compared to declines of between 16% and 23% elsewhere.

Having avoided the worst of the losses in 2008, Latin American investors are well placed to capitalise on the dislocations in markets worldwide and are actively seeking opportunities.

“HNWI and family offices in Latin America were highly liquid and had almost no leverage going into the crisis. This year their focus was on taking advantage of the discounts in public markets. They are now exiting these positions and allocating capital to more sophisticated strategies which exploit the long-term opportunities that have arisen in the wake of the crisis,” says David Brillembourg, CEO of Brilla Group, a Miami-based private equity company with extensive ties with investors in Latin America.

### **Opportunistic optimists**

Brillembourg thinks Latin American investors will increase their allocations to hedge and private equity funds in the near term. “Latin Americans view a crisis as an opportunity. They are very astute investors during periods of volatility, having lived through so many meltdowns in their home countries. Investing in alternatives is very much on their agenda,” he says.

Brazil is the most promising market in the region for international hedge fund managers. The largest economy in the region, Brazil is home to the 10th largest population of HNWI in the world and some of the largest pension funds in Latin America.

The appetite for hedge funds among investors in Brazil has given rise to a thriving domestic hedge fund industry with around \$190 billion in assets under management. However, global hedge fund managers have not found it easy to tap into the market.

While Brazilians have been able to invest freely in offshore hedge funds since the country’s foreign exchange controls were liberalised in 2005, the problem lies in effectively distributing offshore products to local investors. “Investment funds which are not regulated by the Comisso de Valores Mobilirios (CVM) cannot be openly offered to Brazilian investors. There is currently no mechanism by which an offshore fund can be registered with the CVM,” says Camila Goldberg Cavalcanti, a partner at law firm Barbosa, Müssnich & Arago Advogados in Brazil.

Private placements such as those made under the Securities Act in the US are not formally recognised in Brazil. Cavalcanti describes private placements as a “grey area” in the Brazilian funds market.

“Offshore funds are free to accept capital from Brazilian investors as long as the investment is initiated by the investor. These funds cannot be actively marketed to Brazilian investors. Those promoting offshore funds in Brazil have to be very careful about how they do it,” says Cavalcanti.

The best route into the Brazilian market for international hedge fund managers could be through their local counterparts, many of whom are eager to diversify into overseas markets. “As the Brazilian hedge fund industry matures and attracts more capital, it is outgrowing the domestic market,” says Marco Martins, a partner and head of the Latin American practice at the offshore law firm Harneys. “The Brazilian market is itself changing. Interest rates in Brazil have come down significantly over the past decade, forcing local hedge funds to look to other markets to generate the type of returns their investors have come to expect,” adds Martins.

### **Freedom to roam**

Until recently, Brazilian hedge funds were prohibited from investing their capital overseas. Recent regulatory changes have removed these restrictions. Martins points to the rule change in 2007 which allowed Brazilian hedge funds to invest 20% of their capital in international securities. Further reforms in 2008 removed the cap entirely and permitted local hedge funds to invest up to 100% of their capital overseas.

Brazilian hedge fund managers welcomed the reforms but the timing was far from ideal. “Very few Brazilian hedge fund managers took advantage of the rule change in 2008. It made little sense to do so at that time. International markets were in turmoil and investors were redeeming from hedge funds,” says Gustavo Rodriguez Ponti, head of Latin American operations at LaCrosse Global Fund Services.

The number of Brazilian hedge funds establishing offshore vehicles to invest overseas has picked up in the second half of 2009, according to Marc Lopresti, a partner at the law firm Tagliaferro & LoPresti in New York. His firm is currently working on fund structures in the Cayman Islands for Brazilian hedge fund managers seeking exposure to international markets.

“Hedge fund managers in Brazil are looking to diversify their portfolios beyond domestic asset classes. The regulatory change has given the opportunity to expand their offering to investors. It puts the local industry in a more competitive position,” says Lopresti.

Ponti expects Brazilian managers to use offshore structures to gain exposure to the full range of international asset classes, from equities and fixed income to currencies and commodities. However, the strategies they employ will be constrained by the local regulations, notes Ponti.

### **Under scrutiny**

Brazilian hedge funds are highly regulated and far more conservative than a typical hedge fund in the US or Europe. They have to register with the CVM and must report their positions on a regular basis. They are also required to provide daily liquidity to investors and must operate within certain investment restrictions. Any international investments will have to fit within this framework. “This is still a conservative market. Managers need to show the risks of investing internationally are being properly managed,” says Ponti.

The expectation is that Brazilian hedge fund managers will appoint overseas fund

managers to run their international portfolios, at least initially. “Most hedge fund managers in Brazil do not have the expertise to run an international portfolio. Their first step will be to invest with hedge fund managers and fund of funds that already have this capability. There is a great opportunity for international fund managers to grow their businesses by supporting the needs of Brazilian managers to diversify their portfolios,” says Martins.

Over the longer term, pension funds in Brazil could also be potential investors in offshore hedge funds. In October the Brazilian government relaxed the rules governing local pension funds, which are now permitted to allocate up to 10% of their portfolios to hedge funds, up from 3% previously. Under the new framework they can also invest 10% in international securities.

Martins says it could take years before Brazilian pension funds begin to invest in offshore hedge funds. “These institutions are incredibly conservative. They were not about to take a plunge into hedge funds simply because the rules allow them to do so. The local hedge funds will lead the way, with pension funds following further down the line,” he says.

A most established distribution channel for offshore funds into Latin America is through the international banks with a presence in the region. However, the effectiveness of this route has been compromised by the role of the international banks in the financial crisis and the exposure some had to Madoff.

The Madoff fraud and the Stanford case have reverberated around Latin America. Investors in the region had exposure to Madoff through the Optimal fund distributed by Banco Santander, which invested around \$3 billion in the Ponzi scheme.

Around 70% of investors in Optimal are reported to have been Latin American. Madoff feeder Fairfield Greenwich also gathered assets from investors in the region through its own channels.

“The domestic banks in Latin America have come out of the past 18 months in a much stronger position than their global counterparts,” says Jaime de la Barra, chairman of Compass Group, Chile, which provides asset management and investment advisory services to clients across Latin America. His advice to offshore managers seeking a foothold in Latin America is to establish relationships with domestic financial institutions as well as the international wire houses which dominated the business in the past.

Even the investors that avoided Madoff were left exasperated by the inability of offshore hedge funds to deal with the market correction and the subsequent imposition on gates and side pockets by fund managers. The net result was a marked decline in the demand for offshore hedge funds among Latin American investors, says de la Barra.

“Interest in offshore hedge funds is coming back but it is limited to those opportunities that cannot be accessed through domestic managers, such as emerging markets funds and credit strategies. Our clients in Latin America are getting exposure to the major global

asset classes through exchange traded funds [ETFs] or regulated long-only products based in Luxembourg or Ireland,” adds de la Barra.

Wealthy individuals and family offices in Latin America are making more direct investments in offshore hedge funds. Their preference has been to invest with managers who are close to the region. The beneficiaries of this have included hedge fund managers based in Miami, Florida, many of whom have deep ties to the region and enjoy close relationships with their investors.

Latin American investors are also demanding more control and transparency from the managers they invest with. “The current trend is to invest in hedge fund strategies through customised managed accounts,” says Ponti. He attributes this to the problems investors faced with redeeming their assets from hedge funds in 2008.

Allocations into offshore hedge funds by Latin American investors have been concentrated into a handful of strategies: emerging markets, real estate, fixed income and credit.

“Investors in Latin America have a real appetite for fixed income and yield. Fixed-income products have always been a large part of their portfolios,” says Tom Krasner, principal and portfolio manager at Coral Gables, Florida-based Concise Capital, which runs a hedge fund investing in short-maturity high-yield bonds.

Allocations to fixed income among Latin Americans have historically been as high as 40%. This was an extremely successful strategy in the past when interest rates often topped 20%. Rates have fallen dramatically in most countries in the region over the past five years, causing investors to look more closely at the fixed-income strategies offered by offshore managers.

Latin American investors have many of the same concerns as those in the US or Europe, adds Krasner, whose company has attracted capital from the region in the past. “Their primary concerns are safety and downside protection. There is a movement towards managed accounts and greater transparency. There is even more reluctance to invest in riskier strategies or illiquid assets these days given what happened in 2008,” he says.

Krasner sees Latin America as “potentially a huge market” for international hedge funds. However, he sees it as a difficult one for foreign fund managers to penetrate. “The culture in each of the countries in Latin America is very different. There is a tremendous amount of capital in some of these countries, but much of it is going into domestic hedge funds,” says Krasner.

Miami-based Noctua Partners received an enthusiastic response from Latin American investors when it launched its debut hedge fund earlier this year. The Alto Global Fund uses a global macro strategy with an emerging markets focus. “There is tremendous demand in Latin America for emerging markets products,” says Martin Guyot, founder of Noctua Partners and co-portfolio manager of the Alto Global Fund.

“Investors in the region understand that the classification of countries as either G7 economies or emerging markets is breaking down. They are on the cusp of this change. These investors have historically been overweight US assets. Now they are allocating a higher portion of their capital into emerging markets,” says Guyot.

That is not to say investors in the region will not allocate capital to developed markets, he adds. “Latin Americans see the aftermath of the financial crisis as an opportunity to purchase cheap assets in developed markets like the US and Europe. They will make offshore investments if the asset class and the strategy make sense,” says Guyot.

### **Property pull**

He highlights global real estate as one of the asset classes that is attractive to investors in the region. “The value of real estate is going up everywhere in the world with the exception of the US and Europe. Latin Americans see a lot of opportunity in international real estate,” he says.

The demand for real estate investments has been a boon for Miami-based Brilla Group, which focuses on acquiring luxury beachfront hotels and resorts in the Caribbean, Central America and South Florida. Brilla Group raised and deployed around \$100 in capital to the end of September 2009, principally from Latin American investors. The company plans to acquire assets worth an additional \$50 million before the end of the year, says CEO David Brillembourg. He expects the amount of capital invested by Brilla Group to double in 2009.

Brillembourg’s experience is that investors in Latin America are relationship driven. “We have known most of our investors for between five and 20 years. There is a personal component to it. You need to establish a high level of trust. They are long-term investors. Most of them invest with a five- to seven-year horizon,” he says.

Latin American investors are reluctant to dabble in strategies that are complex and lack transparency, says de la Barra. “We do not see a lot of investment in complex quantitative funds or black box strategies. The funds that do well are those that invest in products that investors in the region are familiar with,” he says.

Investors in the region may regain their appetite for global macro and long/short hedge funds once the rally in stock prices runs out of steam, adds de la Barra. “These strategies will become more attractive if markets enter a more volatile environment characterised by sideways movement,” he says.