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PORTFOLIO COMMENTARY : First Quarter, 2012

We remain pleased with the Fund's performance in what continues to be a very volatile and emotional environment for many investors. While the performance for any one month or even a few quarters may appear "disappointing," investors with reasonable and rational time horizons will understand the Fund's ability to provide a unique risk/return profile that does not rely on beta-driven, correlated asset allocation strategies. In order to provide diversification to an overall portfolio in today's momentum-fueled markets, one cannot be investing in the same things as everyone else. You have to be doing something different. As a result, overall returns and performance are likely to come at different times and intervals than other parts of a portfolio. This is the definition of diversification. It may come as a surprise to many investors that even with the significant gains in global equities over the past 6 months, our Fund has actually outperformed the MSCI World Equity Index over the past 12 months, as well as the past 5 years through March 31. Additionally, the Fund produced a positive return during last year's volatile global equity sell-off. This is why we stress patience and discipline. The Fund's overall positioning is relatively unchanged and remains well hedged and defensive. A recap of our positioning is discussed in more detail toward the end of this letter.

It is no secret the structural problems and crises throughout the global economy stem from excess debt. This letter attempts to explain why we think the global economy is in this situation, why the process for creating the problems continues to this day, why financial markets are not out of the woods, and how we plan to manage your money within this environment. We are extremely optimistic about the future investing climate, but only after we get through the final stage of the credit bubble. In our view, the root of the problem stems from the willingness of a broad swath of investors and money managers to bid up asset prices to extreme levels. The price increases are based on short term fundamentals, powerful momentum, and easy money from central banks. This creates a speculative environment that along with easy money, allows borrowers to take on excessive levels of debt based on short term, unsustainable asset prices. Money managers and investors are also providing the supply of credit in addition to the high asset prices that serve as collateral. This again is based on short term, unsustainable fundamentals. Asset prices eventually drop once long-term fundamentals trump the short-term; however the debt remains fixed. This creates an immediate collateral problem for both the borrower AND lender. Again, we blame the allocators of capital (largely using other peoples' money) for this misallocation of capital. The allocators will make large sums of money until investors finally lose faith in the process.

The reason the above process continues today is many investors have learned very little from the credit crisis and multiple investing bubbles over the past decade-plus. They are reverting back to bad investing habits and are chasing short-term performance because markets are going up. You do not need a global survey to realize that investors are now expecting returns monthly and they possess an obsession for relative returns. This is forcing money managers, who fear losing clients to someone else who promises performance, to once again buy what is "working" and sell what is "not working" regardless of valuation or fundamentals. As a result, critical thinking and independent judgments are displaced for fear of being different from the herd or benchmark. The herd grows larger and larger until momentum carries every asset class to a level where investors are "locked-in" to an incredibly low expected return across their entire portfolio. This further stresses the need for short-term performance and puts more pressure on the herd to chase performance. Eventually, momentum dies off and there are no more buyers. A large supply/demand imbalance results and markets fall off of a cliff.

Money managers who brought us the tech bubble, the housing bubble, the bond bubble, and various swings in herding investor psychology have not altered their incentive structures. The incentive structure is not based on whether managers make money or lose money for their clients; that appears to be irrelevant. The focus is on keeping the asset base and waiting for the Federal Reserve to bail them out. If you are skeptical, explain how an entire industry missed the multitude of risks and overvalued markets over the past decade that resulted in multiple bouts of large investor losses? The signs were there and were glaringly obvious in hindsight. And, if the past decade wasn't an appropriate time to think about systemic risks, when would be? Our guess…probably never. The markets, benchmarks and peer groups continue to serve as cover for reason and judgment regardless of potential investor losses. There is no critical thinking. Most of the money management industry simply desires to keep investors invested. Period.

The discussion of the money management industry's inability to manage risk is not about throwing stones. We certainly do not have all of the answers and we will inevitably make plenty of mistakes. However, understanding the financial industry's repetitive conditioning is essential for understanding the ongoing problems affecting banks, the financial system, and the

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economy as a whole. Blindly allocating capital to both winners and losers not only stresses misallocation of capital, but creates discrepancies between assets and liabilities. "Catch us if we fall" attitudes further erode true price discovery. The warning signals that market prices and interest rates normally provide are being suppressed. As the process builds, it becomes insurmountable. Hugh Hendry, a European money manager, recently commented at the Milken Conference about the current credit crisis in Europe, "You can't make up how bad it is." Commenting further he stated, "We have reached a profound point in economic history where the truth is unpalatable to the political class, and that truth is that the scale and magnitude of the problem is larger than their ability to respond, and it terrifies them." We agree. In our view, the financial and political elite are being intellectually dishonest with understanding, managing, and communicating systemic risks and they are attempting to control markets, prices and interest rates. The risks are not complicated and do not require a brilliant mind or a Ph.D. in economics to understand. It is simple exponential math and the ability and willingness to think for yourself.

Why do we believe we are not out of the woods? The seriousness of this process is creating the current, global structural problems because it impacts the most vital element: collateral. Collateral is what serves as the foundation for the current leveraged financial economy globally as it provides the means (the asset-side of a balance sheet) for lending and borrowing. When asset prices rise, additional debt can be created. When asset prices rise artificially, thanks to the effort of central banks over the past decade-plus through artificially low interest rates, it provides an unsustainable foundation for new debt. A simple example of this is the artificial increase in house prices (collateral) that allowed homeowners to take on additional debt and use their home values as an ATM. When prices of homes dropped back to supply/demand equilibrium, the higher levels of debt that were based on artificially high home prices caused a massive collateral problem. The asset/home dropped in value while the liability remained the same, thus wiping out all of the homeowner's equity. This process continues to this day. The Federal Reserve and other central banks try to inflate asset prices through money creation to entice the creation of new credit. This creates more debt on asset prices that are artificially elevated in hopes of kick-starting the economy. Unfortunately, newly created debt today has diminishing marginal productivity and is contributing very little to GDP growth. GDP is simply a measure of spending, <u>not</u> a measure of prosperity or wealth. One-time measures that create spending levels that again are artificial through deficit spending or credit are simply unsustainable (borrow and spend has limits).

Additionally, with interest rates at historic lows, investment models have low hurdle rates for success, which leads to low return-on-investment projects or crowded speculative bets on financial products. Banks have controlled much of the new liquidity and are using additional leverage on low returning bets on real estate, financial instruments and derivatives. These financial bets tend to be short lived and traders withdraw when momentum wanes or they experience losses. Asset prices then drop (think housing) and you have new collateral problems, which now include both borrower and lender, all over again. These experiments to jump start the economy create further credit and solvency problems once supply and demand revert back to natural equilibrium. Credit problems create a further drop in asset prices as banks must sell assets, and collateral problems worsen to the point where there is no fix and it spirals out of control. Collateral is about money and when money is lost, banks run into severe funding problems due to highly leveraged positions on little equity. Enter the financial elite to provide taxpayer funded bailouts. This ongoing financial repression, where failure and speculation are rewarded and savers are punished, is controlled by a small, non-elected group of economists with no market experience and a poor history of understanding anything that isn't constant and linear. These economists fail to understand that the reason capital markets aren't working is because the mechanism for pricing risk (interest rates) is broken. Amazingly, there has never been more blind faith in this group by the "catch us if we fall" investment industry.

Regardless of how much faith investors currently have in central banks, there are limits to creating money out of thin air and faith can disappear quickly. Nothing stresses the gaping income and wealth disparity more than central bank money printing and inflation. It doesn't take long for young, educationally-indebted and highly unemployed generations to resort to severe social unrest and political pressures. The 99% represents a majority last we checked, but even large voter turnouts by small factions can dramatically upend the status quo. Smaller factions have indeed defined democracy and upheaval since the beginning of time. The only thing holding up the current system is propaganda and the ability of the financial and political elite to stay in power. Many things can change the status quo, but the most powerful multiples are the bond markets (rising sovereign yields) and the political process (elections or scandal). This is where the Euro-zone is right now. National elections are pushing back against the bail-out and financial regimes and against German political will to control Euro-zone economic policy. If the status quo is upended and nationalism and self-protection re-roots itself in Europe, there will likely be a reassessment of basic math showing that debts cannot be supported or paid back. Political instability is the last thing Europe can afford right now and it could potentially upset the entire global financial system.

According to the World Bank, almost half of all global trade involves Europe, which also serves as China's largest customer. As Euro-zone economic and credit conditions worsen, we expect global trade dislocations to reverberate; this will likely impact China and the rest of Asia on a large scale. Problems in the Euro-zone could take place simultaneously with China's need to address

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their own credit bubble and economic imbalances. As we've been discussing for almost a year, China has been the main driver of global growth through a massive stimulus phase that fostered unsustainably high fixed investment levels. This has created a severe imbalance between fixed investment and consumption in China that will likely require much slower GDP growth to rebalance. According to analysis by Michael Pettis, even if consumption growth averages 7-8%, a rebalancing of investment vs. consumption implies overall real GDP growth for China averaging not much more than 3% annually over the rest of the decade. A slowing of the investment boom in China, while difficult to time, is mathematically inevitable. Many emerging market countries and even US based companies have enjoyed huge profit growth that was directly tied to the China story. This means that the countries and companies who benefited greatly from China's investment and infrastructure boom, notably those that are capital intensive or tied to industrial commodities, are at risk of a severe downturn. This assumes that China is able to handle its own credit and housing bubble, which could also be called into question once the slowdown begins. We view a hard landing in China as defined not by negative growth, but by subpar real growth. We believe this scenario is very likely, especially given credit strains and elevated inflation levels throughout Asia.

When considering the problems facing the Euro-zone, China, and the potential impact on emerging markets, we have become increasingly optimistic about the future for the United States within the global economy. Europe is a collection of insolvent nations that must come together to avert disaster. However, the opposite is occurring. China has severe imbalances that are the responsibility of a small political committee censoring a nation of very low per capita wealth. Emerging markets live largely off of the successes of Europe and China. While the U.S. has the tools to fix our own problems, Americans must be willing to accept some pain. We are optimistic the U.S. will <u>eventually</u> come out of this better than we went into it and the U.S. economy will greatly outperform on a relative basis in the long run. However, this is not necessarily a positive for broad U.S. markets due to global market correlation and the initial pain needed to tackle our own debt problems. U.S. equity markets have also become heavily dependent on current record profit margins, a declining U.S. dollar, and foreign sources of earnings growth. The positive impact of direct government subsidies on economic growth, corporate margins, and cost of capital will prove to be transitory, unsustainable, and likely costly for many investors. U.S. companies that were leveraged to the China miracle could be exposed to significant downturns. Broadly speaking, U.S. equities are not cheap based on normalized fundamentals and most U.S. bonds are completely unattractive long-term. Most alarming is the massive capital flows into bond funds and bond ETFs. This is coming at a time when Wall Street dealer balance sheets have been shrinking significantly, which should be a red flag for significant liquidity concerns when selling becomes necessary. When viewing the overall environment for asset allocation and highly correlated price movements, the task of a financial advisor could not be more challenging.

We firmly believe managing money in this environment needs to take into account the idea that the risk of loss has been conditioned out of most investors' thought and risk management processes. The Fund's overall positioning is driven largely by the bottoms-up analysis and security selection of our managers, but it also contemplates the environment outlined above. There is an obsession with short-term relative returns and it is resulting in passive asset allocation strategies that are fully invested and very crowded; investors are all competing for the same ideas. This can create significant opportunities for managers like ours, who focus on individual security selection and the mis-pricing of assets. But time and patience are required. Short-term, emotion-driven markets can create a gap between price and value that can remain wide for frustratingly long periods of time; however, price and value eventually converge. We remain committed to our longer-term theses, despite short-term volatility and we are enthusiastic about the potential for a vast re-pricing of risk.

Currently, the Fund's positioning continues to seek opportunity and discrepancy in the pricing of high quality vs. high risk companies (measured by price/cash generation and balance sheet strength). The long equity portfolio is skewed largely toward select domestic companies that have stable economic profiles, attractive valuations, and low sensitivity to cyclical margin pressure. The short equity portfolio leans toward companies where earnings power and valuations are stretched or face significant economic headwinds. These short positions include European financials, China-related growth stories, and select low quality industrial, consumer, and financial stocks in the U.S. Fundamental data and recent earnings reports point out underlying weaknesses and fragile foundations for growth in these businesses. Overlay futures hedges include certain equity indices, Euro currency, and to a lesser extent long-term U.S. Government Debt. The Fund also continues to have a large allocation to convertible arbitrage which we believe provides an attractive balance of risk and reward that can also benefit from equity volatility. In other credit, certain tranches of sub-prime mortgage and asset backed debt remain reasonably priced with attractive yields.

As a reminder, the Fund is designed for patient, disciplined investors who are looking for something to preserve capital and provide a diversifying element to a mix of directional asset classes. Given the high sensitivities and correlations across most global asset classes, diversification can be incredibly difficult; we cannot think of a better time to be using our Fund.

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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.

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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