

Russia's Challenges and Opportunities

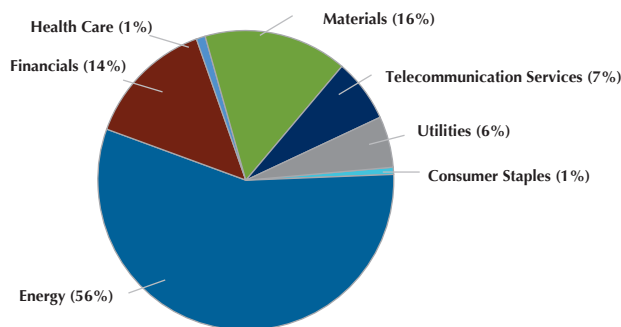
Senior portfolio manager Nathalie Wallace, a member of Batterymarch's emerging markets investment team, outlines Russia's much-discussed reforms as well as its strong equity investment potential.

Russia's substantial energy resources have made it a key player in the global economy. Yet unlike the other BRIC countries—Brazil, India and China—Russia experienced severe economic difficulties during the worldwide recession. While India and China continued to grow throughout the global slowdown, and Brazil's recession was relatively minor, Russia was hit especially hard by a precipitous drop in oil prices, due to lower demand, along with a massive outflow of capital.

After a decade of strong growth, Russian GDP sank 7.9% in 2009, its worst decline on record, as a result of the country's energy-focused economy (Figure 1) and its vulnerability to global credit tightening. In addition, the Russian oligarchs had borrowed heavily from foreign banks, using their equity stakes as collateral, and were forced to sell off as stock prices fell, further battering the Russian equity market.

Figure 1: Russian Economic Sectors

as of May 17, 2010



Source: MSCI

This test, the first since Russia's sovereign debt default in 1998, highlighted a lack of confidence by corporates, citizens and investors in the country's institutions. It also highlighted the need for multiple reforms, including greater economic diversification and tighter financial regulations.

Since then, a sharp upswing in oil prices has helped propel the Russian economy back on a growth trajectory, with the International Monetary Fund forecasting a 3.5% jump in GDP for 2010. Higher oil prices have also bolstered the Russian stock market, whose constituents—energy related or not—are often more correlated with global energy prices than are dedicated energy stocks in other countries. The increase in oil prices is therefore benefiting industries from telecommunications to banking, and investors can find a broad range of opportunities based on positive underlying company fundamentals.

Economic Strengths— and Future Reforms

Russia's sovereign credit quality is arguably second to none, with a 7% debt-to-GDP ratio projected for 2010. In comparison, sovereign debt-to-GDP in other parts of the world ranges from 15% for Australia to 227% for Japan. Balance sheets for Russian households and many corporates are also very strong.

Furthermore, like other emerging markets, Russia has large foreign reserves and is expected to have a current account surplus, giving it monetary and fiscal flexibility. Russian inflation, which skyrocketed in 1992 to more than 2500% as prices were decontrolled, is now at the lowest level since the end of the Soviet era. Inflation has continued to drop as part of a multiyear disinflation trend and could be as low as 6.5% this year, according to Prime Minister Vladimir Putin.

Under these financial conditions supported by new fiscal restraint, the ruble, which lost considerable strength during the 2008-2009 oil price decline, should appreciate while sovereign yields remain low.

Despite these positive aspects, the collapse in oil and commodity prices underscored key weaknesses in the Russian economy, especially its well-known dependence on energy exports. Speaking in November 2009, President Dmitry Medvedev called for greater economic diversification, with less state control. Other necessary changes being discussed include establishment of the rule of law and ethical behavior in government and business, as well as financial reforms. For example, Russia requires an effective and independent bank regulator to permit the expansion of a secure, well-capitalized private banking system. The country also needs transparent corporate lending practices and better accounting and reporting standards.

From an investment perspective, the lack of infrastructure and rigorous stock market regulation remains a significant issue, driving many Russian companies to list on foreign exchanges, primarily in London and more recently in Hong Kong. The Russian market has historically been marked by volatility, with astonishingly strong performance alternating with significant price declines. These swings have been exacerbated by Russia's open capital account, which allows speculation, enabling investors, corporates and individuals to rapidly switch from rubles to euros or US dollars as oil prices and confidence fluctuate.

The impact on the stock market has been further pronounced because of Russia's relatively small domestic investor base—corporate pension plans and a culture of mutual funds have yet to be introduced there—as well as the limited number of shares available. Pension reform that permits investment in the domestic stock market should help Russia develop a larger local investor base, making it less reliant on outside sources of capital, as seen in countries including Poland, Brazil, Chile, Mexico and China.

Such changes have already taken place on the fixed income side. Now that Western banks have constrained lending, corporates have turned to the domestic market, where they can find ample liquidity through Russia's banks and pension system.

While public debate in Russia focuses on the state's role in modernizing and diversifying the economy, companies in the private sector, including retailers and manufacturers, have gradually been making progress through corporate consolidations, joint ventures with non-Russian companies and other actions.

**Growing Opportunities
for Long-Term Equity
Investors**

In Batterymarch's view, Russia's investment outlook is positive for a number of reasons: abundant liquidity, sustainably low interest rates, increasing earnings growth and a stable to strengthening currency—as well as cheap valuations relative to the other BRIC economies (Figure 2).

Figure 2: BRIC Valuations

as of May 14, 2010

	MSCI Brazil	MSCI Russia	MSCI India	MSCI China
Future 12-Month P/E	9.4x	6.5x	14.8x	11.7x
Price/Cash Flow	6.2x	2.5x	12.8x	8.7x
Price/Sales	1.2x	1.1x	1.9x	2.2x
Price/Book	1.9x	0.8x	3.1x	2.3x

We believe that the most effective way to identify promising opportunities in Russia—or anywhere in the world—is through bottom-up stock selection, focusing on individual company fundamentals. The most attractive stocks rank well not only in terms of valuation, but also at the earnings growth, cash flow and earnings expectation levels.

The breadth of attractive long-term investment opportunities in Russia should continue to grow. While the market remains dominated by resource stocks—Gazprom, the world's leading natural-gas producer, accounts for roughly 25% of the MSCI Russia Index, for instance—a stronger ruble and domestic cost pressures are expected to cap earnings growth for these companies. This should help open the door for companies in sectors related to manufacturing, consumer demand and infrastructure development, which are currently underinvested and should benefit as inflation continues to drop. In addition, analysts predict a resurgence of IPOs after a hiatus in 2009.

Combined with the critical reforms laid out by Mr. Medvedev and others, this broadening range of opportunities can help change Russia's cyclical growth story into a secular one.

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