

# DIAMOND AGE RUSSIA FUND

## MONTHLY LETTER TO INVESTORS – JULY 2009



*"Every government is a parliament of whores. The trouble is, in a democracy, the whores are us." P. J. O'Rourke*

After outperforming the Russian benchmarks\* in June by the largest margin since 2005 Fund inception, Diamond Age closed out July again ahead of the RTS, bringing the cumulative return for the 5-month period beginning of March – end of July to +72.90%. Fortunately investors avoided an unanticipated selloff which saw the RTS drop -15.34% (from 987.02 to 835.61) in the first two weeks of trading. This precipitous fall was only the second leg of the much larger straight-line retreat from 1,180.56 starting June 2nd equalling a six week plunge of -29.22% from peak to trough (see chart on the next page). In spite of extremely adverse market conditions and perhaps the Fund's own overly constructive expectations, Fund performance remained strong and with an absolute minimum of volatility.

While admittedly surprised by both the direction and magnitude of this recent correction, the Investment Advisor was not caught flat-footed.

\*June performance: Diamond Age -3.28%, vs. RTS -9.25% and MSCI Russia -14.31%.

### International Business Partners and Terms

<b>Investment Advisor</b>	<b>Diamond Age Capital Advisors, Ltd.</b>
<b>Administrator</b>	<b>CIBC Bank and Trust Co. (Cayman)</b>
<b>Russian Custodian</b>	<b>CitiGroup – ZAO Citibank (Russia)</b>
<b>Auditors</b>	<b>Deloitte &amp; Touche – Cayman Islands</b>
<b>Tax Consultants</b>	<b>Ernst &amp; Young – Russia and Cyprus</b>
<b>Legal Counsel</b>	<b>Turner &amp; Roulstone – Cayman Islands</b>
<b>Base Currency</b>	<b>US Dollar</b>
<b>Hurdle Rate</b>	<b>US Dollar 3-month LIBOR + 50 bps</b>
<b>Inception Date</b>	<b>18 February 2005</b>
<b>Dealing Day</b>	<b>Last business day of the month</b>
<b>Min. Subscription</b>	<b>\$100,000</b>
<b>Bloomberg Ticker</b>	<b>DIAMRUS KY &lt;Equity&gt; &lt;Go&gt;</b>

### Current Asset Allocation

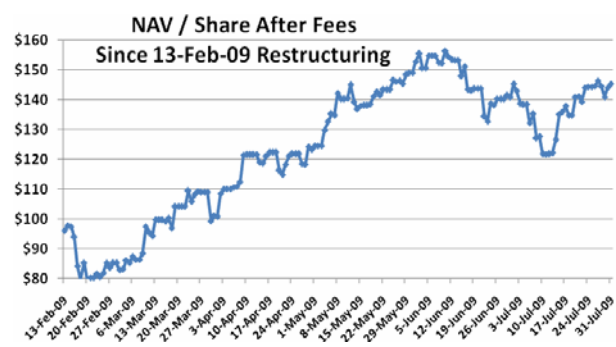
	<b>Long</b>	<b>Short</b>	<b>Gross</b>	<b>Net</b>
<b>Equities</b>	42.75%	6.64%	49.39%	36.11%
Russian Large Caps	10.64%	6.64%	17.29%	4.00%
Russian Second Tier	6.70%		6.70%	6.70%
FSU (CIS)	8.65%		8.65%	8.65%
International	16.76%		16.76%	16.76%
<b>Bonds</b>	0.54%	0.0%	0.54%	0.54%
Ukraine	0.27%		0.27%	0.27%
Georgia	0.27%		0.27%	0.27%
<b>Derivatives</b>	26.97%	23.10%	50.07%	3.88%
Bond		15.07%	15.07%	-15.07%
Commodities	20.53%	1.52%	22.05%	19.01%
Equity		6.50%	6.50%	-6.50%
FX		6.44%	6.44%	6.44%
<b>Cash</b>	0.00%	0.00%	0.00%	0.00%
<b>Total All</b>	<b>70.26%</b>	<b>29.74%</b>	<b>100.0%</b>	<b>40.53%</b>
<b>Leverage</b>				<b>99.42%</b>

### Historical Performance

	<b>2005</b>	<b>2006</b>	<b>2007</b>	<b>2008</b>	<b>2009</b>
<b>Jan</b>	-	13.67%	1.29%	-10.44%	-11.34%
<b>Feb</b>	2.24%	2.73%	5.70%	2.75%	-11.37%
<b>Mar</b>	-0.27%	4.05%	-0.29%	-3.48%	20.53%
<b>Apr</b>	-2.54%	8.80%	1.88%	3.03%	20.86%
<b>May</b>	-0.51%	-3.78%	-0.71%	9.17%	18.71%
<b>Jun</b>	1.84%	-1.67%	2.88%	-7.02%	-3.28%
<b>Jul</b>	7.77%	0.37%	1.75%	-13.09%	<b>3.37%</b>
<b>Aug</b>	8.76%	2.33%	-4.69%	-8.69%	
<b>Sep</b>	12.64%	0.01%	5.07%	-10.76%	
<b>Oct</b>	-6.56%	3.70%	4.99%	-35.75%	
<b>Nov</b>	7.49%	5.36%	-2.96%	n/a	
<b>Dec</b>	7.33%	9.49%	0.80%	n/a	
<b>Year</b>	<b>43.27%</b>	<b>53.70%</b>	<b>16.26%</b>	<b>-57.73%</b>	<b>35.86%</b>

### NAV Data

Fund Price (W/Avg), Main Class	Bid \$144.95; Offer \$147.01
Designated Investment Share Class	Bid \$80.85; Offer \$80.85
Total Assets (AUM)	\$22,159,202



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Rather than cling to an investment rationale rapidly being disproven by the ultimate authority = the market; nimble execution produced an efficiently defensive portfolio. Substantial hedges of (7%) short Forex, (15%) short bonds, (2%) short commodities and approximately (13%) short equities mitigated this downdraft and generated positive returns (*short book 30% of AUM month end*).

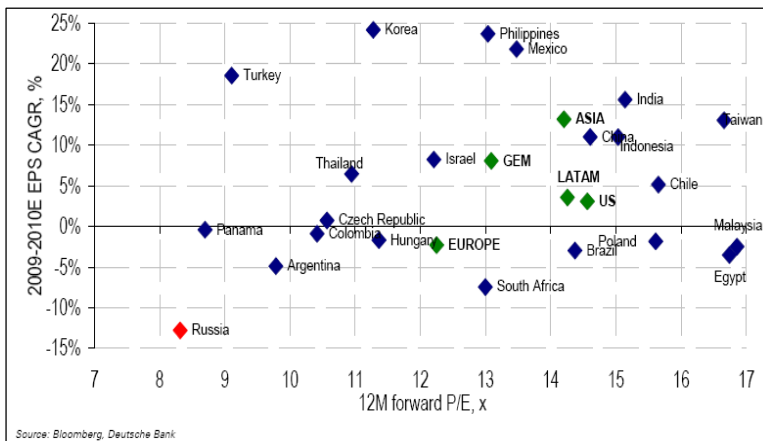
In light of overwhelmingly supportive fundamentals and positive global economic data framing the investment case (as pronounced in the past four letters to investors);



the Fund did not capitulate but rather stayed the course and was not drawn into the proverbial whipsaw. Quite to the contrary, asset allocation going in August has been postured for the further expansion of Russia-related asset pricing, steadfastly emphasised here since the Fund's bullish repositioning in March.

Sector Allocation	
Commodities	16.51%
Bond Derivatives	14.77%
Financials	14.77%
Metals and Mining	10.36%
Equity Derivatives	10.26%
Forex	7.90%
Real Estate	7.49%
Gas Utilities	6.15%
Oil - Integrated	3.79%
Transportation	2.46%
Construction/Infrastructure	2.15%
Industrials	2.15%
Agriculture	1.24%
Oil - E & P	0.00%
Information Technology	0.00%
Coal	0.00%
Media	0.00%
Hotel Development	0.00%
Meat Products	0.00%
Automotive	0.00%
Trading House	0.00%
<b>Total</b>	<b>100.00%</b>

Near -30% selloff in the Russian Benchmark Index Six Weeks Ending July 14<sup>th</sup>



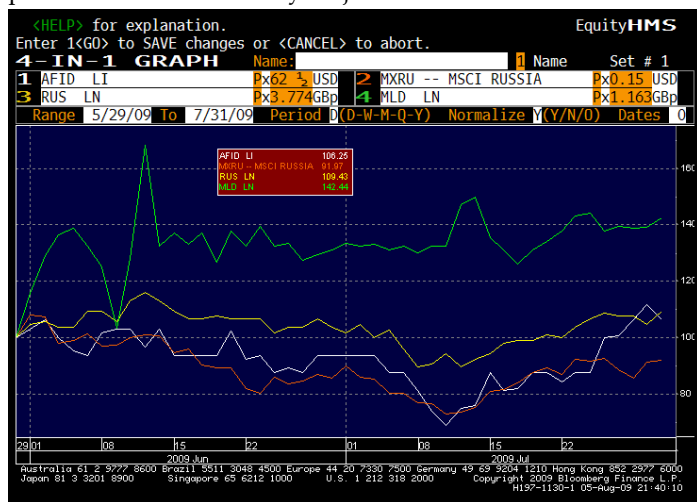
Back to the safety of the lodge? No; we are just cleaning our guns. **Diamond Age** reaffirms that the 2009 - (2014?) bull market has only just begun. The heavy Percheron, thundering the Russian troika back from the bottom is in full stride: a) improving credit markets, b) rising hydrocarbon prices, c) Rouble stability, d) increasing global commodity demand, e) protracted US dollar weakness and f) attractive asset valuations. Consistent with these perceptions, investment capital is now *aggressively* allocated to capture an inequitable (even gluttonous) share of the next, potentially large broad market advance for clients.

**Don't believe it; Russia is still cheap! -68% discount to BRICs composite (IBOV, SENSEX, SHCOMP) and '10 analyst estimates are too low!**

Specifically the Fund has liquidated the last weights in electrical utilities, healthcare, foods, consumer, telecom, and other defensive industries, leaving these sector weights at zero. The Fund continues to build exposure in early-stage cyclical industries and those sectors largely leveraged to economic recovery. Equity preference is for steels, financials, transports, real-estate, infrastructure, media, industrials, construction, coal, information technology and automotive. On the metals side **Diamond Age** grows large positions in copper, aluminium, nickel and platinum; staying short gold. Additionally the Fund is short the integrated oil majors which comprises a bulk of the local indices, hedged against a much larger long weight in the underlying oil commodity via ICE Brent futures.

Real-estate: largely written off for dead, **Diamond Age** finds value in orphaned Russian real-estate plays and has selectively added four positions in the course of the last month. Isolating market *survivors* with no short-term financing requirements, manageable gearing and marked product differentiation, the Fund invested at between 0.23x and 0.55x book value and -90% levels in aggregate from pre-crisis highs.

These valuations coupled with long-term supply/demand dynamic in the Russian real estate market give reason for optimism. Ranked just ahead of Nigeria, Russia has the lowest mortgage penetration rate 3% of any major market in the world. Consider mid 70%-75% penetration rates



in major developed markets and 30% global mean, the young market demographic, and large >140MM population, the upside can be quantified. Printed here: anticipate 300-400% return on these investments over the next two to three years.

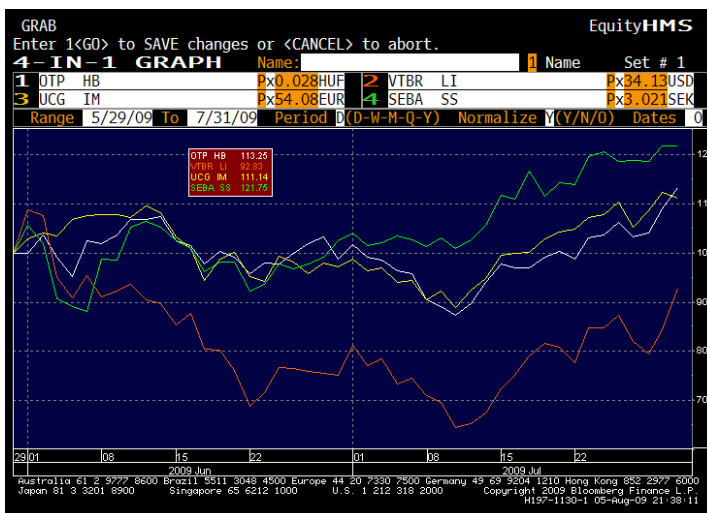
WARNING: a temporarily crippled, highly fragmented industry with major participants holding no more than 5% to ...

Geographic Dispersion	
Russia	47.38%
USA	19.33%
Ukraine	6.29%
China	3.96%
Georgia	2.81%
Kazakhstan	2.68%
South Korea	2.19%
Denmark	1.47%
Norway	1.38%
Finland	1.34%
Hungary	1.31%
UAE	1.24%
Italy	1.22%
Egypt	1.15%
Sweden	1.14%
Taiwan	1.13%
Brazil	1.06%
Turkey	1.06%
Thailand	0.96%
Singapore	0.90%
<b>Total</b>	<b>100%</b>

DA select Russian real-estate +6%, +9%, +42% vs. **RED MSCI Russia -8.03%** two months to July 31<sup>st</sup>

...10% shares, and it would be dangerous to consider “basket investing” as all are not equal. Moreover as many will fail, security selection is critical.

Financials: Within the July period the Fund sold VTB Bank (pre-earnings disappointment), paired back Sberbank (+198% YTD) and added three pariah-status European banks (Milan, Stockholm, and Budapest-based) which are driving loan book and EPS growth from pan-FSU expansion. Most analysts valued the “greater Russia” assets on their balance sheets as liabilities rather than engines of future earnings. While acknowledging the meaningful challenges ahead; at 0.33x, 0.35x and 0.84x book value, these attractive financials with clean balance sheets were purchased at >75% discount to historical book and down -69%, -72% and -93% pre-crisis highs. Investors did not wait long for positive attribution to Fund performance (chart right).



DA select financials +11%, +13% to +22% vs. **RED VTB Bank -13.65%** two months to July 31<sup>st</sup>

Credit resolution themes: Discarding the obits, firms on the edge of solvency have refinanced and restructured. Mechel refinanced at \$2.5B in liabilities at 8.3%! Vimplecom 18 Eurobonds priced to 95 with YTM in single digit yields when trading at 44 in November. Evraz raises \$900MM with 7.25% converts of 2014! Emerging with stronger balance sheets these and similar shares are now following the bonds.

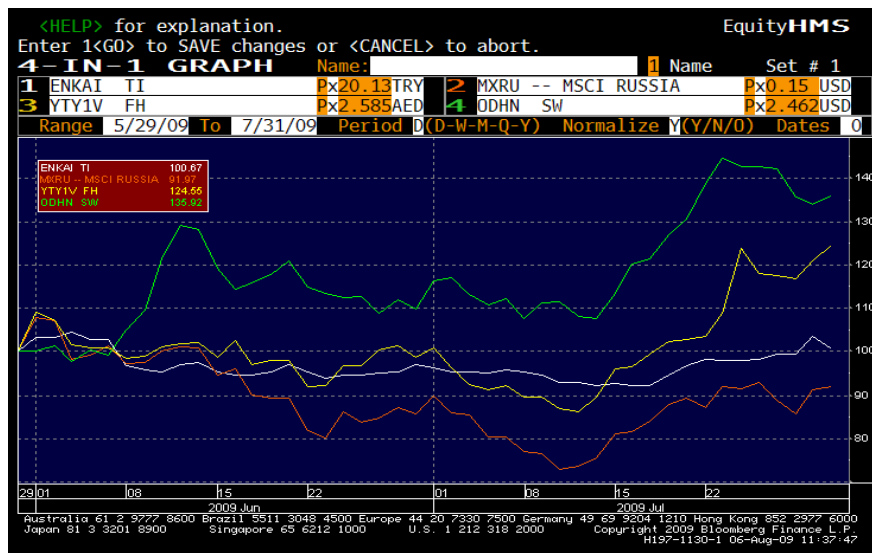
Construction and Infrastructure: Russia, great nation of opportunity and industry...but not all industries are ready for

the global stage. *Banking comes to mind...* and so it is with construction and infrastructure. Rather than tread through the slurry of illiquid and unaccountable local alternatives; **Diamond Age** has historically analysed on a project-by-project basis, the leading global developers whose growing business is in a rapidly expanding CIS theatre. Japan, Turkey and Greece have significant players working alongside their regional counterparts, but in the month of June the Fund began building three positions in Cairo, Helsinki, and UAE-based firms with significant exposure to the “greater Russia” construction story.

“But the cranes are idled, financing is gone, projects are stalled and all the workers have returned to Dushanbe and Tashkent!” “Egypt and Dubai risk – the oil levered Middle Eastern developers are in free-fall.” Partly true but while cognisant of the significant risks; “one size” does not fit all and there is no substitute for bottoms-up financial analysis.

Trading down -76% from 2008 highs, at 3.6x P/E vs. 11.4x INTL peers, EPS actual +78% YoY, financial backing from Saudi bin Laden Group, broad portfolio diversification from aero ports to luxury hotel design, offshore oil installations to entertainment complexes, and geographic dispersion from Russia (26% of backlog 2008A growing to 35% 3Y) to Pakistan; one core Fund position is the absolute least expensive construction company in the world of global comps +/- \$1B USD market capitalisation.

Currency Allocation	
RUB	47.38%
USD	19.33%
UAH	6.29%
HKD	3.96%
GEL	2.81%
KZT	2.68%
EUR	2.56%
KRW	2.19%
DKK	1.47%
NOK	1.38%
HUF	1.31%
AED	1.24%
CHF	1.15%
SEK	1.14%
TWD	1.13%
BRL	1.06%
TRY	1.06%
THB	0.96%
SGD	0.90%
<b>Total</b>	<b>100%</b>



Does not appear in financial statement but the **Diamond Age** is of the *private* view that the firm will be building the massive new \$3B, 400 metre Gazprom Tower and Gazpromneft Headquarters in St. Petersburg starting in 2010. In contrast with the former imperial capital of Russia’s 100 metre height restriction, the tower will stand tall as the Colossus of Rhodes against the St. Petersburg skyline (*actually greater than 13 times taller*).

**DA select global construction and developers +1%, +25% and +36% vs. RED MSCI Russia -8.03% two months to July 31<sup>st</sup>**

Fair disclosure: building permits have not yet been issued by the city. Unesco, local opponents, art critics, film producers, and middling-level politicians have raised concern that the tower will harm St. Petersburg’s image and its “world heritage” status. Others insist that in the midst of the global financial crisis, more “humane” uses of these monies are required.

On the other side of that bet sit hometown “thunder weights,” Prime Minister Vladimir Putin, President Dmitry Medvedev (former Chairman of Gazprom), Alexei Miller (current Gazprom CEO) and Igor Ivanovich Sechin, *formerly a trade interpreter of Portuguese and French languages*, current deputy Prime Minister, Rosneft chairman, “Grey Cardinal” and ranking double-up Siloviki at large. A decision by the municipal zoning board (perhaps “under the influence”) is expected in October. Our money is on “the house.” Targeting +172% upside in two years.

Although no longer exposed to MENA and Central Asian wireless, the Fund is once again in business with the House of Sawiris يسناً سيريواس with our preferred hotel and leisure developer listed in Switzerland. Well known as a leading destination builder (fully integrated resorts and resort towns with golf courses, marinas, etc.) for sun happy Russians in Egypt and Dubai (18% of customer base and the single fastest growing demographic); the firm is branching out to capture the very apex of the Russian wealth ladder with a \$500MM ski resort development (under construction) being built in Andermatt, Switzerland, population 1,312. It is known in some circles, that the Moscow elite have been migrating from Courcheval, France to Switzerland for a few years already and Andermatt will be designed to attract and cater to this segment of the Russian elite...*locales beware.*



**DA core construction holding -76% from 2008 highs at 3.6x P/E, upside +172% 24 months**

The hotel and leisure developers were of the hardest hit industries in the 2008 financial crisis and hugely levered to global economic recovery. Significantly beaten down -65% from '08 levels with the rest of the global peers but largely unrelated the enterprise specific risk; current market capitalisation of \$1.4B CHF represents a fair value for the existing (Egypt, UAE, Oman) hotel business alone \$1.5B CHF (at 5.5x EV/EBIDTA) or 64 CHF/share slightly above the Fund's entry point. But the expansive land bank and extensive properties under construction alone are worth more than 100 CHF/share; plus you receive future Andermatt revenues and all other pipeline projects (Morocco, Jordan, Mauritius) for free. The good bankers at UBS brought them out in May '08 at 152 CHF and nobody on the "street" is beating the drum today. Timing was unfortunate but the valuation will look reasonable in two years (three years from IPO). +150% upside.

**Diamond Age** remains bullish on shipping, cargo and transports; as well as ship builders. In July the Fund added key positions in a Norwegian dry bulk shipper, a Chinese oil tanker, a Danish charter cargo company (coal, fertiliser, grain, sugar and steel) and two Korean heavy industrials.

Lastly the Fund is actively managed for currency risk, and maintains both large short USD dollar and USD 10Y treasury hedges against the long US dollar denominated co-efficient of the portfolio.

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