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Don't Bet on War or Peace…Invest in Volatility

The recent "visit" by unmarked troops with Russian accents to Crimea has brought back visions of the Cold War and encouraged some to recount stories of the many millions of lives lost to famine and war in the region during the times of Stalin and other forceful/brutal Russian/Communist leaders. While some things remain the same from those times, many other things have changed in a dramatic fashion. Yet, regardless of the balance of influence from the past and present, it is folly to rely too heavily on either to predict the outcome of the political posturing taking place. A better course of action from an investment perspective is to take advantage of the benefits that volatility can bring and not lean too heavily in any direction based upon an assumed outcome.

This Story is Over 200 Years Old

The Russians have been fighting for control of Crimea, and the nearby harbors, off and on since the late 18th century. The "Black Sea Fleet" has used it as a base for operations to fight a variety of other peoples/countries including the Turks, the Ottomans and most recently, the Georgians. Crimea became part of the Russian Empire in 1783 and remained so until the Russian Civil War (1917-1922). Crimea's independence from Russia was short-lived and it ultimately returned to Moscow's control via its absorption into the Soviet Union (1921). In 1954 the Supreme Soviet of the Soviet Union (with the support of then General Secretary of the Communist Party, Nikita Khrushchev, a Ukrainian) transferred Crimea to the Ukraine as a "symbolic gesture", ostensibly to commemorate the 300th anniversary of Ukraine becoming part of the Russian Empire, but interpreted by some as reparations for the millions of deaths caused by Stalin's initiatives to collectivize agricultural production (1932-1933) that resulted in a famine known as the "Holodomor". While this story is over 200 years old it is important to keep two aspects of this history in mind: 1) the Pro-Russian Crimeans have very good reason to consider themselves Russian; 2) The Ukrainians who are anti-Russian have very good reasons to not trust, if not hate, Russia.

Lessons from Afghanistan

The U.S.S.R. fought the U.S.-backed Mujahedeen for control of Afghanistan for approximately nine years and it is argued by some that it contributed significantly to the ultimate collapse of the Soviet Union due to its economic cost, its negative impact on the Union's image as a "super-power" and the damage caused by the resulting strains in international relations/trade. It appears that the U.S.S.R's military involvement in

Afghanistan was based more on ideology than economic interest, and even if there was a significant economic interest, the math behind the cost/benefit was highly suspect.

Putin's Real Source of Power

Vladimir Putin has served either as Russia's President or Prime Minister since 2000. While much is made of his "bravado" and his popularity amongst many Russians (that many attribute to his "strong man" persona), his real strength comes from the fact that Russia has enjoyed a reasonably high level of economic prosperity during his tenure with GDP growth averaging over 5% (with the exception of the Global Financial Crisis):

Putin's "special" brand of "totalitarian capitalism" has restored some of Russia's national pride, but it has been funded by a pro-growth energy policy and foreign investment. Unlike Lenin/Stalin, Putin is a pragmatist not an ideologue. As such, he is likely to seize "low-hanging fruit" like portions of Georgia or Crimea, but his assertiveness is likely to be tempered by the threat of real, sustained damage to his political clout which is based more in continued economic progress than in political dogma.

Take and Then Negotiate

The Pro-Russian occupants in southern/southeastern Ukraine are not going to be as easy to "annex" as the ones in Crimea due to factors such as:

- **Geography** (the boundaries of Crimea were quite well-defined)
- **Politics** (Crimea was already somewhat autonomous; Russians represent less than 20% of the Ukrainian population)
- **Military** (while Ukraine is not a NATO member, the odds of it becoming member would likely increase substantially if Russia were to be more overt in its aggression).

Despite the above obstacles, every good negotiator knows that it is best to have something to "give back" so that you can "keep" what you really wanted in the first place. Putin is not likely to give back Crimea under any circumstance, but in order to keep the longer-term strategic costs to a minimum, he may want to "take" some portion of southern/southeastern Ukraine by some means, and to enough a degree, that it provides him a bargaining chip.

How good a poker player is Putin?

So far Putin has called all of the shots, and he has not overplayed his hand, but at the end of the day, his hand is weak and he cannot afford to have his bluff "called". If he pushes too hard, too fast, he will drive the Ukraine into the arms of NATO (which he definitely does not want), he will solidify Ukrainian support for joining the European Union (also something he wants greatly to avoid) and/or exports/foreign investment will dry up (something he cannot afford). Yes, some loss of foreign investment could be made up by China. Yes, the U.S. is "war-weary". Yes, Europe would prefer a "diplomatic solution". Yes, Europe is just coming out of a recession and it can ill-afford an energy crisis at this juncture. Nonetheless, the memory of World War II has not faded sufficiently such that mistakes of the past have been completely forgotten. Putin is well aware of this fact, and unlike the former leaders of the Soviet Union, he cannot demand blind obedience and motivate the Russian people with empty propaganda. This is not Lenin's Russia, it is Jerry Maguire's Russia…he has to "show them (the Russian people) the money (economic progress)!"

"If you smoke around dynamite, intentions don't matter."

Neither the West, nor Putin, want the present situation to escalate out of control as it is not in anyone's best interest, but that may not matter. Whenever you combine hostile parties, weapons and nervousness, anything is possible. Mistakes happen, miscalculations occur and opportunists may endeavor to further their causes by "stirring the pot" and instigating a confrontation that would not otherwise occur. All the political and economic analysis in the world cannot fully account for the "X Factor" that always lurks in the wings during such times as these.

Crisis Myopia

Some are quite confident that concern about this situation is "overblown" and any resulting weakness is a *"buying opportunity".* Even if those possessing this viewpoint are correct, there is an assumption underlying the basis of their investment approach that is quite dangerous and quite common in these situations: ***that the greatest risk to the markets is what is on the front page***.

Humans (investors) have a very bad habit of viewing their lives (markets) from the standpoint of the most visible challenge at the time to the exclusion of other potential "black swans". Just prior to 9/11, many market pundits thought the greatest threat we faced was a rapidly declining NASDAQ and the prospect of a recession. Prior to the Fukashima nuclear disaster, Japan thought its biggest problem was deflation and a sluggish economy. Prior to Katrina, New Orleans thought its biggest problem was a high crime rate and a dysfunctional educational system.

Unexpected circumstances have a way of sometimes violently reorienting people's perspective on what is important and simultaneously making the previous crisis quite irrelevant.

Strategy Implications

We don't know for sure if the Ukrainian/Crimean situation will be resolved peacefully and without economic disruption, just as we don't know if that is what we should really be the most worried about. What we do know is that disruptions do occur and markets have tendency to overreact. If there is an escalation of hostilities, most all capital markets will be affected to some degree. It is very likely our hedges will provide at least partial buffer against the resulting volatility and, provided the market pullback is sufficient enough, gains from the hedges would be used to buy assets that are unduly impacted by a sharp, broader rise in risk aversion. Successful risk management during periods of heightened uncertainty is not so much about forecasting outcomes as it is about not putting too much weight on either foot.

"It is safer to bet that a landmine is not located in a "warm crater" (where an explosion recently occurred) than it is to rely on the accuracy of your metal detector."

"Look to the Future, be Optimistic…but Hedge."

(We want to keep these commentaries brief and focused so as to provide a good "information-to-text-length ratio", but if you have specific questions/topics you want me to address, please let us know.)

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