



Interview with Peter M Halloran, CEO, Pharos Financial Group

EurekaHedge

Pharos Financial Group is one of the most experienced fund managers specialising in the securities markets of Russia and the former Soviet Union. With a 10-year history through up and down markets, Pharos has a proven record of superior absolute returns. Pharos' strength lies in its management unparalleled experience in the growth and development of Russian capital markets and the resulting insight into market events, opportunities and trends. Pharos principals have in-depth, personal knowledge of Russian companies, their history and management. Its management also has extensive Western capital markets experience and the technical expertise to handle complex opportunities involving derivatives and structured product.

The Pharos Russia Fund is a multi-sector Russia and FSU fund, with a diverse portfolio of liquid equities, and can short and use derivatives. At the time of writing, the fund is up 11.9% YTD.

The Pharos Gas Fund is designed to take advantage of the transformation of the gas sector in Russia and Eurasia. It invests in listed and private equity and is the only fund focused on this sector. At the time of writing, the fund is up 11.0% YTD.

The Pharos Small Cap Fund invests in undervalued second and third-tier companies, and can invest in private equity. At the time of writing, the fund is up 6.2% YTD.

Prior to founding Pharos Financial Group in 1997, Peter Halloran was the principal contributor toward building the CS First Boston equity and fixed income brokerage businesses in Russia and the CIS. He has been a leader in the development of the Russian capital markets since their inception in 1994, bringing more than US\$8 billion to the markets through debt, equity and private placements including Russia's first local IPO and more than US\$2 billion of privatisation initiatives. In addition to his activities with Pharos, from 2000 to 2002, he held a stake in and served as chairman of Aton Capital Group, a leading investment bank in Russia which has since been acquired by Unicredito. From 1995 to 1997, Peter managed a US\$300 million proprietary trading account and was directly responsible for all equity trading, research and sales at CSFB in Moscow. During his tenure CSFB became the top-rated broker as measured by research ranking, trading volume and profitability. Peter has also acted as advisor to Soros Fund Management and spent ten years in New York working with CS First Boston, Salomon Brothers and Morgan Grenfell. Peter is a graduate of Yale University (BA 1984).

1. *Although Russia is a lucrative market to invest in, many managers are being drawn to investing in Asia. What's your take on that, and how would you compare Russia as an investment region against emerging Asian regions?*

The dynamic and compelling growth available in select Asian markets has provided investors great returns over the past year at a time when Russia's image abroad has been buffeted by pre-election rhetoric. Much of this rhetoric has been magnified in the imaginations of western investors and embellished by western media. As we move through the electoral cycle in Russia, with the presidential election on 2 March 2008, investors will focus back on Russia's rock solid macroeconomic environment. As compared to Asian markets, Russia is significantly cheaper while having one of the most undervalued currencies in the world, one of the most consistent and highest GDP growth rates in the world and visibility to its ongoing reform agenda. We would expect 2008 to be the Year of Russia as investors rotate from their underweight positions back into Russia to gain exposure to the world's 8th largest economy which is also one of the most liquid GEMs.



- 2. Large caps are known to be relatively less risky and usually driven by fundamentals, unlike small caps, which often prove to be quite risky, especially in markets like what we have seen in the past few months. Were things similar, back in November 2005, when you launched the Pharos Small Cap Fund Ltd? How do you see the fund today, in terms of potential risks and returns?**

The return potential among small caps in Russia is quite compelling. While there are different risks to consider when investing in small caps as opposed to large caps, those examples of shareholder abuse are the exception. Our local presence and long history with the local business community helps us avoid potential problems and, also, we maintain a more diversified portfolio to mitigate our exposure to any potential problem. We see the market does reward strong fundamentals within the small-cap universe, though not as readily; hence the holding periods tend to be longer as does the upside. As both the economy and the market broaden, the potential in the small-cap universe is difficult to resist. When we launched the Pharos Small Cap Fund in November 2005, we saw it as a great opportunity to benefit from Russia's rising domestic economy; we think this trend is well in place and is likely to bear fruit as investors return to the Russian markets in 2008.

- 3. What competitive edge do you offer investors investing in your funds?**

Besides the obvious things like being Moscow-based, with a strong team of professionals with 90+ years of combined market experience and a 10-year track record through up and down markets, we are unique among Russia funds in our use of derivatives. Last year we responded to the growing depth of the derivatives market here by hiring a trader with 15 years of derivatives trading experience in quite senior positions with western market makers. In fact, we always been innovative in introducing new tools to our investment approach as the capital markets mature here. For example, in 2003 we were early in establishing short facilities with a number of local brokers for local shares at a time when it was not considered possible. In 2004 we created mechanisms for investing in restricted shares of Gazprom and Sberbank before they rose 550% and 300% respectively. Ours is a true hedge fund approach toward opportunities and we have seen much lower volatility in our funds over the past year as a result. We are also unique in combining significant western market experience with more than a decade of local market experience, including board memberships with more than 40 Russian companies. Last, we offer niche products – like our Pharos Gas Investment Fund that are unique to Russia and Pharos Russia Fund with daily liquidity – along with a comprehensive website that provides daily performance and market commentary.

- 4. On what basis, and to what extent, do you diversify the portfolios of the Pharos Small Cap Fund Ltd and the Pharos Russia Fund Ltd across sectors? At any time, approximately how many stocks do you hold in the portfolios of each of your funds, and what is your usual holding period?**

Both funds diversify across about eight sectors, with The Pharos Russia Fund targeting a holding period of one year or more and the Pharos Small Cap Fund targeting two years or more. The Pharos Russia Fund keeps half of its portfolio relatively concentrated in six or seven names, with a total portfolio of about 35 names. The Pharos Small Cap Fund holds 45 names with none accounting for more than 5% of the capital.

- 5. Could you briefly take us through your stock selection process? What is the kind of qualitative and quantitative research that goes into selecting the stocks that you finally invest in?**

Our goal is first to identify sectors that are poised to benefit from Russia's macro environment. Within those sectors we focus on the fundamentals of companies through company visits. Our primary research is bolstered by our extensive rolodex of contacts in the local business community where we can verify some of our industry assumptions and check for company specific risks. We discuss ideas regularly as a team, with four of us active in the decision-making process.



- 6. Do you bank on leverage to enhance your fund's performance? If so, to what extent are your investments leveraged? And what is the usual ratio of long to short positions that you hold?**

We do not use much leverage, though our use of a derivatives overlay has put us in a position to get aggressive more often than in the past. At the moment we are anticipating an upward re-rating of the market which will negate any short opportunities, but in the past we have held as much as 30% of the portfolio short following similar re-ratings. We short based upon fundamentals rather than as a hedge.

- 7. With the recent movements across markets, one would believe that strong risk management tools are an absolute necessity. What sort of risk management tools do you rely on to protect the investments of your funds?**

We maintain an imbedded low delta derivatives overlay in our portfolios to help remove the extremes of GEM drawdowns. For example, during this summer's global credit crisis, our funds achieved dramatically lower volatility than the major indices.

- 8. One of your funds – The Pharos Russia Fund Ltd – outperformed the EurekaHedge Eastern Europe and Russia Hedge Fund Index during the last two years, but is lagging by over 14% year-to-date. What do you think is the cause for the notable difference in returns this year?**

We kept a defensive posture in the portfolios during the early days of the global credit crisis at the end of the summer and thus did not participate fully in the up move in September. We have been outperforming more recently and closed the gap significantly. We are positioned to see strong outperformance in the upcoming quarter should the market continue to do well.

- 9. The Pharos Gas Investment Fund Ltd is down nearly 13% year-to-date (with a YTD and 12-month Sharpe ratio of about -0.27 and -0.42 respectively), but returned 53% and 110% in 2006 and 2005 respectively. Could you explain such extreme swings in returns of the fund, over the recent years?**

At the time of writing, The Pharos Gas Investment Fund is now up 11.0% YTD. The Pharos Gas Investment Fund is an investment in the last major restructuring of the Russian economy, the natural gas sector. Over the past 15 years of transition, such sector restructurings have had an early stage of extreme volatility in the stocks followed by massive re-ratings once the process became more transparent. The most recent example is the electricity sector restructuring which has yielded massive returns after initial volatility. After lagging most of the year, our Gas Fund has moved up more than 20% recently as we are moving past that early stage toward a period of increasing visibility for positive changes in the gas sector.

- 10. What is the investor profile that you intend to cater to with your funds? What are the types of investors that have shown interest in your fund over the recent years?**

Our investor base includes private banks and institutions primarily, with some participation by funds of funds and HNW investors. We do not expect much change to this profile.



11. Could you brief us of your outlook of the Russian markets in the near and the medium term? And how, according to you, will Russia fare as compared to other emerging markets such as Brazil, India and China, in time to come?

The Russian economy has been one of the most vibrant in the world over the past eight years, averaging 7% GDP growth per annum and becoming the 8th largest globally. Importantly, the past three years of data reveals its domestic economic activity has overtaken the natural resource sectors. Growth is coming after 15 years of painful re-tooling and restructuring of the former Soviet industrial construct. The opportunities in the regions of Russia are particularly compelling and reflect the scope of the success Russia has experienced. While the western focus has been on the rhetoric of missiles, democracy and Khordokovsky, the real story has been missed; Russia is booming and there's little, short of a deep global recession, to stop it. If the other BRICs do well, Russia will also. However, unlike those other markets, Russia is already an industrialised and urbanised nation that can be more self-sustaining between global demand cycles. And most importantly as an investor, have a look at the multiples – 30% earnings growth in non-resource sectors trading at 12x earnings – clearly one of the most compelling investment opportunities over the medium term.

Contact Details

John J Papesh
Pharos Financial Group
+7 495 221 4991
papesh@pharosfund.com
www.pharosfund.com