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Investing in a Russian Fund of Funds

T I M O T H Y E N N E K I N G , A L T I M A A S S E T M A N A G E M E N T



TIMOTHY ENNEKING has lived and worked in Russia since 1994. Prior to founding Altima Asset Management and the Tera Capital Fund, he was a Director of two diversified private equity funds, one founded in 1996, and the second created in 2005 by splitting the original into two funds, with approximately \$50 million under management.

As Vice President for Mergers and Acquisitions of a major European company, Mr. Enneking has conducted analyses of approximately 1,000 companies throughout Europe,

and he was the Principal on transactions totaling over \$8 billion over the past 12 years. Mr. Enneking holds an undergraduate and three graduate degrees in international business and law, including one post-doctoral degree. He also holds a graduate degree in international security studies. He has taught in English, Russian and French in various undergraduate and graduate business schools in the U.S., France and Russia.

SECTOR — GENERAL INVESTING

(ABT506) **TWST:** What was the impetus behind the founding of Altima Asset Management?

Mr. Enneking: When we were thinking about setting up a fund, we realized that the successful existing funds all have relatively large entry fees. Six years ago, although Russia was wealthy, the wealth hadn't trickled down that much, so there weren't a lot of people who could toss around \$5 million to go in a fund. They didn't have a half a million or a million dollars to go in a fund, although these funds were earning 30%, 35%, 40% a year. I was managing P.E. funds and decided to research fund of funds. I realized that we could gather \$100,000, \$500,000, a million or more dollars from various people and instantly we'd have a lot of diversification across a whole range of funds with a much smaller amount of money. That is what lead us to set up Altima.

TWST: What is the Tera Capital Fund?

Mr. Enneking: Tera is a fund set up on the Cayman Islands. It's the only fund that Altima Asset Management manages. It is a fund of funds that only invests

in funds that primarily invest in Russia. I am told there are no other country-specific funds of funds in the world that invest in another country. In other words, in United States, you will find U.S. fund of funds; in Japan, you will find Japanese fund of funds. You will find others in Europe, where you have a French fund of funds that invests in France; you have funds of funds in Europe that invest in the EU, etc. But Tera takes money mainly from Western investors and invests it in another and, as far as we know, it is the only fund in the world that invests in a single country. And we're definitely the only fund of funds that invests in Russia.

TWST: What is a fund of funds?

Mr. Enneking: Fund of funds means that investors invest in Tera by purchasing shares, and with that money Tera invests in other funds.

TWST: How would you describe your investment philosophy and what is the

strategy you use to implement that philosophy?

Mr. Enneking: Our goal is to maximize diversification

Highlights

Timothy Enneking provides an overview of the Tera Capital Fund, which invests in funds that primarily invest in Russia. He points to Russia's market size, increasing growth rate and large foreign currency reserves to placate investor fears. Altima manages the risk of investing in Russia by making transactions in U.S. dollars and diversifying geographically, by market capitalization, and by type of stocks and sectors, including FMCG, energy, heavy industry, manufacturing and, recently, agriculture. Mr. Enneking points to corruption in Russia as the major reservation many investors have, but reminds investors that Russian corruption is standardized and does not prevent investors from making money. The Tera Capital Fund generated returns of 35% annually for three and half years and continued growing at 17% annually during the 2008-2009 economic crisis. He credits his Ride It Out strategy for obtaining favorable returns during the crises.

and minimize risk. That's really the strategy and almost the tactics as well of what we do. Tera is diversified at several different levels. Even in a country like Russia, you have geographical diversification because you have Moscow versus essentially the rest of the country. Tera also diversifies in terms of strategy and market capitalization, in terms of whether funds invest in blue-chip stocks, second-tier stocks, third-tier stocks or other types of stock. We have radically different sector diversification compared to all Russian indices and almost all other Russian funds. The RTS, the Russian Trading System, is the main dollar-denominated index in Russia. Between 65% and 75% is invested in oil and gas, and oil and gas infrastructure. Tera is 15%, 20% or maximum 40% invested in that sector. Our sector profile is radically different from the sector profile of almost all other funds and all indices. An interesting statistic that results from this is that 80% of equity investments in Russia is made in just 20 stocks.

"Our goal is to maximize diversification and minimize risk... Even in a country like Russia, you have geographical diversification because you have Moscow versus essentially the rest of the country. Tera also diversifies in terms of strategy and market capitalization, in terms of whether funds invest in blue-chip stocks, second-tier stocks, third-tier stocks or other types of stock."

TWST: You mentioned your oil and gas holdings. What are the other sectors you invest in?

Mr. Enneking: After the 2008-2009 financial crisis, we expanded our oil and gas holdings in early 2009 for obvious reason. Oil had fallen to \$33 and it was good time to buy, so we did. The other sectors we track are FMCG, energy, heavy industry, manufacturing. We sometimes add new sectors. For instance, this month we began discussing adding agriculture as a separate sector, because although agriculture was destroyed here after the revolution when it was collectivized, now 20 years after the Soviet Union broke up the agricultural sector has begun to get its act together. And now we are starting to see larger companies and some vertical integration. For example, we are seeing juice companies and milk producers buy farm, processing plants and other infrastructure in the sector.

TWST: How do you manage risk?

Mr. Enneking: We manage risk in a lot of different ways. First of all, structurally, we do virtually nothing in Russia. The management company is located outside of Russia, the fund was formed outside of Russia. The underlying funds were also formed outside of Russia — their auditors, their administrators, their banks, everything possible — is outside of Russia. Although I'm not particularly worried about many types of risk inside the country because we understand the institutions in Russia and we can do things effectively and with little risk here, investors may not see it that way. So for the sake of the investors, we developed all of Tera's infrastructure outside of Russia. Secondly, we're denominated in dollars. Even domestically, there is very little currency risk in most compa-

nies, because the export-based economy is almost entirely denominated in dollars. One of the two major stock exchanges is denominated in dollars; the other is in rubles. A lot of our underlying funds trade Russian equities through ADRs and GDRs in London, New York, Hong Kong, etc. Those funds are all denominated in dollars and much B2B business is denominated in dollars, although paid in rubles. So we've deliberately structured the fund so that there very little ruble exposure.

In terms of trading risk, we minimize that by diversify in the various ways we just discussed about. Taken together, all of these approaches have a tremendous risk-reduction effect. After almost six years, you can see that clearly because our Sharpe ratio, a measure of risk versus return, is almost four times higher than the Sharpe ratio of the index average over the last 12 months, and over twice as high as the Russian fund average.

TWST: You have about 5% cash right now, but some of that is in physical gold. Why do you hold physical gold?

Mr. Enneking: Actually it is one of our underlying funds that owns the gold. We don't like to have much cash at all in the fund, and 5% is really quite high for us. In reality, we have less than 3% cash, if you exclude the physical gold in that underlying fund. Because Tera is a fund of funds, we have to add up the cash in each underlying fund and then add Tera's cash to the total as well. So there's a bit of math involved for what percentage of your fund is actually in cash. Although it wasn't our decision, the decision of one underlying fund to invest in physical gold is an excellent illustration of the kind of diversification an investor can achieve in a fund of funds, which is impossible through a single fund.

"Although I'm not particularly worried about many types of risk inside the country because we understand the institutions in Russia and we can do things effectively and with little risk here, investors may not see it that way. So for the sake of the investors, we developed all of Tera's infrastructure outside of Russia."

TWST: Why did you decide to make Russia the focus of your fund?

Mr. Enneking: I had been working here for a long time and when my partner Alexander Polykovskiy and I had the initial idea, we first considered Western and/or Eastern Europe. Then we decided that given how rapidly markets were evolving, we did not want to invest in a market we didn't live in or know very well. If you do, you can't wake up in the morning, sniff the air and get a feel for which direction things are moving. So we quickly decided that we could read analysts' reports like everybody else about Bulgaria, Romania, the Czech Republic, Hungary and everywhere else, but we really had no competitive advantage in that regard. We decided to focus on what we knew, and obviously we know this place better

than the vast majority of people. I'm probably one of the longest established foreigners in Russia at this point in time.

“This place is skyrocketing and it's going to continue. Even the IMF, which is rather pessimistic, has Russia growing at 5% a year for as far out it predicts. According to the IMG, Russia's GNP will grow by 60% over the next five years and become the eighth largest economy in the world. In fact, it's already become the biggest consumer nation in Europe.”

TWST: What are the major trends in Russia?

Mr. Enneking: When we decided to invest in Russia, we knew that it was taking off and that it is going to explode economically. This place is skyrocketing and it's going to continue. Even the IMF, which is rather pessimistic, has Russia growing at 5% a year for as far out it predicts. According to the IMG, Russia's GNP will grow by 60% over the next five years and become the eighth largest economy in the world. In fact, it's already become the biggest consumer nation in Europe. Russians consume more than Germans, but there are almost twice as many Russians as there are Germans. So although this has been a capitalist country now for 20 years, it still needs almost everything. Moscow has almost all the consumer goods you could ask for, but in some places in Russia you need virtually everything and in most cases you need a lot of it.

TWST: Is corruption a problem?

Mr. Enneking: The single biggest problem I suspect in Russia is corruption. Let me talk, address an initial observation, however. While corruption, lack of an independent judiciary, little independent media, etc., are all problems — and actually they are quite serious problems — they have not prevented, are not preventing and will not prevent investors from making a lot of money in Russia. That's the first point. To an investor, one of my first my responses when this issue is raised is, rather bluntly, “So what? It doesn't prevent people from making money here. It prevents them from making even more money.” For instance, before the crisis, Tera had been generating 35% annually for three and half years. With the crisis, its annualized rate of return fell to about 17% annually. Without corruption, I suspect, we'd still be making 25%, 30% annually. Corruption is a major menace here, but it doesn't mean you can't earn very good rates of return.

One of the things I find really ironic is that investors have less fear of investing in China, which is a communist country and has a tradition of corruption going back thousands of years, than investing in Russia. Yet by any reasonable standard, Russia is both a capitalist and a democratic country — although perhaps an imperfect one — yet people are still more afraid of it. One of the terms Altima has copyrighted that reflects this is “fear arbitrage.” Investing in Russia, notwithstanding many people's fear of it, is arbitraging fear.

Let's say I took a blank sheet of paper, and on that sheet of paper I put the macroeconomic statistics about some single, unidentified country, third largest foreign currency resource in the

world, half a trillion dollars, 143 million people who are now making \$10,000 a year; and in five years, the IMF says that they will be making \$18,000, an 80% increase in personal income, a 60% increase in GNP over five years in a primarily export-based economy where much of that income is virtually guaranteed in long-term contracts. The finance minister of which at the October annual World Bank/IMF Conference in Washington, D.C., was designated as the most successful finance minister in all of Europe, which nowadays is almost 60 countries. The average annual growth of this country for the six years prior to the crisis was 6%-7%, and the growth of which even the IMF says for the next five years will be around 5% — which most people think is a low estimate.

Lastly, the p/e ratios of this country, according to Bloomberg, are the lowest of the 59 largest markets on the planet Earth. If I were to describe that country to any financial adviser that you and I have ever met, they would look at us and say that it is a screaming buy, that they had to invest in that country and that they'd be crazy not to invest in such a place. It goes on. Mortgages as a percentage of GDP in the United States is 80%; in this particular country, it's 3%. All indebtedness added together — governmental, federal, state and local, corporate and personal — in the United States is about 270% of GDP. In this particular country, it's 49% of GDP. So there are no debt concerns with respect to this country. And guess what, it could repay almost all of its debt tomorrow in cash because of its cash reserves. So here is this country that is just an amazing place, and people are saying, “Get out of my way, I want to be in.” Then you add just one little word to this piece of paper and everybody goes nuts and starts retreating. The word you added is “Russia.”

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So we coined the term “fear arbitrage,” because arbitrage is taking advantage of different levels of information, knowledge, etc., in different places. People who are in Russia know you can make incredible amounts of money here, but people who are outside of Russia don't realize that or think you can only do so dishonestly. Why? Because of all the negative news they've heard about Russia, and so they are afraid of it. Consequently, investing in Russia is a fear arbitrage play because the people who know what they are doing and who know Russia aren't afraid of it, and the people who don't know Russia or don't know what they are doing here, are.

One of the reasons for fear arbitrage is yellow journalism. You rarely hear or read positive stories about what is happening in Russia. How is it possible that the largest country in the world in terms of geographic area, with a 143 million people — almost half the population of the United States — the eighth largest economy in the world, soon to be the seventh, never has anything good happen

to or in it? It's totally absurd. So if you look closely at the media coverage of Russia, it's not that the stories are inaccurate, it's that almost no good news is ever reported. And virtually everything that is reported has a negative slant. There is almost positive news at all to overcome the negative. The best example of this I can give you is a CNN report several years ago the point of which was announcing that the opposition could not get the word out about its platform, candidates, etc., to Russians. As the reporter was explaining this, the viewers saw a video of some guy from Yabloko party, which was one of the major opposition parties at the time, standing outside a metro exit handing out flyers. He probably handed out 150 flyers during the commentary. The reporter obviously had no idea what Yabloko was and had no idea he was showing a video that completely contradicted everything he was saying. The anchor then went to address the election of the prime minister in Russia, saying that it would not be a fair election. But a prime minister is never elected. Ministers are appointed. That's why they're called "ministers." There is no such thing as the election of prime minister in any parliamentary system of government that I'm aware of. It's nonsense. In terms of the media, correspondents rarely read, write and speak Russian, so unfortunately what you often get is a distorted view, sometimes intentionally and sometimes nonintentionally, of Russia and what's really going on here.

Returning to your question, corruption is indeed a big problem, but it is a problem in a different way than one might think. Corruption here is endemic. For instance, if you have somebody who is corrupt in the United States, they generally have to be quite careful. It's rather unusual behavior, although certainly not unheard of. Here, it's far more standardized, industrialized and happens quite smoothly. Everybody has got their mechanisms worked out. Nobody is particularly worried about running into any issues or difficulties. It's quite institutionalized and well run, and strange as that may sound when talking about corruption. My theory is that corruption is more prevalent in this culture in particular because under communism people had to have two faces. They had to find ways to survive while singing the praises of communism, all the while knowing it didn't work.

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However, democratic institutions are slowly beginning to form here, and the relaxed attitude is beginning to change. There is also a supply and demand for corruption. As Prime Minister Putin pointed out recently, corruption is a two-way street. There are the people seeking bribes, and there are people giving bribes. If you pay public officials a decent wage, they won't be as likely to seek out bribes. Likewise, if companies simply refused to pay bribes, that

would help eliminate the problem, although the transition would be a tough one because many things would just freeze for a while.

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If you ask a Russian, he will tell you that you'll never drive corruption out of this culture. I think that's mainly due to the fact that that's all they've ever known. If you look at it a little bit from the outside, we are already seeing some small positive trends. The biggest problem of corruption of course is the larger payments, larger kickbacks, etc., and those are going to be more difficult to eliminate even with greater corporate transparency. In fact all major corporations in Russia have to file financial statements according to international accounting standards. The audits that take place now are often conducted by the big four accounting firms, which are enormous here. Further, all of the IPOs that have been and are being completed mean more corporate transparency and that those companies at least are more accountable. So corruption, yes, it's a huge issue. However, there are attempts to mitigate it like never before, so we'll see. Has there been a lot of progress yet? No, because most of these measures are quite recent.

TWST: Tera Capital Fund is ranked the number one performing fund of funds in the world out of 2,468 by Eurekahedge in terms of year-to-date performance through the end of October 2010. What is it about your selection process that has given you this advantage?

Mr. Enneking: I'll give you the quantitative reasons, then I'll give you the qualitative ones. The quantitative reasons are that on the management teams of the funds in which we invest there must be at least one key member who has now survived two crises. We managed through the 1998 crisis, although in different capacities, and we managed the 2009 crisis successfully. On a related point, Tera doesn't really invest in funds, it invests in managing teams. That's the first thing. Second, we obviously want the performance of potential underlying funds to be at least as good as ours, and that's actually getting quite hard as Tera's performance is so much better than most funds. The fund average that we publish consists of 21 funds. It was 29 before the crisis, eight closed during as a result of it, so there are 21 left. There are very large funds in the index and very small ones. When we formed Tera, there were only at a time 29 mainly long equity, mainly Russian funds that existed. Since Tera's creation, it has significantly outperformed them.

We are also unique that Tera is one of the very few funds in the world that doesn't charge a management fee. It only charges a success fee. That notwithstanding, the management company Altima still takes 20%, and we nevertheless outperform the fund and index

averages significantly. Although ultimately we look for performance, there are a number of outperforming funds that we've said "no" to for all reasons — because they are not based in Russia, because they overlap the strategy of another fund, because they are too erratic, too volatile, any number of different reasons. One fund we recently looked at has done very well, but it's recently gone through huge management changes. Another important aspect of how we invest is that we know all of the investment managers. We have known some of these for 10, 12 years. That's probably the biggest intangible factor that really has an impact on Tera's performance.

TWST: You've mentioned several issues that set you apart from other firms. What makes Tera and Altima different?

Mr. Enneking: We have two universes we compare ourselves to. We manage a fund of funds, so we have to compare ourselves to other funds of funds. And Tera invests in Russia, so we have to compare ourselves to other Russian funds and to Russian indices. Compared to all other Russian funds, we are performing extremely well. We're not the top performer all the time, but we are one of the best funds in Russia. When you look at the other universe, funds of funds, for more than five years we have been arguably the best fund of funds in the world, because Tera was number one for 2005, number eight for 2009; this year we'll probably be in the top three. So Tera does very well against various sets of metrics, if you will. But the reasons Tera does so are different depending on which universe you are talking about.

One of the major reasons for our success is really simple, almost embarrassingly so. I don't know why other people don't do country-specific fund of funds. We've been asked to do a country-specific fund of funds for China, we've been asked to do one for India, and Africa and Middle East — both for a region and for individual countries. Again, Tera is totally unique. It is the only fund of funds that focuses on Russia. It is the only fund of funds that is country specific that's not focused on the same country where it is located. It is the only fund of funds and one of the very few funds of any type of whatsoever that doesn't charge a management fee, only a success fee. If our investors don't make money, we don't take 2% of the principal. So Tera has all of those unique things going for it and because of what a fund of funds does, it diversifies, it lowers volatility, it has an incredibly high Sharpe ratio relative to virtually every other fund in the market, etc. The fund of funds mechanism

by itself perfectly suits volatile growing markets such as Russia.

TWST: Is there anything you would like to add?

Mr. Enneking: Two things. First, Tera has been ranked in the top 10 in terms of annual performance 30 times since its inception. It has appeared in one of the top 10 tables — monthly performance, performance YTD and annualized performance — 69 times in the 65 months of its existence.

Secondly, I would explain that part of our investment philosophy is what we now call "RIO," or "Ride It Out." Once the 2008-2009 crisis ended, or at least wound down, we did an analysis of which funds did better during the crisis, comparing funds that tried to time the market and those that simply stayed in it. The market-timing people are those who say, "Okay, we've peaked, let's bail out now and then when things hit bottom, we'll go back in." The other type is guys who say to themselves, "I can't predict markets and I believe in the fundamentals of this market, so I'm staying in." If you look at who did better, what you discover is that there were almost no market-timing funds that got it right and many that got it spectacularly wrong. Selling in December of 2008 and January 2009 and buying back in July and August 2009 was not a good idea. That's the concept of "sell low and buy high." The funds that rode it out did far better. The reason for this in Russia is very simple. The best time to invest in Russia would have been February 25, 2009 because on February 24, the markets bottomed out. Market timers would have been shot had the even suggested investing in Russia then.

Lastly, it's important to note that Tera does not gate and had very few redemptions during the 2008-2009 crisis. The main reason for this was that at no time during that crisis did early Tera investors lose money, even on paper. The performance had been so good during the three years prior to the crisis that it offset all of the drop during the crisis. That made it much easier for Tera's investors to stick with the fund.

TWST: Thank you. (LMR)

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