

INVESTMENT NOTE

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HERMES: IS RUSSIA VALUE, OR A VALUE TRAP?

By Gary Greenberg, Head of Emerging Markets & Lead Portfolio Manager, Hermes Investment Management

“In 2014, the Russia index in dollars was down 48.5% – the worst return among all major indices. Does the market represent value at this level, or a value trap? Is this a fantastic buying opportunity, or have Putin’s actions permanently deterred foreign direct investment?”

“Six months ago, Vladimir Putin was seen as a grandmaster of geopolitics, having outmanoeuvred Obama in Syria, grabbed Crimea, and signed a 30-year energy deal with China. Today, with the rouble at about 67 against the dollar – compared with 33 in the summer of 2014 – and the Russian economy sinking, he looks more like a man out of his depth.

“The Central Bank of Russia forecasts the nation’s GDP to fall by about 4.5% this year and by 0.9% in 2016. The recession could worsen when sanctions start to seriously bite, which will make it difficult for the government, banks and corporations to refinance both internal and external debt. It may have also cut off the lifeblood of modernisation, foreign direct investment. With about \$400bn in reserves, Russia can again deploy stimulus to weather the recession, but its budget is weak. It has few (moneyed) friends, and will be forced to implement unpopular cost-cutting reforms, meaning the government’s popularity could slide.

“So what might Putin’s next move be? With the strike range of a knight rather than a queen, the supposed geopolitical grandmaster is likely to persist with his nationalistic rhetoric while looking for a face-saving deal with the West. A slow-burning conflict in Ukraine serves his purposes well, but at some point he needs the sanctions to lift or the domestic economy will break. It is unlikely Russians will be happy when their incomes decline and their flat-screen televisions are repossessed, or HBO is replaced by Cuban or Chinese state broadcasting.

“The Russian stock market is trading at two standard deviations below its long-term average, relative to both itself and global emerging markets on a price-to-earnings basis. An agreement between Putin and the West, however embryonic, would spark a rebound and reward investors who either stayed the course or bravely bought in on the rouble’s Black Tuesday last December. The absence of such an accord would keep those investors waiting, and probably distressed.

“How should a market so dependent on its authoritarian leader and the price of oil, and one with scant regard for the rights of private companies (let alone their investors), be valued? Recent events dictate that tactical investment based on the fundamentals of a company and its leader’s relationship with the Kremlin – and a keen sense for early warning signs – would be a good start. But this environment remains hostile to the interests of long-term investors such as ourselves.”

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Notes to Editors:

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Hermes manages assets on behalf of more than 200 clients* across equities, fixed income, alternatives and real estate, with £28.6 billion* assets under management. In Hermes EOS, we have the industry's leading engagement resource, advising on more than £134.0 billion* of assets.

We believe in **Excellence, Responsibility and Innovation**

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- **Responsibility:** We believe it is our responsibility to lead discussion and debate about the fiduciary responsibilities of fund managers to our clients, their stakeholders and, ultimately, society at large. We have always sought positive engagement with the firms in which we invest.
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Hermes' investment solutions include:

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- **Fixed Income:** Inflation-Linked, Government Bonds, Investment Grade, High Yield
- **Real Estate:** Segregated, Unitised, Debt, UK, US Residential, European, UK PRS
- **Alternatives:** Multi Asset, Infrastructure, Private Equity

*Please note the total AuM figure includes £3.7bn of assets managed or under an advisory agreement by Hermes GPE LLP ("HGPE"), a joint venture between Hermes Fund Managers ("HFM") and GPE Partner Limited. HGPE is an independent entity and not part of the Hermes group. £0.4bn of total group AuM figure represents HFM mandates under advice. Source: Hermes as at 31 December 2014.