IN BRAZIL, HIGH INTEREST RATES MAKE CURRENCY INVESTING THE REAL DEAL

Ambar Bajaj — Senior Solutions Specialist – ETF Model Portfolios
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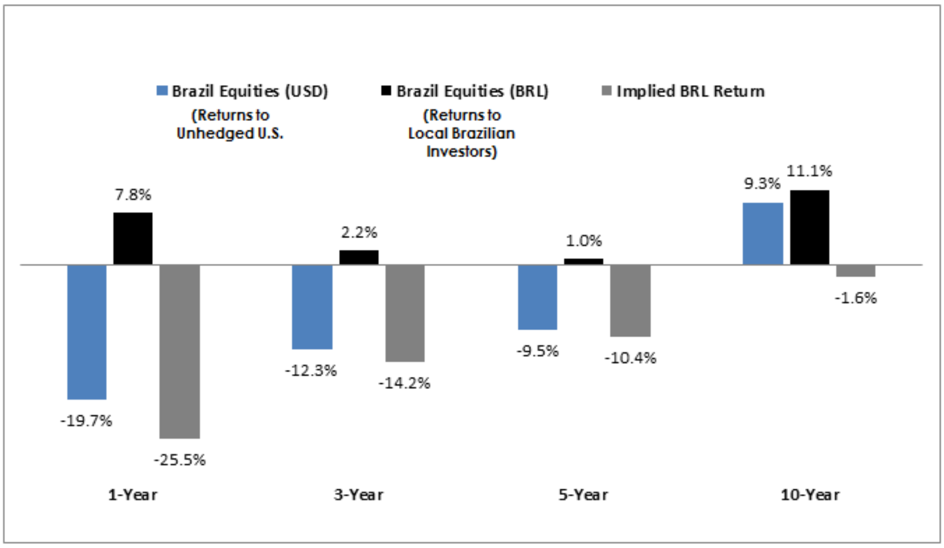
Brazil is at a tipping point. After a corruption scandal, four years of stagnant growth and the stifling effects of political largesse on the economy, markets have been hit hard, with currency, bond and equity markets posting some of the weakest performance in emerging markets (EM) over the past few years. However, with the rebound in oil and a slight pickup in corporate confidence, some investors are starting to see opportunity in the beaten-down valuations embedded in Brazilian assets. Additionally, the Brazilian Central Bank has been taking measures to control inflation and bring stability to the currency by raising Brazil's overnight lending rate to 13.25%.[1]

The question for investors when investing in Brazil is whether it is better to invest in the equity markets or directly in the currency. While many investors may lean toward equities, it is important to note that returns on the Brazilian equity market have been largely dominated by returns on the currency itself.

Brazilian Market Annualized Returns (April 30, 2015)



Sources: WisdomTree, Bloomberg, 4/30/15.
Brazil equities in USD and BRL are represented by MSCI Brazil Total Return Index USD and MSCI Brazil Total Return Index Local, respectively. Implied BRL return refers to the computed currency return implied by the difference between the USD and local currency returns of the MSCI Brazil Index. Past performance is not indicative of future results. You cannot invest directly in an index.

For definitions of indexes in the chart, please visit our glossary.

From the start of the large-scale downturn in April 2011, Brazilian equities, proxied by the MSCI Brazil Index, are down 44.8% through April 30, 2015.[2] What some investors may not realize, however, is that during the same time, the Brazilian real has fallen 47.7%.[3] Over the last 10 years, Brazilian equities alone returned 11.1% annually, but they were dragged down by a 1.6% loss in the currency, for a total return of 9.3%. And over the last five years, Brazilian equities returned 1% per year but were dragged down by a 10.4% loss in the currency. This similarity in returns is not a coincidence.

As WisdomTree has written about at length, to U.S. residents investing internationally, currency returns simply cannot be ignored. The real is no exception. The currency hit a low of 3.29 real versus the dollar on March 19, a level not seen since March 2003. While it has since rebounded from its lows, the real, currently at 3.01, is still below its 100-day moving average of 2.90 and well below its 200-day moving average of 2.66.[4]

However, with the real at such levels, we believe that there may be some opportunities for contrarian investors who are looking to increase allocations internationally. Higher interest rates in Brazil may prove more fruitful for currency investing than for equity investing.

Higher interest rates create two problems for equity investing: (1) They provide a significant hurdle for investors to hedge out the currency exposure of equities. (2) The "equity risk premium" must offer compelling returns ahead of that 13% interest rate to motivate investors to choose equities over keeping money in short-term deposits.

Investing in foreign currencies, especially in the Brazilian real, isn't just about sport currency return. The currency's carry, or implied yield due to interest rate differentials, has averaged over 10% over the past 10 years and currently stands at roughly 13%.[5] Therefore, investing in Brazilian currency forwards, versus just spot currency, boosts an investor's return profile dramatically.

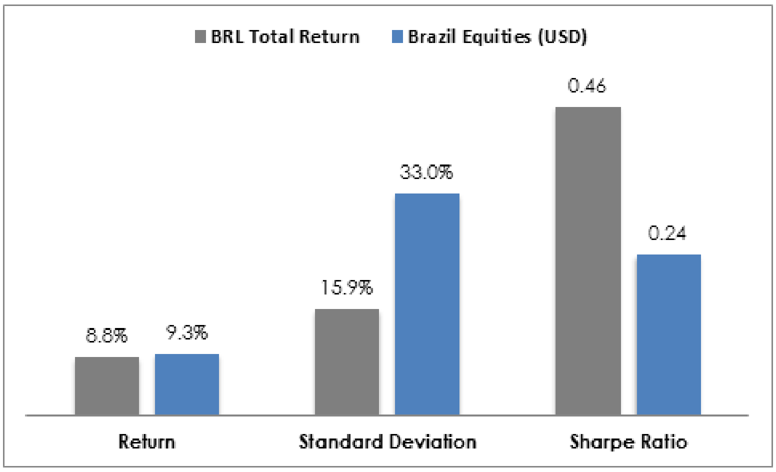
While the spot currency return was -1.6% annually over the 10-year period ending April 2015, when interest income is included in forward contracts, an index of Brazil currency and interest rates returned a positive 8.8% percentage points annually over the same 10 years.

Equity-Like Returns with Less Volatility

The long-term data show that investing in a Brazilian real currency strategy provides comparable returns to investing in Brazilian equities—but with markedly less volatility. To U.S. investors, the majority of these returns came from the currency, while the volatility came from *both* the currency and the stocks themselves.

As shown in figure 2, by eliminating the equity portion of the equation and investing in a fully collateralized portfolio of Brazilian real forwards, an investor can capture almost all of the returns of investing in the equities with less than half of the volatility. The Sharpe ratio, or risk-adjusted returns, of this proposition seems to favor investment in the real as a vehicle for Brazilian exposure.

Annualized Total Return (April 30, 2005 - April 30, 2015)



Sources: WisdomTree, Bloomberg, Zephyr Style Advisor, 4/30/15.
BRL Total Return is represented by the JPMorgan ELMI+ Brazil Index, which tracks the total returns for local-currency-denominated money market instruments in Brazil by using 1-, 2- and 3-month currency forwards collateralized with U.S. money market rates. Brazilian Equities (USD) is represented by the MSCI Brazil Total Return Index USD. Past performance is not indicative of future results. You cannot invest directly in an index.

For definitions of terms in the chart, please visit our glossary.

History suggests that the Brazilian real offers a compelling risk-adjusted return profile for investors who are looking for exposure to non-U.S.-dollar-denominated assets.

[1]Source: Banco Central do Brasil, 4/29/15. [2]Source: Bloomberg, 4/30/15. [3]Source: Bloomberg, 4/30/15. [4]Source: Bloomberg, 5/18/15. [5]Source: Bloomberg, 4/30/15.

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DEFINITIONS

Valuation : Refers to metrics that relate financial statistics for equities to their price levels to determine if certain attributes, such as earnings or dividends, are cheap or expensive.

Inflation : Characterized by rising price levels.

MSCI Brazil Index : Index weighted by float-adjusted market capitalization designed to measure the performance of the Brazilian equity market.

Real interest rate : Interest rate accounting for the impact of inflation. From the nominal interest rate, which does not account for the impact of inflation, the rate of inflation is subtracted to get to the real interest rate.

Hedge : Making an investment to reduce the risk of adverse price movements in an asset. Normally, a hedge consists of taking an offsetting position in a related security, such as a futures contract.

Risk premium : Equity investments are not risk free, but it is thought that investors buy stocks because the returns they expect are high enough to allow them to take the risk.

Short (or Short Position) : The sale of a borrowed security, commodity or currency with the expectation that the asset will fall in value, the opposite of Long (or Long Position).

Carry : The amount of return that accrues from investing in fixed income or currency forward contracts.

Implied yield : The annualized rate of return generated by a fund's investment in forward currency contracts. The calculation is intended to show the yield of forward currency contracts, assuming that foreign exchange rates remain constant.

Forward multiple : A valuation ratio that reflects a company's value on the basis of an estimated financial metric, i.e. forecasted earnings performance.

Volatility : A measure of the dispersion of actual returns around a particular average level. .

Sharpe ratio : Measure of risk-adjusted return. Higher values indicate greater return per unit of risk, specifically standard deviation, which is viewed as being desirable.