Diamond Age Russia Fund

Monthly Letter to Investors – June 2012

In June the Fund gained fractionally +0.42%, and, in fact, started delivering on the Investment Advisor's promise to meaningfully decrease volatility. Here is the most up-to-date example of weekly returns since the Fund's portfolio was re-configured to produce more stable and low volatility returns: +2.40% (week ending June 8th), +2.55% (June 15th), -1.50% (June 22nd), +1.97% (June 29th), +0.50% (July 6th), +0.34% (July 13th), -0.38% (July 20th), -0.07% (July 27th).

The Fund's 15% exposure to the Metals and Mining sector has been a drag on its performance year-to-date, but the Investment Advisor believes that although the world had been slowing, it is impossible to predict the timing and the scope of the world's central banks' repeat of reflation efforts; once announcements are made, actions taken, and equities rally, it is not possible to produce outsized returns by chasing run-away markets, unlike in the case when there is a constructive part of the portfolio already built for this purpose.

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 – Cayman Islands*
Tax Consultants	*Ernst & Young – Russia and Cyprus*
Legal Counsel	*Campbells – Cayman Islands*
Base Currency	*US Dollar*
Advisory Fee	*2% per annum*
Performance Fee	*20% of profits above hurdle rate*
Hurdle Rate	*US Dollar 3-month LIBOR + 50 bps*
Inception Date	*18 February 2005 at US$100 per share*
Dealing Day	*Friday*
Subscriptions#	*Weekly*
Redemptions	*Monthly, 14-day notice*
Min. Subscription	*US$100,000*
ISIN	*KYG2863P1090*
CUSIP	*G2863P 10 9*
Bloomberg Ticker	*DIAMRUS KY <Equity> <Go>*

Historical Performance

	2005	2006	2007	2008	2009	2010	2011	2012
Jan	-	13.67%	1.29%	-10.44%	-11.34%	-0.79%	0.50%	20.43%
Feb	2.24%	2.73%	5.70%	2.75%	-11.37%	0.03%	-3.09%	2.83%
Mar	-0.27%	4.05%	-0.29%	-3.48%	20.53%	11.16%	1.30%	-3.75%
Apr	-2.54%	8.80%	1.88%	3.03%	20.86%	1.02%	2.42%	-3.62%
May	-0.51%	-3.78%	-0.71%	9.17%	18.71%	-21.49%	-13.14%	-21.98%
Jun	1.84%	-1.67%	2.88%	-7.02%	-3.28%	-2.00%	-4.88%	**0.42%**
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%	-26.65%	
Sep	12.64%	0.01%	5.07%	-10.76%	18.41%	12.14%	-30.60%	
Oct	-6.56%	3.70%	4.99%	-35.75%	10.24%	6.31%	22.32%	
Nov	7.49%	5.36%	-2.96%	n/a	3.66%	-0.13%	-22.84%	
Dec	7.33%	9.49%	0.80%	n/a	8.34%	16.66%	4.55%	
Year	**43.27%**	**53.70%**	**16.26%**	**-57.73%**	**103.00%**	**21.92%**	**-55.48%**	**-9.99%**

NAV Data, Current Asset Allocation

Fund Price (W/Avg), Main Class	Bid $106.91; Offer $107.31
Designated Investment Share Class	$64.38
Total Assets (AUM)	$13,719,837

Asset Class	*Long*	*Short*	*Gross*	*Net*
Equities	85.8%	9.7%	95.5%	76.1%
Derivatives	0.0%	0.0%	0.0%	0.0%
Commodities	0.0%	0.0%	0.0%	0.0%
FX	0.0%	0.0%	0.0%	0.0%
Total All	**85.8%**	**9.7%**	**95.5%**	**76.1%**
Leverage	**0.0%**			

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Nevertheless, as could be seen from the sector and asset allocation tables above and below, the Fund's portfolio is well-balanced, with meaningful exposures to sectors which are more "defensive", and with a sizeable cash cushion, as well as reasonable short book. At current historically low levels of equity valuations around the globe in general, and in the Fund's investment universe in particular, the Investment Advisor is NOT of the view that a short-biased portfolio would make any sense in the medium term.

In fact, just the opposite, a meaningful strong long bias should be formed with a 12 to 24 month view. Emerging market equities, of course, tend to have a materially higher beta, both on the upside and on the downside, compared to developed market equities, but a proprietary stock (as well as other asset class instruments) selection should generate alpha far better than passive index investing and far better than negative rates of return in holding cash in the wonderful world of financial repression that we have seen of late. Financial authorities around the world distort asset prices across most, if not all, asset classes – OK, let's not "fight the Fed" and see what could be gained.

Sector Allocation	
Financials	20.69%
Metals and Mining	14.88%
Telecoms	10.10%
Gas Utilities	8.07%
Media	7.09%
Conglomerate	6.10%
Coal	6.04%
Agriculture	5.83%
Fisheries	4.35%
Airlines	3.41%
Industrials	3.02%
Construction/Infrastructure	2.93%
Chemicals	2.92%
Electrical Utilities	2.44%
Real Estate	2.13%
Total	**100%**

One example of the quest for alpha is the Fund's relatively recent acquisition of shares in the world largest technology company (by revenue) – Samsung Electronics Co. [005930:KS]. Sales of its products in Russia and CIS countries are enormous, and the only competitor of this size is Apple. Samsung just announced that its net profit swelled to 5.2 trillion won ($4.5 billion) in the April – June quarter, a 48% jump from a year earlier. Although the earnings were somewhat lower than the median forecast, Samsung shares jumped +5.2% on this announcement to close at a one-month high in Seoul as investors expect its earnings to continue growing strongly. Customers, including those in Russia and the CIS, flocked to Galaxy smartphones, helping Samsung outdo rivals at a challenging time for the global tech industry. Indeed, Samsung is the world's largest maker of mobile phones, televisions and memory chips, and it benefits from runaway demand for its Android-powered smartphones as rivals, including Apple Inc., have yet to release new models. Samsung's second quarter operating profit spiked 79% over a year earlier to 6.7 trillion won and its revenue rose 21% to 47.6 trillion won; the operating profit, also at an all-time high, was up 15% from the previous quarter. Despite nagging worries about debt-crippled Europe, the Investment Advisor expects Samsung to achieve a record profit in the third quarter when Galaxy S3 sales are expected to reach a peak before Apple unveils its new iPhone, anticipated in October. The company is very active in emerging markets, and its smartphone sales in China and Russia are growing. The increase in smartphone sales, the S3 and Galaxy Note will also boost sales of Samsung's mobile processors, thus helping the company to counter weak demand for computer memory chips. Although Samsung and Apple are cut-throat competitors and even have legal disputes between them, they remain close business partners. Samsung is a key supplier of mobile processors for Apple's iPhone and iPad and Samsung's component divisions also make display screens and mobile chips for Apple (thus benefitting from the Apple's success as well).

What's in store for the next 12 – 24 months? The Investment Advisor outlined his predictions under positive scenarios in Russia in his May Letter to Investors "***+100% for the Russian market in 24 months – how?***":

http://www.diamondage.ru/newsletter/Eng_DA_May_12.pdf

But what about global-macro, which we touched upon briefly in the same letter a month ago?

In his article recently published in the Financial Times, Bob Parker of Credit Suisse outlined a view with which the Investment Advisor concurs. Here are some highlights from Bob Parker's article.

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Market cycles are frequently characterised by investor "herding" behaviour, and investor positions currently show a high degree of uncertainty over market direction.

Geographic Dispersion	
Russia	57.28%
Ukraine	9.75%
Kazakhstan	9.05%
Georgia	8.08%
Thailand	4.35%
Turkey	2.93%
South Korea	2.92%
Guinea	2.07%
Singapore	2.03%
China	1.53%
Total	**100%**

This uncertainty is justified given the confusion over four key risks facing the markets: whether US political gridlock in early 2013 will lead to a fiscal contraction and recession; the extent to which is China slowing; whether political and military events in the Middle East will lead to an oil price spike; and how the Eurozone crisis will evolve.

All of these risks are skewed towards prolonged mediocre economic activity or outright recession. There is, therefore, a clear logic to investors chasing negative yields for short-dated bonds in perceived havens such as Germany, the Netherlands, Denmark and Switzerland and accepting historically low, but positive, yields in markets such as France, Belgium, Austria and Finland.

The safer debt characteristics of many emerging economies have also led to investor flows into US dollar and euro-denominated emerging debt with 3-year Brazilian debt in US dollars trading on a yield of 1.5 per cent and four-year Turkish paper in euros yielding less than 3 per cent. There has been a shift in capital flows into corporate debt, too, with investment-grade spreads close to 100 basis points.

By contrast, speculative positions in gold have reversed sharply given concerns over deflation and, excluding weather-affected soft commodities, most commodity prices remain under downward pressure due to recession risk. Emerging debt exposure has avoided investment in local currencies given the depreciation of many emerging currencies as their central banks ease monetary policies.

As reflected in bank bond yields trading over corporate issues and by the depressed price to book and price/earnings ratios of the financial sector, investors are taking a very cautious approach to bank risk. Equity exposures are low except for positions in high dividend defensive sectors and the rally in equity markets since mid-June has not been characterised by a major shift in portfolios. Clearly, positions have been eliminated where investors are uncertain over fiscal or political outcomes, and recent pressure on Spanish spreads indicates a near total investor exit.

The overriding themes of investor behaviour are a fear of recession and deflation, an acceptance of negative or low yields in haven markets and an intolerance to any asset class where either risks are opaque or where there is no trend improvement in risk.

A number of factors, however, suggest that capital flows may change over the coming months. In response to weak economic data from March 2012 onwards, monetary policies in G4 nations are likely to ease further, with quantitative easing in the US and a further round of very cheap loans in the eurozone. The European Financial Stability Facility may embark on a round of sovereign bond purchases.

Chinese and Brazilian policy is clearly focused on monetary and fiscal easing to improve growth prospects. The fall in commodity prices and lower inflation should start to boost consumption and, consequently, after a period of poor economic data, macro indicators should show a pick-up over the next three months. Chinese growth could move back to an 8 per cent-plus annualised rate, while German and northern European data should surprise to the upside. The International Monetary Fund has upgraded its forecast for German growth, which should be boosted by stronger consumption and the weaker euro.

‘Risk off, risk on’ behaviour is unlikely to persist and capital flows should benefit undervalued assets that are under-owned and where risk/reward is improving. Emerging market equities are undervalued relative to historic norms and, versus developed markets, growth and corporate earnings prospects should improve. The recent emerging equities rally should be the start of a reversal in underperformance. Valuations are attractive in Russia, Korea, China, Brazil and Poland.

Likewise, improved consumption, easy monetary policy and the weak euro should encourage flows into cyclical sectors in northern Europe. High dividend yields and increased share buybacks should help. But concerns over US fiscal policy are likely to reverse US equities’ outperformance, while the recessions in southern Europe and the slow pace in resolving the eurozone crisis will prevent renewed flows into Europe’s stressed economies.

Slowing growth, an overvalued currency and deteriorating fiscal position will prevent a recovery in the Japanese market. As deflation risk decreases, investors will reduce their exposure to bonds with negative real yields.

Asset class performance is likely to diverge sharply, with investors switching into higher-yielding assets, but where the security of that yield is strong, risk is less vulnerable to political shock, and growth prospects are improving.

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