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Foreign Investors in Russia Vital to Sanctions Debate

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As the United States and Europe move to punish Russia for its conduct in Ukraine and Crimea with official sanctions, a subtle approach could prove more powerful: pressuring large global investors to reduce their sizable holdings in Russia.

Since central banks began injecting enormous amounts of cash into the worldwide economy in 2009, more than a quarter of a trillion dollars has flowed into the coffers of Russia Inc., part of a broad push by yield-hungry investors into emerging markets.

Most has found its way to companies controlled by the state. Gazprom, the Russian energy giant at the heart of the evolving dispute with the West, counts the American mutual fund giants Pimco and BlackRock among its largest investors and creditors.

But some analysts and economists are pushing for an end to this easy money, a move that would choke off critical funds.

Officials are not likely to take such a major step soon — or ever. Governments are loath to interfere with the free flow of capital; the Obama administration has urged caution in pushing measures that might upset fragile markets. And institutions, with a penchant for profit, generally do not like such restrictions.

Mutual funds and other institutions may, however, feel pressure behind the scenes. As issues of sovereign and corporate governance come into focus, financial specialists note that investors could take it upon themselves to reassess or reduce their exposure.

"I think you will begin to see some pressure put on institutional investors to take a more careful look at their Russian investments," said Eswar S. Prasad, an economist at Cornell who has written books about how emerging economies function within the global financial system. "But this is uncharted territory: The cost of these actions becomes unpredictable given Russia's size and importance."

The money at stake is significant. Russia, along with large emerging economies like China and Brazil, has been a prime beneficiary of a global bond market frenzy stemming from aggressive bond-buying programs of global central banks.

Over the last four years, big investors have sunk $325 billion into stocks and bonds issued by Russian companies and the country's government, according to the research firm Thomson Reuters. Of that, $235 billion has been directed toward corporate borrowings by the likes of Gazprom and state-owned banks like Sberbank.

Demand has been so strong that Pimco, the world's largest bond manager, introduced a socially responsible emerging market bond fund in 2010. According to its prospectus, the fund looks to invest in companies that are reducing governance risks. It also reserves the right to steer clear of the bonds of countries that are listed at the bottom of the World Bank's corruption indicator or are subject to sanctions by the United Nations.

Russia appears to fit those parameters. According to the World Bank, the country's score in its corruption index for 2012 was 16, just ahead of countries like Azerbaijan and Rwanda. And U.N. sanctions, at least, seem far off.

The question is whether the changing geopolitical situation will alter the calculus. Gazprom, for one, functions more or less as an arm of the Russian government.

Russia is a significant focus for the fund. As of the end of 2013, Russian corporate and government bonds accounted for 31 percent of the fund's $292 million in assets, nearly three times the weight in its benchmark, a JPMorgan emerging-market bond index.

Pimco declined to comment.

Investors broadly have remained sanguine about Russia, even though problems in the emerging markets began cropping up last summer. The exposure that sophisticated investors had to Russia has been largely unchanged over the last year at around $86 billion, according to Evestment, which tracks institutional investment flows.

But some are starting to sound the alarm. John-Paul Smith, an equity strategist at Deutsche Bank in London, is among the most vocal.

In 2011, Mr. Smith published a report that criticized the heavy hand deployed by the Kremlin when it came to using the energy giant Gazprom and government-controlled banks such as Sberbank, one of the largest banks in Europe, to further its policy aims. No other government in emerging markets engaged in as much corporate meddling as Russia did, he said.

Last week, he went one step further, saying that Russia, in light of its continued governance failures and the situation in Ukraine, should be removed from the global equity indexes that investors closely track.

In a world where billions of dollars flow automatically into countries and companies based on their size in an investment index, such a move would have a stark effect, prompting investors to sell and removing a

crucial source of funding for Russia's top companies. Billions of dollars are in index and exchange-traded funds that, by mandate, must follow specific country weightings.

For example, Russia's weighting in the MSCI emerging-markets index, a widely used benchmark, is 4.9 percent, just behind larger markets such as China, Korea and Brazil. That means a global investor whose performance is measured against this index is encouraged to invest at least this amount in Russia.

Bond market investors face even more pressure to invest in Russia. As of the end of last year, JPMorgan Chase's emerging market corporate bond index had a 7.6 percent weighting for Russia, the largest for any country in the index.

"We need to bring governance risk into the equation," said Mr. Smith, who argues that given their large size, Russian companies attract large sums of money from less-than-sophisticated equity investors.

"Gazprom and Sberbank are being used to further Russia's geopolitical objectives," he added. "These are just not suitable investments."

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