

Russian Domestic Growth Curve

One of the most dynamic markets in the world, Russia may be difficult to understand for outsiders, but is extremely rewarding for those who know it well. Ticker revisits John Connor, the manager of the Third Millennium Russia Fund, to find out that he still finds Russia an exciting market with improving governance. This year, however, the focus is on the domestic growth story, rather than on the traditional oil exports.

Q: How has the Russian financial market and economy have changed in the past years?

A: Currently Russia is transitioning from a commodity boom to a consumer-based economy and approaching a size \$1.5 trillion. That definitely positions Russia as one of the top ten economies in the world, behind the U.S. and China, but on par with India and Brazil. The country has gone through a dramatic recovery since the 1998 debacle, which established quite a low base for comparison.

Currently, the macroeconomic picture is very strong. Russia has grown by an average of 6% to 7% growth for eight years. For 2008, the projected growth is about 8%. In addition, Russia has one of the most fiscally conservative economies in the world. Actually, I believe that the Minister of Finance, Alexei Kudrin, has kept a tight rein on the fiscal policy and deserves global recognition for that. While piling huge international reserves with trade and budget surpluses, he has managed to keep government spending and inflation in check.

There is already structural inflation in the economy as the income, the consumption, and the costs continue to go up. Under communism, everything was subsidized, and the expenses for gas, telephone, electricity, and occupancy costs are still very low. That leaves a tremendous amount for consumer disposable income, which has gone up about 27% for the last few years.

At the same time, there is extreme restraint on the government level and income taxes are kept low.

Q: What is your investment strategy in this transitional environment?

A: Last year our strategy for outperforming the RTS Index, which is our benchmark, was underweighting the oil and gas companies because we felt that these commodities are getting ahead of themselves, particularly oil. That proved to be a successful strategy, and we did outperform the benchmark.

Now we have an emphasis on the companies related to the local consumer, and I believe that the domestically oriented growth will continue. Moving into the consumer sector, we try to pick the companies that will outperform in the next year or two. We do not have specific sector allocations; we try to pick the winners. For example, last year we had exposure to Far East Telecom and Comstar. Both stocks were among the best-performing telecom stocks.

Q: How do you find the right companies and how do you manage the accounting and the cultural differences?

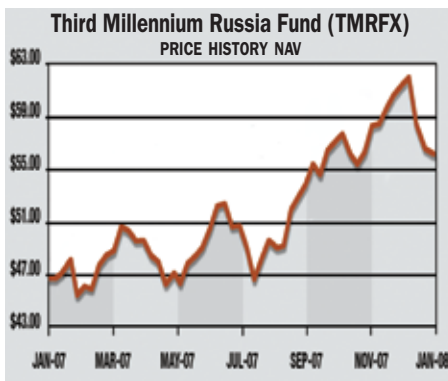
A: First, we read a lot. Second, we travel to the market frequently to meet every company in the portfolio. We may meet with the companies after we have invested in them but, ideally, we would have met them prior to our investment.



JOHN T. CONNOR, JR. is the founder and portfolio manager of the Third Millennium Russia Fund, a US SEC-registered mutual fund specializing in the equities of Russian public companies. Mr. Connor has managed the Fund since its inception in October 1998.

Connor is a member of the boards of directors of SwissFone, an Irish company based in Washington, D.C. and of Teton Petroleum (AMEX: TPE), based in Denver, Colorado. During its start up year, he was the president of Mail.ru, Russia's leading Internet portal with over 7 million registered users and remains an officer and director. Earlier, he headed the Moscow office of the US-USSR Trade & Economic Council, having been deputy director of the US Commerce Dept.'s Bureau of East-West Trade (Oct, 1972 – Jan, 1974).

Connor graduated from Williams College, Phi Beta Kappa, with highest honors, after which he taught on a Fulbright grant at Fergusson College in Pune, India, and from Harvard Law School.



Regarding the transparency and the integrity, I believe that Russia has undergone a mini revolution in that respect. In 2003, Russia reformed its tax system to remove the incentive for transferring funds abroad and for hiding income. Now the income tax is very low, at about 13% flat for individuals and in the mid 20% range for the businesses.

In addition, the imprisonment of Khodorkovsky served as an explicit warning for everyone who was trying to run the country instead of running his own businesses. The epoch of Yeltsin was financed by the people made wealthy by his privatization program, but they got carried away and Putin slapped them down hard by sending Khodorkovsky to jail. The message was “Go back to running your businesses instead of buying members of the parliament.”

Overall, Russia has gone through very rapid changes, and in the period between the tax reform and the current business culture, the people really got themselves together. Now the companies are audited by PricewaterhouseCoopers, Deloitte, and

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KPMG. When I listen to a presentation by a young investor relations person speaking English, I know that things have changed. Now the market is well regulated in a very professional way.

I believe that Russia is one of the most substantial markets in the world and people have a lot of confidence in it. There isn't the gambling element that you have in China, and the domestic Russian market has become significant. Shareholding is widespread because of all the privatization vouchers, and the market is on par with the best practices in other markets. So, I have a lot of confidence in the market and the company information that I get.

Q: Would you illustrate your investment process with some specific examples of stock picks?

A: The telecom sector would be a good example. For years, there was a talk about the telecom expansion to underserved markets. The landline telephony is still very deficient in Russia, which remains a poor European country where many people don't even have telephones. That creates an even greater opportunity for the mobile phone providers.

The current situation reflects the growth in the disposable income. Last year we began to perceive that cell phones are becoming a consumer commodity, as people are talking more and the usage rates are growing. Previously, we did not have big exposure to the telecom stocks, but we invested heavily in them last year and they had a great run.

They are also expanding geographically into Ukraine and around other regions, and I expect the strong growth to continue for another couple of years. These are private companies since initiation, so we avoided the typical problems of the privatized entities that were run by bureaucrats, not by executives.

Q: How have the changes in the demographics and the purchasing power affected the companies?

A: Well, there are many examples of ‘roll-

ups.’ In the pharmaceutical area, the widespread state pharmacies were privatized to their managers and employees. Then, they were bought out and re-branded as ‘Pharmacy 36.6’ and became the leading company in the area. A very successful business was built through the acquisition of the state pharmacies, refurbishing and re-branding them with new counters and lighting.

The situation is similar with Rosinter, the only publicly traded restaurant chain in Russia. That is a very interesting company, run by a talented young man who showed up from Argentina. In his early restaurants, he used different concepts and branded them as Italian, Spanish, and Mexican restaurants. He had locations in downtown Moscow and offered nice décor and good service for low to medium prices.

To become really big, he got the franchise for TGIF. Now he has prime locations all over the place, and runs the biggest public restaurant company in Russia. His original concepts were replaced by a mass approach and he built a higher-end McDonalds type of chain. That is an example of a ‘roll-up,’ because he used a lot of pre-existing restaurant locations with ready kitchens, leases, etc. It is interesting that the ticker symbol for the stock is ROST, which means ‘growth’ in Russian.

Those are two examples of consumer stocks that have achieved very good results in the last few years, and both of them are relatively new to the market. Of course, the most successful company has been Wimm-Bill-Dann Dairy. It is based on the same idea of rolling up dairies and juice lines from pre-existing locations. Now the company is the biggest purveyor of fruit juice and yogurts, and it recorded significant growth last year.

Q: In your view, how would a global slowdown in commodity prices affect the Russian growth story? How dependent is the Russian economy on commodity exports?

A: Right now, everyone wants what Russia has. The Asian demand seems huge

because there is very strong growth in the consumer sectors of India and China, where everyone wants to drive a car. There is high demand for commercial and residential buildings that requires steel, nickel, and many other commodities. When you add oil and gas to the picture, it really becomes huge, and Russia is the biggest exporter of energy.

There are always speculations about the bubble in that area, and I agree that the big question is how long this demand will continue. I think that nobody knows what is going to happen, but as long as the demand from the large developing countries continues, the trend for Russia is positive. The minute this demand slackens, however, the Russian economy will have a problem.

A recession in the U.S. would also affect the Russian stocks, mainly because of the panic. The recession, however, is an open question because the U.S. is still growing albeit at a slower pace. In addition, I believe that the U.S. is not that determinative for the Russian market, at least not in the way it used to be. Now the growth not only in India and China, but also in Taiwan and Vietnam, is becoming more important.

Taiwan, for example, is increasing the intensive cultivation to get higher yield grains and higher quality crops. That means that the Russian exports of potash and other fertilizers are very strong. One of our holdings, Ural Kaliy, had a fantastic year in 2007, up about 800% since we bought it. The stock represents 8% of our portfolio and is one of our biggest holdings, along with Sberbank, which is also a high-growth consumer stock. This is the largest bank in Russia that also got into mortgage lending, retail lending, auto lending.

Q: Does that mean that, instead of worrying about a possible slowdown in one area, you try to figure out the next winner and move before the others?

A: Typically, I am a buy and hold manager. I am not trying to make trading profits or to time the market. We are not trying to prejudice when things have peaked. We do have target prices and we do take profits

but, in general, before we replace a stock, we have to feel that there is something more attractive.


Q: What is your approach towards portfolio construction? Do you follow any benchmarks?

A: Typically, we hold less than 40 positions that we select from about 100 or 110 investable companies. Our benchmark is the RTS Index, which consists of about 50 companies, but as a market cap index, it is very heavily weighted towards oil and gas. Gazprom accounts for almost 50% of the Russian market in terms of capitalization and is the third largest company in the world. As companies from other sectors develop and grow, however, Gazprom, Lukoil, and the other behemoths should get smaller weight in the index.

Q: What kind of risks do you perceive and what is your strategy for minimizing them?

A: With the significant improvement of the corporate governance, the accounting, the transparency, and the integrity, we do not see a lot of currency and corporate governance risks.

On the surface, however, there is substantial political risk. For example, 2007 was a very bad year for public relations between the U.S. and Russia, mainly because of the nuclear-tip missiles. The U.S. admits that it had made a mistake not consulting with Russia beforehand, but Russia overreacted and the tensions remain. So, the communication is not well done in Russia as it doesn't have paid lobbyists, doesn't know how to play that game yet and, therefore, pays a price. That's the reality and also a political risk.

There is also a liquidity risk that we handle through limiting our positions in the second and third tier stocks. If this was a hedge fund, we would be able to take more risks, but as a public company with redemptions, we have to stick to the liquid blue chips and ADRs. Overall, I believe that the main risks are related to politics and fund liquidity, not the currency, corporate governance, and financial market risks. 

Third Millennium Russia Fund

Symbol	TMRFX
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Tel. No.	800-527-9525
Inception	10/01/1998

PORTFOLIO

Total Net Assets*	\$110.4
Avg Mkt Cap (\$ Weighted)*	\$17,300
Average Price/Earnings Ratio	12.16x
Average Price/Book Ratio	2.52x
Turnover Ratio	47%

INVESTMENT INFORMATION

New Investment	Open
Min Initial Investment	\$1,000
Min Subsequent Investment	\$100
Min Initial IRA Investment	N/A

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

Alpha	0.72
Beta	1.43
R-Squared	0.51
Ann. Std Deviation	22.44
Sharpe Ratio	1.14

RETURNS VS. MSCI EAFE ND INDEX

	TMRFX	Index
1 Year (Cum.)	19.77%	0.22%
3 Year (Ann.)	31.43%	13.82%
5 Year (Ann.)	38.25%	20.28%

RETURNS VS. LIPPER EMERG MKT FD INDEX

	TMRFX	Index
1 Year (Cum.)	19.77%	21.79%
3 Year (Ann.)	31.43%	28.38%
5 Year (Ann.)	38.25%	33.33%

FEES AND EXPENSES

Max Sales Charge - Front**	5.75%
Max Sales Charge - Deferred	1.00%
Max Redemption Fee	0.00%
Total Expense Ratio	2.81%

PORTFOLIO MANAGER

John Connor	1998
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*millions **for amount less than \$50,000

Data through: 01/31/2008

Source: Company Documents; Lipper

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