PERSPECTIVE

A Contrarian Case for Brazil

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Many investors in Brazil, including us, have been a little frustrated over the past couple of years with its lack of growth and progress. Gross domestic product (GDP) in Brazil grew a mere 0.2% in 2014 (estimated), a far cry from the 7.5% it saw in 2010.[1] However, we believe Brazil has all the elements in place to achieve much higher rates of growth if the political will is there.

My team and I traveled to Brazil in February to take a pulse-check of the business and economic environment there. We also had a chance to enjoy some post-work festivities at Carnival, where we could see the mood of the people there, too. I'm pleased to say that while Brazil certainly still has problems to work through, I'm a little more optimistic about the investment prospects there than I was six months or so ago—and that's partly because everyone else seems so pessimistic! As the late Sir John Templeton once said, "to buy when others are despondently selling and to sell when others are buying requires the greatest fortitude and pays the greatest ultimate rewards." As contrarian-minded investors, we are looking for individual opportunities in emerging markets that others may be avoiding, but where we think potential lies—including Brazil.

Some Key Advantages for Brazil

- It's the seventh largest economy in the world by GDP; sixth by population.
- Since 2003, some 36 million people have risen out of poverty and joined the ranks of middle class.
- Demographic trends appear favorable, with a median age of 30.7 years.
- Brazil's unemployment rate dropped below 5% in 2014, an historical low.
- It has a diverse economy with a wide range of natural resources.
- Education has been seen as a top priority; literacy rate is above 90%.

Sources: United Nations, "Recent Macroeconomic Trends in Emerging Economies and Implications," February 2014; CIA World Factbook, 2010 data; World Bank, 2013 data.

The press has battered Brazil over the past year for a number of reasons, including criticisms and protests tied to last summer's FIFA World Cup (mainly related to spending and preparations), a contentious election marked by the death of one of the favorite candidates and a narrow victory for incumbent Dilma Rousseff in October, and recently, a corruption scandal involving a major oil company there. All this is an important reminder of why we believe not only in the value of a bottom-up stock selection process in emerging markets, but also in active management; because we are not tied to a benchmark we can be a bit more nimble. I would note that while we are primarily contrarian, value-driven investors, it doesn't necessarily mean we automatically buy or add to our positions in an existing stock just because the price has dropped. If we see major problems and don't see long-term value we will look elsewhere. What it does mean is that we can see beyond short-term market shocks or negative sentiment that drag down the entire market, and focus on the companies we believe will survive and prosper long term. The key is to be patient.

Enjoying some free time at Brazil's Carnival

The positive result of market shocks like the corruption scandal in Brazil is that greater transparency and reforms tend to follow. We have been investing in Brazil for decades and have always felt that state-owned companies in Brazil had a poor track record when it comes to corporate governance. We hope that heightened attention on corruption will help ignite management changes at the corporate level, and ignite reforms at the political level. We were encouraged when we learned how the prosecutors in Brazil have been chasing after those suspected of corruption—and taking action. We would note, of course, that Brazil isn't the only country facing this type of problem; corruption is one of the biggest problems we face as investors around the world—even in the most developed markets.

Post-Election: Getting Down to Business

After winning a runoff election that was among the narrowest in Brazil's history last year, President Rousseff appointed a new economic team led by Finance Minister Joaquim Levy to help restore investor confidence; achieving a primary budget surplus of 1.2% of GDP has been set as a goal for this year. While I admit I may have been a little skeptical in the aftermath of the election that change would happen in Brazil, it does seem that its leaders have been working to improve its fiscal health with measures including tax hikes and removal of subsidies. I also think more spending cuts and a more business-friendly climate are important, too. In my view, the policies former President Fernando Henrique Cardoso adopted during his eight-year term in office, including privatization of state-owned enterprises, are a good model for Rousseff to now follow.

While results won't happen overnight, I believe in about five years or so (maybe even sooner), the investment and economic climate in Brazil should look much brighter than it has in the past couple of years for a number of reasons. First, the population in Brazil is young and getting better educated. This strong and growing consumer market is benefiting from the power of new technology, including mobile phone communications. Second, the recent investigations on corruption should bring impactful reforms in the country. I think Brazil's government will likely develop more efficient and effective policies as well as improving management at the state-owned companies. Third, Brazil has tremendous natural resources, both in minerals and agriculture. Finally, there are some terrific managers in Brazil capable of developing and growing not only local businesses but also moving into international markets.

Oil's Price Drop: Headwind or Tailwind for Brazil?

A sharp drop in oil prices over the past few months could be seen both as a headwind or a tailwind for Brazil. While lower prices result in lower oil export revenue for Brazil, the energy sector is actually a relatively small part of Brazil's economy, with oil rents representing only 3% of GDP (2012 data).[2] Brazil's state-controlled oil firm actually had to import oil at world prices and resell it at a government-capped rate (below costs) in order to keep inflation artificially low and shield domestic motorists from higher global prices. With oil prices falling, it will not have to resell its imports at a loss, which could be seen as a positive. At the same time, lower oil prices squeeze exploration and production revenues.

Lower oil prices could help spur greater economic growth generally in a number of countries that are net oil importers (including China and the United States), boosting consumer spending power and also potential demand for other products that Brazil offers. While exports accounted for less than 15% of GDP in total in 2013,[3] Brazil has a diverse list of key industrial and agricultural commodities that are in demand around the world, including not only oil but also soybeans, iron ore and sugar. In my view, if global growth improves as anticipated in 2016 by various forecasters, the price of a number of now-depressed raw materials will likely rebound and could boost the Brazilian economy; hopefully with other reform efforts in Brazil that should help drive foreign investment and instill confidence.

When we look at markets generally and think about where we should be going, as mentioned, we like to look at those places that are unpopular. And probably the most unpopular place in Latin America now besides Argentina and Venezuela would be Brazil. So in our minds, it probably deserves a closer look, particularly the consumer-oriented sectors that have seen slower earnings as per-capita incomes and consumer spending has stagnated. We are also looking at Brazil's banking sector right now which may offer good opportunities in the future.

For now, consumer spending remains a question mark, spending power is down and there is talk Brazil could fall into recession. Sentiment is quite bad right now, the stock market has been weak, and most business people we have spoken with in Brazil said this year would likely be quite challenging. Despite this, I'd like to point to a few reasons why investors should consider Brazil. Brazil has a vibrant, huge economy that we believe is destined to grow in the future despite the political and reform problems. Brazil's people are more vocal and activist-oriented, and we don't foresee the country as likely to head down the path of Argentina or Venezuela. Therefore, at this time we are actively looking to potentially increase our holdings in the country, particularly in world-class companies that previously were too expensive as well as others that we think have good prospects and appear to have solid management and little or no debt.

What Are the Risks?

All investments involve risks, including possible loss of principal. Foreign securities involve special risks, including currency fluctuations and economic and political uncertainties. Investments in emerging markets, of which frontier markets are a subset, involve heightened risks related to the same factors, in addition to those associated with these markets' smaller size, lesser liquidity and lack of established legal, political, business and social frameworks to support securities markets. Because these frameworks are typically even less developed in frontier markets, as well as various factors including the increased potential for extreme price volatility, illiquidity, trade barriers and exchange controls, the risks associated with emerging markets are magnified in frontier markets.

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1. Source: Central Bank of Brazil, December 2014.

2. Source: The World Bank, 2012 data. Oil rents are the difference between the value of crude oil production at world prices and total costs of production.

3. Source: The World Bank, 2013 data. Exports of goods and services (12.6% of GDP).