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The Hermitage Fund: Media and Corporate Governance in Russia

The court of public opinion is much more effective than the Russian legal system and much fairer.
—William Browder, Manager, the Hermitage Fund

The Hermitage Fund, formed in 1996, was an investment fund focused on investing in Russian equity securities. By July of 2002, the fund's share price had risen 465%, more than double the 184% rise in the Russian market index over the same period. And the fund's annualized rate of return ranked it as the number one international equity fund over the last five years (30.9% annual return), the number three fund over the last three years, and the number two fund in the last year.[1] William Browder, the fund's manager, attributed this return not just to skills in stock picking and timing but also to the fund's focus since 1998 on shareholder activism and corporate governance.

Despite holding minority stakes in Russian firms, Browder was very active, seeking changes in company charters, seats on boards, and changes in Russian legislation. His public condemnations of alleged governance abuses were featured in *The Financial Times, The Wall Street Journal, The Economist, Fortune,* and *BusinessWeek*. "The best protection against misgovernance in Russia is the press," he claimed. And he saw a future in this activist approach. He said, "My ultimate objective is to buy a position and then see the stock rise because the market will see that my presence will limit management's ability to enrich themselves at the expense of investors. I would like to go from being a fighter to an insurance policy." How far he was toward attaining that objective, or even if it was attainable, was a question of some debate.

The fight with Gazprom management was the latest and most high profile of these governance battles. The Hermitage Fund invested significantly in Gazprom in the fall of 2000 and, with this stake in hand, launched a campaign to address governance problems and "unlock intrinsic value." Starting in April of 2002, Hermitage launched lawsuits against PricewaterhouseCoopers, Gazprom's auditor, asking the government to withdraw its license and sought extensive changes in the company's charter and a seat for Browder on the board in the annual shareholders meeting. Largely as a result of Hermitage efforts, the press provided extensive coverage of Gazprom's problems; *BusinessWeek,* for example, called the company "Russia's Enron," picking up on the parallels in allegations of abuses by both managers and the company's auditors.

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[1] All rankings based on *Nelson's Directory of Investment Managers* (Port Chester, NY: Nelson Publications, 2002). All data reported as of December 31, 2001. Fund returns are expressed net of fees. The five-year return was based on a comparison of 374 international equity funds.

By July the results for Hermitage could be read in very different ways. Gazprom's share price had risen by 88% since January. But Browder failed to get a seat on the board in the June 28 annual general meeting, the lawsuits against PricewaterhouseCoopers had been dismissed by Russian courts, and Browder was exhausted from these continued efforts. Was it time to refine or change this activist strategy? These were the questions Browder (and his investors) considered as he left on a long overdue vacation.

Russia[2]

The Hermitage Fund's returns were affected by political and macroeconomic factors that touched all Russian firms. Boris Yeltsin led Russia through volatile reforms from 1991 to 1999. Following significant initial reforms to decentralize economic power and economic decision making, concerns mounted about the decline in the effectiveness of the state and widespread corruption. Vladimir Putin was elected as the second Russian president in March of 2000 and set in motion reforms to reassert federal government authority, both over regional governors and over businesspeople who had developed extraordinary influence in the later years of the Yeltsin regime.

Under Yeltsin, reforms on the economic front first focused on prices with the freeing of most prices in January of 1992. Stabilization of the price level took longer, with an effective tightening of monetary policy delayed until 1995 when inflation was finally brought under control (see **Exhibits 1** and **2**). But economic concerns would continue, for while the government ceased paying for expenditures by printing money, it increasingly turned to borrowing to cover expenditures. The inability to collect tax revenue increasingly became a concern, with the budget imbalance (see **Exhibit 3**) boiling over in a full-scale crisis in August 1998 with a default on domestic debt and massive devaluation of the ruble. The stock market was particularly hard hit, with a 93% decline from October 1997 to October 1998.

Macroeconomic reforms were matched by similarly dramatic microeconomic reforms with a privatization policy that developed in four stages. In the first stage, from January 1992 through June 1994, the government privatized 15,000 firms employing more than 60% of the industrial workforce using voucher methods. Each Russian citizen could receive a voucher that could be exchanged for stock in privatized firms, invested in a voucher fund, or sold for cash. "Voucher auctions" took place all over the country at different times, many receiving little public notice. To increase support for this policy at the affected firms, workers and managers were given preferential access to shares. Workers and managers were allowed to purchase 51% of the voting shares in their firms at a nominal price in one of the most popular approaches. In late July 1994, the government then sold companies through cash sales to foreign and domestic strategic investors.

The strategic industries of oil, gas, and mineral deposits were not included in these waves of privatization. But beginning in 1995 they too were sold in a third wave called loans-for-shares privatization. In March 1995, with the federal government in desperate need of funds, the chairman of Uneximbank, Vladimir Potanin, proposed a solution. He suggested that the government could get loans from Russian banks and use shares as collateral, so if, as expected, the government could not pay back the loans (which were due after the upcoming federal election), the banks could keep the shares. The banks went on to conduct these swaps in auctions that largely amounted to a prearranged allocation across the participating banks. Foreign investors were excluded from the most attractive oil companies and metals firms. Through this scheme, Russia saw a dramatic increase

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[2] For further information on political reforms in Russia see Rawi Abdelal, "Russia: The End of a Time of Troubles?" HBS Case No. 701-076 (Boston: Harvard Business School Publishing, 2001). **Exhibits 1–3** are derived from data in this case.

in the importance of so-called financial industrial groups and the rise to prominence of the oligarchs, the leaders of the most important of these financial industrial groups. Yeltsin won reelection, with significant support from the winners of the loans-for-shares auctions, and shortly thereafter shares were transferred as the government did not make its loan repayments.

In the fourth wave, following the passage of a new privatization law, more emphasis was placed upon competition in sales.

Political and economic factors clearly were involved in these privatization choices. As noted, privatization did provide financial supporters for Yeltsin when it came time for reelection. Privatization also had the political effect of breaking the power of the bureaucracy, which could have potentially stymied all significant reforms. Economically, privatization was expected to increase efficiency because private owners had the incentives and ability to reorganize firms to face the new conditions. In addition, privatization through sales of equity, it was thought, would stimulate financial sector development.

Scholars have long emphasized links between the extent of the financial sector and the level and rate of growth of nations. A well-functioning financial sector—including both the banking system and equity markets—can provide essential services to increase growth such as lowering the costs of mobilizing resources, ensuring those resources are allocated to their most highly valued use, and reducing the costs arising from information gaps between resource providers and users. As the story goes, with developed equity and debt markets, firms and industries with better investment prospects would be able to secure financing to pursue those projects, while those with poorer prospects would see their resources more quickly diverted out of these sectors. And the evidence seems to bear out such hypotheses. Countries with deeper financial sectors see faster subsequent growth. In countries with more developed financial systems, firms most dependent upon external finance see higher relative growth.[3]

Corporate Governance Problems

But the hopes for privatization to spur efficiency and financial sector development were not met. To a large extent the source of the disappointment was seen to come from another crisis whose extent had not been anticipated—a lack of a functioning corporate governance system. Insiders, be they managers who achieved control through voucher privatizations or the oligarchs who assembled controlling stakes through a loans-for-shares scheme, took advantage of their powerful position to enrich themselves.

To some, this was an inevitable part of the transition to a market economy. As Anatoly Chubais remarked, "They steal and steal and steal. They are stealing absolutely everything, and it is impossible to stop them. But let them steal and take their property. They will then become owners and decent administrators of this property."[4]

But for those interested in their investments or in rapid equity market development, the situation could not be so easily dismissed as a transitory phenomenon. As Standard & Poor's reported, abuse

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[3] A useful summary of this literature is provided in Ross Levine, "Financial Development and Economic Growth: Views and Agenda," *Journal of Economic Literature,* June 1997, Vol. XXV, 2: 688–726.

[4] Quoted by Sergei Kovaliev in Chrystia Freeland, *Sale of the Century: Russia's Wild Ride from Communism to Capitalism* (New York: Crown Business, 2000), p. 70. Quotation taken from Rawi Abdelal, "Russia: The End of a Time of Troubles?" HBS Case No. 701-076, p. 4.

was rampant: "Charters of many joint stock companies have not been brought into compliance with Russian law; controlling shareholders ignore established procedures for convening shareholders meetings and take decisions without the knowledge of minority shareholders; major- or interested-party transactions are entered into by the company without proper corporate action; and minority shareholders' stakes are diluted without their knowledge and consent, etc."[5]

Investors responded to these widespread abuses in the traditional ways of trying to use their voice as shareholders to constrain practices against their interests, of exiting the market, and of pricing in expectations of diversion of returns by not being willing to pay much for shares. Investment houses, responding to investor demand, employed analysts with specific expertise in governance who produced weekly summaries of corporate misgovernance and developed proprietary ways to rank firms by their openness to governance abuses. (**Exhibit 4** provides one example of a corporate governance survey instrument for Gazprom, the largest Russian company.) Russian firms traded at fantastic discounts to comparable firms in other setting (see **Exhibit 5**). Not surprisingly, Russia's equity markets remained underdeveloped, disappointing investors and acting as a long-term drag on Russia's growth potential.

The corporate governance crisis was in part attributable to the lack of well-functioning corporate governance institutions. In more developed markets there are a range of institutions to address recognized conflicts between investors of resources and insiders with control over resources. These institutions—such as company laws, accounting rules and regulations, securities regulators, and financial intermediaries such as auditing firms and equity analysts—were slow to develop or did not work as intended in Russia.

A bankruptcy law was passed in 1993 (and replaced in 1998), a securities law was passed in 1995, a securities and exchange commission (FSRC) was created in 1996, and a civil code that reflected many elements of Anglo-American company law was passed in 1995–1996. Laws proved to be weak, with many companies opting out of standard shareholder protections. Russian accounting standards were widely condemned as focusing too much on tax concerns of the government rather than the needs of financial investors. Auditing firms followed Russian rules.

The evolving ownership structure, whereby individuals or groups had majority stakes in almost all enterprises, further contributed to the weakness of other governance mechanisms such as company charters and boards because controlling shareholders often had the votes to change charters and dominate boards.

And above all else, rules were not enforced or were abused. Insiders manipulated judges to find in their favor or just ignored legal judgments against them entirely. Working through regional courts, bankruptcy procedures led to rapid shifting of assets from equity holders to creditors. The FSRC did not have the ability to enforce compliance with its rulings, having to rely upon courts, which often threw out or ignored these rulings. And there was political involvement in corporate cases, with government actors as likely to take actions against the interests of minority investors as to support them.

The weaknesses in the macroeconomic and political environment, combined with these institutional weaknesses surrounding privatized Russian firms, produced a challenging environment for firms. Gross domestic product (GDP) fell and in 1998 was just 55% of its 1989 level. Between 1988

[5] "Corporate Governance Issues in the Russian Federation: What investors should know," Standard & Poor's Corporate Governance Services, November 2000, p. 37.

and 1995, the proportion of Russians living below the poverty line increased from 2% to 50%.[6] This was a challenging environment for any investor, and particularly institutional investors whose stakes in firms were by definition not going to be controlling stakes. The Hermitage Fund deserved attention as the largest public equity fund in Russia and for its strong returns in spite of these problems.

The Hermitage Fund

The Hermitage Fund was founded in April 1996 as an investment fund open to large investors willing to invest $100,000 or more. The typical investor was a very wealthy individual with a net worth of more than $500 million who would invest $5 million. The fund focused on equities in Russia, and its chief asset was Browder, who had an MBA from Stanford and prior experience as a management consultant in eastern Europe for Boston Consulting Group (BCG) and as an investment banker for Salomon.[7] His compensation was tightly linked to the success of the fund, with a performance fee for his management team of 20% of the redemption price that exceeded a benchmark, in addition to a 2% per annum management fee and a 1% per annum administration fee. To ensure focus, the fund did not engage in other investment services such as brokerage, consulting, or investment banking.

The fund had always concentrated on the oil and gas sector, where it had more than 70% of its investments, with considerable investments in electric utilities (17% of the fund in 2000, 9% in 2002) and an increasing investment in financial services (0% in 2000, 16% in 2002). Hermitage characterized its investments as long term, with low turnover of 10% to 20% per annum.[8] It also assured its investors it would not get too focused on particular companies and potentially held up in illiquid positions, committing to take no more than 10% of the shares in any firm and to limit its stake in any particular firm to 20% of the fund's net asset value.

The fund had early success, when it followed a more traditional fund strategy of stock picking. Started as a closed fund in April with initial monthly returns of 40% and 35%, the fund soon opened to additional investors. By the end of 1997, the fund, along with its sister fund Hermitage 2, had a net asset value (the value of all holdings based on market prices) of more than $1.15 billion. But the Russian crisis eliminated these returns. So the Hermitage Fund changed its strategy and focus. Browder said:

> Our approach has gone beyond traditional fund management activity by aggressively focusing on **corporate governance and shareholder activism.** We take large long-term positions in companies which are highly undervalued on a fundamental basis but often have

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[6] The GDP data are in *Transition Report 1999: Ten Years of Transition* (London: European Bank for Reconstruction and Development, 1999), p. 63. The poverty data are in Branko Milanovic, *Income, Inequality, and Poverty During the Transition from Planned to Market Economy* (Washington, D.C.: World Bank, 1998), pp. 68–69. The World Bank estimated that more than 30% of Russians lived below the poverty line in 1994. See *World Development Report 2000/2001* (Washington, D.C.: World Bank, 2000), p. 281.

[7] Browder had a long-term interest in Russia, with his grandfather having been the general secretary of the American Communist party from 1932–1945 and having twice run for president.

[8] Hermitage Fund performance fact sheets, June 2000, June 2002.

> corporate governance problems. Instead of waiting for the world to change, we launch our own corporate governance initiatives to unlock their intrinsic value.[9]

With this new strategy, the fund again saw significant increases in its share price both relative to the Russian index and against returns in other international funds (see **Exhibit 6**).

Browder provided some perspective on both his early success and the motivation for his change in approach:

> When I managed Salomon Brothers' portfolio investing in Russia's voucher privatization in 1995, it was a state secret what the *names* of the oil companies were. I had a big advantage because our sister firm Phibro Energy traded oil with many of those firms, so I was able to put together a proprietary spreadsheet that had the sales and names of oil companies, which no one else knew. When *The Economist* wrote a story of how cheap companies in Russia were, I was one of three people in the world who knew anything about investing in Russia. Immediately I started getting phone calls from wealthy individuals around the world interested in the Russian story. In summer of 1995 I left Salomon and went back to some of the people who had originally called me to raise capital for a new fund. Edmond Safra, chairman of Republic National Bank, took an interest in what I was doing and offered to help me in setting up the Hermitage Fund with an initial investment of $25 million. In these early years, my investment strategy was relatively straightforward, and my main skill was picking stocks. I put together a list of the most important companies as a percent of GDP and a list of the most important companies on the stock market. When a company was on the GDP list but not on the market list, I saw an opportunity because I believed an important economic player would eventually become an important stock market player. The companies that weren't important stock market players often traded at massive discounts to Russian companies that were well researched by the brokers.
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> I had an advantage over other investors in several ways. I was on the ground, so I knew about companies that others were unaware of—what drove my initial picks were not liquidity or companies that were already researched but those companies that looked to me as having good long-term potential that were undiscovered. Also, given the nature of investors in our fund and how I was compensated, I was encouraged to take medium- to long-term positions. Corporate governance was an issue but not a central part of our strategy at the time. We knew most of the majority shareholders were bad guys, but our approach was to align interests with them so that they wouldn't try to harm our interests. For this reason we focused on owning shares where the majority of the same companies were owned by oligarchs, and we shied away from subsidiaries of those same companies where transfer pricing and asset stripping were taking place.
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> With the Russian crisis of 1998–1999, the whole dynamic changed and forced me into a more activist role. Because of the Russian default and devaluation, investors viewed any sort of Russian paper as toxic waste, and the capital markets were closed for Russian issuers. With the absence of positive incentives for good behavior, most Russian managers decided that it was more economically expedient to steal than behave, and Russia entered its worst period of corporate governance abuses.

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[9] William Browder, "The Hermitage Effect: How shareholder activities add value in Russia," PowerPoint presentation, February 2001.

Sidanco—the Start of Activism

Illustrative of this new activist phase was Browder's activities in Sidanco. Sidanco was a little-known oil holding company with stakes in seven sizable Russian oil companies. Hermitage had invested early in 1996, spending roughly $12 million to buy 4 million shares at $3 a share, a 2% stake. At the same time, allies held another 2%, with the remainder held by a controlling group headed by Uneximbank (controlled by Russian oligarch Potanin) and Renaissance Capital. In October 1997, Uneximbank arranged to sell BP a 10% stake from the controlling group, with BP paying $25 a share and the market price rising to a similar level. Hermitage's stake was now worth more than $100 million.

On December 23 Sidanco management proposed a convertible bond issue that would effectively increase the number of shares outstanding almost threefold, from 232.415 million to 634.662 million, with the shares to be available only to the controlling group at a price estimated to be 96% below the market price.[10] Browder said:

> I was on Christmas vacation and couldn't believe it. When I got back to Moscow in early January, I arranged a meeting with an investment banker from Renaissance Capital, their investment bank, and was told, "We're going to dilute you, and there is nothing you can do about it." I said, you don't understand, I'm going to have to fight you, which didn't scare them at all. I didn't want to have any conflicts, but at the same time I was about to lose $60 million of my investors' money. I called my partner, Edmond Safra, and said I didn't think we have any choice, I suggested that we had to go to war. Safra backed me 100%. I hired bodyguards and went to work.

Browder tried to use whatever leverage he could over the controlling shareholder group. He did not go on the legal offensive immediately because he did not think that would work, given the impotence of the security regulator and the corruption in the courts. Instead, "We set out to shame those who had anything to do with the controlling group, to tell their agents to stop doing this." Browder contacted BP and the Harvard University endowment, Unifund. Safra personally called up financier George Soros. And Browder contacted reporters, being careful to focus on reporters from credible and influential Western papers such as *The Financial Times* and *The Wall Street Journal*. Since Uneximbank and Renaissance Capital were involved in capital markets, there was a variety of potential pressure points.[11]

As Browder soon discovered, newspaper coverage was an important part of their approach. The angle newspapers picked up on was BP's inaction in the company. On February 9, readers of *The Financial Times* found reported on the front page that "BP said it was coming under 'moral pressure' from minority investors in Russian oil group Sidanco to intervene in a row over shareholder rights." On the 10th, the LEX column in the paper suggested that BP "should use its forthcoming seat on the Sidanco board to improve corporate governance."

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[10] Technically, the convertible bond issue was a closed subscription to existing parties in the controlling shareholder group. Payment for the convertible bonds was expected to be made through the swap of shares in seven daughter companies for the convertible bonds. If these shares in daughter companies were valued conservatively, based on their price on the exchange at the *peak* of the Russian market, on October 4, 1997, then the implied price per convertible bond would be just $1.11 per share, a 96% discount to the market price of $28.58.

[11] "Certainly, Mr. Potanin, whose Uneximbank controls Sidanco, is keen to bring western partners into his business empire and is therefore sensitive to criticism from foreign investors such as Mr. Soros, a co-investor in Svyazinvest," reported *The Financial Times* ("Fighting with Sword and Shield," *Financial Times (London)*, Survey Edition 1, April 15, 1998, p. 4).

As Browder recalled, "This caught management's attention and Boris Jordan's, the CEO of Renaissance Capital. The next day Boris Jordan called me and said, 'You're not playing by the rules, Bill.'" The response to the story was for Uneximbank and Jordan to go on the offensive. They wrote a letter to Safra complaining about Browder. They organized their own press conference to respond. As *The Wall Street Journal* reported, "Hermitage was notified of the precise terms of the bond issue before it bought Sidanco shares." Browder was delighted: "It amazed me, in an open statement to the press they accused me of being at fault because I should have known they would eventually try to rip me off."

The media campaign helped with Browder's legal strategy. Dimitri Vasiliev, head of the Russian securities regulator (FSRC), was now interested in the case. So the chief counsel of Republic National Bank came to Moscow and with a team of foreign and Russian lawyers wrote a brief to the securities commissioner. In two weeks, by February 26, the issue had not only been suspended but also cancelled, something far from market expectations.[12]

Browder argued:

> The reason he made this decision is that I was screaming bloody murder. He had a great scandal on his hands. Nobody had ever taken such a visible and outspoken position. I was shooting from the trenches, and this gave him cover to take his own steps. You have to remember that, as has become clearer since then, oligarchs owned the government and Vasiliev was worried about terrible things happening to him, professionally or even worse.[13] By not initiating but responding to an attack, he felt more empowered to act. He asked us on a number of occasions to raise specific points in the press because he couldn't go on the offensive until something came out publicly. He was clear that he couldn't be seen as initiating but responding.

Most importantly for Browder, the media strategy had paid off. The stock price recovered much of what it had lost (see **Exhibit 7**). And in March, Sidanco's company president and aides left their posts as part of a significant management shakeup.

Developing an Activist Strategy

The Sidanco experience emboldened Browder to try this approach in other companies, and the Hermitage Fund was active in seven subsequent events, from its investment in Avisma in 1998 amid concerns of asset stripping, to complaints in SurgutNG and Yukos in 1999, battles against UES in 2000 and against Sberbank, Volzhanka, and Gazprom in 2001 (see **Exhibit 8**). The size of his fund and his focus on relatively few positions (he usually had investments in at most about a dozen firms) made it both possible and worthwhile for him to fight. As one example, he pointed to his fight against Sberbank's dilutive share issue, where Hermitage launched 12 different lawsuits against Sberbank and the Central Bank, losing every one of them. Although the lawsuits were all dismissed, his actions generated a large amount of publicity, which came at a time when the Russian Duma was debating a new law on investor protection. The ultimate success of his actions, as he saw it, was the implementation of a new law in January 2002 that outlawed companies from issuing stock without

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[12] "The toothless Federal Securities Commission has launched an investigation, but few expect it to force Sidanco to change its attitude to small shareholders. The problem is not that laws to protect minority investors have not been passed in Russia but that the will to enforce them is weak," reported *The Financial Times* ("Russian Equities—the LEX column," February 10, 1998, p. 14).

[13] Vasiliev resigned from FSCR in October 1999 complaining about a lack of support to address governance abuses.

offering shares to existing investors first. Sberbank's share price went up fivefold after the new law came into effect. As another example, he pointed to companies' activities to support appeals in the Norilsk Nickel case, a company in which Hermitage had minimal shares: "Often we get as much benefit from changes in the general environment as from any specific change in a certain issuer. As [manager of] the biggest fund in Russia, I have as much of an incentive for the country to work properly as any particular company."

Others applauded his efforts. As reported in the magazine *Institutional Investor,* "Bill has shone a light into the darkest corners of Russia, and in my view that has done great service to both investors and the country as a whole," said Dominic Gualtieri, head of equities at Alfa Bank, part of Russia's powerful oil, industry, and financial services conglomerate, the Alfa Group. Added emerging markets doyen Mark Mobius of Franklin Templeton Investments, who sat on the boards of two Russian companies, "I applaud anyone who is prepared to stand up and be activist."[14]

Through these experiences, Hermitage developed a categorization of problems and of responses (see **Exhibits 8** and **9**.) All these campaigns combined public relations with other more traditional mechanisms, such as lawsuits against management, appeals to emergency general meetings, and demands for independent audits. Browder said:

> Our basic approach is to thoroughly research and understand where the corporate malfeasance is taking place and then go to great pains to simplify the story so the average person can understand what is going on. One of the reasons that certain companies have gotten away with various abuses in the past is that no one really understood what was happening because the stories were so complicated. We then share the stories with the press. By doing so, we want to inflict real consequences—business, reputational, and financial.
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> A lot of our value is communication—packaging what happens in a clear way. Fund managers have little training in this. I couldn't get investors riled up unless I could package the story. Here is where my BCG training was helpful. You have to understand that the press doesn't know about the stories, [doesn't] have the ability to understand some of these complicated activities, or can't afford to do research. We have a lot of money invested. We are affected. We can devote the resources to do what it takes to truly understand what is going on. Our goal is to frame the issue so that it is clear to everyone what has happened. We do talk to the Russian press, but our focus is on the international press.
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> And we've gotten better at this. Originally, we would give one reporter the whole story. They would want to check every bit of it out, get the other side's point of view, or ignore it, seeing this as too complicated and time consuming to pursue. Now we give a small piece of the story to a journalist and let them know that we'll give it to someone else in three days if they don't write anything. It seems that journalists are more concerned about losing the story to a competitor than almost anything else.
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> Once the story is out there it takes a life on its own. The bad guys always, always, always publicly attack you. They use the press, legal attacks, but thankfully, so far, no physical attacks.
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> We also go to courts. We've been involved in 32 lawsuits. And we win in terms of public attention regardless of the outcome, where we've lost 31 times. I think the proportion of

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[14] Andrew Capon, "Seeing Red: Fund manager Bill Browder's anger at Russian companies' treatment of shareholders is spurring reforms. It's also making him rich." *Institutional Investor – International*, September 1, 2002.

number of words written in the press when a lawsuit is initiated to when it is dismissed is 50 to 1. The court of public opinion is much more effective than the Russian legal system and much fairer.

Browder also argued that the media campaign was becoming increasingly effective as the oligarchs now sought acceptance in the international community by joining the World Economic Forum at Davos, seeking positions on the boards of trustees of prominent international institutions, and so on. While the Russian oligarch Potanin was successful in his efforts to join the trustees of the Guggenheim Museum in April 2002, oligarchs such as Oleg Deripaska were "disinvited" from participating in the Davos meeting, and Deripaska was stripped of his designation as "one of the global leaders of tomorrow" following negative press coverage of civil lawsuits alleging bribery, money laundering, and worse.[15] Interestingly, these leaders were not as sensitive to their public image in their own country, perhaps because of the lack of credibility of the local media,[16] the lack of shared norms, or both.

Browder was openly critical of other investors who had not fought against misgovernance or had been reluctant to support his campaigns. "In my opinion there are a lot of people out there who are either actively or passively violating their fiduciary duty by not fighting," he argued. Browder provided four rationales to explain other investors' inaction:

> First, the world of asset management is riddled with conflicts of interest. When an asset management firm is a part of a larger investment bank, the investment banking business is just worth too much to risk upsetting any potential clients. As a result they will not say anything is wrong with any company in their portfolio. They will not even vote their shares, and in some cases they will give their shares to management to vote. Just a little less corrupt is an asset management business that is not connected to an investment bank. In most cases, they want to stay out of the press. They would rather sell than fight. Their franchise is more valuable to them than the value of the stocks in their portfolio, and they don't want to get caught in a fight where they might be described as a villain.
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> Second, a lot of people are just naïve. They just don't expect people to lie to them. It is not in their range of experience to have a CEO of a company tell with absolute sincerity a bold-faced lie. It takes them a while to believe that they have been lied to, and in that time the damage often is already done.
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> Third, public battles are unpredictable and have casualties on both sides. The worst thing that has happened to me is when we resolved an asset-stripping dispute by seizing money offshore, which had been taken by the corrupt management. Instead of admitting defeat, the people who organized the asset stripping launched a racketeering lawsuit against me in the U.S. Imagine this, a bunch of Russian crooks accusing me of racketeering. Of course the case was dismissed. But I'm lucky. No one can fire me. Others haven't been so lucky; I had one big ally who was head of a small fund management group that was part of a larger investment bank. When UES proposed a restructuring plan that we saw as harmful for investors, we attacked the plan. After we both played an outspoken role against the restructuring plan, he was fired by his firm. Their logic was "why rock the boat when asset management earns $2

[15] Stefan Wagstyl, "The Road to Recognition," *The Financial Times*, April 6/7, 2002.

[16] The credibility of the press depended in part upon the incentives of the journalists and the owners of the media outlets. In Russia, the media were often owned by oligarchs who had many other business interests. For example, Boris Berezovsky controlled the newspapers *Nezavisimaiaia gazeta*, *Novaia isvestiia,* and *Kommersant*. Vladimir Potanin controlled *Izvestiia, Komsomolskaia pravda*, *Russkii telegraf,* and *Ekspert*. Vladimir Gusinksy controlled the Media-Most group, whose holdings included *Segnia* and *Itogi*.

> million a year and this could possibly put at risk the brokerage business, which brings in $50 million."
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> Fourth, there is the cost of this, which I don't think much of because this basically isn't that expensive. The lawsuits that generate attention aren't that expensive, with out-of-pocket costs ranging from $10,000 to $30,000 a campaign. The real cost is the time.

Gazprom

Hermitage's biggest test of this activist approach was its involvement in Gazprom, the giant oil and gas company, the largest company in Russia. As one indication of the importance of this company, tax revenues from Gazprom accounted for 25% of Russian government revenues.

Gazprom, by most conventional measures, was dramatically undervalued by the market. One metric against which oil and gas firms can be compared is the market value per barrel of reserves. By this measure, Gazprom was described as the cheapest oil and gas company in the world (see **Exhibit 5**). Consistent with this low valuation, Russian analysts suggested it had high corporate governance risk, with low transparency and accountability to shareholders (see **Exhibit 4**). By August of 2000, the company's largest shareholder remained the state.

Hermitage took its first significant stake in this company in late 2000 when it loaded up the fund weighting to 20% of the net asset value of the fund, the maximum specified in its offering prospectus and rumored to exceed 1% of all outstanding Gazprom shares. Since taking this stake, Hermitage had been involved in an ongoing campaign to improve its returns. Browder said:

> Before investing, we were intrigued by the deep undervaluation but worried about the stealing. For us to be comfortable taking a big position, we needed to know how much of the company was left after all the management graft. If it was 90%, great, if it was 10%, that was not so good. To do this we started out by going to equity analysts and the company itself to get some answers. Unfortunately, the analysts knew nothing, and the company just got mad at us for asking impolite questions. But we didn't give up; we were convinced that assets couldn't be stolen without the facts coming out somewhere. Russia is a country where everyone is filling out forms. It was just a question of finding out where the key data was filed. We eventually hit a treasure trove of data at the Russian Securities Commission, which had exhaustive company filings as a result of an $80 million loan by the World Bank to modernize their database. We then had another lucky break. My head of research was able to buy the entire Moscow registration database from a hawker on a street corner. With the securities commission database, we knew the names of the companies that stole assets from Gazprom, and with the registration chamber data, we knew which individuals owned the companies. From that we were able to piece together exactly how much was stolen and by which members of management. The amount of insider dealing was shocking, but so was the most important fact from an investment perspective—only 9.6% of the total reserves had been transferred out of the company, not 90%, which is what the market thought. Given the difference between the terrible market perceptions and the not-so-terrible reality, we increased our weighting in Gazprom to 20% of the fund and decided to share our findings with the world by selectively releasing different examples of the graft to the major Western newspapers in Moscow.

From October 2000 to March 2001, alleged governance problems at Gazprom were featured prominently in the press. Stimulating press coverage increased concerns about a variety of related-party transactions. These included transactions at inflated prices with a pipeline company, Stroytransgaz, reported to be owned by children of former chief executive Chernomyrdin and then-current chief executive Vyakhierev. They included Gazprom's declining to participate in share issues in Sibneftegas, diluting its stake and leading to benefits for Sibneftegas owners who reportedly included relatives of Vyakhierev, the head of internal audit at Gazprom. And, most prominently, they focused on the transfer of assets from Gazprom to Itera at very low prices, again, a company reputed to be owned in part by current and former Gazprom executives. These stories inflamed the investment community and helped Hermitage to convince other investors to sign their proxies to get the necessary 10% required to demand an independent audit of these and other transactions in December of 2000. The revelations also motivated the government to change the CEO of Gazprom in May of 2001.

Hermitage fund managers attributed much of this extensive coverage to their actions to bring to light problems with Itera and other companies, to coordinate shareholders to seek the independent audit, and to raise flags when the audit request was first rejected and then modified. It turned out that this was just the start of their activities. Browder recalled:

> The factual revelations that came out of our analysis were so shocking that nearly everyone who read our research wanted to do something about it. The question we asked ourselves was, "How do we harness this outrage into something constructive?" The answer came from our in-house lawyer, who suggested gathering 10% of the votes necessary to call an independent audit of the company. We knew about this right from when we were dealing with similar problems at Avisma, and it was a perfect way to tap into the indignation in the market. In the end, together with one of the big Gazprom brokers in the market we were able to assemble a voting block of 10.11% of shares and called for an independent audit of the asset stripping at Gazprom. Not surprisingly, both the management and the board rejected this proposal, although they had no legal right to reject it.
>
> We didn't appeal their rejection to the courts because this would have required all the people who gave us their proxies to be involved in a lawsuit, and there was only so far we could push the other investors. But the rejection of the proposal became a big story and was deeply embarrassing to the government. In the next Gazprom board meeting, the government minister of economic development, who was also a board member, started waving the *BusinessWeek* article about the asset-stripping allegations around, saying something had to be done. Later, a compromise was reached between the government and management. An audit would be done, but instead of using an independent auditor, the audit would be done by PricewaterhouseCoopers, the same auditor who didn't flag the asset stripping in the first place.

The audit provided further information to increase attention on Gazprom governance. PricewaterhouseCoopers found no evidence of any wrongdoing. Browder said:

> On April 15 we filed lawsuits against PricewaterhouseCoopers and appealed to the Ministry of Finance to suspend their audit license. Everybody said that there was nothing we could do, but we weren't going to just stand by and watch these bureaucrats cover up for a corrupt management team. If they wanted the benefits, then they were going to have to defend themselves out in the open. They were making $10–$15 million a year from the client and were not going to stop doing the management's dirty work unless they felt some risk from somewhere else.
>
> We also had an unexpected surprise from another player in this game—the United States government. I was asked to speak in Washington at the Carnegie Endowment for International Peace about what was going on at Gazprom. I thought it would be particularly interesting to the crowd to learn about how the U.S. government was giving a grant of $868,000 to Itera—one

of the companies allegedly linked to Gazprom management—to help them develop a gas field that they had stolen from Gazprom. As part of my speech, I outlined my itinerary that day, which included the deputy national security adviser at the White House, a deputy at the State Department, and most importantly *The Washington Post*. After the speech, the phone lines were buzzing, and by the time I got to the White House, I was told I only had five minutes to meet, as he was busy on a conference call with the State Department to discuss the Itera grant. Thirty minutes later the grant had been suspended, and it was on the front page of the Moscow paper the next day. It was a small success, but an important symbol for us.

These efforts again gained some plaudits. Alfa Bank's Gualtieri, for example, said, "The revelations were so bad the government had to act. Using the Western media was a smart political tactic."[17] But Browder did not stop here. He also sought changes in the practices at Gazprom, including a change of auditor, new procedures for shareholder oversight and approval of asset transactions, the adoption of a governance code, and a seat on the board. Mounting what seemed like a political campaign, Browder spent the better part of two months trying to capture the approval of other investors for his board campaign, in which he was vying with another notable campaigner for minority shareholder rights, Boris Fyodorov. Fyodorov and Browder had worked together in the past, but their relationship had soured when Fyodorov had been put on the board of Sberbank by Hermitage and then defied Browder by voting in favor of a dilutive capital increase at the bank against Browder's wishes.

Shareholder Activism as an Investor Strategy

The activist approach was unusual for an institutional investor. In Western markets, tipping off the media to corporate abuses was normally associated with short sellers, not shareholder activists. Institutional investors were far more likely to vote with their feet than voice criticism. As Robert Chappell, chair and CEO of Penn Mutual Life Insurance Co., declared, "Once we lose faith in the management or the trajectory of that company, we sell it. We are strictly passive. [W]e don't feel so much engaged or wedded to [a stock] that we're going to spend time trying to change its behavior. . . . Is that the right thing to do? It's a debate."[18]

Not everyone was convinced that the public approach Browder had taken in Russia was good for his investors or for other minority shareholders. Among the criticisms he encountered were concerns about showboating for his own personal interest, using the media campaigns as advertisements for his funds, using this tactic to provide "greenmail," and concerns that returns could be higher without this activist approach.

The media reported criticism of his approach. "You can't knock the guy's record," said one London fund manager. "But some of his recent antics do strike me as publicity stunts." PricewaterhouseCoopers spokesman Dave Nestor said: "Mr. Browder is looking for publicity. There is no basis for a lawsuit against PricewaterhouseCoopers." Fyodorov suggested it was mainly bluster: "He thinks he single-handedly changed laws in Russia. No one in the government has ever heard of him."[19]

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[17] Capon, "Seeing Red."

[18] "Institutional Investors as a Force for Change," Knowledge @ Wharton, <http://knowledge.wharton.upenn.edu/articles.cfm?catid=1&articleid=655&homepage=yes>, accessed November 11, 2002.

[19] All quotations from Capon.

Hermitage's visible approach differed from that of many other institutional investors in Russia, who tried not to air their dirty linen in public but to get their interests addressed in less public ways. This was similar to the argument expressed by U.K. institutional investors: "Whenever possible, the institutions prefer to operate in the shadows. The prevailing view, even among activist managers, is that 'secrecy and trust are essential.'"[20]

In the United States, the term "greenmail" was given to the practice of assembling a stake that could lead to a takeover and being bought out at a superior price to that available to other investors—as the Bass brothers did in selling their shares back to Texaco at $55 when the market price was $35 for minority investors. While Hermitage had not been linked to such an approach, coalitions of minority investors in Russia had broken up when large shareholders were offered special deals by management. For example, in 2000 Gazprom was alleged to have acquired the votes of the U.S.-based financiers George Soros and Kenneth Dart by having the government convert their Russian shares into American Depositary Receipts that were trading at a significant premium.

Others could argue that the approach of Hermitage was too costly. Hermitage had costs of time, of organizing minority investors, of conducting media campaigns, and of running for seats on boards. It only appropriated gains proportionate to its stakes, with other minority investors riding free on this activism. Since funds competed for the same investors, and since the costs of activism had to be incorporated in a fund's fee structure, in the long run could a fund afford to be activist if others could copy portfolios and avoid the activism costs? This argument was often heard in American capital markets where institutional investors, for the most part, remained silent regarding governance issues. Funds that took an activist stance, like the California Public Employees Retirement System, or CalPERS, were the exception rather than the rule.

There were also alternatives to funds and fund managers taking an active role. For example, in April 2000, with the support of 25 portfolio managers including Hermitage, Russia's Investors Protection Association (IPA) was founded, dedicated to protecting minority shareholders' interests against the predations of Russia's business oligarchs. Vasiliev, the former head of the Russian Securities Commission, headed this body. The IPA had its own representatives ready to take seats on boards. Perhaps this body, or others like it that had the attractive feature of spreading the costs, could take on the role Browder had played.

Decision Point

By the summer of 2002, developments in Gazprom caused Browder to rethink his approach. Hermitage was now managing $600 million in the fund and $200 million in separate accounts. He was delighted with the returns his investors had achieved in Gazprom. Since the beginning of the year, stockholders had seen an 88% return. But the approach was showing some weaknesses. Browder lost his bid for election to the Gazprom board. The lawsuits against PricewaterhouseCoopers were also dismissed. Browder was taking a long overdue vacation and had time to sit back and review the past few years.

Even if Browder decided activism was still warranted, there remained the question of tactics. Litigation had been an important part of his strategy because it generated news stories that gave the firm some leverage and it held the chance that it might actually succeed. So far he had litigated largely in Russia, where filing court cases was relatively inexpensive, with little prospects for success.

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[20] Bernard Black and John Coffee, "Hail Britannia? Institutional Investor Behavior under Limited Regulation," *University of Michigan Law Review*, June 1994, p. 2055.

Should he ramp up his strategy and also litigate in the United States? This avenue would be significantly more expensive. There was also the question of how involved Browder and the fund should be in management. He could also keep up his activism by seeking seats on boards for himself and company representatives. This had met with both success and failure, but one thing was clear, this took up a lot of company time and effort.

Finally, world events were casting a shadow over his activities. In the past he had counted on shock value to generate media coverage and generate responses. Now, with daily stories of corporate scandals in the United States, these Russian events might be less newsworthy, and his leverage would decline. Should he continue his activist agenda? What policies should he follow, and would they continue to work? By the time he returned from vacation, he would have to provide answers to these questions.

Exhibit 1 Consumer Prices, Interest Rates, and Exchange Rates

Exchange Rates	1992	1993	1994	1995	1996	1997	1998	1999
Consumer price inflation[a]	2,508.8	839.9	213.7	131.4	21.8	11.0	84.5	36.6
CBR Refinance Rate				185	110	32	60	57
Overnight Interbank rate				190	48	21	51	15
Official rubles/US$ exchange rate[b]		1.25	3.55	4.64	5.56	5.96	20.65	27.00
Real effective exchange rate[c]		---	91.12	100.00	122.07	128.92	114.15	80.90

Source: *International Financial Statistics*, International Monetary Fund, July 2000, pp. 654–655; *IMF Staff Country Report: Russian Federation*, No. 00/150, International Monetary Fund, November 2000: 43; *Russian Economic Trends: Monthly Update*, Russian-European Centre for Economic Policy, October 11, 2000.

Key to notation:

[a]December to December percentage change.

[b]End of period.

[c]Real effective exchange rate index is derived from the nominal effective exchange rate index, adjusted for relative changes in consumer price.

Exhibit 2 Balance of Payments, 1994–1999 (millions of current U.S. dollars)

	1994	1995	1996	1997	1998	1999
Current Account	8,850	8,025	12,448	2,545	1,040	24,961
Goods and Services	10,958	11,323	17,809	11,611	13,250	32,058
Exports	76,250	93,481	103,844	103,088	87,255	84,346
Imports	-65,292	-82,158	-86,035	-91,476	-74,005	-52,288
Investment income and compensation of employees	-1,802	-3,371	-5,434	-8,706	-11,801	-7,631
Compensation of employees	-114	-303	-406	-342	-164	221
Investment income	-1,688	-3,068	-5,028	-8,365	-11,637	-7,852
Current transfers	-306	73	72	-360	-409	534
Capital and Financial Account	-8,612	730	-6,774	5,480	8,193	-17,403
Capital Account	2,410	-347	-463	-797	-382	-328
Financial account	-11,022	1,077	-6,311	6,277	8,575	-17,075
Direct investment	538	1,658	1,708	4,036	1,734	1,164
Abroad	-101	-358	-771	-2,603	-1,027	-2,145
In Russia	640	2,016	2,479	6,639	2,761	3,309
Portfolio investment	21	-2,444	4,410	45,807	8,619	-614
Assets	114	-1,705	-172	-156	-257	254
Liabilities	-93	-738	4,583	45,963	8,876	-868
Other investment	-11,634	11,173	-13,786	-41,610	-7,032	-15,672
Assets	-17,522	5,186	-29,074	-26,608	-16,003	-15,124
Changes in the stock of non-repatriated export proceeds and nonrepatriated import advances	-3,860	-4,928	-9,773	-11,458	-8,879	-5,384
Liabilities	5,889	5,987	15,288	-15,002	8,971	-548
Reserve Assets	1,896	-10,386	2,841	-1,936	5,305	-1,778
Adjustment to reserve assets	-1,844	1,076	-1,484	-20	-50	-176
Net errors and omissions	-238	-8,755	-5,674	-8,025	-9,234	-7,558

Source: Central Bank of Russia, <http://www.cbr.ru/eng/dp/P_balance94(95,96,97,98,99).htm>.

Exhibit 3 GDP by Expenditure, 1991–1999

	1991	1992	1993	1994	1995	1996	1997	1998	1999
	Annual Percentage Change at Constant Prices								
Gross domestic product	-4.6	-14.6	-7.6	-11.7	-4.5	-6.7	0.9	-5.5	3.2
Consumption	-6.1	-5.2	-1.0	-3.1	-2.7	-3.1	3.0	-2.3	-3.5
Households	-4.6	-3.0	1.2	1.2	-2.8	-4.7	5.4	-3.6	-5.3
General government	-11.3	-11.8	-6.4	-2.9	1.1	0.8	-2.4	0.6	0.9
Nonprofit institutions	34.5	-1.0	0.2	-35.9	-30.5	-0.5	-1.8	-1.6	0.0
Gross investment	-2.3	-36.9	-29.4	-31.2	-10.8	-20.6	-3.6	-31.3	9.3
Capital formation	-15.5	-41.5	-25.8	-26.0	-7.5	-19.3	-5.7	-11.2	2.4
Changes in inventory	264.1	-29.2	-37.4	-47.1	-30.4	-27.3	8.9	---	-55.7
Net exports of goods and services	171.4	717.1	23.2	-13.0	3.2	21.2	-8.8	111.0	60.2
	In Percent of GDP at Current Prices								
Consumption	63	50	64	70	71	71	75	77	69
Households	41	34	41	44	49	49	50	54	50
General government	17	14	18	23	19	20	21	19	15
Nonprofit institutions	4	2	5	3	2	2	3	3	3
Gross Investment	37	36	28	26	25	24	22	15	15
Capital formation	24	25	21	22	21	21	19	17	16
Changes in inventory	13	11	7	4	4	3	3	-2	-1
Net exports of goods and services	0	15	8	5	3	4	3	7	16

Source: *IMF Staff Country Report: Russian Federation*, No. 00/150, International Monetary Fund, November 2000: 29.

Exhibit 4 Example of Corporate Governance Evaluation for Russian Firms

FEBRUARY 2001 RUSSIAN OIL AND GAS SECTOR: AN INVESTMENT PRIMER

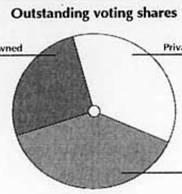
Gazprom

Exposure to potential corporate governance risk

- Vulnerable to high
- Fair to vulnerable
- Low to fair

OWNERSHIP STRUCTURE AND TRANSPARENCY

Outstanding voting shares



Share capital structure as of August 2000

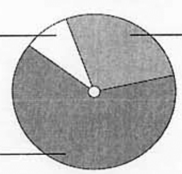
Affiliated parties	
Private owners:	
Management and affiliates	
Ruhrgaz AG	4%
Subsidiaries:	
Stroitransgaz	5.7%
SibUr	51%
Gazmash	92.5%
Gazpromgeofizika	51%
Gaztelecom	84.2%
Metaprom (Arkhangelsk)	60%
EuRoPol (Warsaw, Poland)	48%
Belgazprombank (Minsk, Belarus)	33.99%
Lazurnaya (Sochi)	77.97%
Gorizont Investment Company	35%
Gazprom Finance B.V. (Amsterdam)	100%
Gazprombank	69.7%
Promstroibank, Russia	24.7%
Imperial Bank	8.38%
National Reserve Bank	37.44%
Inkombank	13.21%
Gazpromokhrana	100%
Gazprom-Media	100%

Degree of transparency

- High
- Moderate
- Low

OVERSIGHT AND CONTROL STRUCTURE (2000-01): ACCOUNTABILITY TO SHAREHOLDERS

Board of Directors



	Executive/Outside	IPA	Nominated
Chairman: Dmitry Medvedev, Deputy head of presidential administration	NED		State
Rem Vyakhirev, CEO, Gazprom	EXE		Pvt Own
German Gref, Trade and Economics Minister	NED		State
Boris Fyodorov, President, UFG	INE	√	Portf Inv
Arngolt Bekker, SEO, Gazprom	EXE		Pvt Own
Farit Gazizullin, Property Minister	NED		State
Victor Tarasov, CEO, Gazfond pension fund	NED		Pvt Own
Vyacheslav Sheremet, First Deputy CEO, Gazprom	EXE		Pvt Own
Burkhard Bergman, Deputy CEO, Ruhrgaz AG	NED		Pvt Own
Ilya Yuzhanov, Antimonopoly Minister	NED		State
Viktor Khristenko, Deputy Prime Minister	NED		State

Degree of accountability

- Good
- Adequate
- Poor

MANAGEMENT AND INVESTOR RELATIONS

CEO: Rem Vyakhirev (since 1993)

Management structure
Two-tier management structure. The CEO is backed by a 20-member executive board.

Investors' contact
Olga Borodina
Phone: 7 (095) 719 3001, 719 2786

Web site: http://www.gazprom.ru

Accountability of executive directors
The company management has until recently evaded any control by shareholders due to a passive stance by the government which owns a large stake in Gazprom's equity and two-tier share structure which limits foreign ownership to a tiny percentage represented by a restricted ADR program. Both of the problems are being addressed now as the new government undertakes a close inspection of management activities which may have led to loss of shareholder value and the two-tier structure has come under radical review.

Investor relations

- Friendly
- Adequate
- Hostile

CORPORATE CULTURE

Policy for corporate conduct	
BoD modus operandi	√
Internal auditor modus operandi	√
General meeting protocol	√
Charter and inherent exposure to corporate governance risk	Not reviewed
Incentives for good corporate governance	
Pending ADR program	No
Corporate governance code	No
Governance track record	Volatile

INFORMATION DISCLOSURE AND FINANCIAL DISCIPLINE

Accounting standards	IAS Auditor: PricewaterhouseCoopers RAS Auditor: PricewaterhouseCoopers
Independence of internal auditor	Low
Disclosure record with FCSM	Good
Level of ADR program **Listing of ADR**	144A LSE
Listing of local stock	MSE Regional: SPBEX, ESE
Registrar **Registrar risk**	DRAGA, Moscow Susceptible
Dividend history	Consistent

	1997	1998	1999
Dividend declared	√		√
Dividend paid	√		√

1999 dividends are due in December 2000.

Financial discipline

- Good
- Adequate
- Susceptible

Source: *Russian Oil and Gas Sector: An Investment Primer*, Troika Dialog, February 2001, p. 35.

Exhibit 4 (continued) Example of Corporate Governance Evaluation for Russian Firms

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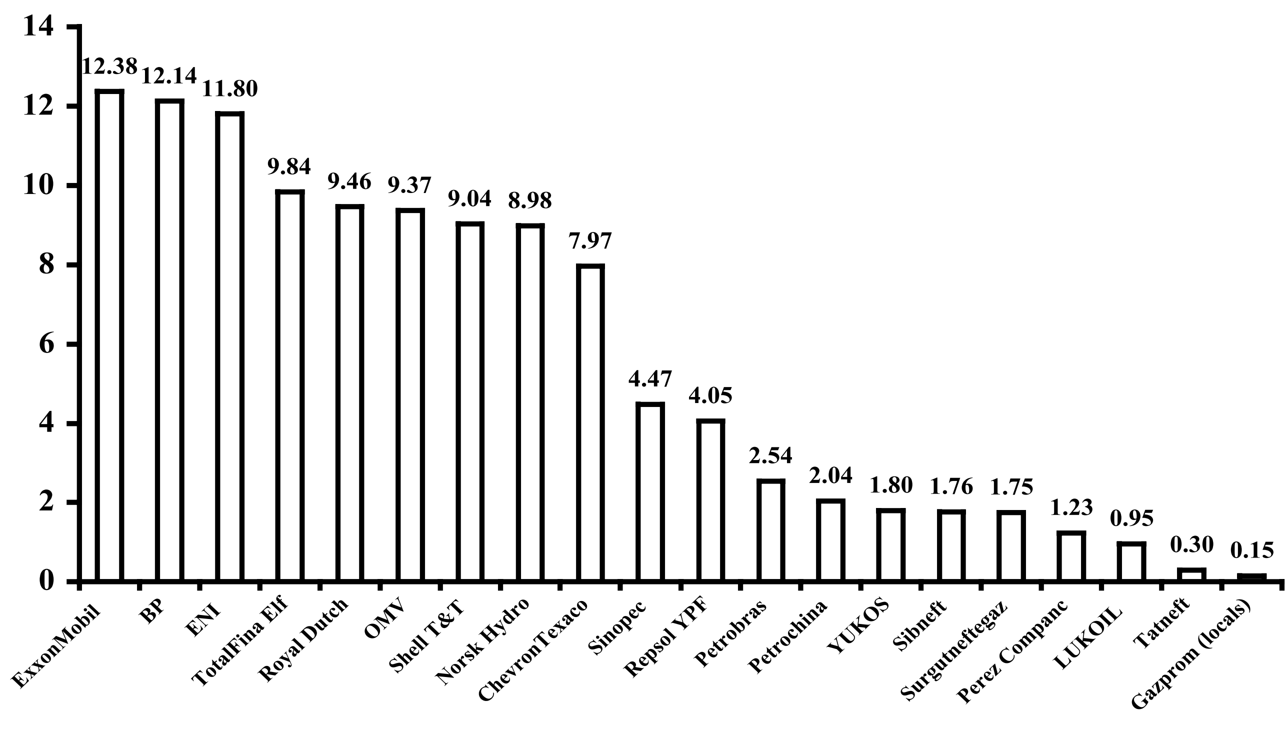
Exhibit 5 Market Capitalization of Oil Companies per Barrel of Reserves (US$ per barrel)



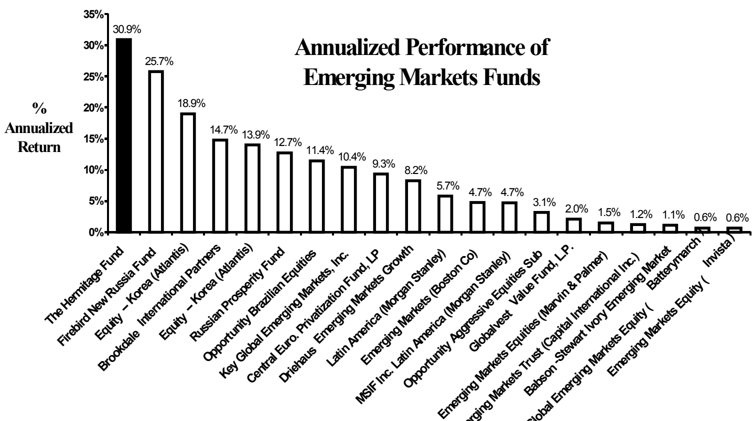
Source: Hermitage Fund data based on Credit Suisse First Boston (CSFB).

Exhibit 6 Hermitage Fund Performance

Hermitage Performance

HERMITAGE CAPITAL MANAGEMENT

Hermitage Fund has outperformed all other emerging market funds in the world over the last 5 years ending December 31, 2001

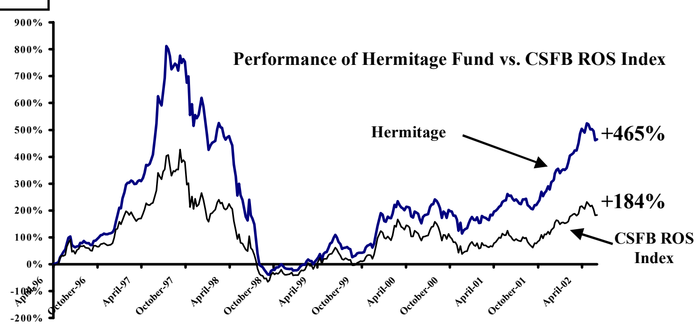


Source: Nelson's Investment Management Database

Hermitage Performance

HERMITAGE CAPITAL MANAGEMENT

Total Return*	YTD	1 Year	2 Years	3 Years	4 Years	5 Years	Since inception**
Hermitage Fund	36%	59%	124%	213%	84%	-9%	465%
CSFB ROS Index	20%	36%	51%	103%	71%	-24%	184%



* Total returns for each period are calculated using the last bid as of June 28, 2002; ** The Hermitage Fund was launched on April 27, 1996

	Hermitage Fund	CSFB ROS Index
2002	**35.96%**	**19.89%**
June	-6.11%	-10.09%
May	-0.32%	-0.48%
April	15.5%	9.9%
March	14.4%	13.5%
February	4.3%	2.0%
January	5.5%	5.3%
2001	**80.6%**	**61.1%**
December	11.6%	11.4%
November	13.2%	14.1%
October	7.1%	9.9%
September	-9.9%	-14.7%
August	0.0%	1.6%
July	-3.9%	-7.1%
June	11.8%	5.4%
May	7.1%	11.0%
April	10.7%	7.4%
March	5.8%	5.0%
February	-8.4%	-13.5%
January	19.9%	24.5%
2000	**-4.9%**	**-25.9%**
1999	**196.0%**	**212.9%**
1998	**-88.6%**	**-82.6%**
1997	**228.2%**	**103.8%**
1996	**119.2%**	**78.9%**

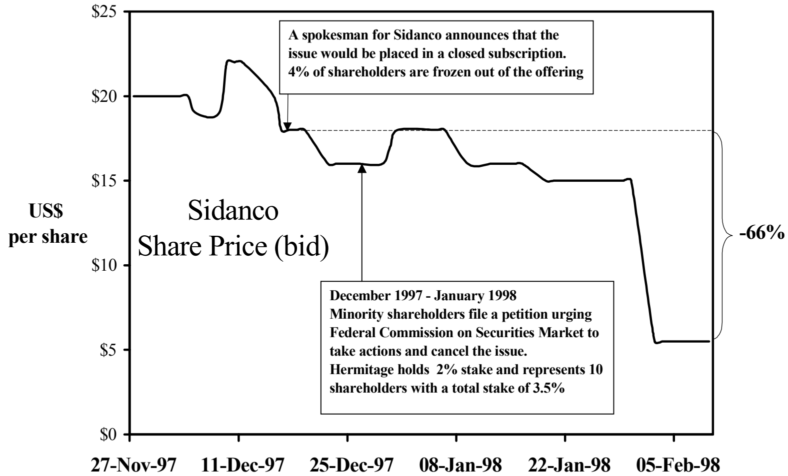
Source: Hermitage Fund.

Exhibit 7 Sidanco Investment and Outcome

Case Study - Sidanco

HERMITAGE CAPITAL MANAGEMENT

The proposed dilutive issue caused the Sidanco share price to plunge by 66%

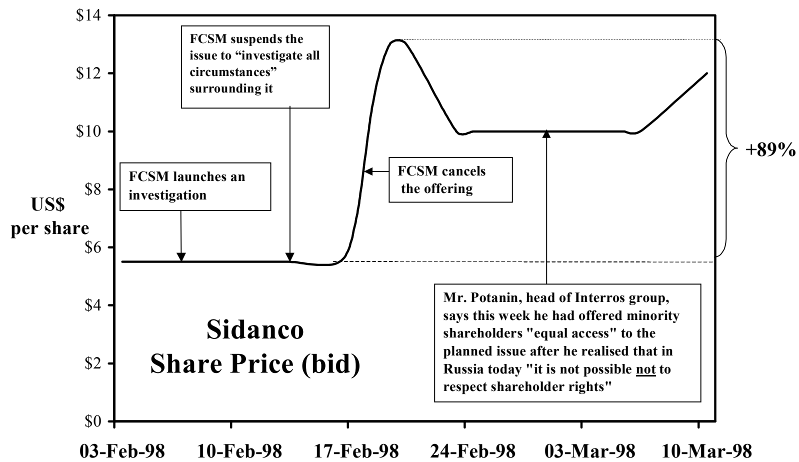


Source: HCML, Reuters

Case Study - Sidanco

HERMITAGE CAPITAL MANAGEMENT

On February 13, 1998, the Russian FCSM cancelled the dilutive issue which led to an 89% rise in the price of Sidanco



Source: HCML, Reuters

Source: Hermitage Fund.

Exhibit 8A Hermitage Summary of Companies, Problems, and Activism

DATE	1998	1998	1999	2000	2001	2001	2001
ISSUER	**Sidanco**	**Avisma**	**SurgutNG**	**UES**	**Sberbank**	**Volzhanka**	**Gazprom**
PROBLEM	Dilution	Asset stripping	Unfair swap	Asset stripping	Dilution	Asset stripping	Asset stripping
HERMITAGE ACTIONS	Appeal to FSC	Legal injunction offshore	PR campaign	PR campaign	EGM & Lawsuit	Lawsuit	PR, Lawsuit & Audit
RESULT	Cancellation of issue	Cash settlement	No positive result so far	New restructuring plan, new charter	Introduction of preemptive rights	Currently in court	CEO fired

Exhibit 8B Hermitage's Advertised "Activist" Approach

Source: Hermitage Fund.

Exhibit 9 Hermitage's Categorization of Problems and Responses

Hermitage Activism

HERMITAGE CAPITAL MANAGEMENT

What the "bad guys" do in Russia

- Asset stripping
  - Sale of subsidiary to interested parties
  - Overpaying for capital expenditures
  - Nonparticipation in dilutive issues of subsidiaries
- Profit skimming
  - Transfer pricing
- Shareholders dilution
  - Closed subscription at below market price
- Unequal treatment of shareholders
  - Different access to financial information
  - Different timing in notifying different shareholders about corporate events
- Self-dealing and interested-parties transactions
  - Granting contract to companies affiliated with management

Hermitage Activism

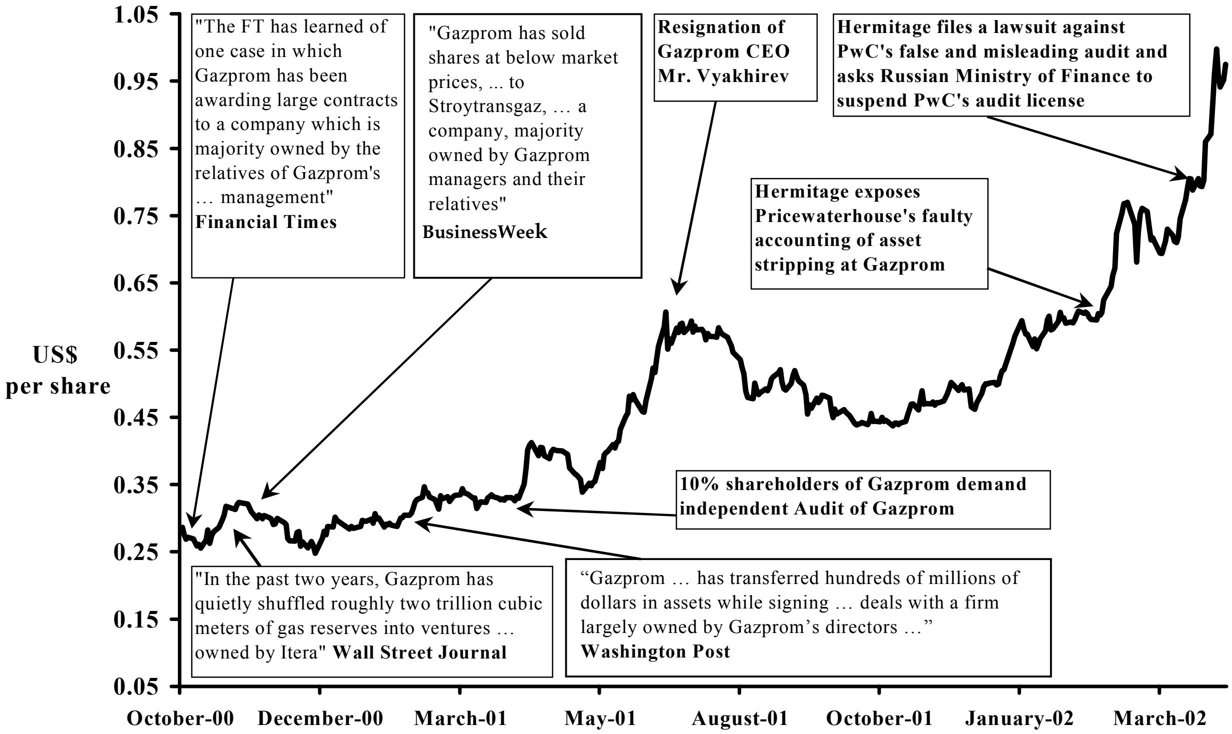
HERMITAGE CAPITAL MANAGEMENT

How Hermitage Responds

- Organize shareholders
  - Fire CEOs
  - Call EGMs
  - Call for External Audit
  - Change the Board
  - Change the Charter
- File lawsuits
  - In Russian Court
  - With Russian Securities Comm
  - In foreign Court
- Organize PR campaign to appeal to
  - Russian government
  - Russian President
  - Other investors
  - Market intermediaries
- Appeal to international organizations
  - EBRD
  - World Bank
  - US government
  - European Union
- Identify allies
  - Political Allies
  - Business adversaries

Source: Hermitage Fund.

Exhibit 10 Hermitage Suggestion of Links between Activism and Gazprom Share Price



Source: Hermitage Fund.