Quarterly Letter – 2008 Q2

The independent return pattern of our frontier markets fund continued to demonstrate itself in the second quarter as we gained 6.3% while major global indices were in the red. Year to date through June we are now up 7.7% while the S&P 500, MSCI EAFE Index, and MSCI Emerging Markets Index are all down 11%-12%. From our November 2007 inception through the end of June 2008, our outperformance versus these three global indices is 25 percentage points or more.

We are off to a strong start, but we are well aware that performance can be random and fleeting. Nevertheless, we believe our process to be one that should allow us to generate acceptable returns over the long run. We are disciplined, long-term oriented investors buying good companies in frontier countries at good prices. We perform intrinsic value work on all of our companies and we only buy when the stock price is at a discount to our estimate of intrinsic value. We actively seek the fundamental mispricings that have become increasingly rare in developed and emerging markets over the years, but which still exist in frontier markets. The approach has allowed us to construct a portfolio with enviable valuation characteristics. Our portfolio PE is 7.3, our portfolio dividend yield is 5.7%, while our weighted average return on ending equity is 35.9%. While there are no guarantees, this combination of low valuations for companies with high returns on capital gives us comfort that we have a well constructed portfolio that should provide both downside protection and upside potential throughout market cycles.

In our 2008 Q1 letter, we spent considerable time explaining the attributes of frontier markets and our investment approach. For the most part, we will not repeat that prose, but we do encourage new readers to view last quarter's letter for background. Without that introductory material this quarter, let's review our portfolio and discuss risks. As we have explained before, due to the illiquid nature of some of our holdings, we limit our portfolio discussion to countries and sectors rather than specific positions.

Portfolio Review

By quarter end, we reached our target range of holding 20-25 stocks in 10 or more countries as our holdings grew to 22 stocks in 13 countries, up from 16 stocks in 9 countries three months ago. Cash declined from 11% to 1% as we fully invested the portfolio. In June for the first time, we reached the state where our ideas exceeded our cash available. We would use additional funds to increase our positions in existing holdings and to establish a few additional positions.

During the quarter, we traveled to seven countries: Columbia, Cote d'Ivoire, Ecuador, Kazakhstan, Kyrgyzstan, Pakistan, and Uzbekistan, in addition to attending an investment conference in London on Tunisian companies. We established positions in four countries for the first time—Cote d'Ivoire, Pakistan, Tanzania, and Tunisia. To give some idea of the value we are able to find in new places, four of the five new positions in these countries trade at a PE under 8, four of the five have dividend yields ranging from 5% to 12%, with the fifth proposing to initiate a dividend of 9%. The lowest return on ending equity (ROEE) of these five new positions is 17%--three of the five have ROEEs above 30%. Table 1 shows the overall valuation statistics for our fund at quarter end.

Table 1 Frontaura Global Frontier Fund LLC Portfolio Statistics June 30, 2008	
Portfolio Price to Earnings	7.3
Portfolio Price to Book	1.3
Portfolio Dividend Yield	5.7%
Weighted Average Return of Ending Equity	35.9%

Earnings and dividends are the most recent 12 months of reported actuals
Portfolio PE and PB are the harmonic means of all positions, weighted by position size
Portfolio dividend yield and ROEE are the means of all positions, weighted by position size

Country exposure. Overall, our portfolio continues to be split across three regions—the Middle East and North Africa, South Asia, and sub-Saharan Africa. See chart 1 for our country mix. Qatar remains our largest country holding at 19% and it and Botswana, now 10% of the portfolio, contributed the biggest dollar gains during the quarter. Since our last letter, the *Economist* reported that Qatar has become the richest country in the world per capita (not your typical frontier country!), a function of its huge hydrocarbon endowment, mainly natural gas, and its small population. Our positive Botswana result is noteworthy as the main stock index there fell 11% during the quarter and is now down 26% over the past three quarters. The other significant country contributor for us in the quarter was Bangladesh, which represents 13% of our portfolio. Our gains there occurred despite a flat overall market in the quarter.

Our second largest country holding, Sri Lanka, at 17% of the portfolio, was flat for us while the market there was down 6%. We have found our best values in Sri Lanka—our stocks there have an average PE of 3 and an average dividend yield of 12%. There are significant risks in Sri Lanka—high and rising inflation and an ongoing insurgency at the macro level, and poor and deteriorating credit quality in parts of the banking system where we have exposure. Nevertheless, it is our role to seek and take risk, where properly compensated for it, and we believe Sri Lanka offers good risk-adjusted value.

Superior performance versus some country indices shows the benefit of our small size. We invested in mispriced stocks with smaller capitalizations than those typically included in country indices. We continue to believe that smaller frontier funds have an inherent advantage over larger funds with frontier exposure as the smaller funds are able to participate in all cap sizes, and mispricings tend to be concentrated in smaller stocks. This was not necessarily the case a few years ago, but after several years of strong performance, the most liquid frontier stocks are no longer as compelling across the board as they once were.

Our biggest country losers in the quarter were the United Arab Emirates (UAE), Pakistan, and Egypt. Rising food and energy costs are straining government budgets and current account balances in the latter two countries, boosting import bills and subsidies required to lower-income citizens. In May, both of these countries rolled out packages of government and central bank coping measures. Markets greeted each package with sharp double-digit losses. To some degree, the market reaction may have been belatedly discounting deteriorating conditions themselves rather than the policy response to the conditions. But there was clear disappointment with some of the policy measures, a feeling we share. Generalizing across these two countries and others, we are seeing governments and central banks implement policies such as those in the following list:

- increased central bank discount rates to combat inflation (necessary and appropriate, but carrying with it a hit to growth, and increasing the attractiveness of fixed income relative to equities)
- higher mandated minimum deposit rates for consumers (will hurt bank profitability)
- higher social spending and government salary increases of up to 20%-30% (not our cup of tea, but the perception is this is necessary to stave off civil unrest)
- rolling back of other subsidies (good, but presenting some surprises that increase near-term uncertainty)
- increased revenue measures including some higher taxes (unfortunate, but necessary to balance the spending increases, if they are to occur[1])
- increased regulation in some areas, especially foreign trade of agricultural products and commodities (often poorly designed with unintended consequences likely)

We are encouraged to see governments trying to maintain fiscal discipline during a challenging time—politicians are trying to match spending increases with revenue gains. Experience tells us, though, that when you plan sizable growth of each, the spending becomes more certain than the revenue, so we prefer plans that are less ambitious on each side of the ledger.

As discussed in *Frontaura Observer #6*, we initiated small positions in Pakistan after the market dropped nearly 30% in US dollar terms. We wrote at the time that our foray into that country might be premature. So far, that has been the case, although we have limited our downside through a small country allocation. In Egypt, we used the weakness to buy additional shares of one holding that gathers most of its revenue from frontier countries outside Egypt.

Performance drivers. Many of our winners at the country and company level were larger positions, and many of our losers at the country and company level were smaller positions, thus boosting our second quarter performance. Rather than restrict all of our position sizes to a standard 4%-5%, we will overweight higher conviction ideas (up to 10%) and underweight lower conviction ideas. We similarly overweight (up to 20%) and underweight our country exposure based on conviction. While concentrating our bets this way can be a double-edged sword, to date it has proven successful.

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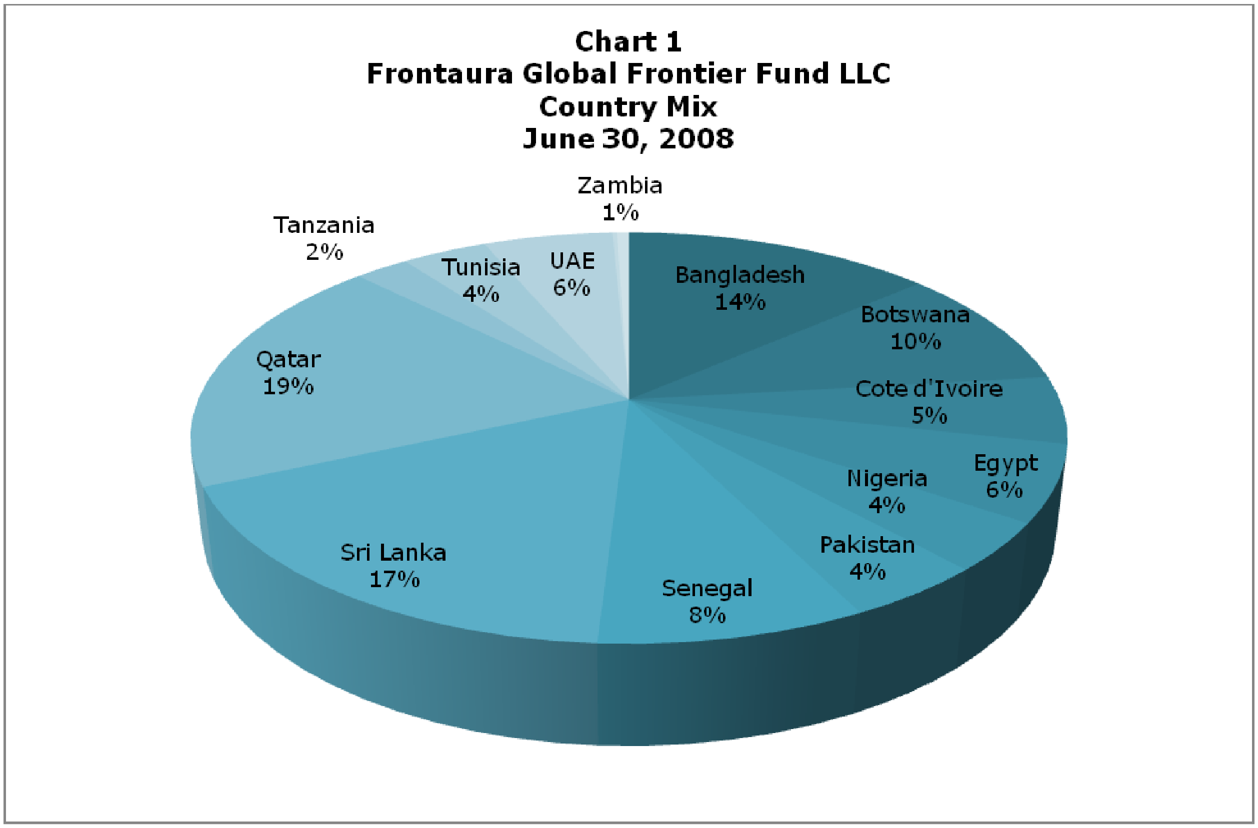
[1] We believe the revenue boost from tax increases is often overstated. It is difficult to generalize here, because a variety of niche tax measures are involved rather than sweeping across-the-board rate changes. The measures where the tax increases are small and geared toward expansion of the tax base are more likely to achieve revenue expansion goals than those pushing rates up significantly. In other words, one must examine whether the present situation is on the left side or the right side of the Laffer Curve. Frontier countries do tend to have narrow tax bases, and broadening the base may be desirable.



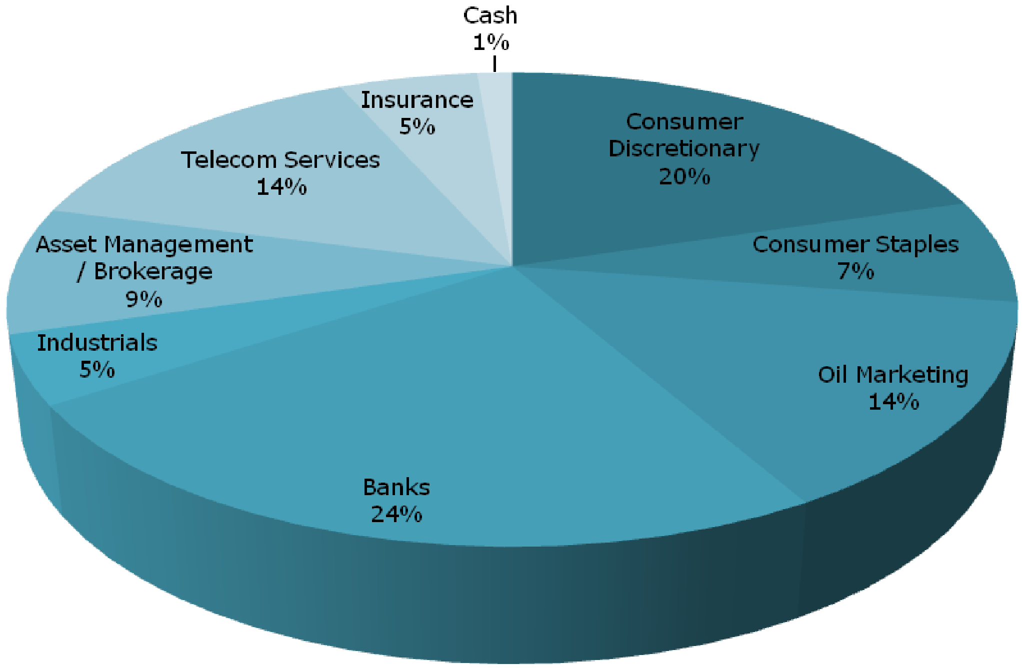
While we have been able to find value and exploit mispricings, several of these mispriced situations have appreciated rapidly within a few months of our purchase. Our intention is to hold a stock patiently for several years. In hindsight, there have been a couple of instances where we should have trimmed positions in stocks that appreciated so rapidly as to temporarily move beyond intrinsic value, before falling back. While we are reluctant to generate taxable gains that are short term, there are situations where that is the prudent move if the gain is large enough to offset the extra taxes from selling overvalued positions held less than one year. Having honed our mindset to exploit downside volatility, we intend to be more aggressive going forward in taking advantage of upside volatility that occurs in frontier markets.

Industry exposure. We were able to broaden our consumer exposure this quarter, as we said that we would like to do in last quarter's letter. Three of the six positions we added this quarter are in either the consumer discretionary or consumer staples sector. Combined, these two sectors represent 27% of our portfolio, while telecommunication services—e.g. mobile phone service, an excellent consumer play in frontier countries[2]—comprise another 14% of the portfolio. See chart 2 for our industry mix. Our desire for consumer exposure results from our belief that there is a rising middle class around the

[2] See Frontier Observer #2 for an anecdote of how consumers in sub-Saharan Africa are prioritizing air time over alcohol with regard to their discretionary spending.

world, and we want to own companies producing the products and services that these new consumers will purchase. Nevertheless, the rise of inflation will be a challenge to these consumers, possibly affecting their spending and the results of the companies we own.

Chart 2
Frontaura Global Frontier Fund LLC
Industry Mix
June 30, 2008



Monthly results. Table 2 shows our monthly performance from inception to date. As a comparison to illustrate the benefit of investing outside the established equity asset classes, we show returns for three mainstream global equity indices.

Most of our current and potential investors have holdings in the US, which we represent with the S&P500 Index; in developed countries outside North America, which we represent with MSCI's EAFE Index; and in emerging countries, which we represent with MSCI's Emerging Markets Index. Although historically there were significant divergences between the return streams of these three indices, those differences have reduced with time. In fact, as table 2 shows, these three global indices have performed similarly since our inception. During this time, geographic dispersion of equities without frontier market exposure has produced little diversification benefit.

Table 2
Frontaura Global Frontier Fund LLC
Inception (November 1, 2007) to June 30, 2008 Performance

Period	Frontaura	S&P 500	MSCI EAFE	MSCI Emerging
Nov-07	0.4%	-4.2%	-3.3%	-7.1%
Dec-07	1.6%	-0.7%	-2.3%	0.4%
Jan-08	0.7%	-6.0%	-9.2%	-12.5%
Feb-08	0.6%	-3.2%	1.4%	7.4%
Mar-08	-0.1%	-0.4%	-1.0%	-5.3%
Apr-08	3.4%	4.9%	5.4%	8.1%
May-08	3.9%	1.3%	1.0%	1.9%
Jun-08	-1.0%	-8.4%	-8.2%	-10.0%
2008 Q1	1.2%	-9.4%	-8.8%	-11.0%
2008 Q2	6.3%	-2.7%	-2.3%	-0.9%
2008 year to date	7.7%	-11.9%	-11.0%	-11.8%
Inception to date	9.8%	-16.2%	-15.8%	-17.7%
Annualized standard deviation since inception	6.6%	11.7%	13.7%	21.5%

Frontaura returns are actual returns, net of all fees, for an investor joining the fund at inception and making no further contributions. Investors joining on other dates or making additional contributions may have different returns. Index returns are on a total return basis, net of any withholding tax.

Risks

Last quarter we wrote of several potential risks. This quarter we focus on one risk that stands above the others in magnitude—inflation. Our concern over inflation and its knock-on effects is even greater than it was in last quarter's letter when we wrote:

> *…food price inflation in emerging and frontier countries is more likely to lead to systemic inflation [because food is a larger portion of the basket of consumer goods than in developed countries]. Systemic inflation causes all sorts of issues for investors—the currency may devalue, valuations decline as investors' required return increases, and corporate free cash flows fall as working capital rises. Finally, there's a short fuse between unaffordable food and civil disorder, which inevitably leads to a government response and the unintended consequences of government action.*

With crude oil prices having risen 40% in the second quarter, we now have two inflation drivers, food and energy, with the latter in turn affecting most goods and services.

From a frontier markets perspective, inflation is different from other global macro risks where the isolation of frontier markets provides shelter. This is especially true with banks, which may represent half or more of the available market cap in some frontier countries. Subprime mortgage and credit crunch issues have generally not affected frontier banks[3],

[3] A notable exception being Kazakhstan's banking system that is suffering from tighter credit as it had become dependent on foreign borrowing as a source of funds. We describe this in *Frontaura Observer #5*.

but inflation may impact a frontier banking system. Rising interest rates could shrink net interest income, as banks must pay higher rates on short-term deposits before they realize higher rates on long-term loans. In frontier countries with a less competitive banking system, such as parts of sub-Saharan Africa, this may be less of an issue if the bank achieves much of its funding through zero or very low interest deposits.

Continuing our earlier discussion of inflationary pressures on governments, we think our two other South Asian country holdings beyond Pakistan, namely Bangladesh and Sri Lanka, most clearly face these risks. We knew this when we first visited Sri Lanka (see *Frontaura Observer #4)*. Perversely, inflation rising around the world since then has made us feel better about Sri Lanka, one of the early countries to see an inflation spike. The macro risk gap between Sri Lanka and the rest of the world has narrowed while the valuation gap of our Sri Lankan holdings has remained.

For individuals and institutions, positioning a portfolio against inflation is a challenge today. Normally, one would want to own real assets—real estate, inflation-protected bonds, commodities, equities in the real estate, energy, and materials sectors, and equities in commodities-rich countries. These normal inflation hedges are challenging today—real estate is in a global slump; real yields on inflation-protected bonds are well below normal and in some cases below zero, and commodities have performed so well that one naturally pauses before putting new money into that asset class, fearing that it could roll over sharply and suddenly.

Our mandate is limited to frontier equities of course, but challenges exist here too. With regard to energy and materials, we wrote in our last letter that we tend not to favor these companies as their pricing is determined on world markets and thus they are more a play on global trends than an investment representative of a specific frontier country. With real estate, the outlook in frontier markets is more favorable than in the developed world, but it is not always a no-brainer, as we wrote in *Frontaura Observer #1* when we discussed Dubai[4]. We do have some real estate exposure through hotels and a middle-income housing developer in sub-Saharan African. Hotels could benefit from rising property prices, but high fuel costs may mean fewer travelers. Frontier housing asset values will likely provide a natural inflation hedge, but a significant percentage of frontier African homebuyers are first-time buyers, and inflation could price them out of the market.

At a simple level, seven of the 13 countries where we hold positions are commodities rich, and the holdings in these countries represent 50% of our portfolio. This is not to say that every position in a commodity-rich country is itself favorably exposed to the commodities cycle and inflation (or vulnerable to a commodities pullback). Further, most of these countries themselves are experiencing a rising inflation problem.

So there are no easy answers to today's developing inflation problem. As inflation tends to result in lower equity valuations, its presence is yet another reason why we prefer stocks to already have low valuations when we buy them.

[4] To paraphrase, we believe in Dubai near term and long term, but the midterm, say the five years beginning about a year out are uncertain. Explosive demand will meet massive supply, and it is not clear to us which will win. Real estate could crash, but it may not. Lacking clarity, we decided to have no significant exposure there. Our one UAE holding has most of its operations in other countries.

Conclusion

Global markets have been challenging for the entire eight-month period of our fund's operation. While we are not immune completely from these challenges, we do experience many of these risks in muted form. While eight months is a short time period from the perspective of a long-term investor, our nascent performance record is distinct from that of the turbulent global markets. We have offered better performance, lower volatility, and lower correlation than other global funds. Rising inflation does concern us, but we continue to find frontier markets more attractive than other global equity asset classes. Simply put we have more ideas than cash, and those ideas are at attractive valuations. For that reason, the Frontaura principals increased their personal contribution to the fund on July 1. We think frontier equities have a place in everyone's risk portfolio and we encourage those watching us to think seriously about investing with Frontaura.

We are optimists who believe the world is getting better through globalization, with a middle class emerging throughout the world. While this evolutionary process will always be one of three steps forward, two steps back, we believe the long-term trendline is upward. We want to invest in and profit from this trend and have designed a fund to do so in a method distinct from existing global equity funds.

Please contact us if you would like any materials, such as our investment presentation, legal documents, or Frontaura Observer trip report newsletters, or if you would like access to our web site, that also contains all of these materials.

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