GMO

Emerging Thoughts

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The Empire Strikes Back

Eleven years ago, at GMO's Annual Client Conference (soon after the collapse of the Soviet Union), I said I believed we were living in a golden age of capitalism. With communism and socialism having been so thoroughly and comprehensively discredited, there was only one competing paradigm for economic development – that of free and open markets and privatization of government owned companies, rather than nationalization and central planning. It was based on this shift that I made my long-term case for investing in emerging markets (although from a short-term point of view, October 1993 did not represent particularly good timing on my part).

I also said that I did not believe that this golden age would last forever, that former socialists/authoritarians had not suddenly turned into committed free-traders, but were biding their time and would surely make a re-appearance some day, selling the same old vodka in new bottles.

That day may now have arrived in Russia.

In my opinion, Mr. Putin is trying to create a model of the modern authoritarian state where private corporations and government owned/controlled entities both serve some greater "national good" in addition to attempting to enrich their shareholders.

The Yukos case serves as a multi-pronged attempt in attaining this goal. On one hand, it is perhaps the first step in reversing some of the privatizations of the early 90s and to establish a "national energy company" – a government controlled energy giant that would play in the same league as OPEC. While economic reasons play a role, the primary motivation is to serve Russia's geopolitical goals. In a post 9/11 world of energy insecurity, Russia's energy assets have more strategic clout than their nuclear missiles.

Another aspect is to send a very clear signal to Mr. Khodorkovsky and his fellow oligarchs that companies that do not toe the Kremlin's line and consider "serving the national interest" as part of their corporate charter may very well end up being renationalized. In short, either you go along with our program or we'll do it for you.

Finally, jailing Mr. Khodorkovsky is a clear warning to other oligarchs and business leaders that they should steer clear of politics and contemplate sublimating their political desires into ownership of sports franchises outside Russia. The San Francisco 49ers could certainly use a deep-pocketed owner. Yo! Potanin, over here!

In short, Mr. Putin intends to have complete control of all levels of political and economic activity. It is telling that the only dissenting voice to speak up is that of his own maverick economic advisor Andrei Illarionov who said, "The sale of Yuganskneftegaz to a mystical, and now not so mystical, company named Baikal Finance Group has won this year's 'shady deal' of the year award." While Mr. Putin has ignored the free-speaking Illarionov's inflammatory comments in the past, it will be interesting to see how he will react to this outburst.

If Mr. Putin succeeds in creating this new paradigm of government sponsored capitalism (and I believe that in the short run, he very well might), my fear is that he will create a new model for development that will be detrimental to minority shareholders such as ourselves, not just in Russia, but elsewhere as well.

So will he succeed? With high oil prices, a reduced foreign debt load, and massive foreign exchange reserves, there are no dark clouds on the horizon. While recent economic growth has been extremely dependent on high oil prices, we have started to see the beginnings of a consumer society that could fuel growth for the next few years.

Looking at the history of other authoritarian regimes, one sees that they tend to succeed in their early phases – what I call the Bill Parcells[1] effect – that intimidation does

[1] Bill Parcells, the current coach of the Dallas Cowboys, is famous for having taken a number of poor football teams under his control and making them successful. However, in my opinion, the secret to his success has been fear and intimidation, which works in the short run, but is ultimately counter-productive – as evidenced by his having to move to a new team every few years.

work in the short run. Thus the next few years could see continued strong economic growth in Russia.

However, authoritarian regimes tend to fail in the medium to longer term for a very simple reason – every petty official from the president on down acquires the ability to be capricious or corrupt without fear of consequences, and frequently chooses to use that power to further their own personal interests. We saw proof of this concept in late December when a senior official within the telecommunication ministry tried (but ultimately failed) to levy punitive back taxes on the cellular carrier Vimplecom. It turns out that this official is affiliated with a major shareholder of one of Vimplecom's competitors.

However, internal affairs within Russia are not the only cause for concern. Recent events in Ukraine also raise the prospect that Russia is on a collision course with the West over what it sees as encroachment onto its home turf.

Having owned and backed the wrong candidate in the recent election, Mr. Putin may be behind by a couple of goals, but make no mistake, it's only the first period in a game that has no ending. And, if the sordid history of Yukos is any guide, Mr. Putin is not a leader lightly scorned. Given that Europe depends on Russia for 30% of its natural gas (a number that will rise, not fall, in coming years) and that 80% of that gas transits through Ukraine, Russia holds a number of very significant cards in this game. One can see Mr. Putin using these cards to pull Ukraine back into the Russian fold – which will exacerbate tensions with the West.

Finally, Russia has started to make overtures to China, India, and Iran – offering them a stake in future energy ventures along with advanced military weaponry, with the explicit goal of driving a wedge between them and the US.

All these factors increase risks for Western minority investors in Russia.

While this kind of speculation makes for good cocktail party chatter, we are in the position of having to make decisions about how we invest your money. As I said in my Emerging Thoughts piece on Mr. Putin's early days in July 2000 ("Putin on the Ritz"), "As fund managers, we need to be able to distinguish the unpalatable from the unprofitable."

So, what are we doing about this situation? Our country selection process has four elements – three based on objective, quantitative data and one based on our judgment, which represents 10% of the overall assessment of a country.

Currently, the quantitative parts of the model are quite negative on Russia, with a combined score of -0.9 (which is quite negative). While the market is relatively cheap (based on high oil company profits) our momentum and macroeconomic models are quite negative. This negative score translates into a moderately large underweighting relative to the benchmark.

Given the risks I've talked about, it makes sense that we should have a negative judgment on Russia. If we were to assess a score of -1.0 on our judgment, the overall score for Russia would fall to -1.2 and our underweighting would increase by 1/2 a percent.

Were the quantitative parts of the model to turn positive over the coming months, we would increase our weight in Russia, recognizing that our judgment serves as a drag on how much we buy, but does not override it.

Would we override the entire process and get out of Russia altogether? Yes, in an extreme circumstance. However, these kinds of systemic overrides are few and far between. The last time we chose to get out a country altogether was when we sold all of our Pakistani holdings when the central bank stealthily imposed capital controls in 2001.

While events in Russia are causing angst and forcing us to watch the situation very carefully, we are not yet close to having to take extreme measures.

It's time to be afraid, but not very afraid.