QuotedData

Initiation | Investment companies

9 March 2017

JPMorgan Russian Securities

Russian recovery

The Russian market has been rebounding on the back of a strengthening oil price but remains one of the cheapest emerging markets. The manager thinks the market could rise further from here. The economy is on an improving trend but, the manager believes that, if President Trump eases sanctions, this could provide a significant tailwind.

JPMorgan Russian Securities (JRS) offers the only pure play on Russia within the investment companies market. It comes with a yield of 2.8% and one of the most experienced investment managers in the sector, Oleg Biryulyov, who has been managing JRS since it was launched, and Russian equity funds for 23 years.

Growth from a diversified portfolio of Russian securities

JRS aims to provide investors with capital growth from a diversified portfolio of investments primarily in quoted Russian securities or other companies that operate principally in Russia. Up to 10% of the portfolio can be invested in companies located in former republics of the Soviet Union. The portfolio is fairly concentrated (typically between 25 and 50 positions). JRS is permitted to use borrowings but has not done so for some years.

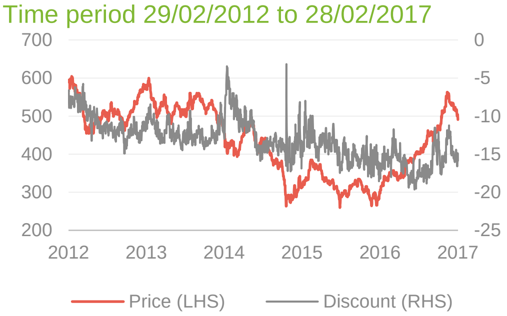
Year ended	Share price total return (%)	NAV total return (%)	Blended bench-mark TR* (%)	RTS total return (%)	MSCI Russia 10/40 TR (%)
28/02/13	(3.4)	1.2	(4.8)	(3.2)	(4.8)
28/02/14	(18.7)	(17.0)	(22.9)	(22.1)	(22.9)
28/02/15	(27.4)	(27.1)	(13.8)	(19.2)	(13.8)
29/02/16	0.2	4.7	(1.2)	(0.1)	(1.2)
28/02/17	70.1	64.6	62.9	67.6	62.4

Source: Morningstar, Marten & Co. *Note: JRS' blended benchmark is the MSCI Russia 10/40 Index until 31 October 2016 and the RTS Index thereafter (see page 4).

Sector	European single country
Ticker	JRS LN
Base currency	GBP
Price	499.75p
NAV	593.5p
Premium/(discount)	(15.8%)
Yield	2.80%

Share price and discount

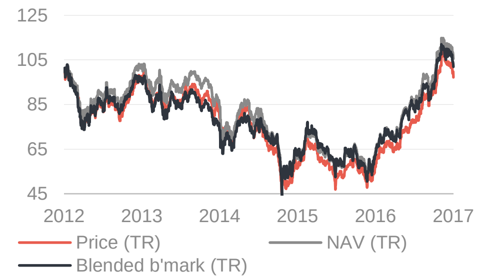
Time period 29/02/2012 to 28/02/2017



Source: Morningstar, Marten & Co

Performance over five years

Time period 29/02/12 to 28/02/17



Source: Morningstar, Marten & Co

Domicile	UK
Inception date	20 December 2002
Manager	Oleg Biryulyov
Market cap (GBP)	262m
Shares outstanding	52.3m
Daily vol. (1-yr. avg.)	70,830 shares
Net gearing	(0.7%)

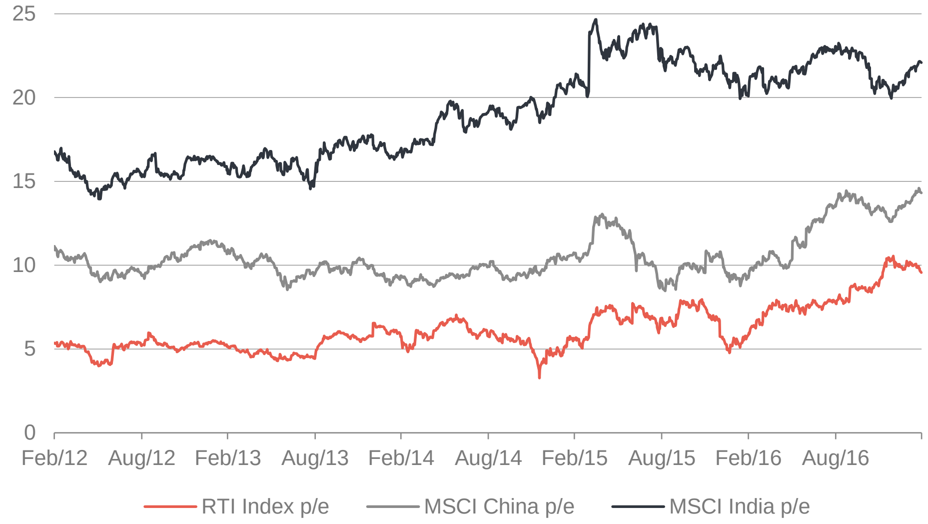
Contents

Why Russia?

Considerable growth potential, trading on a relatively low valuation

Russia's vast size, staggering mineral wealth, turbulent political history and polarising leadership characterise it as a country that provokes strong emotions. Some years ago, Russia was being hailed as one of the dynamic, fast-growing BRIC countries (Brazil, Russia, India and China) as investors got excited about the country's considerable growth potential. However, since then it has fallen from grace. Its stock market and currency have been volatile as they have reacted to various shocks, most recently the collapse of the oil price and the imposition of sanctions in the wake of Russia's annexation of Crimea. Today, Russian equities trade on much lower valuations than their peers in markets such as China and India (as is evidenced in Figure 1).

Figure 1: Russia, China and India price to earnings ratios (historic)



Source: Bloomberg, Marten & Co

Russian market yields over 5%

The manager believes that easing sanctions would be viewed very positively by the market

In addition to trading on a low price to earnings ratio, the RTS Index (see page 4) yields over 5%. The high yield is associated with a high pay-out ratio (the relationship of earnings to dividends) and low valuations.

The recovery in the oil price has improved confidence in the market but the economy is taking time to adjust to lower-for-longer oil prices. GDP growth looks set to be positive but anaemic. A recovery in Chinese demand for its mineral wealth would provide a considerable boost but the manager believes that, if President Trump eases sanctions (imposed after the annexation of Crimea), the market could respond very positively.

Fund profile

Significant investors in Russia

You can access the fund's website at www.jpmorganrussian.co.uk

JPMorgan Asset Management (JPMAM) is one of the world's largest asset managers. It has $1.2bn invested in Russia through dedicated funds (including JRS). A further $400m is invested through regional funds and $3bn through global funds, making JPMAM a significant investor in the Russian market. Oleg Biryulyov (Oleg or the manager) has been with JPMAM and its predecessors since 1993 and has been managing JRS since it was launched. He is a Russian native.

JRS aims to generate capital growth from a portfolio consisting predominantly of quoted Russian companies. Up to 10% of the portfolio can be invested outside Russia in companies located in former Soviet republics.

Blended Benchmark

New benchmark since 1 November 2016

JRS switched its benchmark from MSCI Russia 10/40 Index to the RTS Index with effect from 1 November 2016. A blend of the two indices has been used within this report (as JRS does in its communications with shareholders). The reason for the change in benchmark was that RTS is a much broader index than the MSCI 10/40 (RTS has 49 stocks as compared to MSCI 10/40 which only has 19 constituents) and the board believes that the RTS Index better represents the universe that this portfolio is selected from. There is a small discrepancy between the data supplied by Morningstar for the RTS Index (used in this note) and the data used by JPMAM in its factsheets. This is most likely the result of exchange rate and timing differences.

Manager's view

JPMAM forecasting is based on $45 oil

Oleg notes that the falling oil price and sanctions have had an adverse impact on the Russian economy. The oil-price fall has hit tax revenues as taxes on oil production account for a significant proportion of government income. JPMAM is using a long-term forecast of $45 per barrel for the oil price and expects lower volatility in the oil price in 2017. This would help provide a more stable platform for GDP recovery in Russia.

Improving economic outlook

The manager thinks the Russian economic figures for the first quarter of 2017 should look good compared to the first quarter of 2016. The rouble strengthened by 12% in 2016 (it has been floating free from exchange controls since October 2014). The central bank has been intervening to support the currency as a way of controlling inflation. This has allowed interest rates to come down but real rates (the difference between interest rates and inflation rates) remain relatively high at around 5% and so companies have been reducing their debt.

While consumer spending is depressed, state finances are in reasonable shape

The manager notes that wages have stagnated during the last couple of years, and workers are worried about job security. This is depressing consumer spending. However, he believes that this could improve if the economy continues to grow but, nonetheless, companies are achieving productivity growth. Oleg believes the government has made it easier to do business in the country. Big projects, such as the preparations for the World Cup, are being undertaken by private firms, easing some of the burden on state spending. The manager says that state finances are in reasonable shape and he sees no need for tax increases in the near term. The government's deficit has never exceeded 3% and total government debt is only c10% of GDP – far healthier than most western countries.

Headline movements in population figures are also improving. The population swelled by 2m after the country absorbed Crimea. Ukrainian immigration has also had an effect. The government has been investing in childcare (the government contributes towards the cost of a second child) and healthcare, particularly in the regions. Alcohol consumption is falling and so are mortality rates.

There has been much talk in the press that the US is considering lifting sanctions. The manager believes that this would be viewed very positively by the Russian market should it come to pass. Sanctions have been restricting FDI flows and restricting access to capital.

Investment process

The manager is seeking to identify attractively valued companies with sustainable above-average returns. The investment approach for JRS is based on JPMorgan's emerging market investment process. JPMAM's global team is responsible for producing an outlook for the political and economic backdrop for each country and region. JPMAM also has a large team of researchers that is looking at companies on a sector basis across all regions of emerging markets. Over 40 of the team are involved in research on European, Middle East and African (EMEA) stocks. They help maintain JPMAM's comprehensive in-house research database. Oleg is, in addition to being the lead manager on JRS, head of EMEA within JPMAM and is responsible for research into transportation, utilities, small cap (sub €3bn market cap) and non-index investments in JRS.

Oleg visits Russia at least once a year but the companies also come to London. He says that Russian accounting accords with international standards and Oleg thinks that corporate governance has improved, in general.

Looking for companies with high and sustainable ROE

JPMAM analysts submit ideas for Oleg's approval and he has final say over what goes into the portfolio. The analyst reports review each stock in great detail, looking at a range of measures including return on equity, which they want to be sustainable – this includes an assessment of how capital intensive the business is; cash generation; the strength of the balance sheet; and how sensitive the company is to inflation. They will also examine the durability of the company's business, corporate governance standards and environmental, social and corporate governance attributes.

Estimating five-year returns

Oleg wants to hold companies that look attractive across a range of factors. Returns are derived from earnings growth and dividends, which are within the control of the company, and valuation multiple changes and currency moves, which come from changes in market sentiment. JPMAM prefers companies that can benefit from each of these. Stocks are assessed for inclusion within the portfolio on the basis of predicted returns. The predicted return is derived from a predicted price to earnings ratio when he comes to sell a stock and an internal forecast of returns over the next five years (returns are expected to return to normal levels after the third year).

Oleg breaks down the portfolio into 'trading' stocks – that he will move in and out of on valuation grounds; 'quality' stocks – that will form the core of the portfolio as long-term holdings; and 'premium' stocks – the crème de la crème. Currently, only one stock in JRS' portfolio merits a premium rating, based largely on its track record of delivering high returns relative to peers over more than a decade. Turnover works out to about 25% to 35% per annum.

Risk control

Detailed risk profiling on each stock

There is a 98-question checklist that has to be completed on each stock. This risk profiling produces 'red flag' reports that highlight areas of potential concern. In Oleg's experience, mining and oil & gas sector companies tend to generate more red flags than most other companies. He prefers private companies to ex state owned enterprises (private companies are better managed) but he acknowledges that the state is more involved in the corporate world than it has been.

Investment universe has been shrinking

Restricted investment universe means the portfolio is necessarily concentrated

The manager says that the universe of stocks that are suitable for inclusion within JRS' portfolio is declining (Oleg reckons that of 110 stocks, about half might fit the bill). This is mainly due to merger and acquisitions activity, particularly in the utilities sector. To mitigate this, JRS is also looking at stocks within former states of the Soviet Union. For example, there is a technology company that Oleg likes, a bank in Georgia and a Kazakh oil exploration and production company. With a restricted selection of potential investments, it is, perhaps, unsurprising that the portfolio is fairly concentrated. JRS will typically have between 20 and 50 stocks, yet no more than 15% of the portfolio can be invested in any one stock at the time of purchase.

Oleg points out that liquidity can be quite low, especially in smaller market cap companies. He says that the fund's portfolio is reasonably liquid, however.

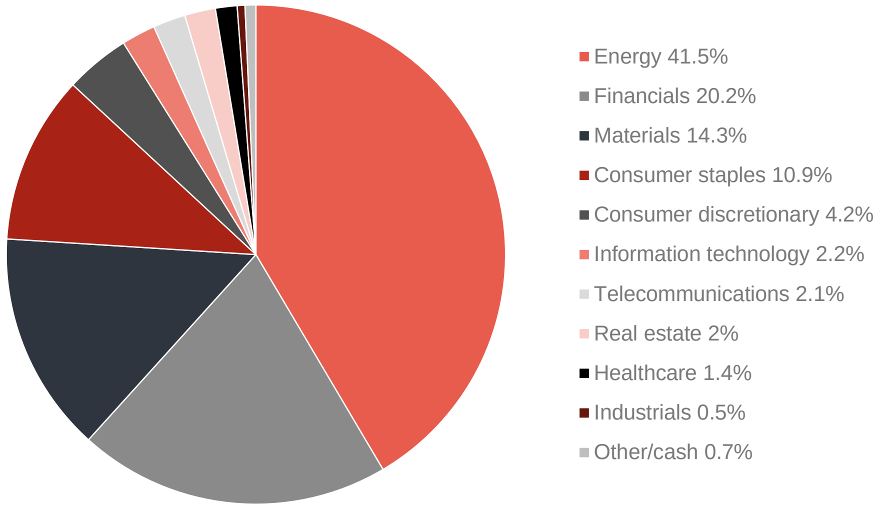
JRS is permitted to have up to 10% in cash and gearing of up to 15% but gearing (borrowing) has not been used in the portfolio for some years (see capital structure on page 12).

Asset allocation

At the end of January 2017 there were 29 stocks in the portfolio and 4.75% of the portfolio was invested outside Russia (in Belarus, Georgia, Kazakhstan and Ukraine).

Industry sector breakdown

Figure 2: Industry sector allocations for JRS as at 31 January 2017



Source: JPMorgan Russian Securities

Figure 2 shows the breakdown of JRS' portfolio by industry sector at the end of January 2017. The high weightings in energy, financials and materials reflect, to some extent, the importance of these three sectors within the Russian economy and the preponderance of large listed companies in these sectors.

Relative to the RTS Index, the portfolio has an overweight exposure to consumer staples and real estate sectors and an underweight exposure to the energy and utilities sectors. Oleg has positioned the fund for a recovering domestic economy.

Top 10 holdings

The concentration of the portfolio is evident in Figure 3 with 72.3% of the fund invested in the 10 largest positions at the end of January 2017.

Figure 3: 10 largest holdings as at 31 January 2017

Holding	Sector	% of portfolio 31 January 2017	% of portfolio 31 July 2016	Change (%)
Sberbank of Russia	Financials	15.3	12.7	+2.6
Gazprom	Energy	14.6	7.8	+6.8
Lukoil ADR	Energy	8.1	6.3	+1.8
Novatek GDR	Energy	6.3	5.3	+1.0
Magnit	Consumer staples	6.1	9.5	-3.4
Rosneft Oil	Energy	5.6	5.7	-0.1
MMC Norlisk Nickel	Materials	4.8	2.9	+1.9
Tatneft	Energy	4.0	3.5	+0.5
ALROSA	Materials	4.0	5.6	-1.6
Moscow Exchange	Financials	3.5	5.4	-1.9
Total		**72.3**	**64.7**	**7.6**

Source: JPMorgan Russian Securities

Sberbank

Sberbank is Russia's largest bank and vies with Gazprom to be Russia's largest company by market capitalisation. It is making a return on equity of c20% yet Oleg believes it can still cut costs. Its strong market position, with 45% of Russian deposits, gives it economies of scale and net interest margins of about 6% look very healthy relative to banks in developed markets. Sberbank's share price was hit quite badly by the imposition of sanctions (which restricted its access to capital) but has recovered strongly since.

Gazprom

Gazprom holds the world's largest natural gas reserves. Although Oleg believes Gazprom is very undervalued relative to its global peers, JRS has an underweight exposure to this stock relative to the RTS index. Oleg feels the company could be run more efficiently. Gazprom claims that it has been largely unaffected by sanctions but it may face a fine from the EU which says it is abusing its monopoly market position to charge unrealistically high prices for gas in eastern Europe.

Lukoil

Lukoil is a significant player in the world oil market, producing around 2 million barrels per day of oil and over 300,000 barrels of oil equivalent of gas. Lukoil is one of the fund's largest underweight positions relative to the benchmark (8.0% weighting at the end of December 2016 against a 12.5% weight in the index).

Novatek

Novatek is one of the largest producers of natural gas in Russia, after Gazprom. In 2016 profits were much stronger than in 2015, reflecting stronger production figures, particularly of oil. Sanctions made it harder for it to raise finance for the expansion of its business. In June 2016, it announced it had secured $18.4bn of funding for its $27bn Yamal liquefied natural gas project. This came from Russian and Chinese sources.

Magnit

The largest retailer in Russia with 10% market share, $150bn of turnover and over 200,000 employees (the largest non-state employer in Russia). It makes margins of about 11%. It is sticking to its local market and is consolidating it – Russia's food retail market is highly fragmented relative to say France or the UK.

Rosneft

Rosneft has suffered from low oil prices and as a consequence of sanctions. Net income in 2016 was 49% down on the previous year. Fourth quarter 2016 figures did show the benefit of rising prices, however. The company has secured funding from China at attractive rates (around 3% as compared to central bank rates of 10% and inflation of c5%). It also benefits from its operations in low tax zones. It is switching to paying dividends twice a year and the timing of payments (designed to boost government revenues) could have a one-off benefit to JRS' income.

RosAgro

RosAgro is JRS' largest overweight exposure relative to the benchmark (2.8% of the portfolio at the end of December against a 0.2% weighting in the index). It is Russia's largest margarine producer, second-largest pork producer, ranks third in sugar production and is a major landholder, Oleg thinks the stock is still cheap even though it has performed well. It is highly profitable. It has been making 25% margins and a through-the-cycle returns on equity of around 25%. The company is undertaking a big expansion of its business in the far east of the country which will export produce to China. It is approaching Korean and Japanese investors about backing the project.

Portfolio characteristics

Figure 4: portfolio characteristics as at 31 December 2016

	JRS	Benchmark index
Price/earnings ratio (forward)	5.9x	6.9x
Price/book value	1.2x	1.0x
Prospective dividend yield	5.6%	5.2%
Return on equity	19.0%	15.2%
Beta	1.00	
Tracking error	4.2	
Number of holdings	29	45
Active share*	30.4%	

Source: JPMorgan Russian Securities, * active share is the proportion of the portfolio that is not represented in the RTS Index

JRS has a lower p/e ratio, higher yield and much higher return on equity than its benchmark

JRS' portfolio exhibits a lower price to earnings ratio, higher yield and much higher return on equity than the average stock in the RTS Index, consistent with JPMAM's investment approach for JRS. Given the small number of stocks in the benchmark, it is perhaps unsurprising that the active share and tracking error are lower than might be the case for JPMAM funds in other markets (JPMAM is targeting active shares of 50%-60% in India and China, for example).

Performance

Figure 5: Returns over periods ending 28 February 2017

Heading	1 month	3 months	6 months	1 year	3 years	5 years
NAV total return	(3.8)	8.4	23.1	64.6	25.6	5.4
Price total return	(5.6)	6.1	26.1	70.1	23.7	(2.8)
Blended benchmark total return*	(4.5)	8.0	22.3	62.9	38.7	1.9
RTS Index total return	(4.5)	8.0	23.1	67.6	35.2	1.9
MSCI 10/40 Index total return	(5.0)	6.6	22.0	62.4	38.3	1.6

Source: Morningstar, Marten & Co *Note: JRS' blended benchmark is the MSCI Russia 10/40 Index until 31 October 2016 and the RTS Index thereafter (see page 4).

Figures 5 and 6 show that, following a period of strong performance, JRS had a more difficult period between the end of February 2014 and October 2015 after which it returned to form.

It is notable that, over five years, JRS is ahead of both indices. As is evident in both Figures 5 and 6, 2014 proved to be a difficult year for the fund. The imposition of sanctions triggered sharp falls in the stock market. At the time JRS had an overweight exposure to smaller companies and consumer stocks relative to the MSCI 10/40 Index. These stocks suffered disproportionately in the market sell-off.

Figure 6: JRS NAV total return performance relative to its blended benchmark over five years*

Source: Morningstar, Marten & Co *Note: JRS' blended benchmark is the MSCI Russia 10/40 Index until 31 October 2016 and the RTS Index thereafter (see page 4).

Looking at shorter-term performance, JPMAM has supplied some performance attribution information for the year ended 31 January 2017 and this is reproduced in Figure 7. Over this period, JRS outperformed its benchmark by 4.1% in NAV terms.

Figure 7: The five largest positive and negative contributions to returns relative to its benchmark over the year to the end of January 2017

Holding	Positive contribution (%)	Holding	Negative contribution (%)
Sberbank	+1.27	Ros Agro	-1.09
VTB Bank	+1.05	Cherkizovo Group	-0.75
Phosagro	+0.91	Federal Hydrogenerating	-0.73
Transneft	+0.76	Severstal	-0.70
MegaFon	+0.65	Mail.Ru	-0.59
Total	+4.64		-3.86

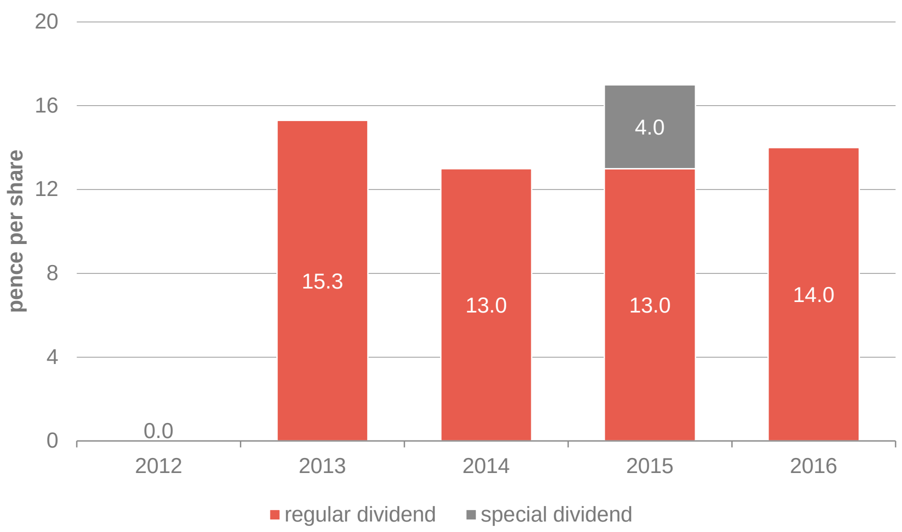
Source: JPMorgan Asset Management

Dividend

Income generation does not form part of JRS' objective; instead it is a residual effect of the manager's stock selection. Nevertheless, in recent years the Russian stock market has delivered reasonable levels of income and, reflecting this, JRS began making dividend payments in 2013.

20% of management fees are charged against the income account as are all other expenses. Subject to sufficient income being available, JRS pays two dividends a year in March and October. Over the course of the accounting year that ended on 31 October 2016, JRS generated revenue of 15.47p per share (down from 19.6p in the year ended 31 October 2015). The dividend for the 2016 period was set at 14p. Figure 8 shows how JRS' dividend payments have evolved in recent years. The special dividend in 2015 related to one-off profits made by Russian companies on their foreign exchange exposure – the rouble fell sharply against other currencies in that period.

Figure 8: JRS dividend history

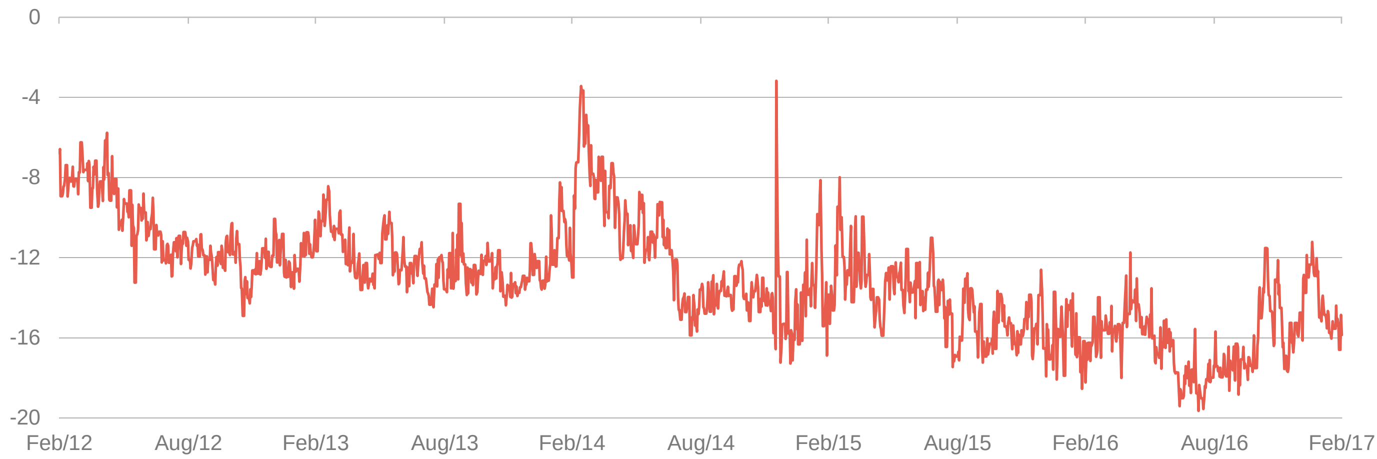


Source: JPMorgan Russian Securities

Discount

Figure 9 shows how JRS' discount has moved over the past five years.

Figure 9: Premium/(discount) over five years to 28 February 2017



Source: Morningstar, Marten & Co

JRS' discount appears to have stopped widening

Over the past five years, JRS' discount has been on a widening trend but now seems to have stabilised in a range of 12% to 17%. The board thinks that it is hard for single country funds, such as JRS, to keep their discounts within a narrow band. This is particularly true in JRS' case as the underlying stock market can be quite volatile. The board considered having a tender triggered by a persistently wide discount (a feature of some other investment companies) but concluded that the volatility of the underlying market would make this plan unworkable.

The company does have powers to buy back its stock (it renews these each year) and the board has said that it will use these where it feels that this will usefully affect the supply/demand balance for shares in JRS. It has decided that it will consider using JRS' share repurchase powers when the discount exceeds 10%. The level of discounts on similar trusts will be taken into account when making a decision.

The spike in the discount on 16 December 2014 reflects a collapse in the rouble around that date. The NAV fell but the share price did not fall as fast.

Fees and costs

The manager and company secretary to the company is JPMorgan Funds Limited (JPMF). Portfolio management is delegated to JPMorgan Asset Management UK Limited (JPMAM).

JPMF is entitled to a management fee of 1% per annum of JRS' net assets. The fee is calculated monthly in arrears. There is no performance fee and the management contract can be terminated, by either party, with 90 days' notice.

The ongoing charges for the year ended 31 October 2016 were 1.40% (2015: 1.43%). This included £219,000 of administration expenses, £149,000 of safe custody fees and £122,000 for directors' fees.

Capital structure and life

JRS has 52,337,112 ordinary shares in issue and no other classes of share capital.

Borrowing is permitted by the board up to a maximum limit of 15% of net assets. However, currently, the company has no borrowing facility in place. JRS had a bad experience with gearing in 2008 and was forced to reduce its borrowings by selling assets close to the bottom of the market. This has made the board more cautious about the use of gearing in the future.

Five-yearly continuation votes

Board recommending vote in favour of continuation

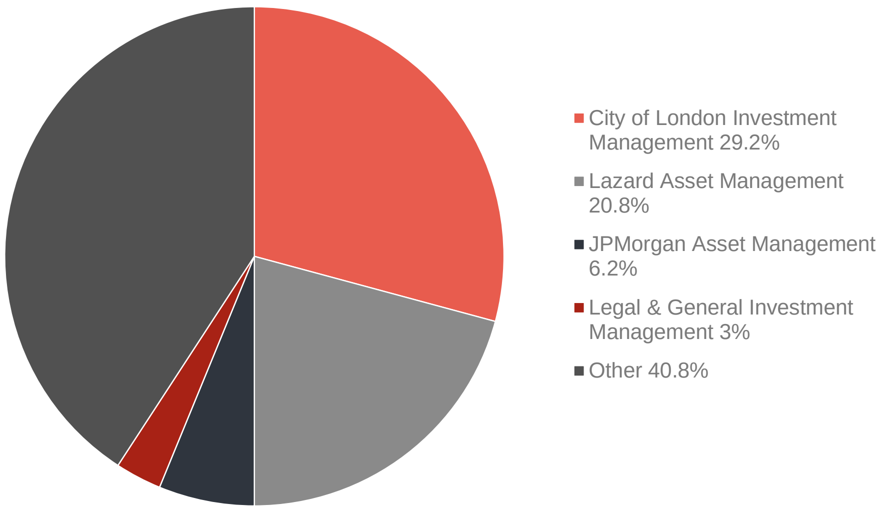
JRS does not have a fixed life but, every five years, shareholders are asked to approve the continuation of the company. The last vote was held on 27 January 2012 and the next will be held on 7 March 2017. The board is recommending that shareholders vote in favour of continuation.

Plans to offer a tender in five years

On 4 January 2017, the board announced that it plans to introduce a measure to oblige it to make a tender offer to shareholders for up to 20% of the outstanding share capital at NAV less costs and less a discount of 2% if, over the next five years (from the start of the current financial year, being 1 November 2016), the company's NAV total return in sterling on a cum income basis is below the total return of the benchmark in sterling terms over the five-year period.

Any tender offer will also be conditional on shareholders approving the continuation votes to be held this year and in 2022.

Figure 10: Major shareholders as at 31 October 2016



Source: JPMorgan Russian Securities

Board

The board comprises five directors all of whom are non-executive, independent from the manager and none of whom sit on other boards together. Three are men and two are women. Gill Nott became chairman on 12 June 2015. There is no senior independent director as the board consider that role is not needed for a company with five non-executive directors. The longest serving director, George Nianis, has been in place for close to nine years. A nomination committee, chaired by Gill Nott, is responsible for selecting new directors when needed. It used a search agency to suggest suitable candidates when appointing Tamara Sakovska.

All directors stand for re-election at each AGM, in line with corporate governance best practice.

Figure 11: Board member – length of service and shareholdings

Director	Role	Year appointed	Fee	Shareholding	
Gill Nott	Chairman	2011	£37,500	3,000	Independent
Alexander Easton	Director	2010	£25,000	12,018	Independent
Robert Jeens	Audit Committee chair	2011	£30,000	15,000	Independent
George Nianias	Director	2008	£25,000	-	Independent
Tamara Sakovska	Director	2016	£25,000	-	Independent

Source: Marten & Co

QuotedData

QuotedData is a trading name of Marten & Co which is authorised and regulated by the Financial Conduct Authority
123a Kings Road, London SW3 4PL
0203 691 9430

www.quoteddata.com

Registered in England & Wales number 07981621,
2nd Floor Heathmans House
19 Heathmans Road, London SW6 4TJ

Edward Marten
(em@martenandco.com)

Christopher Bunstead
(cb@martenandco.com)

Investment company research:

James Carthew
(jc@martenandco.com)

Matthew Read
(mr@martenandco.com)