

# DIAMOND AGE RUSSIA FUND

## MONTHLY LETTER TO INVESTORS – JULY 2011



### Calm before the Storm

*"In my opinion, around these levels US Government Bonds are the short of the century,"* – Dr. Marc Faber, Gloom, Boom and Doom Report

*"Markets can remain irrational for a lot longer than you and I can remain solvent"* – John Maynard Keynes

**Diamond Age** produced a very positive result for the July period with a +6.17% return vs. +2.91% for the benchmark index MSCI Emerging Market Europe, +1.98% for global MSCI emerging markets, and +4.36% for the Russian Stock Market (MICEX), chart next page. Randy Newman is not the house favourite! In July the portfolio's single best performing line item was a large short position in Frontline (FRO NO) Norway which declined -19.1% for the month and was subsequently closed out as the Fund squared the position at a near -60% decline (i.e. +60% gain for investors); and the often discussed and much publicised Mail.ru (MAIL LI) short also continued to produce stellar returns on the short side until covered at \$28.35 early in the new reporting period.

### International Business Partners and Terms

Investment Advisor	Diamond Age Capital Advisors Ltd.
Administrator	CIBC Bank and Trust Co. (Cayman) Ltd.
Russian Custodian	CitiGroup – ZAO Citibank (Russia)
Auditors	Deloitte & Touche – Cayman Islands
Tax Consultants	Ernst & Young – Russia and Cyprus
Legal Counsel	Campbells – Cayman Islands
Base Currency	US Dollar
Hurdle Rate	US Dollar 3-month LIBOR + 50 bps
Inception Date	18 February 2005 at US\$100 per share
Dealing Day	Friday
Min. Subscription	US\$100,000
Bloomberg Ticker	DIAMRUS KY <Equity> <Go>

### Current Asset Allocation

Asset Class	Long	Short	Gross	Net
Equities	129.1%	20.3%	149.4%	108.8%
Bonds	0.0%	65.1%	65.1%	-65.1%
Commodities	42.2%	0.0%	42.2%	42.2%
FX *	0.0%	28.2%	28.2%	-28.2%
<b>Total All</b>	<b>171.3%</b>	<b>113.6%</b>	<b>284.9%</b>	<b>57.7%</b>
<b>Leverage</b>	<b>156.7%</b>			

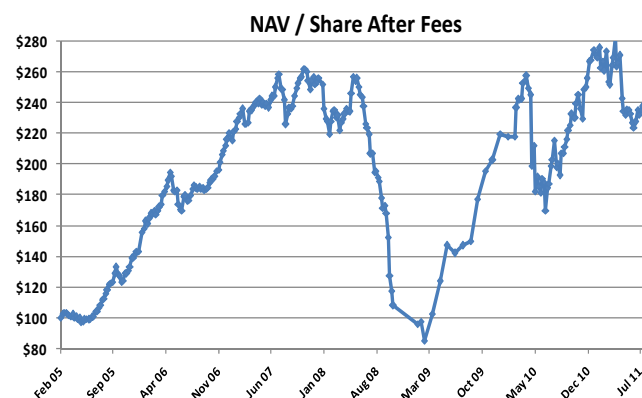
\* not included in leverage calculation

### Historical Performance

	2005	2006	2007	2008	2009	2010	2011
Jan	-	13.67%	1.29%	-10.44%	-11.34%	-0.79%	0.50%
Feb	2.24%	2.73%	5.70%	2.75%	-11.37%	0.03%	-3.09%
Mar	-0.27%	4.05%	-0.29%	-3.48%	20.53%	11.16%	1.30%
Apr	-2.54%	8.80%	1.88%	3.03%	20.86%	1.02%	2.42%
May	-0.51%	-3.78%	-0.71%	9.17%	18.71%	-21.49%	-13.14%
Jun	1.84%	-1.67%	2.88%	-7.02%	-3.28%	-2.00%	-4.88%
Jul	7.77%	0.37%	1.75%	-13.09%	3.37%	7.72%	6.17%
Aug	8.76%	2.33%	-4.69%	-8.69%	1.93%	-4.96%	
Sep	12.64%	0.01%	5.07%	-10.76%	18.41%	12.14%	
Oct	-6.56%	3.70%	4.99%	-35.75%	10.24%	6.31%	
Nov	7.49%	5.36%	-2.96%	n/a	3.66%	-0.13%	
Dec	7.33%	9.49%	0.80%	n/a	8.34%	16.66%	
Year	43.27%	53.70%	16.26%	-57.73%	103.00%	21.92%	-11.37%

### NAV Data

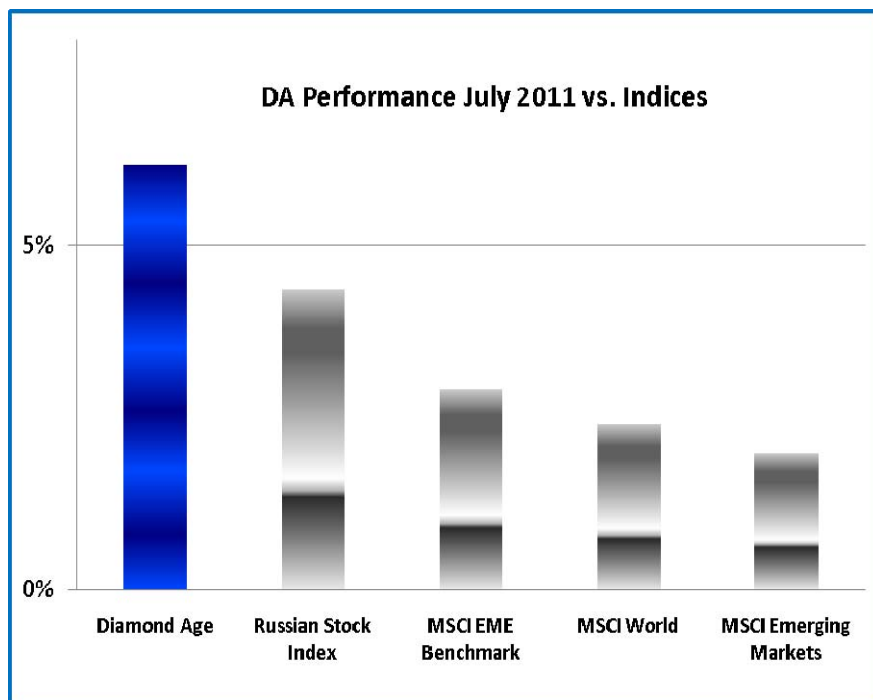
Fund Price (W/Avg), Main Class	Bid \$234.28; Offer \$237.34
Designated Investment Share Class	\$68.09
Total Assets (AUM)	\$28,090,683



**DIAMOND AGE**  
CAPITAL ADVISORS LIMITED

Russian Sub-Advisor: Diamond Age Investment Advisors Ltd.  
10 Testovskaya Street, Northern Tower, 19th Floor, Moscow, Russia 123317  
Tel.: +7 (495) 662-1786; Fax: +7 (495) 662-1762; funds@diamondage.ru  
<http://www.diamondage.ru>

Better than that and with uncanny providence, the three most recent additions to the portfolio, written up and analysed in extensive detail for the *“Sell in May, Go Away Edition... (we just never listen)”* Letter to Investors then occupied the second, third, and fourth best-performing stock spots (out of a +/- 50 line item Fund). All part of the Fund’s unrelenting global protein consumption theme, Thai Union Frozen +18.8% (Thailand), Universal Robina +15.9% (Philippines), and China Yurun Food +11.9% (Hong Kong), made an immediate impact on this strong monthly showing.

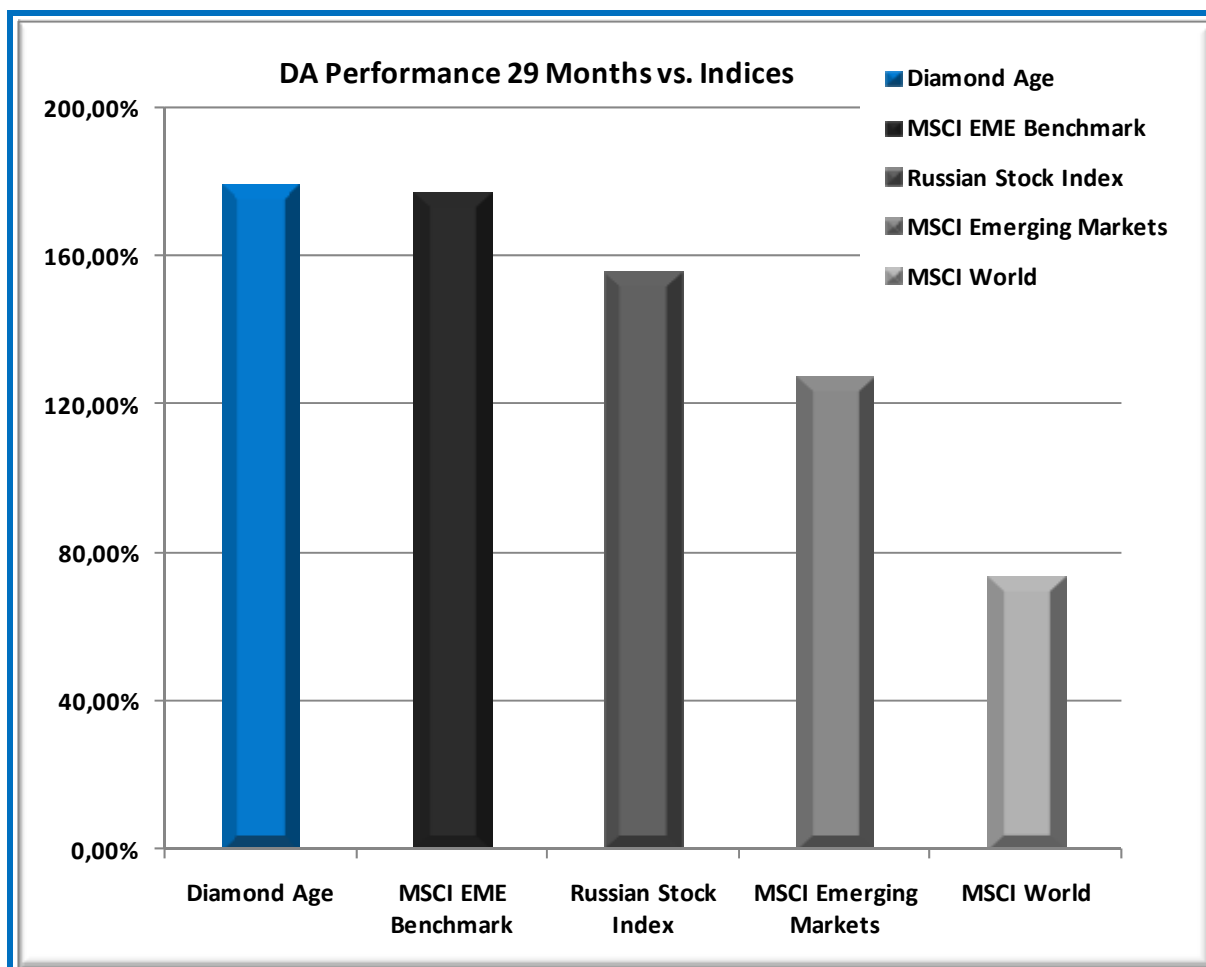


Sector Allocation	
Sovereign Debt	23.19%
Commodities	15.03%
Financials	11.54%
FX	10.05%
Media	6.77%
Agriculture	6.68%
Metals and Mining	6.44%
Real Estate	4.46%
Coal	3.66%
Shipping	3.37%
Conglomerate	3.29%
Construction/Infrastructure	3.11%
Industrials	1.44%
Fisheries	0.95%
<b>Total</b>	<b>100%</b>

<b>DAIMRUS KY</b>	<b>Diamond Age</b>	<b>+6.17%</b>
<b>MICEX</b>	<b>Russian Stock Market</b>	<b>+4.36%</b>
<b>MSCI EME</b>	<b>Benchmark Index</b>	<b>+2.91%</b>
<b>MSCI WORLD</b>	<b>Global Stocks</b>	<b>+2.40%</b>
<b>MSCI EM</b>	<b>Emerging Markets</b>	<b>+1.98%</b>

The Fund also experienced a powerful reversal of fortune in underlying agri-bulk inputs, notably September Wheat +15.0% and the commodity complex in general, especially September Palladium +8.8%. Lastly, the Investment Advisor maintained a zero weight in oil and gas at the end of the reporting period and was perhaps the only “Russia fund” taking such a heretical view at that time, with neither the underlying commodity futures nor any shares from either sector being held in the portfolio (investment rationale detailed in the *“Stock Markets, Race Horses and Marriages Edition”* of the June Letter to Investors). Of significant consequence, Gazprom (OGZD LI), Russia’s biggest company by market capitalisation and the largest publicly traded hydrocarbon stock in the world by reserves, declined from \$17.40 to \$10.60, or -39.08%, and Rosneft (ROSN LI), Russia’s largest oil company by market capitalisation, declined from \$9.70 to \$6.615, or -31.8% in the first 10 days of the new (August) reporting period.

*And the Fund reassumed its leadership role from the benchmark and relevant indices briefly surrendered in June for the first time in more than two years – chart below*



Name		29 Months
<b>DIAMRUS KY</b>	<b>Diamond Age</b>	<b>+179.16%</b>
<b>MSCI EME</b>	<b>Benchmark Index</b>	<b>+177.33%</b>
<b>MICEX</b>	<b>Russian Stock Market</b>	<b>+156.01%</b>
<b>MSCI EM</b>	<b>Emerging Markets</b>	<b>+127.87%</b>
<b>MSCI WORLD</b>	<b>Global Stocks</b>	<b>+73.94%</b>

So what does this mean? Following the trough recovery of global markets from March 2009, The Fund has been able to deliver outsized returns against all relevant indices and is of the top performing “Russia funds” tracked on Bloomberg.

Even so, the Fund maintains its bearish outlook adopted in January of 2011 and remains concerned and keenly focused on risks associated with current portfolio construction. Unabashedly bullish even throughout the throat-knotting market gyrations of 2010, in which **Diamond Age** managed a stellar +22% return vs. +14% return for the benchmark MSCI EME, the Investment Advisor turned cautious on the market at the beginning of the year and published the following downgrade in the same monthly Letter to Investors:

**JANUARY 2011** Something new? Yes. Diamond Age now abruptly changes its bold, brave, bullish position printed here, when the sky was black in May 2010. From that publication, the Fund outperformed the benchmark MSCI EME by 54%, Russian stocks by 31%, and Emerging Markets by 88%. In measured departure from October 2009 cautionary stance, Diamond Age re-aligned portfolio construction back in favour of the “June Moon Boon” in May 2010 when hope seemed lost; and subsequently outperformed the benchmark by 54% over the next eight months.

Even as the lone whistler in a dark, damp place, it was easy to dismiss 2010 market phantoms of “currency wars”, demise of the Euro, US unemployment, end of Chinese commodity demand, Greek contagion, and other false maelstroms which never really threatened to derail the global recovery. Why? Because plain as day - it was bollocks. Consistently however, the Investment Advisor’s position is maintained that EM inflation is both real and present, the knock-on effect to DM has already started, that the rate hike trend accelerates, and the bad news is that this paradigm will likely last the whole of the economic cycle. Markets are primarily driven by rates, monetary policy, Fx, sentiment, and most importantly, future expectations; not current valuations which are of tertiary importance.

**Downgrade maintained.** As such stocks are the least expensive asset class and cheap on virtually any matrix. But they can get cheaper; and in a rising rate environment, remain cheap for an extended duration.



Unfortunately, the most trusted Cassandra Κεσάνδρα sees more difficulties in the short run and chiefly among these remain EM inflation and higher rates in the Fund’s theatre of operations. As described in the Investment Advisor’s “*Two Rate World Scenario*” first published in the *August 2010* Letter to Investors and again, in the *January 2011 “State of the Inflation Address”* Letter to Investors; this once outlandish position has become near consensus.

India and Brazil have already hiked rates five times this year with 8.8% and 7.1% CPI respectively. The People’s Bank of China has raised rates three times over the same period in trying to cool its still poker hot growth-rate. Recent reports quantify that inflation in the world’s second-largest economy accelerated to 6.5% in July, the fastest pace in three years and well ahead of the 4.0% government targets. Having lived and worked in a former life in Beijing, in the capacity of managing director China for a \$714B AUM fund manager, the experience of the Investment Advisor is that the NPC (National People’s Congress) likes to set targets and is remarkably disciplined and dedicated to reaching them.

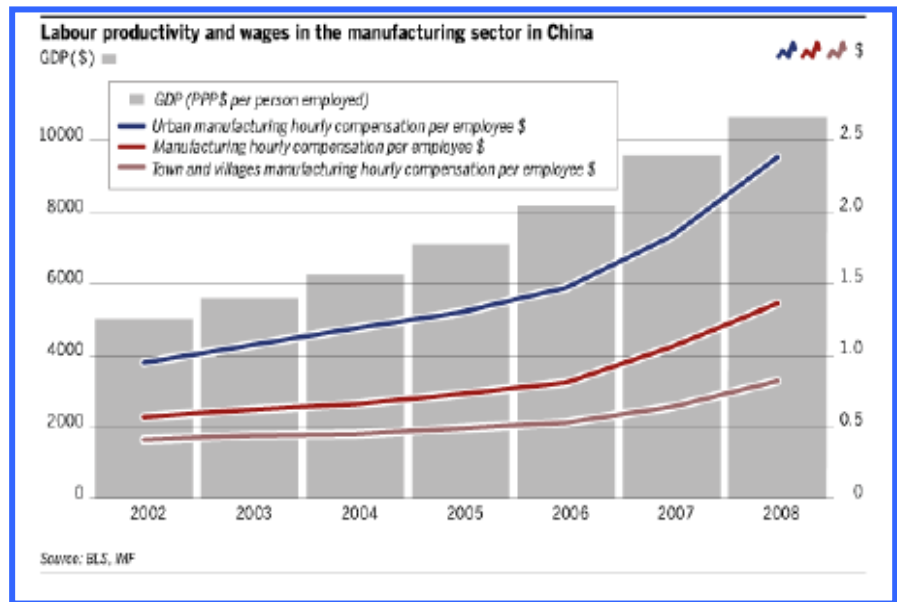
While the Investment Advisor is tempted to join China bulls Jim O’Neil, Dr. Mark Mobius and Jim Rogers, it may still be premature to re-enter the Chinese market (historically the portfolio’s second or third largest country weight) which the Fund exited in Q4, 2010. Despite record low multiples and the view (from some prominent camps) that inflation may have peaked, the Fund may only now begin edging back in and may do so quite gingerly, depending on developments on the ground in the coming months.

Geographic Dispersion	
United States	21.75%
Russia	20.74%
Australia	10.15%
Thailand	8.09%
Canada	7.53%
Singapore	4.79%
Kazakhstan	3.79%
Japan	3.45%
Philippines	2.99%
Georgia	2.43%
United Kingdom	2.15%
Ukraine	1.83%
Hungary	1.61%
Guinea	1.38%
Sweden	1.38%
Norway	1.30%
Mongolia	1.22%
South Korea	1.21%
Turkey	1.11%
China	0.72%
Finland	0.38%
<b>Total</b>	<b>100%</b>

Meanwhile Russia's 9.5% CPI maintains its position as the highest inflation rate of the BRIC's and of the highest of any major market economy in the world. Don't believe The Economist! Emerging markets in general are on a Tiger-roll with Singapore (financial centre of Asia, bellwether of EM trade and barometer of EM economic activity) posting a mind expanding 27.2% YoY 'Q1 GDP number (yes everybody knows it came down to earth in Q2, but this was a real headline).

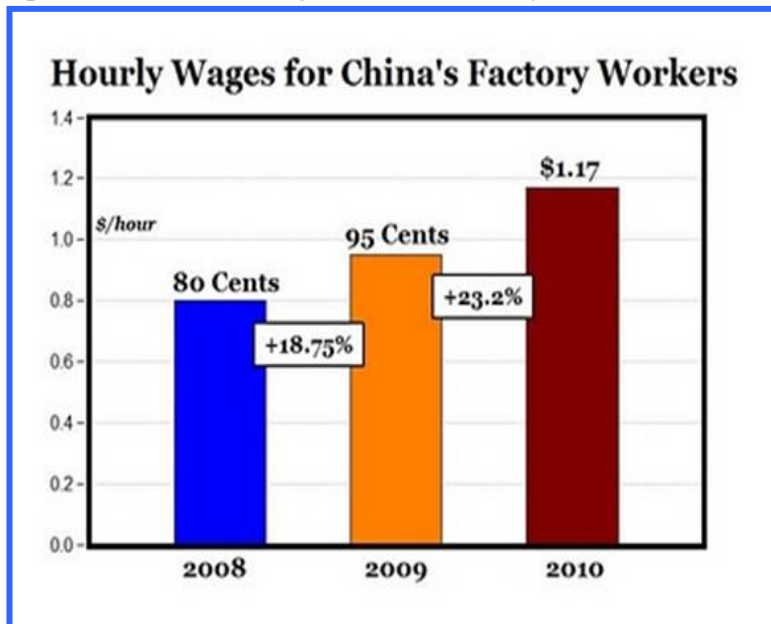
Once again, these inputs are not confined to so-called "noncore" food and energy. Russia's nominal (i.e. not inflation adjusted) wage indicator is +12.2% YoY. There is powerful wage growth in China (Pearl River Delta +24%, Yangtze River Basin +22%, Beijing Municipal workers +20%, Guangzhou lifts minimum wage by +18.6%, etc.) and other important emerging markets export inflation through the cost of manufactured goods to developed economies (import inflation).

**Chinese income disparity between rural and urban workers continues to induce migration toward cities. Urbanisation and industrialisation advance on a scale never seen in human history. That migration alone should increase the average worker's output and earnings, but other factors are also likely to boost wages and inflation in the near term**



If you like many of our friends who work in Moscow and did not receive such a powerful uptick in nominal wages (12.5%), it may now be a reasonable idea to test the waters for the first time

since the ashes of the 2008 crisis.

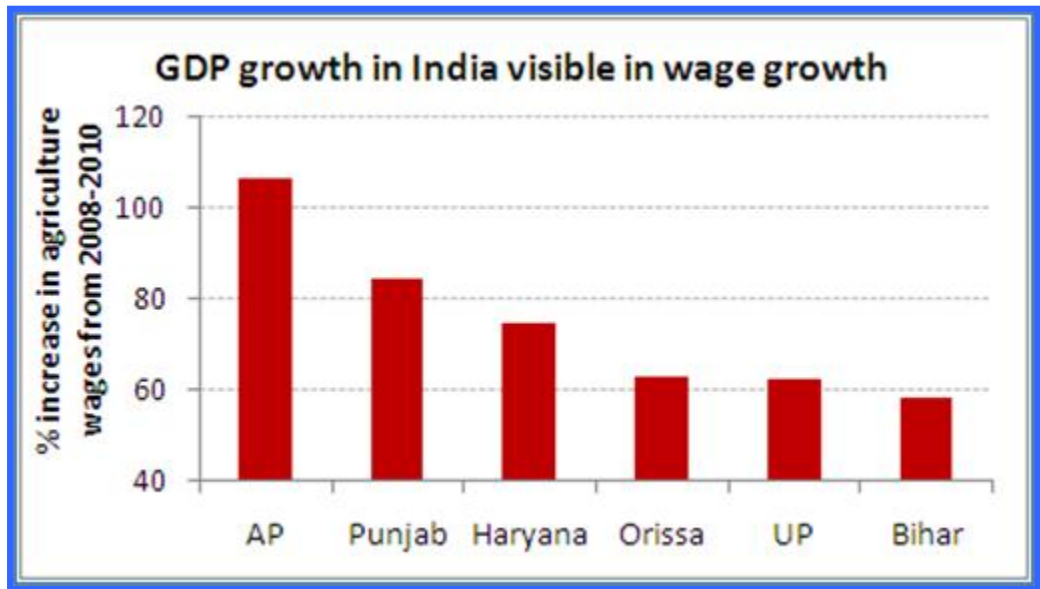


But this is not a Chinese or Russian story but rather a powerful trend in the growth segment of the two rate world:

*Financial Times: "India's industrialists are fighting a sharp rise in salary demands as they strive to hold on to scarce talent in the world's fastest growing large economy after China. India is battling the highest inflation of the big Asian economies. Last week the Reserve Bank of India raised its benchmark lending rates 50 basis points as it tried to bring inflation below 9 per cent."*

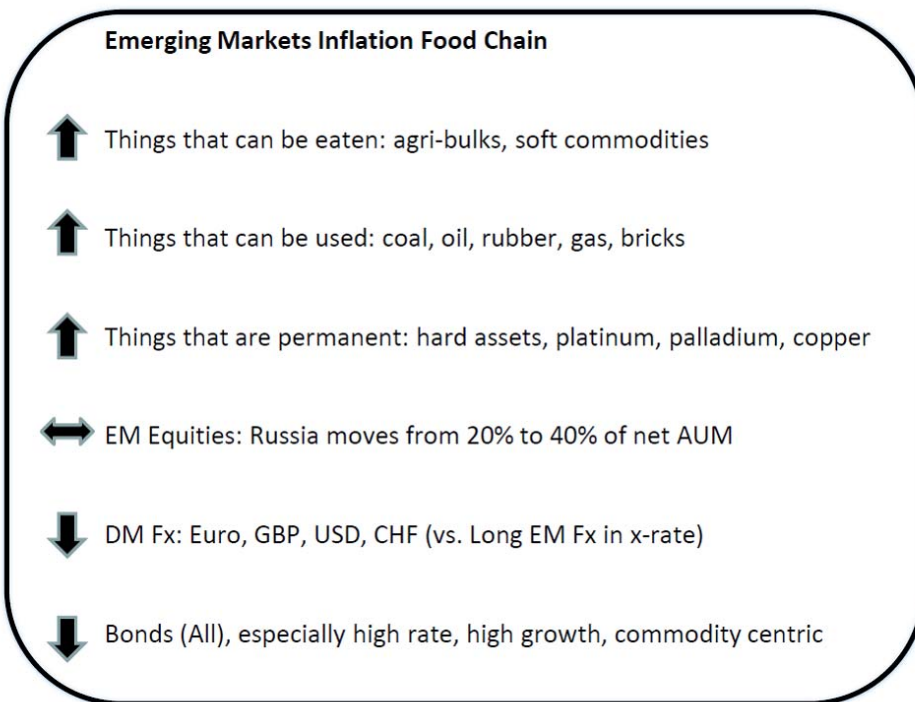
cent."

The Indian economy now has the #4 largest GDP on PPP basis in the world (#10 nominal). Although wage growth is most pronounced in the agricultural sector (chart on the right) representing a massive 51.4% of the workforce and coming from a very low base, according



to recent Hewitt Study: Technology and outsourcing sectors will grow at 9.5% to 10% YoY 2011, while industries like energy, telecom are rising with double digit figures 14%-19%. Banking and financial services have already witnessed a powerful uptick and forecasting 10.5% YoY wage growth in 2011

Thus despite low capacity utilisation, high output gaps and persistently high unemployment in key global markets like the United States, rates have turned, inflation is accelerating, central banks are (in the main) behind the curve and these pressures are not limited to non-core food and energy. Deflation theorists are nothing more than that: “theorists” with scant credibility, in the estimation of the Investment Advisor.



As such the Fund continues to favour portfolio construction positioned for the EM inflation food chain first described in the Diamond Age January Letter to Investors. No longer a maverick on the range here, the herd is drawing near and despite recent pricing action in the credit markets on the flight to safety trade, it is only a matter of time before yields spike and bond prices fall

## July performance attribution:

- **Equities: 129.1% gross AUM top stocks for July: 1. short Frontline (FRO NO) Norway – Shipping (-19.1%), 2. Thai Union Frozen (TUF TB) Thailand – Fisheries +18.8%, 3. Universal Robina Corp (URC PM) Philippines – Agriculture +15.9%, 4. China Yurun Food (1068 HK) China – Agriculture +11.9%, 5. Sberbank Prefs (SBERP03 RX) Russia – Financials +9.71%, 6. International Container Terminal Services (ICT PM) Philippines – Ports +8.62%, 7. Charoen Pokphand Food (CPF TB) Thailand – Agriculture +7.64%, 8. Evraz (EVR LI) Russia – Metals & Mining +7.27%**
- **Commodities: 42.2% gross AUM: October Comex Platinum (PLV1) +3.5%, September Palladium (PAU1) +8.8%, September Copper (HGU1) +4.7%**
- **Soft commodities sub set: 18.49% gross AUM: September Corn (C U1) +5.8%, September Wheat (W U1) +15.0%, November Soybean (S X1) +3.7%, October Sugar (SBV1) +5.1%**
- **Credit Markets: short (65.1%) gross AUM: short Australian 10Y bond futures (XMU1) +0.4%, Canadian 10Y bond futures (CNU1) +2.8%, US 10Y bond futures (TYU1) +2.8%**
- **FX derivatives: short (28.2%) AUM slow growth, low rates currencies – the USD, Euro and GBP – and long inflationary, fast growth, high-rate, commodity centric currencies – Australian Dollar, Korean Won and Singapore Dollar currency derivatives (90 days NDF's) X-rate trades**
- **The Fund held no Oil and Gas exposure (0.00% weight) at month end**

## July's door prize (don't forget the goodie bag on your way out):

On the last day of the reporting period, Friday July 29<sup>th</sup>, and long after markets closed in Moscow, Standard and Poor's did the unthinkable (except for readers of this publication). The world's leading ratings agency downgraded AIMR defined "risk-free" US Sovereign credit rating from AAA to AA+ consistent with the Investment Advisor's longstanding view that US debt was wrought with risk and short on value. In the short run however, and in panic, investors have scurried for the shelter of the very security whose safety has been drawn into question and bonds advanced following this unprecedented downgrade. World gone mad? Of similar logic, investors don't trust banks and dump bank shares; then deposit the cash redemptions in the very same banks.

From the *"Tōhoku Earthquake Special"* March Monthly Letter to Investors:

**"In March, U.S. spent 8x monthly tax receipts, including maturing treasuries. The treasury netted \$128B in tax receipts, but paid \$1.05 trillion: \$49.8B Social Security, \$47.4B Medicare, \$22.58B Medicaid, and \$37.9B in defence. However, the U.S. paid out the most for maturing U.S. treasuries, equalling \$705.3B. In order to stay afloat with only \$128.18B, it had to spend \$72.5B from its balance of cash, which ended the month at only \$118.1B, and sell \$18B worth of TARP assets. But most importantly, the U.S. treasury had to sell \$786.5B in new treasury bonds."**

While the Investment Advisor will not attempt to look too far forward into the future, it was clear the night of July 29<sup>th</sup> that this was far more than a symbolic act of defiance against the political pressures from Washington to maintain the AAA status. This was a development articulately supported by PIMCO, the world's largest bond fund manager, which would have a potentially hugely disruptive, damaging and wide ranging impact on capital markets world-wide. A ripple effect across other bond

classes and the beginning of a string of downgrades that may span the globe is likely (or at bare bones minimum) and it may spend some considerable time in blood-letting in Europe.

Sovereigns, municipals and financials are all at risk here, most especially in Europe. In fact while the United States is the number one borrower in absolute terms, its debt to GDP ratio remains well below that of many of its G7 peers (*if you exclude unfunded social liabilities + entitlements + Freddie + Fannie*), and the country's ability to tax, raise revenues as required, and print money indicate the chance of default at near zero. The Fund has never been short the bond market with the view of even the most remote chance of default, rather that simply global inflation knows no borders, rates will move higher, bond prices will fall, and the trend will be long lived (duration of the economic cycle). Treasuries (from many sovereign issuers) do not represent a "risk-free" investment but rather the world has entered a period in its history where bonds (particularly on the long end) present considerable capital depreciation risk.

In some matrices, the US seems in better shape than many other developed markets...

	<b>Real GDP 2012 E</b>	<b>Industrial Production (Latest)</b>
<b>USA</b>	<b>2.9</b>	<b>3.4</b>
<b>Japan</b>	<b>2.8</b>	<b>-1.6</b>
<b>Canada</b>	<b>2.7</b>	<b>5.0</b>
<b>Germany</b>	<b>2.1</b>	<b>7.5</b>
<b>Euro Area</b>	<b>1.9</b>	<b>2.2</b>
<b>UK</b>	<b>1.9</b>	<b>-0.8</b>
<b>France</b>	<b>1.7</b>	<b>2.6</b>
<b>Italy</b>	<b>1.0</b>	<b>1.8</b>
<b>Spain</b>	<b>1.2</b>	<b>0.8</b>
<b>Greece</b>	<b>-1.2</b>	<b>-10.0</b>

...but significantly lagging developed Asia and global emerging market powers

	<b>Real GDP 2012 E</b>	<b>Industrial Production (Latest)</b>
<b>China</b>	<b>8.7</b>	<b>15.1</b>
<b>India</b>	<b>8.6</b>	<b>5.6</b>
<b>Indonesia</b>	<b>6.2</b>	<b>9.2</b>
<b>Singapore</b>	<b>4.9</b>	<b>10.5</b>
<b>Russia</b>	<b>4.6</b>	<b>5.7</b>
<b>Turkey</b>	<b>4.5</b>	<b>8.0</b>
<b>Brazil</b>	<b>4.1</b>	<b>0.9</b>
<b>Korea</b>	<b>4.0</b>	<b>6.4</b>
<b>Mexico</b>	<b>3.4</b>	<b>4.6</b>

Unwavering in its position since March 2009, the Investment Advisor maintains that we are in the midst of a post-crisis global recovery which is largely consistent with historical post-crisis recoveries. This will never be a one-directional "constant" with some months slower and others quicker – no surprise there will be setbacks on the long uneven road to still higher elevations.

The investment climate for "Russia" maybe fairly characterised by world-wide growth albeit at a slower pace; inventory restocking continues but the cycle appears to be approaching an end; urbanisation and



industrialisation advance unabated; with associated demand for raw materials. Important to note that while inflation is an important driver of paper asset price depreciation, it does not mean the end of natural resource and materials consumption, or indeed pricing of the underlying commodities which may well serve as an inflation hedge. Understanding that during the inflationary “Great Bear” Market in the 1970’s, stocks and paper assets were devastated and commodity prices and hard assets made new highs, one can make an observation that 40 years later to this day these prices still remain significantly below (inflation adjusted) all time high prices (see *“Bracketville: Manama Madness Edition” of the February Letter to Investors*).

**Diamond Age** remains long and leveraged to Russia-related assets, the risk trade, basic materials, and agriculture. The Fund plans to continue maintain its exposure to agricultural shares and soft commodities while reducing its exposure (in general) to emerging market equities. At month end the Fund was short long dated bond futures; short G7 and safe heaven Fx (no longer).

Favoured stock sectors remain agriculture, metals, industrials, coal, construction and real-estate. As such the Fund has zero exposure to defensive sectors of healthcare, consumer staples, telecommunications, food retail or electrical utilities. **Diamond Age** owned no oil or gas exposure in shares or underlying commodities at the end of the reporting period.

The Fund’s portfolio composition is of course specifically constructed not to replicate a stock index or mirror a Russian ETF. It is being managed to generate meaningful wealth creation for investors; with global, diversified, performance returns commiserate with the risk of investing in Russia-related assets, the risk-trade, commodities, and emerging market equities.

While the world is in constant flux, the opportunity to generate powerful returns, in this unique EM strategy “Greater Russia” investment mandate, has not dissipated.

**Diamond Age Capital Advisors Ltd. receives sub-advisory counsel from Eighth Continent Capital Pte. Ltd.; a partnership which represents a continuity of investment advice dating back to initial Diamond Age Russia Fund inception February 2005. Content of this Letter to Investors provided by Eighth Continent Capital Pte. Ltd. in cooperation with Diamond Age Investment Advisors Ltd.**

---

**Disclaimer:** This material is for information purposes only and does not constitute an offer to sell, nor a solicitation of an offer to buy shares in the Diamond Age Russia Fund (the “Fund”) in any jurisdiction to any person to whom it is unlawful to make such an offer or sale. Subscriptions will only be received and shares issued on the basis of the current Offering Memorandum for the Fund, and prospective investors should carefully consider the extensive risk warnings and disclosures for the Fund set out therein. Investors should also consider any other factors that may be relevant to their circumstances, including tax considerations, before making an investment. An investment in the Fund is speculative and is not intended as a complete investment program.

© 2011 Diamond Age Capital Advisors Limited. All rights reserved. No part of this material may be reproduced or transmitted in any form or by any means – electronic, mechanical, electro-optical or otherwise – without the prior written permission of the copyright holder for which written application should be made.

