

## NEWS FEATURE — Strong fundamentals of Russian economy expected to tempt investors back into market

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### News

*By Stephen Quigley*

**In the wake of severe disruption to Russia's stock market, investor confidence both inside and outside the country has been severely dented. Hedge funds appear to be taking a contrarian view, believing the country is strong enough to withstand the economic upheavals because of its strong current account balance, trade surplus and foreign exchange reserves.**

Russia has been hit by a series of crises. Billions of dollars of foreign capital exited the country in August following worries over the financial effects of Russia's invasion of Georgia.

The collapse of Lehman Brothers and AIG in the US together with other economic problems in the US impacted Russia, translating into severe falls in shares prices and capital outflows.

The flight of foreign investors from Russia began to expose a small domestic retail investor base with insufficient cash in the stock market to shield it from the effects of international market turmoil.

The Russian regulator has decided on several occasions to step in and close two main stock exchanges the MICEX, which targets individual investors, and the dollar-denominated RTS, a derivatives exchange and over-the-counter market for small-cap stocks. With significant sharp falls or rises, the authority prefers using the crude but effective closure to calm markets and give traders time to reflect. Many believe the intervention has been effective and appropriate in the current situation.

The early September stock exchange suspensions acted as a catalyst for the Russian government. It decided immediate action was needed to inject liquidity into the banking system and, hopefully, also help calm Russian markets. A \$130 billion financial package to shore up liquidity was announced to stop a collapse in Russian stocks and restore confidence in the inter-bank market.

As part of the package, the Finance Ministry will inject R1.13 trillion (\$39 billion) into the banking system through loans to Russia's three largest banks: Sberbank, VTB Group and Gazprombank. The government hopes this will then encourage the larger banks to start lending roubles to smaller banks.

Other measures for bolstering the banking sector include the central bank offering loans to banks without collateral.

As part of the effort to inject liquidity, Russia's Finance Ministry held auctions on September 30 and October 1. At the September 30 auction the ministry offered R200 billion (\$7.9 billion) for a term between October 1 and November 5 at a minimum rate of 8.25% a year. At its second auction, the Finance Ministry offered up to R300 billion (\$11.9 billion) from October 2-9 at a minimum rate of 8% a year.

Peter Halloran, CEO of Pharos Financial Group based in Moscow, manages three Russian-focused hedge funds. He says the package was only the first step in providing liquidity for the system.

"I would expect more measures to come in to provide liquidity as it is needed. The central bank and the government know what they have to do and there will be more to come," says Halloran.

Liam Halligan, chief economist at Prosperity Capital Management which manages around \$5 billion in Russian equities and has six funds investing in the Russian economy, believes the fundamentals are extremely strong in Russia. Halligan points to the facts that Russia has large foreign exchange reserves and is the ninth largest economy in the world.

The denting of investor confidence has been overstated, he believes. "Events in the US are so tumultuous that every economy is affected. Of the major economies in the world, Russia has a low proportion of its trade with the US," he says.

Halligan says Russian and foreign investors believe the country will be one of the few major growth centres over the next few years.

"The injection of money will improve the situation. It has put a floor under valuations for now and it has made people think about the fact that the market is so undervalued. We are seeing clients increasingly thinking of this as a buying opportunity given valuations are so low. There is also a lot of corporate money that is coming back into the market to take advantage of these low valuations," Halligan commented.

Thomas Fasbender, director of investor relations at ParusKreml, the Russian based manager of the Sokol Russian Equity Opportunity Fund, is optimistic about investment opportunities in the country.

The Sokol fund invests in undervalued stocks from the Russian small cap universe. Fasbender thinks Russia can challenge developed economies as it has growing international investor interest in small and medium capitalised companies.

Fasbender believes the first post-privatisation era is coming to an end and there will be new structures and practices. The merger of stock exchanges will be an example of this restructuring, he says. "Most Russian shares are listed outside of Russia and it would be very useful if Russia had one strong index and one

strong stock exchange so the crisis may be used for restructuring and consolidation. If Russia wants to be a major financial player, it must professionalise and develop its stock exchange, its system of inter-bank loans and its stock market," Fasbender observed.

He applauded the move to shut the exchanges in September but he thinks the Russian stock market must develop.

"The authorities had no choice but to close the stock market given the situation of the falling stocks. The problem is that the Russian system of bank re-financing is highly leveraged and short term which leads to margin calls and then a collapse. Then, because the stock market is not developed enough, it regained around 20% following the input of the liquidity and could not cope with this sharp increase and closed again.," Fasbender says.

Money which was taken out of the market during summer 2008 by investors may flow back to Russia, believes Fasbender. He thinks several companies could benefit from investors returning to the market.

One is brokerage service company Otkritie, the only Russian-based brokerage operating in London. Although a number of Russian companies offer brokerage services to access the Russian markets from Cyprus, Otkritie is the only full service Russian-owned brokerage company based in London and fully regulated by UK Financial Services Authority. Otkritie plans to open a brokerage in New York with Securities and Exchange Commission approval by the end of 2008.

The brokerage is a subsidiary of Otkritie Financial Corporation, one of the leading diversified financial services providers in Russia, operating on the stock market since 1995 as a broker, financial consultant and investment bank. The company serves as a strategic advisor to corporations, institutions and individuals worldwide.

According to CEO Roman Lokhov, Otkritie Securities, is well placed to help other brokers and hedge funds navigate around the Russian exchanges enabling them to invest in Russia through London.

"Funds will also be able to unwind their positions through us when the exchanges close and we will provide a full service to them," explains Lokhov.

Lokhov approved the closure of the exchanges. "The sell-off of shares was so rapid that the correct decision was taken. This decision was good for us because we were able to help when they closed."

He thinks the Russian market still has strong fundamentals and enough money to withstand the current market issues. "I think we will see more hedge funds invest into Russia as the fundamentals in Russia are strong. We can help them because we provide the infrastructure, technology and the compliance that a hedge fund needs. We provide a centralised service so hedge funds do not have to be concerned with audit trails," he concludes.