

March 2008 Market Commentary

	NAV	March	YTD
PHAROS RUSSIA FUND	225.0	-2.9%	-8.8%
PHAROS GAS INVESTMENT FUND	4281.6	-0.2%	-6.3%
PHAROS SMALL CAP FUND	143.3	-7.5%	-8.0%

Dear Friends and Investors,

During the month of March the Pharos Russia Fund was down 2.9%, the Pharos Small Cap Fund was down 7.5% and the Pharos Gas Fund was down 0.2%; these returns are all net of all fees. Volatility measures for the Funds with annualized volatility for the 12 months ended March being 17.0%, 13.9% and 23.8% respectively for the three funds as compared to 25.9% for the MSCI Russia Index over the same period.

The month of March opened with the election of Dmitry Medvedev to succeed Vladimir Putin as President of the Russian Federation. We have already commented extensively on the positive implications this transition will have for political stability and renewed economic reform in previous investor letters, so we will not focus on that here.

In classic electoral fashion, the Russian indices faded following the election to reach their six-week lows in the middle of March only to be rejuvenated by the US Fed's 75bp rate cut on March 18th. Volatility remained extremely high during the month, and one notable and highly unusual characteristic was that the longest the indices held a trend was two trading sessions. This is a strong indication of the lack of conviction in the market and of the exaggerated role being played by short term traders. The best performing market sector during the month was that of the long out-of-favor wireline telecoms, which racked up a 9% gain. Several of the telecoms announced shortly after the presidential election that they would increase their tariffs, a step that was unexpected by most of the market. The excitement was short lived, however, as the following week the companies backtracked on these announcements and said tariff increases would be put on hold to help prevent a further increase in inflation. Following this postponement, we expect the sector to again be a poor performer as it awaits clarity on the long delayed privatization of state telecoms holding company, Svyazinvest.

Oil companies performed strongly as the government started discussing tax cuts for the sector. Production is stagnating in Russia, and oil companies have long complained that the punitive taxes levied on the sector make new E&P unprofitable. The government appears prepared to address this reality now that the elections are behind us, and has taken the first steps toward lowering and rebalancing the tax code to encourage companies to invest in both new exploration and in upgrading their refining capacity to produce higher value products. In the past, the Finance Ministry has blocked attempts to lower taxes on the sector as the industry has bankrolled Russia's Federal budget and allowed the government to rebuild Russia's macroeconomic position. Now that external debt has been paid down, reserves built

up and the budget is in surplus, it is time to address the oil sector's needs. There have been many calls in the past years by government officials to cut taxes on the sector, but the Finance Ministry always stood in the way.

The situation changed dramatically in March, when Finance Minister Alexei Kudrin announced that his Ministry would propose lower taxes for the sector. The market reaction was immediate, as oil majors Lukoil and Rosneft traded up sharply. While Mr. Kudrin's proposal is for a relatively minor \$4B in tax cuts, the details of his initial proposal are irrelevant. Ultimately, the structure of the tax changes will be debated and negotiated over the coming months amongst different government ministries, the presidential administration and the companies involved, and be rubber stamped by the Duma. We expect the final package of tax cuts and tariff schedule changes to add up to far more than the \$4B proposed by Mr. Kudrin, to encourage increased investment into the sector, and to help reverse the recent decline in Russian oil production.

On the negative side, power utilities equities performed poorly during March. The sector is in the final stages of a long and complicated restructuring that has seen most investors step to the side and wait for clarity to emerge. The end game arrives on June 6, when utility holding company Unified Energy Systems (UES) will cease trading on the stock exchanges. Shareholders of record on that date will receive shares in 23 separate generation, transmission and distribution companies at the beginning of July. Most of those companies already trade in the market, but liquidity will be dramatically increased in July when current shareholders of UES become direct shareholders in these new companies. UES has long been one of the two or three most actively traded stocks in the Russian market, and its share price has suffered in the last few months as liquidity has dried up in the name and intra-day traders shift their speculative attentions to the RTS futures market. UES is now trading at a deep discount to the sum of its traded parts, and we see excellent fundamental value beginning to emerge in the shares. There is no question that the complicated nature of the restructuring has caused many investors to sell their holdings, but over time value will win out and buyers at these levels should see handsome returns. We expect to see utilities share prices fall further into April and May, and will start to build positions in select utilities names as they do.

Oil and other commodity prices continued to be strong throughout the month, but the most notable development was the rapid increase in global steel prices. Steel makers of course have had to deal with very rapid increases in input costs as iron ore, coking coal and energy prices are all rapidly escalating. So far they have been able to pass these rising costs on to their customers without any demand destruction. In our view, this dynamic bears very close monitoring, as continued strong demand for steel amidst record high price increases will be a very strong indicator that globally the "real" economy is weathering the credit crisis. While it remains too early to declare victory on this issue, the initial signs are supportive of the case for coal, iron ore and steel investments. Steel and mining stocks were weaker in March, and we used that weakness to increase our positions in this critical sector.

Our overall view remains unchanged. We are extremely positive about the fundamental case for Russian equities, but recognize that the current global financial crisis and resulting reduction in risk appetite will prevent equities from re-rating until global volatility eases. However, once fundamentals become the driver of share prices globally, Russia is poised to become a major beneficiary of investment flows.

It appears that a familiar pattern has asserted itself over the past eight months as a bursting bubble in the financial construct has dampened risk appetites and led to monetary easing. The next step in this pattern should be a return of risk appetite with a lagging monetary policy maintaining its easy stance. This typically sparks a rally in high beta plays like emerging markets. This pattern was seen clearly during the technology meltdown earlier this decade, and created the bottom for GEM stocks in 2001. We are positioning for a return to global stability at some point over the next twelve months with a consequent re-rating of Russian equity valuations. In the meantime, we are maintaining an overlay of derivatives to help protect against another leg down in the market cycle.

For performance information and daily market comments please visit our website www.pharosfund.com.

Please feel free to contact us at any time.

Best Regards,

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