

Rising Values in Eastern Europe

Pro-market economic reforms, rising political stability and large-scale foreign investments in Eastern Europe resulted in booming economies, growing purchasing power and rising profits of companies related to the local consumer. Thomas Neuhold, co-manager of the Eastern European Equity Fund, believes that Eastern Europe will continue to grow faster than Western Europe and the U.S. and is playing the theme of the long-term structural growth.

Q: The fund that you manage focuses on investments in Eastern Europe. What makes this market appealing?

A: After the fall of communism at the beginning of the 1990s, most of the countries in Eastern Europe incorporated quite a liberal economic system with relatively low taxes and light bureaucracy. Then, several countries joined the EU, and the legal and political risks in these countries became very similar to the risk in the rest of Europe. There is also a big difference in the wages between Western and Eastern Europe, which makes the region very attractive.

The tolerable risk level, combined with attractive wages and taxes, triggered a lot of foreign investment. In many countries, foreign investments reach 5% to 10% of the GDPs. That is a very positive trend as these investments stimulate the local economies and create jobs.

In addition, the European Union is pouring a lot of money for an upgrade of the local infrastructure, including roads, railways, IT systems, and power generation. The EU subsidies for infrastructural spending amount up to 3% to 5% of the annual GDPs in the new EU countries. This spending also boosts the domestic economies.

Separately, the former CIS countries, such as Russia and Ukraine, benefited from the rising commodity prices. Russia and Ukraine are highly dependent on commodity exports and we have seen very high GDP

growth rates, rising wages and income levels, and booming economies.

Overall, the investments in the region result in rising productivity, which leads to growing wages and, respectively, to rising profits of the companies related to the local consumer. We believe that this trend will continue for at least another five to fifteen years. In a nutshell, we expect Eastern Europe to continue to grow faster than Western Europe and the U.S.

Q: What is your definition of Eastern Europe? Which countries does the region include?

A: It includes all the new members of the EU, like Poland, the Czech Republic, Hungary, Romania, Bulgaria, and the Baltic states, as well as the former CIS countries like Russia, Ukraine and Kazakhstan. We also include Turkey and Israel in our investment universe and all the companies that generate more than 50% of their sales and/or profits in this region.

Q: Which sectors do you expect to benefit most from this growth trend? Where do you focus your investments?

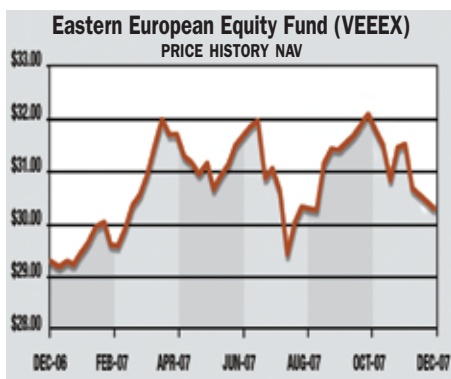
A: For us, the most attractive sectors are the ones linked to the local consumer, or the sectors that benefit from the increase in the purchasing power of the population, such as real estate, financials, consumer staples, telecom, and pharmaceuticals. We overweight them because our main investment theme is the attractive long-term



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Neuhold started his career at PricewaterhouseCoopers in 1996, where he worked as an auditing assistant. In 1997 he joined the Bank Austria Creditanstalt group at CAIB and gained more than seven years of experience as an equity analyst. He holds an MBA in Business Administration from the University of Graz in Austria.

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structural growth potential in these sectors.

The commodity sectors are highly related to the global commodity story and do not depend much on the local developments. However, these stocks have had a tremendous run in the last years and are trading at high normalized earnings and cash flow multiples. In addition, the growth in the wages and the appreciation of the currencies led to rising cost pressures. In the case of a global slowdown and a decrease in commodity prices, the margins of the commodity producers in the region will be squeezed.

Therefore, a much safer way to invest is through exposure to sectors that depend on the growth of the local consumption. Eastern Europe still lags behind Western Europe and the U.S. by a substantial margin, and the gap will close in the long term, not in the immediate future. That provides excellent growth opportunities for the next five, 10, to 15 years.

The Czech Republic and Slovenia are closest to Western Europe in terms of GDP per capita, banking penetration etc., so a great deal of the catch up process has already happened in some sectors in some countries. The further east you go, including Romania, Bulgaria, Ukraine, and Southeast Europe, the potential is greater.

Q: What is your strategy for finding the companies in which to invest? What type of companies do you look for?

A: We are bottom-up investors and we start with a liquidity check. Liquidity is very important in such markets, especially for

the exit strategy. Currently, we have about 300 million euros in assets under management in the region, and we require an average trading volume of at least 1 million euro before we consider a company. That may not sound like a high threshold, but currently only 150 to 180 companies fulfill this criterion.

Considered on a global scale, most of the stocks in the Eastern Europe would fall in the small to mid-cap range. There is a misconception that the region is a huge market and many investors overlook the liquidity risks. Liquidity was not a big issue when the markets were booming and the small-cap and high-risk companies increased the most. When the markets are turning down, however, the small caps are hardest hit. And nothing is worse than having to sell an illiquid position when the market is dropping and everyone has outflows.

The second step of the process is building in-depth understanding about the specific sector and country. If we analyze financials, we start gathering information about loan/GDP and deposits/GDP penetration, and compare it to the developments in Western Europe and the US in the last 30 years. In that way, we get a feeling of how sectors and companies stand globally. We also analyze the profitability of the company compared to its sector and global peers.

Then we look at company specifics, such as market share, historic performance, management changes, and quality of the management. We need to know if a company is doing well because of the industry or the management. When the growth is sector-driven, the company is hard hit during a downturn. When there is strong management, it can cushion the downturn and preserve the stability, the productivity, and the predictability of the cash flow.

The next step is making detailed projections about the revenues, the costs, and the cash flow for the short and the long term. We aim to make prudent and reasonable assumptions regarding the sustainable returns on equity (ROE) and the return on capital employed (ROC). For example,

many people think that the commodity companies in Eastern Europe are cheap because they trade at 10 or 12 times earnings, but their ROE now reaches 30% to 40%, compared to historical levels of 10% to 12% over a cycle. When there is a cyclical downturn, these companies tend to earn ROE of only 1% to 3%, or even record losses.

To come up with a reasonable long-term earnings model, we normalize the ROC and the ROE to a sustainable level. Short-term cyclical fluctuations may lead to high margins and seemingly low multiples, but when we normalize the earnings, the P/E ratios turn out to be much higher.

Q: How many investable companies are there in Eastern Europe?

A: I think that the number of listed companies exceeds 3,000. There was massive privatization in the middle and the late 90's in all the countries, but many of the companies have very small free flow and we do not follow them.

The biggest liquidity is in Russia and Turkey because of a couple of large-cap companies and many mid-cap companies. In Central Europe, Poland is relatively liquid, but even in the WIG20 Index, which represents the 20 largest stocks, some companies would be considered small and micro-caps on a global scale. And Poland is among the biggest markets in the region.

In Hungary and the Czech Republic, there are probably only five to seven names with sufficient liquidity; the situation is similar in Romania and Bulgaria. In smaller markets like Serbia and Ukraine, you can hardly find companies with trading volume of more than \$1 million a day. From a liquidity perspective, these markets are still true and risky emerging markets.

We always keep that fact in mind. With 15 years of investment experience, we have learned the hard way that liquidity is a huge issue in a bear market. For example, the mWIG40 Index in Poland had a tremendous run for five years because of dedicated mid-cap funds that were able to

raise a lot of money. Given the low liquidity, those inflows provided a huge boost to prices and everyone was happy. Between June 2007 and January 2008, however, the mWIG40 dropped from 5,700 points to 2,900 points.

Q: What are the milestones of your portfolio construction process?

A: We don't have specific country allocations because that doesn't make too much sense. The portfolio construction is based on building significant positions in companies that we believe are extremely undervalued. To avoid building a portfolio that is too concentrated, we have limited our exposure to a country or a sector to 1/3 of the portfolio, regardless of how cheap this segment is.

We are not benchmark sensitive because we only care if the stocks are cheap or expensive. When the stock prices exceed our target prices, we would rather hold cash. In the beginning of the fourth quarter, for example, our cash position was almost 50%, because we viewed many of the companies as extremely expensive. That referred even to sectors that we liked, such as the Polish banks. The strategy paid off nicely because many of those stocks dropped about 30% in the last four to six weeks and we were able to redeploy part of our cash again.

Q: Could you give us some specific stock-pick examples?

A: One of our successful stock picks was Open Investments, a Russian real estate company. It has a very smart business model of buying agricultural land close to Moscow, getting residential permits, and building closed communities for the affluent Russians. That still is an excellent business model, but the share price increased more than 6 times since 2004. We sold the stock last summer after enjoying 500% increase in the stock price.

Another example would be the Russian mobile phone sector, where we had big positions for a long time. When we bought them, those companies were trading at 80% to 85% below the current level. The mobile phone market in Russia is very attractive


because there are only three licensed operators. The margins are very healthy, and the risk of new licenses is low. Despite the growth, the telecom spending per user is still very low compared to Western Europe, so there was a big catch-up potential.

We completely exited the sector in the fourth quarter because we thought that the stocks were becoming very expensive, even in the perspective of continued growth. Currently, these stocks are already down 20% to 25% from the top. If they drop another 10% to 15%, we will start to accumulate positions again.

Q: What is your view of the investing risks in the Eastern Europe and how do you manage them?

A: Liquidity is among the biggest risks and we manage it by focusing on liquid names. Another risk is the high dependency on commodity prices for Russia and Ukraine, whose economies will suffer in the case of a global recession. We avoid those sectors, while other investors easily overlook the cost increase when commodity prices soar by 20% or 40% annually. In the case of a slowdown, however, there will be huge pressure on the margins and a large downside.

It will be also difficult to sustain the growth of the banking sector in Eastern Europe, which experienced a boom in the last seven to eight years. Due to the rising inflation in many countries, the growth rate in consumer lending may decline and some banks may have problems with the loan quality. It will become increasingly difficult for the banks to issue bonds and equity to keep up the loan growth rates and to maintain the legal requirements for the solvency ratio.

The growth and the lending boom also led to deterioration in the current accounts. The current account deficit exceeds 10% or 20% in some countries, such as Romania or the Baltic states. Financing the deficit was not a problem in the last couple of years because of the huge foreign direct investments and portfolio investments, but this situation might change in the future. 

Eastern European Equity Fund

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Tel. No.	800-527-9525
Inception	02/15/1996

PORTFOLIO

Total Net Assets*	\$70.73
Avg Mkt Cap (\$ Weighted)*	\$2,700
Average Price/Earnings Ratio	8.31x
Average Price/Book Ratio	0.81x
Turnover Ratio	N/A

INVESTMENT INFORMATION

New Investment	Open
Min Initial Investment	\$2,500
Min Subsequent Investment	\$50
Min Initial IRA Investment	N/A

RISK (AGAINST MSCI EAFE ND INDEX - 3-YEARS)

Alpha	0.07
Beta	0.98
R-Squared	0.63
Ann. Std Deviation	11.67
Sharpe Ratio	1.09

RETURNS VS. MSCI EAFE ND INDEX

	VEEEX	Index
1 Year (Cum.)	0.52%	0.22%
3 Year (Ann.)	15.06%	13.82%
5 Year (Ann.)	28.30%	20.28%

RETURNS VS. LIPPER EMERG MKT FD INDEX

	VEEEX	Index
1 Year (Cum.)	0.52%	21.79%
3 Year (Ann.)	15.06%	28.38%
5 Year (Ann.)	28.30%	33.33%

FEES AND EXPENSES

Max Sales Charge - Front	5.75%
Max Sales Charge - Deferred	0.00%
Max Redemption Fee	0.00%
Total Expense Ratio	2.54%

PORTFOLIO MANAGER

Thomas Neuhold	2004
Guenter Faschang	2001

*millions

Data through: 01/31/2008

Source: Company Documents; Lipper

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