

Voucher Investment Funds

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All established processes undergo a dramatic and rapid change when a country as big and as complex as Russia drastically alters the nature of its economy within a few years. The implementation of Russia's system of voucher investment funds is an excellent case in point. In a short span of eighteen months, investment funds were conceived, then collected vouchers from citizens and invested them. In 1992, less than ten small funds existed in Russia. A little more than a year later, more than 640 funds were competing for individual vouchers. As of mid-1994, voucher investment funds have millions of shareholders, and have proven to be the most active players on the privatization field.

As the first stage of Russian privatization—voucher auctions—comes to an end, investment funds will try to survive in a highly competitive environment, while maintaining their images as sound financial institutions. This chapter analyzes the present status of voucher investment funds, describes how they arose, and reflects on pertinent characteristics of their present forms.

Voucher sales and their results

Approximately 150 million vouchers were distributed in Russia, with each eligible individual receiving one voucher. Some employees of companies undergoing privatization used their vouchers to purchase stock in their own firms. All other voucherholders had to either take part in a voucher auction, exchange their vouchers for shares in investment funds, or sell them on the open market for cash. A survey carried out in June of 1994, revealed that:

- 30 percent of those questioned had sold the voucher

- 18 percent had exchanged the voucher for stock in privatized companies
- 28 percent had exchanged the voucher for shares in voucher funds.

The option of exchanging vouchers for shares in investment funds proved to be quite popular, despite a number of apparent obstacles. Initially, there was a great deal of speculation that lower-class and elderly citizens would sell their vouchers immediately for cash. However, available information indicates that a large proportion of working-class voucherholders decided to invest in funds. Furthermore, inexperience with securities and market operations and a lack of understanding of the nature of investment funds was supposed to create a reluctance to invest. A third factor impeding fund investment was that no infrastructure existed for the distribution of the funds' shares. Given such obstacles, the fact that 28 percent invested in funds is quite remarkable.

Most funds hired their own sales forces to collect vouchers. Inter-regional funds established networks of sales offices in different cities. In addition, several funds used existing networks of Sberbank (a state-owned savings bank with 42,000 local branches) and post offices. This approach proved more effective in terms of collecting vouchers, but was quite expensive. Some funds invited individuals to send in their vouchers by mail. Unfortunately, due to the poor quality of the Russian postal service, thousands of vouchers were lost in transit.

Kinds of vouchers

In order to analyze the role of voucher funds in Russia, one must disaggregate the funds into categories and identify them by their representative characteristics. There

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Voucher fund classification by type of promoters and managers

Voucher funds promoted by large Financial Institutions

Special fund management companies were set up by a few large banks. Most of these funds raised their capital with vouchers from the banks' individual clients and from employees of institutional customers. These fund management companies chose to pursue very conservative investment strategies. Most of the assets were invested in privatized companies that were and remain the banks' customers.

Voucher funds promoted by smaller financial and consulting firms

Many investment funds were organized by brokers or investment consultants working in the field of financial services. These funds have followed a range of investment strategies and have used varying investment techniques without a discernable pattern.

"Amateur" funds

Amateur funds were so called because

they were designed by industrial plants (nonspecialists) to encourage employees to buy shares of their companies at voucher auctions. Some amateur funds were also started by individuals and private companies. Of the amateur funds that were set up, few have survived due to their lack of capital or professional expertise.

Many amateur funds were organized by local or regional authorities. Although regulations supposedly prohibited authorities from directly promoting funds, local bureaucrats designed numerous ways to indirectly create and support funds.

Fraud funds

Unfortunately, a number of funds were set up with only one goal in mind—to collect as much money and vouchers as possible and then subsequently disappear. These funds capitalized on the naivete of Russian investors and on the lack of well-developed of Russian financial regulatory law.

expertise of their managers with advertising slogans such as "leading foreign investors trust us." Some funds appealed to sectoral interests of valuable assets (for example, oil, gold, and diamonds), while others targeted specific social groups including the military, veterans, and police officers.

Several funds even turned to gimmick advertisements to lure the attention of individual investors. One fund advertised that investors could win a luxury apartment in Moscow, while another claimed—falsely—that it had been given a certificate of Honor by the King of Belgium. In most cases false advertising backfired on the fund. Interestingly, in many cases the appeal of an advertising campaign did not seem to bear a strong correlation to the actual content of the advertisement. Instead, advertising success appeared to be based on the frequency with which advertisements appeared on Russian television or radio programs. Russian investors proved to be highly responsive to advertisements heard most frequently and were attracted by funds with large advertising budgets.

are several ways to classify voucher funds. Box 5.1 offers a classification criteria based on the goals of promoters and managers, while Box 5.2 characterizes funds according to their size and geographic spread.

Advertising and public relations

Most funds started to market their shares within one or two months after their registration. Each fund had to overcome the liability of being a new and untested institution and had very little time to build confidence based on actual results. The most successful marketing strategies included aggressive advertising and huge public relations campaigns. In fact, most voucher funds spent 3 percent to 10 percent of their assets on advertising.

Marketing approaches tried to capitalize on the strengths of each individual fund. Regional funds that promoted local investment sought to exploit sentiments of regionalism or nationalism in ethnically homogenous areas, while large firms claimed that stability was naturally associated with size. Some funds tried to stress professionalism and the

Registrar system

Fund managers had no prior experience in placing large issues, but surprisingly their actions proved quite effective. Most funds issued certificates of shares, while only a few maintained book-entry systems. There was no depository and registrar system available for voucher funds in 1992. Consequently, the creation of registrars was very time-consuming and expensive. In a number of large funds reviewed, between ten and thirty-six people were simultaneously entering in computers information about shareholders. A two to three month delay in registering shareholders was the norm.

Under registrar guidelines fund shareholders either had to apply to registrars personally (quite a difficult feat for shareholders of inter-regional funds), or they had to apply through a fund's local office that acted as a transfer-agent for registrars. However, most funds scrapped their decentralized system of local offices after they finished selling shares, thus further complicating the process.

Trading and liquidity

The lack of an efficient registrar system placed severe limits on the organization of a liquid secondary market for fund shares. However, now that regulations on registrar and depository activities have been introduced, it has become possible to increase the number of secondary transactions by developing local secondary markets.

For example, Adamant Financial Corporation (Derzhava fund manager) became a market-maker in Derzhava shares in January 1994. The volume of secondary transactions has increased to about 20,000 shares a month (0.8 percent of shares outstanding) in approximately 500 transactions in Moscow and five local offices.

Unfortunately, there is still no use of stock exchanges because of the inadequate trading, clearing, and settlement systems. Secondary markets for funds shares are thus based solely on market-makers. Many managers have begun the process of buying and selling funds shares, but most markets are insufficiently liquid due to poor registrar systems, insufficient sales infrastructure, or inadequate cash reserves of fund managers. In their transactions, fund managers prefer to deal with each other face to face for the following reasons:

- There is a lack of public corporations with listed stocks. Most corporate stocks attract just a few investors; usually large institutions or top corporate management, both fighting for control, with the result that liquid secondary markets do not exist.
- Trading, financial information, depository, custodial, clearing and settlement systems are being developed, but they are still embryonic and ineffective.
- While some "networks" exist, there are no obvious leaders in trading systems. Consequently, fund managers hesitate to join any one particular network because the probability of their customers being members of the same trading system is very low.
- There is not enough competition between banks and brokers in existing trading systems, and the high cost of commissions is prohibitive for invest-

Voucher funds classified by size and geographic spread

BOX 5.2

Small regional funds

Several hundred small regional funds were started. With 1,000–10,000 shareholders and capital of \$20,000–\$300,000 they do not have the resources to cover the expenses of fund management. Recognizing this, many small funds have already started the process of merging with larger ones.

Larger regional funds

There are about fifty regional voucher funds comprising 50,000–300,000 shareholders, possessing a capital base of \$1.5 million–\$12 million. Most of the assets in these funds are invested within their own region. Due to the local nature of investments, regional funds tend to have much better information with regard to the status of privatized companies, and also tend to enjoy more personal relations with firm management. While greater ac-

cess to information serves as a definite advantage for regional funds, the closer relationship with management can also operate as a serious shortcoming from a shareholder's perspective.

Inter-regional funds

Between forty and sixty inter-regional funds possess 40,000–250,000 shareholders and enjoy a capital base of \$1 million–\$10 million. These funds have expanded their marketing and investment activities across a number of different regions.

Large national funds

Five large voucher funds in Russia possess 1 million–3 million shareholders and a capital base of \$25 million–\$50 million. These funds profited from aggressive advertising in all regions of Russia, and from share sales by post offices.

ment funds. At the same time, fund managers are not admitted to these markets directly.

- Privatized companies do not follow full disclosure principles. Investment managers have partial and conflicting information about the same companies and prefer to deal in a more confidential manner.

In these circumstances, every transaction on the market takes a great deal of time, effort, and money. Counterparts have to meet each other face-to-face to sign contracts (to date there are no other ways to manage this in the Russian legal system). Furthermore, taxes on securities' transactions are paid independently, and then the contract and confirmations of tax payments have to be brought to the registrar of the company to transfer the stocks.

To some extent, these issues do not present major problems since most funds are not actively managed and have only three to ten transactions each month. Voucher speculations were something of an exception, but in their case there was no need to register deals.

It is still too early to discuss the possibility of "opening" existing funds. First of all, the low liquidity of the stock market

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makes it impossible to raise cash quickly by selling stocks, and also prohibits the use of net asset valuation (NAV) as a basis for share prices. Secondly, registrar and depository systems need to expand in order to serve a large number of transactions more efficiently, and fund managers need time to develop their back offices. The final reason why it is premature to "open" existing funds is that special accounting for closed investment funds and mutual funds needs to be introduced. Currently, funds cannot create and cancel shares simultaneously.

While it will take at least two or three years for mutual equity funds to appear on the market, it is possible that open money-market funds could be started in six to twelve months, if the accounting system for open funds is introduced.

Commissions

Most funds pay their fund managers the legal limit of compensation, or 10 percent of average net assets as a fund-management fee. While some have complained that this payment is exceedingly high, it is important to take note of several considerations. First, the fees are usually paid after the end of a quarter and high inflation reduces the real value of payment compared to the real value of assets at the end of the period. Second, Russian fund managers have to spend a great deal of money finding information on privatized companies and developing their activity. These start-up investments should increase the performance of portfolios significantly to the benefit of funds' shareholders. Third, net assets are now calculated on the basis of the historical costs of assets. The book value of a particular holding may be exactly the same for a few years in spite of a rise in the market price. Furthermore, all balance values of stocks must be multiplied by 0.5, except stocks 'with market value.' The Securities Commission is supposed to announce the list of such securities, but to date the announcement has yet to come. Therefore, a lot of stocks bought in January of 1993 for 10 million rubles had a NAV of approximately \$11,236 (445 rubles to the dollar times 0.5) in January of 1993, and \$2,577

(1,940 rubles to the dollar times 0.5) in June 1994. Fund managers are forced to buy and sell assets much more than necessary, simply to keep the balance value closer to the market price.

Some fund managers initially employed too many people, an especially pressing problem for small funds. At the same time, any increase in management fees would damage funds. Consequently, fund managers are looking for ways to strike a balance between the quality of management and its costs. Unfortunately, most managers manage small funds, and therefore the realistic alternatives open to them are expanding their businesses by raising additional capital, launching new investment and pension funds, or simply getting out of the fray.

Investments

Very few funds followed one specific investment strategy throughout the privatization process. Most funds changed their investment objectives repeatedly, thereby making the classification task more difficult. Nevertheless, some of the most popular investment approaches may be defined.

The speculative approach

Many fund managers made their investments purely on a speculative basis, with the hope of immediately reselling the stocks. Privatization in Russia provided fertile ground for speculative adventures for two reasons. First, managers and insiders in privatized companies fought for control against external investors. Quite often top-level management used the cash of the company to do so. This practice was technically illegal, but impossible to effectively control. Consequently, there was always at least one buyer interested in keeping control of a company regardless of price. Second, the voucher auction procedure was guided by the principle that the more vouchers invested, the higher the stock price. While it was nearly impossible for a single investor to buy all of a company's shares, in many situations large investors bought lots of shares from other

participants at an auction. Frequently, it was more efficient to take part in the auction with a small amount of vouchers and use saved cash to buy stocks after the auction.

Many funds benefited as a result of this favorable environment for speculation. At the same time, it was hard to predict whether large investors would participate in a particular auction, or if an auction would prevent insiders or large external investors from buying shares at the higher price.

Furthermore, in many cases it was easier and less expensive for large investors to buy shares from employees who had obtained them at a discount. One voucher fund bought 15 percent of the shares outstanding for the same amount it had previously paid for 4.6 percent of the company's shares. As a result, although speculative funds benefited from lucky reselling, they also held many nonliquid stocks of poor investment quality.

Some funds concentrated on speculations with vouchers. Buying small lots of vouchers from individuals or small dealers, and then selling them in big lots to various companies proved to be a profitable business. However, several sharp unpredictable changes in the price of vouchers (three times a gain in price of 100 percent to 150 percent within a week, once a loss of 60 percent within three days) brought big losses for voucher speculators, because voucher prices went up when most speculators held cash and vice versa. Overall, speculative funds have thus far produced quite moderate results compared to other funds.

Sector specific approach

Many funds chose specific industrial sectors as their investment priorities. Better knowledge of specific industries was supposedly a serious advantage of these funds in the mass privatization environment. Sector specific funds ended with almost no stocks of poor investment quality in their portfolios. But most of these funds were promoted by companies from the same industry, and therefore managers had—and have—other goals in mind besides simply insuring the top performance of portfolios for the benefit of their clients.

For the next several years, industry oriented investment funds will remain among the most stable. But when amateur and fraud funds disappear and competition among funds and between other institutions becomes severe, fund managers using the sector specific approach will probably have to revise their investment strategies.

Short-term speculation plus venture investments

Some fund managers decided to finance new ventures or develop new investment projects and have invested a substantial part of their assets in business centers, industrial plants, or high-technology companies. The huge discrepancy between funds' assets and capital required for any serious greenfields venture forced managers of these funds to be very active in forming various financial groups, or issuing stocks of new companies. The First Voucher Fund now promotes a First Pension Fund to increase capital available to finance their numerous projects. Many smaller funds have followed this policy, and some thirty to forty private pension funds have been started recently by voucher fund managers. This group of funds has not managed to announce any positive results thus far, though a quick and high return for investors was promised in their advertising.

Long-term portfolio investments plus venture investments

This group of funds started with long-term portfolio investments in privatized companies. Managers of these funds are now developing restructuring and investment projects mainly for the companies where they have major holdings. Fund managers expect large returns on capital invested from the increased efficiency these companies should, it is hoped, soon enjoy.

Portfolios of these funds may be easily divided into active and passive components. Managers try to be active investors in a select set of privatized companies and therefore attempt to influence their management. In most cases, fund managers would prefer to have dominant control of the company so

The existing tax system will kill investment funds if substantial change is not forthcoming.

that post-privatization restructuring, unpopular with employees, can be performed as quickly and decisively as possible. Investment funds are allowed to purchase up to 25 percent of the common stocks of any one company, and they actively do so in the firms in which they have a major interest. Two or three voucher funds often share effective control of these companies. As passive investors in other companies, fund managers are not terribly involved in their management, but still carefully monitor the actions of companies' top executives to prevent any serious damage.

Uncertainties and persisting problems have forced managers to select stocks more carefully and pay attention to investment quality rather than speculative potential. This group of managers has not promised any immediate profits for investors and, consequently, the financial position of these funds is much more stable than most others.

Diversified funds

Most regional funds diversified their portfolios and currently hold shares from 70 to 240 (usually) small companies. The average investments of \$15,000 to \$20,000 are too small to make a difference, and operational costs and the costs of protecting funds' ownership rights are high. Due to over-diversification, all future prospects of these funds are closely intertwined with the economic situation in Russia in general.

Taxation

Investment funds in Russia are not tax transparent for final investors. Funds pay tax on profits (38 percent in Moscow) that is equivalent to a capital gains tax. Since January of 1994, voucher funds have received a tax exemption on dividends received within two years of initial registration. However, this privilege does not cover dividends from 1993, and most voucher funds will celebrate their second birthday before the end of 1994. Most funds will thus not be able to reap the fruits of this tax relief.

Investment funds must pay municipal taxes (for roads, police support, and education), while investors have to pay an in-

dividual income tax which can be no lower than 12 percent on dividends received from investment funds or on capital gains.

Inflation levies heavy burdens on investment funds as well. If a stock was bought in January 1993, for 10,000 rubles (\$22.47 at the current exchange rate) and sold in June 1994, for 20,000 rubles (\$10.31), the fund would have to pay a 38 percent tax on 3,800 rubles (\$1.96), even though this investment turned out to be a net loss.

The existing tax system will kill investment funds if substantial change is not forthcoming. As it currently stands, the system significantly hinders and distorts the investment decisions of fund managers.

Accounting

Investment funds do not have a special system of accounts and accounting procedures; yet they still use accounting principles of normal enterprises. Consequently, accounting is inconvenient and costly for fund managers because they must go through many useless steps and procedures. It is also impossible for investors to evaluate the current position and financial results of investment funds, and numerous opportunities for account manipulation exist. It is quite possible that manipulations cannot be prevented before a truly liquid stock market develops or before funds hold listed securities. However, a way should be found to make accounting more appropriate for fund managers and investors in the interim.

Prospects

Although many investment funds did not announce any dividend payments after 1993, the financial positions of most funds are not terrible. Speculations with equities of privatized companies have proven profitable enough and the potential for long-term growth is great. But many fund managers still feel uneasy in the fund management business. Most managers want to diversify their business, seek the right to buy real estate, borrow money, or provide commercial loans. They want to continue

their business expansion but not in fund management, because other types of financial services are not nearly as regulated. Moreover, the current dissatisfaction of investors makes it difficult to raise more capital in existing funds, and the tax system is viewed as unfair.

Possible scenarios for voucher funds include:

- *Bankruptcy.* Many small voucher funds will merge with each other, with larger funds, or will eventually be managed by large groups. Some fund managers will simply disappear, unable to survive in the new competitive environment.
- *Holdings.* Many sector-oriented funds will prefer to hold portfolios of closely-related stocks over a long period of time and will choose to be actively involved in managing these companies.
- *Investment companies.* The most popular role for a fund manager to behave is that of investment consultant, broker, or investment banker. Many funds will take on more of a role as providers of investment services and financial advice.
- *Venture and portfolio investments.* Some funds will continue to follow strategies of long-term portfolio and venture investments. These funds will be among the most active players on the post-voucher stock market.

- *Portfolio investments.* It is difficult to imagine voucher funds becoming normal portfolio investors, at least in the near future. Some new investment funds will be managed according to established portfolio principles.

Few opportunities for quick profits remain in the fund management business. Fund managers may hope for high and stable profits, but this will only come about in an environment of equal treatment of all financial services and with the implementation of a fair tax system. As foreign investment in Russian equities grow and the Russian private sector actively invests, the liquidity of the Russian stock market will continue to improve. This will create a more comfortable environment for portfolio management. The first international fund management groups have started their operations in Russia. It is hoped that they will increase foreign investments substantially and will introduce high standards of fund management.

In the next century, Russian fund management companies will continue to grow. They will manage more funds with larger assets and play an increasingly vital role in the restructuring of the Russian economy and the development of a sound financial system.