March 4, 2022

Perspective on Ukraine and Russia

In under a month, Russia's saber rattling and threats to Ukraine's sovereignty have degenerated into a grim and deadly reality. It has also left investors with large losses on Russian and Ukrainian security holdings. Rising chances of a broadening and sustained conflict in Eastern Europe have hit share prices around the world, while the sanctions imposed by Western governments have indirectly hit share prices of Western banks as the risks of counterparty failures and other unintended consequences have risen.

Two of our strategies have sustained losses from holdings of Russian companies: our Emerging Markets (EM) strategy started February with more than 8% invested in Russia, while our International strategy held more than 2%—in each case, more than double the weight of the respective benchmark index.

Although our International Small Companies strategy sold its lone Ukrainian company in late January, our EM and International portfolio managers have, thus far, taken no action to alter our Russian holdings, now much reduced in value after steep market declines for all Russian shares. We are averse to knee-jerk reaction to market shocks, a habit developed since the founding of our firm in March 1989 across many such shocks, beginning with the fall of the Berlin Wall in November of that year followed by the Iraqi invasion of Kuwait and the US-led response in the first Gulf War of 1990-91—the first one a positive shock and the other a negative. In both cases, one's initial—emotional—response to the situation (such as embracing either "OstPhantasie" or Canadian oil stocks) would have been a poor long-term choice, and a more deliberate mode of decision-making proved the sounder course.

Daniel Kahneman fleshed out these two modes of making decisions in his book *Thinking, Fast and Slow* about flawed human reasoning. On average through many market shocks, our preference for slower, more deliberate thinking has proven beneficial, but resisting reflexive actions won't always be the correct choice. Our decisions to sit pat on Russia this time looks to be one of the instances where an instinctive, rapid reaction to President Biden's warning, in hindsight, would have been better, as markets became disorderly when the scope of the invasion became clear. Still, the damage to portfolios has been tempered by some long-term thinking. Our insistence on portfolio diversification, with risk guidelines limiting maximum country and region exposures, means that our holdings in Russia will not swamp the entire portfolio, even as performance suffers. Our mistrust of antiquated settlement and trading structures in Moscow caused us to prefer the more open and efficient markets of ADR and GDR secondary listings for our Russian holdings, which disappointingly has not allowed us to sidestep security marketability issues, as US and European banking sanctions have effectively halted trading in depositary receipts of Russian companies, but may offer respite from Russian restrictions should Western banking sanctions be fine-tuned.

It's worth examining why we've continued to hold investments in Russian companies at all over the years. After all, we once owned Yukos, a Russian oil company built up in the chaos of the collapsing Soviet Union, only to see it dismembered a decade later by Mr. Putin and his oligarch allies. Our view remained that, while a grasping and ruthless government posed extra risks, companies able to navigate those political risks and build sound, growing businesses delivering products or services that their customers valued highly could generate strong business returns. Due to fears of extra Russian risks, they also traded at discount valuations which could lead to very strong stock market returns for intrepid investors. The political risks were always present but bore almost no correlation to other risks faced in our portfolios. Hence, portfolio managers of some of our strategies included these holdings in their portfolios even as their colleagues helming other portfolios were unprepared to accept the political or governance risks, especially if Russia was a small part of their benchmark.

That diversity of attitudes towards the risk of heavy-handed interference was sharpened following China's regulatory crackdown over the past 18 months which delivered a painful reminder that every company anywhere in the world is vulnerable, to varying degrees, to abrupt shifts in government priorities. Moreover, as portfolio managers began to anticipate the aftereffects of massive monetary and fiscal stimulus on the global economy, the role of Russia's natural resources as an inflation hedge also factored into some PMs' favorable view.

Nevertheless, the naked aggression was unexpected by most of us, even after Russia's incursions into Georgia and Crimea several years ago. We certainly contemplated further encroachment gambits and bullying by Putin's Russia against its neighbors, but had assumed a more calculated, incremental approach that would not spark a united and robust response from the West, and not imperil the business activities of the companies we own. The current invasion appears to be galvanizing previously divided allies, seemingly shamed into action by the courageous resistance of the Ukrainians themselves.

With the imposition of sanctions that exclude much of the Russian economy from the international financial system, the business risks to Russian companies have risen. While we still do not expect outright Western bans on ownership of all Russian stocks, we are paying very close attention to developments. More importantly, depending on how the application of sanctions evolve, we are trying to think deliberately about the Russian businesses we own, and what they might look like in the future, relative to the low prices their shares may command should they resume trading.

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This perspective has been updated to reflect changing circumstances since its original publication on February 28, 2022. Read the original version.

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