

“We look deeper into a broad universe of names and issuers of both debt and equity which are not widely followed and are generally misunderstood”



The ‘once in a generation’ buying opportunity of Russian stocks may be over, but John Winsell Davies, Managing Director, Diamond Age Capital Advisors, is hunting out the new names which will provide significant upside

Your fund has been described as the “polar opposite of other funds”. What differentiates Diamond Age from competing hedge funds? I think that it is fair to say that 90% of our competitors are making a long-only, equity-only, one directional bet on the top 10 or 12 names in the Russian stock market. Some might even be described as ‘shadow portfolios’ or virtual mirrors of the index. We actively manage a long-short multi-asset class fund investing in debt, equity, currencies, and derivative investments from the Baltics to the Chinese-Kazakh border. As of last week, for example, the Russian ‘Blue Chips’ made up a modest 29.2% of the Diamond Age portfolio. Almost 12% of our hedge fund is in Hryvnia-denominated assets from Ukraine, 5% Tenge-denominated assets from Kazakhstan, and we are the only firm that I am aware of that has been investing in Lari-denominated holdings from the Republic of Georgia.

We would not disagree with our competitors in the sense that there is no debate that a blanket ‘Buy Russia’ strategy has worked extremely well in the past. From the ashes of the Russian financial crisis in early 1999 to one of arguably several seminal events: 1) perhaps the arrest of Platon Lebedev in July 2003 or 2) the arrest of Mikhail Khodorkovsky in October of the same year, Russian stocks were a nearly straight-line advance.

While we absolutely concur that many securities in Russia are inefficiently priced, deeply undervalued, and we maintain a long directional bias, we do not feel that the ‘once in a generation’ buying opportunity will repeat itself in the reasonable future. In addition to hedging our core long holdings and protecting principal, we intend to profit from periodic sell-offs and meaningful declines in asset valuations by selective participation on the short side.

Further, the top blue chips are heavily bro-

kered, overly-owned, concentrated in only four sectors, and therefore represent less upside for the fund. Because these somewhat crowded trades do not represent meaningful alpha for our investors, we look deeper into a broad universe of names and issuers of both debt and equity which are not widely followed and are generally misunderstood.

These are companies in the process of consolidation or markedly improving corporate governance or they are eliminating practices such as transfer pricing, which (at least in terms of their balance sheets) will make them much more profitable. As a result, their valuations will become much cheaper: this is in part due to the fact that the Putin administration is forcing CFOs to declare higher operating profits and pay the resulting higher taxes. In other words, companies are being compelled to report what they are really making and are no longer able to ‘shield’ earnings from the tax ministry.

We cast a very broad net; we do not just focus on the highly regulated hydro-carbon and energy space, which is about 60% of the index. Although oil prices have remained persistently high, the sector, as represented by companies domiciled in Russia, is less attractive as it is heavily taxed on every marginal dollar above \$28 for Urals blend. More importantly, the industry is under the heavy-handed process of consolidation and control by the Kremlin. We want to be in all sectors and segments of the economy – the areas which are growing much faster and which are not represented by constituents on the RTS.

For this reason, we created our proprietary expanded coverage universe of some 274 publicly traded issuers of stocks and bonds domiciled anywhere in the world which have a core business-focus in Russia and the former Soviet Union. This provides for greater diversification, from healthcare to transports, financials to

retail, infrastructure to consumer staples.

Additionally, we think that we can generate excess return by holding assets denominated in undervalued, very attractive, local currencies. Our investments have experienced capital appreciation when currencies which were formerly pegged or non-convertible, are allowed to float. For example, the Lithuanian Litas has advanced 31.8% from 4.00 to 2.73 to the US dollar in the past three years and, more recently, we have seen a 6.1% move in the Ukrainian Hryvnia over the last three weeks. We anticipate that there will be more such opportunities in the future and have been long on the ruble against the dollar since inception.

On the bond side, we look well beyond Sistema and Gazprom. We were, for example, among the very first to buy Georgian sovereigns following the US-orchestrated Rose Revolution. It seemed to us, that for a very small, risk adjusted percentage of the portfolio, the spreads on short-term paper were too high. We made a bet that the United States would not allow its hand-picked ‘friendly’ government to default on its debt. So despite some liquidity constraints, we participated in treasury auctions and saw spreads tighten from 54% to our last purchase at 15.5%. Now, consider that on Wednesday 4 May, the Georgian government sold 182 day Treasuries at a remarkable 9.34%! We currently maintain an approximately 30% long (basket of local currencies) fixed income weight and short 9% weight (US dollar).

Institutional investors are relatively uninvolved in the markets that you operate in. Is that an opportunity?

Excellent point: they have been burnt by the name that they knew the best - Yukos. We are on record in multiple sources in the public domain as far back as September 2003 as being short on Yukos. Foreign institutions were just

getting over the pain and memories of the 1998 GKO evaporation and Russian financial crisis. As a result, the market has been supported by domestic liquidity for the last two years, but it is exactly the absence of the institutional investor that enables us to find value. Yes you are exactly right, this is one of the reasons for our opportunity and Russia trades at a >35% discount to its EEMEA and GEM peers at 6.1x '06 price to earnings.

Reflecting on my lunch meeting with Victor Yuschenko a few years ago: 'The Bill Clinton of the CIS' was all but clairvoyant in his detailed expectation of future events. He even predicted one (or more) failed assassination attempts on his life, that he would win the popular vote but lose the election, and that his forces would rally behind his cause and the truth would ultimately prevail. I listened to him speak about NATO, EU accession and tried to pretend that I wasn't in awe – but it all came to fruition.

Since July of 2003, we have been buying attractive Ukrainian corporate debt with short maturities and compelling yields in the 16-18% YTM range plus currency appreciation. In addition to the low debt to equity ratios and often better coverage ratios than the Russian comps, we have also benefited from the rather powerful Hryvnia advance against the falling dollar 'currency kicker'.

Does the accuracy of his predictions not raise questions about how events in Ukraine were orchestrated and who is behind Yuschenko?

Yes – but this is no secret. The question is: would you rather be paid in Swiss Francs by a nice man in an Hermes tie from Zurich? Or would you rather be paid in rubles back behind the wall of the Kremlin? Either way, there were and are western interests supporting not just the Orange or Rose or Yellow Revolutions, but also supporting democratic change across the FSU. In April, US Secretary of State, Condi Rice's somewhat ill-advised remarks about the 'Last Tyranny in Europe', in reference to President Lukashenko's Belarus, is evidence of that.

Recently, hedge funds have been the subject of criticism in the UK, notably with John Sunderland, President of the Confederation of British Industry and Chairman of Cadburys Schweppes, highlighting the short-termism and increased volatility that hedge funds bring. What effect will hedge funds have on Russia's financial markets?

Prominent leaders of "British Industry" have been critical of hedge funds before, lest we

forget George Soros and the revaluation of the Pound Sterling! As it relates to Diamond Age, I can prove qualitatively that our volatility is only a third of that of the RTS. Our volatility, annualised, is 7.89% compared to 23.36% on the RTS. If you prefer to use Beta measurement, our Beta is currently at 0.29, again about a third of the volatility of the RTS. In fact, we have only six pillars in our stated investment objective: reduced volatility, poor correlation to the RTS, smoothed returns, increased diversification, lower risk profile, and ultimately, market outperformance. Once we have the other longer-term data available, we anticipate an attractive SHARPE ratio as well.

As far as the effect of hedge funds on the Russian market, there honestly are not enough true hedge funds with meaningful assets under management to have a measurable impact on the market. If one assumes that the total dollar capitalisation of the Russian equity market is in the \$250b range and perhaps less than five per cent of those assets are held in hedge funds, there is not, at present, a critical mass to move the market.

You cite 'poor correlation to the Russian RTS index' as one of the investment objectives of the fund. Many people believe that the market is due a rally. If and when that happens, you will presumably hope to achieve good correlation with the market?

I agree with your assessment. Despite the fact that the market performance has been abysmal recently, we have never been more bullish. While we maintain some currency and fixed income short positions, we have taken all of our equity shorts off the table. When the market shrugs off overwhelmingly bullish macro-economic data and looks for any excuse to sell – we are the buyers. Sir John Templeton's 6th Maxim: "To buy when others are despondently selling and to sell when others are greedily buying requires the greatest fortitude, even while offering the greatest return." I subscribe to The Five Rules and 22 Maxims and we will seek to outperform the market in the next rally by superior security selection, rather than by timing the market.

Many asset managers seem to be removing 'oligarch discount' because they think it unlikely that Putin and friends will pursue another Yukos-style affair. At the moment, therefore, Russian corporate debt is very much in fashion, but are people looking deeply at the fundamentals?

The area that we find most attractive, when

we make reference to corporate debt, is actually outside Russia. We do have ruble bond exposure – which is fine – and we are long on the ruble versus the dollar. But because Russia is investment-grade credit quality according to all three major rating agencies and spreads have tightened to inside 200 bps to the US Treasury, domestic yields are no longer very attractive. We only hold 11.5% of the fund in Russian corporate debt and yes, you are correct, domestic liquidity is buying up many issuers with sometimes little regard for fundamentals.

In 'Russia proper', we find many investment opportunities which represent a better value than corporate bonds, especially in areas of consolidation. We like second and third tier names which are brides rather than suitors. We are also yield-seekers and are buying preferred shares that not only trade at big discounts to the common ordinaries of the parent company, but also offer attractive yields. We have a basket of preferred shares that represents about 10% of the fund, which is currently trading at a 31% discount to the ordinaries in aggregate and pay out about an 8% yield while we wait. We anticipate capital appreciation as the spreads narrow, plus we receive a distribution of free cash flow with attractive dividends.

These portfolio constituents are more attractive to us than buying the top one or two oil names, for example. People want to buy Russia because of the energy story. This is both good and bad. It is true that many of these companies are very cheap on an EV/DACF or P/E basis, but they are priced at a discount for a reason. The government taxes up to 90% of every marginal dollar above \$28 on Urals blend and has been very clear in both rhetoric and deed in declaring its intention to control this strategic sector of the economy. Therefore, if you are a Russian-domiciled firm, even if oil is trading North of \$50/bbl, your marginal return is diminished.

That said however, we know that these valuable reserves are in the ground and we want to own this exposure. Our strategy is to compliment our under-weight Russian oil holdings by seeking out non-Russia domiciled companies (Ireland, Canada, UK, US) with operations, reserves and upstream E&P projects here in the FSU (Russia, Azerbaijan, Kazakhstan, etc.) Same \$50/bbl and low F&D lifting costs, but not under the heel of the same repressive tax regime. This is another area which delineates us from our competitors. 