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PORTFOLIO COMMENTARY : Second Quarter 2013

In our last quarter commentary we posed a simple question: *"Why does the economy need so much stimulus and quantitative easing for so little growth?"* Over the last two years or so, we feel that we have identified and explained the structural issues and risks very clearly. But in the second quarter, the equity and credit markets may have done a better job offering investors a true glimpse of the realities facing global markets. From roughly mid-May to mid-June, investors were given a wake-up call to the extensive price-risk and high correlations that exist across almost all asset classes globally. Long-time beliefs regarding asset-class diversification were dismantled very quickly. Just about every asset class performed poorly and some had signs of serious volatility and liquidity issues.

At the same time, if investors needed a better understanding and real-time insight into our Fund's exposures and positioning, this was a good test. We have been positioned for these risks and our Fund actually had a nice positive return during this period of time. Given the correlations we recently witnessed, diversification couldn't be more important right now and our Fund was one of very few investments that provided a firm leg to the stool.

Incredibly, this short-lived panic across all markets was seemingly caused by ambiguous Fed remarks simply mentioning the possibility of thinking about tapering their latest QE experiment. Additionally, markets quickly recovered after the Fed immediately started backpedaling, as if to say, "just kidding." To us, this is a clear sign that the entire central bank and government stimulus that has been used to conceal structural cracks and weaknesses is turning into a toxic stew. Even Ben Bernanke appears "puzzled" and concerned that the markets' did not follow their Ph.D-approved script. As we have stated routinely, there's so much liquidity in the market that market participants have confused luck with investment skill. It appears Mr. Bernanke may also have been "lucky" for a while. However, investor "faith" in the Fed may soon be called into question. Fundamental analysis, which has been replaced by daily central bank jawboning, will eventually return to the spotlight as investors contemplate what will happen when liquidity is no longer entering the market. To quote one of our equity managers:

> *"Over the past 18 months, any move lower in the markets has been quick and orderly. Maybe that is what concerns us most. Few investors are fearful because there is so much calm in the markets. But that calm can quickly turn into anxiety, which can quickly turn into all-out panic. Because it has taken years to inject so much liquidity, any disorderly unwinding of this liquidity has the potential to quickly become a panic—a financial risk that no investor should underestimate. The central bankers of the Federal Reserve claim to control far more than they can or indeed should be allowed to control. These bankers expect more debt to create a wealth effect that in turn improves the job market. But here is the problem: investors must remain submissive for this scheme to function properly and we can almost guarantee that investors will not remain passive when they see through this illusion."*

The illusion is the tremendous upward move in bond and equity markets over the past two years to levels that would be considered overvalued during good times. This has occurred not from tremendous economic growth, but from submissive investors agreeing to reach for yield. Much to the objection of the financial media, global economic growth has not been strengthening; it has weakened dramatically, especially in China, Europe and emerging markets. Additionally, almost every real data statistic has been continuously revised lower notwithstanding efforts to create initial positive headlines. Despite annual expectations for US GDP growth to accelerate to 3-4%, we haven't had such a year in almost a decade. In fact, there has not been ONE QUARTER of year-over-year real GDP growth of 4% or more since 2004; prior to that was 2000. The overall GDP growth trend has been declining since 2000, and ideas of annual GDP growth in the 3% range appear highly unlikely in the near future. Europe is worse and China and emerging markets are starting to experience serious levels of credit strains.

Corporate sales and earnings growth has not been strengthening, it is actually stagnant. Revenue growth has been non-existent and has been negative for the past 2 quarters. Earnings have been much weaker than expected and are being boosted by financials (which are only growing thanks to levered carry trades and the suspension of mark-to-market losses). Excluding financials, S&P 500 earnings have had negative growth for 3 out of the past 4 quarters; this trend is worse than the 2007 market peak. With no revenue growth and profit margins already at record highs with no fat left to trim, earnings are likely to continue to disappoint as profit margins have started to weaken and interest rates rise. According to GMO, profit margins averaged 4.9% between 1926 and 1999. If margins revert only to 6% from current high levels, stock markets would likely be much lower even if the economy improves and interest rates remain extraordinarily low. All else being equal, that's a potential 40% drop in stock market prices.

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All of the above fundamentals don't really seem to matter since global investors have faith that central bankers are in firm control of global market levers. However, as our Fund investors are well aware, we are not willing to be part of this submissive scheme, and we do not wish to pledge the responsibility of money management to a reckless central authority. We are very comfortable with our overall positioning, especially in light of the global market stress-test of a world on life-support. Those temporary price dislocations illustrated how deeply flawed excessive monetary accommodation has become and it would appear highly imprudent to believe the liquidity hypothesis can go on forever. As such, we continue to analyze risk and diversification largely as a function of how sensitive an investment is to central bank efforts.

We are abundantly aware of the "cost" of short-term performance concerns, yet we remain steadfast in our views that global fundamental risks are real and the monetary illusion is very fragile. Diversification away from this illusion must at least be considered if not implemented aggressively by prudent investors. We feel our Fund may be one of the few investments available to those who seek some form of protection from the potential negative effects of central bank experiments.

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.

The Fund may purchase securities of companies in initial public offerings. Special risks associated with these securities may include a limited number of shares available for trading, unseasoned trading, lack of investor knowledge of the company and limited operating history. The Fund may leverage transactions which include selling securities short as well as borrowing for other than temporary or emergency purposes. Leverage creates the risk of magnified capital losses.

The Fund may also invest in derivatives which can be volatile and involve various types and degrees of risks, depending upon the characteristics of a particular derivative. The Fund may invest in options and futures which are subject to special risks and may not fully protect the Fund against declines in the value of its stocks. In addition, an option writing strategy limits the upside profit potential normally associated with stocks. Futures trading is very speculative, largely due to the traditional volatility of futures prices.

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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