LATIN ASSET MANAGEMENT

Wealth Management

Overview

Private-Client Fund Distribution in Brazil

This report combines an analysis of the wealthy in Brazil and their investment considerations, with a detailed look at how investment products are distributed and how global firms are finding ways to participate.

Thomas V. Ciampi
thomas.ciampi@fundpro.com

Guillermo J. Mazzoni
guillermo.mazzoni@fundpro.com

Table of Contents

Page

Index of Exhibits

Page

- **An undeniably attractive wealth-management marketplace has developed in Brazil** as a result of a stable political environment, a flourishing economy, a strengthening currency, a boom in foreign capital flows to fund mergers and acquisitions and private-equity deals, a spike in real-estate prices, and surging demand for commodities. Investors with US$1 million or more to invest is approaching 200,000, with tens of thousands more being created each year.

- **Almost half of the hundreds of billions of dollars in wealth-management assets are allocated to mutual and hedge funds**, followed by direct investment in fixed-income and equities. Brazil is Latin America's largest mutual fund market and is home to more than 400 specialty asset-management shops.

- **While Brazil was once a haven for cross-border asset-gathering, it is now a decidedly onshore market.** Managers with a long-term vision that seek to gather assets in the country are urged to consider an onshore operation. Wealthy Brazilians' posture over the years toward investing in non-domestic vehicles has been impacted by numerous factors, especially institutional stability, tax policy, local interest rates, local exchange rates, local-stock-market performance, and the global political economic outlook.

- **Large multinational players no longer dominate the Brazilian wealth management sector.** Those firms – which had no expertise on Brazil and no local products, either – lost their mojo when Brazilians' confidence in their own country improved and their bias for capital preservation in US Dollars ended. The wealth-management business in Brazil is now dominated by distributors offering onshore solutions, such as domestic banks like Itaú, and Banco do Brasil, and local multifamily offices and boutique advisories like BTG Pactual.

- **Brazil is relatively friendly to pure-play managers.** An open-architecture approach is supported by two widely accepted practices in Brazil: the use of funds of funds and the use of exclusive funds that are custom-made for one investor or up to a handful of investors. Many of Brazil's independent asset managers are run by well-known ex-bankers, economists, central bankers, etc., and the renown of these personalities is an important selling point for distributors, since access to them is important for clients.

- **Over the last three years, there has been a steady stream of acquisitions of firms that are very active in Brazilian wealth management circles,** with the purchasers being mostly international firms. The wave began with acquisitions of boutique asset management companies, but have more recently been focused on niche distributors.

- **The advisory component of wealth management in Brazil is constantly improving,** thanks in part to the existence of the Certified Financial Planner (CFP) program, which is supervised locally by the Brazilian Institute for the Certification of Financial Professionals (IBCPF).

- **Close to 20 major fund brands were identified as having some sort of presence in Brazil,** ranging from the housing of research analysts to support cross-border BRIC funds to full-fledged local fund operations with a complete lineup of locally-domiciled products. The report provides details on activities on most of these managers while analyzing which approaches have the most merit.

Chapter I: The Wealthy in Brazil

Brazil is Latin America's largest economy, and in 2011 the country became the world's sixth largest economy, ahead of the UK, Italy, Russia and India. It has grown by leaps and bounds since the mid-1990s, with the establishment of stable democratic rule and competent management of fiscal affairs. Blessed with ample natural resources and supported by a competitive manufacturing base, Brazil has emerged as a noteworthy global economic power, garnering the attention of the world's investors, who seek to participate in this promising stage of the country's development.

As we will explore in this chapter, incredible wealth has been created over the course of the last two decades, via mergers and acquisitions, private-equity deals, a real estate boom, explosive growth in global demand for commodities, and a surge in acquisitive power among a broad swath of the Brazilian public.

The purchasing power of Brazilians themselves – especially the burgeoning middle class – has enabled energetic entrepreneurs to prosper. Access to consumer loans (e.g. credit cards) has fed a credit boom, enabling long-repressed consumption by average working people. Auto loans have kept demand high for locally manufactured vehicles, while access to home loans has fostered a real-estate boom, which in turn has helped keep unemployment at historically low levels.

Brazil's immense size and potential have made it a magnet for multinational companies wishing to participate in all sectors of the economy, from insurance to mining. Their arrival has boosted demand for well-educated executive class, and sent salaries for talented workers skyrocketing.

Wealth generation in Brazil was quite stagnant in the first half of the 2000s, on the heels of the Argentine default, the busting of the tech bubble and uncertainty surrounding the election of Lula. But when owners of family firms saw opportunity in 2005 and began to go public and sell stakes in their firms in 2006 and 2007, the assets of local businesspeople took off, with hundreds, if not thousands, of new millionaires created. In 2008, confidence in Brazil grew when the US entered into a credit crisis at the same time Brazil was finally granted investment-grade status by the ratings agencies.

Characterized by large and well-developed agricultural, mining, manufacturing, and service sectors, Brazil's economy outweighs that of all other South American countries and is expanding its presence in world markets.

Manufacturing and exporting

Brazil has one of the most diverse industrial sectors in Latin America, well represented in the production of motor vehicles and parts, textiles, shoes, chemicals, cement, lumber, iron ore, tin, steel, aircraft, and other machinery and equipment. Automobiles are the most important manufactured items in Brazil, with well over three million units produced annually, with the majority exported to the rest of Latin America and consumed internally.

While it is becoming a competitive exporter of technology and manufactured goods, especially vehicles and aircraft, Brazil has fortified its position as a leading agricultural exporter. Brazil replaced the US in 2005 as the world's leading exporter of soy, for example. Meanwhile, worldwide demand for grains – especially from China – has driven up land values in Brazil and created wealth outside of the country's major cities.

Merger-and-acquisition activity

M&A deals in Brazil are heavily aimed at the future growth of the expanding middle class and export-related industries. In 2010, M&A deals in which a Brazilian firm was the target climbed into US$100 billion territory, and were expected to sustain those levels in 2011. There were 143 deals done in 2010, and 179 in 2011, for a total of US$84 billion.

The country is going through an infrastructure development boom, in anticipation of the 2014 World Cup and 2016 Summer Olympic Games in Rio de Janeiro.

Private-equity deals account for a larger and larger proportion of M&A deals, nearing 50% of the total. Most private-equity transactions involve buying controlling stakes in privately-held family-owned companies rather than taking public companies private.

M&A Deals, 2005-2011

Year	US$ Billion	Number of Deals	BRL Billion
2005	18.4	54	44.8
2006	60.8	75	132.3
2007	70.1	148	136.5
2008	68.5	99	125.9
2009	59.6	95	119.0
2010	105.0	143	184.8
2011	84.0	179	142.8

Source: ANBIMA.

Initial public offerings

Initial public offerings have not been a major contributor to wealth generation in Brazil, especially when compared to M&A and private-equity transactions. A weak stock market in recent years has contributed to a slowdown in IPO activity, which peaked in 2007 when 64 new issues were launched. Since the market crisis of 2008, less than US$10 billion per year has been raised via IPOs. (The data below excludes secondary offerings, e.g. the US$60 billion secondary offering of state-controlled Petrobras in 2007.) Until there is a significant recovery in Brazilian stocks, IPO activity is likely to remain in the second tier behind mergers and acquisitions and private-equity deals.

Chapter II: Investment Considerations of the Wealthy

There has been a great transformation in the investment habits of the wealthy in Brazil over the last two decades. Most importantly, when the country was struggling economically in the 1980s and early 1990s, and uncertainty reigned, investors' chief interest was in protecting and preserving the value of their wealth, usually via the offshore purchase of US Treasury Bills, dollar-denominated savings accounts, and other risk-free vehicles.

Today, following 16 years of not just economic stability but tremendous economic growth and growing confidence in the country's future, the wealthy are no longer in a hurry to invest outside of Brazil. Quite the contrary: it's hard to convince them that allocations to non-Brazilian risk are worthwhile, considering, on the one hand, attractive yields on domestic fixed-income, an appreciating currency, and a booming real-estate market, and on the other, the disorder and uncertainty surrounding developed markets.

In this chapter we will take a closer look of the present state of mind of affluent Brazilians, vis-à-vis current macro trends and the investment alternatives readily available, as always trying to maintain our focus on the sale of asset-management products and services.

Brazilian investment culture

Brazilians, like most Latin Americans, have traditionally focused much more on fixed-income vehicles than equities, a by-product of the boom-and-bust economies of the past that never allowed investors to take a long-term approach. Most individual investors are very much in tune with prevailing yields on short-term paper and bank certificates of deposit. But relatively few are aware of the Bovespa stock index's performance over the last six or 12 months.

Also like their regional neighbors, Brazilians like to invest in bricks and mortar, i.e. vacation homes, rental units, small businesses, etc. Soaring prices for real estate in Brazil have made many people very wealthy, including those investing in investment trusts and private-equity ventures that back construction of new commercial buildings, resorts and condo complexes, etc.

Wealthy Brazilians were very nervous in the wake of the election to the Presidency of Luiz Inácio "Lula" da Silva in 2003. As a candidate for the Workers' Party, Lula was known for his incendiary rhetoric and the business sector, the wealthy, and multinationals were naturally fearful of an abrupt end to the relative stability that Brazil was enjoying since the creation of the Plan *Real* in the mid-1990s and the election of beloved president Fernando Henrique Cardoso.

However, when Lula ended up providing continuity to the previous administration's social, fiscal and economic objectives – with renewed vigor and urgency to boot – the wealthy stopped worrying about having the bulk of their assets exposed to the domestic market and invested heavily in the local economy. Ironically, Lula did more than his predecessors to grant Brazilians the freedom to invest more freely in international markets, while at the same time attempting to curb tax evasion by cracking down on transfers of undeclared assets.

Risk profiles of affluent Brazilian investors

In broad terms, older Brazilians' bias toward short-term fixed-income investment was a creature of necessity given the historical inability of investors make long-term predictions about the future of the country, which continually struggled with inflation, bank runs, currency devaluations, and weak institutions.

In the last 15 years, despite Brazil's successful turnaround, investor preference for fixed income has endured, thanks to the very attractive yields that short-term instruments pay. And they've assumed virtually no risk in taking these positions: yields have remained high, as noted earlier, because the Central Bank sets borrowing rates high to keep the economy from overheating and causing inflation.

Despite Brazil being an investment-grade country, the the borrowing rate continued above 10% in 2011 (see chart, page 10), and has been as high as 20-25% in the last 10 years.

Most smaller investors rarely venture outside the bounds of fixed income. They deal mostly with banks at the retail level, and agents there rarely take the time to suggest some diversification into equities. The probability of suffering monthly losses in an equity fund – when the risk-free rate of return in fixed income is a nominal 10% or more – is most often a non-starter for small and mid-size investors.

Mutual and hedge funds' place in the range of available investment options

According to a survey of the local mutual-fund and capital-markets association, 44% of the assets of affluent clients is targeted to mutual funds (including multimarket hedge funds). Direct investment in fixed-income instruments commands 32% of affluent investor allocations and direct investment in equity close to 20%.

Distribution of private-client assets in the financial services sector, December 2011

Type of Instruments	Market Share (%)
Mutual funds	43
Bonds	37
Stocks	14
Others	6

Source: ANBIMA (Excludes real estate).

It's important to note that the major distributors of investment products in Brazil are large full-service banks, so their range of product offering is naturally quite wide. Smaller but more sophisticated firms such as multi-family offices and global private banks operating locally in Brazil tend to emphasize funds to a greater extent, playing up their exclusive access to local experts, to whom they delegate security selection. Smaller, sophisticated managers that are found on

Chapter III: Distribution in the Wealth Management Segment

The wealth management marketplace in Brazil has evolved considerably in the last decade, in terms of the size of the market, the product demands of typical clients, the sheer number of distributors competing for these assets, etc.

Historical background and evolution

The two previous chapters discussed how Brazil's economic advances have created vast amounts of new wealth, changed the public's perceptions about Brazil's country risk, and generated a new set of expectations for investors in terms of asset selection.

Along with this evolution, we've seen a great shift in market shares of among entities competing in the private-client segment. Ten to 15 years ago, Brazilians were still wary about institutional stability in general and the soundness of the banking system, and they feared contagion in Brazil from other emerging-market shocks.

This scenario played into the hands of multinational broker-dealers and private banks, which were the dominant asset gatherers at the time. In most cases, these firms offered little or no expertise on Brazil, no local products, either. But they wholeheartedly facilitated the opening of foreign-domiciled accounts loaded with non-Brazilian risk usually in a portfolio biased to capital preservation.

This was in contrast to the approach of onshore domestic banks, whose core operations were based on local-currency deposits and lending; these entities lacked access to international product platforms and were less expert at supporting and monitoring, from an advisory perspective, the investments of their clients.

But as Brazil's economy strengthened in the mid-2000s and international flows inundated the country, the overwhelming majority of assets is began to stay onshore. Large multinational players that once dominated in Brazil – brands like Credit Suisse, Merrill Lynch (now Bank of America), Prudential (now Wells Fargo) - suddenly found themselves at a tremendous disadvantage. As we will explore later, some of these brands (JP Morgan, Credit Suisse, and UBS, for example) have reinvented themselves in Brazil, creating new product lineups and beefing up their advisor corps in order to stay relevant. Others, like Merrill and Prudential successor Wachovia, decided to abandon Brazil in response to reduced international budgets following the economic collapse in 2008 and 2009.

With the private-client business in Brazil now overwhelmingly dedicated to locally-domiciled solutions, distributors that are growing the fastest in Brazil are those with onshore solutions available for the clients. Players that have claimed large swaths of the private-client market are domestic banks like Itaú, Banco do Brasil and Safra, as well as local multifamily offices and boutique advisories, such as BTG Pactual. Brazilian clients' hesitance to start new relationships with US- and European-owned firms in the wake of the subprime and Eurozone crises has been a big driver of growth for domestic distributors.

Chapter IV: Global Asset Manager Participation in the Brazilian Market

As we have attempted to show in previous chapters, the asset-gathering landscape has evolved considerably in Brazil in the last 15 years. Through it all, global asset managers eyeing the Brazilian market have witnessed important transformations in terms of the country's increased institutional stability, a broadening of the base of affluent clients, a shift in wealthy clients' investment goals and expectations, a change in leadership among top third-party-fund distributors, etc., among other things.

In this chapter we will take a brief look at previous efforts of international firms to gain a foothold in the Brazilian mutual fund market, via an onshore or offshore presence, taking into account the regulatory restraints and distribution options in existence at the time. Then, we'll investigate more closely how they've structured themselves, expose the dilemmas that they now confront in light of the evolving market conditions of the last few years, and finally suggest a roadmap to help navigate the present and future asset-gathering landscape in Brazil.

Historical efforts to participate in Brazil

Global pure-play asset managers were fairly quick to establish a local presence in Brazil in the years following the implementation of the Plan Real in the mid-1990s, which curbed rampant inflation, stabilized the currency and led to a boom in capital markets. Most of these ventures were established from the ground up, but there were also a few firms that bought their way in to the market or established joint ventures with Brazilian firms.

In retrospect, most of the firms that made this initial incursion were very misguided because they misunderstood the market, or thought they could overcome its dynamics:

1) Back then, the private-client segment was much smaller than it is today, and not growing nearly as quickly and robustly. This left mostly corporate and retail investors as potential buyers of their local products.
2) The retail segment was – and still is – dominated by large retail banks, which sell their own proprietary funds to small clients. Open architecture is still limited even at the mass-affluent level to this day.
3) The corporate segment was a viable target, and foreign managers were able to sell Brazilian-domiciled products to these sophisticated clients. However, the core product was a very basic short-term fixed-income fund offered by most asset managers.
4) Large bank-owned-managers were able to outperform independents by lowering fees of these short-term funds down to a handful of basis points. The banks in general had more tools at their disposal to convince their corporate clients to continue to invest in bank-owned funds.
5) Independent firms were forced to lower their fees to remain competitive, but this meant reduced income and made it more difficult for them to reach their break-even point.
6) The Brazilian-domiciled funds launched by global managers were unable to invest internationally due to regulatory restrictions, thereby negating a natural advantage they had over local asset managers.

In the end, most firms that did not associate with Brazilian firms ended up selling themselves to larger domestic managers. This was the case for Invesco, Fidelity, UBS Asset Mgt. (years prior to the Pactual deal), and Lloyds Asset Mgt. Also part of this list should be JP Morgan Chase, which opened and later closed, and has now returned to Brazil with a more defined mission and larger focus on distribution. All of these firms had local funds operating in Brazil in the late 1990s-early 2000s or established a local presence with that intention in mind. Schroders was one of the few firms to launch in the 1990s with a *de novo* approach and live to tell about.

Most of those that remain in Brazil today did so because they gained access to clients via their distribution platform – like Principal Financial (via its relationship with Banco do Brasil in the retirement sector), Franklin Templeton (via its relationship with Banco Bradesco selling funds strictly to institutional investors). Alliance took a similar approach to Templeton, forming a joint venture with local bank Banco de Crédito Nacional, but the partnership was dissolved when the bank was purchased by rival Bradesco.

Other firms like Deutsche and ING participated briefly in the fund management sector as a complement to larger business activities, but were later sold off. Credit Suisse's asset management unit, which exists at present as Credit Suisse Hedging Griffo, was initially formed via Credit Suisse's mid-1990s acquisition of Banco Garantia, principally an investment-banking and private-banking play.

Global manager activity since 2005

Two other more recent incursions into the Brazilian market were almost accidental:
- Legg Mason's purchase of Citigroup Asset Management's worldwide operations in 2005 converted the global manager into a major player in the Brazilian market, with an inherited space on the Citi distribution platform. Roughly three-quarters of the firm's assets is derived from the Citi relationship.
- BlackRock arrived in the Brazilian market via its purchase of Barclay's iShares unit in 2009. Barclay's had already taken initial steps to launch exchange-traded funds focused on Brazilian securities, and BlackRock continued those efforts. Though staffing itself quite heftily in Sao Paulo, the firm did not launch actively-managed local funds in Brazil while it wrestled with securities regulators, the exchanges and tax authorities on the ETF launches.

Current paradigms for global managers

After the shakeout described above, there were very few onshore incursions by pure-play global managers in Brazil, despite the issuance of regulations that finally enabled some international investment. Limiting the interest of global managers was their inability to add value or sell their diversification message in a market in which local short-term fixed-income products reliably posted double-digit returns and Brazil's stock market seemed to be on an unstoppable upward climb.

Firms with an onshore-only or offshore-onshore approach

Firms like Schroders managed to have some success by grooming local equity analysts, hiring away others, and launching niche products focused on Brazilian stocks. By outperforming local competition, locally-domiciled Schroder funds