

Nikitsky Russia/CIS Opportunities Fund

Inaugural Fund Update – July 2006

Dear Investor,

July, our first full month for purposes of valuation, has proved gratifying – our official performance for class 0 was: +2.35%, which rather understates the real results since our core second-tier positions trade with wide bid/offer spreads, and we are now seeing paper go across at offer/offer-minus, rather than the bid-side trades common just a few weeks ago.

This is much as we expected, and having closed our Yukos short (Yukos is now trading close to its option-value, and given the danger of a suspension of trading, we do not find the risk-reward ration at all compelling) we are now nearly long-only, with – by our conservative standards, a fair degree of leverage. In short, we are bullish – the May-June market shakeout, substantially deeper than what we had expected, should provide an excellent base for further RTS appreciation in 3Q 2006.

This is as it should be. Russian macroeconomic fundamentals are almost embarrassingly excellent; GDP is on track for 7%+ growth, inflation is declining, despite an appreciating rouble industrial production is surprising to the upside, and the huge twin surpluses (budget and current account) continue to swell. The gradual appreciation of the rouble has a mechanical effect, increasing the dollar price of Russian assets, as well as is prompting further capital repatriation by Russian nationals – most of this cash is going into real estate or venture capital, but the equity market is receiving its share.

While global factors remain a realistic source of worry, at least the risk of Fed overkill is apparently declining. The US economy is clearly slowing – indeed, there is a substantial body of opinion which expects the US to go into outright recession, given the extreme consumer leverage in the face of rising rates and stagnant/falling real-estate prices. While there are reasons for concern as regards the impact of a US slowdown on emerging markets, the current global macroeconomic situation is clearly unsustainable – simple common sense tells us that the US will have to rebalance its current account and reverse its structural tendency towards negative savings. The sooner this happens – the better it will be for everyone involved...

There is no consensus as to what effect this deceleration will have on the emergings, in particular the Asian economies. In the past decades, the emergings simply amplified the volatility in G7 markets - we are thus now hearing warning about those “five most expensive words in Finance” i.e. *This Time it's Different*. Of course, we remember hearing the exact same warning in 2000 – from an eminent local oil analyst explaining why we should not be fooled into buying LUKoil at around \$6.50 (it is currently nearing \$100 – yet the analyst in question still has a job... such are the joys of the sell-side!) History does not simply repeat itself – that would make matters far too easy – it is the historians who repeat themselves... success in finance requires the identification of major inflexion points.

It is almost tautological to say that we are facing an unprecedented situation in the global economy – yet the rise of the newly industrialized Asian economies has changed the world forever. There shall be relative winners and relative losers. It is the fund managers' s job to pick them. For now, we believe that those countries self-sufficient in oil and capital – Argentina, Brazil, Venezuela and, of course, Russia – will be the relative out-performers; we would be ready to short those (such as Turkey, Poland, Hungary etc.) which are chronically dependent upon foreign capital inflows and are seriously impacted by surging commodity prices.

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On the Russian front, oil money keeps pouring in, FDI is increasing at a furious pace, and the serious accumulated lack of fixed investment is finally being convincingly addressed. Most importantly, the market is still pricing the oil and metals stocks for a theoretical return to the mean of commodity prices – we find slightly ridiculous; oil is simply not going to come back to anywhere close to \$40 a barrel!

Our preferred second tier assets would appear to be lagging the chips by a tad. We say “appear to” for the reason described above: they tend to be more thinly traded. Given the fact that the only objective basis for valuation is the mid-price – i.e. half-way between bid and offer (last-prices are frequently manipulated) relative out-performance of illiquid assets can initially be masked by the spread.

We are enthusiastic of the Chelyabinsk group (pipes and zinc), Vyksa, selected constructions companies, chemicals and petrochemicals, a range of Russian preferred shares, nuclear fuels, and, as usual Tatneft and Bashneft. We are neutral on the phones, and confess that we do not understand the likely effects of UES restructuring on its several hundred subsidiaries, so aside some modest exposure to the OGKs, we remain underweight electricity.

Inveterate bargain hunters (your manager shops for clothes once a year – and that, only during the sales...) – as per usual, we shy away from the high-PE retail “growth stocks” trading at or above Western European prices. The blue-chip segment of your fund is concentrated in natural gas and metals.

Thanks for your confidence – we are looking forward to an interesting autumn!