The Impact of the Russian Crisis on H2O AM Portfolios

Until mid-February, under previously difficult market conditions with a notable decline in most stock market indices, H2O funds recorded significantly positive performances, demonstrating the capacity of global macro strategies to provide diversification within a portfolio allocation. Indeed, since March 2020, we have been developing a strong growth scenario which has proven to generate higher than expected inflation and a stronger reaction from central banks.

In light of the current conflict in Ukraine, these same strategies have significantly underperformed over the past few days.

We have previously experienced periods of decline during local/regional shocks - this was the case during the Greek crisis in 2015, during the sharp drop in oil prices at the end of 2015/beginning of 2016 or as a result of Brexit in 2016 – all followed by a strong outperformance. This crisis bears the same financial characteristics, unlike the Covid crisis, which was of systemic nature. Current events do not call into question our central scenario, although we are reassessing the situation daily in case the situation escalates.

What is the impact on our portfolios?

Our funds recorded a net negative contribution over the past few days. The main negative drivers are:

- Our Forex and emerging bond strategies, which include direct exposure to the Russian ruble;
- The underweight on US duration strategy as US bonds benefited from their safe-haven status;
- The short US dollar strategy, with the dollar index fulfilling its protective function in times of market turbulence;
- For relevant funds, direct exposure to equity strategies which particularly favour European and cyclical securities;
- Our hedges did not counterbalance the negative impact.

However, when the market stabilizes and correlation normalizes, these strategies should strongly recover.

Please note that we did and do not have any exposure to neither Russian nor Ukrainian equities. Regarding fixed income securities, our funds have an exposure to Russian debt which sits today between 0% and less than 1,5%. Moreover, our funds have a longstanding exposure to a range of emerging market currencies, including to the Russian ruble. As of March 3rd, the long Russian ruble exposure of our funds sits below 7,5% of their overall gross currency exposure.

The decision to maintain our portfolio exposure to Russian assets, until February 24th, was supported by the Russian Central Bank's ability to step in, as well as its significant reserves in case selling pressures were exerted ($630 bn). Our view has naturally switched and the sanctions to forbid access to Central Bank reserves are another game changer.

What have we done since February 24th 2022?

- We have reduced our exposure to Russian debt securities as new sanctions impair their liquidity
- We are maintaining our exposure to the Russian ruble, for three reasons:

  1. Historically, Forex channels have never been impaired simultaneously and we do not anticipate it. Contrary to fixed income and equity assets, we therefore expect the Forex market to carry on operating.
  2. Russian exporting companies are forced to repatriate 80% of their profits, or based on historical data, about $45bn per month, while locals are prohibited from buying foreign currency, creating an imbalance in favour of an appreciation of the Russian ruble.
  3. The Russian ruble currently bears an embedded hedge. The higher the risk of escalation, the stronger the reaction from US and European Central Banks to support the market through fiscal measures, thus protecting consumers from increasing energy prices, and macro imbalances. Our portfolios therefore maintain a positive beta on commodities, which benefit particularly from the increase in oil prices.

Finally, we consider that selling Russian assets should not be realized at a strongly discounted price as this would benefit more the buyers, including the Russian government, than the unitholders.

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