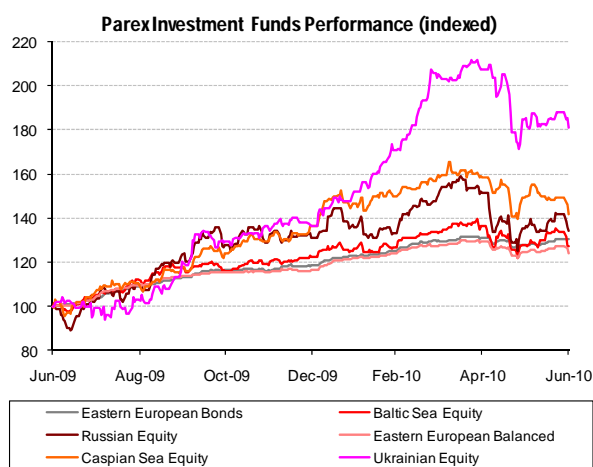




# PAREX FUNDS MANAGER REPORT

JUNE 2010

In June, continuing worries over sovereign credit risk in peripheral Europe, along with a worsening outlook for growth, set a negative tone for risky assets. In general, markets switched to consolidation mode, although the performance of asset classes differed somewhat. Most equity markets in Eastern Europe suffered minor losses, while benchmark bond and emerging market bonds gained. In the fixed income segment, Russian and Kazakh debt markets added 2.4-2.5%, while Ukraine underperformed, adding only 1%.



Funds	Currency	Performance (as of June 30, 2010)				
		1m	3m	6m	12m	Since inception*
Parex Eastern European Bond Fund	USD	2.15%	0.87%	10.38%	30.64%	6.79%
Parex Eastern European Balanced Fund	EUR	-0.42%	-2.72%	6.88%	24.26%	5.44%
Parex Russian Equity Fund	USD	-1.57%	-11.51%	2.77%	34.36%	11.70%
Parex Baltic Sea Equity Fund	EUR	-0.76%	-5.07%	3.62%	27.04%	2.81%
Parex Caspian Sea Equity Fund	EUR	-5.39%	-10.62%	4.12%	41.75%	-23.55%
Parex Ukrainian Equity Fund	EUR	-2.41%	-11.53%	32.71%	80.89%	-37.85%
Parex Baltic Real Estate Fund II	EUR	-0.05%	-0.10%	-0.34%	-16.67%	-16.43%
Parex Baltic High Yield Fund	EUR	0.50%	12.30%	6.80%	16.27%	1.58%

\* % annualized

## Parex Eastern European Bond Fund

In June local developments were still positive but more mixed than in the previous months due to several factors. First, the latest industrial production statistics of major CIS economies revealed that the recovery of the industrial sector continued in Russia and Kazakhstan, while Ukraine lagged due to deteriorating demand for steel. Second, compensating for the disappointing IP, Ukraine turned out to be on track to secure all necessary budget financing for 2010 and 2011, thus, mitigating sovereign default risks. The Ukrainian government borrowed at least \$2b from Russia's State-owned VTB Bank in June, so the \$14.9b IMF program is now very likely to revive. The country plans to tap the Eurobond market for additional funds in July. Naturally, successful financing of the ailing State budget is also very positive for the Eurobond market. Third, recent statistics for the Russian banking sector revealed that banks have become more eager to lend, which undoubtedly is positive, while asset quality still continued to marginally deteriorate. Seeing that operations in the country's banking sector have almost returned to normal, the Russian government plans to cancel its

anti-crisis measures by the end of this year. Despite the signs of stabilization seen earlier, asset quality of Kazakh banks continued to deteriorate in May; deposits, however, continued to flow in, improving the liquidity of Kazakh banks. Loans over 90 days overdue increased by 0.75pp to 26.9% of systemic gross loans, against 36.7% of systemic provisioning. Many banks in Kazakhstan are over-liquid, since the funds collected from depositors are not being lent out. Nevertheless, major banks plan to increase their loan portfolios in 2H10, which would positively affect the economy of Kazakhstan. Finally, Kazakhstan's National Fund Samruk Kazyna announced that it is considering selling once largest BTA bank and conducting IPOs of State-owned KMG and Kazatomprom in the next 3-5 years. The news was positive for the Eurobonds of Kazmunai (less so for equities due to potential dilution) and Kazatom, as both companies need investments.

With the secondary market recovering from the May weakness, activity in the primary market was fairly high in June too. New supply from the Russian quasi-sovereign and private issuers reached almost \$3bn. In particular, MTS borrowed \$750 million, Sberbank and VEB each placed \$1 billion worth of bonds, while at the very beginning of July, Promsvyazbank issued a

\$200m subordinated bond. Despite the globally complicated environment, the new issues were welcomed, not least due to placement premium provided.

Our Fund performed roughly in line with the market adding 2.2%. The main drivers of growth came from the longer-duration securities, such as KazMunaiGaz'15, Alliance oil'15, Metinvest'15 and MOL'17. There were no meaningful declining positions in June. Transaction-wise, we were not very active on the market. Using the dip in the prices of Hungarian assets, we added MOL'17 to the portfolio due to our fundamental positive view of the company, and the trade performed very well. In June, we also received cash and the new RUB securities of RBK-TV as the very long-lasting debt restructuring finally completed. In June, Russian Standard'10 matured and we also used the put option to further reduce the GAZ ruble bonds. As a result of market moves and transactions enacted, the average yield of the Fund has decreased to 8.7%, while duration has slightly risen to 2.6.

Looking ahead, our market view has not changed much – sovereign risk may well (deservedly) remain a topic of discussion and debate, but politicians are increasingly aware of the problems and their extent, even if they opt for different routes to tackle the problem. Of course, the risk of slower economic growth poses a threat to cleaning up sovereign balance sheets, but it also implies loose monetary policies for a longer period, which does appear to strongly support the emerging fixed income markets. In the meantime, local news flow in Eastern Europe continues to be more positive than negative. Therefore, all factors combined, we suggest that the medium-term investors continue to add Eastern European debt exposure.

#### Parex Baltic High Yield Fund

During June there were no transactions in the Funds assets – we only received coupon payments on some of the bonds and continued negotiations over certain transaction terms.

#### Parex Eastern European Balanced Fund

The fund's NAV slightly declined in June, primarily due to the equity component. In particular, Kazmunaigaz, MRSK holding and ENRC were the main negative contributors to the Fund, while Uranium One and Olainfarm were the most positive contributors. The bond portfolio produced flat results with the gains on the overall portfolio (MHP'15, Kazmunaigaz'15 and Alliance Oil'15 the most positive contributors) erased by the losses from the conservative revaluation of our position in International Industrial Bank securities (1.5% of the Fund). While the fate of the IIB bonds remains uncertain as of the time of writing, we opted for a conservative valuation as we view the risk of an unfriendly restructuring attempt to be very real.

There was not much trading in the Fund during June, and the average yield has slightly declined to 10.9%, while duration went up slightly to 2.3. Equity exposure remains slightly below 20%, which is still considered an adequate exposure for the near term.

#### Parex Caspian Sea Equity Fund

Central Asian equities dropped in value last month, sending the Fund lower. The region's equities underperformed their GEM peers, mostly due to the large share of commodity-related stocks in the region's equity universe. Investors plunged into a wave of risk aversion, as a relatively weak set of economic data both from the developed world and China added to fears on the sustainability of the global economic recovery.

Central Asian mining and energy stocks led the decline. Taking into account the mounting global economic growth concerns and risk aversion, the news flow from the region negatively contributed to investor sentiment. Kazakhstan announced that it was considering re-introduction of customs export-duty for extraction industries, as global commodity prices had stabilized. It was indicated that duty for oil exporters could reach \$2.7/bbl and be introduced as early as this autumn, while duty for miners would not be introduced until 2011. This news is likely to weigh on the stocks until this matter is resolved. Furthermore, Kazakhmys (-16.1%) added to investor concerns, saying it saw a slowdown in demand from China and expected copper prices to further decline towards the level of \$5500/ton. The latest reports indicate that, triggered by the slowdown in the stainless steel industry, ferrochrome producers in South Africa agreed to a 4% decline in 3q10 contract settlement price in 2q10, which we see as relatively modest. The news, however, had a minor positive impact on the shares of ENRC (-14.2%). Among the oil stocks, KMG E&P continued to suffer from negative investor sentiment (-13.3%), due to relatively poor publicity of the company YTD. Last month, it was reported that NC KMG could issue a \$1.7bn bond, which could be bought by KMG E&P, thus, once again reminding investors that the use of its vast cash balance is not fully under the company's discretion. The junior oil E&Ps Max Petroleum (-30.9%) and Tethys Petroleum (-17.5%) plunged on disappointing drilling results. Dragon Oil (-0.9%) was a relative outperformer in the energy complex, as investors were happy about the company's agreement with SOCAR that implies that Dragon is now allowed to transport most of its oil via the Baku route, since the company had to drop the previously used more profitable Iran route. Uranium One (+15.6%) turned out to be one of the top performers last month, as the company announced a deal with the Russian State company ARMZ, as a result of which ARMZ would get a majority stake in the company. While the deal structure is quite complex, we generally see it as positive for Uranium One, as it should reduce political risks for the company, which, in our view, had increased over the last year. The junior miners also showed relatively strong performance, especially Hambledon Mining (+37.2%), as the company has finally begun to show the first signs of a turnaround in performance.

In the banking sector, KKB plunged 23.2%, as Kazakh banking statistics in May showed a significant increase in overdue loans across all categories for the bank. BCC (unch.), on the other hand, continued to show broad improvements, while Halyk Bank (-6.1%) showed modest increases in overdue loans. We remain of the opinion that the bottom has been reached in the Kazakh banking sector, and we tend to

see the latest swings in asset quality figures as the surfacing of existing problems rather than a further worsening of the situation in the sector. Halyk Bank has started taking measures to deal with excess liquidity that is weighing on its net interest margin, by repaying deposits to Samruk Kazyna (SK) ahead of schedule. The bank and its majority shareholders are also in negotiations with SK over the buy-out of its equity holding in the bank. Halyk's majority shareholders have the option to buy-out the government's stake within a 4y time period, but it is possible that this right would be passed over to the bank itself, which would be positive news for its minority shareholders.

In the Fund, during the month we performed several purchase transactions to increase some of our positions on share price weakness. Thus, we increased our holdings in KKB, Kazakhmys, Max Petroleum, ENRC, and Dragon Oil. With respect to the latter, we, however, reduced our holdings later in the month, fixing some profits, to stay within regulatory bounds. We sold some of our holdings in Centerra Gold for the same reason. At the end of the month, cash position in the Fund stood at 13.5%. Looking into projections for July, we expect another volatile month ahead of us, driven by swings in global investor sentiment. Despite the fact that the situation in the region has so far been improving faster than expected (e.g. Kazakh January-May GDP growth reached 8.3% yoy), the dominant market drivers retain overall investor risk aversion and global economic outlook. Given the large uncertainty prevailing in the market, at this stage we remain on the cautious side, but we will closely monitor the situation and may take the opportunity to reduce the Fund's cash position if we see a turn in market sentiment.

### Parex Russian Equity Fund

Compared to turbulent May, June was very quiet for Russian equities. Market dynamics were mixed, and the RTS index ended the month with only a modest decline of 3.27%. The first half of the month was marked by slow price appreciation, accompanied by a gradual volatility decline that was fueled mostly by calming international markets. The second half was much more dynamic and, unfortunately, was characterized by a sharp reversal of sentiment and a significant sell-off. Renewed concerns about PIGS financials, as well as a slowing momentum of global macroeconomic indicators convinced investors that further de-risking and de-leveraging is the most appropriate strategy in the current environment. An especially cautionary sign is that there was almost no evidence of "window dressing". It is worth noting, however, that the Russian equity market still holds well above its May's lows, while major developed market stock indexes successfully broke down the levels set during May's sell-off.

Domestic macroeconomic data was extremely encouraging. Industrial production jumped 12.6% YoY in May (+10.4% YoY in April), and manufacturing surged 18.7% YoY (+16.5% YoY in April). Domestic consumption also continued rapid recovery in May: retail sales advanced 5.1% YoY, real wages surged 7.0% YoY, and disposable income increased by 2.8% YoY. Surprisingly enough, unemployment rate plunged by almost 1 percentage point – from 8.2% to 7.3%.

At the beginning of the month the Central Bank of Russia (CBR) unexpectedly cut its refinancing rate by 25 bp, bringing it to a record low of 7.75%. The step is undoubtedly positive as it confirms the expansionary monetary policy of the CBR and will probably lead to further acceleration of lending growth. The oil giant Lukoil surprised the market with its 1Q10 financial results. Investors' reaction was very positive as Lukoil's shares outperformed the market significantly last month. Rosneft was under pressure again (especially compared to Lukoil performance) on the back of potential introduction of export duty for East Siberian oil and speculations about BP's selling of 1.2% Rosneft stake. Shares of WimmBillDann were also aggressively offered on the market after Danone announced it is considering the sale of its stake in the company. According to Interfax, E.On might sell its 3.5% stake in Gazprom. The agency also speculates that shares could be sold not on the market, but to a Russian company with state participation.

Compared to May, the Fund's trading activity was significantly lower in June. We only increased our holdings in Mobile Telesystems, Inter RAO and Kuzbassrazrezugol.

### Parex Ukrainian Equity Fund

Throughout the month, trading was quite volatile in the Ukrainian stock market as market participants looked towards global markets for guidance. At the same time, it should be noted that the monthly performance of individual names substantially deviated from the UX. Utilities name Zakhidenergo outperformed the market, posting 30% growth, rather due to a lag in share price movement compared to its peers than to the claimed liberalization of the energy sector. It was followed by Ukrtelecom and Raiffeisen Bank Aval, gaining 9.6% each. Motor Sich did well too, posting a 3.4% return, while other liquid names of machine-engineering sector closed mainly lower. Meanwhile, most metals & mining stocks underperformed the market considerably, declining 11%-18% on sentiments that metal stocks were overpriced in the wake of flat steel prices and shrinking demand.

On the corporate level, Ukraine's second-largest steel producer Mariupol Ilyich Iron and Steel became one of the main newsmakers in June due to a reported merger with Metinvest Group. For this purpose, the company decided to increase its authorized capital by 3.7 times to UAH 3.09b through an additional share issue, and included Metinvest in the investors list, among whom the additional shares issue will be placed. As a result of the new issue, a 75% stake in Mariupol Ilyich Iron and Steel are expected to belong to the Metinvest group, and about 23% of the shares are to remain under the control of the current CEO Volodymyr Boiko. The news is positive for both companies: as a result of the merger, Metinvest Holding is expected to expand its product portfolio with flat products, while Mariupol Ilyich Iron and Steel is to benefit from the secured raw material supplies, as well as gain access to CAPEX financing.

Another big story of June was the repeat privatization of a 76% stake in Luganskteplovoz, Ukraine's monopolistic producer of locomotives. In line with market expectations, the stake was acquired by Bryansk Machine Engineering, a subsidiary of Russia's Transmasholding, which had already owned

Luganskteplovoy in 2007. The sale price was UAH410m (vs. the starting price of UAH 400m), which was 48% below the company's market price.

In the macroeconomic environment, the State Statistics Committee announced that consumer prices in Ukraine declined by 0.6% m/m in May, bringing y/y inflation to a three-year low of 8.5%. Contrary to consumer prices, the PPI increased by 4.4% m/m in May, which led to 27.9% growth in y/y terms. Ukraine's industrial output fell by 2.4% m/m in May, decelerating on a y/y basis to 12.7% vs. 17.4%. At the same time, the government estimated that Ukraine's economic growth was 6.1% y/y in 5m10.

Although data indicated that Ukraine's economy was in recovery, fiscal problems presented a challenge for

policymakers and investors. In May, the consolidated budget ran a UAH 11.4b deficit, bringing the 5m10 gap to UAH 15.2b. The positive news was that Ukraine's government received a \$2b loan from Russian VTB Bank last month which is expected to help Ukraine plug its budget gap left by the delay in funding from the IMF.

There were no transactions in the Fund in June. The cash position, however, was quite volatile due to significant inflows and outflows from the Fund. After recent market correction we are starting to see some interesting market opportunities with reasonable valuations, and we are more willing to allocate our cash resources. Specifically, we are watching closely Metals&Minig, Machine building and Agricultural sectors.

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