



MARKET INSECURITY. The last month seasoned players on the world's financial markets have felt the anxiety that they endured during 2008.

Financial turmoil from a helicopter perspective

No one has missed it - August was a difficult time on the global markets and emerging markets were not spared. The unease will prevail into September and most likely continue during the autumn. But keep your chin up, it is in times like these that the long-term investor in emerging markets can actually take advantage of the market turbulence.

Following a week in the US I felt updated and ready to reflect upon what is happening in the world's largest economy and how it affects the world economy. What could offer a better perspective on the situation than a number of interesting meetings, a pile of books and periodicals, and several hours over the Atlantic? Yes, this is how I prepared myself for this month's newsletter.

The late summer has been a turbulent time on the world markets. The markets watched, with increasing skepticism, as political leaders in Europe and the US, in different ways, avoided

reaching constructive solutions. This is exactly what was not needed in a situation where already fragile economies in Europe and the US were starting to recover. Especially disappointing were the discussions in the US that focused on party politics instead of the current precarious state of the American economy. The credit-rating agency Standard & Poor's responded by lowering the US credit rating one grade, which accelerated concerns worldwide.

Actually nothing new had happened, but seasoned players on the world's financial markets immediately felt the anxiety that they most recently felt during the summer of 2008. To feel that angst, the same angst that led to the collapse of the world's stock exchanges during the autumn of 2008, does of course not feel good.

Enormous confidence crisis

What we are experiencing right now is an enormous confidence crisis for the world's politicians. It doesn't matter if they are in Italy, Greece, Germany, or even in the US. Confi-

dence is too low and the feeling that politicians are only out to be reelected, in other words focused on popular short-term measures during a time when long-term measures are needed, leaves the financial markets and all its players dejected.

Did I become much wiser after the flight? No, unfortunately not.

What I'm even more convinced about today, however, is that of all the world markets, emerging markets will perform the best in the coming years. These countries are developing faster than countries in the West and furthermore, they do not have the same degree of debt as the West or Japan do.

Press on emerging markets

What is most ironic about the situation is that despite these hard facts, stock exchanges in emerging countries have an old habit of being pressed down more than in the West. There is no logic to this.

However, it is still a concerning factor since there is a risk that we will see further decline on the financial markets in the West, probably for the most part in the US, and it is difficult to see a situation where emerging markets rise while US stock exchanges are weak.

This means that the unease and focus on what is happening in the Western world will continue in the near future. In the long-term there is no doubt that one should invest in emerging markets. Valuations on some of the largest markets in which East Capital's funds invest have now come down to levels that existed during the autumn of 2008. We believe that these are good levels to invest at. Chinese companies, in other words H shares listed in Hong Kong, are today trading at a P/E ratio of 10 (share price per earnings) while companies are showing a profit growth of 30% for this year. It is in times like these that the long-term investor chooses to increase exposure to stocks.

Peter Elam Håkansson
Chairman and Head of Public
Equity investment team

Written on flight BA 284 (British Airways) between San Francisco and London



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Photo: AP Photo.

MASS AFTER KILLING. Thousands of Lithuanians mass outside the Parliament House in Vilnius in January 1991 after Soviet troops stormed the republic's broadcast station killing 13 people.

“I have never felt such a strong fear”

Kestutis Sasnauskas, partner East Capital, was on the barricades in 1991

20 years after the Baltic independence

One Monday in August, Peter Elam Håkansson and Karine Hirn (co partners in East Capital) asked me to join them for a short walk to Norrmalmstorg in Stockholm. It was a meeting to celebrate the 20-year anniversary of the independence movement in the Baltic states, with the Prime Ministers of all three Baltic states present. It was held on Monday at 12 o'clock, just as the meetings used to be held 20 years ago to support the Baltic states' aspirations to free themselves from the Soviet regime.

Standing there and listening to speeches by politicians and independence movement activists, my mind went back to the days when I was growing up in Vilnius. I was turning 17 and attending my last year in high school when Lithuania declared its independence on 11 March 1990. Change was in the air. The Baltic people's wish to live in freedom was stronger than ever. No economic blockade or threats could stop it.

Almost every afternoon after school, my brother and I used to take part in different gatherings on the Cathedral Square or by the Parliament House. The crowds were breathing the hope of becoming a free and democratic

society. But the road to freedom was not that easy and straight. In January 1991, Soviet troops made an attempt to reinforce the old regime. I will never forget the sound of tanks rolling on the streets of our calm and cosy Vilnius, nor the shootings that we could see and hear whilst looking at the TV tower on the night of 12 January.

That night - 12 January - 14 people lost their lives as Soviet troops in armoured vehicles stormed the singing crowd of people protecting their hope for a better life. The TV tower and the main TV and radio stations were besieged and a group of Soviet Generals made an attempt to restore the old regime. I have never felt such a strong sense of fear, anger and determination. The following days we spent most of our time behind the barricades, waiting for Soviet tanks to attack the Parliament House where the newly formed independence government was residing. We just had to do it - it felt wrong to leave the barricades and it felt wrong to stay at home.

The troops never came to the Parliament House and the attempt to reinforce the Soviet regime soon failed. The Lithuanian republic received international recognition (the Soviet Union included) in September 1991.

It is difficult to summarise the change my country and I have experienced during the last two decades. Standing in a live chain of 2 million people, connecting the three Baltic states in a silent protest against the Soviet occupancy in August 1989, I could never have imagined the three countries later becoming full members of the European union. And now the Baltics form an integral part of the European and Nordic markets and in the Estonian case even the currency. The booming economies of the last decade have also revealed a number of mistakes made in the aspiration to catch up with our Nordic neighbours.

However, the public courage and consent to the enormous public spending cuts that the Baltic countries have undergone in the last three years once again prove the Baltic people's unflinching determination to deal with any problems that arise on the way to a better future.

Kestutis Sasnauskas
Partner and Head of Private
Equity investment team



In the midst of market volatility: Our Chinese holdings deliver

Most of our fund holdings have now reported for the first half of 2011. It has been pleasant reading with the real estate developer COLI reporting 35% growth for example. Sure, China will not go unaffected through a global downturn in growth. But China's economy is largely driven by domestic investment and consumption and not exports.

In most cases our fund holdings have come in with very strong growth in both revenues and net earnings for first half of fiscal year 2011. Actually, most of the MSCI China index members have now reported and the average earnings growth at the end of August for these companies was close to an astonishing 30% increase over the same period last year.

Equally encouraging is the fact that after the market turmoil in August, valuations of Chinese companies are only around 25% higher than the multiyear record lows during the global financial crisis in 2008. On 1 September, the MSCI China index traded at 1.8 times book value and 10.1 times this year's earnings estimate; in other words, far below long-term averages.

Profit from the lack of logic

One can question the logic in Chinese equities moving down largely in tandem with US and European stocks, when the latter's concerns are mainly related to over-indebtedness and faltering growth in the Western economies and not in China. Sure, China will not go unaffected through a global downturn in growth, but China's economy is largely driven by domestic investment and consumption and not exports. One can wonder about the logic, but one can also try to profit from the lack of it. Now could be a good opportunity to do so.

As was widely anticipated, economic growth in China is easing somewhat as a consequence of successful economic policy combined with a slowdown in exports. Premier Wen Jiabao said on 31 August that China's key priority is to stabilise prices, and that there is no reason

to make any major changes in the current economic policies. We see no reason to worry about either too fast or too slow growth in China. It seems as if inflation has now peaked and will begin to recede in the coming months, which will allow Chinese policy makers to ease off the brakes.

Highly prudent provisioning

The alarmist reports in the media and from analysts on Chinese banks' exposure to local governments have subsided lately. Part of the reason for that may be that the interim reports from the banks included detailed and positive information on the progress with classification and provisioning on these loans. As an example, the world's largest lender by market cap, ICBC, reported that only 5.8% of their RMB 931bn in loans to local governments is not fully or largely covered by project cash flows. Just to put this number in perspective, even with a very pessimistic assumption of all of the 5.8% leading to full losses, that would amount to only one quarter of ICBC's operating income this year. It is also worth pointing out that the provisioning already done by the large banks must be described as highly prudent, with coverage ratios (reservations compared to non performing loans) of over 200%.

House prices continue to rise only modestly, at a rate slightly below the growth in disposable incomes, i.e. at around 1 percent per month. Also the discussions about a possible real estate bubble in China have become less frequent. That is partly explained by the successful government policies aimed at discouraging people from buying homes solely as an investment vehicle.

One of our holdings, real estate developer COLI, reported 35% growth in net earnings in the first half of the year, and has already reached 75% of its ambitious RMB 80bn contract sales target for this year. The company is heading for a seventh year of earnings growth of close to 40%. The stock is trading at multiple year lows, due to the Western world's concerns over its own indebtedness

China continues to pass economic milestones at a dizzying pace. China has now also become



Photo: Ilze Ivanova

LARGEST MARKET. China has become the largest PC market in the world and our holding Lenovo continues to gain market share in China.

the largest PC market in the world, and our holding Lenovo continues to gain market share in China, as well as globally. The growth in China's PC market is likely to accelerate further as disposable incomes move up and the world's largest mobile operators roll out 4G in the coming years.

Gustav Rhenman
Portfolio Manager



Market comments

Eastern Europe

Equity markets around the world fell sharply during the first two weeks of August on the back of the deteriorating growth outlook and poor policy response to the mounting debt challenge in the US and the Eurozone. The markets in Eastern Europe, which do not have the same kind of growth and debt problems, were strongly affected as investors once again fled to perceived safety. A number of frontier markets in the Baltics and the Balkans managed to limit the drops to single digits while frontier markets in the CIS dropped around 20%. The five large index markets - Czech, Poland, Russia, Hungary and Turkey - fell between 10-15%. The newsflow from the region was very thin and all the focus was on the external problems. The situation is worrying but it does not seem as bad as in the fall of 2008.

East Asia

The domestic Chinese markets fell somewhat during August, with the CSI 300 index falling 3.3% in US Dollar terms. A report showing US consumer spending falling to 2008 levels and lackluster net job creation figures weighed on China's export sectors. Hong Kong fell 8.2% during August, with stocks trading lower across the board. Banks were affected, as were export-oriented and commodity-related stocks. Korea was the worst performing of all major Asian stock markets in August. The Korean Kospi Index fell 12.7%, and was led lower particularly by stocks in cyclical industries such as shipbuilding as technology. The Taiwanese markets dropped 10.1%, with large sectors such as tech, petrochemicals and financials all being affected.

two of the country's largest banks. Indonesia's stock market dropped 7.6% with significant money outflows of around US\$990m. Malaysia was down 6.4%, with banking and engineering services stocks being affected particularly hard. Philippines dropped 3.5% during the month.

The main South East Asian stock markets all exhibited negative share price performance in August. Singapore dropped 8.3% with cyclical industries such as airlines, shipping showing negative performance whereas property and telecom stocks performed relatively well. Thailand fell 5.4% after sell-offs during the beginning of the month. Sentiment later reversed somewhat after Moody's upgraded

Eastern European Funds	NAV (31.08.2011)		August (%)			2011 (%)	
	USD	EUR	USD	EUR	USD	EUR	USD
Swedish registered	SEK	USD	EUR	SEK	USD	EUR	SEK
East Capital Russian Fund	1227.45	-14.9	-15.3	-14.8	-11.6	-18.5	-17.1
East Capital Baltic Fund	43.96	-9.7	-10.1	-9.5	-7.3	-14.6	-13.1
East Capital Eastern European Fund	35.34	-14.2	-14.5	-14.0	-13.1	-20.0	-18.5
East Capital Balkan Fund	11.13	-11.3	-11.7	-11.2	-13.8	-20.5	-19.1
East Capital Turkish Fund	7.15	-16.8	-16.9	-16.5	-26.1	-31.7	-30.5
Luxembourg registered	USD	EUR	USD	EUR	USD	EUR	EUR
East Capital (Lux) Convergence EE Fund, Class A	53.90	48.65	-16.5	-16.8	-19.9	-26.2	-19.5
East Capital (Lux) Russian Fund, Class A	86.64	78.38	-15.7	-16.0	-12.7	-19.5	-19.5
East Capital (Lux) Eastern European Fund, Class A	65.97	66.42	-13.8	-14.1	-13.0	-19.9	-19.9
China Funds	NAV (31.08.2011)		August (%)		2011 (%)		
	EUR	EUR	EUR	EUR	EUR	EUR	
East Capital China East Asia Fund, Class C	183.96	-10.9	-10.9	-18.0	-18.0	-18.0	
East Capital China Fund, Class C	110.62	-10.0	-10.0	-18.5	-18.5	-18.5	

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