Diamond Age Russia Fund

Monthly Letter to Investors – January 2011

State of the Inflation Address

"A coward dies a thousand deaths; the valiant tastes of death but once." **William Shakespeare, *Julius Caesar***

Following a world-beating +16.66% performance in December, the Fund returned an unremarkable +0.50% vs. +2.19% for the benchmark index, MSCI Emerging Markets Europe (MXMU) in January. In the final hours of a six month +57.77% advance, in which **Diamond Age** was the #2 performing of all Russia funds and Russian hedge funds tracked on Bloomberg, the Fund deleveraged the book. Over the course of the last three trading days of the year, the Investment Advisor sold down the Christmas rally.

Emerging market equity positions were paired in keeping with this publication's August 2010 "Two Rate World" scenario and November 2010 view, that EM inflation is a real and present threat to 2011 portfolio construction. Indeed for the YTD performance period, MSCI Emerging Markets (MXEF) was down -2.81% and EM inflows have turned markedly negative.

International Business Partners and Terms

Investment Advisor	*Diamond Age Capital Advisors Ltd.*
Administrator	*CIBC Bank and Trust Co. (Cayman) Ltd.*
Russian Custodian	*CitiGroup – ZAO Citibank (Russia)*
Auditors	*Deloitte & Touche – Cayman Islands*
Tax Consultants	*Ernst & Young – Russia and Cyprus*
Legal Counsel	*Campbells – Cayman Islands*
Base Currency	*US Dollar*
Hurdle Rate	*US Dollar 3-month LIBOR + 50 bps*
Inception Date	*18 February 2005 at US$100 per share*
Dealing Day	*Friday*
Min. Subscription	*US$100,000*
Bloomberg Ticker	*DIAMRUS KY <Equity> <Go>*

Current Asset Allocation

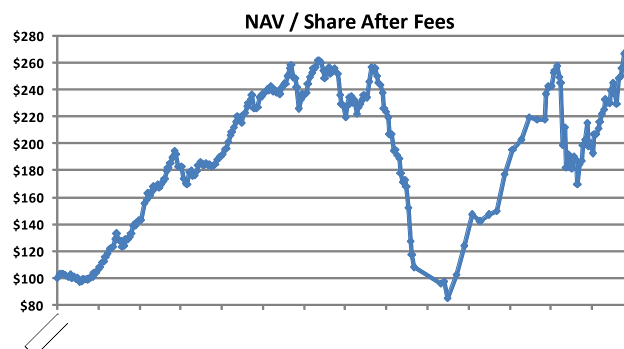
Asset Class	*Long*	*Short*	*Gross*	*Net*
Equities	115.7%	5.5%	121.2%	110.2%
Bond	0.0%	32.9%	32.9%	-32.9%
Commodities	39.4%	0.0%	39.4%	39.4%
FX	0.0%	25.1%	25.1%	-25.1%
Total All	155.1%	63.5%	218.6%	91.6%
Leverage	118.6%			

Historical Performance

	2005	2006	2007	2008	2009	2010	2011
Jan	-	13.67%	1.29%	-10.44%	-11.34%	-0.79%	**0.50%**
Feb	2.24%	2.73%	5.70%	2.75%	-11.37%	0.03%	
Mar	-0.27%	4.05%	-0.29%	-3.48%	20.53%	11.16%	
Apr	-2.54%	8.80%	1.88%	3.03%	20.86%	1.02%	
May	-0.51%	-3.78%	-0.71%	9.17%	18.71%	-21.49%	
Jun	1.84%	-1.67%	2.88%	-7.02%	-3.28%	-2.00%	
Jul	7.77%	0.37%	1.75%	-13.09%	3.37%	7.72%	
Aug	8.76%	2.33%	-4.69%	-8.69%	1.93%	-4.96%	
Sep	12.64%	0.01%	5.07%	-10.76%	18.41%	12.14%	
Oct	-6.56%	3.70%	4.99%	-35.75%	10.24%	6.31%	
Nov	7.49%	5.36%	-2.96%	n/a	3.66%	-0.13%	
Dec	7.33%	9.49%	0.80%	n/a	8.34%	16.66%	
Year	**43.27%**	**53.70%**	**16.26%**	**-57.73%**	**103.00%**	**21.92%**	**0.50%**

NAV Data

Fund Price (W/Avg), Main Class	Bid $265.65; Offer $269.13
Designated Investment Share Class	$68.62
Total Assets (AUM)	$32,355,619



Diamond Age
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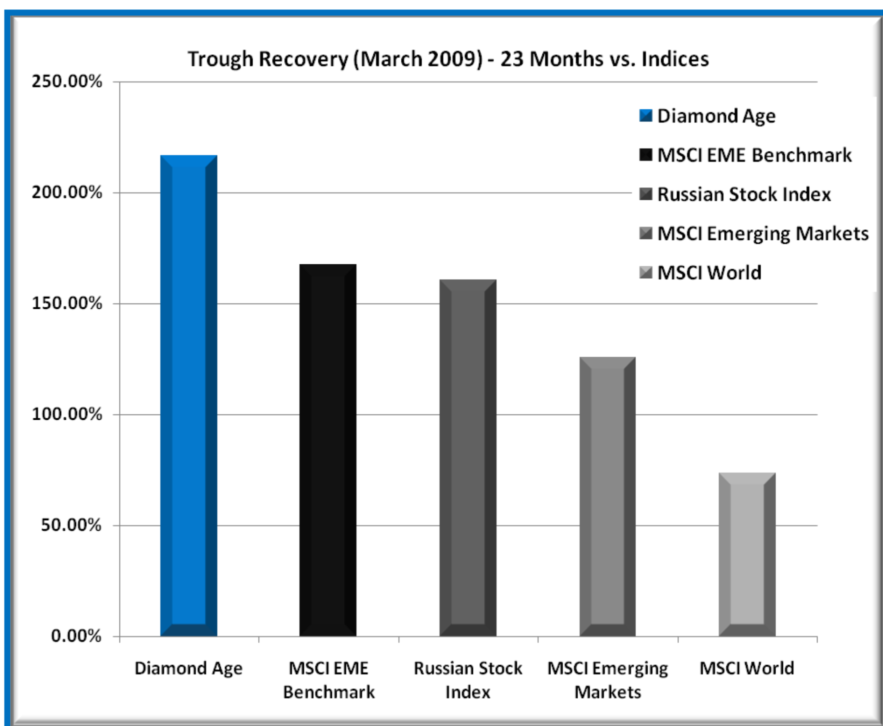
Fund NAV remains at an all time high and stands at $269.13 per share, having passed the pre-crisis high water mark at yearend 2010, while outperformance vs. all-comers expands; now +216.53% since calling the market bottom in March 2009, some 23 months ago.



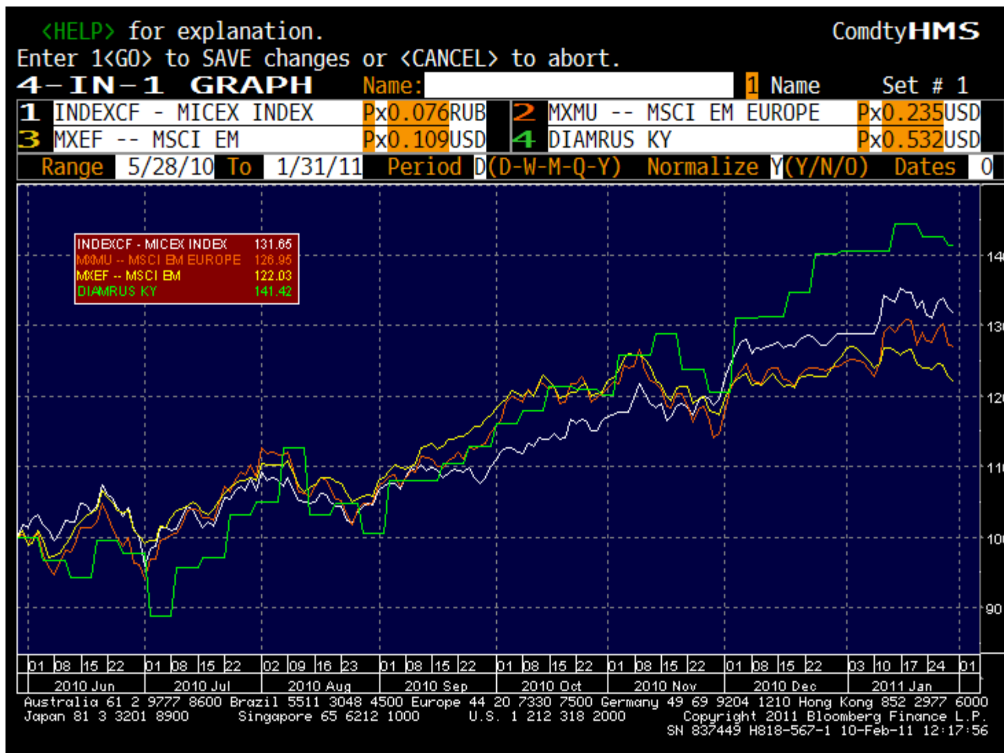
Sector Allocation	
Commodities	18.04%
Financials	15.21%
Sovereign Debt	15.02%
Metals and Mining	12.12%
FX	11.49%
Real Estate	5.34%
Agriculture	4.69%
E & P	3.15%
Coal	2.84%
Shipping	2.71%
Industrials	2.43%
Construction/Infrastructure	2.23%
Conglomerate	1.32%
Information Technology	1.29%
Media	0.82%
Chemicals	0.69%
Automotive	0.60%
Total	100%

Name		23 Months
Diamond Age	(DIAMRUS KY)	216.53%
MSCI EME Benchmark	(MXMU)	167.50%
Russian Stock Index	(MICEX)	160.49%
MSCI Emerging Markets	(MXEF)	125.57%
MSCI World	(MXWO)	73.42%

Despite broad EM geographic dispersion in some 23 countries, DA performance fared better than emerging market equities (-3%) in part, as the Fund packed the wagon at month end, with March Brent COJ1 Futures to 13.59% of gross NAV on early Tunisian developments. Ensuing Egyptian contagion was of positive utility, as oil rallied from $92.30/bbl (intraday) on January 5th to above $100/bbl at month end January 31st.

Diamond Age remains of the mind that following a post crisis period of broad-based economic growth, coupled with extraordinarily expansive monetary policy in much of the world, capacity constraints, rising resource and raw material inputs, and a persistently weak dollar, has lead to a period of higher than anticipated inflation in many emerging markets. EM central banks are, in the main, behind the curve in addressing these material inflation threats.

Something new? Yes. Diamond Age now abruptly changes its bold, brave, bullish position printed here, when the sky was black in May 2010. From that publication, the Fund outperformed the benchmark MSCI EME by 54%, Russian stocks by 31%, and Emerging Markets by 88% (chart below).



In measured departure from October 2009 cautionary stance, Diamond Age re-aligned portfolio construction back in favour of the "June Moon Boon" in May 2010 when hope seemed lost; and subsequently outperformed the benchmark by 54% over the next eight months

Geographic Dispersion	
United States	21.00%
Russia	19.39%
Australia	7.06%
Thailand	6.40%
Canada	4.93%
Kazakhstan	4.88%
Singapore	4.06%
Georgia	3.95%
Switzerland	3.62%
United Kingdom	2.93%
China	2.72%
Ukraine	2.25%
Hungary	2.22%
Cyprus	2.09%
Guinea	2.01%
Ireland	2.00%
South Korea	1.70%
Sweden	1.57%
Norway	1.26%
Turkey	1.20%
Finland	1.03%
Turkmenistan	1.01%
Philippines	0.75%
Total	100%

Even as the lone whistler in a dark, damp place, it was easy to dismiss 2010 market phantoms of "currency wars", demise of the Euro, US unemployment, end of Chinese commodity demand, Greek contagion, and other false maelstroms which never really threatened to derail the global recovery. Why? Because plain as day - it was bollocks. Consistently however, the Investment Advisor's position is maintained that EM inflation is both real and present, the knock-on effect to DM has already started, that the rate hike trend accelerates, and the bad news is that this paradigm will likely last the whole of the economic cycle.

Markets are primarily driven by rates, monetary policy, Fx, sentiment, and most importantly, future expectations; not valuations which are of tertiary importance.

Anecdotal: ***Listening to Nouriel Roubini at the recent Troika Dialog Conference in Moscow two weeks ago was a disquieting experience. Having been of the most visible and vocal bears in the entire world (and wrong as sin for the last two years), Mr. Roubini a.k.a. "Dr. Doom" seems to have gotten bullish. His "bottle is half full" speech was grandiose yet hallow, and perhaps even apologetic. Curly words which had smart-boy trigger fingers thumbing for the sell button on i-Pads across the forum, and simply gave us the creeps.***

Once again the internal question is, should investors be willing to accept a 20% or perhaps even greater pullback of uncertain timing, in order to reach greater heights and attain still more profitable levels? Our impression is yes. It is impossible to imagine a 217% return in less than two years without measurable risk. While current short book represents 63.5% of gross AUM, and certain of our focused hedging strategies are in place precisely to mitigate (or even profit from) inflation spikes, let us be clear: present portfolio construction represents significant unhedged risk.

Is it different now? Yes. Inflation.

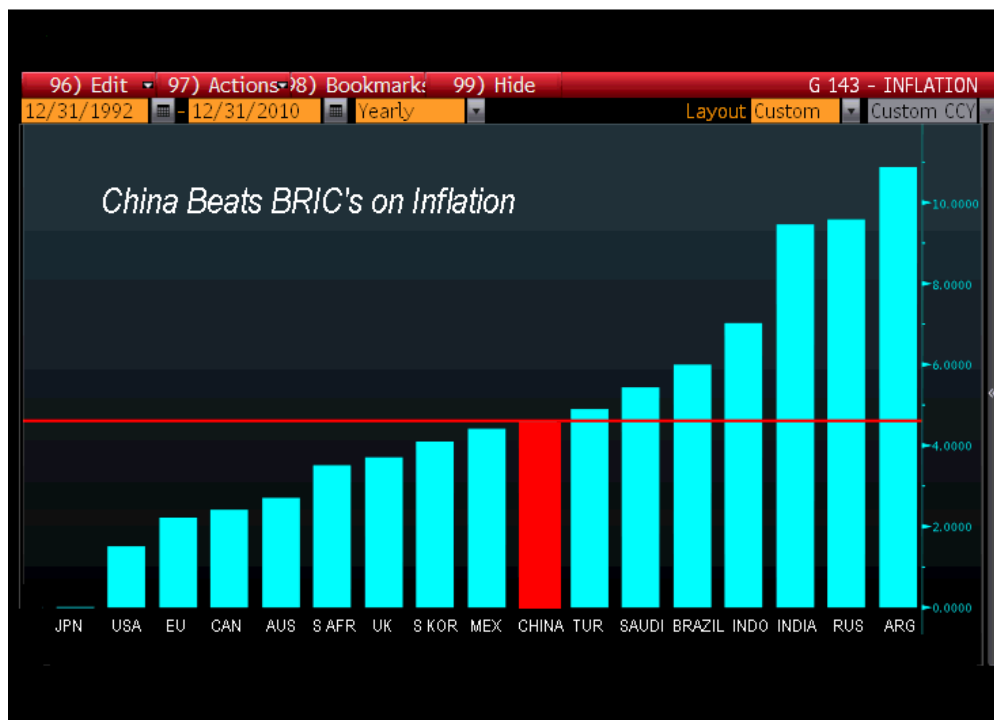
Food and energy inputs (non-core inflation) represent 71% of total consumer spending in emerging market economies vs. just 24% in developed market economies. Select EM economies are also experiencing rapid growth

in core-inflation inputs in addition to food and energy; notably wage inflation in China and elsewhere in Asia. Inflation pressures originating in the EM economies are now spreading into DM economies. In America, import price inflation nears 5% and further weakness in the US dollar will accelerate this trend.

None of this seems credibly disputable, despite what embattled Ben Bernanke is selling on "the Hill." We all have a master and his master's priority is job creation (a responsibility not typically assigned to the Federal Reserve). The Fed Chairman's historical charter is to maintain a delicate balance between economic expansion and inflation. In the present incarnation, politics trump inflation and we see populism over pragmatism at the highest levels of government.

The central message from the "great Bear" of the 1970's and the unchecked inflation of that day is that there is no Chinese Wall between headline inflation and core inflation.

It is like the mythical "no smoking section" that exists in perhaps no more than five or six restaurants in the whole of Russia. Both sections are in the same room and are separated by an imaginary "air wall" between two adjacent tables. The non smoking section starts with the three little girls, while the smoking section starts just three feet away, with the three fire breathing dragons. Spill over effects are inevitable and once inflationary pressures gain traction, inflationary expectations become entrenched and become all the more difficult to subdue.

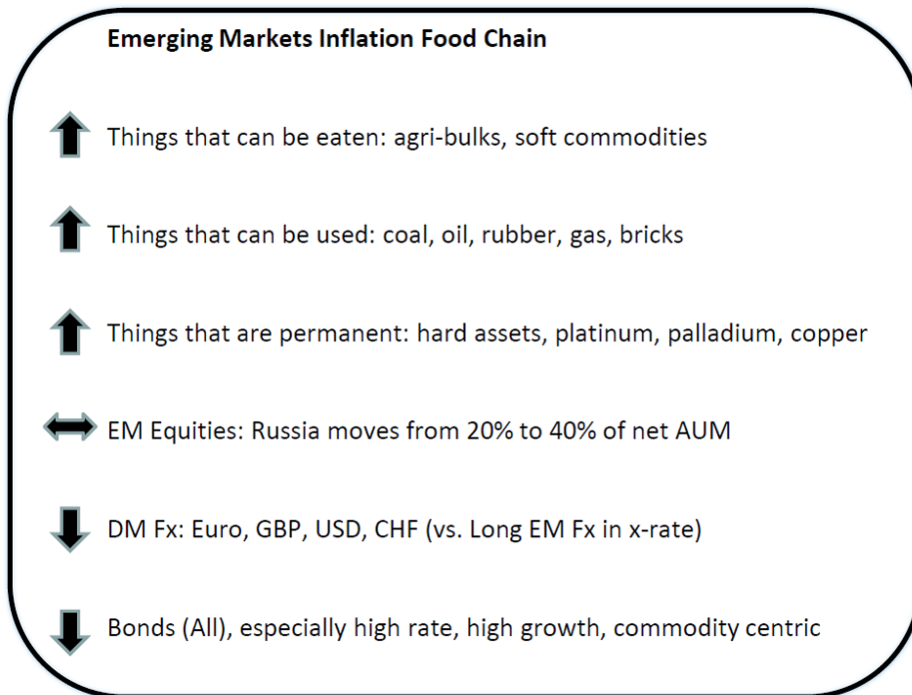


And China is not the only inflation fear on the EM horizon. What about India and... Russia (second from right)? Russia Producer Prices +16.5% YoY, CPI +9.6% YoY, Real Wages +10.2% and Money Supply +22.4%, grease on a slippery slope

What can the Asian (or even FSU) economic powers do and what will they "give up?" Something must be sacrificed. 1) Tinkering at the margins with food price fixing, energy price fixing, adjusting loan mandatory reserve ratio requirements, and token 25 bps rate hikes would be a suboptimal selection. This would essentially be giving up on inflation. 2) A significant increase in real (inflation adjusted) rates would be an appropriate but improbable selection; as this is politically indigestible and would perhaps give up too much growth. And there are many other variants but the Investment Advisor is of the view that 3) managed and well telegraphed currency appreciation, coupled with orderly, co-ordinated, and moderate rate hikes may constitute the best way forward. Of added benefit is that measured currency appreciation will spur domestic demand and help exporters into EM countries including America, Europe and of course Russia. It is a certainty however, that the further central banks fall behind the curve and the steeper the inflation trajectory, the more expensive and pronounced the ensuing dislocation.

Consistent with these perceptions and in fact the market reality, China weight in the Fund was reduced from 7.69% of gross AUM month end November to just 2.72% month end January, to an anticipated 0.0% month end

February. Geely Automotive 175 HK, China Shipping 1138 HK, Xinyi Glass 868 HK, and China Lumena 67 HK, will be eliminated from the portfolio. Other EM positions were cut by 50% and some by 1/3.



In an extreme EM "Inflation Trap", portfolio construction might quickly be rotated to replicate this proprietary emerging markets "inflation food chain" (left). A feeding order which favours assets whose value would not deteriorate as the result of significant, above-expectation, and long-lived inflationary growth

As detailed in December, one of the greatest risks to relative performance is the Fund's 19.39% Russia weight (up from just 16.69% in November) vs. 61.23% for the benchmark MSCI EME.

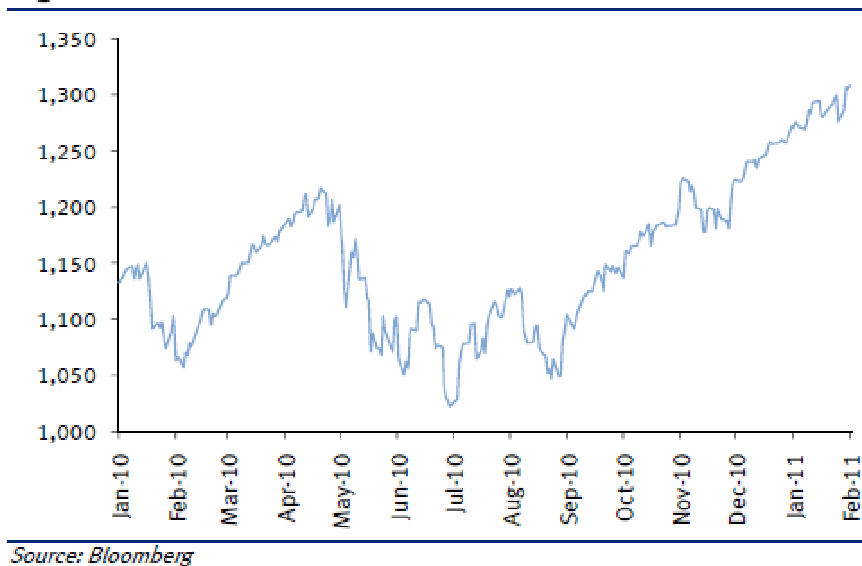
As the Russian stock market advanced an aggressive +2.10% MICEX and +5.65% RTS in January, even as MSCI Emerging Markets retreated, the Fund did not keep pace. It continues to be the Investment Advisor's stated objective to bring the Russia co-efficient of net assets to 40% by Q2 and will likely stand at not less than 25% by month end February.

This being said the Investment Advisor is also very cautious about Russia. Due to pronounced inflation fears within the BRICs, there has been a risk-averse rotation out of China and Brasil. India is also feeling the business end of the inflation prick and there has been a meaningful change in sentiment regarding the domestic consumer story (some shares trading at 5-6x book). With Brent hovering around $100/bbl and with significantly lower valuations than BRIC peers (albeit deservedly so), Russia was allocated much of this dedicated BRIC capital in January.

But is this the beginning of a trend? Has anything really changed? We do not believe so. Russia is a high-beta play on both EM equities and the risk trade. As such it is improbable that any material rotation out of emerging market equities into developed market equities or elsewhere, such as we have seen YTD, would leave Russia unscathed. Russian shares will likely continue to outperform on the way up and likewise underperform on the way down.

August 2010 Monthly Letter to Investors: **"While the following may inspire chuckles and hoots, it is the Fund's perception that even many developed markets including the US look very attractive right now (-31% 10 year return August 31st 2000 to August 31st 2010). 2008 all over again? No. The world has changed. SPX deleveraging in scope and scale never before seen; tumbling valuations, cash and cash equivalent per share breaking the piggy bank, driving M&A and share buyback. Stocks are the cheapest asset class with yields higher than bonds; the SPX trades at the 30 year low of 11.7x 2011 earnings with 34% EPS YoY growth in 2010 and 18% in 2011."**

Standing all alone in August 2010 with the lonely view that US equities were a most attractive asset; the S&P rallied 37% (chart right), and now in 2011, this macro call is increasingly becoming a crowded trade. US traded assets 21% of AUM now constitute largest country weight in the Fund



While **Diamond Age** does not run a US equity strategy, it is good to see that our then heretical August call that US capital markets were in excellent shape, that US equities were a most attractive asset, that "Ma and Pa Kettle" (the US consumer) was alive and well come shopping season, and that Q4 GDP would be closer to 4% than the 2% widely espoused, has now become global consensus. The S&P 500 has rallied 37.43% since that publication and US traded assets at 21.00% of AUM now represent the Fund's single largest country exposure (even ahead of Russia at 19.39%).

Performance Attribution

Equities: 121.23% of gross AUM; top stocks for January: 1. Mirland Development (MLD LN) Russia – Real-estate +20.98% 2. Bank of Cyprus (BOC GA) Cyprus – Financials +22.09% 3. OTP Bank (OTP HB) Hungary – Financials +12.73% 4. MHP (MHPC LI) Ukraine – Agriculture +13.16% 5. Swedbank (SWEDA SS) Sweden – Financials +8.42% 6. Dragon Oil (DGO LN) Turkmenistan - E&P +7.99% 7. Evraz (EVR LI) Russia – Metals & Mining +12.07%

Commodities: 39.44% of gross AUM; Fund largest line item March ICE Brent Crude COH1 representing 13.59% of gross AUM. Also March COMEX Copper HGH1 10.18%, April Platinum PLJ1 6.40%, and March Palladium PAH1 9.27%

Credit Markets: short (-32.82% of gross AUM); Short Australian 10Y bond futures XMH1 (9.17%), Canadian 10Y bond futures CNH1 (10.79%) and US 10Y bond futures TYH1 (12.87%)

FX: short (-25.11% of gross AUM); Short US Dollar, Swiss Franc, and GB Pound via Fx derivatives and Long Australian Dollar, Korean Won, Thai Baht, and Singapore Dollar in X-rate trades. Long Kazakh Tenge, Russian Rouble, Norwegian Krone, Swedish Krona, Georgian Lari, Turkish Lira, and Hungarian Forint via securities held

Outlook

Consistent with its global agriculture theme, the Fund plans to add to soft commodity exposure via CBOT Futures at 6-8% gross AUM, SB K1, C H1, SK1, and W K1 and will hold onto underperforming Charoen Pokphand (CPF TB) Thailand down -14.07% for the month. **Diamond Age** continues to favour its Chinese race for African resource themes. Following Riversdale (RIV AU) Mozambique takeout by Rio Tinto (RIO AU) at consequential +45% profit and selling Sundance Resources (SDL AU) Cameroon at astounding +111% profit, the Fund has added to Bellzone Mining (Guinea), which now represents the single largest equity line item in the portfolio at 4.40% gross AUM (2.01% net). The Fund continues to raise Russia country weight vs. R.O.W. (like the macro ex-government, but not the micro) from all-time low 16.97% Oct 2010 to a targeted 40.00% Q2 2011.

Diamond Age maintains that the confluence of urbanisation, EM population growth, resurgent demand, rising extraction costs and scarcity of resources indicate that commodities have entered into a period of a "super-cycle": a decades-long period of higher prices driven by the emerging middle classes, rising living standards, and

eventually American-style individual consumption levels, in a one directional shift in power, prestige, and demand moving from West to East.

Unwavering in its perception since March 2009, the Fund maintains that we are in the midst of a post-crisis global recovery, which is largely consistent with historical post-crisis recoveries. The investment climate for "Russia" may be fairly characterised by world-wide growth, inventory restocking, industrialisation, and associated demand for raw materials.

Diamond Age remains long and leveraged to Russia-related assets, the risk trade, natural resources, and emerging market equities. The Fund is short select equities Frontline Norway (FRO NO) and Mail.ru (MAIL LI), short long-dated bond futures; G7 and short safe haven Fx. Largest long holdings include April Brent ICE futures, May COMEX Copper, April Platinum, and May Palladium futures. Favoured stock sectors remain metals, financials, industrials, coal, construction, real-estate, and agriculture. As such the Fund has zero exposure to defensive sectors of healthcare, consumer staples, telecommunications, food retail or electrical utilities.

Diamond Age Capital Advisors Ltd. receives sub-advisory counsel from Eighth Continent Capital Pte. Ltd.; a partnership which represents a continuity of investment advice dating back to initial Diamond Age Russia Fund inception February 2005. Content of this Letter to Investors provided by Eighth Continent Capital Pte. Ltd. in cooperation with Diamond Age Investment Advisors Ltd.

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