White Paper June 2010

BRAZIL: WHY AND WHY NOW

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Introduction

Over the last two years our Research Team has visited Brazil, Russia and China (twice) in order to gain a better understanding of the opportunities and risks these markets offer our clients. These economies, which together with India form the "BRIC" group of emerging markets, are increasingly important to global economic growth. To learn about them first-hand, we have met with dozens of professional money managers on the ground in Hong Kong, Shanghai, Moscow, Sao Paulo, and Rio de Janeiro. In addition, our research has allowed us to directly observe the culture and structure of finance and investing in these nations. Our vital and incredibly productive research trips have been essential for gaining a fuller understanding of local investment styles, regulations, and capital markets.

Until now our client portfolios have been neutral Brazil. We have taken this view in part because of the limited Brazilian investment products available for US investors. Even the most liquid and popular of these, the MSCI Brazil ETF, has failed to impress – but more about this later. Despite the limited opportunities, Brazil has continued to be appealing – simply what one gleans from the surface makes it sound and feel like a good place to invest. However, before being able to recommend a more meaningful exposure in client portfolios, we needed to dig deeper not only into the numbers, but also into the culture and structure of local investment styles, regulation, and capital markets. Doing so has been more than a part of our firm's due diligence; it has been essential for gaining a richer understanding of the risks and opportunities Brazil affords prudent investors.

Interviews this February with a number of investment banks and professional money managers in Sao Paulo and Rio de Janeiro made us appreciate that the long-term growth story in Brazil is significant. It also confirmed our opinion that the construction of the MSCI Brazil ETF does not reflect the future growth story of Brazil. In addition, we quickly learned that the majority of local professional money managers have different portfolio construction (in particular, concentration risk) from what we are accustomed to. Lastly, we came away with the view that – in the short-term – Brazilian equities appeared expensive and "priced for perfection."

Just three quick months later, partially due to the structural concerns of Europe and a lower appetite for risk, the Brazilian equity market – as measured by the Bovespa – has dropped over 20%. We believe this systemic correction presents an attractive entry point for a more meaningful exposure to Brazil in client portfolios. In this report we highlight why Brazil and why now.

Brazil: Land of Contrasts

There is more to Brazil than soccer, samba, caipirinhas, and an immense bounty of natural resources. It is the largest country in South America, the fifth largest country in the world by population and geography, and the eighth largest economy in the world. It is a well-functioning democratic republic with an incredibly diverse urban population that is heavily concentrated along the Southern coast. Sao Paulo is the third largest city in the world and Rio de Janeiro, a quick 50 minute flight away, has 11.5 million people. Only by setting foot on the ground and exploring Brazil's contrasts in person could we get the kind of local knowledge that gives crucial context to investment analysis.

Immediately after we got off the airplane in Rio, the international airport struck us as old and in need of repair. It contrasts sharply with, for example, the modern domestic and international airports of Sao Paulo. Once out of the airports and into the cities, it became obvious to us that the quality of Brazil's infrastructure varies dramatically. The nation's highways offer diverse driving experiences; some are old and congested while others are brand new and flow freely.

The gap in Brazil between the poor and growing middle class stands out to anyone driving through the cities. Brazil's urban slums, whether intertwined within Rio or on the outskirts of Sao Paulo, contrast harshly with the housing of the economic elite (a three-bedroom apartment in Sao Paulo can cost $1mm) and shopping malls of the middle class. Over the last decade, rising incomes have brought about a significant decline in income inequality. However, as measured by the Gini Index, which measures the degree of inequality in the distribution of family income in a country, Brazil ranks as the 9th worst country. A quarter of the population remains below the poverty line.[1]

As might be expected, there are enormous differences in educational opportunity in Brazil. The public schools available to the masses suffer in comparison with the expensive private schools that cater to affluent Brazilian families. Education reforms appear to be addressing access to and the quality of education in Brazil. Although Brazil offers universal basic education, the literacy rate is only 89%. With total school life expectancy of 14 years, university training remains out of reach for most. Brazil is ranked 105th in the world in education expenditures (4% of Brazil's GDP).[2]

The culture of Rio differs from that of Sao Paulo. The Fluminense of Rio enjoy their playground and seem to substantiate popular stereotypes of Rio as a city of great beaches and cocktails. By comparison, the Paulistas of Sao Paulo come across as relatively intense – they work hard, play hard, and try to keep their immense city clean and orderly. What the cities have in common, however, is the youthfulness of their people.

Youth in Brazil seem to be everywhere, not just at the shopping malls. People under 30 years old make up the largest segment of the population. Two-thirds of the population is 15-64 years old, and only 7% of the population is 65 years and over. The middle class is growing quickly and now comprises the largest population segment. An illustration of Brazil's outstanding growth in income is measured by the World Bank's GDP per person employed which increased 44% from 1990 to 2008.[3]

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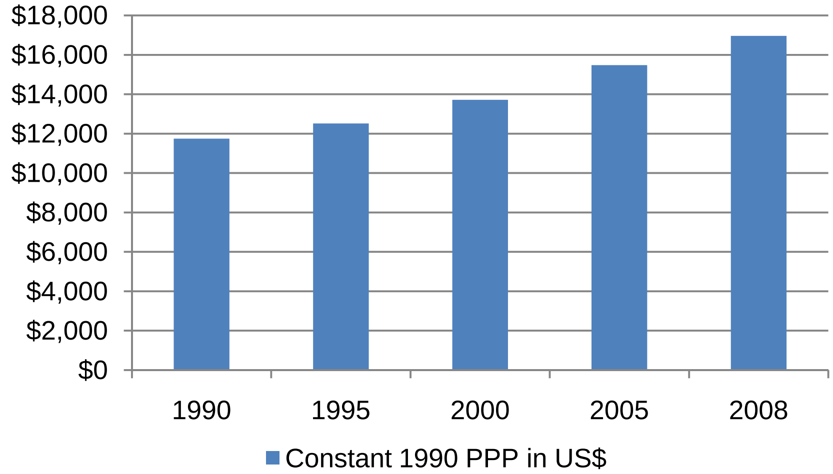
[1] Central Intelligence Agency: https://www.cia.gov/library/publications/the-world-factbook/fields/2172.html
[2] Central Intelligence Agency: https://www.cia.gov/library/publications/the-world-factbook/fields/2206.html?countryName=Brazil&countryCode=br&regionCode=sa&#br
[3] World Bank: http://devdata.worldbank.org/AAG/bra_aag.pdf

Brazil GDP per Person Employed: 1990-2008



Source: World Bank

We visited a number of shopping malls and each featured a wide range of goods from fashion to electronics and food, but most brands were unfamiliar to us. Most Brazilian retailers provide their own credit through installment plans – more like store charge accounts than credit cards issued from banks. The trend in Brazil is towards more credit and debit card usage. For example, Redecard – a Brazilian company that provides credit and debit cards – has experienced tremendous growth in credit card transactional volume. In its most recent quarterly announcement, the firm reports 21% growth in credit card volume in 2009 and provides an outlook of 17-19% growth for 2010.

Import taxes encourage consumption of domestically produced products. A local beer (Cherpa) typically costs 2/3 of the price of an imported beer and an iPhone costs $700 (which is 3 times the price in the US). Tariffs on goods like imported cars can account for up to 50% of the cost. A large imported vehicle like a Toyota 4Runner can cost $70,000.

Brazil experienced dramatic hyperinflation in the 1980's and 1990's. According to the International Monetary Fund, consumer prices increased by a factor of one trillion from 1980 to 1997.[4] That means that what cost one Real (the Brazilian currency) in 1980, cost one trillion Real in 1997. Although Brazil's inflation rate was tamed to 7% by 1997, the staggering inflation levels of the 1980's and 1990's left their mark on the Brazilian consumer – he tends to spend rather than save. Brazil's culture of saving and spending is pretty straightforward: spend your entire monthly salary each month. Brazil's household savings rate has fluctuated around 17% of GDP over the last decade (much more attractive than the US but a number that contrasts sharply with China's 45% savings rate) and its ratio of household debt to income has risen from 18% in 2005 to 35% in 2009.[5] There are, however, some incentives to save for the purchase of a house.

In recent years, housing has become increasingly affordable for lower-income Brazilians. This is in large measure because of a law passed in 2005 that has dramatically improved the availability of affordable mortgages. Before that, under law banks had no right to evict a defaulted mortgage borrower from the property. In addition, interest rates declined below 10% at the same time that

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[4] International Monetary Fund: http://www.imf.org/external/country/BRA/index.htm
[5] Financial Times: http://blogs.ft.com/economistsforum/2010/01/brazils-consumer-as-a-driver-of-growth-a-one-legged-stool/

the maturity for mortgages lengthened from 5 to 30 years. There are approximately 60 million households living in private homes today.[6]

To further support home building and ownership, the government has created programs to help people gain access to mortgage credit. For example, at depositor banks, certain savings accounts offer preferred rates if the capital is used to make mortgage loans. Up to 70% of these deposits are backed by the government in those cases. In addition, for lower income earning segments of the population, there are programs similar to Fannie Mae/Freddie Mac. These allow a homebuyer who puts down a deposit of 20% to receive from the government a matching subsidy of 20% on the purchase. In addition, the buyer is eligible for a below market mortgage rate on what he borrows in the mortgage. What he moves into usually resembles utilitarian block structures one finds in Chicago, Amsterdam, Moscow, or Beijing. The neat, new entry-level housing is often located near squalid slums, a visual clue that reinforces for us the notion of Brazil as a land of contrasts.

Brazil's Capital Markets & Local Investment Philosophies

The equity market capitalization of Brazil is relatively small – we estimate it at roughly $1.2 trillion. For comparison purposes, this is similar to the combined size of Exxon Mobil, Microsoft, Apple, Wal-Mart and Procter & Gamble. The universe of publicly traded stocks is roughly 400; however, most of the local money managers suggest that less than 150 companies are worth consideration for investment based upon liquidity, float and governance.

There is a regulatory term called "Novo Mercado" which was created to identify quality companies in terms of – including but not limited to – liquidity, float and governance.[7] More than one manager interviewed, however, said that this is still not a "seal of approval." Many good companies fail to pass at least one criteria (such as float), while numerous firms with highly complicated structures will pass the test.

Minority shareholder rights are a key component to evaluating a company. There are typically multiple share classes from the same company (such as ordinary and preferred) with different rights. Foremost among these are "tag along" rights. Essentially this means that a minority shareholder has the option to "tag along" on a buyout offer of the controlling shareholder at the same price. Without specific "tag along" rights, an investor seeking control may pay one price to the controlling shareholder and a lower price to minority shareholders.

Many of the 400 companies listed on the Bovespa are still family controlled and therefore raise questions on the agent/principal dilemma, poor succession/hereditary management, and poor investor relations. While the word "activist" was frequently used by money managers, the types of activity one typically observes is advising on governance, connecting businesses with capital or planning strategy, and assisting with investor relations material. Insider restrictions seem lax as trading is only restricted for material insiders for 10-15 days before earnings announcements. This is different from the US whose insiders face material corporate and regulatory restrictions.

Accordingly, the portfolio construction among money managers in Brazil is quite different from what we are accustomed to in the US. Most managers try to invest "off index" in an effort to avoid companies driven by macro considerations outside of their control; instead, they focus on firms with stable, predictable cash flows driven from domestic sources. Given the small universe of "quality" companies and the focus on domestic drivers, portfolios tend to be highly concentrated

[6] Brazilian Institute of Geography and Statistics: http://www.ibge.gov.br/english/
[7] BM&F Bovespa: http://www.bmfbovespa.com.br/en-us/home.aspx?idioma=en-us

by US standards. Portfolios of 6-12 stocks are common and it is not unusual to see a 30% position size of one company in a portfolio. Often this leads to portfolio managers owning more than 5% of the float of a company.

The investment culture of Brazil has been predominantly fixed income. It is fairly typical for fixed income to be 75% or more of a client portfolio since historically yield has been high. Given the fixed income-centric culture, domestic investors tend to have little appetite for volatility. Many domestic equity vehicles are constructed in a market neutral "pair trading" strategy. Most investment products benchmark themselves to some multiple of CDI (the fixed income benchmark similar to our risk free rate) as opposed to an equity benchmark such as the Bovespa Index.

Borrow can be hard to come by for shorting equities and it is expensive. A lender of securities can be paid from 5 to 8% of value. However, there is less risk of a short being called as market regulations lock-in lent securities for periods of 30 days while the securities borrower can close the position at any time. Currency hedging is also expensive. Because today's hedging rates can cost around 8 to 10%, a bullish view on Brazilian equities must coincide with a bullish view on its currency.

Brazil's CVM (equivalent of the SEC) has strict regulations regarding long-only and long-short equity funds with certain disclosure parameters that must be followed. Unlike the US where mutual fund and limited partnership investment structures are regulated differently, all Brazilian investment products are subject to the same regulations and disclosures.

Most of the managers we met admitted that they are not good market timers and recognize that money flows will affect overall market direction. They also said that short selling profitably is difficult given the few publicly available stocks. To curb the amount of foreign investment flow, the government has imposed a 2% fee (called the IOF) on foreign capital into any investment product.

Brazilian-based managers have similar fee structures. Long-short strategies charge a 2% management fee and 20% performance allocation while long-only strategies charge a 1.5% management fee and 10% performance allocation. Liquidity differs based upon investment style and manager attitude. While all managers use high water marks, some use hurdle rates for performance fees. Performance fees are uniformly charged on a semi-annual basis. This is a result of the Brazilian investment banking culture where bonuses are paid out semi-annually.

Structural Tailwinds for Sustainable and Stable GDP Growth

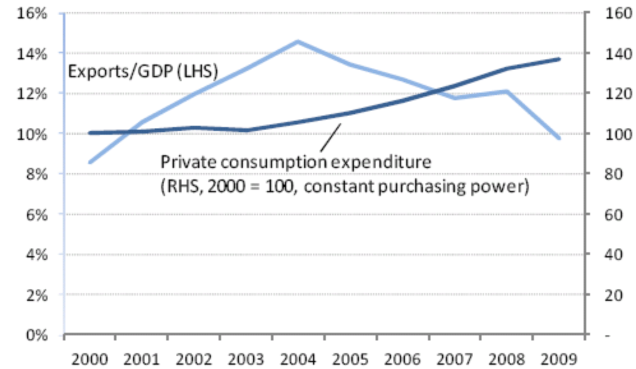
Contrary to the economic stereotype of Brazil being a well-developed agricultural and mining country tied to the hip of China, Brazil has a largely independent and diverse economy. Domestic consumption, rather than commodity exports, drives Brazil's GDP growth. Total Brazilian exports accounted for just 9.7% of GDP in 2009. China is the biggest single buyer of Brazilian exports (13% of total) but less than Latin America (23% of total).[8] The majority of Brazilian exports are classified as basic or intermediate goods – as opposed to basic and industrialized commodities – so commodity price volatility has even less impact on the movement of GDP. One could argue that Brazil's export commodity exposure may be only 5% of GDP; therefore, a slowdown in global economic growth or a prick of the China property market bubble may not substantially impact Brazil's future growth as some investment professionals fear.

Stable and predictable GDP output driven by the consumer is at the center of Brazil's future growth story. The 2008-2009 global credit crisis and recession proves the resiliency of the

[8] Credit Suisse

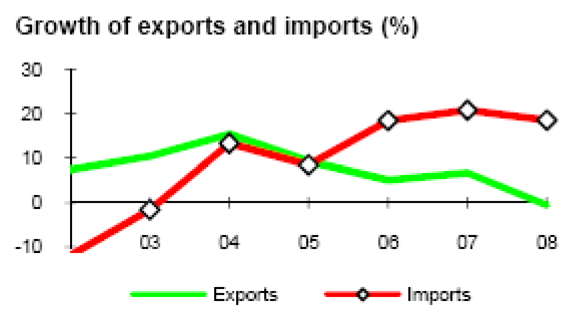
domestic consumer; Brazil was one of the few countries to maintain the same year-over-year output during this dark period. Contrary to popular belief, Brazil is largely a protected domestic economy. Brazil's GDP composition is dominated by Services (68%) and Industry (26%).[9] In addition, Brazil's massive natural resources make it less dependent on importing energy and materials. While it exports nearly as much oil as it imports, it produces nearly as much oil as it consumes.[10] Its major risks are not necessarily aligned with developed market risks.

Brazil Exports vs. Brazil Domestic Consumption



Source: Goldman Sachs

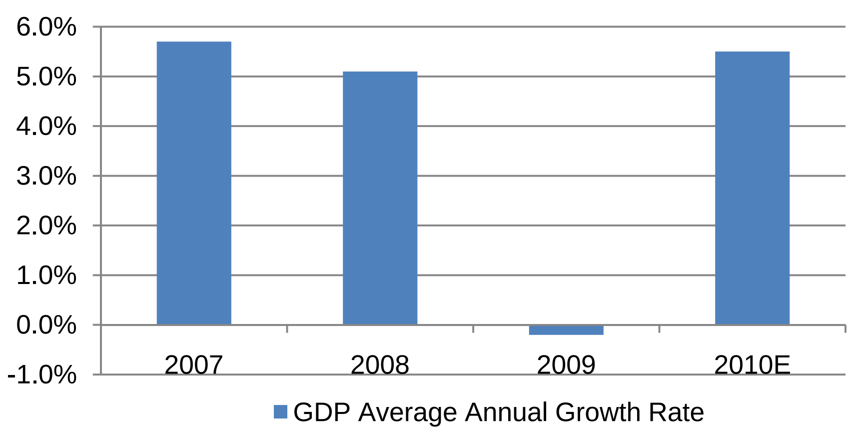
Brazil Growth of Exports vs. Imports



Source: World Bank

Annualized GDP growth is estimated to increase between 4-6% over the next two years. The Bloomberg 2010 March survey of expected GDP growth has been ramped up since the 2009 December survey from 5.0% to 5.5% in 2010.[11] The Brazilian government also recently forecasted overall economic growth of 5.5% per year between 2011 and 2014.[12]

Brazil GDP Growth: Historical & Estimated



Source: World Bank and Bloomberg

How will Brazil sustain its attractive GDP growth? We asked this question often on our trip and subsequent follow-up conversations. The "back of the envelope" response we commonly heard is that in order to achieve sustainable 3-5% long-term GDP growth, Brazil will need to rely on the following:

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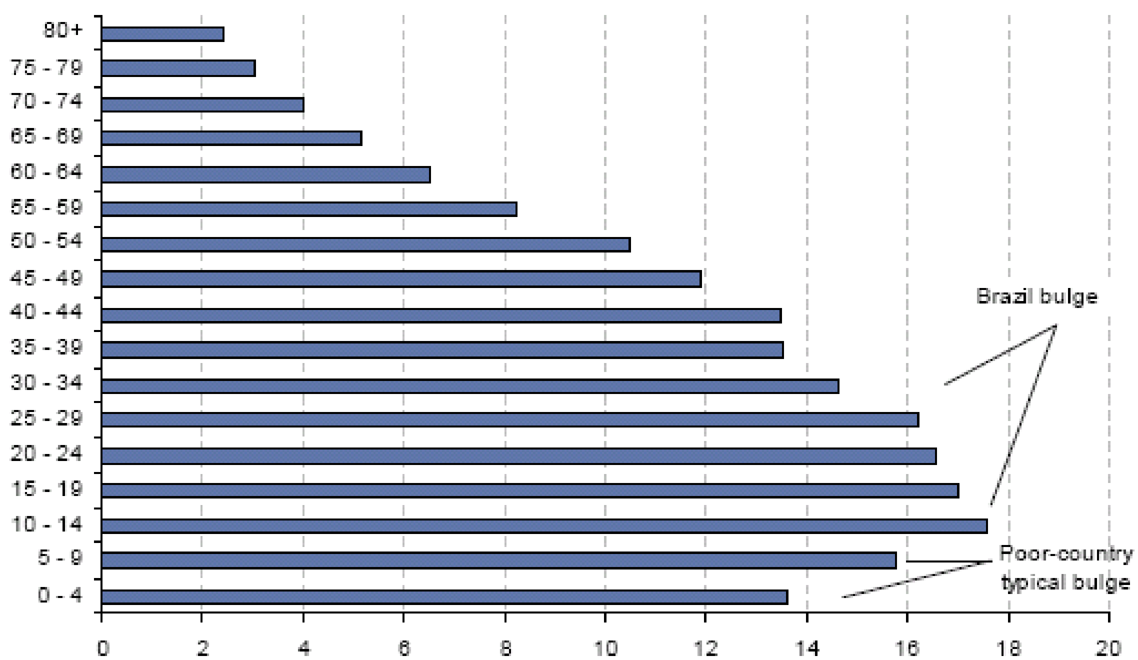
9 World Bank: http://devdata.worldbank.org/AAG/bra_aag.pdf
10 Central Intelligence Agency: https://www.cia.gov/library/publications/the-world-factbook/geos/br.html
11 Bloomberg
12 Brazil – U.S. Business Council: http://www.brazilcouncil.org/news/pac2-includes-nearly-900-billion-investments

Population Growth: ~1.5%
Wage Growth: ~2.0%
Credit Growth: ~1.5%

There are some structural reasons why long-term GDP growth is sustainable beyond Brazil's vast natural resources. The nation's promising demographics are somewhat the inverse of those in the developed world. A sample of this structural tailwind is Brazil's growing middle class and declining levels of income inequality; since 2003, nearly 25 million Brazilians have entered the middle class.[13] This huge migration out of poverty presents a tremendous increase in domestic purchasing power.

The majority of the population is also in the young-adult range (much like the US baby boomers who began entering the workforce in the 1960's). The number of non-working age people as compared to the number of working age people has never been lower (this is known as the dependency ratio). Incredibly, the unemployment rate continues to decline (most recently 7.3% in April, a new low since 2001) despite such a large proportion of the population in or entering into the workforce.[14] This attractive dependency ratio is quite the opposite of the developed world, particularly in Japan and Europe.

Total Population by Age Group



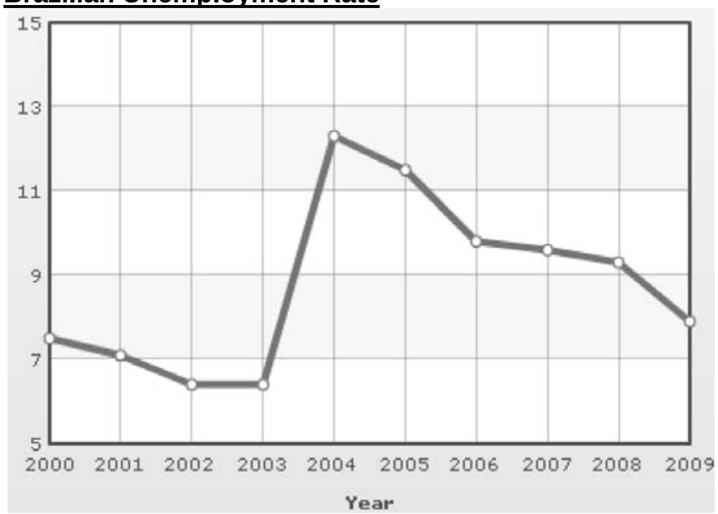
Source: Goldman Sachs

The attractive demographic trends and dependency ratio partially explain Brazil's solid financial condition. Brazil's balance sheet has never been in better shape. The country remains a net foreign creditor with $249 billion of reserves and little dependence on foreign funding. The majority of its outstanding debt composition (77%) as of 2008 is from private creditors. Total debt

[13] World Bank and Getulio Vargas Foundation
[14] Brazilian Institute of Geography and Statistics: http://www.ibge.gov.br/english/

to GDP is 16.2% (down from 30.7% in 1988) and its interest payments as a percentage of GDP is just 1%.[15] In 2007, two ratings agencies, Standard and Poor's and Moody's, awarded invest grade status to Brazil's debt. Its banks also have limited direct exposure to European sovereign debt and use less leverage than its US and European peers. The nation's disciplined fiscal and monetary policies also make Brazil appealing (particularly compared to the developed economies).

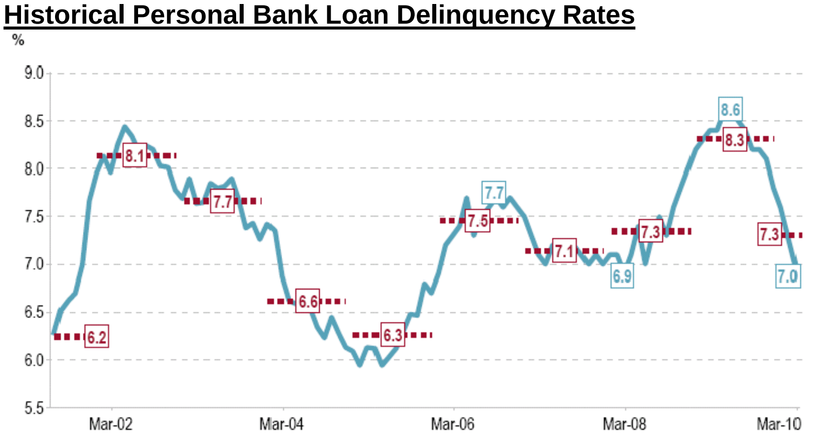
Brazilian Unemployment Rate



Source: Index Mundi

The growth of consumer credit in Brazil is another tailwind. According to Brazil's leading consumer credit agency, Serasa-Experian, demand for consumer credit rose 32.5% from March 2009 to March 2010 and the trend toward greater consumer credit is likely to continue through 2010.[16] Consumers also draw on credit from retailers through installment plans and from banks through credit cards. Delinquency rates have ranged from 6% to 9% since 2002. Credit is a cyclical business, but over the long-term the trend is towards consumers using more credit.

Historical Personal Bank Loan Delinquency Rates



Source: Credit Suisse

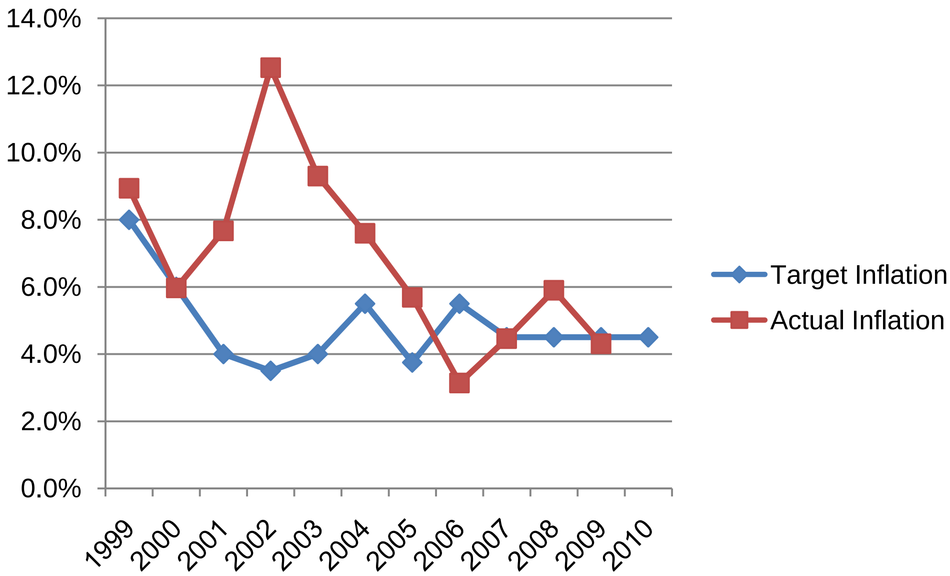
Another structural tailwind is Brazil's commitment to improving the infrastructure. The current government's Program for Accelerated Growth is now entering its second phase, PAC-2, which

[15] World Bank: http://devdata.worldbank.org/AAG/bra_aag.pdf
[16] Wall Street Journal: http://online.wsj.com/article/BT-CO-20100412-712609.html

proposes nearly $500 billion to be invested in energy, utilities, transportation and communications between 2010 and 2014.[17] This is on top of the $280 billion being invested during PAC-1 (which is not yet complete). In addition, PAC-2 includes 29,000 small social projects such as day care centers, public health posts, and police stations. Some of the infrastructure investment will be directed towards Rio de Janeiro, the host city of the 2014 World Cup and 2016 Olympics. PAC-1 and PAC-2 stimulus are helping to fuel Brazilian jobs and wealth.

Should Brazil sustain attractive yet stable GDP growth, inflation is likely to remain subdued. In recent history Brazil has benefited from responsible monetary policy enacted by the Brazilian Central Bank which has been successful over the last 5 years in meeting its modest 4.5% inflation target.

Inflation Targeting in Brazil

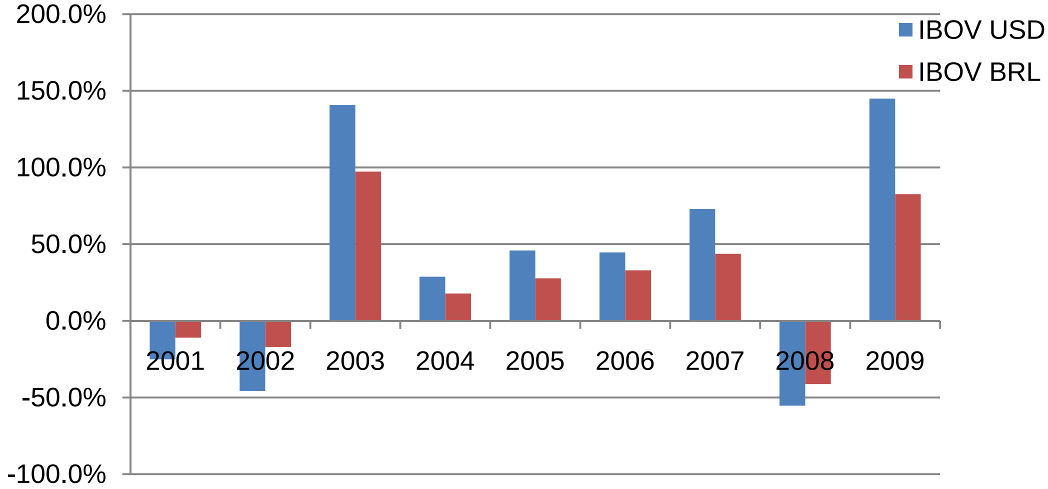


Source: Banco Central Do Brasil

If Brazil can continue to meet its modest inflation targets, the Real should remain strong. Excluding the global credit crisis and recession, the Real has been in a prolonged period of appreciation. In US dollars, the Real has increased 71% since May of 2004. But the Brazilian Real is certainly volatile. It decreased 36% from its $0.64 all-time high in August 2008 to a 5 year low of $0.40 just three months later. As we mentioned before, in Brazil's case a bullish view on equities must coincide with a bullish view on its currency given the cost of hedging. Not surprisingly, the Bovespa in US$ has historically performed better than in the Brazilian Real during bull markets but has underperformed in bear markets.

[17] Brazil – U.S. Business Council: http://www.brazilcouncil.org/news/pac2-includes-nearly-900-billion-investments

Bovespa Index Performance: USD vs. BRL Calendar Year Returns



Source: Bloomberg

Sound Brazilian Corporations

There are some fantastic Brazilian firms focused on domestic growth that appear to have lower operating risk and greater earnings growth potential than their peers in the developed economies. Brazilian corporations have healthy balance sheets, low debt, attractive operating margins, and are relatively independent of foreign sources of funding. Below we summarize the fundamentals of Brazilian corporations using the constituents of two Brazilian indices as a proxy. These companies, on average, are not highly leveraged, enjoy healthy margins, and have attractive earnings growth characteristics.

Brazilian Corporate Fundamentals

	Large Cap	Small Cap	Average
Debt to Assets Ratio (Avg)	29.6%	24.8%	27.2%
Leverage Ratio (Avg)	4.3x	2.9x	3.6x
Operating Margins (Avg)	21.5%	16.6%	19.5%
Est. Long Term EPS Growth (Avg)	15.7%	40.1%	35.5%
Weighted Avg Dividend Yield	3.7%	1.6%	2.7%
Weighted Avg Market Cap	$85.1B	$2.5B	$44.0B

Source: Bloomberg, BlackRock, and 4asset-management

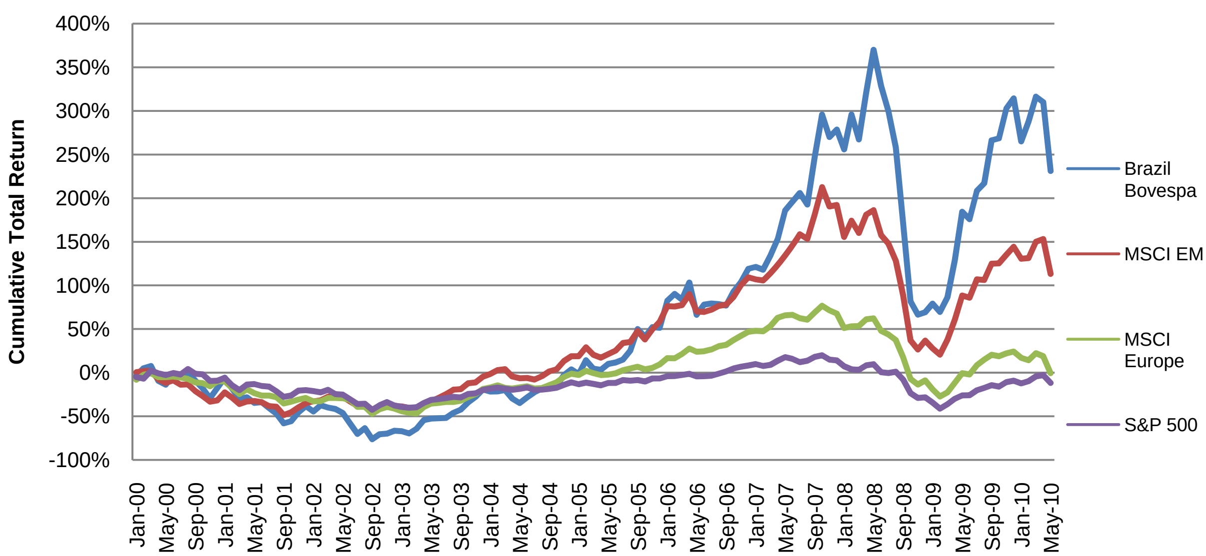
Europe’s sovereign debt crisis and China’s potential property market bubble are real, systemic threats to the global economy. These macro concerns may certainly impact Brazil’s commodity (iron-ore, paper, and oil) exporters such as Petrobras and Vale. In addition, Brazil has experienced substantial inflows of foreign capital into funds and direct investment. These fund flows can force prices higher. Should the trend in fund flows reverse itself, it can pressure prices lower. Nevertheless, the long-term fundamentals of Brazil’s domestic expansion are intact and “alpha” may be generated by professional investors who focus on healthy Brazilian corporations that are driven by domestic demand.

Why Now?

Brazil and the emerging markets have long been perceived as risky – and much of this has to do with their liquidity and currency. Given its high beta profile, the Bovespa typically goes down more than the developed markets in times of stress. In “flight to safety” environments, US investors in Brazilian equities get whipsawed by large drawdowns in the local markets plus depreciation in the local currency. Conversely, the Bovespa typically goes up more than developed markets in dramatic bull markets. We have experienced this recently. In 2008 the Bovespa was down 55% in US$ while in 2009 it was up 145% in US$. In both instances, the Bovespa moved beyond the S&P 500.

The recent correction in global equity markets has been no exception to this historical rule. At this time, however, we do not envision a “crash” scenario; instead, we welcome this correction as an opportunity. Year-to-date, the Bovespa is down over 20% whereas the S&P 500 is down just 3% at the time of this writing. We see this correction as a prudent opportunity to buy on the dips. There is now a much higher margin of safety priced into Brazilian equities than at the time of our visit in February. Brazil is enjoying sound fiscal policy, political stability, economic stimulus, and attractive demographics. We see this as a prudent time to pay less in terms of price to earnings for better growth characteristics than we can generally find in the developed world.

Brazil vs. Developed and Emerging Indices
10-Year USD Performance Chart
January 1, 2000 - May 25, 2010

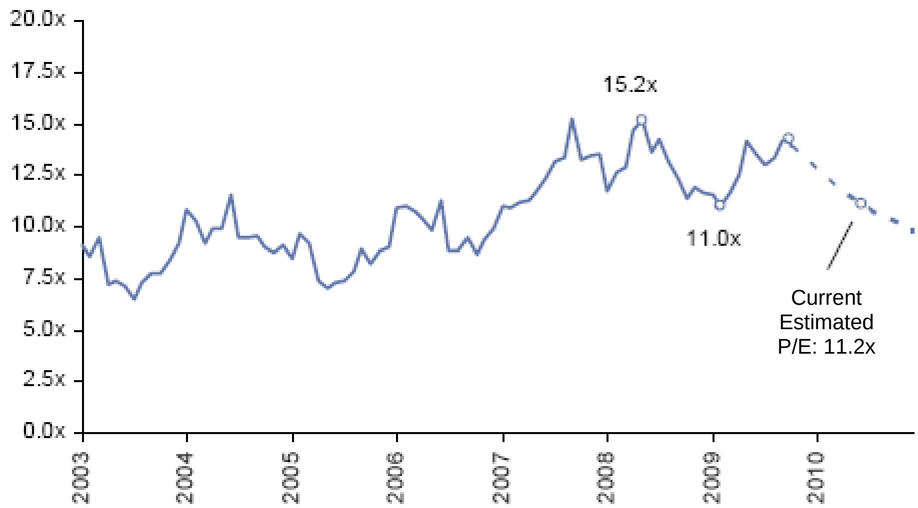


Source: Bloomberg

Like any market, the Brazilian equity market has its peaks/bubbles and troughs/fear environments. Since 2003, the Bovespa has traded on average 14.3x current earnings with a high of 25.5x and a low of 7.1x. The current price to earnings multiple is 12.8x. This compares favorably to the developed markets indices, such as the S&P 500 (15.5x) and the MSCI EAFE (16.3x), which arguably have less attractive growth characteristics and massive consumer and government debt loads. While the global economy could possibly enter into a double dip recession, we argue that its domestic growth story shields Brazil somewhat from these macro concerns (assuming, of course, that a global equity crash is not in the cards). According to a recent JP Morgan study, based on fifteen regional “corrections” of more than 20% over the past two decades, buying Latin American equities at this point of a correction may generate a one year return of 27%.

Historical & Estimated P/E Multiples Since 2003: Bovespa Index

	Current	Average	Median	High	Low
P/E	12.8x	14.3x	12.9x	25.5x	7.1x



Source: Goldman Sachs and Bloomberg

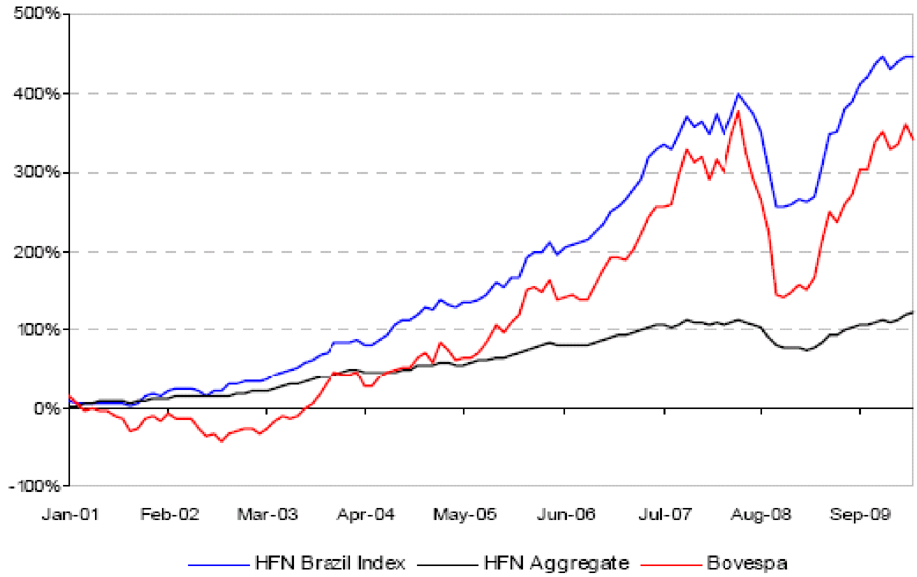
Implementation Risk and Constraints

The way to capture this opportunity is very important. Not all methods are created equally. The easiest and most popular is the MSCI Brazil ETF (ticker EWZ). This vehicle, however, does not reflect Brazil's important domestic demand story. This investable index is the "old" Brazil. The companies highly exposed to commodities represent 54% of the MSCI Brazil ETF. Moreover, its top five holdings make up 45% of the portfolio and only one of those companies – Itau Unibanco – is not a commodity producer.

It is challenging for foreigners to invest in Brazil. There are only 30 Brazilian companies that issue ADRs and trade on US exchanges. Many of these are either commodity driven companies or have limited trading volume. As part of its monitoring of foreign investment flows, Brazil does not allow retail investors to buy Brazilian securities on the local Bovespa exchange. Foreign investors have to receive regulatory approval to trade securities in Brazil. Consequently, implementation is not as easy as one would think, particularly if you want to capture the Brazilian domestic demand story.

Using recent performance data of the HFN Brazil Index as a proxy, active Brazilian managers (consisting of fixed income, long-only equity, and long-short equity strategies) have outperformed the Bovespa and with less risk since inception of the index (1/1/01). The average annualized return is 19.9% vs. 17.3% for the Bovespa, and the annualized standard deviation is 19.0% vs. 27.1% for the Bovespa. On a cumulative basis, the HFN Brazil Index has outperformed the Bovespa by more than 100 percentage points. While on paper this diversified basket of active Brazilian managers has proven to outperform the Bovespa Index, one must have a complete understanding of the risks of these underlying funds, such as portfolio strategy, construction, concentration, liquidity, offshore structures, and tax implications.

HFN Brazil Index vs. Bovespa: 1/1/2001-4/20/10



Source: HedgeFund.net

What are the risks?

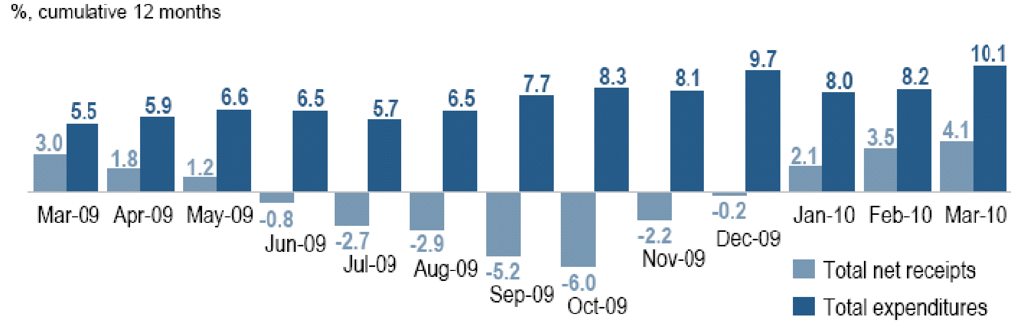
No investment opportunity is without significant risk, particularly in the emerging markets. Below we summarize the major risks to our thesis that now is a prudent time to invest in Brazil's important domestic growth story:

Politics: Although the leading candidates for November's presidential election are both market friendly, a shift towards more conservative fiscal stimulation and regulatory reform is possible. Such a move would, for example, impact infrastructure investment and curb consumer credit for discretionary spending and housing.

Infrastructure: While Brazil is currently addressing its existing infrastructure issues, any derailing of PAC-1 and PAC-2 would negatively impact domestic growth.

Inflation/Currency: As seen below, the government has been running a deficit of late; although since last fall, net government receipts have been gradually catching up with total government expenditures.

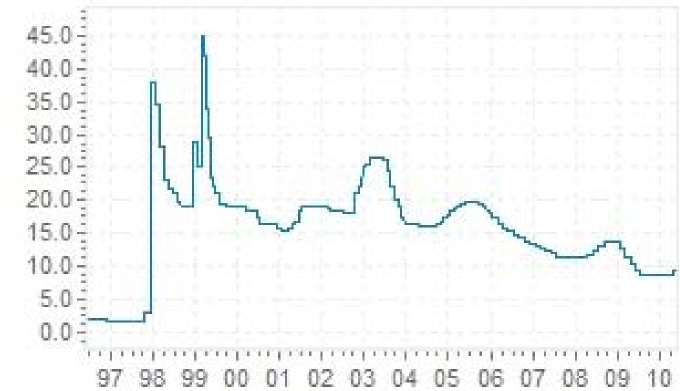
Central Government Growth in Net Receipts and Expenditures



Source: Credit Suisse

Moreover, rising interest rates from its current 9.5% rate to double digits would negatively impact the consumer demand story – particularly housing affordability, installment plans for retail purchases, and consumer credit. Interest rates are at decade lows, but were as high as 25% in 2003.

Historical Interest Rates (BACAN SELIC Rate)

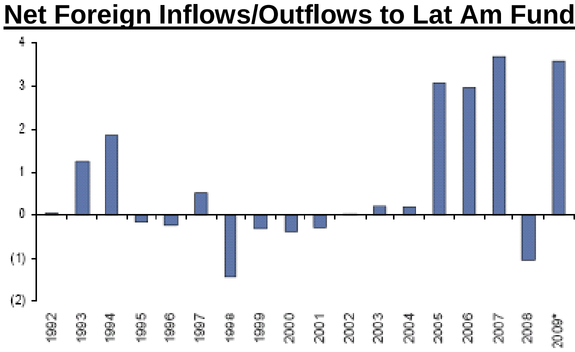


Source: global-rates.com

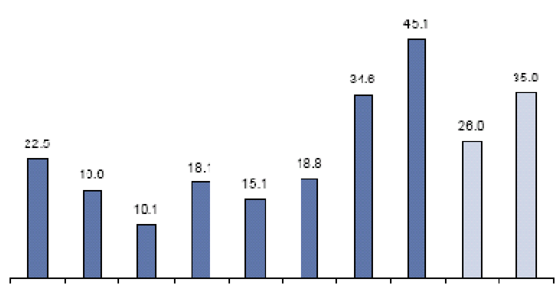
Global Systemic Risk: All equities are nearly perfectly correlated in times of stress. Even sheltered companies driven by the domestic demand story can sink with all ships. Moreover, unhealthy capital markets make it difficult for corporations to effectively raise capital. This has been a reality of late; the Brazilian corporate debt market has essentially shut down in the last month. The Brazilian equity market has suffered in similar ways; Brazil's biggest company – Petrobras – has been unable to execute a secondary offering since it was announced several months ago.

Fund Flows: A major tailwind for Brazil has been foreign fund flows. The net foreign inflows to Latin American mutual funds have been substantial since 2005. The foreign direct investment to Brazil also has been strong during this decade. For example, net fund flows to Latin American funds peaked in 2007 (near the top of the market) while 2008 experienced a net outflow. This liquidity outflow was a major factor for the Bovespa's downfall. Should fear reign, liquidity will become a major factor and would most likely lead Brazilian equities lower.

Net Foreign Inflows/Outflows to Lat Am Funds



Total Foreign Direct Investment to Brazil



Source: Goldman Sachs

Funds are in US$ billions

Funds are in US$ billions

Conclusion

The current discount in Brazil presents a prudent long-term buying opportunity. Our approach to investing leads us to evaluate opportunities in the context of a time horizon that is typically 3 years or longer. While investment theses can play out over shorter time-frames, short-term price fluctuation is often little more than noise. There are opportunities in certain instances when short-term price changes deviate from the long-term fundamental outlook.

The swift return of risk aversion in May 2010 has created such an opportunity in parts of the world where the fundamental outlook for growth remains robust. Our trip to Brazil in February confirmed our conviction in the secular growth story – specifically targeting the domestic demand story of a younger population (that is not over-leveraged) entering their prime earning years and set to benefit from a low cost of borrowing unavailable before. The recent risk aversion has not changed the long-term fundamentals of Brazil's domestic expansion.

Valuation and technical issues such as the small size of the publicly traded market and the impact of foreign capital flows led us to wait and see earlier this year. While we remain concerned about the technical issues, we see a high margin of safety now that price to earnings valuations on the Bovespa have fallen to well below the US equity market (12.8x versus 15.5x) while boasting higher long-term growth rates (from 15-40% depending on capitalization). Fear may cause more near-term pressure on these markets, but price suggests that prudent long-term investors may be rewarded.

We appreciate your interest in reading our research and long-term thesis on Brazil. Please contact us with any questions.

May 26, 2010
All Bloomberg data is as of May 25, 2010 unless otherwise noted.

Sources

Edge Capital Partners, LLC, Central Intelligence Agency, World Bank, Banco Central Do Brasil, International Monetary Fund, Wall Street Journal, Getulio Vargas Foundation, Bovespa, Financial Times, Brazil – U.S. Business Council, Brazilian Institute of Geography and Statistics, Bloomberg, Goldman Sachs, Redecard, CDK, Credit Suisse, global-rates.com, JPMorgan, BlackRock, Index Mundi, HedgeFund.net, and 4asset-management