

# Citadele Eastern European Bond Fund

January 2012



**Citadele**

# Citadele Eastern European Bond Fund

## Fund Facts (January, 2012)

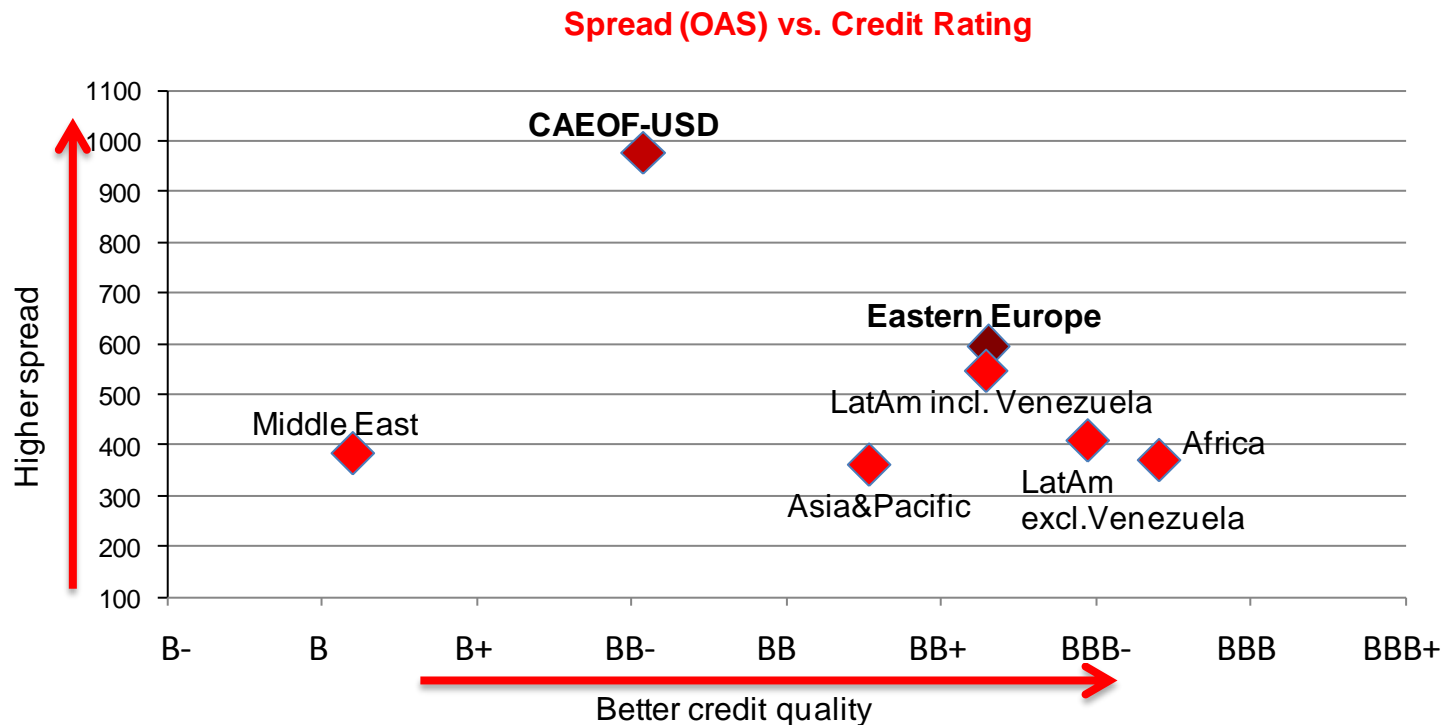
- Name of the investment fund
- Name of the sub-fund
- Morningstar Rating™
- Inception date
- Base currency
- Net assets, in base currency
- ISIN
- Fees
- Compliance status
- Valuation, redemption period
- Recommended investment horizon
- Investment manager

Citadele Eastern European Fixed Income Funds	
Citadele Eastern European Bond Fund - USD	Citadele Eastern European Bond Fund - EUR
★★★★★	NM*
March 2003	October 2003*
USD	EUR
USD 19.9m	EUR 11.0m
LV0000400125	LV0000400174
Load fee – 1%, management fee – 1.5% p.a.	
Open-end UCITS III	
Daily, redemption T+1	
A minimum of 3 years	
„Citadele Asset Management” IMJSC	

# Citadele Eastern European Bond Fund

## Why Eastern European bonds?

- High-yielding segment within the global emerging markets universe
- Eastern Europe is persistently undervalued to its actual credit ratings
- The Fund (CAEOF-USD) has a significant spread pick-up at a competitive credit quality

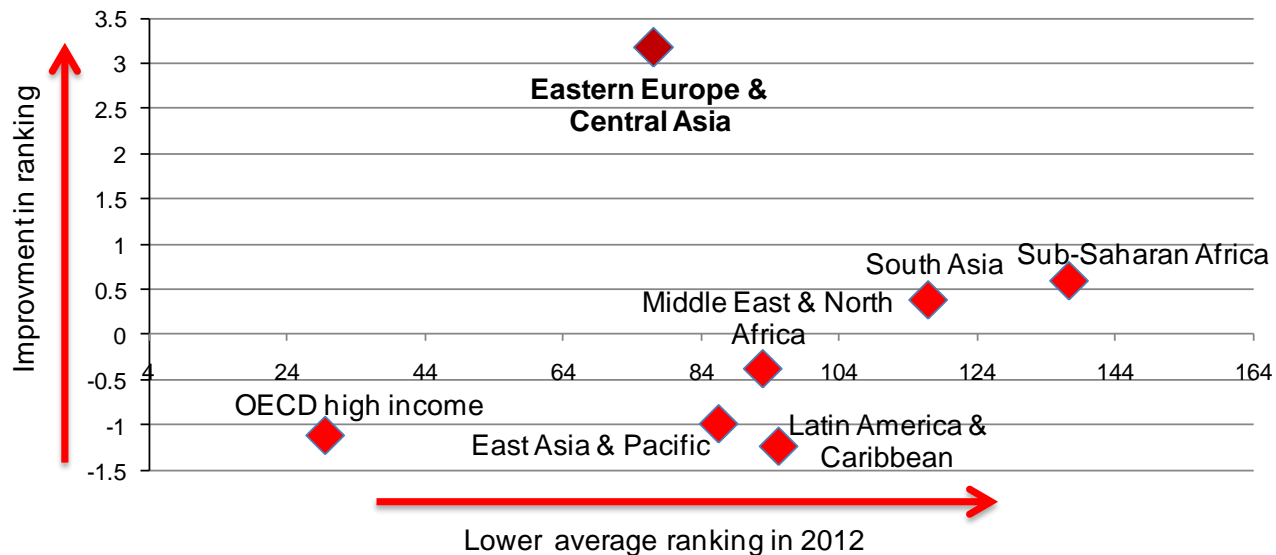


# Citadele Eastern European Bond Fund

## Why Eastern European bonds?

- The World Bank's "Doing Business report" provides objective measures of business regulations and their enforcement across 183 economies
- The region of Eastern Europe & Central Asia demonstrated the most significant improvement in ranking on average in 2012 and is ranked the highest across other emerging markets

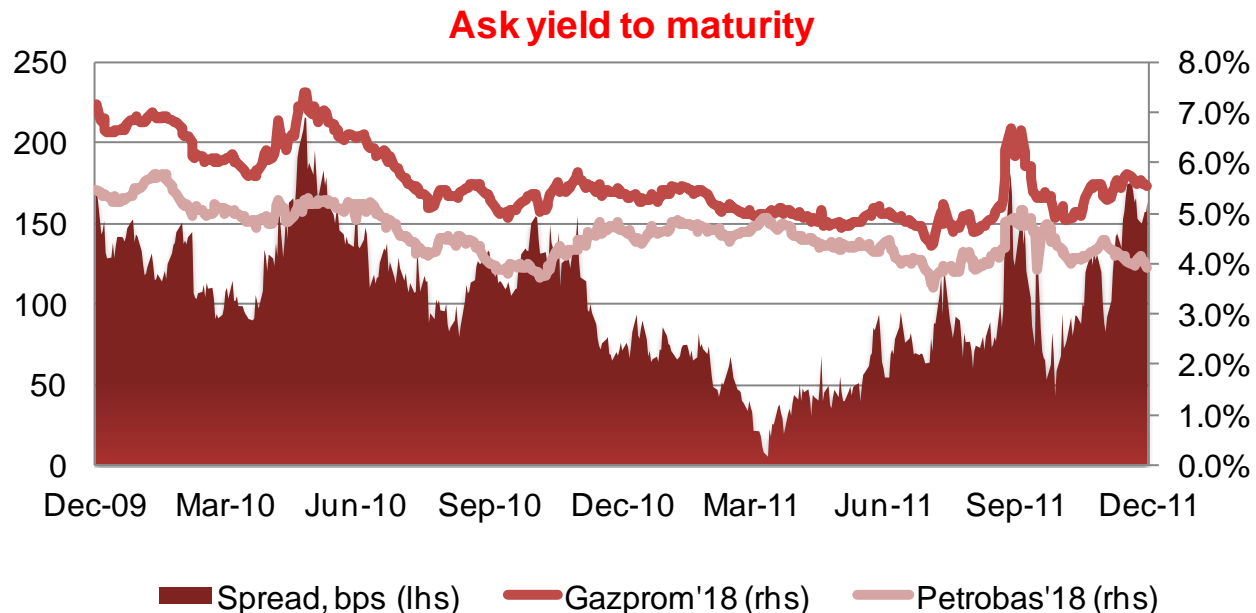
Average Ease of Doing Business ranking and change in 2012 by regions



# Citadele Eastern European Bond Fund

## Why Eastern European bonds?

- Region's corporates constantly undervalued to their EM peers
  - E.g., Gazprom Eurobonds yield more than comparable Petrobras bonds, despite comparative fundamentals and the same BBB composite credit rating



# Citadele Eastern European Bond Fund

## Why Citadele Asset Management?

- Leading investment specialist and wealth management service provider in the Baltics
- Solid track record in mutual fund management (over 10 years):
  - Eastern European fixed income and balanced funds
  - Equity funds in Russia, the Baltics, Ukraine
- Local presence in the Baltics, Belarus, Russia, Ukraine, Lithuania, Azerbaijan and Kazakhstan
- Regular research team support and feedback (incl. weekly overviews)
- Open architecture platform allows to focus on client needs
- 100% subsidiary of Citadele banka (main shareholders 75% Latvian Privatization Agency, 25% EBRD)

**Citadele**

Eastern Europe Fixed Income: Weekly Overview  
23 – 29 August, 2010

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- Russia's fixed income market led 0.35% during the week, while spreads widened by 130p (JPM RUB)
- Metals & mining was the only sector with positive performance within the RUB10 index
- Ukraine was flat, while Kazakhstan dropped in line with Russia (TKX indices)
- The Economy Ministry of Russia improve GDP growth forecasts for 2010-2013
- Naftogaz to settle gas dispute with its former gas trading intermediary RosUkrEnergy
- Corporate news: EuroChem, Alliance Oil, Stanbank, MTS, BCC, KMG, AvtoVAZ
- Our positive view of the market for Q3 at the start of previous month has proven correct. Many security prices are already at their all-time highs and in our opinion correction risks once market participants return from beaches to their trading desks are increasing. We thus suggest more conservative approach to investing in Eastern European debt over near term, while over medium-to-longer term we are still positive.

**General news**

Deputy of the Minister of Economics of Russia revealed that seasonally adjusted GDP in July dropped by 0.3% m/m, thus affirming weakening recovery trend of the country's economy. Nevertheless, the Ministry has just updated its macro forecasts for the next three years, where GDP growth for 2010 was improved to 4.2% from previous estimate of 3.4%, and for 2012 to +3.5% from 3.0%. However accelerated inflation is expected to return earlier, thus forecasts for 2010 was revised from 6-7% to 7-7.5% and for 2011 from 5.5-6.5% to 5-7%.

Naftogaz finally developed a scheme to settle its gas dispute with the former gas trading intermediary RosUkrEnergy (RUE). As a result of the scheme, Naftogaz will secure gas supplies for the heating season, while RUE (50/50 owned by Gazprom and local oil giant Orlen Finance) will lock a profit of around \$200m. In our view, the news that Naftogaz is going to request the ruling by Ukrainian Arbitration Court is positive for the company's eurozone and Ukrainian exorbitant market in general. Naftogaz is likely to receive another equity injection by the State to make the necessary payments to RUE, thus we believe the news is neutral for Naftogaz equities.

**Corporate news**

During the previous week a reporting season of second quarter 2010 financial results started in CIS. On Monday, Russia's fertilizer manufacturer EuroChem released credit-neutral 1H10 financial results. Its top line and EBITDA increased by 24% and 25% y-o-y, respectively, and higher selling prices and volumes. EuroChem's leverage, calculated as total debt to annualized 1H10 EBITDA, is moderate at 1.6x. Besides, recently the company has demonstrated good access to long-term debt markets as it secured two ECA-backed facilities, attracted \$200m credit line from Nordea and issued note bonds, thus mitigating liquidity risks. Following results, yield of its Eurobond with maturity in 2012 increased by roughly 20bp or in line with the market. Overall, the bond seems slightly undervalued and currently we have a neutral view on it, as new Eurobond supply is possible, in our view.

On Tuesday, mid-size Russian oil producer, Alliance Oil Company published weaker than expected 1H10 financial results. The company's revenues jumped by almost 50% y-o-y, while EBITDA increased by just 2% y-o-y. Alliance Oil Company's deteriorating profitability was offset due to 50c/y planned maintenance works at its Kizilarskaya refinery, since the company was forced to buy gasoline from third parties at market prices. According to the management, next planned works are scheduled for Q210, thus implying relatively stronger Q210. Due to the ongoing modernization of Kizilarskaya refinery and upstream investments, the company's leverage is increasing and at the end of 1H10 reached 2.4x (total debt/1M EBITDA) and 1.6x (net debt/1M EBITDA). Moreover, after the reporting date it finally signed \$100m long-term loan from VEB and placed \$100m equivalent of cable bonds. Hence, it is

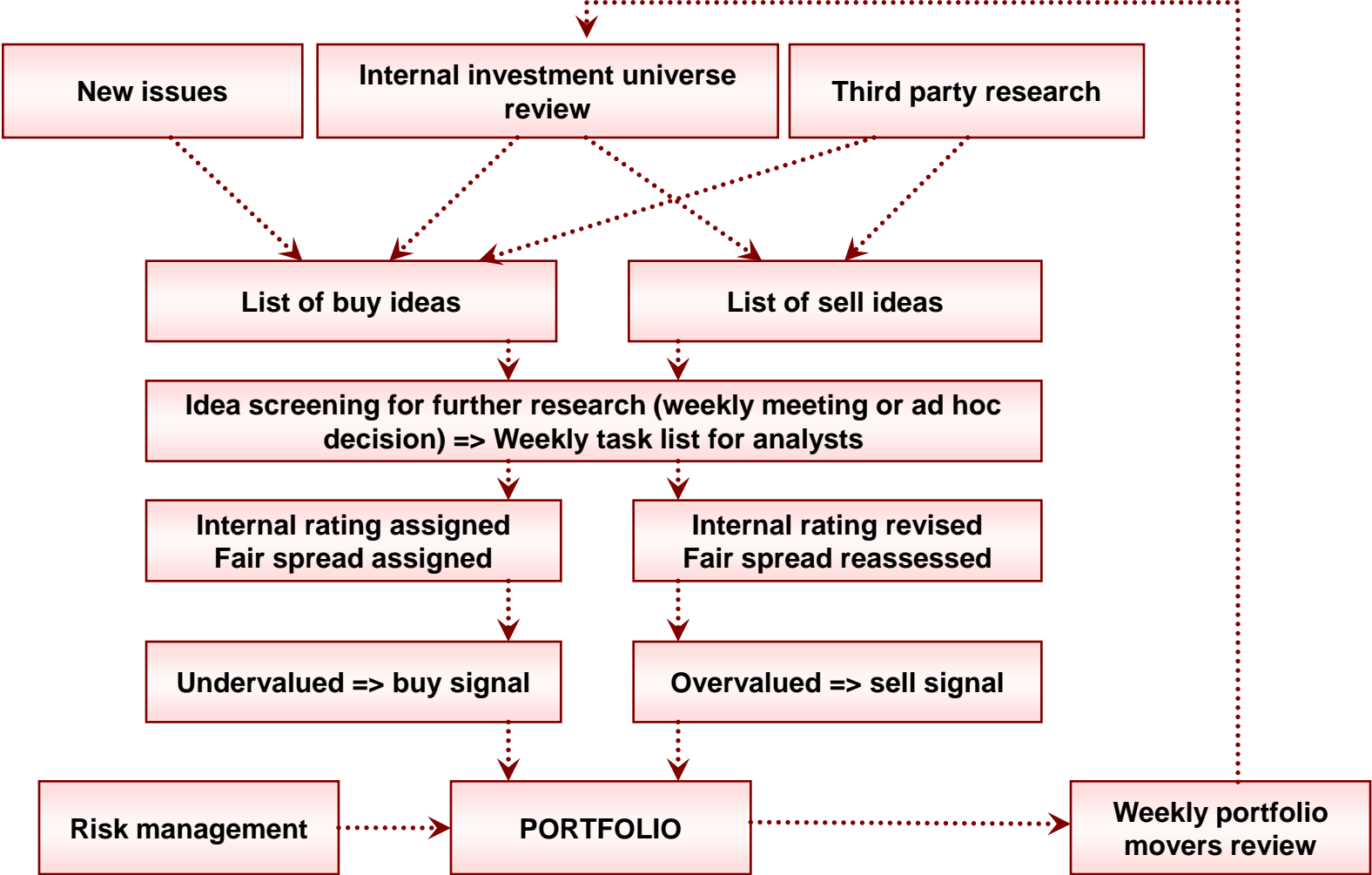
# Citadele Eastern European Bond Fund

## Investment Philosophy

- We are dedicated long-term investors who believe in fundamental value and exercise a disciplined team-based approach
- We believe we can add value through local expertise and on-the-ground presence
- We are not benchmark-driven, but focus on intensive in-house research and bottom-up value-based security selection
- In addition to conducting company-specific research, we formulate an in-house view on global markets through combination of in-house and third-party research, in order to identify global trends affecting companies and sectors in the region
- We normally take a long-term perspective with a relatively low portfolio turnover

# Citadele Eastern European Bond Fund

## Investment Process



# Citadele Eastern European Bond Fund

## Investment Process – Overview

- Continuous generation of buy and sell ideas
- An organized meeting of portfolio managers and the analyst at least every week
  - Monitor portfolio changes, including largest movers and portfolio security valuation scores
  - Develop the weekly work plan for further in-depth analysis
  - Research results are normally reported to PMs when ready, but not researched ideas are to remain open post weekly meeting
- Ad hoc adjustments to the analysis work plan are allowed (swift new issues, attractive price offers, corporate action announcements, etc.)
  - Yet the incremental amount of work amount needs to be realistic not to completely overrule the weekly plan
- Openness and constant communication within the team are the building blocks of the investment process, but the previously mentioned elements are purposefully added to ensure discipline
- Our investment process is bottom-up, benchmark unaware, and aimed to add value in the medium to long term
- We possess flexibility to evaluate any investment opportunity from the benchmark-size bonds to niche trades, e.g. local currency debt, distressed debt and active trading triggered by news flow



# Citadele Eastern European Bond Fund

## Investment Process – Valuation

- The backbone of our instrument valuation is the internal credit rating assigned to each issuer based on internal credit research
- Fair spreads for the particular rating/duration combination are determined based on aggregate market data (compiled by maturity/duration and credit ratings) and market peers
- Comparison of actual and fair spreads on an instrument level leads to a clear buy and sell discipline
- This provides a systematic and flexible approach, allowing us to identify undervaluation in a multitude of situations (high grade, high yield, distressed, etc.)
- Investments on local currency debt markets are predominately prompted by a positive view on the currency itself, while the choice of a particular instrument is a result of desired credit and interest rate risk combination

# Citadele Eastern European Bond Fund

## Investment Process – Examples

- MOL Hungarian Oil and Gas Eurobond with maturity in 2017
  - Bought on the secondary market, when undervalued to internal credit rating (valuation score 0.6x)
  - Sold when reached near intrinsic value (valuation score > 0.9x)
  - Annualized total return +23%
- Niche trade – UAH-denominated VTB Ukraine bond
  - Purchase supported by strong credit quality and a positive view on UAH, YTM 16%
  - Annualized total return +25%, both due to bond performance and UAH appreciation

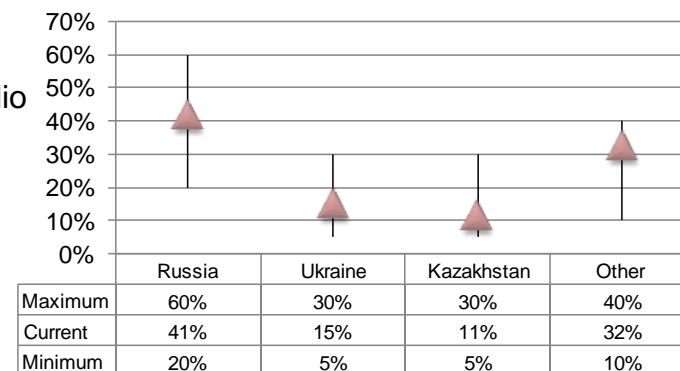


# Citadele Eastern European Bond Fund

## Risk Management

- Ex-ante – within the investment team
  - Credit risk at instrument and aggregate portfolio level based on internal and external credit scores
  - Duration risk on a portfolio level
- Ex-post – company management, Fund’s investment committee
  - Independent monthly report for the company management:
    - Return analysis – absolute and versus benchmark
    - Risk analysis – changes in maturity split, rating structure, country/currency/sector allocations
    - Any observations and worries are thoroughly discussed with the portfolio managers
  - Each transaction authorized for settlement by all investment committee members
- Investment restrictions and internal guidelines
  - Standard UCITS III restrictions apply
  - Currency risk management guidelines:
    - The Fund is focused on hard currency Eurobonds, but local currency debt allowed to max of 30%
    - In Eurobonds, all non-USD risk is normally fully hedged at all times. Max active position is +/-5%
    - In local currency debt, currency risk vs. USD is normally not hedged
  - Additional internal policies:
    - No single issuer credit risk over 5%
    - Country allocation guidelines are set

Country allocation



# Citadele Eastern European Bond Fund

## Portfolio Breakdown as of 31 December 2011

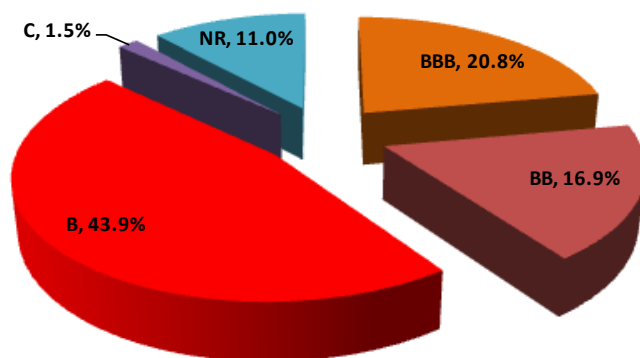
### Top 10 Holdings

Issuer	Maturity	Weight
Russia Government	Mar-30	4.95%
Alfa Bank Ukraine	Jul-12	4.32%
Eurasian Development Bank	Sep-14	4.28%
VTB bank	Jun-35	4.19%
Bank CenterCredit	Jan-14	4.08%
KazakhGold Group Ltd	Nov-13	3.99%
Citadele Banka SC	Feb-12	3.98%
Gazprom OAO	Jul-14	3.91%
EuroChem Mineral & Chemical Co	Mar-12	3.87%
Alfa Bank Russia	Mar-15	3.86%
<b>Total</b>		<b>41.44%</b>

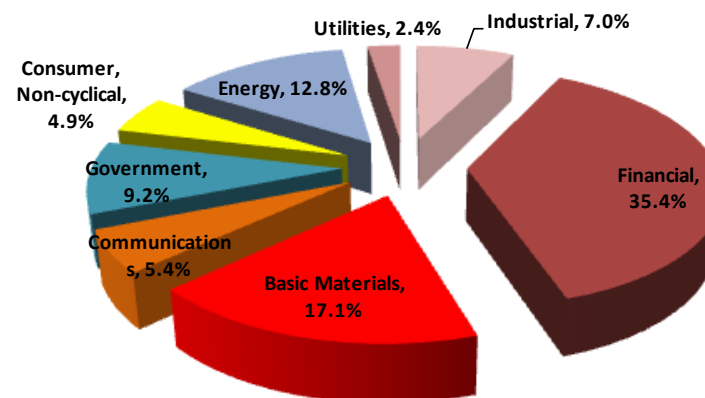
### Portfolio characteristics

Bonds Average Duration	2.3
Bonds Average Yield to Maturity	10.1%
Number of issuers	33
Number of securities	35
Average weight of an issuer	2.9%
Average weight of one security	2.7%
Weighted-average rating	Ba3

### Portfolio breakdown by rating



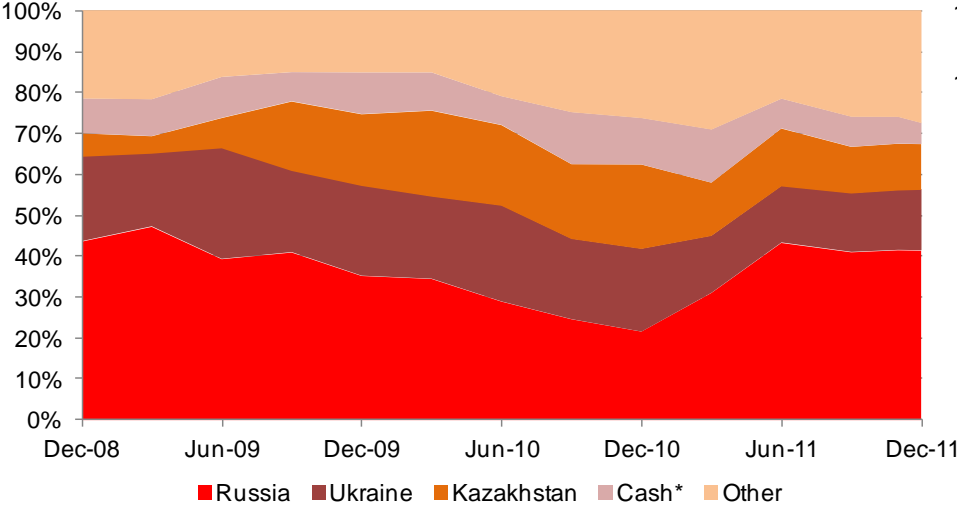
### Portfolio breakdown by industry



# Citadele Eastern European Bond Fund

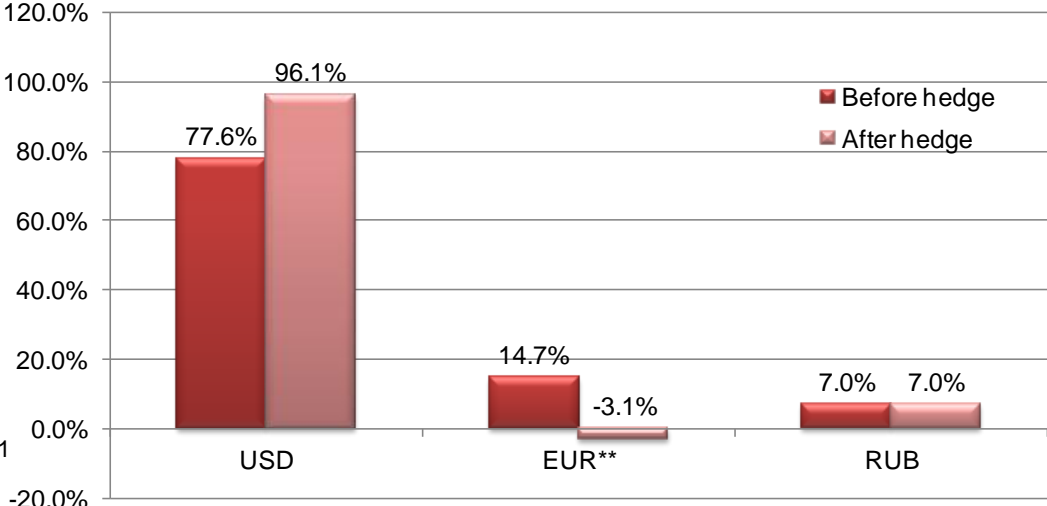
Portfolio Breakdown as of 31 December, 2011

Portfolio breakdown by country



\* - cash represents cash and net derivative position

Portfolio breakdown by currency



\*\* - negative exposure to match the indirect exposure to EUR inherent in the RUB

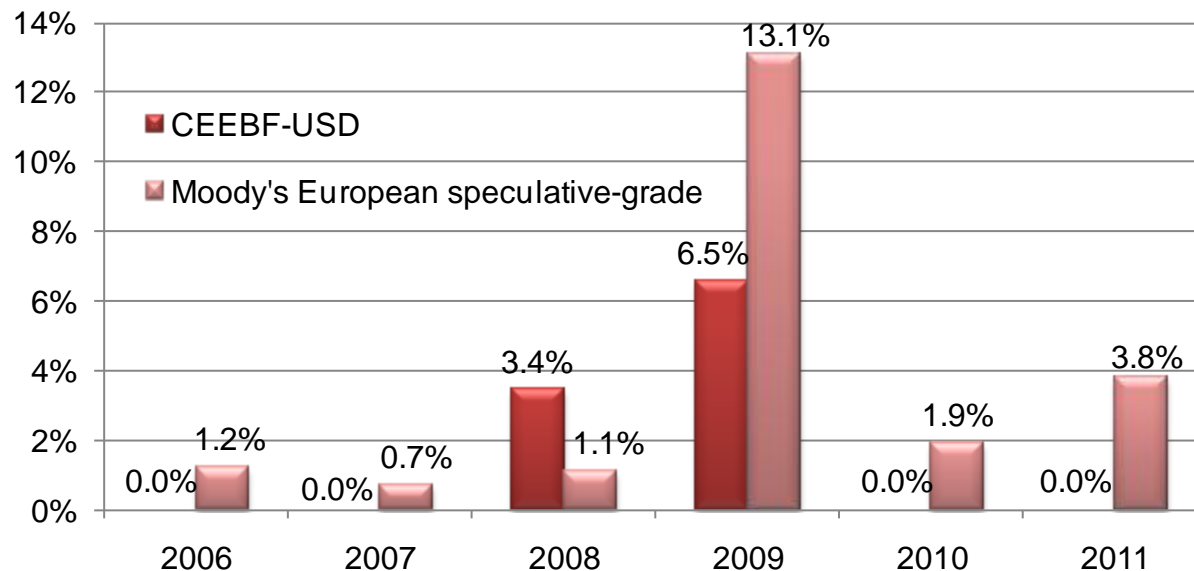


# Citadele Eastern European Bond Fund

## Default Rate – Fund vs. Market

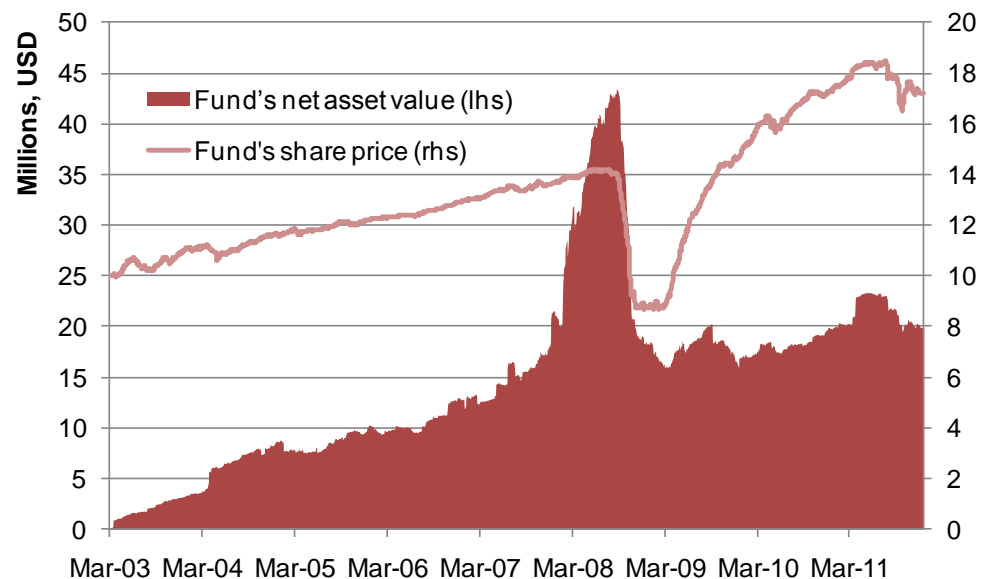
- The Fund has lower losses from issuer default than the market overall
  - Fund's default rate calculated as initial amount divided by the Fund's average net assets in a given year
  - European speculative-grade bond default rates collected by Moody's
  - No aggregate data available for Eastern Europe – the market default rate is possibly understated

### Volume-weighted default rates, %



# Citadele Eastern European Bond Fund

## Portfolio Performance as of 30 December 2011



Ratios	1 month <sup>*</sup>	3 months <sup>*</sup>	6 months <sup>*</sup>	1 year <sup>*</sup>	3 years <sup>**</sup>	5 years <sup>**</sup>	Since inception <sup>**</sup>
Total Return	-0.46%	2.56%	-5.95%	-0.52%	25.48%	5.91%	6.37%
Standard Deviation				7.96	13.98	16.26	13.12
Sharpe Ratio				0.24	1.81	0.31	0.39
Sortino Ratio				0.36	5.03	0.45	0.50

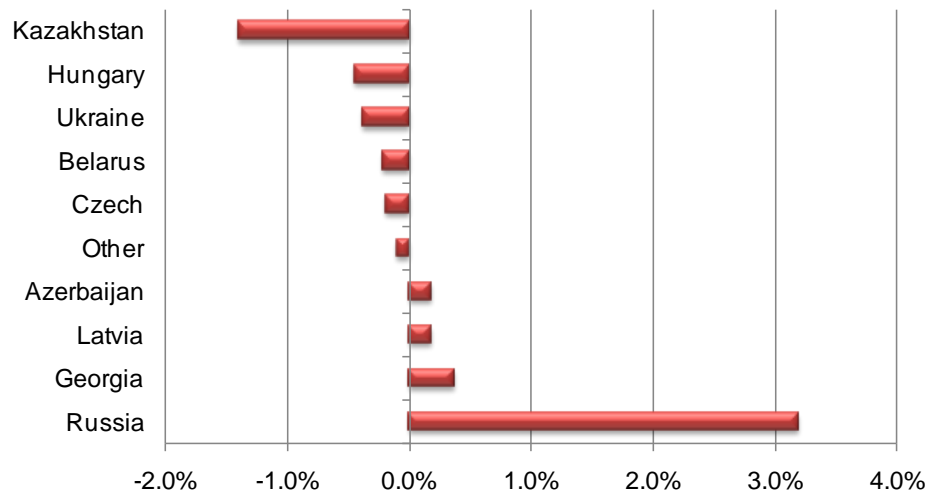
<sup>\*</sup> - the performance is calculated as the fund share price change compared to its value in the start of the defined period

<sup>\*\*</sup> - annualized fund performance is calculated, using ACT/365 method

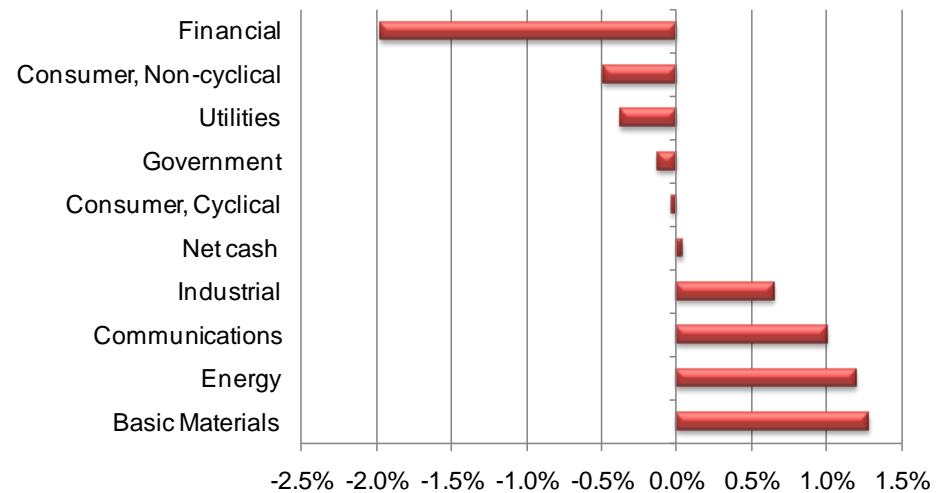
# Citadele Eastern European Bond Fund

## Return Contribution in 2011

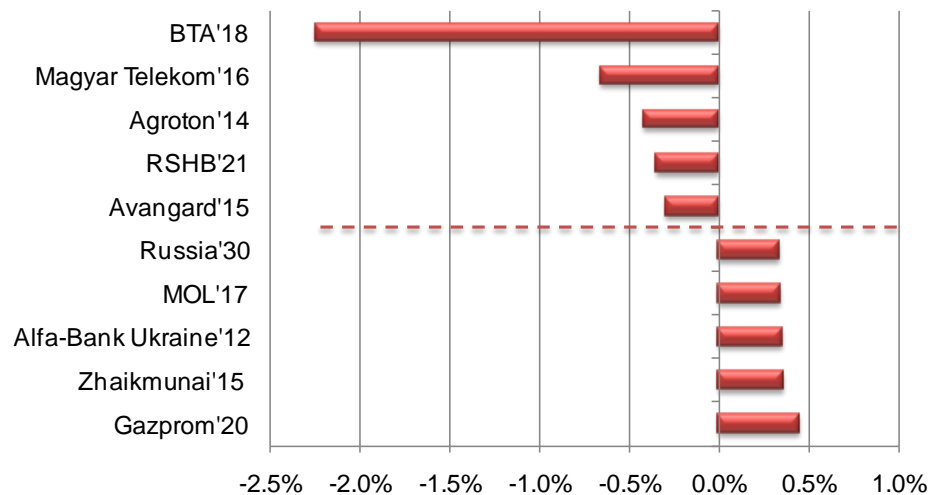
Return contributors by country



Return contributors by industry



Top/bottom contributors

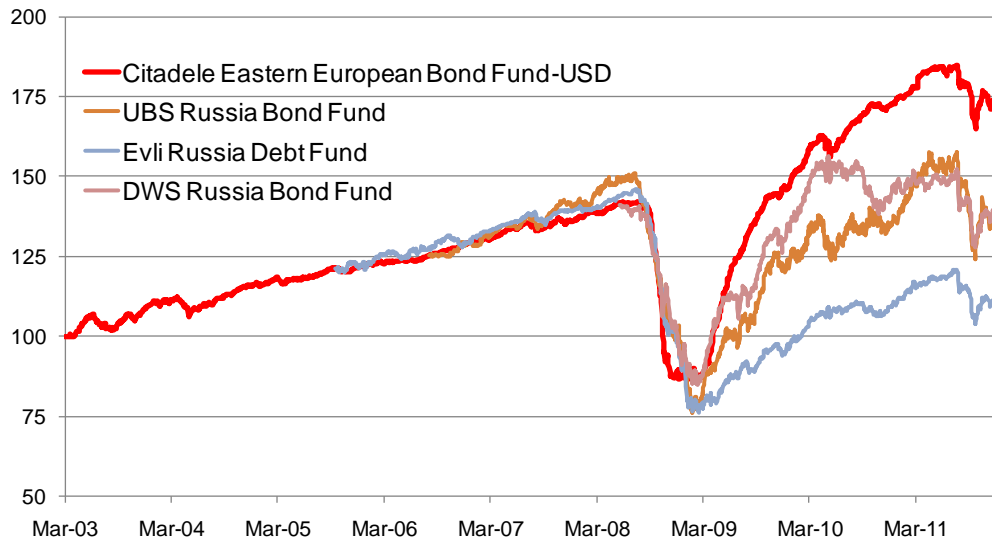


# Citadele Eastern European Bond Fund

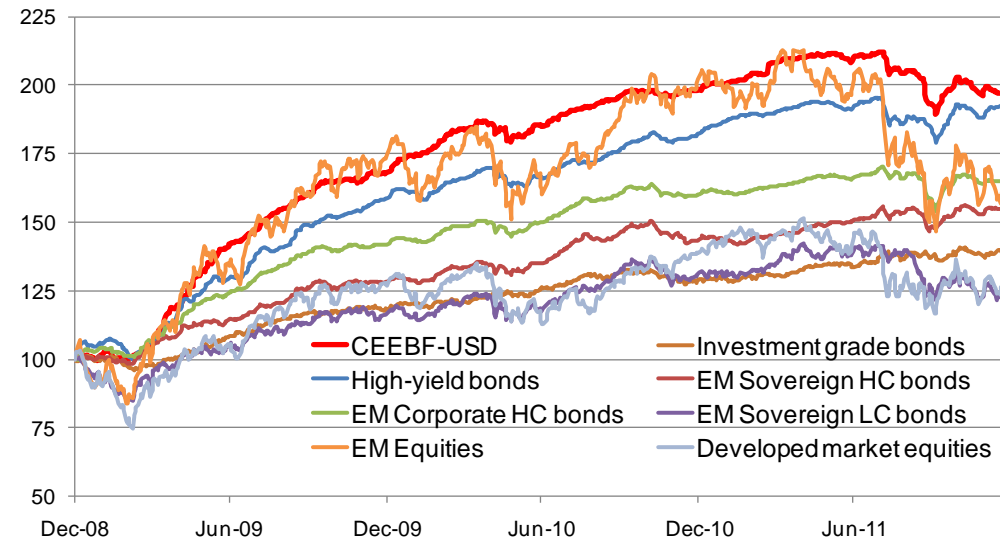
## Relative Performance

- Outstanding long-term track record comparing to closest peers:
  - UBS Russia Bond Fund - invests in government and corporate bonds in Russia and CIS
  - Evli Russia Debt Fund – mostly invests in ruble-denominated corporate bonds
  - DWS Russia Bond Fund – invests in ruble-denominated government and corporate bonds
- Despite global turmoil, the Fund has demonstrated exceptional performance and lower volatility compared to various asset classes during the last 3 years

Relative comparison to peers since inception



Relative 3Y performance across asset classes



# Citadele Eastern European Bond Fund

## Eastern European Debt Markets Outlook

- Emerging market debt appears to be in a “sweet spot” at the start of 2012:
  - Continuing loose monetary policies by the world’s major central banks
  - Economic growth in the developed world is hovering
- Emerging market growth momentum still exceeds that of the developed world
- Fiscal metrics of many, if not most, emerging market economies are still better than in the developed world, even accounting for the higher cyclicity of these economies
- Due to developed market debt problems EM debt appears to have finally become a truly stand-alone asset class. Fund inflows have been and are expected to remain strong
- Supply/demand structure expected to be supportive in 2012
- Valuations are not stretched, especially in EM corporate debt, where the actual average spread corresponds to a two-notch lower rating than actual despite the still positive rating cycle
- We expect Eastern Europe to perform in line with other EM regions in H1’2012 as the more attractive valuation is outweighed by the proximity to “old” Europe and political concerns
- Within Eastern Europe, several Kazakhstan’s quasi-sovereigns provide rather attractive valuation compared to peers
- Several Central European opportunities continue to be attractive relative to their CIS comparables. We continue to operate on a fully bottom-up valuation basis in the Central Europe’s market



# Citadele Eastern European Bond Fund

## Fund Management Team



**Andris Kotans, CFA  
Senior Fund Manager**  
Mr. Andris Kotans is the portfolio manager of all Citadele AM fixed income investment funds. Mr. Kotans joined Citadele Asset Management in October 2007.

Prior to that, he was a portfolio manager at Hansa Investment Funds managing Central and Eastern European local currency bonds. Mr. Kotans is a CFA charter holder. He has received a Master's degree in economics from Central European University in Budapest and his Bachelor's degree in economics and business administration from Stockholm School of Economics in Riga.



**Edgars Lao, CFA  
Fund Manager**  
Mr. Edgars Lao is the manager of Citadele Eastern European Fixed Income Funds, he is also responsible for credit analysis of corporate bond issuers.

Mr. Lao joined Citadele Asset Management in December 2007. Prior to that he acted as a credit risk analyst with Latvijas Krajbanka. Mr. Lao holds a Bachelor's degree in BA from the School of Business and Finance and currently is acquiring his MBA from Riga Business School. He is also a CFA charter holder.



**Kaspars Locmelis,  
Fixed Income Analyst**  
Mr. Kaspars Locmelis is responsible for credit analysis of corporate bond issuers. Mr. Locmelis has been with Citadele Asset Management since July 2011.

He has received his Bachelor's degree in BA from the School of Business and Finance. Currently he is acquiring his MBA from Riga Business School.

# Eastern Europe Region Highlights



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# Eastern European Region

## In Focus

- Our definition of Eastern Europe includes the following countries:

Albania, Belarus, Bosnia and Herzegovina, Bulgaria, Croatia, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Republic of Moldova, Romania, Russia, Serbia, Montenegro, Slovakia, Slovenia, The former Yugoslav Rep. Of Macedonia, Turkey, Ukraine, Kazakhstan, Azerbaijan, Georgia

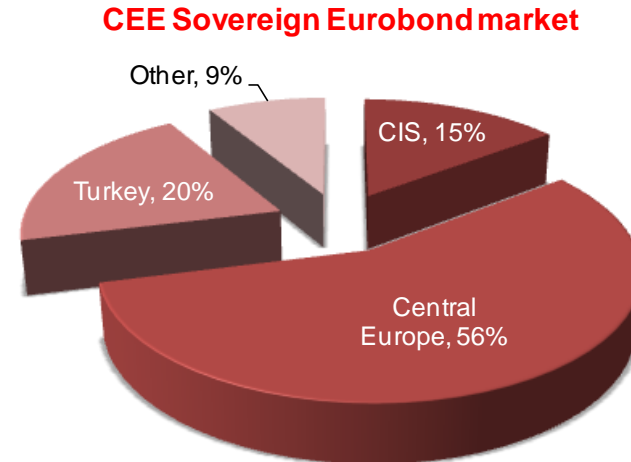
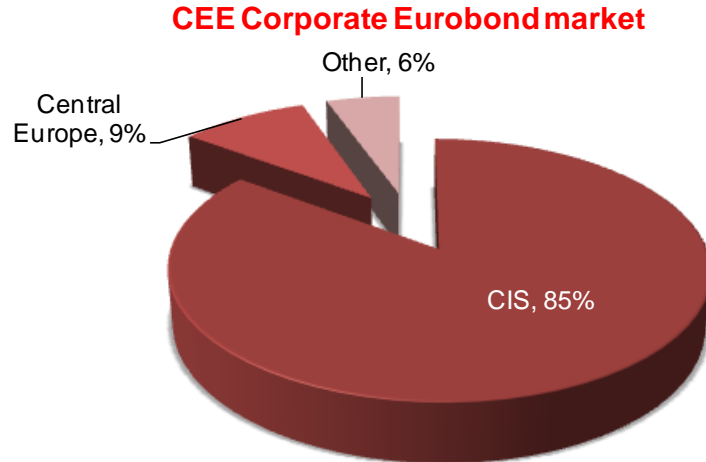
- Population: 400 million
- Territory: 19 million km<sup>2</sup>
- Nominal GDP of EUR 3,564 billion
- Strong earnings growth as a result of economic growth
- Improving corporate governance
- Developing market infrastructure to participate in economic development
- Our primary focus on CIS corporate debt due to generally more appealing risk/reward opportunities



# Eastern European Region

## In Focus

- CEE Eurobond markets can be divided in three segments: CIS, Central Europe and others. In the corporate space CIS is the dominant market, while in the sovereign space Central Europe dominates
- The regional convergence story resulted in shrinking sovereign spreads in the past, which, in our view, is to be followed by corporate spread contraction in the future
- Bearing in mind our expertise, we primarily focus on the corporate segment of the CIS Eurobond market, but we do not disregard select opportunities in the rest of the region



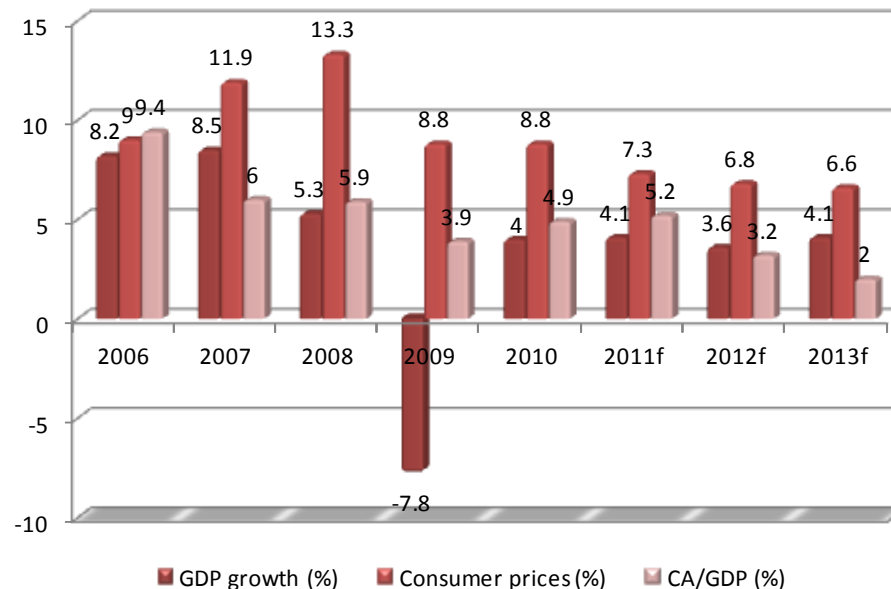
# Eastern European Region

## Biggest Eastern European Economies – A Closer Look

### Russia



- The economy performed well in 2011 amid robust recovery of domestic demand, however it is expected to weaken in 2012 and limit the overall growth
- Following the parliamentary elections on 4 December 2011, the opposition's activities intensified and several mass protest took place across the country reminding investors about embedded political risks
- Tensions on the political front are expected to remain until March 2012, when the presidential elections take place. As a result, around USD 74bn of private capital has left the country during Jan-Nov and triggered ruble depreciation



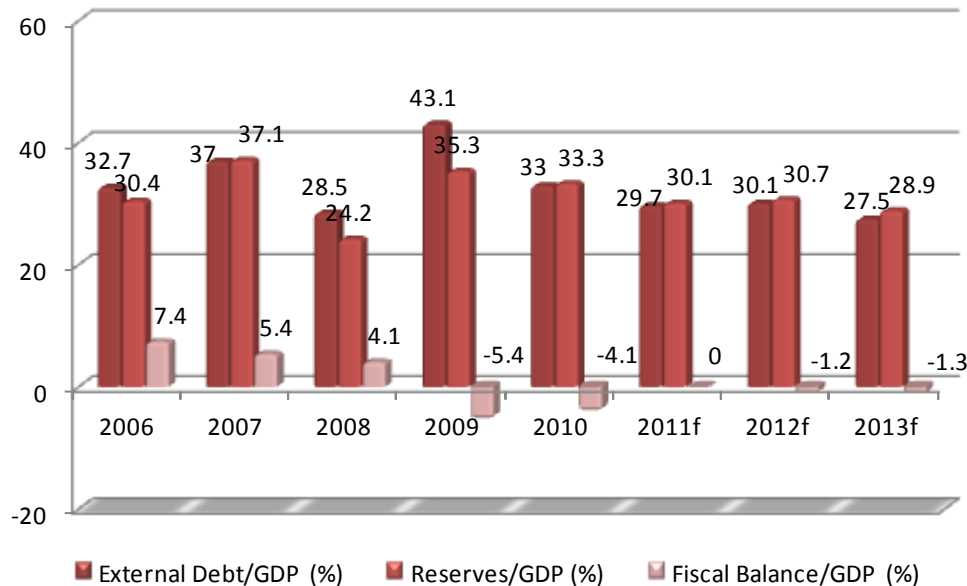
# Eastern European Region

## Biggest Eastern European Economies – A Closer Look

### Russia



- The country's balance sheet remains very strong with external debt of USD 527bn vs. USD 517bn in country's international reserves. Moreover, the government accounts for only 6% of the total external debt
- The budget is expected to break-even this year on higher average oil price, while high non-oil deficit (around 10% of GDP in 2011) implies that Russia remains vulnerable to oil price swings
- Russian sovereign is rated investment-grade by all rating agencies



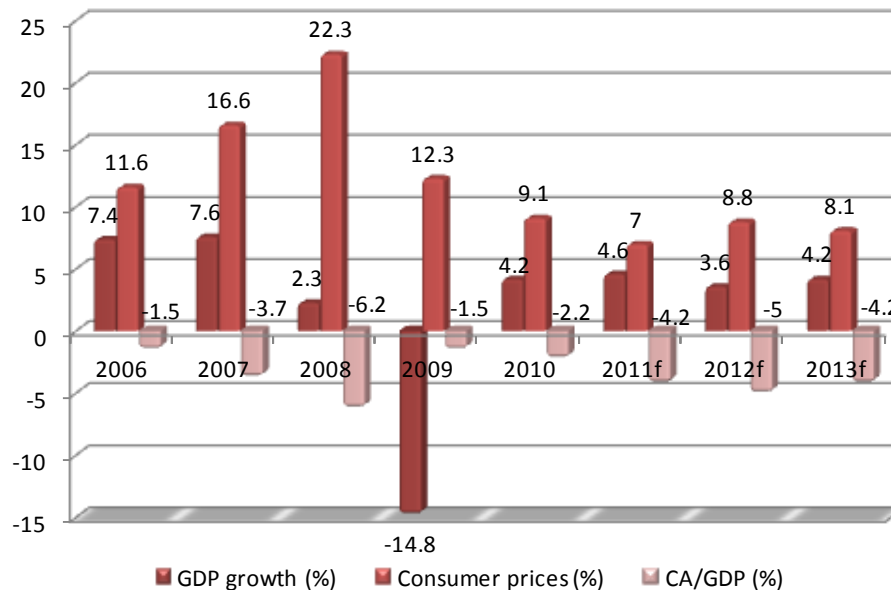
# Eastern European Region

## Biggest Eastern European Economies – A Closer Look

### Ukraine



- Due to the lack of financing from IMF, pressure on UAH exchange rate still persist, while government is reluctant to increase tariffs on gas in the light of upcoming elections. At the same time banking sector remains currency mismatch
- Deal with Gazprom towards new gas agreement is still the subject to further negotiations as budget for 2012 is based on gas price of around \$416



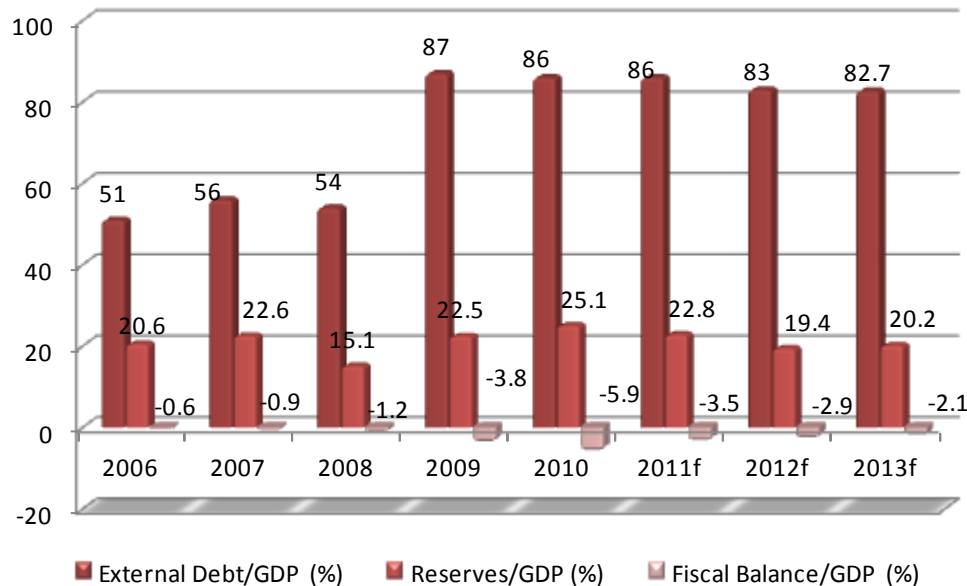
# Eastern European Region

## Biggest Eastern European Economies – A Closer Look

### Ukraine



- Ukrainian may face liquidity problems as external debt stands at USD 120 bn and fiscal balance remains negative, while external debt markets are relatively closed due to contracting market conditions
- Relatively undiversified economy and slump in steel prices resulted to 4 consecutive months of slowing growth rate at the end of 2011, which puts pressure on further growth in deteriorating environment



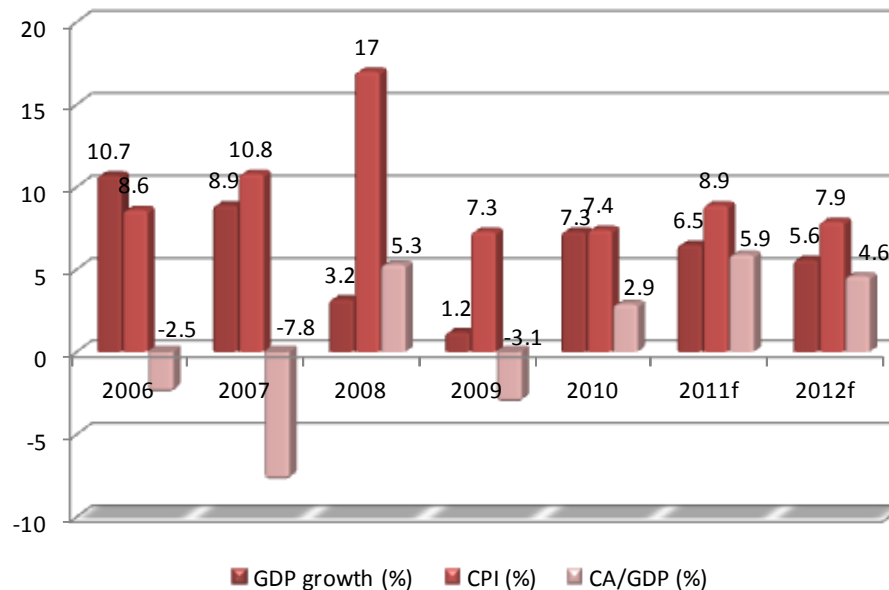
# Eastern European Region

## Biggest Eastern European Economies – A Closer Look

### Kazakhstan



- The real economy has recovered from global financial recession
- Rating upgrades by several agencies stresses out the strengthening of balance sheet as well as expansion of the oil and mining sectors, underpinned by a significant increase in production output
- Economy remains dependent to further commodity price fluctuations, although oil price above \$100 allows to generate substantial positive external cash flows



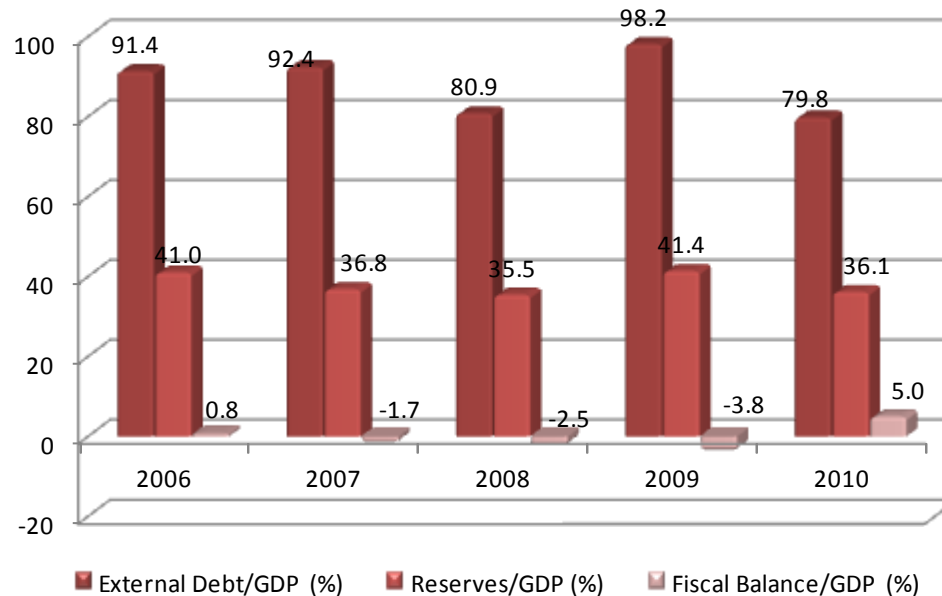
# Eastern European Region

## Biggest Eastern European Economies – A Closer Look

### Kazakhstan



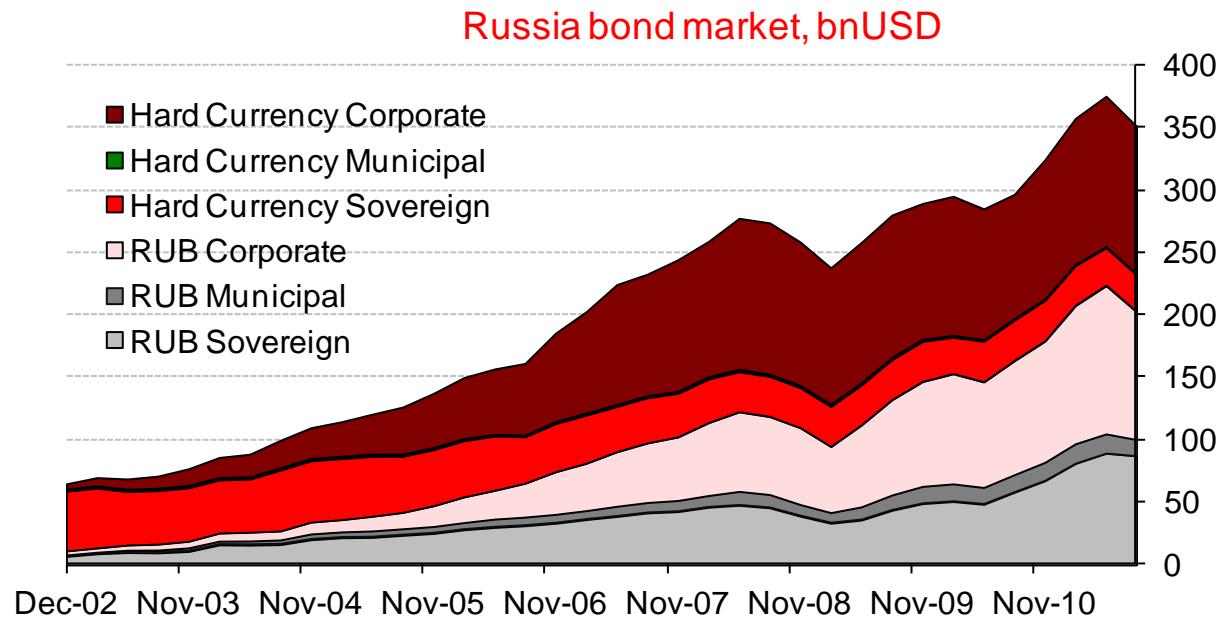
- Relatively riskier banking sector struggles to substantially improve asset quality as loans over 90 days overdue represent 31%, although upcoming law reform will allow certain tax benefits, which may trigger some write-offs
- BTA story is on the list and proposed second debt restructuring process in 1H12 may determine market sentiment towards high yielding sector Eurobonds



# Eastern European Region

## Russian Debt Markets Overview

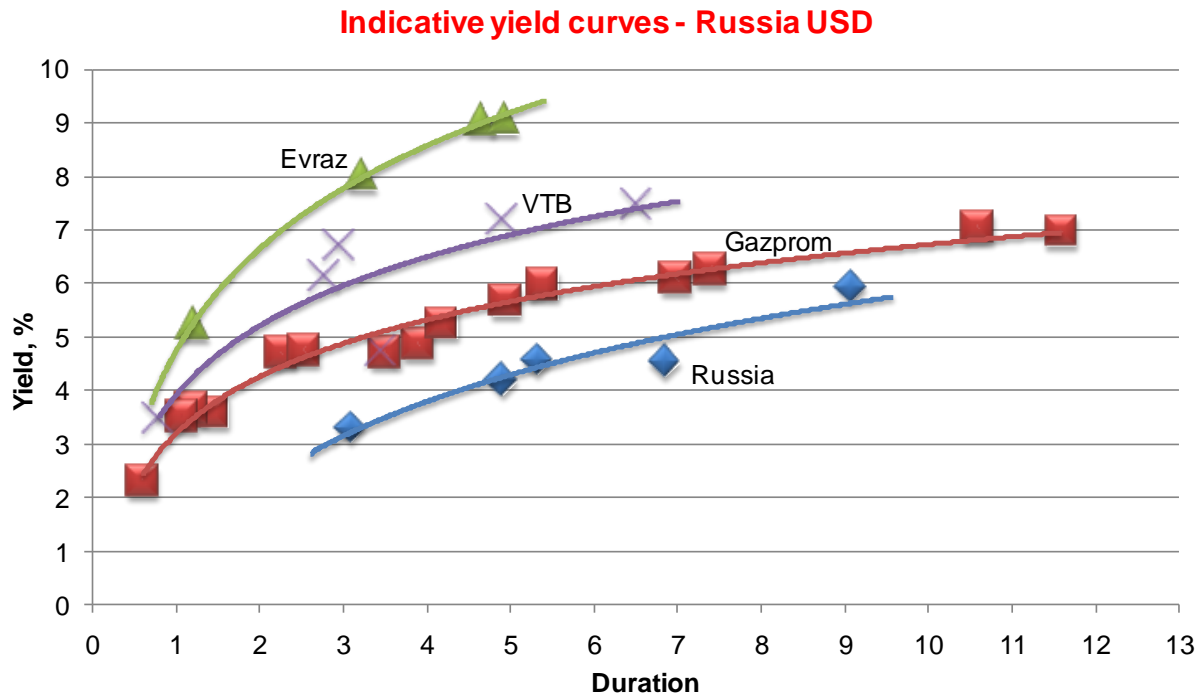
- Russia has by far the largest bond market in the CEE
- Since the beginning of 2009, rapid revival of new issuance is observed
- The overall outstanding bond market has reached USD 350bn by nominal



# Eastern European Region

## Russian Debt Markets Overview

- Steepness of yield curves remains elevated
- Premium for additional credit risk has recently increased
- Average yield for qualitative issues varies in the range of 2 – 9%, while opportunities in double digit yields are still rare

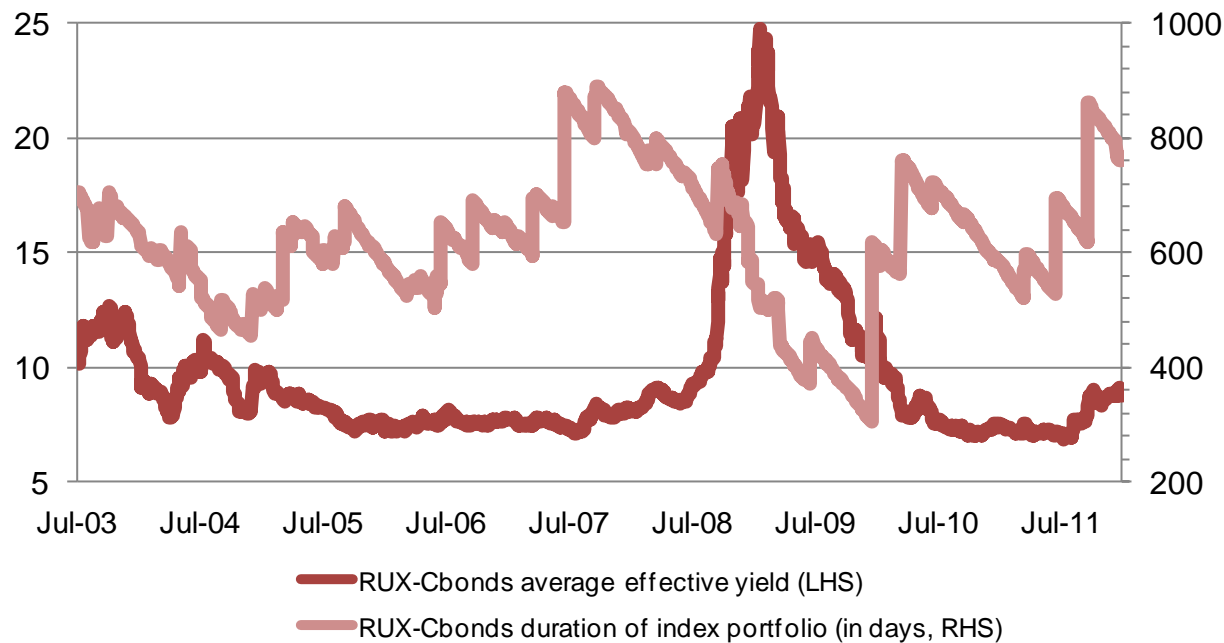


# Eastern European Region

## Russian Debt Markets Overview

- Large company liquid local currency bond yields 8.8% on average, duration 3.2
- The relative appeal of the local bond market is slightly muted due to potential ruble volatility amid the current election cycle and the uncertain development of European debt saga

IFX-Cbonds index average yield and duration

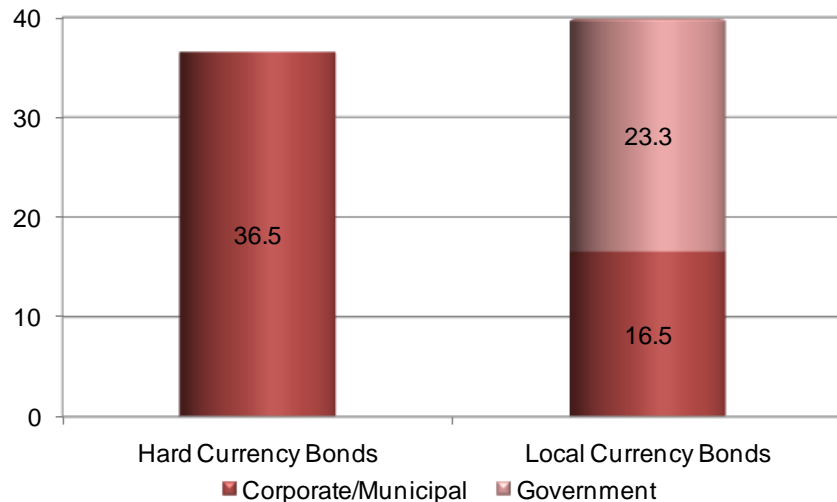


# Eastern European Region

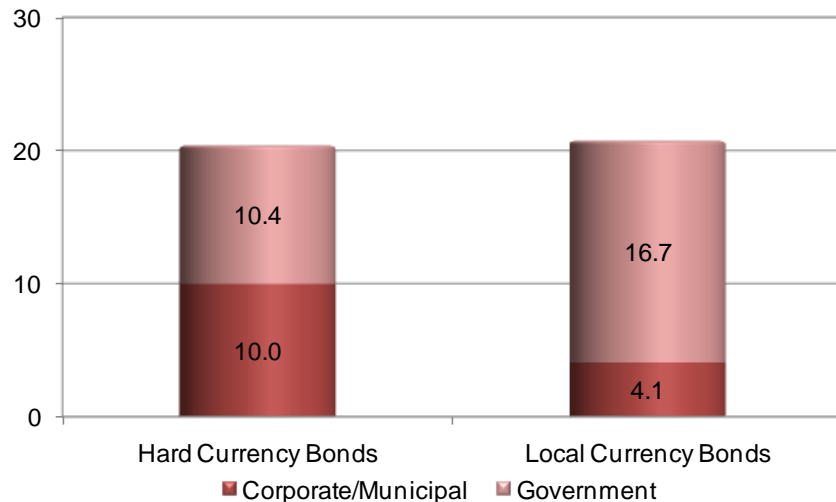
## Kazakh and Ukrainian Debt Markets Overview

- Kazakhstan and Ukraine – second and third largest bond markets in CIS
- Hard currency markets are dominated by banks
- Local currency markets are present, but technically difficult to access. Liquidity is another barrier

**Kazakhstan Bond Market size, blnUSD**



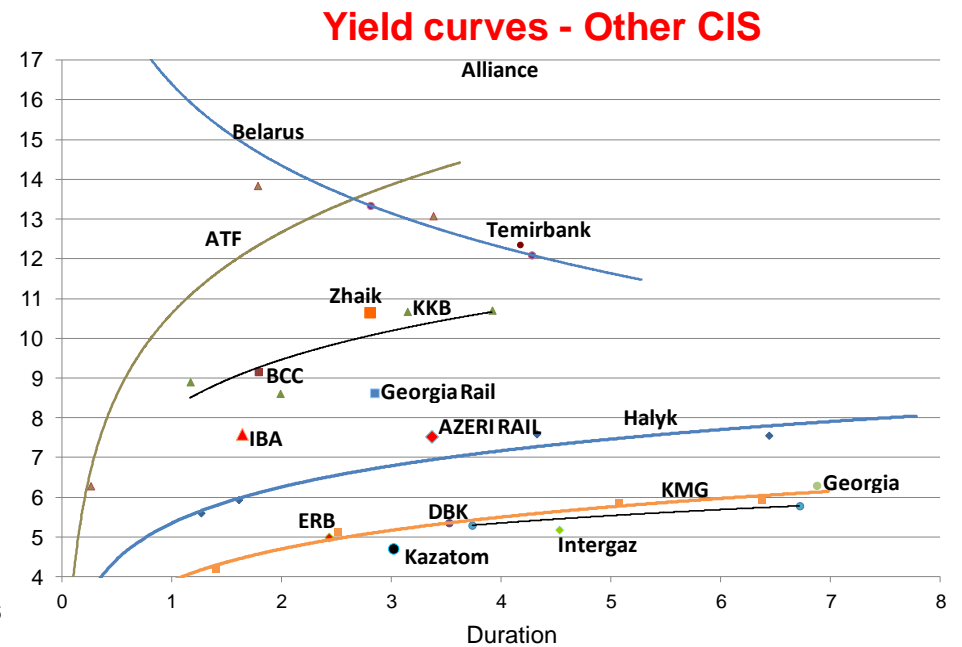
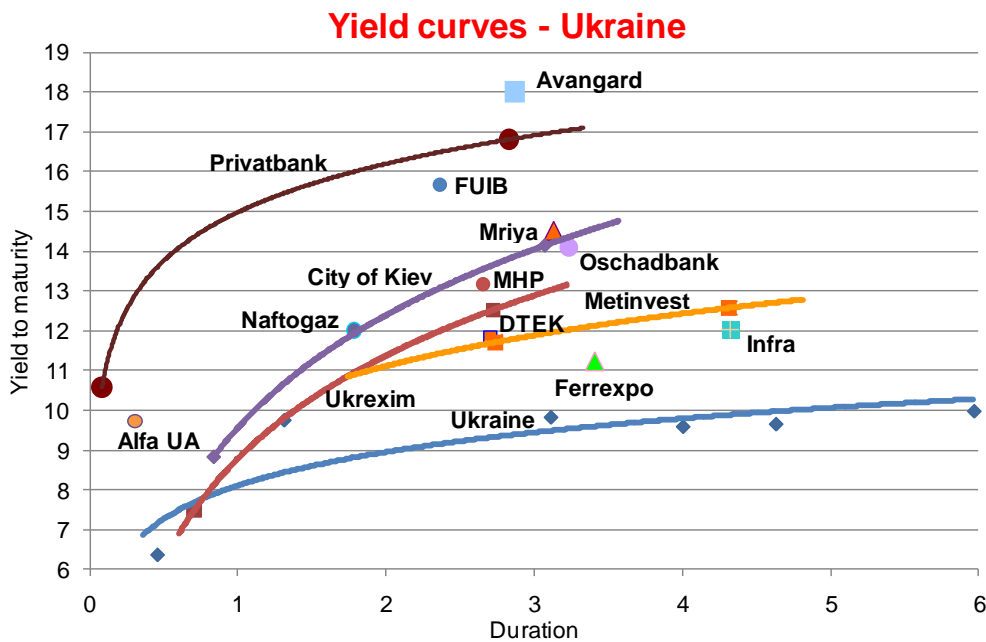
**Ukraine Bond Market size, blnUSD**



# Eastern European Region

## Kazakh and Ukrainian Debt Markets Overview

- Ukraine is the region's high-yielder with YTM ranging from 6% (short sovereign) to 18% (Avangard). All market segments are present: sovereign, municipal, banking and corporate.
- Kazakh market is middle-yielder in our universe, and is represented by quasi-sovereign entities and banks, with one private corporate (Zhaikmunai). Yields range from 4% for KazMunayGaz to 14% for ATF bank

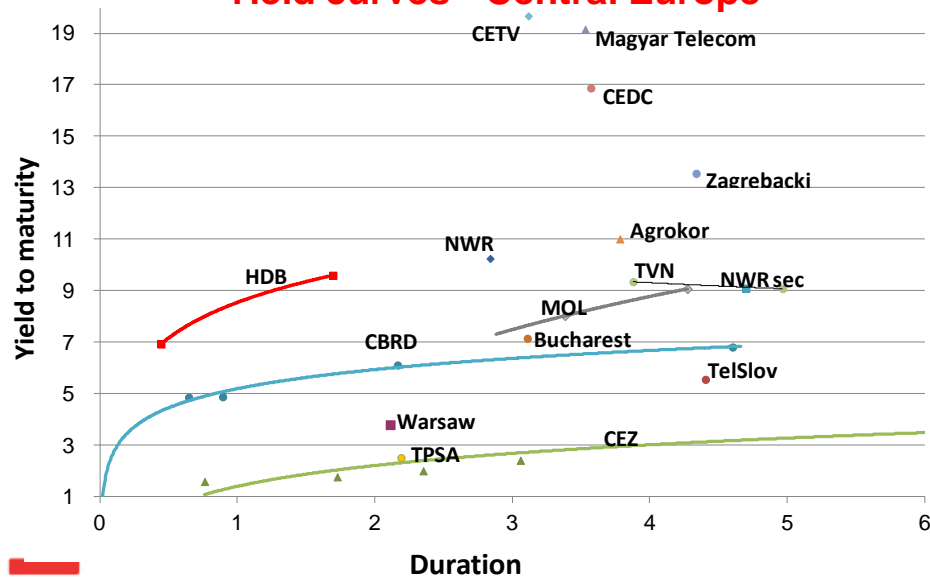


# Eastern European Region

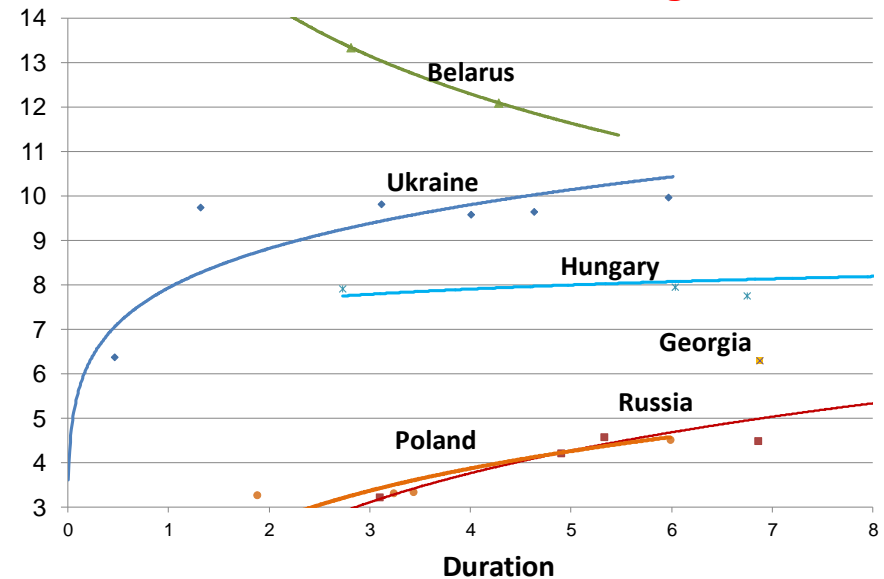
## Central European Debt Markets Overview

- Central European hard currency market is dominated by EUR-denominated sovereign paper. Sovereign heavyweights by outstanding bonds are Poland (\$46bn), Slovakia (\$29bn), Hungary (\$21bn) and Slovenia (\$19bn). Though, yields are comparatively low
- Corporate Eurobond market is highly fragmented and can be divided into high grade and high yield. Largest corporate markets are Czech Republic and Hungary, followed by Croatia and Poland

### Yield curves - Central Europe



### Yield curves - sovereign



# Citadele Asset Management

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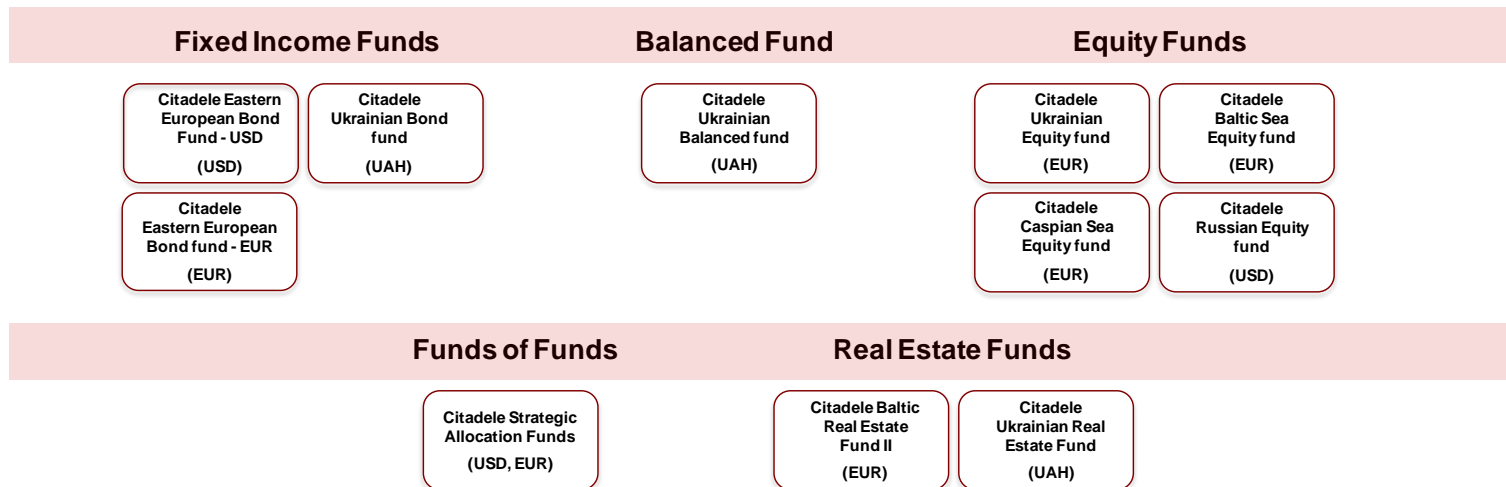
## Our Core Business

### ■ Fund Management

- Regional Fixed Income, Balanced and Equity funds
- Regional Funds of funds
- Real Estate funds investing in the Baltics and Ukraine
- Tailor-made solutions
- Pension fund management
- Institutional portfolio management

### ■ Portfolio Management

- Portfolio Management Global asset allocation for clients
- Core client base – Baltics and Former Soviet Union
- Over 20 000 products available from leading fund managers covering all asset classes and geographical regions



- Citadele Universal Strategy Fund – USD
- Citadele Universal Strategy Fund – EUR
- Citadele Balanced Strategy Fund – USD
- Citadele Balanced Strategy Fund – EUR
- Citadele Active Strategy Fund – USD
- Citadele Active Strategy Fund – EUR

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