U.S. Global Investors

Searching for Opportunities, Managing Risk *September 2009*

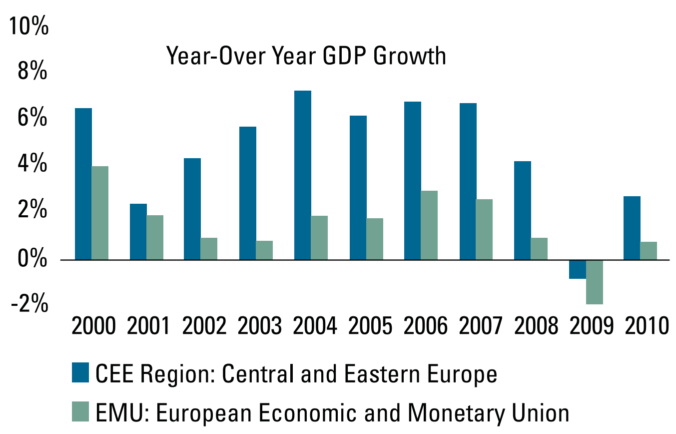
Tapping the Potential of Emerging Europe

Why Invest in Emerging Europe?

Despite a wealth of negative commentary that has driven currency and market valuations lower, many countries in Emerging Europe appear to be on track to recover from the global downturn more rapidly than their more developed counterparts in Western Europe. In part, this is because their cyclical vulnerabilities are counter-balanced by structural strengths. These strengths play an important role in the decision-making of foreign investors. Already, in mid-2009, we have seen foreign investment return to Emerging Europe countries. Although serious risks remain to the health and recovery of the region, the case for investment in Emerging Europe is strong for many reasons, including:

- Emerging Europe and Western Europe are becoming inextricably linked. Eleven of the 27 European Union member states are in Eastern Europe. In these countries, investors have opportunities to benefit from the potential for increased earning capacity, which may be accompanied by a reduction in risk levels.
- Since 2000, the GDP of Emerging Europe has grown faster and declined less than the GDP of the European Union. Estimates for future GDP growth also favor Emerging Europe, as you can see in the chart.

East Outperforms West



[1] In this chart, Emerging Europe includes: Albania, Armenia, Belarus, Bosnia & Herzgovina, Bulgaria, Croatia, Cyprus, Czech Republic, Estonia, Finland, Georgia, Greece, Hungary, Kosovo, Latvia, Lithuania, Macedonia, Moldova, Montenegro, Poland, Romania, Russia, Serbia, Slovakia, Slovenia, Ukraine.

Source: UniCredit Group

- Eastern Europe and Central Asia have led the world in regulatory reforms that have made it easier to do business for five consecutive years, according to Doing Business 2009, a series of reports published annually by the IFC and the World Bank.
- Turkey, Hungary and the Czech Republic have some of the least leveraged banking systems in Europe. These countries already have reduced interest rates and, unlike many Western European countries, they appear to have room for further fiscal and monetary easing.
- Poland is the second most economically competitive country in Europe, according to the 2009 European Jobs and Growth Monitor. Tight monetary policy and strict government regulation may help its economy recover more quickly than those of other countries.

Investment opportunities in all Emerging Europe countries are not equal. This is the reason that the U.S. Global Investors Eastern European Fund (EUROX) currently focuses its equity investment in Russia, Poland, Czech Republic, Hungary and Turkey. In this paper, we will provide a brief overview of these countries, as well as discussions of some of the companies whose shares are held in the fund.

Why invest in Emerging Markets?

The case for investing in emerging markets is strong for many reasons, including:

- Continued growth in the mobility of capital
- Demographic trends that support stronger growth in emerging markets
- Improved corporate governance
- Emphasis on profit growth
- Trends in corporate outsourcing
- Portfolio risk management benefits

Currency: Companies in Ukraine, Russia, and Poland may benefit from undervaluation.

The global recession may provide an advantage to countries with weaker currencies The Economist's Big Mac index is based on the theory that exchange rates should equalize the price of a basket of goods in countries throughout the world. If a country's exchange rate leaves a Big Mac costing the same as it would in U.S. dollar terms, it is considered to be fairly valued.

As you can see in the table below, some Emerging European currencies—including the Russian ruble—are quite undervalued. In our opinion, concerns about the resilience of Western and Emerging European countries has caused some currencies to fall further than can be justified by their fundamentals. Deeply undervalued currencies should strengthen by the end of the year, which creates attractive opportunities for investors with higher risk profiles.

Big Mac Prices

	Local currency	U.S. Dollars	Implied Purchasing Power Parity of the dollar	Actual dollar exchange rate July 13, 2009	Under-or over-valuation against the dollar (%)
United States	$3.57	3.57			
Euro Area[2]	€3.31	4.62	1.08[3]	1.39[2]	+29
Turkey	Lire 5.65	3.65	2.45	1.55	+2
Czech Republic	Koruna 67.92	3.64	19.0	18.7	+2
Hungary	Forint 720	3.62	202	199	+1
Latvia	Lats 1.55	3.09	0.43	0.50	-13
Estonia	Kroon 32	2.85	8.96	11.2	-20
Lithuania	Litas 7.1	2.87	1.99	2.48	-20
Poland	Zloty 7.6	2.41	2.13	3.16	-33
Russia	Ruble 67	2.04	18.8	32.8	-43
Ukraine	Hryvnia 14	1.83	3.92	7.66	-49

[2] Weighted average of prices in Euro area
[3] Dollars per Euro
Source: *The Economist*

Russia

Russia would like to reclaim its former status as a world power. Since the country's first free elections were held in 1991, the Russian Federation has pursued a republican form of government. The President, who is elected every four years, appoints the Prime Minister, who then appoints the government. Rather than offering competing platforms aimed at attracting specific demographic groups, Russia's political parties tend to define themselves by their support or opposition to those in power.

Main exports 2007	% of total	Main imports 2007	% of total
Oil, fuel & gas	65.2	Machinery & equipment	43.9
Metals	13.5	Food & agricultural products	11.7
Machinery & equipment	5.0	Chemicals	12.0
Chemicals	5.5	Metals	6.6
Major markets 2008	**% of total**	**Major suppliers 2008**	**% of total**
Germany	9.5	Germany	16.0
Netherlands	7.1	China	12.2
Turkey	6.0	Japan	6.0
Italy	5.6	Ukraine	5.2

Source: Country ViewsWire

Transitioning to higher standards

Russia's transition from a state run economy to private enterprise has been challenging. Russian companies must navigate sometimes demanding political waters. Government connections continue to be important; however, we believe the financial crisis has made it clear that the Russian government does not want to pursue a course of nationalization. It will continue to pursue state capitalism—a course that has been adopted by many developed and developing countries since the financial crisis began. Along with China, Russia is a leader in the strategic deployment of state-owned enterprises.

Transparency issues persist in Russia. Company reporting often has been deficient relative to that provided by companies in more developed countries, and frequently has lagged the quarter significantly. There are some signs of improvement. Gazprom's earnings reporting, which once lagged the quarter by six months, is now just one quarter behind. Russian retail companies, which are highly sensitive to market perceptions, are more open about performance and willing to talk with investors.

Pursuing a more diversified economy

In addition to understanding the need for greater transparency, the Russian government and the country's business leaders are acutely aware of the need to diversify the economy. The government introduced tax incentives for the oil industry that were designed to encourage the production of value-added products. Some companies responded by building refineries near population centers where demand is expected to grow; others have acquired refineries in the Netherlands and Greece to facilitate the delivery of value-added goods to the European market

Shifting the balance of power in Europe

Russia's uneven relationships with countries in Western and Emerging Europe are influencing the balance of power in the region. The struggle is evident in the proposals for pipeline development over the coming decades. An influential German has been promoting the development of two pipelines from Russia to Europe: Nord Stream and South Stream. As you can see on the map on the next page, the Nord Stream pipeline would bypass Ukraine, whose rocky relations with Russia have destabilized gas supply to Europe. It might also increase the vulnerability of eastern countries that are quite susceptible to Russian influence.

At the same time, the European Union has been pursuing the Nabucco pipeline, which will connect Europe to Central Asia through the Balkans. Once completed, it will produce about one-fifth of the gas currently supplied to Western Europe by Russia. The pipeline is expected to tap into gas resources in Azerbaijan and Iraq's Kurdish region. An additional project that is under consideration would enable Turkmenistan, which currently sells all of its gas exports to Russia, to export directly to the Euro-zone through a pipeline under the Caspian Sea. Of course, pipeline security might become an issue as Russia is the only naval power in the Caspian Sea.

Current and Proposed Pipelines

Source: The Economist

Still an energy super power

Russia continues to be an energy superpower. It is the leading natural gas producer in the world, has the largest natural gas reserves, and is one of the leading oil exporters. In addition, the country has developed strong ties to other major energy exporters, such as Iran, Venezuela, and Libya. Russia's vast supply of oil, gas, and other natural resources provides it with significant political and economic bargaining power. Currently, Russia provides 30 percent of Europe's oil and 50 percent of its natural gas. There also is speculation that Russia may negotiate a return of the Kurile Islands, triggering an influx of Japanese capital for the development of eastern Russia.

Russian resources also are in great demand among the fastest growing economies in the world. China has been providing capital to Russia, as well as to Brazil, in return for guaranteed access to essential resources. Currently, Russia provides just 3 percent of its exports to Asia. During the next 15 years, it expects to increase energy exports to the region to 30 percent. Construction of a pipeline from East Siberian oil fields to the Pacific will help.

In the energy space, we particularly like **Lukoil** and **Rosneft**. Lukoil, Russia's leading integrated oil company, is fully privatized. The company is responsible for about one-fifth of Russia's crude oil production, and has proven reserves of about 20 billion barrels of oil equivalent, most of which is located in Russia. The company operates in Russia and 30 other countries; owns seven refineries, four in Russia and three in Emerging Europe; and has more than six thousand gas stations, including almost 2,000 in the United States.

Lukoil has strong earnings momentum, driven by: a healthy pipeline of exploration and production projects and refining and marketing projects; sector leading leverage to Russian refining; and potential upstream tax breaks from 2009. The company's shares trade at a discount relative to their peers, creating a very attractive investment opportunity.

Also an integrated oil firm, Rosneft conducts oil and gas exploration throughout Russia, as well as pursuing projects in Algeria, Kazakhstan, and Turkmenistan. It has combined proven and potential reserves of 49 billion barrels of oil equivalent and recently announced a sizeable discovery in the Vankor group of fields. The company, which is three-fourths owned by the government, has seven refineries, and operates shipping and pipeline companies, as well as a network of 1,700 gas stations. Rosneft generated more than $1.1 billion in free cash flow during the first quarter of 2009, which allowed it to reduce net debt by more than $2 billion. We like the company because it has strong, high-quality, low-cost, intermediate-term production growth potential, as well as preferential access to resources within Russia. China recently signed a long-term, $35 billion contract with Rosneft.

Steel: Adding value through vertical integration

Russia's steel industry is vertically integrated with the country's iron ore and coal mines, helping diversify the country's economy through the production of high quality steel. The company appears to be well-positioned to meet demand created by infrastructure development in China, India, and other rapidly growing regions of the world. We entered the space late in 2008, and reaped the benefits as American analysts upgraded Russian companies, causing share prices to increase significantly. Russian steel companies are currently at 100 percent capacity, and have sold out of September and October supply.

In this sector, we like **Novolipetsk Steel**, Russia's fourth largest steel producer. The company manages the entire steel production process—from mining iron ore to distributing its finished products. It is Russia's most advanced flat products manufacturer, producing hot and cold rolled, slab, galvanized, pre-painted, and electrical steel, as well as pig iron, through its steel-making and rolling businesses. Novolipetsk is one of the most profitable steel makers in the world. It is the lowest-cost Russian steel producer and has a strong balance sheet.

Telecommunications: Cell phones becoming a consumer staple

In many emerging countries, cell phones have become a consumer staple. In Russia, telecommunications is an investable, defensive sector that has performed reasonably well, although we don't expect to see explosive growth in the industry. It has a stable customer base, and predictable average revenue per user. We like Mobile TeleSystems (MTS), a leading digital mobile phone service provider that uses the Global System for Mobile Communications (GSM) standard. The company's reach extends across Russia, into Belarus, Armenia, Turkmenistan, Ukraine, and Uzbekistan. It was originally formed by Sistema and Deutsche Telekom in 1993. In our opinion, MTS has a good structural story, defensible earnings power, and strong cash generation. The market should become more appreciative of these attributes as macroeconomic pressures in the region ease.

The European Union: Emerging and Western Europe Intertwined

Europe's economic and political union, in 2008, encompassed 27 independent countries throughout developed and developing Europe. Seventeen of the member states are in Emerging Europe. Eleven of these are in Eastern Europe. As the EU works to restore economic prosperity, these countries will benefit from the financial support of the organization, which has committed roughly €400 billion—about 3.3% of its gross domestic product—to stimulate economic activity within EU member states. This is in addition to budget commitments for 2007-2013.

EU Member States

Austria	Germany	Netherlands
Belgium	Greece	Poland
Bulgaria	Hungary	Portugal
Cyprus	Ireland	Romania
Czech Republic	Italy	Slovakia
Denmark	Latvia	Slovenia
Estonia	Lithuania	Spain
Finland	Luxembourg	Sweden
France	Malta	United Kingdom

Turkey

Since the Turkish Republic was formed in 1923, it has aligned its political and economic structures with those of western nations. Today, it is a secular democratic state ruled according to the provisions of its constitution, which was adopted in 1982.

The Turkish economy was hit hard by global recession; however, Turkey has survived the credit crunch better than many developing countries. Its banks had little exposure to mortgages and toxic assets, and did not require an injection of public money. We like the Turkish bank space where, we believe:

- Valuations remain attractive
- Economic outlook is improving
- Risks are relatively lower
- Consensus estimates are too low

In particular, we like **Garanti Bank**. The bank's loan portfolio includes a significant number of large, high quality corporate loans; none of which have become non-performing assets. A change in this situation is unlikely as the country's economic outlook is slowly improving. Garanti Bank's shares recently were trading at a 17% discount to the Turkish bank average and a 36% discount to the EMEA (ex Russia) [4] average, which makes them very attractive on a relative basis.[5] We anticipate that Garanti will deliver strong earnings growth over the shorter term, which should drive stock prices higher. Our long-term positive outlook for the stock could be negatively affected if interest rates moved higher or non-performing loan ratios increase.

Major exports 2008	% of total	Major imports 2008	% of total
Clothing & textiles	17.4	Mineral fuels & oil	23.9
Road vehicles	15.8	Chemicals	12.6
Iron & steel	12.8	Mechanical machinery & parts	10.4
Agro-industry	6.9	Road vehicles	7.5
Leading markets 2008	**% of total**	**Leading suppliers 2008**	**% of total**
Germany	9.8	Russia	15.5
UK	6.2	Germany	9.3
UAE	5.9	China	7.8
Italy	5.0	U.S.	5.5
EU27	48.0	EU27	37.0

Source: Country ViewsWire

[4] Europe, the middle East and Africa

[5] Credit Suisse, Equity Research, Turkish Banks

Czech Republic

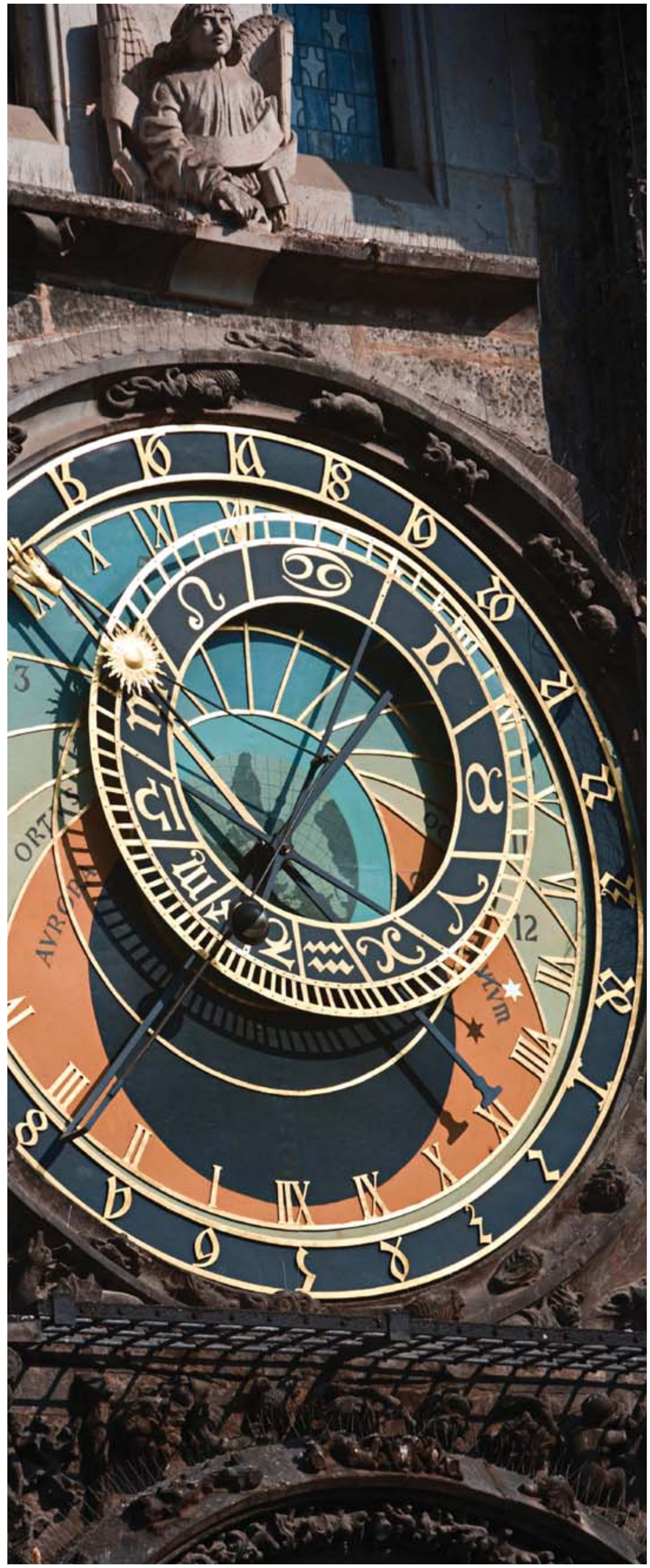
In 1993, the Czech Republic emerged from the remains of Czechoslovakia, a communist regime that was overthrown during 1989's 'Velvet Revolution.' It is a parliamentary republic, currently led by a non-partisan government that includes representatives from the Civic Democratic Party, the Czech Social Democratic Party, and the Green Party. This group will govern until October 2009 elections.

Major exports 2008	% of total	Major imports 2008	% of total
Machinery & transport equipment	53.5	Machinery & transport equipment	41.2
Intermediate manufactured goods	19.7	Intermediate manufactured goods	19.8
Raw materials & fuels	6.1	Raw materials & fuels	13.0
Chemicals	5.9	Chemicals	10.3

Leading markets 2008	% of total	Leading suppliers 2008	% of total
Germany	30.8	Germany	26.8
Slovakia	9.3	Slovakia	5.6
CIS	4.3	CIS	8.8
Russia	2.8	China	8.8
China	0.5	Russia	6.4
EU27	85.1	EU27	67.0

Source: Country ViewsWire

We expect the Czech economy to contract throughout the remainder of 2009, although economic growth is expected to resume during 2010. Even if growth is slow, we anticipate that utilities will remain relatively attractive. **CEZ**, the Czech Republic's main provider of electricity, produces, distributes, and sells electricity and heat to about 7 million customers at home and in neighboring countries. The government is the majority shareholder and is pursuing a strategy of tactical acquisition that is designed to establish the Czech Republic as a hub in the regional energy market. The company is leveraged to the recovery in Western Europe and we anticipate that it will outperform its peers. That said, it's important to recognize that CEZ is extremely sensitive to power price movements in developed Europe, so its shares may be more volatile than those of other European utilities.



Poland

Poland formed the first non-communist government in Eastern Europe following partly free elections in 1989. The country has a parliamentary republic. Poland joined the European Union in May of 2004 and, in terms of GDP growth, has outperformed Germany in recent years. It was one of the few countries in Europe to show growth during the first quarter of 2009, and ranked as the second most economically competitive country in the 2009 European Jobs and Growth Monitor. Tight monetary policy and strict government regulation may help Poland's economy recover more quickly than other European countries.

Major exports 2008	% of total	Major imports 2008	% of total
Machinery & transport equipment	41.5	Machinery & transport equipment	35.3
Manufactures classified by material	21.9	Manufactures classified by material	18.8
Miscellaneous manufactured goods	12.9	Chemicals & related products	13.1
Food & live animals	8.4	Mineral fuels & lubricants	11.5
Chemicals & related products	7.3	Miscellaneous manufactured goods	8.6
Leading markets 2008	**% of total**	**Leading suppliers 2008**	**% of total**
Germany	24.8	Germany	28.2
France	6.2	Russia	9.8
Italy	6.0	Italy	6.2
UK	5.7	China	5.4

Source: Country ViewsWire

Hungary

In the 1990s, free elections bought the first reform-oriented party to power, giving Hungary's market-based system a shot in the arm. The country's government remains a multi-party democracy with a unicameral parliament that elects the President. Hungary joined the European Union in 2004, and about 80% of Hungarian exports now go to the EU. The German market accounts for more than one-quarter of imports and exports. Fiscal consolidation is helping to improve Hungary's macroeconomic environment; however, this is likely to depress domestic demand and slow recovery.

Major exports 2008	% of total	Major imports 2008	% of total
Machinery & equipment	61.2	Machinery & equipment	49.5
Other manufacturers	26.9	Other manufacturers	32.0
Food, beverages & tobacco	6.7	Fuels & electricity	13.1
Fuels & electricity	2.4	Mineral fuels & lubricants	11.5
Chemicals & related products	7.3	Food, beverages & tobacco	4.7
Leading markets 2008	**% of total**	**Leading suppliers 2008**	**% of total**
Germany	26.6	Germany	25.3
Romania	5.3	Russia	9.4
Italy	5.3	Austria	6.1
Austria	4.9	China	5.7

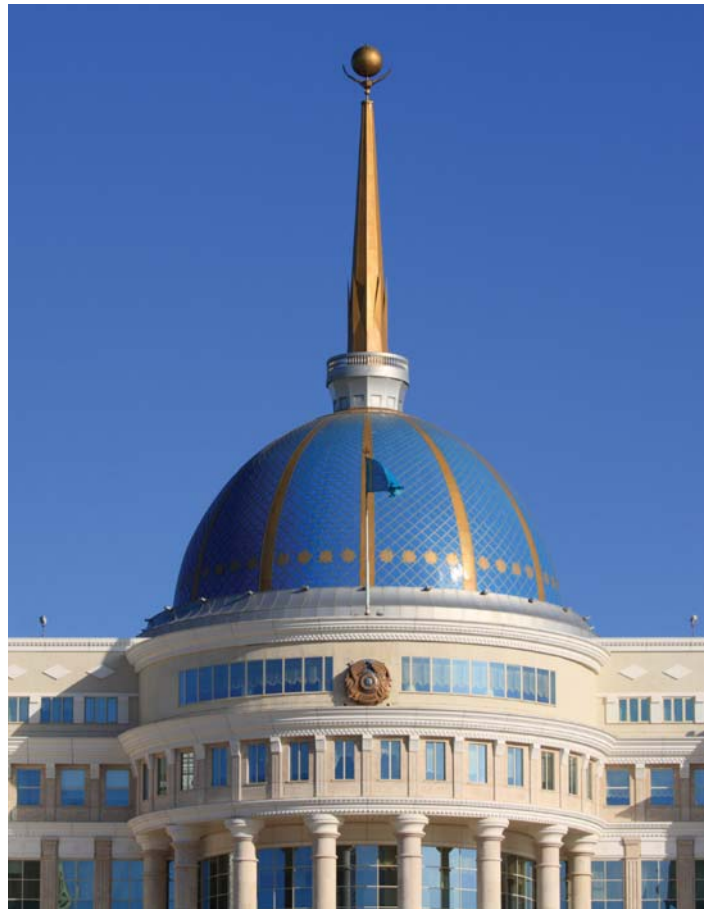
Source: Country ViewsWire

Kazakhstan

Kazakhstan declared independence from the Soviet Union in 1991. It is a presidential republic that has been under the control of Nursultan Nazarbayev since 1989. The President has near total control over all branches of government and sets national policy priorities. The strength of the country's economy has been oil. Over the short-term, government policy is aimed at creating liquidity in the banking sector and reviving growth. Longer-term, Kazakhstan is expected to focus on diversifying its economy.

Major exports 2008	**% of total**	**Major imports 2008**	**% of total**
Mineral products	73.0	Machinery & equipment	40.8
Metals	15.2	Metals	16.8
Food products	4.2	Mineral products	15.8
Chemicals	3.5	Chemicals	10.5
Leading markets 2008	**% of total**	**Leading suppliers 2008**	**% of total**
Italy	16.7	Russia	36.3
Switzerland	15.8	China	12.0
China	10.8	Germany	6.8
Russia	8.7	Ukraine	5.6

Source: Country ViewsWire



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