

## June 2010 Market Commentary

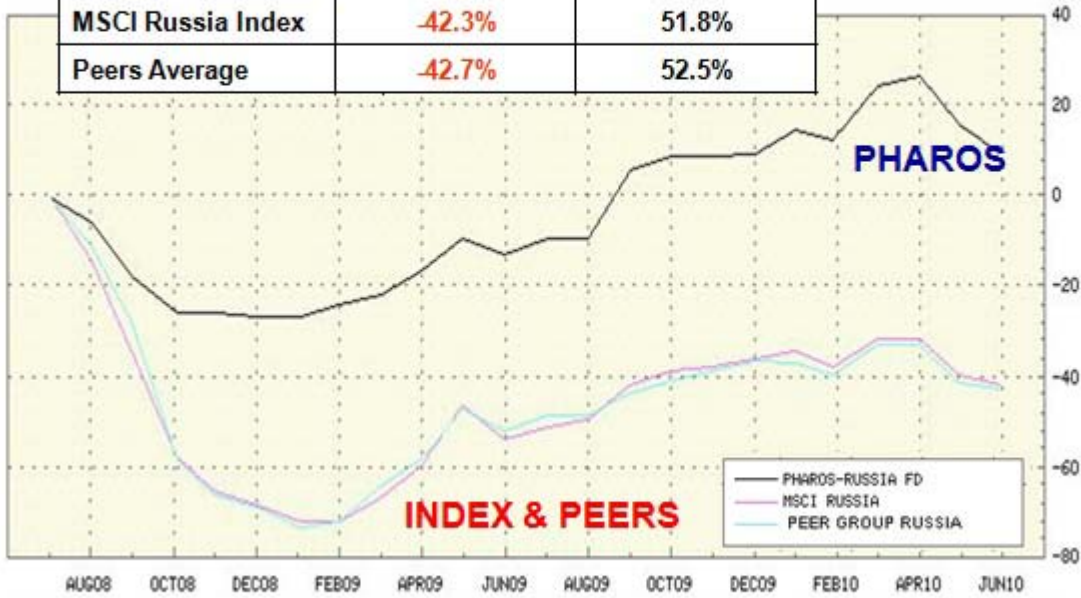
	NAV	Jun.	YTD	Volat.
<b>MSCI RUSSIA INDEX</b>	707.5	-4.2%	-11.1%	52.0%
<b>PHAROS RUSSIA FUND</b>	231.0	-5.6%	+0.1%	25.1%
<b>PHAROS GAS INVESTMENT FUND</b>	3515.4	-3.1%	-3.9%	24.5%
<b>PHAROS SMALL CAP FUND</b>	141.5	-3.0%	-3.5%	35.5%

Dear Friends and Investors,

During the month of June, the Pharos Russia Fund was down 5.6%, the Pharos Gas Investment Fund was down 3.1% and the Pharos Small Cap Fund was down 3.0%. Meanwhile the MSCI Russia Index declined 4.2% over the same period. Twelve month annualized volatility for the three funds ending in June was 25.1%, 24.5% and 35.5%, respectively, as compared to 52.0% for the Index over the same period.

Since the beginning of the crisis in August 2008, the Pharos Russia Fund is up 9.2%, versus a decline of 42.3% in the MSCI Russia Index, with less than half of the market volatility (see chart below).

	Performance	Volatility
<b>Pharos Russia Fund</b>	<b>+9.2%</b>	<b>23.7%</b>
<b>MSCI Russia Index</b>	<b>-42.3%</b>	<b>51.8%</b>
<b>Peers Average</b>	<b>-42.7%</b>	<b>52.5%</b>

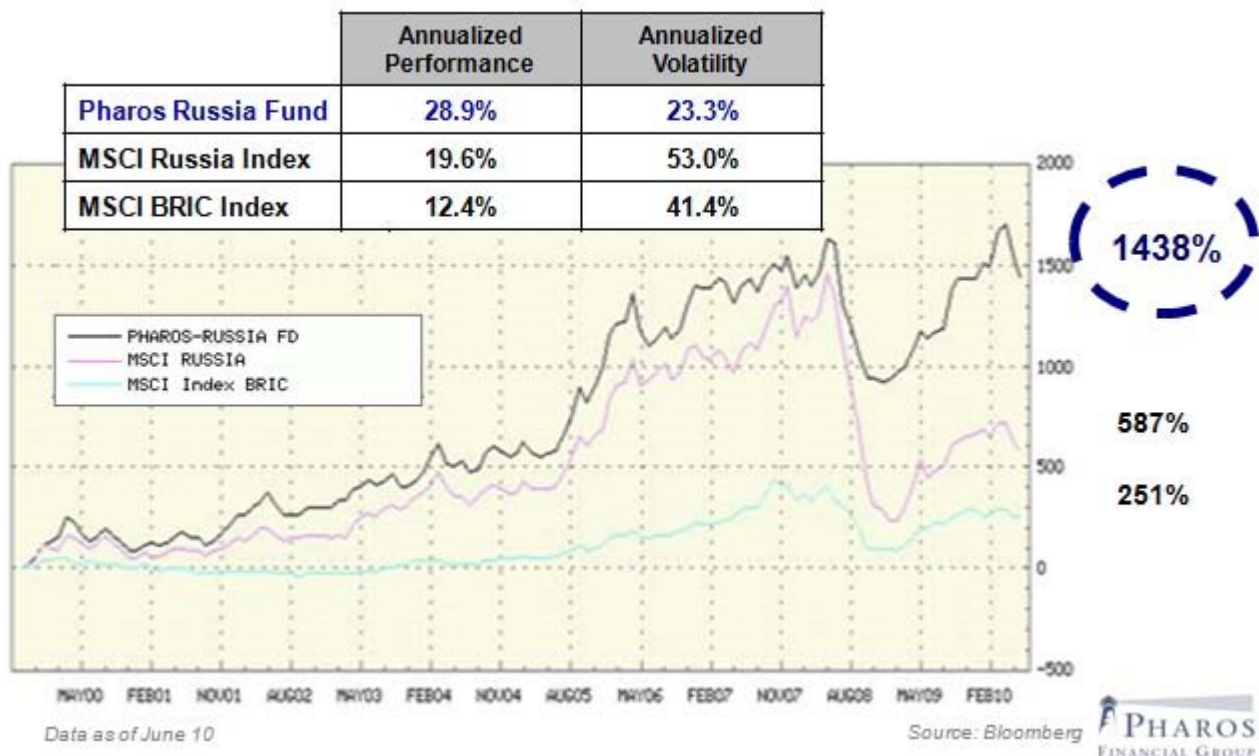


Data as of June 10

Source: Bloomberg



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 June 30, the Pharos Russia Fund posted a positive 17.7% annualized return and 25.4% volatility against only 6.9% annualized return and a much higher volatility of 52.0% for the MSCI Russia Index. During the previous decade the Pharos Russia Fund posted a positive 28.9% annualized return (total return of 1438%) with volatility of 23.3% against an annualized return of 19.6% for the MSCI Russia Index (total return of 587%) with much higher volatility of 53.0% (see chart below).



June was characterized once again by a volatile, whippy market that turned regularly from optimistic to pessimistic about the prospects for either continued growth or renewed crisis. Our portfolio changed very little during the month as the equity themes we have been playing are still very much intact. We see the residential real estate sector as having the biggest upside leverage to economic growth as purchasing activity continues to be very strong and prices continue to increase steadily. The huge undersupply of quality residential real estate in Russia gives strong structural underpinnings to this market while a newly resurgent mortgage market is increasing the pool of potential buyers. It is worth stressing that this market has been built on cash buyers - only 25% of purchasers use a mortgage of any kind, and total outstanding mortgage debt/GDP is less than 4%. Consequently the real estate market in Russia is exactly converse to the deflating real estate bubbles found among western markets, with leverage only now being applied to a market showing signs of significant pent up demand.

In this regard, June set another record for secondary residential real estate transactions in Moscow of 8,959 units, up 7% month-over-month and 97% year-over-year. Prices continue to increase as well, and as they do, the effect on developer valuations will be dramatic. The sell side is already (belatedly) busy revising their models and increasing target prices, but they will be stuck in a pattern of chasing the market if sales prices continue to increase. For example, we own shares in one company whose target price has 4% upside sensitivity to every 1% increase in Moscow residential real estate prices. We also see great upside potential in the warehousing market, as there is a huge undersupply of quality Class A warehousing space. As the economy continues to develop, more sophisticated logistics needs will drive demand for this type of space sharply higher.

But twenty months into the global economic crisis, where is the risk centered in the Russian economy and market? Apart from some companies that remain heavily levered and vulnerable should the "second wave" of the global financial crisis strengthen and lead to a sustained slowdown in global growth and a step down in commodity prices (Rusal is a good example), the commercial real estate market is also a source of stress. Unlike the residential and warehousing sectors, the office real estate market remains depressed and unlikely to return to growth in the near term due to a classic overbuilding in the years leading up to the crisis. (As an interesting aside, Pharos moved our Moscow office 14 months ago as our previous lease came up for renewal and our landlord refused to accept the new market realities. Even though rental rates and demand were in freefall and space was well supplied, our landlord came up with the argument that he actually intended to greatly increase our rent as our previous lease was three years old, and so the small increase that he offered was actually a concession on his part. This was of course an absurd argument, but a telling insight into the psychology of denial that accompanies crisis. Our more than reasonable offer was rejected, and so we moved to our current location. Our old office, which is a terrific space in a great building in a prime location, is still empty. Our office manager noticed it listed on a real estate website several weeks ago for a rental price more than 30% less than we offered to pay.)

While much of the rest of the economy has gone through painful but necessary restructurings of their operations over the last 20 months - closing uneconomic capacity and increasing efficiency and productivity - the office market remains oversupplied and vulnerable to a further slowdown. The vast majority of developers would be insolvent had they not received debt restructurings from the big state owned banks, but these restructurings have merely delayed the day of reckoning for both borrowers and lenders. If occupancy rates do not improve sharply in the next two years, many loans will once again need to be restructured or foreclosed on. And while the market is currently ignoring this risk, it does concentrate much of the risk of a renewed slowdown in the hands of the state banks that hold these loans. And while the default risk of the big banks such as Sberbank and VTB may be very low due to the huge state reserves that could be deployed in a recapitalization, equity investors are at risk if real estate related charge-offs lead to slashed earnings, and potentially even new equity issues. However, this looks to be a potential problem for 2011 and 2012 as the banking system currently has excess liquidity and a slowly improving asset base.

Amidst the short term volatility and incessant direction changes in the market, our overall outlook remains the same. We see tremendous value in Russian equities as a whole, and from a bottom up view have a huge number of very interesting investment opportunities to choose from. While the recovery in Russia has been slower than we would like, inventories are low, companies have restructured their operations and cut costs and are in strong competitive positions. If the global economy somehow avoids the many stresses and imbalances that threaten to shock the system again, then Russia will be one of the best performing markets in the coming years. Valuations remain extremely - even historically - cheap compared to EM peers, and therefore Russia is on the right side of any period of mean reversion that may occur (absent a collapse in the oil price). And consumer credit extension is finally starting to show signs of increases that may help drive demand for durables, consumer electronics, automobiles and residential real estate to new highs.

But even as the domestic economy is showing stability and growth prospects that makes equity valuations

look very compelling, the overall market framework and investment returns for the foreseeable future will continue to be dominated by the global development out of - or deeper in to - financial crisis. Developments here are not particularly encouraging. Policy makers in the developed world are still resisting dealing with the consequences of the crippling debt buildup, and instead continue to pin their hopes on a global growth revival that will absolve them from having to make unpopular - but necessary - decisions. To be sure, there have been some encouraging moves by some states on the periphery to deal with their fiscal imbalances, but it remains to be seen whether they will be able to force these changes through in the face of opposition from vested special interests. On this front, the rest of 2010 may well be a defining time. Markets seem closer to forcing issues of fiscal sustainability out in to the open. That was the driving force behind the May global sell-off, and while painful in the short term, these changes are necessary. The huge public sector employment expenses and general social benefits in the developed world are simply unsustainable, and must be restructured.

It is unfortunate that Russia and other Emerging Markets are caught up in this developed market storm, but it is of course understandable. The interconnected state of the global economy and financial market flows ensure that. But it is also the case that the end game of this crisis will likely be friendlier to the Emerging world than to the Developed world. One casualty of the crisis will likely be those terms - "emerging world" and "developed world" - which carry value and risk judgments that are a relic of the pre-2008 world. But keeping those terms for now, it is clear that for the first time in modern history the painful adjustments must be made by the Developed World, which is accustomed to a lifestyle that is simply unsustainable, and was possible in large part due to 1. a debt bubble, which is now ending and 2. the never-to-be-repeated opening of global markets in the 1990's following the collapse of communism. Now those debts are coming due and a demographic change is settling in to Japan, Western Europe and to a lesser degree the US that will make it that much harder to service these debts and sustain the status quo.

Compared to that macro picture, Russia and other Emerging Markets look much more stable. They have a fraction of the debts of the Developed Markets, and sustainable government budgets. And while corporate debt levels are more comparable to DM non-financial sector debt levels, sovereign and consumer debts are negligible. Those low debt levels offer a potential economic boost that developed markets simply do not have.

Psychologically, the populations of EM's are also more prepared to deal with crises, due to their experience in 1997-1999. Financial markets like to talk about things they can model and dismiss things they cannot, but this psychological threat should not be ignored. People spend money when they feel confident about their present and future circumstances, and save money when they do not. The populations in Emerging Markets as a whole have seen their prospects improve dramatically in the last 10 years and see a brighter future for their children. The same cannot be said for citizens of the US, Japan and Western Europe, who collectively for the first time in the post war period are all looking at the possibility of bleak futures and declining standards of living. The Emerging Markets are much more likely than the Developed Markets to come out of this crisis with their confidence intact, and more ready to invest, grow and move forward. Russia is poised to be in the lead of this process. Its export economy is geared towards producing the goods that are essential elements

of the infrastructure build-out that is a central factor in Emerging Market, and perhaps future Developed Market, economic development. Domestic demand is in a secular growth pattern which will grow as a proportion of GDP, and there are still fundamental restructurings in the economy (most notably in the gas sector) that are in their early stages and will unlock huge value for investors. All of this remains the case, and underpins the medium to long term investment case for Russia. But its full potential will not be unleashed until the debt burdens suffocating the developed world are restructured and the global economy passes through the crisis period. Until that end game emerges, markets will remain stuck in a wide trading range that will present many excellent investment opportunities, but that also requires rigorous risk management practices to maximize investment returns.

For performance information and daily market comments please visit our website [www.pharosfund.com](http://www.pharosfund.com).

Please feel free to contact us at any time.

Best Regards,

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