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A CLOSER LOOK AT RUSSIAN EQUITIES

Often lost in the (not so inspiring) news cycle that dominates all things Russia is the fact that its equity market has performed quite well. In fact, the MSCI Russia Index has annualized 11.8% over the past half-decade, compared to 9.6% for emerging markets equities broadly. Russian equities have outperformed global indices and compare quite favorably to the much-hyped US and Chinese markets. Take out the top technology related names in the S&P 500 and MSCI China Index, and Russia becomes one of the best performing equity markets globally. Russia does not have a single tech related holding in the top ten names of the MSCI Russia Index. When one considers the conditions under which the Russian market managed to succeed it is even more impressive. After all, Russia has gone through painful adjustments in the last five years.

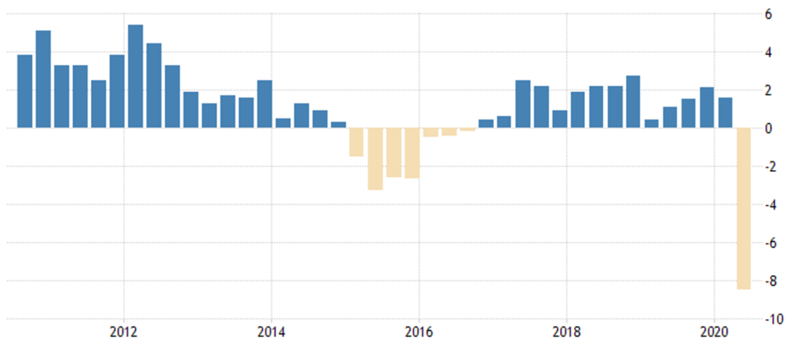
5 Year Annualized Returns (USD)

MSCI Russia	**11.77%**
MSCI EM	8.66%
MSCI ACWI	10.21%
MSCI China	13.72%
S&P 500	14.43%
*S&P 495**	9.96%
*MSCI China ex-Top Two**	8.93%

Source: The RockCreek Group, MSCI, S&P
*Calculated using constituent holdings of the SPY and MCHI ETFs. As of August 31, 2020

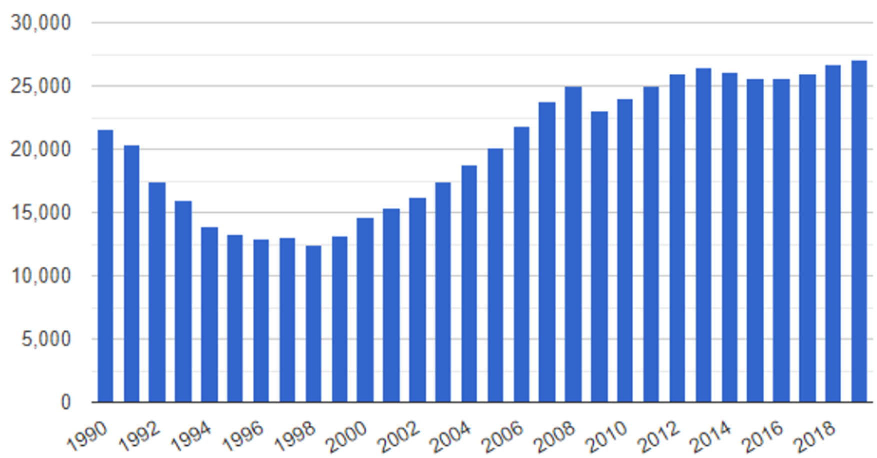
In mid-2014, Russia began to face the consequences of collapsing oil prices - revenues from the sale of crude oil, petroleum products, and natural gas account for about half of Russia's federal budget. In addition, the passage of US and EU sanctions after the invasion of Crimea in 2014 forced the Russian government to focus its attention inward, undertaking a series of steps to make the difficult adjustment to domestically led economic growth. These measures led the Russian economy to contract significantly in 2015 and 2016. The country only managed to return to growth in 2017. Fiscal and monetary authorities decided to concentrate on a painful policy mix of import substitution, pension reform, and controlled currency appreciation to weather the downturn. These adjustments allowed GDP per capita to remain relatively stable from a purchasing power parity perspective. Exports of commodities eventually rebounded even though they have not come close to pre-2014 levels.

Russia GDP Annual Growth Rate



Source: The RockCreek Group, Statista

Russia - GDP Per Capita, PPP

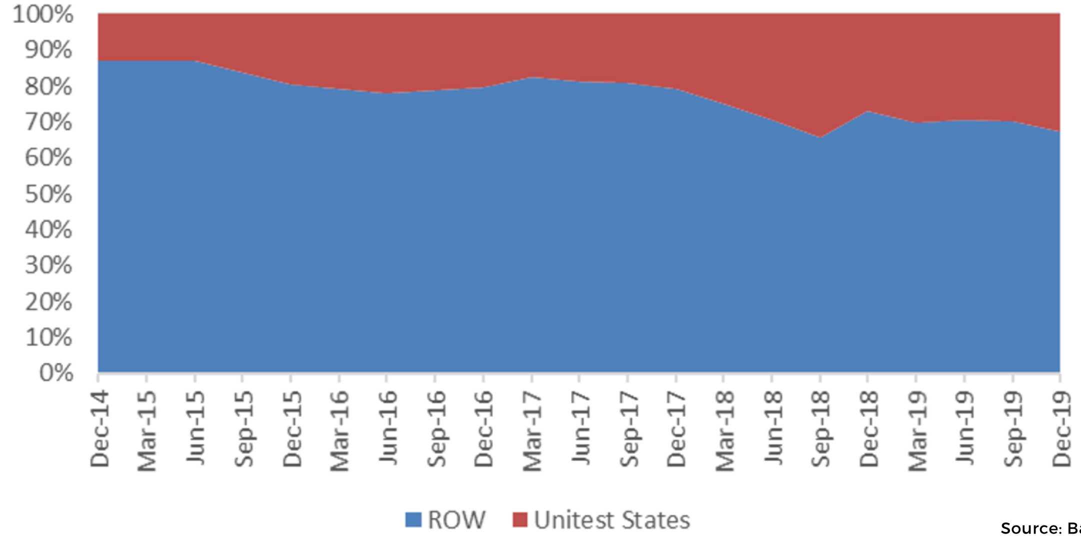


Source: The RockCreek Group, Trading Economics

Domestic policy adjustments coupled with the easing of some sanctions, including the failure of the US government to pass the much feared and more consequential financial sanctions, allowed Russian companies, particularly energy conglomerates, to consolidate and renew capital expenditure. While Russian authorities were busy shoring up the economy and maintaining stability, one would have expected foreign investors to flee en masse. Herein lies the paradox. In the last five years, the total value of foreign participation in the Moscow Exchange has more than doubled. Against expectations, this increase in foreign participation has been led by US institutional investors. In 2019, North American institutional investors accounted for over half of the foreign capital flowing into Russian stocks, according to the Bank of Russia. By comparison, European investors accounted for only 26%.[1] Moreover, among actively managed global emerging markets strategies, Russian equities have remained a consensus 'overweight' versus industry benchmarks through 2020.

[1] Source: Moscow Stock Exchange, Forbes

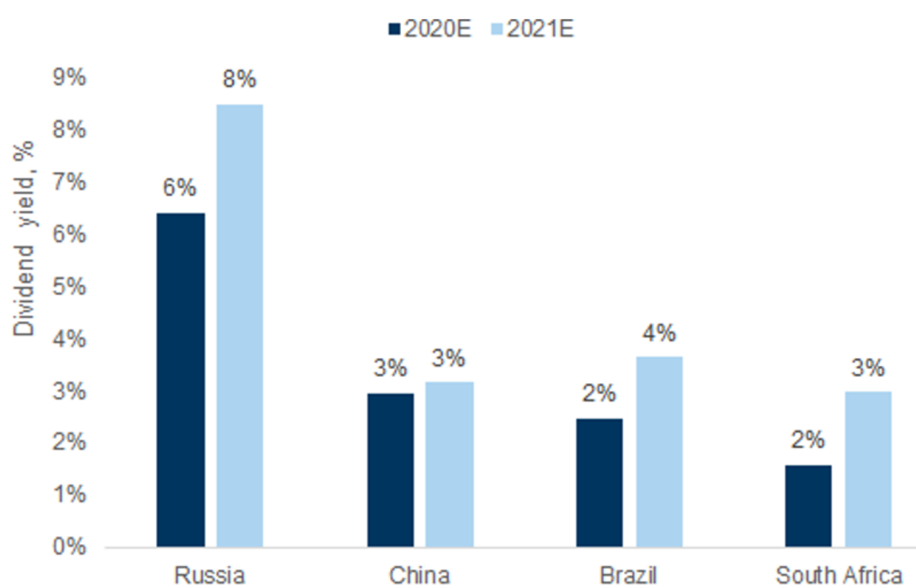
Foreign Ownership of Russian Stocks (%)



Source: Bank of Russia

Russian companies have managed to navigate the complexity of Russia's role in global geopolitics, the vagaries of the commodities markets, and the domestic Russian consumer. They have maintained healthy balance sheets, adjusted their growth strategies all the while maintaining one of the highest capital payout ratios in the world. And they are cheap – very cheap. With a P/E of less than 9x and a dividend yield more than 3x times that of emerging markets as whole, it is little wonder Russian equities continue to attract investors. In the short term, the country is also well positioned to benefit from a global recovery in commodity demand post-Covid19.

Russia provides the highest dividend yields in 2020/21 among EM peers



Source: The RockCreek Group, GS

Russia is of course never really without its risks. Indeed, the fallout of Mr. Navalny's recent ghastly poisoning could well include new sanctions and the suspension of the new Baltic Sea pipeline to Germany. Saudi Arabia's recent push to cut oil prices will put renewed pressure on the Russian budget. Structural weaknesses remain. Russia ranks 31st in the World Bank's ease of doing business index and business confidence in the country's legal system remains weak. Intellectual property infringement is a real source of concern. Nevertheless, if recent history is any indication, Russian assets can still be a source of attractive risk-adjusted returns. Like with other asset classes, one must remain vigilant of the risks and always know the location of the emergency exits.

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