

Mirzam Capital Appreciation Fund
February 2008 Fund Commentary by Albert Meyer

More Sellers than Buyers January 2008 was unnerving for investors. The S&P500 closed down -6.12% for the month; it was down -13.5% at one stage. February 2008 brought no reprieve, even though the month started out on a positive note. The S&P500 closed the month with a negative return of -3.48% .

Fund Performance Despite the strong headwind, the fund held its own and ended the month with a positive return of $+1.99\%$. The fund is up $+2.18\%$ for the year to date, while the S&P500 is down -9.38% . Since the inception of the fund, August 20, 2007, to the end of February 2008, the S&P500 declined -7.95% . The fund, on the other hand, shows a $+8.10\%$ positive return during this period. It is far too early to pat ourselves on the back. The next six months will be challenging.

Portfolio While others sold in panic this month, we used the opportunity to increase our equity holdings by 24% and reduce our cash holdings to 47% of the total value of the portfolio. At the end of February 2008, the fund's equity holdings were split 60%:40% between foreign and domestic stocks, respectively. The average dividend yield on the equity portion of the fund's portfolio is currently 3.32%.

Mark-to-Market: Part 1 Those who know us well are aware of our cynicism about the way in which Corporate America interprets and applies the accounting rules. Recently, in his letter to shareholders, Warren Buffett pressed the point. He writes, "Former Senator Alan Simpson famously said, 'Those who travel the high road in Washington need not fear heavy traffic.' If he had sought truly deserted streets, however, the Senator should have looked to Corporate America's accounting."

The questionable application of accounting principles has manifested itself in the financial sector with devastating results. First, it is a fundamental concept that financial information should have predictive value. For example, when a company allows for doubtful debts, it is on the strength of a sound and rational prediction that certain receivables on the balance sheet will ultimately not be collected. If the resultant charge for doubtful debts lacks veracity, the financial information will lose its predictive value. Management writes off or depreciates an asset over, say, ten years, because it can fairly estimate that the asset's useful life will not exceed ten years. If it willy-nilly changes this estimate to five or fifteen years, the financial information loses its predictive value, and this undermines its value to investors.

In the current situation, the blame for the questionable application of an accounting rule does not rest with Corporate America – a welcome change. The Financial Accounting Standards Board (FASB) determined that companies should mark financial assets (securities, derivatives and other financial instruments) on their balance sheets to market, that is, they must carry these assets on the balance sheet at market values. This rule works fine when financial assets trade on exchanges where market prices are transparent and where liquidity is not an issue.

Doomsday Device However, when it comes to illiquid structured securities that are rampant in the sub-prime market, the inflexible application of the mark-to-market rule morphs into a veritable “Doomsday device,” as described by John Dizzard in the *Financial Times* (February 26, 2008). In illiquid markets, management has to rely on indices and models that take into account a number of variables, for example, interest rate spreads.

In the current environment, this exercise has caused financial institutions to write-down loans and other financial assets to the tune of billions of dollars at a time. Understandably, the market responded negatively, which, in turn, threw financial models and indices into disarray. Interest rate spreads widened even further, which set in motion a new round of write-downs, far greater in magnitude than the previous write-down. This pattern is repeating itself to the point where once highly liquid markets, such as the short-term municipal market, are now clamming up. The Doomsday machine has gone into overdrive and to date, aggregate mark-to-market losses on mainly illiquid structured securities have run in excess of \$150 billion. This is not a material amount, but taken out of context and bellowed over TV is bound to send the market into a tailspin.

To gain perspective, it helps to review the response of those who are afflicted by the mark-to-market madness. Warren Buffet, again in his letter to shareholders, writes, “... accounting rules for our derivative contracts... will sometimes cause large swings in reported earnings, even though Charlie [Munger] and I might believe the intrinsic value of these positions has changed little. He and I will not be bothered by these swings – even though they could easily amount to \$1 billion or more in a quarter and I hope you won’t be either.” In other words, discount the predictive value of these losses.

Space does not allow us to quote from conference calls held by the financial institutions that are sweating under the current accounting regime. However, the unanimous conclusion from the management teams is that the unrealized market valuation losses are not indicative of the losses they will suffer over time. Hence most of these losses will reverse as the liquidity crunch abates and interest rate spreads narrow. The process is being hampered by an accounting regime that never envisaged the negative feedback loops currently experienced in the market.

Federal Reserve Chairman Perplexed Fed Chairman, Ben Bernanke, in a congressional testimony on February 28, said that the accounting rules may be forcing banks to put artificially low values on little-traded assets when they mark them to market. This lack of observable market values is “one of the major problems that we have... I don’t know how to fix it. I don’t know what to do about it,” he said (*Bloomberg*, March 4, 2008). One analyst points out that these financial institutions are marking their securities against an index that predicts losses at 32 times the actual loss experience.

We’ll revisit this topic next month. In the meantime, don’t take these huge write downs at face value – accounting aberrations are masking the true underlying economic realities.

-Albert Meyer

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