Investing in Emerging Markets: Brazil

November 2010 Client Letter

In the early 1980s, the stock market's tank was fueled up and ready to roll. Short-term interest rates had topped 19% by January 1981. In October 1981, 30-year mortgages were 18%. As interest rates began a two-decade secular decline, the stock market exploded. From August 1982 through March 2000, the S&P 500 returned an amazing 19% a year, nearly double what it had returned the previous five decades. A whole generation of investors grew accustomed to a seemingly endless run of asset growth.

Today we have an interest rate environment that is a one-eighty reversal of the early 1980s. If declining rates helped the stock market for 20 years, what will happen if we have a secular *incline* in rates? I believe today's investors face a daunting environment ahead in the form of much higher interest rates and inflation.

For the time being, inflation does not appear to be an immediate concern. As I wrote last month, the Fed has signaled a willingness to restart quantitative easing. Quantitative easing is a fancy name for money printing. When the Fed engages in quantitative easing, it simply buys Treasury securities from member banks. As the Fed buys more Treasuries, yields are driven down.

With uncompetitive U.S. Treasury yields and somber growth prospects in the U.S., some investors are piling into emerging-market equities. According to EPFR, a firm that tracks fund flow data, year-to-date emerging-market equity inflows now exceed last year's record-setting $44.2 billion.

The case for investing in emerging markets is often based on growth.

Economic growth in emerging economies is widely expected to outpace growth in the developed world. The argument is greater economic growth leads to rising corporate profits. Since corporate profits drive stock prices, greater economic growth must drive emerging-market shares higher. Simple, right? Unfortunately, while this investment thesis sounds well reasoned, it doesn't hold up to scrutiny. An examination of the historical record shows there is little correlation between a country's stock-market returns and its rate of GDP growth.

There are many reasons GDP growth and a country's stock market returns are not correlated. As many investors painfully learned in the tech-stock bubble of the late 1990s, high rates of growth don't necessarily translate into higher stock returns. If investors are anticipating high growth, chances are that growth is already baked into prices. It is also possible that industries experiencing the highest rate of growth in an economy may be inaccessible to stock-market investors. This is especially true of emerging economies, where capital markets are underdeveloped. The majority of businesses in an emerging economy could be private, state-owned, or foreign-owned.

It is also important to

evaluate the quality of economic growth and not just the quantity. In an economy such as China's, where the state is still heavily involved in the economy, GDP growth is high but quality is low. China's currency is intentionally kept undervalued to subsidize business, loans are granted on preferential terms to industries and businesses favored by policy-makers, and there are distortive incentives to encourage excessive fixed-asset investment. In our view, China's economic growth model fosters overcapacity and uneconomic business ventures—neither are conducive to sustainable stock market gains.

Allocating funds to

emerging markets solely on the assumption that high future economic growth results in higher stock-market returns is not a strategy we follow. We take a more systematic approach to investing in emerging markets. We pay attention to the growth prospects of an economy but also consider valuation, political stability, economic policy, currency values, interest rates, and investor transparency, among other things. When we evaluate these factors today, Brazil appears to compare favorably to other emerging markets.

Brazil is a middle-income country with a population of about 200 million. GDP growth averages between

4% and 5%, half of what it is in China and India. Unlike many emerging-market countries, Brazil is not overly dependent on commodities or exports. Brazil’s economy is highly diversified, with personal consumption expenditures accounting for 60% of GDP and exports accounting for only 11% of GDP.

In contrast to the single-party system in China, Brazil is a democracy with a government structure similar to that of the U.S. Brazil is divided into 26 states and one federal district, each with its own local government. The national congress is bicameral. The federal senate, the upper house, comprises three senators from each state and three from the federal district. Senators serve eight-year terms. The lower house is the Chamber of Deputies. The chamber comprises 513 deputies who are elected to serve four-year terms.

The executive branch comprises a president and vice president who run on the same ticket and are elected to four-year terms. The president has a two-term limit. He serves as both head of state and head of government and appoints his own cabinet.

Brazil's independent judiciary consists of a supreme federal tribunal with 11 judges appointed by the president and confirmed by the senate, a higher tribunal of justice, and regional federal tribunals. Judges are appointed for life but face mandatory retirement at age 70.

For an emerging market, Brazil’s corporate governance requirements offer foreign investors a level of comfort not attainable in some emerging markets. There are four different levels of corporate governance: Standard, Level 1, Level 2, and Novo Mercado. All publicly held companies are required to disclose material developments to the securities regulator.

Level 1 companies must disclose an annual corporate agenda and consolidated financial statements, but these can be based on local standards. Level 2 and

Novo Mercado must prepare quarterly and annual financial statements in English and according to IFRS or US GAAP. Novo Mercado is the highest level of corporate governance. In addition to publishing international financial statements, Novo Mercado companies have share class restrictions and independent board membership requirements.

Long term, we believe Brazil is well positioned to succeed in a competitive global economy. Brazil owns what the world needs. The country is the world’s leading exporter of iron ore, coffee, soy, orange juice, beef, chicken, sugar, and ethanol. Brazil has 958 million acres of highly productive arable land, with 222 million acres yet to be farmed. Brazil holds 12% of the world's fresh water supply and generates 73% of its energy needs from renewable hydroelectric power. Brazil is also home to one of the top 10 largest oil reserves in the world, the Tupi field.

Brazil's endowment of vital natural resources is an important component of our investment thesis on the country, but not the only reason we are investing there. For decades, Brazil's economy suffered from political and economic instability. Hyperinflation and currency debasement were common themes.

Instability distorted the economy. Prohibitively high interest rates and volatile growth made corporate and household borrowing impractical. However, since former president Cardoso implemented economic reforms that have been maintained by current president Lula da Silva, economic vibrancy and vitality have returned to Brazil. Though still elevated, inflation and interest rates have come down considerably over the last decade. Brazil's government debt is now rated investment-grade, total debt to GDP is only 45% compared to over 60% in the U.S., and foreign currency reserves stand at $264 billion, which is equivalent to 15 months of imports.

To gain exposure to Brazil we are investing in Brazilian real–denominated debt, individual Brazilian companies, and the Market Vectors Brazil Small-Cap ETF. We favor the Market Vectors fund over the large-cap fund iShares MSCI Brazil for two reasons. First, the iShares Brazil fund is dominated by a handful of companies. In our view, the fund lacks proper diversification. Second, the largest weightings in the iShares fund are in multinational companies. Multinationals are influenced more by the global economy than the Brazilian economy. We believe the Market Vectors fund provides more direct exposure to Brazil's economy.

Of course, our investment case for Brazil is not without risks. We favor a meaningful position in the country, but no more than that. Brazil is still an emerging market. Political and economic stability are a recent phenomenon. Free-market capitalism is not embraced by all in Brazil. There is heightened risk of government meddling in the private sector. Hot foreign money inflows are also a risk, as are Brazil's uncompetitive tax code, burdensome regulations, and rigid labor laws.

In our view, it is the ongoing transition from instability to stability that offers the most promise for investors in Brazil. We view an investment in Brazil as a secular re-rating story. Over the long term we expect interest rates to decline, the currency to appreciate, the economy to remain strong, and asset price valuations to rise to reflect this new economic paradigm.

Have a good month and, as always, please give us a call at (888) 456-5444 if your financial situation has changed or if you have questions about your investment portfolio.

Sincerely,

Matthew A. Young

President and Chief

Executive Officer

P.S. Lately, there has been some grumbling among the CNBC analysts and the Wall Street crowd about the low-growth prospects of AT&T (NYSE: T) and Verizon (NYSE: VZ). It may be true that AT&T and Verizon are fighting for a smaller piece of the maturing domestic wireless market and the wireline business has not evolved for decades. But at Richard C. Young & Co., Ltd., our focus is on cash flow and compounding, not chasing growth stocks around the big board. AT&T and Verizon are major cash generators, and the companies are sharing that cash with shareholders. Each company offers a current yield approaching 6%.

P.P.S. Another high-yielder we are buying for clients is Bonterra Energy. Bonterra is a Canadian oil and gas company based in Calgary, Alberta. Bonterra's assets are located primarily in the Pembina field in Central Alberta. The firm's reserve base is long-lived and considered to be low-risk and predictable. At current production rates, Bonterra has a 20-year supply of oil and gas as well as a land base that offers a 14-year inventory of drilling opportunities. Bonterra's production and reserves are weighted about 75% oil and 25% natural gas. The company's dividend policy is to pay 60% to 75% of cash flow out to shareholders. Dividends are paid monthly and may vary depending on oil and gas prices. Today Bonterra's shares yield 6.5%.

P.P.P.S. One of our favorite closed-end funds today is BlackRock Enhanced Dividend Achievers Trust (BDJ). BDJ focuses on equities of companies that have long, steady records of dividend increases. BDJ maximizes its own distributions by using a covered-call strategy to increase payments to shareholders. The trust's current distribution rate exceeds 11%. Top holdings in the fund include Johnson & Johnson, Procter & Gamble, and General Dynamics. We look to buy

BDJ when its price drops below net asset value.