ABSOLUTE strategies FUND

Q312 PORTFOLIO COMMENTARY

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PORTFOLIO COMMENTARY : Third Quarter, 2012

Our overall outlook and positioning remains relatively unchanged. The Fund remains defensively positioned with low net exposure to the overall equity and credit markets. Our concerns continue to be a debt-driven slowdown in the global economy (largely driven by China, Europe and now India) and the resulting impact on credit and corporate fundamentals. These concerns are becoming more and more real.

Overall fundamental problems are getting worse, despite recent central bank induced equity market performance. Corporate earnings and revenue growth have stalled and have turned negative for the first time since the financial crisis. Countless multinational American companies in a variety of industries have warned of a global slowdown. Incredibly, Wall Street earnings estimates remain quite elevated. Europe continues to weaken and, other than very short-term ECB influence, the Euro-area debt problems are much worse than they were 12 months ago. Growth expectations for China, Germany, Japan and India are much lower than they were 12 months ago. The US continues to grow at a 1-2% rate and the fiscal cliff has not been addressed at all. The S&P 500 Shiller P/E, which appropriately adjusts for cyclical earnings trends, is currently 22. This is 38% higher than its long-term average. Regression to the mean would put the S&P 500 near 1000.

While we recognize the desire for the financial industry to wish away such non-positive facts, we are quite amazed by their continued hold and influence on investor behavior that overpays for past performance and reaches for yield. The stock market is thought to be 'safe' after it has risen for many weeks and months, while it is considered 'risky' after it has declined substantially. The bigger the rally, the safer the market appears, and the opposite holds true for market declines. This is undeniably irrational. This cycle of behavior continues to create large gaps between asset prices and fundamentals when approaching both market tops and market bottoms. Even long-term investors have been drawn into the momentum game. Recognizing the error in such behavior is not being 'bearish'; it is thinking in an un-biased, logical and opportunistic way. We also recognize that investor patience is being tested as the price vs. fundamental gap seems to last much longer than expected. However, the resulting re-pricing of risk usually makes the wait nearly irrelevant. We remain optimistic about our strategy. We cannot imagine a better time to stress why we are so different.

There are money managers and investors who utilize independent, critical thinking and have a desire to protect capital. This is our role. Our job requires reason, discipline and intellectual honesty, not spin. Our job is not to bet that central banks and governments can fix everything, but to recognize that their forecasts and interventions have had very poor results with vast unintended consequences. Our job is not to sugar-coat, ignore, and hope; it is to <u>understand</u>.

This is what we think we see and understand:

Any logical and reasonable person would attest that recessions are a natural and necessary part of the business and economic cycle in a free-market, capitalist system. Recessions are 'corrective' phases that cleanse the imbalances and return the system to equilibrium so credit and growth trends can be re-established. Somewhere along the road (particularly over the past 15 years), the word recession has become not just a four-letter word, but has become politically and academically unacceptable. The political process of avoiding the R-word has evolved into economic central planning by the government and the Federal Reserve. The ideas have further been encouraged by ivory tower academics, the financial services industry and the media. By attempting to 'prevent' or forestall recessions over the past 15 years through ongoing deficit spending, stimulus, and monetary policy, we have been unable to efficiently cleanse the system. Not only does this make sustainable growth impossible to re-establish, but the inevitable corrective phase builds to a point where a crisis is unavoidable. This ongoing fight has reached the point where trillion dollar annual deficits and zero percent interest rates have almost no positive effect on the economy. In fact, we are likely trapped in an inescapable path with potential negative effects.

It has been at least 15 years since our own economy has grown organically. European growth has also been artificially driven by unsustainable debt and deficit-driven demand. Enormous stimulus and investment demand out of China and India now appear to be unsustainable and recession is a real possibility. Corporate profit margins are well above average due to global deficit spending, extraordinarily weak labor compensation, broad cost cutting, and low interest and tax rates. Could it be possible that the natural level of economic activity is not at some higher recovery level, but below where we are today? We continue to worry what the next low tide will reveal. There's so much global central bank manipulation that there's no way of knowing what's really going on beneath all the artificial demand and stimulus (real or imagined).

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Blind faith in a process that has routinely failed is true insanity. Yet, the Federal Reserve's punch bowl has become incredibly large at a time when groupthink belief is at epic proportions. As a reminder, here are a few snapshots from Mr. Bernanke's history leading up to the last financial crisis (via Grant's Interest Rate Observer):

Feb. 15, 2006 – "Our expectation is that the decline in activity will be moderate; that house prices will probably continue to rise but not at the same pace that they had been rising" (House prices have declined 31% since Feb 2006).

Mar. 28, 2007 – "At this juncture, however, the impact on the broader economy and financial markets of the problems in the subprime market seems likely to be contained." (He repeated this belief near the stock market peak).

Jan. 10, 2008 – "The Federal Reserve is not currently forecasting a recession" (one month into the Great Recession).

We have our own questions for the Fed Chairman. What is the 'wealth effect' of housing prices down 30%? What benefit comes from overpaying for equity prices that have twice caused 50% losses for many investors? What benefit comes from increasing the prices of things people need and stressing the financial situation for the vast majority of its citizens? What benefit comes from taking savings rates for its citizens down to zero in an effort to rescue irresponsible banks? Don't these policies continue to benefit the 1% at the expense of the 99%? (We find it highly ironic that many left-leaning academics, including a certain Nobel Prize winning economist, favor even more money printing).

One of our equity managers, Robert Mark of St. James Investment Co., very clearly assesses the QE-inspired market environment:

By employing QE3, the Federal Reserve refuses to let real-world evidence get in the way of academic theories, as QE operations provide no permanent fix to the economy. In fact, we think that the actions of the Federal Reserve mutate the very economy it is trying to improve.

Yet, like Pavlov's dogs, stock markets responded to the latest announcement of money printing by pushing stocks higher. …one wonders if value-oriented analysts should simply stop analyzing company fundamentals and just focus on the relentless stream of headlines generated by central banks. We question just how firm the footing of this central bank-inspired market rally really is. Previous efforts by the Federal Reserve have merely provided the markets with a temporary sugar rush – stock prices momentarily pushed higher but without an increase in underlying earnings. Meaning, once the euphoria of the Federal Reserve's actions wear off, reality will reappear when investors focus once again on the market's weakening fundamentals.

We find it impossible to imagine how the Federal Reserve will reduce its balance sheet back to its pre-quantitative easing state. Like a roach motel, QE operations are easy to enter but impossible to exit in a practical manner. The Federal Reserve has gone 'all in' with QE3 on the bet that money printing will not lead to a rise in consumer prices. Eventually our central bank will face a dilemma: sacrifice the stock and bond markets or risk a complete loss of confidence in our paper-based monetary system.

It is naïve to believe the Fed can artificially sustain higher asset prices or prevent market losses given their history.

We, along with our Fund's managers, continue to believe that appropriate financial adjustments have not been made. The distortions in the pricing of risk are so large that it seems nearly impossible that there won't be hell to pay. It appears quite visible to the unbiased eye that we cannot simply extract ourselves from zero percent interest rates and trillion dollar deficits. There is no way our economy merely shifts gears to some higher growth rate. Much like the aforementioned Bernanke history, the financial community sits back and ignores it all once again. This should not come as a surprise. After all it's not their money at risk. And, their fiduciary duty has been assigned to a benchmark. How can a logical, rational person believe that this will end without significant financial adjustment?

We do not write commentary for the purpose of sounding pessimistic. The purpose is to stress how we are different and to discuss topics that others in the industry fear mentioning or simply avoid. The Fund is not positioned to bet that everything will end badly. We take a fairly agnostic and patient approach to the financial markets and do not pretend to be able to forecast their direction. We are hopeful that the appropriate adjustments will be made. However, the adjustments, when they come, will not be pain free. The potential for serious unintended consequences from the actions of global central planners is not immaterial. The chance of things going badly could result in a permanent loss of capital. Almost every asset class is correlated and priced for very low expected future returns. The minimal opportunity cost of protecting capital is nowhere near the potential loss of real wealth. We believe it would be irresponsible for us to become stuck in groupthink and ignore the probability for negative outcomes. Real diversification is an absolute must.

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We continue to maintain the Fund's exposures to managers with the flexibility to handle a variety of outcomes. We look at the portfolio as one large, liquid option that can adjust at almost any time and any price to potential opportunities. Waiting patiently may not be exciting, but we do not lose sleep over it either. Vanity holds no influence in investing. We would rather compound wealth tediously than puff out our chests when we gain back that which was lost.

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.

ABSOLUTEstrategies FUND

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