Investing in Latin America's Growth Centers

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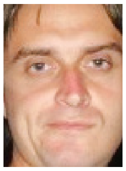

When looking at analysts long term forecasts for the Latin American region, most of the bullish arguments center on the elevated commodity prices we are currently seeing, stable foreign investment inflows, and sustainable levels of available international credit. These factors have been the main drivers in the region's improved growth rates for the last decade and recent reports from the IMF suggest that there is little evidence that we will see prolonged periods of slowdown as long as Latin American governments continue to invest revenues in ways that are economically sound. As a whole, the Latin American region has decreased its debt-to-GDP ratios by roughly 15 percent, as many of these countries have replaced national deficits with

surpluses and improved on regional poverty levels (by nearly a third) in the last 10 years.

Most of the region's growth has come from commodity exports, with some of the key examples seen in countries like Argentina (producing soybeans and grains), Uruguay (producing beef and rice) and Peru (producing copper and gold). External influences are also present, however, as expansionary government policies in Argentina, greater domestic demand in Uruguay, and increased foreign direct investment in Peru have also helped to increase productivity levels.

The Expanding Middle Class

Another highlight of the Latin American progress story can be seen in its growing domestic consumption levels and the rapid expansion of its middle class. Some of the best evidence of this expansion can be seen in the substantial increases in both mortgage applications and approvals with Chile, Mexico, Brazil, Colombia, Uruguay, and Peru all seeing gains of at least 15 percent in the last 10 years.

Not all economies in the region display the same characteristics and advantages, however, as distinctions can be made between those countries considered to be commodity exporters with financial integration in the global markets (Brazil, Chile, Colombia, Uruguay and Peru), and those which have not yet reached this level of assimilation (Ecuador, Argentina, Paraguay, Bolivia, and Venezuela). Of course, economic progress favors investments in the financially integrated group as lower inflation levels, stronger macroeconomic management, and improved savings rates suggest a more stable economic performance going forward.

GDP Expectations for 2012

While it can be argued that the second group has so far been unable to take full advantage of international financing and commodity demand, the real economic test for the region's performance prospects will be seen if external economies experience further deterioration, lending costs increase or if commodity demand declines. But since the economic ties between Latin America and Europe are much looser than what is seen in Asia and North America, there are strong prospects for end-of-year GDP results that are higher than what most analysts are expecting.

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With these factors supporting long term prospects in Latin America's companies, investors are likely to gravitate toward value opportunities seen in closed-end funds with heavy exposure to the region. Here we will discuss three potential investment choices for clients, all of which are well-positioned to capitalize on the advantages seen in the region while still trading at attractive discounts to NAV all three cases. We will look at

the Latin America Equity Fund, The Chile Fund and The Mexico Fund to identify investment opportunities in companies likely to benefit from Latin America's main growth drivers.

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Economic Environment in the Second Quarter

Looking at the market activity seen into the end of the second quarter, Latin American equities were, for the most part, higher (matching trends seen in emerging markets as a whole) as risk sentiment improved and investors moved out of safe haven assets to look for higher returns in a more stable financial climate. Mixed results in commodities markets led to somewhat similar results in the broader South American economies as gains were strongest in Chile and Mexico while GDP growth in Argentina and Brazil (the main laggard of the group) slowed on weaker export sales.

At the national level, inflation increases in Mexico were balanced by moderating consumer prices in Chile and Brazil, but central banks in all three areas left interest rates steady during the period. In Mexico,presidential elections brought the Institutional Revolutionary Party to power for the first time in 12 years (creating the possibility for reforms in the fiscal and energy sectors) and Colombia and Peru finalized a trade deal with Europe to boost agricultural and mining exports to the region.

The Impact of Central Bank Actions

As the pace of economic activity varied throughout the Latin America, central bank activities also showed some significant differences in policy approaches. On the positive side, strength was seen in Mexico and Chile as exports rebounded along with improvements in manufacturing activity while Peru's main economic indicators benefited from government stimulus programs. In contrast, growth figures in Argentina and Brazil were negatively impacted by declines in export activity.

In light of these factors, policy intervention picked up in various areas across the region. Specifically, central banks in Chile and Brazil reduced interest rates, sending lending rates in Brazil to a new record low at 8.5 percent. Additionally, the Brazilian government extended tax cuts on consumer goods in an effort to support local manufacturing activity. These measures are coming along with strategy moves to help stem the value of the Brazilian Real (keeping export products at attractive prices), so the stage is set for foreign demand to improve in the coming quarters.

The Latin America Equity Fund

When looking for investment funds that are well-positioned to capitalize on these factors, one standout choice can be seen in the Latin America Equity Fund (LAQ), which has a clearly established record of buying high-quality companies at reasonable valuations. "When we talk about quality, we're talking about fairly straightforward things" said Nick Robinson, Portfolio Manager of the Latin America Equity Fund at Aberdeen Asset Management, in a recent interview. "Essentially, we define quality companies as those with strong balance sheets, limited debt levels, transparency in quarterly earnings results and a stable record in terms of cash generation."

When looking to invest in high-quality companies a key factor to watch is long term viability and the ability to remain relevant in a changing consumer environment. For example, wired telecom companies (which are more likely to become outdated and uncompetitive) are less preferable than wireless telecoms. Since the companies in the Latin America Equity Fund tend to show a strong focus in this area, the next issues to watch (when looking at trans-national funds) are seen in the valuation calculations, which must run across borders and take trends in all emerging markets into consideration.

Looking at some of the specific investment choices in the Latin America Equity Fund, it becomes clear that a central focus is on the middle-class consumer in Brazil and the continuing growth trends in this area. With formerly lower class consumers seeing substantial increases in disposable spending power, companies catering to this demographic will likely see a strong tailwind going forward. Roughly 35 million new middle-class consumers have been created in Brazil in the last decade, so some of the Latin America Equity Fund's investment choices (such as Lojas Renner, a Brazilian department store formerly owned by J.C. Penney) are well-positioned to capitalize on these factors.

In other Fund-related developments, recent stories have centered on Vale, a Brazilian miner, which was granted a preliminary license to develop the 90-million-ton-a-year Serra Sul project in the Amazon. The project is significant not only because the Serra Sul project is the the largest iron ore mining project in the company's history but also because of this year's rally in commodities (and specifically in manufacturing materials), which will likely lead to large increases in Vale's profit potential in 2013.

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The Mexico Fund

Another fund to watch is The Mexico Fund (MXF), which is more specific in its geographical focus and is positioned to benefit from the shift to positive growth that has been in place since 2010. Mexican GDP rose by 3.9% during 2011 and 4.6% during the first quarter of 2012, well above recent quarterly growth levels in the US (which have come in at roughly 1.7%). The figures are impressive, given the level of risk aversion that is still present in equity markets and this strong performance will likely be supportive for the Mexico Fund as well.

During the first half of this fiscal year, the Fund's market price saw returns of 10.82%, with the Fund's NAV per share generating returns of 12.96%. To gain some perspective on this performance, these returns can be positively compared with NAV per share returns registered by the Morgan Stanley Capital International (MSCI) Mexico Index and the Bolsa IPC Index, which came in slightly lower at 11.02% and 11.97%, respectively.

Even with the enhanced volatility that was seen during the period, the Fund has elected to continue with its Managed Distribution Plan in 2012, at the annual rate of 10% of NAV per share. During the first half of 2012, the difference between the Fund's market price and its NAV showed an average discount 8.3%, and reached as high as 9.3% at the end of April. Positive trends are becoming apparent when looking at these measures, as the discount was seen at 7.25% at the end of the 2011 fiscal year and has shown stable improvement since then.

In terms of potential outlooks, there are some positive factors that should continue to support the region and The Mexico Fund itself, as Mexico's stable macroeconomic framework has shown greater resilience than many other economies in dealing with fiscal and solvency problems that have become apparent in many areas around the globe. This is due, in large part, to the country's healthy public sector finances, which show only a modest fiscal deficit (2.5% of GDP), robust GDP growth (5.4% and 3.9% in 2010 and 2011), and large increases in Trade Balance activity (exports and imports rose by 17.2% and 16.4% in 2011). With Mexico's economic resilience and stable bond markets, direct foreign investment remains healthy and prospects for the region's equity markets look strong.

Aberdeen Chile Fund

Equity markets in Chile rose into the end of the first half of the year as interest rate cuts in China helped to bolster an already strong rally in commodities and coordinated efforts in the Eurozone to calm troubled debt markets helped to support foreign trade prospects. Chilean GDP growth came in at 5.6% for the first quarter, as fixed capital investments were one of the period's main economic themes. Chile's central bank held interest rates steady at 5% as inflationary pressures eased and the country's labor market showed additional signs of improvement.

To gain exposure to these developments, the Chile Fund (CH) is one option, as its investment strategies focus on companies that are well-positioned to benefit from the domestic demand created by Chile's expanding middle-class. At the moment, the Fund's positioning is overweight consumer cyclicals and the financial sector but additional positions in Chile's low-cost producers of commodities (such as pulp and fertilizers) are held as well. This high level of diversification provides a solid layer of protection against potential volatility in any one of these areas.

Looking at recent developments directly related to companies held by the Chile Fund, Banco de Chile secured a three-year credit line from China Development Bank (valued at US$150 million). This enhancement of available capital comes after the bank raised US$145 million after issuing 1.1 billion shares of stock as a means for financing future growth projects. In other sectors, Copec (an energy and forestry company) announced plans to buy Canada's Flakeboard (a product panel manufacturer) for US$ 242 million. Key benefits of this purchase include the fact that dampen the negative effects of cyclicality in the pulp industry and enhance overall production capacity for future project developments. With these supportive stories on the company level and the strengthening economic environment in the region, the Chile Fund is positioned to make favorable progress in the coming quarters.

Attractive Valuations and A Strong Macro Picture

Performances seen in Latin American equity markets during the first half of the year suggest that a long term bottom is in place after the bearish moves seen in 2008. A strong macroeconomic picture, supportive monetary moves from several central banks and massive rallies in commodity markets have tuned analysts forecasts positive for the region and this is expected to continue as long as all of these trends continue. External risks could be seen if materials demand in the Eurozone begins to weaken. But given the fact that Latin America is far less dependent on the Eurozone when compared with other major export markets, investors can limit their risk levels and capitalize on commodity market rallies by focusing on the Latin American region as a stable and sustainable alternative. ■