

CONFERENCE CALL: Hedge funds see more complex Russia strategy

Nicholas Watson in Geneva
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One might expect that a meeting of Russia-focused hedge fund managers on the morning of September 18 would resemble more a wake than a gabfest. And indeed, Jochen Wermuth of Wermuth Asset Management, as the keynote speaker at Jetfin's "Russia Hedge Funds 2008" conference, began proceedings by asking delegates for a minute's silence for the Russian stock market.

However, behind the jokes and dismal morning newspaper headlines about a Russian stock market whose capitalisation fell by a quarter in a matter of days lay some genuine optimism couched with a caveat - while the Russia sell-off has opened up some great buying opportunities, investors need to become more sophisticated in their investment approach to the country from now on.

To many speakers and delegates, the global financial crisis that was roiling the markets while brutal, was a natural process and a reflection of the major shifts that have occurred in the world economy over the past decade. "Productivity is not everything, but in the long run it's almost everything," Mattias Westman of Prosperity Capital Management quoted the economist Paul Krugman.

Westman went on to explain that while incomes in emerging markets have, to some extent, risen to reflect these improvements in productivity, western nations have continued to consume with debt as if there had been no relative changes. "It wasn't sustainable and built purely on confidence, and when that cracked, it was like a house of cards," says Westman. "People who consume more than they produce will eventually have to consume less."

The key investment criterion going forward, therefore, is to follow the consumption, despite these periodic batterings emerging markets will take - this one because a collapse in the US housing market had destroyed almost \$1.5 trillion in wealth, which was like a black hole sucking up money from the rest of the globe.

Though the reputation of Russia - as well as that of its BRIC relatives, Brazil, India and China - for being a safe haven has taken a beating in the latest crisis, over the long term, backed by its solid fundamentals, the country is still reckoned to be a good place to put money. "We still think it's one of safest havens, a better long-term bet than the US," said the preternaturally bullish Werthur.

Philippe Collot, a founder of the newly established Collot & Ahlstron hedge fund in London - "it's been tough," he admits to *bne* about the timing - is one who shares Werthur's optimism. He's never invested in Russia before, but is now seriously considering doing so of as the recent sell-off has created huge opportunities, not only in straight equity plays but in alternative investments like private equity, which he predicts will have a huge impact on Russian companies.

Werthur, whose firm already has two closed-end funds that invest in private equity and is in the process of setting up a private equity operation, agreed that buyouts will have a big role to play in Russia, while investing in stocks like Lukoil, Russia's largest oil firm, at a price/earnings ratio of 2.5 times is like investing back in 1998, the year the Russian government defaulted on its debt and the ruble collapsed.

Some also talked of the nadir of the Yukos affair, when the Kremlin, using quasi-legal means, bankrupted the country's then-largest oil company and stripped it of its assets. "Russian shares are now very, very cheap - they're at a P/E of 4, which is on a par with the bottom of the Yukos affair," said Westman.

Indeed, some of the optimism displayed by many hedge fund managers was partially borne out on the following day of the conference when trading resumed on Russia's stock exchanges - trade was

suspended on September 17 due to the huge falls that caused the market's capitalisation to halve - and the RTS index soared 18%.

However, while most could agree that Russian stocks were cheap - some still worry about the level of political risk for equity, particularly given Prime Minister Vladimir Putin's penchant for speaking to the gallery - there was more disagreement about how to play the market from hereon in.

Not back to the future

Speaker after speaker warned that the recent sell-off in Russian equities could end up reinforcing the long-bias that they've been trying so hard to overcome. A common refrain from delegates was: "Is this not 1998 all over again, where investors can buy cheap stocks and hold them, watching their money increase by 100 times?" No, was the answer.

"The Russian market's obviously oversold, but I don't see [an RTS index of] 1500-1600 happening soon, there's too many things weighing on Russia and their combined effect will weigh on Russia for sometime," said Carl Meurling of Emeralt Investments, which was established precisely to pursue a long/short investment strategy, which involves buying long equities that are expected to increase in value and selling short equities that are expected to decrease in value. "The goal of a modern portfolio in Eastern Europe should be to combine emerging market returns with developed market risk."

James Beadle of Pilgrim Asset Management said the reason the long-bias was so hard to overcome was because it was so successful - until now. "We were always waiting for one more leg up before hedging, always one more leg up," he sighed.

Another reinforcing factor is the enduring myth that hedging in Russia is too expensive and hard. While delegates were right when they complained it was nearly impossible to hedge right now - "the idea is to get the insurance before the house catches fire, not while it's on fire," remarked one manager dryly - many like Douglass Welch, head of derivatives at Troika Dialog, insisted that the market is evolving and liquidity of exchange traded derivatives and forwards now regularly exceeds the underlying spot market. "Just buy the RTS futures contract while you build up the single-stock futures in your portfolio," Welch recommended. "You can hedge \$50m-100m with no problem."

Meurling's portfolio for Eastern Europe is a balance between large- and small-cap stocks. "The portfolio structure should be a combination of a hedged element in the more fairly valued large caps and a directional element to small-caps," he says.