



"Gap risk is difficult to account for in any sensible investment framework"

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Mind the Gap

by Mark Wright, CFA

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

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

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

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

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

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

Maybe the best option is to simply exclude countries, such as Russia, from one's investable universe, accepting that it is simply not possible to value the assets of companies in those countries. At Momentum Global Investment Management (MGIM), we do not claim to be specialists in emerging markets, instead entrusting our clients hard earned savings with specialist global emerging market managers.

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

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

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

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

Market Focus

- » **Global equities declined -1.9% last week**
- » **The Russian invasion continues with 2.5M Ukrainians having fled the country**
- » **Brent crude fell -4.6% to 118.11 a barrel, and the USA banned oil imports from Russia**
- » **Gold gained +0.9% to \$1970.7 per ounce**

US



- » US equities fell -2.9% last week. Energy, oil, and gas outperformed; industrial and financial sectors underperformed.
- » US Treasuries fell -1.6% last week.
- » The Senate approved \$13.6B in aid for Ukraine as part of their spending bill.
- » Weekly jobless claims of 227k came in higher than estimated (217k).

Rest of the World/Asia

- » The benchmark Global Emerging Markets index fell -3.8% last week.
- » Chinese equities fell -9.2% last week. The government locked down the city of Shenzhen, home to some of its biggest tech businesses and more than 17M people due to Covid-19 concerns.
- » Japan's equities fell -2.5% last week. Q4 2021 GDP 1.1% was lower than expectations (1.4%).
- » EM dollar bonds are starting to look attractive. The extra yield offered by developing-nation sovereign debt over Treasuries has risen above 500bps, crossing a threshold breached only two other times in more than a decade.
- » Russia has lost access to almost half of its \$640B in foreign reserves and sees more risks due to increased pressure on China. The Bank of Russia extended a halt on stock trading on the Moscow Exchange until at least the end of this week. The local equity market has been closed since 25th February.

Europe



- » European equities rallied +2.6% last week, with Banks and Travel outperforming, whilst Food, Beverages and Personal Household sectors declined.
- » Russian fighting continued on the outskirts of Kyiv but also moved towards the Polish border over the weekend. The EU is discussing sanctions on prominent Russians.
- » PE ratios of Europe's top 600 equities are at a 30% discount to the USA Tech 500, the steepest gap since 2005.
- » Goldman Sachs cut Europe's earning growth forecast to 2% from 8% for the year, citing rising energy bills, weaker consumption, supply chain issues, shipping costs and potential gas shortages.



UK

- » UK equities rallied +2.7% last week.
- » UK gilts fell -3.3% last week.
- » February GDP year-on-year 10% stronger (vs 9.3% estimate). Manufacturing production for January was 0.8% stronger (vs 0.2% estimate).
- » Nickel short squeeze caused a price spike to over \$100k a tonne putting the LME in turmoil not seen since the Tin Crisis of 1985.

Market Summary

Cumulative returns					
Asset Class / Region	Currency	Week ending 11 March	Month to date	YTD 2022	12 months
Developed Markets Equities					
United States	USD	-2.9%	-4.1%	-11.6%	7.8%
United Kingdom	GBP	2.7%	-3.7%	-0.8%	12.8%
Continental Europe	EUR	2.6%	-5.2%	-13.4%	1.8%
Japan	JPY	-2.5%	-4.1%	-9.6%	-4.5%
Asia Pacific (ex Japan)	USD	-3.8%	-5.5%	-10.6%	-17.9%
Australia	AUD	-0.4%	1.5%	-3.8%	9.5%
Global	USD	-1.9%	-4.6%	-11.9%	2.6%
Emerging Markets Equities					
Emerging Europe	USD	-47.7%	-62.1%	-73.6%	-71.3%
Emerging Asia	USD	-4.8%	-7.1%	-12.8%	-21.8%
Emerging Latin America	USD	-0.8%	1.7%	13.6%	9.4%
BRICs	USD	-8.3%	-12.6%	-18.9%	-31.5%
China	USD	-9.2%	-13.2%	-19.2%	-40.3%
MENA countries	USD	-0.3%	3.8%	11.2%	32.6%
South Africa	USD	2.8%	3.7%	14.5%	3.7%
India	USD	2.0%	-2.2%	-6.7%	5.3%
Global emerging markets	USD	-5.1%	-7.3%	-11.7%	-18.3%
Bonds					
US Treasuries	USD	-1.6%	-0.5%	-3.6%	-2.4%
US Treasuries (inflation protected)	USD	0.6%	3.2%	-0.1%	7.5%
US Corporate (investment grade)	USD	-2.7%	-1.9%	-8.0%	-4.8%
US High Yield	USD	-1.5%	-1.7%	-5.5%	-1.2%
UK Gilts	GBP	-3.3%	-0.9%	-6.6%	-5.6%
UK Corporate (investment grade)	GBP	-2.6%	-1.2%	-7.0%	-6.4%
Euro Government Bonds	EUR	-2.5%	-0.4%	-3.7%	-5.3%
Euro Corporate (investment grade)	EUR	-2.1%	-0.8%	-4.8%	-5.1%
Euro High Yield	EUR	-0.9%	-1.2%	-5.3%	-3.4%
Japanese Government	JPY	-0.3%	0.3%	-1.3%	-1.0%
Australian Government	AUD	-1.5%	-1.0%	-4.0%	-3.9%
Global Government Bonds	USD	-2.0%	-1.3%	-4.7%	-7.0%
Global Bonds	USD	-1.9%	-1.6%	-5.7%	-7.7%
Global Convertible Bonds	USD	-2.6%	-3.7%	-9.9%	-14.9%
Emerging Market Bonds	USD	-0.4%	-7.8%	-17.5%	-16.0%

Source: Bloomberg Finance L.P. Past performance is not indicative of future returns.

Market Summary

Cumulative returns					
Asset Class / Region	Currency	Week ending 11 March	Month to date	YTD 2022	12 months
Property					
US Property Securities	USD	-1.5%	-0.4%	-8.8%	20.5%
Australian Property Securities	AUD	-0.5%	-2.3%	-11.7%	14.0%
Asia Property Securities	USD	-2.3%	-3.1%	-3.6%	-11.9%
Global Property Securities	USD	-0.8%	-1.4%	-7.9%	8.4%
Currencies					
Euro	USD	-0.1%	-2.9%	-4.1%	-8.8%
UK Pound Sterling	USD	-1.4%	-2.5%	-3.6%	-6.6%
Japanese Yen	USD	-2.1%	-1.2%	-1.9%	-7.4%
Australian Dollar	USD	-1.0%	1.3%	0.3%	-6.1%
South African Rand	USD	1.4%	0.8%	5.7%	-1.6%
Swiss Franc	USD	-1.7%	-0.7%	-2.4%	-0.9%
Chinese Yuan	USD	-0.3%	-0.3%	0.3%	2.4%
Commodities & Alternatives					
Commodities	USD	-2.5%	12.1%	28.3%	55.5%
Agricultural Commodities	USD	-0.4%	9.1%	17.4%	44.2%
Oil	USD	-4.6%	15.1%	44.9%	61.8%
Gold	USD	0.9%	5.2%	8.7%	15.4%
Hedge funds	USD	-0.2%	-0.9%	-2.4%	-0.5%

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