

JPMorgan Russian Securities

Low valuations and rising yields

Weak oil prices and a deteriorating relationship with the US have weighed on the Russian market for some time. Hopes of a rapprochement with the West in the wake of President Trump's election have fizzled out. Russia has learned to live with the environment it finds itself in and earnings growth is starting to materialise. Falling inflation has highlighted excessive real interest rates, leaving scope for further cuts.

Investors have been avoiding Russia and this is evident in a forward p/e ratio for the market close to 5x and a prospective dividend yield of 7% (as at end July 2017).

JRS offers investors a more balanced portfolio than an equivalent ETF and one that draws on the wider pool of stocks that are not constituents of the main indices (see page 9). This gives it the freedom to perform and it is available on an attractive discount.

Growth from a diversified Russian portfolio

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 gearing but has not done so for some years.

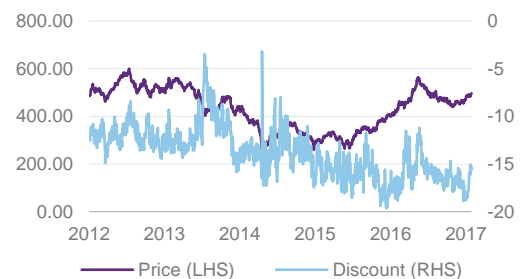
Year ended	Share price total return (%)	NAV total return (%)	Blended benchmark TR. (%)	RTS total return (%)	MSCI Russia 10/40 TR (%)
31/08/13	2.8	4.6	1.5	(0.9)	1.5
31/08/14	(12.8)	(13.0)	(11.4)	(10.0)	(11.4)
31/08/15	(27.8)	(25.3)	(19.0)	(20.4)	(19.0)
31/08/16	45.7	45.4	39.3	40.3	39.3
31/08/17	24.8	25.0	22.9	23.5	20.2

Source: Morningstar, Marten & Co

Sector	European – single country
Ticker	JRS LN
Base currency	GBP
Price	497.0p
NAV	588.7p
Premium/(discount)	(15.6%)
Yield	4.6%

Share price and discount

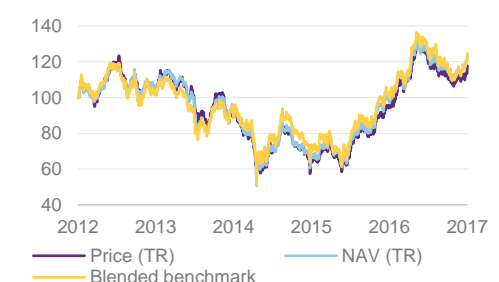
Time period 31/08/12 to 26/09/17



Source: Morningstar, Marten & Co

Performance over five years

Time period 31/08/12 to 31/08/17



Source: Morningstar, Marten & Co

Domicile	UK
Inception date	20 December 2002
Manager	Oleg Biryulyov
Market cap (GBP)	259.7m
Shares outstanding	52.262m
Daily vol. (1-yr. avg.)	90.8k shares
Net cash *	0.2%

* As at 22 September 2017

[Click here for our initiation note](#)

Manager's view

Russia's IT underweight relative to global emerging markets has held back its relative performance

Global emerging market performance YTD has been driven by IT stocks in the view of Oleg Biryulyov (Oleg or the manager), JPMorgan Russian Securities' (JRS') investment manager. However, IT in Russia is a tiny component of the RTS Index (it does not feature at all in the MSCI Russia Index) and so Russian indices have lagged their emerging market peers and are trading on just 5x forward earnings. This deep value opportunity is coupled with earnings and dividend growth. Dividend yields are rising: despite JRS' capital growth focus, 50% of its portfolio has a yield of 5% or more; 20% yield 0-1%, whilst 30% yield 1-5%.

Russian economy adjusting to weak oil price

Figure 1 shows the recent history of the RTI Index versus the oil price (WTI in US dollars), showing that the falling oil price had a negative effect on the market in 2014/15 but, since early 2016, the Russian index has been pulling ahead as the economy has adjusted to the new paradigm.

Figure 1: RTI Index versus WTI in US dollars, three years to 31 August 2017



Source: Bloomberg, Marten & Co

Scope for stronger rouble

The rouble had been recovering from the effects of the oil-price shock but has been depreciating since May. Oleg thinks that there is scope for the currency to strengthen again.

Oleg says the view could be described as 'half full/half empty' at the moment. He says that the key issues are sanctions, the oil price and the cost of capital. In the very short-term, the Russian market has been strong on the back of a perceived strengthening in the oil market and strong results from several large Russian companies.

Sanctions

The hope that President Trump's election would lead to an easing of sanctions has now evaporated. If anything, tensions are rising as accusations about Russia interfering in

the US and other elections have grown. Additional sanctions were approved by President Trump in August and a row has blown up around diplomatic missions in both countries on the back of this.

Nevertheless, Oleg says that good companies untainted by sanctions are able to raise money as is evident from the 13 eurobond issues from Russian companies YTD. While these have been across a range of sectors, exporters have dominated issuance.

Oil

New tax regime for oil designed to encourage production

On the oil price, Oleg believes that US shale production will contract. He reckons with rising inflation that the profitability of these projects will be questionable, with marginal production dropping away, which will give support to the oil price. Mineral extraction taxes imposed on the Russian oil industry take a high proportion of revenue when the oil price is \$60 or higher. The plan is to replace both these and export taxes by a profits-based tax in the hope that this will lead to higher production. In the meantime, some existing and new fields have received specific tax breaks. For example, one JRS investment, Novatek, got a \$10bn tax advantage on a new LNG project and another, Rosneft, got a tax holiday on a development of a challenging brownfield site.

Russia has been making big investments in both LNG plant and pipes to transmit natural gas to China, which it sees as a valuable trading partner.

Oleg says that oil companies' earnings growth has been better than expected. JPMorgan Asset Management (JPMAM) is expecting EPS growth in excess of 15% next year, plus dividend yields from these companies of around 5%. Currency moves could impact on that, however, and this could be significant.

Global interest-rate cycle

Real rates are very high

Russia has rationalised and restructured its banking system over the past few years. Oleg says the government had to bail out and conduct rescues of the larger banks. It also had a crackdown on smaller undercapitalised and poorly managed banks. The number of banks was cut by a third (from 850 in 2014 to 700 at the end of 2015 and 500 plus today). Oleg thinks that the central bank did a phenomenal job and it is thanks to its actions that inflation is now at a new low. As inflation has fallen, hitting a new post-Soviet Union low of 3.3% in August, real rates in Russia have been rising and are now around 5%, well in excess of those in the developed world which is offering negative real interest rates. Nevertheless, the threat of higher US rates did weigh on emerging market sentiment.

Politics

Putin is likely to be re-elected in 2018

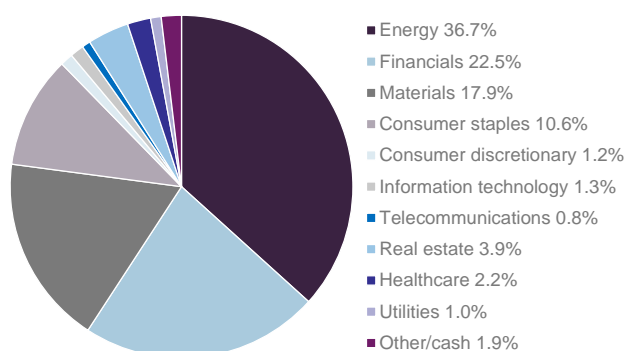
There seems little doubt that President Putin will win the presidential election scheduled for March 2018. However, elections ultimately create uncertainty. Under Putin, Russia has re-emphasised the military and has become bolder in pursuing its foreign-policy objectives, as evidenced by its involvement in Syria. Oleg talks about the military as a national priority for Russia: we asked whether this is something he is able to get exposure to. It turns out that the answer is no. The military companies are not listed. Oleg says that, in the space industry, there are a couple of listed companies but they are state-controlled and there is limited transparency.

MiFID II

The advent of MiFID II is creating problems for some asset managers as they will have to now pay to access brokers' research. JPMAM says it is highly aware of the issues involved with the implementation of MiFID II and has been investing heavily in its own internal research capabilities. The manager says that the sheer scale of JPMAM's operations gives it an advantage in this regard and it has made a big investment in its internal systems to make sure that this data is available across the firm. It spends US\$150m on internal research globally per annum.

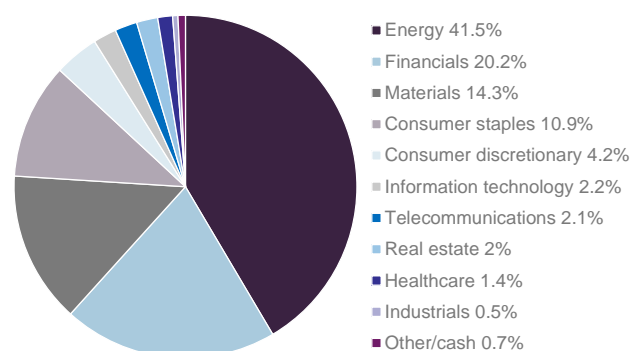
Asset allocation

Figure 2: Industry sector allocations as at 31 August 2017



Source: JPMorgan Russian Securities

Figure 3: Industry sector allocations as at 31 January 2017



Source: JPMorgan Russian Securities

As you can see from Figures 2 and 3, the portfolio's exposure to energy sector stocks has fallen by 4.8% since January, which can be explained by lower exposure to Gazprom and Novatek as evidenced in Figure 4. Consumer discretionary exposure has dropped by 3%. Weights have risen in the real-estate sector by 1.9% and in the other/cash category by 1.1%.

Figure 4: 10 largest holdings as at 31 August 2017

Holding	Sector	% of portfolio 31 July 2017	% of portfolio 31 January 2017	Change (%)
Sberbank of Russia	Financials	18.5	15.3	+3.2
Gazprom	Energy	12.8	14.6	-1.8
Lukoil ADR	Energy	7.5	8.1	-0.6
Magnit	Consumer staples	7.3	6.1	+0.8
MMC Norlisk Nickel	Materials	5.9	4.8	+1.1
Novatek GDR	Energy	5.0	6.3	-1.3
Rosneft Oil	Energy	5.0	5.6	-0.6
Tatneft	Energy	3.8	4.0	-0.2
ALROSA	Materials	3.0	4.0	-1.0
Polyus Gold	Materials	3.0		
Total		71.8		

Source: JPMorgan Russian Securities

We talked about many of JRS' larger holdings in our initiation note. Some of the others are covered here. The manager highlights a number of transactions including the sale

of MTS early in the year; trimming of positions in X5 and Gazprom; and the acquisition of Polyus.

■ MTS

Oleg has sold JRS' position in MTS (an abbreviation of Mobile Telephone Systems – referred to as MTC in Russia), a telecoms company with operations in Russia, Ukraine, Belarus, Armenia and Turkmenistan, and 110m clients. It has suffered collateral damage from a legal dispute. Russian conglomerate Sistema owns a 50% plus stake in MTS. Rosneft is suing Sistema for 170.6 billion roubles (\$2.9 billion) in damages over the purchase of oil producer Bashneft. The court has 'arrested' Sistema's shares.

The proceeds of the sale were reinvested in MegaFon, the second largest mobile phone operator in Russia and the third-largest telecom operator in Russia. Oleg says it is a 'clean company'.

■ X5

Supermarket company, X5, is consolidating a fragmented industry and had been expanding through M&A activity. This was weighing on its ROE. More recently, however, organic growth has been driving higher returns. Revenues were up more than 25% in 2016 and margins rose from 7% to 8%. Oleg continues to like the company and it remains a core holding but he trimmed the position on valuation grounds.

■ Polyus Gold

Polyus Gold is a top-five global gold producer which recently launched an IPO in London. JRS bought some stock at this time. Oleg thinks that it could be the world's largest gold producer in five years' time – he favours companies that have potential to become market leaders. It is currently ramping up production and has invested in the infrastructure needed to get the gold from mine to market.

The company has a new gold deposit which was found in Soviet times but never exploited. Polyus is adding this new capacity at a time when the gold-mining industry is struggling to add production. Oleg says that Polyus' cost of production is below \$800 per ounce (it is an open-pit mine and will benefit from state-of-the-art production methods) and that this puts it way down the industry cost curve. It also benefits from a more stable workforce (South African competitors have been suffering from labour unrest) and the weak rouble (costs are in roubles but sales are in dollars).

■ MMC Norilisk

MMC Norilisk is a global leader in nickel and PGM (platinum group metals – platinum, osmium, iridium, ruthenium, rhodium and palladium). It has benefited from an increase in the palladium price and Oleg says it will benefit from a recovery in the nickel price.

Oleg says that, like Polyus, the company is a classic exporter – its output is priced in US dollars but with the rouble down its costs are down and so its margins have expanded.

The company pays a dividend yield of 8%. Oleg says that it has previously had ESG issues but it has invested heavily to reduce the pollution it produces and so has improved its environmental 'footprint'. He also says that the company is transparent.

Tatneft

Tatneft is a major oil producer. It is reportedly the sixth-largest oil company in Russia. It operates in the old oil region. It is a steady producer and has expanded its downstream capacity (it is recognised as being a vertically integrated holding company). This expansion should improve the predictability of its cash flows. It benefits from a tax subsidy for depleted fields.

ALROSA

ALROSA ranks second globally in terms of diamond production, after De Beers and before Rio Tinto. It produces rough diamonds – its website (<http://eng.alrosa.ru/>) says that it accounts for almost a third of rough diamond production, that it has the largest rough diamond resources in the world and has a resource base sufficient to maintain production for 30 years. Oleg says that the company has government support because it is a global champion.

Once again, revenue (priced in US\$) is flat whilst costs (priced in roubles) are down, hence profitability has increased. The business stockpiles diamonds and runs stocks down when prices are high, so it can actually make more money when it is producing less.

It has a 50% payout ratio. Oleg says that the state is the largest holder of the company and it wants dividends. It pays a 7% yield and there is the potential for this to increase.

In August 2017, ALROSA was hit by an accident in one of its mines, one that accounts for around 5% of its production. The Siberian pit mine flooded after water burst from a quarry. There were 142 workers underground at the time and 133 were brought back to the surface. It appears there were nine fatalities. This has led to an investigation with production at the mine being halted.

ALROSA is an upstream producer. Oleg thinks that this is a nice part of the chain to be in. The middle men who do the polishing and cutting etc. have very high working capital requirements and associated costs. They have to pay the big producers (ALROSA, De Beers and the like) but are not paid by the end buyer (jewellers such as Tiffany's, for example) until much later. ALROSA is not exposed in this way.

Etalon

Etalon may fall outside JRS' top 10 holdings but it is its largest overweight exposure relative to the benchmark with 2.6% of the portfolio at the end of June 2017 (this reflects the fact that Etalon is not a constituent of the benchmark). Housing has been a low-priority sector for the government. High real interest rates have affected mortgage demand. The government is alleviating the problem with a subsidy of 2% and this has bolstered the real-estate sector in 2017.

Etalon is a private developer focused on standard housing for the middle class. Oleg says that they are seeing increased demand as the take up of mortgages increases, accounting for 35-40% of sales this year.

Portfolio characteristics

The numbers in Figure 5 have changed significantly from the equivalent table in our previous note (based on figures as at the end of 2016). Valuation multiples have

dropped and yields have risen (which could mean that JRS' yield will also rise). The active share is up a little, from 30.4%.

Figure 5: portfolio characteristics as at 31 July 2017

	JRS	Benchmark index
Price/earnings ratio (forward)	5.6x	5.2x
Price/book value	0.8x	0.6x
Prospective dividend yield	6.7%	7.0%
Return on equity	12.5%	11.9%
Beta	0.9	
Tracking error	3.9	
No. of holdings	30	47
Active share	31.1%	

Source: JPMorgan Russian Securities

Performance

Figure 6: Returns over periods ending 31 August 2017

	1 month (%)	3 months (%)	6 months (%)	1 year (%)	3 years (%)	5 years (%)
NAV total return	9.7	7.7	1.6	25.0	35.9	23.6
Price total return	8.0	5.7	(1.0)	24.8	31.3	17.7
Blended benchmark total return*	11.4	8.4	0.3	22.9	38.6	24.6
RTS Index total return	11.4	8.4	0.3	23.5	38.0	23.1
MSCI 10/40 Index total return	10.2	8.1	(1.4)	20.2	35.6	21.9

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).

August was a strong month for the Russian market, helped by a weak dollar and a strengthening oil price. As Figures 6 and 7 show, over the past six months JRS has outperformed local indices and this has extended its outperformance over the past year.

Figure 7: 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).

Up-to-date information on JRS is available on [QuotedData](#)

Tatneft made the strongest positive contribution to the fund's performance over the 12 months ended 31 July 2017, adding 1.0%. The fund has a slightly overweight position in IT (see page 4) but this has had little impact on performance. What the fund gained from holding EPAM Systems (a positive contribution of 0.48%) was offset by not holding Yandex (a negative contribution of 0.46%, the largest detractor from relative performance).

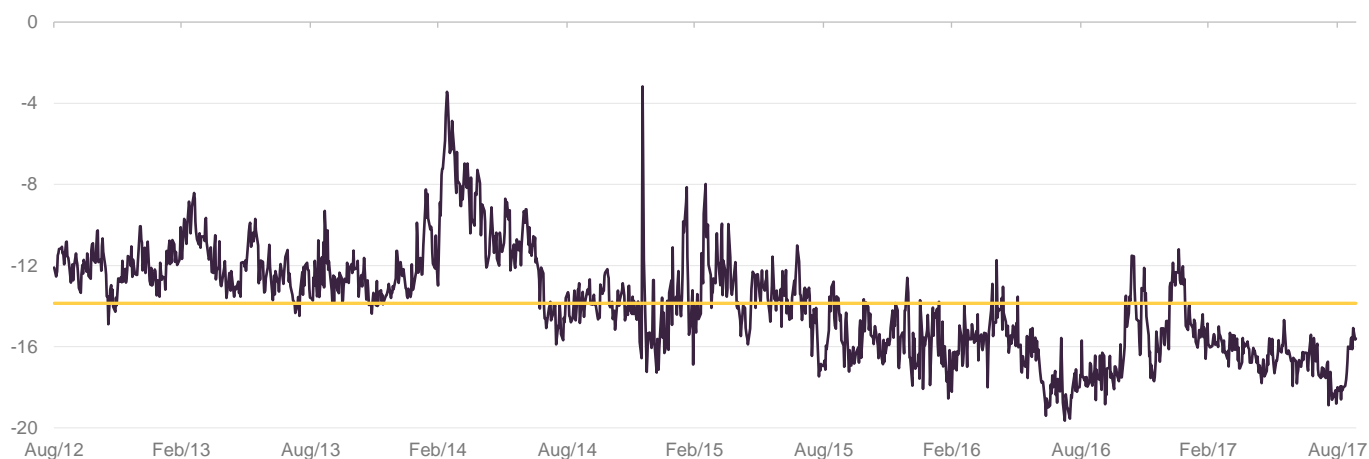
Financials stocks have also done well. Oleg says that Sberbank generated 20% EPS growth, 25% ROE and a 5% net interest margin. Its share price has been flat but, against the index, this means that relative performance has been strong. Oleg argues that it is difficult to find banks with this sort of profile elsewhere in the world. He cites the example of India which also has high real interest rates but he says that the equivalent Indian bank will be on a more expensive valuation. Georgian bank, TBC Bank, was the third- largest contributor to relative performance.

The second-largest detractor from relative performance was the absence of a holding in Aeroflot, the Russian flag carrier. Oleg says that Aeroflot has benefited from both a restructuring and from lower oil prices (although he expects oil prices will be higher in future). These effects will soon drop out of comparative figures and so Oleg thinks it will be difficult for Aeroflot to do as well.

JRS' yield forms an important part of shareholders' returns and, given the high yield available from the market, this is likely to continue to be the case. One disappointment this year has been Gazprom's failure to increase its dividend materially. A 50% pay-out ratio, which had been discussed, would put it on a yield of 15%.

Discount

Figure 8: Premium/(discount) over five years



Source: Morningstar, Marten & Co

Arguably reflecting market sentiment towards Russia (primarily an increasingly fractious relationship with the US) the general trend has been one of discount widening year to date. However, as illustrated in Figure 8, this trend has recently reversed so that JRS, while trading at a discount wider than its five-year average, at 15.6% is towards the middle of its one-year trading range (between discounts of 11.2% and 18.9%).

The narrowing follows the company's decision to repurchase and cancel 75,000 shares at the beginning of September. The board says that the discount had widened beyond the level that it considers the shares should trade at.

Fund profile

Significant investors in Russia

You can access the fund's website at

www.jpmorganrussian.co.uk

JPMAM is one of the world's largest asset managers. It has \$1.1bn invested in Russia through dedicated funds (including JRS) and around three times as much as this invested through regional and 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 1994 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. In March 2017, shareholders voted to approve the continuation of the company for a further five years.

Blended benchmark

JRS switched its benchmark from MSCI Russia 10/40 Index to the RTS Index with effect from 1 November 2016. We have used a blend of the two indices 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 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.

Freedom to perform

With the comfort of a closed-end structure, the freedom to invest outside Russia and to hold stocks that are not constituents of the main Russian indices, the manager has the ability to make long-term stock selection decisions (turnover is typically 25%-35% per annum) and produce returns that are differentiated from index benchmarks.

Previous research

We published an initiation note on JRS on 9 March 2017 – [Russian recovery](#) – this goes into the workings of JRS in some detail. We have reproduced the contents page of that note below.

Contents

3	Why Russia
3	Fund profile
4	Blended benchmark

4	Manager's view
4	Investment process
5	Risk control
5	Investment universe has been shrinking
6	Asset allocation
6	Industry sector breakdown
6	Top 10 holdings
7	Sberbank
7	Gazprom
7	Lukoil
7	Novatek
7	Magnit
8	Rosneft
8	Ros Agro
8	Portfolio characteristics
9	Performance
10	Dividend
11	Discount
11	Fees and costs
12	Capital structure and life
12	Five yearly continuation vote
12	Plan to offer tender in five years
13	Board

Authorised and regulated by the Financial Conduct Authority

123a Kings Road, London SW3 4PL

0203 691 9430

www.martenandco.com

Registered in England & Wales number 07981621,

2nd Floor Heathmans House

19 Heathmans Road, London SW6 4TJ

Investment company sales:

Edward Marten
(em@martenandco.com)

Christopher Bunstead
(cb@martenandco.com)

Investment company research:

James Carthew
(jc@martenandco.com)

Matthew Read
(mr@martenandco.com)

IMPORTANT INFORMATION

This marketing communication has been prepared for JPMorgan Russian Securities by Marten & Co (which is authorised and regulated by the Financial Conduct Authority) and is non-independent research as defined under the Financial Services Act 2000 (Financial Promotion) Order 2005. It is intended for use by investment professionals as defined in article 19 (5) of that Order. Marten & Co is not authorised to give advice to retail clients and, if you are not a professional investor, or in any other way are prohibited or restricted from receiving this.

information you should disregard it. The research does not have regard to the specific investment objectives, financial situation and needs of any specific person who may receive it.

The research has not been prepared in accordance with legal requirements designed to promote the independence of investment research and as such is considered to be a marketing communication. The analysts who prepared this research are not constrained from dealing ahead of it but, in practice and in

accordance with our internal code of good conduct, will refrain from doing so. Nevertheless, they may have an interest in any of the securities mentioned in this research.

This note has been compiled from publicly available information. This note is not directed at any person in any jurisdiction where (by reason of that person's nationality, residence or otherwise) the publication or availability of this note is prohibited.

Accuracy of Content: Whilst Marten & Co uses reasonable efforts to obtain information from sources which we believe to be reliable and to ensure that the information in this note is up to date and accurate, we make no representation or warranty that the information contained in this note is accurate, reliable or complete. The information contained in this note is provided by Marten & Co for personal use and information purposes generally. You are solely liable for any use you may make of this information. The information is inherently subject to change without notice and may become outdated. You, therefore, should verify any information obtained from this note before you use it.

Investment Performance Information: Please remember that past performance is not necessarily a guide to the future and that the value of shares and the income from them can go down as well as up. Exchange rates may also cause the value of underlying overseas investments to go down as well as up. Marten & Co may write on companies that use gearing in a number of forms that can increase volatility and, in some cases, to a complete loss of an investment.

No Advice: Nothing contained in this note constitutes or should be construed to constitute investment, legal, tax or other advice.

No Representation or Warranty: No representation, warranty or guarantee of any kind, express or implied is given by Marten & Co in respect of any information contained on this note.

Exclusion of Liability: To the fullest extent allowed by law, Marten & Co shall not be liable for any direct or indirect losses, damages, costs or expenses incurred or suffered by you arising out of or in connection with the access to, use of or reliance on any information contained on this note. In no circumstance shall Marten & Co and its employees have any liability for consequential or special damages.

Governing Law and Jurisdiction: These terms and conditions and all matters connected with them, are governed by the laws of England and Wales and shall be subject to the exclusive jurisdiction of the English courts. If you access this note from outside the UK, you are responsible for ensuring compliance with any local laws relating to access.

No information contained in this note shall form the basis of, or be relied upon in connection with, any offer or commitment whatsoever in any jurisdiction.
