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Russia Has Become "Uninvestable" For Index Funds

"Often, we mistake stability, in terms of security and economic activity, to mean a country is doing well. We forget the third and important pillar: rule of law and respect for human rights". – Kofi Annan

Russia's disastrous invasion of Ukraine has led to the shutdown of the Russian equity market. The Moscow Exchange is closed, and London and New York exchanges have halted trading of depositary receipts of Russian firms. As Russian equities have become untradeable, MSCI and FTSE Russell have taken steps to remove Russia from their standard indexes.

SUMMARY

- Russian stocks have become uninvestable. No Russian equities or depositary receipts are being traded in Moscow, London, or New York.
- Fund sponsors will likely be forced to write off the value of most Russian stock holdings.
- Key index providers have announced the effective removal of Russian securities from Ex-US and Emerging Markets indexes
    - FTSE Russell deleted Russia constituents at a zero value on March 7th.
    - MSCI will reclassify Russia indexes to "Standalone Markets" upon the close on March 9th.
- "International ex-U.S." and emerging markets index funds, widely held by defined contribution plans, are affected.
- While impacts to DC plans will be widespread, small positions in Russia mean effects won't be extreme.

INDEX PROVIDERS REMOVE RUSSIAN STOCKS

While trading Russian equities became difficult after that country's February 24th invasion of Ukraine triggered a broad sell-off, pursuant events have made it impossible. Western economic sanctions have cut Russia's links with global markets. Russia has instituted capital controls and a ban on foreigners selling securities locally. The Moscow Stock Exchange has been closed since February 25th, and New York and London exchanges have halted trading of depositary receipts of Russian firms. Under these conditions, Russian stocks have become effectively uninvestable.

In response, index providers MSCI and FTSE Russell announced on March 2nd that they would remove Russian equities from their standard benchmarks. FTSE Russell zeroed out the value of Russian index constituents listed on the Moscow Exchange on March 7th, and MSCI is set to reclassify Russia indexes from "Emerging Markets" to "Standalone Markets" at a price that is "effectively zero" upon the close on March 9th.

DC plans that offer a fund that tracks an "international ex-US" index (e.g., the MSCI ACWI Ex-U.S. or FTSE All-World ex-US indexes) or an emerging markets index (e.g., the MSCI Emerging Markets or the FTSE Emerging Markets All Cap China A Inclusion Indexes) are likely affected. Popular offerings from BlackRock, Fidelity, State Street, TIAA-CREF, and Vanguard are included.

IMPACTS ARE WIDESPREAD BUT RELATIVELY MODEST FOR INDEX INVESTORS

Ex-U.S. and emerging markets index funds with allocations to Russia are widely held by 401(k) and other defined contribution plans. Vanguard's "How America Saves 2021" indicates that over three-quarters of the retirement

plans they keep records for offer an international index fund. A large portion of those likely follow an affected index.

Fortunately, the impact of the crash of Russian stocks is relatively modest compared, in absolute terms, to a severe downturn in a country with a more significant allocation, such as Japan, China, or the U.K. For example, at the end of 2021, the iShares MSCI ACWI ex U.S. ETF (used for its holdings transparency) had just over 1% of its assets invested in Russian equities. This compares to over 14% invested in Japan and more than 9% in China and the U.K (the fund's three largest holdings). Hence, even a 10% drop in Japanese stocks would have a greater impact than Russia's collapse.

The impact on indexed emerging markets investors is more painful but still modest compared to a crash in a larger economy.

The iShares MSCI Emerging Markets ETF held 3.5% of assets in Russian equities at the end of 2021. By February 25th, the day after Russia's invasion, this had fallen to 2.2% as investors dumped Russian stocks and prices crashed. On March 2nd, the day that MSCI and FTSE Russell announced plans to remove Russia from their standard indexes, the allocation stood at 1.5% of the fund.

By the close on the 7th, Russia exposure had fallen to zero as BlackRock, sponsor of the iShares ETFs, "suspended the purchase of all Russian securities in [its] active and index funds."

OUR PERSPECTIVE

While certainly not a non-event, the collapse of Russian equities (and bonds, for that matter) will likely be less severe than other financial impacts of the war for index investors, including the ramifications of soaring oil prices (or gas, neon, nickel, or wheat prices). Just as relevant is the fact that the deed is done; the pace of events has already baked in the loss, perhaps easing the burden on sponsors who have been called upon to divest from Russia.

However, events in Ukraine should serve as a wake-up call that the "political risk" in investing is still a real thing and that manmade global disruptions are not something that the world has outgrown. Furthermore, the world is likely entering a period of greater instability. Beyond Russia, the possibility of geopolitical disruption abounds. Whether it's the ascent of autocratic and often belligerent China, the impact of climate change, or the severe bifurcation of politics in the U.S., sponsors and investors should ensure that their eyes, ears, and minds are open.

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