



Portfolio Manager Commentary

THE MAGIC OF FLOODING THE FARM WITH FERTILIZER

MOATX
CASTX

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SECOND QUARTER LETTER

MARKET COMMENTS

“Everything that needs to be said has already been said. But since no one was listening, everything must be said again.”

—André Gide

Rarely have market participants placed such confidence in the central banks’ abilities to protect financial markets and rescue economies. As the risk of an eventual Federal Reserve interest rate increase is largely ignored, there exists a widely-held notion that central bankers will make everything all right. Investor memories are short and faith in central banks misplaced.

Beneath the seemingly calm surface, the U.S. stock market shows increasing signs of anxiety. The S&P 500 trades at 21.5 times its net earnings for the past 12 months, far above the historical average of 15.5. Further, future earnings growth projections are a mere 1.4%--the worst since the recession ended in 2009, according to Thomson Reuters I/B/E/S. Although major indexes are near record price highs, only half of all stocks listed on the New York Stock Exchange trade above their average prices for the past 30 weeks—an internal weakness that often signals a market change. Of course, as long as market participants believe that central banks hold the answers to any and all problems, the benign financial environment will continue until perceptions meet reality.

Index funds have emerged as the giants of today’s market, accounting for 35% of total assets in all stock mutual funds and exchange-traded funds at the end of 2014 (up from 25% in 2010, according to Empirical Research Partners, a firm in New York). Passive index funds essentially buy and hold all the securities in a market index regardless of valuation. In the past five years,



Morningstar estimates that investors pulled \$73.6 billion out of “active” U.S. stock funds and added \$208.8 billion to “passive” index funds. If investors keep funding vehicles that have no opinion as to which stocks or bonds are better than others, one wonders how prices will be set. What will stop all stocks and bonds from going up and down together?

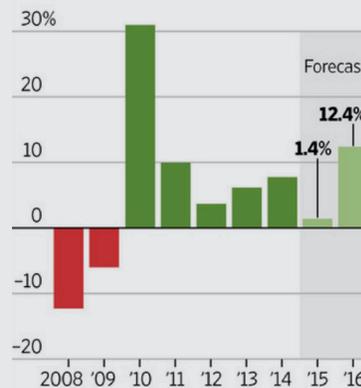
Last year, according to S&P Dow Jones Indices, 87% of active U.S. equity mutual funds underperformed the S&P Composite 1500 Index, a broad measure of the stock market. As a result, the triumph of indexing seems indisputable. However, financial history teaches us that once financial market participants believe something to be obvious it doesn’t last. As Benjamin Graham warned on the first page of his book *The Intelligent Investor*, “*There are no sure and easy paths to riches on Wall Street or anywhere else.*”

History suggests that the popularity, ease and apparent certainty of indexing will leave many of today’s new index owners disappointed. Most people do not have the biological makeup to buy low, hold for an indeterminable period of time, and then sell high--there is an almost irresistible human urge to stay with the consensus. Retail and professional investors alike fear acting differently – motivated by heightened sensitivity to periods of underperformance. Of course, owning the market cannot give an investor returns that are different from the market. As a result, the more people index their investments, the better the opportunity for those who do the opposite and conduct fundamental research.

Howard Marks, chairman of Oaktree Capital Management in Los Angeles, wrote last year that “*Unconventional behavior is the only road to superior investment results, but it isn’t for everyone.*” Clearly, if unconventional behavior were for everyone, then it would no longer be unconventional. Indexing allocates capital not as it should be allocated—according to the marginal return on invested capital—but rather according to fluctuations in the market capitalization of the underlying assets. In a normal world, investors should expect the distribution of asset performances to be wide and uneven. In fact, a large dispersion of investment performance should ensure that capital is being properly allocated. Instead, capital is today increasingly allocated according to the market capitalization of the assets under consideration, as capital is progressively directed to an investment if it outperforms. In simple terms, this means that capital is allocated to companies with rising stock prices, not on returns on invested capital. Today indexing has become the dominant asset management style. Investments dictated by changes in market capitalization are another way of saying that capital is now deployed according to momentum-based rules.

Logically, if investors always followed a “return to the mean” investment approach; meaning, when the price movements of an asset became excessive compared to its expected return on investment capital (ROIC), then one bought—or sold—the asset. With capital increasingly allocated towards marginal variations in the price of the asset, the more the asset goes up in price, the more index managers invest in the asset. Likewise, the more the asset goes down in price, the less the index managers own. A return to the mean methodology leads naturally to a more stable, but moving, equilibrium. Momentum-based investing predictably creates market environments where asset prices swing wildly from booms to busts and back again. Coupled with the current monetary policy advocated by central banks, these price swings will grow more pronounced—both up and down.

Annual percentage change in earnings of S&P 500 companies



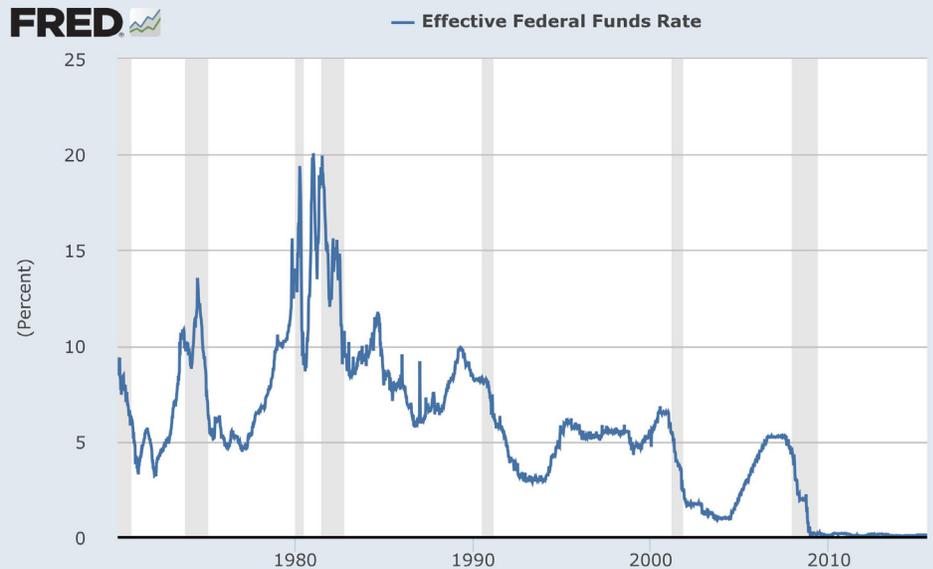
S&P 500 as a multiple of its companies’ net profits



Sources: Thomson Reuters I/B/E/S (earnings); Birinyi Associates (P/E ratio)
THE WALL STREET JOURNAL.



The short term rate of the Federal Reserve Board, officially known as the Federal Funds Rate, continues to stand at 0% since the financial crisis in 2008. The Federal Reserve has never lowered and kept its short-term interest rate at zero percent, let alone for more than six years. And yet, after years of staying on the sidelines, the individual investor is once again being drawn to the price action in the stock market. Investing in stocks is once again popular because investors increasingly believe that there is no other investment choice other than investing in stocks. Bank savings accounts yield nothing; bonds are universally labelled as ‘bad’, and, in the long term, one ‘always wins’ with stocks.



Source: Board of Governors of the Federal Reserve System (US)
Shaded areas indicate US recessions - 2015 research.stlouisfed.org

Today, the higher that asset prices climb, the less performance dispersion among investors, as each index investor increasingly owns the same assets in the same size. Strangely enough, the goal of every socialist experiment is for everybody to earn the same amount of money—in today’s investment landscape, we appear to have achieved the same utopian socialist result. Unfortunately, our collective investment capital is being massively misallocated. And, yet, economists wonder why they see no economic growth.

As Charles Hugh Smith from the website “*Of Two Minds*” suggests, think of current central bank policies as similar to monoculture agriculture practices where a farmer grows a single crop in a field at a time. At first, the farmer deploys large amounts of nitrogen and phosphate fertilizers, herbicides and pesticides across the fields which, in turn, yield bumper crops. In similar fashion, the Federal Reserve’s zero percent interest rate policy and massive injections of credit appear to work wonders on the economy and financial markets. Unfortunately, the magic of flooding the farm fields with fertilizer does not last forever. The soil is eventually stripped of nutritional value and crop yields plummet. Likewise, the marginal investment returns diminish over time when central banks flood the economy with credit: only marginal borrowers and the riskiest speculation remain. Similar to insects developing resistance to pesticides, the economy develops resistance to cheap credit. Because interest rates cannot fall much below zero, investment gains stagnate. The economy has pulled forward future demand—qualified borrowers have already bought a new vehicle or home. As flooding a field with fertilizers and pesticides does not restore the soil, flooding the financial system with liquidity and cheap credit does not restore health to a stripped economy. Just as monoculture agriculture erodes the soil, financialization hollows out the economy and strips away the values that underpin a sustainable and healthy economic expansion.

This increasingly short term focus on economic results by bank officials goes against numerous studies by psychologists which demonstrate that people who can focus their minds on more distant objects tend to have greater self-control and a heightened ability to defer gratification. Studies of individual and institutional investors find that those who trade less earn more—partly because more trading generates realized gains subject to taxes in addition to brokerage commission costs. Because many investors

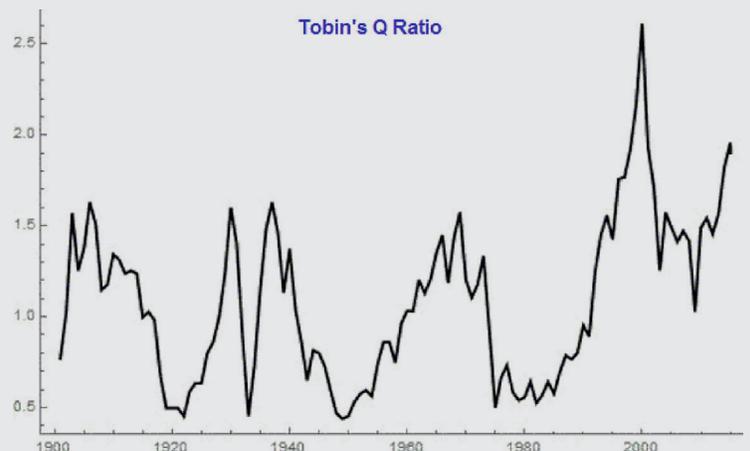


exhibit a habit of buying what is hot right before it goes cold and selling what is cold just before it turns hot, investors squander their greatest advantage—time. Investors cannot compete in a high-speed race that even most professional trading firms lose. “Time arbitrage”—the ability to invest on a longer horizon than most other people—is harder than ever for many investors, who are compelled to measure whether they are beating the market this year, this month, this week, this day, this hour, this minute. As Warren Buffett wrote in 1991, *“the stock market serves as a relocation center at which money is moved from the active to the patient.”* Let the rest of the world grow ever more impatient. In the long run, we believe that less trading equals greater gains.

According to the New York Stock Exchange (NYSE), annualized turnover—the rate at which stocks are bought and sold—is down to 63% from a high of 110% in 2010. If a 100% annual turnover rate equals a holding period of one year, a 63% rate implies that investors are holding the average NYSE stock for 19 months at a time, up from an average of 11 months five years ago. Mark Twain’s quote *“Lies, damned lies, and statistics”* would best describe this turnover data. Far from market participants growing more patient, investors are actually jumpier when one considers that the NYSE turnover figures only cover those stocks listed and traded on the New York Stock Exchange. Many of the same stocks also trade elsewhere; about three-quarters of the total volume for these stocks occur on other exchanges and trading platforms. Including trades on all marketplaces, the annual turnover rate in U.S. stocks is actually running at 307% so far this year, up from 303% in 2014, according to investment bank Credit Suisse. Although turnover peaked at 481% in 2009, today’s average holding period still only amounts to seventeen weeks. This turnover figure does not include exchange-traded funds (ETFs) which, according to John Bogle, founder of the Vanguard Group, the twenty largest ETFs traded last year at an average turnover rate of 1,244%. That figure includes activity by individual and institutional investors as well as high-frequency traders who rapidly buy and sell via computer. A 1,244% turnover rate implies a holding period of only 29 days—a period of time that is completely disconnected from fundamental investing.

More evidence of this detachment from reality can be found in a statistic known as Tobin’s Q ratio, a way of measuring equity valuations developed by the late Nobel Prize-winning Yale economist James Tobin. Tobin’s Q compares the total value of stocks against the replacement value of the underlying assets (inventory, equipment, buildings, property, etc.). In a simple math exercise, the underlying assets of the companies in the market are subtracted from the overall market value. If there is residual cash, essentially indicating that the market is trading above replacement cost, then Professor Tobin would consider the stock market overvalued. Today, based on the current Tobin Q ratio, stocks are currently more overvalued than at any time in history with the exception of the 1999 technology bubble.

Logically, if the average company becomes higher valued relative to its tangible capital, this implies the company earns high returns on its existing equipment. If so, the company will allocate more capital to investments in equipment. The company’s subsequent growth from the additional investment should, in turn, generate a higher valuation in the market; thereby paying for the additional investment. But in an efficient and competitive market, each additional increase of investment leads to smaller increases in valuation, and the average company’s Q ratios subsequently reverts back to the mean. Correspondingly, if the average company’s Q ratio is too low, then one assumes the company will dispose of equipment, or at least stop replacing it—therefore pushing Q ratios back up.





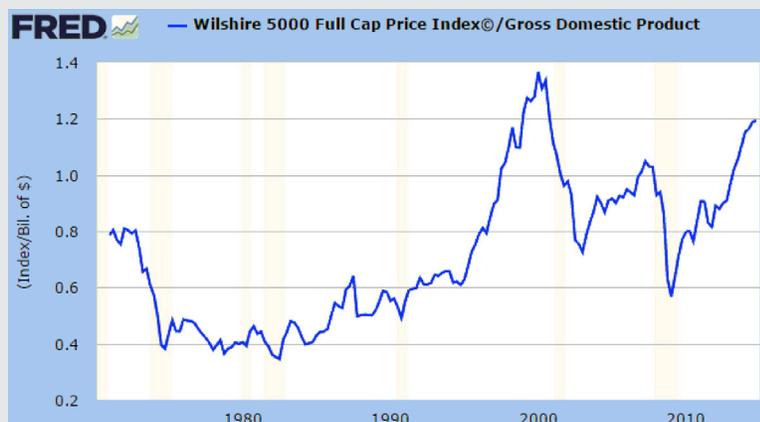
We believe the Q ratio's doubling, since 2009, is an unsustainable symptom of companies diverting money from their businesses and over to the stock market, choosing buybacks over capital spending. An extended period of zero percent interest rates continues to elevate the paper value of assets over the underlying tangible physical assets, as corporate investment in physical plant and equipment lags, while purchases of paper stock escalate. With equity prices surging and investment growth lagging, the Q ratio stands 58% above its average since 1900, according to data maintained by the U.S. Federal Reserve. This unnatural environment carries negative implications for long term economic growth.

Corporate America now practices policies that we believe virtually ensure the value of publicly-traded equity outpaces the replacement costs of underlying assets. Companies use today's record low interest rates and insatiable investor appetite for corporate bonds to issue record amounts of debt. The problem is that money raised from new debt issuance is not allocated to capital expenditures in order to generate future growth but, rather, towards stock buybacks. Standard & Poor's 500 Index members last year spent 95% of their profits on share buybacks and dividends according to data compiled by S&P Dow Jones Indices. Through April of this year, companies announced \$400 billion of buybacks, with February, March and April ranking as three of the four busiest months in history.

Investors must now navigate a market where stocks climb higher thanks to a perpetual bid from price insensitive corporate management teams repurchasing expensively-valued stock. As a consequence of artificially low interest rates, corporate balance sheets grow increasingly leveraged while investments in productive assets deteriorate. Eventually, the long-term impact will be sluggish top line revenue growth and, in turn, the strained ability to service debt costs once interest rates normalize at higher levels.

In finance, a "black swan" is a major event that 'comes out of the blue'. Of course, a stock market decline should not be a complete surprise as the market's valuation resides at what we believe are unsustainable levels. Every market-based economy contains negative feedback loops that should logically prevent massive valuation swings. Unfortunately, we now operate in a market subject to intervention by non-market forces, primarily central banks. For example, when interest rates are naturally low, caused by an abundance of patient savers, businesses spend on investment and production. When interest rates are artificially low, savers chase yield through leverage while businesses spend on stock buybacks and dividends in order to attract the investors who desire yields beyond what the artificially distorted market offers. This artificial dynamic drives stocks and, subsequently, valuations higher.

Other value-based indicators with reliable long-term track records echo the same warning as the Tobin Q ratio. The Wilshire5000/GDP ratio provides a simple way of comparing the stock market's equity capitalization against the country's economic output. Currently, the Wilshire5000/GDP ratio stands 15% higher than at the 2007 market peak, although, like Tobin's Q ratio, it still sits below the high reached during the dot-com bubble. Nobody should be surprised if stocks drop in order for valuations to return to, or below, their historic valuations. But, of course, almost everyone will be surprised.





Market drops are not dreaded “black swan” events. They are logically predictable; the same logic that says governments cannot manipulate market prices without creating distortions that will always prove counterproductive. Any time the market falls, we are told that the fault resides in some surprising economic or geopolitical shock. An unexpected event might serve as a proximate cause but not the ultimate cause. The ultimate cause is the same ultimate cause that has been demonstrated historically: artificially distorted markets push asset valuations to unsustainable levels. The markets are speaking to us yet again. This time around, we need to listen.

INVESTMENT PHILOSOPHY

“At the root of value investing is the belief, first espoused by Benjamin Graham, that the market is a voting machine and not a weighing machine. Thus an investor must have more confidence in his or her own opinion than in the combined weight of all other opinions. This borders on arrogance, the necessary arrogance that is required to make investment decisions. This arrogance must be tempered with extreme caution, giving due respect to the opinions of others, many of whom are very intelligent and hard working. Their sale of shares to you at a seeming bargain price may be the result of ignorance, emotion or various institutional constraints, or it may be that the apparent bargain is in fact flawed, that it is actually fairly priced or even overvalued and that sellers know more than you do. This is a serious risk, but one that can be mitigated first by extensive fundamental analysis and second by knowing not only that something is bargain-priced but, as best you can, also why it is so. You never know for certain why sellers are getting out but you may be able to reasonably surmise a rationale.”

—Seth Klarman

The stock market is not a machine that assigns prices based on a calm and objective assessment of value. In fact, when it comes to value, the stock market is totally clueless. This reality is contrary to the way many strategists and analysts portray the market—they discuss the stock market as if it were an all-seeing prophet. However, if this were true then dramatic price swings would never occur. The simple fact that such price adjustments occur quite often reflects the reality that the stock market is composed of a manic-depressive crowd which is typically far too optimistic or far too pessimistic.

We view the stock market as an emotional pendulum -- the further it swings in one direction the closer it comes to swinging back in the other direction. Unfortunately, there are no rigid benchmarks and we can never be sure that the pendulum has swung as far in one direction as it is going to go. There is always the possibility that the market pendulum will swing even further.

Echoing André Gide’s sentiments, because everything that needs to be said has already been said but no one was listening, everything must be said again: governments and central banks distort the financial markets. Their actions amplify the market’s emotional pendulum. Due to the central bank’s manipulation of the money supply and interest rates, valuations are able to go much higher during the pendulum’s up swing than would otherwise be possible. As the size of the market’s down swing is typically proportional to the size of the preceding up swing, then we all need to listen to what history teaches us.

CASTLE FOCUS FUND



PM Commentary :: Q2 2015

Investor Class: MOATX Class C: CASTX

We believe that there are two types of investors. There are those investors who see things for what they are, and then there are those investors who see things for what they want them to be. We believe that we see the current environment as it really is and remain ready to act when the market's perception inevitably meets reality.

With kind regards,

Robert J. Mark
Portfolio Manager

The opinions expressed are those of the Fund's portfolio manager and are not a recommendation for the purchase or sale of any security.

The S&P 500, or the Standard & Poor's 500, is an American stock market index based on the market capitalizations of 500 large companies having common stock listed on the NYSE or NASDAQ. The S&P 1500, or S&P Composite 1500 Index, is a stock market index of US stocks made by Standard & Poor's. It includes all stocks in the S&P 500, S&P 400, and S&P 600. The Wilshire 5000 Total Market Indexsm (Wilshire 5000[®]) is defined as a U.S. equity index that measures the performance of all U.S. equity securities with readily available prices.

The Fund's investment objectives, risks, charges and expenses must be considered carefully before investing. The prospectus contains this and other important information about the Fund, and it may be obtained by calling 1-877-743-7820, or visiting www.castleim.com. Read it carefully before investing.

Performance data quoted represents past performance; past performance does not guarantee future results. The investment return and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Current performance of the fund may be lower or higher than the performance quoted. Performance data current to the most recent month end may be obtained by calling 1-877-743-7820.

The risks associated with the Fund, detailed in the Prospectus, include the risks of investing in small and medium sized companies and foreign securities which may result in additional risks such as the possibility of greater price volatility and reduced liquidity, different financial and accounting standards, fluctuations in currency exchange rates, and political, diplomatic and economic conditions as well as regulatory requirements in foreign countries. There also may be risks associated with the Fund's investments in exchange traded funds, real estate investment trusts ("REITs"), significant investment in a specific sector, and nondiversification. Technology companies held in the Fund are subject to rapid industry changes and the risk of obsolescence. The Fund is non-diversified, meaning it may concentrate its assets in fewer individual holdings than a diversified fund. Therefore, the Fund is more exposed to individual stock volatility than a diversified fund. Distributed by Rafferty Capital Markets, LLC-Garden City, NY 11530, Member FINRA.