ABSOLUTE CONVERTIBLE ARBITRAGE FUND

PORTFOLIO DISCUSSION

Convertible Arbitrage - 2008 vs. 2018

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Convertible arbitrage was one of the most popular hedge fund strategies prior to 2008. Interest in the strategy changed considerably following that year. The structure of the convertibles market is very different today. A brief discussion is below.

Entering 2008, convertible arbitrage hedge funds and proprietary trading desks dominated the convertibles market. Convertible arbitrageurs were believed to own as much as 75 percent of the securities outstanding and these funds were estimated to be levered 3x to 5x on average [1]. Unlevered long only funds were relatively small players in the market in 2008. The unrecognized vulnerability of the convertible arbitrage strategy in 2008 was the assumption that every hedge fund and proprietary desk would always have the ability to finance positions with high degrees of leverage.

The credit crisis suddenly removed the ability of hedge funds and prop desks to finance positions. This removal caused an extreme situation of forced liquidation by the dominant holders of securities. In typical fashion, fund of funds, which made up a large percentage of investors in hedge funds, panicked and exacerbated the selling with massive redemptions. In 2008, many convertible securities ended up trading at unprecedented discounts to theoretical value as relatively small, long only investors had insufficient capital to absorb the massive selling from hedge funds and prop desks.

The first buyers to step up in the crisis were the issuing companies themselves which opportunistically bought back their own converts at prices far below par value. Interestingly, the default rate of convertibles did not materially rise in 2008 and 2009. The entire move down was driven by price movement (not defaults) as securities had to change hands from highly levered arbitrageurs to unlevered investors. Propelled by prime brokers suddenly pulling the rug out on financing, the sellers had to act instantly. The large number of forced hedge fund sellers overwhelmed the buyers as buyers had to go through the longer process of convincing investors to allocate them new money. That time lag between instant massive selling and new money buying, combined wih an overlevered and unbalanced hedge fund dominated market, was why prices moved down so dramatically over a short timeframe.

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Today, the convertible market is in a very different place. Unlevered long only investors make up the majority of convertible buyers. The hedge funds that do still exist today use very moderate leverage compared to what was employed 10 years ago. The convertible arbitrage strategy has not regained its popularity in the hedge fund community and continues to struggle to accumulate assets today. Proprietary desks on Wall Street have generally become non proprietary brokers of securities with minimal prop trading books. In 2008, the convertible market was vulnerable, unhealthy, and lopsided to the extreme with "fast money" players. Today, the market is healthy with long only buyers the dominant players, hedge funds in the minority and the entire market minimally leveraged.

See Reverse for Sources & Risks

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Sources:
(1) *Limits of Convertible Bond Arbitrage: Evidence from the Recent Crash* - Clifford Asness, AQR (page 6, paragraph 5)
Asset Pricing and Returns

HEDGE FUND CONVERSION - In August 2017, a hedge fund managed by Mohican Financial Management LLC reorganized into the Fund. The Fund's performance for periods prior to the commencement of operations is that of the hedge fund and is based on calculations that are different from the standardized method of calculations adopted by the SEC. The performance of the hedge fund was calculated net of the hedge fund's fees and expenses. The performance of the hedge fund is not the performance of the Fund, has not been restated to reflect the fees, estimated expenses and fee waivers and/or expense limitations of the Fund, and is not necessarily indicative of the Fund's future performance. If the performance of the hedge fund had been restated to reflect the applicable fees and expenses of the Fund, the performance may have been lower. The hedge fund was not registered under the Investment Company Act of 1940 ("1940 Act") and was not subject to certain investment limitations, diversification requirements and other restrictions imposed by the 1940 Act and the Internal Revenue Code of 1986, which, if applicable, may have adversely affected its performance.

Past performance does not guarantee future results. 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.

Asset allocation decisions may not always be correct and may adversely affect Fund performance. The value of a convertible security is influenced by changes in interest rates, with investment value declining as interest rates increase and increasing as interest rates decline. The credit standing of the issuer and other factors also may have an effect on a convertible security's investment value. Debt securities have interest rate, inflation and credit risks and are subject to prepayment and default risk. High yield and junk securities involve greater risk and tend to be more sensitive to economic conditions and credit risk. Short sales may be considered speculative and it may be difficult to purchase securities to meet delivery obligations. 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. Diversification does not prevent loss or enhance returns. Foreign investments present additional risk due to currency fluctuations, economic and political factors, government regulations, differences in accounting standards and other factors. Investments in emerging markets involve even greater risks. Small, mid and large cap stocks are subject to substantial risks such as market, business, size volatility, management experience, product diversification, financial resource, competitive strength, liquidity, and potential to fall out of favor that may cause their prices to fluctuate over time, sometimes rapidly and unpredictably. The Fund is actively managed and may experience high turnover. This may cause higher fees, expenses and taxes, which could detract from Fund performance.

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Investors should carefully consider the Fund's investments 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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Distributor: Foreside Fund Services, LLC
SKU: ARB-COMM-2008