



Bradley, Foster & Sargent, Inc.

Quarterly Market Commentary

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Russia: Avoid Investing in this BRIC Country

While the State exists, there can be no freedom. When there is freedom, there will be no State.

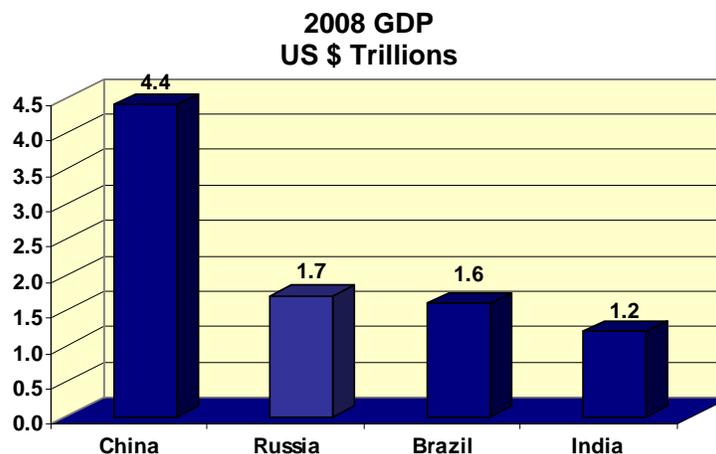
Vladimir Ilyich Lenin, *State and Revolution*, 1918

I cannot forecast to you the action of Russia. It is a riddle, wrapped in a mystery, inside an enigma; but perhaps there is a key. That key is Russian national interest.

Winston Churchill in a radio broadcast, 1939

Six years ago, Jim O'Neill led a team of economists at Goldman Sachs in writing an essay, *Dreaming with BRICs: The Path to 2050*. The theme of the essay was that the BRIC countries – Brazil, Russia, India and China – may eclipse most of the world's wealthiest countries by 2050 and become the four leading global economies. They predicted that China and India would become the dominant global suppliers of manufactured goods and services respectively, and Brazil and Russia would become similarly dominant as suppliers of raw materials. It was macro-economic research and analysis at its best, as the BRIC countries have indeed become engines of global growth, affecting everything from the price of oil and iron to the yield on U.S. Treasuries.

Over the past four years, we have written about China, India and Brazil in our quarterly commentaries, and a small but growing number of clients have asked us to allocate a modest percentage of their portfolios to investments in these stock markets. This commentary takes a look at Russia. One of our partners has visited both Ukraine and Russia during recent years to get a firsthand impression of these countries. Ukraine is still struggling economically. But Russia is now the eighth largest economy in the world, although its increasingly antagonistic relationship with the U.S. and other NATO countries has overshadowed its economic progress. While Russia's GDP represents less than 12% of the U.S.'s GDP, the size of its economy has nonetheless passed both India and Brazil as the chart below indicates:



Source: International Monetary Fund

Russia Before 1991

Historians date the origins of Russia to the 9th or 10th century when the Rurik dynasty established Kiev as the capital of Russia (now Ukraine) and made Christianity the state religion. In 1240, the Mongol hordes invaded and occupied Russia. When Europe was experiencing the intellectual and cultural awakening of the Renaissance, Russia was dominated by the harsh Tatar culture for 250 years. Throwing off the Mongol yoke, Ivan III and his son, Ivan IV (Ivan the Terrible), established the absolute power of the Russian Tsar which lasted with only one brief interruption until 1917. That interruption lasted from 1598-1613, which is called in Russia “the Time of Troubles.” The death of Ivan the Terrible’s son left Russia without a Tsar, and the political vacuum unleashed a 15-year period of starvation, occupation by Poles and Lithuanians, and anarchy. The elevation of Michael Romanov to the throne in 1613 launched the Romanov dynasty which conquered the vast territory. Over several centuries, this became the largest contiguous empire in the world, which still encompasses 11 time zones.

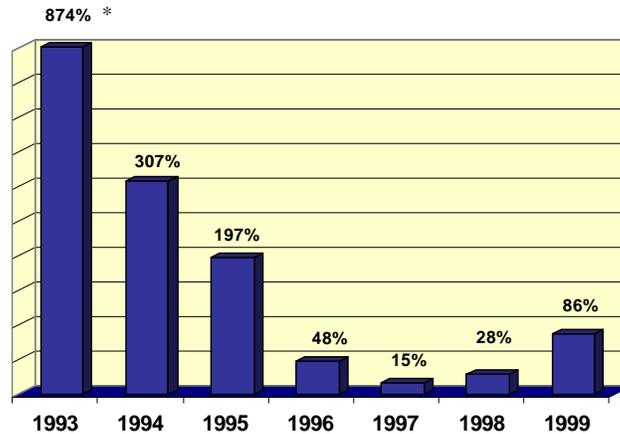
During World War I, the combination of sheer incompetence by Tsar Nicholas II and the Russian upper class, poor leadership in the Russian Army, and a determined Bolshevik party led by Lenin ushered in the 1917 October Revolution. A civil war in Russia (1917-1921) resulted during which an estimated 15 million people died. This second “time of trouble” unleashed desperate fighting, famine, starvation, disease (typhus killed 3 million in 1920), and anarchy (described vividly in Pasternak’s *Doctor Zhivago*). Having led the Communists to victory, Lenin died in 1924. Stalin succeeded him. While Lenin never hesitated to use terror and murder to gain power, Stalin trumped him many times over, purging his rivals for power and killing the majority of the Communist Party and Red Army leadership. He also created the vast Gulag of slave labor camps and prisons and ordered the execution and deportation of millions during the collectivization of the kulaks. More than 5 million people starved to death in the 1930’s, when the peasants were forced to give up their farms. Overall, Stalin was responsible for the deaths of as many as 20 million people during his reign of terror (not including the many millions of Russians killed in World War II). After Stalin’s death in 1953, a succession of Soviet leaders governed through a totalitarian system in which the state owned all land and businesses, set prices, and controlled all economic and political activity. In 1985, Gorbachov became the leader of the Soviet Union. His policy of perestroika (political and economic reforms) and glasnost (openness and transparency) was a key factor in the fall of the Berlin Wall and helped end the Soviet occupation of Eastern Europe. In 1991, Russian hardliners attempted a coup against Gorbachov. The coup failed, and Yeltsin’s brave opposition to the coup brought him to power at the end of 1991. Shortly before he assumed the Presidency, he and Gorbachov jointly dissolved the Soviet Union.

1992-1999

In many ways, this eight-year period was the third “time of troubles” for the Russian people. Upon Yeltsin’s formal assumption of the Presidency at the end of 1991, he and the reformers launched a program to introduce a democratic system and a free market economy. This meant privatizing the majority of the state owned companies and Russia’s national resources, the most important of which were vast oil and gas reserves. Due to corruption and widespread crime, much of the national wealth fell into the hands of a small group of people (known as the “oligarchs”). Many of the free market policies were ushered in without the necessary legal and commercial infrastructure in place, and the result was economic collapse. Although Russian GDP numbers during this period are seen by many as inaccurate, economists generally agree that Russian GDP contracted approximately 40% between 1991 and 1998. This is a greater contraction of economic output than the 26% drop which the U.S. experienced during the Great Depression. Millions were forced into poverty, and corruption and crime became endemic. Hyperinflation

(see the chart on the following page) occurred soon after Yeltsin took power and happened again after the Asian financial collapse in 1998, which caused Russia to default on \$40 billion of domestic ruble bonds.

Russian Hyperinflation 1993-1999



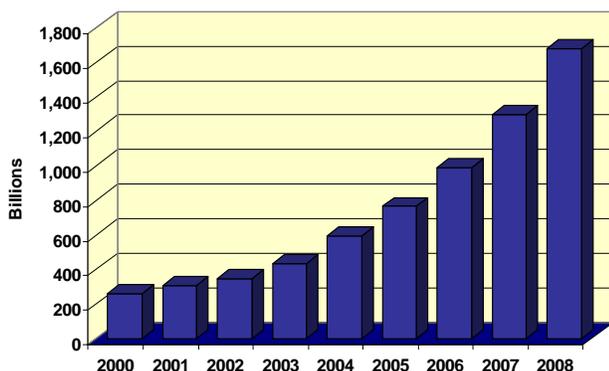
* not to scale
Source: International Monetary Fund

The Era of Putin

On the last day of the decade and the century, Vladimir Putin was appointed Acting President of Russia by Yeltsin. In May, 2000, Putin was elected President by the Russian people. A KGB operative from 1975 through 1990, Putin climbed the political ladder first in St. Petersburg from 1991-1995 and later in Moscow. Upon becoming President, he executed a policy of focusing on economic growth through a quasi free market system but returning Russia to a political system dominated by one party. His party, United Russia, monopolizes power, although it is assisted in minor ways by the Communists and other minor affiliates. Parliament passes virtually all bills which the government presents, and news reporting by television is controlled by the state. Political challenges to the government are not tolerated. Russia's brief flirtation with democracy from 1990-2000 is over, and the majority of Russians consider it good riddance. When Russians in polls are asked to choose between "freedom" and "order," they overwhelmingly choose order. Richard Pipes, the eminent professor emeritus of Russian history at Harvard, writes that Russians generally identify political freedom (democracy) with anarchy and crime. Freedom reminds them of the time(s) of troubles.

On the economic front, Putin's presidency was characterized by rapid GDP growth, recovering prosperity and a robust stock market. The charts below tell the story of GDP compounding at 7% a year and the Russian stock market's powerful increase (in U.S. dollar terms) from 2000-2008:

Russian GDP



Russian Stock Market (RTS Index in US \$)



Source: International Monetary Fund

Much of the success of the Russian economy has been due to rising energy and commodity prices during the decade, as sales of oil, gas and other raw materials dominate the Russian economy and federal budget revenues. This has been reflected in Russia's foreign exchange reserves, which grew from \$12 billion in 1999 to almost \$600 billion by July 2008, before falling to their current level of \$413 billion (still the third highest in the world after China and Japan). Putin's approach to governing Russia has struck a welcome chord in the majority of the Russian people. His popularity grew throughout his two terms, and the handpicked choice of his protégé, Dmitry Medvedev, as President, while his remaining in power as Prime Minister, has not diminished his support.

2008: A Bad Year for Russia

As Russian economic power has grown during the last 10 years, so has Russia's obsession with being recognized as a "Great Power." Russia's ability to influence world affairs stems partially from her unique geopolitical location, which enables her to exploit to her advantage crises in Europe, the Middle East, and Asia. It is hard for Westerners to comprehend, but the majority of Russians feel nostalgia for the passing of the Soviet Union and for Stalin (who recently in a TV poll was voted the third greatest Russian in their history). This longing for national greatness has strongly influenced Putin's foreign policy in various ways, most of them problematic for the U.S. and its allies. Obvious examples are: Russia's flirtation with Hugo Chávez in Venezuela, selling him missiles and fighter aircraft; Russia's refusal to support the West's attempts to persuade Iran to abandon its quest for nuclear armed missiles; and fiercely opposing the missile defense arrangements made between the U.S. and Poland and the Czech Republic. However, it was Russia's invasion of the Republic of Georgia in 2008 which signaled to the West that Russia will resist challenges to its own self interest in countries which she considers to be in her own sphere of interest (such as Ukraine, Poland, the Czech Republic and Georgia). The armed conflict in Georgia in the summer of 2008, which took place at the same time that the CEO of British Petroleum's Russian joint venture, TNK-BP, was forced to flee Russia due to physical threats to his person, caused a massive outflow of capital from Russia. During the last 15 months more than \$150 billion has left Russia, while the stock market plunged more than 70% (in dollar terms).

Summary

Russia has made rapid economic strides during the past decade. Russian foreign exchange reserves and GDP rank higher than both Brazil and India. Despite its precipitous fall in 2008, the Russian stock market has nevertheless increased fivefold since 2000. There appear to be excellent investment opportunities in Russia – especially in energy, commodities and companies focused on the growing middle class. The new Russian President, Medvedev, has spoken out strongly about enacting long delayed reforms. On the other hand, the use of the state's power to force foreign investors out of Russia or to re-negotiate contracts and the re-nationalization of many important Russian companies (with the state owning 52% of the country's publicly traded equity) is worrisome. Additionally, Russia's shrinking population (the life expectancy of men is approximately 60 years), the rule of men and not law, and the endemic corruption, give us pause when considering investing in the Russian stock market. Finally, Russia's more aggressive foreign policy in recent years (especially in areas which it regards as its "privileged zone of influence") lead us to question whether Russia is a safe place for foreign capital. Thus, with regard to investing in the BRIC countries, we at Bradley, Foster & Sargent, Inc. will stick to investing in the BIC countries and refrain from investing in Russian stocks until Russia changes its foreign policy and is more welcoming to foreign capital.