Quarterly Letter – 2011 Q3

In the last two quarterly letters, we discussed the arguments of the bears (markets face high political risk; inflation and interest rates are rising in emerging and frontier countries; economic growth is slowing; and the European sovereign debt crisis is unresolved) and of the bulls (markets through mid-year have absorbed a lot of bad news without dropping and valuations are becoming cheaper). In Q3, this impasse was resolved in the bears' favor and markets dropped like a stone. We lost 10% in Q3, and we are down 10% year to date. As figure 1 shows, the indices we track did worse. Emerging markets lost more than double this in the quarter (-23%) and for the year to date (-22%). Frontier markets did a bit worse than we did in the quarter, down 12%, and are off 17% for the year. The S&P 500 declined 14% in Q3, but the relative safe haven of the US makes it the relative outperformer for the year at an unimpressive -9%.

While the factors specific to our universe—political risk, inflation, and interest rates—may have held back portfolio gains in the first half, it was the global factors outside of our universe, namely fears of global recession and of European defaults and the interplay of each, that set us back in Q3. At times, August and September 2011 felt like a replay of September through February 2008-2009, albeit not quite as bad. This demonstrates, in case anyone had forgotten, that while frontier markets may somewhat chart their own path in normal times, a significant enough global macro event can overwhelm our markets, and for that matter, nearly all risk-based asset classes, at least temporarily.

Opportunity Time?

What do we do? Sell and go to cash? No, transaction costs are too high and our markets are not liquid enough for that. Besides, market timers need to be right twice, both on the way out and on the way back in. In hindsight, the horrible selloff in 2008 and 2009 proved to be a time of great opportunity for us. Losing 35% from peak to trough was difficult, but the values created were so good that we were able to gain 46% in 2009 and 37% in 2010. For the three years 2008-2010 as a whole, we advanced 44%, even though the MSCI Frontier Market Index lost 37%. The keys to this outcome were for us to: 1) avoid overvaluation; 2) avoid overleveraged and fundamentally weak countries and companies; and 3) buy undervalued companies, weighting the greatest bargains most heavily.

So this August and September, we stuck to our process. We bought steadily, typically buying modest amounts each day, as today's bargain might become tomorrow's even bigger bargain. We insisted on greater discounts to intrinsic value than we normally do. As a result, cash declined from 14% to 6% during Q3. We can't say when these purchases will pay off. We recall how the buys we made in August 2008 looked stupid the following month once Lehman collapsed, and dumber still in the months to follow as prices continued their downward trajectory. But eventually nearly all of those buys made money. We were comfortable buying in Q3 2011 because the discounts available relative to our estimates of intrinsic value were the most we'd seen since the 2008/2009 period.

This is not to say that we would necessarily expect another rebound like that of 2009-2010. Generals are said to be forever fighting the last war, and portfolio managers shouldn't expect an exact repeat of history either. If not managed well, the inevitable Greek default and its knock-on effects could spin out of control and bring down much of the European banking system, an outcome with worse potential than Lehman collapsing. Governments worldwide don't have the fiscal and monetary maneuvering room they did three years ago, so they may offer a weaker policy response, which could lead to a larger global drawdown and a longer recovery period. And the longer a recovery takes, the more potential there is for civil unrest, trade wars, or actual wars. On the other hand, with nearly two years of preparation time already, everyone should know by now that Greece is going to default. One factor why there may not be another Lehman event is that the original Lehman event was only three years ago. Policymakers have this seared into their collective memory as something to avoid. While European politicians have failed to impress at every opportunity, forever being a step behind markets with their grand pronouncements that are weak on details, we are open minded, although not convinced, that they still might get their act together at the very last moment, but not a minute sooner!

Process and Technology

So there are a wide range of possible global outcomes, from something worse than 2008/2009 to only a mid-cycle economic soft patch that does not lead to recession. Turning back to our portfolio, we continue to value companies using cyclically adjusted revenue growth, margins, and returns on capital that consider up to 10 years of data. Thus, economic turning points are less likely to fool us, because our models already assume that above-normal margins and returns will revert to the mean. Our process also naturally corrects for leverage-induced performance by including debt in a company's capital base when we calculate its return on capital. Further, we ask ourselves qualitatively whether these are companies and countries that we are comfortable owning for a period of five years or more, even if their price does not advance. We favor companies that are plays on their countries' domestic economies, and we avoid companies that are too complicated to understand, or where we have no edge. Thus, we tend not to own commodity producers, real estate plays, or financials that have complexity beyond the traditional banking business of taking deposits and making loans. And buying companies at the biggest discount to our intrinsic value estimate gives us a margin of safety against overpaying.

One challenge with managing money during periods like August and September is that the flow of price change information can overwhelm you. In the first two weeks of August, when the S&P 500 had a run where it was up or down 4% five days out of six, we were seeing the equivalent of a several month's worth of price changes each day. Stock mispricings occur more frequently when volatility is high, so this is a time to be on top of your game. Back in 2008, there were times when we felt less in control than we would like, so we developed a number of tools and processes then that helped us this time around. These include adjusting fundamentals to cyclical averages; creating an automated portfolio system that calculates intrinsic values daily and sorts by the biggest discounts several times per day; and developing a system of watch lists, price alerts, and news alerts. This combination of tools alerted us to a selloff in one new stock in Q3 in time for us to buy it at an attractive price. We probably would have missed this opportunity a few years ago.

Inflation Inflection Point

In our Q2 letter, we wrote:

> *From our frontier markets vantage point, we've written about inflation risk for 18 months and the risk materialized. We now wonder if some countries are showing the first sign of this inflation peaking. That's a low confidence comment as year-over-year rates are likely to continue increasing for several more months. We have noticed some disinflation on a month-over-month basis, however, in countries such as Sri Lanka (where the June price level is below that of February), Uganda, and Vietnam. The data points and the countries are too few to call this a trend, though.*

Although Uganda has proven a poor example to cite for disinflation, we can say more clearly now that we think that inflation in frontier markets will decline over the coming six months. We track this each month by country. The number of countries where year-over-year inflation is falling now equals the number where it is still rising. Lower commodity prices should allow disinflation to gain the upper hand over inflation in the coming two quarters. This is good news, although we offer three caveats to this. First, some of the disinflation is due to lower global economic growth, and the possibility of global recession brings a new, different set of risks. Second, the disinflation is reversible. One likely effect of the US Federal Reserve's QE2 policy was to raise global food and fuel prices, affecting emerging and frontier countries most severely. While QE2 is over in the US, further monetary adventures of the Fed and other developed world central banks could again twist prices of frontier staples upward. And let's not just point the finger elsewhere—some frontier countries are also guilty of too-loose monetary policy, so frontier inflation is never really slain, it just lurks in the shadows waiting for a central bank to fall behind the curve again. Finally, we still count more frontier countries raising interest rates than lowering them. This should reverse, as many of those still putting rates up now were too slow to respond to inflationary pressures that began building in 2010. In other words, their rate increases have more to do with inflation already in the system than new inflationary pressure, so we do not expect these rate increases to continue beyond the short term.

Regional Performance

Figure 4 shows our five best and worst performing countries in Q3, with the usual wide dispersion of results around the world, ranging from +24% in Sri Lanka to -32% in Botswana. The results by region (not shown), are illuminating. Central and Eastern Europe, generally meaning the former communist countries, was our worst performer, losing 20% in the quarter. It is not surprising that this region, which comprises 16% of our portfolio, did badly given its proximity to the European sovereign debt problems. But why didn't our low valuations there protect us better? We had one company-specific issue where a bank we own was part of a lending consortium to an infrastructure project that was suspended due to corruption allegations against the main contractor. This required the bank to take extra provisions, hurting first half earnings, and causing its stock to decline. We suspect the government is likely to resolve this situation favorably; the project is prominent and necessary, and it employs too many people for it to remain idle. We expect better second half earnings from this bank. We should also call out our Cyprus exposure. This island nation suffered a Japan-like catastrophe in July when a munitions dump explosion wiped out half the country's electrical capacity. This body blow depressed markets in a country already deep in the economic doldrums due to its geographic and cultural proximity to Greece. In hindsight, our 2010 entry into this market was ill timed, although even here there is a lesson in the benefit of buying things cheaply and avoiding companies with the worst fundamentals. We lost 22% in Cyprus in Q3 and are down 23% this year. This is a truly bad result, but it is somewhat less horrific than the 41% Q3 loss in the local stock exchange index, which is now down a whopping 56% this year. Further, Cyprus was only 2% of our fund when Q3 began.

The sub-Saharan region, representing one-third of our portfolio, was the next worst region in Q3, dropping 13%. Currency weakness accounts for around one-fifth of this decline, as increased stock market volatility led to the dollar's rise. While most of our sub-Saharan Africa losses were due to general market declines, one of our companies sold off when a dispute between government and striking workers threatened to affect its method of receivable collection. This issue is ongoing. We also saw weakness in one sub-Saharan telecom whose first half results were a disappointment, primarily due to an unexpectedly higher tax rate, but secondarily due to increased competition and a maturation of its market, a trend we have seen in telecom markets around the world. We have gradually reduced our telecom exposure from nearly 20% of the portfolio in 2008 to 5% now as the profitability of the great mobile phone growth wave has waned. Telecom is back to being a value play; all three of our telecom holdings have yields of 11.5% or better. The other half of our portfolio—Asia, the Middle East, and Latin America—held up better, losing only 2% in Q3.

The View from Europe

We met over 30 Central and Eastern European companies between September 19 and October 5 on a road trip and at an investor conference. We saw companies from Croatia, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Romania, Serbia, and Slovenia. Conditions remain tough overall, as has been the case since 2008, but more companies said business is improving in 2011 than said it is getting worse.[1] We asked specifically about August and September sales, as consumer confidence in the US and some Western European countries plummeted in these months, fueling global recession fears. So far, nearly all of the companies we spoke with are seeing stable demand. Remembering well how revenue fell off a cliff post-Lehman, they are watching for this. One clothing retailer told us they expected a decline, but have been pleasantly surprised that none has occurred. One food retailer said that August was soft, but September was not. Only one company, a manufacturer of consumer durables, said they are definitely seeing weaker results since the end of July. We take these reports as good news, but we also note that the European sovereign debt crisis has likely not reached its climax yet. By the way, no one objects any more to the premise of the question, "What happens when Greece defaults?" People now accept that this will occur.

[1] Government measures, however, have turned from helpful to hurtful, due to austerity. This is especially true in Hungary, where we have no investments. The government there has shown great creativity in taxing private companies such as banks and pharmaceutical companies. As an example, the latter must now pay roughly $50,000 annually per sales rep employed, as a way both to raise government revenue and to force down government-reimbursed drug prices. Naturally, the pharma companies are firing sales reps in Hungary, while hiring them in other countries such as Russia, where drug sales are still growing.

Valuation

We can report that our cheap portfolio has become even cheaper. From 7.8 at the end of June, our weighted average trailing PE dropped to 7.0 at the end of September. The last quarter end where it was lower was June 2009, when it was 6.8. Our price/book is 1.1. This is its lowest quarter-end level since 1.0 in March 2009, the month when global markets bottomed. We now have a 4.9% dividend yield and our companies have a weighted average return on ending equity of 23.4%.

We show quarterly performance, investment mix, and attribution in the Appendix.

Regards,

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Appendix

Figure 1
Frontaura Global Frontier Fund LLC
Performance[2]
30 September 2011

Period	Frontaura	S&P 500	MSCI EAFE	MSCI Emerging	MSCI Frontier
2008	- 28%	- 37%	- 43%	- 53%	- 54%
2009	46%	26%	32%	79%	12%
2010	37%	15%	8%	19%	24%
2011 Q1	2%	6%	3%	2%	- 5%
2011 Q2	- 1%	0%	2%	- 1%	0%
2011 Q3	- 10%	- 14%	- 19%	- 23%	- 12%
2011 YTD	- 10%	- 9%	- 15%	- 22%	- 17%
Inception to Date	33%	- 20%	- 35%	- 28%	- 45%
ITD CAGR	7.5%	- 5.6%	- 10.5%	- 8.0%	- 14.3%

Figure 2
Frontaura Global Frontier Fund LLC
Monthly Performance
30 September 2011[5]

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD
2007											0.4%	1.6%	2.0%
2008	0.7%	0.6%	-0.1%	3.4%	3.9%	-1.0%	-0.8%	-2.2%	-7.9%	-17.5%	-10.7%	1.4%	-28.1%
2009	-2.0%	-0.4%	0.7%	7.7%	14.4%	4.1%	1.4%	4.7%	10.6%	-1.4%	-0.2%	0.2%	46.0%
2010	-0.9%	4.2%	6.6%	4.5%	-1.2%	1.9%	3.4%	0.7%	4.7%	3.5%	1.5%	3.3%	37.1%
2011	2.8%	-3.7%	2.7%	-0.4%	1.0%	-1.7%	-2.4%	-4.0%	-3.9%				-9.6%

[2] Returns commence 1 November 2007. Frontaura returns are net of all fees, for an investor joining the fund at inception, making no further contributions, and making no withdrawals. Investors joining on other dates, making additional contributions, or making withdrawals may have different returns. Index returns are in US dollars on a total return basis, net of any withholding tax.

Figure 3
Frontaura Global Frontier Fund LLC
Portfolio Mix and Statistics[3]
30 September 2011

Holdings Summary

Country	Holding
Vietnam	16%
Qatar	9%
Pakistan	9%
Tanzania	9%
Serbia	6%
Iraq	5%
Nigeria	5%
USA (cash only)	4%
Senegal	4%
Zambia	4%
Botswana	4%
Romania	3%
United Arab Emirates	3%
Zimbabwe	3%
Bulgaria	2%
Sri Lanka	2%
Cyprus	2%
Rwanda	2%
Ghana	2%
Colombia	1%
Estonia	1%
Cote d'Ivoire	1%
Oman	1%
Montenegro	1%
Others	1%

Industry	Holding
Banks	33%
Consumer Staples	14%
Industrials	14%
Consumer Discretionary	8%
Cash	6%
Telecommunication Services	5%
Energy	4%
Specialty Finance	4%
Insurance	3%
Materials	3%
Diversified	2%
Health Care	2%
Asset Management/Brokerage	1%

Portfolio Statistics

Portfolio Price to Earnings	7.0
Portfolio Price to Book	1.1
Portfolio Dividend Yield	4.9%
Return on Ending Equity	23.4%

[3] Portfolio valuation statistics use the most recent 12 months of reported fundamental data as of 30 September 2011. Portfolio PE and PB are the harmonic means of all positions, weighted by position size. Portfolio dividend yield and return on ending equity are the means of all positions, weighted by position size. The yield on Frontaura Global Frontier Fund is less than our portfolio dividend yield due to cash held, withholding taxes, management fees, and operating expenses. At present, we retain all income rather than distribute it.

We hold most, but not all cash, in the United States. We also include in the US total, any euros we hold in non-frontier, non-emerging countries. These euro amounts often are not material. We include all other cash we hold outside the US in that country's total, regardless of currency. For example, Vietnam is a prefunding market, so we include our cash there in the Vietnam total, even though nearly all of this cash is in US dollars.

Figure 4
Frontaura Global Frontier Fund LLC
5 Best and Worst Performing Countries
2011 Q3

5 Best Countries			5 Worst Countries		
Country	Frontaura Return	MSCI Return[4]	Country	Frontaura Return	MSCI Return
Sri Lanka	24%	-2%	Botswana	-32%	-20%
Cote d'Ivoire	8%	--	Ghana	-28%	-17%
Rwanda	6%	--	Serbia	-28%	-31%
Iraq	5%	--	Nigeria	-24%	-21%
Jordan	3%	-5%	Romania	-22%	-32%

Figure 5
Frontaura Global Frontier Fund LLC
Significant Quarterly Country Mix Changes[5]
2011 Q3

Country	Percentage Point Change	Explanation
Romania	+3	New position (first in Romania)
Rwanda	+2	New position (first in Rwanda)
Vietnam	+2	Added to positions; outperformance relative to fund
Serbia	-2	Underperformance relative to fund

[4] MSCI country indices stated on a total return basis with dividends net of any withholding tax. We show "--" if MSCI does not have an index for a given country.

[5] We show countries whose weighting has changed by two percentage points or more. Total may not add to 0 due to rounding and exclusion of countries changing by less than two percentage points. Note that we do not show the United States as we only hold cash there. See the Figure 3 footnote for a discussion of how we classify cash by country.

Figure 6
Frontaura Global Frontier Fund LLC
Portfolio Concentration[6]
30 September 2011

	Companies	Countries	Change from Prior Quarter Companies	Change from Prior Quarter Countries
Positions	50	26	+2	+4
Top 5	24%	48%	- 2	+1
Top 10	40%	71%	- 2	0
Top 20	64%	91%	0	+2
Top 20 + US (Cash)	69%	96%	- 6	- 4

[6] We do not include the US in our country count and most of the percentage totals as we hold only cash there. Change from Prior Quarter represents the change in the number of positions and the change in percentage points for the top 5, 10, and 20 positions. The Top 20 + US row does include the US cash percentage in the percentage totals. See the Figure 3 footnote for a discussion of how we classify cash by country.