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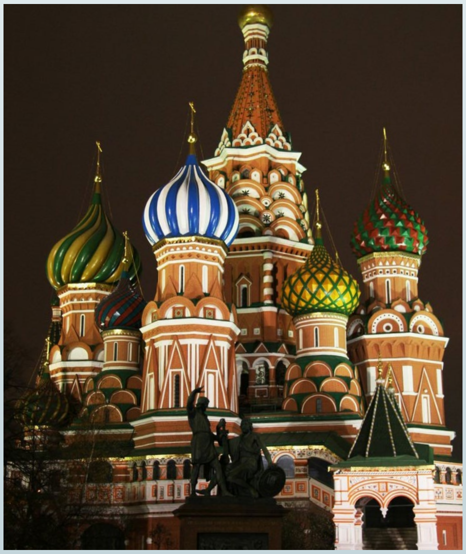
HEDGE FUND INVESTING IN RUSSIA



Before 2022, many emerging market fund managers were intrigued by Russia. From 2010 through 2021, the local benchmark stock index, MOEX, nearly tripled in value in local currency terms. It has given back nearly two-thirds of that from February through April. And veteran emerging market investor Mark Mobius, founder of Mobius Capital Partners, believes, "it will be impossible to invest in Russia for a long time."

Institutional Investor reported in early April a "significant number of funds, all under $2 billon and many quite small — well under $500 million — had exposure to Russian equities of between 10 and 20 percent. More than 10 funds had between 20 and 40 percent exposure, while four funds had 40 to 70 percent exposure — including a number of funds from Firebird Management, which are exclusively focused on Russia."

A longtime colleague and emerging market hedge fund manager, who has an extensive track record of generating consistent returns while effectively managing risk, provides ground-level insight about investing in Russia. Because of the subject and his firm's reticence for press, he provides his thoughts anonymously.

He's been investing in Russia for many years. In 2021, with commodity prices rebounding, he saw a number of compelling blue-chip Russian energy and financials based on attractive corporate finances, valuations, growth prospects, and dividends. "These companies' reliance on global auditors, along with a maturing and liquid marketplace," explained the fund manager, "brought a reasonable degree of comfort to this kind of Russian exposure."

In the energy space, he had liked Gazprom and Lukoil. In financials, he saw potential in Sberbank, which, before the war, was trading at book value, with a return on equity of 24%, and a dividend of more than 7%.

However, in the lead-up to invasion, the manager cut his significant exposure to Russia by two-thirds. His weighting moved inversely with the number of Russian troops massing around Ukraine's borders. He did this despite widespread optimism among his Russian-based financial sources that war was unlikely. Other asset managers he spoke with shared a similar optimistic sentiment.

Why was he cautious? "In seeing equity prices declining and uncertainty rising, I didn't see any compelling reason to maintain significant exposure to Russia. I could always reestablish these positions if I was wrong." This decision echoes the manager's steady focus on risk to limit shocks to his portfolio.

As Russia became financially isolated, it halted foreign trading of local securities, and hedges stopped working. Before sanctions took effect, sufficient liquidity enabled shorting of large-cap Russian stocks and ETFs. Russian credit default swaps were viable hedges.

It's the first time the manager could recall when hedging in a reasonably evolved market failed and where bankruptcy could be triggered because custodians couldn't make payments to creditors. The manager posits that rating agencies and courts may have a problem identifying reasons for pending default: Were they caused by violation of international law and the imposition of sanctions or by an inability to pay?

Even before such a reckoning is made, many institutional investors completely wrote off their losses, including the likes of Fidelity, T. Rowe Price, and UBS. This manager did the same. The question they all face: what to do with these assets?

Russian capital markets have reopened. But foreign investors can't trade them. And if foreign investors attempt to execute a trade with a non-Russian party, they currently get nickels or dimes on the dollar.

The manager believes Russian blue-chip companies are worth more than what foreign investors can now receive for them. "It makes sense for the time being to hold on to these positions," he explains. "The question is not one of valuation but whether Russia will be an investable market in the future, even if Putin is no longer in charge."

The matter has gotten more muddied for investors who held global depositary receipts of Russian companies in their respective local markets and currencies. Russia recently canceled these GDRs, transforming them into ruble-denominated shares.

How will this all play out? The manager's best guess is that two markets for Russian shares will evolve: one for higher-priced domestic Russian investors; the other for foreign investors whose shares will be worth much less. Arbitrage that normally keeps the prices of such dual listings in balance when markets are fungible will likely benefit only Russian investors.

While it's hard to see an end to the current crisis, the fund manager reminds us, "Russia has a lot more to offer the world than hacking, assassination, and war. It's home to remarkable creativity in the arts, music, literature, and science. It's an important commodities market and is developing other sectors, including technology.

"But in a single, mindless action, the government has erased decades of market improvements. The Russian economy will not be embraced by the West for quite some time and only when the Kremlin turns less belligerent, committing itself to being part of the world order rather than seeking to break it."

Mindful of Russian history, it might take a while for that to occur.