CASTLE INVESTMENT MANAGEMENT

Portfolio Manager Commentary

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Sub-Advisor to the Fund

CASTLE FOCUS FUND

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FOURTH QUARTER LETTER

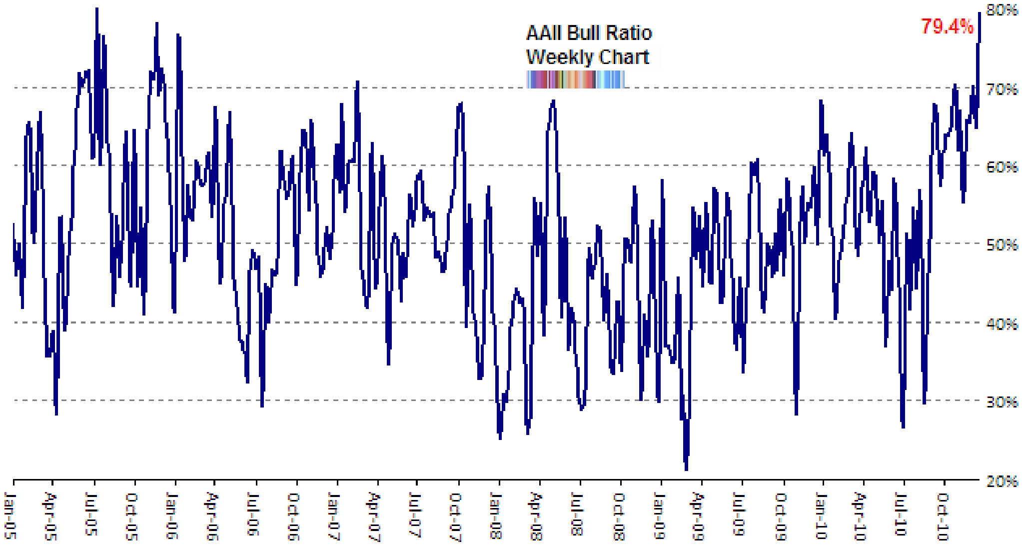
MARKET COMMENTS

The year 2010 started strong with an optimistic economic outlook. By April the market was higher by roughly 10%. But then fear over European sovereign debt defaults caused traders to reduce risk--the dollar jumped, and the Euro plunged and worries about a "double dip" in the economy dominated the headlines. The market dropped nearly 17% by early July. Interest rates drifted lower. Enter Mr. Bernanke, the Federal Reserve Chairman, who gave a notable speech on August 27th. Although he saw "unusual uncertainty" in his economic outlook, he comforted the markets with a promise that the Federal Reserve was prepared to use "unconventional measures" to ensure a recovery, including the purchase of longer dated securities. September and October turned in their best combined market performance since 1998. December was no slouch either, turning in its best performance since 1987. For the year, the S&P 500 Index was up 15%, reaching levels last seen before the collapse of Lehman in September, 2008.

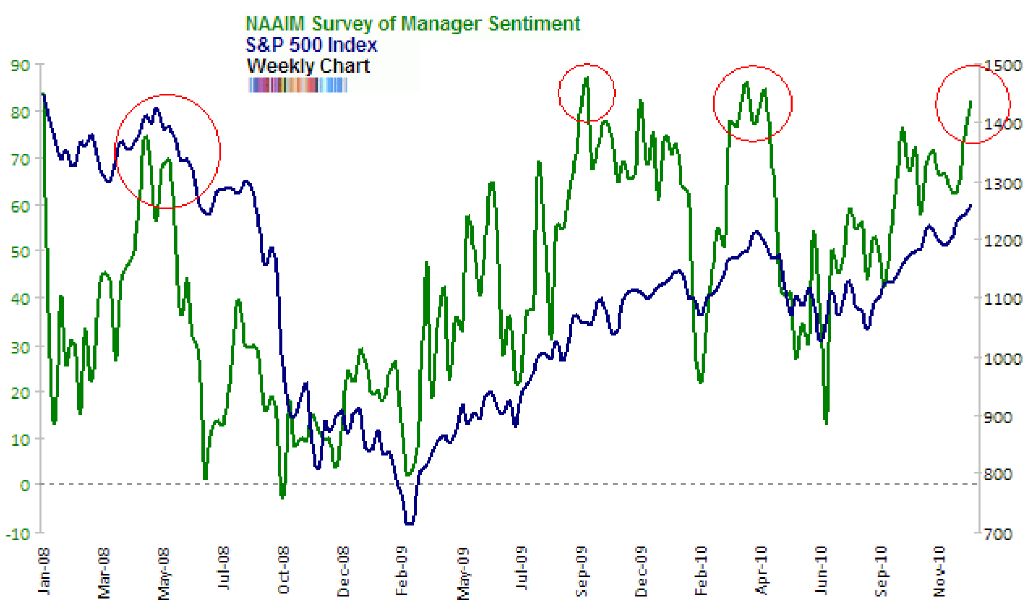
Looking ahead, there is certainly room for optimism. Corporate earnings could rise to record levels. Valuations in some areas of the market remain attractive. The economy appears to be gaining strength. Business confidence coupled with healthy balance sheets could lead to increased merger and acquisition activity. An increase in investor sentiment could lead to further multiple expansions on corporate earnings, leading to further gains in the equity markets. The tax package will almost certainly stimulate further consumer spending. On the monetary side, the Federal Reserve continues its efforts to further ease credit markets with unconventional Treasury purchases, hoping that low interest rates spur more borrowing and force investors, perhaps unwillingly, into riskier assets to improve returns.

On the other hand, going into 2011 we wonder just how much of this optimism has already been discounted, as year 2010 was a difficult year in which to handicap the financial markets. Despite what we see as an extremely disappointing economic recovery, the equity and fixed income markets performed extremely well. Looking forward to 2011, we do not know if the S&P 500's return to the level it held before Lehman Brothers collapsed is a confirmation of the market's strength or if the last marginal buyer has arrived and signals a temporary or perhaps longer term lasting market peak.

Retail investors recently polled by AAII were 63.3% bullish with only 20.3% bearish. We last saw individual investors as bullish back in November 2004 when 64.1% were bullish. Taking into account the relative bullish sentiment through the bull ratio (AAII BULL RATIO = % BULLS / (% BULLS + % BEARS)), the current condition grows more interesting. The current bull ratio jumped to 79.4% – meaning excluding those who are neutral, almost 8 out of 10 individual investors are expecting higher prices – a level last exceed back in July 2005 when the ratio was 80.5%. The bull ratio has only been higher 2.6% of the time. Historically, the S&P 500 has struggled going forward when confronted with such a degree of optimism. When the bull ratio is 80% or higher, the S&P 500 fares the worst in the medium term with an average return of -2.7% for the following two months.



And it's not just individual "retail" investors who appear increasingly confident. The most recent survey of active money managers shows a continuing increase in institutional portfolio's long equity exposure. The average exposure is 82% with the median at 92.5%. This is the highest level of optimism from this indicator since April 2010, just as the S&P 500 was peaking.



And finally, according to TrimTabs, almost 50% of the hedge fund managers (the self-proclaimed "smart money") recently surveyed as bullish on the S&P 500 index. Just 19% are bearish while 88% intend to keep or increase their current leverage. Perhaps akin to the end of Monty Python's, *The Life of Brian*, which closes with the singing of 'always look on the bright side of life' -- everyone seems to think that good things are much more likely to happen than bad things.

In today's market it somehow appears that monetary, fiscal and regulatory policy is judged by how the financial markets perform. Maybe this is due to a continuing belief in efficient markets coupled with a persistent short-term focus of money. Markets are short-sighted animals. The fact that the markets are performing well should not be construed as an endorsement that monetary and fiscal policy are on the right course. Some of the economists we respect make a convincing argument that these policies are trapping the economy in a boom and bust cycle that is unnecessarily disruptive and destructive of economic value. The simple reason that the Federal Reserve reverted to further quantitative easing, known as QE2, is that our current economic recovery has so far been rather lackluster despite the initial efforts of QE1. As for QE2, it has so far failed in its central goal of lowering mortgage borrowing costs since rates have actually risen since the announcement.

Investors, economists and policymakers have proven capable of deluding themselves for long periods of time. Unfortunately, their delusions matter to economic outcomes that people experience in the real world. The historical recurrence of financial and economic instability indicates just how easily we can deceive ourselves with the promises of new-era investment themes that eventually prove half baked. Investors are also quite capable of deluding themselves with economic policies that at first appear successful, but eventually prove quite damaging to long-run progress and prosperity.

While recent economic data in the United States suggests that the economic recovery is gaining some momentum, we remain curious as to whether this momentum can be maintained once the stimulus provided by the federal government and Federal Reserve Bank is eventually withdrawn. Those arguing that the recovery is becoming self-sustaining may be jumping the gun since it is uncertain whether demand will continue to grow in the absence of government stimulus. At the very least, the rate of growth – self-sustaining or not – is unlikely to exceed the bare minimum of 3% that is required to give this country a chance of growing employment and absorbing some of its considerable overcapacity. For the first time since the beginning of this recession, the economic data is beginning to offer some hope that government stimulus is spurring private sector growth. We wonder if this is a case of government stimulus finally starting to gain traction at the moment when it may have to be withdrawn.

At the moment, improved corporate earnings have helped stocks shrug off economic worries and have prompted Wall Street strategists to once again extrapolate the recent past and raise their forward estimates. Analysts expect companies in the S&P 500 to grow earnings by 33% this year and another 15% in 2011. Consider that near the end of 2007, just after stocks hit their all-time high, Wall Street consensus was calling for the S&P 500 to earn a record $102.78 a share in operating earnings for 2008. Actual earnings were $57.20, a little over half of expectations. Current trailing twelve month reported earnings are $79, placing the S&P 500 actual reported P/E ratio at 16. Despite the disconnect between actual reported earnings and forward operating earnings, analyst consensus of forward operating earnings remains Wall Street's preferred benchmark. It now stands at $94.80 a share, valuing the market at a forward price-to-earnings ratio of 13.3 times.

We suspect that this estimate is too optimistic. Then again, one wonders how accurate are "consensus" estimates in the first place. McKinsey & Co. compared analysts' consensus earnings-per-share growth forecasts since 1985 against the actual compound growth in reported EPS that occurred. Over the 25-year period, analysts' earnings-growth estimates ranged from 10-12% annually, almost double the actual growth of around 6%.

Revenue growth is expected to decelerate to 6.3% in 2011 from 8.8% this year. Revenue growth is intrinsically tied to nominal gross domestic product growth. U.S. nominal GDP growth averaged 3.25% in the past decade, but companies in the S&P 500 grew their sales by an extra 2.75 percentage points on average. This additional revenue growth stems from nearly half their sales that go overseas, aided by a thriving emerging markets and a large decline in the dollar. With *reported* inflation tepid, global growth merely fair and the dollar recently strengthening, nominal GDP may grow by only 3% next year and sales may not do much better.

Far more concerning is expectations that profit margins will reach 9.11% next year, a level more appropriate with the peak of the boom years. As we now know, much of that profitability came from a financial sector generating artificially high profits during the housing boom. The long-run average profit margin going back to 1997 is just 6.8% and there are few economic series that revert to the mean as reliably as corporate margins. Therefore, some very optimistic assumptions get Wall Street to next year's 15% earnings growth. What if we assumed revenue growth of 5.75% -- forecast nominal GDP growth plus the extra revenue growth that S&P 500 companies have produced over the past decade, and then applied the average corporate margin? Earnings would be just $71 a share in 2011, or a P/E multiple of 17.7 – materially higher than the 2011 forward operating multiples of 11x and 12x we hear from ever-optimistic Wall Street strategists.

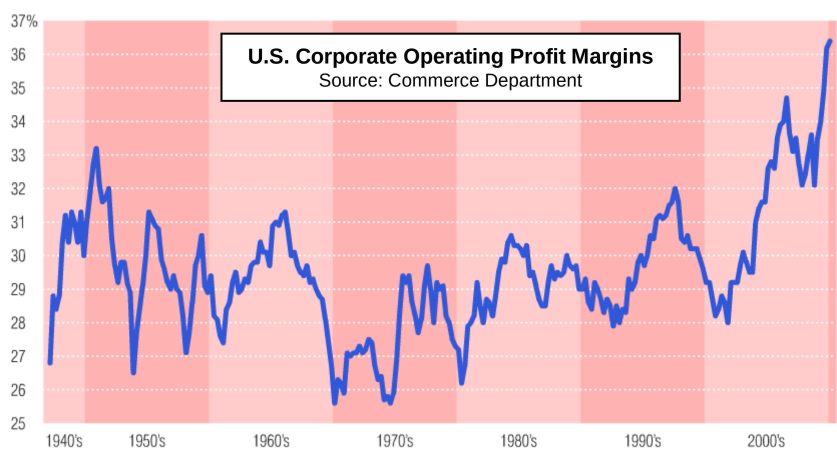
With the current bullish corporate headlines, many will find it difficult to become overly bearish. Then again, the consensus has a cruel tendency to lure investors into trouble. As value investors we pride ourselves on buying cheaply after building in considerable room for error in estimating a company's future prospects. Given today's questionable macroeconomic environment, a disciplined value investment philosophy is as important as ever. The question isn't if the market is going to correct. We know it will. The question is... when? Apparently, a lot longer than most people think, including us. This brings to mind a piece of advice given by Warren Buffett:

> *The less prudence with which others conduct their affairs, the greater prudence with which we must conduct our own affairs.*

INVESTMENT PHILOSOPHY

Although the equity markets were originally established to provide capital to businesses, many investors argue the markets no longer feel like a trusted store of value or a reliable source of income. The quality of information they provide also appears to be deteriorating. Daily index movements are often a by-product of larger external forces. Individual stock prices tell us little, since many move in lock-step with the market itself. Volume appears increasingly meaningless, since maybe half of it now consists of information-free "flash" trading. Perhaps markets are really reflecting a deeper distrust of the market's fundamentals.

The Shiller P/E ratio provides a long-run measure of the equity market's price versus real earnings. It currently sits well above its historic average. Profit margins are at an 80-year high. Common sense suggests that profits margins are more likely to fall than rise from here. In order to justify the current Shiller P/E multiple of earnings, the market is implying



impressive future growth. This is where we have our strongest doubts. Will domestic and global growth over the next several years be enough to cover up the concerns surrounding global imbalances?

What if we experience rising inflation? Or what if profit margins revert back to the mean? Those risks are real enough that we are left wondering if the market is adequately discounting those risks. Can the Federal Reserve actually succeed with its stated goal of raising inflation, but not by too much? As for profits, the main issue once more is that of margins. If we think that the equity markets are dysfunctional, it is because it sits in the middle of a decade-long crisis in a financial system which may not yet have run its course.

With the overall stock market selling at almost 18 times earnings, we emphasize a more prudent investment posture. We believe eighteen times earnings is above fair value for most public companies. Markets get truly cheap when they sell around 10 times earnings. We're nowhere near that level. The overall dividend yield of the U.S. market is around 1.8%. At this level it would take an investor about 40 years to double their money. Additionally, the stock market's capitalization is almost even with the economic output of the United States. The U.S. market is selling for around 96.2% of our $14.75 trillion current dollar GDP. Historically, stocks become truly attractive when they get down 80%. As we approach 100%, we grow cautious.

And yet investors are "all in". They are holding just 15% in cash. On average, individual investors tend to hold around 25% in cash. Stocks and bonds are expensive but the financial media remain complicit in its encouragement to participate. The front cover of a recent weekend edition of *USA Today* read, "5 Wall Street Heavyweights say '*It's Time To Get Back Into Stocks*.'" This is why cash is so important. We presently hold enough cash to take several major new positions if the market keels over and coughs up some bargains. Holding cash is not exciting or fun, but it's better than losing money when an expensive market drops.

For argument's sake let's assume that this market remains range-bound for a number of years. There is no bull or bear market. First, stocks will meander up and down, sometimes in sharp, volatile motions. Second, average equity valuations will likely fall throughout the duration of a market that trends sideways. In fact, stocks have gone sideways since early 2000. They have fallen sharply twice (2000-2002 and 2007-2009) and rallied twice (2002-2007 and 2009-2010). Overall, stocks have gone nowhere for 10 years. But valuations have declined. The S&P 500 traded in excess of 40 times earnings at the peak in 2000. The market bottomed at 13.3 times earnings in March 2009 and today trades around 16.8 times earnings. A range-bound market always starts with rich valuations and historically does not bottom out until it falls below 10 times earnings. We have no reason to expect the current market will be any different.

There are basically only three ways to take more cash out of the stock market than you put in to the market: 1) Valuation – an investor buys a stock that is trading at 10 times earnings and sells it for 20 times earnings. Even if the earnings do not grow, the investor takes more money out of the market than he put in the market. 2) Earnings growth -- one buys a stock that is earning $1 a share. Over time, earnings grow to $2 a share. Even if the valuation remains the same (i.e., 10 times earnings), the investor takes more cash out of the market as shares rise from $10 to $20. 3) Dividends -- when corporations pay shareholders a portion of earnings in cash. Since 1926, about 43% of the S&P 500's total return has come from dividends.

In a range-bound market, overall valuations don't grow. They shrink. Fundamentals eventually catch up with stagnant prices. Therefore, purchase price is critically important. The patient investor must remain disciplined and buy only solid companies trading at attractive valuations -- not what the market dictates at any given moment.

In 1974, two years before his death, Benjamin Graham offered these words of counsel to experienced and would-be investors alike. The passage of time has only reinforced the wisdom of his words.

"Let me close with a few words of counsel from an 80-year-old veteran of many a bull and bear market. Do those things as an analyst that you know you can do well, and only those things. If you can beat the market by charts, by astrology, or by some rare and valuable gift of your own, then that's the row you should hoe. If you're good at picking the stocks most likely to succeed in the next twelve months, base your work on that endeavor. If you can foretell the next important development in the economy, or in the technology, or in consumers' preferences, and gauge its consequences for various equity values, then concentrate on that particular activity. But in each case you must prove to yourself by honest, no-bluffing self-examination, and by continuous testing of performance, that you have what it takes to produce worthwhile results.

If you believe – as I have always believed – that the value approach is inherently sound, workable, and profitable, then devote yourself to that principle. Stick to it, and don't be led astray by Wall Street's fashions, its illusions, and its constant chase after the fast dollar. Let me emphasize that it does not take a genius or even a superior talent to be successful as a value analyst. What it needs is, first, reasonable good intelligence; second, sound principles of operation; third, and most important, firmness of character.

But whatever path you follow as financial analysts, hold on to your moral and intellectual integrity. Wall Street in the past decade fell far short of its once praiseworthy ethical standards, to the great detriment of the public it serves and of the financial community itself."

We have no desire to make any predictions for 2011 other than to expect a certain amount of the unexpected which will lead to at least some volatility in stock prices. At this moment, there are few desirable companies that can be bought with a decent margin of safety. This isn't to say that there aren't a lot of good companies whose stocks are worth continuing to own. But the unforeseen potholes that certainly lie ahead will once again give us opportunities to put fresh capital to work on more favorable terms. Being patient is not always pleasant, but the eventual rewards of being able to buy the stocks of solid operating companies trading cheaply are always worth the wait.