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INVESTING STRATEGIES REPORT

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Finding Macro Opportunities in Emerging and Frontier Markets

KARL TONNA, FUND MANAGEMENT GROUP

KARL TONNA is the Chief Investment Officer of Fund Management Group, a pioneer in emerging and frontier markets since 1989. Before joining FMG in 2015, Mr. Tonna was Co-Portfolio Manager of SphereInvest, a specialist fixed income manager. Here he co-managed a fund focusing on high yield bonds and was also responsible for the trading and credit analysis for the fund. He has over 10 years' experience managing; he managed the cash, liquidity and foreign exchange desks.

SECTOR — GENERAL INVESTING

(AGX500) TWST: Can you tell me a little bit about your firm and your role in it?

Mr. Tonna: The FMG Group was founded in 1989, and we are specialists in emerging and frontier markets. Over the years, we were pioneers in these regions and were among the first to invest directly into countries such as Russia back in 1995, and one of the first to launch an Iraq dedicated fund in 2010 and also one in Mongolia in 2012. We utilize a comprehensive system of quantitative and qualitative analytics that allows us to identify opportunities in emerging and frontier markets. I am the Chief Investment Officer of FMG Group and have been with the firm since 2015. I am responsible for all the portfolios as well as the trading operations and investment exposure of the FMG Group.

TWST: Does the company have an overarching investment thesis, and generally, what types of investments are made?

Mr. Tonna: We operate from a top-down, macro perspective. We identify the best macro opportunities in emerging and frontier markets at the time. Then, we allocate our funds accordingly, with some of our funds being dedicated country funds, such as China or India; some others being regional, such as Africa and MENA; and still others being a mixed allocation, like Rising 3, whereby we invest in Russia, India or China. At the moment, we are extremely bullish on Russia and Iraq.

Highlights

Karl Tonna discusses Fund Management Group. The firm specializes in emerging and frontier markets, and its funds are focused on a dedicated country, regions or mixed allocation. Mr. Tonna uses a top-down perspective to identify the best macro opportunities. In addition, most of the firm's portfolios use a hybrid multimanager approach. By looking at track records and experience, Mr. Tonna finds the best-performing on-the-ground managers. In addition, he uses a long-term technical model that helps him determine which markets to invest in. Currently, Mr. Tonna is extremely bullish on Russia and Iraq.

Companies discussed: Gazprom PAO (OTCMKTS:OGZPY); Sberbank Rossii PAO (OTCMKTS:SBRCY); NK Lukoil PAO (OTCMKTS:LUKOY); Turquoise Hill Resources Ltd. (NYSE:TRQ) and Rio Tinto plc (NYSE:RIO).

TWST: Can give us a little bit more of a sense of the investment process and perhaps any quantitative screens that you use?

Mr. Tonna: First of all, apart from our Iraq and Mongolia funds, all our portfolios are a hybrid multimanager approach. So we identify the best managers in, for example, China, India, Russia, Africa, MENA and so on. Our selective approach is as follows. We look at the track record and the operations of the company itself and the staff and the portfolio managers' experience, and basically, we decide the best-performing managers out there.

That is just one aspect of it that represents usually between 60% to 70% of each of our funds, and the rest, the remaining 30% of the fund, is driven by what we call a very long-term technical, quantitative model, which takes into account trending models and allows us to gauge whether we should be in or out of the markets. We do that by basically just buying market beta of that particular country.

TWST: Why are you bullish on Russia and Iraq?

Mr. Tonna: Russia, predominantly for valuation reasons. Post U.S. sanctions, the country did selloff considerably, and you have got companies such as **Gazprom** (OTCMKTS:OGZPY), which is trading at four times p/e. **Sberbank** (OTCMKTS:SBRCY) and **Lukoil** (OTCMKTS:LUKOY) are still trading at attractive valuations.

Iraq has sold off considerably, and we are now seeing a rebound in the market as I.S. continues to lose ground, and the economy is back on track supported by higher energy prices. For example, in Mosul, we are noticing that the Iraqi forces entered the city from the east, and so they are taking control of the whole area again. I believe that Iraq, fundamentally speaking, is in an OK position, and when the war against I.S. ends, then we should see activity pickup.

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TWST: Now, many of the areas that you are investing in are very developing nations in some instances or distressed regions. How do you allay people's concerns and potential investors' concerns that, particularly if they were to invest a lot of money in the fund, they should take that risk?

Mr. Tonna: Historically speaking, emerging markets are volatile in nature and are known to exhibit some risk. Some of that can be outlier risks, i.e., something that is not forecasted. However, as things stand today, going back to all our 25-year history, emerging markets are the main drivers of economic growth and have been one of the best-performing asset classes.

If you look at Europe in GDP terms, despite being much larger than most of the emerging markets, it is exhibiting little to no growth. The U.S. has just recovered from the deep recession that occurred in 2008 and has only in the past three years picked up growth. And when you look at behemoths like China and India, which are growing at 6% or 7%, and at countries such as Russia, and also the Middle East and Africa, which are growing considerably, then those are driving growth for global GDP for the next 30 to 40 years.

We do recognize that there are quite a few risks, and we control those risks by selecting the best on-the-ground managers as well as navigating the market trends through our technical models. This allows us to be temporarily in cash and adopt a defensive stance should we be concerned about prevailing market conditions.

TWST: Within the funds themselves, how do you ensure that they are managed around the volatility?

Mr. Tonna: Within each of our funds, we can lower the volatility by being invested in a number of managers that we don't really trade in and out of. Further, we manage the volatility by, at times, aggressively going into cash. There are points in time when we can be 30% to 45% in cash, and that is one of the main benefits of our technical models. Also, we manage volatility by focusing our exposure to the best managers and thereby have a more concentrated approach. I personally am not too fond of too much diversification, as I would rather have three or four managers that I am extremely confident about that have exhibited the ability to outperform both on the upside and on the downside.

TWST: Are there any kind of overarching rules that govern most or all of your funds? For example, do you limit the number of holdings, or aim for certain industry or sector weightings? How does that work?

Mr. Tonna: If you look at our funds, in terms of number of holdings, since we allocate to managers, we basically have between five to seven managers at any one point in time. When we are getting bearish signals from our models, we do, as a "rule," act on that signal in the same way across the funds. When we decide to go into cash, we basically reduce our exposure accordingly, like I mentioned previously.

In the second instance, for example, when you have dedicated funds, such as those for Iraq and Mongolia, we typically hold around 10 to 15 securities. We look at those securities purely from a bottom-up perspective, and they are ranked like the best stocks that have the largest earnings growth potential and/or dividend yield at attractive valuations.

Then, finally, we have the mixed allocation funds — for example, the Rising 3 Fund, which gives us exposure to Russia, India or China. For this fund, we have a parameter of having exposure between 20% and 45% to each of those countries at any one point in time. How we decide to allocate between 20% and 45% depends on the sentiment and also what the technical models are showing us. Right now, for example, our models are long Russia and India, so we would be overweight in those two countries, whereas we would be underweight in China.

TWST: Why would you be underweighted in China?

Mr. Tonna: Because the signals within our models are giving us an indication that we should be underweight in China. Taking the Rising 3 Fund as an example, if we have three buys or three sells, try and identify which will be the best- or worst-performing markets over the next few months and allocate accordingly.

1-Year Daily Chart of Turquoise Hill Resources

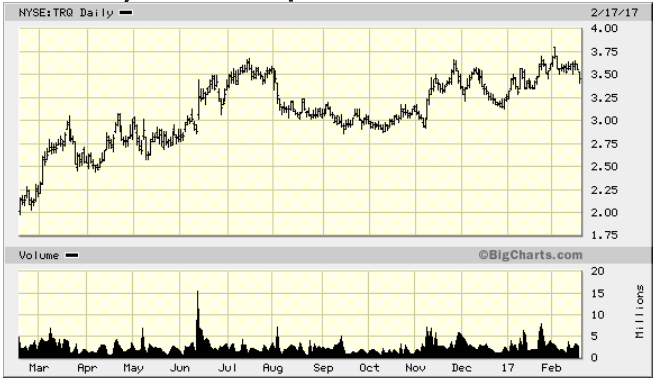

Chart provided by www.BigCharts.com

TWST: Do you specialize in certain sectors? Are you very heavily focused toward energy, for example?

Mr. Tonna: No, I would say that sector or the industry selection is driven by our managers' views. But it must be noted that, for example, in Russia, 60% of the index is skewed toward oil and gas, so you have a strong bias driven by the index itself due to the fact that the larger stocks are operating in the oil and gas sector. But in terms of sector selection, I wouldn't say that there is a particular focus from our end.

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Maybe in Iraq and Mongolia where, for example, in Iraq, we are relatively skewed toward the banking sector growth and quality aspects, but our plays are more toward regional allocation. The industry selection is such that we don't necessarily let our allocation be dictated by it, but we would let the managers decide accordingly. One area we do decide is, for example, in India, where you have a mix of managers who focus on large caps, but some others focus on midcaps. That is one of the selection criteria we also utilize.

TWST: What trends are you monitoring most closely, and why? I know there are probably several trends you, as a CIO, have to be looking to at any given time, but can you begin that by talking about the relationship you see between Russia, China and the U.S.

Mr. Tonna: One particular trend that we are looking at right now concerns Russia. Russia has come from a massive rally in 2016, which we believe may be repeated this year for the reasons I mentioned earlier. Another trend that we are monitoring closely is China's potential rebound. FMG has historically been involved in the China A-share market, which is the domestic retail market, which is not currently bought or is only sporadically purchased by foreign investors. The reason for that is because we believe that does remain a growth engine for Chinese equities.

The Chinese equity market experienced a 12% decline in 2016, and we are closely monitoring the renminbi because it has been selling off slightly. There is also talk of a devaluation of the Chinese currency, although we are not in that camp, so we think that most of that risk has already been priced in, even if it had to happen. Comparing it to the U.S., obviously, the U.S. and the S&P have been rallying for five, six years now. With President Trump officially taking office a few weeks ago, we believe that sectors such as the infrastructure and industrial sectors stand to benefit over the next few years.

TWST: What do you mean by that?

Mr. Tonna: What I mean is that he has so far gone on record talking about being accommodative toward Russia, and that is another reason why we believe that Russia will pick up further from here. Also, domestically speaking, he has talked about bringing back the production of certain industries to the United States, which will create an inflationary scenario, which is what we expect to happen with Trump. Taking imports but not exports is also a move in this direction. In other words, we believe that the industrial sector is going to benefit because there is talk of the infrastructure being rebuilt slowly in the U.S. Since infrastructure is needed, the infrastructure companies should stand to benefit.

TWST: Does it concern you as a CIO, and how do you react when you hear Trump talking more fervently about industrial policy, which is perhaps, in his mind, about more protectionism around trade? How do you personally react to that? Does it make you think any differently about investments around countries that heavily trade with the United States, and does it impact the way your guidance is within the company? How?

Mr. Tonna: Obviously, the election of Trump has sent shock waves across the industry. I frankly think that it is more talk than reality. Despite all the hype, I do not think that the policies will be significantly different than those under the Obama administration. What I think will be different is the process in which things will happen. So Trump, coming from a business background, is used to getting things done his own way, which will make it hard for him to be able to pass laws across the Senate and the Congress. Basically, what's going to happen is that we are going to have an inflationary scenario under Trump.

As a boutique investment house, we can act swiftly to changing environments, proven by our long-term track record. At the moment, we are taking a bit of a contrarian view versus our peers. We are overweight in Russia. And that is predominantly, again, because of the close ties we expect them to have with the Trump administration. Let's not forget, Rex Tillerson, the Secretary of State, is a clear indication of the accommodative stance to Russia the new administration will be taking.

TWST: What else do you think that you are looking at in the market that others are not, in keeping with that idea of being a contrarian? What do you think is underappreciated or that you are observing that others aren't?

Mr. Tonna: We are always focusing on the fact that the growth of the world comes from the developing market and not the developed ones. Also, the fact that long-term performance in developing is much stronger than in developed, and the fact that most investors we talk to are severely underweight developing markets. So in that sense, we are contrarian by advocating higher exposure to these markets. If I look at the way developed markets have reacted, I would say that Europe is especially in a bit of a bad spot. Year to date is more or less flat, but I think it is significantly overvalued, and in some of our other funds, we are actually taking a bit of a market-neutral approach to Europe whereby we are trying to buy the best stocks, but we are shorting the market's beta because we want to minimize that sort of risk.

I'm also a bit wary of oil. I think oil has stabilized quite a bit, which is supportive for emerging markets. But we have to be careful with oil because you might still see it fall back down to around $40 a barrel.

Other than that, our ideas are, again, Russia, Iraq and China. We love India from a long-term perspective, but at the moment, equities are a bit stretched from a valuation perspective, but it has a strong economic story behind it. We are also invested in the Middle East and Africa, and those are two very long-term stories.

One key area to watch out for over the next five to seven years is the Middle East recovery. Obviously, the Middle East, since the Arab Spring, has been in the limelight for all the wrong reasons, but there are some very, very strong stories there, such as Saudi and the UAE. Once all the negative news regarding geopolitical risks is removed, and we believe that the Trump administration will assist in that, then we can start looking again at the recovery of the Middle East.

TWST: Can you talk about any particular holdings?

Mr. Tonna: In one of our funds, we are long and skewed toward Brazil. Rising 6 is the only fund we manage with Brazil as an exposure. We were early investors in Brazil back in February 2016, timing the market to perfection. The Bovespa is now up 80% since then.

TWST: Is there another holding that is reflective of not only the company's philosophy but also reveals some trend about the market itself?

Mr. Tonna: Yes, I'd like to talk about one holding. It is a very exciting story. We have, in the Mongolia fund, **Turquoise Hill Resources** (NYSE:TRQ), and it basically develops the Oyu Tolgoi gold and copper mine in Mongolia, and as you know, Mongolia is heavily skewed toward gold, copper, ore and coal production. The story behind it is that the company sits on a world-class mine with some of the largest untapped reserves of copper in the world, and it is quite likely that a bid for the company is imminent. Now, Mongolia has not fully opened up as an economy to institutional international investors or to privatization. But we believe that this buyout, and with such a large player like **Rio Tinto** (NYSE:RIO) coming into Mongolia, it will open up the economy tremendously.

Over the past 10 years, **Turquoise Hill Resources** has been trading between $1.50 and $20, and it is now at $3.70. The selloff came due to delays in the project, but the mine expansion is on track again, and we are starting to see a lot interest from **Rio Tinto**. If a deal was announced — it is likely to happen in the next few quarters — I would say then that would open up not only **Turquoise**, which by the way we hold 40% of it in the Mongolia fund, but also as a whole, it would ignite the investment theme. Mongolia is sitting on some of the world's largest untapped hard commodity resources and with a geographical advantage of the near proximity to the end users, such as China. That is one of our key stories at the moment from a stock perspective.

TWST: I want to give you free reign to mention a particular holding that might speak to the kind of investing your company does.

Mr. Tonna: Given we are multimanagers, the underlying stocks are of lesser importance than if we had to buy stocks directly. I think one thing we should mention is that a lot of our funds have performed very, very well, and it is because we stick to a very basic process, which is that we build up our funds in two ways, like I mentioned before, using a mix of technical models and a mix of the best managers out there. To give you an example, our best-performing fund over the past five years has been the Rising 3 Fund, which is up 41% over the past five years, whereas the benchmark MSCI BRIC is down 10%. Through our mix, we are able to significantly outperform the markets on an annual basis and on the long term.

TWST: To what do you owe the success of the Rising 3 Fund?

Mr. Tonna: I'd say mostly to using our proprietary technical models, which allow us to go overweight or underweight Russia, India or China. Investors, retail and institutional, have been extremely satisfied by our performance, and the success is from strict due diligence of the underlying managers, strict operational review of the underlying managers and timing the markets very well, and that has enabled us to produce that kind of performance

TWST: Is there anything else you wanted to mention that we haven't covered?

Mr. Tonna: We have covered quite a bit, but did you know that over the past 10 years, the top-performing market — on an annualized basis — of the world has in nine instances been an emerging market?

TWST: Thank you. (KJL)

KARL TONNA
Chief Investment Officer
Fund Management Group
Airways House
Sixth Floor
Gaiety Lane
Sliema SLM1549
Malta
+356-2014-1220
+356-2014-1203 — FAX
www.fmgfunds.com