

Mind the Gap

by Mark Wright, CFA

It took less than a week for investors in Russian equities to see their holdings effectively become worthless. The Russian stock exchange has been closed for trading since Monday 28th February, which meant depositary receipts listed on stock exchanges in London and elsewhere felt the full brunt of anyone wishing to head for the exit.

Having fallen to near zero, these securities were then suspended and index providers, such as MSCI, started removing or assigning nil value to Russian equities that were constituents of various emerging market indices.

Putin's invasion of Ukraine and the collaborative application of sanctions by the West has served to remind investors of the gap risk associated with investments, and in particular, emerging market investments.

Gap risk is difficult to account for in any sensible investment framework. In derivative markets, binary options pay a fixed sum or nothing at all depending on whether the price of an underlying index or asset crosses a pre-set threshold. They are considered a trader's worst nightmare, because of the gap risk they entail.

Derivative traders effectively embed additional premium into the pricing of such options when selling them to customers. The hope is that in the long run the cumulative additional premium charged will outweigh the inherent heavy costs that can occur from hedging such options as they approach maturity. They also typically form only a small part of a much larger derivatives trading book i.e., the risk can to a large extent be diversified away.

But traditional long-only investors don't have the same luxury. In theory, investors could apply an additional risk premium when appraising the value of assets in countries perceived to pose a significant risk of "gapping" to the downside. It is difficult, however, to calculate what exactly that should be, and most long-only investors will not have the same level of diversification that a high volume, derivatives trader will likely have.

Maybe the best option is to simply exclude countries, such as Russia, from one's investable universe, accepting that it is simply not possible to value the assets of companies in those countries.

At Momentum Global Investment Management (MGIM), we do not claim to be specialists in emerging markets, instead entrusting our clients hard earned savings with specialist global emerging market managers.

One such manager is Aikya. The company was established in 2019, headed up by Ashish Swarup, who established a strong performance track record at Stewart Investors (formerly First State). Good stewardship is at the heart of the investment philosophy at Aikya and as a result the Aikya Global Emerging Markets Fund in which our clients are invested had zero Russian equity exposure prior to Putin's invasion of Ukraine.

In fact, the investment strategy employed at Aikya has had no Russian equity exposure for over five years and there wasn't even a single Russian equity on their watchlist. The reason being "weak rule of law, weak institutions and also the fact that there are no companies without some form of links back to Putin / oligarchs".

Diversification for the sake of diversification, whether by geography or asset class, combined with an underappreciation of gap risk can lead to bad outcomes, as those emerging market managers that were heavily invested in Russian assets are now realising. We have the utmost confidence that Mr Swarup and his colleagues will continue to generate an investment track record that many emerging market managers will be envious of, despite excluding big emerging economies, such as Russia.

Remember the concept of investing in BRICs (Brazil, Russia, India and China)? What an overly simplistic and evidently flawed concept that has proved to be. It's better to put in the hard work to find a diligent active fund manager with a clear philosophy and investment process that lends itself to outperformance in the long run. That is what we do at MGIM.

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