MANNING AND SZABO REDUCE RISK AS OIL ROUT RAVAGES LATIN AMERICA

Aberdeen Latin American Income was badly hit by the oil price crash and the Petrobas scandal but its managers have reduced energy exposure and increased that to fixed income

JENNIFER HILL

The oil price crash has given Aberdeen Latin American Income investment trust a torrid time, but its managers hope their sale of Petrobras, the corruption-hit Brazilian energy company and once the trust's largest holding, and an increase in fixed income allocation will stem losses.

The Latin American stock market previously benefited from the commodities super cycle. The MSCI Emerging Markets Latin America index returned a total of 885% in sterling terms from the start of 1999 to its peak in January 2011, but things have changed markedly since.

Unloved region

'There's huge potential for capital appreciation in Latin America, but as a region it is even more volatile than global emerging markets and has been pretty unloved for the past three years, significantly underperforming other emerging markets,' said Fiona Manning, a senior investment manager at Aberdeen Asset Management and manager of the trust's equity holdings.

'It's suffered quite a lot, not just from [the downturn in] commodities, but also from the lack of maturity of the equity market,' she said. 'It's quite dependent on foreign flows and, over the past five years, we've seen outflows to developed markets, particularly the US.'

Aberdeen Latin American Income

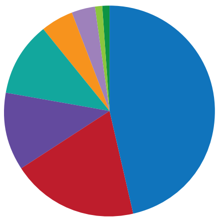
Sector: Latin America

Discount to NAV: 8.5%

Market cap: £42 million

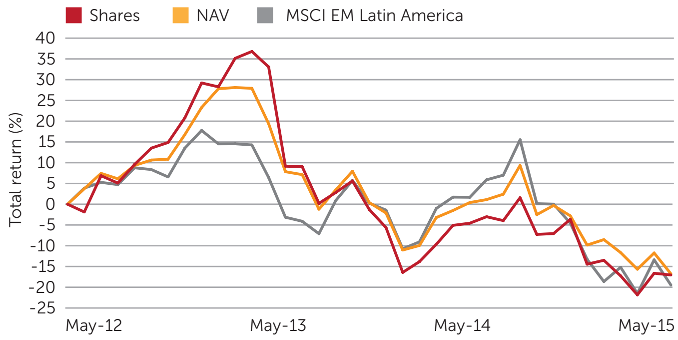
Net yield: 7%

GEOGRAPHIC BREAKDOWN



Brazil	46.6%
Mexico	19.3%
Uruguay	12.1%
Columbia	11.4%
Peru	4.9%
Chile	3.7%
Argentina	1.0%
Cash	1.0%

THE TRUST HAS BEEN HIT HARD BY LATAM ECONOMIC TURMOIL



TOP FIVE EQUITY HOLDINGS

3.6%	Banco Bradesco
2.9%	Itaú Unibanco
2.1%	Vale
2.0%	Lojas Renner
1.8%	FEMSA

TOP FIVE FIXED INCOME HOLDINGS

10.5%	Uruguay (Rep of) 5% 14/09/18
10.0%	Brazil (Fed Rep of) 10% 01/01/17
9.9%	Colombia (Rep of) 9.85% 28/06/27
7.3%	Brazil (Fed Rep of) 10% 01/01/25
4.7%	Mex Bonos Desarr Fix Rt 8% 07/12/23

Weakness in emerging market currencies since mid-2011 has also hurt the performance of Aberdeen Latin American Income's high-conviction portfolio, which has just 53 holdings and hedges neither equity nor fixed income exposure.

The trust has made losses of 17.1% in share price terms and 16.8% in net asset value (NAV) terms over the past three years, against a 19.5% drop in the MSCI Emerging Markets Latin America index. Since inception, its share price is down 23.5% and NAV 15.5%, compared with a fall in the index of 26.8%.

Losing on Petrobras

The slump in commodity prices affected the fund badly. 'It was a huge shock for the whole LatAm region, where lots of countries are dependent on commodities,' said Viktor Szabo, senior investment manager of fixed income at the trust.

In response, and as the region entered a period of lower growth, the managers sold Petrobras at a significant loss at the end of last year. They also started to reposition the trust to have most of its assets in fixed income holdings, a process that continued into the start of this year.

Petrobras ADR preference shares were trading on the New York stock exchange at $26.73 when the trust launched on 16 August 2010, but had fallen to $7.58 by the end of 2014, by which time the trust had exited its position. Last week, shares in Petrobras, whose total debts of $170 billion (£107 billion) make it the third-most indebted non-financial company in the world and the biggest debtor in the oil industry, were trading at $8.65.

Despite reducing its weighting to energy stocks from 17% of the equity sleeve in October 2013 to 5.9% today, taking it from an overweight position versus the index to an underweight, the trust still holds pipeline manufacturer Tenaris and Ultrapar, the Brazilian petrol station and convenience store operator.

With a sharp rebound in commodity prices unlikely to

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>
> **Fiona Manning** Aberdeen Asset Management

SZABO: Has upped holdings in Brazilian bonds

BRAZIL BLUES: The trust has been increasing allocation to the country, spotting value despite the deep recession

materialise, Latin American countries will 'have to live with a lower commodity price environment', which has tempered long-term economic growth from 5%-7% to 3%-4% and 'potentially lower for Brazil', said Szabo.

Tilting to bonds

The trust is required to have at least 25% of assets in equities and 25% in fixed income. At its launch, its allocations were 60% equities and 40% fixed income. Today, that position has reversed.

Despite Brazil's woes – Latin America's biggest economy is expected to shrink by 1% this year, the deepest recession in 25 years, and unemployment is rising, with inflation running at more than 8%, almost twice the official target – Szabo sees value and has been increasing allocation to the country, which now accounts for more than a third of fixed income holdings.

He argued the current recession was a necessary but temporary evil. 'The country has to go through recession, and it's happening now,' he said. 'We've been increasing exposure as the fiscal adjustment programme is being implemented.'

The trust holds a mixture of Brazilian fixed rate government bonds, with average coupons of 10%, and index-linked government bonds.

One-fifth of fixed income holdings are in Uruguayan index-linkers, which pay close to 12% due to inflation running at around 8%, while less than one-fifth are in Mexican fixed-rate bonds, paying around 6%.

Equities opportunities

Despite the trust's retreat from equities, Manning is finding opportunities in consumer-related stocks and retail banks, having added Arca Contal, the Mexican snack and beverage business, and Santander México, the Mexican unit of Spanish bank Santander, in the first quarter of this year.

'Typically, banks in the region are very profitable and have avoided blow-ups with regard to non-performing loans. They're generally quite conservative in lending,' she said, citing other bank holdings as Brazil's Banco Bradesco and Itaú Unibanco.

Looking ahead, the managers expect volatility in LatAm equities to continue, but point to the trust's rosy 7% net yield. The trust benefits from a carry trade in borrowing at an average variable rate 'well below' that. Gearing is currently around 18% against a maximum 20%.

'We've produced a steady flow of income in a declining interest rate environment: that should be appreciated by investors,' said Szabo.

ADVISERVIEW

RODDY KOHN
Managing director, Kohn Cougar

> I'd expect volatility to increase further in Latin America

Aberdeen Latin American Income is pretty unique as an investment trust because it combines a predominantly fixed interest exposure with equities. It is benchmarked against a composite index, though the portfolio deviates considerably from this with a view to outperforming. On a positive note, the trust yields an attractive 7%. However, in total return terms it has underperformed the benchmark over all time periods.

Aberdeen launched the trust in August 2010 and, if you were unfortunate to have bought it, you'd be staring at a loss of nearly 24% today.

Evidence suggests it is difficult for active managers to outperform the Latin American index even over the long term, so I see little value in choosing an active over a less expensive passive strategy.

Half of the MSCI Latin American index is invested in Brazil, which has growth and inflation issues of its own, and when the US starts to tighten monetary policy further, I'd expect volatility to increase further in Latin America. Investors in the region should be happy to take on a lot of volatility and hang on to their investments for the long term.

ANALYSTVIEW

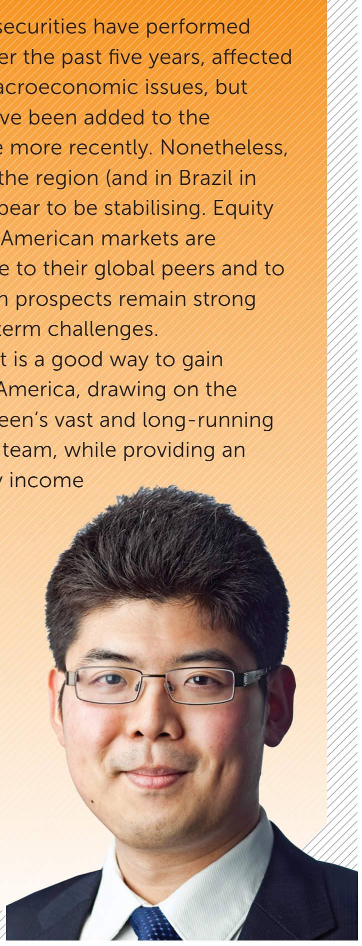
CHARLES TAN
Investment companies analyst, Cantor Fitzgerald

Aberdeen Latin American Income presents a unique proposition for investors, providing them with a means of gaining exposure to the Latin American market via a diversified mix of equity and debt.

The trust currently has a fully covered dividend yield of around 7%, paid quarterly, which most investors should find attractive in the current low-yield environment. This source of income should help smooth out returns in what has traditionally been a volatile market, and reward investors for their patience while they wait for a longer-term recovery.

Latin American securities have performed disappointingly over the past five years, affected by a number of macroeconomic issues, but political factors have been added to the underperformance more recently. Nonetheless, conditions across the region (and in Brazil in particular) now appear to be stabilising. Equity valuations in Latin American markets are inexpensive relative to their global peers and to history, and growth prospects remain strong despite the short-term challenges.

Overall, this trust is a good way to gain exposure to Latin America, drawing on the expertise of Aberdeen's vast and long-running emerging markets team, while providing an attractive quarterly income alongside an appropriately cautiously positioned portfolio.



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