

Opalesque Exclusive: Timely examination of macro context at Russia and CIS hedge funds conference

By [Benedicte Gravrand](#), Opalesque London: The Russian Stock Exchange slumped 11% in trading on Tuesday 15th September 2008, and Russia's Federal Service for Financial Markets halted trading after dramatic early falls in Wednesday trading.

Yesterday (Thursday), the country ordered its main stock exchanges closed for another day, according to CNN. President Medvedev pledged a 500bln rubble (\$20m) injection into financial markets to restore confidence in the economy - but not all is bad as the government has a huge cash reserve. Russian banks are also tightening their liquidity ([Source: CNN](#)).

The Russian stock market is reopening today (Friday).

The whole experience has proved that Russia is not immune from the ills that afflict other markets, reported the BBC. Oil prices, which are now falling, have also taken their toll. "We have sufficient reserves and a strong economy, which guarantees the avoidance of any shocks," President Dmitry Medvedev told a televised meeting of top officials in the Kremlin on Thursday.

Analysts estimate that \$36bln in foreign investment has left Russia since early August, the Reuters news agency said earlier this week. Aside from global problems, and falling oil prices, there is another factor: politics. Russia's military conflict with neighbouring Georgia, the battle over the oil company TNK-BP and Prime Minister Vladimir Putin's criticism of the mining company Mechel - which resulted in a massive fall in its share price - have all made some investors decide it is time to leave Russia ([Source: BBC](#)).

So at yesterday's Jetfin conference on Russia and CIS hedge funds ([details here](#)), attendees were more interested in the macro-economics of the region than in particular funds. And the speakers obliged.

The keynote of the conference was that of a negative outlook in the short term and a positive one in the long term. Someone said that the dirty secret among managers at the conference was that they were all facing heavy withdrawals from investors; "lots of funds will blow up before the end of the crisis." Another manager said his Russia fund had just lost 25%. He added resignedly, "this is part of the game."

As a reminder, here is a list of the former soviet republics ([Source: TIME](#)):

- The Baltics (North-West border of Russia) include Estonia, Latvia and Lithuania.
- Eastern Europe (West border of Russia) includes Belarus, Ukraine, Moldova.
- The Caucasus (South-West) includes Georgia, Armenia and Azerbaijan.
- Central Asia (South) includes Kazakhstan, Uzbekistan, Turkmenistan, Kyrgyzstan and Tajikistan.

The Commonwealth of Independent States (CIS), led by Russia, includes all of the above countries apart from the Baltic states, which are seeking strategic affiliation with the European Union.

"A minute of silence for the Russian market"

"A minute of silence for the Russian market," said Jochen Wermuth (Wermuth A.M., Germany) at the start of the conference. He added that since 1997, Russians had been building a strong war-chest for situations like these. "We still think it is the safest haven around, in the long term." Mr. Wermuth firmly believes in the righteousness of Russian officials, saying they were not interested being "stinking" rich. He should know, he has met with them. Mr. Medvedev focuses on the rule of law and equal treatment of the people. Even though the country has been ranked 156th country in terms of honesty, corruption problems are being tackled via incentives through various pension levels. Furthermore the Russian govt cares about the free market; that is why it is only getting involved now.

Georgia started the conflict by attacking South Osettia, he said, which has tried to gain independence since 1989. The perception of Russian is changing too, as the importance of PR is better understood (Medvedev and Lavrov wrote in the FT, for example.)

Russia has a strong back-bone

Timothy McCarthy (Valartis A.M., Switzerland) who runs a small hedge fund called Red Star, is a believer in strong fundamentals. The Russian market was down more than 50% since May, but so was China's and India's. The market declines are about global asset flows. Emerging market currencies around the world are experiencing a carry trade. But the Russian reserve of \$582m (as at 31st August) shows it has a strong back-bone.

The impact of war in Georgia, problems at TNK-BP, Norilsk and Mechel lead to a drop of \$16bln in one week, the ruble going down 8.7% vs. the US\$, \$400bln in market capitalisation since May, the possibility of a WTO withdrawal and a G8 expulsion (especially if McCain gets the U.S. presidency), more defensive spending...

Oil and gas make up for 51% of the budget revenues. The structural cost of producing oil break even at \$70 per barrel, and \$50 p.b. is the sweet spot. Russian stocks are priced at \$86 p.b. Mr. McCarthy added that Russian banks will get lots of cheap funding. He expects that in the next few months, there will be a continued outflow of money amounting to around \$15bln per month. But the long term is positive.

"It is a capitalist society now"

Matthias Westman (Prosperity Capital, Russia, UK) said that the current dislocation was global and that this was the nature of the market. 15 years ago, things were different. Since then, productivity in BRIC countries has increased while consumption in the West continued to an unsustainable level built on confidence. He added: "We are seeing the effect now, we need to delever and consume less."

Russia has had access to a tectonic shift in the world markets. The reasons to believe in Russia are the Russian shares which are now cheap, and the Russian companies which are doing very well. The Caucasus troubles were misrepresented; there had been provocations from Georgia. This should not be taken as the beginning of the cold war, Russia will not invade countries. "It is a capitalist society now." Yes, there are problems from the empirical point but there is also a success story; the Russia government grew the economy ten times.

The market is trading at levels last seen in 2005, said Olga Logvina (Troika Dialog A.M., Russia). There are higher risks, higher costs per capita, lower commodities. Investors are leaving fundamentally attractive assets at any price. Meanwhile, the market is getting cheaper and cheaper. We are now at the bottom of the cycle. The economy is growing at 8% and a good sign is that oil is sticking to around \$100 p.b. Tax cuts will also improve sentiment and help continue the macro growth. Now is not an easy environment and it will last a little while longer.

The Russian way of dealing with the liquidity crisis is very smart

"We have seen worse than this in our history," said Ian Hague (Firebird Mgmt, USA). "Russia will eventually come out of it." This is a global crisis on a generational scale across all financial markets and Russia is not more down than other markets, particularly among BRIC countries. As investors are leaving the Russian market, the ruble is going to safe havens, as usual. The Russian way of dealing with the liquidity crisis is very smart; they for example use state banks to buy smaller banks.

The problems at the Kremlin is deeper than PR. It is a weak state. The Rule of law does not work. Government officials act with impunity: people are actually afraid of policemen. "We have to be more (careful) in our approach." His firm likes retail, unlisted banks and commodity exporters and does not like state-owned firms and corrupted firms.

Strategies dos and don'ts

There has been a decrease of 42% in the RTS index since Monday, said Douglass Welch (Troika Dialog, Russia). The current implied volatility is near 100%, which not good if you use volatility arbitrage. As for the capitalisation of the RTS exchange, "we would like that changed; hedging could be deemed as dangerous." Hedging is flexible and one can make money shorting, especially shorting index funds, single stocks on the RTS exchange, and put options /sell call options. There are also affordable ways to insure one's portfolios.

Mr. Welch also announced that the Lehman portfolio in Russia had been successfully auctioned on Wednesday.

Back in 1998, Russia was "worse than the plague" and everybody avoided it, said Carl Meurling (Emaralt Investments, Sweden). Within the evolutionary stages of the hedge fund industry in Emerging Europe, we are at the "long-short equity fund" stage. Portable alpha, market neutral strategies and hybrids have yet to come as the market is not yet developed enough. The 3-step process to creating a fund should take into account (1) the opportunity to move out of markets and in again, (2) opportunities in the large caps and (3) a L/S portion of the portfolio in blue chips and reconsidering long net investments. "Shorting in Russia is now a risky thing," he pointed out.

"We see lots of risks in investing market neutral right now," said James Beadle (Pilgrim A.M., Russia). But long-only managers recommend market neutral, which has its conflicts. Why should one be market neutral in a cheap market? Most people remain long-biased and this strategy is hard to overcome. Yet the market is ready for more.

The Prime Minister speaks

Lado Gurgenedze, Prime Minister of Georgia since November 2007, presented, in perfect American English, the Georgia case. "The world would be an uglier place," he said, "if the crucial pillars of inviolability of territory were violated regularly." The Russian attack had caused him to cancel a number of important meetings with business leaders and financiers.

But in Georgia, it is business as usual, certainly in the banking sector. There have been no electricity or gas supply (and export) interruptions, railways have been repaired swiftly. "Resilience is our middle-name," he said. Since August, the currency has appreciated. The banking sector lost 13% of its deposits. It is however seeing new inflows this month. The Galt and Taggard stock market index went down 37% but it is up again. The conflict will cost a few percent of GDP growth. But things are moving quickly; the IMF is helping, the E.U. renewed its commitment to accelerate free trade ties.

Georgia is cutting taxes "very passionately" and is committed to further cuts (tax on dividends and capital gain will be soon abolished). The central bank's objective is to keep inflation at single digit levels. The key investable sectors and opportunities are in financial services, consumer goods/agribusiness, real estate, tourism and hospitality, retail, hydro power, transport and logistics. Mr. Gurgenedze said that Georgia was lucky that Hank Paulson (the US Treasury Secretary) was in place. He added: "We are in the early days of some paradigm shift... I don't wish any regulatory initiative around the world - but they might be some, done too hastily."

Banks: now a matter of substance over form

The banking system in Russia is much stronger than people think, said Richard Hainsworth (GlobalRating, Russia). People have invested a lot in them. Furthermore, the majority of banks are not investable, but many of them are going to be so to finance their growth. Rating banks in Russia is now a matter of substance over form as opposed to before. Banks are borrowing short and lending long, which is a problem. Quality is much more important, but there is not enough money to continue lending. Regional banks are more profitable as they are more client-oriented. "I am an advocate for Russia and the CIS," he said, "not an apologist for the Russian government."