Tera Capital Fund

December Special Newsletter

Altima asset management

Tera is the only Fund of Funds in the world which pays no expenses and takes no fees other than a success fee

The Liquidity Crisis in Russia

The liquidity crisis made itself felt in Russia later than in most of the world. Although it began with the sub-prime crisis in United States in about August of 2007 and we now know that a recession officially began in that country in December 2007, Russia's stock market actually continued until May 19, 2008, when the RTS hit a record high of 2487.92. There was only one relatively minor interruption in January 2008, However, when the liquidity crisis finally did hit Russia, it did so with a vengeance. In five months the RTS fell from that high to a four-year low of 549.43 on October 24, 2008,[1]

The Russian market had already been weakened by issues related to TNK-BP, Mechel Steel, Georgia and falling commodities prices. As a result, the liquidity crisis hit even harder than it might have otherwise.

Is the Crisis Over?

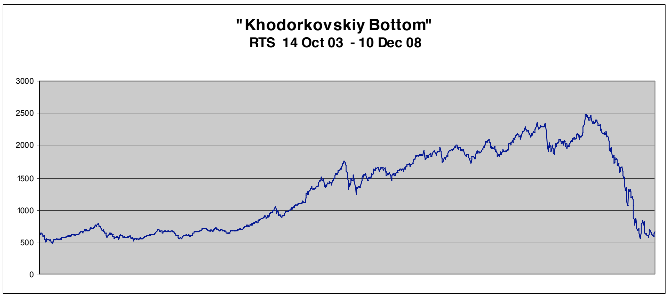
The obvious question is: Have the Russian markets hit bottom? We feel that the answer is yes. We also feel that hitting bottom marks the end of the crisis and the beginning of the recovery. The distinction may be semantic, but the crisis itself is largely psychologically driven, so semantics play an important role.

There are several reasons for this belief. The first is simple and objective: enough national governments throughout the world have announced enough plans, pledged enough support and taken enough action to halt the precipitous drop in equity markets. US, Western European and Asian markets have all settled around slightly above the lows they hit at the end of October. Russia has done the same.

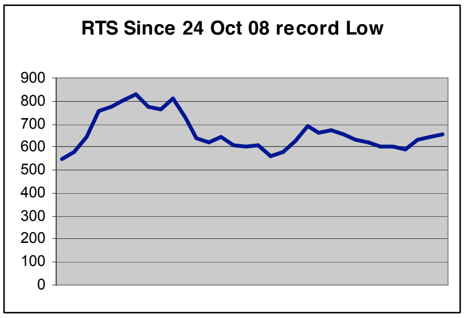
The second is technical: the RTS is above a very strong historical support level and, no matter how hard it seems to try, it has not fallen below it.

The "Khodorkovskiy Bottom"

Shortly after the arrest of the Yukos president. Mikhail Khodorkovskiy on October 25, 2003, the RTS began falling from its record high of 640.53 set 10 days before and fell to 534.41 on December 5, 2003. With the exception of two trading days in July 2004 this bottom has held and was not tested at all until now.



The critical day turned out to be October 24, 2008 when the RTS closed at 549.43, just above the 2003/4 lows. If no support had appeared at that level, it would have been difficult to predict where the RTS would have ended up. The next real bottom below that was set during the 1998 currency crisis -- but at a rather absurd level of 38.53[2].



Fortunately, the "Khodorkovskiy bottom" has held and held strongly – more than once, which for technical analysts (which we do not claim to be) is crucial. During the five trading days after October 24, the RTS rose 46% to over 800. After holding at about that level for five trading days, over the next eight it fell back to 552.09, testing the "Khodorkovskiy bottom" as second time. After climbing back to almost 700, the news regarding the potential "Big Three" auto bailout in the US and related financial news have caused US and Western European indices to drop sharply, while the RTS has only fallen slightly, to just under 600. Whether it will again test the 534 level or not is, of course, unclear, but it seems unlikely that it will now fall below that level.

The Investment Case for Russia

The third reason that causes us to believe that Russian markets have hit bottom is simply that equity prices in Russia have simply fallen too far to fall further. At the 600 RTS level, Russian stocks sell for a 2008 P/E ratio of 2.1.

Fourth, during the first half of 2008, Russian equities outperformed almost every other market. Then outside factors, primarily requirements to find liquidity to cover redemption requests to funds that had investment in Russia, margin calls of those same funds and a generalized fear of emerging markets, drove down prices. In one way, this is a compliment to Russia: investors needed money elsewhere and took money out of Russia because they could – the market is deep, liquid accessible, transparent (that is, the operation of the stock market, not the country itself) and not subject to onerous repatriation restrictions. In other words, the steep drop and continued functioning of the market, albeit with frequent closings at one period when a 5% trigger was hit, show how solid and well run the Russian stock market is.

Fifth, the overall level of Russian debt – government, corporate and private – is very low (in stark contrast to the high levels of leverage used by many investors who invest *in* Russia). Total bank lending totals 40% of GDP in Russia, compared to 120% in France, Germany and China, 190% in the UK and just over 200% in the US. Further, the two months with the highest level of corporate repayments are December 2008 and March 2009, falling off steeply thereafter.[3] Consequently, it is clear that the overall domestic impact of the liquidity crisis on Russia, Russian companies and the Russian people will be much less and much more short-lived than it will be in most other countries.

Sixth and finally, many people have tried to compare the liquidity crisis with the 1998 currency crisis which Russia arguably triggered and was certainly severely damaged by. There is, however, almost no comparison between the two situations.

Contrast with the 1998 Currency Crisis

First, the facts. The record high before the 1998 currency crisis was set on October 7, 1997 at 571.66. Perhaps coincidently, the resistance level prior to 1998 is remarkably similar to the apparent support level in 2008. The record low during the 1998 crisis was 38.53, a drop of 93.3%.

The drop from the new record high of 2487.92 on May 19, 2008 to the October 24, 2008 low of 549.43 was 77.9%. While this is certainly a huge drop, falling back to the levels of just under four years ago is hardly comparable to nearly seeing the entire

[1] The RTS last closed below 561 on December 20, 2004. Source: RTS

[2] On October 5, 1998. Source: RTS

[3] Source: Rosstat.

market wiped out – which almost happened given that the RTS opened at 100 on January 9, 1995.

Second, some statistical comparisons. In 1998, Russian government debt totaled over $200 billion or 80% of GDP; it is now 6% of GDP – and the GPD is much higher. Russian reserves now total almost $500 billion – even after the various actions to support the Russian economy and the ruble – compared to a trivial $7 billion in 1998.[4] FDI in Russia last year totaled over $50 billion, comparable to that in China.

In 1998, the oil & gas sector accounted for 60% of GDP; today it accounts for 25%.

In 1998, Russia had both a budget deficit and a balance of payments deficit. Today, both are running large surpluses. In 1998, oil cost $12 a barrel ($16 when adjusted for inflation); today, oil costs over three times as much, notwithstanding the sharp drop from the $147 record high set on June 6, 2008.

In 1998, GPD per capita was 11% of what it is today.[5] The GDP growth rate in 1998 was *minus* 5.4%; in 2007 it was 8.1% and it is estimated to be 7% this year. The average wage was *7%* of what it is in 2008.[6] Finally, the annual inflation rate in 1998 was 84% and the estimated 2008 inflation rate is just over 13%.

What lies ahead?

The most pessimistic growth rates for Russia in 2009, based on an average oil price of $50, *i.e.*, assuming almost no increase from the levels at which oil appears to have currently stabilized, is 3-3.5%.[7] This contrasts to negative growth in much of Western Europe and the United States, at least at the beginning of 2009.

In 2008, Russia overtook Germany to become the largest retail market in Europe. Real wages are growing at double-digit rates. Russian consumers earn four times more than their Indian counterpart and 11 times more than their Chinese counterpart.

Many Russian companies are experiencing growth rates of 30, 40 and 50%. The Russian government has committed over $1 trillion dollars to infrastructure spending by 2020. Perhaps most importantly, productivity is skyrocketing in Russia, building on a low base established during Soviet times.

As a result, one Russian investment fund estimated that the RTS will increase by two-thirds in 2009.[8]

Contrast to Other Markets

P/E ratios in India are now approximately 10.5; in China, they are approximately 15. In the United States, they are over 18. Oil reserves held by Russian companies are valued at 12% of the value of the same oil in some of the same ground held on the books of "Western" oil companies. Power assets are valued even lower.

Compared to other BRIC countries, Russia has enough reserves to fund almost 2 years of imports. The other three countries have significantly less. Russia is the only one of the four countries that is running a budget surplus and it has by far the lowest public debt as a percentage of GDP of all of them.

It is also important to note that the Russian market has very little securitized debt – and Russian banks have virtually no "sub-prime" assets on their books.

The Fund

If we date the start of the crisis using a month in order to compare similar, monthly figures, it started in June 2008 (although, if we had to pick a date, it would be May 20). If we do the same for the end, it appears that the last month will be November even though the record low was hit on October 28.

This requires a bit of an explanation. If the record low was set in October, and November closed higher than October, how could the markets have fallen again in November?

In short, October was a rather remarkable month – in terms of net monthly drop, October 2008 was one of the worst, if not the worst on record. However, at the same time, in almost all markets, the last week of October was one of the best, if not the best, week on record. (You can see this on the second chart on the previous page which shows RTS performance since it hit its recent record low on October 24.)

November closed above the October record low but below the October end-of-month level. Thus, the RTS fell almost 15% in November, but still managed to close above the October low.

Benchmark Comparison

From June through November, the three major Russian indices (RTS, MSCI and ROL) all fell sharply and about the same amount. The RTS fell almost 74% and the other two indices comparably.

Six of the 27 funds in the AAM Index fell more than 68% from May to October (November data is not yet available for all funds); 15 were down more than 59%. Tera Capital Fund was down almost exactly 50% -- steeply, of course, but significantly outperforming almost all other funds and all major Russian indices. While the Fund exceeded its benchmarks during this period, the outperformance margin was still lower than it has been historically for one simple reason: there was almost no place to hide as virtually every sector and almost all stocks fell sharply.

An Interesting Metric…

While the above comparisons are interesting and certainly reflect favorably on Tera's performance, strange times call for innovation and there may be another metric that better expresses comparative performance: how far back one need go to reach the level to which an index' level or a fund's NAV has fallen.

As pointed out above, the RTS has fallen to a level it last reached almost exactly four years ago. The other two indices have fallen slightly less. By way of comparison, the US Dow Jones has fallen back over five years (at 8,200, last hit in April 2003) and the NASDAQ has fallen about the same (1,300, last hit in March 2003).

As of the end of October, the AAM index has fallen to a level that is 7% above its start date in May 2005. The index average has fallen to a level that is 10% above that level. By contrast, Tera is **32%** above its initial level, resulting in a healthy return, notwithstanding the current liquidity crisis.

Further, Tera Capital Fund was the number one fund of funds (out off 2,600) in the world rated by Eurekahedge in terms of annualized return through end of August and was among the top 10 at the end of September.

Conclusion

The crisis *per se* is effectively over; we are now in the recovery phase. While that recovery phase is almost certain to last years, there are certain to be periods of very strong growth. The Russian stock market would have to increase over 400% simply to get to its pre-crisis levels. It has already risen 20% since its low. November should be the last negative month of the crisis – and it was only down at all because of the extraordinary behavior and timing of equity markets in October.

The investment case for Russia is better than ever – maybe better than at any time in its history.

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[4] In late November, Russian reserves began growing again as the Russian Central Bank eased efforts to defend the ruble and incurred fewer expenses to support the Russian economy as most had been incurred already, increasing reserves to $454.9 billion.

[5] $1,328 v. $12,012. Source: Prosperity Capital Management

[6] $50/month v. $715/month. Source: Bloomberg

[7] Sources: World Bank, OECD, Bloomberg

[8] Source: Bloomberg, Dec. 4, 2008.