Opalesque Exclusive: Russia hedge fund survivors ride rising stock markets
By Benedicte Gravrand, Opalesque London.

Fund managers are still underweight on Russian securities, despite the MSCI Russia Index climbing 21.8% in April and 28.4% YTD - after a drop of 74.2% in 2008. This is reportedly the best performance among the 23 major markets, as oil surged 43% and the rouble gained around 12% against the dollar. Today, US$1 trades for 31.2 RUB.

But that the rouble has depreciated by about 30% against the U.S. dollar since July 2008 (IMF) and stocks fell by about 75% last year may have scared quite a few investors away, and has certainly affected neighbouring countries which are dependent on remittances. Although the recent currency rebound may also affect the competitiveness of non-energy businesses in Russia and risk pushing the country back to a "boom-bust cycle," as Renaissance Capital, an investment bank focused on the emerging markets, told Bloomberg.com (see article below).

So Russia is not out of the woods yet, as fundamentals such as changing oil prices, slow economic growth, government budget being spent on repairing banks and economy, all may contribute towards a precarious environment for a while.

According to the Economist Intelligence Unit, there is however light at the end of the tunnel: the Russian economy is expected "to contract by 3% in real terms in 2009, after a growth of 5.6% in 2008, as a result of sharply lower commodity prices, restricted access to external financing and reduced external demand. However, a recovery is expected from 2010, and annual growth is forecast at over 4% in 2011-13."

Hedge fund survivors

Most hedge funds focusing on the region benefited from the increasing oil price and the strengthening rouble in April. Those who did hence survived 2008, which proved to have been almost lethal as some had to restructure and block redemptions.

The Eurekahedge Eastern Europe & Russia Hedge Fund Index, which dropped 54.24% in 2008, is up 11.76% (est.) in April, and 15.58% YTD. And the HFRI Emerging Markets: Russia/Eastern Europe Index climbed 9.61% in April and 8.89% YTD (compared to -53.23% in the last 12 months).

The Pharos Russia Fund, a hedge fund focused on securities in Russia and the former Soviet Union, was up 6.3% in April and 14.3% YTD (after losing 37.7% in 2008). In the last 10 years, the fund annualised 23.5% compared to an annualized return of only 15.3% for the MSCI Russia Index. The fund is managed by Pharos Financial Group, a 12-year old firm managing around $60m and based in Moscow.

Peter Halloran, CEO of Pharos, talked to Opalesque about investing in Russia.

Russian Market

Peter Halloran believes that Russia was one of the strongest performers in the world over the past couple of months because it responded to oil prices, which bounced for the $30 level to $50 /$60. It is good for stabilising the fiscal budget, the current account and the currency.

"For Russia, the exposure to oil prices is fairly unique," he added. "If oil trades at $70 or $100, it does not matter but if it trades at $35 to $45 then that makes a big difference."

The market also responded to the currency, which stabilised a few months ago. "In emerging markets, currency is what can always get you no matter how right you were, how good the numbers looked, if the currency goes, everything unravels," he pointed out.

He thinks Russia and other emerging markets will remain a highly volatile environment. In that context, his fund will close still higher by the end of the year but with draw-downs along the way. And so he is positioning by going long on some puts and shorting off some securities that are a bit ahead of themselves: securities in the steel sector for example, as prospects for their fundamentals are fairly grim and their price would be highly sensitive to the market.

Argument for investing in Russia has changed

The argument for investing in Russia has changed quite a bit since last year as some companies have changed dramatically.

According to Halloran, what was feeding fundamentals going back each year was companies's ability to borrow money - which is certainly true around the world. When you change that and add outstanding debt, then everything changes. So companies who did not over-expand or borrow to expand, and that a year ago would not have been as exciting for investors, are now the most exciting - whereas levered competition is struggling with debt repayments.

The investment case has also changed because of fiscal realities where, last year, there was a fiscal surplus which was ear-marked toward the infrastructure bill.

"There was a big infrastructure play in Russia which was going to be led by the government," he said. "That's pretty much off the table because they're spending a greater percentage of GDP this year rather than last year and spending to shore up the banking sector and shore up the corporate sector through the banking sector. This means that they don't have the fire power to launch a new issue of infrastructure spending.

"When we look around we see that investors are still underweight Russia, but Russia is a market that is a fairly central economy in the world," he concluded.

Some see Russia as an important, significant player with massive potential; others would not dip a toe in it. The country is facing widely differing opinions, and may not see as much foreign investment as it would like as a result.