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Russian Financial Markets, Pension Funds and ETFs

In this brief, I consider problems arising from the virtual non-existence of index funds and/or Exchange Traded Funds (ETFs) in the Russian financial markets. While the Russian economy requires cheaper money for firms' investments and better options for pensioners, there are almost no instruments that allow stocks for long-term value acquisition by the pension funds. I argue that more passive options and better representation of Russian stock indices may be beneficial for both the real economy and future pensioners.

Russian financial markets

In Russia, banks play a more important role in the economy than financial markets (see Danilov et al., 2017). Comparing the two, we observe bank assets to GDP ratio of about 100%, and financial markets to GDP of less than 45%. The current proportion of sources of corporate and household financing (2/3 of banks and 1/3 of financial markets), and the value of financial markets to GDP, is similar to Germany. However, the banking system in Russia is smaller and less stable. For example, it attracts passives that are very short-term, with average duration of less than 3 years.

One of the causes of the underdeveloped financial markets is the low amount of money in non-government pension funds, and the restrictive regulation that requires them to protect initial capital of future pensioners. This reduces the investment opportunity set of these pension funds, as volatile stocks are unattractive to them, and instead the funds mostly choose to invest in bonds. This is specific to the Russian market: for example, there are no such restrictions in the European approach (European Commission, 2017). However, both in developed countries and in emerging markets, stocks provide higher long-term returns than bonds. Thus, future pensioners in Russia lose on the upside, and the economy sticks to banks as the main source of investment.

The macro economy is also less effective due to the small financial markets. In the data (see Cournède et al., 2015), we see a positive correlation between the growth of outstanding stocks/bonds and the economic growth for low enough levels of total value of financial markets. While causality goes in both directions (higher GDP means need for more financial instruments), this is a compelling reason to develop financial markets.

Finally, people in Russia do not “believe” in stocks and bonds. If one compares the deposit rate in a bank with the yields of the same bank, the former is almost uniformly lower than the latter. Yet, even in the case of Sberbank, the largest bank in Russia, individuals prefer to keep their money in deposits or in foreign currency. This is a signal of low financial literacy, as well as of low income, or lack of trust; this is evident in many surveys (S&P, 2015).

Therefore, our research question is: what could be done to make the Russian market more attractive to domestic investors, and make them invest and save for pensions?

Indexing

There are many papers regarding diversification and investment opportunities of individual investors. As recent research shows (see Bessembinder, 2017), individual stocks are not good for investment even on US market. Namely, most stocks return less than Treasury bills at monthly horizons. Due to this property of financial markets, it is important that domestic investors have access to wide indices.

Moreover, Berk and Binsbergen (2015) demonstrate that active mutual funds generate as much of profits as they retain as fees. This means that individual investors are better off if they choose passive options, like index funds or Exchange Traded Funds (ETFs), as their main investment vehicle. Index funds and ETFs mostly invest in one index, say S&P500 of the 500 largest US stocks, and their explicit mandate is to stick to this index. Index funds can only be bought through a broker, while ETFs are traded on an exchange, like stocks. This makes them different in terms of possibility of active portfolio rebalancing. However, both are very passive by nature.

These arguments lead to the **first conclusion**: to improve investment opportunities of pension funds and individual investors, as well as the macroeconomic stability, the regulator might motivate institutional market participants to provide more passive, diversified, and stock-based portfolios.

ETFs and robo-advising in Russia

One way to increase the number of passive options is to allow more ETFs in Russian stock exchanges. As ETFs and their availability to investors have to be confirmed by the regulator (the Central Bank), one cannot immediately add new ETFs to the market. Index funds are another option. However, they have a long and sad history in the Russian market: most (about 95%) of the so-called "index funds" deviate from their benchmarks and do not follow indices. This has to do with the openness of the funds: while mutual funds and index funds have to report their stock/bond/cash holdings once a quarter, ETFs publish it daily. So one can check that ETFs follow their mandates with ease. Moreover, ETFs are usually cheaper and thus save returns for investors.

While existing ETFs on the Moscow Stock Exchange already cover a wide range of markets and even some sectors (including the Russian stock market, US S&P500, Europe and China), they are still too small in terms of assets under management (about $150 millions) and are issued by one company (FinEx). Currently, FinEx ETFs are almost the only option to invest passively, and to diversify, in the Russian market. At the same time, in most markets, index funds are marginally better saving/retirement/investment vehicle as they require less trading fees and thus save returns for low-income investors.

Regulators can facilitate the process of indexation in at least two following ways: (i) allow introduction of more index funds or ETFs in the market (requires regulator's supervision and confirmation); and (ii) provide incentives to brokers and financial advisors to make them their first recommendation to individual investors and pension funds (as is done in the US, see BNY Mellon, 2016).

Another way to cater to low-income investors is robo-advising – an ongoing revolution in the financial markets. This tool allows investors to get wealth management advice for a small fee (about 0.15% in the best case), and it mostly invests in low-cost, passive ETFs that allow diversification of investments. While this is still new for Russia (and done by FinEx with partners from banks), it has become more widespread in developed markets. Assets under management with robo-advisors increase rapidly and now exceed $220 billions. This tool is useful for investors who are not financially literate, do not have economic or financial education, but still need good investment opportunities. In Russia, robo-advising may become a norm for so-called "non-qualified" investors – people with low enough savings and no educational certificates on financial markets. The regulator has not yet confirmed this, but we see many signs that it will go in this direction. One problem for this market is that it is still not official, and human financial advice is considered as a norm for non-qualified investors if they would like to expand their investment universe to say derivatives.

A big positive side of robo-advising is the reduction of human errors. As Richard Thaler, Nobel Prize winner of 2017, has persuasively shown in his research that humans make many judgement errors. These mistakes lead to lower returns on investment, too much trading that eats returns due to fees, and higher wealth inequality. Robo-advisers avoid all that and allow individual investors to save and invest more long-term.

The **second conclusion** is: regulators should help the financial industry to develop better robo-advising software that uses ETFs; use these robo-advisers as replacement for human advisers; and advertise this as the option for long-term investment, including pension funds.

Conclusion

Russian financial markets should provide more financial instruments to Russian firms and higher flexibility for investors. The Central Bank as the supervisor of financial markets, and the Ministry of Economic Development as the main government branch responsible for economic growth, may take additional steps to increase availability of passive investment options for Russian citizens. Reforms of incentives of brokerage firms might be needed, yet the ultimate goal is to improve well-being and pensions, and probably make good use of the money of long-term domestic investors. One possible option is to widen already existing ETFs market and allow individual investors to use robo-advising to invest in many instruments, even if these investors are not highly qualified or wealthy.

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