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To Russia With Hope

By ERIN E. ARVEDLUND | [MORE ARTICLES BY AUTHOR](#)

Peter Halloran brings home rich returns for investors in his Pharos Russia hedge fund

January Hedge Funds: Best, Worst, Biggest

Year after year Russia scores embarrassingly low on Transparency International's corruption-perceptions index. Last year, for instance, it garnered a score of 2.1, putting it above the renegades Somalia and Sudan, but below the likes of Libya and Yemen. You would think the country's reputation for nogoodnik behavior would scare off sensible money managers, even those who know their way around emerging markets. But in the case of Peter Halloran, CEO of Pharos Financial Group and manager of the Pharos Russia Fund, you would be wrong.

Halloran, an American, founded Pharos in 1997, with seed capital from Soros Fund Management and CS First Boston. The firm currently oversees \$1.5 billion in several hedge funds, including its oldest, Pharos Russia, which has returned an annualized 25.6% in the past 10 years, compared with a return of 19.6% for the MSCI Russia Index (MXRU). Pharos Russia was one of the few funds that didn't "gate," or restrict, investors from redeeming funds when the Russian stock market crashed in 2008.

"What investors have missed is that Russia's private sector has grown from zero to 65% of total GDP [gross domestic product], from \$180 billion at its low up to \$1.6 trillion," Halloran says. "Its stock market is one of the most liquid among emerging markets, with \$6 billion in volume per day. The Kremlin has tamed hyperinflation and built a stable

currency with no capital controls. In addition, Russia has one of the biggest foreign-exchange reserves—\$500 billion—in the world."



Gary Spector for Barron's: *Peter Halloran*

All this often is overshadowed by stories of the other Russia, which garnished the country's biggest oil company, Yukos, and threw its CEO, Mikhail Khodorkovsky, an opponent of Russian Prime Minister Vladimir Putin, in jail. The Kremlin also has picked fights with investors, and it expelled activist money manager William Browder, head of Hermitage Capital Management, in 2005.

"People are paying us to stay out of trouble and take the returns in the market," Halloran says. "If you can avoid the rare blow-ups, either where management steals from investors or runs afoul of the government, it helps outperformance tremendously. Yukos doesn't happen to everybody. You can anticipate these things and get out of the way."

PHAROS RUSSIA FUND BALANCES its holdings between companies geared to global growth and commodity prices—such as iron ore, coking coal and steel—and companies with domestic drivers, such as banks and utilities. Halloran thinks that mix offers the best way to protect against the periodic sell-offs and constant volatility driven by changes in local sentiment. The realized volatility of Russia's market is somewhere around 32, compared with emerging-market volatility of 22 and U.S. market volatility of 16, as measured by the VIX, or CBOE Volatility Index.

"Our aim is to capture market upside, with only two-thirds of the volatility of the market over time," Halloran says. "By dampening volatility we aren't losing as much during the downturns."

Unlike some other Russia hedge funds, Pharos also trades FTSE Russia IOB index options, and put options on the Russian Depositary Index, or RDX.

Halloran notes that Russia and other emerging markets look more stable today than developed markets, with a fraction of most developed countries' debt, as well as sustainable budgets. Russia's corporate-debt levels are more comparable to those in developed markets, but the country's sovereign and consumer debt is negligible.

As for Russia's GDP, Halloran sees it growing by 6% in 2011, up from 4% in 2010. Inflation is likely to head lower, to the 7.5%-to-8% range from a current range of 8.5% to 9%.

"Inflation is one of the key risks," he says. "The government may have to be in a tightening phase in second half of 2011."

Halloran tends to study both price/earnings ratios and price-to-earnings growth rate, or PEG, ratios among markets. Russia trades for 7.5 times expected earnings, a significant discount to the MSCI Emerging Markets Index P/E of 12 to 13 times.

He also looks at valuations on Russian stocks after stripping out natural-resources exporters. "Those are low-multiple stocks, dependent on commodity prices, and less on how the economy is growing," he says. "Excluding these stocks, Russia is still compelling, at a little over eight times earnings, with an earnings growth rate of about 35% annually."

Emerging-market earnings generally are growing at "closer to 15%," he notes.

Russian stocks could get a boost later this year if the country finally wins membership in the World Trade Organization, which it has been pursuing for almost two decades.

Admission, says Halloran, "sets up a reform agenda as a catalyst, gives more incentive for reforms and transparencies for business leaders and political powers, and could add 0.3% a year to GDP over time."

Gazprom (ticker: OGZPY) is one of Pharos Russia Fund's major picks today. "It is the ultimate market proxy for a few reasons: Russian market sentiment is swinging toward the positive, while Gazprom's fundamentals are turning from negative to positive," Halloran says.

Late in 2009, European natural gas prices were weak due to oversupply. At the same time, Gazprom was spending huge sums on big projects that were value-destructive. Now spot prices for natural gas have rebounded to \$300 per thousand cubic meters from \$150.

"Demand is up in Europe and profitability was restored for European, sales," Halloran says.

As a result, he adds, "Gazprom is likely to be the most profitable company in the world. The company will see massive free-cash-flow generation, with its big projects now finished, and could even surprise with a dividend increase."

Halloran speculates that Gazprom's 1% dividend yield could double this year.

Gazprom trades for 5.36 times earnings. Its U.S.-listed American depositary receipts are selling for about 28.50, and he thinks they could rally to 40 this year.

Sberbank (SBER.Russia) is another Pharos holding—a play on the macro picture in Russia, and on a bank with improving net interest margins that had been under pressure in the past 18 months. Lending rates have fallen, but Sberbank wasn't able to drop the rates it pays on deposits as fast as loan rates were declining. Thus, the company's cost of funds was increasing, along with more competition from other banks. Now net interest margins are poised to widen again, he says.

INFRASTRUCTURE SPENDING is expected to pick up in Russia, which could boost another Pharos holding, steel manufacturer **Evrax** (EVGPF). Halloran has a target price of 52 per ADR, versus a current price of around 38, based on his expectation that Ebitda could jump by 60% in 2011. Evrax, he says, is a solid play on domestic steel demand, spurred by renewed infrastructure spending and residential construction.

Pharos Russia also owns **Eurasia Drilling** (EDCL.Russia), which trades for 32 but could rise to as much as 42. A dominant oil driller that was spun out of **Lukoil** (LUKOY), Eurasia Drilling is gaining market share. Ebitda could increase by 40% in 2011, and another 30% in 2012. The stock is "a play on firm oil prices and steady capital spending from the oil sector," Halloran says.

Like most hedge funds, Halloran's fund also sells stocks short. One potential target is **Alliance Oil** (ALNC.Russia), although he says that the stock looks overvalued, and that it could suffer under a new Russian oil-tax regime.

Pharos Russia owns electric-utility stocks, and Halloran is betting on accelerating earnings in the sector as an asset-based tariff plan is implemented for distribution companies. But the fund recently sold one utility, MRSK Holding, because Putin "made populist comments about capping their tariff growth at 15%, as it is an election year.

Russia might never rise much in the transparency rankings. But Halloran has demonstrated a deft ability, so far, to see through the country's myriad troubles and capitalize on its abundant opportunities.

ERIN ARVEDLUND is a freelance writer based in Philadelphia.