

2008 IN REVIEW

As we set our sights on the New Year, we want to take a moment and share our observations regarding the market activities over the past twelve months. Most notable, in 2008, we witnessed one of the largest wealth destructions in the history of capital markets. Furthermore, last year will remain on record as one of the most “bearish” periods and one in which profound changes to the world financial systems unfolded. A year in which the unthinkable happened: the end of Wall Street titans such as AIG, Lehman Brothers and Merrill Lynch.

Although multiple factors contributed to these disastrous results, there are two facts worth mentioning; as one affected the other. First, real estate prices in the US began departing from historical norms and second, the credit market turbulence weighed heavily upon the World capital markets.

As for real estate, the market was fueled by easy borrowing (low standards) pushing mortgages to unsustainable levels; levels that eventually collapsed in 2007/2008. Furthermore, for good or bad, the easy borrowing prompted consumer spending which of its own was pressed by borrowing against rising real estate prices. At the end, the real estate bubble burst, creating a financial avalanche that buried capital markets.

What has made this situation particularly severe was the fact that many mortgages (and mortgage related securities) were concentrated in major investment banks (including some of the World banks), which in turn leveraged these securities. And when the housing market turned, it simply decimated the capital base of all these financial institutions; effectively pushing them into bankruptcies and freezing the credit markets worldwide.

Policymakers, both in the US and abroad, responded to the crisis with dramatic programs (injecting billions of dollars into the system) designed to help stabilize the financial markets but those results, at least for now, are mixed. Clearly, the authorities have been fumbling for answers to the problems they ignored for so long until it was simply too late.

Does all this mean that the developed world is heading for a some type of Armageddon, certainly not. However, it means that in 2008 US market and overall Global markets have dropped a stunning 37% and 42%, respectively. With that, the tough times are not yet over, as many of the World's largest economies will shrink in years to come.

Emerging Markets of Europe

“Don’t give up on Eastern Europe” we’ve heard from many managers at the end of year. Frankly, we do agree with the statement, however we acknowledge and recognize the very poor showings of the past eight months. Even more, we are concerned about the next eight months as we can’t call the market bottom, not yet, based on the stress and uncertainty still present in the markets.

In 2008, Emerging Europe tumbled as heightened fears over Global financial distress and slower World growth drove investors to sell riskier assets. Commodity producing nations, such as Russia, and those with high external financing needs, such as Turkey, came under particular pressure. The classic flight-to-safety pattern (that was supposed to have ended with the so-called “decoupling” theory) took over the markets.

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For the first time in about seven years the region underperformed the other Emerging Global markets; the Hungarian market lost 58%, while Russian stocks, fell 74%. Elsewhere, the results were similar with Poland dropping 60% and the Czech Republic shedding 55%.

Clearly these results reflected the lack of investor confidence in Global equities, lower appetite for risk and hemorrhaging of commodity prices. Also, the preference (the strength) of the US dollar, which we witnessed in 2008, served to weaken currencies across the region and companies with US dollar debt.

Though we remain quite cautious about near-term prospects, we remain bullish on the longer outlook for Emerging Europe versus Developed markets. No question, Global economic growth is slowing down (Developed markets could be 0%) but in Emerging Europe growth could be as high as 4%. These markets are increasingly more supported by domestic demand rather than exports. Furthermore, some of the countries in the region still have very large FX reserves and solid balance sheets (a key theme in market recovery). Certainly, current low stock prices and valuations which are very attractive are solid entry points for any investor into these fast growth economies.

Eastern Capital Fund Ltd.

Against this backdrop, the Eastern Capital Fund saw its value tumble. The Fund ended the year (December) with NAV of \$17.31 per share. Without saying this was the most challenging year in the history of the Fund, as all stocks in the region retreated hard. The strong underperformance of Russian stocks relative to the overall Emerging European (EE) market since June of 2008 has been striking and negative for the Fund. The 2008 resurgence of negative political developments (invasion of Georgia), falling oil prices (about 30% after trading as high as \$148 in July), weakening of the Ruble and continued lack of confidence in overall Global capital markets have created the “perfect storm” over Russia, and the EE region as a whole.

To be perfectly clear, Russia, Poland or China for that matter, the fall was such a “wide base” that there was no place to hide (see Table I).

The short-term outlook for the Fund remains tough and although individual holdings valuations are solid, it is only after local credit markets begin to function normally and World financial markets stabilize that such value(s) will stand a chance to generate a positive return. In the long-term, we retain our strong belief in Emerging Europe. There has been a sharp contraction and consequently we believe will be followed by a swift recovery; as the necessary corrective measures being put in place (around the world) will start having an impact in the months to come.

Whatever we may face in 2009 we believe; (1) the next three years should provide respectable gains from today's depressed Fund's level and (2) this is an attractive entry into a rapid growth region of Emerging Europe.

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Where Do We Go from Here

We have been pouring through the usual year-end predictions, outlooks and have reviewed the usual price targets, the sectors, the stocks and so on but have come away from the table feeling a little empty, at least for the short-term. With every economic data deteriorating across the globe, the picture for 2009 is bleak. We also see the weakness of the US economy as the biggest drag on any chance of recovery in the overall World capital markets.

For that reason, all investors, in our opinion, should consider taking a mid-to long-term view (5-plus years) while the current situations play out. Furthermore, that strategy should rely on a diversified, carefully constructed mix of stocks, bonds and other investment instruments suitable to one's personal goals. Some balance of US and non-US investments, and Emerging markets being more important than ever, is and will be key.

Over the past decade, we've seen, survived and taken full advantage of a number of stocks market crises. This one will not be an exception. As we stated over the past months, we believe that all the major changes that we are currently witnessing (and feeling the pain) in the World financial systems will benefit the Emerging high growth economies. Therefore, staying invested, constantly assessing new opportunities in conjunction with rigorous research and a long-term outlook will yield the best results.

"Failure is simply the opportunity to begin again, this time more intelligently" said Henry Ford. This was true then, as it was in 2008.

Best regards,

M.G. Kaminski and Robert Lada

Wayzata Capital Management, Inc.

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Table I

MSCI Barra Index(s)	Global Emerging Markets	Return(s) in 2008
	China	-51.94%
	India	-65.07%
	Korea	-55.87%
	Brazil	-57.64%
	Argentina	-55.32%
	Mexico	-43.98%

Sources: MSCI Barra December 31, 2008.