

Investing In Russia: An Interview With Pharos' Peter Halloran

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On a consistent basis, the media ask me about ETFs and/or the management of money. From time to time, however, the media ask me to jump behind the camera lens; that is, to interview prominent fund managers or exchange-traded fund executives. In this case, it's Seeking Alpha that requested I run the interview below.

Here, then, is my interview of [Peter Halloran, CEO of Pharos](#), the Russian hedge fund. (Quick Note: I do not necessarily endorse the Pharos funds described herein, nor do I necessarily agree with the responses.)

Q: Why should an American investor take a serious look at Russia right now as a part of his/her international portfolio?

Russia trades at one of the lowest P/E's in the global emerging market arena despite being one of the few area poised to show accelerating earnings growth in 2008. It is one of the least exposed markets to the G3 economic slowdown, while domestic demand should remain buoyant. The non-oil domestic sectors trade at 13 times 2008 earnings while we estimate earnings growth of 29% for the year. This compares quite favorably to its peers which trade at the same multiple but offer half the growth.

Q: Emerging markets, particularly Eastern Europe, have recorded above-average returns for 5 years (2003-2007). How does the risk-reward profile of Russia look today in 2008? How has it changed from 5 years ago?

Russia has achieved a remarkable degree of economic stability over the past 5 years, with political stability coming as a result. The story of the emerging markets themselves has changed as trade barriers have fallen away and structural reforms within these markets have been widespread. While we believe it is too early to argue that economic decoupling will be taking place, it is clear that these economies are poised to continue growing more quickly than the developed economies. As for Russia, it has turned the corner over the past 5 years as the domestic economy has taken root and now drives 85% of Russia's economic expansion. Russia has become far less dependent on commodity prices, foreign

borrowing and foreign capital flows over the past 5 years. It is no secret that Russia's economic and financial recovery has been due in large part to high oil prices and high commodity prices. That results in strong foreign reserves.

Q: Devil's advocate here... isn't an investment in Russia merely an investment in oil services. Why not? How is it different?

As the domestic economy has grown, oil has become much less of a factor for economic stability. In 2007, for example, oil and gas revenues will come to about \$225bn while overall GDP will be around \$1.3 trillion—this compares to a decade ago when the entire economy was only \$200bn. The pivotal year was 2004 when the domestic economy supplanted resource exports as the engine of growth. Today nearly all growth in the market comes from the domestic economy yet old habits die hard and too many investors have slept through this transition.

Q: What are some of the major economic trends in Russia today, and how might that affect an interested investor going forward? How might the changing political landscape play a role?

President-elect Dmitry Medvedev has outlined areas where the state will be spending, and looking for private investors to join. This includes infrastructure development which is already underway. Medvedev was a pro-reform candidate which means investors should expect ongoing reforms in telecoms, banking and utilities, while the nascent liberalization of the gas sector should accelerate. We would expect the state to switch over to a positive role on most corporate governance issues as it seeks to develop its interests acquired over the last term under Putin; we think it unlikely that the state will expand its ownership role significantly in the economy from here.

*Q: More devil's advocate. The **Market Vectors Russia ETF (RSX)** has outperformed the **Pharos Russia Fund** in its short tenure. **Third Millennium Russia [TMRFX]** is up 39% annualized in 5 years versus 29% for **Pharos Russia Fund**. What conclusions should interested investors draw?*

We have shown a 33% annualized gain over the past 5 years—not bad for an absolute return approach. The alternatives you mention offer pure beta at a time when the overall market has re-rated. The Pharos Russia Fund has shown lower volatility during that period given its mix of short positioning and derivatives, thus we provide better risk adjusted returns over time. We believe alpha going forward will be more readily available to our strategy as the market enters a more mature phase in its development. Meanwhile, our more beta oriented funds, the Pharos Gas Investment Fund and the Pharos Small Cap Fund, have tended to exceed the returns you mention above, having been ranked among the top-10 performing funds in past years by Bloomberg and Eurohedge.

Q: Why should investors be interested in single country funds? Wouldn't it be better to diversify across Eastern Europe with an ETF or across emerging markets with the BRIC concept?

That approach was more appropriate during the early days of emerging markets investing. Today, the asset class offers significant liquidity and opportunity to differentiate. In fact, studies have shown that picking the right market is the single biggest determinate of successful emerging market investing.

Q: Where do ETFs and mutual funds fail Russia investors where hedge funds would be more beneficial?

As the market matures and broadens, stock picking will become more important. We are already seeing this trend as market volumes have grown from \$300 million per day 5 years ago to \$6 billion per day now. Add to this proper use of the derivatives market, futures market and shorting, it will be hard to justify sitting in a pure beta product like an ETF or mutual fund. Our local stock picking edge comes partly from more than a decade of local presence and more than 40 board seats on Russian companies, this is not available from an ETF. There are 3 Russia funds at Pharos.

Q: How might an investor determine his/her course of action to get exposure to Russia through one or more of the hedge fund products?

The flagship Pharos Russia Fund provides the most balanced exposure to the market opportunities and offers daily liquidity. The Pharos Small Cap Fund should be viewed as a longer term play on the explosive growth of Russia's domestic economy and the broadening of the market overall. And lastly, the Pharos Gas Investment Fund is designed to tap into the value unleashed by last big reform initiative in Russia at a time when energy prices are at historic highs.

Q: What individual Russian stocks are most compelling today? Can investors get them on the U.S. exchanges?

The most compelling stocks have listed in London rather than New York. An exception to this is Vimpelcom ([VIP](#)) which is a great play on consumer spending power and increasing broadband penetration.

Q: The currency crisis in 1998 hit Russia pretty hard. Is there anything on the horizon that could adversely impact Russian investments?

There are two risks worth watching. The exogenous risk is an acceleration of the credit crisis which would threaten global growth and liquidity; the Russia risk is inflation which has ticked higher over the past few months.
