OPALESQUE

Opalesque Round Table

MOSCOW

Introduction

Dear Reader,
In the middle of the financial storm at the end of September 2008, I went to Moscow and sat down with Russian hedge fund managers and the CEO of the Russian stock exchange (RTS) to discuss the impact and the outlook of the current crises for Russia. Together with the other BRIC countries, the extent of the losses and the vanishing of liquidity surprised international investors and locals alike.

The result of that meeting is this Opalesque Russia Roundtable, a summary of our discussions which took place on Sept. 29th at the RTS Stock Exchange. **We thank RTS** for sponsoring this Opalesque Roundtable, where we united the following experts:

- Andrei Smirnov. founding partner of MARS Capital
- Oleg Jelezko, founding partner of DaVinci Capital
- Maxim Tishin, Senior Portfolio Manager at UFG Asset Management
- Roman Goryunov, CEO of Russian Trading System Stock Exchange (RTS)
- James Fenkner, founding partner of Red Star Asset Management
- Andrei Ivanov, partner at ARBIC
- Kevin Dougherty, portfolio manager at Pharos Financial Group

In this Roundtable Script, you will learn:

- **How do Russian hedge fund managers cope with the severe losses that the Russian markets incurred?**
- **What is their outlook? Where are the best opportunities now? Which strategies still work?**
- **What is behind the disappearing liquidity?**
- **How did the Russian financial infrastructure cope with the events? How will the market infrastructure further develop?**
- **What are the latest developments in the Russian pension system and the concept of a qualified investor?**
- **How has corporate governance developed? How do local Russian managers judge the level of governance? What are their issues when investing in domestic small, mid and large cap firms?**
- **Is Russia's fate inescapably linked to commodities? What are the opportunities beyond commodities?**
- **What hedge fund strategies can be played in Russia?**

The purpose of the Opalesque Roundtable Series is to provide a catalogue of intelligence on the world's most important hedge fund centres and introduce you to some relevant local players of each jurisdiction. New York, London, Geneva, Stockholm, Singapore, Hong Kong, Tokyo, Sydney, and Auckland are also covered (see the Roundtable archive on the Opalesque website).

Enjoy "listening in" to the Opalesque Russia Roundtable!

Matthias Knab
Director Opalesque Ltd.
Knab@opalesque.com

Cover Photo: Moscow. The Red Square

Participant Profiles

(left to right)

Roman Gorynov, Matthias Knab, Oleg Jelezko, Kevin Dougherty, Andrei Smirnov, Maxim Tishin, James Fenkner and Andrei Ivanov

Introduction

Oleg Jelezko
Da Vinci Capital Management

My name is Oleg Jelezko, I am the founding partner of DaVinci Capital. My background is running structured products and alternative investment businesses at Renaissance Capital, Credit Suisse First Boston, and in management consulting before that. Da Vinci Capital manages two funds; we have a closed-ended private equity fund and an open-ended hedge fund. Our total assets under management are $120 million in the funds and $110 million under advisory mandates. Our main strategies in the private equity fund are investing in private companies that go through the transformation from private ownership to more public structures, through IPOs or by selling stakes to international investors. With the hedge fund we employ a number of event driven, long-short strategies and producing alpha from special situations.

Maxim Tishin
UFG Asset Management

My name is Maxim Tishin, I am Senior Portfolio Manager at UFG Asset Management. UFG Asset Management runs three hedge funds and five mutual funds. We have over $1.2 billion in liquid investments and in addition to that we run private equity and real estate funds. We offer long-short Russian equity strategies, long-only equity strategies for institutional investors, and fixed income strategies for funds and institutional investors as well. I am in charge of fixed income and derivatives products. We are seven experts in the investment team, running $1.2 billion.

Roman Goryunov
RTS Stock Exchange

My name is Roman Goryunov, I am the RTS CEO. Russian Trading System Stock Exchange is the dominant derivatives market operation in Russia and one of the leading local cash equity markets. Since 1995, the RTS Index has been the major benchmark for Russian equities. Index linked derivatives are the leading instruments of the Russian market. RTS was ranked 15th by FIA among the world's top 30 derivatives exchanges. Before the financial turmoil, the daily turnover on RTS had been about $2.5 billion.

RTS offers the widest range of the derivative instruments in Russia, about 65 contracts. These are futures and options on indices, stocks, money market instruments, bonds and commodities, a fine selection of instruments for hedging purposes. In various trading modes RTS provides quotations for securities from over 2,000 issuers.

James R.Fenkner
Red Star

My name is James Fenkner, I am the founding partner of Red Star Asset Management. We were a $100m plus million fund at the beginning of the year, and we have come down essentially the same as the market. The strategy is long/short focusing primarily on liquid Russian stocks. Our current claim to fame is that neither of our prime brokers - UBS and Credit Suisse - have blown up.

Andrei Ivanov
ARBIC AM

My name is Andrei Ivanov, I am a partner in ARBIC. This is a Russia-based investment boutique focusing on Russian and BRIC hedge funds employing a long/short strategy and a bottom-up approach to investing.

Andrei Smirnov
MARS Capital

My name is Andrei Smirnov. I am the founding partner of MARS Capital, an alternative investment platform created in 2004 and specialized in emerging markets.

Prior to launching MARS Capital, I held different positions in emerging markets investments, sales, trading, structuring and risk management at Crédit Agricole Indosuez (now Calyon) and Société Générale in Paris.

MARS Capital is not a pure Russian hedge fund, though the Russian exposure represents a significant part of our books particularly in credit, equity, asset based lending and real estate strategies. We employ 20 people in Jersey, Geneva and Moscow and we have 9 funds in multi-strategy space, single-strategies and client tailor-made products.

Kevin Dougherty
Pharos

My name is Kevin Dougherty, portfolio manager at Pharos Financial Group. Pharos was started in 1997, which makes us one of the oldest hedge funds in the Russian market. We run three funds right now, the Russia fund, a small-cap fund and a gas investment fund. These three funds invest across Russia and the CIS in long-short strategies.

To this point our funds have had a long bias, but with lot of hedging, especially over the last two years when derivatives have become a viable instrument in this market. Our funds so far this year are down between -16% and -25%, which compares favorably to the RTS which is down -44%. In addition, our funds have significantly less volatility than the market as a whole.

Matthias Knab **What is your outlook on Russia going forward? What does the current economic scenario mean for Russia and for your funds, and are there opportunities?**

Kevin Dougherty Well, obviously the markets, not just here but globally, are under severe stress and in the next few weeks they are going to continue to be under a lot of stress. I believe there are really three main things to look at. One is the economic and business conditions globally and in Russia, the second is valuations, and the third is flows in and out of the market.

The Russian equity market has been hit extremely hard, much harder than developed markets, certainly much more than the US. The commodity sell-off is one of the primary reasons for this, but the sell-off has been exacerbated due to the nature of the investor base in the Russian market. In effect, everyone is a short term investor and has been heading for the exit at the same time. There have been forced sellers as well, so the third factor that I mentioned above – flows in and out of the market – have driven the market well below where the first two factors would have taken us. Stating the obvious, until these forced selling flows moderate, the market will not recover. But once this stressed flow situation is behind us, we can re-focus on the fundamentals. Key among those will be where commodity prices stabilize. With markets falling globally and no clear idea where things will settle, it is too soon to make fundamentals based forecasts for markets anywhere, and it is impossible to calculate with any conviction what current or future valuations are. While Russian equities are trading around 5x 2008 earnings right now, making it one of the cheapest markets in the world, if commodities sell off another 50%, Russia is certainly not cheap.

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Within Russia, there are a couple of other key things for the medium-term that we are looking at. Clearly the actions of the Russian government will be big factors, two of the most important being where government spending and investment is directed, and then tax policy, which is an extremely important element of the profitability outlook for different sectors of the economy.

In addition, government directed buying can have a very big, very out sized impact on prices in the thin, relatively illiquid markets that we are seeing right now. The government has promised to inject liquidity into the financial system, which initially resulted in a big short squeeze in the market.

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In addition, government directed buying can have a very big, very out sized impact on prices in the thin, relatively illiquid markets that we are seeing right now. The government has promised to inject liquidity into the financial system, which initially resulted in a big short squeeze in the market. However, there is little evidence that this liquidity has actually arrived and credit markets are effectively still closed, so equity markets will continue to be nervous with high volatility. There

are great opportunities now, but the market can certainly get hit harder before we finally reach the bottom.

Matthias Knab **You mentioned you are watching government actions regarding tax policies and also direct government action in less liquid markets. Can you give us a little bit more background, has anything been announced, is anything likely, and how would this effect the markets?**

Kevin Dougherty The government did lower taxes on the oil sector, which had been among the highest in the world, in recent months, but the falling oil price has overwhelmed that positive change. Quite frankly, the government needs to go further than it has gone to this point. They have huge surpluses and a huge stabilization fund which was set up to help in difficult markets and difficult economic times. That is what we have right now, no? Not using these funds because they don't want to touch them until the government has a revenue shortfall would be a mistake in my view.

The government earlier in the year discussed cutting tax for the oil sector but compensating by increasing taxes of another sectors. I believe they don't need to do that. There is no need to raise taxes in order to compensate for the lost tax revenue from the oil companies, and we would be certainly happy to see the government come to that realization, even if it means tapping into the surpluses. They are still running a surplus this year, they will run a surplus next year with oil above $70 a barrel.

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So, with the economy and financial system under severe stress right now, they need to act and forget about their principles of running surpluses for the next few years. That should be one consideration. The other consideration is direct government action in the market. Again, the liquidity has dried up dramatically. We are seeing the market pushed around by marginal buyers or marginal sellers...Most funds are relatively inactive right now, but you will still see 5% moves in the market, maybe not on a daily basis, but several times a week.

The government has said that they are going to invest $20 billion into the market, but it's not likely to happen until the beginning of next year. The way things look right now, waiting that long will be too late. And if they do implement that buying in conjunction with steps to address the liquidity problem in the banking sector, then that could have a very big, immediate impact. The market move that we saw a week and a half ago in which the RTS Index was up +22% in one day is an indication of the type of moves that we could see. That was an extreme move and we may not witness a rebound of that magnitude again, but +22% over a few weeks or a month is certainly possible.

Oleg Jelezko The recent events in the Russian market show that the Russian market is not insulated from the world trends. In the last two weeks, Russia also experienced a significant liquidity crisis. People call it a perfect storm scenario, and the reason why it's a perfect storm is because overall the economy is still in a reasonably healthy condition in comparison to most other markets.

The GDP is growing, the level of investment, foreign direct investment, is still growing, the only victims currently are the players in the stock market, players in the fixed income market and now we were starting to see the liquidity crisis spreading unfortunately to the commercial sector. Banks are withholding the liquidity and Russian companies are not being able to take further loans, simply working capital loans. This is quite dangerous, because the liquidity crisis can spread to the real economy.

The Russian market is also showing that it is quite a thin market. If the Western investors get scared, the Russians also start to run away. There are general factors like a lack of confidence in corporate governance, failing commodity prices, and then the war in Georgia that contributed to the crisis. To be precise I wouldn't say Western Investors ran away, they simply stopped investing, because as far as the out flows from the western funds, we haven't seen such big out flows yet.

But the liquidity in this market is quite thin and the pension system still does not provide enough inflows in to the stock market. In addition, the REPO type of financing created a lot of issues for the Russian market. My mid-term outlook is an uncertain one: Russia can gradually recover, the question is the time of this recovery. It will depend on how hard the government pushes the liquidity throughout the system.

Oleg Jelezko

I hope that the liquidity will somehow make its way to the market participants and the companies. The government needs to be more active, needs to push the banks to open the limits on each other and also the investor confidence needs to be restored.

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I think, the time frame for this transition back into a normal situation, where people start paying attention to fundamentals, could be three to six months ahead of us. I believe we will see a full come back to more or less normal market situation not less than in a year's time.

Maxim Tishin

I would just like to highlight this peculiar situation of the local market that we all here are so used to that we don't realize how peculiar that is. Fundamentally, I think we have many reasons to say that Russia is decoupling from the rest of the world. We haven't completed a full cycle yet in this country, so it would be a moot point to say that we are in a different part of the cycle.

The market is very thin and is driven pretty much by inflows and outflows by foreign players, which is one of the greatest deficiencies of the market that needs to be addressed by regulators, the government and infrastructure companies like exchanges, in order to bring more institutional money, domestic institutional money into this market.

The assets of the pension system are not huge compared to the size of the market. There are about $10 billion in the reserves of the whole pension system of Russia but that is growing +20% per year through inflows, because the pension system is so young. One of most important things to accomplish over the next few years will be the development of a strong and reliable domestic institutional base.

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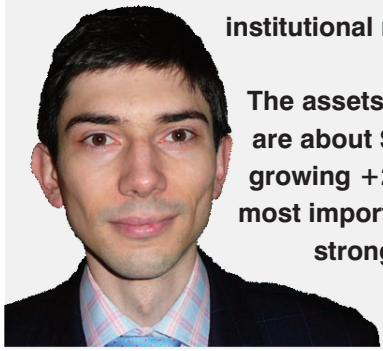

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James R. Fenkner

We are in the middle of extremely market dislocation. Either this market is pricing in extremely low commodity prices and if so, if that turns out to happen, the traffic of Moscow will clean up, the housing prices will fall dramatically and you will be able to get in to any restaurant you want in this town within six months or a year. Otherwise, if commodity prices do remain firm, this is one of the best times ever to invest in Russia.

If oil prices do move downwards to the $50/bbl that is implied in Gazprom, and share prices go down according to what is implied in the Lukoil share prices, then the real economy is going to be hit extremely hard. Just like we saw with the crisis in the West, it took time to translate through to this part of world. If, on the other hand, it is the current liquidity crisis which is forcing these prices down here, and should the commodity prices remain strong, we are going to see just a fantastic rally in this market.

Our strategy then has become very, very simplistic. We are long in liquid blue-chip commodity stocks and we are shorting through commodities. As I said, something seems to be off: either commodities fall rationalizing the current equity valuations or commodities hold and the stocks rally.

If oil prices do move downwards to the $50/bbl that is implied in Gazprom, and share prices go down according to what is implied in the Lukoil share prices, then the real economy is going to be hit extremely hard. Just like we saw with the crisis in the West, it took time to translate through to this part of world. If, on the other hand, it is the current liquidity crisis which is forcing these prices down here, and should the commodity prices remain strong, we are going to see just a fantastic rally in this market.

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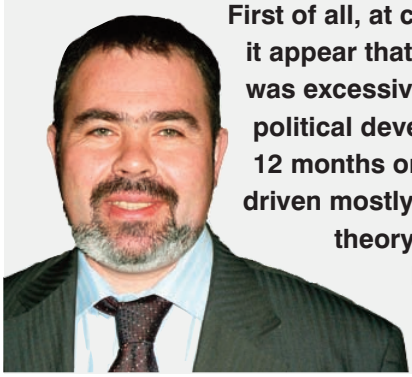
James R. Fenkner

Andrei Ivanov

I fully agree with James that Russian market now is solely driven by the investors' sentiment on commodities, which massively turned around from euphoria to panic. Given that commodity related sectors in Russia account for over 75% of market capitalization, the incoming revisions of profit growth and market movements may be dramatic. As such we may see now a classic value trap in Russia, when analysts continue to expect quite substantial profit growth next year implying that market trades at extremely low price to earnings multiples and looks very attractive. From other side, the market tells us that investors already expect that commodity prices will continue their free fall leading to inevitable waive of earnings downgrade.

I do not intend to predict oil prices over short term, but I believe that under environment of global panic and forced liquidations, market can not form fully rational view on commodities. Longer term oil can not be below marginal cost of production, which is well above $80 per barrel. Decline in oil industry capex coupled with huge increase in liquidity after credit crunch is over will lead to new uptrend in oil prices.

For the longer term horizon we probably have a lifetime opportunity to invest in Russia now. Why is that?



First of all, at current levels the market probably overpricing the commodity risks. Secondly, it appear that recent worsening in perception on political and corporate governance risks was excessive. Historically investors used to exaggerate both positive and negative political developments in Russia, and they have quite a short memory. I would say that in 12 months or two years the latest, political risk premium will disappear and market will be driven mostly by fundamental factors again. Thirdly, investors throw out the previous theory of emerging markets economic decoupling and started to incorporate hard landing scenario in developing countries.

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First of all, at current levels the market probably overpricing the commodity risks. Secondly, it appear that recent worsening in perception on political and corporate governance risks was excessive. Historically investors used to exaggerate both positive and negative political developments in Russia, and they have quite a short memory. I would say that in 12 months or two years the latest, political risk premium will disappear and market will be driven mostly by fundamental factors again. Thirdly, investors throw out the previous theory of emerging markets economic decoupling and started to incorporate hard landing scenario in developing countries. I however believe that importance of emerging markets and major drivers of global growth is underestimated.

Andrei Smirnov

Markets are usually driven by two main factors, fear and greed. Clearly, fear is the theme now on the investor side, and there is a number of reasons why they should be afraid.

The banks completely changed their profile in the last decade: from being intermediaries of pure credit to intermediaries of all sorts of risks. The financial bubble stimulated by "easy" money and new kind of intermediation is about to burst now.

While there is a trend towards a global recession, particularly in the developed world, we still think that emerging markets will suffer just a slow down, and will keep a relatively reasonable rate of growth of possibly between +4% and +6% due to domestic factors. We also believe that it is very important to differentiate between individual emerging market countries.

We still believe that the commodity story is not over. We think that the balance of demand and supply is quite favorable for the commodity producers over the long run.

If you add on the top of that sound monetary and economic policies, then you may have a very good cocktail for growth in individual regions and countries. Russia is probably one of the strongest chains globally and in the emerging markets in particular, thanks to its unique fundamentals. Of course, there are a number of things that should be improved, but Russia has a real willingness to change. This country has recent crisis experience from 1998, and people are aware how hard it can hit.

In general, I would say that the Russian financial system has adopted a more prudent risk management approach than the one used in the late 90s, when a tremendous amount of leverage was involved.

Andrei Smirnov

As far as the commodity markets are concerned, when the prices' spikes occur (like the one bringing oil to 145$), we are dealing here certainly with a number of fundamental factors driven by demand and supply, but there is also a big portion of "greed" from speculators who put their money at work in the futures market.

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In general, I would say that the Russian financial system has adopted a more prudent risk management approach than the one used in the late 90s, when a tremendous amount of leverage was involved. Those institutions who have implemented prudent risk management will be able to benefit from the current economic environment.

My view on Russia is quite positive. Economically, politically, and internationally, this country can come out of this crisis much stronger. The significant war chest which was built up in public finance area can be deployed to stimulate the economy, for example via huge investments in infrastructure (roads, communications etc.). Investments in infrastructure will then act as a catalyst for further growth. Rather then spending money on purchasing stocks and bonds (though I do not exclude such investments for the short term purposes of supporting domestic financial markets), it is in Russia's long term interest to spend this money in a way that the real economy would benefit most.

Another point I would like to make is the consolidation within different sectors of the Russian economy. This will inevitably happen: weak companies will disappear, and stronger companies will play a role of consolidators, causing big changes for Russia but also big challenges.

The form in which this consolidation will take place will be very important. The Russian economy cannot be reduced to government finance (which is quite healthy now), some of the state owned banks and a number of state owned oil companies. The process of consolidation will be the most important structural challenge, in my view.

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In the coming months, we will be looking at maturities and put options on a number of Russian domestic and international corporate bonds as an indicator of how the consolidation will take place. If we see the companies taking credits from state owned banks and ultimately ending up being consolidated as a sort of private equity investments of these banks, this would mean financial or external mode of consolidation will prevail. If we see the industry consolidation through M&A, much healthier and more natural way of consolidation we think that the players will be coming out much stronger.

Andrei Smirnov

I agree to the fact that equity valuations are quite low now, though this factor is not so important when people look for safety. Maybe sometime in the future probably in mid to end 2009, we will see the equity market recovering.

Before that happens, we need to go though a big challenge on the domestic fixed income market where several companies are experiencing very difficult liquidity conditions.

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Roman Goryunov

I would like to point out that the Russian market is not all about commodities - last year, when the prices for oil were $60 per barrel, the RTS index was +40% higher than it is now.

I would like to say a few words about the infrastructure of the Russian stock market. The reliability of the infrastructure is a critical issue for foreign investors, and for a long time it has been underestimated.

From my point of view, the exchange infrastructure of the derivatives market has proved its security and reliability even under the high pressure of extraordinary volatile market. We are experiencing this volatility on huge volumes with a lot of open positions.

Very few countries and exchanges managed to stand such a test and continue operating under such conditions. At least, I can't think of any top derivatives exchange experiencing a 42% intraday movement of the index futures, as we did last week for the futures on the RTS Index.

Another aspect is the OTC market - large volumes of trades both in equities and derivatives were done on the OTC market. The OTC market participants experienced difficulties in fulfilling their

obligations and opening limits on each other. The only way out for them is turning to the exchange and using its clearing services.

Going forward I expect a significant structural change with more trades being executed on the exchange, rather than on the OTC market.

There is one more thing I would like to bring up. The reliability of trading with 100% preliminary

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depositing of assets on MICEX, which requires the availability of both securities and money at the moment of a trade execution, has been widely doubted. This scheme is not viable unless used alongside with the repo market and generates liquidity based on opening bilateral limits without any guarantees on the part of the exchange.

In this connection we expect in the nearest future a wave of interest towards the Central Counterparty trading technology offered by RTS.

Matthias Knab **What is the make-up of your investor base? Who invests in Russian hedge funds, and what dynamic do you observe?**

Kevin Dougherty All of our investors are non-Russian; mostly North American and European based family offices, hedge fund of funds or institutional money. We are very grateful to the investors that they stuck with us this year. I believe this was due to our outperformance, our hedging strategy and our constant communication with them so they understand how we are positioned. They have an understanding of what we are doing and they are sticky money with a long term view. The most recent change was in fact a small subscription, about two weeks ago, and prior to that the last redemption was about two months ago.

Oleg Jelezko The investor base we have for both private equity and hedge funds is mostly foreign. The private equity base is more long-term and stable, while the hedge fund investor base has a tendency to get in and out, trying to achieve a kind of market timing...

We have very few Russian investors. I tend to believe that there is a fundamental issue with Russian investors, because there is a lack of trust and knowledge about what the regulated and the institutional funds do.

Maxim Tishin The investor base for our hedge funds is primarily European based, London, and Geneva, and we have some investors from the United States as well. Now that our flagship product celebrated five years of track record, the stickiness of the money has improved compared to the early days. We see some flows, both inflows and outflows, in this market but overall we are very satisfied with the quality of the investment base that we have.

In addition to the offshore money, we have a fair amount of Russian investments both in the hedge funds and in domestic regulated products. The dynamics for the Russian institutional money have been completely different from the offshore money. They seem to be sort of living in their own world, although the size of that funds is small relative to the offshore money.

James R. Fenkner

Our asset base is primarily Europe with a little bit of US money. We have also been fortunate with redemptions; we had one redemption all year. I think that most investors who are looking at this market are sweating it out. We have a pretty concentrated investor base, which makes it easy to communicate and kind of hold hands.

We had discussed the local brokerage community in terms of the liquidity - at Red Star, we have an over-anxious COO who set up accounts with everybody. We have, I think, 18 different counterparties in Russia. When the problems emerged, even the top global counterparties would not make markets, nobody was putting risk out there. That is a fundamental problem.

Andrei Ivanov

Our client base is equally spreading among the Russian and international private clients and family offices. We had quite limited redemptions since the beginning of this year. I would say that this is mostly because the clients generally have a long term horizon and continu to believe that Russia remains fundamentally attractive market. Additionally we are in constant contact with our clients and they are satisfied with our market view, investment style and our bottom-up approach for the company selection.

The crisis made painfully clear that there is a lack of domestic investors in the market, particularly institutional money. I also believe there will be some changes in the structure of international investors in Russian market with reduction of share of UK and US investors. These investors becoming particularly sensitive to political risks and market transparency. At the same time we may see increasing inflow of investors from other emerging markets, particularly from Asia and Middle East, which are much more tolerant to corporate governance and political risks. We already see interests from these investors, which were not presented in the Russian market, but are becoming more and more active.

Andrei Smirnov

We are a bit different as a large part of our investors are Russian institutions and high net worth individuals. Some of them know us for more than ten years. We have an increasing number of European investors as well, particularly funds of funds, family offices, high net worth individuals and hedge fund derivatives desks through their ”best of breed” EM managers products.

Recently, we experienced small redemptions but also had small subscriptions in our funds. Our core investor base didn’t move. They have a long-term investment horizon and an ultimate belief in the manager’s ability to deliver superior returns compared to what the market may offer directly. Our current strategy is to preserve maximum capital for our investors.

Today, speaking about the lessons from crisis, we can say that the most important factors affecting hedge funds are the stability of investor base, level of leverage and access to quality counterparties and products in the market.

You should know and diversify your counterparties. We had 30 counterparties globally worldwide before these events, now we have a much smaller number but we did have a possibility to maneuver and hence did not suffer from any counterparty default so far.

The other problem is a lack of simple, liquid and non credit sensitive products in our markets to express your view on a market direction. That has sometimes pushed us to use less efficient OTC products. Going forward, we may change our exposure and use simpler, exchange-traded products.

Counterparty risk is very important issue in situations like the current one. Some counterparties are quite nervous, post unreasonable margin requirements (beyond any risk consideration) maybe because they may experience their own liquidity problems.

The other important thing is that while fundamentals are probably the first stimulus for an investment, tactical asset location and market technicals can be very important and very tricky in particular in times of distress.

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For example if we look at the utility sector reform that took place in Russia this year and the restructuring of the RAO UES. This was a crowded trade in the market betting on sum of the parts' value post restructuring being larger than pre-restructuring value. At the end of the day, such trade was not successful due to index tracking funds who indiscriminately liquidated positions in RAO UES shares on anticipation of the stock being excluded from the index. Watch out also for liquidation of positions in the markets, and in particularly big ones, as they may hurt.

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The legal aspects also matter, not only in Russia but everywhere. Now there are a number of Blue chip hedge funds that are stuck with prime brokerage accounts at Lehman Brothers, where one thing just can change the whole picture. I am referring particularly if they had ticked that box in the prime brokerage agreement allowing or not allowing your prime broker to use your assets automatically for securities lending purposes. In the worst case you may end up queuing for your assets with other unsecured creditors, which is a very unfortunate position for a hedge fund.

On the other subject, like structured notes. Lehman issued a number of them where investors were supposed to be 100% capital protected. They ended up queuing with other unsecured creditors in bankruptcy proceedings because the investment vehicles used were not bankruptcy remoted. Such issues may be hidden in some small sub-clauses of your investment documents (term sheets, information memorandums etc), but in times of stress they come up to the surface.

Matthias Knab

Can you share your views with us about the evolution of Russia as an investment destination? How is the economy developing and diversifying? International investors are still watching the Hermitage case where it was reported that some parties are trying to seize $300m assets through fraud... As Russia-based asset managers, what is the latest regarding corporate governance according your observations?

Andrei Ivanov

First of all, I would like to say that I see some positive aspects from the current crisis situation for Russian market. It seems to me that Russia avoided large bubble both in the market and in the economy. There were real risks of over investment and excessive leverage in Russia if the current trends in economy and in commodity markets continued for several years. In such a situation

global meltdown would have much worse outcome for Russia.

Secondly, the positive outcome from the crisis is the need to address risk management issues both in the market and on the corporate level on the earlier stage.

And finally, I believe the fall in commodity prices will also have a long term implication and serve as stimulus to develop non-commodity sectors.

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Talking about political risks, I should mention that investors took unrealistically positive view on progress in fight with corruption, defense of property rights and other liberal reforms immediately after election of President Medvedev. At the same time the complete turn around in investors view on the political risks after conflict in Georgia and pressure on Mechel is also unfair. The main issue here is the absence of transparency and proper public relation functions on the government level.

For example, market reaction on investigation against Mechel implied complete revision of property rights. I however believe that it was just ab attempt of the government to use administrative ways to fight with commodity driven inflation. The absence of continuing dialog of the government with the market and its failure to explain the key economic decisions leads to significant risk premium for political risks. The similar situation arisen around conflict in Georgia, when the state completely lost in its public relation and PR campaign and failed to deliver a proper message to the investors and to the global audience. As a result Russia lost dozens of billions of dollars in capital flight.

I would say that on the corporate level, the situation is much better with continuing improvement in transparency and corporate governance standards. Such improvement is directly linked to the development of IPO market and increasing importance of capital markets as the source of corporate financing. Most large companies already follows international accounting practice and have proper investor relation functions.

Andrei Smirnov

Corporate governance issues are in particular sensitive in the small-mid cap sector. One of our funds invests in such securities in Russia and CIS. Sometimes we have to fight with the owners of the company in order to protect the investors' interest in cases of fraud, improper valuations on corporate actions or violation of rights of minority investors. I would agree that there is a positive

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So far we also had a number of positive experiences where we as an investor were following an activist approach, in the positive sense of the word. That does not mean we go to the company, request a seat on the board and say, "Hey! You are not doing the right things"... On the contrary, what we are trying to do is to sit down with management and shareholders and say "your company may be worth twice the amount of your current market cap. That is what we think you need to do and we can work together with you to achieve this goal and bring our own expertise to the table." Usually, that works pretty well.

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If we look at large caps, the situation is different because these companies act in international markets borrow though syndicated loans, eurobonds or issue depository receipts in the Western markets.

But there is still quite a large room for the corporate governance to improve.

Matthias Knab **Next question would be regarding the current regulatory framework in Russia, what is it like to run a hedge fund out of Russia?**

Oleg Jelezko The most typical framework of operating a hedge fund that is invested into Russian securities is using an investment advisory company that advises the management company on the investment decisions. The ultimate investment decisions are made by the regulated company and that can sit somewhere in Guernsey or officially in the European Community. This is a standard structure which I believe is similar to the some hedge fund set-ups in the U.S. and London.

So from a technical point of view, no one actually runs the hedge fund out of Russia. Each hedge fund company has a board of directors that formally approves the investment recommendations. Now the question is whether this environment could be made better or worse. I think Russia is not immune to the global trends where for example the U.S. is trying to introduce some of sort of hedge fund regulatory standards, and I am not going to dwell on this.

The regulators in Russia actually tried to implement some local hedge funds which would be run tax-exempt, in the same way how the mutual funds are run. The details of this proposal are to yet to be seen; according to the latest draft, the hedging facilities were limited.

So the main point here is that Russia might move ahead with the introduction of a local hedge fund regime, versus the current offshore set up. That would be an interesting step as far as the local institutional and high net worth investor base could move ahead in further accepting hedge fund investments.

Maxim Tishin Another important development would be establishment of the concept of the qualified investor in the local Russian regulatory framework. Once that is formally established, together with some other regulatory changes which need to be finalized and completed, many things would become possible under the local Russian regulatory framework that are currently available for off-shore investors only.

Hedge funds are just one of these options, and of course it’s yet to be seen if that’s going to be very successful, or given that investor base even sort of in the current unqualified space of local Russian regulated money, sort of said, So it’s yet to be seen if this introduction of the qualified investors concept would bring any additional money into the markets. Nevertheless this is a very important step which brings the local regulatory framework closer to other established regulatory regimes.

My wishes for the regulators and for the infrastructure of this market would be to introduce more transparency in all markets that we trade, namely cash equities, fixed income and derivatives.

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The fact that there are substantial arbitrage opportunities between local stocks on the local exchange and the ADRs from time to time - even if the stock is fully fungible - is something the local regulator and local exchanges should be really ashamed of. Local MTS shares could be seen trading at a discount over 40% to US-listed MTS ADRs. This is something regulators and local exchanges should look at. This chart should be on their wall, because this shows how the real efficiency of the local market infrastructure.

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It's a well known fact that only a little amount of Russian cash equities are traded on the Russia regulated exchanges, and significant volumes are traded on foreign regulated exchanges in forms of ADRs and the OTC markets. I hope that one of the consequences of this crisis would be more that we shall see improvements in transparency of trading and efficiency of settlement and clearing infrastructure.

Matthias Knab **Roman, do you want to address this from the exchange point of view?**

Roman Goryunov

As to the legal framework and hedge funds, a fair amount of work is still needed. We expect the Federal Financial Market Service to approve all the necessary regulatory acts and impose this legislation.

This will open up new opportunities for managers servicing qualified investors, as Maxim has already mentioned. It will also boost the development of the asset management industry in Russia. Regarding the discussion on the liquidity concentration, I fully agree that establishing a liquidity center inside Russia is absolutely necessary.

This issue is already being addressed on the government level and therefore cannot be dealt with by one or another exchange, or the regulator alone. The point here is to win the investor confidence and to make the Russian market attractive for foreign investments and trade inflows.

This is a very clear need, and I do believe we are well placed to address it. On the part of my colleagues, I can say that we apply a lot of efforts to develop the infrastructure, to improve the reliability of the systems and the technology and to extend the choice of instruments offered to investors.

Matthias Knab **What is the future for hedge funds in Russia?**

Kevin Dougherty

I think in a lot of ways it's very similar to the future of hedge funds globally After this crisis, risk management is going to be an even more important factor when investors consider which funds

they invest with. Operational due-diligence and regular communication between the fund and the investors will be even more important.

As we saw after the crisis in 1998, it took quite some time, in fact a number of years, before new funds opened in Russia. So I expect that the players which we see today will be the same group for some time going forward. The investors are going to be very choosy, looking at track records and wanting to have managers with experience. There will be come consolidation in the market. And going forward, the funds that survive will have to be real "hedge" funds – that actually hedge – and not just long only funds that charge hedge fund fees.

The other global factor is leverage. Although in general this has been less a factor in our market, still some domestic investors were very highly leveraged and that helped exacerbate some recent stresses in the market. The whole hedge fund industry is deleveraging, I don't think hedge funds are going to be able to get away with being massively leveraged and posting good returns that way. Their performance is going to be more dependent on developing ideas and executing trades that end up working out, and not just gearing up ten times and riding a bull market.

Andrei Smirnov

We can look at the future of hedge funds in Russia from two perspectives: first, from the point of view of the investor base and second, regarding different investment strategies that can be deployed.

As far as the investor base in concerned, I think that it will be growing and become more sophisticated. Back to mid 90s, Russian investors were net borrowers of funds and used substantial amount of leverage compared to their equity capital. Today, they become net lenders of funds, and they are interested to diversify their exposure and to make investments in hedge funds and private equity strategies. They will sometimes do that directly but more and more they tend to outsource this service to professional managers. The issue of confidence in the managers by Russian investors is still there, but they are taking more and more professional hedge fund of funds' type approach and do more due diligence. We think that this investor base has a bright future.

Looking at the investment strategies, it is important to notice that most of hedge fund strategies are represented in Russia.

Being a part of the global financial system, the Russian assets reacted in line with the global risk aversion or risk appetite trends. The introduction of global macro overlay in multi-strategy products may be a promising way to smoothen the performance of a pure Russian credit or equity strategy.

Systematic hedging of all sorts of risks becomes also a very important issue. Be it against U.S. systemic risk, geo-political risk like potential war with Iran, currency risk or market directional risk. Managers will use more and more systematic hedging in this respect.

Looking at the investment strategies, it is important to notice that most of hedge fund strategies are represented in Russia. Long/short equity will enjoy a very good future, once the dust settles down. When we get out of this vicious circle of redemptions, liquidations and lack of confidence, people will start thinking about valuations, but that will probably not happen in a very immediate future.

Credit shortage and liquidity crunch will give very interesting opportunities for asset based lending strategies. Restrictive banking regulations actually help creating ABL solutions for companies. If we look at the overall transformation of the current industrial and financial landscape, we also think that M&A activities will become quite important in the coming months. This creates a very good general background for distressed and event driven strategies.

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If we look at the overall transformation of the current industrial and financial landscape, we also think that M&A activities will become quite important in the coming months. This creates a very good general background for distressed and event driven strategies. Companies will probably use more and more financial techniques to manage actively their assets and liabilities, and this is another interesting opportunity for hedge fund managers. But one has to be careful about possible corporate defaults.

Currently the small and mid caps space is offering good opportunities for activist investment approach.

In conclusion, both dimensions - investor-wise and strategy-wise, Russia is a very good place to be. Hopefully current actions of regulators and authorities in Russia will allow Moscow to become a world class financial center and we will see a number of hedge funds settling here, rather than in London or in Switzerland.

Oleg Jelezko

As far as the alternative assets are concerned, I think in the next three to six months we will see one of the best opportunities to get into Russia. The current environment, this "perfect storm" created a number of mis-priced opportunities across all the asset classes. And for those counter cyclical investors who want to go against the crowd, that presents enormous opportunity, even given the fact that there are also quite a few mis-priced opportunities in the developed markets and other emerging markets, Russia will mark a unique entry point due to its fundamentals and dynamism.

We will see a lot of private equity opportunities in consolidating companies, for example helping strong companies to buy other firms at single digit P/Es because they have liquidity issues. We see opportunity in asset backed lending with the liquidation of some equity finance portfolios as well. There could be activity in the small and mid-cap space through activism or just building stakes at relatively low prices.

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We will see a lot of private equity opportunities in consolidating companies, for example helping strong companies to buy other firms at single digit P/Es because they have liquidity issues. We see opportunity in asset backed lending with the liquidation of some equity finance portfolios as well. There could be activity in the small and mid-cap space through activism or just building stakes at relatively low prices. The traditional long-only and long-short strategies become interesting again. There will be M&A flow, and the valuations will rise again. The current crisis is polarizing the market in effect, stronger companies will perform better and weaker companies may go all the way down to the bankruptcy. This also creates an ideal situation for short sellers as well, even if the market recovers at some time.

Matthias Knab **How has risk management changed in Russia in the past years?**

Maxim Tishin

Talking about risk management, you also have to put our little universe of Russian hedge fund managers into a global context. We have to agree that we were blessed with strong performance of

our market over the last decade. This resulted in a fact that as an industry, we have not built up excessive levels of leverage.

When this massive deleveraging unfolded, fundamentally we actually find ourselves in a bit more stable position than other regions or asset classes, where excessive leverage has built up. Secondly, while some Russian hedge funds may fail or be forced to merge with larger operations, I do not expect witnessing a major fund blowing up with a bang that would damage the industry as a whole. When one of the largest Russian investors wound down his fund for completely different reasons that we all know, it didn't bring down the whole sector, it didn't change us by a large extent.

Certainly risk management today gets more attention than it had a year ago, and I think we generally spend a bit more of our time answering due diligence questionnaires from our clients and writing reports. We talk to our own risk managers to get a better judgment of where we are and if anything needs to be improved. The risk manager gets more time of the principals now than he used to a year ago and so on, but again, I would like to underline that we were not the sector that was hugely overstretched and leveraged.

James R. Fenkner

Let's look at this from a sheer business point of view. Leverage coming down, fees likely to be competed down and high water marks unlikely to be reached for possible 12 or 18 months, depending on what happens to the market. So this all means consolidation within the local hedge fund industry. The question will be how the consolidation will happen in detail, whether it is consolidation based on the assets, track record, size etc., whether the fund has a bank behind them - these things will be interesting.

Andrei Smirnov

I think that the Russian Hedge fund industry will experience the same general trends that we see in the hedge funds industry globally.

Consolidation of hedge funds and managers will certainly happen in Russia. The barriers of entry to the hedge fund business will become increasingly dissuasive, be it in terms of access to capital, operational requirements or in terms of access to good service providers. It will be more difficult for a hedge fund manager to start and survive.

The key issue will be the investor capital stability - if you have good core investors, you have a huge advantage.

As a hedge fund manager, our most important task will remain to beat through our performance the long term "real" inflation (not an official inflation figure but a real increase in price of a consumer basket of your investors). The opportunities we were discussing here are creating a very good entry point for those investors which were so far on the sidelines.

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