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# Russia Diversified: Hedge Funds Hone In On Growth Story

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Private equity and hedge fund managers alike are smitten by Russia and just not for its oil. Experts say the once energy and commodity-based economy is now diversified into other sectors such as banking, telecom, real estate and infrastructure, making a case for continued and new foreign investments.

**The Trickle-Down Effect**

**New Red Star's Timothy Seymour** "The market continues to broaden dramatically as opportunities to diversify outside the resource sectors have come forward," says Timothy Seymour, managing partner at New Red Star Asset Management. "The Russian Stock Exchange is flat but second tier indices, which contain exposure to utilities, banking, consumer and steel, have outperformed. The macro story remains very much intact and continues to trend higher, and we see no reason for that to change."

Red Star's flagship fund, the Double Alpha fund, launched in June 2005 and is now managing some $80 million. The absolute return, relative value strategy has averaged returns of 29.5% since inception.

Across the pond, U.K.-based hedge fund managers share Seymour's sentiments. Mathias Siller, a portfolio manager for Baring Asset Management's EMEA Absolute Return Fund, says the Russian government is looking to improve the country's internal infrastructure through public spending initiatives, supported by tax receipts from strong oil revenues.

"Russians are changing their lifestyles moving from living with their parents until they're 40 to living on their own and picking up their own mortgage," says Siller. "Russian banks are catching up to consumers' needs and are trying to serve them rather than seeing themselves as corporate lenders. We see a mortgage system emerging slowly but surely."

Another U.K.-based hedge fund, emerging markets specialist Charlemagne Capital, is also bullish on the region. The firm this month increased its OCCO Eastern European Fund's gross exposure to the country to 103%, a record high for the fund, representing 59% of total gross exposure. Year-to-date, the fund has returned 8.17% through March, while the Eurekahedge Eastern Europe and Russia Hedge Fund Index rose 6.48% with more than twice the volatility, according to the firm.

**A Private Equity View**

**Colin Breeze of Breeze Ventures Management** While all the attention has been justifiably given to the public market–the RTS Index reached new historical highs of over 2,000 points on April 13–the private equity market has fueled the growth, says Colin Breeze, founder of Breeze Ventures Management. The Palo Alto, Calif.-based fund of funds shop invests in managers focused on BRIC countries.

“The public markets have done extraordinarily well, posting gains of over 50% gain since last June and over 200% over the last two-and-one half years,” says Breeze. “While these are great numbers, we’re looking at opportunities in the private market environment, which is much broader and deeper. While public companies in our region are focused on oil, gas, telecoms, and energy, the p.e. environment offers consumer goods, retail, media, and real estate. It’s a very diverse economy that is still quite young in its development stage.”

**Overcoming Obstacles**

Breeze says the risks associated with Russia are essentially the same basket of risks tied with private equity investing anywhere in the world, such as execution, market and technology risks. However, the real question mark for a Russian “growth phase” company is its management. “The benefit of investing in a place like Russia is that the population is incredibly well educated; with a 98% literacy rate. But the country lacks a ‘managerial class’, and that level of talent is still being developed. The growth phase companies that can solve this problem first should show some great returns but this is a real risk,” he says.

And while the risk of government interference is much talked about, Breeze says this risk is considerably less in private equity investing because the deals are not privatizations, do not involve strategic assets, and are not large enough to elicit government reaction. “For the most part, we are seeing investments in the $5 million to $35 million range (up to $75 million for the larger funds),” he says.

Although political risk is more prevalent in the public market, Siller says the government knows when to play by the rules. “What Russia needs is the know-how to transform its energy and commodity-dependent economy to something that is competitive on a sustainable basis. The Russian government realizes that to attract this know-how they have to adhere to international rules. Their own fates depend on how well they integrate Russia into the global economy,” he says.

“The opportunities offered by this kind of environment justifies the risks that you have to take.

*by Hung Tran*

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