



ADVANCE INVEST MUTUAL FUND

**INVESTMENT COMMENTARY
as of 31 December 2008**

**Daniel Ganev
Portfolio Manager**

Advance Invest Mutual Fund Overview as of 31 Dec 2008

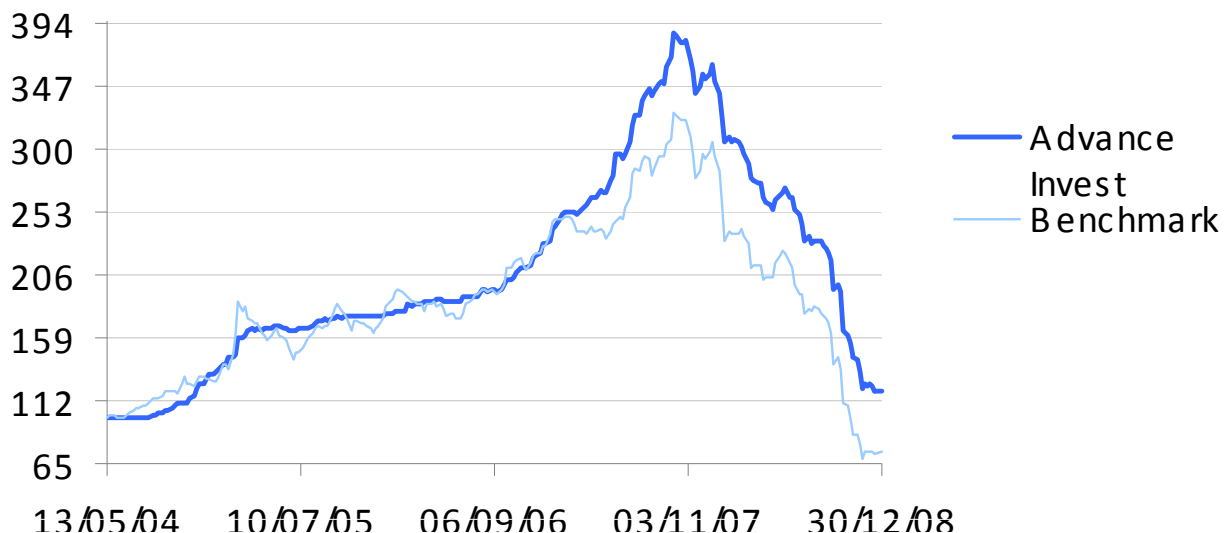
With the advent of 2009, let's wish for health and success for many years on end, and may none of them be like the one we just saw off! 2008 – the year which brought nothing but pain for the financial industry as one of the worst nightmares for the global capital markets. The year of a dramatic financial crisis that changed the sector to incognizability, and lead to unbearable losses for investors in stocks (as well as real estate, commodities and almost all other asset classes except cash) and to the start of a long global economic recession. The markets of focus for Advance Invest – Bulgaria & Romania – were swept away by the tsunami to a full extent.

A number of shares in these markets lost over 90% of their value under the pressure of fleeing international investors, panic among the locals, and liquidation of positions by institutionals. The negligible liquidity of the Balkan markets “helped” too. This lead to a drastic decline in the turnover of the local exchanges. Toward year-end the crisis began to cast its shadow upon the real economy, and was reflected in the financial statements of the listed companies – the end of a prolonged trend of ever-rising revenues and profits.

Here are the blunt figures: the major BSE index SOFIX set a record as the worst performer in Eastern Europe with a loss of 79.7%! Romania's BET wasn't far behind with a dive of 70.5%. Additionally, the Romanian currency depreciated by more than 10% vs. EUR. The small-caps – the stars of the bull market – were pounded a lot more drastically.

In view of the above, the fund registered a negative annual return for the first time since its establishment – in the amount of – 66.6%. Thanks to the more conservative approach in 2008 the decline is nevertheless smaller than that of the benchmark SOFIBET – 75.9%.

Percentage Change of ADVANCE INVEST Price vs. SOFIBET Benchmark*



*index constructed by Karoll comprising 50% of Bulgarian SOFIX & 50% of Romanian BET with basis 2006 beginning

YEARLY RESULTS OF THE FUND	Fund	Benchmark SOFIBET*
2008	-66.57%	-75.92%
2007	55.37%	34.31%
2006	31.20%	35.30%
2005	32.60%	32.00%
2004	38.00%	37.60%
Since Launch (annualized)	3.76%	-6.48%

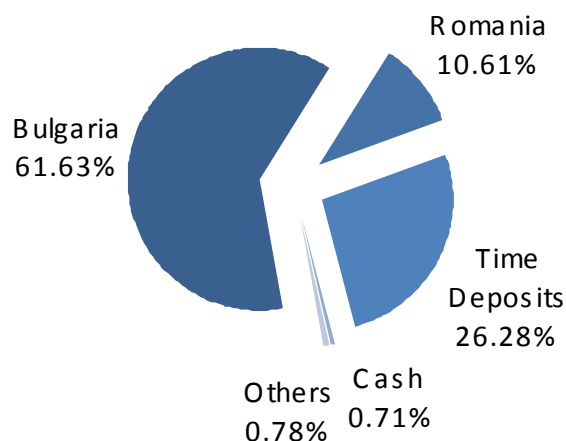
*index structured by Karoll comprising 50% of Bulgarian SOFIX & 50% of Romanian BET with basis 2006 beginning

The fund's return was realized by assuming a much lower risk than the SOFIBET benchmark (standard deviation of 22.1% for the fund compared to almost 31.1% for the benchmark). The fund's risk-return performance in comparison to the benchmark is statistically demonstrated below, e.g. beta of 0.66, alpha of +2.3%, etc.

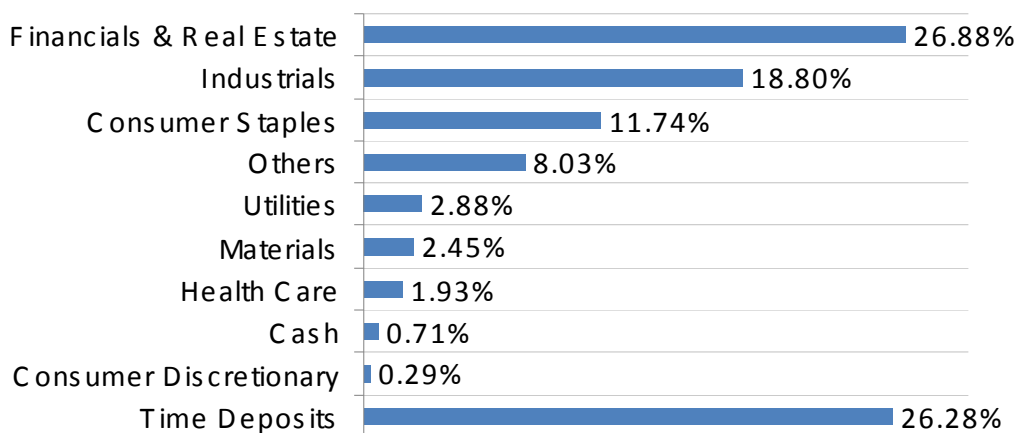
ADVANCE INVEST RISK METRICS	
Beta	0.66
Alpha (annualized)	2.3%
Standard Diviation (anualized)	22.1%
Sharpe Ratio	-1.7
M Squared	-46.5%
Information Ratio	0.3
Разминаване с пазара (Tracking Error)	8.5%

*The data for the risk measures is annual, calculated weekly over 2 years, and the benchmark is the SOFIBET index structured by Karoll.

In these brutal market conditions Advance Invest bet on a more conservative strategy – most of the time the weight of the cash exceeded 20% of assets (26.3% at year-end), that of bonds – above 5%, and defensive stocks – representatives of non-cyclical industries were raised (although the latter to a large extent failed to lend significant support for the portfolio). As a result of the reduction and liquidation of a number of portfolio positions, Bulgarian equities represented around 54% of assets (vs. more than 60% a year earlier), and the share of Romania shrunk to 10.6% (vs. more than 15% at the beginning of the year).



Sector-wise, as of year-end financials & real estate (REITs, venture capital, banks and insurance) pull the largest weight – 26.9% of assets (which is a reduction compared to the previous quarter as a result of position reductions and depreciations), followed by industrial companies (conglomerates, Romanian SIFs, chemicals, construction, etc.) - above 18%, consumer staples (trade with food products) - nearly 12%). To a great extent, with very few exceptions, portfolio trades were exclusively sales with the purpose of securing liquidity, boosting the cash position, and reduction of stocks which the portfolio manager deems most vulnerable to price drops.



Top 5 Stock Holdings	
COMPANY	SECTOR
SAF Magellan	Consumer Staples
Advance Equity Holding	Venture capital
Aktiv Properties REIT	REIT
Advance Terrafund REIT	Agricultural land REIT
Billboard	Industrials

As of 2008-end the NAV of ADVANCE INVEST falls significantly to BGN 10.6 mln following the serious depreciation of portfolio holdings in combination with the net outflows throughout the year.

BULGARIAN Stock Market Development and Expectations

Let us begin by looking back to what happened in Bulgaria in 2008. As a country with an open economy that attracted in the recent years considerable investment capital from abroad, Bulgaria was wiped out by the world financial crisis in its full power. If the players on the Bulgarian stock exchange left 2007 exulting at the record high gains and completely disregarding the slight comments that the honey moon on BSE is over, 2008 clearly brought to an end the romantic period for the local investors and made them mention the word “gain” only in past tense.

Few main tendencies gave the outlook to the Bulgarian market in the past year:

- Dramatic drop in share prices (reaching 90% or even more for some of the issues);
- A fall of 70% in total turnover on the Bulgarian Stock Exchange, an ever more dramatic drop of turnover in shares and a significant decrease in lots traded;
- Mass withdrawal of foreign investments;
- Deteriorating corporate financial figures, particularly visible in Q3 financial statements, and worsening outlook for the companies’ future performance in the light of a deepening recession in the European Union - Bulgaria’s main export destination;
- Mass exodus from investments in mutual funds and a brutal meltdown in their assets under management; decrease in the assets of local pension funds;
- Tightening credit conditions and increasing interest rates;
- Early symptoms of deterioration in Bulgaria’s economic health.

The Bulgarian stock market began 2008 with positive sentiment though it erased more than 10% off its peak in October 2007. The commentaries suggested this was a healthy correction of the “overheated” local market. The volumes were high, the expectations for endless corporate profits – strong, and the credit crisis – something that is happening out there. The first wave of mass panic flooded the market in mid January when huge sell-offs drove SOFIX down 11% in 3 days only. But the big drop was yet to come...

In the next few months Bulgaria switched from the holy land to one of the countries with worst performing markets in the world. The shocking macroeconomic news abroad transferred into massive sell-offs at home. By mid of the year SOFIX lost 35% off its value, and by end of August – 42%. And just when it seemed the things could not be worse, the most cruel write downs arrived in the market. Frustrated by the bankruptcies and gloomy macroeconomic news from USA and Europe, squeezed by liquidity needs and additionally troubled by the worsening results from the local companies, in September some of the investors started selling literally at all cost and the buy orders on some of the positions practically disappeared. The desire for purchases evaporated off the market though the tempting at first glance P/E for SOFIX at around 5x (with 30x at the same time in 2007) and P/B below 1x for many companies.

The panic sell-offs in the low liquid local stock market literally led the stock prices melt in the following 3 months, with October and November registering the biggest intraday losses since 2001. In the last 4 months SOFIX shed 769 points, or 68% of its value. That way the oldest index on BSE ended the worst year since its launch with a 79.7% loss. The BGREIT index, tracking the performance of the local REITs, was also not spared and its value collapsed with 53% within a year. In 2008 the volumes on BSE severely dropped – to BGN 2.91bn from BGN 9.95bn for the previous year. The average daily trading volume on the regulated stock market collapsed even more drastically – down to BGN 2.5m compared to BGN13.3m for 2007, BGN 9.2m for 2006 and BGN 5.2m for 2005.

The perspectives ahead of many companies, especially in the metallurgy and machined construction sectors, swiftly worsened after their main export destinations entered into recession and sharply reduced their consumption. The extraction sector, the textile and transport sectors are also among the worst hit by the global crisis. A big chunk of the companies were additionally hindered by the stricter loan requirements and the higher interest rates. The real estate industry with the related sectors being the GDP growth engine in the last years also felt the crises in their backs. On one side the EU froze millions of euro subsidies for infrastructure in Bulgaria due to sparkled corruption scandals. The direct victims appeared to be the road construction companies. On the other side, the obvious outflow of foreign investors from local estates, the density of real estate developments in some parts of the country and the limited mortgage lending also led to sector slow down. The crisis influence over the real sector was evident from the half year reports and more clearly outlined in the third quarter results. If the at the end of June the average income growth was over 20% and 2.6% for the profits, the third quarter results showed income growth slowing down to 14.5% and the average profit fell by 6.3%.

Although under currency board, having the national currency pegged to the euro, enjoying strong GDP growth (over 6.5% for 2008) and having substantial budget surplus (over BGN 5bn), our country faced warnings from many international institutions for growing risk of hard landing of our quickly expanding economy in the last years due to drastic slow down in foreign financing and domestic consumption (based on unemployment growth). The credit agencies downgraded the country debt due to similar worries. The CPI index peaked in June at 15.5% but gradually decreased its growth to 9.1% y-o-y at end of October. As of October the current account deficit grew to 19.4% of GDP forecasts compared to 16% a year earlier. Meanwhile the direct foreign investments for the first 10 months dropped to BGN 4.87bn against BGN 5.36bn a year ago and now cover barely 74% of the current account deficit compared to 116% as of October 2007. The unemployment remained at 5.9% in November and is expected to significantly rise.

What is yet to come?

After wishing for a good year, it is reasonable to come back to reality. It is surely not nice and seems that much trouble is yet to come. The market situation remains unfavorable. The daily liquidity is miserably low with volumes rarely over BGN 1m. The market P/E is 5x which is actually not so remarkable after taking account of the worsened perspectives ahead of the companies (many of the market participants do not consider this fact and fall in the so called value trap thinking they are buying undervalued stocks). We expect dazzling consequences of the crisis in the financial reports of the public companies. Even without the gas crisis (which will be used as an excuse for many of the forthcoming reports) the sales and profitability of the industrial companies suffer from demand contraction under deflation conditions.

The local institutional investors are pressed by the continuing assets fall (already barely BGN 300m from BGN 900m a year ago) and though they have enough cash to ensure their liquidity, they curb stock purchases and this is likely to continue over the entire year. Considering the worsening macroeconomic conditions, the liquidity lack on the Bulgarian market coupled with the own problems of the foreign investors, a short-term comeback of foreign investors is unrealistic.

The GDP in the 2009 budget is set at 4.7% but taking account of the much worsened conditions worldwide, the decreased foreign demand and the expected drop in direct foreign investments, then this figure is unrealistic. According to the last IMF forecast and the pessimistic government forecast, the GDP growth will slow down to 2%. In our opinion, it is possible to see at least one quarter with negative growth. The current account deficit (currently at 20% of GDP) is likely to register some shrinkage in 2009. However its coverage by FDI will worsen (due to the expected substantial drop in the latter). Due to possible income failure in the government budget it is becoming more likely for us to witness deficit instead of the traditional for few years solid surplus. As a result of lower demand we should then expect further price declines for the main goods and thus the CPI forecast for 2009 is below 5%. The significant drop in demand for companies' production led to layoffs for many of them. The official government forecast for 7% unemployment rate seems unrealistic and it is more logical to expect the current 5% to roughly double. The currency board remains stable and considering the high coverage of money circulation by foreign reserves, as of now the risk of devaluating the local currency, as some regional countries did, is low. Our entry into the Euro zone is moving further away. It is extremely unpleasant that there was no improvement in unfreezing the blocked euro funds. That capital is valuable growth source especially in times of crisis but it is likely that they will be unavailable to the business for 2009 too. In summary, there are more and more indications that the previously unimaginable hard landing scenario is materializing.

Summing up the effects from the factors above we think that all sectors are now threatened but at the moment mostly the machine manufacturing (in recession the demand for investment goods steeply declines), metallurgy (the negative effects are expect to unfold both from demand for such goods and commodities price drops), real estate (falling real estate prices and contracted mortgage lending), the banking sector (considerably lowered liquidity worldwide that shrinks and makes more expensive the available capital). Some representatives of those sectors are likely not to weather the crisis.

Sectors influenced to a lower extent will be the agriculture (as an encyclical sector we consider it less vulnerable to the world recession), tourism (on one side there is outflow of

foreign tourists following the crisis while holes in the family budget should attract low cost destinations such as Bulgaria), the consumer sector (an encyclical sector with the necessities being the least hit), insurance (due to the obligatory nature of some of the insurance policies where premiums are expected to rise). With lowered expectations for audit reports, when determining the fair company value using the discounted cash flows method the investors should include the more expensive cost of capital (WACC) which will reflect the higher debt cost and a much higher risk premium due to loss confidence. At a micro level it is wise to bet on those companies that will avoid bankruptcy. These are the ones belonging to the mentioned sectors above in combination with strong balance sheets (low debt levels), solid cash reserves and cash inflows. As a rule of thumb these that weather the crisis have the chance to operate in less competitive environment and thus increase their market share.

The SOFIX index in 2008



From a technical point of view the fact that the SOFIX index did not meet support on some key levels between 600 and 400 points and the drop was quick and steep indicates that the move downwards is not over yet. This thought is brought also by the market spirit – at the end of 2008 the majority of investors were negative (measured by opinion polls of some specialized media) while few weeks later the optimism rushed back (without an obvious reason since the index was at the same level as before). This suggests that there are no conditions for long-term trough yet – that will form only with far negative sentiment and massive sell-offs. The bad news is that we are in another steep fall (which will drive the index to and may be below 200 points), but the good news is that with such a move the bear market is likely to end and conditions for the “big” trough will be in place from where the long awaited stock appreciation will begin. If the forecast is correct that should happen before the summer this year. We will have a confirmation with a past date only when we have seen the trough and are up move. It is very important for the market to demonstrate power (strong appreciation with good volumes). Otherwise if the volatility is low and the market experiences long consolidation then there will be no life in the market and the recovery could be long and painful (much longer than that of the developed markets).

ROMANIAN Stock Market Development and Expectations

In the past year the Romanian market measured by the main BET index collapsed by more than 70.5% in local currency (additionally the Romanian lei depreciated by more than 10% against the euro). We can see a well defined bear market. The pressure on the market was smashing at all fronts – massive sell-offs from foreign investors, redemptions in the open-end funds, panic among the local players. That coupled with the low liquidity led to collapses for many of the stocks. The culmination was on 8th December when for a first time ever the trading was closed with the main index falling more than 10%.

Worst hit were the stocks of small and medium market capitalization due to their miserably low liquidity and big spreads. With no buy orders a stock could lose 30% of its value in a day even when trades are lacking. That way the market capitalization against GDP went back to its 2003 level (below 10%) and the stocks volume was squeezed in half even though the number of trades and traded shares remained close to the 2007 levels.

The correlation with the western markets remained high in its worst scenario – where the red color is dominant. That was reinforced by the extended trading window till 16.30 local time arguing that the foreign investors can more adequately and actively participate in trading – something which already brought grief to the local players. The volatility was greater than in Bulgaria, the appreciation trials were more frequent and convincing. Such short-term rises were quickly punished with sell-offs predominantly by foreign investors.

From a macroeconomic perspective Romania is also seriously shaking. Compared to the expected 9% GDP growth for the past year, the rating agencies predict minimal growth or even contraction for the economy in 2009. Hence we are again speaking for a classical hard landing case which is already evident in the Baltic region. The record high economic growth in the last quarters is misleading since the tertiary and construction sectors contributed 2.7% and 2.4% respectively. A considerable contribution came from the agricultural sector due to the good harvest. Towards year end the first signs of slow down were felt when in October the industrial production dropped 3% for a first time in years while the trading volume collapsed by 9% y-o-y. The expectations for the unemployment increasing are alarming. In the last two months alone of 2008 more than 20 000 jobs disappeared (twice the expected) with most affected being the auto industry, real estate, the textile sector and metallurgy. After the companies make a sober judgment about the depth of the crisis in the first half year, overhauls will begin and a new wave of lay-offs is likely to follow. According to the EC the unemployment in 2009 will increase from the current 4% to 6.1% (much more based on our expectations).

Another main problem for the Romanian economy is the huge current account deficit which at the moment is 50% higher than the 2006 level and is approaching 15% of GDP. Another problem is the fact that since 2007 the FDI covers barely half of the current account deficit and there is a tendency for the deficit to widen since the investments are contracting at a higher pace than the deficit itself. With should not forget that a big chunk of FDI in the 2005-2007 period was in the real estate sector which currently is at a complete stand. The budget deficit should also not be disregarded: it reached 4% at the end of 2008 following the populist expenditure at the end of the previous government and at the same time sudden drop in tax revenues (down 25% y-o-y). Last but not least we should point out the risk coming from the currency depreciation which commenced at year end. Since beginning of December the Lei lost 12% against the Euro and registered historical lows (currently standing at 4.25 – 4.30 for

the Euro compared to 3.78 a year ago). This endangers the loan servicing in foreign currency which comprises a big share of the bank loans in the country (over 60%).

At the end of November were held parliamentary elections and the results were pretty much in line with the opinion polls expectations. The good news is that the battle in the ruling coalition between Tariceanu and Basescu is over. It however brought some political moves that increased the economic risks for Romania. Unsurprisingly the political instability in Romania is one of the main factors making S&P and Fitch downgrade the credit rating of the country to junk in the last 12 months. Some of the populist measures that Tariceanu took in the last year are the increase of the minimum wage by 28% in the beginning of 2008 and the pensions with the striking 43% initially and 33% further in 2009. These are figures far above the inflation and growth production levels. The same applies for the big budget deficits which the government registered in the last 7-8 months following the populist government politics of increasing government expenditure.

At the elections the Basescu led Democrat-Liberal party came first (with roughly 40% of the votes) and it will attempt form a coalition cabinet. Basescu, the president, gave green light for government formation to Teodor Stolyian, the Democrat-Liberal leader, who is also supported by the second in place Social-Democrat party (together both parties have 70% of the votes). Few days later Stolyian surprisingly rejected the mandate he was given and it was given to another party leader – Emil Bok (a major of one of the biggest cities, Cluj-Napoca, a capital of Transilvania), who was appointed prime minister a day before Christmas. Effectively the new government is a coalition between the Basescu party and the recently opposition Social-Democrat party. It is expected the leading figure “in shadow” to be Basescu who is enjoying high confidence level among society.

The analysts are expecting the new government to become aware of the depth of the problems and to concentrate efforts on restore the confidence in the economy and revitalize consumption. The previous government at its tenure end approved an economy package worth EUR 10bn in the next four years. The main points are linked to providing loans for small and medium sized enterprises, stimulus for companies taking on unemployed and tax reduction for reinvesting dividends. Nevertheless, Romania is threatened by a negative scenario where the foreign investments are drastically contracting which additionally widens the imbalances and leads to government expenditure that reduces the foreign reserves of the country.

In this case it is possible to witness recession and serious economic problems in 2009-2010, including the banking sector which is in a pretty good shape now. At the same time the high leverage level in the private sector will become problematic and it will be unable to meet its obligations and bankruptcies and high unemployment will follow. Such risks create a number of questions about the medium-term stability of the Romanian economy and they understandably keep away the foreign portfolio investors.

The average P/E ratio is one of the lowest in the region (below 5x) and P/B is around 0.6x. This is a messenger of the negative effects of the crisis on the public companies in 2009-2010. In Q3'08 the results of the Romanian companies came out considerable worse. The pharmaceuticals reported an average income growth close to zero which reduced the growth for 9M'08 down to 3%. The banks also are slowing down in their growth where the Q3 profits rise just with 12% for BRD and 15% for TLV against 30%-35% in 2007 and first half of 2008.

Even with secured liquidity owing to lowered MCR by the central bank, the credit market in Romania remains frozen and hence we expect the bank profits to fall in 2009 from their peaks in 2008. The utility services are performing better than the rest of the sectors, taking account of the constant consumption and the state regulated prices. In that sense, there are no big surprises, though the expectations are for noticeable decline in electricity and natural gas consumption. The oil companies will be negatively affected by the collapse of the oil price and the amounting losses are dangerously destroying capital. Undoubtedly the real estate sector will be the one most impacted in 2009 and the developers with more debt and already commenced developments without secured capital are likely to experience liquidity difficulties, and some will go out of business. Awaiting such scenarios, the real estate stocks were among the hardest hit already in 2008 – losses reached an average of 90%.

The BET index in 2008



The negative factors moving the market in 2008 keep full power for the future. Pressure from sell-offs from foreign investors (even though their share melted in half), redemptions in the mutual funds (total AUM is barely EUR 50m), the pension funds avoiding the local market, and the discouraged local players will keep suppressing the market. From a technical perspective in Romania too we expect to see lower index values (below 2000) before the market reaches trough and reverses the trend. The nice thing here is that the drop will likely be lower than the one we expect in the developed markets in the first half. There is the risk however such a weaker move being compensated for a further depreciation of the local currency.

Investment Strategy of Advance Invest Mutual Fund

The fund strategy is based on the “stock picking” method – selection of Bulgarian and Romanian stocks, which the asset manager believes to perform better than the market as a whole. Owing to the heightened risks for these markets and our expectations for H1 declines, we are undertaking a highly defensive approach. The portfolio protection during that period will reflect on greater cash holdings – between 30% and 40% of assets (including deposits in EUR due to the amounting risk for the local currencies), bonds – over 5% (although the risk of problems with corporate issues is becoming more visible), and as much as possible a selection of defensive stocks of financially sound issuers from non-cyclical sectors. The share of the Bulgarian stocks is to be reduced to below 40% (possibly with a restructuring via switch from low liquid stocks to blue chips that we expect to recover faster), and the Romania share will remain around 10% (again with the replacement of small caps by major liquid stocks).

The manager will continue to observe the liquidity risk and strive to reduce the fund price volatility. Traditionally, the portfolio management will continue to aim at achieving an optimally high return, potentially better than that of the selected benchmark – SOFIBET, in observance of the adopted risk-return parameters.