



Advance Invest Mutual Fund

**Investment Commentary
as of 30th September 2008**

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Advance Invest Mutual Fund Overview as of 30th September 2008

While you are reading this commentary, thousands of investment bankers are probably clearing their desks to leave, new home owners are not able to make their mortgage payments for their cheap homes, corporations are facing the fact we are in recession, and the most common word in the media is “bailout”. This is the world we woke up to after years of cheap credit. It was surprising the speed with which this crisis hit us. Many of us hoped that it would pass by fairly quickly, but in fact it is much deeper and the recovery will take some time.

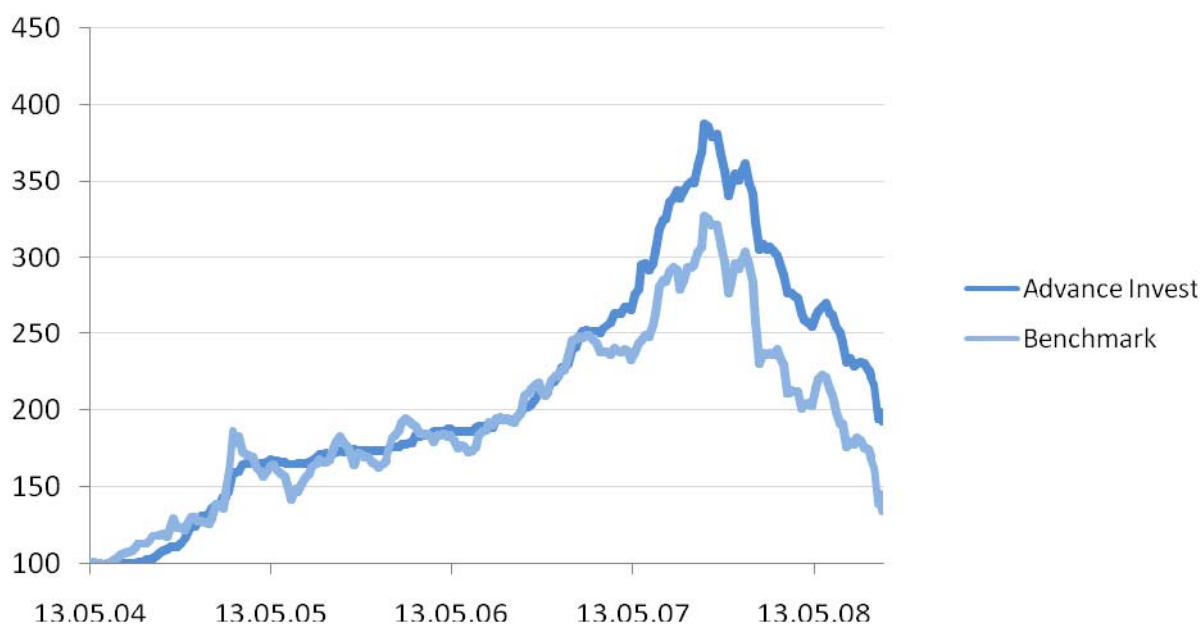
September was one of the worst months seen in the history of stock markets in terms of decline and volatility as it nearly ended the notion of investment banking on Wall Street. Even the Pope criticized the model of free markets and that it “has grown too much and in the wrong direction in the last twenty years”.

The two markets where the fund invests – Bulgaria and Romania, also fell significantly. During the last quarter the Bulgarian Index Sofix fell by 31.3%, while the Romanian BET collapsed by over 34.5% in local currency. In September only SOFIX fell 22.9% and BET 21.5%. On the last day of the month the index suffered its biggest ever loss of 6.8% (I would like to make a slight correction here in the sense that the biggest fall up to date, also known as Black Monday to local investors, was on 6th October, which falls outside the investment commentary time period).

Both the Bulgarian and Romanian market came under intense selling pressure combined with low volatility. The latest is true particularly for the share price of small and medium sized companies, which suffered the most. Quarterly results were disappointing as the rising price of commodities and other inputs were reducing profit margin. Banks in Eastern Europe are also experiencing problems (on the face of the huge losses suffered by western financial institutions) due to more expensive financial resources and tightening of credit conditions. All this was reflected in the share price of these institutions.

Even though the P/E ratios have fallen significantly since the beginning of the year (P/E is below 9x on SOFIX and below 7x for BET), they are still not attractive enough for investors to come back to the market. The major problem is lack of liquidity. Clearly investors now require much bigger risk premium from regional markets.

Given all this, Advance Invest recorded a much small loss compared to the index (decline of 14.71%, while SOFIBET of 22.23%). Since the beginning of the year the fund is down 45.8% (SOFIBET is down 55.8%). This was achieved due to the more defensive approach taken and the large portion of cash and defensive stocks in the fund.



Fund return	Fund	Benchmark SOFIBET*
1 month	-14.71%	-22.33%
1 year	-48.42%	-56.62%
Year to date	-45.76%	-55.78%
Since launch (annualized)	16.09%	6.98%

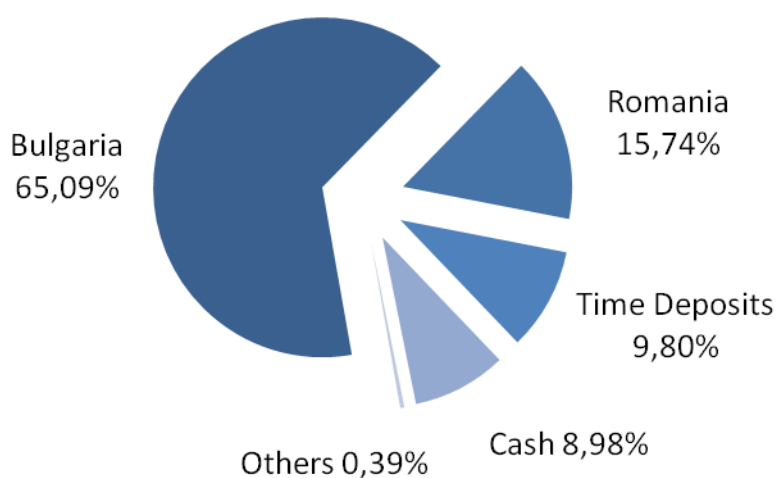
Reurn by year	Fund	Benchmark SOFIBET
2007	55.37%	34.31%
2006	31.20%	35.30%
2005	32.60%	32.00%
2004	38.00%	37.60%

*Index constructed by Karoll, which includes 50% Bulgaria 50% Romania with starting base 2006

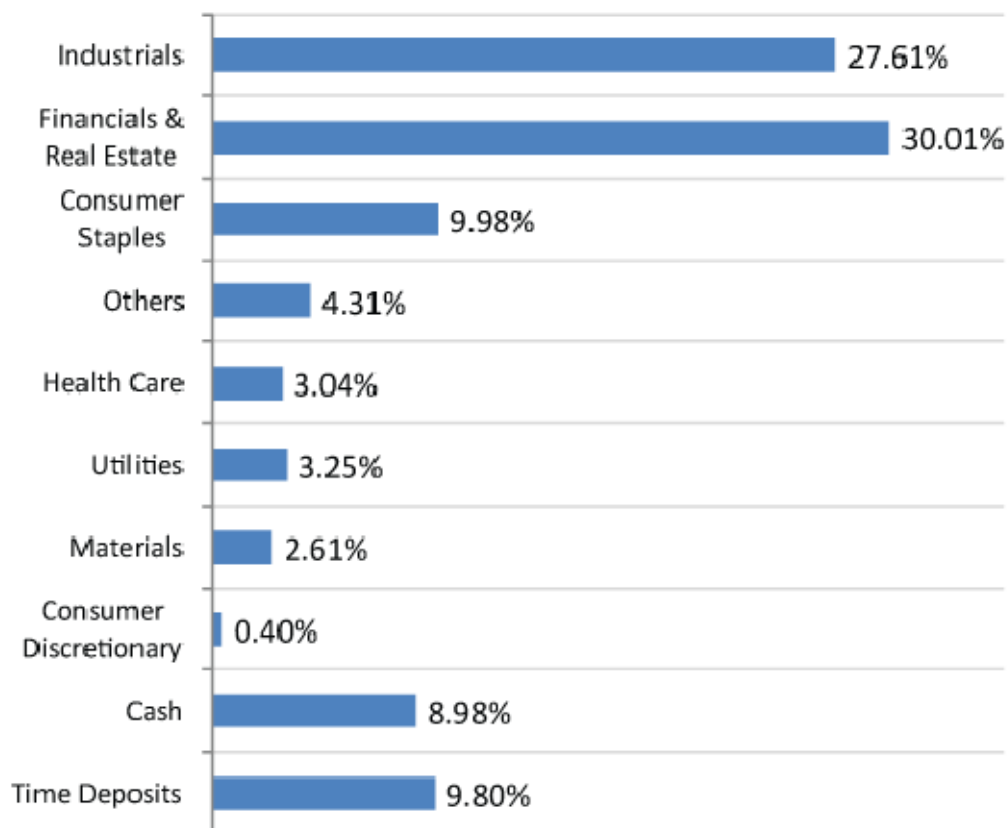
The fund's return was realized by assuming a much lower risk than the SOFIBET benchmark (standard deviation of 17% for the fund compared to almost 24% for the benchmark). The fund's risk-return performance in comparison to the benchmark is statistically demonstrated below, e.g. alpha of +8.8%, etc.

Advance Invest Risk Metrics	
Beta	0.630
Alpha (annualized)	8.8%
Standard Deviation (annualized)	17.1%
Sharpe Ratio	-0.2
M Squared	-0.4%
Information Ratio	1.1
Tracking Error	8.0%

At Q3-end Bulgaria is once again the market with the largest weight in the fund with about 61% of assets (almost as much as at the beginning of the year). Romania pulls nearly the same weight as before – around 16%. Bonds as a defensive element comprise close to 4% of assets, while the share of cash and time deposits (the most profitable part of the portfolio recently) stands at around 19%.



Sector-wise, financials and real estate (REIT, banks and insurance) take up the leading position (over 30% weight), followed by industrials (holdings, Romanian SIFS, construction, chemicals) - nearly 28% of assets, consumer staples (trade with food products) close to 10%. In the third quarter the fund sold most of its shares on the Bulgarian stock market and increased its share of deposits.



Top 5 holdings	
Company	Sector
SAF Magellan	Consumer Staples
Advance Terrafund	Financials & Real Estate
Advance Equity	Financials & Real Estate
Active Properties	Financials & Real Estate
Eurohold Bulgaria	Industrials

As of Sep 30 the NAV of ADVANCE INVEST falls to BGN 20.4 mln following the depreciation of portfolio holdings and the net outflows.

BULGARIAN Stock Market Development in Q3 2008

The bear market on BSE–Sofia completed one year! Unfortunately no equity investor is up to party as the market has lost 70% of its high back in October 2007. It's no surprise more and more investors are asking themselves "is there life after death". Let us first begin with what's happened in the last three months.

The negative sentiment on BSE-Sofia reached unprecedented dimensions during the last three months, which were marked by fears, bankruptcies and tightening credit conditions through the entire financial globe. The main index of BSE – Sofia, SOFIX, lost 31.3% of its value during the period and finished the quarter at 792.48, its lowest close since August 3rd, 2005. The index is 55.2% down from the beginning of the year and 60% down from its all-time high registered in October 2007. Additionally, investors' activity continued to shrink, with average daily turnover falling to BGN 4.6 mln. in Q3 from BGN 7.45 mln in Q2 and BGN 10.2 mln in Q1 '2008. The bulls were totally inactive although many of the shares reached quite attractive levels, with average P/E for SOFIX approaching 10. Anyway, investors have already stopped looking at the fundamentals when making investment decisions. Clearly, investors are looking for much higher premium from the regional markets.

After SOFIX lost 12.1% in July, it regained some of what had been lost advancing by 1.35% in August. However, hopes soon evaporated when September brought a cold shower to the investors with news of defaulting financial giants, forced bank buyouts and emergency state interventions. The massive selling on stock exchanges worldwide sucked down the local market as well. SOFIX lost almost 23% of its capitalization during the month, while the wider BG40 dropped 21% with all of its components dressed in red.

Although the H1 financial results announced during the quarter did not confirm the darkest expectations for slumping earnings driven by the shrinking global demand and volatility of the commodities prices, certain drawbacks are apparent. Despite the fact that most of the companies managed to increase their top line, the profitability of many of them was pushed down by surging expenses on raw materials and salaries. Among the hardest hit were companies from the extracting and processing sector, some of the industrial conglomerates and companies with great exposure to the foreign markets. There were however companies with strong performance, like battery producers, fertilizer producers and machinery producers. The banks listed on BSE also performed well, as four of five achieved more than 30% revenue growth and over 20% increase of the bottom line. The global credit crisis, however, has already affected the banking sector in Bulgaria with tightening credit conditions and increased cost of financing. Growth of the banks' credit portfolio has been slowing down constantly since the beginning of the year and at the end of August is 27% higher than the end of 2007 whereas the annual 2007 over 2006 growth was 67%.

One of the major events during the quarter was the introduction of short selling and margin trading on the Bulgarian market. Although currently 7 companies meet the criteria, the start is

yet to come due to some technical and organizational setbacks. One of the obstacles is the lack of a clearing house to maintain the settlement of the deals and to guarantee the payments.

At the macroeconomic level, GDP growth is 7.1% in real terms during the first six months. Current account deficit during in the first seven months grew to 13.9% if GDP compared to 10.7% in the same period last year. Foreign direct investment for the period January-July fell by 14% to 2.8 bln. euro. Inflation between January and August 2008 is 13.8% p.a. Moody's lower the prospects for Bulgarian treasuries from "positive" to "stable", while keeping the Baa3 rating unchanged. The main reason for this was lack of stability and the perspective of lower economic growth during 2009. The government (which successfully managed to survive sixth vote of no confidence due to the stoppage of funds from EU) is planning to ask the parliament to spend 1.2 bln. leva from the state budget on infrastructure. It is estimated 55% of it to be spent on social work and 45% to be used for infrastructural projects and improvements on the railway system.

Analyzing current market conditions and the impact of the financial crisis on the Bulgarian economy, we can conclude the following:

- Lower economic activity in developed markets – according to the latest predictions by the IMF the global economy is heading into recession, and the economies of developed countries will experience much lower growth in 2009. The global economy is expected to grow with 3% for 2009 driven by the major economies of the world. GDP of US is expected to grow by 0.1% next year (1.6% expected for this year), UK -0.1% (previously predicted growth of 1.6%), Italy by -0.2%, France 0.2%, Germany 0% (previous predictions of 1%). Among the worst affected companies are export orientated and these will be mainly from the industrial sector (machinery, metallurgy etc.) We believe that countries exporting to our region, other than the developed world, such as Russia, Turkey i.e. developing emerging countries, will be less affected from this.
- Tighter credit conditions – on one side it will be much more difficult to obtain credit, which means a lot of companies may re-group their investments. On the other side, interest rates will rise.
- Lower construction activity – as a result of tighter credit conditions and lower economic activity one would expect the construction sector to suffer as well. This will turn affect other sectors linked to construction – trade with building material, REIT etc.
- Price of natural gas – from the beginning of October the price of gas will rise by 23.89% and is expected to rise by another 21% from the beginning of 2009. On the face of the global crises, such price increase will have negative effect on the industrial sector and will result in reduced investments. Most affected will be metal factories, glass makers and farmers.
- The price of petrol – at the moment the price of petrol is falling which will have positive effect on the transport and chemical industry. After all though, given the substantial increase in the price at the beginning of the year, we would expect negligible effect for companies which use up petrol in their activities.
- Price of metals – there is tendency for prices to be falling, which would more likely have negative impact for Bulgarian companies. Given world process of metal are falling, companies will see fall in revenue and despite falling prices in natural resources, more likely scenario is lower profitability due to fixed costs.
- Electricity – higher company costs due to rising prices of electricity.

- Human resources costs – the effects here are contrasting, but after all we believe they will affect profitability. Considering the global crises and the effect it will have on companies it is highly unlikely there will be increase in personal and remunerations. On the other hand, salaries are relatively lower compared to the average for the EU, which will exert pressure on wages. However, the overall effect will be rise in salaries, which will increase costs.
- Foreign exchange – USD/EUR. There is tendency for the dollar to be getting stronger now. Companies that export their goods in dollars will benefit i.e. US, Turkey, partially Russia, as well as those paying in euro. As such, companies that imported natural resources denominated in dollars will suffer now (metal companies). The fall in metal prices will to some extent neutralize the rise in dollar.

Summing up the above factors, we believe the main sectors to be affected are machinery (during recession the need for investment goods falls dramatically), metallurgy (fall in metal prices and need for manufactured goods), construction (given the growth of this sector in recent years and the current tightening of credit conditions, the sector is expected to experience slowdown), infrastructure (despite the need to improve infrastructure, the outlook is not great due to the freeze of the EU funds), banking sector (reduced liquidity, which will limit free banking resources).

To a less extent will be affected the agricultural sector (assuming non cyclical are less affected by global recession), tourism (here, on one side we see outflow of British and German tourists due to the large number of hotels built and low quality of services, but on the other cheaper holiday destinations such as Bulgaria will be more attractive), consumer staples (non cyclical, where demand for necessary goods will be least affected), insurance (we believe this sector will not be affected much from the economic cycle, due to the need of insurance, which may in fact go up in price over the years). In calculating the company's fair value using discounted cash flow, the price of WACC has significantly gone up due to an increase in the cost of both equity (risk premium has gone up) and debt (interest rate has gone up).

Movement of the SOFIX for the past year



After the sharp decline of the stock market in Bulgaria it is possible to have reached a short term bottom (levels of the SOFIX around 600). Therefore there is a chance of temporary rise as the market was oversold. This however may indicate a long and painful recovery and in the meantime we may see new all time lows. It may take some time for the index to reach the highs of 2007. We shouldn't forget the economy follows the stock market. Therefore given the steep decline of the index we would expect the economy to slow down considerably (hard landing). All the factors we listed earlier are likely to continue having an effect in 2009 and have negative impact on the economy and company's results (worsening financial indicators such as P/E, P/S, P/B etc). Logically when things improve, the market is likely to react first and investors' expectations to be incorporated in prices moving up.

ROMANIAN Stock Market Development in Q3 2008

During the third quarter of 2008 the Romanian market measured by the BET index collapsed by more than 34.5% in local currency (apart from this Romanian RON depreciated by 2.4% against the EURO). We are observing strong bear market here as well. Those levels of Romanian indexes were present in 2004. We are four years back in time in just a few months. The pressure over the market is massive – huge sell-offs from foreign investors, redemptions in open ended funds, panic amongst local players. This combined with low liquidity resulted in collapses in most of the stocks. The culmination was on October 8th when for the first time the trading was suspended after a 10% drop of the main index and the Romanian Stock exchange closed. Most of the suffered were small and midsize caps due to their extremely low liquidity and big spreads where only by removed buy orders a stock may loose over 30% for a day without any trades being executed.

High correlation with western markets was kept especially when red color was predominant. In addition the prolonged trading session - until 16:30 local time only made things worse. This was made with the argument that western investors can be more active and trade more adequately (local participants are certainly felling very sorry now). Fluctuations were bigger

than those in Bulgaria. Attempts for upside moves (usually in the mornings before western colleagues start work) were often seen. Such rises were instantly punished with sell-offs mostly from international investors.

The average P/E of BET index is presently under 0.8x, compared to 18.0x in the beginning of the year. This is due to lower stocks prices. In result, valuations are equal to the average for the region of Eastern Europe. Expected profits should be revised in downward direction since risks for local economies are growing together with the global crisis.

Macro economically speaking Romania is number one in the EU with record GDP growth of nearly 9% for the second quarter of 2008. The inflation rate is almost the same but expectations are that it will go down to 6% for the year. The Central bank surprisingly rose interest rates with a quarter of a basic point to the highest interest in EU – 10.25% (compared to only 7% in the end of last year). The government has also announced for expected EUR 2 billion of investments until 2012 in three key sectors – automobile industry, food industry and construction materials industry. At the moment those news are not helping for capital markets recovery and the plunge at high volatility is continuing.

We have to take into account some negative facts implying that in some of the sectors of the Romanian economy we will inevitably see a slow down and shrink of the profits compared to the period 2006-2007. The first reason is that from the end of 2007 we are witnessing a process of fast growing inflation that is raising the cost of local products and services (increased prices of energy, food products, services, labor costs and others). The fore stated is due to the process of convergence with the average prices of goods and services in the EU and the inability of the local companies to quickly transfer the increased prices of commodities to the clients, as well as, the global high inflation expectations. Second reason is the strong competition at the local market and over saturation in some of the Romanian economy sectors. Typical example is the sector of real estates. Those macroeconomic risks (plus stated factors in the comment for Bulgaria) bring forth a number of question marks about the mid-term stability of the Romanian economy and eventual “hard landing”. The latter could be a stop for foreign portfolio investors for months.

In addition, the present political situation in Romania carries certain risks for the capital market, even though they are indirect. The struggle between the governing coalition of Tariceanu and the party of the president Basescu often leads to improvident economic measures that can endanger the macroeconomic stability of the country. The governing coalition is trying to compensate constantly growing popularity of Basescu’s Democratic Party with populist means that are additionally widening recently appeared macroeconomic misbalances. In the end of 2007 the parliament decided to increase the minimal wage with 28% from 2008 and 43% for pensions in 2008 and another 33% for 2009. Recently there has been declared a teachers’ salary increase of 50%! All of this results in huge account deficits in conditions of a global crisis.

Movement of BET index for the past year



The graph of the Romanian index resembles that of the Bulgarian one (as well as graphs of most of the regional indexes for the last couple of months). Here we are also expecting to see lower levels before market hits bottom and reverses. Until then there will be a period of high volatility. More concretely about the expected duration of the bear market and prognosis for reverse trend in time we will make in our next investment commentary after 3 months.

Investment Strategy of Advance Invest Mutual Fund

The strategy of the fund is based on the stock-picking approach – selection of Bulgarian and Romanian stocks, which the asset manager believes to perform better than the market as a whole. In a negative market as is the case now, the latter should be stocks that are defensive by nature (preserve or increase in value when the rest of the stocks decline). As far as such instruments are available in these markets, the best candidates are agricultural land REITs, representatives of the consumer staples sector, and other stocks with low correlation with the market (low beta stocks). Currently, we will aim at maintaining a cash position larger than normal. The main goals of the asset manager will be to strictly control the liquidity risk, to attempt to reduce the volatility of the fund's price as much as possible despite the expected high volatility in the markets, and at the same time to try to make the most of the emerging investment opportunities.

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.

For further information: **www.karoll.bg**

Risk statement

The value of shares and the income from them can go down as well as up, profits are not guaranteed, and investors assume the risk that they may not recover the full amount of their investment. Investments in the mutual fund are not guaranteed by a state guarantee fund or any other institution. Past performance of the fund should not be viewed as a guide to future performance. Before making an investment decision, please read carefully the prospectus of Advance Invest. The prospectus and the fund's charter documents are publicly available for investors in all offices of Karoll Capital Management as well as at its website.