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INSTITUTIONAL INVESTOR WORKSHOP: IDENTIFYING ALPHA IN EMERGING MARKETS

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Moderator:

Chrystia Freeland, Editor, Thomson Reuters Digital

Panelists:

Michael Calvey, Senior Partner, Baring Vostok Capital Partners

Walid Chammah, Senior Advisor, Morgan Stanley International

Alexander Galitsky, Managing Partner, Almaz Capital Partners

Carlos Gutierrez, Vice-Chairman, Institutional Clients Group, Citigroup Inc.

Roland Nash, Senior Partner, Chief Investment Strategist, Verno Capital

Viatcheslav Pivovarov, Chief Executive Officer, Altera Capital

Andrei Shemetov, Chief Executive Officer, ATON Group

C. Freeland:

Thank you for joining us. My name is Chrystia Freeland. I am the Editor of Thomson Reuters Digital. We have a really exciting subject and a terrific group of panelists. They gave me my choice of panels to moderate, and this was the one I wanted, mostly because of the brilliant panelists here, but also I think this subject is really a central one for so many of us: where are the capital flows in the world going? Which emerging markets are getting the money? How are those capital flows being divided between the Western markets and the emerging markets? Those are the big questions that we are going to ask. We will know the answers at the end of this hour and fifteen minutes, so be prepared to rebalance your portfolios.

The way we are going to conduct this session all morning is very conversationally. I am going to introduce each of the panelists very briefly and then throw a question at each one to get each engaged in conversation. You are all welcome to chip in, and we will talk for about 45 minutes. Then there will be half an hour for questions from the audience, so please prepare your questions. Being journalists, you may think that asking questions is easy, so it will be your chance to prove how easy it really is.

I am now going to go through the panel in alphabetical order, so please do not think that any status, or lack thereof, is implied. We will do that very quickly, and then we will start talking.

Michael Calvey is the Senior Partner of Baring Vostok Capital Partners. He is a man of extensive experience with Russia and also has an emerging market perspective because of some larger committees that he sits on.

Walid Chammah is the Senior Investor at Morgan Stanley International and an economist of very great perspective. He warned me at the beginning of this session that he knows nothing about investing, but he knows a lot about economics, so we will ask him about that.

Next we have Alexander Galitsky. I first heard of Alexander some years ago when I asked Eric Schmidt a question about Russia, and he said he had no views about Russia; whenever he wanted to know what to think, he just called his friend Sasha

(Alexander). I think that is all the introduction Alexander needs. He really is the man who introduced Silicon Valley to Russia, and vice-versa.

We have Carlos Gutierrez, who is the former Secretary of Commerce and current Vice-Chairman of the Institutional Clients Group at Citigroup, and the former leader of Kellogg. He is someone with government experience, investing experience, and experience in actually running a company.

Then there is my good and old friend, Roland Nash. Roland is known to everyone here who has Russian experience. He started off on the policy side in Russia and has been one of the leading economic analysts for many years now, and is now one of the leading investors. He is now at Verno Capital.

Viatcheslav Pivovarov is the Chief Executive Officer of Altera Capital, and he is someone, again, with extensive experience investing in Russia and on Wall Street.

And last, but certainly not least, Andrey Shemetov is the Chief Executive Officer of the ATON Group, and again, someone with great investing experience, particularly in this market.

Those are the very quick introductions. I am going to ask Michael a question first, as threatened. The tyranny of the alphabet puts you first. Tell me: Here you are in Baring, and different groups are fighting for capital. How does Russia stack up in that internal fight, and how do you make the case for Russia versus other emerging markets?

M. Calvey:

Our experience is just in private equity and investments in private businesses, but out of all the emerging markets in the last 18 years, since I have been involved in the company, Russia has been the most profitable, despite two major crises that affected Russia’s economy severely over that period. But I would say that there is a surprising number of similarities behind all the deals and the motives of the entrepreneurs, as well as what they are using the money for. The industries tend to be very different. In Russia, we are investing mostly in service companies: software, media, financial services, healthcare, retail and things like that. In Asia, there are a lot more manufacturing companies and export-oriented businesses. When we are looking at investments here, we are mostly trying to understand the dynamics in Russia, rather than the global dynamic.

I think the growth has been great everywhere. The growth of private Russian companies has been the same as the growth of Chinese companies in the sectors where we are investing, but, of course, the runway for growth is much longer in places like China and India. The last thing I would say is that, at the end of the day, supply and demand of capital and opportunities makes a big difference, and Russia is by far the least competitive market in terms of private equity. There are at least 300–400 private equity firms each in China and India. I do not know exactly how many there are in Russia, but probably less than 10. So in terms of just private equity, it is a far less competitive market here in Russia, but there is also a lot more domestic capital here in investing in private assets from oligarchs and state companies than you see in most other countries. So the total amount of capital is probably the same, but there is very little capital from people like us.

C. Freeland:

Are you saying that Russia’s relative lack of popularity is a good thing for you?

M. Calvey:

It has been a great thing for us so far, yes. Countries that have a lot of opportunities and a very small amount of investors tend to produce better returns than those that have hundreds of people with identical perspectives and strategies looking at the same types of deals.

C. Freeland:

OK, I am going to ask Walid to pick up from there. Walid has been doing some work on capital flows into emerging markets. Please tell us about that.

W. Chammah:

I will start with my conclusion. My conclusion is that we are significantly underinvested in emerging markets. I believe one of the panelists here mentioned earlier that he came from a conference in Monaco where they came to the opposite conclusion. Today, the amount that is invested in emerging markets after the global diversified portfolio is only about 10%. Emerging market economies are about 36% of the GDP. The size of the capital markets in emerging markets is about 18–20%, but what is invested is only 10%. In particular, when you look at traditional US investments like pension plans, endowment funds and insurance companies, somewhere between 5–6% of their global investment is in emerging markets.

So I believe it is time that emerging markets be seen as an asset class. It is time that people allocate a certain amount of their investments, day-in and day-out, to this asset class. I believe that if conventional asset managers around the world increased their investments in emerging markets by 1%, it would add USD 570 billion per annum. If economies added 3.5% over the next two to five years, we would see a flow of USD 2.5 trillion into emerging markets. If we make the same assumptions for private wealth, it would add another USD 1.5 billion. We could see a situation over the next several years where the flows exceed USD 3–5 trillion because people are re-allocating more money into emerging markets as an investor class.

Who is going to be the beneficiary of that? Clearly, in sectors, it is going to be fixed income not equities, because most emerging market investors are already happily invested in equities, but they are not invested in fixed income. To give you an example, US pension plans have invested less than 1.7% of their investments in fixed income in local emerging markets. So when they readjust their calculations and take investments to normal percentages, you will see new allocations and new flows into emerging markets.

As for the countries that will benefit, in general, I would say that China, Russia, Korea, and Indonesia, to a certain extent, will all benefit. Where alpha will probably be less optimal will be India, Turkey and Mexico. Where alpha will be neutral will probably be Brazil and the southern core. Thank you.

C. Freeland:

Wow, I think we could just stop there! We know what our final conclusions should be. Carlos, can you help us resolve this mystery that Walid has put to us: why is there underinvestment in emerging markets? Or is there? Maybe you disagree with him.

C. Gutierrez:

I think it is corporations; that would be my viewpoint. There is a private equity viewpoint and an economist's viewpoint. I would think about it as a corporation putting its money into a country. Most US multinationals still do the bulk of their business or more than 50% of their business in the US or the US and Europe. I think the important thing to recognize is that, in the economy in the US and the European Union, there is a sense that once we get past this hump, once we get past this problem, we are just going to go back to how we were. That is a very dangerous point of view, because not only are we facing some short-term problems that can be fixed – in the US, we have a deficit that is one of the top five in the world, and we can fix that eventually – but there are two things that are going to make a difference over the long term and drive investors to emerging markets.

One of those things is that, if you look at the period from 1980–2007, by and large, it was a wonderful time to invest. That was what we call the ‘baby boomers’. Those people were coming into their careers, investing heavily in stocks, buying homes, and those baby boomers are now entering the age when you reduce your investments in stocks, and would rather go and rent an apartment in Miami than have a house. There are fundamental structural issues that are going to drive people away from many developed countries, the US being one example. So the emerging markets is a trend. It is not a fad. It is a real trend that is going to continue. We will have ups and downs, and people will run when we have the downs. They will say, “I told you emerging markets are dangerous”, but they will come back, and we will see this fluctuation throughout the next several decades.

C. Freeland:

I am feeling increasingly sorry for Michael, because if you guys are right, his competition-free environment is going to come to an end. Alexander, can you talk specifically about the technology and innovation opportunities in emerging markets generally, and in Russia in particular? I should just let everyone know that Alexander is so deeply immersed in this issue that he tweeted from the Skolkovo Board Meeting that he attended this morning about how great Skolkovo is. "We might not see it yet," he said in his tweet, "but tonnes of progress is being made". I know that there are some Skolkovo sceptics in Russia, and perhaps even on this panel, so maybe you would like to start there.

A. Galitsky:

First of all, I would like to make some comments. Many corporations try to invest in emerging markets, and they do it by holding money in offshore accounts because they cannot bring it back to the US. It is a trick, yes? So they need to find a place to put the money. Maybe I am kidding, but it is the truth.

C. Freeland:

Surely, you are not accusing American CEOs like Carlos of such tricks!

A. Galitsky:

The second point is that all money held offshore gains, and in the money flow to any emerging countries, the common impetus is really move and go. So everyone is going to China and India because they have large populations. Why are people going to other countries? Why are people going to smaller countries since, and back to my point, today it is a much bigger fight to find smart people? If we are talking about economies, about changing and driving innovation, or if we are talking about the Internet becoming a model for how to do business in general, it is not only a point of view. In the past, IT was a tool for improvement in business, and now it is the driving point of business.

From this point of view, you have to ask why people are going to emerging countries. It is, first of all, to find talent, and secondly, it is the rate of market growth in general, since this is a factor that builds many businesses. For me, as a high-tech guy, life is very nice. Looking at the global opportunities, at Russia, for example, 70% of our investments are in companies that have gone global. If you look at the software industry in Russia, it is 1.4% of possible sales for Microsoft, 3% of Cisco's total sales, and the US is 45% of software sales. From this point of view, for us, investing money in emerging countries brings vast opportunities to find interesting deals that can be brought to the global market, and to organize companies globally. If I may make an example, we have a company portfolio which was created by a few guys who never saw each other until they came to raise capital because they were located in three different countries.

C. Freeland:

Can you tell us what the company is and what they do?

A. Galitsky:

It is very simple. It is a Java hosting company which hosts Java companies in the cloud. The name of the company is Jelastic. My friend James Gosling, who is the father of Java, was so impressed that he is now running all of his liquid robotics with an interesting company in California on their platform. So, the Internet has brought a completely new opportunity for emerging markets, so talented people can be delivered to the world.

C. Freeland:

I think it would be good to go into that in greater depth in a moment, but first I am going to bring Roland into the conversation. Roland, I am going to start by asking you to be a reporter. I would like you to elaborate on the remark which so much captured Walid’s imagination about the Monaco hedge fund conference that you have just returned from. What was the prevailing or conventional wisdom there?

R. Nash:

I think we can go further than what we heard earlier in terms of the differences between the so-called emerging world and the developed world. It is close to 50% of global GDP on a PPP basis, but nearly two thirds of global savings comes out of that part of the world, three quarters of global growth comes out of that part of the world, and it has 80% of the world’s population. In addition, debt is obviously much lower there, and that is where a lot of national reserves are stored. Then, on the other side, in the so-called developed world, you only have to read the newspapers or go to conferences, and everything we hear says that that is where the problems are. The problems are in Europe and the US.

What always amazes me is the conclusion, after you have thought about that – here is the opportunity and here is all the world’s problems – the conclusion is to sell that part of the world where all the opportunity is, and invest it into that part of the world where are the problems are.

C. Freeland:

Is this the ‘safe haven’ argument?

R. Nash:

Yes. The question is then: how do you get to that conclusion? The answer is: that is where the safe haven is. Invest into the safe haven during periods of uncertainty. How is it the safe haven when you have already described that all of the problems are there, and all the opportunities are somewhere else? That is the excuse that is given; that it is the safe haven, but in economic terms, I find it very difficult to understand. I think there is some very large consensus-type trade that is going on that encourages people to think like that, and sometimes the collective investing mentality gets it wrong.

C. Freeland:

I take it that you think now is one of those times?

R. Nash:

The problem is, and it is the classic thing to say, as Keynes put it: the market can stay wrong for longer than anyone can stay liquid. Unfortunately, you have to take into account the way in which money is flowing. Eventually, I am sure that I am right. In the short-term, it is much more difficult to try and answer. I think the answer to that is that you have to be very careful at the moment. I think the trend is going to be in that direction, but you have to be very, very careful in timing that.

C. Freeland:

Viatcheslav, you know the Russian market and Wall Street very well. Is Roland right in his characterization of current prevailing Western conventional wisdom, and is he also right in believing that it is wrong?

V. Pivovarov:

I would say the short answer is the deception of the Russian market and the BRICS overall right now is fairly poor. I would comment on Russia more specifically that, if you look at the private equity world, the FDI last year reached a little over USD 50 billion, but most of it was capital repatriated from Cyprus, Luxemburg, and the Netherlands. Very little capital came in directly from the US, or any developed market countries. If you look at the public evaluation, which is also a very good barometer for how interested investors are in the Russian market, it rates below book value at five times trade earnings. That is a USD 0.50 discount with a ten-year average, and a similar discount for emerging markets overall.

That tells you that, at the moment, there is no appetite for risk, and Russia is out of favour. However, where I do agree with Roland is that global institutions have to look for yield, growth and returns. As another speaker mentioned in the beginning, the capital will undoubtedly continue to reallocate progressively towards the emerging markets and BRICS, in particular, and Russia more specifically. So the long-term trend is there, but like Roland, we are very cautious for the short term.

C. Freeland:
Can you help Roland out by predicting when that turn is going to come?

V. Pivovarov:
Can I help Roland?

C. Freeland:
And all of us.

V. Pivovarov:
Well, Roland is a very good friend of mine, so I will definitely give him a call!

C. Freeland:
We would like to hear from you also! Do you have a view?

V. Pivovarov:
Well, right now, our markets largely depend on policymakers. We know the Fed and the Central Bank of China are fairly proactive, and they will act in a pre-emptive manner. Yet policymakers in the European Union are a very big concern because of the struggle between inflation in Southern Europe and Germany's position in Northern Europe. I do not know when this will be resolved, but in the meantime, we will stay cautiously optimistic. As for Greece, it is not an option for them to leave the eurozone, and it is not an option for Germany to allow contagion in Spain and Italy. But how much more pain the markets will have to endure before there is a decisive action in terms of the conversion of the European stability mechanism for banks and

the introduction of the DIC for the European Union, this I do not know, but we are watching closely.

C. Freeland:

Like everyone else, we are all watching the Europeans. Andrey, you have both the privilege and punishment of being our last speaker in the first round. You can take it where you will. I guess I am particularly interested in your assessment of the interest in the Russian market right now.

A. Shemetov:

I would like to explain the situation from the point of view of a Russian institutional broker. To be honest, we see very little foreign money in the market: all of the capital comes either through state contracts, or from state-owned companies. There is very little private capital coming into Russia independently. It is true that this capital sometimes plays a role in small private equity deals, but on the whole, few people are interested in Russia. I think that we are unlikely to see a significant inflow of foreign capital into Russia in the short term. It is important to understand that Russia is hostage to two sets of circumstances. On the one hand, there is the deep crisis in Europe, and as far as we are concerned, the consequences of this – we are not as optimistic as Viatcheslav – have still not become completely clear, and we will continue to feel those consequences for a long time yet. This is the first thing. On the other hand, Russia is traditionally constrained by China, and the risk of falling production in China is a serious one for us, as is economic growth generally in China. All of this is unlikely to facilitate good buying. If we compare PR ASIA's views on Russian companies with Chinese and Indian companies, not to mention companies from Eastern Europe or developed markets, then we look extremely undervalued. These factors are not working at all. Nobody is prepared to buy anything in the current conditions. It seems to me that to overcome this, Russia should first of all demonstrate political will: show that we are prepared to protect foreign institutional investors' capital, that we are willing to compromise, to be more open. Only after we do this can we start talking about some real investment portfolios. I think that at the moment, the conditions for genuine long-term investments do not exist in Russia. Yes, we do get speculative money coming in, but only as part of short-term projects. I am sorry for expressing such a pessimistic view.

R. Nash:

I have a question on this. I think that you are probably right that Europe is going to go through a long, drawn-out, painful and slow demise – demise might be too strong of a word, but it will be a very difficult time over the next several years. In Russia, you have growth, cheap assets, low debts, banks that are lending, and there is not much leverage in the economy. Obviously it has a lot of problems, but those problems were there five or ten years ago, and they are still there, and that is part of the problem. Where would you advise people to put their money in this situation: into the part of the world that is going into this demise or into the part of the world that, by a lot of measures, looks pretty good?

C. Freeland:

To help you, Andrey, I will say that my friend Mohammed El-Erian likes to describe this situation as the “cleanest dirty shirt dilemma”. He says that all the shirts in the world are dirty right now, and as an investor, your job is not to find a clean shirt, but to find the cleanest dirty shirt. So is Russia the cleanest dirty shirt?

A. Shemetov:

Actually, I do not know. In the long term, a lot of hedge funds will close and give money back because they have no ideas for the market now. I think we should be very careful now and choose protection stock like dividends stocks and stocks with good speed ratios, but it is a very difficult time, so be careful and keep your positions in cash.

C. Freeland:

OK, Viatcheslav.

V. Pivovarov:

I would just like to mention that the hedge fund industry is actually at its peak with record assets and manages about USD 2.2 trillion today. Indeed, a lot of funds are closing, but more have started since 2011. But also, what is important to remember is that most of the money is made at inflection points, and sooner or later, we will reach this inflection point not only in Europe, but in Russia as well. Hopefully everything that the President mentioned today during his opening speech starts to be realized, and Russia should start to re-rate.

Actually, when you look back, every country has had its own time. For Brazil it was when Lula came to power in the early 2000s. India has been growing at 3% for decades; it used to be called ‘the Hindu growth rate’. When the Congress Party of India won the election in May 2004, India started to invest heavily in infrastructure, which we talked about today, bringing infrastructure up to 27% of the GDP. That is when Indian growth stepped up and reached 7–9%. There is a likelihood that Russia could follow this example and move into a substantial success investment which will drive GDP, and then the market would re-rate. Not long ago, the inflation in Brazil was in the double digits, as well as in Russia. At the same time, Brazil’s P/E was in the single digits, where Russia’s is today. I do not believe that Russia will have to trade at book value with five times earnings forever. Its time will also come, and we would like to be there at the table.

M. Calvey:

Can I say something about that? I think that the key is what sort of time horizon you take, because every time there has been a global spike in risk in the last 15 years, Russia has suffered disproportionately. It is not just the equity markets but also the currency that usually suffers, so it does affect the real economy. This time may be no different. Let us not have any illusions. If the eurozone unravels in any kind of an ugly or unplanned way, it is going to have a bad impact everywhere, and Russia's financial markets will probably be affected worse than most others. But if you can take a view that looks beyond that, a five or ten-year view, there are really great companies in Russia run by smart and very ambitious people that have customers that are happy. They do not have any debt, so the customers want more and more of what those companies produce or provide. I think that the short term might indeed be quite ugly, but hopefully the longer term will still be attractive.

V. Pivovarov:

I would agree with my colleague. This issue is the time horizon. If we are trying to solve the investment question for tomorrow morning, clearly Roland is right. People will go for safe havens, and 'safe haven' does not mean the US. It is the currency, really. People go for the dollar because it is the most sacred currency in the world, and then they have to buy US assets because they own US dollars. But that is not what I think we are trying to do here today. I think we are attempting to look into the future and make a decision about whether there is a migration of capital from the West to the East, and I do believe there is one in today's environment. That is number one. Number two, we need to look at whether we are focusing on cyclically investing or structurally investing. Either our portfolio for the future is being structured into emerging markets, or are we going to decide tomorrow morning that it would be great to buy into Gazprom: "Let's buy into Gazprom, that will make us money, and then we will go to the next investment." Or are we going to make structural allocations for Russia because Russia deserves to be part of every international portfolio going forward, in good or bad situations, because Russia will always exist, and the same for China, Brazil, Mexico and other emerging markets.

I think I would like to ask my panelists if they agree that there is a migration in capital from the West to the East, if it is permanent, and what are the implications of that migration? Is that going to provide alpha to emerging markets?

C. Gutierrez:

I do not think anyone knows if it is permanent because there are things that are going to happen that none of us can see. If there is one reality that we can be sure of, it is that there will be surprises over the next five to ten years. It is not going to be a straight line, and it is not going to be easy to predict. One factor that we have not talked about that is also on the horizon is the political factor. Political risk used to be something that was only related to emerging markets. Today, I hear more and more questions about the political risk of investing in the US, the political risk of investing in Europe. If you think about Europe and where they are going, centralizing more power in Brussels, becoming more Europe, not less Europe; that is going to invariably generate a certain type of politician that will be able to capitalize on people's fears, on nationalism. That is something that frankly concerns me and that we should be looking out for. We should be thinking about political risk in developed markets also. In the US, political risk includes taxes going up, if there is a pro or anti-business environment, if there are too many regulations, if the US is capable of solving problems, etc. People are asking those questions today. Interestingly, the notion of political risk is now being shared across the world.

C. Freeland:

I am very glad that you brought up politics, but I would like you to answer your own questions about the US, the questions of whether taxes are going up, is there an anti-business environment, and is the US capable of leadership or governance?

C. Gutierrez:

I would say yes to all three questions. Are taxes going up? If the elections go a certain way, then taxes will go up. Are regulations going to increase? If the elections go a certain way, then yes, regulations will increase.

C. Freeland:

Is there an anti-business environment?

C. Gutierrez:

There are actions that have impeded businesses from growing. There are actions that have impeded businesses from hiring and investing. So yes, I would say that.

C. Freeland:

Is the US capable of governing itself?

C. Gutierrez:

Yes. I think in the long term, the system has a way of attracting leadership and entrepreneurs. Fortunately, in the short two-hundred-year history of the US, when it counted, the right leaders came along to fix a certain problem. I hope that leader is our President. If not, then I hope another leader comes along.

There is one more thing I want to say about the US, because we talked a lot about this. I mentioned this demographic problem in the US with housing and the stock market. There is one thing that can fix that, and it is precisely the one thing that our Congress and our Government have not been able to fix in many years, and that is immigration. Immigrants have always made the difference in the US. Immigrants have been the investors in Silicon Valley. A big portion of the magic of the US economy is immigration, and if we can get that right, I think the US will be in very good shape in ten to twenty years. If we do not get that right, then what a pity that would be, because the US has been doing this for a long time. Unfortunately, the political problem has not allowed a solution to come forward. Once again, there is political gridlock.

C. Freeland:

OK.

A. Galitsky:

One thing about Russia is it is a political heaven, yes? Since it does not have this two-party system or presidential comedy, everything is clear. There is no political risk, so it is the best place to go. I am kidding a little.

C. Freeland:

No, this is the sardonic Russian humour, but Sasha, I do think we are in Russia. Is there not political risk in Russia? Russian politics, for me, as a journalist, has become interesting again. What is the investor perspective on that?

A. Galitsky:

Again, I am not an immigrant; I am a Russian citizen. Secondly, I would like to say it is great to be in the high-tech field since there is no problem with political risk, in general, because software is moving electronically from any place where you would like to implement it. But of course you have a little political risk. In Russia, it is stability. Whether political risk exists or does not exist, we will have to ask and see. But in general, at the moment, in Russia, the country is moving strategically to make things happen. Even looking back at today's speeches, two very important things were mentioned: the movement of capital, which is not happening in other emerging markets, especially in China – capital stays. The second very important thing is that Russia seeks to find independence from oil and gas. I do not know if this will happen, but it is a very strong political message, especially for me, that it is great to develop high-tech companies over here, so it will give the opportunity to continue development.

Back to Skolkovo, my involvement with Skolkovo started on day one. I see the dramatic progress. Of course, nobody can reproduce Silicon Valley. However, the building of Silicon Valley took 20–25 years. It did not develop in the course of one year. I always like to remind people that in 1970, private businesses only invested USD 100 million in Silicon Valley, and the US Government invested USD 4.5 billion. The US Government continues to invest the same amount of money now in different types of businesses in Silicon Valley, but private businesses reached almost USD 30 billion.

Russia has been talking about a virtual Skolkovo since a physical Skolkovo does not exist today. Possibly now is the time for a virtual Silicon Valley. There is not only one Silicon Valley in the United States today, but there is one in the West and another in the East, in Florida. But in general, it is possible to develop this idea. As of now, to gauge Skolkovo's progress, Skolkovo gained 500 residents in the last two years. This is a significant number. One hundred and twenty of those got grants, not investments, ranging from USD 1–10 million. Now, what I dream about is foreign entrepreneurs. As some of my colleagues have mentioned with immigration in the United States, we hope that the Russian Government will bring entrepreneurs from all over the world to Russia, since Russia still provides capital to this innovative development. This is why I see no political risk.

C. Freeland:

OK. Skolkovo is your one safe place in Russia. Roland, I would love to hear your perspective both on Walid's question to you, which is whether the shift in capital from the West to the East is permanent, and also the political issue that Carlos brought into the conversation, and particularly on Russia.

R. Nash:

Yes, I think it is very clear where capital should flow. It should flow from West to East. But I am not sure that it is true that we are seeing that capital flow at the moment. If you think about the US, there is a classic example. In 2007, it borrowed USD 700 billion, and that was part of the reason why you had the bubbles that emerged there and the subsequent collapse. This year, the US is going to borrow USD 500 billion, which is not much less than the USD 700 billion, and at lower interest rates. So it is not clear that the money is flowing from West to East. In fact, if anything, at the moment, it is actually flowing from the East to the West.

But, going on to the political point, this actually creates a really big opportunity for those countries in the East, including Russia, which can set up the right environment to attract that capital. We in this room all know what the major barriers to those capital flows are. But more importantly than us knowing what they are, the President knows what they are, because we heard him clearly spell out what was wrong with Russia earlier today and why money does not come in: corporate governance, lack of rule of law, and corruption. He spelled out what those problems were, and he actually offered solutions to a lot of them. We have heard these kinds of comments in the past. It is good that the understanding is there. If there can be implementation of that, then I think that is when you will actually start seeing the capital flows from the West to Russia. We have been waiting a long time, but Russia has had this ability to surprise, so I hope it does it again.

C. Freeland:

What about democracy? Does that matter? We have seen some real rolling back when it comes to rights of assembly and treatment of opposition leaders recently.

R. Nash:

Of course democracy matters; that is clear. I think the oversight of governments and pressure on governments to do the right thing is very important. In the past, the oil prices were the major driver of reform in Russia. Now you have a real movement to push for a better business environment in the country, and I think that can only be positive.

A. Galitsky:

What about China? China has no democracy, a lot of corruption, and capital stays there. So why does everyone invest in China?

R. Nash:

Capital cannot get out. The problem, as you said earlier, is that China has capital controls in place. That is one of the reasons.

A. Galitsky:
So why do people invest in China?

R. Nash:
They invest in China because they think there is very big opportunity in China.

V. Pivovarov:
It is a very big market, yes?

C. Freeland:
Sasha, is your point that these journalistic concerns about democracy really do not matter to capital?

A. Galitsky:
I am a very democratic guy, but the point is that I do understand. People come to a country today for two reasons. In the past, it was to make money, because of the market, because of the possibility to gain and gain – the opportunities. But today, which really pleases me, people come for intellectual capital as well. Nothing else drives people to put money in markets today. The economic interest is to build business and to sell and sell, and secondly, to get access to intellectual capital. Russia and all emerging countries, even Vietnam, have a lot of smart people. You can go and get very interesting results with these emerging countries not only from the point of view selling something, but to get access to the people.

C. Freeland:
Viatcheslav? Same question, Roland's question about structural moves and democracy.

V. Pivovarov:

Well, I think only George Soros invested in Russia. He said that it is becoming a democracy but it is unfinished.

C. Freeland:

Yes, that was a particularly ill-timed democracy momentum to trade.

V. Pivovarov:

But speaking more seriously, of course democracy tends to be better for markets because decisions are implemented in a well-researched way. That is how it should be. Searching for political consensus between different layers of society releases potential steam so that it does not go overboard, which in turn creates a more stable environment. Typically, democracy should be good for markets, but once again, the key, as I think Alexander mentioned, is the size of the market, the returns on invested capital that people are expecting and the potential for growth. If those ingredients are there, capital comes as a result.

C. Freeland:

What about the secular shift question?

V. Pivovarov:

I definitely believe that there is a secular shift that has started over the past 30 years. If you look at world growth since the 1980s, it has averaged 3%. In the BRICs, it was over 6.5%. Just in the past ten years, BRIC economies created USD 8 trillion of GDP – this is the same as what the US economy created. According to the IMF, sometime in 2014, all things remaining as they are, the BRIC economic pool should overtake the US. Today it is the size of the EU, nominally, not in PPP. It should overtake the US as the largest economic area. Clearly, where there is growth, there are returns, and that is where capital should be flowing. I think this is a trend that is structural and will be there long term.

C. Freeland:

Carlos wants to take over my job now and ask you a question.

C. Gutierrez:

I would just like to play the devil's advocate. Challenging the pro-emerging market side, which I am very much on, but just to pose the question I have: it appears that there is a trend of capital flow to emerging markets. How big that is, is up for speculation, but there is also a countertrend of talent moving out of emerging markets to places like Canada, Western Europe and, even, the US, although we are not bringing in enough talent. Where are all the best scientists in the world going, and how does that play into this idea of the growth trend of emerging markets?

C. Freeland:

OK, emerging markets, guys. We know, Carlos, that the very best scientists are going to Skolkovo, but apart from those...

R. Nash:

You know, I heard a very interesting statistic the other day. Russia certainly has very good scientists, and some of them are going abroad. That deficit is made up of very good economists, accountants, financiers, and business people, and the demand here is growing very rapidly because there is not enough supply. The statistic I heard was that there are now more Germans coming to Moscow than there are Russians going to Germany because the opportunity is actually here. I am sure that the talent pool has been going toward Germany because that is where the education is, but I think once they are educated, although I do not have numbers on this, I feel that trend is going back toward this part of the world now.

C. Freeland:

OK, Michael wants to jump in.

M. Calvey:

Russia is more exposed to this problem than most of the other BRICs. We see that basically there is a two-sided demographic problem. Everyone knows about the drop in the number of babies that were born in Russia in the 1990s. If you think about it, a baby born in 1992 would have been 20 years old today and just about to enter the workforce. We are just about to enter a ten-year period or so when the number of 20-year-olds entering the workforce is going to fall catastrophically in Russia. We already see a problem with there being more companies that are growing than there are young people to hire, so there has been serious wage inflation. It is now cheaper for most Russian companies to import foreign talent than it is to hire local talent, and we are talking about mid-management types of positions.

The other side of it is that people get burned out in Russia at an age when they would be entering their prime production years in most other markets. I know many Russians that are 40 or 45 years old that are already retiring or doing something else, which is a real loss for the country.

C. Freeland:

OK, Michael, can you explain this to me? I have encountered this point made by my friends in Russian investing. In fact, one of Roland's former partners, who shall remain nameless, who was at Renaissance and who is no longer in Russia, said to me that he was in Russia for ten years and it was like ten dog years, meaning that it felt like 60 years. Why do you burn out so much working in the Russian market?

M. Calvey:

Well, I have not burned out.

C. Freeland:

OK, why do other, weaker men burn out?

M. Calvey:

I do not know. I think it is a good question. I think that traffic jams and infrastructure issues have an impact. You could say it is the weather, but there are plenty of Canadians, Swedes and Finns that work until they are 70 years old and do not slow down. I think it is corruption, perhaps. My own view is that the biggest impact of corruption is the demotivation that it causes among productive people. When they look around and see undeserving people becoming rich or wealthy, it tends to really deflate the enthusiasm of the most productive people. I think, economically, corruption is much less of a problem today. In my opinion, it is not as bad as it was ten or fifteen years ago, but the demotivation factor is probably costlier, because so many other things are working properly now in Russia that were not 15 years ago that it stands out, and it tends to cause a lot of people to get angry and decide to throw in the towel.

C. Freeland:

OK, I am going to bring Andrey in one more time, and then I am going to open the discussion up for questions. Please get your questions ready; do not disappoint me. Andrey, you can comment on whatever you like. I would especially like to hear your point of view on whether capital is shifting permanently to emerging markets, and also, does democracy in Russia matter?

A. Shemetov:

I think if we want to receive capital from the West, we should create Russian liquidity first. It is very simple, but how can we do it? In Russia, we have a very strange situation. Gazprom is number one in the London Stock Exchange in terms of volume, for example. Of course, that is not typical. In Gazprom, there are bonds, but Russia’s pension funds can buy them. Of course, it is not typical, and I think some things should change. When the Russian political system can change with the situation, there will be liquidity, because right now, in the open position, we want to close at the right time. If you have liquidity, this is possible, and then we can give hedge funds institutionally-established liquidity. This will create a lot of money in Russia, and step by step, I think there will also be private investments in equity deals. This is a process that I think should continue for many years to come.

C. Freeland:

OK. What about the democracy question, Andrey? Democracy in Russia: does it matter?

A. Shemetov:

I think we can look to China. What about China not having a democracy? I think the Russian situation is much better. I think the Russian market has many more upsides.

C. Freeland:

I take that as a “no”.

A. Shemetov:

If we are talking about democracy, I mean.

C. Freeland:

OK. Are there any questions?

D. Wolfe:

I have question amplifying Andrey’s point. We have not really talked about the absence of a local investor base, and I wonder if you think that is one of the places where an inflection point comes, because that would really diminish the volatility that Michael was talking about earlier. Amongst the many failures of the Russian Government over the last 20 years, there is the failure to create a local investor base that does not go to other countries because they are here, and they understand the investments here. In fact, you have had a lot of capital flight from places that might naturally be part of that investor base. I was just wondering if you think that is one of the things that might make Russia more attractive long-term to outside investors.

C. Freeland:
Is that a question for Andrey?

D. Wolfe:
Yes, the question is for Andrey, if possible.

A. Shemetov:
Of course, this is one of the main problems, because, for example, in Russia, mutual funds almost do not work. It is not popular. We have no life insurance, no mutual funds. It is peanuts; it is not serious money. A Russian pension system does not work in equities. We have a strange situation. They can invest in bonds with an A-rating. But Gazprom, for example, has a B-rating because they do not have two independent directors on the board. Russian pensions could buy Gazprom bonds. We have a lot of atypical situations like this in Russia. I think we should change this. Russian citizens, of course, do not trust the Russian market and equity. They prefer to deposit their money in the bank. For example, in Russia, we only have 100,000 active clients out of the entire population. These are the people that make one deal per month. Only 0.7% of citizens invest in financial markets. In America it is about 70%.

C. Freeland:
Viatcheslav?

V. Pivovarov:

I think Andrey pretty much covered it. Just to summarize, I think it is pension reform that is needed. There is some competition from high deposit rates, but pension reform is primarily what is needed.

C. Freeland:
Is it also that ordinary Russians do not trust investors?

V. Pivovarov:
I do not know. I think a lot of people trust more broadly, so I think the problem is not here.

C. Freeland:
No, but is it in the wake of that?

V. Pivovarov:
No, I do not think that is the key issue. The key issue is that there is no domestic pool of savings that could be regulated and invested in equity.

C. Freeland:
Roland?

R. Nash:
Russian asset markets are strange in a global context. You have to let the markets fall so far that foreigners eventually step in and support the market, because there is not a natural domestic investor base to step in above those levels. When foreign money is very scared, you have to squeeze down evaluations so far that you have this extraordinary volatility. I think it could be one of those inflection points if you could create a true domestic investor base, but I think what is missing are the domestic institutions like the domestic pension funds and mutual funds. It is not really hedge funds that are missing in this market; it is institutional money. If you

look anywhere else in the world, it is not individuals that buy the market. Even in sophisticated markets like Germany, the UK, or France, there are no individuals that step in and buy the market, whereas here, the only people that are really investing on an active basis are individuals. There are no pension funds or mutual funds. There is no domestic professionalization of that business to speak of. When that is created, I think it will squash out the volatility, and if you squash out the volatility, that will raise evaluations.

C. Freeland:

OK, another question? Perhaps we will take two more questions, because time is running out.

From the audience:

As I understand, what you are all saying is that risk in Russia is fundamentally mispriced, yet every time I speak to my limited partners, especially the foreign ones, I hear complaints like poor corporate governance, a malfunctioning law system, absence of a level playing field, etc. So, do you agree that risk is mispriced, and if so, why is there such a perception gap, how can it be fixed, and will it be fixed?

C. Freeland:

Can you name one or two panelists to whom you would like to chiefly direct the question?

From the audience:

Probably mostly to Michael as an investor, and maybe Walid as well, because you were saying that Russia is underinvested and you expect new capital flows to come into Russia.

C. Freeland:

OK, and we will take one more question.

From the floor:

I have a question for Roland. What do you think about smart money? We know hedge funds under management are rising quite rapidly, even post-crisis. Do you think that smart money can be the facilitator of capital flow from developed countries to developing countries, because hedge funds are more likely to invest in riskier assets, right? In terms of the American economy, the under management is rather small in terms of the economies of emerging markets. Can they bring substantial changes? Is there anything to that?

C. Freeland:

OK, we will start with you, Michael.

M. Calvey:

The fact that there is very little private equity capital is not because of the lack of trying. There have certainly been a lot of people trying to raise funds that have not succeeded because there is limited demand from institutional investors to invest in Russian private equity. I would say there are two main reasons for that. The first is that the range of outcomes in private equity here is wider than normal. The average is a little better than most other emerging markets and has been better than most developed markets too, but that disguises a huge range of variability, and there have been a lot of funds that have totally blown up and left investors at zero. That does not happen very often if you invest in private equity in the United States. I am talking about later-stage strategies, not start-ups.

C. Freeland:

Are we talking about expropriation, confiscation – Russian partners took everything?

M. Calvey:

There are certainly some governance issues where people mismanaged, but mainly it is because the only time that most managers have been able to raise funds in Russia has been at the peak of market cycles. So there were three, four, or five funds raised in Russia that were first-time funds in 2006 and 2007, and they put all their money to work at the peak of the pre-crisis market. No matter who you were or how smart you were or how good your team was, those funds are not going to look really good today. It is a market that is structurally difficult for first-time funds.

But I also think that, in Russia, the investor image is less business-focused, and more politics- or geopolitics-focused, maybe because Russia is more engaged in geopolitical issues than other emerging markets are. When people think about Brazil or India, they are not thinking about geopolitical issues; they are thinking about Indian consumers or Brazilian football teams. When they think about Russia, they think about all the geopolitical issues where there are friction points, and that is what is mainly reported in the press. No one is thinking about Russian consumers or Russian growth or success or entrepreneurial stories, even though they do exist. There is a disconnect between perception and reality that is probably bigger in Russia than in most places.

C. Freeland:

Walid?

W. Chammah:

I think Michael said it all, but I will add that sometimes perception is reality. There is a lack of transparency, there is a lack of corporate governance, and that is part of the premium you pay in Russia. But as Roland said earlier at one point, it is cheap enough. In my opinion, it is the most undervalued BRIC country. It is rich with resources, has skilled labour and has high-quality management in certain cases. Basically, I think that money will find its way to the right opportunity. Clearly, for the last several years, we have seen a big push from the political establishment here in Moscow to basically improve corporate governance, to focus on it, make it more transparent and to be more active about it. If you heard President Putin's speech this afternoon, he again referred to it from that point of view. I think there is a clear effort to make some of the perception disappear and have a new reality here in Russia.

C. Freeland:
OK, Alexander wants to jump in.

A. Galitsky:
I would like to say that when we raised our first fund in 2008, it was a difficult time and there was a crisis. We raised our sights, but we did not do it in Russia. We do not have any Russian money. From this point of view, it was pretty difficult to raise since even people in private equity had problems raising capital. For us, it was more difficult, since it was a venture capital company. Now, as it always happens, Russia had some success, and those successes came out of the market. Due to our current successes, limited partners are calling us and asking if we would like to have investments. From this point of view, the country is changing. The country will change when you have more and more success stories. When you have bad stories, people will not invest, but if you have good stories, people want to repeat them. So from this point, I will remain optimistic.

C. Freeland:
OK, Carlos would like to jump in.

C. Gutierrez:
I just wanted to mention a couple of things. First of all, Russia does not have a monopoly on corruption. I think that anyone who has done business around the world will know that every market has its unique circumstances. The other thing is that Russia is moving ahead and evolving. It is making major steps, and one example of this is the WTO. That is a major badge, a seal of quality. That is going to

help. Little by little, I think steps will be taken that will take away your point, which I think is an excellent point, about the geopolitical aspects. That does drive a certain fear among business that they do not understand, so they stay away.

C. Freeland:

If I could just make a comment, and maybe you all can answer this in the next round, on the geopolitical point that Michael made. You contrasted the thinking about Russia with the thinking about Brazil and India. There is a fundamental political difference in the form of governance that Brazil and India have versus the government in Russia. Do you think that could be part of the scepticism?

C. Gutierrez:

It is still too early to claim success. Brazil has been through tremendous turmoil if you go back just 15 or 20 years. That is one aspect. India does have a democracy. My sense of India, and this is just from personal observation, is that it is probably the most conservative country in the world in the sense that change happens very, very slowly. So you can pick any country, and every country will have its pros and cons.

M. Calvey:

I agree that there is no investment paradise that exists in the world, but I am not sure that democracy and returns are that closely related. Capitalism and returns are closely related. So before China adopted capitalism, it was incredibly impoverished, and as soon as they did, they have been on a non-stop economic boom. What matters, I think, is institutions and property rights. Can people have property and defend it against the state? If you can have that, then obviously democracy helps in other ways. It is a check on abuses of power and tends to lead to less corruption, but it also leads to an inability to do sensible things about your budget, about tax policy, about implementing infrastructure and investments. So there is a trade-off. Obviously, as a citizen, you like democracy because of the other advantages, but I am just talking about it from a business investment perspective. I do not think the verdict is that clear.

I also think that you have to look at Russia as a moving picture, not a snapshot in time. This is the most democratic election that Russia has had in the 20 years that I have lived here, and I think it is really exciting to see young people feeling politically engaged, and it is all in a very peaceful way. I think as long as guns stay off the street, then I would view this as a very positive thing that will develop over time, rather than a disaster from an investment perspective.

C. Freeland:

OK, Viatcheslav has been wanting to say something, and then we will get to Roland's answering the smart money question.

V. Pivovarov:

I just wanted to add that corruption is definitely not a Russia-specific disease. Over a number of years investing in global markets, we have seen this all the time in different countries. Just recently, the scandal in China with Evergrande the Chinese developer. With Repsol in Argentina, and Indian telecom licenses were being cancelled. Unfortunately, this is something that happens everywhere all the time. There was a study done that shows a very strong relationship between the GDP per capita and the occurrences of corruption in the society, and apparently it is very strongly correlated. As the wealth of a society grows, the higher the opportunity costs of corruption, and therefore yield declines. In terms of corruption discounting the Russian market, there might be some truth to it, but I think the key factor for the Russian population is the volatility of the market.

C. Freeland:

OK, and while we are talking about corruption, and I cannot help but note that the Gupta trial just concluded in New York. Roland?

R. Nash:

We have been able to raise money over the last couple of years, but I think it was not because we were able to take more risk, but because we were able to manage that risk more effectively. The sort of people that have been giving us money to invest have tended to be very long-term monies, and they recognize that it might not be now or even one or two years' time, but eventually the upside in this market will be very large indeed. What they need is organizations like Slava's and mine that are able to manage that risk and that money effectively and professionally. That sort of money has the luxury of being long-term and is therefore smart. They are recognizing a lot of what this panel has been saying, which is that there is huge opportunity here and there is still quite a bit of risk, but in the long term, it is pretty clear where the capital flows will be going.

C. Freeland:

OK. Our time has come to an end. We are just going to conclude very quickly with a few 'blitz round' questions. Are you ready, gentlemen? The first question is: if I give you USD 100 million to invest, and you cannot invest it in Russia because that is our host country and that would be boring, which country or asset class would you invest it in?

M. Calvey:

US, low-income housing.

C. Freeland:

Walid?

W. Chammah:

Asia, energy.

C. Gutierrez:

US, energy.

A. Galitsky:

US, energy.

R. Nash:

I think the emerging markets, middle-class, in one form or another.

V. Pivovarov:

I know that you said we cannot invest in Russia, but I would still say Surgutneftegaz.

C. Freeland:

You could say oil, how about that? That was cheating, which says something about the mentality of the Russian investing class. Andrey?

A. Shemetov:

US treasury.

C. Freeland:

For the final blitz round, we are going to start with Andrey. We talked a little bit about Europe, not as much as I thought we would given how much that spectre is hanging over the world's economy, but the question is: straight yes or no, January 1, 2013, does the euro have the same number of member states it has today, or fewer? Andrey?

A. Shemetov:

I hope not. No.

C. Freeland:

Roland?

R. Nash:

Yes.

M. Calvey:

Well, I am just going to say no, because I like to bet against conventional opinions.

A. Galitsky:

I just wanted to say that I recently invested money in a foundation which is building protection for Earth from asteroids. I have been telling everyone that it is a good idea to protect in Earth from what will happen in 2030. There is a big probability that the Earth will be hit by a big asteroid. American astronauts actually created this foundation – the B162. You can go to their website, but if you have money, you should invest in it.

C. Freeland:

But this would not be an investment. It would be purely philanthropic, because you will not get a return for your investment.

A. Galitsky:

No, you can put a plate with your DNA on the ship, since it will be around the Sun, and in two million years, another ship will go through our solar system and will find this object with your DNA, and they will rebuild your human body again. Who knows?

C. Freeland:

OK, I think I cannot resist concluding on that note. I think you now all understand why Eric Schmidt loves talking to Alexander Galitsky and considers him to be one of the most creative and original minds in Silicon Valley and, indeed, in the world. Thank you for concluding on that cosmic note, and thank you to the entire panel for a really wide-ranging and insightful conversation. I enjoyed it very much.