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Russian Stocks Are Hurting, But Hope Remains

By James Beadle

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Russian assets are falling. Since the beginning of the year, the ruble has dropped 10 percent against the dollar, and the MICEX has dropped 11 percent. Part of this trend reflects an issue with global capital flow. In January, for example, global emerging market equities lost nearly 7 percent. But recent events in Ukraine have drowned the medium-term dynamic, and selling has dramatically accelerated. Investors holding rubles and Russian shares today face difficult decisions : Sell today at a loss, or hold on in hope of a recovery?

Russia started the year with natural headwinds caused by the relative improvement of economics in developed markets, especially the U.S. back in January, Russia investors faced tactical decisions — sell short-term and reallocate to developed markets or hold on, capturing healthy yields with an eye to the point when developed world growth would again stimulate emerging economies.

With Russia hosting the Winter Olympics, drawing interest and tourists from all corners of the planet, the decision to sell Russian assets was far from obvious. How quickly the story

changes! The MICEX was universally viewed as cheap, a top pick among its peers for many strategists this year. But in March, the Russian equity market has fallen another 7 percent, underscoring that whatever the valuation when you buy equities, downside risk is always there.

Buy and hope has always been a risky strategy in the world of equities, prone as they are to sharper falls than rallies. Where possible, it is better to sit in cash and, in the words of Warren Buffet: "Buy when others are fearful, sell when they are greedy." With such a strategy, wily investors bought Russian assets on Monday at levels substantially lower than today's prices. If the panic reoccurs, such investors will move in again, deploying more capital and gradually building positions with superior risk-reward characteristics.

For those that did not keep their powder dry, the decision is more complex. Is this the beginning of a rout, a last chance to salvage some value before the market enters a death plunge? Or is the worst over? Is it now better to wait it out, and hope to recover some value?

Investing is without question the most stimulating and infuriating of economic challenges. We are so often damned if we do and damned if we don't. Perhaps this manifestation of Murphy's Law is a good starting point. Given your economic position, which is a worse psychological outcome? Sitting in the market and risking a further substantial set back as prices fall further? Or taking the hit today and accepting the losses?

Another approach that has helped many in the past is the simple "can I sleep?" test. Never hold a portfolio that is causing chronic stress and disrupting your regular life. It is better to lock in the losses, even if it means starting fresh.

For those still uncertain, the decision path involves an assessment of several factors. What price you originally paid is not one of them. A rational assessment of your options demands that you forget about how much you have earned or lost, and focus exclusively on the current and future dynamics of prices.

The first question, then, is whether Russian assets are cheap, fairly priced or expensive. Most analysts agreed they were cheap at the beginning of the year. What has changed since then?

The economy has disappointed, and the Central Bank has raised interest rates buy 1 1/2 percentage points. Needless to say, this is a bad combination. Any high school economics student will tell you that a weaker economy would prefer a lower interest rate. The concern is what impact it has on valuation. For highly indebted companies and those companies that depend on people using debt, the impact is obvious: Future business has been hurt.

The weaker ruble has the same impact on companies that depend on imported goods. Conversely, exporters now earn more rubles for their dollar-based sales. The dollar's reserve currency status benefits Russian exporters at times like this. Some equities will lose from the current situation, others will gain. Start now, by rebalancing your exposure to hold more exporting businesses. It is worth remembering that the combination of higher oil prices and a weaker ruble has saved the Russian economy before. Most notably in 1999, after the national debt default, accompanied as it was by a massive devaluation.

The next question is whether these gains and losses are reflected in the price changes that we

have observed in recent times. The market is down across the board for the simple reason that investors hate uncertainty, and there is little more uncertain than a nation's army crossing its neighbor's border without the support of the global community. Prices are not only down for those stocks that now see a less certain future, but also for those that can expect profitable circumstances. Commodity prices are largely unaffected by events in Ukraine, so Russian equities are looking cheaper since the beginning of the crisis.

Finally, there is the most challenging factor to consider: What happens next? Perhaps Russian assets are cheap today, but will the next events in the crisis further weaken their prospects? As a basic rule, invasion, occupation and military activity lacking international support are bad for a country's economic outlook and asset prices. If the crisis should escalate further, expect prices to suffer.

At the same time, Russia had a lot more work to do this year to lure investment and stimulate growth. That path now looks closed, even if the Ukrainian crisis fades from view, Russia's best-case outlook is less positive than it was a month ago. Anyone thinking about buying Russian shares for a sharp rebound would better wait for another bout of panic selling.

Nobody has a crystal ball, yet an accurate reading of future events is essential to successful investing in a time like this. As such, everyone must ultimately decide for themselves what to do with their Russian investments — buy sell or hold.

Ukraine too big to fail, and the scale of this crisis is enormous. The potential for economic and human pain is far greater than price movements today imply. Yes, there is always downside risk. But for this very reason, exactly because the worst possible outcomes do not bear consideration, there is hope that cooler heads will prevail.

My view is that prices might continue to decline for now. Holders of Russian equities should rebalance quickly toward exporting companies, and they should be ready to make painful decisions if events escalate again.

But absent such an escalation, it is probably better to hold out for some kind of diplomatic resolution. Russian equities will be hamstrung whatever the outcome, but they have the potential to rise from these depressed levels.

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