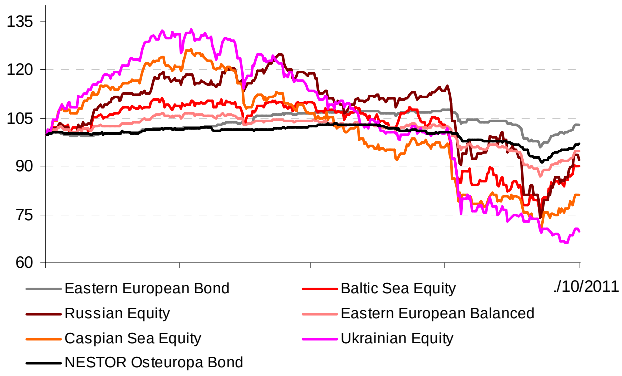
Citadele

Fund Manager Report. October 2011

During October, European politicians managed to deliver a meaningful package of intended solutions for the debt crisis, which increased the clarity on the issue and resulted in a considerable rally in risk assets. The debt problems, however, remain serious and unresolved in the long term and the uncertainty about global economic growth will remain in place for a while, leaving us still cautious on the risk assets. In October, all risk assets advanced, including equities, bonds, gold, metals and crude oil, but the risk free sovereign bonds, as one might expect, fell slightly.

Citadele Funds Performance (indexed)



Fund	Currency	Performance (as of October 31, 2011)				
		1m	3m	6m	12m	Since inception*
Citadele Eastern European Bond Fund	USD	5.24%	-4.28%	-3.49%	2.85%	6.81%
Citadele Eastern European Balanced Fund	EUR	6.06%	-7.51%	-9.19%	-5.40%	4.74%
Citadele Russian Equity Fund	USD	13.50%	-18.91%	-22.43%	-7.89%	10.63%
Citadele Baltic Sea Equity Fund	EUR	13.27%	-12.48%	-17.99%	-9.93%	2.53%
Citadele Caspian Sea Equity Fund	EUR	10.16%	-15.58%	-23.98%	-19.04%	-20.66%
Citadele Ukrainian Equity Fund	EUR	-5.24%	-30.12%	-38.44%	-30.12%	-34.89%
NESTOR Osteuropa Bond Fund	EUR	4.46%	-3.69%	-5.45%	-3.10%	1.61%
Citadele Baltic Real Estate Fund II	EUR	-0.06%	-0.22%	0.74%	-5.33%	-13.47%
GFM Cossack Bond Company	USD	0.49%	0.82%	2.40%	6.69%	17.28%
Citadele Ukrainian Bond Fund	UAH	-1.36%	-4.26%	1.64%	15.42%	13.50%
Citadele Ukrainian Balanced Fund	UAH	-1.32%	-23.25%	-32.60%	-22.45%	3.12%

* % annualized

Citadele Eastern Europe Bond Fund - USD

During October, investors scaled back some of their apocalyptic views over Eurozone, which lead to a significant rally in risk assets. Indeed, European politicians did eventually manage to deliver a meaningful package of intended solutions, yet the longer term assessment remains open as a lot of details still need to be crafted out.

In October, Eastern Europe's corporate debt rallied impressive 8.4% thereby considerably outperforming Emerging Market corporate debt that rose 6.3% (JPM CEMBI index data). Eastern Europe's sovereign debt performed in line with global EM peers adding 4.5% (JPM EMBIG index data). Within Eastern Europe, the more stable Russian market slightly lagged the recovery of the Kazakh and Ukrainian markets.

The region's macro pulse decelerated in September, as indicated by industrial output figures. For example, in Russia the output actually decreased for the first time in seven months, while declining output of metals and natural gas negatively affected macro growth in Ukraine and Kazakhstan. All in all, given the global macro backdrop and the region's export-oriented economies, the weakening trend in the macro pulse is likely to persist until the year-end.

Despite sluggish macro indicators, the region's banking sectors released solid growth figures. In Russia, aggregate loan portfolio advanced by 4.6% m/m and deposits jumped by 6.3% m/m. In Kazakhstan, loan portfolio was up by 1.6% m/m and deposits rose 4% m/m resulting in improved liquidity positions of banks. In Ukraine, loan portfolio increased by 3.3% q/q and banks managed to decrease the share of loans in foreign currency, while deposit inflow was flat q/q. Despite these positive statistics, banking sector requires close attention going forward in the light of the elevated global financial market volatility and slowing local economies.

Major news in October was Georgia's proposed compromise to Russia with regards to the latter's accession to the World Trade Organization (WTO). A dispute with Georgia remains the last obstacle for Russia's 18-year long accession process to the WTO, which could be finished already by the year end. Accession to WTO is widely believed to have positive long-term implications for Russia's economy amid additional foreign direct investments and push for modernization of local bureaucracy, while the short to medium-term impact would be mixed across industries.

In Ukraine, the former Prime Minister Yulia Tymoshenko was sentenced to 7 years in prison. The verdict is widely believed to be politically driven and risks complicating relationships with the EU and the IMF. Further developments in the case should be expected, however, as evn the President Yanukovych stated the sentence is not final. In parallel, Ukraine's parliament cancelled previously announced export duties for wheat and corn. The announcement is likely to have a positive effect for local grain exporters, although the effect is expected to be clearly visible only in the end of 2011.

Due to the improved global risk appetite in October, Eastern Europe's debt markets experienced some awakening following almost three months of a freeze-up and the region's issuers could tap external financial markets. Similarly to the spring of 2009, Gazprom played the role of ice-breaker again as the company borrowed a total of $500m in two attempts on the short-term eurocommercial paper market. This was followed by a similarly structured Russian Standard Bank's $150m issue. However, the primary market is still not completely running in a usual mode, as companies are unable to attract long-term financial resources at a reasonable price yet.

During the month, we performed several fine-tuning trades in the Fund. In Ukraine, we used an attractive pricing episode to switch from DTEK to Metinvest as DTEK' privatization plans are still underway and the company is potentially more exposed to any devaluation if that materializes. In Russia, we reduced banking sector exposure as we sold Nomos and reduced VTB Eurobonds on still fairly tight valuations and the possible tail-risks to financial sector across the globe. We bought into the shorter-end of the Vimpelcom Eurobond curve due to the attractive valuations coupled with the improved visibility for cash flows in the medium term. In Russia, we also slightly raised our ruble bond allocation by adding Evraz domestic bonds after the sizable weakening of the ruble. We became more cautious on Hungary's sovereign debt and eliminated our exposure. Finally, we also slightly reduced Russian sovereign for rebalancing purposes.

In October, the Fund demonstrated the best performance in more than two years adding 5.2% in a month and returned to a positive territory in year-to-date terms. Nonetheless, the Fund slightly underperformed the overall market due to more defensive positioning in Russia in terms of duration. Without a surprise, September's major losers turned out to be the best performers in October. In particular, Russia's Metalloinvest, subordinated bonds of RSHB and the distressed BTA were in the lead. Only few, rather illiquid positions were loss-making, as they did not benefit from the overall market recovery. At the end of the month, the Fund's average yield declined to 9.6% and duration slid to 2.5, while the net cash balance was around 6% of the Fund's assets.

Citadele Eastern Europe Bond Fund - EUR

In October, the Fund recovered most of its previous month's loses and grew by 6.1%. Unsurprisingly, September's losers became top contributors in October. In particular, residual exposure of equities was led by a sharp rise of Uranium One, Mechel and ENRC, while among debt positions the distressed BTA and high-yielding Metalloinvest and Zhaikmunai were the best performers. Only few, less illiquid positions were slightly in the red, as they missed out on the overall market recovery.

In October, our small position in GE Money Bank bonds successfully matured. Several fine-tuning trades were also performed. In Russia, we increased our exposure to ruble dominated Evraz and Russian Railways bonds, while Russia's sovereign bonds were slightly sold off to fine-tune the size of the position. We also replaced Nomos Eurobonds with 1.5-year Eurobonds of Vimpelcom and Alfa Bank Russia notes. In Ukraine, we switched out of DTEK into Metivest using an appealing pricing episode and the better fundamental view on the latter. We also added state-owned Oschadbank Eurobonds using what we saw as exaggerated decline of the price in the light of the very high capitalization of the bank. Hungary's sovereign debt was sold out as our opinion of the sovereign became more cautious. At the end of the month, the Fund's average yield declined to 10.3%, while the average duration remained unchanged at 2.6. The net cash balance was slightly below 5% of the Fund's assets at the end of October.

Citadele Caspian Sea Equity Fund

Improved global sentiment, re-ignited after Eurozone authorities made progress on resolution of the sovereign debt crisis, allowed Central Asian equities to enjoy confident recovery in October. Rencasia Index advanced by 13.9%, thereby beating Emerging Markets universe represented by MSCI EM Index, which gained 9.0% during the month, in EUR terms. The Fund delivered 10.2% return, lagging behind the benchmark. This was mainly due to the more conservative asset allocation and the large index weight of Uranium One, a high beta stock that skyrocketed 43.5% during the month. Moderate EUR appreciation relative to USD and CAD over the period left the Fund almost unaffected, as the mentioned open currency positions were hedged to a large extent.

Kazakhstan was the major positive contributor last month, which is in line with the Fund's exposure to the country. Region's core energy and materials sectors delivered strong returns, driven by appreciating oil and base metals prices globally. In metals, ENRC gained hefty 16.9% and Kazakhmys advanced by 19.4%. Relatively defensive telecoms also demonstrated solid dynamics on the back of Kazakhtelekom adding 10.4%, while traditionally cyclical financials did not impress as Halyk lost 4.6% and KKB slid by 7.1% on general investor reservation towards the sector. Turkmenistan was the second largest contributor in October, represented by shares of Dragon Oil adding 16.8% as the company reported strong 3Q operating results. Elsewhere, strong performance in Mongolian names Ivanhoe Mines (+34.9%) and Southgobi Resources (+29.8%) was capped by the sliding shares of Metromatad, which plunged by 39.3% on continuously poor test drilling results.

Over the month we have kept the structure of the Fund almost unchanged. The only trade was of a technical nature, where we partially sold ENRC to meet compliance requirements. Despite the recent rebound of the region's equity markets, it is too early to call an end to the volatile period. Local valuations are still expected to be tightly related to the global sentiment, and European debt problems are still far from being resolved. As a result, we plan to continue to keep a decent cash position within the Fund amid the ongoing turbulence and uncertainties. Nevertheless, reiterating our comment from the previous month, we still perceive the fundamental macroeconomic indicators of the region to be solid. Kazakhstan's current account surplus is deeply positive and international reserves amount to hefty USD 72.5 bln, more than enough to cover country's moderate debt to GDP burden of 18%.

Citadele Baltic Sea Equity Fund

October was spent with a very optimistic investor sentiment and the equity markets recovered part of their earlier losses. The Fund gained 13.3% during the month. In October, equity markets reacted positively to several decisions which increased the clarity regarding the European debt crisis. From geographical perspective, all of the region's equity markets advanced, among which the largest gains were in Russia (16.6%), Germany (11.6%) and Norway (10.5%). On the other hand, the main laggards were Danish (3.5%) and Baltic (5.5%) equity markets, while Finland (9.4%), Sweden (8.8%) and Poland (8.4%) performed in line with the average of the Fund's markets. From currency perspective, the Fund lost slightly from EUR appreciation against USD, but gained from the depreciation of EUR against Scandinavian and Polish currencies.

During October, all sectors within the Fund posted positive returns, with cyclical sectors leading the rally. The strongest growth was posted in Metals, Industrials and Consumer Discretionary sectors, following their largest losses past month confirming their genuine cyclicality. Materials sector growth was partly affected by the rebound in metal prices, while Industrials and Consumer Discretionary sectors were mostly moving in line with the global economic growth expectations. The Energy sector outperformed the market as well, driven by a 6.5% increase in Brent Oil price. The worst performing sectors were Consumer Staples, Telecommunication and Utilities, while Health Care, Financials and IT stayed in line with the market.

We performed several transactions with the Fund's assets adjusting our portfolio to the redefined target allocations. We also exploited the strength in stock markets and increased our cash position to 6% by the end of the month. Since we were cautious on oil prices in the short term, we used the positive sentiment in equity markets and reduced the Fund's allocation to energy names. We reduced our positions in Lukoil, Statoil, Petroleum Geo-Services and divested from TGS Nopec Geophysical. We also used the temporary strength in CEDC price to halve the position, due to its recent high beta behaviour. Furthermore, we reduced the Fund's allocation in PKO bank and in Atlas Copco in order to reduce our exposure to cyclical names. Finally, we sold all of our shares in Mobile Telesystems as our outlook on Russian mobile telecommunication sector worsened due to the fierce competition in regions and high saturation rate. We replaced this company with Tele2 since as we liked its strong position in key markets and its outstanding cash generation. We also added such defensives as Novo Nordisk and MRSK Holding to the Fund and increased the position in Fresenius SE.

As a result of uncertainties in Eurozone and growing concerns of global economic growth, we plan to further increase our cash position, but will be ready to adjust our strategy if any turnaround realise. Moreover, we intend to exploit tactical opportunities that will arise as a result of possible large price swings in the stock markets.

Citadele Russian Equity Fund

During the previous month we witnessed high volatility on the markets, with risky assets mostly recovering after heavy losses during the previous rapid September sell-off. In Russia, the benchmark RTS index delivered a 16.6 % growth while global Emerging Markets universe (MSCI EM) grew 13.2% during the same period. As a result, the valuation spread between Russian and global EM (MSCI Russia P/E vs. MSCI EM P/E) slightly narrowed, leaving the discount of Russian market at 50%, which is still well above its 5-year average level of 30%. At the first glance, this fact creates plenty of space for Russia to catch up with the other EM peers as soon as the market turbulence diminishes. On the other hand, this excessive discount is mainly due to the large weight of energy sector in the Russian market, which has persistently low valuation ratios. Closer look into the matter in fact reveals that not all sectors have a large discount to global EM and some even tend to have sizable premiums over their EM peers. Moreover, during highly uncertain market cycles, the tendency of discount widening is natural for Russia, as was observed also during the latest crisis of 2008. As a result, in the portfolio construction we pay close attention to valuations in each sector rather than stick to the „Russia is cheap" story.

By the end of October, the Fund increased its value by 13.5%. This underperformance relative to RTS was mostly due to the Fund's more conservative structure, as we had previously increased the level of defensiveness in light of the highly turbulent markets.

Sector wise, consumer staples (+32.9%), financials (+29.6%) and energy (+22.1%) sectors were top performers during the period. Energy sector underweight and relatively large (around 10%) cash position were the main source of underperformance. From the security selection perspective, the Fund's portfolio did well, particularly gaining from the superior selection of equities in the consumer staples, financials and energy sectors.

In October, we concluded a significant amount of trades, turning around almost 19% of the Fund. The main idea was to fix profits in previously opened positions mostly in blue chips, which behaved more beneficially during the previous month, as expected. Therefore, we performed tactical trades with Norilsk Nickel, Novatek, RusHydro, Sberbank, MRSK Holding and Magnit equities.

While we have observed a strong rebound in the markets, there is still a risk that it may not last until clearer resolution of European debt problems is achieved. In case of a global growth slowdown or the realization of "western" recession, the performance of the markets may be quite negative. A risk-off investor behavior would most probably lead to extra decline of Russian equity values. Despite this possibility, existing price levels and valuations do not appear stretched from a long-term perspective, especially considering Russia's relatively strong macroeconomic indicators and growing internal market.

Citadele Ukrainian Equity Fund

Last month the Ukrainian equity market continued to show cautious movements, trading mostly in the red amid growing concerns about the eurozone's debt crisis and the slowing of global economy. However, the market surged in late October and managed to win back most of the losses it incurred in the first half of the month and to close with a relatively modest loss of -3.1% in EUR terms. The primary driver of this rally appeared to be the positive developments on the overseas markets, which rallied in response to epy debt deal announced by the EU leaders to contain the sovereign debt crisis in the region. Corporate news also drove gains as investors appeared to be generally encouraged by 3Q11 earnings reports, especially from domestic electricity generating companies.

The Fund lost 5.2%, slightly underperforming the broader market as gains provided by industrials and telecommunications were not enough to cover the losses generated by utilities, materials and consumer staple names included in the Fund's portfolio.

Stock-wise, Yasynivsky Coke (-54.1%) and Pokrovske Coal Mine (-32.8%) fared the worst following the resumption of trading in mid-October after a 5-month regulatory suspension. At the same time, Ferrexpo (+18.3%) managed to record the best monthly result among the Fund's allocations in a volatile trading despite the worsening iron ore price outlook. Elsewhere in the materials sector, Alchevsk Steel (+9.8%) and Yenakiyevo Steel (+3.1%) posted gains with the former benefiting from the reported strong 3Q11 net income of UAH 0.5b and the latter being backed by the rumors of a buyback by Metinvest. Meanwhile, their peer Azovstal (-4%) depreciated, weighed down by poor 3Q11 results, indicating the company's EBITDA and net income reverted to negative territory over the period.

In the utilities sector, electricity distributors PES-Energovugillya (-54.6%) and Zhytomyroblenergo (-23.3%) turned out to be the major drag due rather to their illiquid nature than to any fundamental reasons, while electricity generating company Centerenergo (-3.5%) ended the month with a relatively small decline supported by strong released 3Q11 financials, revealing a 35% y/y surge in its net sales, a 4-fold y/y growth in EBITDA and a 42-fold y/y boost to the net income on the back of higher electricity tariffs.

Every agricultural name fell except for Kernel (+10.8%), which benefited from prospects of a more favourable export environment due to the cancellation of wheat and corn export duties and the resumption of VAT reimbursement for grain exporters. Meanwhile, Astarta (-7.4%), Agroton (-7.3%) and MHP (-16.4%) produced negative monthly returns as investors ignored the announced good harvesting and operating results.

The major positive contributors to the Fund performance was Motor Sich (+17%), a traditionally defensive stock, which enjoyed strong buying support on its 9M11 financials, reporting the company's net sales reached UAH 3.9b (+22% y/y) over the period, EBITDA was at UAH 1.5b (+46% y/y) and net income stood at UAH 0.9b (+23% y/y). The data imply EBITDA and net margins of 37.9% (+6.2p.p. y/y) and 22.1% (+0.1p.p. y/y), respectively. Meanwhile, railcar builders showed contradictory dynamics, with Kryukiv Railcar growing by 16.8%, and Stakhaniv Railcar losing 24% on unexpectedly weak 3Q11 results with posted 64% y/y decline on its bottom line.

Elsewhere, telecommunications name Ukrtelecom (+4.2%) influenced the Fund's performance positively, supported by improved 3Q11 performance, confirming market expectations for gradual recovery of the company after its privatization. In 3Q11, the company increased its revenue by 3% y/y to UAH 1.7b, its EBITDA grew by 36% y/y to UAH 455m while its net profit reached UAH 5m vs. a UAH 110m net loss in 3Q10.

During the month we have reduced exposures to the liquid Ferrexpo and MHP in favor of cash, which reached over 15% level by the end of the month. The decent cash level was the result of our preference to be more defensive as political uncertainties prevailed.

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