January 2010 Market Commentary

	NAV	Jan.	YTD	Volat.
MSCI RUSSIA INDEX	814.3	+2.4%	+2.4%	53.0%
PHAROS RUSSIA FUND	242.7	+5.2%	+5.2%	24.1%
PHAROS GAS INVESTMENT FUND	3878.9	+6.0%	+6.0%	26.2%
PHAROS SMALL CAP FUND	154.1	+5.1%	+5.1%	27.6%

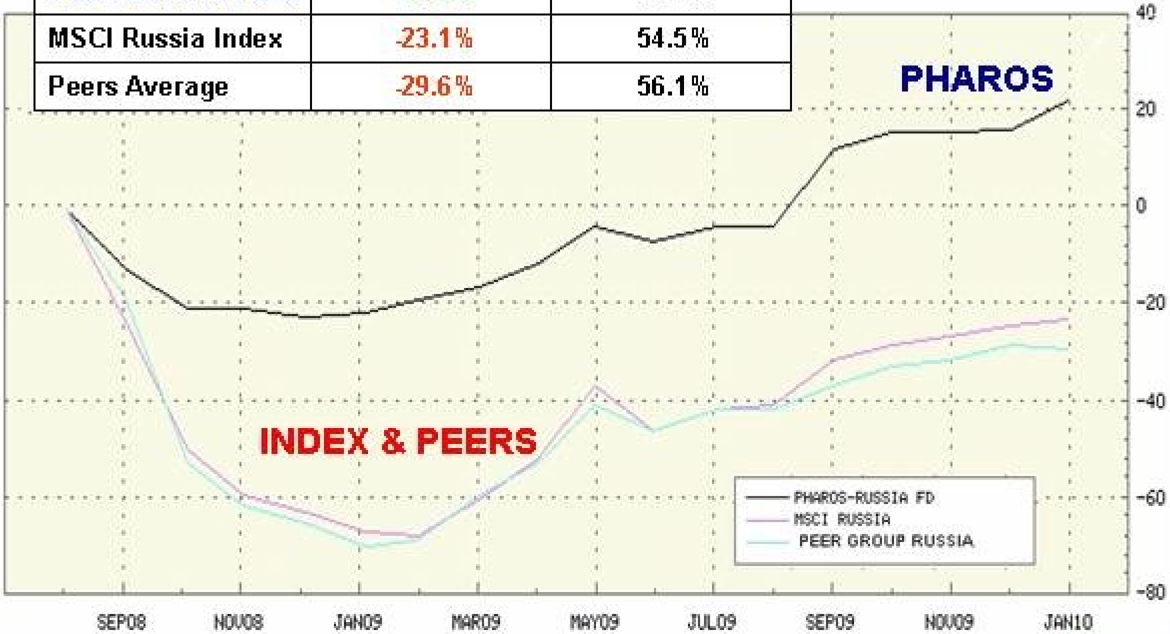
Dear Friends and Investors,

During the month of January, the Pharos Russia Fund was up 5.2%, the Pharos Gas Investment Fund was up 6.0% and the Pharos Small Cap Fund was up 5.1%. Meanwhile the MSCI Russia Index rose 2.4% over the same period. Twelve month annualized volatility for the three funds ending in January was 24.1%, 26.2% and 27.6%, respectively, as compared to 53.0% for the Index over the same period.

Since the beginning of the crisis in August 2008, the Pharos Russia Fund is up 22.0%, versus a decline of 23.1% in the MSCI Russia Index, with roughly half of the volatility (see chart below).

Best performer since the beginning of the crisis

	Performance	Volatility
Pharos Russia Fund	+22.0%	23.7%
MSCI Russia Index	-23.1%	54.5%
Peers Average	-29.6%	56.1%



Data as of January 10 *Source: Bloomberg* PHAROS FINANCIAL GROUP

Pharos' long term returns also show very strong outperformance as measured against the indices and our peers during nearly any relevant period. For example, over the 5 year period ending January 31, the Pharos Russia Fund posted a positive 19.3% annualized return and 25.3% volatility against only 11.3% annualized return and a much higher volatility of 48.2% for the MSCI Russia Index. In the 10 year period ending in January 2010, Pharos Russia Fund posted a positive 26.1% annualized return (total return of 962%) with volatility of 23.7% against an annualized return of 19.0% for the MSCI Russia Index (total return of 489%) with much higher volatility of 52.7%.

Pharos has consistently outperformed over the past 10 years with nearly double the total return of the market with less than half of its volatility (see chart below).

Sustained outperformance over time

	Annualized Performance	Annualized Volatility
Pharos Russia Fund	26.1%	23.7%
MSCI Russia Index	19.0%	52.7%
MSCI BRIC Index	12.2%	45.9%

January 2010 unfolded with similar trading patterns as in January 2009. Both months started out with strong gains for Russian equities, followed by a quick reversal that resulted in a near flat monthly performance for the overall index. The best performing sectors in January were those tied to continuing global and domestic recovery, with metals and mining, real estate developers and utilities leading the way. Utilities benefited from the extremely cold weather in Russia in January, which was 7 degrees celcius colder than normal. Oil and Gas was the worst performing sector in January, down 2% for the month. The 5.8% return in the Pharos Russia fund was generated by a 6.23% return from our stock selection and a cost of 0.43% from our hedges. On average, we were 83% net invested during the month. As we mentioned in last months letter, our heaviest exposure is in the metals and mining complex, and we benefitted from the strong outperformance of this sector in January. We are most bullish on the iron ore and coal companies, who will continue to benefit from the tight supply/demand balance in their markets, a structural problem that will increasingly benefit them as global growth continues to recover and idled steel capacity in Europe and North America comes back on line.

In last month's letter, we warned that the consensus scenario of strong global markets in the first half of 2010 on continued global recovery, followed by challenges from tighter monetary policy in the 2H10, was likely to prove too rosy. We wrote that rarely do post crisis markets progress as smoothly as anticipated, and that the tightening cycle may begin this time with China, rather than with the US. As February begins, that is precisely what is beginning to happen as China raises several policy rates and begins to withdraw its overly easy fiscal stance. This on its own would not be much of a concern, as China's fiscal posture remains accommodative and has a long way to go before it can be considered restrictive. However, in combination with the sovereign credit crisis that has emerged in Europe, global markets are now experiencing their first serious test of the recovery consensus.

Markets first woke up to the risk of stretched sovereign finances with the Dubai crisis of November/December. That event of course caused global markets to sell off for a few days, but then markets stabilized as this was seen as a crisis with specific characteristics - the problems of "name" lending in the Gulf markets, quasi sovereign guarantees and an assumption that Abu Dhabi would step in to support Dubai - that made it a localized problem. Round two of the "sovereign debt crisis" emerged with Greece in January, but in critical contrast to the Dubai situation, the problems highlighted by Greece threaten to be far more damaging for global markets and indeed global financial stability for several reasons. Dubai raised the issue of sovereign credit risk, but the current crisis in Europe brings two more elements that have historically been associated with most serious global financial crises - contagion and currency.

While Dubai's problems caused other Gulf financial markets to sell off in the short term, those other states do not have the level of severe fundamental financial imbalances at the heart of Dubai's problem, and so contagion did not spread far. In contrast, the problems faced by Greece are also faced by other, much larger European countries, and so contagion quickly spread into Portugal and Spain. As we have seen in past financial crises, problems have a way of spreading rapidly and unpredictably - in fact, it is that unpredictability that becomes the driver of the crisis - as investors in other countries, regions and asset classes sell amidst fears of a wider panic. And as the financial crisis of 2007/8 started out in sub-prime but spread to the wider credit universe as it was a general credit problem, and not a problem contained in sub-prime, the systemic risk now is that Dubai, Greece and the other PIIGS are simply the first stages of a wider systemic sovereign credit crisis. In fact it is remarkable how similar the voices now saying that Greece can be "contained" are to the voices saying subprime would be contained.

The final element that makes this European situation far more dangerous than the Dubai crisis is the currency element. Currency crises are a classic ingredient of financial crises, but historically in a different way. The typical currency problem is based on a liabilities mismatch, as countries lose access to external capital and run into difficulties servicing their FX denominated debt. When that government loses the confidence of investors, a debt sell-off and run on the currency typically follow, with devaluation and a repudiation or restructuring of debts. That is the classic pattern that we witnessed in Latin America in the 1980's, and Asia and Eastern Europe in 1997/8.

While the structure of European finances means that this roadmap will not be repeated - as they do not face the problem of FX debt, and cannot devalue their currency - the currency problem here threatens to be far more damaging to the global financial system than past problems with the Peso, Baht or Ruble, as this current crisis raises fundamental questions about the stability of the Eurozone and the Euro. As confidence in the Euro has waned, the US Dollar has rallied as a "safe haven" despite its own shortcomings. While the US benefits on a relative basis, its longer term difficulties only add to the current sense of ongoing instability among global financial markets. Recent USD strength has spilled over to losses across asset classes as the USD has been negatively correlated with risk assets since the beginning of the financial crisis. The net result has been a return of uncertainty and volatility to the markets, and our hedges are increasing in value on the back of this.

Against this backdrop of renewed global concerns, Russia's economic environment continues to improve. Manufacturing PMI rose in January to 50.8, indicating expansion for only the second time in the last 18 months. New orders were especially strong at 53.0, which points to further growth in the overall index. Recently released December statistics (data releases are unfortunately not as structured as in more developed countries) are also pointed in the right direction, with industrial output up 2.7% in December, transportation up 6.4% and agricultural output 6.9% (all year over year). Demand indicators are also showing improvement, with retail sales up strongly over November by 20% and investments soaring 66.9%, the second biggest increase on record. These figures point to a very strong reversal in domestic demand that is becoming more evident by the week. Importantly, inflation has also remained very subdued in the face of this demand recovery, and is on track to be under 6% in 2010. This keeps on track one of the key bullish dynamics we have highlighted for Russia this year, which is that it is one of the only economies which is likely to experience interest rate cuts. In Russia's case, the Central Bank of Russia has stated that it will cut rates as much as inflation allows, and the subdued inflation readings we see mean the CBR can comfortably cut rates by another 1% or more.

Gazprom has been at the top of the news recently. We met with the company several days ago and they gave a positive operational update for 2009 and an optimistic forecast for 2010. Gazprom reached a milestone in 2009 as domestic sales were profitable for the first time ever, and they are confident that structural price increases will continue. They expect 2010 production to increase 12% and for European sales to reach pre-crisis levels again in 2011. Perhaps of most importance, fears that its European customer's take-or-pay obligations or changes to the oil linked pricing mechanism appear unlikely. In fact, in 2009, European customer's actual purchases only undershot their take-or-pay obligations by 6bcm, much less than market fears and Gazprom's own expectations.

Gazprom has also extended its supply contract with Poland out to 2045. The new contract calls for increasing purchase levels, with 11bcm in 2010, up from 9bcm in 2009, 85% of which will be subject to "take or pay" obligations, and pricing will continue to be linked to an oil price basket. This is a very positive development for Gazprom, and reaffirms its strong position as a structural price setter for Europe. Poland is the European country with perhaps the best prospects for shale gas, so the fact that they have just signed this long term contract with Gazprom while keeping the two critical status quo conditions intact of "take or pay" and an oil linked price setting mechanism is a huge victory for Gazprom.

We expect this tug of war between attractive fundamentals and global uncertainty to continue buffeting Russian equities going forward. Our outperformance against the Russian indices has increased through early February as our investment themes are playing out nicely and our hedges protect us against general market declines. The Eurozone crisis will not be solved quickly, and will exacerbate market volatility as speculative money shifts between fear of renewed crisis and optimism that this is merely the latest dip to be bought.

In this environment, hedging is crucially important to protect against a severe drawdown and maximize returns. We currently have 100% notional coverage via equity index put options, and have bought a 5yr Russia sovereign Credit Default Swap. CDS spreads will likely be volatile for the duration of the Eurozone crisis and beyond, and we bought our position at a very attractive price. Even though Russia's sovereign fiscal position is one of the best in the world, markets are not perfect, and prices are subject to more than just fundamentals. Investment flows and psychology matter more during crisis moves than a sober look at balance sheets and cash flow statements, so even though we remain very bullish on Russia's strong fundamentals and medium term outlook and are long names that will benefit from continued recovery, the very short term is a time for increased caution.

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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