

Frontier Markets: Opportunities and Challenges

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I. Overview

Given the boom in emerging markets over the last several years, with investment returns in the equity markets far exceeding developed countries in the last five years, there has been a considerable flow of capital into markets previously considered off-limits to institutional investors. Investors appear to have become more comfortable with the risk and return trade-off of emerging markets, in both equity and debt markets, and have decided that a 5-7% or larger allocation to the asset class is not only prudent but necessary if they were to benefit from the global growth drivers of the 21st century. However, as these countries have increasingly become integrated into the global trade arena, concerns have grown that future returns and volatility will become increasingly correlated with developed markets. For that reason, certain investors have decided that it is time to begin exploring the “frontier markets,” those markets that are considered less developed than emerging markets, where the growth prospects and investment returns may still be outsized and dependent on internal development instead of exogenous factors. Frontier markets are viewed as the “emerging markets of the future.” While Brazil, Russia, India and China were the story of the 1990-2000s, Vietnam, Bulgaria, Nigeria, and Kazakhstan are purportedly the stars of the next two decades. We believe that, while the prospects for development in these markets is significant, with high levels of GDP growth possible, the risks of investment are not immaterial and may be very different than those faced in the previous wave of investment in the now-established emerging markets. Further, early investors in the emerging markets first got their feet wet in the very liquid global debt markets through Brady bonds and a whole host of additional investments, whereas the investment universe in tradable instruments in frontier markets is extremely limited. We estimate that total market capitalization of the frontier equity markets (as defined by our selection criteria) was close to US\$ 2 trillion at the end of 2007 and foreign and local currency government bonds outstanding close to US\$ 363 billion as of June 30, 2008. We believe that frontier markets can be a useful subset of an emerging markets portfolio allocation, but that for such allocation to be meaningful it will need to include non-tradable instruments in private equity, private lending, and other instruments through capable managers with appropriate expertise.

In this brief overview report, we will begin by defining frontier markets, outline the rationale for investing, discuss the investment opportunities, and then conclude with a review of key risks and challenges. Although we have attempted to use 2007 macro data and real time market data whenever available, certain metrics are not collected on a timely basis on all frontier markets and thus we have used the most current data readily available.

II. What are the Frontier Markets?

Frontier markets are commonly defined as those countries that are in the early stages of their economic development, have undeveloped financial markets, and weak political institutions. A frontier market was first defined by the International Finance Corporation (IFC) in 1995 to differentiate the smaller, illiquid markets with total market capitalization below \$1 billion. The IFC now uses a broader definition for “frontier” countries, which includes those whose income per capita is below US\$1,065 and that have high risk ratings for private sector investments (total of 90 countries in 2007). Frontier markets have traditionally been closed to foreign investors given investment restrictions, high capital gains taxes and illiquid currency markets. However, many frontier markets have recently been eliminating restrictions and actively promoting the maturity of their financial markets, particularly their equity markets.

Index providers MSCI Barra and S&P and investment banks Merrill Lynch and Deutsche Bank have capitalized on investors’ growing demand for frontier markets and recently launched their own frontier market indices and country composition. Their country selection is mainly based on the trading activity and volumes of their equity markets and their openness and accessibility to foreign investors. These indices have a similar country composition and the most common inclusions are Bulgaria, Estonia, Vietnam, Kazakhstan and Lebanon (refer to Appendix 1, which summarizes the country selections in the various indices).

Gramercy believes that the frontier markets need to be viewed more broadly than S&P and more strictly than IFC. The S&P selection methodology has an equity trading bias by definition (ignoring fixed income markets), while the IFC selection includes many countries that lack appropriate markets for either debt or equity instruments and have very limited private investment opportunities today or in the foreseeable future. Gramercy has developed its own selection criteria, which includes countries that are typically considered neither developed nor emerging and that are: (a) countries of relatively high development level (such as Bulgaria) that are too small to be considered mainstream emerging markets; (b) countries at a lower development and per capital income level than the existing emerging markets (such as Nicaragua or Vietnam); or (c) countries with investment restrictions that have only recently begun to loosen (such as the countries of the Cooperation Council for the Arab States of the Gulf). Our list, which is outlined together with a variety of investment and macroeconomic metrics in Appendices 2, 3, and 4, includes 53 countries that we believe capture a more complete spectrum of investment opportunities in frontier markets.



III. Rationale for Investing in Frontier Markets

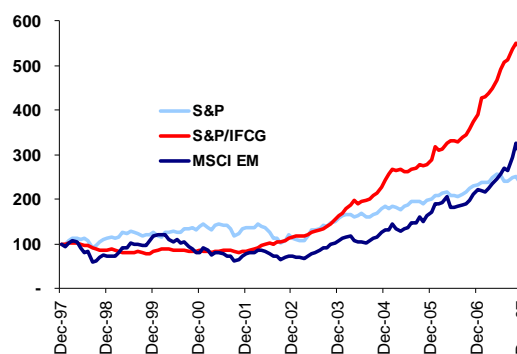
A. Economic growth potential

From a fundamental perspective, investors seek exposure to the economic growth potential offered in frontier markets, especially after their strong performance in the past 10 years (Exhibit 1a and 1b). Annual real GDP growth in low-income countries was 6.1% during 2000-2006, outpacing both middle income (e.g. emerging markets) and developed markets at 5.5% and 2.4%, respectively, according to World Bank data (Exhibit 2).

Exhibit 1a: Asset class returns (%) since 1997

	S&P/IFCG Frontier Markets Composite	LB Aggregate Bond	Dow Jones Wilshire 5000	US T-Bills	MSCI EAFE Index	MSCI Emerging Markets	S&P GSCI
1997	-10.9	9.7	31.3	4.8	1.6	-11.8	-14.1
1998	-13.4	8.7	23.4	4.7	20.1	-25.6	-35.7
1999	-5.6	-0.8	23.6	4.6	26.7	66	40.9
2000	3.5	11.6	-10.9	5.5	-14.2	-30.8	49.7
2001	-1.6	8.4	-11	3.5	-21.4	-2.6	-31.9
2002	39.1	10.3	-20.9	1.5	-15.9	-6.2	32.1
2003	39.9	4.1	31.7	0.9	38.6	55.8	20.7
2004	49.6	4.3	12.5	1	20.2	25.6	17.3
2005	18.2	2.4	6.4	2.5	13.5	34	25.6
2006	35.9	4.3	15.8	3.9	26.3	32.2	-15.1
2007	45.6	7	5.6	4	11.2	39.4	32.7
3 Years	32.7	4.6	9.2	3.5	16.8	35.2	12.3
5 Years	37.4	4.4	14	2.5	21.6	37	14.9
10 Years	19	6	6.3	3.2	8.7	14.2	9.3

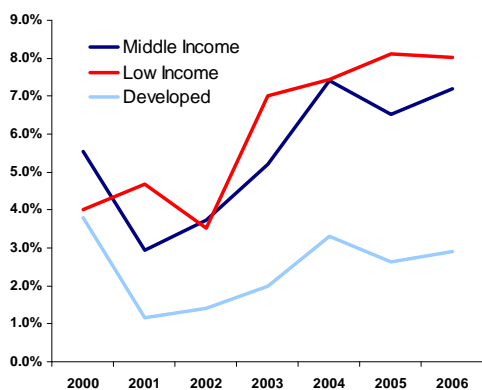
Exhibit 1b: Frontier market equities performance versus emerging and U.S. markets (1997-2007)



Source: Bloomberg Note: S&P GSCI (commodities)

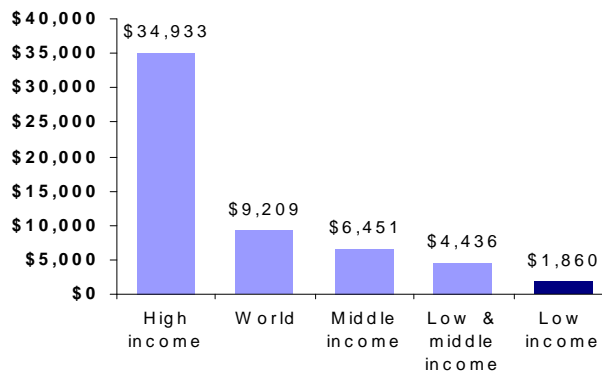
Moreover, their growth potential is vast given the small size of their economies and low-income levels. For example, GDP per capita (using PPP) in low income countries was \$1,860 in 2006, which represents only 5% of that of high income and 29% of middle income countries (Exhibit 3). Frontier equity markets (using S&P/IFCG Frontier Markets Composite as benchmark) have outperformed developed and developing markets during period 1997-2007, increasing by almost 6 times, versus 3 times for emerging markets (MSCI EM) and about 2 times for the U.S. market (S&P 500). An important driver of economic growth in frontier markets has been rising commodity prices. Many of these countries are rich in natural resources and are net exporters of commodities. However, improvements in economic policy, governance and private investment have also contributed. The inflation problem in Sub-Saharan Africa has been significantly contained, with rates falling below 10% since 2000 for the first time in decades (excluding Zimbabwe). The external position of many frontier markets has significantly improved as these have accumulated foreign exchange reserves through their currency pegs or heavily managed floats.

Exhibit 2 – Real GDP growth by income groups



Source: World Bank

Exhibit 3 – GNI per capita, PPP (2006 US\$)



Source: World Bank



B. Portfolio diversification

From a tactical perspective, investors gain diversification by adding exposure to frontier markets in their portfolios. Frontier markets are now playing the role that emerging markets such as Russia and Brazil did in the 1990s. Emerging markets have become tightly integrated and correlated with the global economy, and have lost some of their appeal as a diversification tool. Frontier markets still remain largely dependent on the performance of their local political economies and are largely isolated from the global economic cycle. For example, the correlation between the returns of frontier equity markets (S&P Frontier Markets Index) and the S&P during the past 10 years is close to 0, while it is 0.45 with emerging markets (MSCI EM) (see Exhibits 4 and 5).

Exhibit 4 – Correlations between frontier markets and other assets classes (1997-2007)

	S&P Frontier	S&P	MSCI EM	S&P GSCI	U.S. T-bills	EMBI+	Leh US Agg
S&P/IFCG	1.00						
S&P	-0.08	1.00					
MSCI EM	0.45	0.29	1.00				
S&P GSCI	0.38	-0.15	0.35	1.00			
U.S. T-bills	-0.72	-0.04	-0.39	-0.15	1.00		
EMBI+	0.51	0.63	0.59	0.50	-0.71	1.00	
Leh. US Agg	-0.18	-0.30	-0.89	-0.21	0.26	-0.37	1.00

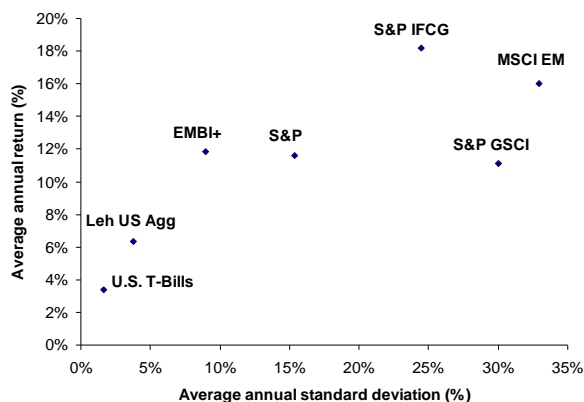
Source: Bloomberg

Note: S&P GSCI (commodities)

C. Higher risk-adjusted returns

Sharpe Ratios for the S&P Frontier Market Index (S&P/IFCG) are higher at 0.74 than MSCI EM at 0.49 and equal to the S&P at 0.75 for the period 1997-2007. However, we will note that this lower volatility in frontier markets is partly a consequence of their low trading volumes (Exhibit 6).

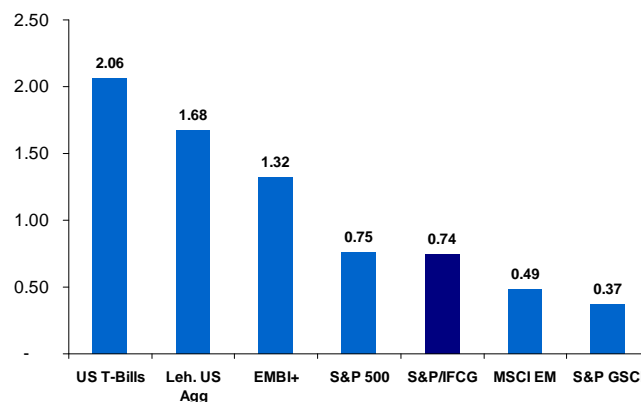
Exhibit 5 – Risk/Return profile of frontier markets and other assets classes (1997-2007)



Source: Bloomberg

Note: S&P GSCI (commodities)

Exhibit 6 – Sharpe Ratio comparison (1997-2007)

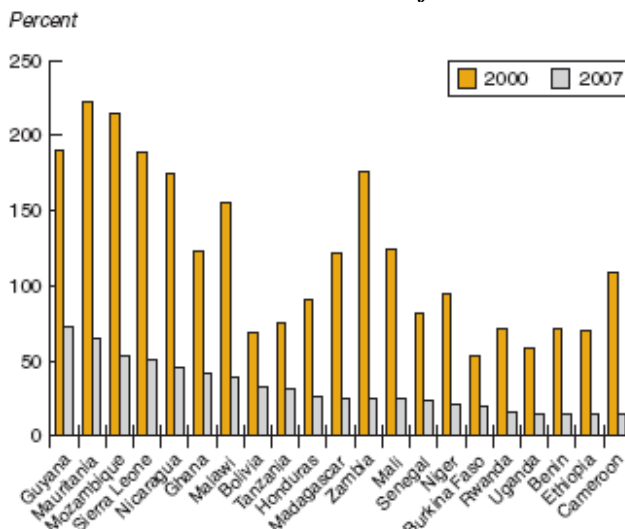


D. Fundamental improvements in the investment climate of many frontier markets

Economic and financial fundamentals have improved significantly in many frontier market countries, reducing investors' perceptions of risk. Progress has been made in implementing structural reforms such as land ownership rules, privatizations, and private sector development. At the same time, improved macroeconomic stability along with the adoption of more flexible exchange rate regimes in many of these countries have enhanced investor confidence, making investors more willing to take on exchange rate and default risk. Further, most low-income countries have gradually liberalized capital controls since the mid-1990s, to the extent that neither capital controls nor tax policies, as they appear on the books, remain major constraints to foreign participation in most local markets (although there are still issues to be addressed in many countries in practice).

Finally, debt relief provided under the HIPC Initiative and the Multilateral Debt Relief Initiative, along with additional debt relief provided by the Paris Club of creditors, has significantly reduced the debt burdens of qualifying countries considerably. Along with these debt relief initiatives, the shift from bilateral ODA loans to grants, ongoing over the past 40 years, has significantly reduced the debt burdens of many previously highly-indebted countries. In 2007, 14 of the 21 HIPCs that had reached the completion point by the end of 2006 had external debt-to-GDP ratios below 37.5 percent, the median for other developing countries (Exhibit 7). In 2000 the median external debt-to-GDP ratio for those same 22 countries was 109 percent, twice the median level for other developing countries (53 percent).

Exhibit 7 – External debt as a share of GDP in 21 HIPCs



Source: *Global Development Finance 2008: The Role of International Banking*, World Bank

IV. What are the investment opportunities?

Local equity markets have been the preferred and easiest way to gain exposure to frontier markets, as these have become increasingly accessible to foreign investors and their size and liquidity has increased during the past five to ten years. Moreover, there are only a few foreign-listed equities from frontier markets. Fixed income opportunities in frontier markets have traditionally been limited to local institutional investors. Their local bond markets (corporate and government) consist mainly of only a handful of small issues and there are few active secondary markets, while there are only a few issuers in external debt markets. During the past few years, a few sovereigns made their debut in the external debt markets, while a few corporates issued Eurobonds opportunistically as investor appetite rose, and more aggressive emerging markets investors have begun to participate in the local fixed income markets. Lastly, opportunities in private equity and private lending for experienced investment managers are growing as these markets evolve. In some cases, it is the only way to gain exposure to frontier markets with no conventional bond or equity markets. See Exhibit 8 for Gramercy’s subjective assessment of investment opportunities.

Exhibit 8 – Gramercy’s subjective assessment of investment opportunities in frontier markets

	Opportunities	Accessibility	Trading Liquidity	Attractiveness
Sovereign local debt	**	**	*	*
Sovereign external debt	**	***	**	*
Local equities	**	**	*	*
Foreign equities	*	***	*	*
Private equity	**	*	*	***
Private lending	***	*	*	***

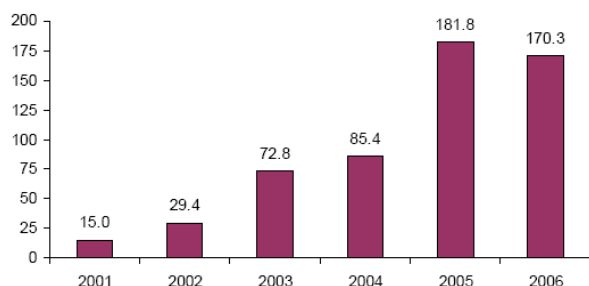
(*) Limited/Low (**) Moderate (***) Abundant/High

Source: Gramercy

A. Public Equity

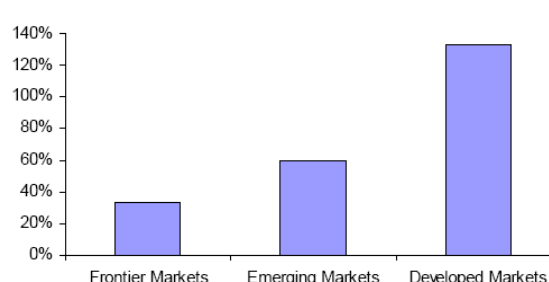
Equity markets have been the preferred and easiest way to gain exposure to frontier markets, as these have become increasingly accessible to foreign investors. Foreign investment restrictions have been eliminated or reduced, capital entry and exit has been simplified, and tax levels are more reasonable. Among the frontier markets that have recently turned more investor-friendly are Bahrain, Bulgaria, Colombia, Croatia, Jordan, Oman, Pakistan, Romania, Sri Lanka, the U.A.E. and Vietnam, according to S&P. All of these countries are considered to have relatively free entry for foreign investment and only Vietnam has some restrictions on repatriation of income and capital. Market capitalization and trading liquidity have also increased dramatically over the past years. In sample of countries included in the S&P New Frontier Index (e.g. Bulgaria, Colombia, Jordan, Pakistan and Romania), market capitalization has more than quadrupled during 2001-2006, growing at an annualized rate of 50% (Exhibit 9), and the size of each country’s stock market as a percentage of GDP increased by an average of 62% during this period to 35% (Exhibit 10). Trading volumes grew more than tenfold (Exhibit 11) and turnover (value traded divided by market capitalization) increased to 71% from 37%. However, using trading volumes and market capitalization data from the World Federation of Exchanges, which includes a more diverse and larger sample of countries, indicates that the gap is still large between frontier markets and the more developed and liquid markets (Exhibits 12 and 13).

Exhibit 9 – Stock market capitalization in selected frontier markets (US\$ billions)



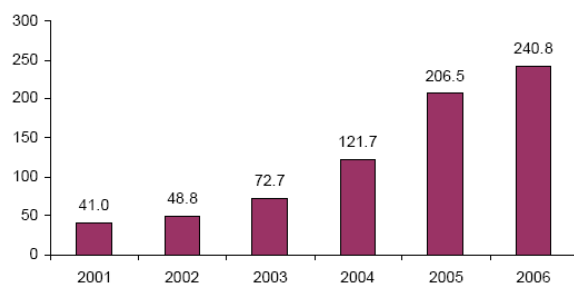
Source: S&P

Exhibit 10 – Median stock market capitalization as a % of GDP



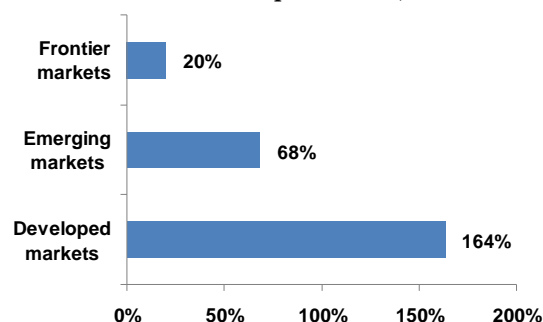
Source: S&P

Exhibit 11 – Total annual value traded in selected frontier markets (US\$ billions)



Source: S&P

Exhibit 12 – Stock market turnover (trading volumes/market capitalization) in 2007



Source: World Federation of Exchanges

Investment flows into frontier markets have increased strongly recently, in spite of rising risk aversion. Net inflows into African regional equity funds hit \$650 million in 2007, up from about \$100 million in 2006, whereas Middle East regional equity funds drew net inflows of \$402 million last year, versus \$130 million of outflows in 2006, according to data from EPFR Global. Moreover, frontier market funds have taken in \$2.5 billion of net inflows this year to date through June, while the combined emerging market equity funds have had outflows of \$5.3 billion, according to same source.

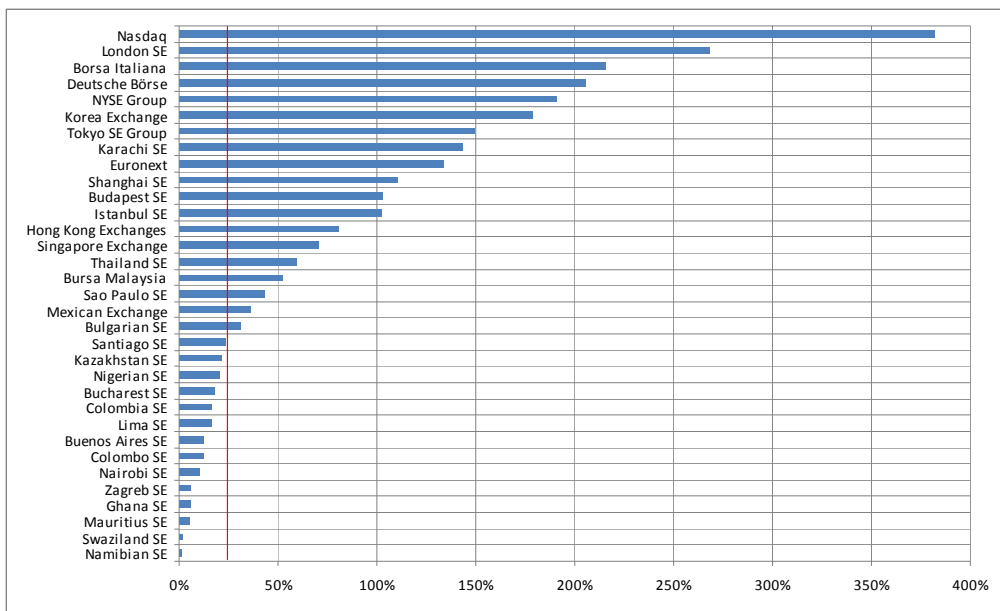
All these factors have contributed to a strong performance in frontier equity markets. These markets have outperformed developed and developing markets during period 1997-2007, increasing by almost 6 times, versus 3 times for emerging markets and about 2 times for S&P 500 (Exhibit 1). However, it appears that the growth potential in frontier markets is already reflected in stock prices. Valuations of many frontier equity markets reached record levels in 2007, with price/earnings ratios reaching 54 times in Bulgaria, 51 times in Vietnam, and 42 times in Slovenia, according to S&P. Most of these markets have suffered sharp corrections with recent market volatility and their valuations have turned more reasonable.

Investors interested in gaining exposure to frontier markets through equity indices or funds have several options available (some examples as follows).

- Advance Frontier Markets Funds (AFMF)
- Claymore/BNY Mellon Frontier Markets ETF (FRN)
- DB x-trackers S&P Select Frontier ETF (XSFR)
- T. Rowe Price Africa & Middle East Fund (TRAMX)

Most of these vehicles have a very short track record given their recent launch (most in 2007). However, investors are encouraged to pay close attention to the composition of these investment vehicles, as some that are being marketed as “frontier” have only a minor exposure to frontier markets. For example, Claymore/BNY Mellon Frontier Markets ETF has 64% of its holdings in stocks from Poland, Chile, and Egypt, countries that are classified as emerging by major index providers. Only 21% of the index’s total market capitalization comes from countries classified as frontier by major index providers.

Exhibit 13 – Stock market turnover (trading volume / market capitalization), 2007

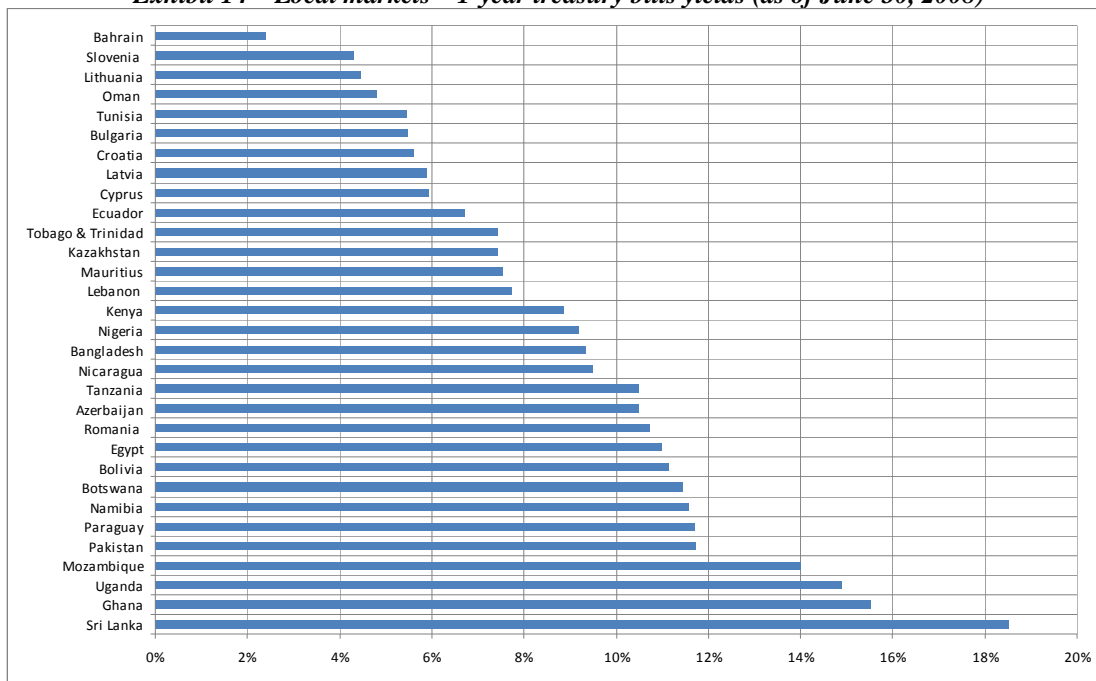


Source: World Federation of Exchanges

B. Public Debt

The investment opportunity for fixed income investors in frontier markets is somewhat limited, given that local bond markets for the most part consist of only a handful of small issues and there are no meaningful secondary markets. Except for a few countries that have established bond markets (both local and foreign denominated), most domestic government securities markets have been dominated by short-term treasury bills that domestic banks or domestic institutional investors (e.g. pension funds and insurance companies) purchase for liquidity management purposes. The improved macroeconomic environment in frontier markets has allowed some governments to develop their domestic debt markets, and to issue domestic debt instruments for the first time or to extend maturities to 10 or 15 years. In Sub-Saharan Africa, Nigeria and Tanzania have recently issued 10-year government bonds, while Kenya issued a 15-year bond. We estimate there is close to US\$ 363 billion in local and foreign denominated government debt outstanding in frontier markets (using our country selection) with yields averaging about 8.49% for 1-year treasury bills and 8.30% for Eurobond yields (Exhibit 14 and Appendix 3). Institutional investors have slowly entered the local debt markets. Many Sub-Saharan African countries have succeeded in selling treasury bills in their own currency to foreign investors. At the end of June 2007, foreigners held about 11 and 14 percent of Ghana's and Zambia's domestic currency government debt, according to the IMF. Investors in Asia and Latin America have also raised their exposure to local currency bonds. The local fixed income markets continue to grow as governments increasingly meet their financing needs with local issues.

Exhibit 14 – Local markets – 1-year treasury bills yields (as of June 30, 2008)



Source: Bloomberg

Less intrepid emerging markets investors looking for higher debt yields in frontier markets have usually limited their participation to investments in Eurobonds. Countries such as Ecuador, Egypt, Croatia, Lebanon, Morocco, and Serbia have Eurobonds that trade actively in the market. Increasing investor appetite has allowed some countries to tap the international markets for the first time. Two sub-Saharan countries, Ghana and Gabon issued US\$750 million and US\$1 billion bonds in the second part of 2007. Gabon utilized the proceeds to repay Paris Club debt, while Ghana said it would use funds for infrastructure. The local corporate debt market is still in its infancy in most of frontier economies. Thirteen sub-Saharan African countries have issues of corporate bonds (mainly banks), but there are no real markets and there is no secondary trading. This has often led to buy-and-hold strategies that slow the development of liquid markets. The Eurobond corporate market is slightly more active although it still mostly composed by banks and financial institutions. Some companies took advantage of the strong appetite for yield that prevailed in the past years and tapped the international debt markets. Ghana Telecommunications issued a \$200 million 5-year bond at the end of 2007, the first US\$ bond coming from an African country outside of South Africa and Nigeria. Exhibit 15 provides details on several first time Eurobond issuers since 2005.

Exhibit 15 - Gross first-time external bond issues by developing countries: 2005-2008

Date issued	Country	Issuer	Sector	Value (US\$)	Currency	Coupon	Tenor	Credit Rating
Low income								
2005-Oct	Vietnam	Socialist Republic of Vietnam	Sovereign	750	US\$	7.25%	10	BB-
2007-Mar	Vietnam	Vietnam Shipbuilding Industry Corp	Public corporate	187	Viet. Dong	9.00%	10	—
2007-Jan	Mongolia	Trade & Development Bank of Mongolia	Public corporate	75	US\$	8.94%	3	BB
2007-Jan	Nigeria	GTB Finance BV	Public corporate	350	US\$	8.81%	5	BB-
2007-Mar	Nigeria	First Bank of Nigeria PLC	Private corporate	175	US\$	10.15%	10	B
2007-Sep	Ghana	Republic of Ghana	Sovereign	750	US\$	8.68%	10	B+
Lower-middle income								
2005-Jun	Jamaica	Air Jamaica	Public corporate	200	US\$	9.60%	10	B+
2005-Jun	Romania	City of Bucharest	Subsovereign	606	Euros	4.28%	10	BB+
2005-Dec	Macedonia	Republic of Macedonia	Sovereign	177	Euros	4.69%	10	BB+
2006-Sep	Fiji	Republic of Fiji	Island Sovereign	150	US\$	7.12%	5	BB
2007-Feb	Georgia	Bank of Georgia	Sovereign	200	US\$	9.20%	5	BB-
2007-May	Belarus	Polesie Trading House	Private corporate	19	Rubles	13.37%	3	—
2008-Apr	Georgia	Republic of Georgia	Sovereign	500	US\$	7.64%	5	BB
Upper-middle income								
2006-Sep	Seychelles	Republic of Seychelles	Sovereign	200	US\$	9.47%	5	B
2007-Mar	Serbia	ProCredit Bank AD	Private corporate	165	Euros	6.00%	5	BB-
2007-Dec	Gabon	Republic of Gabon	Sovereign	1,000	US\$	7.85%	10	BB-

Source: *Global Development Finance 2008: The Role of International Banking, World Bank*

C. Private Equity

The lack of conventional bond or equity markets in many frontier economies makes private equity investing the only way to gain exposure to countries such as Cambodia or Laos. Private equity investment flows to frontier markets continue to rise as major emerging countries become overcrowded. More than \$59 billion was raised for emerging markets (including frontier) in 2007, up from \$33 billion in 2006, according to the Emerging Markets Private Equity Association (EMPEA). Private equity flows to emerging markets have increased on average over 150% per year since 2003, after these practically halted earlier in the decade due to very disappointing results in the 90s. Driving this new wave of investment flows to these markets is attractive risk adjusted returns and improvements in their political and economic risks. Surveys show that investor appetite for frontier markets is increasing rapidly. Fundraising for investments in Sub-Saharan Africa have tripled in the past 2 years, according to EMPEA (Exhibit 16). Survey data also indicate that private equity investors in emerging markets expect net returns of 23% in 2008, similar to 2007.

Given the nascent grouping of countries into frontier markets, most data and experiences are anecdotal. EMPEA survey data shows that the region where investors have increased their investments is Africa, which grew more than seven-fold to 30% in 2007 from 4% in 2006. Investors also project that for the next 3 – 5 years, they expect to increase their share of investments to Pan-Africa, Middle-East and Pan-Latin America, while reducing their shares to the BRIC countries and other emerging markets. Despite the attractive opportunities present in these markets, investors need to carefully assess their exit options, which remain mainly limited to management buyouts and sales to strategic investors.

Exhibit 16 – Emerging Markets Private Equity Fundraising Totals, by Region, 2003-2007

	Emerging Asia	CEE / Russia	Latin America	Sub-Saharan	MENA	Pan-EM	TOTAL
2003	2,200	406	417	350		116	3,489
2004	2,800	1,777	714	545		618	6,454
2005	15,446	2,711	1,272	791	1,915	3,630	25,765
2006	19,386	3,272	2,656	2,353	2,946	2,580	33,193
2007	28,668	14,629	4,419	2,340	5,027	4,077	59,161

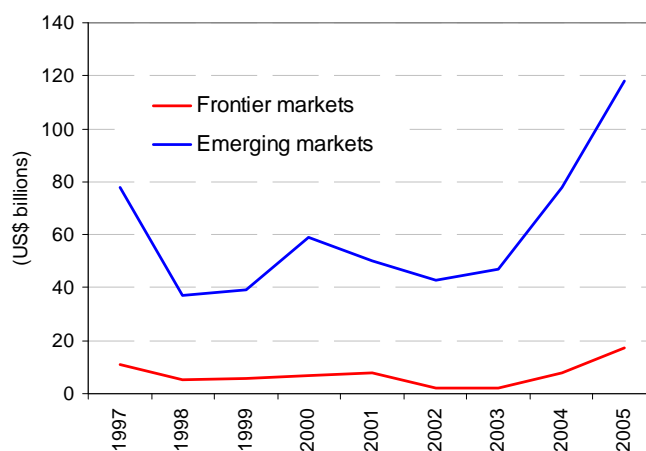
Source: EMPEA estimates

Note: Sub-Saharan and MENA data was aggregated in 2003 and 2004

D. Private Debt

Similarly to private equity, the lack of conventional bond markets in many frontier economies makes private lending an important alternative in providing financing to companies and infrastructure projects. The main areas of private lending fall into the categories of (a) infrastructure lending on a tag-along basis with international financial institutions such as the International Finance Corporation (IFC), (b) trade finance, with the traditional letters of credit and acceptance financing mechanisms, (c) equipment financing supported by guarantees of export credit agencies, (d) other private financing supported with political risk insurance or off-shore structures. Separately, there is growing interest in shariah-approved financing structures coming out of the Gulf States and other predominantly Muslim countries. Despite the strong growth in international and domestic finance, there remain significant limitations for private sector companies with respect to access to finance. In the case of international finance, most loan syndications continue to go to non-frontier countries (Exhibit 17). Typical private structures are often highly structured and capture export flows on an offshore basis due to the individual country risks.

Exhibit 17 - Gross Private Bank Syndications to Private Sector in Developing Countries

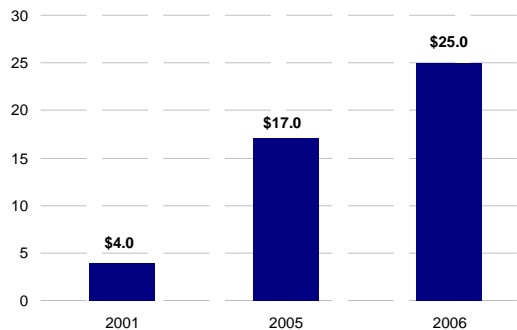


Source: IFC, Dealogic

Microfinance has been a particular area of interest in frontier markets due to its ample growth potential, given the large population that is not served by the formal banking system. Microfinance institutions (MFI) provide small loans to low-income individuals, usually entrepreneurs or self-employed, without any payback guarantee or collateral. The average loan offered is for about US\$100 at annual interest rates of 15% to 70%. MFIs were originally established as non-profit organizations and the majority continues to operate under this framework. It is estimated that there are over 10,000 MFIs that hold an estimated loan volume of \$25 billion as of 2006, up 47% from the previous year, according to Deutsche Bank (see Exhibit 18). Grameen Bank in Bangladesh is the largest institution with over 6 million customers as of 2006. The MFI business model has proven to be very sustainable and even profitable for some of the leading organizations, which exhibit high returns on capital. According to a survey conducted by “The MIX” in 2006, the 176 leading MFIs (in the sample of 704) had ROEs of 17.2% and average loan write-offs ratios of only 1.1%, which are comparable or even superior to those of commercial banks.

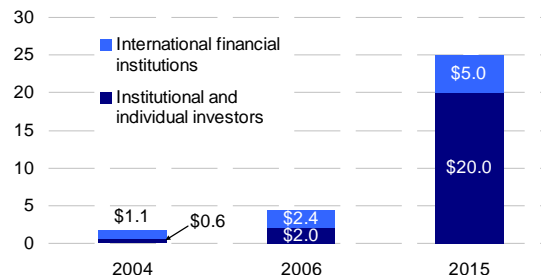
Deutsche Bank estimates that out of the roughly 1 billion potential micro-borrowers globally (mostly in emerging and frontier markets) only 100 million are currently being served. The main hurdle to close this gap is lack of funding, which is estimated at \$250 billion. As a result, the sector is currently in a transition, seeking to adopt more commercial practices and capture funding from private investors. Estimates indicate that institutional and individual investors in the sector can grow by 10 times to \$20 billion by 2015 from the \$2 billion in 2006 (Exhibit 19). Although there have been a few examples of MFIs that have issued public debt or equity (Mexico’s Compartamos is a notable exception), we expect that most opportunities in the near term will be in the form of structured debt instruments, securitization of loan portfolios, and private loans. Structured US\$ debt products that funded MFIs launched in 2007 paid an average coupon of 6% in their senior tranche and 9.5% in their mezzanine tranche, according to Deutsche Bank.

Exhibit 18 – Microfinance loans outstanding (US\$ billion)



Source: Deutsche Bank Research, *The Mix*

Exhibit 19 – Forecasts of institutional and individual investments in MFIs (US\$ billion)

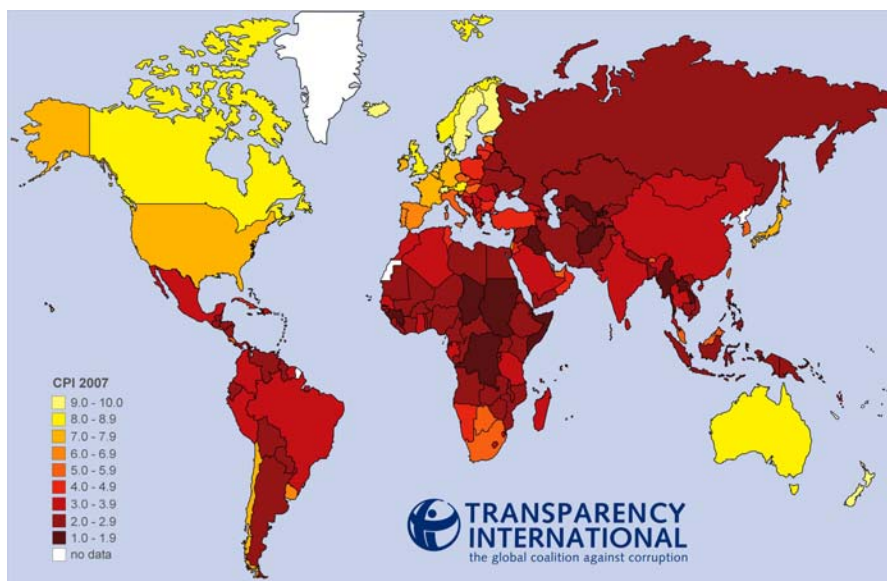


Source: Deutsche Bank Research

V. Key risks and challenges of investing in Frontier Markets

- Low liquidity:** Frontier market investors need to be aware of the low depth and liquidity of these markets and be capable of withstanding periods of high volatility. Low liquidity demands investors to adopt “buy-and-hold” type strategies rather than active secondary market trading. Trading volume in these markets is below 30% of their market capitalization, compared to over 100% in liquid markets (Exhibit 13).
- Performance data bias:** The large increase in investment flows to assets in frontier markets relative to the size of the investment opportunity tends to cause an overcrowding effect and performance measuring bias. It is clear that a significant portion of the outperformance of frontier markets equities versus developed and emerging markets during the past 10 years can be attributed to higher multiples paid for frontier market equities, rather than fundamental and earnings growth. Given the small size of these markets, a slight change in expectations can lead to rapid and sizable corrections (see case of Vietnam in Annex 5).
- Corruption:** Frontier markets, especially those in Central Asia and Sub-Saharan Africa, are at the bottom of the Corruption Perception Index produced by Transparency International (see Exhibit 20 and Appendix 4).

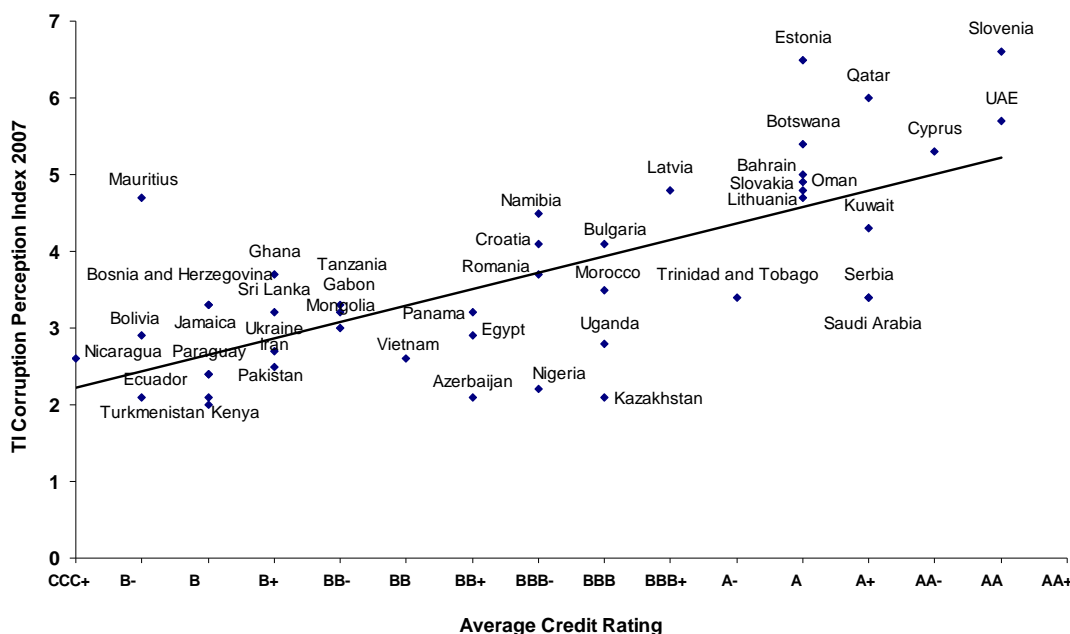
Exhibit 20: Transparency International’s Corruption Perception Index World Map



Source: Transparency International

- Limited data and statistics:** Investment analysis in frontier markets often tends to have a large qualitative component due to the lack of relevant data and statistics. The majority of the companies do not adhere to internationally accepted accounting or auditing standards and have deficient financial reporting. Moreover, there are no rating agencies to provide information on the credit risk of most local corporate issuers. Governments usually lack capacity to collect, process and distribute information and data on a timely basis. Only a few governments subscribe to the data benchmark initiatives and data dissemination standards supported by the IMF (e.g. SDDS, GDDS).
- Deficient legal framework:** Securities laws and creditor protection rights, if any, are weak and only sporadically enforceable in frontier markets. Bondholders should not count on the courts to respect creditor rights in a corporate bankruptcy, and equity investors should not assume that basic minority shareholder rights (e.g. tag along rights) are available or enforced. Private equity investors need to acknowledge the difficulties of implementing their business plans or restructurings and in monetizing their investments. Frontier markets rank at the bottom in the World Bank’s Doing Business ratings (see Appendix 4).
- Currency controls:** In addition to currency depreciation risk that is imbedded in any investment in emerging markets, currency markets in frontier economies tend to be very illiquid and governments frequently impose discretionary currency controls. These factors make hedging currency exposure difficult.
- High political risk:** Weak political systems in many frontier markets make these highly susceptible to shocks associated with political risks. Despite that many frontier economies are going through a democratic transition, the development of real democracies is very limited. In sub-Saharan Africa, only Mauritius is classified as a “full democracy”, while 23 are “authoritarian regimes” according to the Economist Intelligence Unit. For example, Kenya was widely praised for its smooth transfer of power earlier in the decade, but a closely disputed election in 2007 brought ethnic violence and raised doubts into the sustainability of its recent economic performance. Credit risk is highly correlated with corruption and other governance indicators (Exhibit 21). S&P reports that of the 28 governments rated in the B category, 20 have defaulted on their commercial debt since 1987, 13 in the past decade, whereby political factors are often the source of uncertainty upon an economic shock.

Exhibit 21: Correlation between corruption and credit ratings (as of July 18, 2008)



Source: Transparency International, Rating Agencies

- **Insufficient economic growth:** While economic growth has picked up in most frontier markets, it still remains low relative to the global average and not sufficient to make a real reduction in poverty levels. The average income per capita in frontier markets (low-income countries) was \$1,860 in 2006, representing only about 5% of that in developed markets, according to World Bank data. Low income countries grew on average 6.1% during the period 2001-2006, compared to 5.5% for middle income countries and 2.4% for high income economies, according to World Bank data. For convergence in income levels, frontier markets need to grow at faster rates, with estimates closer to 8-10%. Faster growth will also reduce poverty levels, which remain well above the third of the population in the majority of these countries.
- **Capacity constraints and bottlenecks:** The pick-up in growth over the last five years, against a background of rapid urbanization, is putting considerable strains on existing infrastructure in some frontier markets. Most infrastructure and public utilities in frontier markets are still inefficient state-owned enterprises. In cases when these are private, the government usually applies heavy regulation, eroding any incentives for these to make investments. For example, power shortages in many sub-Saharan Africa countries have been increasing as the infrastructure becomes stretched. Although an unreliable electricity supply has been a long-standing problem in Nigeria, it only became a problem for an increasing number of countries in 2006-07, notably Ghana, Kenya, Senegal, Tanzania, Uganda and Zambia. Lack of access to reliable electricity, water, highways, etc. will likely remain an impediment to growth in Latin America, South and Central Asia, and Sub-Saharan Africa for the next two decades.

Appendix 1 – Frontier Markets – Indices and Countries Included

MSCI Frontier Market (19)	S&P/IFC Frontier Markets (24)	ML Frontier (17)	DB EMEA New Frontiers (18)
Bulgaria	Bangladesh	Morocco	Armenia
Croatia	Estonia	Nigeria	Azerbaijan
Estonia	Lebanon	Kazakhstan	Angola
Kazakhstan	Slovak Republic	Pakistan	Bosnia
Romania	Botswana	Vietnam	Botswana
Slovenia	Ghana	Croatia	Egypt
Ukraine	Lithuania	Cyprus	Iran
Kenya	Slovenia	Estonia	Iraq
Mauritius	Bulgaria	Romania	Lebanon
Nigeria	Jamaica	Slovenia	Mauritius
Tunisia	Mauritius	Ukraine	Morocco
Bahrain	Tobago & Trinidad	Bahrain	Mozambique
Kuwait	Cote d'Ivoire	Kuwait	Nigeria
Oman	Kazakhstan	Lebanon	Qatar
Qatar	Namibia	Oman	Saudi Arabia
UAE	Tunisia	Qatar	Serbia
Lebanon	Croatia	UAE	Tunisia
Sri Lanka	Kenya		UAE
Vietnam	Panama		
	Ukraine		
	Ecuador		
	Latvia		
	Romania		
	Vietnam		

IFC (90)

Sub-Saharan Africa

Angola
Benin
Burkina Faso
Burundi
Cameroon
Cape Verde
Central Africa
Chad
Comoros
DRC
Republic of Congo
Ivory Coast
Djibouti
Equatorial Guinea
Eritrea
Ethiopia
Gabon
Gambia
Ghana
Guinea
Guinea-Bissau
Kenya

Liberia
Madagascar
Malawi
Mali
Mauritania
Mauritius
Mozambique
Niger
Nigeria
Rwanda
Senegal
Seychelles
Sierra Leone
Somalia
Sudan
Swaziland
Tanzania
Togo
Uganda
Zambia
Zimbabwe

South Asia

Bangladesh
Bhutan
India
Maldives
Nepal

Middle East

Afghanistan
Iraq
Pakistan
Syria
West Bank and Gaza
Yemen

Latin America

Antigua
Belize
Bolivia
Dominica
Grenada
Guyana
Haiti
Nicaragua
Paraguay
Saint Kitts and Nevis
Saint Lucia

Europe and Central Asia

Albania
Armenia
Belarus
Bosnia and Herzegovina
Georgia
Kyrgyz Republic
Moldova
Tajikistan
Turkmenistan
Uzbekistan

East Asia and Pacific

Cambodia
Fiji
Laos
Marshall Islands
Micronesia
Mongolia
Myanmar
Palau
Papua New Guinea
Samoa
Solomon Islands
Timor-Leste
Tonga
Vanuatu
Vietnam

Appendix 2 – Frontier Markets – Macroeconomic Indicators (as of December 31, 2006)

	GNI, PPP (US\$ billion)	GNI per capita, PPP (\$US)	GDP growth (annual %)	Gini coefficient	External debt (US\$ billion)	External debt (as % of GDP)	Market capitalization (US\$ billion)	Market capitalization (% of GDP)	GDP (US\$)
Latin America									
Bolivia	36	3,810	4.6	59.2	5.3	47.41	2.22	20	11
Ecuador	90	6,810	3.9	46.0	16.5	39.94	4.04	10	41
Jamaica	19	7,050	2.5	45.5	8.0	79.75	12.28	122	10
Nicaragua	15	2,720	3.7	43.1	4.4	82.83	NA	NA	5
Panama	29	8,690	8.1	56.1	10.0	58.43	5.72	33	17
Paraguay	24	4,040	4.3	56.8	3.4	36.94	0.41	4	9
Trinidad and Tobago	22	16,800	12.0	NA	NA	NA	15.57	86	18
Eastern Europe & Central Asia									
Azerbaijan	46	5,430	34.5	36.5	1.9	9.57	NA	NA	20
Bosnia and Herzegovina	27	6,780	6.0	26.2	5.7	46.26	NA	NA	12
Bulgaria	79	10,270	6.1	31.6	20.9	66.46	10.33	33	31
Croatia	62	13,850	4.8	29.0	37.5	87.31	29.00	68	43
Estonia	24	18,090	11.4	34.0	NA	NA	5.96	36	16
Kazakhstan	133	8,700	10.7	30.4	74.1	91.54	43.69	54	81
Latvia	34	14,840	11.9	37.7	22.8	113.32	2.71	13	20
Lithuania	49	14,550	7.7	36.0	19.0	63.68	10.19	34	30
Romania	219	10,150	7.7	31.0	55.1	45.32	32.79	27	122
Serbia	69	9,320	5.7	30.0	13.8	43.24	10.98	34	32
Slovak Republic	92	17,060	8.3	26.0	27.1	49.20	5.58	10	55
Slovenia	48	23,970	5.2	24.0	NA	NA	15.18	41	37
Tajikistan	10	1,560	7.0	32.6	1.2	41.03	NA	NA	3
Turkmenistan	19	3,990	NA	40.8	0.9	8.39	NA	NA	10
Ukraine	286	6,110	7.1	31.0	49.9	46.86	42.87	40	106
Uzbekistan	58	2,190	7.3	36.8	3.9	22.66	0.71	4	17
Middle East & Gulf									
Bahrain	25	34,310	7.8	NA	NA	NA	17.36	108	16
Iraq	102	3,600	5.0	NA	100.9	182.13	NA	NA	55
Kuwait	122	48,310	8.5	NA	NA	NA	130.08	161	81
Oman	495	19,740	5.8	NA	4.8	15.63	15.27	50	31
Qatar	NA	NA	6.1	NA	NA	NA	87.32	206	42
Saudi Arabia	528	22,300	4.3	NA	NA	NA	326.86	94	349
UAE	NA	NA	8.5	NA	NA	NA	225.56	174	130
Africa									
Botswana	22	11,730	2.2	63.0	0.4	3.85	3.95	37	11
Cote d'Ivoire	30	1,580	0.9	44.6	13.8	78.86	4.15	24	18
Cyprus	19	25,060	4.0	29.0	NA	NA	15.90	87	18
Egypt	366	4,940	6.8	34.4	29.3	27.30	93.48	87	107
Gabon	15	11,180	1.2	NA	4.4	45.57	NA	NA	10
Ghana	28	1,240	6.2	39.4	3.2	24.73	3.23	25	13
Kenya	54	1,470	6.1	44.5	6.5	28.68	11.38	50	23
Lebanon	39	9,600	0.0	NA	24.0	105.46	8.28	36	23
Mauritius	13	10,640	3.5	39.0	2.0	31.47	3.60	57	6
Morocco	118	3,860	8.0	40.0	18.5	28.28	49.36	75	65
Namibia	10	4,770	2.9	70.7	NA	NA	0.54	8	7
Nigeria	204	1,410	5.2	43.7	7.7	6.67	32.81	28	115
Tanzania	39	980	5.9	34.6	4.2	33.17	0.54	4	13
Tunisia	66	6,490	5.2	40.0	18.5	60.99	4.45	15	30
Uganda	26	880	5.4	45.7	1.3	13.42	0.12	1	9
Asia									
Bangladesh	192	1,230	6.6	33.4	20.5	33.15	3.61	6	62
Cambodia	22	1,550	10.8	41.7	3.5	48.59	NA	NA	7
Iran	687	9,800	4.6	43.0	20.1	9.23	37.94	17	218
Laos	10	1,740	7.6	34.6	3.0	86.86	NA	NA	3
Mongolia	7	2,810	8.6	32.8	1.4	46.11	0.11	4	3
Pakistan	383	2,410	6.9	30.6	35.9	28.31	45.52	36	127
Sri Lanka	74	3,730	7.4	50.0	11.4	42.45	7.77	29	27
Vietnam	194	2,310	8.2	37.0	20.2	33.12	9.10	15	61
Total Frontier Markets	5,382	9,146	6.7	39.3	737	2,094	1,389	57	2430
Low income	4,501	1,860	8.0				1,085	67	1619
High income	36,005	34,933	2.9				46,361	126	36795
Middle income	19,920	6,451	7.2				7,444	74	10059
World	60,210	9,209	3.8				55,247	114	48462

Notes: Kuwait, Oman, Bahrain data is as of 2005. Gini coefficients (latest year available) and Iraq data from The World Fact Book (2007)

Source: World Bank, IMF

Appendix 3 – Frontier Markets – Fixed Income Markets (data as of June 30, 2008)

Country	Local treasury yield (1-year)	Eurobond yield	Total market size (US\$ million)	Total Issues	Avg. Maturity	Debt Ratings
Latin America						
Bolivia	11.13	NA	2,332	592	2010	B3 / B- / B-
Ecuador	6.72	10.22	6,912	38	2027	B3 / B- / CCC+
Jamaica	15.67	8.50	7,205	228	2018	B1 / B / B+
Nicaragua	9.50	NA	1,082	25	2011	Caa1 / NR / NR
Panama	4.00	6.39	7,702	27	2025	Ba1 / BB+ / BB+
Paraguay	11.71	NA	175	9	2010	B3 / B / NR
Tobago & Trinidad	7.41	6.24	1,288	16	2022	Baa1 / A- / NR
Eastern Europe & Central Asia						
Azerbaijan	10.49	NA	53	8	2008	Ba1 / NR / BB+
Bosnia and Herzegovina	NA	5.93	546	2	2017	B2 / NR / NR
Bulgaria	5.47	5.62	4,995	33	2013	Baa3 / BBB+ / BBB
Croatia	5.60	5.66	13,944	60	2012	Baa3 / BBB / BBB-
Estonia	NA	NA	469	1	2020	A1 / A / A
Kazakhstan	7.42	NA	9,498	37	2013	Baa2 / BBB- / BBB
Latvia	5.92	6.02	2,383	12	2014	A2 / BBB+ / BBB+
Lithuania	4.47	5.60	6,538	15	2014	A2 / A- / A
Romania	10.74	6.81	10,419	55	2012	Baa3 / BBB- / BBB
Serbia	4.90	7.13	5,583	13	2015	A1 / AA- / A+
Slovak Republic	5.04	5.11	23,656	26	2013	A1 / A / A
Slovenia	4.31	5.05	10,848	28	2014	Aa2 / AA / AA
Tajikistan	NA	NA	NA	NA	NA	NR / NR / NR
Turkmenistan	NA	NA	NA	NA	NA	B2 / NR / NR
Ukraine	NA	8.36	7,977	23	2013	B1 / B+ / BB-
Uzbekistan	NA	NA	NA	NA	NA	NR / NR / NR
Middle East & Gulf						
Bahrain	2.40	NA	6,004	29	2010	A2 / A / A
Iraq	NA	8.65	2,700	1	2028	NR / NR / NR
Kuwait	NA	NA	5,772	16	2009	Aa2 / A+ / A+
Oman	4.80	NA	914	5	2010	A2 / A / NR
Qatar	5.00	5.65	4,123	6	2016	Aa2 / AA- / NR
Saudi Arabia	NA	NA	4,722	74	2011	A1 / AA- / A+
UAE	NA	NA	10,282	13	2016	Aa2 / NR / NR
Africa						
Botswana	11.45	NA	3,930	22	2009	A2 / A / NR
Cote d'Ivoire	NA	38.50	3,076	9	2018	NR / NR / NR
Cyprus	5.92	5.17	7,396	48	2012	Aa3 / A+ / AA-
Egypt	11.00	5.36	38,500	120	2010	Ba1 / BB+ / BB+
Gabon	NA	7.44	1,238	2	2017	NR / BB- / BB-
Ghana	15.51	NA	1,300	NA	2008	NR / B+ / B+
Kenya	8.86	NA	5,456	103	2012	NR / B / B+
Lebanon	7.75	8.36	21,677	117	2013	B3 / CCC+ / B-
Mauritius	7.55	NA	5,193	221	2009	Baa2 / NR / NR
Morocco	3.50	6.55	27,900	180	2015	Ba1 / BBB- / BBB-
Namibia	11.59	NA	1,157	30	2012	BBB- / NR / NR
Nigeria	9.20	NA	21,520	197	2010	NR / BB- / BB-
Tanzania	10.49	NA	1,557	77	2009	NR / NR / NR
Tunisia	5.46	NA	8,539	45	2014	Baa2 / BBB / BBB
Uganda	14.90	NA	1,414	69	2009	B / NR / NR
Asia						
Bangladesh	9.34	NA	15,656	90	2013	NR / NR / NR
Cambodia	NA	NA	NA	NA	NA	B2 / B+ / NR
Iran	NA	NA	NA	NA	NA	NR / NR / NR
Laos	NA	NA	NA	NA	NA	NR / NR / NR
Mongolia	NA	NA	NA	NA	NA	B1 / BB- / B+
Pakistan	11.74	10.74	17,616	84	2012	B2 / B / NR
Sri Lanka	18.53	10.86	10,373	147	2010	NR / B+ / B+
Vietnam	NA	7.58	11,472	574	2012	Ba3 / BB / BB-
Total / Averages	8.49	8.30	363,089	3,527	2014	

Source: Bloomberg, IMF, Africa Development Bank

Appendix 4: Frontier Markets – Doing Business and Corruption Rankings

Country	Doing Business Ranking (178)	Corruption CPI Ranking (180)	Corruption CPI Index (1-10)
Latin America			
Bolivia	140	105	2.9
Ecuador	128	150	2.1
Jamaica	63	84	3.3
Nicaragua	93	123	2.6
Panama	65	94	3.2
Paraguay	103	138	2.4
Trinidad and Tobago	67	79	3.4
Eastern Europe & Central Asia			
Azerbaijan	96	150	2.1
Bosnia and Herzegovina	105	84	3.3
Bulgaria	46	64	4.1
Croatia	97	64	4.1
Estonia	17	28	6.5
Kazakhstan	71	150	2.1
Latvia	22	51	4.8
Lithuania	26	51	4.8
Romania	48	69	3.7
Serbia	86	79	3.4
Slovakia	32	49	4.9
Slovenia	55	27	6.6
Tajikistan	153	150	2.1
Turkmenistan	NA	162	2.0
Ukraine	139	118	2.7
Uzbekistan	138	175	1.7
Middle East & Gulf			
Bahrain	NA	46	5.0
Iraq	141	178	1.5
Kuwait	40	60	4.3
Oman	49	53	4.7
Qatar	NA	32	6.0
Saudi Arabia	23	79	3.4
UAE	68	34	5.7
Africa			
Botswana	51	38	5.4
Cote d'Ivoire	155	150	2.1
Cyprus	NA	39	5.3
Egypt	126	105	2.9
Gabon	144	84	3.3
Ghana	87	69	3.7
Kenya	72	150	2.1
Mauritius	27	53	4.7
Morocco	129	72	3.5
Namibia	43	57	4.5
Nigeria	108	147	2.2
Tanzania	130	94	3.2
Tunisia	88	61	4.2
Uganda	118	111	2.8
Asia			
Bangladesh	107	162	2.0
Cambodia	145	162	2.0
Iran	135	131	2.5
Laos	164	168	1.9
Lebanon	85	99	3.0
Mongolia	52	99	3.0
Pakistan	76	138	2.4
Sri Lanka	101	94	3.2
Vietnam	91	123	2.6
Frontier Markets (average)	89	97	3.4

Sources: World Bank Doing Business Rankings 2008, Transparency International Corruption Perception Index (CPI) 2008



Appendix 5: Vietnam – Frontier Markets Investment Case

Vietnam is a recent case of how a sudden change in market sentiment can dramatically alter an investment case in frontier equity markets. Vietnam’s main stock market, the Ho Shi Minh stock exchange, is one of the worst performers in 2008, with a 55% decline as of May 30, 2008 (Exhibit 22 and 25) and 65% off its peak in March 2007. However, the scenario was very different just a couple of years ago, when investors rushed into what it is still considered the leading Asia’s rising tiger. Vietnam’s stock market attracted enormous flows of capital and it became one of the best performers in 2006 with a return of 144%. The Ho Chi Minh index increased 7 times from 167 at the end of 2003 to a peak of 1,171 in March 2007.

Vietnam started a speedy transition from a central planned economy to a market-oriented economy in 1986 that lifted economic growth from 5.4% in the 1980s to 7.1% in the last 10 years. Investors saw Vietnam as the leader in the next generation of Asian tigers and the country attracted enormous foreign investor interest and capital inflows. The capital account balance rose to 24.5% of GDP in 2007, from 5.1% in 2006, according to Morgan Stanley. The rapid pace of development went ahead of itself and was not coupled with a stronger institutional framework. Large capital inflows, a pegged exchange system and loose monetary policy supported a strong credit cycle and caused a major asset price bubble that pushed macroeconomic indicators to unsustainable levels. Credit growth accelerated to 64% in March 2008, compared to 33% at the start of 2007; annual inflation accelerated to 26.8% in June 2008 (Exhibit 23) from 7.8% in June 2007, and the trade deficit shot up to 6.4% of GDP from 0.9% in June 2007 (Exhibit 24). Investor’s rising concerns of the macroeconomic outlook, global market volatility, and government efforts to restrict bank’s funding of equity investments catalyzed a stock market collapse in late 2007.

Many investors ignored the fact that Vietnam was one of the most undeveloped and illiquid stock markets in the region, one that only opened in 2000. The liquidity boom encouraged many local investors to speculate in the stock market, frequently using borrowed funds from banks. Foreign investors also participated despite the limited opportunities, with market capitalization of only \$18 billion and 38% annual trading turnover in 2007. The large amount of investment flows into the equity market pushed the price/earnings ratio above 50 times in 2007. Although there was a small market rebound of 22% in July 2008 (through July 18th), significant improvements in the macroeconomic picture are required before further advances would be justified based on fundamental analysis.

Exhibit 22: Ho Chi Minh stock market performance (2003 – Present)

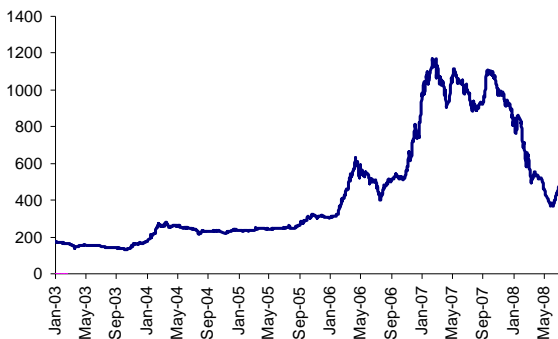


Exhibit 23: Vietnam - CPI Inflation (yoy)

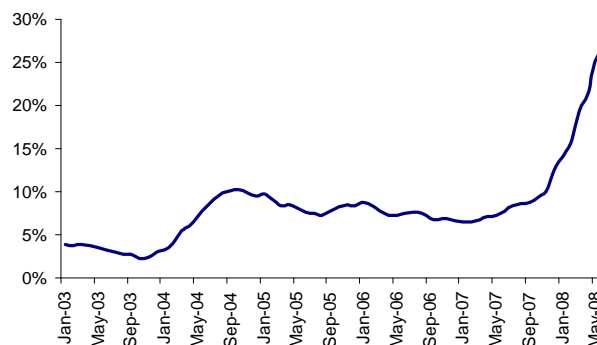


Exhibit 24: Vietnam - Trade Balance (% of GDP)

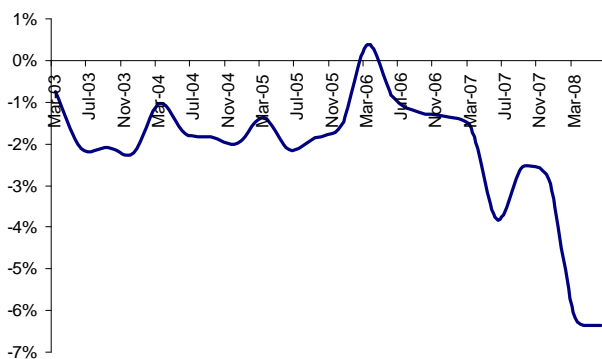
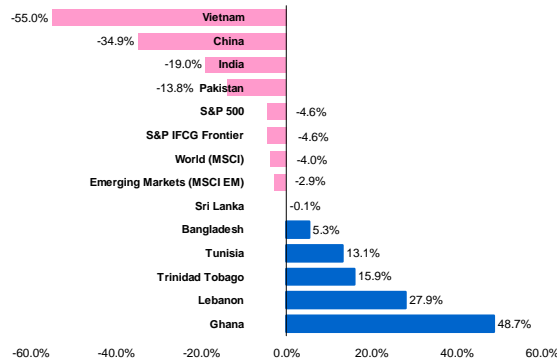


Exhibit 25: Stock market performance (year to May 30, 2008)



Source: Bloomberg

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