FOCUS

Exciting Opportunities in Emerging Europe, Middle East and North Africa

July 2010

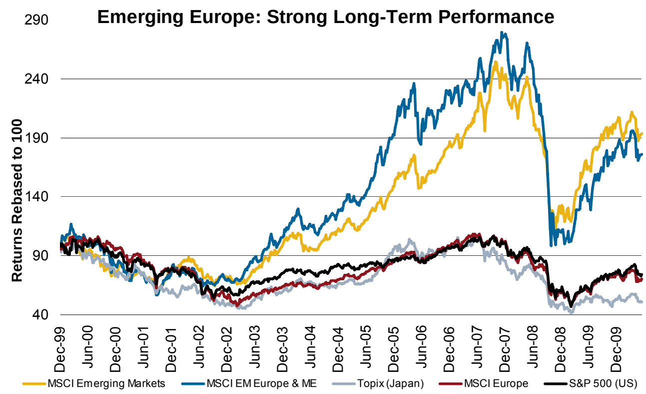
Emerging and Far East Equity

We believe that Emerging Europe, Middle East and North Africa is an exciting region that offers investors the opportunity to buy into a multi-year growth story at very attractive levels. Marcin Fiejka, manager of Pioneer Funds – Emerging Europe and Mediterranean Equity discusses some of the key attractions of this region.

→ It substantially outperformed developed and global emerging markets in the noughties until the collapse of Lehman Brothers.
→ It has led other markets in the post-Lehman recovery.
→ We believe that it can outperform going forward.
→ It is less exposed to global trade than other emerging regions and relies more on consumption and investment for growth.
→ Countries like Turkey and Egypt have excellent demographics and rising incomes, a powerful combination that will drive consumption.
→ Russia offers the dual attractions of Energy supremacy and a positive consumer story.
→ North Africa and the Middle East are good development areas that are likely to yield growing opportunities.
→ Valuation – the cheapest region globally – Russia is the cheapest country in the world on 12m-forward PE multiples; Turkey is not far behind.
→ The region has held up well in the face of the sovereign debt worries in Europe – a good sign of confidence in the region in the face of a crisis due to relatively sound fiscal and monetary health.
→ A lot of investors' money is still in cash, which will eventually seek better returns – Emerging Europe looks very appealing on a risk-reward basis.

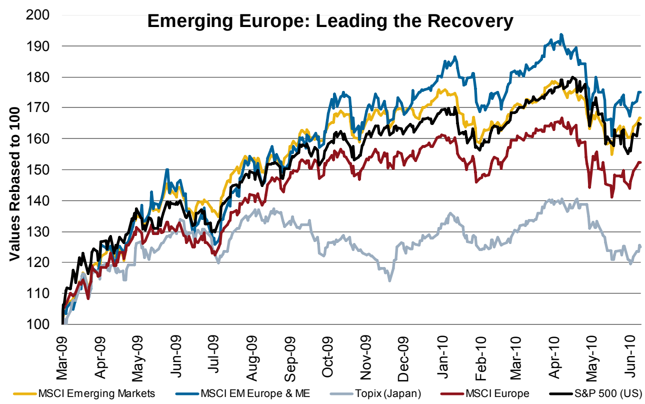
Market History: Strong Performance

Throughout most of the past decade, the Emerging Europe and Mediterranean region was a star performer compared to other global areas or countries. This was especially true compared to developed markets, but it also outperformed global emerging markets until shortly after the collapse of Lehman Brothers in September 2008.



Source: Bloomberg, weekly data, local currency, 31/12/99 – 11/06/10

The MSCI Emerging Europe & Middle East Index peaked on 7 December 2007, although it was still holding its own relative to other markets through the middle of 2008. However, as the credit crunch unfolded, and especially following the collapse of Lehman Brothers, its relative performance deteriorated (with Russia very weak) before reaching a trough on 20 November 2008, slightly after global emerging markets (27 October). This means that the period of underperformance for emerging markets was really only around four or five months, although the pullback was extreme. Indeed, developed markets continued falling until 9 March 2009. Investors quickly realised that the severe falls in emerging European markets were overdone and were prepared to reinvest several months before being enticed back into developed markets, which were the source and main area affected by the credit crunch.



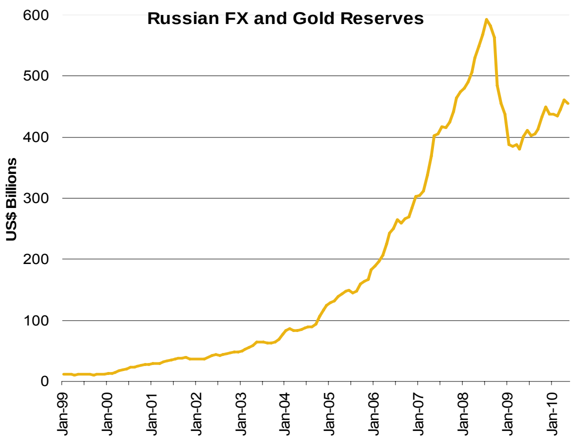
Source: Bloomberg, daily data, local currency, 09/03/09 – 17/06/10

Overreaction to the Credit Crunch

The fact that our region suffered heaviest during the initial part of the credit crunch was, in general, an overreaction. Some of the region's countries were justifiably avoided in a risk-averse environment such as Ukraine, Kazakhstan, Bulgaria, Hungary and the Baltic states, as they were negatively impacted by the credit crunch and liquidity problems. Russia also had the dual negatives of a very weak oil price and liquidity problems due to an unbalanced banking system. Although, we believed that the sell-off in Russia was an overreaction and presented a good buying opportunity. Russia mobilised its extensive reserves which helped it through the liquidity problems and on the path to a strong recovery.

In general, countries in emerging Europe have strong balance sheets and did not face the same solvency issues as many developed markets. Investors were unnerved by the region's high percentage of short-term debt to GDP, which was a lot worse than other emerging countries. However, this again was an overreaction as the key markets of Turkey, Russia and Poland were reasonably sound on this issue. There were bigger issues in countries such as the Baltic States, Bulgaria and Ukraine and these drove the headlines scares but the whole region was punished.

Looking at the source of financing paints a similar picture. The ratio of private sector loans to deposits was above 100% in countries including the Baltics, Slovenia and Ukraine, meaning deposits were not sufficient to finance lending activities and thus a reliance on external financing. The situation in Poland and Turkey was much better; Russia was around 100%. However, Russia had a specific problem due to the unbalanced nature of its banking system: Sberbank, easily the largest bank, held most of the deposits, but most of lending came from the smaller banks that were reliant on wholesale external funding, which dried up. Russia's sizeable reserves were utilised to help this liquidity crises.

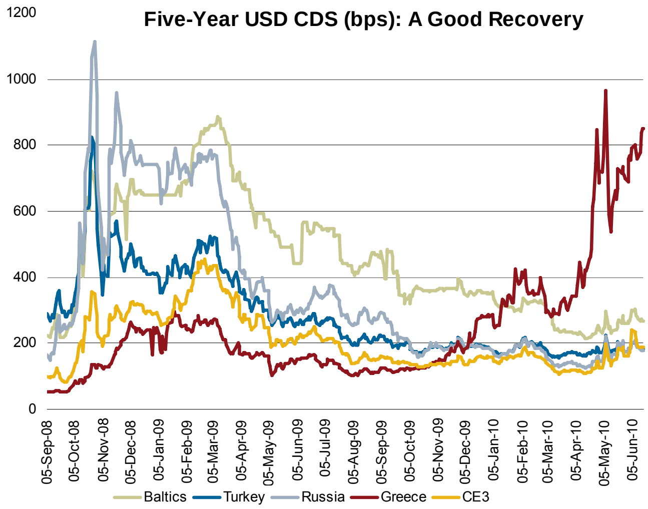


Source: Bloomberg, monthly data, 29/01/99 – 17/06/10

Strength Now More Apparent

The rapid recovery from the banking-sector-inspired credit crunch is starkly highlighted by looking at debt spreads in emerging Europe. There has been a big contraction in spreads, as demonstrated by credit-default swaps (CDS), which highlight the much-reduced risk in the region. The lower risk profile of eastern European countries is further highlighted by comparing spreads with European countries like Portugal, Italy, Greece and Spain. The so-called PIGS have seen spreads widen considerably, often to record levels, in this new government-debt phase of the credit crises. What is especially reassuring for our markets is the contrast in how they have behaved relative to developed countries recently compared to mid-late 2008.

As at 16 June, five-year sovereign CDS on Russia, Turkey and Poland were lower than all of the PIGS countries. Indeed, even Hungary (313 bps) and the Baltic States (weighted combination) are now lower than Portugal; at 268 bps, insuring against default on the Baltic States is only slightly more expensive than Spain (258 bps).



Source: Bloomberg, daily data, 05/09/08 – 16/06/10

Consistent Investment Approach

We have a 'growth-at-reasonable-price' style. Our investment process is bottom-up driven with top-down risk controls and thematic considerations. Our bias is toward mid- and small-cap companies, as this is where we see the biggest growth opportunities and entrepreneurial spirit. Typically we have a three-year horizon when making investments, with pragmatic and conviction-based decision making and we are not afraid to go significantly overweight or underweight.

A Dynamic and Exciting Region with Growing Opportunities

Emerging Europe and the MENA (Middle East and North Africa) region is a dynamic part of the emerging-market universe. Pioneer Funds – Emerging Europe and Mediterranean Equity targets the best opportunities in this area, whether in the benchmark or not, such as Egypt. Since the end of May, Israel is no longer a part of our benchmark, the MSCI Emerging Markets Europe and Middle East 10/40 Index. This leaves the benchmark consisting of only five countries: Russia, Turkey, Poland, Hungary and the Czech Republic. Even when Israel was in the index, Russia represented almost half of the benchmark, but this will rise to well over 50% in the new breakdown. At present, we do not know what, if any, countries will be added to the benchmark, although we have always looked for potential opportunities in non-index countries. It is unlikely that there will be changes in the next 12 months but Qatar and the UAE have been mentioned as potential contenders to move from the Frontier to developed universe.

We believe that the region is rich in current opportunities but with even more potential in the future: the overall size of the market will increase due to strong economic growth, new listings, better broker research, improved corporate governance and more investor interest. We essentially break the opportunity set into four areas:

1. Russia – an energy superpower but also good potential from rising consumer spending and living standards.
2. Turkey – a dynamic country with huge long-term potential. Can be a counter-balance to Russia on energy prices.
3. Eastern Europe – the CE3 countries of Poland, Hungary and the Czech Republic. We would also include non-index countries like Romania and the Baltics in this area. Euro convergence has been a key theme.
4. Middle East and North Africa – a small but growing opportunity in non-index markets

Central Eastern Europe

Joining the euro was a key priority for these countries prior to the collapse of Lehman Brothers. Following the collapse there was a renewed impetus to continue the reforms to join the single currency to eliminate currency volatility. However, recent sovereign-debt and liquidity worries have cast doubt on the need to join as soon as possible because having flexibility on currency and monetary policies has been a big help in emerging from the crisis. We believe that the timetable for Poland joining has been pushed back and is now more likely to be around five years rather than three. They don't want to experience the boom and bust scenario like, say, Ireland, where they would become less competitive; low wages are still a big part of their competitive advantage and they would be scared to loose this edge that helps attract inward investment. There is no real option other than to join the euro but politics will play a big part in the timing and there is likely, in general, to be less haste than there was. Estonia will join next year.

Countries in Eastern Europe are in good fiscal health despite the headlines and are certainly in better positions than peripheral developed European countries concerning budget deficits and total debt. Hungary is the most indebted but reforms are continuing and the recent comparisons between it and Greece seems were political games rather than a picture of reality.

Out of the CE3 countries (Poland, Hungary, the Czech Republic), we see the best opportunities in Poland, which is easily the biggest market. However, a caveat is that the country is becoming less of an emerging market than most others in our universe. Despite this, we still see some good options especially due to corporate restructuring or in the small- and mid-cap area. Hungary is quite a narrow market, with only a small number of publicly listed companies that are liquid enough to interest us. In this respect the Czech Republic is similar. There are only around five companies in each market that we would consider investing in.

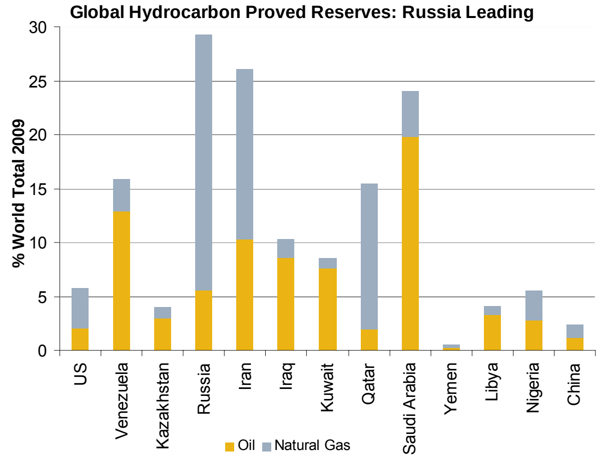
Although we are underweight in CE3, we have investments in all countries, including Hungary, and will be looking for new opportunities. We recently invested in the IPO of PZU in Poland.

PZU is Poland's largest insurance company. The company controls around one third of the domestic life and non-life markets, significantly more than its nearest competitors. It has robust sustainable profitability and good medium-term growth potential from restructuring, better prices for corporate motor policies and low penetration levels of the Polish insurance market (less than half of the eurozone level). Longer term, there are opportunities in medical insurance and pensions, where it is only the third-largest player. The company is relatively low risk due to being a dominant player in a growth market; it offers an attractive dividend yield and potential for a large special dividend.

Russia

An Energy Superpower

Russia is well known for being a play on commodities. Recently published research from BP suggests that Russia was the world's biggest oil producer in 2009, with 12.9% of total global production and a 1.5% increase on the previous year. For comparison, Saudi Arabia, the biggest producer in 2008, decreased production by 10.6% in 2009 to record a 12% share. In natural gas, Russia (17.6%) ranks just behind the US (20.1%) in production, but they are well ahead of third placed Canada (5.4%).



Source: BP Statistical Review of World Energy 2010, published June 2010

It is not just in current production that Russia leads the world. Russia also has the largest supply of proved reserves. Although energy prices are volatile, supply is finite even if it has been revised higher recently due to unconventional extraction measures such as shale. This means that momentum will stay behind prices over the medium term. Thus, Russia's strategic importance to the global economy should continue for decades to come.

Overall, we were slightly overweight in Russian Energy as at the end of May (26.62% vs. 24.68%). We are positioned to benefit from planned changes of taxation rules for oil companies from revenue to profit-based measures. Currently these changes only benefit companies producing oil off-shore and in East Siberia such as Rosneft and Surgutneftegas. Further changes in Russian tax rules are needed if the government production and revenue targets are to be reached. These changes would boost valuations and help jump start capital expenditures in the oil services sector. However, the government has gone in the other direction recently by eliminating some of the existing tax breaks in East Siberia due to fiscal constraints. Therefore, in the short term, we see few triggers to raise the low valuations of Russian oil companies that suffer from a punishing tax regime and recent price declines.

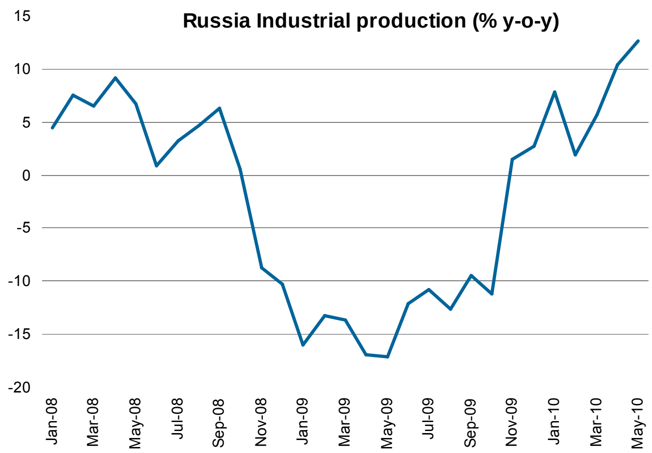
We are more optimistic longer term although it is hard to ignore the current compelling valuations, which have been getting even more attractive due to market falls since mid-April.

One of our favourite Energy stocks in Russia is TMK, an oil-services company that produces pipes. TMK will be a big beneficiary of any tax changes in the Russian energy sector but it also has growth opportunities in other countries, especially the US, which is rapidly expanding production of natural gas from shale. Indeed, the US will be a major driver of performance in 2010.

Russia: Big Opportunities in the Consumer Space

There are some positives to come out of the crisis, such as falling inflation and interest rates, which is a powerful combination to help boost consumption. The reserve funds and a strong government balance sheet enabled Russia to refinance the banking system and put the economy on the path to recovery. The country is now in good shape, with economic growth estimates continuing to be being revised higher: GDP in 2010 could substantially exceed government estimates of 4%, with most analysts looking for around 5.5% - 6.2%, although some are as high as 7.5%.

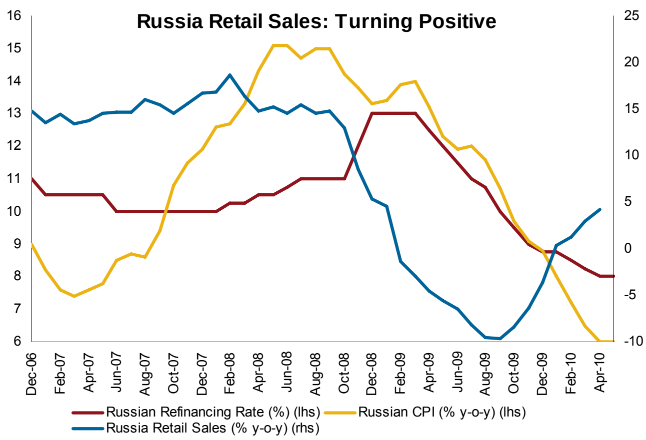
Additionally, other indicators such as industrial production and unemployment have shown good momentum recently and have beaten expectations. Industrial production in May was 12.6% ahead of the same month in 2009 but the turnaround from last November when it was -11.2% has been very strong.



Source: Bloomberg, monthly data, January 2008 – May 2010

Source: Bloomberg, monthly data, December 2008 – May 2010

Although, we are positive on oil and gas prices over the medium term, we are even more positive on the consumer areas. This has been the biggest sector bet in the Portfolio for some time, with large positions in Russia and Turkey, although in Russia we are very underweight Financials, with the opposite being true in Turkey. Our consumer exposure in Russia is in areas such as from food retail (X5, Magnit), Vodka (Synergy), cars (Sollers), television (CTC Media) and grain and sugar (Razgulay). We have also recently initiated some new positions in PIK (property), Cherkizovo (meat products) and Pharmstandard, (pharmaceuticals). Our consumer exposure highlights our preference for higher-growth medium-sized companies that are often not in the index.



Source: Bloomberg, monthly data, December 2006 – April/ May 2010

New Stock Idea: PIK

PIK is one of Russia's leading vertically integrated house builders, with a focus on mass-market construction, especially in the Moscow region. It is a high-beta stock but improved market conditions, a positive management outlook, potential for further debt restructuring, reduced refinancing risks and a huge land bank are positives that could drive growth. PIK has a market cap of around US$1.85bn (17 June).

New Stock Idea: Cherkizovo

Cherkizovo is an integrated meat producer (pork, poultry and meat processing) and distributor, with coverage across Russia. It has an excellent track record with compound annual top-line growth of 24% between 2003 and 2009 and even stronger earnings growth (over 40% per annum). This was a period of expansion (organic & M&A) and efficiency improvements that is now largely finished. It should benefit from strong cash flows going forward and recently released first-quarter results showed strong growth in all three business divisions. Cherkizovo has a market cap of around US$1.05bn (as at 17 June).

New Stock Idea: Pharmstandard

Pharmstandard is the largest domestic pharmaceutical producer and the fourth largest in Russia on sales. It produces generic and original products in areas such as pain relief and flu. Since its creation in 2003 it has consistently outperformed the market and achieved strong margins. The company has strong management and a clear strategy of organic growth plus acquisitions if they add value. We had a good entry point following a 7.7% fall in the shares on 11 May after the GDRs were excluded from the MSCI Russia index. Revenue growth was very strong in 2009 and first-quarter results were solid, with further upgrades likely. Pharmstandard has a market cap of around US$3.4bn (as at 17 June).

Russia: Can it avoid the Dutch Disease?

We are referring to the fact that Russia is very reliant on energy and basic resources. The key question for its long-term prospects is whether it can adapt and use the income to develop other areas of the economy and create growth that is more balanced. This is certainly a priority for the government. Indeed, the St. Petersburg International Economic Forum, which began in mid-June, is being used by the government as a push to modernise the economy. One of the key initiatives for the President is creating a Russian 'Silicon Valley' with high-tech business in areas such as IT and nanotechnology. It is too early to tell how successful they will be in using the tax system to boost capital into other areas but we are happy with our focus on the consumer and the oil & gas sector and underweights in Financials and Materials.

Turkey: A Consumer Focus

Structural Improvements

Turkey has benefited from structural reforms and much better fiscal discipline over recent years. The central bank aggressively loosened monetary policy by 1025 bps in the year to November 2009; interest rates have since remained at the all-time low of 6.5%. Inflation has picked up in recent months, but it is not the problem in Turkey that it once was, with CPI remaining pretty stable and mostly in single figures, since 2004.

A Growing Regional Superpower and Energy Hub

Turkey is emerging as a regional superpower, looking to expand its sphere of influence throughout the MENA region. The country did not need IMF financing last year and there is less emphasis on EU accession due to a very resilient economy and growing confidence about its own future. For instance, there is a new Caspian oil pipeline coming into Turkey, which will boost its strategic importance to Europe. There has also been a lot of investment in oil and gas processing.

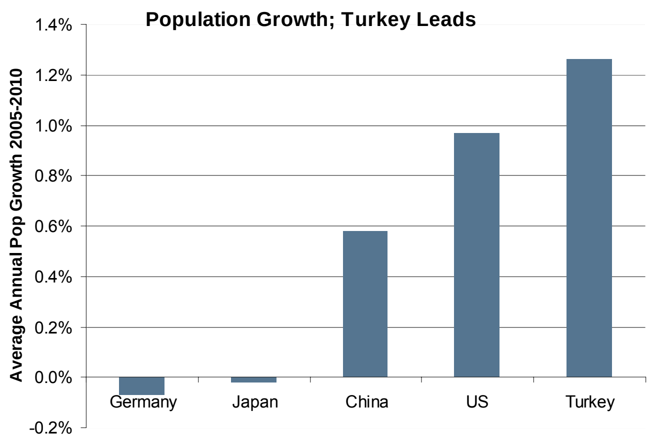
One of our favoured holdings in the Energy area is Tupras-Turkiye Petrol Rafine, which is trading on a decent discount to peers. While domestic sales were still weak in the first quarter they should pick up from here and export sales were very strong (145% increase y-o-y). This highlights the fact that companies are increasingly looking beyond domestic boundaries for growth.

One of our new holdings is Turcas Petrol. The company has a diverse energy and power-generation portfolio (power generation is also a recent theme behind some new buys). Turcas is a partner in Turkey's largest fuel retailer, Shell & Turcas, but it is also involved in refining and petrochemicals, power generation and trading, and gas wholesale.

Consumption

One of our overriding themes is domestic consumption, with investments in areas like banking, automobiles and electronic goods. The cost of loans has come down sharply, which will boost consumer loan growth and drive discretionary and non-discretionary spending progress across many areas of the market. The central bank of Turkey has stated that interest rates may have to stay low for an extended period as it expects inflation to remain well behaved and is mindful of exogenous shocks.

Turkey also has one of the best demographic profiles among developed and developing countries, with a young and growing population, combined with rising GDP per capita. According to IMF statistics, GDP per capita in Turkey will rise from US$8,723 in 2009 to US$11,207 in 2015, a 28.5% increase. The combination of these two factors will give consumption serious momentum over the short, medium and long term.



Power Generation

One of the new themes or trends that we like is power generation. Turkey is the fastest-growing electricity market in Europe, where compound annual growth is expected to be between 6% and 7% between 2009 and 2018, driven by robust population growth, higher incomes and urbanisation. In order to drive the necessary growth in the sector, the government is liberalising the sector and has started privatising assets, with 37% of total installed capacity due to be sold. Thus, there may well be more opportunities over the coming year or so. Although only a small part of the Portfolio, we recently bought holdings in two power companies, Akenerji Elektrim and Aksa Enerji

Aksa Eneji is the country's largest independent power producer (IPP), accounting for 24% of IPP capacity. We bought our holding in the IPO in May. It is aiming to increase installed capacity by around 180% by 2014 with a US$3bn investment programme. This should translate into net-earnings growth of over 30% per annum during this period. Aksa has a market cap of around US$1.77bn (17 June).

Akenrji is the fourth-largest IPP with a portfolio electricity generation plants (three gas and one wind), although it is planning several hydro plants over the next couple of years. The company is likely to be a bidder for some of the upcoming privatisation tenders of power generation and electricity-distribution grids, which could serve as a catalyst for the stock. In addition, weak spot prices in the first half of 2010 could reverse in the second half. Akenerji has a market cap of around US$800m (17 June)

Political

Increased political tensions in Turkey can, and recently have, negatively affected sentiment, but we remain positive on the market and do not expect events to escalate much further. Paradoxically, political tensions between the ruling

AK Party and the secular establishment have a positive effect as they give the AK party a strong incentive to align the country with EU and continue with economic reforms. Maintaining economic growth will be a key priority for the AK party.

Recent political developments in Turkey are potentially positive for the economy long term but could cause raised tensions in the short term. The article of the proposed Constitutional Amendment package on party closures was defeated in Parliament. In addition, the rival CHP party elected a new leader, which will help make it a stronger and more credible opposition to the AKP. These developments strengthen the democratic process; they are good for voters and mean that the secular establishment is less likely to lean on the military for support.

Turkey: A Consensus Overweight

Turkey has become a more consensus overweight market recently, although we have been overweight since December 2008 and have benefitted from good selection even before this time. A good example of this has been leading discount-retailer BIM. We purchased the stock back in the middle of 2005 and it has been a star performer. As more investors discovered its attractions, so the share-price-appreciation increased. We have taken advantage of this stellar performance and less compelling valuation and have been gradually taking profits and reducing exposure to BIM since the middle of last year, although it remains a significant holding. However, we have found plenty of other opportunities in Turkey. Nevertheless, with it becoming a consensus overweight, we are also becoming keener to pursue other emerging opportunities in areas such as Egypt.

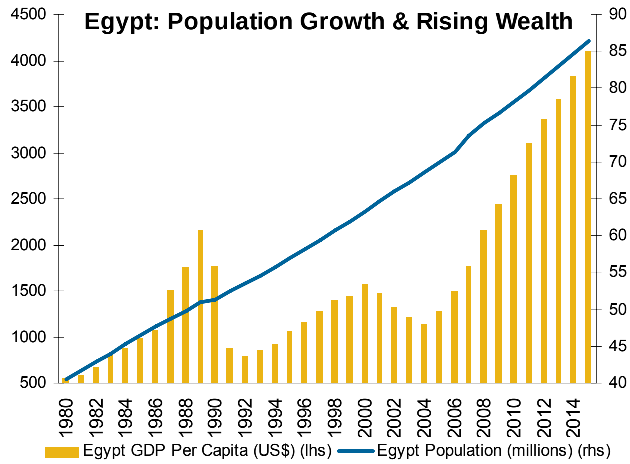
Middle East and North Africa (MENA): Future Potential

They are all non-index countries but finding good stock ideas in these markets has been a growing focus for us. We already have a good knowledge of the Egyptian market as we have been following and investing in it to various degrees for several years. Currently, we only have 106 bps invested in Egypt, although this and investments in other countries is likely to grow. There is also the possibility that some of these countries may join the index, which would be a further catalyst and a good reason to invest early. However, our criteria is the same as any other investment and any company has to look attractive in its own right.

We have three investments in Egypt, Commercial International Bank (the country's leading bank), Lecico, which is one of the world's largest sanitary ware (bathrooms etc) producers, and a new position in Olympic Group Financial Investments.

Olympic is a manufacturer of household appliances such as white goods, vacuum cleaners, boilers and air conditioners. It is the largest player (29%) in a fragmented local market, offering a broader range of products than its competitors. A major catalyst for the company is a deal with Electrolux that will bring benefits from 2011 and could see output double over the next five years, with growth in the domestic and export markets.

We believe that there is huge long-term potential in the consumer sector in Egypt and other North African countries. Rising incomes, a growing population and increased use of financial products like loans and credit cards will all help drive growth in the consumer sector. The penetration of financial products in Egypt is very low, with only around 10% of the population having bank accounts (credit cards 4%); retail loans are only 8% of GDP. We have been looking at increasing our Egyptian exposure for a while and will build on our initial position in Olympic over coming months while keeping an eye out for further opportunities. Egypt is the most populous country (78m) in the MENA region (Middle East & North Africa) and it has excellent demographics: only 4% of the population are aged over 65.



Source: IMF World Economic Outlook Database, April 2010

Conclusion

This is a very exciting time for investing in the emerging Europe and Mediterranean region. Structural changes are transforming former investment backwaters into genuine opportunities. This change will play out over the long term and we believe that investors should seriously consider its attractions. There are many positive drivers for the region over coming years, not least stronger economic growth and consumption, manageable debt levels and better fiscal health, and lower valuations. Compared to other emerging regions that are more heavily dependant on world trade, emerging Europe is still driven by domestic consumption, which bodes well in the current climate.

In addition, the problems in Europe have highlighted that the developing world can be seen as less risky than developed markets. With retail cash levels in money-market funds remaining elevated, the attractions of less risky but higher-growth assets and cheaper prices should be an appealing combination for investors.

Household consumption is a key priority for emerging European countries and is the biggest focus for our Portfolio. Problems in the eurozone will constrain export growth but consumption is by far the largest driver of GDP. Therefore, we will continue to focus on countries with lower levels of household debt, like Turkey and Russia, which can maintain healthy levels of consumer activity. Some countries such as Hungary, Ukraine and the Baltics will struggle relative to Turkey and Russia, although they will still maintain higher growth rates than western economies, which should enable them to grow out of current difficulties.

Important Information

PIONEER Investments®