

PENDO LLC



THE VALUE INVESTOR

## **International Core Value Strategy Quarterly Commentary Q2 2009**

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### **BRAZIL: POISED FOR 'REAL' GROWTH**

There are a few economies of the world that are better positioned to recover from the continuing global economic crisis quicker than others. These countries share a few major, general attributes: good fiscal policy, a disciplined long-term approach, an expanding domestic economy, and the needed 'fuel' (energy, commodities, labor, etc.) to stoke their economic engine. One of the countries that we think will not only recover sooner than others, but actually help lead the rest of the globe out of its "Great Recession" is China (see Q1 commentary). Another is the subject of this quarter's commentary: Brazil.

It was not long ago that much of Latin America was ruled by dictatorships, and struggled economically under extreme socialism. Today, with notable exceptions, democracy and capitalism thrive. Brazil itself was ruled by a series of feckless governments since WWII, until a military junta seized power in 1964. It was not until 1988, when the Federal Constitution was enacted, that democracy was firmly established. Brazil is now governed by a presidential system. Characterized by large and well-developed agricultural, mining, manufacturing, and service sectors, Brazil's economy outweighs that of all other South American countries, and Brazil is expanding its presence in world markets. Today, Brazil is the world's fourth largest democracy and tenth largest economy.

Under the rule of current President Luiz Inácio Lula da Silva, Brazil's economy has made massive strides. President Lula, a fiscal conservative, has helped the country react and recover quickly, and through sound fiscal policy has prepared the economy to prosper and grow for many years to come. GDP grew at 5.1% in 2008. Consensus opinion is that the Brazilian economy will contract by one-half of one percent this year, although increase by 3 to 4% in the second half; 4.5% growth is expected in 2010. We expect a mild, but positive growth for this year, somewhere between 1 and 2%. In fact, for the first quarter, GDP shrank 1.8%, against a -2.8% median consensus estimate.

Even in the current environment, Brazil's economy is already responding relatively well. They fared better than most in the economic downturn, thanks to prudent government actions. As the fear of a US/global depression has diminished, lending rates have been pulled back, encouraging investment. While the US has its eyes trained downward, scouring the landscape for the highly elusive 'green shoot', Brazil is looking straight ahead, and powering their economy forward. This year has seen 3 interest rate cuts, with record low borrowing costs helping the economy expand while still slowing inflation, as well as pushing the currency up 19% vs. the dollar YTD. The Brazilian real is in fact the second-best performer

of the 16 most-traded currencies in the world vs. the US dollar for this year. Unlike the US, they had virtually no exposure to the banking crisis, as they had kept their interest rates and lending requirements high to discourage speculative lending. The current money stimulus and reduction of debt is expanding the domestic economy, mitigating the effects of contracted exports in some sectors.

In 2007, they launched a \$300B plan to upgrade and expand their infrastructure, modernizing road networks, power plants, and ports. Rich in natural resources, they are not only well positioned to expand their infrastructure, but to profit from the rest of the developing world doing the same, China included, by being a primary exporter of commodities such as copper, iron ore, steel, and ethanol. The 2007 plan has recently been supplemented by new spending initiatives, on projects such as low income housing, along with tax cuts on construction materials as well as automobiles. Unlike the US, Brazil does not need to print money or run up huge amounts of debt to fund their stimulus. Their increased spending is cushioned by the \$200B (and growing) of foreign reserves accumulated over the last few years.

In a concerted effort to make themselves more attractive to foreign investment, the *Comissao de Valores Mobiliarios*, or CVM (the Brazilian version of the SEC), is taking pre-emptive measures and tightening regulations in order to improve disclosure and protect investors, and instill confidence within the investment community (meanwhile the SEC, despite numerous warnings over the years, finally took the bold move of barring admitted Ponzi-schemer Bernard Madoff from the securities business in *mid-June of 2009*). Within Brazil, the \$600B mutual fund industry has been two-thirds invested in government bonds. With interest rates declining, fund managers are making a huge re-allocation into equities. The CVM has taken a bold, proactive position, which should further help the already admirable reputation of the Brazilian market. Indeed, VisaNet just successfully completed the world's biggest IPO in over a year, raising \$4.2B. This should spur other companies to raise capital, increasing investment along with foreign reserves.

A primary exporter of commodities, Brazil also became a net energy exporter last year. Leading the way is Petrobras, the state run oil company, who has discovered huge reserves of oil (and natural gas) offshore in the Carioca and Tupi fields in the Santos Basin. Estimates are as high as 33 bbl of high-quality reserves exist, which would represent the third largest discovery ever, and the largest in over 60 years. The Carioca field alone may contain more reserves than the entire United States.

If one reads traditional Wall Street research, one would find that most Brazilian companies, regardless of their balance sheet or valuation, are rated 'risky'. Although we acknowledge that Brazil is technically an emerging market, and overall riskier than developed markets, we also believe that there are exceptions to this generalization. Finding those exceptions allows us to make investments, at the current depressed prices, in companies that we believe have little downside and great upside. Our value approach affords us a margin of safety to our downside, and enables us to purchase a 'value' security in a 'growth' market.

Like China, Brazil suffered last year in part due to massive misunderstanding and fear. After a huge run-up, once the markets started to contract, people abandoned what they least understood. Since emerging markets are sparsely followed and not always well-interpreted (generally, if they are being followed at all, it is by a junior analyst), they tend to move *en masse*. If 'Brazil' is falling, people will sell everything 'Brazil'. In most cases, no attention is paid to individual companies or their correlation (or lack thereof) to each other or other markets in general. Our biggest risk then becomes one of time, and not fundamentals.

In the years between 1990 and 2000, only 20% of mutual fund dollars were invested in foreign-oriented vehicles. By 2007, as often happens, people were chasing a bubble, pouring twenty times as much into

foreign. As the appetite for risk dropped, a massive retreat took place. This collapsed the Brazilian benchmark IBOVESPA index 57% from its 2008 highs, in only five months (May-Oct.) in 2008. They have recovered somewhat from this over-reaction and panic, and are up 37% for 2009, and 65% from the lows of 2008 (these numbers, if not the exact time frame, closely parallel China).

The majority of the companies in our portfolio not only do not conduct business with the United States, but do a majority of their business in their own country (and currency). A fall-off in exports to the US would not affect these companies. We saw the collapse in prices as an opt-in point, giving us a greater margin of safety. We decreased our cash position, and added additional equity positions to the portfolio. Those non-correlated companies in non-correlated markets, China and Brazil in particular, have been the first to recover, and are driving performers to date.

\*Representative composite stocks:

CIG, PBR, BVMF3.SA, AGRO3.SA (held through CRESY)

We at Pendo LLC hope that this review is of help to you, and will better enable you to understand our thinking and strategy.

Sincerely,

Tina Larsson  
CEO  
Lead Portfolio Manager  
Pendo International Core Value Strategy

Mark J. Foley  
President  
Pendo LLC  
Pendo Capital LLC

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