



CARNEGIE ASSET MANAGEMENT  
FONDSMÆGLERSELSKAB A/S



Investment report  
Second quarter 2010

# Distinct trends in the global economy

By Bo Knudsen, Portfolio Manager

We are currently in the wake of one of the most severe economic downturns ever seen. Politicians around the world are trying to mitigate the negative effects of the 2008 credit crisis through extensive fiscal stimulus plans. So far, there have been certain positive effects, but growth rates are now receding. For the next couple of years, we anticipate weaker, more volatile global growth trends. While being fully aware of the caution necessary when predicting future trends in the financial markets, we see three distinct long-term trends in the global economy that will be of major importance to investors measuring their horizon in years rather than days.

## ■ Underlying growth remains strong in emerging markets, including in China

The most recent cooling of growth rates is a result of deliberate political intervention intended to reduce growth rates. In the meantime, US media continue their schizophrenic coverage of China, which, according to them, is on its way to an economic meltdown one month and overheating the next. In our view, the truth is rather that China has the economic prowess to continue to manage its economy at 7–9% domestically-driven growth for the years ahead.

## ■ The USA taking the usual route of trying to grow out of its problems through expansionary monetary and fiscal policies

The USA is basically a dynamic society with sustained population growth. It is a debt-intensive economy that will benefit from higher inflation. The USA has the special advantage that the US Dollar, although having suffered a few dents during the financial crisis, is still considered the number one reserve currency. Assuming a certain degree of credibility in the political measures introduced in the USA, domestic and foreign financing may help fund the country's expansionary policies. The times when consumer spending was driven by people using their home equity to obtain cash, capitalising on appreciating property prices, are over. Although there are budding signs of the property market stabilising, this sector does not have the strength to support the economy. On the other hand, the banking system stability has improved, but the politicians will still have to support sector recapitalisation while avoiding excessive

regulation. We believe that the outcome is continued low economic growth driven by public spending.

## ■ Germany driving Europe towards a more restrictive approach to solving the growth and debt issue

The benefit of this model is that it provides an exceptional opportunity to implement necessary adjustments to welfare models that for many countries have long been unsustainable and inconsistent with what they can actually afford. However, there is no electoral support in Europe for major fiscal policy tightening. Europe's ageing population and the well-established welfare model in which everyone believes they are entitled to large public benefits only leaves room for gradual change. It will be interesting to follow Greece in this perspective. The key issue to monitor in Europe is how the European Central Bank (ECB) will handle the situation. As in the USA, support for the financial sector will be essential. Less restrictive policies from the ECB might weaken the euro further and create sufficient export growth and economic momentum to solve the problems Europe will be facing in the years ahead. Will Germany allow this scenario? We believe it will!

## A double dip?

Right now, the memory of 2008 fresh in mind, many people fear a complete meltdown of the credit markets and a new recession. We are still in the midst of the largest stimulus project the world has even seen following what in a historical perspective was a long recession. The state of health of the banking system plays a material role in our models. Regardless of any improvements to capitalisation, especially in the Western banking system, the sector remains under pressure. Similarly, debt levels in both the private and the public sectors remain at high levels all over the world. Previously, we have been surprised by the strength of the global 'V'-shaped recovery. There are now substantial fears of a double dip, or shaped like a 'W', in which the economy very quickly falls back into recession. From our viewpoint, this is a possible but not likely scenario for three reasons: 1) the political reaction will still be focused on growth; 2) the underlying growth trend remains strong, especially in the emerging markets; and 3) double dips are very rare in a historical context.



Confidence is of the essence. Assuming that they manage the stimulus plan in a reliable manner, the politicians will be successful in implementing their balancing act, because in this scenario market confidence will remain sufficiently high. Future growth is what will be needed to solve the debt issue, and that is the model the politicians are looking for. Because we live in a world with a good physical and virtual infrastructure, we can trade and exchange ideas very efficiently across national borders. That also means that we live in a world designed for growth. The global economy has a good ability to mend itself. Jonathan Wilmot of Credit Suisse has authored an interesting research report in which he points out that a double dip scenario of the economy quickly falling back into recession after a brief recovery is rare. He notes that since 1884, such a scenario has occurred only three times in a total of 38 recessions. In all three cases, the double dip occurred after an initial mild recession. There are no examples of a double dip occurring right after a severe credit-driven recession such as the one we have just experienced. Had Mr Wilmot included the

1870s in his report, it would also have covered the longest recession ever seen, which lasted six years. As we explained in our Q4 2008 quarterly report, that recession dragged on for so long because no one responded to a severe global credit crisis like the one we have just witnessed. There was no financial infrastructure and no lender of last resort, such as a central bank. There was no deposit guarantee scheme, so rumours of a bank having problems would cause a run on the bank by customers wanting to withdraw their funds, which in turn had a disastrous effect on the credit system. The US central bank was only established in 1913 and not until 1933 did the USA introduce the crucial deposit guarantee scheme. Deposit guarantee schemes are now in place all over the world and central banks communicate with each other. A concern this time could be a situation in which central banks cease to cooperate or the de facto global central bank, the Federal Reserve, changes its behaviour in a way that causes confidence in the monetary system to disappear. Although this is a possibility, it is not considered to be very likely.

We believe that the political system, and with it the major central banks, understands that money is like electrical power: if there's no power, the lights go out and failure to restore power quickly has severe consequences. Money must flow so that healthy businesses that depend on ongoing credit are not dragged down. That is also why it is essential that the politicians allow the banking system to be profitable and restore its capital foundation during this phase, even though it might be tempting to penalise the banking system for making too ample amounts of money available during the years leading up to the financial crisis. In particular, it is necessary to regulate the shadow banking system, which was a driver of credit granting from 2000 to 2008. It is essential to find the right balance so that the banking system can continue to grease the different parts of the global economic engine.

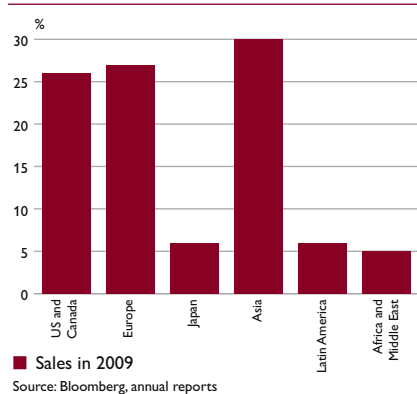
### **Global growth is a top political priority**

The pecking order of the global economy has been fixed. The emerging markets (including China) constitute the main driving force in the equity markets and on the macroeconomic front ahead of the USA and with Europe in third place. The story in mid-June that China would resume the gradual appreciation of its currency, the Yuan, was very

good news and it shows China's pragmatic position relative to the rest of the world. Although Europe (read: Germany) would probably prefer cut back rather than spend, all the politicians of the world agree on one thing in general: economic growth is number one on the agenda. In order to achieve this goal, optimism must be restored among the population, so that the people will have the same growth priority. Hunger is a key driver of growth. The world we live in continues to have a good potential for underlying growth. The populations of the emerging markets have the greatest hunger for economic growth followed by the USA and Europe.

This is reflected in the Carnegie Worldwide global equity portfolio through its 40% underlying exposure to emerging markets (30% to Asia) in terms of where businesses generate their sales, as shown in the table below. We believe this to be an important dimension in an evaluation of the future growth prospects for the stocks in the portfolio.

**Carnegie Worldwide:  
The companies geographic exposure**



Regardless of the obvious political and economic differences between the regions of the world, there is also another shared feature: Politicians today have greater influence on the economy. Accordingly, political analysis should also play a greater role when general trends are discussed and equity investments are made. More regulation and intervention in the market forces is an agenda that we will have to get used to, because of the severe recession we witnessed recently.

We anticipate moderate returns and low, volatile economic growth, given the increased political control and greater indebtedness of the global economy. We see competitive returns in the equity markets relative to the low yield levels available in the bond markets. We do not anticipate a double dip, unless the global economy is hit by a new, massive negative factor, and we expect the slow healing process to continue. Expansive monetary and fiscal policies return to the agenda during periods of declining growth. Especially in debt-ridden countries, there will be a bias in the next few years towards solving the debt and growth issue by way of inflationary policies in the most debt-ridden countries with inflation-proof assets such as houses and equities in the USA and the UK.

In this scenario, we believe that major capital-intensive and, preferably, dividend-paying companies with a bias towards emerging markets will be best positioned in an environment where it will pay off to be in control of your destiny rather than being dependent on others. Such companies are mainly able to catch the wind from distinct trends in times of uncertainty.

## Gold as an investment theme

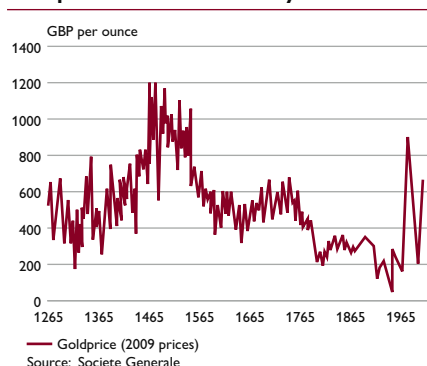
**“Gold gets dug out in Africa or some place. Then we melt it down, dig another hole, bury it again and pay people to stand around guarding it. It has no utility. Anyone watching from Mars would be scratching their head.”**

*Warren Buffett.*

*By Morten Springborg, Portfolio Manager*

Gold is a wondrous metal. Gold has no industrial significance, such as copper, lead or nickel have, and yet gold has been in demand all through the ages. That is because gold has always met a single purpose; namely being considered as the ultimate, stable investment. In fact, the real price of gold is the same today as it was in 1265, although it has been very volatile during the years. The reason why gold has had a stable value over time is the fact that gold is difficult to find and produce. The price of gold rising does not mean that more gold will be produced. For example, gold production fell from 2,650 tons in 2001 to 2,350 tons in 2009, while the price of gold has risen from USD 250/oz. to just over USD 1,200/oz. today. Gold production from existing mines is extremely profitable, but starting up new mines is risky and takes up to ten years from the time reserves are discovered until production start-up. In addition, major gold finds are becoming increasingly rare, and production from existing mines declines the older the mines get. We do not expect the world will produce substantially more gold than is already being produced.

**Goldprice since 13th century**



Demand for gold is for around 4,000 tons per year. Accordingly, mining production accounts for only about 60% of the overall supply, indicating a structural underproduction of gold.

The difference between mining production and demand has been made up partly by way of scrap gold and partly by central banks having sold gold from their stocks during the past 20 years.

What is so special about gold is that the bulk of the gold produced throughout the ages is still available. Gold does not disappear, precisely because it is so valuable! A total of about 161,000 tons of gold has been produced during the ages and given its density of 19.3, all historically produced gold could actually be placed in a 20\*20\*20 metre cube, meaning that it can “easily” fit on a tennis court. This volume grows by about 1.5% per year. For that reason, the annual mining production is not important relative to the price of gold. It is more important to consider the quantity of scrap gold sold by gold owners in emerging economies, because they have always used gold as a store of value, and to estimate demand for gold as an investment object among Western investors and consumers. In addition, central banks’ buying and selling of gold is also important, because combined they are the world’s largest gold owners.

Scrap sales depend on the price of gold, but the average has been around 1,300 tons during the past three years. India is a particularly important gold market (25% of the global gold jewellery market and 20% of the coin market), but the Middle East, China and Turkey are also major gold markets that also experience substantial trading when gold prices have risen sharply over a short period of time. Over time, however, emerging economies should be expected to demand more gold as their purchasing power grows.

During the past ten years, the central banks have had an agreement to sell 400 tons of gold per year, but in reality they have only sold about 200 tons, and in 2009 the central banks were net buyers. While the Western central banks typically have large shares of their reserves in gold (the USA has about 70% of its currency reserves in gold, for example, Germany has 66%, whereas Denmark only has about 3–4%, unfortunately, equal to 66.5 tons), the emerging economies have very small holdings of gold. China’s

gold holdings equal 1.6% of its currency reserves, while India's is about 7.5%. In 2009, India bought just over 200 tons from the IMF, which sells gold to fund its support measures for the weak economies of Europe. China has quietly doubled its gold reserves in a gradual process since 2003 by buying up largely all the gold produced in China. The explanation is that the currency reserves of emerging market economies have been growing quite strongly in recent years at a time when Western currencies, which China has otherwise mainly invested in, have lost some of their stability. Obviously, this creates a logical desire to diversify investments in order to reduce risk. If the central banks in China, India and other emerging market economies wanted to increase their gold reserves, it would have a significant impact on the gold market. In order to increase its gold investments to 10% of its currency reserves, China would have to buy 5,500 tons of gold, or more than two years of global gold production.

In addition, a new type of buyer has come to the market within the past few years: ETFs (Exchange Traded Funds), which invest in physical gold. Typical buyers of these products are high net worth individuals and institutional investors, and their interest is a reflection of uncertainty regarding the stability of the Western financial systems. Today, ETFs hold about 1,800 tons of gold, for an investment worth about USD 70 billion.

Allocations to gold investments are estimated at about 1% of the total value of capital under management in the global economy. The value of all of the world's gold mines accounts for only about USD 300 billion of this amount (which largely equals the oil company Exxon Mobil's market capitalisation). How demand from financial investors will develop will depend on the future economic developments, but we believe that investors will want to increase their gold investments in the years ahead in order to diversify their savings.

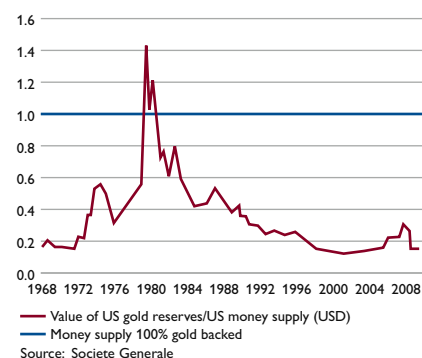
### Why do we think that gold prices may rise even further?

The global economy is in a challenging situation right now. In the Western world, the indebtedness of both the private and the public sectors is too high. This has created a new savings behaviour in the private sector, and governments around the

world have reacted by implementing major stimulus packages that have led to further indebtedness. Several countries, especially the USA and the UK, have introduced so-called quantitative easing, meaning that their central banks buy securities, such as government bonds, mortgage bonds or other structured products, in order to assist the funding of government budgets and to relieve the banking sector's imbalancing problems. This is an advanced way of printing more money, and it weakens the central banks own balance sheets. At the end of the day, the central bank's balance sheets are what guarantee the value of the money supply.

Throughout most of history, the means of exchange in our economies has in one way or another been related to gold or other metals, such as silver. Only at the collapse of the Bretton Woods system in 1971 did we adopt a system based on so-called Fiat Money, ie. a legal tender guaranteed by a government but with no underlying physical security. Since then, and particularly since the early 1990s, the money supply has risen sharply in all Western economies. While previously there was a 1:1 coverage of the money supply, the US gold reserves amount to only 15% of the money supply (the value of the gold at Fort Knox is USD 320 billion, whereas the money supply in dollars is USD 2,000 billion). This is quite remarkable, but the ratio of gold reserves to the money supply during the latest goldmania in 1980, when gold rose to USD 850/oz., was 1.4, as shown in the chart below. Parity between US gold reserves and the money supply would imply a gold price of USD 7,600/oz. This is not a forecast, but rather an indication that the price of gold can go up by quite a bit before it would again become unreasonably expensive.

**US: Goldreserves and money supply**



## How the economy develops from here will be crucial for the price of gold

One scenario for economic developments in the Western world is sustained weak or zero growth and a continuation of the public sector debt crisis, as exemplified by Greece. The European Central Bank (ECB) has been forced into buying government bonds, but so far it has refrained from actual debt monetisation. In case the European debt crisis worsens, the ECB will likely be forced to introduce quantitative easing or, in popular terms, to print more money, which would be very positive for gold.

On the other hand, if the business cycle develops closer to normal, central banks will most likely be very reluctant to hike their lending rates, because the economies are highly debt-ridden and will not be able to honour excessive interest payments. The risk of the banking system becoming weaker is also a case for higher interest rates. Eventually, expectations will be for higher inflation, which is also positive for gold.

In all circumstances, it would be reasonable to assume that monetary policy in Europe will be very lenient and that fiscal policies will be tightened; which is precisely what we are witnessing right now.

The biggest threat to gold is rising interest rates. The reason is that gold does not generate a cash flow (there are no interest payments for holding gold), so gold loses its attraction with rising interest on alternative placements. We believe that there is very little likelihood of interest rates in the Western world rising above 2% in real terms (ie. net of inflation). Historically, this is what gold has been able to withstand without depreciating in value.

Overall, it is difficult to envision a scenario in which demand for gold will decline within the foreseeable future. First of all, no Western currency appears to be strong enough due to the very lenient monetary policies. The large public sector deficits will eventually result in rising inflation, and this will contribute to financial investors allocating more of their investments to gold. At the same time, emerging market economies, which have historically had a big appetite for gold, will experience a huge increase in wealth. Finally, we still have not seen the mining companies react to the high gold prices by producing more gold, which to us is an indication that gold is not just lying in the ground waiting to be



extracted. Producing gold is difficult, and in particular it is difficult to increase production sharply.

For that reason, in our Carnegie Worldwide/Global Equities fund, we have invested in the world's second-largest gold mining company, Newmont. Newmont does not offer high production growth, but the company will be able to maintain a stable annual output of around 5.5 million oz. for many years to come and to generate a substantial free cash flow for the benefit of its shareholders. In our European Equities and East Europe funds we have held stakes in Petropavlovsk, a gold mining company operating mines in eastern Russia, for quite some time. The company has some of the lowest costs among the world's mining companies and will be able to double its gold output over the next three to four years, giving it a very unique position among gold mining companies. Finally, East Europe has invested in Anatolia Minerals, a Canadian mining company operating gold mines in Turkey. This company is described in further detail in the report on the East Europe fund.





# Carnegie Worldwide

## Summary

Carnegie Worldwide/Global Equities outperformed equity markets in general, recording a negative return of 10.4% (USD), compared with the negative 12.1% (USD) return of the global equity markets. The powerful economic recovery that began in March 2009 lost momentum, creating an opportunity for some of the more stable stocks to perform well, especially in June. Year to date the fund's performance is consistent with the general equity market performance.

Strong focus on the possibility of another global recession produced negative undertones during the quarter. We acknowledge the large debt issues, especially in the Western world, but we believe that emerging markets headed by China will help to suppress or perhaps even pull us out of this growth downturn later in the year. Given this environment, our focus is on the individual stocks in our portfolio, as greater macro uncertainty also leads to above-normal fluctuations for individual stocks.

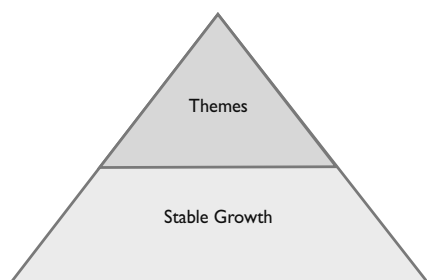
## Difficult to avoid the general market loss

The overall Q2 performance was a loss of 10.4% (USD). By comparison, the Morgan Stanley All Country World Index lost 12.1% (USD). This was another quarter characterised by great price fluctuations. We outperformed the market by a wide margin, especially towards the end of the quarter. Indian company HDFC and Nestlé were the largest contributors when taking position weighting into account. The top performers were newcomer Daimler and Apple, which gained 10% (USD) and 9% (USD) respectively. On the negative side, we suffered big losses on three positions: Monsanto, Transocean and Nokia. Monsanto fell due to still disappointing earnings and very competitive markets for the Round Up Division. As a subcontractor to BP, Transocean has unfortunately become involved in the oil spill in the Gulf of Mexico. This caused the stock to fall, and we sold it during the quarter. Nokia disappointed due to a lack of product launches and we also sold this stock during the quarter. Read more on this below.

## The fund's current investment strategy

Our investment strategy remains based on expectations of weak global economic growth. It is still imperative that the debts of Western economies are reduced from the current historical highs, regardless of the drastic initiatives by politicians to restore growth. They only serve to mitigate the effects of the general economic downturn. Political initiatives increase the risk of inflation long term.

Carnegie Worldwide has a high proportion of multinationals, which benefit from global growth driven by emerging markets, and the fund's US investments have moderate exposure to US consumer spending.



The indirect and direct sales exposure to emerging markets is at 40%, and we believe much of the sales and earnings growth will derive from these markets. We see strong growth in the so-called virtual, or parallel, universe, and accessibility to this world has become easier thanks to smartphones, which we expect will spread strongly over the next three to five years.

### Portfolio changes

During the quarter, we added Newmont Mining, one of the world's leading gold mining companies, to our portfolio. As explained in one of the feature articles of this quarterly report, we see a good potential for the price of gold to continue rising. We consider Newmont a stable gold producer with an attractive pricing. We have held a constructive view on the price of gold for some time, but gold stocks have been overpriced. Following an extended period of rising gold prices, gold stocks have begun to lose steam. Combined with the operational gearing inherent in a gold mining company, this has made several gold stocks attractive, including Newmont Mining.

We financed the purchase of Newmont Mining by selling Transocean and Nokia.

Transocean is the world's leading supplier of deepwater rigs. Largely all oil reserves outside of OPEC territories are located offshore. The major finds are made at vast ocean depths of 2–5 kilometres and require extremely advanced equipment. That is what makes Transocean's equipment so valuable. We expect deepwater oil exploration to continue. We also believe that being a shareholder of Transocean involves too much uncertainty; even at the present, lower share price. The uncertainty is rooted in the risk of future lawsuits against Transocean, especially from BP. In certain scenarios of the events in connection with the accident on 20 April 2010, Transocean may be held liable, and that is a risk we are not willing to take.

We take a positive long-term view of the growth prospects for the smartphone market. Looking for more exposure to this trend, we bought Nokia after an extended period of weakness, believing that the company would bring a powerful, mid-price smartphone product to the market. Unfortunately, Nokia has failed to meet this expectation. The company is under threat in the high-end segment by Apple, which is already in our portfolio, and at the low end by Chinese manufacturers using Android software. Google's Android software platform is a major threat to Nokia's proprietary software, facilitating access for new manufacturers, especially in emerging markets.

### Expectations for Carnegie Worldwide

Following a highly volatile spring season, summer will also be a turbulent period for the global equity markets. A lack of confidence as to economic developments in China, Europe and the USA has put a cap on equity prices. In the private sector, classical virtues such as more savings and less debt are the dominant factors. On the other hand, the public sector is trying to retain the position as the key growth driver all over the world. The balancing act may be successful if executed with political skill, but the net effect will be an extended period of weak global growth, initially with low inflation but with a risk of much higher inflation longer term. China will be the first to emerge from this crisis to the benefit of the entire world.

We have moderate expectations for the rest of 2010. We expect Carnegie Worldwide/Global Equities to outperform the general trend in global equity markets. We expect major, stable quality stocks to outperform in 2010, and we therefore maintain high exposure to this type of stock.

## Investment philosophy

Carnegie WorldWide is a Sub-Fund of 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 market with a moderate risk profile as measured by standard deviation. The aim is to have a portfolio's standard deviation level at or below that of the market.

Our experience in managing focused portfolios has taught us that a concentrated portfolio of 25 to 30 high conviction stock picks ensures a sufficiently high risk diversification. The fund endeavours to understand and capitalize on the trends of the future. Most importantly though is to be optimally prepared for the future with a sturdy portfolio of unique stock picks.

The fund invests in equities listed on global stock exchanges and has no geographical or sectorial restrictions.

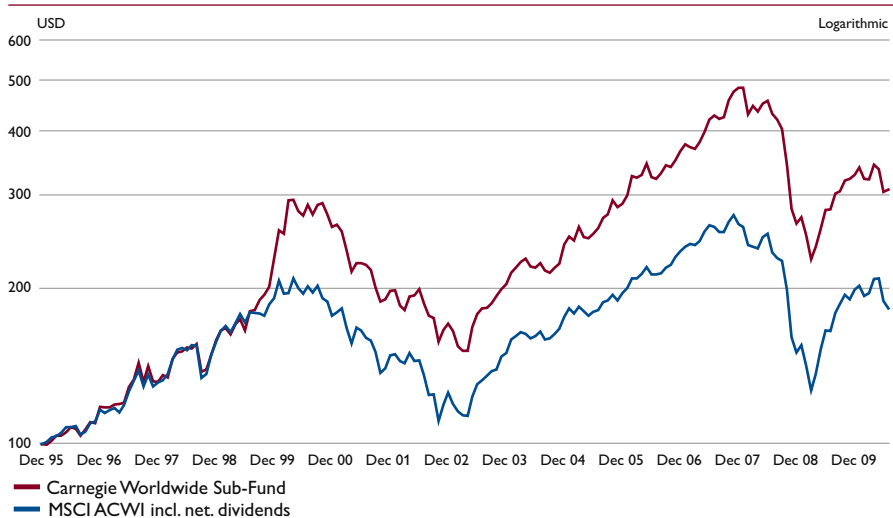
Key figures	30-Jun-10	31-Mar-10
NAV (1,000 USD)	2,383,168	2,755,438
NAV per share (USD)	61.8	68.97

ISIN	LU0086737722
Launch date:	15-Dec-95
Read more:	<a href="http://www.carnegieam.com/cw">www.carnegieam.com/cw</a>

Return/Excess return in %	1 year	3 years	5 years	10 years	Since launch
Return on Portfolio	9.3	-28.0	18.6	7.0	209.0
Return on Benchmark*	10.8	-30.2	0.8	-9.2	82.6
Active return (arithmetic)	-1.5	2.3	17.8	16.3	126.4

Risk	3 years	5 years	10 years	Since launch
SD Portfolio (%)	22.9	19.7	17.6	17.6
SD Benchmark (%)	22.9	18.8	17.0	16.3

## Investment Performance Graph (Indexed)



## Carnegie WorldWide as of 30 June 2010

	USA & Canada	UK & Ireland	Continental Europe	Japan	Pacific ex. Japan	Emerging Markets	Total	Benchmark*
<b>Energy</b>	Peabody 3.1				Sinopec 2.5		5.6	10.5
<b>Materials</b>	Monsanto 1.8 Newmont Mining 3.4		Holcim 4.8				10.0	8.2
<b>Industrials</b>	Praxair 4.1		ABB 2.8				6.9	10.5
<b>Consumer Discretionary</b>			Daimler 3.8				3.8	9.5
<b>Consumer Staples</b>	Lorillard 3.0	BAT 8.0 Diageo 2.6	Nestlé 8.5	Japan Tobacco 2.9			25.0	10.0
<b>Health Care</b>			Roche 4.1				4.1	9.0
<b>Financials</b>	Bank of America 2.7	Standard Chartered 3.4	Allianz 4.0		HDFC 7.2 ICBC 3.3 China Life 2.2		22.8	21.1
<b>Information Technology</b>	Apple 3.3 Cisco Systems 3.5 Google 3.7			Canon 3.0	Samsung Electronics 2.4		15.9	12.1
<b>Telecommunication</b>		Vodafone 2.6					2.6	4.8
<b>Utilities</b>							0.0	4.3
<b>Others</b>					Carnegie Asia 2.3	Carnegie East European 1.0	3.3	0.0
<b>Total</b>	28.6	16.6	28.0	5.9	19.9	1.0	100.0	-
<b>Benchmark*</b>	47.5	8.3	16.6	9.1	4.9	13.6	-	100.0

\* From 1.1.2010 the benchmark has been changed from MSCI World to MSCI All Country World Index incl. net. dividends. The number behind the name of the share states the percentage of the fund's holdings.



# Carnegie European Equity

## Summary

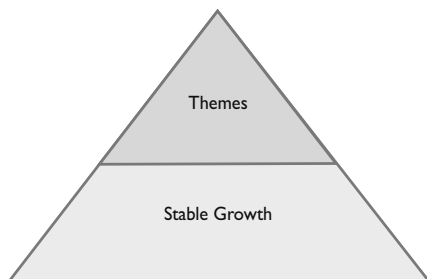
The fund's NAV fell by 2.0% (EUR) in Q2, 4.3 percentage points better than Morgan Stanley's Europe Index, bringing the fund's H1 return to 4.9% (EUR), whereas the benchmark index has lost 2.4% (EUR). The good performance was driven by the fund's stable growth stocks and commodity stock investments.

We still expect equity markets to fluctuate in 2010 until we get more assurance of the strength of the economic recovery in Europe and the rest of the world. The low level of interest rates and the weaker euro have a positive effect on economic growth in Europe, while the fiscal policy tightening has the opposite effect.

The overall weak demand for gas in Europe has made us sell Gazprom. We also sold Nokia after the company announced a profit warning and postponed product launches. Instead, we bought Temenos, one of Europe's most interesting software companies.

## Q2 performance

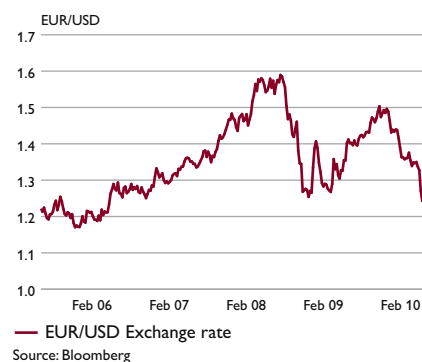
This was a quarter of fluctuating and falling markets, but the fund managed to limit the loss. The fund's NAV fell by 2.0% (EUR) in Q2, 4.3 percentage points better than Morgan Stanley's Europe Index, which lost 6.3% (EUR). This brought the fund's H1 return to 4.9% (EUR), whereas European markets have lost 2.4% (EUR). The strong performance was attributable to a number of the fund's stable growth stocks, as especially Novo Nordisk, Swedish Match and BAT all performed well. The gold mining company Petropavlovsk and ferrochrome manufacturer ENRC also performed well, whereas Nokia provided the biggest disappointment.



## The fund's current investment strategy

The major EU countries are tightening their economic policies in order to reduce their budget deficits. European politicians appear to be united on this which might suggest that the stimulus packages will be eliminated and that focus will be on reducing deficits and debt. This means major reductions in public expenditure and higher taxes. In the UK, reform of the public sector wage and pension system will be at the centre of attention, and the government will probably introduce a capital gains tax on house sales and a new tax on bank earnings. The banking sector will also be facing political opposition and a risk of increased regulation. As a result, the fund retains its very small exposure to the sector.

The public spending cuts will hurt, but they will not prevent public sector debt from continuing to rise. The UK budget deficit is astronomical at more than

**Exchange rate**

### Expectations for Carnegie European Equity

Our main scenario is still for equity markets to fluctuate in 2010 until we get more assurance of the strength of the economic recovery in Europe and globally.

The low level of interest rates and the weaker euro have a positive effect on economic growth in Europe, while the fiscal policy tightening has the opposite effect. This means that economic growth in Europe will most likely not rise above 1–2% in 2010 and 2011. Germany will be the locomotive, while it will be uphill for southern Europe and other countries

We are still identifying many attractive stocks. Especially the large stable growth companies carry an attractive price tag.

10% of GDP. Obviously the aim of the cuts is to avoid the debt trap that Greece is in. For many of the eurozone countries, this process is hampered by the fact that they are unable to devalue their currencies. Europe's underlying problem is that several countries have fallen hopelessly behind in terms of competitive strength; compared not only to low-cost countries such as China or India, but also to Germany and the high productivity growth the country has experienced during the past decade.

There are growing concerns that the widespread spending cuts will push Europe back into recession, as best illustrated by the recent severe weakening of the euro. On the other hand, the weak euro is a big help to Europe's exporters, which make up the core of the fund's investment strategy. Stable growth stocks account for about half of the portfolio. These are large multinationals, many of which have substantial exposure to emerging market growth. These companies have strong balance sheets and generate high, stable free cash flows. In fact, several of them are so financially sound that they can raise funding at the same or even at lower rates than their countries of domicile. The good news is that the companies are very attractively priced due to the lack of confidence in the global economy.

In addition to the core of stable growth companies, our portfolio consists of a number of investments in themes which we consider to have an attractive long-term potential. The largest themes are Emerging Markets and Infrastructure, each accounting for just over 10% of the portfolio. We expect both Asia and Latin America to sustain their strong economic growth. Major infrastructure investments and rising incomes for the growing middle class are important drivers in both regions.

### Portfolio changes

The weak demand for gas and power in Europe has made us sell Gazprom. Longer term, we are also a bit concerned as to whether the minority shareholders will receive their share of the profit considering Gazprom's enormous investment programme which will soak up most of the company's future earnings.

We sold Nokia after the company announced a profit warning and postponed product launches. Unfortunately, our expectations that Nokia would stage a comeback by launching a competitive mid-priced smartphone did not materialise. We bought the stock to gain exposure to the sharply increasing penetration of smartphones worldwide, but unfortunately, there is a realistic long-term risk that Nokia will not benefit sufficiently from this trend. Nokia is facing severe challenges due to threats from both the high-end (Apple and others) and the low-end segments (Android-based phones, especially in emerging markets).

Instead, we bought Temenos, one of Europe's most interesting software companies. Based in Switzerland, this company has developed software that is used by more than 1,000 banks all over the world. Temenos' core product enhances their customers' earnings by strongly reducing development and maintenance costs of in-house systems. We believe that Temenos stands a good chance of lifting its sales to new and existing customers.

# Carnegie European Equity

## Investment philosophy

Carnegie European Equity 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 Dec. 20, 2002.

The investment objective of the fund is to achieve long-term capital growth exceeding the return of the European market with a moderate risk profile as measured by standard deviation. The aim is to have a portfolio's standard deviation level at or below that of the market. The fund invests in equities listed on European and Pan-European stock exchanges and has no sectorial limitations. The fund's experienced and dedicated portfolio management decision team works closely together in an open environment together with the portfolio managers of the other sub-funds.

The portfolio consists of selective investments in companies which have their principal activities in the European countries, including selectively and opportunistically those outside the Euro-zone.

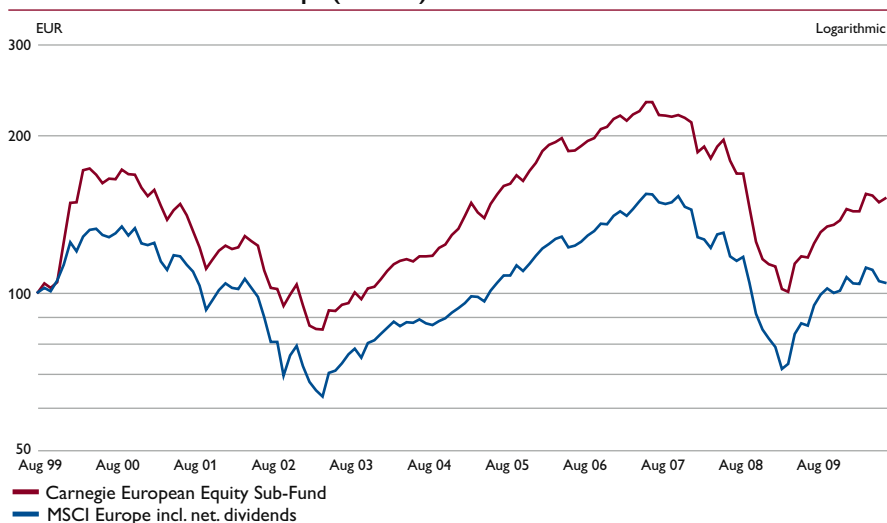
Key figures	30-Jun-10	31-Mar-10
NAV (1,000 EUR)	44,952	55,113
NAV per share (EUR)	15.21	15.52

ISIN	LU0093943974
Launch date:	2-Aug-99
Read more:	<a href="http://www.carnegieam.com/eu">www.carnegieam.com/eu</a>

Return/Excess return in %	1 year	3 years	5 years	10 years	Since launch
Return on Portfolio	30.1	-34.9	-1.8	-8.5	52.1
Return on Benchmark*	21.0	-32.4	0.2	-18.2	4.5
Active return (arithmetic)	9.1	-2.5	-2.0	9.7	47.6

Risk	3 years	5 years	10 years	Since launch
SD Portfolio (%)	21.1	17.9	17.0	18.6
SD Benchmark (%)	20.6	17.3	17.2	17.2

## Investment Performance Graph (Indexed)



## Carnegie European Equity as of 30 June 2010

	Nordic countries	UK & Ireland	Central Europe	Southern Europe	Eastern Europe	Total	Benchmark*
<b>Energy</b>		BG Group 3.9 Tullow Oil 2.6				6.5	9.9
<b>Materials</b>		Petropavlovsk 5.2	Holcim 4.4 Syngenta 2.8		ENRC 3.0	15.4	9.6
<b>Industrials</b>	DSV 4.5		Siemens 3.8 Linde 2.1	Prismian 2.0		12.4	10.5
<b>Consumer Discretionary</b>						0.0	8.2
<b>Consumer Staples</b>	Swedish Match 5.3	BAT 6.9 Diageo 2.7	Nestlé 7.2	Jeronimo Martins 4.7 Ebro Puleva 5.2		32.0	13.2
<b>Health Care</b>	Novo Nordisk 4.3		Roche 2.7			7.0	10.8
<b>Financials</b>		Standard Chartered 3.2 Prudential 2.4	Allianz 3.7 Zurich Financial Services 4.2		Garanti Bank 2.9	16.4	22.6
<b>Information Technology</b>			SAP 2.8 Temenos 2.7			5.5	2.9
<b>Telecommunication</b>		Vodafone 4.8				4.8	6.7
<b>Utilities</b>						0.0	5.6
<b>Others</b>						0.0	0.0
<b>Total</b>	14.1	31.7	36.4	11.9	5.9	100.0	-
<b>Benchmark*</b>	9.0	33.6	46.6	10.8	0.0	-	100.0

\* The benchmark is MSCI Europe incl. net. dividends.

The number behind the name of the share states the percentage of the fund's holdings.



## Carnegie East European

### Summary

The imbalances of the Western world have yet to be addressed, creating uncertainty regarding economic trends going forward. In any circumstance, the Western economies will be facing growth prospects for many years to come. On the other hand, most emerging markets have made it through the financial crisis in good shape, although certain economies had to make some severe adjustments, especially in Central and Eastern Europe. Growth has now recovered to healthy levels in the most important countries of Eastern Europe, including Russia and Turkey which are expected to see 5–7% growth this year. The negative influence from the West is the main source of uncertainty. In light of the surging prices seen since the trough in 2009, we have only moderate expectations for the portfolio return. We have weeded out some of the weaker companies in the portfolio during the past couple of quarters, focusing instead on strong and liquid companies that we believe will be able to endure another recession for the Western economies.

We strongly believe that the emerging economies will catch a second wind and that Eastern Europe remains an attractive region for long-term investors, because its economies and the companies with exposure to the region are set to outgrow companies in Europe and the USA by a wide margin.

### Hard times for eastern European equity markets

After a year of surging prices, the global equity markets fell on hard times in Q2 and a large majority of markets suffered a set-back. The background was uncertainty about the economic recovery in the USA, debt problems in Europe and concern about the effects of the tightened economic policies in China. Carnegie East European lost 11.8% (USD) while the benchmark dropped 18.5% (USD). Year to date, the Carnegie East European has lost 3.6% (USD), compared with the benchmark's loss of 13.4% (USD).

Reasons for the fund's decent performance include the fact that the fund has virtually no positions in Poland, Hungary or the Czech Republic, all markets that have been relatively hard hit by the problems in Western Europe, and a number of good investments in companies such as Russian railway operator Globaltrans, which has attributed positively to performance since we added the position to the portfolio in 2009. In addition, we added gold mining company Anatolia Minerals in Q2 (see below) which also gained during the quarter. Finally, Petropavlovsk continued to outperform, driven by the rising price of gold and confidence that the company can create value for its shareholders by developing its iron ore resources. The only really negative performer of the quarter was Regal Petroleum, which fell sharply due to production difficulties and made us sell the stock.

### The fund's current investment strategy

During the past few quarters, the fund has adjusted its investments in a slightly more thematic direction, and the illiquid stocks have more or less all been sold. The structure of the portfolio can briefly be described as exposure to domestic demand in Russia and Turkey, demand for commodities from emerging markets and investments in gold mining companies used to safeguard against continued financial instability. Please see the feature article for more on this.

Given the presence of good stocks at attractive prices, we retain our high investment weighting in Turkey and Russia. The fund will retain its limited exposure to Central Europe 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.

### Portfolio changes

A number of not so liquid stocks were sold during Q2: Black Earth Farming, East Capital Financials Fund, A&D Pharma, BPT Secura and Regal Petroleum. We also sold BIM and Comstar.

### Expectations for Carnegie East European

There is a lot of uncertainty as to whether the global economy is on the road to recovery or if the Western world is headed for another recession. Given the surging prices seen since the trough in 2009 and the current signs of weakness in the global equity markets, we have moderate expectations for the eastern European equity markets in the short term. With Turkey and Russia as the exceptions, most equity markets are no longer cheap, unless growth surprises strongly to the upside. We therefore expect substantial price fluctuations in the months ahead.

We consider the East European markets to be attractively priced for long-term investors.

Our goal is that the fund's focused investment style will help the fund outperform the market.

During the quarter, the fund invested in Anatolia Minerals, a gold mining company registered in Canada which owns the Copler gold mine in central Turkey. The mine is scheduled for production start-up in Q4 2010, and we expect it to produce 175,000 oz of gold per year on production costs of around USD 300/oz. At the current price of gold of around USD 1,200/oz., this would mean that the company will generate an operating cash flow of around USD 150 million per year. Given its market cap of USD 750 million, Anatolia is one of the lowest-priced gold mining companies in the world.

The fund also invested in Tyrkie Sinai Kalkinma Bankasi (TSKB), a privately-owned investment and development bank. TSKB offers long-term financing to SMEs as well as infrastructural investments in Turkey. The bank generally raises funding through multilateral organisations such as the World Bank and the European Investment Bank, giving its access to lower financing costs. Over the years, TSKB has enjoyed a very good credit rating, and combined with government guarantees for part of its loan portfolio this has helped the bank to stay virtually clear of bad debts. Despite being well-capitalised, the company still provides a 20% return on equity. The stock is trading a P/NAV of 1, which we believe is much too low.

Finally, we bought the Hungarian oil company MOL, because we expect the healthy demand to lead to rising refining margins, especially for diesel, which is one of that company's core products. Also, MOL has taken a stake in Croatian oil company INA, gaining exposure to the growing oil production of Croatia and Syria. Finally, the company holds oil licenses in northern Iraq in fields that we strongly expect will perform very well over the next couple of years and which could transform MOL from being mainly a refining company into an integrated oil company. This potential is not reflected in the share price which indicates a P/E of 7 on its 2011 earnings.

## Investment philosophy

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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.

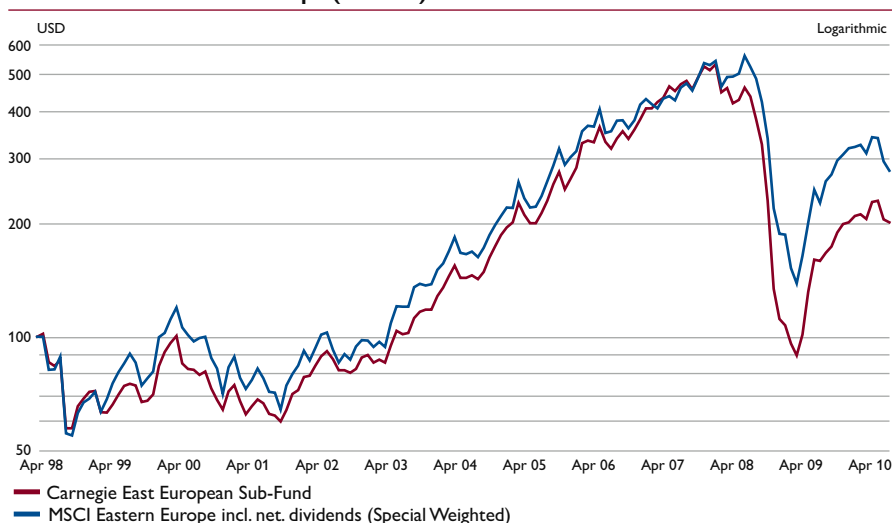
Key figures	30-Jun-10	31-Mar-10
NAV (1,000 USD)	29,542	36,149
NAV per share (USD)	40.46	45.85

ISIN	LU0086737482
Launch date:	1-Apr-98
Read more:	<a href="http://www.carnegieam.com/east">www.carnegieam.com/east</a>

Return/Excess return in %	1 year	3 years	5 years	10 years	Since launch
Return on Portfolio	27.0	-57.2	-5.5	148.4	102.3
Return on Benchmark*	21.9	-39.9	17.0	186.1	177.9
Active return (arithmetic)	5.1	-17.3	-22.6	-37.7	-75.6

Risk	3 years	5 years	10 years	Since launch
SD Portfolio (%)	49.0	41.3	32.5	33.8
SD Benchmark (%)	43.9	37.7	32.5	35.0

## Investment Performance Graph (Indexed)



## Carnegie East European as of 30 June 2010

	Hungary	Czech	Poland	Russia	Other	Total	Benchmark*
<b>Energy</b>	MOL Hungarian Oil and Gas 2.8			Gazprom ADR 8.5 EOS Russia 4.2 LUK Oil 4.2	KazMunaiGas 3.1 Dragon Oil 6.8	29.6	39.9
<b>Materials</b>				Petropavlovsk 10.3 Uralkali GDR 3.4	Uranium One 1.6 ENRC 5.2 Anatolia Minerals Development 4.4	24.9	10.3
<b>Industrials</b>			Budimex 1.8	GlobalTrans 4.7	Reysas Logistics 3.1	9.6	0.4
<b>Consumer Discretionary</b>						0.0	1.1
<b>Consumer Staples</b>				Magnit GDR 5.2		5.2	2.0
<b>Health Care</b>						0.0	1.6
<b>Financials</b>					Bank of Georgia 4.7 East Capital Baltic Property 1.6 Halyk Savings Bank of Kazakhstan 2.4 Sinpas Gayrimenkul 3.7 Turkiye Garanti Bankasi 4.1 Turkiye Sinai Kalkinma Bankasi 2.9	19.4	27.2
<b>Information Technology</b>						0.0	0.7
<b>Telecommunication</b>				North-West Telecom 3.0 Sibirtelecom 3.1 Mobile Telesystems ADR 5.2		11.3	8.1
<b>Utilities</b>						0.0	8.7
<b>Others</b>						0.0	0.0
<b>Total</b>	2.8	0.0	1.8	51.8	43.6	100.0	-
<b>Benchmark*</b>	7.7	7.5	25.0	59.8	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 MSCI incl. net. dividends. The number behind the name of the share states the percentage of the fund's holdings.

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