Diamond Age Russia Fund

Monthly Letter to Investors – May 2012

+100% for the Russian market in 24 months – how?

In May the Fund lost 21.98%, slightly more than its benchmark, the MSCI Emerging Markets Europe Index, which fell by 18.58%. However, the Fund is still outperforming the benchmark and other relevant indices, such as the MSCI Russia Index and the RTS Index, from the 2011 market "local bottom" November 25th, 2011 to end-of-May 2012.

The Fund reduced its leverage to zero in May (and has 14% cash), and continues swimming closer to the shore for the time being. However, in this Letter to Investors, the Investment Advisor will put forward a game plan for positioning the portfolio to a +100% appreciation of the Russian stock market within the next 24 months, provided a certain set of scenarios materializes. When "risky asset" prices, such as equities and commodities, are priced such that anything less than "the end of the world" is just not possible, "non-risky assets", such as bonds, trade at levels not seen in decades, and as if they indeed were "non-risky" assets…

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%	
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%**	**-10.37%**

NAV Data, Current Asset Allocation

Fund Price (W/Avg), Main Class	Bid $105.65; Offer $106.86
Designated Investment Share Class	$63.83
Total Assets (AUM)	$13,702,711

Asset Class	*Long*	*Short*	*Gross*	*Net*
Equities	85.8%	3.4%	89.2%	82.4%
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%**	**3.4%**	**89.2%**	**82.4%**
Leverage	**0.0%**			

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Sector Allocation	
Financials	21.19%
Metals and Mining	17.42%
Telecoms	10.27%
Gas Utilities	8.23%
Agriculture	6.54%
Conglomerate	5.97%
Coal	5.74%
Fisheries	4.57%
Industrials	3.69%
Airlines	3.48%
Chemicals	3.03%
Real Estate	2.74%
Media	2.41%
Electrical Utilities	2.38%
Construction/Infrastructure	2.33%
Total	**100%**

Another round of near-panic selling, coupled with constant stress in Europe, drove the markets to a heightened "flight to quality" in May, and US Treasuries rallied for the second month in a row. U.S. and global equities, meanwhile, demonstrated one of the top 10 worst May performances since 1930. Emerging markets took a big hit and reversed all the gains from early 2012. Continued worries of a global slowdown in growth and the appreciation of the US dollar caused Brent crude to drop 14%.

In these circumstances, it is difficult to get optimistic, isn't it? What would it take for the Russian market, in particular, to re-rate? A combination of two factors: (1) the global storm abating and (2) structural reforms in Russia.

Nicholas Colas, the ConvergEx chief market strategist, came up with a David Letterman-style Top 10 list for a "contrarian view".

These days, after the Great Recession of 2008/2009, many US and global corporations are managing risk and doing more with less. A modest possible pullback in earnings would still leave companies in solid shape profit-wise.

Consumer confidence is still pretty high. Gasoline prices are coming off their highs – still high, but certainly lower.

Capital markets are still operating OK for companies to raise money.

Mortgage rates are still falling. Home borrowing rates at record lows are slowly but surely lifting the industry off its bottom – one of the main conditions for emerging from the Great Recession.

Retail investors have been out of the equity market for years, *en masse*, thus they are not wiped out and can and will return.

If Romney wins, the largest market (and by extension – global market too) gets a market-friendly president. If Obama wins, it's because the economy has recovered sufficiently for this to happen.

China is not falling off a cliff at all, despite all the noise about a hard-landing and Armageddon – would 7.5% or so growth constitute Armageddon in China?

High levels of market sentiment in either direction are generally considered contrarian signals – lots of bears – perhaps it's time to buy.

And lastly, "The end of the world only happens once – Monday probably isn't the day." Despite all the recessions and depressions, flashes and crashes, we're still here! "For all the well-publicized challenges facing markets and investors, financial Armageddon is still an unlikely occurrence," Colas writes. "And even if it does happen, what are the chances you really have enough gold coins, freeze-dried food and double-aught buckshot anyway? It is OK to prepare for disasters; just make sure you plan for success as well."

At the end of the day, let's keep in mind that global equities have rarely been so undervalued. US equities have been outperforming most other markets, both DM and EM, since emerging from the Great Recession, with a 12-month earnings yield for the SPX of 8.46% versus just 1.6% for 10 year Treasuries. Global calm and the end of the on-going "risk off" trade would gradually result in the Russian market getting halfway to a +100% appreciation from the current levels.

We do not need to walk very far to find out about Russia's particular concerns… not to Bolotnaya Square, not to Sakharov Prospect, not to the Pushkin monument on the Boulevard Ring. No, there are plenty of clues. Most of them are listed in the McKinsey's report on Russia's efficiency, productivity and ways to boost GDP. Here they are.

The most generic measure of productivity is GDP per capita, which in Russia is 70 per cent lower than in the US. In most other measures, too, the country is well behind the more advanced economies.

In energy, it is likewise one of the world's least efficient countries. A unit of GDP requires twice the energy input as in China, and six times that of the US. Meanwhile, capital investment in projects such as roads and power plants is 30 to 50 per cent more expensive than in the EU and multiples of the figure in China.

Geographic Dispersion	
Russia	54.50%
Ukraine	11.31%
Kazakhstan	9.78%
Georgia	7.86%
Thailand	4.57%
South Korea	3.03%
Guinea	2.57%
Turkey	2.33%
Singapore	2.09%
China	1.96%
Total	**100%**

Overall, McKinsey estimates that labor productivity must increase by 6 per cent a year in order to hit the 2020 growth target.

Improving productivity also requires capital investment, and Russia has pledged to raise investment as a percentage of GDP to 25 per cent by 2020, from less than 20 per cent at present. This compares with a 30 to 40 per cent level in other emerging markets such as China and India.

Infrastructure presents a serious bottleneck. The road network, for example, expanded at 4 per cent a year in Soviet times, but, under Mr. Putin, it has effectively stopped since 2000. Measured in kilometres, roads have nudged up from 754,000 km in 2000 to 776,000 km in 2009. That is a quarter the rate of increase that was seen even in the economic crisis years of the 1990s. In the World Economic Forum's competitive rating, Russia gets 130th place for road quality, below Angola, Kyrgyzstan and Tajikistan.

At the same time, the vehicle fleet has grown by an average 5 per cent a year since 2000.

Increasing investment would be made easier by improving the efficiency of capital spending. Part of the reason for limited road building is the expense: a kilometre of road costs an average $10.5 million compared with $4.3 million in the EU and $1.3 million in China.

With a huge infrastructure deficit, the cost of building a combined heat and power plant (CHPP) is $2,500 per kWh of capacity, compared with $1,800 for the EU and $720 for China.

The cost of building a distribution centre in Moscow, meanwhile, is €945 per square metre, 34 per cent higher than in London.

Some of these greater costs are due to high labour costs, climate and transport distances. But a fair portion is due to "leakage". In a detailed study by McKinsey up to 30 per cent of the cost of building a power plant was "unexplainable".

Reducing all these inefficiencies significantly over a reasonable period would see the Russian market completing the second half of the total +100% appreciation from the current levels.

Additionally, it is the belief of the Investment Advisor, that EM markets will outperform DM markets, including the US, in the longer term for the next 10 – 25 years. A global investment portfolio should contain EM stocks as well as those DM companies which have a significant business exposure to EM. We are living at the dawn of the EM century, and especially the Asian century, where explosive changes are coming. Today, 500 million Asians enjoy middle-class standards. In barely eight years the number, according to some estimates, is set to explode to 1.75 billion. Russia is in a unique position to profit immensely from this development and change itself too.

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