



CARNEGIE ASSET MANAGEMENT
FONDSMÆGLERSELSKAB A/S



Investment report
Fourth quarter 2009

A return to normality in 2010?

“Abnormal is so common, it is practically normal.”

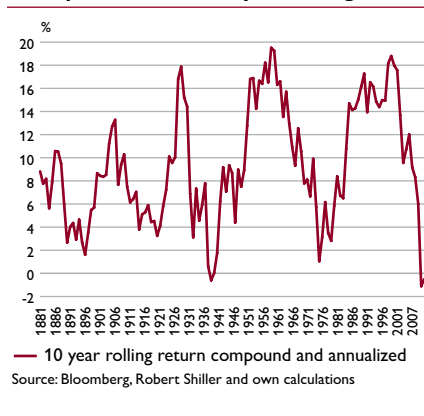
Nevertheless, it would be fair to ask whether 2010 will be a more stable year than 2009, which beat the breath out of most equity market participants. 2010 may very well turn out to be an equity year, in which returns will be close to normal levels of 5-8% in nominal terms. However, 2010 cannot be a normal year for the sole reason that we will see unexpected repercussions following the most extensive global monetary stimuli in world history.

The extraordinary conditions prevailing during the past couple of years have created a strong investment case for investors with a long-term horizon for equity investments. We will unveil this investment case in this quarterly report. Carnegie WorldWide/Global Equities is strongly exposed to this investment case, which we expect will provide us with a good start to the new decade.

2010 – on a razor’s edge

2010 will be an unusual year for the sole reason that the events of the upcoming year will be inextricably linked with the developments of the financial crisis of the past couple of years. 2010 will be a balancing act in which politicians and central banks will once again play leading roles the way they have for the past couple of years. Having hit an all-time low in March 2009 measured by ten-year returns on US equities, as shown in figure 1 below, the market rallied for the remainder of 2009.

Figure 1: US Equities return - 10 year rolling



The US federal reserve lowered short-term interest rates to close to 0%. Politicians took heed of the lessons learned from the 1930s in the USA, and short-term interest rates fell to all-time lows in most regions around the world. China aggressively stimulated the economy, and the country has such strong underlying dynamics that it, and not the USA, became the first country to emerge from the crisis. In other words, we have witnessed an unusual rescue action for the global economy. As shown in figure 2 below, which describes the health condition of the global economy in a

Figure 2: The global wave



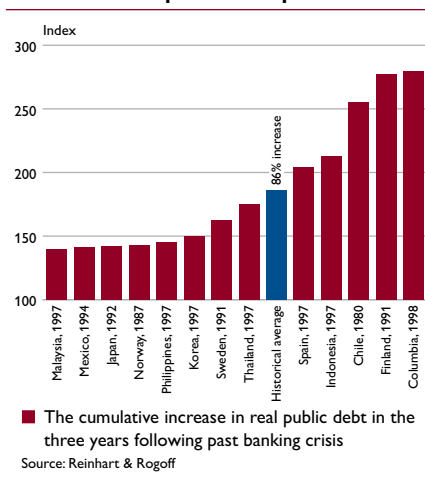
chart, the operation was successful. The patient is out of the emergency room but still needs very expensive and risky medicine – described by some sceptics as heroin. The medicine is slowly being withdrawn, and the first phase in which central banks reduce access to loans to the squeezed and vital banking sector has been initiated. However the nationalisation of the credit granting process is still in progress in the USA. In an announcement released on the day before Christmas, it was announced that the two major players in the US home financing market, Fannie Mae and Freddie Mac, which buy US home loans, will have unlimited access to federal aid for the next three years, whereas a cap previously applied to such funding. The next and difficult withdrawal phase involves hiking short-term interest rates. Individual countries such as Australia and Norway have already begun. There are some countries which already at the present stage need to tighten their fiscal reins quite dramatically, including Greece and Ireland. The rest of the western world, in particular, will follow suit with tighter public budget management when the local and global economies

are considered more stable. However, this is where the major challenges lie. How does one combine tighter public budget management with a world in which governments play an increasingly important role?

Governments as growth drivers

After the last couple of years, in which the otherwise well-tested model built on free markets malfunctioned, governments moved in to act as the saviour at the time of crisis. The predictable and typical outcome is that the global public systems dramatically push up debts. This is one of the themes of the recommendable book by Rogoff and Carmen “This Time is Different”. Figure 3 below shows that public debt after a financial crisis increases by 86% over a subsequent three-year period.

Figure 3: Increase in real public debt past crisis



As governments do not have any funds of their own, they need to borrow from today’s and tomorrow’s tax payers and savers to finance today’s public consumption. The government cannot and will not withdraw quickly as growth driver as described in previous quarterly reports. That by itself does not necessarily herald disaster for global growth. There are examples of how governments can sensibly allocate capital. China is a successful centralised example, while the Nordic countries have also performed well, in spite of heavy government involvement. However, a big state which also needs to act as a growth locomotive is expected to lead to weaker global growth trends for the next three to five

years, and greater fluctuations. In particular, growth will be weaker in countries that were financially weak before the crisis. Most of the industrialised world belongs in this category, whereas China and other selected countries are at a different point in their structural economic cycle and still have a strong platform for growth.

The risk arises only if the government finds difficulty in sourcing funds from savers and tax payers. As a result of the huge government deficits especially in the USA, both Japan, China and businesses, private individuals and banks will have to buy large quantities of government bonds to secure continued funding. So far, this appears to be sustainable, and especially the banking system held a relatively low proportion of government bonds in a historical perspective. We would refrain from buying a 10-year government bond at the current yield levels and keep it for ten years. However, most government bond buyers do not hold the bonds until maturity. They buy bonds for lack of a better alternative in a world in which cash carries close to 0% interest. Governments can only obtain funding at 2-4% as long as short-term rates remain much lower. That leads us to the all-important risk factor for 2010 and 2011; what will happen when short-term rates are hiked – how will it impact the global equity, bond and property markets?

The simple solution would be to merely continue keeping interest rates at the present, extremely low levels. However, we cannot continue to have short-term rates of close to 0% due to the high risk of new bubbles. If the cost of capital is too low, it may lead to sub-optimal investment behaviour. Too much cheap money in circulation increases the risk of inflation getting out of hand. So central banks need to tighten monetary policy and hike interest rates again at the right time. We expect that this could happen once the banking system has recovered and been appropriately recapitalised. We’re not quite there yet, but given the stabilisation of the property market and improvements in the more risky parts of the credit market, there is a strong probability that central banks will hike rates in 2010. The market should be able to cope with gradual rate hikes, but there is a high risk of instability.

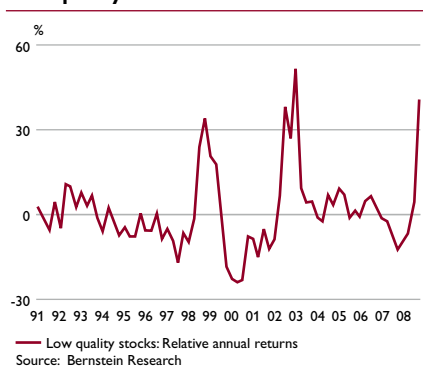
The global forex markets are experiencing an imbalance which is important to address politically as well financially. China still has a sky-high surplus on its trade balance and

current account, whereas the Anglo-Saxon economies, with the USA at the helm, have major deficits. Part of the solution to this imbalance is for China to start revaluing the Renminbi again. There are sound practical, political and market-psychology reasons for doing so. We would guess that the Chinese will re-launch the revaluation process initiated in the summer of 2005, with a monthly and gradual revaluation relative to the US dollar of 4-8% per annum. Failure by the Chinese to do this may create a basis for an escalating trade conflict and protectionism in an atmosphere marked by continuing high unemployment, especially in the USA. This would have a negative effect on global equity markets.

Quality on sale

High quality US companies had an unusually difficult period in the 2nd and 3rd quarters of 2009. According to US finance house Bernstein, these companies underperformed the market by as much as 23%, whilst companies with a lower credit rating outperformed the market by 56%. Over a longer period of time, figure 4 shows that low quality

Figure 4: Low quality stocks



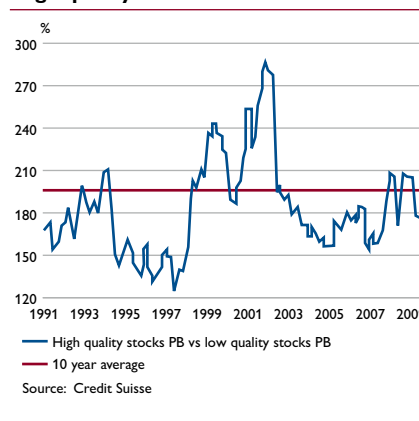
companies typically perform well during relatively short periods. The figure also shows that the strong additional returns of the past year match earlier periods during the late 1990s and 2002-2003. The reason is that investors with high risk profiles and short investment horizons have had access to extremely cheap funding. These investors play a very important role in an environment with easy access to cheap funding. They drive price developments in these more risky companies, causing lower quality companies to outperform.

2010 will most likely be the year in which we see some degree of normalisation of the very lenient monetary conditions. The consequence may well be that more fundamental and long-term investors will gradually take over price developments in the equity market.

It is important to note three factors in this respect:

- 1) The historical pattern is clear. After a year such as 2009 in which low quality strongly outperformed high quality, the pattern is the very opposite in the following year. Quality stocks thus perform 9% better on average in the following year.
- 2) Quality stocks can outperform the market even in strong market rallies. That has happened on a number of occasions.
- 3) Quality stocks are inexpensive. As shown in figure 5 below, these types of companies trade at attractive levels relative to history and relative to the category of lower quality.

Figure 5: High quality stocks Price/Book



In many ways, it feels like a sale in a furniture store that only sells designer furniture. High quality brands are on sale, and the sale may last for quite some time. As long as money comes cheap and is easily accessible, speculation will abound. People are queuing at the casino table, tempted by juicy investment categories with high returns, at high risk. If interest rates on government and credit bonds continue to fall, investors will continue to make bets.

Overall, we believe that long-term investors will make the most money. Now is a good time to buy quality stocks at

attractive prices. Therefore, we retain a strong overweight of these companies.

Quality pays in the long run

At Carnegie WorldWide, we focus on buying stocks and keeping them for many years. In our experience, this provides the best long-term return net of all costs. Consequently, we focus on the characteristics of a company that may generate a high long-term return. One such characteristic is quality. One of our long-standing customers once said, with a twinkle in his eye, that a quality stock to him was a stock that went up! The question remains for how long the price of the stock will rise and how big an overall return the company will yield.

Dividends are an important, but neglected, part of the return on stocks over longer periods. This is one of the arguments of Dimson, Marsh and Staunton's book "Triumph of the Optimists", in which the re-investment of dividends doubles the annual return on stocks. Some companies, however, are in a better position to pay dividend than others. These companies generate a high and stable return on their share capital, have low debt and a low investment level to maintain production of the goods and services they sell.

Over long periods of time, these companies on average outperform the market and at lower risk. For example, Bernstein found that the annual average additional return on US quality stocks from 1982 to 2009 was 1.6% per annum, whilst low-quality companies fluctuated far more and on average they underperformed by 1.6% per annum.

This simple historical fact based on common sense plays a pivotal role for the way in which Carnegie WorldWide builds its portfolios. We seek to optimise our portfolio over longer periods of time, and even though we could potentially profit from shifting from high to low quality in the short term, this could result in an unproductive and expensive discipline. We will continue to invest in companies that we believe offer long-term value.

Conclusion

We began this article by emphasising that the turbulence in the equity markets has opened up for sound investment



opportunities. Buying quality stocks and maintaining a long term investment horizon. In other words, invest instead of speculate. These are the values we emphasise and which have created strong results for our investors during the past 20 years.

2010 cannot be a normal year and should not be seen in isolation due to the extreme conditions in the fixed income markets and the recent financial crisis. Today, speculating is more the norm than investing. Investing with a short time horizon has become the normal thing to do rather than making long-term investments. In such a world, one should consider taking the advice of the successful US actress Jodie Foster: Normal is not something to aspire to, it is something to get away from!

Be abnormal, but stay logical and rational in your decision making. Buy quality. That is the opportunity available in the equity markets right now.



Carnegie East European

Summary

Market developments in Central and Eastern Europe in 2009 were in some ways a reflection of developments in 2008. After massive declines in 2008, we saw increases on an almost similar scale in 2009, and the weakest market in 2008 – Russia – was the strongest market in 2009. After pausing, the more thematically driven investment strategy for several quarters and focusing on oversold equities instead, our Q4 investments included several stocks enjoying tail wind from more structural changes. We foresee great uncertainty surrounding global economic developments. Will the enormous economic stimulus packages work? Or is consumer spending in the western hemisphere doomed to stagnation for years ahead? We do not know, but we believe that the new stocks in our portfolio will perform well irrespective of economic conditions, driven by strong market positions and competent management.



Continued strong increases in East European

The positive developments seen earlier in 2009 continued in Q4. The fund gained 10.6% (USD), while the benchmark was up by 8.7% (USD). For the year to date, East European gained 96.1% (USD), as compared with its benchmark, which increased 71.6% (USD).

Russian stocks were among the best performers again in Q4. The fund's investments in regional telecommunications companies NorthWest and Sibir were the two best stocks in Q4. This was spurred by renewed optimism that a long awaited restructuring of the Russian telecoms sector now finally seems to be materialising. This is expected to cause a substantial increase in the two companies' share prices.

The fund's current investment strategy

Throughout the past quarter, the fund adjusted its investments slightly more in a thematic direction, away from the strong focus on oversold stocks. This is a natural step given the significant market increases throughout 2009. The region's economies are normalising after the severe shock of the financial crisis and the resulting decline in commodities prices and widespread liquidity shortage. This makes it easier to look a little further into the future and hopefully identify long-term winners available at attractive prices today.

The fund will retain its limited exposure to Poland and Hungary for some time yet. While it is unclear how Hungary will emerge from the recession, it is difficult to find attractively priced stocks in Poland. We retain our focus on relatively liquid companies to ensure that the portfolio structure can be easily changed, if necessary.

Portfolio changes

We bought four new stocks in Q4. We invested in **Magnit** to get exposure to Russian consumer spending, which is expected to surge longer term. Magnit is the largest retail goods company in Russia with more than 3,000 discount supermarkets in the southern, central and Volga regions. The company's business strategy is partly to utilise its very strong position within logistics (the company owns more than 1,300 lorries and numerous storage facilities) and partly to focus on small cities, meaning that Magnit will mainly extend its shop network in cities with a population of less than 500,000. These cities typically have an old-fashioned retail structure with small grocers and open-air markets rather than modern retail stores. Magnit is far more competitive, as the company offers an attractive product range at substantially lower prices than its competition. The company is thus increasing its market share, and we expect growth to continue for many years, as modern retail trade players only command a market share of just over 40% today.

As the global economy slowly recovers, we believe that Russia will again experience strong growth in capital investments and commodities exports. In order to get exposure to these trends, we invested in **Globaltrans**. Globaltrans is Russia's largest private railway operator. Russia is undergoing gradual liberalisation of rail transport, which means that competition is emerging on freight transport using privately-owned wagons, whereas the state-owned Russian railways still have a monopoly on the operation of railway engines and network ownership. Private operators are far more competitive than the state-owned company, which is why a company like Globaltrans is winning market share from the state-owned company. In the coming years, rail transport tariffs are set to increase significantly and, at the same time, rail transport is expected to maintain attractive freight volume growth rates, as railways are de facto the only transport option in this vast country. Accordingly, rail transport has a market share of 92% of all freight transport in Russia (excluding oil), as compared with 49% in the USA and 10% in Europe. We therefore believe that Globaltrans offers huge growth potential and represents attractive exposure to a normalisation of the Russian economy in the wake of the global recession in 2008–09.

After keeping its investments in banks at a minimum over the past 18 months, the fund invested in **Halyk Bank**. Halyk Bank is one of the three largest banks in Kazakhstan. With a branch network twice the size of its closest competitor, this bank has greater competitive strength due to its large deposit portfolio, which gives the bank a low funding rate. Like other Kazakhstan banks, Halyk Bank was hard hit by the recession, and bad and doubtful debts threatened to undermine the banking system. However, we believe that 2009 marked the trough and that 2010 will offer stabilisation. It is our assessment that Halyk Bank can emerge from the crisis in a significantly stronger position, as weak competitors will have disappeared entirely.

Finally, we invested in **Regal Petroleum**. Regal Petroleum is a Ukrainian oil and gas company. The company is focused on developing two, for the Ukraine, very large gas fields. Over a number of years, this company is expected to be able to increase production to the equivalent of some 45,000 barrels of oil per day. This production level is not reflected in the valuation of the company.

Expectations for Carnegie East European

Following their very strong appreciation in 2009, we believe the markets may still see moderate increases driven by the strong liquidity and mounting growth expectations. However, most equity markets are no longer cheap, unless growth rates surprise very positively. We therefore expect great volatility in the months ahead.

On the long horizon, we consider the markets to be very attractively priced, offering good acquisition opportunities for long-term investors.

With the fund's focused investment style, we are continuously striving to outperform the market.

Carnegie East European

Investment philosophy

Carnegie East European is a Sub-Fund of the CARNEGIE FUND, an unincorporated open-ended collective investment fund registered in Luxembourg under Part 1 of the Law of December 20, 2002.

The investment objective of the fund is to achieve long-term capital growth exceeding the return of the East European market with a moderate risk measured by standard deviation. The aim is to have a portfolio's standard deviation level at or below that of the market.

The fund has a diversified portfolio of investments which consists principally of quoted equities of Central and East Europe, including those of the former Soviet Union.

The fund focuses on East European convergence, including the structural changes which takes place in the less developed economies in the east and southeast for example the former Soviet Union and Turkey.

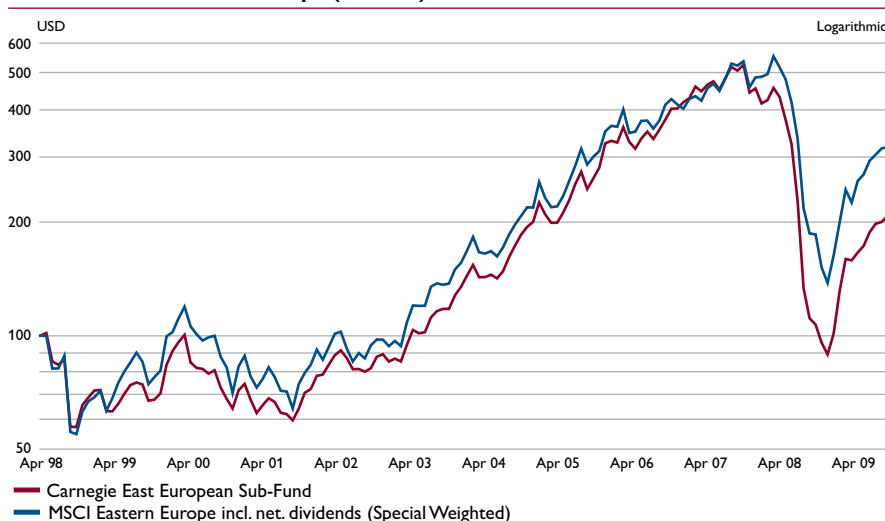
Key figures	31-Dec-09 30-Sep-09	
NAV (1,000 USD)	33,142	30,996
NAV per share (USD)	41.98	37.97

ISIN	LU0086737482
Launch date:	1-Apr-98
Read more:	www.carnegieam.com/east

Return/Excess return in %	1 year	3 years	5 years	10 years	Since launch
Return on Portfolio	96.1	-48.4	7.1	151.4	109.9
Return on Benchmark*	71.6	-25.7	45.1	222.2	221.0
Active return (arithmetic)	24.5	-22.8	-37.9	-70.8	-111.1

Risk	3 years	5 years	10 years	Since launch
SD Portfolio (%)	48.7	41.4	32.8	34.2
SD Benchmark (%)	43.2	37.7	32.4	35.3

Investment Performance Graph (Indexed)



Carnegie East European as of 31 December 2009

	Hungary	Czech	Poland	Russia	Other	Total	Benchmark*
Energy				Gazprom ADR 6.4 LUK Oil 2.3	KazMunaiGas 3.4 Dragon Oil 5.7 Regal Petroleum 1.7	19.5	40.0
Materials				Petropavlovsk 6.4 Uralkali GDR 2.2	Uranium One 1.6	10.2	10.2
Industrials			Budimex 1.4	Open Investments 1.3 GlobalTrans 2.7	XXI Century Invest. 0.2 Reysas Logistics 2.6	8.2	0.4
Consumer Discretionary	Danubius Hotel 1.3					1.3	0.6
Consumer Staples				Magnit GDR 3.9	Efes Breweries Int. 3.8 BIM Birlesik Magazalar 3.5	11.7	0.5
Health Care					A&D Pharma 2.5	2.5	2.3
Financials				East Capital Financial Funds 0.9	Bank of Georgia 3.2 East Capital Baltic Property 2.7 Halyk Savings Bank of Kazakhstan 2.3 Sinpas Gayrimenkul 3.9 Turkiye Garanti Bankasi 3.4	16.4	27.3
Information Technology						0.0	0.7
Telecommunication				Comstar United Telesystems 2.1 North-West Telecom 4.0 Sibirtelecom 4.2 Mobile Telesystems ADR 7.1 VimpelCom ADR 3.6		21.0	9.9
Utilities		CEZ 3.5		EOS Russia 4.6		8.1	8.1
Others				Black Earth Farming 1.6		1.6	0.0
Total	1.3	3.5	1.4	53.3	40.5	100.0	-
Benchmark*	10.2	7.7	23.4	58.7	0.0	-	100.0

*Benchmark consists of the market value weight of the development between Russia, Poland, Hungary and Czech Republic, where Russia contributes half the market weight. Benchmark is being calculated by Morgan Stanley incl. net. dividends. The number behind the name of the share states the percentage of the fund's holdings.



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