Realinsights

The Russian Invasion of Ukraine: Sanctions, Market Closures and Their Impact on Indices and Portfolios

Realindex Team

March 2022

For Institutional and Adviser Use Only

Note: The Russian-Ukraine conflict has created significant turmoil in financial markets, and significant changes happen daily (or even hourly). We have written this note to do our best to communicate to clients what we believe to be important issues around what has happened and what we plan to do. At the time of writing (8th March 2022), we believe the information here to be right, but of course change can and probably will happen swiftly.

Overview

On the 24th of February 2022, Russia invaded Ukraine. This has led to numerous sanctions being imposed upon the Russian regime by the international community. Sanctions are typically issued by governments targeting individuals, corporations or governments in order to force their compliance with laws, condemnation of actions or threats to peace. Sanctions usually take a diplomatic or economic form and aim to provide incentive for the target to change their course of action. Previous forms of sanctions include the US Government sanctioning Chinese military companies in response to perceived national security threats[1], and the European Union sanctioning individuals from Russia, Myanmar and Syria in response to terrorism and human rights infringements in those countries[2].

The current round of Russian sanctions have primarily focused on damaging the Russian economy through asset freezes and restricting Russian access to the global banking system. The imposition of these sanctions have led to:

- Restrictions on the financing of Russian projects and withdrawal of foreign capital
- Increased costs of doing business in Russia due to the expulsion of several Russian banks from SWIFT, Mastercard and Visa payment networks[3]
- Numerous corporations withdrawing their business operations from Russia
- Freezing of overseas assets owned by Russians

1 https://home.treasury.gov/system/files/126/13959.pdf
2 EU imposes Russia, Myanmar, Syria & terrorism sanctions - EU Sanctions (europeansanctions.com)
3 Visa and Mastercard suspend Russian operations - BBC News

- Restrictions on trade conducted with Russia
- Halting of the Nord Stream 2 gas pipeline

On top of government sanctions, we have also witnessed companies behaving proactively. For instance, Shell, ExxonMobil and BP have all announced their divestment and exit from all Russian oil and gas assets[4].

Although existing sanctions have targeted a significant proportion of the Russian economy, they have largely avoided the energy sector due to Europe's dependency on Russian supplies. There is still the possibility of future sanctions that target the oil and gas trade from Russia which would have a significant impact on global oil prices and a very direct effect on the Russian economy[5].

Closure of Russian Markets

The impact of the sanctions have led to the Moscow Stock Exchange (MOEX[6]) index, the primary Ruble-dominated benchmark for the largest 50 and most liquid Russian stocks[7], crashing 39% on the 24th of February 2022[8] before being suspended on the 25th. This has been compounded with the sharp devaluation of the Russian Ruble, declining by 23% from Friday the 25th to Monday the 28th of February. On Friday 4th March 2022, the Ruble was trading at 0.011 against the AUD, down from 0.018 two weeks earlier[9].

The closure of the Moscow Exchange has created issues in reducing portfolio exposure to Russian stocks. Furthermore once the exchange reopens, the Russian Central Bank has issued instructions to Russian brokers to restrict the sale of Russian securities by foreign investors[10]. American Depositary Receipts (ADRs) and Global Depositary Receipts (GDRs) are shares that represent holdings for companies that are domiciled overseas, which are also being impacted by the Russian situation. On the 3rd and 4th of March, the London Stock Exchange has also suspended the trading of 28 Russian GDRs on their exchange[11] further amplifying the difficulty in trading Russian assets. Similarly, NYSE and NASDAQ have also halted any trading for securities domiciled in Russia on the 28th of February[12], which has made it virtually impossible to adjust any positioning in Russian shares. Further, the restrictions imposed by preventing SWIFT transactions makes it immensely difficult to settle trades at a fair and transparent price for Russian securities.

A list of Russian securities - which includes common stock listed on MOEX and ADRs/GDRS listed on the LSE and NYSE - appears in Appendix 1. All are in trading halt at the time of writing.

---

4 Shell to sell Russian investments due to Ukraine conflict - BBC News
5 U.S. weighs sanctions on Russia energy flows, but time is not 'right now' | Reuters
6 Formed in 2011 with the merger of the Moscow Interbank Currency Exchange (MICEX) and the Russian Trading System (RTS)
7 https://tradingeconomics.com/russia/stock-market
8 Russian stocks crash and Ruble plunges to record low - CNN
9 https://www.currency.me.uk/convert/aud/rub
10 Russia's Central Bank Closed Its Stock Market, Blocking Foreign Sales (businessinsider.com)
11 London Stock Exchange suspends trading in several GDRs of Russian firms, Stocks - THE BUSINESS TIMES
12 https://www.reuters.com/business/nyse-nasdaq-halt-trading-stocks-russia-based-companies-2022-02-28/

Russia announced on March 2nd that they plan to spend up to $10 billion Rubles to purchase local stocks in an attempt to support the valuation of Russian securities. Although this will assist in improving the liquidity of the Russian equities, the valuation would still be significantly impacted by the possible withdrawal of investor capital once the exchange opens.

What are the Index Providers doing?

The closure of Russian markets has created the need to understand the underlying methodology of Index Providers to ensure that the benchmark accurately reflects public information. This is particularly important for companies that have multiple listings; for example, where a Russian domiciled security isn't trading while a secondary listing (e.g., an ADR) is still being traded. Index providers, typically, only use the primary listing of the security to determine their benchmark weight which may be problematic due to the dispersion of prices between their listings since the Moscow Exchange closed on the 25th.

MSCI

MSCI indices are calculated using the last transacted prices from the exchange. In the event of market closure, MSCI will bring forward the last transacted security price to calculate their indices[13]. This is problematic as there will be a dispersion of performance between the secondary listing, which is not reflected on the index, and the primary listing, which has been closed.

MSCI announced on the 24th of February (just prior to the February quarterly index review) that due to the recent US sanctions and market feedback regarding the investability and replicability of the MSCI Russia indices, the previously announced rebalance changes to 3 Russian securities with an increase in the number of shares would not go ahead. This would keep the Russian securities at their current weights at the rebalance.

After trading on the MOEX was suspended MSCI sought feedback from market participants. This resulted in the announced on the 3rd of March that as a result of the Russian market being "uninvestable" they would downgrade Russia to a 'standalone' market which would lead to the deletion of all Russian securities from the MSCI EM index and the MSCI ACWI indices on the 9th of March[14]. *MSCI will price Russian securities at zero value following the downgrade.*

MSCI perform an annual global market classification review[15] each June – where countries can be promoted or demoted from their indices in a subsequent rebalance. We anticipate that it could be 18+ months before Russia could become eligible for inclusion back into the MSCI EM index. Argentina was the last market to be demoted from EM to standalone in November 2021 due to the prolonged severity of capital controls.

---

[13] https://www.msci.com/eqb/methodology/meth_docs/MSCI_IndexCalcMethodology_Feb2022.pdf

[14] https://www.bloomberg.com/news/articles/2022-03-02/msci-pulls-russian-equities-out-of-its-key-emerging-market-index

[15] https://www.msci.com/our-solutions/indexes/market-classification

S&P

S&P Indices are calculated using the most recent transacted price for the security. In the event of a suspension, S&P will use the last available closing price for the security for up to 60 business days before they get reviewed for possible index deletion[16]. This poses a similar problem to MSCI indices as the prices reflect their primary listing which has been suspended. S&P announced on March 4th that they will also be removing Russia from their indices and downgrading their market status to 'standalone' on the 9th of March[17]. S&P will then re-evaluate Russia's country classification as part of their S&P DJI Country Classification annual review.

FTSE

FTSE Indices are calculated using the official closing price of the security from the exchange. In the event of a suspension, FTSE will use the last available closing price for up to 20 local business days, before they are reviewed for index deletion[18] - creating issues with the pricing of the indices. However, FTSE may also include depositary receipts from secondary listings, which are currently able to be freely traded. On the 3rd of March, FTSE also announced that Russia would be classified as an "Unclassified" market within the FTSE Equity country classification scheme. This will result in the deletion of all Russia securities at a zero value from the FTSE Emerging and All World indices on the 7th of March[19]. The status of the market will be re-evaluated as part of the FTSE Equity Country Classification process.

IMPACT

The expulsion of Russian securities from indices would force market participants that use these indices as a benchmark to reduce their exposure to Russia. However, this would be difficult to implement due to Russia restricting the sale of securities by foreign investors.

Russia had 26 stocks representing a weight of 1.5% on the MSCI EM index and 26 stocks representing a weight of 0.18% on the MSCI ACWI index as of the 3rd of March 2022. Russian stocks comprised 1.7% of the FTSE Emerging Index and 0.19% on the FTSE All World Index. The removal of Russia from these indices would lead to other countries benefiting from inflows from an increased weighting on the index. In particular, China, Taiwan and India stand to benefit the most from the increase in their weighting on the MSCI EM Index with an increase of 45 bps, 25 bps and 19 bps respectively.

---

16 https://www.spglobal.com/spdji/en/documents/methodologies/methodology-sp-equity-indices-policies-practices.pdf

17 S&P Dow Jones will remove all Russia stocks from its indices - CBS News

18 https://research.ftserussell.com/products/downloads/FTSE_Russell_Index_Policy_in_the_Event_Clients_are_Unable_to_Trade_a_Market.pdf

19 https://research.ftserussell.com/products/index-notices/home/getnotice/?id=2603553

Name	Current Weight	Proforma Weight
China	29.63%	30.08%
Taiwan	15.97%	16.22%
South Korea	12.25%	12.44%
India	12.20%	12.39%
Brazil	5.14%	5.22%

Table 1 - Expected MSCI EM Weights after deletion - Source UBS / MSCI

Name	Current Weight	Proforma Weight
China	32.22%	32.78%
Taiwan	18.05%	18.36%
India	14.81%	15.07%
Brazil	6.52%	6.63%
Saudi Arabia	4.54%	4.62%

Table 2 - Expected FTSE EM Weights after deletion - Source UBS / MSCI

However, prior to markets closing, there was not expected to be any immediate effect on index fund related flows as *both* the indices and index tracking funds would be recognising the deletion by ascribing Russian stocks a zero weighting[20]. Other flows – from non-index tracking funds or other sources – might have arisen due to this write down. However, the current inability to trade Russian securities prevents any existing holdings from being exited until the market reopens, and there is no clarity on when that might be.

Recent Performance Summary

The impact of Russia's invasion of Ukraine has caused a significant decline in Russian equities totalling -54.12% at the end of February in Australian dollars. The majority of this decline occurred during the last 2 weeks of the month, when Russia started invading Ukraine.

Index	1 Month Performance AUD (as of 28/02/2022)
MSCI EM	-5.81%
MSCI ACWI	-5.42%
MSCI Russia	-54.12%

Table 3 - Performance Summary – Source Realindex / FactSet

[20] Russia: Exclusion from Indices - Research - J.P. Morgan Markets (jpmorgan.com)

Similarly, the MSCI EM index and MSCI ACWI index also suffered a drawdown due to their exposure to Russian securities within their indices. However, the decline in these 2 indices do not fully reflect the actual price changes, due to the MSCI methodology in using the last available transacted price as the Moscow Exchange was closed on the 28th of February. Therefore, the official performance will not accurately reflect the actual performance which will be elaborated on in the following section.

Russian GDR vs Local Pricing Impact

Realindex has performed some analysis on the dispersion of performance if the MSCI EM was calculated using depository receipt pricing over the suspended primary listings in Russia as depicted in Figure 1.

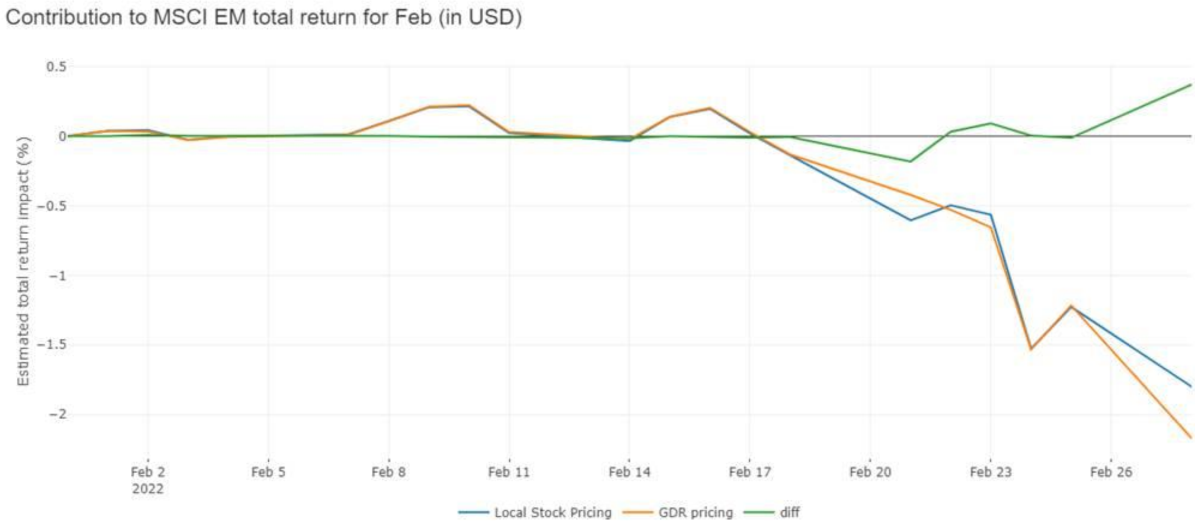

Figure 1 - Performance difference between local pricing and GDR pricing

Although, the decline in the Ruble has accommodated some of the drop in the value of Russian securities, a significant proportion of return has not been reflected in the index due to MSCI relying on the last transacted price of the primary exchange, as shown in Table 3 and 4.

Table 3 and 4 highlights the impact of the pricing difference between local and foreign listings which would have totalled 37 bps of performance for the MSCI EM index during February. Furthermore, due to the closure of the Russian market since the 28th of February, the difference in pricing would have been further amplified which would have created an additional drag on MSCI EM performance.

Ticker	Company Name	Industry	MSCI EM Jan 31 Weighting (bps)	Feb Return, Local Listing (USD %)	Feb Contribution, Local Listings (bps)
GAZP-RU	Gazprom PJSC	Energy	65.7	-51	-33.39
SBER-RU	Sberbank Russia PJSC	Banks	47.9	-64	-30.81
LKOH-RU	Oil company Lukoil PJSC	Energy	47.6	-48	-23.03
NVTK-GB	Novatek JSC	Energy	24.8	-82	-20.28
GMKN-RU	MMC Norilsk Nickel PJSC	Materials	23.0	-37	-8.57
YNDX-RU	Yandex NV Class A	Media & Entertainment	18.8	-62	-11.61
TATN-RU	TATNEFT PJSC	Energy	11.8	-49	-5.76
ROSN-RU	Rosneft Oil Co.	Energy	11.2	-61	-6.88
TCSG-RU	TCS Group Holding Plc	Banks	11.1	-56	-6.15
PLZL-RU	Polyus PJSC	Materials	6.9	-37	-2.57

Table 3 - Top 10 Russian Exposures Local Return. Note: Novatek is a GDR
Source: MSCI / FactSet / Realindex as at 2/3/2022

Ticker	ADR Company Name	ADR currency	Feb Return, GDR Listing (USD %)	Feb Contribution, GDR Listing (bps)
GAZP-RU	Gazprom PJSC Sponsored ADR	USD	-69	-45.53
SBER-RU	Sberbank Russia PJSC Pref.	RUB	-62	-29.85
LKOH-RU	Oil company LUKOIL PJSC Sponsored ADR	USD	-73	-34.72
NVTK-GB	Novatek JSC Sponsored GDR RegS		-82	-20.28
GMKN-RU	MMC Norilsk Nickel PJSC ADR	USD	-51	-11.77
YNDX-RU	Yandex NV Class A	USD	-61	-11.38
TATN-RU	TATNEFT PJSC Sponsored ADR	USD	-64	-7.54
ROSN-RU	Rosneft Oil Co. Sponsored GDR RegS	USD	-64	-7.12
TCSG-RU	TCS Group Holding Plc Sponsored GDR Class A RegS	USD	-86	-9.56
PLZL-RU	Polyus PJSC Sponsored GDR Class S	USD	-31	-2.15

Table 4 - Top 10 Russian Exposures GDR Return. Note: Novatek is a GDR
Source: MSCI / FactSet / Realindex as at 2/3/2022

Australian superfunds planned divestment of Russian Assets

On the 3rd of March, the Australian Government released a statement outlining their expectation of super funds to fully divest any Russian assets[21]. This is estimated to be over $1 billion AUD with Russian assets comprising 0.03% of the superannuation sector. The largest holdings are held by Australian Super having holdings worth $180 million AUD[22], Australian Retirement Trust, formerly QSuper and Sunsuper, holding $130 million AUD of Russian assets[23] and the Australian Future Fund's holdings totalling $200 million AUD[24]. However, the divestment will be particularly difficult with the Russian Central Bank restricting the sale of securities by foreign investors and most Russian assets being suspended from trading.

What is Realindex doing?

In the lead up to the invasion and events of the 24th February, due to the increased uncertainty and risk facing Russia, Realindex pre-emptively placed a no buy restriction across all funds on Russian names. Realindex continued to monitor the situation in Russia as well as decisions by index providers as to how they would treat Russian stocks. During this time the trading in local lines were suspended with FX transactions also being restricted. ADR and GDRs were also suspended a couple of days later.

When the trading in these stocks is again available, Realindex will look at sell out of our exposure in a thoughtful manner whilst respecting the interest of our clients. If a client provides a mandate to exit Russian securities, we will aim to implement the mandate as soon as practicable. Realindex will continue to closely monitor these rapidly changing events in Russia and assess their implications for the regional and global markets within our portfolios.

Summary

The Russia-Ukraine situation is continuously evolving with various sanctions and restrictions being introduced on a frequent basis. When sanctions were first announced Realindex opted to act conservatively and implemented an immediate purchase restriction of all Russian securities. With the MOEX exchange closed for a number of days, sanctions limiting access to SWIFT impacting currency movements and the London Stock Exchange suspending Russian ADRs/GDRs it has been very difficult to sell the Russian holdings. Further, Russia's ban on foreign investors selling Russian equities has created a highly complex situation where we are unable to sell Russian securities. However, the team at Realindex will still aim to react to any changes in the operating environment swiftly with the aim of ensuring the best outcome for all clients.

21 'Unequivocal signal': Government calls on super funds to exit Russia (smh.com.au)

22 Australia's biggest superannuation fund commits to divesting Russian assets | Superannuation | The Guardian

23 Mega fund dumps $130m of Russian assets as Frydenberg urges divestment (afr.com)

24 Australia's Future Fund to divest $200m of holdings in Russian companies | Australia news | The Guardian

Appendix 1: Largest Russian Stocks and ADR/GDRs and the ADR/GDR Foreign Listing Exchange[25]

Company	Foreign Listing
VTB Bank	LSE
EN+ Group	LSE
Fix Price Group	LSE
Global Ports Investments	LSE
Globaltrans Investment	LSE
HMS Hydraulic Machines & Systems Group	LSE
LENTA International	LSE
MD Medical Group	LSE
Novolipetsk Steel	LSE
Novatek JSC	LSE
Gazprom	LSE
Lukoil	LSE
Magnitogorsk Iron & Steel Works	LSE
MMC Norilsk Nickel	LSE
Phosagro	LSE
Rushydro	LSE
Tatneft	LSE
Polyus	LSE
Rosseti	LSE
Severstal PAO	LSE
Ros Agro	LSE
Rosneft Oil Company	LSE
Sberbank of Russia	LSE
Surgutneftegas	LSE
TCS Group Holding	LSE
VK Company	LSE
X5 Retail Group	LSE
HeadHunter Group	Nasdaq
Ozon Holdings	Nasdaq
Qiwi	Nasdaq
Yandex	Nasdaq
Cian PLC	NYSE
Mechel PAO	NYSE
Mobile TeleSystems PAO	NYSE
Magnit	LSE
Rostelecom	LSE
Sistema	LSE
Polymetal International	
Moscow Exchange MICEX-RTS	
Alrosa	
Federal Grid	
Inter RAO	
United Company RUSAL international	Hong Kong

[25] https://docs.londonstockexchange.com/sites/default/files/documents/n0622.pdf

Disclaimer

This material has been prepared and issued by First Sentier Investors (Australia) IM Ltd (ABN 89 114 194 311, AFSL 289017) (FSI AIM, Realindex), which forms part of First Sentier Investors, a global asset management business. First Sentier Investors is ultimately owned by Mitsubishi UFJ Financial Group, Inc (MUFG), a global financial group. A copy of the Financial Services Guide for FSI AIM is available from First Sentier Investors on its website.

This material is directed at persons who are 'wholesale clients' (as defined under the Corporations Act 2001 (Cth) (Corporations Act)) and has not been prepared for and is not intended for persons who are 'retail clients' (as defined under the Corporations Act). This material contains general information only. It is not intended to provide you with financial product advice and does not take into account your objectives, financial situation or needs. Before making an investment decision you should consider, with a financial advisor, whether this information is appropriate in light of your investment needs, objectives and financial situation.

The product disclosure statement (PDS) or Information Memorandum (IM) (as applicable) for the Realindex funds, issued by Colonial First State Investments Limited (ABN 98 002 348 352, AFSL 232468) (CFSIL), should be considered before deciding whether to acquire or hold units in the Fund(s). The PDS or IM are available from First Sentier Investors.

MUFG, Realindex, their respective affiliates and any service provider to the Fund do not guarantee the performance of the Fund or the repayment of capital by the Fund. Investments in the Fund are not deposits or other liabilities of MUFG, Realindex, their respective affiliates or any service providers to the Fund and investment-type products are subject to investment risk including loss of income and capital invested.

Any opinions expressed in this material are the opinions of the individual author at the time of publication only and are subject to change without notice. Such opinions: (i) are not a recommendation to hold, purchase or sell a particular financial product; (ii) may not include all of the information needed to make an investment decision in relation to such a financial product; and (iii) may substantially differ from other individual authors within First Sentier Investors.

To the extent permitted by law, no liability is accepted by MUFG, Realindex nor their affiliates for any loss or damage as a result of any reliance on this material. This material contains, or is based upon, information that Realindex believes to be accurate and reliable, however neither MUFG, Realindex nor their respective affiliates offer any warranty that it contains no factual errors. No part of this material may be reproduced or transmitted in any form or by any means without the prior written consent of Realindex.

Any performance information has been calculated using exit prices after taking into account all ongoing fees and assuming reinvestment of distributions. No allowance has been made for taxation. Past performance is not indicative of future performance.