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PORTFOLIO COMMENTARY : Fourth Quarter 2014

Many of the fundamental themes and concerns we have outlined over the past couple of years, particularly surrounding China, Europe and Emerging Markets, continue to establish themselves. Meanwhile, most market participants continue to ignore these "novel" concepts and instead remain faithful and addicted to central bank soothsaying. At what point real risks are actually acknowledged is anyone's guess. For those who are still interested in the true fundamental picture, here's a tally of the global "recovery," and the benefits of over $22 trillion of global central bank support which is now in its <u>7th</u> <u>year</u>:

- According to McKinsey & Co., global debt has increased by $57 trillion since 2007, far outpacing world GDP growth. Total global debt is a staggering $199 trillion with Debt/GDP of 286% as of Q2 2014, (that is not deleveraging).
- China's $5 trillion in GDP growth since 2007 has been fueled by $21 trillion in new debt. China's growth has slowed dramatically since 2011, and many emerging markets are either in or near recession. Some are already experiencing currency crises.
- Oil, copper, iron ore and other major commodity prices have collapsed over the past 6 months and are down 40-60% since 2011. Many emerging market economies are heavily exposed to falling commodity prices. Global incomes, corporate earnings and capital expenditures are expected to take a major hit.
- US dollar strength is pressuring China and emerging markets, which have borrowed vast amounts in US dollars thanks to aggressive Fed policy. Multinational companies, which export goods or have benefited from prior EM growth are also at risk.
- Europe is very fragile and is simply not able to create real growth. ECB QE only further fractures what is supposed to be a unified currency by creating independent silos for losses, no fiscal policy coordination, and the potential exclusion of certain members. As a reminder, ECB bank stress tests did not include any deflation in the worst case scenario.
- Over $7 trillion in government debt is trading at negative yields. 52% of all government bonds currently yield 1% or less. German 10yr yields 0.30%.
- US real economic growth for all of 2014 is now expected to be just 2.5%, with nominal GDP down vs 2013. There was no escape velocity and falling interest rates appear to be pricing in a slowdown. Total US debt to GDP is 327% (deleveraging?).
- According to Elliott Management, as much as 1/3 of US GDP growth came from expansion of the US energy industry over the last few years.
- The median price to sales on the S&P 500 is at an all-time high, eclipsing the level at the bubble peak in 2000, and more than 2x the level of the mid-1990s. Adjusting for historical average profit margins, the price to earnings ratio on the S&P 500 would be around 30x. Stock market capitalization to GDP is the highest in history outside the 2000 bubble top.

In our prior commentary, we discussed a growing sense of uneasiness and the worry that central bank credibility may begin to be called into question. This could lead to acts of desperation by central banks that could result in heightened levels of volatility. It is amazing how quickly these themes are unfolding. While we are tiring of sounding like a broken record, the mirage of stability created by central planning and financial engineering may be beginning to sour. Financial markets are far too complex to be "gamed" forever and the volatility in major currencies and commodities is causing currency wars and global instability. This may add to global deflationary pressures. Maybe central banks and policy makers can maintain some credibility and avoid losing complete control for a while longer. That could encourage a risk-on attitude and a possible melt-up in equity markets. However, that is hardly the game of a prudent fiduciary especially considering that any future stimulus may already be priced in.

The following quote from Philadelphia Federal Reserve President Charles Plosser is an honest admission to the risks of continued central planning:

> *One of the things I've tried to argue is look, if we believe that monetary policy is doing what we say it's doing and depressing real interest rates and goosing the economy and we're in some sense distorting what might be the normal market outcomes at some point, we're going to have to stop doing it. At some point the pressure is going to be too great. The market forces are going to overwhelm us. We're not going to be able to hold the line anymore. And then you get that rapid snapback in premiums as the market realizes that central banks can't do this forever. And that's going to cause volatility and disruption.*

See Reverse for Definitions & Risks

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Swiss investors recently found out what Mr. Plosser is suggesting when the Swiss National Bank suddenly removed their peg to the Euro without warning and caused violent price swings and large losses for investors. We would further suggest that the real consequence of global monetary experiments is yet to be determined and the outcomes are unknowable. However, once markets begin to price in the longer-term ramifications, it seems clear that central banks will no longer be in control and confidence will disappear. Recent violent shakeouts in some currencies and commodities suggest such confidence can be lost at any moment. Central banks already seem to be boxed in. The Bank of Japan is having a very difficult time producing any positive results, and movements in the Yen are causing real pain for their domestic economy as well as world trade. The European Central Bank was forced into a situation that now fully illustrates the lack of unity and trust regarding the Euro. The Federal Reserve is in quite a pickle as well. They are desperate to normalize policy and get ahead of the next recession, but any further US dollar strength may well cause a downturn in corporate earnings or crash the global economy. As such, monetary ammo may be nearing exhaustion.

For our Fund's strategy, we welcome uncertainty and we are finally seeing signs that our positioning could be well suited for an evolving market cycle that is likely to look very different than the past few years. New opportunities are also starting to emerge as a result of recent volatility. Certainly some short term risk-on trends can work against us, but we do not expect smooth sailing ahead for the momentum crowd. The Fund is uniquely and conservatively positioned for global volatility, and has had negative correlation to both equity and credit markets. We have produced positive returns over the past year and our largest returns have been produced in down markets. To be able to produce alpha in a difficult market environment for our strategy gives us a great deal of confidence in our approach should markets become more volatile.

Sources: Bloomberg, Bank of America Merrill Lynch, McKinsey & Co., Elliott Management Corp, Zero Hedge.

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. It is not possible to invest directly in an index or average. Alpha is the measure of performance on a risk-adjusted (beta) basis. Alpha takes the volatility (price risk) of a fund and compares its risk-adjusted performance to a benchmark index. The excess return of the fund relative to the return of the benchmark index is a fund's alpha. 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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