ABSOLUTEstrategies FUND

Q113 PORTFOLIO COMMENTARY

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PORTFOLIO COMMENTARY : First Quarter 2013

Why does the economy need so much stimulus and quantitative easing (QE) for so little growth? Such a simple question; yet investors couldn't be happier with all the QE they are pricing in without ever wondering why.

We continue to be amazed by the willingness of many investors to place the management of their life savings and financial future (or fiduciary duty) into the hands of the worlds' central bankers without ever asking why. Over the past 12-18 months, a wide range of economic data and corporate sales/earnings throughout the US, Europe and Asia has come in far below investor expectations. Investors' faith in the magic of central bankers has pushed equity and credit markets to new highs in what appears to be an historic reach for yield based almost entirely on sentiment. While it would be tempting to look back in hindsight and wish we had taken on more exposure, we would have done so by ignoring a deteriorating fundamental picture, wandering from our investment process and holding our noses. In the words of one of our managers, "we clearly do not see what the market sees." But that's now in the past and has no impact on how money should be managed going forward.

Our current defensive approach continues to follow the idea that we are nowhere near the path toward a "more normal" financial and economic environment. The right path in our mind is capitalism, where the real threat of failure helps to ensure efficient use of scarce capital and adequate returns on that capital. What we have experienced over the past decade-plus is too much cheap capital and centrally planned attempts to limit failure and recession. Policy makers' contrived efforts to engineer growth and throw good money after bad has resulted in a highly cyclical and correlated global economy with large boom/bust tendencies. Investors' willingness to return to the punchbowl and bid up asset prices on cyclical, unsustainable profits only adds to the grand speculative environment. We believe investor faith in the Federal Reserve is wildly misplaced and belief in the Fed's premise is merely an excuse for speculation. As a reminder, transcripts from FOMC meetings in 2007 showed that these same policy makers believed the problems in housing and banking were isolated and unlikely to damage the economy. We disagreed with them back then too even as faith pushed the equity market to record highs throughout 2007; enthusiasm over market performance proved to be foolish and irrelevant.

Alongside a global economy that has been artificially driven by continuous stimulus, deficit spending and a lack of savings, long-term valuation metrics in both equity and credit markets leave little for investors to look forward to. A fully invested portfolio is "locked-in" to a very disappointing long-term expected return *even if* the economy returns to past growth rates. Market participants appear to be confusing cyclicality with long term growth and sustainability. Corporate profits have benefited greatly from aforementioned artificial drivers as well as cost cutting and generous accounting methods. This has boosted profit margins to levels well beyond prior historical records. Profit margins ranged consistently between 4% and 8% for more than 50 years with a historical average of 6%, but have recently spiked to 10% (Sources: GMO, Bloomberg). Many of the tailwinds responsible for this spike, including deficit spending, record low interest rates, and a lack of savings, are simply unsustainable. A reasonable reversion of profit margins to the downside, even if simply to historical highs, is likely to result in a decline in overall corporate earnings and a vastly overvalued equity market.

Look back at our lead question of why so much stimulus for so little growth. One has to consider the scary reality that our economy has been inflated by deficit spending and successive massive stimulus endeavors over the past decade and it has been concealing large structural weaknesses. In 1998, a simple 75 bps Fed rate cut helped to mitigate the risks from the collapse of Long Term Capital Management (a small hedge fund in today's world) and ignited an equity bubble. Throughout the 2000s, rate cuts and tax cuts along with government spending ignited a housing bubble. Following the 2008 collapse, massive global stimulus, led by China, along with QE I and QE II provided an enormous cyclical profit and commodity boost and helped energize financial markets. We are now faced with sustained $1 trillion in Fed QE, along with additional global QE and deficit spending in attempt to maintain 1-2% GDP growth in the US, sub-par growth in China, and a recession in Europe. Market participants are clearly looking for more. If there aren't enough stimuli available this time around, it will only be a matter of time until the structural weaknesses are revealed. Given the cracks and political pressures surfacing in Europe and Asia, time and resources may be limited.

This premise is also highly aligned with long term valuation metrics, including the Shiller cyclically-adjusted PE (CAPE), market capitalization to GDP, and price to sales. Prior to the late 1990s many of these metrics peaked at levels far below where they stand today. It's difficult to imagine that prior to the late 1990s, the price to sales ratio on the S&P 500 was around 1.0 at market highs or under 0.4 in 1982 as opposed to 1.45 in today (Source: Bloomberg). Stock market capitalization to GDP has never been higher than it is now at over 100% as opposed to just 30% in 1982 (Source: Ned Davis Research). Additionally, profit margins on the S&P

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500 hovered around 4% in the early 1980s, leaving plenty of upside for corporate earnings. For those reluctant to do the math, 4% profit margins or 1982 valuations would place the current S&P 500 at an unimaginable level (under 500). It may be very difficult for most investors to digest that valuations can revert back to historical lows. But those lows in 1982 were the starting point for valuations and profit margins that attributed so much to investor success, experience and future expectations for the past 30 years. Investors need to acknowledge that the basic arithmetic today is the inverse of 1982, and simple math will prevent them from earning reasonable returns on most of their investments even if a recession or crisis is averted. The equity market may go up more in the short term, but that will only further weaken future returns.

Historical valuations, normalized profit margins, and "organic" global GDP are all likely below current levels; this is the antithesis of early 2009. With bonds selling well above par, yields at all-time lows and equities priced for very low expected returns, it's hard for us to imagine a diversified portfolio earning anything north of 3-5% long term annually at best. In fact, there may not be a worse time in the history of asset allocation to be locked-in to a traditional balanced portfolio. More notably, a correlated directional portfolio cannot alter that long term prognosis unless it has new money with which to buy. Much like the past decade, investor excitement for market performance is likely to be driven by the recovery of losses. As such, we believe this is the time to be allocating more heavily to strategies that can vary their capital at risk and help protect against downside risk.

As a reminder, our Fund is designed to help compound and preserve wealth over a full market cycle, not to provide direct access to financial markets. Our portfolio positioning remains largely the same; we are finding pockets of opportunities both long and short, mostly in global equities. The Fund's NAV recently reached a new high even with a defensive posture and an incredibly frustrating environment; a straight up equity market and an incredibly tight credit market is one of the most difficult environments for our strategy. However, our optimism for future performance rises along with the gap between the market and fundamentals. There will be a time when others will be forced to sell into a highly illiquid equity and credit market. Buyers will be quite scarce. We plan on being one of them.

All commentary is available on our web site at
www.absoluteadvisers.com

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INVESTMENT ADVISERS

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.*

The Shiller P/E ratio is computed by taking the current price (of the S&P 500) and dividing by the average inflation-adjusted earnings from the previous 10 years. Market cap to GDP is equal to stock market capitalization (of the S&P 500) divided by gross domestic product (of the US). Price to sales is calculated by dividing the current price (of the S&P 500) by its revenue per share for the trailing 12 months.

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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