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How will Bolsonaro impact the Brazilian hedge fund sector?

There are high hopes for favourable economic and financial reforms

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Jair Bolsonaro will be sworn in as Brazilian president on January 1.

The former army captain and seven-term congressman's promises to stamp out corruption and kickstart the country's stuttering economy proved popular with voters and investors, although he has attracted international condemnation for his racist, misogynistic and homophobic remarks.

The Bovespa opened at a record high the day after Bolsonaro won the Brazilian presidency, securing 55.2% of the vote. Markets clearly expect great things of him.

But what exactly will the election of this political firebrand mean for the Brazilian alternative asset management sector?

The incoming president hasn't divulged much granular detail on his plans for financial policy. However, he has made clear that he intends to make Brazil an easier and more attractive place to do business.

Brazil ranked 72nd in the World Economic Forum's latest competitiveness league table, behind other emerging market heavyweights such as India, China and Russia. Even before entering office, Bolsonaro has taken steps to liberalise the country's economy with a view to bolstering its international standing.

Bolsonaro pleased markets by naming Paulo Guedes, BTG Pactual co-founder and University of Chicago alumnus, as his economy minister.

Guedes has espoused tax simplification and is expected to embark on a sweeping campaign of privatisation of state-owned companies upon entering office.

This stands to benefit Brazil's already sizeable alternatives industry, with a ramp up in M&A activity and stock market listings likely to open up a feast of trading opportunities.

At present there are just under 450 companies listed on Brazil's Bovespa stock index and, of those, only around 100 are highly liquid.

A deepening of the country's pool of traded stocks is certainly an alluring prospect for the country's equities-focused managers.

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With economic liberals in office, the domestic hedge fund industry also sees an opportunity to lobby for regulatory changes that would benefit the sector.

As things stand, Brazilian asset managers are subject to exacting leverage and asset-diversification requirements.

These controls mean the country's long/short firms aren't hedge funds in the traditional sense of the term, rather referred to locally as 'multimercado' or 'multi-market' managers.

Some are looking to Bolsonaro's government to relax operational constraints for the fund management industry.

Industry-watchers also predict that the country's shorting mechanisms could be simplified under the new administration.

At present, short positions in Brazilian firms need to be rolled over on a regular basis, making it difficult for managers to bet against ailing firms.

Tim Chamberlain, founding partner at the fundraising and advisory firm Brunel Advisors, suggests that these rules could be reviewed by the Bolsonaro government.

"We don't know if they're going to do it, but it fits with Paulo Guedes to simplify shorting," he says.

Francine Balbina, executive director at the fund governance and compliance specialist DMS, echoes the sentiment that hedge funds are likely to face less restrictions going forwards.

"I only see the regulation for asset managers becoming more and more open and market friendly. I don't see it going the other way," she says.

Raising assets

Commentators believe the liberalisation of the Brazilian economy will spur more domestic hedge funds to expand internationally.

But it's not just established domestic players that could be set to benefit from Bolsonaro's market-friendly policies. Some predict it could encourage high-profile Brazilian managers who've retired in recent years to return to trading. Others suggest it could spur a fresh wave of Brazilian start-ups.

International managers are also likely to muscle in on the action.

Historically, it has been relatively difficult for non-Brazilian hedge funds to raise assets in South America's largest economy. However, an increasing number are now targeting local investors.

Oaktree Capital Management, which runs around \$124bn in assets, recently launched its absolute return global credit strategy in a real-denominated feeder fund. The California-headquartered manager entered a distribution deal with the Brazilian third-party marketing firm Itajubá Investimentos to raise assets for the fund.

Pimco has gone one step further, independently launching and marketing its absolute return hedge fund strategy in a real-denominated feeder earlier this year.

Brunel Advisors' Chamberlain suggests several other big international players are preparing to follow Oaktree and Pimco's lead.

“It wouldn’t surprise me if there are a dozen managers who have plans in the works and who are waiting to see how the others fare,” he says.

Assessing the risks

While Bolsonaro’s election victory may open new opportunities for hedge fund managers, it creates risks as well.

The main concern is that Bolsonaro could undermine Brazil’s fledgling democracy.

The incoming president has praised members of the military dictatorship that ruled Brazil from 1964 until 1985. He also stated in a media interview, conducted in the late 1990s, that he would shut down Congress if he were president.

Any deviation from democracy would undoubtedly deter institutional investors from allocating to Brazilian managers.

However, many within the hedge fund sector are quick to dismiss the notion that Brazil could return to dictatorship.

“We don’t see a risk to the respect for institutions in Brazil. I think Bolsonaro has stated clearly since his victory that he’s going to respect the constitution,” says Alexander Gorra, a founding partner at the \$2.4bn Rio-headquartered hedge fund Truxt.

The appointment of top judge Sergio Moro as Brazil’s justice minister has helped assuage investor jitters over whether the rule of law will continue to be respected in the country.

Moro rose to prominence while spearheading the sprawling “Car Wash” corruption investigation, which culminated in the jailing of former Brazilian president Luiz Inácio Lula da Silva.

Moro’s role in exposing corruption has earned him plaudits in Brazil and beyond.

Concerns over respect for the constitution aside, there are also questions as to whether Bolsonaro will be able to make good on his campaign trail pledges.

The president’s PSL party holds a minority of seats in the Brazilian Congress, so it will have to rely on deals and alliances to translate its agenda into reality.

Thierry Larose, senior portfolio manager at Vontobel, sums up the situation in a client note, writing: “So far, markets have given him [Bolsonaro] a lot of credit, but execution risk looms large.”

Looking at the bigger picture

How the Brazilian hedge fund industry fares in coming years will only depend in part on politics: there are many other factors at play.

Global interest rate trends are perhaps the most important of these determiners.

Rising interest rates in the US are likely to weigh on international demand for Brazilian funds, regardless of policy changes enacted by Bolsonaro’s government.

Conversely, Brazil’s record-low interest rates are set to continue to be a tailwind for the country’s alternative managers.

Over the past 20 years, interest rates in Brazil have averaged around 15%. Now the Brazilian central bank’s benchmark lending rate stands at 6.5%.

Lower interest rates are part of what spurred Moody’s to upgrade its outlook for the Brazilian asset management sector in early November.

The rating agency expects alternatives managers to grow at a faster rate than the industry as a whole, as investors re-allocate from fixed income funds to hedge funds in search of higher returns.

Brazilian hedge funds also benefit from the oversight of a range of non-governmental organisations.

Chief amongst these is Anbima, a trade body representing the interests of Brazil's financial services firms.

DMS' Balbina believes the new Anbima self-governance code, which managers will have to comply with by the start of next year, will galvanise international interest in Brazilian hedge funds.

"The new code is very aligned with international standards when it comes to best practice and compliance," she argues. "Brazilian managers will be better placed to pass due diligence once they comply with the code."

Looking ahead

The tectonic plates underlying the Brazilian asset management industry are shifting. Political, technological and economic forces are combining in new ways; unleashing an energy that's reverberating through the South American country's asset management industry.

There's certainly a lot of optimism amongst Brazilian fund managers about what Bolsonaro can achieve. However, given the political unknowns, there are plenty of reasons for caution too.

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