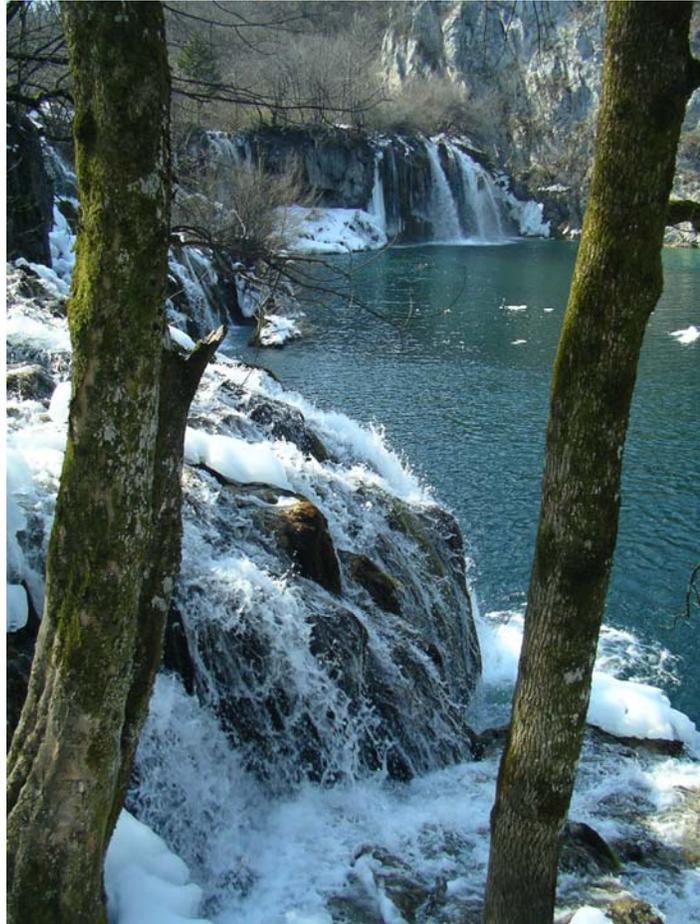


Daughters of Time – Serbia, Montenegro, Macedonia, Croatia

June 2011

The history of the Balkans is written in blood. Stretching back a thousand years, violence in the region has claimed the lives of the mighty and the poor alike. It was here, in Sarajevo, that Archduke Ferdinand was assassinated in 1914, igniting World War I. And it was here in the Balkans that factions competed against the other in the 1990s to avenge centuries old atrocities.

After NATO bombings and peace accords, new boundaries and new nations have been established while others, such as the state of Kosovo remain to be defined. With peace, capital flowed in, sometimes too much, resulting in valuations that were irrationally exuberant in 2008, when Price/Earnings valuations were 20x or more for many stocks and even entire markets. In the midst of the global financial crisis, Eastern European frontier markets dropped by 75% or more. In Macedonia, for example, the market peak was 10,300 and the low was 1,800. We count ourselves lucky that we avoided these markets then, but now it is time for a closer look. There is a Balkan folk saying that “we have reached rock bottom, but we continue to dig.” (Wilson Quarterly, Winter 2011) Perhaps now they have started to dig their way out....



Plitvicka Jezera: At peace at last

When I went to China in 1987, the outrages of the Cultural Revolution were fresh in the minds of everyone I met. Now in the Balkans, memories of the horrors of the 1990s are still fresh. Mladen Dodig, our broker in Serbia, remembers watching his army barracks bombed by NATO, and he counts himself fortunate that the building where he worked in communications had a red cross painted on the roof. In Croatia, Plitvicka Lakes, two hours south of Zagreb, was occupied by Serbian troops who damaged the buildings and ate the wild animals. They both caused and suffered many casualties between 1991 and 1993. Now, the deer, wolves, wildcats and bears are back in Plitvicka Jezera National Park, and the waterfalls are as beautiful as ever.

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After a week of travel in the Balkans with one of our clients, we are far from experts. But we were exposed to dozens of business people in Serbia, Montenegro and Macedonia, plus dozens more ordinary citizens, including those in Croatia. Without exception, they criticized their politicians, much as we do here at home, but almost without exception, they were optimistic about the future. We too are cautiously optimistic. All we need is to find stocks at decent valuations, and the picture will be complete.

	Serbia	Montenegro	Macedonia	Croatia	Romania	Zambia
GDP Growth (2011 est)	3.0%	1.5%	3.0%	3.0%	1.0%	6.0%
Inflation	7.0%	1.5%	2.0%	2.0%	7.0%	7.5%
Population (mil)	7.3	0.67	2.1	4.5	22	11.8
People / km sq	95	48	81	79	96	16
% Literate	96.4%	N/A	96.1%	98.1%	97.3%	80.6%
% under age 15	15%	16%	19%	16%	16%	45%
Life expectancy	70.1	73.7	74.9	75.6	73.7	38.6
% Urban	52%	60%	67%	57%	54%	35%
GDP / cap (PPP)	\$11,000	\$9,900	\$9,400	\$17,500	\$11,500	\$1,600
% Unemployed	17%	20%	33%	18%	8%	50%

Source: CIA World Factbook, March 2011, Frontier Market Asset Management estimates

Timeline:

World War II	10% of the Balkan population killed. Brutal atrocities by the Croatian Ostase party led to resistance from the Serbs. Eventually Tito emerged on top, creating Yugoslavia. He severed relations with Stalin in 1948. After Tito's death, Slobodan Milosevic came to power as a Serbian ultra-nationalist.
1991	Slovenia declared independence, won a short war.
1991 June	Croatia declared independence and immediately the Serb minority in Krajina declared independence from Croatia.
1991 Summer	Yugoslav Army seized 25% of Croatia and blockaded its ports. 10,000 killed; Montenegrin troops shelled Dubrovnik in Croatia.
1991 Sept	Macedonia voted for independence.
1991 October	Bosnia & Herzegovina declared independence, but this led to four years of civil war in Bosnia between Bosniaks, Bosnian Serbs and Bosnian Croats, costing 200,000 lives.
1992 January	UN brokered ceasefire in Croatia.
1992 May	Croatia joined the UN.
1993	Serbian hyperinflation, 500 Billion Dinar bank notes.
1993 January	Croatian army offensive against Serbs in Krajina.
1994 February	Greece imposed economic embargo on Macedonia to protest use of the name "Macedonia".
1995 May-Aug	Croatian army offensive against Serbs in Slavonia, east of Zagreb, Serbs shelled Zagreb.
1995 July	Bosnian Serbs, led by Ratko Mladic, massacred 8,000 Muslims at Srebrenica.
1995 Sept	NATO air strikes against Serbia ended the siege of Sarajevo in Bosnia.
1995 Dec	Dayton Peace Accord, set Croatian borders and partitioned Bosnia & Herzegovina by ethnicity into three regions.
1998 January	Serbs moved to ethnically cleanse Kosovo of Albanians, Macedonia sheltered 400,000 Kosovo Albanians.
1999 June	Serbs, under Milosevic, withdrew from Kosovo after 78 day NATO bombing of Belgrade, Serbia.
2001 Winter	Macedonia attacked by separatist Albanians, six month war, then autonomous rights for the ethnic Albanians.
2001 April	Milosevic extradited to The Hague for trial on charges of crimes against humanity before the "United Nations International Criminal Tribunal for the former Yugoslavia" (ICTY).
2003 March	Zoran Dindic, Serbia's first democratically elected Prime Minister, assassinated.

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Daughters of Time

Frontier Market Asset Management, LLC

2006 May Montenegro voted for independence from Serbia.
 2007 May Twelve members of Serbian State Security found guilty of murdering PM Zoran Djindjic.
 2008 May Kosovo voted for independence, but not recognized by Serbia.
 2008 April Greece blocked Macedonia's NATO invitation over use of the name "Macedonia".
 2011 +++ Unresolved issues: Kosovo is de facto an independent country, but it will take time for Serbian politicians to accept that (although most people in the streets already do). Meanwhile, the acting prime minister of Kosovo has been described as "one of the biggest fish in organized crime in the region"....(*The Economist*, January 29, 2011). Finally, there is the fear that Kosovo, which is ethnic Albanian, might join with Albania and even carve out part of Macedonia for form "Illyria", or Greater Albania.



Serbia

Walk along Knez Mihailova, the pedestrian street in old Belgrade (Beograd – the white city). Pass along the wide boulevard of elegant Belle Époque buildings with fashionable stores, galleries and coffee shops. At the end, you come to the vast Kalemegdan Citadel, attacked in more than 100 battles but still guarding the juncture of the Sava River and the Danube. Across the Sava you look down on New Belgrade, where chrome and glass office towers and a huge sports and entertainment arena signal the bright economic future of Serbia.

Before our visit, protestors took to the streets of Belgrade to demand a change in government. They are fed up with a bloated public sector and wasteful spending. They want economic growth; and they want EU membership, which has been held up until more war criminals are turned over to The Hague (where Milosovic died in 2006 and where now the former Serbian chief of police was has been sentenced to jail for 27 years).



Source: CIA World Fact Book; www.cia.gov

The stock market has good companies, although their attitudes can be primitive. Some managements ask "why should I meet with investors and give away company secrets..." Another challenge I found is that several companies seem to be betting on big strategy changes to make their futures brighter than the past. Tigar has recently sold its tire production facilities to Michelin, and it now wants to become a big factor in rubber recycling. Meanwhile, the company's mainstay is the manufacture of rubber rain boots, similar to ones we had seen produced at Bata Shoe's simple factory in Zambia last October. Tigar does have some clever designs with bright colors, but rain boots may not be the blockbuster product that they hope for. Another company in transition is AIK Banka, whose senior managers have close connections with local businessmen. During the financial crisis, they made quick emergency loans, demanding high rates and considerable collateral. With this high margin, hardball business will dwindle as financial markets return to normal, and the company's new strategy of retail lending in rural areas is untested. Another interesting company is Alkaloid, which has a 25% market share in agricultural pesticides. Return on equity is high, but the dividend is low because of costs to build dossiers on their products for the

European Union. They hope for approvals to sell in the EU, but even if they are accepted, this will take five years. Meanwhile, their market in Serbia is saturated. It is a mystery why they didn't start the approval process sooner.

A stay at Serbia's old Moskva Hotel, near the Knez Mihailova, is iconic of the nation. Built in 1906, it has been remodeled and patched up time and again. The lobby entrance is now down three steps off a side street, with the elevators back up three steps. The rooms are narrow, seemingly redone last when Tito was alive... but pairs of heavy double windows open up to a panoramic view across the Sava to New Belgrade. It's worth the stay for the view alone... and certainly not for the quality of the coffee.

Like the Moskva Hotel, Serbia has been patched up and remodeled time after time. The latest version has many of the ghosts from the past, but it has salvaged some of the glamour too. A lot of hopes are now pinned on acceptance by the EU for membership candidacy later this year, which would bring "accession" funding for infrastructure projects. But this may be contingent on the politically challenging extradition of war criminals who are in hiding, such as Ratko Mladic, mastermind of the massacre at Srebrenica. Meanwhile, the stock market has run up 25% since the fall of 2010. Perhaps we need to wait for more visibility into the future for the companies and the country to gain support for further gains.



Kalemegdan Citadel and the Sava River at sunset



Montenegro

Ringed by snow topped mountains, Podgorica, formerly Titograd, holds 200,000 people, or almost a third of the nation's population. With temperatures at least ten degrees warmer than Belgrade, there are even palm trees, reminiscent of San Diego. In fact, staying at the Best Western Hotel, in a new neighborhood of condos on the West edge of town, is almost exactly like being in San Diego!

East of the river, however, are blocks of dirty 50 year old apartment buildings that define communist era architecture. But there are some parks, trendy new shops and even a large shopping mall. There is also a beautiful new church, nearing completion after more than a decade, that boasts a great dome and tall stone towers with a dozen huge bells, one as big as a truck.



The Millennium Bridge, which spans the Moraca River, opened on July 13, 2005.

In Serbia, Mladen had provided outstanding one page summaries with everything an investor could want: full financials, plus a company description, ownership structure, ratios of Price/Earnings, Price/Book, ROE, yield and profit margins over four years. By contrast, in Montenegro we could not even obtain annual reports. With little information to go on, we managed three company visits that left us with more questions than answers.

Planteze, (Planta-shea) started in 1963 on 2,310 hectares of rocky soil, and now they produce 17 million bottles of wine... and it tastes pretty good. The problem is that the state owns 73% of the company, the management seems complacent, and the stock is down from 5 Euros to 0.30 where it still sells at 20x PE. They may be able to build their quality reputation and increase prices from 2.5 Euros per bottle to 3.5 Euros. As for shareholder interests, however, they still seem to have the old communist view that they are a producer of jobs, not profits. If the state should ever sell out, their land holdings would rise from 40 cents per square meter to 30 Euros per square meter, but that doesn't seem likely any time soon.

Crnogorski Elektroprnoski Syste is a power transmission company that has just signed an agreement with Italy that will change Macedonia's economy. An \$800 million hydro-power project in the mountains will dam the Moradi River and allow Montenegro to shift from importing 30% of its power to exporting as much or more beneath the Adriatic Sea to southern Italy. This project will not be completed until 2016 or so, but at that point Montenegro's GDP could soar. For now, however, the economy is finally starting to grow slowly. Real GDP was down 1% last year, but it could be up 3% in 2011. Meanwhile, inflation is calm at 1% in 2010 and perhaps 1.5% in 2011.

All in all, a wonderful country - but at this point, not a wonderful...or transparent market.



Macedonia

It's a long time since Alexander the Great roamed these hills, but pride runs deep. The Republic of Macedonia celebrates its 20th birthday this year, but it hasn't been easy, especially with the Greeks vetoing EU membership, NATO membership and even objecting to the name of the country. Perhaps with Greece's credit running low in Europe these days, things may change....

Skopje, the capital of this small country of two million people, will be beautiful once the construction is completed and the grand (or grandiose) buildings in the new city-center have developed some patina of age. For now, however, the constructions sites are an eyesore. The new Supreme Court building and the new museum are viewed by people we met as extravagances, wasting money that would have been better spent on efficiency oriented infrastructure.



Caesar's Palace on the right... Oops, that's the Supreme Court.

Real GDP is estimated to grow 3% in 2011 versus 1.5% in 2010, with inflation running at 1.5%. One surprise here is that, in contrast to most of Eastern Europe, the population is actually growing slightly.

In a short, busy day, we managed three meetings plus a visit to the stock exchange. The companies are interesting, and their disclosures are good. Among the opportunities is a generic pharmaceutical company with plans to expand to Russia and possibly even produce there. Also, the banks seem poised for growth, especially among retail customers. Financial strategies differ: one bank pays out 60% of earnings and has just completed a 10% capital increase., and another bank announced that it would forgo dividend payments for two years in order to avoid doing a capital raise, but its stock dropped 7% on the news. Clearly investors in Macedonia love to receive dividends, and this is true in many of the frontier markets, where retail investors dominate the trading activity. However, from our perspective as financial analysts, we'd prefer to have companies skip the dividend payments, save the investment banking fees and avoid the dilution.



Croatia

While the Holiday Inn in Skopje was showing its age, the Hotel Esplanade in Zagreb, Croatia wears its age with dignity and grace. Built in 1925 for the Simplon Orient Express, it is likely that Agatha Christie (and perhaps even James Bond) stayed here - along with countless dignitaries over the years.

Our mission in Croatia, however, was not to mingle with dignitaries, but to spend Saturday in Plitvicka Jezera (pronounced "Plit-vitch-ka Yazera").

This is a land of falling waters. The waterfalls are not as high as at Iguazu on the Argentine-Brazil border, yet they are no less spectacular. Twelve turquoise lakes span twelve kilometers and spill water over hundreds of falls and cascades. They are created by the interaction of algae with limestone to create growing dams of travertine. Wooden walkways cross over torrents of water, offering an exciting perspective of nature in action.



Veliki Slap – The Big Waterfall

Conclusion – The Daughters of Time, New Nations in the Balkans

“Truth is the Daughter of Time....”
- Old Proverb¹

After years of violence and retribution, and after much time, new nations are now alive in the Balkans. They are not as “multi-ethnic” as the Western Powers has hoped, and some of their boundaries may not prove as settled as we might like. But I believe that these new nations are deciding to compete in economic rather than in military terms. Perhaps some of the politicians don’t understand this yet. Perhaps they will squander their capital as statesmen to appeal to base populist and nationalist interests. But I hope not. The younger people in these countries seem to care more about their families and their pocketbooks than their flags. They would rather be consumers than soldiers. As their generation comes into leadership, we hope the Balkans will become a solid part of Europe, not, as Winston Churchill said of them: “a place that produces more history than it consumes...”

After World War II, it must have been hard to imagine that Western Europe could achieve today’s economic success and political stability. That progress could be a good guide to the Balkans today. People in the region are weary of war. They may be suspicious of their neighbors, but economic competition can make them all healthy.



Knez Mihailova, Belgrade, Serbia... try the Vuk (wolf) restaurant, four blocks up on the right.

*“How many times must the cannonballs fly,
Before they’re forever banned?”*
– Bob Dylan, “Blowin’ in the Wind”, 1963

¹ Tey, Josephene, [The Daughter of Time](#), Touchstone, 1951

About Frontier Market Asset Management

Founded in 2006, Frontier Market Asset Management holds more than 45 years worth of investment experience including work in Emerging and Frontier Markets since 1987. For more information, please contact us at (858) 456-1440.

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