ASSET MANAGEMENT IN RUSSIA KEEPS DEVELOPING ON DOMESTIC MONEY

Interview with Aylin Suntay, First Vice President, Head of Asset Management Business, Gazprombank Group

You have been leading a successful asset management company for more than three years and prior to that you had been working for well-known asset managers in Europe and the US. What particular differences in business approaches in Russia vs. the West countries you can list?

On the positive side, comparing Russia to Europe and the US, the role of compliance and legal teams is more to support business rather than to prevent business. Europe and the US have taken compliance to such an exaggerated level that it is tough to perform for clients and to be efficient given the number of restrictions. Central Bank of Russia is also moving in this direction but I hope they take a softer approach than the West and can learn from their shortcomings. Another positive in Russia is a very hardworking, young and talented staff, especially very advanced in mathematics. My team manages to surprise me positively everyday!

When it comes to the negatives of Russia compared to Europe and the US, it is the amount of paperwork, the amount of process of the process that is required and the urgent need to move to more electronic signatures and approvals. It is definitely happening! But not fast enough. The other thing that surprised me a lot when I moved to Russia is a lack of IT systems and IT automation in asset management. Given how famous Russia is for its IT engineers, I was surprised to see how much is done on excel spreadsheets. Of course the situation improves and we are moving fast with internal IT development.

How would you estimate asset management business perspectives in Russia?

I believe that Russia has a lot of potential and is still in the nascent stage of development in asset management. Even the largest player has only slightly above USD 5 bln under management and top 10 asset managers have USD 36 bln of AUM where an important portion of it is still captive. Therefore the growth potential of the industry is quite large in all segments from corporates, especially pension funds, to HNW clients or mutual funds, as the involvement of population in the investments is still extremely low. On the other hand the marginality of asset management business as well as of investment banking and brokerage, is steadily going down and Russia is not an exemption. In my view the industry in Russia will consolidate and only the top players will have the market share.

What are the key drivers for future growth? Does the legislation help?

The key drivers for future growth will be a more stable Russian economy with lower inflation and lower interest rates which will make investments in the public markets much more attractive for investors and stimulate growth in the market across client types. Let's not forget that until recently, asset managers were competing with USD annual deposit returns of 6-10% which our clients received depending if they had their money with top tier or second tier banks. Now then the interest rates are down to 2% per annum, they are considering alternative investments in the markets. Clearly the other key growth driver for the markets is legislation. Especially this is the key for both pension funds and endowments. For the later, the law requires liquidation if their return is -50% in 1 year or -30% in 3 years, this makes endowment investment policy extremely cautious. For pension funds, the issue is more about expected returns which are still an issue. While there is no longer a requirement for capital preservation by law, most pension funds still require their asset managers to give annual guarantees for returns and set hurdle rates which require the asset managers to be more conservative in terms of their asset allocation.

For the individuals the tax issue should be resolved. The investments in bank deposits are tax free and the returns from fixed income instruments are still the subject for taxation. So the net returns of first tier corporate bonds could hardly compete with the deposits. But even here the situation improves as the Government introduced recently the new “personal pension account”, which could be tax exempted for the minimum holding period of 3 years. Meanwhile the maximum size of the annual donation to such an account is limited, which makes “personal pension account” reasonable only for small retail clients.

Could you describe the risk/return profile of a Russian individual investor?

In general we could not say that the Russian individual investor is a sophisticated one, thus the risk/return profile is risk averse. The majority of the individuals use bank deposits to gain, staying liquid, and real estate to save the value. So the outliers who go into different investments start with fixed income and usually do not deviate from it as fixed income instruments are easy for their comprehension and market risk is minimized as all investments are held to maturity. Of course it is a portrait of an average individual, who comprise around 70% of asset management individual clients, while only more experienced investors are interested in asset management services. These 30% are looking for exposure to derivatives, some structured products, active allocation between fixed income and equities or are targeted to absolute return.

According to the world practice, pension funds have always been the main investors in equity markets. On the other hand Russian pension funds are in fact less involved in equity market. What is the key point and what could be done to reverse this trend?

Pension Funds in Russia are extremely risk averse. It is based on three facts. The first one is that one part of pension funds (called "pension reserves") was capital protected by law with the asset managers' own capital and

the "pension savings" (the other part) also required similar guarantees even though not being obligated by the law. This made the standards of the investment policy in the industry extremely conservative, as no one asset manager could bear the risk of going bankrupt being obligated to cover the potential losses in absolute terms, given the size of assets in pension funds. So the core investments were bank deposits and even the bonds with the duration above 1.5 were considered dangerous, with equity exposure probably being completely out of the question. Now the legislation is not so restrictive, but the practice of "capital protection" or "asset manager guarantee" is still the most popular requirement in the pension fund tenders.

The second reason is the legislation requirement on portfolio structure. The portfolio composition and investment requirements are so protective that there is not much space for the asset managers to implement all the investment ideas they have. And pension funds themselves are even more protective, imposing restriction on certain issuers, banks, sectors as well as any equity allocation via investment policy statements. Of course all these restrictions have their reasoning and did not appear from scratch. Their aim is to protect the retirees from fraud, which is unfortunately still in place on the undeveloped and relatively young Russian investment market.

The last and the least reason is the Russian equity market itself. It is interesting and has been constantly providing a lot of opportunities to make good money, but it still doesn`t provide examples of a steady growth with excellent corporate governance or a dividend history for a significant period of time. But it is the matter of time as the market develops fast and there are enough mature companies, which could be considered as solid long-term investments for the pension funds.

Regardless of more than 20 years of Russian collective investments market history, it is still far away from "developed market" condition with population participation ratio of <0.5%. In your opinion, what is really missing in this sector?

Actually the reasons are not so obvious. It is a combination of the historical and cultural features. The concept of "lending money" is not encouraged by the Russian church, which is why the banking was never the strongest Russian industry. After the revolution communism prohibited lending, investments and any private property whatsoever. The modern Russian population was not taught by their parents to think about retirement plans as they themselves had no need for this in the Soviet Union. There is no historical tradition in Russia to think about long-term investments and this is the first reason.

The second one is also linked to the Soviet Union. Being the leader in education and the absolute leader in mathematics, physics and engineering, the school system was not targeted to economic education as there was no need for it in the government planned economy. So the education system changed only recently to grow enough "economically educated population".

This is a natural process of market evolution and it proceeds at an accelerated pace in Russia and I hope to see this "participation ratio" to increase significantly in the next 5 to 10 years.

Talking about the debt market of Russian issuers nominated in USD, despite the fact of local economic downturn, the global markets still see the strong credit quality of Russian issuers and it reflects the recent rally on the Russian Eurobond market. Which investors drove this significant price increase in the recent year?

The main and the strongest demand we saw was from the local banks and individuals. Everyone who clearly understands the Russian economy and credit profiles of top tier Russian corporates could not leave behind such an opportunity to invest in high quality fixed income instruments with double digit yields. Also the dollar liquidity in Russia remains at a high level that still pushes the yields lower and the prices of Eurobonds higher. But the local demand was and is not

the only one in the market. Acting as an advisor and being an asset manager for international funds we also see strong foreign demand for Russian Eurobonds as the yields are still too attractive for the given credit quality, especially comparing them to the EU or US USD denominated rates.

What is your favourite sector in terms of equity growth perspective and stable debt capital demand?

As we observe a moderation of economic slowdown in Russia, it's time to get positioned towards sectors that provide exposure to recovery and behave as leading indicators, such as the Financials. With a more benign interest rate environment and cost of risk gradually reverting to mid-cycle normals, particular banks are likely to restore ROE to mid-teens (or higher) already in 2016. Going forward, we see commitment from the Central Bank of Russia to deliver a meaningfully lower inflation in the next 1-2 years, meaning further key rate decline and therefore triggering downward repricing in cost of equity. This will help P/B multiples in the financial sector to expand. At the same time, financial sector is the main driving force of local fixed income market, especially on the demand side, as Russian banks hold almost 50% of local bonds and more than 15% of Russian Eurobonds outstanding. If recovery in commodities proves to be sustainable, associated names might as well present a compelling equity growth perspective together with debt capital story.

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