Portfolio Manager Commentary

DO YOU KNOW TINA?

MOATX
CASTX

October 7, 2016

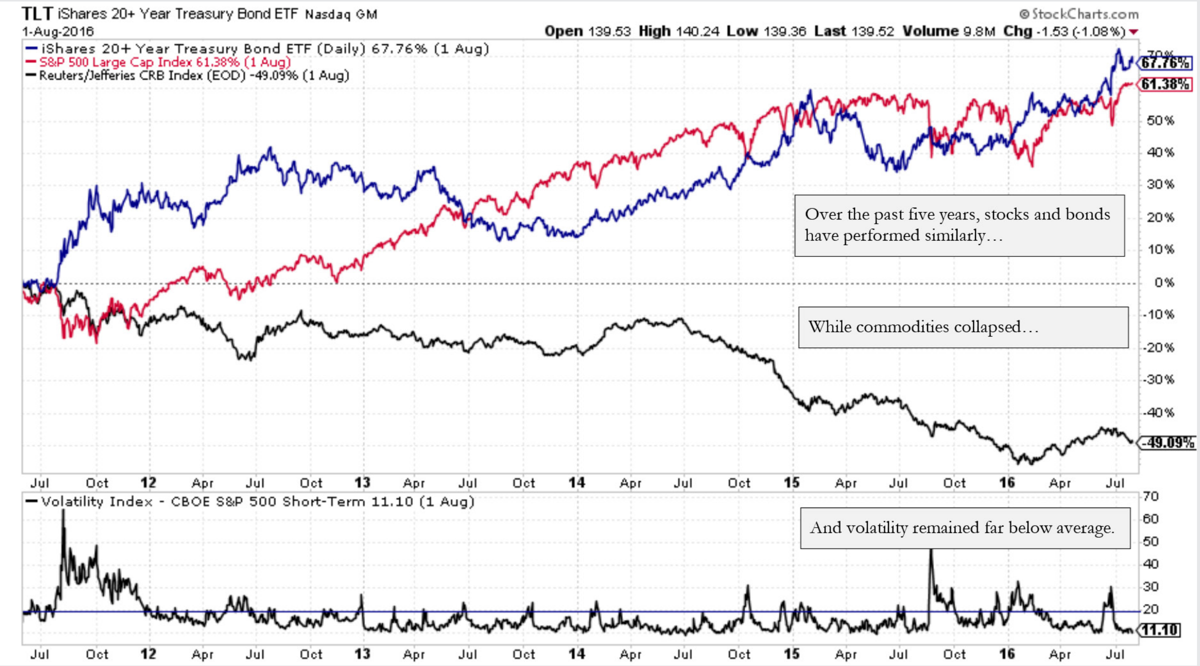
Third Quarter Letter

MARKET COMMENTS

"The problem with Cassandras, such as Gross and Jim Grant and Stanley Druckenmiller, among a host of others, is that they can be compared to a broken watch that is right twice a day but wrong for the other 1,438 minutes."

--Bill Gross, Investment Outlook, September 2016

We live in a baffling era, as both the stock and bond markets in the United States sit near their all-time highs. Not long ago this was considered an impossibility when utilizing a conventional investment framework: stocks perform well when the economy is growing and bonds outperform when the economy is slowing. Commodities, which normally exist in finite quantities, historically follow the rate of inflation. Clearly what once worked in a typical allocation no longer holds true today. Extreme levels of debt continue to weigh on the U.S. economy, thereby resulting in anemic economic growth—an ideal condition for long-term bonds but an environment where commodities should suffer from slack in the economy. Which begs the question as to why have stocks have performed so well over the past five years?



In a healthy economy, interest rates roughly follow economic growth. Little economic growth means little demand for savings because businesses are not expanding and consumers are not buying. Interest rates fall in response to the lower demand. Eventually the economy begins to grow again and interest rates rise, reflecting the greater demand for capital. Thus, the system is typically cyclical and self-correcting.

Higher interest rates increase the “hurdle” that new investments must clear and new investment opportunities must be more profitable to clear the hurdle. In turn, business owners and investors must be prudent when allocating capital. If their project fails to produce enough new revenue to pay the costs of the resources devoted to it, including the cost of capital employed, they destroy value.

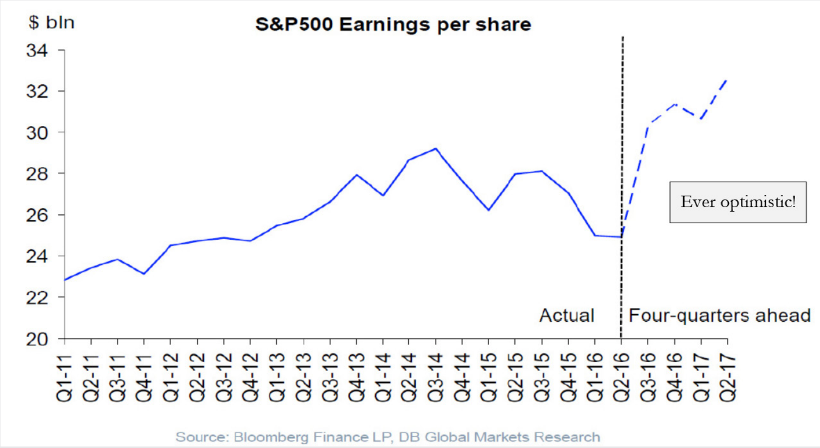
The essential truth of an honest, correctly functional economy is that capital is always scarce. As a result, one must invest savings wisely. Interest rates reflect the price of money and simply designate the scarcity of capital. Typically, rising interest rates limit new investments and slow the economy. As the economy slows, interest rates (or the price of money) follow and fall lower. Then, as the investment hurdle is lowered, businesses invest in new opportunities and the economy grows again.

This cyclical economic model seemingly no longer exists today, as the current view is low interest rates alone spur an economy. Thus, all one must do is lower interest rates again, and again and again - with the natural expectation that the economy will always grow. Economic bureaucrats employ this academically-motived journey to “zero bound” interest rates in an attempt to stimulate a recovery. Business owners, investors and speculators enjoy capital that is readily available at negligible cost. As a result of this ‘easy money’ environment, we see increased speculation and investors showing little concern to be careful with capital or to use it wisely. Unfortunately, the persistent problem created by these conditions is consistently weak economic growth, while the habitually referenced “year-end recovery” never quite materializes.

From observation, depressed interest rates also depress the economy. In a healthy economy, interest rates mark the balance between the availability of surplus capital and the demand for surplus capital - valuable information that allows investors to make informed capital allocation decisions. The same principles apply to money, as money is not the same as wealth. An economy does not magically produce more wealth simply because of low interest rates or creating more dollars. Low interest rates, zero or even negative interest rates, do not make the economy run more smoothly, efficiently, and productively. Manipulated interest rates at these levels just confuse and obscure the efficient allocation of capital.

Although the process of allocating capital is clouded, market participants apparently have no qualms about investing in the stock market as it continues to levitate. Despite slowing revenue growth since 2011, investors remain compelled to stay fully invested in the stock market (Institutional investor confidence remains high with bulls at 56% and bears at just 20%). With negative top line growth and higher operating costs, corporate profits are feeling the squeeze. After six consecutive quarters of annual earnings declines, Wall Street consensus now expects third quarter earnings-per-share (EPS) to drop by 2.1% according to FactSet. By comparison, as recently as March, analysts expected EPS growth of 3.2% for the third quarter.

Wall Street seems to start every year with an optimistic tone by collectively forecasting double-digit EPS growth. Actual reported growth is often lower. While reported earnings have grown at a very respectable 8% over the past thirty years, Wall Street once again expects S&P 500 earnings to soar in the second half of 2016 by double-digits (chart). Economic reality has yet to sink in on Wall Street, as analysts cite a never-ending parade of one-off factors to account for this negative growth in fundamentals, ignoring the close relationship between corporate sales and nominal GDP growth. Stock prices continue to drift higher with the misguided confidence that somehow today's expensive valuations, underpinned by weak fundamentals, will resolve without consequence.



Because hope is not a viable investment strategy, investors must always consider that stocks represent fractional ownership in companies, which own real assets and generate cash flows. The aggregate earnings of an index such as the S&P 500 provide little detail about the durability or quality of the individual company cash flows. While many on Wall Street claim to be "value investors", seeking out mispriced investments, they are in fact actually "valuation investors". They look at metrics such as stock prices versus forward operating earnings, but make little effort to sort through the underlying assets of real-world businesses. A value investor must first understand a company's fundamentals, and then must value the company by employing a valuation framework that abides by the laws of finance.

Back in April *The Wall Street Journal* published a strange story about a Danish couple with a mortgage, *"Negative Rates Around the World: How One Danish Couple Gets Paid Interest on Their Mortgage."* The bank paid the couple interest on their mortgage, instead of the couple paying interest to the bank. Surprisingly, Denmark is not the only country employing negative interest rate policies (NIRP). Switzerland, Sweden, the European Central Bank and the Bank of Japan all use negative rates in an effort to drive economic expansion. The story of the Danish couple carries implications that are far-reaching when applied to the laws of finance, as negative interest rates bend everything we know about financial discipline and, in many ways, break its core tenets. Today, investors operate in uncharted territory.

The most important consideration in finance – the time value of money - is starting to break down. This concept centers on the principle that a dollar today is worth more than a dollar tomorrow (the dollar invested today at a positive interest rate will be worth more in the future). The time value of money is critically important for investors because future free cash flows, within a valuation framework, are worth less when these future cash flows are discounted back to today. A negative discount rate implies something entirely different. Although the cost of equity dictates that discount rates remain positive even under negative interest rate policies (NIRP)—there always exists a non-zero equity risk premium. An asymptomatic situation unfolds as total discount rates approach zero - as the discount rate mechanism gets ever smaller, stock prices rise exponentially.

Valuing Proctor & Gamble illustrates this conundrum. Over the past ten years Proctor & Gamble's annual earnings per share growth rate was 1.1%. If we provide the company the benefit of the doubt, we'll assume that the company grows future earnings at 6% for the next twenty-five years[1]. Discounting those future profits back to today's present value at 10% suggests P&G is worth $56 per share (versus the current price today of $89)[2]. By contrast, discount those same future profits at a rate of 5% and P&G is valued at $98. Both scenarios employ the same valuation framework, yet discount future cash flows at entirely different rates. Distorted interest rates obscure the valuation process.

This distortion is most apparent in the least risky and lowest cost of capital sectors of the stock market: dividend-paying consumer staple corporations, utility companies and real estate investment trusts (REITs). As a result, many attractive business models now trade as though they are aggressive growth companies, valued at multiples of twenty-five times 2017 earnings. Even stranger, most of these companies carry net debt positions - therefore the magnitude of enterprise value (market capitalization plus net debt) verus future earnings is even greater than simply comparing equity market capitalization versus future earnings. With many investors now comfortable paying a multiple of twenty-five times 2017 earnings in light of existing conditions, why not pay thirty times 2018 earnings and forty times 2019 earnings? Many view this scenario as good news because it means higher stock prices, but in the event the market continues to move higher, investors should understand that the advance is increasingly driven by ever-falling assumed discount rates.

A recent note to Citibank clients from a trader captures the current mentality on Wall Street: *"I remain fairly bullish here, but it's worth thinking about how this phase of the rally will play out. Volatility is dropping and bonds prices continue to rise. Not gapping higher, but steadily higher. Low vol and rising prices is a perfect recipe for fast money and the Street getting longer. You no longer get punished on random positions and your P&L keeps steadily ticking higher. Thus you feel emboldened to get longer as you don't feel the risk that you are carrying. Everyone gets longer for a period of time and then finally you have the ability to have a sell off. I know how it ends, I just have no idea when that is."*

In the late stages of every bull market there is always a narrative to justify why prices will continue to rise despite expensive valuations. In the early-1970s the story was the "nifty fifty". Investors believed that a group of the fifty largest and most popular traded stocks on the New York Stock Exchange could be bought at any price because the quality and the growth rates of the underlying companies suggested that stock prices would maintain their upward trends. The "nifty fifty" not only collapsed with

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[1] 6% is the approximate nominal rate of growth in the U.S. economy from 1946 through 2015
[2] We view 10% as an appropriate rate given the inherent risks associated with publicly-traded equity markets
[3] Citibank note to clients, August 14, 2016 at 6:30 PM, Jack Weaner, Bond and CDS trader

the overall market during 1973-1974, but most members of the group under performed the overall market from 1973 to 1982. In 1999-2000 the story centered around the technology-driven productivity miracle. The belief was that accelerating technological progress coupled with the internet made it reasonable to value almost any dotcom company at multiples of annual revenue. In 2006-2007 the narrative revolved around the unstoppable growth in emerging markets and the ever expanding housing market. Of course, reality returned in 2008.

The story is always different, yet sounds plausible while prices are rising. Unfortunately, most narratives turn out to be misleading. One of the more popular stories used today to explain why the stock market continues to thrive despite expensive valuations is a term called "TINA", which stands for "There Is No Alternative". With interest rates near zero and likely to remain there for the indefinite future, today's story justifies paying a high price for almost any stock that offers an attractive dividend yield. There is simply no alternative. TINA will eventually go the way of the "nifty fifty", but no one knows when. REITs and utility companies provide investors some of the highest-yielding stocks and exemplify the TINA theme. In a low-interest or no-interest environment, the stocks of dividend-paying companies look more attractive to yield-seeking investors despite unusually expensive valuations.

The Vanguard REIT Index Fund (Ticker: VGSIX) has grown to $67 billion in assets this year from $38 billion in early 2013 and just $6 billion in early 1999. Since the financial crisis ended in 2009, the main REIT indicies have risen by 209%. Although there has been a rebound in real estate prices since 2009, the main attraction to REITs is the high yield, as these trusts pay out 90% of their net income as dividends in exchange for tax-free status at the corporate level. This characteristic has made REIT funds particularly attractive to mutual fund investors, as well as former holders of bond funds. Simple math shows that a ten-fold increase in the size of the Vanguard REIT Index Fund, after a three-fold investment return, means investors are literally throwing investment dollars at the fund. Based on the fund's investment return and its current asset level, the Varguard REIT Index Fund has gained $40 billion in new capital since 2009. Investors are stuffing these REIT funds with new money as a result of bond yields being so low. Clearly there is widespread belief that there is no alternative.

INVESTMENT PHILOSOPHY

"Not everything that can be counted counts. And not everything that counts can be counted."

--W.Bruce Cameron

Paul Singer founded Elliott Management in 1977 and we believe he is one of the smartest and shrewdest hedge fund managers in the industry. In a recent letter to his investors, Singer writes that today's investment landscape is one of *"the most peculiar periods we have faced in 39 years."* Singer describes a world with nearly $14 trillion in negative yielding bonds and the "continued stampede" to buy such bonds. Today's environment marks *"the biggest bond bubble in world history"*, leading him to declare that *"the global bond market is broken."* Singer does not understand the "mentality that flies to an asset class regarded as a *"safe haven" even when there are low or nonexistent returns attached to it and no guarantee that current conditions will persist",* and warns buyers of negative yielding debt to "hold such instruments at your own risk; danger of serious injury or death to your capital!" Singer concludes that *"trading in this market is particularly difficult. Everyone is in the dark. Experience doesn't count for much, and extreme confidence may be fatal."*

After reading Paul Singer's comment, one realizes that even the most respected and successful investors believe that today's markets are treacherous. Daily oddities appear with troubling frequency. Recently, the VXX security traded more volume than any stock in the S&P 500. As Bloomberg reported[4], *"for the first time on record, the iPath S&P 500 VIX Short-Term Futures ETN recorded more volume on Tuesday than any company in the S&P 500 Index, with a record 110 million shares changing hands. The closest was Bank of America, with 89.3 million shares trading."* The herd mentality leads investors to chase popular trends with the hope of gaining quick profits. When volatility-linked derivative securities based on an underlying construct of implied S&P 500 volatilities increasingly account for three out of the top ten most-traded products on a daily basis, we fear that the leveraged derivative tail is now wagging the entire stock market dog. Like Paul Singer, we suspect this will not end well.

Investors must appreciate that any commentary on the high valuations of stocks makes the argument that equities are expensive compared with their historical valuation metrics. However, the problem with broad-based valuation metrics is that they are not precise and warnings about irrational stock valuations inherently require patience. We believe that U.S. stocks have been overvalued for almost the entire post-2008 financial crisis bull run, yet stock valuations can always go to new heights. No one knows when or how it ends, but the mission for all investors should be to defend against losses. Further, cash yields nearly nothing but remains an important tool for managing risk and positioning one's portfolio to take advantage of future market dislocations. There is an old adage that investors make 80% of their money in 20% of the time. A patient, long-term investor should probably do nothing 99% of the time, as the human compulsion to act is the enemy of good investing.

Rather than feeling anxiety about not fully participating in the current rally, investors should prudently hold some cash while waiting for opportunities to buy assets at reasonable values. The market consists of millions of people making individual market decisions every day, making it impossible to predict markets with any consistent accuracy. But, investors can focus on the one advantage available to them—behavior. To outperform, we think that an investor must behave differently than the herd. When the herd trades an index they know little about and purchases bonds where they have to *pay* interest, we can only guess that they are bored. Boredom is never a justification for a trade.

Jason Zweig recently wrote in his *Wall Street Journal* column[5] that "a bored investor is a dangerous thing." Zweig noted that during August the S&P 500 did not move up or down by more than 1% in a single day all month and daily volume averaged 20% below the daily trading volume for the first seven months of the year. This lack of volatility did not deter investors from putting $900 million into risky leveraged exchange-traded funds in August, only after having removed $205 million from these very same products during July. Zweig concludes that this is awful behavior, exactly the type of behavior one should avoid if one wants to gain a behavioral advantage. Unfortunately, bored investors take more risks.

We do not allow boredom to seduce us into doing anything we should not do, as these days we believe there is little reason to do anything. We continue to find few very attractive companies that trade at compelling valuations. As a result, we focus our attention on evaluating potential new portfolio positions with care while remaining prepared to act when higher volatility returns. There are thousands of stocks in the market and we only need to find a handful worth owning to make an impact. Importantly, we strive to own only companies where we possess a high conviction because we always define risk as the permanent loss of investment principal.

[4] http://www.bloomberg.com/news/articles/2016-09-14/volatility-is-market-s-favorite-trade-as-vix-note-sees-frenzy
[5] http://on.wsj.com/2c7kogQ

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.

As of September 30, 2016, the Fund does not own any of the following securities mentioned in this letter: Proctor & Gamble; Vanguard REIT Index Fund; iPath S&P 500 VIX Short-Term Futures ETN

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.