Report
Dynamo 31
PUBLISHED BY DYNAMO ADMINISTRAÇÃO DE RECURSOS LTDA. – 2nd QUARTER 2001 www.dynamo.com.br

Forget the illiquidity premium; long may live the CDI[1]

For 15 years beginning in 1985, as the chief investment officer for the Yale endowment, David Swensen established a new paradigm for the management of funds for American institutional investors. With an average annual return of more than 16%, Swensen placed Yale among the biggest endowment funds in the U.S. by growing the amount under management from US$ 1 billion to US$ 7 billion. Consistently superior long term investment returns, especially in a competitive market like the U.S., always attract our attention, and it was for no other reason that we decided to research the work of Swensen and his team[2].

His success can be summarized in a few words. His approach relies on the intelligent use of the comparative advantages that an investor with long term funding possess. By not being pressured to produce short term results, he is able to invest more heavily in less liquid instruments (so-called alternative investments like small cap stocks, private equity, venture capital, etc) and, as such, obtain the benefits of assets that are mispriced more often than in efficient markets. Just consider the following figures: between December of 1925 and December of 1998, one dollar invested in Treasury bonds was multiplied by 44; in large cap stocks, by 2351; and in small cap stocks, by 5117. The core of Swensen's strategy lies on the development of a technology for the selection of fund managers that are able to deliver superior performance in these imperfect markets. Generally speaking, his approach to investment analysis emphasizes the fundamentals over market timing, which he considers inadequate for long term institutional investors for reasons that he illustrates with a quotation from Charles Ellis, one the most prominent advisors to the pension fund industry: "There is no evidence of any large institutions having anything like a consistent ability to get in when the market is low and get out when the market is high. Attempts to switch between stocks and bonds, or between stocks and cash, in anticipation of market moves have been unsuccessful much more often than they have been successful."[3]

Yale's investment policy leads to a portfolio with controlled risk, low concentration in fixed income securities, a good portion of its assets managed by third parties and a high volume of so-called alternative investments (even during the recent abnormally strong bull market, Yale remained sub-invested in liquid stocks). The long term results speak for themselves: in the last fifteen years, Yale's endowment has better returns than 96% of all American endowments and 98% than all of the local pension funds.

To David Swensen, the big institutional investors should balance the potential benefits of liquidity with the historical consideration that it might not be there when you really need it. The exit door for large investors is always narrower than it looked on the way in. On the other hand, less liquid investments do have their comparative advantages. They are scantly followed – if at all – by analysts and investors, information is scarce and of poor quality. All of which makes these kind of investments more difficult but if done with competence, they can produce very interesting results. It is for no other reason that during the period between 1987 and 1997, the median of annual returns of investments in fixed income, equities and private equity were, respectively, 9.2%, 18.3% and 14.5%. However, the median of the first quartile of returns were, respectively, 9.7%, 19.5% and 24.1%. The obvious conclusion is that there is a significant premium, in relation to the mean, for the best investments in less liquid assets. Or still, the standard deviation is much lower for the returns of highly liquid investments. As a consequence, one of the more important tasks for investors looking to benefit from the advantages of less liquid assets is to build a framework for the correct analysis and choice of the right investments, which can be done directly or through managers that focus on the specific business.

And what about Brazil? What could we say about our institutional investors, in particular of the local pension funds that control an ever growing portion of the country's savings? Even considering the obvious differences between the two markets, and even more so, between the two economies, it is surprising to realize that, in this subject, we are not moving slowly, in synchrony with our general delay, but we are going in the exact opposite direction. The vast majority of local institutional investors (our largest reserve of capital for long term investments) is increasingly focusing in fixed income and highly liquid investments, in a perfect combination of microeconomic[4] inefficiency with macroeconomic inadequacy. But how did we arrive to this situation?

First of all, there are historical reasons. For a long period, the main experiment of pension funds outside the fixed income

(1) CDI is the overnight rate, or the Brazilian equivalent to the FED Funds rate. However, whereas in the U.S., the FED Funds rate is not really meaningful, in Brazil the CDI represents the real alternative cost, or yet, the risk free rate, for most investors. The reasons for such short term perspective derive mostly from the fact that there is no real market for either Treasury Bills or Bonds in Brazil.

(2) For those who are interested, we suggest the reading of David F. Swensen, "Pioneering Portfolio Management", The Free Press, 2000

(3) Charles D. Ellis, "Winning the Loser's Game: Timeless Strategies for Successful Investing", 3d. Ed., New York, Mc Graw-Hill, 1998, page 11

(4) On the macroeconomic importance of organizing the private equity and venture capital markets in modern economies, please check the preface to the Brazilian edition of the biography of Robert A.G. Monks, "A Traitor to his Class" by Hilary Rosenberg

world was the acquisition of preferred, or better, non-voting, minority positions in Brazilian listed companies. Their experience, like the ones from most other investors travelling the same route, was not good. In our last reports, we have tried to analyze the problems related to the non-democratic corporate structure of most Brazilian companies, the private benefits enjoyed by controlling shareholders, the asymmetrical distribution of effective results among majority and minority shareholders, the recurrence of conflicts of interest situations with the controllers and last, but not least, the lack of capacity of our regulatory authorities (we actually think that they have been doing a very good job with the resources they have). All of which explain why the returns of such investments are so often mediocre even when they involve companies with good fundamentals.

The second investment phase of the pension funds began with their acquisition of the control of Perdigão. Following the frustration which resulted from the previous preferred share investments, the movement towards controlling positions was natural and predictable. The privatization program created the necessary opportunities for the pension funds to invest along these lines in a scale compatible with their size. In fact, pension funds were almost summoned to participate in the blocks of shareholders that were formed to bid in the privatization. The results of this new investment policy are still not evident but there is no doubt that life within these several shareholders' agreements is incredibly more complex than a financial investor with a diversified portfolio, such as the pension funds are, can deal with. The absence of courts specialized in corporate law coupled with the virtual absence of jurisprudence on the matter can be particularly harmful to companies governed by shareholders' agreements to whenever there is a divergence in the compliance of such contracts. In sum, the cost-benefit equation of this route has not been very promising.

Almost simultaneously with the increase of investments through controlling blocks, pension funds also began to allocate resources to private equity and, in a much smaller scale, to venture capital. In this instance, where the results and relationships are of even longer term nature, what seems to be happening is a rapid deterioration of the interaction between investors and fund managers. We prefer to abstain from any detailed analysis of the reasons that led to this situation but the fact is that the partial results of this venue are also far from justifying any increase in its volume or its definitive adoption as an important investment allocation. All in all, the inevitable conclusion is that the life of the pension funds in the world outside of the fixed income investments has been extraordinarily complicated.

As a consequence of the historical reasons, follows the more practical reasons. The result of what we described above was that the new executives of the pension fund inherited a collection of problems that are so complex and demand so much attention and energy for the monitoring and eventual exit that they cannot help but wonder how their lives would be incredibly simpler, and their returns probably higher, if their portfolios were only comprised of plain vanilla short term government bonds, the types of which you can buy or sell with a mere telephone call. It cannot come as a surprise that so few pension funds are still looking at less liquid investments as an opportunity for the future as opposed to a heavy baggage from the past that consumes all the time and energy of every senior executive without producing the expected results and hampering the more important job of running the pension fund as a whole. Unfortunately, the assortment of ill-fated, botched investments during this period only helped to foster, within the pension funds, a desire to move away from the correct paradigm instead of pushing them towards it, and that is understandable. But there we go again in the opposite direction of the American capital markets, the functioning of which we all have long been admirers.

> *" .... the life of the pension funds in the world outside of the fixed income investments has been extraordinarily complicated."*

There is still another technical reason. In the American market, more liquid stocks are followed by countless smart analysts which means that their prices rarely steer too far from their fair value. In order to obtain more sizeable gains, investors gradually migrated to less liquid stocks, that is, to companies for which there is much less quality information readily available, and from then on to private equity, venture capital, seed capital, etc ... There is an intrinsic logic in such sequence that induces even small entrepreneurs to shape the growth of their companies towards the capital markets. In Brazil, everything is happening without this coordinated chronology. Consequently, in the less liquid region, investors have to analyze projects without appropriate information, which is expected, but, more importantly, run by people without the adequate financial and entrepreneurial culture that would be developed if the market went through a normal maturing process. The investment becomes more difficult and riskier. As a corollary of this theorem, in practice, it is unthinkable for large institutional investors to make such investments directly as they would demand a disproportionate dedication from their officers. As such, if large investors are to become more involved with less liquid investments, they will need a more substantial industry of trustworthy and competent fund managers focused on this market. The relevance of such work even in the U.S. can be gauged by an initiative from CALPERS, which launched a program to support the development of fund management firms that will focus specifically in the areas of investment that the pension fund is interested[5]. In fact, this program has gone even further. More recently, CALPERS has been acquiring direct participation in a few of such companies so as to be able to influence their management. Unfortunately, the truth is that even if none of the problems that we referred to in this report existed and the Brazilian pension funds sought to follow the same route as Yale, for example, they would be barred from doing so by the atrophy of our universe of specialized independent asset management industry.

Finally, and as the last reason, the well known financial distortions. In a country where successive attempts to achieve monetary stabilization produced the anomaly of consis-

(5) Pensions & Investments, July 9, 2001, page 12

tently high real interest rates, it is only natural that the CDI attract a large crowd of investors, even the more long term oriented. The notion that interest rates will someday fall feels like the diet that is always left for next Monday. Especially when overnight interest rates are so high, even when they are on a downward trend, and the benchmark (the actuarial cost) is relatively so low. The concept that the basis for the development of any capital markets lies on the perception from investors that in the medium and long term, the rate of return of productive activities is on average always higher than financial assets gets downgraded to academic book rhetoric. At least in theory, financial assets should only serve as means for financing production and Government spending, which by its turn, produces its revenues from whatever is produced in the economy. In Brazil, as long as we are pointed in the opposite direction, it is obvious that roads in the short-term fixed income world will remain much smoother than in any other investment route, no matter how nonsensical this may be from a macro economic perspective.

The summary of everything we are saying is roughly the following. The executives of the pension funds that are responsible for their investment policy are extremely busy with complex negotiations around positions that were already in their portfolios when they arrived. The focus on new investments is, at best, marginal. Meanwhile, all cash available is invested in CDI, or if they are feeling particularly lucky, they might try an index fund with a small amount. On the other hand, the discrepancy between the local interest rate and the growth rate of the economy (which, at the end of the day, is the collateral for all these debt instruments) keeps the short term cost of such alternative very low (we hope the same cannot be said of the long term cost). The anemia of the local industry of asset management companies only helps to worsen the situation (mind you, they know the CDI story only too well to bother with illiquid investments). It can only be for theses reasons that we ended up in a situation where, through the recently enacted Resolution 2829 of the CMN (National Monetary Council) the government induces the pension funds to assume as priority exactly what should be their priority in the first case: eventually move from liquidity for good corporate governance and quality long term investments. And there is more, the BNDES (Brazilian development bank) launches private equity funds and then goes around trying to convince the pension funds to join, when perhaps the opposite should be going on.

It is rare to find issues that, at the same time, produce micro and macro economic effects. Yet, more common is the problem of collective action where the interests of everyone (in this case, the rate of return from long term investments) are not enough to cause individuals to act (to abandon the short term fetish), which is why its solution always entail some degree of coordination. Because of what this may mean for investors, fund managers focused on this area, and also for the public interest, it is critical that this theme be included in the agendas of all interested parties.

Dynamo Cougar x Ibovespa x FGV-100

(in US$ dollars - commercial selling rate)

Period	DYNAMO COUGAR*			FGV-100**			IBOVESPA***		
	Quarter	Year to Date	Since 09/19/94	Quarter	Year to Date	Since 09/19/94	Quarter	Year to Date	Since 09/19/94
1993	-	38,78	38,78	-	9,07	9,07	-	11,12	11,12
1994	-	245,55	379,54	-	165,25	189,30	-	58,59	76,22
1995	-	-3,62	362,20	-	-35,06	87,87	-	-13,48	52,47
1996	-	53,56	609,75	-	6,62	100,30	-	53,19	133,57
1997	-	-6,20	565,50	-	-4,10	92,00	-	34,40	213,80
1998	-	-19,14	438,13	-	-31,49	31,54	-	-38,4	93,27
1st Quar/99	6,81	6,81	474,80	11,91	11,91	47,20	12,47	12,47	117,36
2nd Quar/99	24,28	32,75	614,36	24,60	39,44	83,41	2,02	14,74	121,76
3rd Quar/99	3,17	36,96	637,01	-4,71	32,87	74,77	-7,41	6,24	105,34
4th Quar/99	49,42	104,64	1001,24	62,92	116,46	184,73	59,53	69,49	227,58
1st Quar/00	6,15	6,15	1068,96	11,53	11,53	217,56	7,08	7,08	250,77
2nd Quar/00	-2,43	3,57	1040,57	-6,26	4,55	197,67	-9,03	-2,59	219,10
3rd Quar/00	4,68	8,42	1093,99	0,88	5,47	200,31	-6,10	-8,53	199,63
4th Quar/00	-4,98	3,02	1034,53	-7,69	-2,63	177,23	-10,45	-18,08	168,33
1st Quar/01	-0,98	-0,98	1023,40	-10,06	-10,06	149,33	-16,00	-16,00	125,39
2nd Quar/01	-6,15	-7,07	954,28	-1,76	-11,64	144,95	-3,73	-19,14	116,97

(*) The Dynamo Cougar Fund figures are audited by KPMG and returns net of all costs and fees, except for Adjustment of Performance Fee, if due.
(**) Index that includes 100 companies, but excludes banks and state-owned companies. (***) Ibovespa average.

For any further information, visit our web site:

www.dynamo.com.br

DYNAMO

DYNAMO ADMINISTRAÇÃO DE RECURSOS LTDA.

Av. Ataulfo de Paiva, 1351 / 7º andar – Leblon – 22440-031
Rio – RJ – Brazil – Phone: (55 21) 2512-9394 – Fax: (55 21) 2512-5720