

# Russia Matters

*Russia's time of troubles, as reported by the media, is only part of the story; there are ways to take smart risks in this transforming land.*

BY JASON R. KOEPKE

Although generally accurate, reports on all matters Russian usually don't provide the important information every investor ought to know about Russia, the transparency of its markets or the value of investing in them.

The story doesn't begin with the 2003 arrest of *Yukos*' (OTC: YUKOY) chief Mikhail Khodorkovsky on tax-related charges. Rather, it's directly connected to Russia's attempt to create a democratic and capitalist system.

Privatization of Russian companies is difficult in any situation, and there were severe problems with it throughout the first half of the 1990s. But the most shocking period was the mid-'90s.

At that time, a plan emerged to stave off budget problems and the possibility of defeat for then-president Boris Yeltsin in upcoming elections. This plan, dubbed "loans-for-shares," provided Russia's bankers with shares in the state-controlled companies in exchange for loans.

The transfer of these shares was conducted through an auction process consisting of little more than back-room deal making. In the end, the most prized state-owned companies were transferred to private hands—those private owners are now referred to as Russia's "oligarchs"—on the cheap.

Out of these events emerged the energy giants known around the world, including *Yukos*, *LUKoil* (OTC: LUKOY), and *Sibneft* (OTC: SBKYY). Some of these companies' controlling stakes were sold for less than one-tenth of their market value.

## Putin's Push

During this period, the state was weak and unable to enforce many of the laws, in part because of financial difficulties and in part because the system had become decrepit and corrupt.

As a result, the oligarchs were able to cement their political bonds and were, to a degree, free to do what they liked.

After Putin came to power in 2000, he made a tacit deal with the oligarchs that allowed them to avoid paying the price for past improprieties

so long as they didn't meddle with the government and his reform efforts.

His goal was, and remains, to strengthen the power and effectiveness of the Russian legal code and improve Russia's long-term outlook, even if that meant letting past ills go unpunished.

In some ways, this deal isn't entirely different than in the US, where officials focus on improving the current system and prosecuting current perpetrators rather than sifting through the past. And it's very similar to other emerging and transitioning economies where various officials make deals that put the past behind them in order to move ahead.

For those oligarchs who kept their end of the deal, the Russian business climate has remained relatively safe and secure. For instance, *LUKoil* chairman Vagit Alekperov has kept quiet politically and is, therefore, left to pursue his business interests—which he's done rather well considering he's worth about \$4 billion.

For those who haven't kept quiet, Putin reminds them the Russian state is in charge. As a result, many of the oligarchs opposing Putin either fled for safety (e.g., *Sibneft*'s Boris Berezovsky, Russia's first billionaire who now lives in London) or found themselves in jail (e.g., *Khodorkosvsky*).

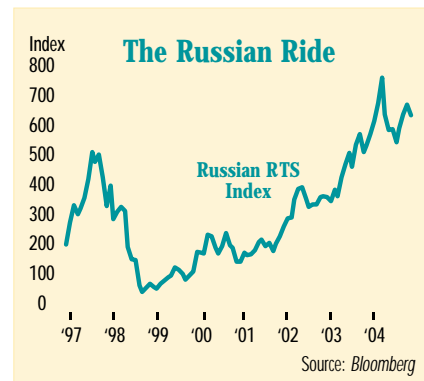
Putin's efforts to entrench the free market system are sometimes viewed as erratic, personalized and dangerous. But, to him, entrenching is necessary, as a weak state can't enforce business contracts, collect taxes or improve the public's general welfare.

The market has reacted well to Putin's firm approach thus far, but there are significant political problems that must be addressed by the Russian government and people.

## What is to Be Done?

With a complex present and a confusing future, what should investors do? On one hand, Russia matters: Its potential is undeniable and its recent performance—see the graph above—is attractive.

On the other hand, the business climate remains unpredictable. And until a consistent and transparent



path through this transition exists, the situation is unlikely to change.

**Approach this market with a great deal of caution.** While the payoff eventually could be big, so is the risk.

One way of handling the risk is through a managed fund with Russian picks. One advantage of a fund is that your investment is overseen by a fund manager with more resources and knowledge than any non-specialist could muster. That doesn't insure you against a disaster. But it does tilt the odds in your favor.

Our pick is the **Central Europe and Russia Fund** (NYSE: CEE). This fund was originally added to the Growth Portfolio when it was called the Central European Equity Fund and didn't include Russian picks. Our hope was to capitalize on those transition economies and their relationship with the European Union.

Eventually, the fund added a Russia dimension to its portfolio and changed its name. At first, we were a bit hesitant, but the change is a good one that provides limited exposure to a risky, but possibly highly rewarding market.

The entry into Russia has paid off; the fund has outperformed that market with a 16 percent year-to-date total return, and it's three-year return is 32 percent.

At the same time, it's underperformed the Central European markets, meaning the geographic diversification has already protected investors from being at the mercy of a given market.

The fund has about 40 percent of its assets in Russia, 15 percent in Turkey—another market worth cautiously investing in—and the remaining 45 percent in Central Europe. **Buy the Central Europe and Russia fund below 30.**

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