Jay Compson is the portfolio manager for the Absolute Strategies Fund and Principal and Co-Founder of Absolute Investment Advisers LLC

PORTFOLIO COMMENTARY : Fourth Quarter, 2012

While much of the fundamental picture has played out as we expected over the past 18-24 months, the financial markets appear to be concerned solely with the existence or non-existence of macro headlines and events. There seems to be a disconnect between market movements and fundamentals which means doing real work based on intellectual honesty and logic puts you at a disadvantage. Chasing momentum and profiting from central bank market manipulation appear to be the current winning strategies. This can be frustrating for us, but we've been through this before and question how long it is sustainable.

We have continued to stress that long-term, secular trends driven by a multi-decade, global buildup in credit along with a reliance on deficit spending, stimulus, tax reductions, and central bank intervention to promote artificial growth are simply not sustainable. Most policy makers have chosen to throw more dirty shirts onto the pile in hopes of some miraculous recovery. The truth is that it now takes ever-increasing amounts of debt to generate even slight increases in GDP growth and we are 4 years into the recovery process. When do they decide it's simply not working? Additional attempts to bypass the cleansing process will not only cause more headwinds, but will act as a long-term drag for future growth. Intervention is not a solution and there is a cost to all of this.

Our ongoing concerns and themes about the fundamental picture have actually happened much as we suggested:

1. European debt problems were likely to persist and weigh on economic growth and potentially cause a recession. What happened: most of Europe is now in recession and future growth is questionable; unemployment, especially among youth is approaching dangerous levels.
2. China and the rest of Asia and emerging markets were likely to experience an unexpected slowdown in growth. What happened: China growth was expected to continue to be at least double digits; they just had their worst 12 months of growth in 10 years and there are serious questions as to the validity of economic data. Additionally, concerns with wealth-management products (WMPs) in China are reminiscent of 2006-2007 US Collateralized Debt Obligations (CDOs); some are experiencing sizable credit and liquidity risk and represent a large percentage of Chinese savings.
3. US growth would continue to be quite tepid as opposed to the acceleration of 3-4% expected by economists due to Federal Reserve quantitative easing (QE). What happened: US growth continues to trend in the 1-2% range even with additional Federal Reserve QE. Some form of austerity and tax increases on most taxpayers are now being implemented; this will be a further drag on growth and corporate profits going forward and a recession in the next year or two should not be ruled out.
4. All of the above would cause global corporate revenue and earnings growth to stall and to come in well below expectations. What happened: Earnings estimates for the S&P 500 were expected to be around $110/share for 2012. S&P 500 "operating earnings" (earnings that usually exclude certain expenses), are now expected to be around $98/share with GAAP Net Income of $90/share; both amount to about 2% growth over 2011. S&P 500 earnings and revenue growth ex financials has decelerated for 6 quarters in a row and was slightly negative in the third quarter. Financials earnings have been driven largely by loan loss reserve reversals and "extraordinary one-time items". Earnings for the MSCI EAFE (Europe, Australasia, Far East) for 2012 are expected to be down 10% from 2011 and down 28% from 2010. Even if you take out the "one-time bad stuff," MSCI EAFE earnings are still down almost 13%. This index returned almost 18% in 2012, and most areas are still experiencing growth and debt issues.

Much of these analytics explain the frustration with the Fund's long vs. short equity performance. Generally speaking, our long equity exposure was tilted toward domestic US securities, had solid fundamentals, but underperformed global markets in 2012. Our short equity exposure on the other hand had a meaningful bias in financial and cyclical companies with sensitivity to Europe and China. These securities rallied strongly in 2012 on the belief that the European Central Bank (ECB) has solved the risk of a banking crisis despite deteriorating fundamentals and no real resolution.

So, why the disconnect? In our view, investors are distracted by events and financial media. We believe investors globally have focused on "risk" being solely defined as some form of exogenous shock or other tail-risk event such as Lehman's failure or other financial crisis. If they perceive that a near term "event" will be averted and the environment is deemed "safe", they will choose risk-on regardless of fundamentals. If not, they believe a sovereign entity or central bank will step in to save the day. If the event doesn't happen, everything must be better. Or, they look to the recent performance of a market index to provide the all-clear signal. To us, this is absolute insanity. However, it does appear to be the typical cycle and bubble mentality of the current investor generation. To be more succinct, many investors may be correctly thinking and worrying about tail risks, but they are acting aggressively and perhaps recklessly, especially in credit markets. The time for aggressive action was late 2008 and early 2009. But, as usual, investors seem to be trying to play catch up.

See Last Page For Definitions & Risks

[Continued on Next Page]

Market drawdowns or usual financial losses rarely start with an event or crisis. They begin with deteriorating fundamentals versus high expectations resulting in mispriced assets. The event or crisis may come as a result, but is rarely the cause of initial losses. The most likely cause is the price paid for the asset. Initial losses actually go unnoticed for some time. As a reminder, the financial sector was down well over 50% 2 months BEFORE the Lehman event in 2008. Housing prices had already dropped significantly BEFORE any event unfolded. The Nasdaq was down over 60% long before WorldCom and Enron became household names in 2002. Even 9/11 had little to do with igniting market losses as the S&P 500 was already down 30% from its high the day before that fateful event. More recently, the mighty Apple required no "event" to decline 38%, which is more than the S&P 500 loss in 2008.

Unfortunately, for those waiting for some "event" or other sign to guide their way, they seem to be distracted from the simpler fundamental picture. The global economy suffers from the anchor of Ponzi-like debt issuance, moral hazard and the resulting misallocation of capital. It is what it is. There's nothing to recover from except years of propped up economies and artificial growth from large stimulus and deficit-driven gains. It's been going on everywhere and it now appears to be over; there doesn't appear to be any artificial growth levers left and central banks are all-in. Averting a financial crisis is not stimulus and, despite their beliefs, the interventionists are not more powerful than the markets. It must be questioned what is truly holding all of this up and how much the current economic equilibrium will change as global stimulus and deficit-spending reverse course.

Looking ahead, it should come as no surprise that economic growth and earnings estimates for 2013 are once again very aggressive and almost entirely back-end loaded; and why not after recent quarterly earnings are flat at best. These "next year" estimate cheers that never happen are the only way Wall Street analysts can quote the market as being cheap. With sales growth currently flat and corporate margins already well beyond historic highs, we doubt these estimates are achievable. Any normalization of profit margins would cause earnings to drop. Additionally, despite all of the rhetoric and Federal Reserve QE, the US dollar index has actually rallied and stabilized since March 2011; corporate profits will be pressured further should the US currency continue to surprise.

Applying the long-term average profit margin to the S&P 500 would place the price/earnings (P/E) ratio north of 20; this is similar to the Shiller 10-yr cyclically-adjusted P/E of 22 vs. an historical average of 16.5. Another way to expose high profit margins is to look at price/sales or overall market capitalization to GDP. The price/sales on the S&P 500 is over 1.4; prior to the late 1990's bubble it ranged mostly between 0.5 and 1.0. Market capitalization to GDP is currently at 1.1 vs. a median of 0.7 and an historical range of 0.35 to 0.9 prior to the late 1990s equity market melt-up. This simply illustrates that while the equity market may be less expensive than bonds, it is not cheap.

However, we do not doubt the power of Wall Street propaganda and markets may continue to rally. Corporate profits could rebound a bit. There is also a large push to get people to rotate from fixed income into equities because it is "the only game in town." We do not play such games with other peoples' money. We do not engage in asset allocation services of substituting one high-priced asset class for another one; especially at a cost that only weakens diversification. We also do not buy because we feel we have to. In fact, we've never heard of investing success described as always buying something, even if it's the best of a bad bunch. It's as if the entire range of future opportunity sets could never be better than the one seen today; (or, in the case of most investors, yesterday). In our view, this is the antithesis of logic and intellectual honesty.

Others may try to keep dancing a bit by holding expensive securities with low prospective returns. This approach involves the risk of significant capital impairment. We will stick to our discipline and remain patient for when the odds are in our favor. We do not fear the role of contrarian whether it is near a market top or market bottom; this was the case for us in late 2008 to early 2009 as well. We are confident that our collection of underlying managers allocate capital prudently and have the patience needed to invest across an entire market cycle. Just like when markets correct to the downside, what many confident investors may be experiencing now could turn out to simply be explained as market volatility.

As famed investor and author Howard Marks recently penned:
"If the herd is doing the wrong thing, and if you're capable of seeing that and doing the opposite, it's still highly unlikely that the wisdom of what you do will become apparent immediately. Usually the crowd's irrational euphoria will continue to take prices higher – possibly a long while – or its excessive negativism will continue to take prices lower. The contrarian will appear wrong, and the fact that his error comes in acting differently from most people will make him look like nothing but an oddball loser."

The easiest story to sell is the one that most people want to believe. In investing, the easiest story to sell is also the one that eventually contributes the largest losses. There isn't a harder story to sell out there right now than our Fund. We think this speaks volumes.

See Last Page For Definitions & Risks

ABSOLUTE
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.*

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

SKU: ASF-COMM-Q412

Three Canal Plaza, Suite 600, Portland, Maine 04101
(888) 99-ABSOLUTE or (888) 992-2765 www.absoluteadvisers.com
Distributor: Foreside Fund Services, LLC