



Pharos Finds Investing is a Gas

By Martin de SaPinto, Senior Financial Correspondent | Thursday, February 07, 2008

MOSCOW (HedgeWorld.com)—Since taking up residence in Russia in 1995, Peter Halloran has seen the boom-bust-boom cycle there in its entirety. He has learned the hard way about the ex-Soviet regions, but he has also picked up some important lessons.

Mr. Halloran was active in the birth of Russia's capital markets, participating in the country's first initial public offering and in the first placement of local debt, via GKO's, or short-term zero-coupon Russian Treasury bills. "We got out of GKO positions when the debt crisis began to loom," Mr. Halloran said in an interview. "At one point, they were a great investment, but they turned into a terrible one. Getting the timing wrong on those signaled the death knell for many funds."

Mr. Halloran previously worked at Salomon Brothers for 10 years and had a stint at Morgan Grenfell before running Credit Suisse First Boston's brokerage unit in Moscow between 1995 and 1997, when it had the largest share of market transactions among the city's brokers. He was also responsible for the unit's trading, research, sales and its \$300 million proprietary trading desk. In the intervening years, he was an adviser to Soros Fund Management from 1999 to 2000 and ran local investment bank Aton Capital from 2000 to 2002. His early experience in Russia included investing in the privatization vouchers issued from 1994 following the launch of the country's privatization program in October 1992. "That was a good risk-adjusted trade, even though the risks were high," he said.

He founded Pharos Financial Group in 1997. Unfortunately the firm launched its first hedge fund, the Pharos Russia Fund, at precisely the wrong time, in October of that year. The economies of Southeast Asia had gone into meltdown mode, and the Russian economy was itself beginning to show the cracks that would eventually lead to the debt crisis that broke in August 1998. In its first quarter of trading, the long/short equities fund slumped 23.2%. Worse was to come in 1998, when the fund cratered a further 75.3%.

That might have been enough to convince a lesser mortal to pack his bags and return to the more benign and less violently volatile markets of the West. But not Mr. Halloran; he kept faith with his fund. "Pharos was set up to be opportunistic, and initially looked at equities, private equity and fixed income," he said. "But after the financial crisis, we decided that equities were the best place to be."

The fund rebounded 68.1% in 1999, and although it slipped back by 9.7% in 2000, the following year was another bumper one with returns hitting 66.7% in 2001. Over the past five years, the fund has achieved annualized returns of 33%. Over the most recent 12-month period, it has had a standard deviation of 13.8% with a downside deviation of 8.7%.

For downside protection, the fund uses an overlay of index puts with some single-stock put options. "We look to pick up delta," explained Mr. Halloran. "However, we don't short single stocks, because for those that are liquid enough to short, the correlation with the indexes is just too high."

The fund, which today manages around \$65 million and invests across Russia and the ex-Soviet states, has a positive outlook for its markets and is hence maintaining a long bias. It is focused on the traditional Russian sectors of gas (25%), oil (18%) and metals and mining (14%), with large allocations to the developing sectors of banking (19%) and telecoms (16%). Smaller allocations go to consumer goods (6%), utilities (1%) and media (1%).

Mr. Halloran said he is particularly enthusiastic about Russia's pre-eminence in the gas market, so much so that in April 2004 he launched a fund to focus specifically on the sector. Since inception, Pharos Gas Fund, which manages around \$40 million, has returned 356.7%. "This is probably the only fund focusing solely on gas that I know of," said Mr. Halloran. "It's a good time to be focused on this sector because of the ongoing restructuring in the industry and the secular pricing story, both of which will impact the outlook and profitability of the industry. Prices are roughly doubling every three years, and could triple over the next four years."

There are sound macro reasons favoring the longer-term prospects of the fund. The Russian Federation alone has 48 trillion cubic meters of proven gas reserves, or 27% of the world's total. Other countries in the Commonwealth of Independent States, including Kazakhstan, Turkmenistan and Uzbekistan, have a further 10.2 trillion cubic meters of proven reserves, amounting to 5% of the world's total. Russia is also the world's largest natural gas producer, and in 2004 produced 634 billion cubic meters of natural gas, or 24% of worldwide production. Of this, government-controlled Gazprom accounted for 543 billion cubic meters.

Mr. Halloran said one attraction of the sector is the growing European supply gap, with consumption increasing by 2.4% per year while internal European production remains flat. He said he expects developing investor perceptions to lead to a re-evaluation of the entire sector. "This re-rating has already happened in electric power following market liberalization," he said. "Those stocks are up by four or five times over the last few years, and we are looking for similar performance here."

"Prices into the European Union are expected to rise from \$250 per 1000 cubic meters of gas to \$350 this year," said Mr. Halloran. "Gazprom will be a huge beneficiary of this, even though the bulk of its sales are domestic, and hence at far lower prices." The firm will also benefit from the liberalization of prices in Russia, where government subsidies have been removed.

"We invest in the whole vertically integrated sector," said Mr. Halloran. "The fund invests mainly in the securities of issuers with exposure to the natural gas industry as a component of either their asset base or revenue stream or both. So we invest in the exploration, production, transportation, distribution, storage and processing of natural gas, not only in Russia but also in key strategic areas such as Kazakhstan and the Caspian Sea area. We also have some peripheral investments in companies which have access to Uzbek production."

The fund also looks at global depositary receipts listed outside the Russian markets, but is wary of valuations. "Some of them are quite interesting, but they are also expensive and quite illiquid. In some cases, there is very little free float, so volumes are tiny, which can constitute a major risk if you need to offload a large stake," says Mr. Halloran. To protect against sharp reversals, the fund uses single stock options on Gazprom and Novotec, and may also use 12- to 15-month RDX futures contracts as a proxy hedge.

The third fund in the Pharos portfolio is the Pharos Small Cap Fund, which invests in small and medium-sized listed companies across Russia and the ex-Soviet states. Since inception in December 2005 the fund, which has assets of around \$40 million, has returned 55.8%. "The fund invests across all sectors looking to profit from the internal growth story in the region," said Mr. Halloran. "We invest in infrastructure, small banks, retailers, manufacturers, some publicly traded real estate companies and so on. For this fund we employ broad downside protection via a proxy hedge with a liquid index designed to protect against overriding market risk."

It has been a tough start to the year, and the three funds sustained sizeable losses in the choppy January market. Pharos Russia was down 9.1%, Pharos Small Cap lost 4% and Pharos Gas gave up a whopping 13.5%. "In spite of the losses, we have to remember the context—the Russian RTS index was down 16.7% in the month," said Mr. Halloran. "Our overlay works well in these markets, and our volatility was a lot lower than the index also."

All three Pharos funds have a minimum investment of \$250,000, and charge an annual management fee of 2% and a performance fee of 20% with a high water mark. Subscriptions are monthly and redemptions monthly with 30 days' notice.

The funds, all of which are domiciled in the Cayman Islands, are advised by British Virgin Islands-registered Pharos Financial Advisors Ltd. The prime broker for all three funds is Citigroup Global, and the administrator is Custom House (Dublin). The legal advisers are Dechert LLP (New York), Walkers (Cayman Islands) and Akin Gump (Moscow).
