The Investment Fund Industry in Costa Rica

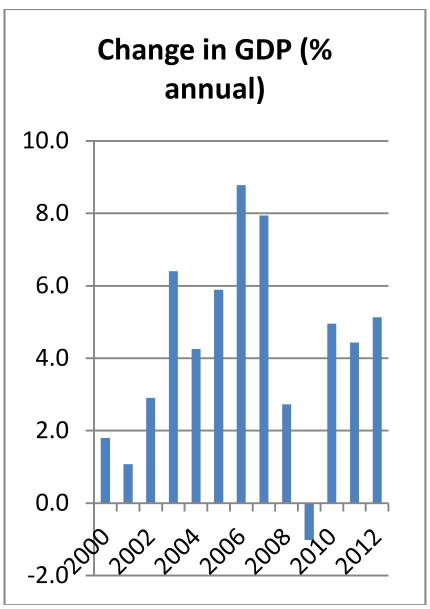
Costa Rican Socioeconomic and Geographic Profile

Costa Rica is located in the Central American isthmus, bordering both the Caribbean Sea and the North Pacific Ocean, between Nicaragua and Panama. The country's total area is 55,400 sq Km (roughly 21,390 sq miles) and its topography is mostly mountainous with alternating lowlands throughout its coastlines.

Costa Rica has a population of 4,652,459 with an alphabetization index of 95%, a life expectancy of nearly 79 years and a per capita GDP of US$9,494.

Economic Development

Economic Activities: Notwithstanding the economic slowdown of year 2009, Costa Rica has enjoyed steep annual economic growth, between 4% and 5%, for the last years.



However, during the first six months of 2013, the economy showed a deceleration, when grew only 2,5%, due to the low path of the international economy and because the inner demand.

Economic Growth Expectancy: As a result, the GDP is expected to grow at 3% by the end of 2013, but with a recovery for 2014, with an expectancy growth of 4%.

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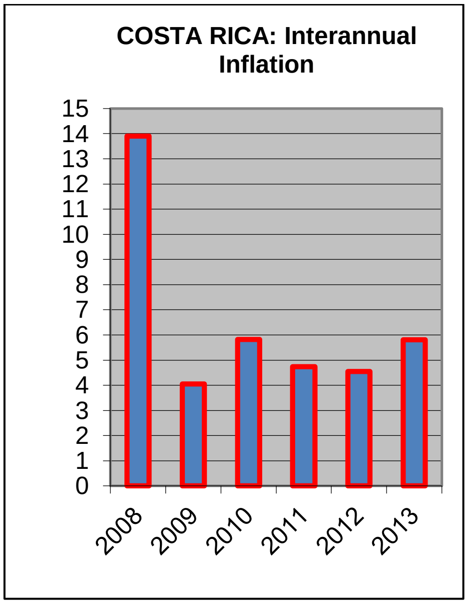
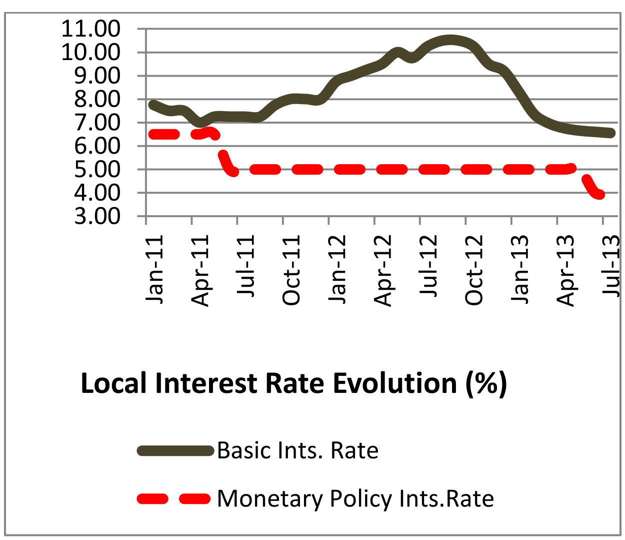


Prices: After the prices world crisis of 2008, Costa Rica has achieved the stabilization of its inflation rates, keeping it under the 10% rates during the last five years. Indeed, for the current year 2013, the Costa Rica Central Bank had the goal of ending with an inflation range between 4%-6%, but analysts estimate that the number will be closing between 5% and 6%.

Unemployment: This has been an issue of special attention for the economic authorities. During the first quarter 2013, the open unemployment was 9,6%, representing a little decreasing, since it was 9,8% as of the end of 2012.

Interest Rates: Recently, the Central Bank reduced the monetary policy rate from 5% to 4%, arguing that there are not pressure on prices on the medium and long term, as well as, because the economic activity needs additional incentives. This has conducted to an Interest Basic Rate (average raising rate on terms between 150 days and 210 days of all financial intermediaries), around 6,5%, after being situated around the 11% one year before.



Interest Rate Expectancy: Even when it seems that there is no inflation margin to drop the interest rates, due to Central Bank arguments and the situation of economic activity, it is possible to expect a policy margin for a fringe decrease in the interest rates.

Exchange Rates: Currently the Costa Rica exchange rate is parked on the lower bound (the exchange rate band regime was implemented since 2006), that is ¢500.00 per US$. The table shows the stability gained by the local currency during the year 2013.

Average Exchange Rate for First Semesters from 2009 to 2013

	2009	2010	2011	2012	2013
Echange Rate	572.59	544.17	508.35	512.08	505.26
Standard Deviation	7.13	17.90	3.26	4.04	1.82

Estimations from Costa Rica Central Bank

	2012	2013	2014
Change in real GDP	5.10%	3.00%	3.70%
Inflation rate	4%-6%	4%-6%	4%-6%
Current Account (% of GDP)	-5.30%	5.00%	5.10%
Commercial Account (% of GDP)	13.70%	13.00%	13.20%
Fiscal Deficit (% of GDP)	-5.10%	-5.80%	-6.60%

Public Finances: The Costa Rica Central Bank estimates a fiscal deficit of 5,0% of GDP for the end of 2013 (5,8% for whole Public Sector) and of 5,8% for 2014 (6,6% for whole Public Sector). Even when this deficit will be partially financed with local bonds, the foreign emission of bonds, already approved, for EUA$1.000 millions yearly, would reduce pressing on the hike of local interest rates.

In light of this, it is estimated that the proportion Debt/GDP could be near to 37% for 2013 and 40% for 2014.

Economic Growth Expectancy

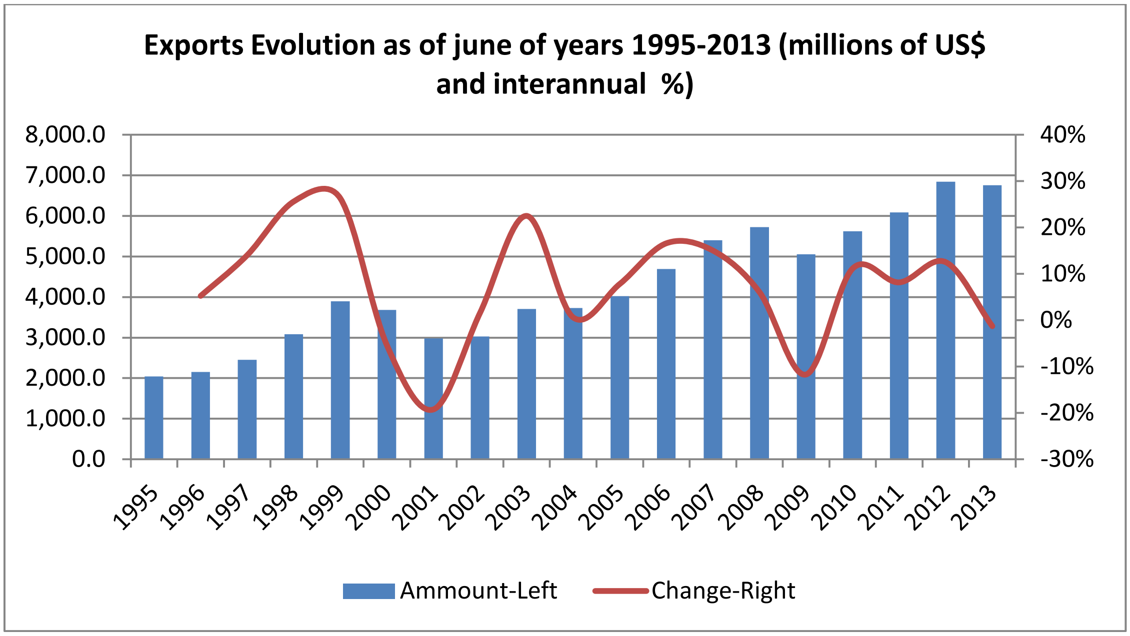
Widening and Diversification of exportations portfolio: One of the most remarkable changes, is the way Costa Rica has been adding more new products to his exportation base, avoiding the former dependency on agricultural products, for an evolution and sustention on industry, technology and free zones. See table following.

Costa Rica: Exports Composition

	2000	2005	2010	jun-13
Exports FOB	100%	100%	100%	100%
Traditional Products	15.0%	10.8%	11.4%	11.6%
Coffee	4.7%	3.3%	2.7%	3.9%
Bananas	9.3%	6.9%	7.4%	6.3%
Meat	0.5%	0.2%	0.4%	0.5%
Sugar	0.5%	0.4%	0.9%	0.9%
Others	85.0%	89.2%	88.6%	88.4%
Agricultural and sea products	9.0%	11.0%	11.7%	11.6%
Manufacturing	18.5%	20.3%	22.5%	21.8%
Assets Enhancing	6.9%	5.5%	1.9%	2.4%
Free Zones	50.5%	52.4%	52.5%	52.6%

As a result, traditional export goods, dropped from representing 15% to 11%. In the opposite, no traditional products and free zone exportations are gaining space in the portfolio (52%).

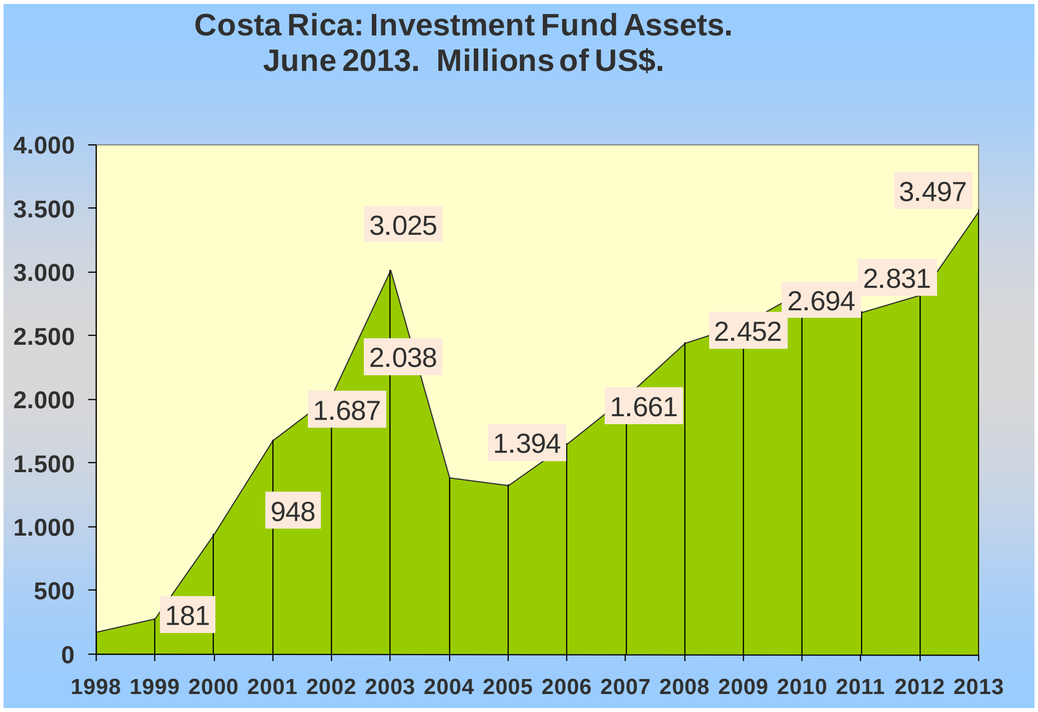
In the other hand, when analyzing the inter annual exports evolution as of June 2013, it is clear a small reduction on the trend, due to the low path of the international economies:



Investment Funds in Costa Rica

Background

Investment funds were first introduced in Costa Rica through the 1990 Stock Exchange Regulatory Law. However, they did not really become mainstream until this law was amended in 1998. At first, some independent or non-bank fund operators offered mostly Money Market short-term funds. Later, fixed-income and growth funds were also set forth.



After the 1998 law, the investment fund market became attractive to many banking groups, who multiplied distribution channels, introduced new financial products and developed new non-financial products, such as real-estate funds (1999)[1], mortgage funds [2], international portfolio funds and, more recently, funds of funds (mega funds) and real-estate development funds[3].

In short, we can identify three general periods:

1. 1990-1998: Non-bank fund operators offering financial short-term and high liquidity hedge funds. Low volume of assets under management.

2. 1999-2003: Banks and Brokerage Firms start operating funds, which expands the representation of the financial sector in the market.

[1] Real Estate Income Funds, invest directly in acquisition of building, which produce monthly rentals for the fund. They use to distribute the net income among investors. Shares of the fund can be traded in secondary market of the stock exchange.

[2] Mortgage Income Funds, invest in secondary market bank mortgages. They use to distribute the net income among investors. Shares of the fund can be traded in secondary market of the stock exchange.

[3] Real Estate Development Funds, invest in real estate construction projects. Once the building, or any other kind of real estate is constructed, it is sold or rented. Capital gain from sale, or net income from rent, is distributed among investors. Shares of the fund can be traded in secondary market of the stock exchange.

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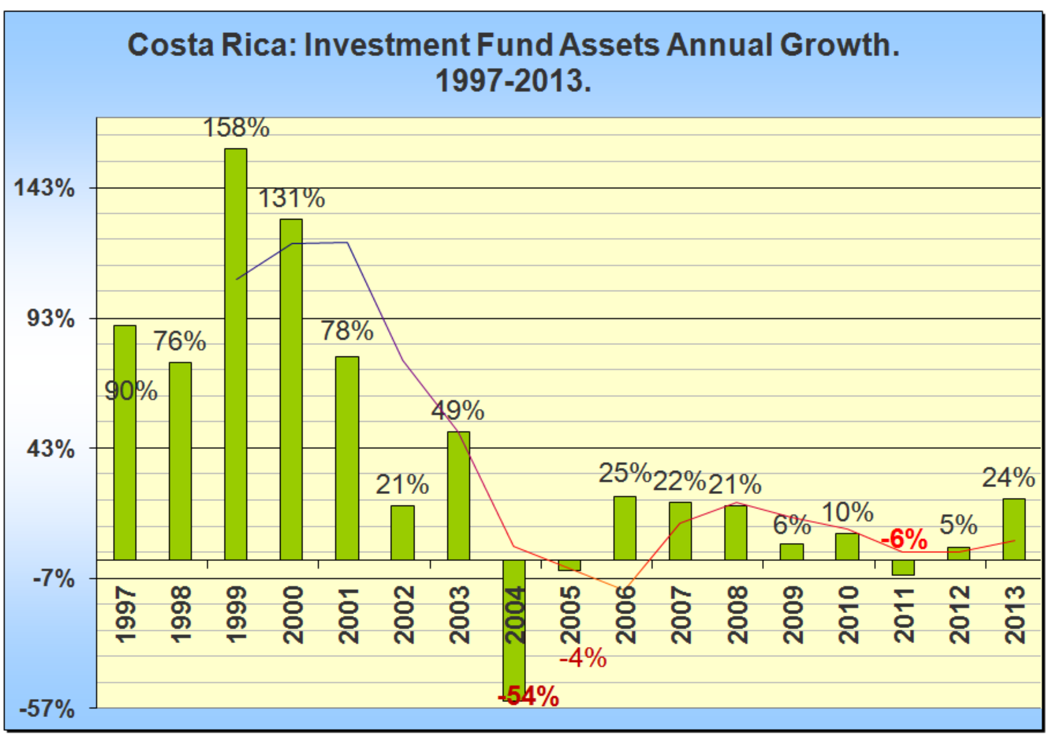
In this period, the industry experimented steep growth (more than US$3,000 million) focusing on long-term products (fixed-income and growth funds) and some innovations, such as mutual, real-estate and mortgage funds.

3. 2004-2013: In the first part of this period (2004-2005), the number of assets under management was significantly reduced, but the industry recovered shortly afterwards. At its most critical, there were only US$1,334 millions in assets under management, when, in June 2013, the current assets under management amount to US$3,497 millions. In the last year (2012-2013), the market has been boosted by greater portfolio diversification and increases in real-estate, real-estate development and foreign investment funds of funds.

Recent developments for the Investment Fund industry

In the 2012-2013 (june) period, assets under management have increased 24% to amount to US$ 3,497 millions. 64% of this amount (US$2,238 millions) refers to funds in US Dollars, and 36% (US$1.254 millions) to funds in Costa Rican Colones (local currency).



For the aforementioned amount, the ratio between assets under management through investment funds and the GDP is 8,5%. This index has increased in the last three periods, but it still fails to match 2004 levels, when it reached 17.3%.

Regarding the total product offer, there are 97 investment funds distributed among 14 operators and 47,821 investors. Most of the existing funds, both in volume and in assets under management, are open-end: 59 funds and US$2,153 millions, representing 61.6% of total number of industry assets. There are also 38 closed-end funds, which manage US$1.344 millions or 38.4% of all industry assets.

Open-End Funds

Open-End funds are mostly Money Market funds; 47 funds with assets for US$1,946 millions, representing 56% of the investment fund market. In addition, this category groups 33,014 industry customers (69% of all investors).

Closed-End Funds

The most important of all closed-end funds are Real Estate Income funds, which manage assets for US$1.030 million (29% of total funds) in 19 funds. Only one of these funds is in Costa Rican Colones and the rest are in US Dollars. These funds are owned by a total number of 6,802 investors, who basically invest in income-generating real estate.

Industry Profitability

The observed average returns by fund type, in their corresponding investment currency, are detailed below. All returns are nominal, without any inflationary adjustment.

Investment Fund Market Analysis

The recent past volatility in the markets, as well as the oncoming rising interest rates expectancy, both at the domestic and international level, have contributed to polarize collective savings in two ends.

On one side, a defensive liquidity strategy from investors and portfolio managers. On the other, liquidity positions have been abandoned for options allowing greater returns without greater relative volatility.

In Costa Rica, where the fixed income markets have traditionally dominated, the market has diversified towards investments on foreign securities and the real-estate sector. In the latter case, some operators have fostered the creation of real-estate funds which already evidence an effective high-return and low-volatility track record for the previous 12 years. In fact, the effective return average for real-estate funds in US Dollars is 8% for the previous 10 years. However, since this is a closed-end fund with a slow growth level due to the nature of its purchases (real-estate), it has not been able to fully develop its savings potential yet.

In other words, there is room for new efficient products outside the real-estate sector. Even when small efforts have been made towards foreign investments, these portfolios are yet to reach optimal global diversification levels; they are still not significant enough in terms of currencies and variable returns.

Regarding regulatory compliance, the regulations from the Securities Regulator Authority demand detailed information before, during and after the fund selling process. Besides mandatory contracts and prospects, funds must submit customer profiles and anti money-laundering information. In addition, financial and general ledger information must be submitted on a daily, monthly, quarterly and yearly basis. Likewise, all funds are subject to risk assessment in order to provide better guidance to investors.

In other hand, market supervision is highly technological as evidenced by constant electronic communication between fund operators and the Regulatory Authority.

Both fund sales representatives and financial portfolio managers are required to become licensed or certified to perform said activities. The local association, the Costa Rican Chamber of Investment Funds, has been licensing applicants and certifying risk analysts since 2006, and Real-Estate Portfolio Managers since 2008.

Perspectives

In this moment, the Chamber, the operators and different representatives of the market and the Regulation Authorities, are working on the writing of a new Securities Market Law. In this context, the Investment Fund Regulations would also be amended, as well. Since there is a general conscious around the importance of Investment Funds as a factor of economic and social development, we estimate that the product would gain flexibility and transparency, and thus, would promote a better ambience for investments, new products and businesses.