The Mutual Fund Industry in Russia: Beyond the Stage of Initial Growth

Poor financial education and a limited number of stocks are holding back the industry's development

Alexei Goriaev

Russian mutual funds date back to 1996, but it was only in the 2000s, with the recovery of the Russian stock market from the 1998 crisis, that these funds were given a major boost. High returns on Russian stocks — on average, over 40% a year after 1998 — contributed to the rapid expansion of the industry. While in 2001 there were 35 management companies offering 55 funds, at the end of 2006 investors could choose from among 587 funds and 282 management companies. During the same period, the assets under management increased from US$30 million to US$16 billion, or 0.5% of Russian GDP (for comparison, in the US this ratio is about 70%). Thus, the mutual fund industry demonstrates an impressive rate of growth, but still accounts for only a small segment of the Russian financial market.

What Restrains Growth?

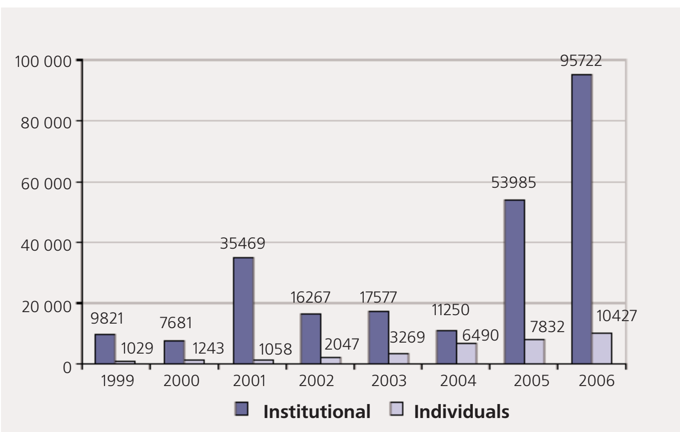
What is holding back the development of the asset management industry in Russia? One reason is the poor state of financial education in the country. During Soviet times, knowledge about financial investment was considered to be part of a market economy that was irrelevant in a country where the state assumed major risks connected with wages and pensions.

A lack of organizational failures and impressive yields since 1998 helped to attract new private investors to mutual funds, yet even now they account for a mere 2% of Russia's population — its most dynamic and educated groups. Oddly enough, the numerous slumps in the Russian stock market have played a positive role disabusing investors of the notion that easy money can be made through mutual funds and making them more risk-conscious.

Another restraining factor is that the Russian equity market is not highly developed. In spite of the impressive dynamics, a limited number of stocks is regularly traded, with the bulk of liquidity coming from a few blue chips like Gazprom and RAO UES. Moreover, liquid stocks are concentrated in several sectors of the economy, mainly extraction industries. As a result, mutual funds can hardly form a truly diversified portfolio and their returns are largely determined by Russia's country risk and other factors that are hard to quantify. Until recently, legislation effectively banned Russian funds from including foreign assets and derivatives in their portfolios.

At the end of 2006 only 23% of the Russian mutual funds were of the open type; that is, marking their price to the market daily. The remaining funds invest a large part of their portfolio into second-tier stocks, real estate and other illiquid assets. The choice of strategies is also limited: large funds usually hold a portfolio close to the market index whereas small ones actively rebalance their portfolios trying to time the market. In recent years, we have seen many index and sector funds emerging, but their portfolios may turn out to be very different from what their names suggest.

Investors in Russian Mutual Funds



Qualified Assessment Needed

In the current environment, it is very important to have a qualified independent assessment of the performance of mutual funds, which would guide investors and give funds proper incentives for composing their portfolios. In the developed financial markets such assessment is provided by rating agencies, which divide funds into categories in line with their actual (not formally declared) investment strategy and rate them relative to other funds in the same category. A fund's performance should be adjusted for risk, since funds can easily outperform the market index with an aggressive strategy when the market is growing.

Unfortunately, until now Russia has had no fund rating system meeting these requirements. The mutual funds are usually divided into three broad categories: equity, bond and mixed funds, even though such a breakdown does not adequately reflect the investment risks. As a rule, funds are rated according to raw returns, or at best according to the Sharpe ratio (i.e. return per unit of total risk) or Jensen's alpha (i.e. the component of a fund's return unrelated to the market index). However, given the specifics of the Russian financial market, these measures do not always reflect the true added value that a fund provides to investors. A new classification and rating system is needed to evaluate the performance of Russian funds properly.

Alexei Goriaev is an Assistant Professor at New Economic School and Senior Researcher at CEFIR, Moscow. The article is based on the results of the author's research on mutual funds. The author has participated in the development of a new rating system of open-end mutual funds in Russia in collaboration with the National League of Managers and the Expert-RA Rating Agency. **BT**