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‘We thought it would be different...but it turned out the same’ - Viktor Chernomyrdin Russian Prime Minister 1992-98 (source New York Times obituary 04/11/10).

Where to Russia? --- Still a long way to go before this vast country can be considered a serious investment prospect

Key Issue—as Russia finally accedes to membership of the WTO and with the RTS’ equity valuations so modest, investors would be forgiven to look again at this market.

Key Recommendation—Russia will continue to benefit from its substantial raw material wealth. However, the spoils are likely to be held tightly by a close knit group centred around the President. International investors are well advised to only sparingly play this game.

Russia was in many ways the ultimate emerging market. There were many promising signals - breaking free from the destructive hand of communism, and with an empire of riches, underutilised factories, basic but workable infrastructure, and above all, an educated population yearning to do business. While it may be that the political process stalled out more than ten years ago, the advancement in living standards for ordinary citizens has only been surpassed by the riches garnered by the oligarchs.

WTO membership --- a sign of confidence

It is hard to believe that Russia's first request for membership was made back in 1993. Beaten by Albania who joined in 2000, and even the fellow Soviet republic of Armenia since 2003 (source WTO website).

Nevertheless, membership which is due to finally accede this August will confer considerable benefits for this fast developing society. A reduction of duties across a range of products will be matched with protection for property and other legal rights across the WTO's 155 members.

'Russia's entry to WTO will show its true promise' - Dr Michael Hecker (source CNBC.com 3/08/12). The fact that the country has chosen this moment to join demonstrates an understanding that the old energy dependent export driven economy can no longer be totally relied on. The nation's businesses will fare better for themselves with greater international connection, and competition.

Mined/pumped/grown in Russia

With an over 17mio square kilometre land mass, **comprising more than 12% of the earth** this is the largest country in the world. While much of this vastness lies undiscovered plenty of riches have already been exploited.

'Raw materials and Russian infrastructure' - Dr Sergei Cherkasov (15th September 2007, The Schiller Institute website).

Running neck and neck with Saudi Arabia as the largest global oil producer (Saudi Arabia still exports more, as there is greater domestic demand), the country possesses the largest aluminium producer **Rusal** and nickel producer **Norilsk Nickel**. A major producer of grains, Russia has the largest timberland and the world's greatest supply of freshwater (Lake Baikal).

After the fall of communism a genuine level of privatisation led to real de-bottlenecking in many products. Today's successful and largely debt free economy is this testimony.

CRB index -- long term upswing (source Bloomberg) As the bear market in overall commodities ended at the finale of the 1990s, Russia has benefitted from these rising prices.

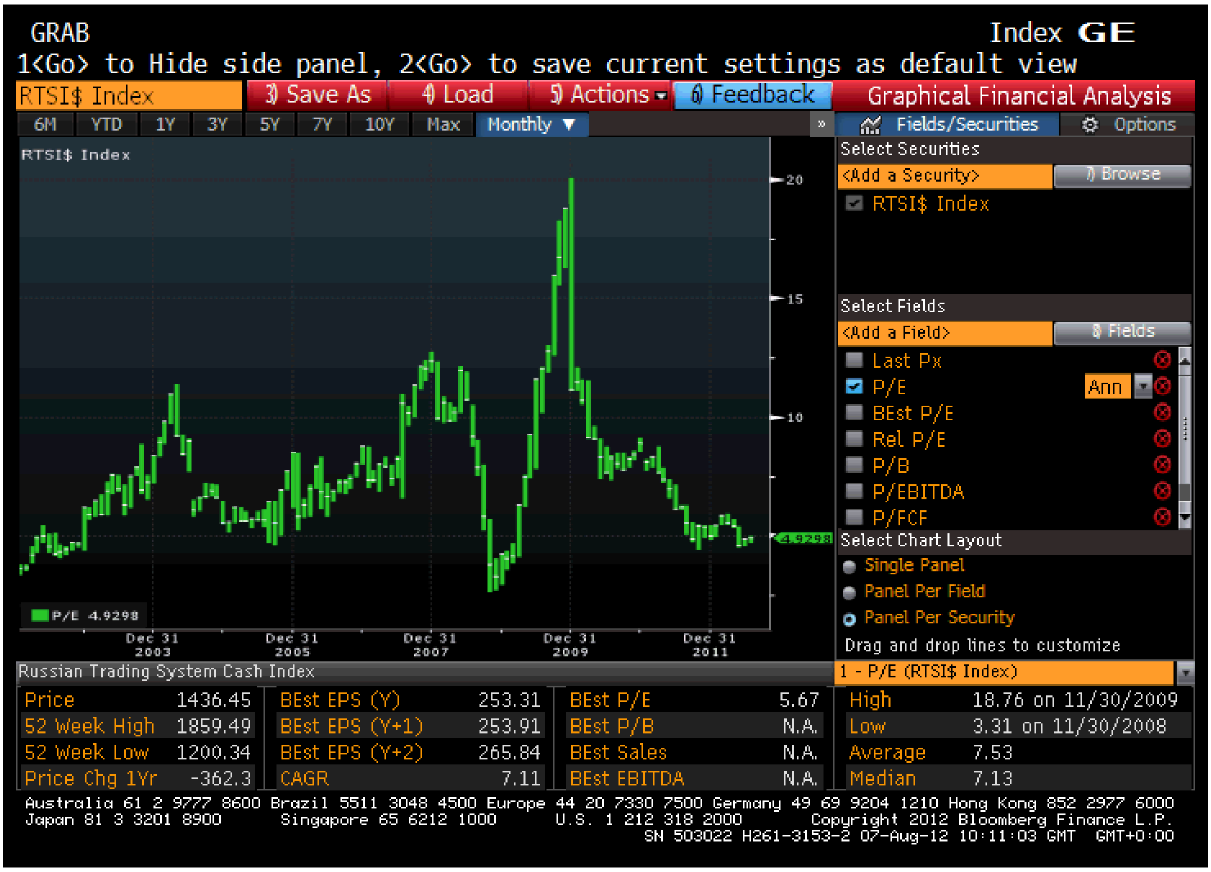
'Russia is ridiculously cheap' - Nick Timberlake HSBC (source Daily Telegraph website 07/08/12)

Renewed political uncertainty since the botched parliamentary elections in December coincided with a general risk aversion backdrop. These factors have given a poor stage set for the RTS - Russia's main index. Many emerging markets have been similarly affected.

'I have invested in Russia since the market was opened to foreign investors in 1994. Since then there have been three buying opportunities—the crashes of 1998, 2004 and 2008.' So continues Timberlake, who is putting his money where his mouth is by investing £300m in this region.

The timing may be auspicious for general 'risk-on' but the problem with this 'value' based investing is that Russia has generally been the cheapest of the major EM players**.** **'Investors are not stupid,** and this is the reason why the Russian market has not gone up...the reason for this is that **people understand that behind one number, one relatively low P/E, there is a much more complicated picture' -** Steven Dashevesky (source www.rt.com).

A heavy tax burden and a complicated and intrusive regulatory regime in an uncertain legal environment, are all major issues that undermine valuations. The high proportion of energy based companies is another reason why the RTS index has proven so volatile.



RTS P/E ratios at the cheaper end of the range, but single digits is not unknown (source Bloomberg)

Chernomyrdin was right ---- rule of law still elusive

The Schumpeter column for the Economist, in reporting on the recent St. Petersburg International Economic Forum (SPIEF) conference, described carefully both the similarities with WEF's more famous event in Davos, and its differences.

CEOs from Goldman Sachs and McKinsey's gave addresses and the likes of PepsiCo and Mercedes-Benz gave lavish parties. Even Henry Kissinger was on hand to dispense homilies. However, they noted 'SPIEF man is far more ambivalent about the building-blocks of global capitalism than Davos man' (source The Economist 30/06/12). While in private many Russians were embarrassed at how Putin had returned to the Presidency, in public the need to be obsequious was obvious.

Rather more ominously for a country supposedly hungry for investment **'Mr Putin made a point of keeping the bosses of four western energy companies waiting to see him in a dark, chairless foyer for three hours'** reported the newspaper.

BP—caught in a bear hug

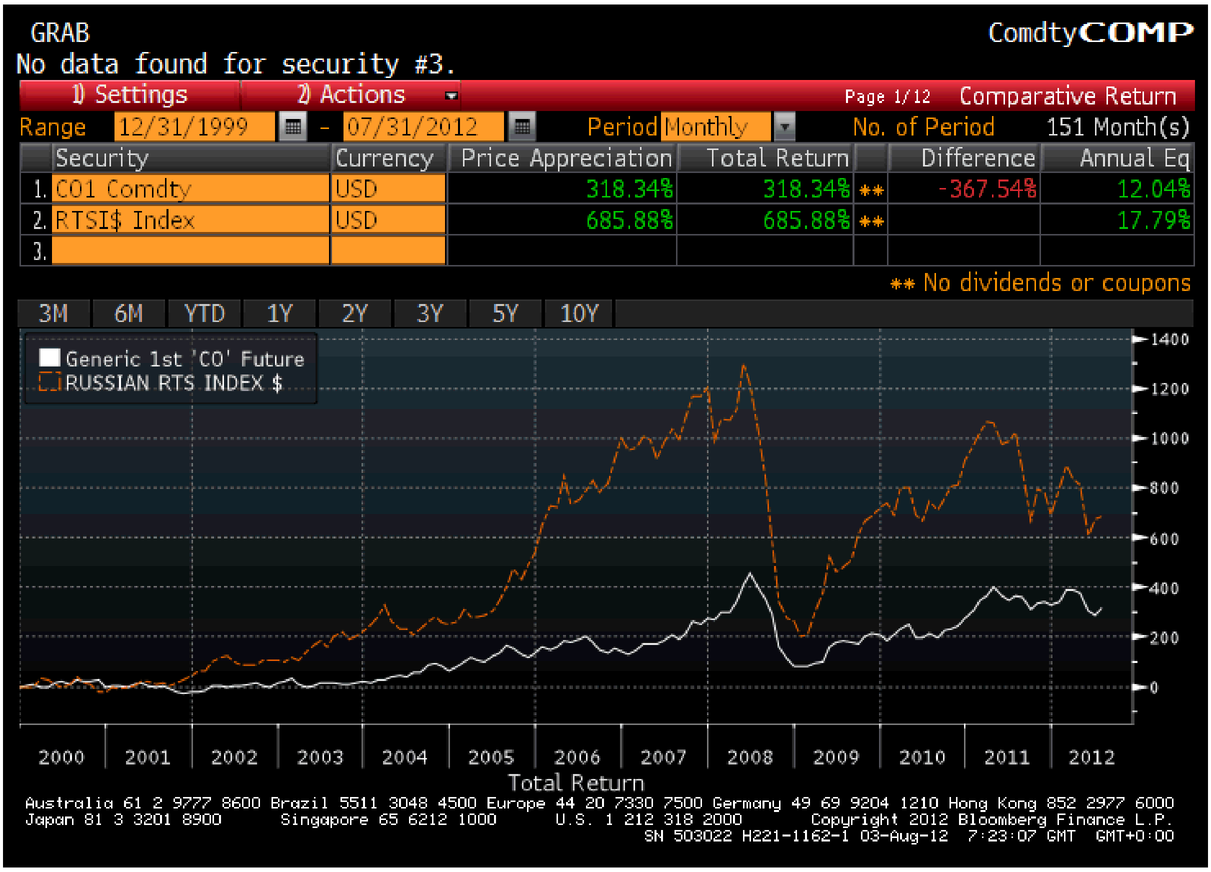
Since the tail end of the Soviet era, BP had targeted Russia as a fresh area to recoup some of its global reserves that were depleting rapidly. A substantial investment both in financial and prestige terms was made; the TNK-BP alliance was the result. This company has enjoyed many billions in dividends as the Siberian oil fields came on stream providing a rich cash flow. But, as a vehicle to develop a greater long term presence in Russian exploration, the alliance with TNK has failed.

As BP struggled to find a direction post the Gulf of Mexico disaster, it decided to withdraw from this investment. However, in either direction the company has found itself under attack from both the other oligarch controllers of TNK, and from the Government. In what has become a typical hallmark of doing business in Russia, obscure court action ensued, with **BP being ordered to pay $3.1bn** damages to its joint venture partners. Shell faced similar difficulties with its Sakhalin project.

BP said it considered the claim **"an attempted corporate attack**" (source FT.com 27/07/12). Caught between the government and the oligarchs is not a comfortable place.

Conclusion --- a leveraged play on oil or a place for the few to make serious money?

An autocratic country with massive commodity firepower has emerged from the Soviet morass. Those investors that buy into a long term bull market in raw materials may take comfort from the correlation that this market can provide.



RTS a leveraged play on the oil price (source Bloomberg)

As the political process consolidates around Putin as a sort of 19th century Tsar-like figure, the real money is increasingly being made and dispensed by a small group surrounding and feeding off this power. As the President starts what might be an eight year haul in office, it is difficult to see this changing. Even well placed multi-nationals like BP and Shell have found it nearly impossible to operate.

In this context we believe that investors should look elsewhere for emerging market exposure. We favour markets like sub-Saharan Africa and Indonesia.

As many a London private banker, estate agent, or dog walker has found, the best way to make money out of Russia is to service this wealth from afar.

Summer rally gathers pace --- bears confounded

Serial bears like Nouriel Roubini have licked their lips as the long drawn Euro crisis has staggered on seemingly forever. This great economist has been early in reporting the gathering global slowdown that may have originated in Europe but is spreading fast around the globe.

However, investors need to differentiate between movements in the economy and financial assets. This very economic weakness has led to yet further major bond market rallies, with US/UK and German ten years rallying to yield around 1.5%. **It is this search for yield that has steadied~~,~~ and now bolstered dividend paying stocks.**

'These are very high return on equity businesses, with strong cash flow - which is very important to allow the companies to produce good returns for shareholders in good times and bad' Rob McIver Jensen Portfolio (source CNN.com 11/08/12).

While the Fed may yet be conserving its bullets, central banks from around the globe, from **Korea** to **India** and **Brazil**, have also eased policy, again driving **global yields lower**.

For this reason we see a nice summer rally as continuing and we remain overweight both equities and gold.

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