



Wermuth Asset Management GmbH
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Dear Co-Investors,

As always, the cultural components of the St Petersburg Economic Forum were just as important to the event as the economic and political discussions themselves. They ranged from the Marinsky Theatre's classical ballet company dancing Romeo and Juliet by Prokofiev to Valery Gergiev conducting Wagner's Walkure and Parsifal and reminded everyone of their common cultural heritage.

The highlight of the "white nights", however, was Boris Eifman's "Anna Karenina". A modern ballet based on Tolstoy's novel about a married woman with a young child who tragically falls in love with another man - and out of love with her husband and the father of her son - it was performed to music by Tchaikovsky. The international audience loved it. The opening scene alone, the graciousness and beauty of Anna's first few steps towards her sleeping child steps reminded one in just a few heartbeats about all the wonderful things which Russia can be and of its tremendous potential - if one takes the time, persists through the difficulties, finds the place, introduces some order, and then is able to relax, smile and openly receive pure genius and beauty, banning the dust and hustle of the street from one's mind...

While the forum had started in rainy weather, the sun finally broke through on the last day. There was St Petersburg in its full beauty!

President Medvedev had opened the discussions with a presentation of Russia as a constructive player on the world stage, one of the last bastions of a free market economy, a country which is not busy blaming others anymore for the collapse of the global economy. He rather wondered why the country had been so vulnerable. The Russian leadership understands many of its problems and is focused on fixing them - its dependence on natural resources, the poor enforcement of many of its laws and the lack of properly functioning institutions, inefficient state bureaucracy and corruption. The opposition is granted only a limited platform to debate political ideas. In some cases it even appears that courts are used for commercial purposes rather than to uphold the rule of law. Yet, I left the event with little doubt that the Russian leadership aims to maintain a free market economy, protect private property, thereby laying the groundwork for a working democracy, and eventually to move towards stronger institutions. A free debate of ideas is officially very welcome – and indeed very vibrant on the internet, in parts of the printed press and occasionally also on some progressive TV shows – but one can not but note that the actual "vertical of power" has effectively eliminated any serious opposition.

The new head of the EBRD, German Chancellor Willy Brand's former Chef de Cabinet, Thomas Mirow, urged Russia to improve its international reputation: it keeps thousands of small and medium-sized businesses from investing in Russia and also makes it difficult for Russians to invest abroad. He felt Russia should be a country which is seen as a reliable partner which respects the rule of law. He lauded the Russian President for having understood the challenges and his resolve in addressing them. For him, the main issues are: since Russia is too exposed to the global economy, it needs to diversify its economy; WTO entry negotiations need to be concluded – this build trust among foreign investors; the re-launch of capital markets is urgently needed, including an improved legislative framework for the enforcement of creditor claims; the establishment of a truly independent judiciary is key.

The main theme of Jean Lemièrre, the former head of the EBRD and presently advisor to BNP Paribas, was "Why not invest in Russia?" He stressed that the country offers macroeconomic stability, very competent crisis management by the government, a commitment to the rule of law, 25% of the world's oil and gas reserves, and, in the future, a huge potential in agricultural products. There is no doubt that Russia will always be able to pay back its debt. Moreover, he sees a commitment by the leadership to participate in the international division of labor, including investments abroad. This would create incentives to respect foreigners' property rights. He felt the decision to use foreign currency reserves to support the income of the socially weak, the lending of banks and to invest in infrastructure and new technologies was the right decision.

The Head of the German Business Federation's "Ostausschuss", Mr Klaus Mangold, went as far as saying that Russia had no image problem with German business. Over 6000 German businesses were operating in Russia without any problems relating to property rights etc. The only problems were how to finance the many investment projects; German exporters had hoped for a sizable share in these.

A special section was dedicated to Russian-Arab relations. These were historically based more on Soviet political aims than on common business interests. Now, however, it has become clear that Russians and Arabs face many of the same challenges, primarily the diversification away from oil and gas. Russian entrepreneurs are welcome in Arab countries world, just as Arab investors are welcome in Russia. A first step of cooperation has been an Arab Sovereign Fund that invests in one of the projects of the Olympic Winter Games 2014 in Sochi, on the shores of the Black Sea. We see additional potential for cooperation in alternative energies, high tech, real estate, infrastructure, agriculture and forestry and, more straightforward, listed debt and equity investments.

Nouriel Roubini pointed out that he would expect the global recession to continue for at least another six to nine months. There is the risk that it could drag on because the debt overhang cannot be easily resolved. Governments may resort to heavy taxation and try to stimulate inflation as a way out. There will be a wave of defaults. So far all one has seen has been the shift of debt from the private to the public sector. He was thus concerned that the recent rally in commodity prices and equities was premature. The likelihood of a "W-like" recession was considerable - "green shoots" could soon be wilting away. His main recommendation was to ensure an alignment of incentives when using leverage – such as the "put your money where your mouth is-approach" which our firm has been using – to ensure that bank managers don't pay themselves heavy bonuses for six years and then go bust in the seventh year, leaving the problems to the state. He argued that countries with ample reserves and relatively little debt, like Russia, would fare much better than over-indebted countries which had no other options but to increase taxes, inflate away their debt, or default...

We thus left the Forum confident that the investment case for Russia remains in place, especially after last year's sell-off. Investors can now acquire assets at average valuations which are four fifths below previous tops. The decline in asset values has been far more severe than elsewhere. I believe this had more to do with reputational than rational reasons. Some assets are now ridiculously cheap. To give an example: 1 MW of powerplant capacity is available in the market for the price of a pick-up truck - \$50,000 -; in the US it would cost about \$1m to install 1 MW.

On the other hand, some stocks are expensive again. A smart long-short investment approach can pay off well, or a careful focus on the most valuable stocks from a traditional value investing point of view. Our strategy worked out quite well last month: the market fell more than 20% from its early June top, while the long/short Greater Europe Fund Select actually made money. The deep value/activist Greater Europe Fund Side Pocket, the Greater Europe Deep Value Fund, the Greater Europe Deep Value Fund 2 and the Greater Europe Fund Electricity Fund all made money over the course of June. We had carefully selected value stocks and taken profits when valuations started to look somewhat rich.

The opportunities in Russia are plenty, be it in the long/short space, in the deep value space, the private equity or the distressed real estate space. We look forward to hearing from you should you be interested in participating in these opportunities.

Yours sincerely,

Jochen Wermuth

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