INNOVATIVE INVESTMENT PRODUCTS IN LATIN AMERICA

by

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The gap between the introduction of new instruments in the US and in LAC is fast decreasing, partly because you can use them now, where before, they were illegal, and partly because soem of them are more profitable in the more volatile markets of LAC than in the USA.

WHAT HAPPENED?

The broad, radical economic reforms in the region have been essential in building stronger and more competitive capital markets. The changes really represent a transformation, a 180 degree turn from policies of just a few years ago.

- o Most countries have abandoned policies where governments controlled interest rates, directed bank credit, controlled trade and capital accounts, and severrely restricted competition among financial institutions.

- o Real Live fiscal discipline and newly independent Central Banks have made a major contribution to raising confidence in the region's financial markets.

- o New securities laws emphasize greater market transparency, adequate protection of investors, and greater competition in the financial markets. They're also improving trading systems, settlement and clearing procedures and accounting and disclosure standards.

  Foreigners can now participate actively in most investment activities in the region, with taxes on capital gains and dividends reduced, rationalized or simply eliminated.

- o We're finally seeing the creation of private sector, long-term savings institutions (such as pension funds and insurance companies) that are large enough to have an impact. The most obvious evidence is the lengthening of maturities. In Argentina, "long-term" used to mean 7-day funds. Now you can get a mortgage for your house.

  In Chile, where the process first started, local utilities can now raise 25-year money at internationally competitive rates. In fact, the yield curve is negative in Chilean pesos, with the 30-year money cheaper than five-year money. This is possible because the country's private pension fund system has accumulated pension savings equivalent to 1/3 of GDP.

It's not yet a perfect world. Bank supervision, for example, has generally not kept pace with the changes, and we cannot discount the possiblility of other incidents like the Banco Latino collapse in Venezuela.

RESULT:

As a result of these changes, the region's equity markets have grown much more efficient and attractive to domestic and foreign investors alike. At the same time, they're becoming increasingly integrated into international markets.

Keep in mind, though, that it is probably a mistake to think of "Latin America" as a single entity. It's convenient shorthand based on geography and language, and most of them are going through a similar transformaiton at the same time. However, even now the economies are growing (or not) at different rates. Investors should think of them as countries, not as parts of a single whole.

Having said that, I'm going to ignore my own advice and lay out some indicators of the magnitude of change in the region's financial markets:

- International bond issuance by Latin American companies was $24 billion in 1993; new ADR issues amounted to $5.6 billion.

- A new element for these markets is the rapidly growing cross-border investment flows within the region, in contrast to the flows from the developed countries to the region. These include agreements between Columbia and Venezuela, and between Argentina and Chile, and more formal sub-regional trade and investment pacts such as the Andean Group and Mercosur. Not counting portfolio investment flows, there were 30 such direct acquisitions in 1993 with a value of $1.9 billion. Chile, Mexico and Venezuela were the largest buyers. In comparison, there were 73 deals where US-based companies acquired Latin American firms for a total of $2.8 billion.

- Total market capitalization has increased 434% in the last three years. It's not just size, it's also liquidity. The monthly value traded on these markets increased even more, by 453%. Even where markets fell in the Q1 of this year, trading volumes continued to rise.

However, note the concentration: Mexico alone is 43%, and with Brazil, the two account for about 75% of the region.

VOLATILITY:

A word of caution to the potential investor: large changes, especially sudden changes, can also bring volatility. A good example is Brazil, as shown in the graph, which shows the past three years in dollar terms to take into account frequent changes in currency and spiraling inflation (now running at almost 50% a month). The average change over this period was 6% each week, equivalent to about 50 points on the Dow every day. Of the 17 weeks of 1994 so far, there have been three weeks where the index jumped 16%, and two weeks where it fell 13%.

But don't get smug! Compare this with Japan, same time period, same scale. Japan's not volatile, but if you had invested there three years ago, you would be basically back where you started. You would have tripled your money in Brazil. High risk, high return. Low risk, low return. It's a classic trade-off.

INNOVATIONS:

There is something of a virtuous circle here: As the markets get larger and raise their standards, they attract more attention, more liquidity, more investors who require higher market standards, which leads to nore investors, etc.

Another results is the availability of more instruments.

ADRS: Common now, but remember that it was only in 1990 that that the first LAC company (CTC) listed on the NYSE. Last year, $5.6 billion was issued. A dozen companies from Chile have announced plans to list in 1994.

Convertible bonds: Finally catching on, slowly. Would grow faster if only the underlying equity markets would stop growing so fast.

Sector funds: Telecommunications, infrastructure ... the needs are huge and investors are showing a bigger appetite for long-term investments.

Privatization: Chile, Argentina and Mexico are most advanced (Mexico alone raised $23.8 billion in 1988-1993). They are not finished: next up is infrastructure. In Venezuela, the process began but stalled before last fall's elections. A new government took over in February 1994 and it's still not certain what will happen to the program. Brazil's program has been on/off since 1991, with almost two dozen firms sold.

Private equity: Little venture capital has been done in the region, where it has usually been a function of a bank's lending department that takes equity. Interest is now growing rapidly: since last summer, I've heard of more than $1 billion in private equity funds gathered for everything from wine to hydroelectric dams.

Index funds: For large institutions taht don't want to pay high fees for active management, index funds will offer a low fee solution. We've counted about $1 billion in indexed emerging market funds, with maybe 1/3 targeted to Latin America. Even if you are not into index funds, the facts are pretty blunt, as seen in the chart: the actively managed funds do not outperform the indexes. This is data from Micropal.

Asset backed securities: Examples:

Telephone and credit card receivables: mostly hard currency for mostly foreign investors with mostly private placement so far.

Power; especially if there are fixed contracts for the output, foreign investors are interested.

Home mortgages; with high inflation, there were few long-term mortgages in the region. As low inflation catches on, the market for asset backed mortgage securities is likely to grow quickly.

Derivatives: These are now getting regulatory approval in many countries. For balance sheet management, liquidity, leverage and speculation.

Warrants: In March, outstanding equity warrant issues totaled $1.7 billion, covering 120 issues. Contrast: end June, 1993, only $120 million for 23 issues. Increasingly, the options are written on baskets of stocks not denominated in $US. After IBM, the most heavily traded equity option in the US is on a Mexican stock (Telmex).

OUTLOOK:

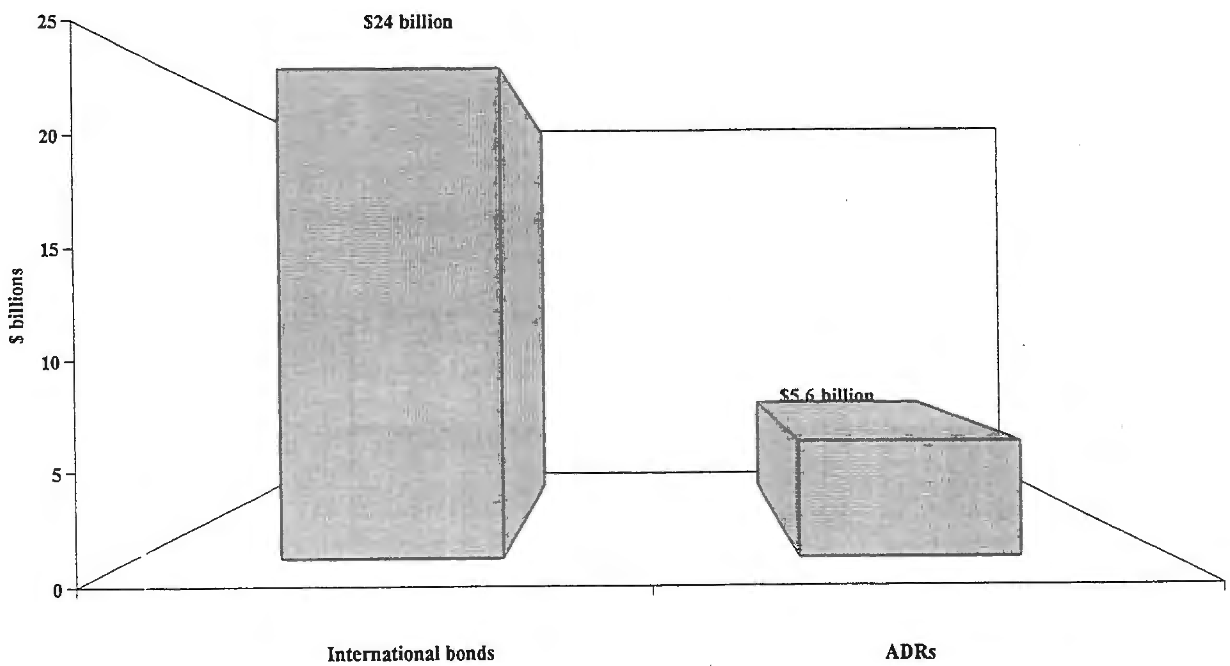
There is still a long way to go. S&P gives the "investment grade" stamp of approval on foreign currency government debt only to Chile and Columbia. And Institutional Investor just published its annual ranking of country risk, with Chile (#34) as the least risky in Latin America, ranked below China (#31), while next in the region is Mexico (#42), roughly on a par with Botswana (#44).

Even in Chile, only the largest companies have gained access to the long-term domestic and international markets, leaving small and medium sized enterprises without access to good sources of medium- and long-term financing.

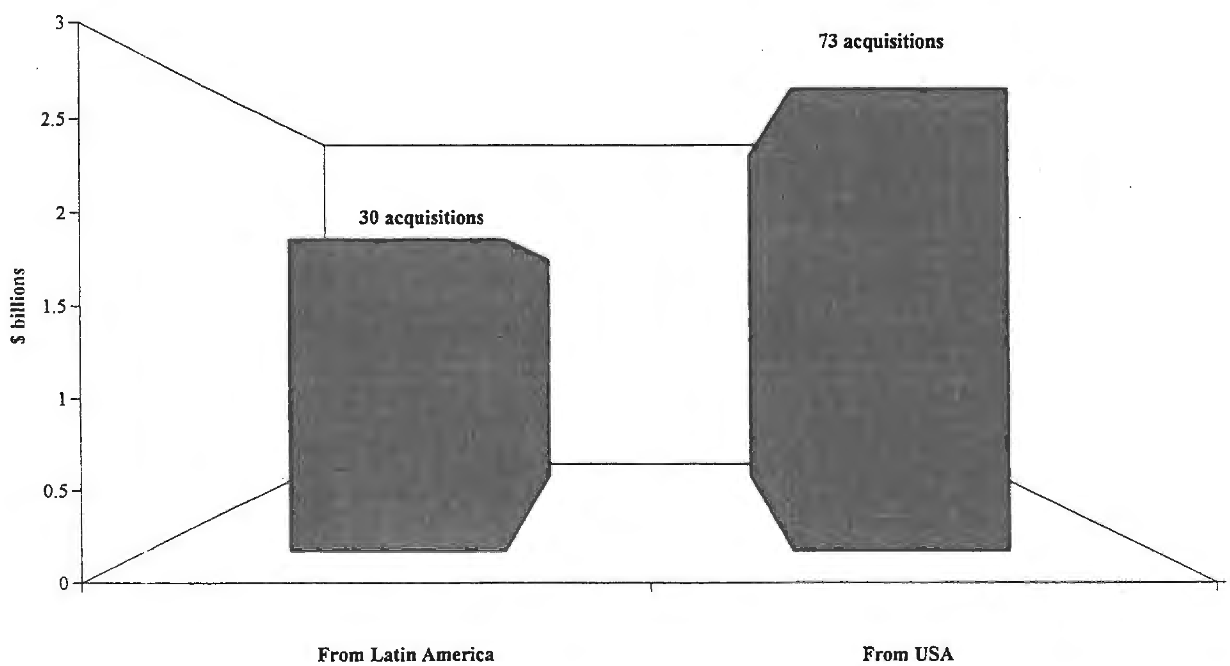
That tells us that there is more for IFC to do in the private sector. We have just completed several key transactions in the areas of: private pension fund management; several specialized investment vehicles, such as the first fund for power generation in emerging markets; and unusual equity instruments such as a Brazilian buy-out fund. Work is also underway to set up Argentina's first leasing company, a private sector Fannie Mae type company in Columbia, a small-cap investment fund in Chile, and a Peruvian debt-to-equity privatization fund.

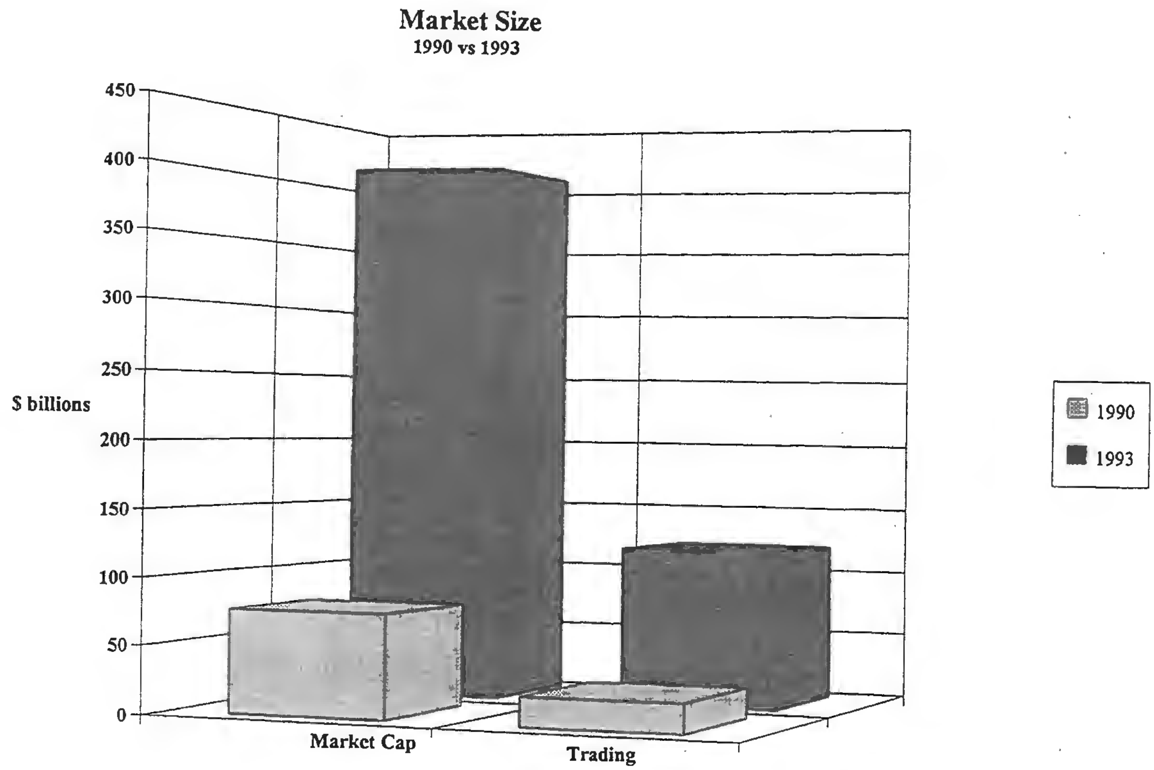
In sum, where others see only risk, we see long-term opportunities.

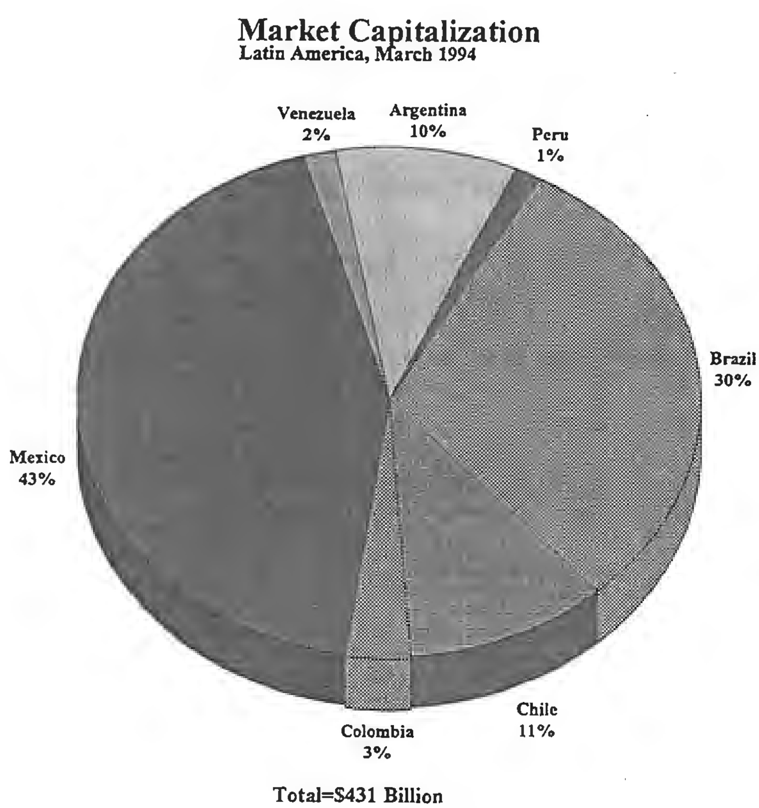
New Corporate Issues in Latin America, 1993

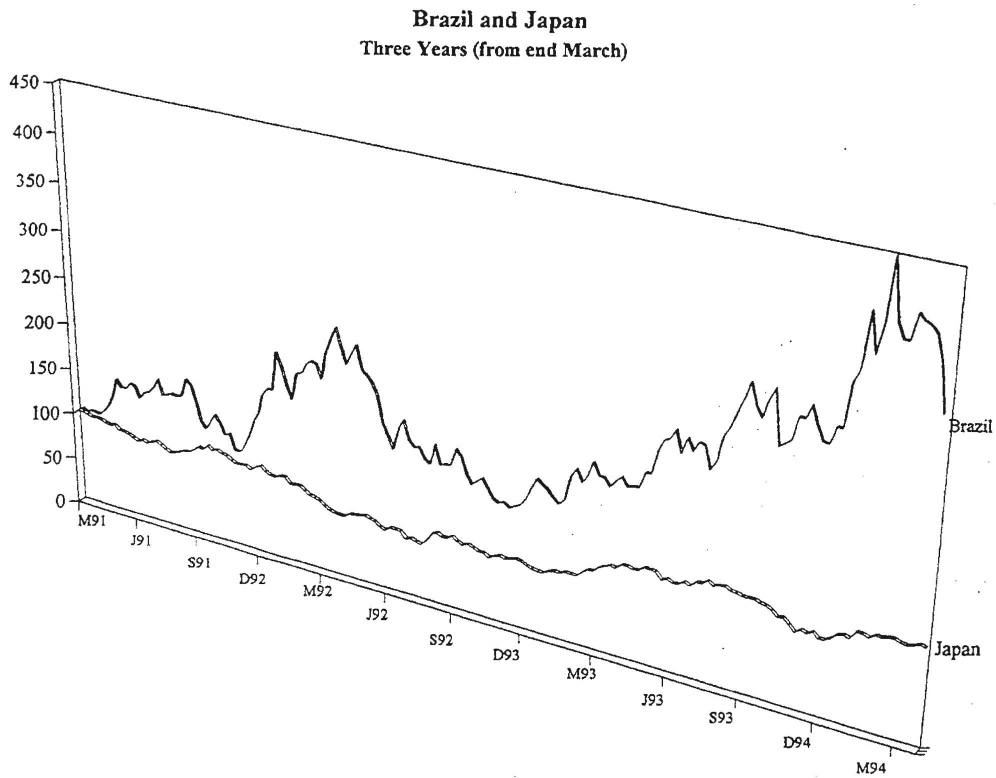


Cross Border Acquisitions in Latin America, 1993




Market Size
1990 vs 1993
450
400
350
300
250
200
150
100
50
0
$ billions
Market Cap
Trading
1990
1993


Market Capitalization
Latin America, March 1994
Venezuela
2%
Argentina
10%
Peru
1%
Brazil
30%
Mexico
43%
Chile
11%
Colombia
3%
Total=$431 Billion

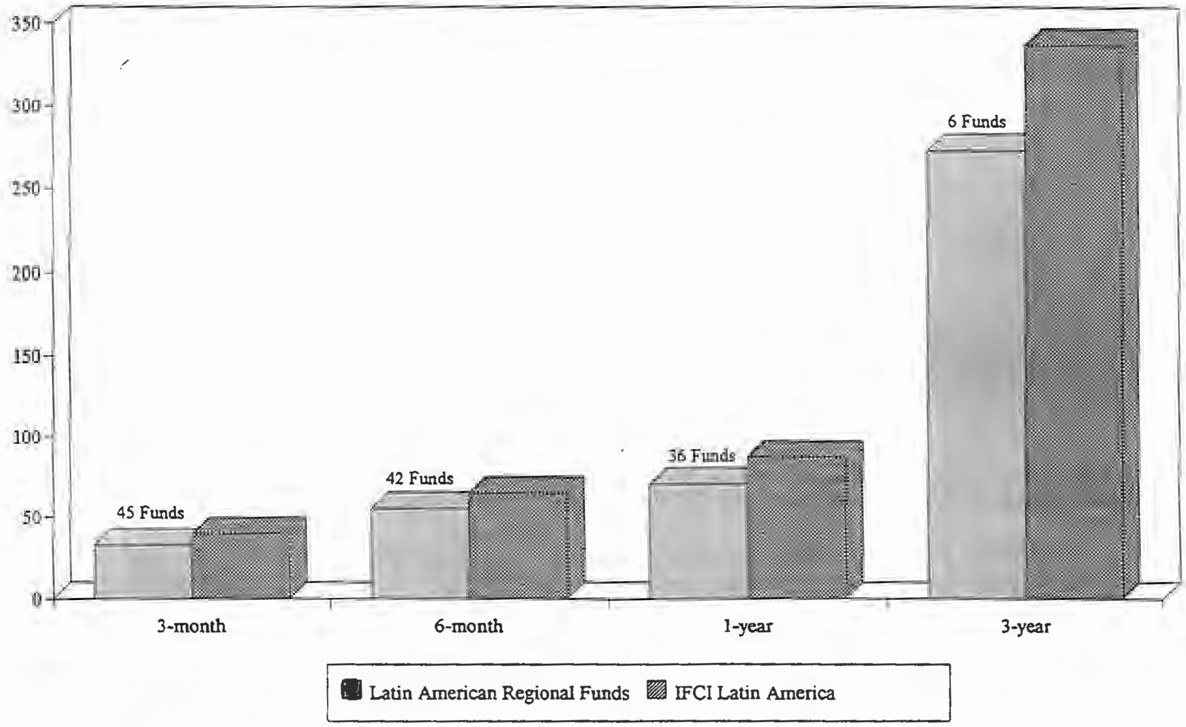


NEW INVESTMENT VEHICLES

- ADRs
- Convertibles
- Sector funds
- Private equity funds
- Index funds
- Asset backed securities
- Derivatives

Active Manager Returns vs IFC Investable Benchmark

(Periods ending January 31, 1994)



Source: Micropal

Outstanding Warrants on Latin American Equity Issues