Q313 PORTFOLIO COMMENTARY

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Over the past two years we believe we have sided with good judgment as it relates to our Fund's investment process, which focuses on fundamentals and a longer term view. We realize this has been at the expense of short-term performance and opportunity cost. While our positioning may be uncomfortable for many, we remain fully committed to our investment discipline. Such commitment is more important than ever when there is a growing disconnect between price and fundamentals. Our experience of independent and, often, contrarian thinking, tells us we are once again taking the right course of action. Reviewing the history of our efforts, we correctly judged the pre-2008 period as one of extreme speculation and risk seeking by investors who learned nothing from the 2000 bubble collapse. Much like 1999-2000, price and valuation played almost no role in investor appetite for risk in 2006-2007. In late 2008 to early 2009, we correctly judged that investors were overly panicked about losses and we sought numerous opportunities to put dry powder to work and completely removed our overlay hedges designed to dampen downside market influences. In both instances we tended to be a tad early in assessing further investor behavior, but timing is not a skill we pretend to possess. In the end, our judgment was wise. It focused on fundamentals, and we took action to vary the Fund's capital at risk.

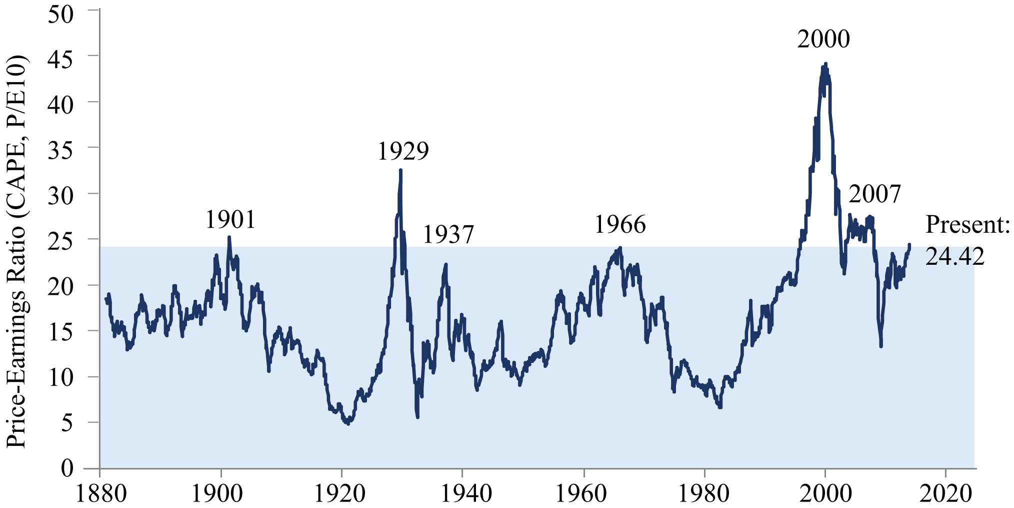
For the past two years, there has been tremendous momentum in various financial markets, yet once again fundamentals have played almost no role in this process. Here are some supporting facts:

- Global operating earnings *PEAKED* in the 3rd quarter of 2011. The cumulative trailing 12 month operating earnings growth of the MSCI World Equity Index since then has been *negative*, yet the index is up 44% since 2011 and is at a new 5-yr high.
- The S&P 500 is a bit better with a total return of 45% and at an all-time high, at a time when total cumulative operating earnings growth since 2011 has been roughly 6%, including significant stock buybacks.
- The Russell 2000 trailing 12 month earnings have been flat since 2011, while that index is up over 50% and has a price/earnings ratio near 40.

Keep in mind this latest advance is *AFTER* markets had already advanced roughly 100% from the 2009 low. Additionally, global GDP growth has been in a steady decline since 2010 dropping from roughly 5% to 2%. Why such exuberance with stagnating economic and operating results?

Our primary objective remains to seek to protect investor capital from large drawdowns, especially when asset markets become inflated and overvalued. In other words, it is our job to increase our hedging or shorting of securities in market environments where prices diverge from fundamentals. This is exactly what we see occurring now; we believe asset prices of BOTH bonds and stocks are now at levels that are approaching some of the highest risk points in history.

Below is an illustration of equity market risk using the Shiller CAPE Ratio. The CAPE applies a consistent historical approach measuring the price to earnings ratio using a 10-year average earnings, adjusted for inflation. The ratio has been extremely accurate at showing significant peaks and troughs in equity market valuation over more than 100 years. The accompanying table illustrates the resulting performance of the DJ Industrial Average at each peak in the Shiller Ratio that were near current levels.



Source: yale.edu/shiller, and Bloomberg

Price decline of DJ Industrial Average following peaks in Shiller Ratio:

1901-1903: -46%
1929-1932: -88%
1937-1938: -49%
1966-1974: -42%
2000-2003: -37%
2007-2009: -54%

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Historically, each time the Shiller PE peaked near or above current levels, equity markets eventually produced very large losses. Even if you exclude the 1930's Great Depression, the average loss was 45%. The Shiller ratio is not the only metric signifying high equity valuations.

- The Price to Sales ratio of the S&P 500 is currently at 1.6, which is *higher* than 2007, and *double* the historical average.
- Price to EBITDA (cash flow) of the S&P 500 is also *higher* than the 2007 peak, and *double* the historical average.
- Equity market capitalization as a percent of GDP is also *double* the historical average.

On top of that, corporate profit margins are 50% above the historical average and well above prior peaks; profit margins tend to be quite cyclical. Total debt to GDP is *double* the level from the mid-1980s and interest rates have started to rebound from record lows. Has there ever been a time in history when this combination of valuations, profit margins and interest rates has been so at odds with a buying opportunity or future investment success? The reversion to the mean of any of these could put significant pressure on equity prices.

Outside of excessive US equity and credit valuations, we continue to worry about the perceived notion that Europe and China are improving. In a nutshell, China is in the midst of a credit bubble where credit has been growing 35% annually with total financing now over 200% of GDP. China ranks third behind Belgium and Sweden among major economies with corporate debt-to-GDP ratios exceeding 160%. China's banking profits to GDP are now almost 3 times the US banking profit/GDP peak in 2006. The credit-driven growth miracle is in uncharted territory at a time when GDP growth is slowing. The tightening of credit and slowing of fixed investment growth in China may have a much larger impact on global economic and financial markets than many realize. Other large emerging markets, including India and Brazil are already seeing large drop-offs in economic activity as well as increasing inflation pressures.

Unfortunately, the scale of the problem in Europe remains no better. Despite five years of recovery, Eurozone real GDP has actually never recovered and the growth outlook is tepid at best. Real household consumption is at 7-year lows and unemployment is now above 12%, an all-time high. Overall banking leverage has not been reduced and loan growth has started to decline. Total assets-to-equity ratios for individual banks are between 50% and 200% higher than the levels of US banks, and corporate loan fundamentals are very weak. The IMF recently warned that 30-50% of the companies in Spain, Italy, and Portugal barely have enough cash flow to meet interest payments (reminder: interest rates are at all-time lows). As such, non-performing loans represent an excessive amount of European bank equity. Even the perceived safety of the Nordic banking system is suspect. At nearly 6x GDP and with leverage over 20:1 assets-to-equity largely funded on a wholesale basis, the Swedish banking system possesses significant embedded funding and credit risk, and likely faces the repercussions of a highly-extended housing market that the OECD estimates is nearly 30% overvalued (Longhorn Capital).

Given that the Fund has been correctly positioned for a tepid growth environment, our performance over the past 2 years has been nothing short of frustrating. We positioned the Fund to be long companies where fundamentals could improve and withstand a slowing economic environment, and hedged or shorted areas that were susceptible to earnings struggles or a slowing economic environment. In our estimation, even if the overall markets continued to advance, we would perform well with low net exposure and low beta. Looking back at the last two years of company and economic fundamentals, it is hard to challenge our judgment and positioning. In fact, we believe the Fund was better positioned over the last 2 years than it was in 2006-2007, a time when our performance was up over 12%. Unfortunately, bad news is no match for hope if investors are willing to dismiss current reality and "look through" to perceived greener pastures.

Modern central bank attempts to underwrite the waiting period has only emboldened investors and they now fear missing the next melt-up. Distortions in asset prices due to Fed policy have been a major factor in the Fund's short-term performance. We believe this has caused our value-bias in long equities to slightly underperform our short positions and overlay hedges which tend to have higher beta. Not to oversimplify the equity positioning, but the Fund is effectively long a portfolio trading at 15 times growing earnings and short a portfolio trading at 30-40 times flat or declining earnings. Much of the Fund's short equity exposure is also sensitive to increases in credit risk, or equities that have little tolerance for increases in cost of capital; this is in line with our views of an over-heated corporate bond market that lacks real liquidity.

Separately, the Fund has consistently maintained concentrated short exposure to financial institutions in both Europe and China (see above). The thesis for these exposures has been based on the view that creative accounting and government policy support have not eliminated the problems of outsized troubled loan portfolios, significant undercapitalization, and excess leverage. Much, if not all of the equity value of these businesses may be insolvent or illiquid without government intervention. As a reminder, even US bank rescues and bailouts did not save equity values from being wiped out.

In credit, the Fund maintains an allocation to convertible arbitrage as well as distressed "sub-prime" mortgage and asset backed

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securities that may offer moderate risk-adjusted returns. Outside of these areas, the fixed income exposure is minimal with little exposure to straight corporate or government debt.

Outlook

Many in the financial community allow politicians and their surrogates to lead us away from the wisdom of markets and become enamored with academic judgment and fancy mathematical models to guide the way for pricing ultra-complexity of trillions of dollars in financial assets. Today's investor understands this to mean that central banks have systematically eliminated risk from the markets. As such, many investment strategies choose to ignore such ancillary details as price and fundamentals in favor of market momentum and a universal belief in a Fed "put" (this "put" existed during the 2000 and 2007 market peaks as well and central banks eased interest rates all the way down). Regardless of your beliefs, a prudent investor portfolio should assess the probability that central bank inspiration may fail. We believe QE has greatly distorted asset prices and we do not believe central banks can simply hold the bond market on a string. How can anyone really determine what the financial landscape will be when the Federal Reserve stops buying or is forced to sell? What percentage of a portfolio should completely rely on such a binary outcome?

The truth is, eventually momentum just runs out of gas when everything becomes *PRICED-IN, including QE*. There will likely be no signal or catalyst for future market losses. There was no news or event that took place in March 2000 or October 2007, and very few acknowledged any risk at the time. Even Ben Bernanke himself top-ticked the equity market in October 2007, stressing he was in control and that "sub-prime risks were contained." Most others' attentions were focused on buying the next dip in asset prices. Only in hindsight do losses reveal their cause and then everyone claims to have seen it. In our view it's usually quite simple: <u>a growing disconnect between price and fundamentals increases the risk of meaningful losses</u>.

As always, markets will eventually separate good judgment from bad judgment (or no judgment). Our experience managing long/short portfolios and recognizing 15+ years of speculation and panic tells us that we are using reason and common sense. We certainly do not underestimate the power of markets, but we are fairly confident that the current financial landscape is not normal or sustainable. We understand this environment is ripe for performance chasing and has made the process of choosing the right investment strategy very confusing. As such, investors should think clearly about what type of investment style makes more sense long term and which managers can stand the test of time. Or, maybe we're just wrong and market experience is not a matter of judgment. And, maybe the only decision anyone ever needs to make is to be fully allocated to risky assets all the time and at any price. In that case, take your pick of bias and experience from the following:

> Alan Greenspan, Oct 23, 2013: *"In a sense, we are actually at relatively low stock prices…so-called equity premiums are still at a very high level, and that means that the momentum of the market is still ultimately up." (Bloomberg)*
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> Seth Klarman, CEO of Baupost Group, Oct 22, 2013: *"Only 5 years after a crisis that nobody saw, we are right back at all time high levels of speculation—it's astonishing. I don't know how this financial experiment ends in anything but tears." (Grant's Conference)*

Our strategy and objective is very different than those of a traditional portfolio. We seek both long and short opportunities in an effort to help reduce risk while maintaining flexibility to vary our exposure. Simply put, we seek to buy low and sell high, sometimes at the same time. We do not chase beta or momentum. We do not try to keep up with equities by jumping on the Fed's speculative bandwagon and keep on dancing until the music stops. We currently maintain a strong discipline around hedging and low beta. We are even more excited about our overall positioning as price/fundamental divergences grown, especially for short opportunities. We would expect to fare quite well in a difficult market for stocks and bonds, but a bear market is not a requirement for performance. We would simply like an environment with a little more volatility, and one where finance leans a bit more toward capitalism and leans a bit less toward easy money speculation and distorted asset prices. Further, a re-pricing of risk will enable us to change our positioning, possibly to a large degree.

> <u>Footnote</u>: Seth Klarman has one of the best investment track records over the past 30 years and is the author of the investment book, *"Margin of Safety."* Baupost Group manages $30 billion in assets.
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> <u>Sources</u>: Longhorn Capital, Bloomberg, Zero Hedge, St. Louis Federal Reserve

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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.

ABSOLUTEstrategies FUND

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