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## PORTFOLIO COMMENTARY : First Quarter 2014

One of our sub-advisers, Robert Mark, recently wrote a quarterly letter highlighting how "groupthink" has caused many a seasoned professional to follow others off a cliff toward bad decisions. Many studies have been done over the years illustrating how group pressure can alter opinion or even obvious facts. Robert highlights one study in particular by Solomon Asch, a social psychologist, who was well known for conformity experiments. In 1951, Asch brought together a group of students in a study and asked them to solve a set of problems. These were simple problems with obvious answers, such as whether or not two lines were the same length. However, several of the students were actors hired by Asch and their job was to purposely give the wrong answers in front of their peers to see if it would sway the students' opinions. Asch repeated the study with varying numbers of actor-students calling out the wrong answers. As a result, just one in four of the students consistently gave the right answer when their acting peers disagreed with them.

When everyone around gives an obviously wrong answer, we tend to second-guess ourselves for fear of embarrassment. Our natural desire to conform can undermine our rationality.

For this commentary, we have assembled a modest list of simple facts that are quite meaningful, but are rarely discussed in public by the investing community. It's as though the actor-peers that Solomon Asch used for his studies have replaced the various talking heads and asset gathers that make up what is best described as the status-quo. The following items may not be as obvious as whether two lines are the same length, but they should give pause to a reasonable person, who possesses a moderate understanding of finance and investing, as to whether the current market environment is divorced from fundamentals.

**<u>Corporate Earnings and Valuation:</u>**

*Global equity operating earnings peaked in 2011, yet the MSCI World Equity Index rose almost 50% from 2011-2013 on no earnings growth.*

*S&P 500 operating earnings grew a cumulative total of 10% from 2011-2013 (expectations were for 36% growth), yet the index gained almost 55% over that time.*

*Russell 2000 operating earnings fell 20% from 2011-2013 (expectations were for 100% growth), yet the index gained 60% over that time. The Russell 2000 operating P/E ratio is near 50 and the GAAP P/E is over 80. (Note: most published results of the Russell 2000 P/E ratio, such as iShares IWM ETF, now exclude companies with negative earnings and cap all other P/E ratios at 60 in an effort to make the index appear less expensive).*

*The Shiller cyclically-adjusted P/E ratio of the S&P 500 recently reached 26, a level that has only been met 3 other times in over 130 years of data, 1929, 2000, and 2007; each peak preceded at least a 50% decline in the S&P 500.*

*Except for the 2000 peak, the Price/Sales ratio and Price/EBITDA ratio of the S&P 500 is the highest in history and double the historical average despite historically low growth for revenue and earnings.*

*Corporate profit margins have always been cyclical and have averaged 6% since 1950. If the S&P 500 profit margin reverted to 6% and maintained a P/E of 15, the price of the S&P 500 based on current revenue would be around 1000; at a 7% margin it would be around 1150. The price of the S&P 500 as of March 31 was 1872.*

**<u>Economic and Macro Data:</u>**

*China's banking assets total $25 trillion and represent 33% of all Global GDP, higher than both Japan and the US at their respective bubble peaks. China credit growth has accounted for more than $15 trillion of the $30 trillion in worldwide credit growth since 2008. To put this in perspective, US subprime totaled $1.2 trillion.*

*China and Emerging Markets have been the main drivers of economic growth since 2009. Growth has slowed dramatically since 2010 while debt levels have surged. The latest Markit PMI Index for Emerging Markets signaled near-stagnation conditions bordering on contraction*

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*45% of global imports flow through China and Emerging Markets compared to only 14% for U.S.*

*Real U.S. GDP growth was only 1.9% in 2013, which was actually lower than 2012's growth rate. The U.S. has been operating with $1 trillion budget deficits augmented by $1 trillion in Fed monetary liquidity to create about $300 billion in annual economic growth.*

*Despite claims that the U.S. economy is going to reach sustained GDP growth of 3-4%, U.S. real GDP growth has only been 3% or higher in just 2 out of the past 13 years; both of which occurred during the housing bubble. The average growth rate of the U.S. economy since 1999 has been 1.9%, or right where we are now, even with tremendous stimulus.*

**Speculative and Miscellaneous concerns**

*NYSE margin debt is at historic highs and well beyond 2000 and 2007 peaks. U.S. Covenant Lite and PIK lending have surged well beyond 2006-2007 levels.*

*Many internet, biotech and technology stocks are trading at 1999 dot.com levels. Over the past 6 months, 74% of companies IPOs have no earnings, the highest level since March 2000.*

*The Fed has said QE helps to keep interest rates low, yet the yield on the U.S. 10-yr note doubled from July 2012 to December 2013. The Bankrate.com 30-yr mortgage rate rose from 3.4% to 4.5% in 2013.*

*According to Dallas Fed President Fisher, by the end of QE3 the Fed will hold more than 40% of the MBS market and almost 25% of outstanding Treasuries. With the decline in mortgage supply, the Fed's QE is absorbing 85% of fixed-rate MBS issuance; the fall in net MBS supply is outpacing the taper.*

*Greece, an economy on the verge of bankruptcy with debt to GDP of 175% and a 27% unemployment rate, recently issued 5-yr bonds with a coupon of 4.75%, and a yield of 4.95%. Spain's 5-yr yield has fallen to parity with both US and UK equivalents, (Spanish GDP has not recovered and growth has been negative, unemployment is over 25%, house prices are down 30% and loan delinquencies are over 13%).*

*The correlation of the HFRI Equity Hedge Index to the Russell 2000 is 90%.*

The above fundamentals are very important and they speak for themselves. There's no need to defend or object to them because they are basic fundamental facts, (although we are sure readers will be surprised by many of them). Despite these glaring facts, investor sentiment is uniformly bullish. Overall, financial markets have spent the past couple of years discounting a future economic and earnings environment that remains unfulfilled and may now be well out of reach. As stated above, it's not a stretch to place fair value on the S&P 500 around 1000. That doesn't mean the market needs to drop there immediately, but it does mean that the market has already priced in an incredible future scenario.

We continue to be amazed by the counterintuitive desire to go long risk in overvalued markets, yet shun risk when markets are undervalued. Not only do we see investor preference for risky assets, investors are choosing investments, including higher-beta hedge funds, which have been highly correlated with a market advance devoid of fundamental reasoning. In effect, investors are choosing the highest point in the market cycle to take on aggressive allocations after avoiding aggressive tactics near the low point of the market cycle. From our point of view, this can only be explained by our opening paragraph and the fear of non-conformity with markets designed by central bank determinations. We view this environment as very fragile and ultimately unsustainable.

In a recent memo by Howard Marks of Oaktree Capital, he emphasized that in order to achieve investment success over time you must be able to bear the inescapable risk of looking wrong:

"Non-consensus ideas have to be lonely. By definition, non-consensus ideas that are popular, widely held or intuitively obvious are an oxymoron. Thus such ideas are uncomfortable; non-conformists don't enjoy the warmth that comes with being at the center of the herd."

Most money managers and asset allocators never need to worry about "looking" wrong because they are either passive or they hug a benchmark. Unfortunately for their investors, not looking wrong has absolutely nothing to do with investment risk or avoiding large losses. This ultimately defines our willingness to be uncomfortable and not take the same actions as everyone else. Understanding that the financial industry is currently built on conformity vs. rationality gives us tremendous optimism.

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**Definitions:** *The S&P 500 Index is a broad-based, unmanaged measurement of changes in stock market conditions based on the average of 500 widely held common stocks. The HFRI Indices are equally weighted performance indexes, utilized by numerous hedge fund managers as a benchmark for their own hedge funds. It is not possible to invest directly in an index or average. Beta is the measure of a fund's relative volatility as compared to the S&P 500 Index which by definition is 1.00. Accordingly, a fund with a 1.10 beta is expected to perform 10% better than the Index in up markets and 10% worse in down markets.*

**Additional Risks:**
Since the Fund utilizes a multi-manager strategy with multiple subadvisers, it may be exposed to varying forms of risk. The Fund's net asset value and investment return will fluctuate based upon changes in the value of its portfolio securities. There is no assurance that the Fund will achieve its investment objective, and an investment in the Fund is not by itself a complete or balanced investment program. For a complete description of the Fund's principal investment risks please refer to the prospectus.

The Fund is non-diversified and may focus its investments in the securities of a comparatively small number of issuers. Concentration in securities of a limited number of issuers exposes a fund to greater market risk and potential monetary losses than if its assets were diversified among the securities of a greater number of issuers.
The Fund may invest in small- and medium-sized companies which involve greater risk than investing in larger, more established companies, such as increased volatility of earnings and prospects,higher failure rates, and limited markets, product lines or financial resources.

The Fund may invest in foreign or emerging markets securities which involve special risks, including the volatility of currency exchange rates and, in some cases, limited geographic focus, political and economic instability, and relatively illiquid markets.
The Fund may invest in debt securities which are subject to interest rate risk. An increase in interest rates typically causes a fall in the value of the debt securities the Fund may invest in.

The Fund may also invest in high yield, lower rated (junk) bonds which involve a greater degree of risk and price fluctuation than investment grade bonds in return for higher yield potential. The Fund's distressed debt strategy may involve a substantial degree of risk, including investments in sub-prime mortgage securities.

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***Investors should carefully consider the Fund's investment objectives, risks, charges and expenses before investing. This and other information is in the prospectus, a copy of which may be obtained by calling (888) 992-2765 or visiting the Fund's web site: www.absoluteadvisers.com. Please Read the prospectus carefully before you invest.***

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