ABS GLOBAL INVESTMENTS
EMERGING MARKETS EQUITY

The Russian Quagmire

Market Insight

March 14, 2022

INTRODUCTION

Equity trading in Russia began in 1992, shortly after the Soviet Union was dissolved. It was initially a thinly traded market, consisting of recently privatized vouchers. It was not until 1995, with the establishment of the Russian Trading System (RTS) that trading volume grew[1]. Since then, the market has had its share of volatility, starting with the debt default in the late 1990s, the financial crisis of 2008, the annexation of Crimea in 2014, and finally culminating in the suspension of the market altogether, after the invasion of Ukraine in February 2022.

Guilherme Valle, portfolio manager and founding partner of ABS, started following the Russian markets in the mid-nineties, making his first trip to Moscow in 1996. ABS has been invested in Russia since 2006. Over the years, the ABS research team has developed a wide range of contacts in Russia, including local fund managers, regulators, companies, and other investors. The team has conducted frequent due diligence visits to the country, with the last one happening in October 2021. Throughout this time, we have witnessed the growth not only of the economy but also of the stock market. What started as a market dominated by state-owned enterprises in mainly the energy and export sectors, it has grown into a more balanced market with the emergence of privately-owned companies in "new economy" sectors such as ecommerce and internet – related. Importantly, corporate governance for minority shareholders improved throughout these years, with companies diversifying their boards and increasing their dividend payouts. By the end of 2021, Russian stocks had among the highest dividend yields in the world.

Despite the ever present, and rising, geopolitical tensions between Russia and the West, the investment environment in Russia steadily opened and became more “friendly” to foreign investors. Of course, this all ended abruptly. As of today, the market is no longer investable as sanctions and counter sanctions have effectively isolated Russia from the rest of the world.

What follows is a review aimed at helping investors understand recent events and their impact on global markets.

UNDERSTANDING RECENT GEOPOLITICAL EVENTS IN THE CONTEXT OF RUSSIA AND UKRAINE’S RELATIONSHIP

Ever since Ukraine became independent in 1991, the relationship with Russia has been complicated. There has been a tug-of-war over political influence between Russia and the West. On one hand, the cultural and political boundaries between Ukraine and Russia were seemingly blurred during the early post-Soviet era. Ukraine is home to the largest Russian community outside of Russia, and they are the largest minority in the country. Russian is the native language to approximately 30% of the Ukrainian population, and almost every Ukrainian can speak the language. On the other hand, a large portion of the Ukrainian population has demonstrated a desire to pull away from Russia’s sphere of influence and orient themselves toward Western countries. The latest attitude expressed by the Ukrainian government, to one day join NATO, was a big setback for Russia’s attempt to reassert itself as global power in the post-Soviet world.

While this push-pull dynamic has been a regular feature in Ukrainian society, and Russian geopolitics in general, very few expected the recent escalation and full-blown invasion of Ukraine in February 2022.

An Independent Ukraine

Shortly after the fall of the Soviet Union, more than 90% of Ukrainians voted for independence, creating Europe’s second largest country by landmass in 1991[2]. Ukraine’s proclamation of independence was renewed in 1994 by the Budapest Referendum. Following the collapse of the Soviet Union, nuclear weapons were scattered across former Soviet states and Ukraine was in possession of one-third of the world’s nuclear stockpile. In exchange for giving up this nuclear arsenal, Ukraine signed an agreement with the Unites States, United Kingdom and Russia with assurances that both its independence and sovereignty would be respected. The agreement also included a promise to refrain from the threat or use of force against the country.

Tug of War: Alignment with Russia or the West

Little more than a decade after its independence, visions for an independent Ukraine started to change, splitting those who sought greater alignment to the West from those who favored closer ties to Russia. Ukraine, sharing thousands of miles of border with Russia, found itself in tug of war of influence, culminating in the events happening today.

In 2004, the Orange Revolution in Ukraine marked a turning point in what some consider to be an "awakening" for the population. The wave of protests in late 2004 took place in the aftermath of the presidential election, which featured a pro-West candidate, Viktor Yushchenko, against a pro-Russian candidate, Viktor Yanukovych. Initially the pro-Russian candidate won, amidst widespread allegations of voter fraud and corruption. The protests were so significant that a re-vote took place, in which the pro-Western candidate was declared the winner.

In the 2010 presidential elections, that same pro-Russian candidate won the election, only to again be forced to step down due to massive social unrest in the country. This event marked the escalation of relations between Ukraine and Russia to a confrontational level. Shortly after the pro-Russia candidate was overthrown and fled to Russia, pro-Russia separatists and Russian troops took control of Ukraine's Crimean region prompting international outrage. Violence in eastern Ukraine continued until early 2015 when Russia and Ukraine agreed on a ceasefire (the Minsk Agreement). Part of this agreement also called for an eventual discussion involving two areas of Ukraine, Donetsk and Luhansk, to become autonomous. These discussions never took place, which only fueled further tensions between the two countries.

Since 2014, the US, the European Union and its allies have attempted to punish President Putin and Russia for the annexation of the Crimea region with several sanctions. Measures have ranged from imposing travel bans, asset freezes and economic restrictions on Russian individuals and companies. While the effects of these sanctions can be debated, the Russian government learned to adapt, and to even grow its economy post the events of 2014.

NATO Expansion

Originally formed in 1949 as a military alliance between 12 countries with the aim of containing the Soviet Union and communism, NATO's purpose changed to guarantee the freedom and security of its members through political and military means[3]. In addition, the organization began expanding eastward in a post-cold war era. In 2004, the alliance added seven members, all of which were in Eastern Europe, including some former Soviet Union states (Estonia, Latvia and Lithuania). Ukraine has long voiced a desire to become part of the alliance, but Russia has been equally as vocal in their opposition. Most notably, the 2008 NATO summit was marked with intense debate about extending a "Membership Action Plan to Ukraine (the first step towards admittance into the alliance). In 2008, William Burns, the American ambassador to Moscow, wrote to Secretary of State Condoleezza Rice: "Ukrainian entry into NATO is the brightest of all redlines for the Russian elite"[4]. Fast forward to 2020, and Ukrainian President Zelensky "approved Ukraine's new National Security Strategy, which provides for the development of the distinctive partnership with NATO with the aim of membership in NATO"[5].

2022 Russian Invasion of Ukraine

In February 2022, Russia invaded Ukraine, using NATO encroachment as a pretext. The buildup of Russian military near the Ukrainian border sparked attention in April 2021 and in December, Russia began demanding security guarantees from the US and its allies, including explicitly stating no NATO expansion into Ukraine. Those demands went unheard and despite some diplomatic efforts, Russia deployed troops into Luhansk and Donetsk on February 22, declaring them as independent states. Two days later, Russia launched a full-scale invasion into Ukraine.

Putin's decision took the world by surprise, including many Russians who have cultural and family ties to the country. In numerous conversations with our local contacts in Eastern Europe, the consensus was that a full-scale invasion of the Ukraine was highly unlikely. The reasons given were that Putin was ultimately a rational actor, and the economic consequences (heavy sanctions, total isolation) of such an action would be a sufficient disincentive. Furthermore, Russian people showed limited support for such actions (the close cultural ties equate to "fratricide"). However, this consensus was wrong. Looking back, Putin likely viewed further NATO encroachment as an existential threat, outweighing whatever concerns he might have had of being isolated from the world stage.

THE ECONOMIC IMPORTANCE AND THE GLOBAL RESPONSE

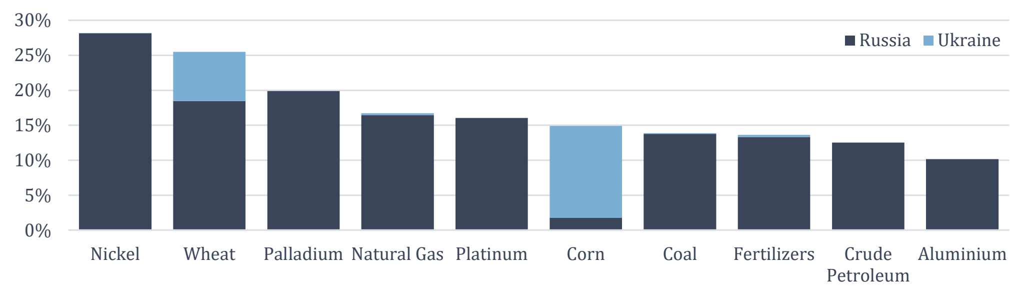
The world reacted swiftly to Russia's attack on Ukraine, condemning its actions. What started as a military conflict between Russia and Ukraine, quickly evolved into an economic war. Western allies responded to Russia's aggressions with sanctions aimed at economic and financial isolation. The move has been unprecedented in the level of coordination among Western allies and speed of their response. In less than one week, Russia has become a global pariah.

Today these sanctions and countersanctions are defining the macroeconomic environment globally. As the war on the economic battlefield unfolds, the world is looking to understand the impact these measures are having on Russia and its resolve in Ukraine. In addition, the world is looking to understand the impact these measures may have on the rest of the world which is still in the process of recovery from the 2020 pandemic crisis.

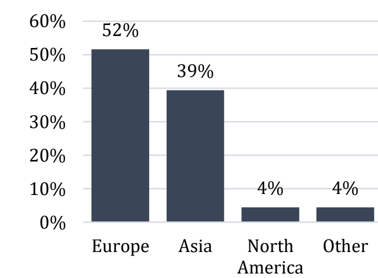
Russia & Ukraine: Economy at a Glance

Russia is the world's largest nation by land mass and among the most abundant in natural resources. Its meaningful footprint in select commodities, particularly within the energy sector, makes it an important player in the global economy. It is the world's largest exporter of wheat, second largest of natural gas and third largest in oil[6]. Meanwhile, Ukraine is also an important global economic player, particularly within the grains, iron and steel industries.

Russia & Ukraine's Exports, share of world total % (2019)



Russia's Export Destinations (2019)



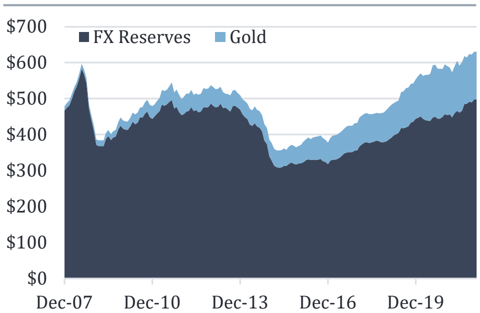
Source: OEC as of 2019. Past returns are not a guarantee of future results. Graphs are presented for illustration purposes only and should not be relied on to make an investment decision

Fortress Russia

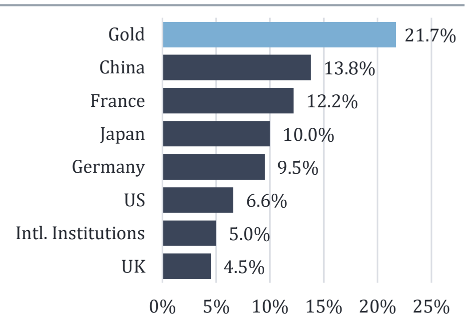
In 2014, Russia's economy came under pressure from a combination of plunging oil prices and sanctions from the West. Since then, Russia has built up its economic defenses to weather geopolitical and economic hurdles. Dubbed by Timothy Ash of Bluebay Asset management as the "Fortress Russia" strategy, the main goal was to make the Russian economy sanction-proof[7]. This strategy included reducing dollar dependency, supporting import substitution, and improving macroeconomic discipline.

Russia has adhered to a strict savings policy which allowed international reserves to grow from $ 376 billion in January 2015 to $630 billion in January 2022[8]. Not only have their reserves grown but they have become more diversified in terms of currency and jurisdiction where these reserves are located. Indeed, the share of dollar assets dropped to 22%, down from more than 40% in 2018[9]. In addition, they have reduced their external debt. They have also diversified their economy; in 2020, Russia became a net exporter of agricultural produce for the first time since the collapse of the Soviet Union. In essence, Russia was as prepared as ever to endure any future sanctions. While it is still early, signs of cracks in the "Fortress" have started to surface as the West unleashed restrictions on central bank assets.

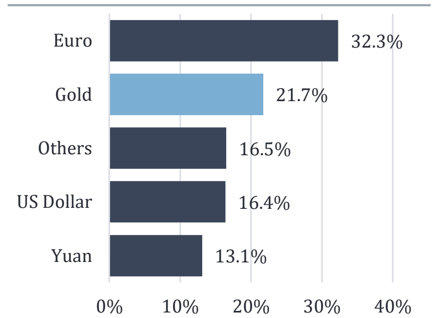
Russia's International Reserves



Largest Holders of Reserves by Location/Type



Share of Reserves by Currency/Type



Russia's International Reserves Source: Russian Central Bank as of January 2022. Breakdown of Reserve locations, type and currency source: Statista and the Central Bank of Russia as of June 20, 2021 Graphs are presented for illustration purposes only and should not be relied on to make an investment decision. Past returns are not a guarantee of future results.

The West's Response: 2022 Sanctions

Following Russia's invasion of Ukraine, the US, European Union, and other allies across the globe have joined together to impose an unprecedented package of sanctions against Russia. Even Switzerland, which has historically been known for its neutrality, has implemented the West's curbs against Russia. Sanctions have targeted:

- **Individuals close to President Putin's regime** – Assets of Russian leaders, oligarchs and their families' have been seized and are estimated to be worth billions of dollars. In addition to sanctions, travel restrictions have been imposed on many of these individuals and their families.
- **Fortress Russia** – Western sanctions have aimed to limit the Russian central bank's ability to access the global financial system. This move essentially froze its assets and limited its ability to tap into its reserves. Without this access, the

central bank resorted to hiking interest rates from 9.5% to 20% and compelling companies to convert most of their dollar revenues into Rubles. However, these measures proved to be insufficient in avoiding the subsequent crash in the Ruble.

- **Russia's Economic Activities** – On February 26, Western allies banned a selection of Russian banks from the swift messaging system, the financial-messaging infrastructure that links the world's banks. This move removed the ability of key Russian banks to communicate with the rest of the world and in turn has destabilized the country's economic activities. In addition, Western allies placed limitations on access of technological exports to Russia, including semiconductors, computers, lasers and telecommunications equipment, considered to be essential to key defense and other industries.
- **Lack of Sanctions on Strategic Sectors -** Initial sanctions were specifically designed to carve out strategic sectors in an attempt to minimize the collateral damage to the global economy. The most notable exclusions thus far were oil, gas and agricultural exports. European nations such as Germany and Italy are dependent on Russian gas. Ukraine and Russia together represent 25% of global wheat exports[10]. With that in mind, Russian banks handling energy payments were specifically excluded from the swift messaging ban. As the war on the military battlefield progresses, western allies are re-evaluating whether to include those strategic sectors in sanctions used in the economic battlefield.

Almost equally as notable as the sanctions is the exodus of Western businesses out of Russia. Since the start of the crisis, various companies exiting Russia have been going beyond what is required by sanctions. Large oil companies such as BP, Shell and Exxon have announced plans to exit joint ventures and Russian operations. Businesses ranging from accounting firms to retailers to credit card acquirers have declared plans to cut ties with Russia. Google has suspended all advertising in Russia. Car manufacturers such as Volkswagen, Ford, Mercedes Benz and Nissan have suspended exports and production of cars locally.

Russia's Capital Controls

As Western countries advanced plans to economically isolate Russia, Russia has implemented countermeasures which have acted as capital controls. These countermeasures included:

- **Block on Foreign Selling -** Russia's central bank ordered brokers to suspend the execution of all orders from foreign entities and individuals to sell Russian securities, effectively banning foreigners from selling Russian assets.
- **Conversion of Foreign Revenues to Rubles** – After the West curtailed Russia's central bank's ability to stabilize the Ruble using their foreign reserves, the central bank and foreign ministry ordered exporting companies to convert 80% of all foreign revenues to Ruble. The measure aims to support the Ruble in the absence of the central bank's access to foreign reserves.
- **Payments and Transfers Abroad Banned -** Payments to banks and other financial-market organizations outside of Russia and money transfers through foreign payment service providers have been barred.

As of December 2021, foreign investors held $20 billion in Russian dollar debt, $41 billion in Ruble denominated debt and $86 billion in local equities (traded on the Moscow exchange)[11]. Russia's exclusion from the swift system and recently imposed capital controls mean that a large portion of those assets are likely stuck in Russia with no clear exit. Sovereign wealth funds and pensions funds who had announced plans to redeem from Russia investments have had little ability to implement these plans. Companies who announced plans to divest from joint ventures also have few practical options to execute their intentions.

MARKET REACTION

Markets tumbled in the days following Russia's invasion of Ukraine as investors assessed the potential economic impact on the world economy. Risk aversion rose and there has been a flight to inflation protected and safe-haven assets.

As expected, the bulk of the pain was felt across Russian securities. The MSCI Russia Index was down -52.8% in February and has continued its drawdown into the first days of March. While the local equity markets have been closed since February 25th, shares of Russian companies listed in London (GDRs) continued to trade into the first days of March, and losses have been staggering. For example, Russia's largest bank, Sberbank (SBER LI), dropped 74% on February 28 and then another 95.7% in first two days of March[12].

Meanwhile, commodity prices have rocketed as concerns over supply shortages grew. With threats of further conflict and instability and prospects for inflation, the outlook for global economic growth has come into doubt.

What is Open? What is Closed?[13]

As sanctions were announced and markets unraveled, most trading of Russian assets has stopped or has been severely impaired.

This is not the first time Russian authorities have closed the market, as markets were also closed multiple times in late 2008 in response to substantial liquidity-driven losses stemming from the financial crisis.

- **Local Equities on the Moscow Exchange -** The Moscow exchange suspended trading until further notice after plummeting on February 25 when Russia officially invaded Ukraine.
- **Global Depository Receipts (GDR) -** The overseas listings of major Russian companies such as Sberbank , Gazprom , Rosneft , and Lukoil initially remained open, but stopped trading on March 2.
- **American Depository Receipts (ADR)** – Markets are closed and ADRs have not been trading since February 25.
- **Bond Markets -** While bond markets are closed, there is some trading happening over the counter.
- **Currency Markets -** While it is possible to trade foreign currencies, there are a number of hurdles. Additional fees have been levied for investors trying to convert Rubles to US dollars, British Pounds or Euros.

MSCI Decision

With market closures, capital controls and Russia's links to global markets severed, emerging market investors have grappled with their investments in the region. After consulting allocators and market participants, MSCI determined that the Russian market is "uninvestable". As a result, the index provider will write down all Russian stocks in the index to zero and remove them from its global indices on March 9. The impact on the MSCI Emerging Markets Index will be a loss of 1.6% in March from its Russian exposure. All-in, the MSCI Emerging Markets Index will show a total loss of the 3.6% allocation from Russia in Q1 2022[14]. This decision prevents any recovery from taking place at the index level.

THE ABS REACTION: WHAT ARE WE DOING?

For emerging market investors like ABS, the current situation creates a few hurdles, mainly stemming from the fact that no Russian securities can be sold or settled at this time. For context, direct exposure to Russian stocks only exists in our ABS Emerging Markets portfolios. Within those portfolios, total Russian exposure at the time of market suspension ranged from 2-4%, representing a very small overweight relative to the benchmark weight. We remain focused on assessing the current issues at hand. As it relates to our investments in Russia, we are:

1) Assessing these investments daily with local specialists and ensuring compliance with US sanctions and regulations.
2) Providing clients with a fair valuation of our assets. In times where there is lack of clarity in asset pricing, we are striving to offer our clients with the most transparent and just assessment of their investments.
3) Tracking economic, geopolitical and market activity. The situation remains very fluid.
4) Staying close to our local partners in Russia and elsewhere, ensuring that information channels keep flowing.

Conclusion

As we publish this white paper, it has been less than two weeks since Russia's invasion of Ukraine took most of the investment world by surprise. The thought that a market like Russia, which was one of the pillars of Emerging Markets and part of the infamous "BRIC" acronym, could disappear from the investment universe seemed impossible. While we are deeply saddened by the evolution of events and hope for a peaceful resolution in the near term, what happens next is unclear. The situation remains highly volatile and fluid; possible outcomes range from a quick and permanent ceasefire to internal pressure and regime change in Russia (although unlikely), to a long struggle, which prolongs effects of the military and economic conflict. The one certainty we do have is that Russia must now deal with a significant loss of confidence from the investor community.

Elsewhere in the world, investors will have to grapple with the implications and consequences of recent events across other markets. Regardless of how and when tensions dissipate, they have already triggered meaningful shifts. Countries most exposed to Russian exports such as western Europe have suffered the most and will likely need to review their defense and energy policy going forward. Meanwhile, commodity prices have rocketed intensifying the threat of inflation at a moment when global growth will likely show signs of slowing.

In summary, there is no doubt that the events in the Ukraine and Russia will have ripple effects across the globe from an economic, social and human perspective. There will be few, if any "winners" emerging from these events. And while this is a highly uncertain period, we are confident that our team's experience, processes, and on-the-ground networks will see us through to the "other side".

DISCLOSURES

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[1] The Russian Securities Market: 20 Years of Development. Prof. Dr. Boris Rubtsov. Financial University under the Government of Russian Federation Moskau. https://publishup.uni-potsdam.de/opus4-ubp/frontdoor/deliver/index/docId/6640/file/EFC_Rubtsov_105_118.pdf
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[14] Bloomberg and MSCI as of March 2022