BRAZILIAN PENSION FUNDS GO FISHING ABROAD

After a decline in the once extraordinary yields on government bonds at home, Brazilian pension funds are diversifying into international assets to find new ways to make money and improve overall returns.

BY RODRIGO AMARAL

For many years, Brazilian pension funds invested pretty much all of their portfolios in local assets. It was a nail-biting affair at times. The ups and downs of the Brazilian economy and politics could yield losses if played poorly, but handsome returns if done right.

Pension fund managers are a hardy bunch to say the least. But after so many years of focusing their investments in the local market, they are starting to shift more money abroad. This strategy is designed not just to reduce this perennial risk in their backyard but to actually boost the performance of their portfolios.

The process is incipient, but more managers are cottoning on to the benefits of increasing their exposure to foreign bonds, stocks and other assets.

The main driver is pretty straightforward. Investing a good chunk of the pension fund in Brazilian government bonds had been highly profitable for many years. The country's central bank kept to benchmark interest rate above 10% for much of the period between 1998 and 2017, boosting yields on government bonds. Brazil's 10-year government bond yielded between 8% and 18% between 2006 and 2019, according to Trading Economics.

The central bank, however, cut the policy rate to the single digits in 2017, prompting pension funds to look for ways to improve their returns as the 10-year bond yield dipped to as low as 6% between 2019 and 2020. A further reduction in the policy rate to as low as 2% last year in a bid to pull the economy out of a sharp contraction after the onset of the COVID-19 pandemic added fuel to this foreign diversification strategy. Even while the rate was raised to 5.25% in August this year as inflation touched 10%, taking the 10-year government bond yield to 11% in September, more pension fund managers are now looking abroad to boost overall returns.

"We have done well so far," Sérgio Wilson Ferraz Fontes, a board member at the Brazilian pension funds association ABRAPP, says of the initial efforts.

But more can be done, he admits. "From now on," he says, "we need to increase our exposure to risk, and international allocations are very important for that."

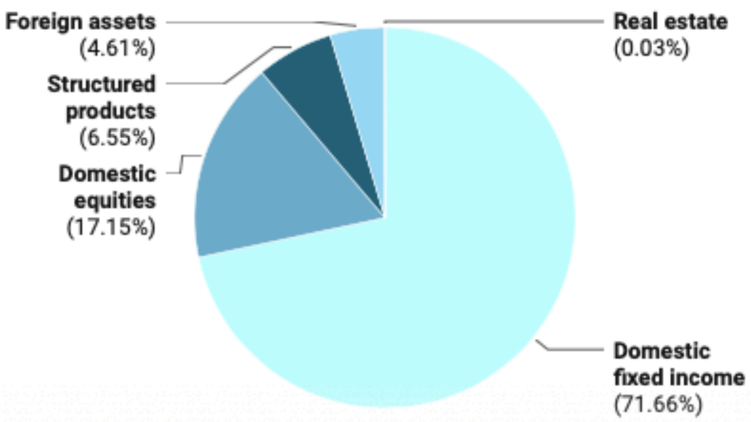
There is a hitch to the strategy. Brazilian pension funds can only allocate a maximum of 10% of their portfolios to assets outside the country, far less than the 50% in Peru and 80% in Chile. Still, Brazilian funds are far from reaching even this low ceiling. A study by Aditus Consultoria Financeira, a São Paulo-based investment advisory, estimates that as of July the allocation to international risk was only 2.74% of the portfolio in a universe of 119 funds.

Pension funds are starting to increase this share.

"When we were preparing investment strategies for 2021, not even 5% of the funds vetoed international investments," says Guilherme Benites, a partner at Aditus.

Brazilian Pension Fund Allocation

Portfolio allocation by Brazilian pension funds in July 2021



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There is much yet to do. Brazil's pension funds are the second-most biased toward their home market in the world, trailing only Indonesia, according to a study by Mercer, a New York-based asset management firm.

Even so, regulations are still holding back the growth of allocations in international investments. The 10% limit was approved in 2009 and still stands. At first, however, regulators required funds to set up dedicated vehicles to invest in assets abroad in which each pension fund could have a maximum share of 25% of all the assets, a limit that slowed their expansion into international assets.

That restriction of using dedicated vehicles has since been lifted, and this is prompting more fund managers to step up their investments abroad. This is the case with Jorge Simino, chief investment officer at Vivest, which manages the pension funds at several companies owned by the state of São Paulo. His efforts have made Vivest one of the few funds to nearly reach the 10% ceiling, a strategy that Simino advocates to diversify risk.

"International markets are extraordinarily liquid and you do not get exposed to the same risks all the time, which happens when you only invest at home," he says. "We can also have access to sectors and companies that do not exist in Brazil, such as in the biotechnology industry."

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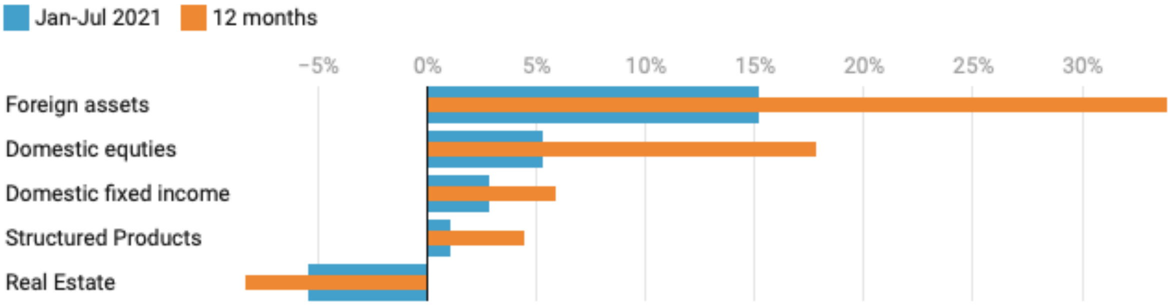
This strategy paid off for Vivest in the first half of this year. While Brazilian stocks were erratic on concerns of political instability, the pandemic and a struggling economy, equity markets surged in the United States and other countries. Brazil's benchmark equity index rose 6.7% in the first half of this year, less than half of the 16.1% gain in the S&P 500 index over the same period.

Indeed, by the end of August, Vivest had achieved year-to-date local currency returns of 1% with Brazilian equities, 2.5% with international fixed income and 18% with global equities. Vivest has around BRL3 billion ($567 million) allocated in international assets.

Brazilian Pension Fund Performance by Investment Class



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A PROTECTION STRATEGY

Other funds are poised to follow suit, such as Petros, the pension fund of workers at Brazil's state-run oil giant Petrobras.

"As 90% of our risk exposure will be in Brazil, we see international investments, above all, as a protection strategy," says Petros CIO Alexandre Mathias. "We want to have assets abroad for the times when our Brazilian assets do not perform well."

Alexandre Mathias

Petros is implementing two strategies for its international allocation, both of which are designed to protect its portfolio. The first strategy is defensive, with the aim of making a return of 400 basis points over the US dollar while restricting volatility between 4% and 5%. The second is a more aggressive growth strategy targeting the dollar plus 600 basis points and volatility of 8%.

"When we believe that the dollar will do well, we will prioritize the growth strategy," Mathias says. "When it does not look so good, we will go defensive. In both strategies, the goal is to minimize our exposure to equities and commodities, which are highly correlated to Brazilian stocks."

This strategy could change if regulators increase the foreign allocation limit to 20% or more, which Mathias thinks will happen by 2022. If so, Petros will continue to allocate 5% to 10% of its portfolio to foreign assets and use another 10% on riskier strategies, he says.

THE CURRENCY RISK DILEMMA

Fundação Real Grandeza (FRG), which manages pension funds at several electricity utilities, is also about to deploy its international investment strategies. ABRAPP's Fontes, who doubles as FRG's CEO, says one challenge for newcomers to the international markets is to time when best to make the leap, given the fickleness of currency markets.

"Those who entered the market when the dollar was at BRL5.80 have already had a loss due to the currency fluctuation," he says. "It is part of the game. But the ideal situation is to get in when the dollar is lower."

The greenback reached the peak mentioned by Fontes in March, but by mid-September each dollar purchased only BRL5.20. To avoid this volatility, some experts recommend investing in derivatives and other instruments to hedge currency risk. But others say that currency risk can work both ways and hedging can undermine some of the performance of foreign-based assets. Simino says that Vivest, for example, hedges currency risk for its international fixed income investments, but not for the much larger equity exposure.

Currency risk is one of the factors that investment managers need to take into account when they argue the benefits of going global to their boards. It is not an easy task, as pension funds grew used to harvesting the stratospheric returns from investing in Brazilian Treasury notes for nearly two decades.

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>
> – Leonardo Ozorio, Luz Soluções Financeiras

"The culture of offshore investing is still developing, but it has solidified in the past 10 years. Allocation is on the rise and there is a movement in the industry to raise the limits," says Leonardo Ozorio, a director at Luz Soluções Financeiras, a financial consultancy in São Paulo. "Clients of ours that did not have the option to allocate investments abroad until last year are doing it now."

The asset management industry has responded to this new demand by introducing a wide range of products that can meet different investment needs. Although US equity funds still dominate in this niche of the market in Brazil, Aditus' Benites estimates that investments can be made in some 200 funds to develop a significant variety of strategies. When adding in the Brazilian Depository Receipts traded on the B3 stock exchange in São Paulo, including some new products that replicate US-based ETFs, the universe of products surpasses 300.

"Investment managers are beginning to look more at equity markets in Asia and Europe, although the predominance of the US market continues to be huge," Ozorio says. "There are also ESG-themed funds with a wider global exposure."

Mauricio Martinelli, head of investments at Mercer Brasil, estimates that the potential pool of investments that can be allocated to foreign assets reached BRL5 billion in 2021. “Most of the mandates we see today want to capture the performance of the S&P or MSCI indexes,” he says. But as the foreign investment strategy takes hold, it is certainly bound the grow. **LF**