

DISCUSSION PAPER

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7th ANBIMA Investment Fund Congress

New Directions, New Outlooks

Antonio Filgueira and Caroline Jorge



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The Discussion Paper series will address topics related to the financial and capital markets, as well as document specialized debates at the Association's events and forums.

7th ANBIMA Investment Fund Congress

New Directions, New Outlooks

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Introduction

This first edition of the Discussion Paper series documents the debates at the 7th ANBIMA Investment Fund Congress held in São Paulo in May 2013. The main topics included ongoing innovations and the challenges faced by the fund industry due to the macroeconomic environment, characterized by historically lower interest rate levels, all of which has mobilized sector representative forums.

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The low level of interest rates in Brazil has brought new challenges for the local fund industry and should lead to structural and cultural changes, with the resizing of the profitability, liquidity and financial risk triad.

1. Executive Summary

The low level of interest rates in Brazil, the result of a lengthy stabilization process and structural changes in the economy, has brought new challenges for the local fund industry. A discussion of the impact of this new scenario, which has been mobilizing sector representative forums, underpinned the debates at the 7th ANBIMA Investment Fund Congress, held in São Paulo in May 2013. The issue has gained even more importance with the general consensus that the historically lower level of interest rates will prevail in the coming years. This assessment was ratified by the panel on the domestic and international economic scenarios, despite the short-term outlook, which is dominated by monetary policy adjustments to ensure compliance with the inflationary targets.

If confirmed, the medium and long-term scenario should act as a catalyst for change in the domestic fund industry. In general, the view is that the economic environment will lead to structural and cultural changes, with the resizing of the profitability, liquidity and financial risk triad. Investors and fund managers will be encouraged to extend terms, take on more risk and increase the diversification of their portfolios. From the asset management point of view, the main incentive will be the need to generate portfolio returns. This tendency will also require considerable fine-tuning of liquidity management in order to ensure compatibility between assets and liabilities, as well as greater specialization, in order to incorporate new products into the portfolios. Investors, for their part, will be forced to reassess their demand for liquidity and their tolerance for risk in the pursuit of greater returns, which will

The expected changes in the fund industry may require adaptations and improvements to segment legislation, given that the extension of terms and the increased share of private securities should bring further challenges in regard to liquidity management.

require careful planning and a broader process of financial education.

All these changes may require adaptations and improvements to segment legislation, given that the extension of terms and the increased share of private securities should bring further challenges in regard to liquidity management. In addition, increased diversification and the creation of new products will require the monitoring of additional risks, as well as more specialization on the part of fund managers and greater transparency for investors. The increase in the relative weight of operating costs in fund profitability against a background of low interest rates, has also fueled the debate over the industry's efficiency, leading to an evaluation of the structural alternatives prevailing in other jurisdictions. This is the case of the multiple class funds, which potentially lead to reduced costs through gains in scale, or exchange-traded funds (ETFs), which are being increasingly used as an alternative means of asset management, particularly in the United States.

The aim of this paper is to systematize the issues discussed at the 7th ANBIMA Investment Fund Congress. The event, held on May 14 and 15, 2013, was attended by asset managers, securities brokers, investors, government representatives and representatives of national and international regulatory bodies, as well as the Treasury Department, the BNDES and the World Bank. Following a presentation of the challenges facing fund managers and investors, we will present the debate on the need to adapt the regulatory framework, including in regard to structured funds and new products.

2. Macroeconomic Scenario

The consensus is that price stability in Brazil has reduced an important source of financial investment uncertainty.

In order to understand the challenges facing the fund industry and its future prospects, we must first examine the national and international economic scenario, which, in the final analysis, determines the environment in which the fund industry is forced to evolve. Consequently, the country's economic changes and the scenario foreseen by the agents in the coming years was also the subject of debate at the ANBIMA Congress.

The consensus is that price stability in Brazil has reduced an important source of financial investment uncertainty and created a more predictable business environment for investors. An economic policy based on a floating exchange rate, as well as primary surplus and inflationary targets, has proved to be highly successful in controlling prices and reducing the debt/GDP ratio, creating room for a substantial improvement in the profile of the public debt. These factors have helped strengthen the country as a destination for foreign investments, which, together with the improvement in the terms of trade, has helped reduce its external vulnerability, allowing economic policy to endure over time.

The result of this process was the development of a solid financial market supported by a consistent regulatory framework. Consequently, the Brazilian fund industry was able to confront the international financial crisis with lower managed asset losses than its peers in other jurisdictions, in turn permitting a rapid and sustained recovery. The strength of the economy also favored a reduction in interest rates to a level closer to the international standard. This new low-interest environment, in addition to helping the country confront the economic crisis that followed the financial one,

The high correlation between current domestic interest rates and the exceptionally low international rates is regarded as a risk factor in the midterm.

created opportunities and brought fresh challenges for the Brazilian fund industry.

In regard to the international scenario, according to Martin Feldstein, Harvard University professor and president emeritus of the National Bureau of Economic Research, the current global indicators are highly unfavorable and are pointing to exceptionally modest economic growth in Europe, China and the United States. If we factor in the Brazilian economy's sluggish reaction to the government stimuli in 2012, the international scenario ends up reinforcing the likelihood that Brazilian interest rates will remain low.

Nevertheless, increasing concern over inflation in the short term led the Central Bank to initiate an upward interest trajectory at April's Copom meeting, fueling uncertainties regarding the magnitude of the monetary squeeze. The high correlation between current domestic interest rates and the exceptionally low international rates, which will almost certainly return to normal levels at some time in the future, is regarded as a risk factor in the midterm, even though the consensus is that the domestic rates will not return to the exceptionally high levels of previous years.

In any event, all these changes appear to indicate the end of a period of comfort, when there were greater chances of reconciling high-return assets with liquidity and low risk. For the fund industry, these changes represent a need for diversification, greater risk assumption and greater portfolio duration in order to obtain higher returns. The gradual reduction in the portion of government bonds indexed to the Selic (LFTs) and other measures encouraging deindexation, such as changes in the rules of the open pension funds, have accelerated this process.

In addition to the reduction in interest rates, the distribution of wealth and the demographic change in the Brazilian population are also likely to impact the fund industry. The

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former has led to upward social and economic mobility which initially triggered an increase in consumption, but which also led to greater savings capacity and, consequently, a need to invest. For the fund industry, this process represents an opportunity in terms of potential new investors in the coming years. The latter change refers to the so-called “demographic dividend”, a historically singular occurrence as Eduardo Giannetti emphasized, when most of the population is economically active, generating income and with the capacity to accumulate capital. The outcome of this “dividend” is the inversion of the demographic pyramid, fueled by reduced fertility rates and an increase in the life expectancy of the population. In a context of exceptionally low interest rates, these changes reinforce the need to rethink the ways of allocating savings, particularly in regard to pensions, given the challenge of maintaining the living standards of the ageing population.

Consequently, the likelihood is that in this new and complex macroeconomic context, the fund industry will have to branch out in new directions and help investors to adopt new outlooks and solutions for their finances. This translates into challenges and opportunities for portfolio management, which will need to become increasingly sophisticated, and for investors, who will need to understand the different products and allocate their resources more effectively.

3. The Challenges for Fund Management

The industry's main challenge in regard to the new interest rate scenario appears to be how to reconcile the pursuit of higher profitability with the still high demand for liquidity.

Despite the lower level of interest rates and the likelihood that this situation will persist in the years ahead – notwithstanding the monetary policy adjustments – the lengthy period of inflation and the industry's important role in financing the public debt mean that portfolios are still prioritizing liquidity and that government bonds and/or repo operations involving these securities are still predominant. In fact, the industry's turnover is 140%, a rate that is only comparable to the U.S. Money Market funds, the most liquid in that market. This indicator, measured by the volume of redemptions over the industry's total assets under management in 12 months, shows how asset structure reflects the liquidity demanded by investors.

The industry's main challenge in regard to the new interest rate scenario appears to be how to reconcile the pursuit of higher profitability with the still high demand for liquidity, given the alternatives for generating greater returns. Assets with a longer duration, for example, add volatility to the portfolio, while private debt instruments can make pricing difficult since they are normally less liquid and with somewhat restricted market availability.

In any of these cases, there is an alteration in the funds' risk profile, which goes against Brazilian investors' aversion to risk and preference for liquidity. The modest share of equity funds in the Brazilian industry's total assets, one quarter of the global average, plus certain tax issues, also reflect this greater risk aversion.

In any event, with annual net sales averaging around R\$100 billion in recent years, it is likely that demand for assets will

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remain high. The portfolio share of private securities, especially debentures, is still small, given the relatively undeveloped secondary market and the consequent difficulty in pricing these assets. In addition, and thanks to restricted market availability, securities with healthy returns tend to be held until maturity, which also hampers growth of the secondary market.

Fund managers believe that, due to investors' low tolerance for volatility, the transition to longer-term and higher-risk investments will be a gradual one, but it is already under way, encouraged by regulatory stimuli. Due to the reduced liquidity of these investments, there is clearly a need for greater caution vis-à-vis product sales, a process to which not only brokers, but also the regulator and the self-regulator will have to remain alert.

Although the increase in demand for longer-term assets is a natural process against a backdrop of lower interest rates, managers will still have to respect mandates, given that around 90% of investment fund liabilities are of one day only, i.e. fund share liquidity is daily. In such a scenario, dealers have a fiduciary duty to educate investors and administrators will have to give the necessary support to increasing the share of private debt securities in the portfolios, maintaining the Brazilian market's high degree of transparency, and with prices that effectively represent these positions. The pursuit of greater transparency in regard to assets with reduced liquidity, or even illiquid assets, is what led ANBIMA to expand the pricing spectrum of private fixed income assets.

One other possible result of the reduction in interest rates and the consequent upturn in portfolio diversification is greater specialization on the part of fund managers. Although the differing strategies already applied to the balanced/mixed and equity categories reflect the industry's progress in recent years, the routing of managers towards different illiquid

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assets is a clear tendency, which will also require greater specialization on the part of these professionals. The existence of administrators in the Brazilian industry will, in turn, allow managers to concentrate their efforts on asset niches, further strengthening this tendency.

Another relevant issue is the concentration of clients in investment funds offered by banks, which is similar to the European model. For the managers, the current situation reflects the different possibilities for accessing the client base among the distribution channels. As the market becomes more sophisticated, with growing use of the internet as a means of distribution and the offer of products by the various asset managers, this concentration is expected to diminish, resulting in a shift towards the U.S. model, where asset management is much more fragmented. However, it is worth remembering that this same concentration has helped develop the institutional framework of the Brazilian fund industry. In addition, in the past, independent asset managers' products were only distributed through private banking. Now this has changed and banks appear increasingly willing to adopt platforms in a gradual process that is also affecting retail, increasing managers' responsibility for aligning products with the continuing process of investor education.

A survey conducted by ANBIMA in conjunction with the consulting firm Casey Quirk, which is specialized in asset management, revealed certain factors that are affecting the global asset management industry. These include low population growth, in turn resulting in more modest managed asset growth; globalization, which favors the expansion of managers with international products; volatile markets and the erosion of captive distribution, which favors the independent managers; and the adoption of alternative and passive portfolio strategies.

Management efficiency, measured by the ratio between the volume of assets under management and the number of employees, at first sight appears to leave the leading national managers extremely well positioned in relation to the global average.

In recent years, global funds and independent managers have shown the highest growth, led by Latin America and the Middle East. In Brazil, the survey showed that the main challenge, without doubt, is adaptation to the low interest scenario, which will also bring opportunities. As a result, 77% of national managers intend to expand their strategies, including internationalizing their portfolios, mostly involving the sale of Brazilian funds abroad (54%), although another relevant percentage intends to develop funds abroad for the allocation of Brazilian resources (31%).

Management efficiency, measured by the ratio between the volume of assets under management and the number of employees, at first sight appears to leave the leading national managers extremely well positioned in relation to the global average, in that they allocate proportionally less employees to distribution and the operational areas. However, the almost exclusive use of local assets, the so called *Kit Brazil*, simplifies management and may partially explain this result. As the industry diversifies, or becomes more globalized, it may be necessary to look again at this structure.

Casey Quirk believes that the volume of assets under management will continue to grow (32% between 2013 and 2017), driven by the open pension funds, in turn fueled by the demographic dividend that the country will continue to benefit from in the coming years. Secondly, it believes that globalization will constitute the main challenge and opportunity for national managers, driven by the reduction in interest rates. Finally, the survey envisages the adoption of a “guided” and less closed fund distribution framework, responsible for most of the funds’ costs. All these innovations should come from the supply side. i.e. as the initiative of the industry itself, rather than from the demand side, as in the United States.

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Some managers, however, believe that these changes will also be demanded by investors as part of the pursuit of higher returns. In this case, there will be a tendency towards the greater use of alternative products and global diversification, especially when one considers an efficient global frontier for investment. In the case of institutional investors, for example, the pursuit of better opportunities is part of their fiduciary duty and not to do so would constitute a dereliction of this duty. In the opinion of some managers, the creation of new domestic assets is also an option, as well as active portfolio management, which has already been generating positive results if one compares the performance of equity funds with that of the Ibovespa in the last 12 months.

In order to prepare for these changes, the industry will have to increasingly focus on its clients, identifying their needs, especially in regard to suitability, which also involves educating investors and a change in the investment culture towards a more long-term approach.

4. Investors

The culture of high liquidity and risk aversion constitutes a major barrier against the diversification and extended duration of investment portfolios, which is necessary to ensure higher returns.

From the investor's point of view, the fund industry's biggest challenge is to transform the culture of high liquidity and risk aversion. The comfort zone provided by high interest rates led to a conservative investor profile, accustomed to daily liquidity, low volatility and high returns. Consequently, the changes the industry will have to pass through due to the new macroeconomic scenario, will also involve an ample process of financial education for Brazilian investors.

Firstly, the liquidity culture constitutes a major barrier against the diversification and extended duration of investment portfolios, which is necessary to ensure higher returns. The current magnitude of daily liquidity, which is rare in the international industries, is seen by managers as an anomaly in the local industry, being wholly incompatible with the tendency towards market sophistication based on longer duration portfolios. A second locus for change is the intolerance of volatility. Currently, price oscillations trigger strong feelings of insecurity among investors, who respond to negative returns with rapid redemptions. In addition to jeopardizing portfolio composition, this behavior also harms investors, since they incur losses that could be neutralized or even reversed if the investment remained in place for a longer period.

Research by Wei Xiong, a professor at the University of Princeton, showed results that match the behavior of Brazilian investors. The research, based on behavioral finance theory, deals with the motives and emotions that tend to jeopardize investment decisions. Among these, he particularly drew attention to over-confidence, limited attention, excessive trading, especially in times of capital loss, and a tendency to extrapolate trends in the recent past into the future, without

According to professor Wei Xiong, the motives and emotions that can jeopardize investment decisions include over-confidence, limited attention, excessive trading in times of capital loss, and a tendency to extrapolate trends in the recent past into the future.

looking more deeply into the investment. He also cited excessive “patriotism”, expressed as a preference for investments in the investors’ own countries, resulting in home-biased portfolios that consequently fail to incorporate opportunities for potential gains in other markets.

Facing up to these issues requires a process of financial education and cultural transformation that results in a reassessment of individual liquidity demands and an understanding of volatility as an inherent element of a diversified and long-term portfolio. With the new level of interest rates, investors will gradually see the need to assume more risk and diversify their portfolios into new products in exchange for higher returns. In order to do so, it is imperative to realize that one’s objectives in life are not fungible and, consequently, cannot be packaged in a single investment. This portfolio allocation strategy should be slowly replaced by one based on different combinations of terms, risks and returns as a result of more sophisticated financial planning.

Although not immediate, these changes are already under way, especially among more sophisticated investors seeking new alternatives in differentiated products, based on information and independence. The fund managers emphasized that this should be a gradual process, with no undue surprises for investors, as well as highlighting the importance of the press in this process. The role of the fund industry is to ensure transparent information and give expert and customized advice regarding the needs of each investor, with an emphasis on asset allocation. A survey by McKinsey, a consulting firm, showed that there was a demand for advice even among more knowledgeable investors and that they were willing to pay for this service.

The task of brokers, therefore, is to present those products that are most suited to the needs of their clients, as well as making them permanently aware of the underlying risks and

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benefits. The expansion of privileged access to differentiated products and new types of higher-return asset should come about as a natural result of this new scenario. The impact of the reduced profitability of savings accounts and of CDI (Interbank Deposit Certificates), along with the consequent increasing concern with maintaining quality of life in retirement show that, despite the challenges, investors' knowledge, as well as their willingness to diversify their portfolios and assume more risk, will tend to increase. The introduction of education as one of the pillars of ANBIMA's strategic agenda will tend to fuel this process and contribute to a future scenario that is even more favorable to the fund industry in the coming years.

5. Regulation

One of the regulator's main worries is how to leverage the industry's performance without compromising security.

As we have already mentioned, the reduction in Brazilian interest rates has also resulted in a need to adapt the regulatory framework to cope with the incorporation of additional portfolio risk, either arising from extended duration or from the acquisition of new assets. In addition, the consequent reduction in profitability brings the subject of industry costs to the table. Consequently, one of the regulator's main worries is how to leverage the industry's performance without compromising security.

In the personal opinion of a CVM representative, the high number of fund categories in Brazil generates distortions for investors and results in a loss of scale, which in turn leads to less efficiency. Although the current framework offers investors greater security and transparency, the concentration of distribution among the banks and the large number of fund categories limit the industry's efficiency gains. Consequently, the main challenges facing the regulator are rationalizing the number of fund categories; altering the legal framework, since its basis – the legal concept of condominium – prevents the adoption of multiple class funds that permit gains of scale; and improving the distribution system¹, including, among other measures, allowing managers to sell fund shares directly.

The role of the various industry participants was also subject to reappraisal. The top of the pyramid is occupied by the administrator, who, according to the prevailing rule (article 56 of CVM Instruction 409) can contract service providers to perform the funds' other activities, including asset management. Recognizing the importance of the independent

¹ In November 2011, the CVM held public hearings on a proposed regulation to replace CVM Instruction 306/99, which governs fund administration and the distribution of fund shares. The Instruction has not yet been published, however.

According to Finra, the main ongoing trends in the U.S. include the rapid growth of ETFs (exchange-traded funds) and the creation of alternative investment funds.

asset managers could lead to more differentiated regulations, although this could also push up the industry's costs. In addition to management and custody activities, investor protection, management fees and performance fees are also on the Brazilian regulator's agenda.

According to the U.S. regulator, the Finra (Financial Industry Regulatory Authority), the main ongoing trends in that market include the rapid growth of ETFs (exchange-traded funds) and the creation of alternative investment funds; changes in the sales channels; potential changes to the Money Market funds; reduced costs and commissions; and the more frequent use of social media and crowdfunding, based on the JOBS Act² of April 2012, which may open the door to possible fraud in regard to private asset issues. In the specific case of the ETFs, the main growth drivers are lower operating costs and greater tax efficiency in the U.S., plus the possibility of intraday trading.

The representative of Alfi (Association of the Luxembourg Fund Industry), the world's second largest fund industry in terms of assets under management and the home of funds from more than 70 countries, talked about the challenges of adapting to the European regulations – UCITS³ and AIFMD⁴, and certain U.S. regulations (FATCA⁵), which require details on investments outside the United States, with consequent extra-territorial effects. In general, although these rules have increased the degree of control over the industry, in his opinion, they did not always result in greater efficiency.

² Jumpstart Our Business Startups Act, which aims to encourage the capitalization of small businesses by loosening the securities regulations.

³ Undertakings for Collective Investment in Transferable Securities Directives, a group of rules authorizing collective investment structures to operate freely throughout the EU based on authorization from a single EU member.

⁴ Alternative Investment Fund Managers Directive, which regulates alternative investment fund managers (basically hedge funds and private equity funds).

⁵ Foreign Account Tax Compliance Act, which requires U.S. citizens to furnish information on financial accounts outside the United States and requires foreign financial institutions to furnish information on their U.S. clients.

Increased portfolio exposure to international assets will require greater attention to risk control, as well as responsibilities in regard to distribution.

In the opinion of the managers, the high number of funds and fund categories in Brazil is definitely a major challenge and is already being discussed in working groups specially set up by ANBIMA for this purpose. The main issue here is the trade-off between transparency and simplicity. In relation to transparency, the huge diversity of categories and types helps investors to understand the fund's main risk factors. On the other hand, a lower number of categories would ensure greater simplicity and increased scale.

The other regulatory challenges include the adoption of the multiple class fund framework in Brazil, which will involve altering the prevailing legislation, and increased management sophistication involving a greater degree of internationalization. Increased portfolio exposure to international assets will also require greater attention to risk control, as well as responsibilities in regard to distribution.

In regard to creating new rules for fund managers, essentially in response to their increased responsibilities, there was a consensus that the introduction of minimum capital limits for these institutions could restrict competition which nowadays is extremely healthy and has helped the industry diversify. The separation of functions within the industry was considered important for ensuring greater specialization, sophistication and control, especially in terms of the back-office.

The managers also singled out tax issues as one of the challenges for the industry's development, including six-monthly income tax on investment funds (except those with an equity content of at least 67%), the so-called *come-cotas*, which, by anticipating income tax on income not yet perceived by the fund shareholder, reduces final returns for the investor, distorting comparisons with other assets. Another issue mentioned was the asymmetry of tax treatment meted out to direct investments in equities and investments in equity funds by non-resident investors. In practice, the current rule, which

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exempts capital gains by non-residents on direct investments in equities, but taxes the same investments if made through an equity fund, basically means the exportation of national management, with a loss of the transparency provided by the regulatory and operational framework guaranteed by Brazilian legislation, with no corresponding gains in tax revenue.

Although the best means of adapting the legal framework to the new economic environment is not yet clear, given the substantial challenges ahead, there is a clear consensus over the need to further increase cooperation between the regulator and the self-regulator in order to find the best solutions. In this context, both ANBIMA and the CVM are moving in the same direction.

The challenges for managers and investors include the incorporation of new products into fund portfolios, such as structured funds.

6. Diversification and new instruments

In this period of transformation for the fund industry, the challenges for managers and investors, as we have mentioned, include the incorporation of new products into fund portfolios, such as structured funds. The degree of development of these markets varies in line with their specific characteristics and their windows of opportunity. Below we present the main topics, in the view of the agents, debated at the Congress.

6.1 Exchange-traded funds (ETFs)

The panel on exchange-traded funds (ETFs), in addition to analyzing the use of the product in Brazil and the world, also presented and debated the project for the first fixed-income ETF in Brazil, supported by the World Bank and with the Treasury as sponsor.

Although most ETFs are based in Europe, the U.S. accounts for the largest share of global volume, with around 75% of total assets under management. Due to high growth in recent years, this comes to more than US\$2 trillion, or more than two times the total volume of the entire Brazilian fund industry, which in turn represents 3.19% of the global industry's total assets under management. In regard to the product's

There is plenty of room in Brazil for the development of new products, especially in regard to structuring foreign index and fixed income ETFs.

distribution per type of asset, equities lead with 59%, followed by commodities, with 19%, and fixed income, with 15%.

In Brazil, where only ETFs pegged to equity indices are regulated⁶, there are 15 funds listed on the Exchange. Whereas in the United States ETFs account for around 10% of total assets under management, in Brazil the ratio does not exceed 0.15%, underlining the product's enormous growth potential. As for the pegs, the Ibovespa responds for around 90% of ETF traded volume in Brazil. In the U.S., however, trading is much more evenly distributed, with the S&P 500 representing 48% of the total, international index ETFs for 17%, and other ETFs for 35%.

Consequently, there is plenty of room in Brazil for the development of new products, especially in regard to structuring foreign index and fixed income ETFs. In the first case, a fund share acquisition and redemption model is currently being discussed. In the second case, the Congress was presented with a pilot program by the World Bank, which, together with the Brazilian government, plans to develop fixed income ETFs with government bonds in emerging markets in order to promote the development of the local-currency securities market.

In order to render the projects feasible, three initial conditions are necessary: a minimum breakeven size; minimum secondary market liquidity; and an adequate legal, tax and regulatory structure. The World Bank and the Treasury's participation in the project aims to establish a market structure that is both viable and appropriate for the new product, as well as ensuring a fair and efficient market from the investor's point of view.

⁶ After the 7th ANBIMA Investment Fund Congress, on September 16th, 2013, the CVM issued Instruction 537, which permitted and regulated the constitution of fixed-income ETFs.

According to the Treasury, the idea is that the Fixed Income ETF will become yet another instrument for consolidating prefixed and price index benchmarks in the Brazilian fixed-income market.

The project, which was developed in conjunction with financial market entities, envisages the direct involvement of the issuer (the Treasury) in its creation, from the choice of the benchmark (aligned with its objectives, the provisioning of public bonds, with the direct sale of securities in accordance with the fund benchmark and the market price, with no subsidy, ensuring that the fund is totally replicable and liquid right from the start), to the issuer's possible future operation, if there is great demand for the fund's growth.

From the Treasury's point of view, the main challenges for the public securities market are deindexation; transparency; liquidity and diversification. Consequently, the idea is for the ETF to become yet another instrument for consolidating prefixed and price index benchmarks in the Brazilian fixed-income market, contributing to the deindexation process and aligned with the aims of the PAF (Annual Federal Public Debt Financing Plan). In addition, there are expectations of opportunities for arbitrage between the prices of the securities making up the index and the market price of the fund shares, thereby helping increase the liquidity of the underlying public securities. Other expected effects include the dissemination of the index as a result of market trading, with the expansion of the investor base and the dissemination of prices, fueled by the pursuit of intraday price references of the public securities for the pricing of the fund shares being traded.

The Treasury's participation should facilitate the creation of an ETF with a substantial initial volume, eliminating the need for the acquisition of a diversified portfolio by the fund manager and the allocation of seed capital⁷. The securities will be issued in favor of the ETF at market prices, thereby eliminating exposure to higher spreads in the case of the less liquid assets. In addition, the higher initial volume will allow the manager to reduce the payback⁸, possibly resulting in

⁷ A company's initial capital.

⁸ The time needed to recoup the investment.

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lower management fees for the investor. By strengthening the fixed income references, the project is also expected to encourage the liquidity of private securities.

In this context, the IMA (ANBIMA Market Index) and its components, a family of indices constructed through an agreement between ANBIMA and the Treasury, are natural candidates for use in fixed-income ETFs, thanks to their representativeness (around 98% of the public debt) and their extensive use by investment funds. In addition, in recent years the secondary market has developed due to the increased trading of long-term assets pegged to the IPCA consumer price index.

The norm governing these funds was the object of public hearings by the CVM⁹, which were concluded in October 2012, and the regulation of the fixed income ETF is expected to be published in the coming months. The World Bank and Treasury project envisages a bidding process to determine the fund manager and a special issue of off-the-run securities specifically for this end. The international experience, discussed by the panel, recommends clarity in regard to product regulation, thereby avoiding the grouping of different products (for example, spot market and derivatives), accompanied by transparency for investors and high-quality assets.

⁹ SDM Public Hearing Notice 8/2012.

6.2 Private Equity Funds (FIPs)

The entry into effect of the ABVCAP/ANBIMA Code for the FIP and FIEE market has enabled the creation of a database of these assets.

In March 2011, the ABVCAP/ANBIMA Code for private equity funds (FIP) and emerging company funds (FIEE) came into effect. Among other points, it established the need for registration and delivery of information, enabled the creation of a database of these assets, increased transparency and expanded the possibilities for market analysis. By April 2013, the database contained 545 registered funds and a further 26 under analysis, representing practically all the funds registered with the CVM. Of this total, 286 funds are restricted, i.e. 50% or more of their asset value is held by a single fund shareholder. The remaining 265 are diversified, i.e. comprising a plurality of fund shareholders.

Although 2011 and 2012 were marked by the growing incorporation of funds into the Association's database, and, therefore, may not reflect tendencies with absolute precision, the 2012 figures point to a 30% increase in committed capital, i.e. the sum of the total amount invested and the balance available for new investments. They also show that the volume of national capital exceeded that of foreign capital, a tendency led by pension funds and other domestic investors. Investments grew by 25.5% in 2012, led by the infrastructure sector, with the other sectors presenting relative stability in their proportion of investments over the year before. Divestments totaled around R\$6 billion, 66% up on 2011. Although they recorded a decline in comparison with the other modalities, divestments through stock-market IPOs still accounted for the greater portion (46%), followed by sales to strategic investors (24%).

In addition to presenting the FIP and FIEE market panorama, the panel also dealt with investments in certain sectors of the Brazilian economy.

In addition to presenting a segment overview based on the new database, the panel also dealt with investments in certain sectors of the Brazilian economy.

In regard to agribusiness, an important sector in Brazil's economy, the panel presented the local sector's comparative advantages in a global context characterized by scarce water and declining agricultural yields. In this sense, Brazil is exceptionally well-positioned, especially due to its abundance of water, its climatic variety (the so-called latitude effect), the availability of arable land, the existence of rigorous environmental protection laws and the incorporation of new technologies by Embrapa, allowing two annual harvests without irrigation. By presenting specific cases, the panel demonstrated the investment theses and the process of value creation. The basic agribusiness strategy consists of acquiring land with good soil and attractive prices in regions with easy access or with prospects of improved logistics, factors which make the structuring of sector FIPs an attractive option.

Necessary investments in the infrastructure segment are estimated at R\$100 billion per year, 38% of which financed by own capital, 37% by the BNDES and 10% by the foreign debt. The remaining 15% (or R\$15 billion) represents an opportunity for senior debt funds, subordinated debt funds and private equity funds.

In the education sector, the panel highlighted the need for risk diversification through the acquisition of different categories of assets: basic education, post-secondary education and unregulated education (e.g. language schools), as well as educational content and technologies. It was shown that there was a strong movement in the digital media sectors, expanding the possibilities of international operations. The panel also presented four perspectives for the sector: universal access to quality education; education financed by

FIP managers cited the increase in domestic consumption, sustainable comparative advantages and the country's improved infrastructure as being among the main investment pillars in Brazil.

the capital market; digitization and the use of technology in education, with the propagation of knowledge; and globalized education. The possibility of arbitrage between listed and unlisted companies was also mentioned.

The panel also dealt with the health sector. In this case, the reasons for investing were based on the growth of domestic consumption, in turn based on increased earnings and credit, which should ensure the sector's sustainable growth in the coming years.

In short, the managers cited the increase in domestic consumption, sustainable comparative advantages – associated with abundant natural resources and the freeing up of global trade – and Brazil's improved infrastructure as being among the country's main investment pillars. In regard to value creation, the panel highlighted the need for growth fueled by sector consolidation, the strengthening of financial management teams, corporate professionalization and the creation of boards of directors, the streamlining of operating and financial processes, and the establishment of formal goals.

Following the issue of CVM Instruction 531, managers expect the FIDCs to record a better performance in 2013.

6.3 Credit Receivables Investment Funds (FIDCs)

As mentioned in the 14th ANBIMA Panorama¹⁰, 2012 was not a good year for the FIDCs, which reported annual net redemptions of R\$5.3 billion, largely due to problems with specific funds and regulatory changes, such as the new rules for disclosing financial information and accounting statements (CVM Instruction 489).

However, with the issue of CVM Instruction 531, following a meticulous analysis of the FIDCs' weaknesses through dialogue with the market, managers expect these funds to record a better performance in 2013, gaining in importance as a Brazilian capital market securitization instrument. The Instruction calls for improved controls on the part of the administrator and the leading service providers, with a much clearer definition of respective responsibilities. The alterations are designed to mitigate the conflict of interest associated with the undue concentration of functions by a single participant and ensure good governance for these vehicles.

Some of the most important changes refer to the outsourcing of services. The specialized consultant that used to analyze and select the receivables to be acquired will now only help the administrator/manager in the analytical process. Checking through sampling, which previously had no defined periodicity, will now take place every quarter and will include all replaced and defaulting credits. In addition, it will now be possible to contract third parties not linked to the originating assignor, consultant or manager, to hold the documents, which previously had been the sole prerogative of the custodian. Finally, service providers and related parties are

¹⁰ Cf. <http://portal.anbima.com.br/informacoes-tecnicas/estudos/panorama/Pages/panorama-anbima.aspx>

*According to the
CVM's IR
Superintendent,
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now barred from directly or indirectly assigning or originating credit receivables for the funds¹¹.

As a result of these regulatory changes, the outlook for 2013 is an optimistic one. Demand for the first public offering of FIDC shares within the orbit of CVM Instruction 531, concluded last March, exceeded supply, indicating an apparent improvement in the instrument's risk perception. According to the CVM's IR Superintendent, Francisco Santos, the new instruction offers investors greater security and any eventual increase in operating costs will tend to be offset by fewer demands for compensation by investors and gains in scale from the sustainable growth of the securitization industry in Brazil.

In a scenario of credit expansion and portfolio diversification, the outlook becomes even more positive. On the one hand, investors will perceive the improved level of governance and will put more trust in this market; on the other, latent demand for FIDCs by the assignors of credit constitutes an opportunity for fund managers, given the product's attractive risk/return ratio.

¹¹ For more details on the changes envisaged by CVM Instruction 531, see ANBIMA's FIDCAbridged Legislation at: <http://portal.anbima.com.br/informacoes-tecnicas/legislacao/sumulas/Pages/default.aspx>

One essential condition for fueling Brazilian economic growth is the availability of long-term financing to ensure sufficient funding in regard to volume, rates and terms for the investments, especially infrastructure projects.

6.4 Infrastructure Investment Funds

Thanks to the new macroeconomic scenario characterized by lower interest rates, there is now room for increased investments and more pronounced economic growth in Brazil. As mentioned on ANBIMA's portal¹², one necessary condition for this virtuous scenario is the guarantee of adequate funding in regard to volume, rates and terms, for the investments, especially infrastructure projects, whose maturation period is normally lengthy. Currently, investments in this sector represent around 2% of GDP, versus the estimated 4% needed to ensure an adequate level of international competitiveness. This corresponds to an additional R\$2.5 trillion over the next 25 years, or R\$100 billion per year.

¹² Cf. <http://portal.anbima.com.br/informacoes-tecnicas/estudos/financiamento-de-longo-prazo/Pages/default.aspx>

The reasons for investing in the infrastructure sector are based on its attractive returns, its low correlation with economic and market cycles, as well as with returns from other investment assets, predictable and stable cash flows, and the fact that such investments act as a hedge against inflation and as a natural hedge against long-term obligations.

Consequently, there is a clear need for financing to fill the country's existing infrastructure and logistics investment gap. In addition to financing by the banks, both public and private, the panel argued that financing through capital market debenture issues was a potential and viable alternative. In a period in which portfolio diversification is becoming increasingly important, the reasons for investing in this sector are based on its attractive returns, its low correlation with economic and market cycles, as well as with returns from other investment assets, predictable and stable cash flows, and the fact that such investments act as a hedge against inflation and as a natural hedge against long-term obligations (ALM¹³ for pension funds).

Given the sector's investment needs and these advantages, government tax incentives to encourage the construction of a private long-term financing market, as per Law 12.431 of 2011, are absolutely essential. Article 2 of this Law calls for tax exemption/reductions on debentures with specific compensation characteristics issued by SPEs constituted to implement infrastructure investment projects considered to be a priority by the government. The complementary regulation for these infrastructure debentures was the object of Decree 7.603 of November 9, 2011, which stated the conditions governing project priority and the respective issue of debentures eligible for the benefits (total income tax exemption on earnings by individuals and a 15% rate for legal entities).

Article 3 of the same law deals with the possibility of creating infrastructure funds, whose advantage, in addition to the same tax benefits conferred on the underlying assets, lies in the existence of a manager specialized in analyzing the operations in question. Given the difficulty of investing directly

¹³ Asset Liability Management – the integrated treatment of assets and liabilities in order to minimize the risk of portfolio mismatches.

The limited offer of assets and the low volume of issues still constitute a challenge to the development of the infrastructure funds, especially in regard to attracting foreign investors.

in the debentures due to the complexity of the analysis involved, the presence of a specialized manager will tend to increase investor access, especially in the retail segment. The extension of the tax breaks to non-resident investors will also tend to strengthen the market, although greater standardization, transparency of information and due diligence will still be essential in order to attract such investors to this type of investment.

Of the 33 projects approved and prioritized by the government, eight have already resulted in debenture issues totaling R\$2.35 billion. The limited offer of assets and the low volume of issues still constitute a challenge to the development of the infrastructure funds, especially in regard to attracting foreign investors. For managers, the creation of funds without the guarantee of new issues represents a major source of insecurity. The liquidity of the underlying assets is also considered to be another source of uncertainty preventing more distinct market progress. Given the limited offer and the advantages associated with the securities, their holders will tend to opt for carrying to the detriment of trading. However, the current level of trading can be considered to be satisfactory and it is worth noting that one of the debenture issues (CART12) is among the ten most traded on the market. In addition, given that total investments in the authorized projects are estimated at around R\$68 billion, this market has enormous potential, both in terms of issues and trading, which, together with tax breaks in a climate characterized by the pursuit of higher returns, should ensure favorable prospects for the consolidation of funds pegged to these assets.

6.5 Real Estate Investment Funds (FIIs)

The real estate market is expanding in a balanced manner, constituting an investment opportunity, especially through funds, thanks to income tax exemption on the returns of individual investors.

Public offerings of real estate investment funds have been growing recently and the agents expect 2013 will be as good as, or even better than 2012, which was itself a record year. The monthly trading of fund shares, although still low, is also growing. As for the real estate market, which generates the assets to which the funds are pegged, although certain segments and regions are appreciating rapidly, the consensus is that we are not heading for a bubble. The real estate market as a whole is expanding in a balanced manner, constituting an investment opportunity, especially due to income tax exemption on the returns of individual investors¹⁴.

The market's low correlation with short-term economic oscillations was singled out by one of the managers as an advantage of the product. As an example, he argued that although an interest rate shock leading to a lengthy economic slowdown would certainly affect the real estate market, short-term interest cycles would not have the same effect. In addition, returns from funds generating earnings from rent, indexed to the IGP-M, are protected from inflation.

Even though the IFIX¹⁵ is recording higher growth and is less volatile than the Ibovespa at the moment, it is worth warning investors that the real estate segment does present volatility. Given that most Brazilians regard property as a secure and

¹⁴ In order to qualify for tax exemption, the fund must have at least 50 shareholders, each of whom may not hold more than 10% of the fund, and fund shares must be traded exclusively on the stock exchange or the organized over-the-counter market. Legal entities will pay 20% income tax on their returns, the same rate attached to the sale of the fund shares (capital gains tax – Law 11.033, art. 3º, III).

¹⁵ The BM&FBovespa Real Estate Investment Fund Index (IFIX) measures the performance of a portfolio comprising shares of real estate funds listed on the BM&FBOVESPA. These shares are selected for their liquidity and weighted in the portfolio by their total market value (total number of shares issued multiplied by their latest market price). Source: BM&FBovespa.

Private banking investors, who are more specialized, are already procuring the FIIIs as an alternative investment, chiefly due to the associated tax benefits.

non-volatile asset, managers should advise investors of the sector's distinctive dynamics, with its price swings and associated risks.

Still on this point, there is a consensus among industry players that the risk of disinformation is greater in the retail segment, where investors are often unaware that the fund is only a vehicle and that they are not investing directly in a property. Thus the development of this market will necessarily involve educating investors. As this process moves ahead, the retail FII market will tend to be highly favorable, given the strong appeal engendered by investors' proximity to the underlying asset.

Private banking investors, who are more specialized, are already procuring the FIIIs as an alternative investment, chiefly due to the associated tax benefits. Of the half trillion reais in segment resources invested in funds, 1.4% are allocated to the FIIIs and this ratio will almost certainly move up. Investors' main worry in this segment is not the possibility of a real estate bubble, but rather the possibility of vacancy associated with economic cycles, impacting returns from the rent-based FIIIs. This is also a concern for managers, who will be using all their expertise to ensure decisions that leave investors feeling comfortable.

Finally, institutional investors, also more specialized, see the market as an excellent opportunity for diversification. Although still somewhat insecure, given the sector's incipient development, these investors are aware that they have been slow in routing resources to real estate funds and expect to step up their investments substantially – between 3% and 5% of total institutional fund investments, are expected to be allocated to the FIIIs in 2013. The message of the managers is that latent demand represents a major growth opportunity for institutional investors, most of whom are already preparing internally for such a move.

The recent introduction, in June 2013, of a chapter on the FII's in ANBIMA's Fund Code, will tend to encourage good governance practices and help the product's sustainable growth.

To sum up, the growth foundations in this market niche, as in the others, are based on educating investors and aligning the supply of products with their risk profiles. Nor are the difficulties in regard to governance and decision making trivial ones. However, the recent introduction, in June 2013, of a chapter on the FII's in ANBIMA's Fund Code, will tend to encourage good governance practices and help the product's sustainable growth. With increasing investor interest, the future could well be bright.

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7. The Challenges for Pension Funds

The Brazilian complementary pension fund industry has current assets of close to R\$1 trillion, around 70% of which managed by investment funds. The reduction in interest rates and the recent changes in the regulations and configuration of these segments have generated a series of challenges for the coming years.

7.1 Closed Plans

In the case of the closed pension plans, which are worth almost R\$700 billion and involve around 6.8 million individuals, there has been a change in relations between investors, managers and regulators, as well as in the way the plans are apportioned, with a clear migration from the DBs to the DCs. At the end of 2012, the plans were distributed as follows: DB – Defined Benefit (386 plans, or 30%); VC – Variable Contribution (380 plans, or 30%); and DC – Direct Contribution (519 plans, or 40%). An analysis of the interest rate trajectory of the DB plans shows a reduction in the maximum rates adopted since 2008. In the latter year, 73% of the plans adopted an actuarial target of 6% p.a.; by 2012, however, this ratio had fallen to 17%. In the same period, plans with an actuarial target of up to 5% increased from 21% to 53%.

In regard to portfolio asset distribution, R\$270 million is invested in public securities, the portion invested in private securities has moved up slightly and the equities portion has

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remained flat. Currently, the regulations state that technical reserves have to be invested in six distinct segments, it being increasingly necessary to seek out differentiated returns. In December 2012, 61.7% of assets under management were allocated to fixed income, 28.6% to equities and the remaining almost 10% to alternative investments¹⁶. However, if we exclude the equity investments of the three leading pension funds (Previ, Petros and Funcef), the concentration in fixed income increases substantially.

The reduction in interest rates and the issue of CNPC Resolution 10/2012¹⁷, which extended the life expectancy used to calculate benefits and established a gradual reduction in the actuarial target, pushed the complementary pension plan segment into a management adjustment phase. As a result, the operators are being forced to alter their benefit plans, migrating from the DBs to the DCs, undertake portfolio adherence studies, and increase risk and product diversification.

The concentration of public securities in EPFC portfolios should give way to other strategies with the help of regulatory changes and the increasing share of private securities. A survey by ABRAPP (the Brazilian closed pension fund association) showed that managers plan to expand their portfolios' share of private securities in the next 12 months, while reducing their share of public securities. In the case of the DC and VC plans, they also intend to expand the equity and structured fund portfolio. As a result, managers will have to adopt an increasingly long-term view beyond their respective mandates.

¹⁶ Figures from ABRAPP's Consolidated Statistics, available at: <http://www.abrapp.org.br/SitePages/ConsolidadoEstatistico.aspx>

¹⁷ CNPC Resolution 10/2012 altered the actuarial table of the EFPCs (complementary pension plan operators) to AT-2000, reducing the maximum interest by 10% and adopting a declining rate of 5% to 3.5% between 2012 and 2018.

Even in years of crisis, as in 2008, the PGBLs and VGBLs recorded net sales, being regarded by participants as a long-term investment.

All these factors imply that investors will want more information on their pension investments. In this context, they should be made increasingly aware of what type of returns they are obtaining, i.e. if returns are truly earnings or the result of portfolio pricing. As this information becomes more clear and investors gain a new outlook on the need to save for future expenses in a low interest environment, so will pension funds add more value to their participants. This process will also require managers to undergo a re-education process, so they can develop a better understanding of their investors' needs and adapt to the new low interest scenario. With this in mind, Previc (the pension fund regulator) will be concentrating its efforts on training managers and board members, especially in regard to risk analysis and how to generate added value in the long term, unlike previously when the forward-looking horizon was no longer than five years.

7.2 Open Plans

Although the open pension plan industry is comparatively recent – the flagship PGBL and VGBL products were created in 1998 and 2001, respectively – the segment is already worth around R\$300 billion. Since these products were created there has been a mutual learning period for managers and participants. Even in years of crisis, as in 2008, the PGBLs and VGBLs recorded net sales, being regarded by participants as long-term investments.

There is also the benefits and insurance segment, so it is necessary to think of returns in an integrated manner, including the four markets (capitalization, insurance, reinsurance and open pension plans). The challenges, in

It was suggested that the rules of the open and closed plans be standardized, with greater alignment between products and consumer profiles.

addition to low interest rates, which is common to all the industry's segments, include two specific regulation-associated issues. One is the adoption by Susep (the insurance regulator) of risk-based capital models, which should increase the amount of capital required, given that the more profitable portfolios will also require riskier assets. In addition, National Monetary Council Resolution 4176, which calls for lengthening the average maturity of the pension fund portfolios, implies more volatility, so investors will have to change their habit of checking their fund shares on a daily basis and develop a tolerance for the volatility of their investment. By instituting a calculation of the average portfolio term, the Resolution created further challenges, such as limiting managers' conditions to protect investors in a scenario of upward interest rates, given that the average fixed income beta is higher than in other industries. It was therefore suggested that this calculation of the average term should apply to the entire portfolio, including (appropriately weighted in the calculation formula) equities and other long-term investments, given that they have the longest average term and a structured and fully operational secondary market.

It was therefore suggested that the regulators and the participants rethink the industry, both in terms of redemption terms and higher exposure to equities, and that the rules of the open and closed plans be standardized, with greater alignment between products and consumer profiles, given that different rules hamper management and the understanding of participants.

In regard to suitability, the creation of the "qualified Investor/participant" concept was recommended, as occurs in other investment industries, enabling increased diversity and a wider range of products, including those geared towards investors more willing to assume the risk/return ratios inherent to longer-term investments.

In regard to suitability, the creation of the “qualified Investor” concept was recommended, as occurs in other investment industries, enabling increased diversity and a wider range of products.

It was further proposed to segregate provisioning funds for insurance, capitalization and reinsurance, while open pension plan resources would be separated into the following types: qualified participant; life-cycle pension funds, and the traditional plans, based on funds specially constituted for this purpose.

8. Conclusion

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Despite the series of challenges imposed on the fund industry by the current scenario, the debate at ANBIMA's 7th Investment Fund Congress, which also included discussions on the various structured funds and new products, left a clear message of optimism. On the one hand, Brazil is passing through a unique period in the history of a nation, the so-called "demographic dividend". This means that the majority of the population is economically active, generating income and accumulating capital, especially pension-related resources, favoring the continuation of the fund industry's growth trajectory observed in recent years. On the other, we have the successful and internationally recognized history of the Brazilian fund industry, which lost the least resources during the last international financial crisis and was the quickest to recover, thanks to a sophisticated and robust infrastructure, underpinned by talent and innovation.

In conclusion, the industry has the necessary foundations to enable managers and investors to overcome the challenges associated with extended duration and the assumption of new risks. For the managers, the ability to generate liquidity and reconcile assets and liabilities will become increasingly important, while investors will have to seek more information and reassess their demand for liquidity. Against a background of a consistent regulatory and self-regulatory framework, this process, which is already under way, will tend to consolidate as rapidly as the industry players adapt to the changes and implement the necessary improvements in association with the regulator.