Commentary

July 2014

The Ongoing Conflict in Eastern Ukraine

- The situation in eastern Ukraine has continued to deteriorate, and resolution remains a long way off.
- It's not yet clear if the recent downing of a civilian aircraft will serve to escalate or de-escalate the conflict.
- Our Funds remain well diversified, and both SEI and its managers are watching developments closely.

Last week, a fragmented and chaotic situation in Eastern Ukraine was intensified by two important events. On July 16, the U.S. Treasury Department announced escalated sanctions against Russia. And on July 17, a civilian aircraft flying over the region en route from Amsterdam to Malaysia was shot down. These developments have brought the stubborn and chaotic nature of the event, the complicated political maneuvering between Russia and the West, and—unfortunately—the conflict's mounting human toll into stark relief. As we stated in our May 2014 commentary, "Russia—Balancing the Risks against the Realities," developments in eastern Ukraine "indicate a very complicated situation that could take a long time to resolve." Last week's events only strengthened that view.

The U.S. Tightens the Screws

After a short-lived ceasefire fell apart in late June, the Ukrainian government in Kiev took more forceful military action against rebel forces in the East, including air and artillery attacks. Meanwhile, Russia, in addition to maintaining troops along its border with Ukraine, appears to have supplied rebel forces with more advanced weaponry (including rockets capable of shooting down high-altitude aircraft). In response, the Obama administration announced on July 16 that it was expanding the scope of U.S. sanctions against Russia. Previous measures had been narrowly targeted at select individuals with close ties to the Kremlin. The latest round was designed to put pressure on Russian businesses and newly formed rebel political organizations in Eastern Ukraine.

For investors, the most relevant aspect of these sanctions is the prohibition against several companies—including publicly traded entities—from obtaining financing on U.S. capital markets. The objective of this measure was summed up in the accompanying press release: "By imposing sanctions on entities within the financial services and energy sectors, Treasury has increased the cost of economic isolation for key Russian firms that value their access to medium- and long-term U.S. sources of financing."

The Conflict's Mounting Human Costs

In our previous commentary, we also observed that, "To the extent that local elements influence the situation, it could make for a more drawn out and volatile affair." That has certainly been the case with the downing of a Malaysian Airlines passenger jet over Eastern Ukraine. According to media reports, separatist forces in control of the region are not equipped to handle this type of tragedy (much less administer entirely new political entities). The situation has also highlighted serious internal divisions within the separatist movement, and the extent to which the conflict has undermined the region's existing institutional resources and infrastructure.

Our View

In some ways, Eastern Ukraine is now reminiscent of the "proxy" conflicts that occurred during the Cold War between the U.S. and the Soviet Union. The two best-known examples are Vietnam in the 1960s and 1970s, and Afghanistan in the 1980s. Although their direct involvement is more limited in the conflict at hand, Russia and the U.S. (and, by extension, Western Europe) are clearly fighting for influence in the region.

In regard to the latest U.S. sanctions, we are somewhat concerned that publicly traded companies are now being targeted. However, it's important to note that these measures, while tightening the screws a bit, are not likely to impose significant hardships on the publicly traded firms that they target. For example, the sanctions do not prevent short-term financing (90 days or less) from U.S. markets. And although the targeted companies are in capital-intensive industries, some of them should be able to finance operations with internal capital for some time. The amounts they have raised on U.S. markets over the past 18 months have been relatively modest to begin with. Most importantly, these sanctions do not prevent these companies from obtaining financing from capital markets elsewhere in the world. While the Europe Union has promised to ratchet up economic pressure, its ability to do so is more limited, given Europe's current dependence on

Russian energy supplies and its banking system's close ties to Russian enterprises. If western sanctions should ever reach levels that truly inflict significant costs on Russian companies, Russia's government should be able to provide a good deal of support, given the country's healthy fiscal position and ample foreign-currency reserves. That said, there are still reasons for concern. Escalating sanctions indicate that little progress is being made toward a solution. They also increase the risk that the Russian government could take actions that would harm foreign investors' interests (although we believe the probability is still quite low at this point). The renewed selloff in Russian equities reflects the heightened concerns among investors caused by these recent events.

Regarding the Malaysian Airlines tragedy, its impact on the situation will not be known for some time. On the one hand, it could potentially help to de-escalate the conflict; however, it seems to be having the opposite effect at the moment, with rhetoric heating up on all sides. As an unfortunate result, the on-the-ground violence and human casualties that preceded the incident seem likely to continue for the foreseeable future—especially with the conflict now enveloping Eastern Ukraine's two largest cities (Donetsk and Luhansk).

We continue to expect a chaotic, drawn out and, at times, messy affair in Ukraine; clearly, the investment-related risks remain elevated and volatile. But as we noted in May, "Adopting a reasonable balance between risk and return is a critical part of the investment process, and it is something professional money managers do every day." The situations in Russia and Ukraine highlight the importance of portfolio diversification, and our managers will continue to carefully assess the risks and opportunities that the conflict—and, hopefully, its eventual resolution—give rise to.

Our Funds

At the end of June, our Emerging Markets Equity Fund had no positions in Ukraine, and overall positioning in Russia was slightly higher than the benchmark MSCI Emerging Markets Index (5.87% and 5.40%, respectively). Our International Equity Fund had no positions in Ukraine and a small off-benchmark position (0.41%) in Russia. Our World Equity Ex-U.S. Fund held a 1.06% position in Russian stocks, and our Screened World Equity Ex-U.S. Fund held a 0.20% position. The MSCI All Country World Ex-U.S. Index (the benchmark for both Funds) held an exposure of 1.15%.

