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Why the Stock Market Is Doomed to Be Cheap

By Kim Iskyan

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Russia's stock market is one of the cheapest in the world. As the conflict with Ukraine drags on — or escalates — it will only get cheaper.

This isn't a temporary correction or a short-term aberration. Russian shares will continue to be volatile, and nimble traders could do quite well if they take advantage of that. But to the detriment of foreign and international investors, as well as Russian companies and ordinary Russians, Russia's stock market will remain cheap for a long time to come.

The Russian stock market trades at a 2014 price-to-earnings ratio of 4.5, according to Bloomberg, compared to a global emerging markets range of about 9 to 12. The discount of Russian shares on a price-to-book basis, another way investors use to value shares, relative to other markets is similarly large. Russia's stocks have historically been significantly cheaper than that of other markets. But current valuation discounts are substantially larger than usual.

The international media has noticed. "Bargain hunters move into Russia," Financial Times said on March 7. "Will it pay to invest in Russia now [that] shares have plummeted?" asked The Guardian. "Russia's Roulette: Why Investors Are Rolling With the Punches," read a headline in Britain's Telegraph.

Analysts and investors focused on the Russian stock market have long complained that the country's shares have been unfairly discounted compared to other markets.

For most of the time since the birth of the Russian capital markets in the mid-1990s, many of these people — for about a decade, I was one of them — have made a career of pointing to the potential for Russia's stocks and other assets to "re-rate" — that is, for the entire market to move from a P/E of, say, 7, closer to an emerging markets average of around twice that.

This process would sharply drive up the share prices of Russian stocks. It would also allow Russian companies selling new shares to raise more capital by selling a smaller stake of the company.

All it would take to drive a re-rating, these shot-glass-half-full analysts explained, was for global investors to cast aside their lingering Cold War prejudices, rethink their opinion of President Vladimir Putin, and accept that every emerging market has some warts ... and then everyone could get rich.

This argument held some merit.

First, historical baggage plays a big role in the enduring negative perception that the rest of the world has of Russia. The country is the punching bag of an international community that nearly 25 years later still labors under the stale assumptions of the Cold War. In fact, the opinion of Russia has even gotten more negative than during the Cold War. One poll found that the number of Americans with a negative opinion of Russia is nearly double, at 50 percent, the number that had a negative opinion of the Soviet Union in 1989, back when the Cold War was still in full swing.

Popular opinion does not dictate investment decisions or valuations. But it does form the backdrop of the investment environment. If a fund manager stuck in a 1980s frame of mind is afraid to visit Russia, he is not going to trust companies there, let alone want to invest in them. And investment committee members who wonder if there are still bread lines on Tverskaya will not approve a big position in Russian stocks.

Second, Russia enthusiasts have long insisted that Putin is not really such a bad guy — and that stocks should not be penalized because of him.

But Putin's stern demeanor evokes the Western caricature of a made-for-television KGB bad guy. His endless faux macho stunts over the years invite derision. And the top-heavy structure of governance Putin has cultivated — in which he personally holds a tremendous amount of power — makes investors uneasy. It also results in inherently weak governance structures.

And headlines like "Why Is Vladimir Putin Acting So Crazy?" from Bloomberg Businessweek in August — well before Crimea was a pebble in Putin's shoes — do not help to improve

the level of concern among international investors toward the country.

The third piece of the argument says that Russia is not the only emerging market with problems. Yes, the economy is doomed to boom and bust in line with the price of oil. A poor business environment, widespread corruption, and weak rule of law stifle the economy, kill innovation and scare away foreign investors.

But the reality is that other emerging markets are plagued by similar challenges. None of the other BRICS countries — Brazil, India, China and South Africa — are particularly easy places to invest or do business. That is why they are called emerging markets, and not Norway or Switzerland.

Before Ukraine and Crimea entered the center stage of geopolitics — in what Ian Bremmer of political risk consultancy Eurasia Group recently called "the most seismic geopolitical events since 9/11" — there was still hope that Russian stock valuations might increase. Analysts hoped that the fact that central Moscow feels and looks like a European capital — with better-dressed people and more money — could eventually erase images in investors' minds of old men in furry hats saluting missiles on Red Square. If Putin returned to his early 2000s reformist form, investor concerns about him would be assuaged. And eventually, investors would appreciate that corruption and the business environment in Russia are, at worst, comparable to other emerging markets.

But the hopes of a re-rating of Russian stocks are officially dead. Russia's Ukrainian adventure has shown that it is not only the rest of the world that still views Russia through a Cold War prism: That is how the Kremlin sees itself. Putin has backed up his theatrically menacing exterior with actual force. He acted like the bad guy because, well, he is a bad guy.

Global investors never really bought the illusion that Russia is just a snowier, bad-food version of China or India, or Brazil — and thus deserving of the higher valuations usually assigned to those markets. Now, investors' doubts have been confirmed.

Today, Russia suffers from low levels of investment and enormous — and rapidly increasing — capital flight. The current crisis will exacerbate the ongoing economic slowdown. Wealth creation — for investors and for millions of Russians — is permanently stunted. And there will not be any fundamental improvement in the perception of Russia for a long time.

Of course, there is a price for everything. Russia's stock market may rebound strongly once the perception of political risk recedes. But Russian shares and assets will remain cheap compared to other markets.

Should you buy Russia?

Perhaps. But keep in mind that the story has changed.

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