

Mirzam Capital Appreciation Fund – October 2008 Commentary

Performance At the end of October 2008, the S&P500 was down *-16.8%* for the month and *-34.0%* for the year. Only four periods in the last 100 years (two of them during the 1930s) match the *-46%* slide since the S&P500 reached an all-time high in October 2007. Mirzam could not withstand the downdraft either and registered a *-16.34%* decline for the month and a *-31.63%* decline for the year-to-date. Please view www.mirzamfunds.com/performance.cfm to view the standardized performance data.

Volatility Performance statistics are difficult to interpret in an environment where the market moves as much as ten percentage points in a day. For example, one day after closing at a 5½-year low, the Dow Jones Industrial Index leapt *+10.88%* on October 28, 2008 to 889.35, which followed the *+11.08%* increase registered on October 13, 2008, when it closed at 936.42. On November 13, 2008, The S&P500 traded down *-3.9%* after the open, only to finish the day *+6.9%* higher – a *+10.8%* swing from trough to peak. These moves were short-lived and only accentuated the extreme volatility in the markets.

In seven trading days, October 24 to November 4, Mirzam ramped *+19.9%*. The S&P500 was up *+14.7%* during the same period. The fund has pulled back since then in sympathy with the market, but in these volatile markets a *-30%* year to date decline could become a *-10%* decline in a matter of days.

Such dramatic swings have caused investors to experience profound psychological shock and distress. Volatility, a statistical measure of how much stocks move unexpectedly in a year, is usually in the 15%-range, but daily volatility in October was 75% on an annual basis. The month of October, especially, saw lots of de-leveraging, disintermediation and forced selling. Investors who bought stocks on margin or pledged shares as collateral on loans were forced to sell in a weak market. Some, such as defined-benefit pension funds and university endowment funds with backstop commitments were forced to capitulate to honor their commitments. Others just sold because they could not stomach the volatility and losses, turning the selling frenzy into a rout.

Main Themes While our returns do not make for good reading, these are still relatively early days for the fund. We have been investing the bulk of the fund's assets during the past six months as the markets fell to unprecedented levels. There is method in our madness. Our portfolio is built around a couple of main themes.

We believe that the emerging markets have a lot to offer the global economy, especially the four dominant countries in this space: Brazil, Russia, India and China – the so-called BRIC countries. Over the long-term – and we are long-term investors – economic growth in these countries should continue to spur urbanization. This should lead to improved communication and transportation services, and increase the demand for commodities, food and medicines. The need for energy, especially oil and gas, should become ever more critical.

We have serious doubts about the current resurgence in the value of the dollar, relative to other currencies. This has hurt our portfolio returns of late, but we believe that over the longer term the dollar is bound to lose its luster. The emerging summit of the G-20 (20 advanced and emerging market economies) nations met in Washington in November 2008 in search of a permanent solution to the credit crisis and the impending global economic slowdown. One of the demands, the pundits surmised, would be an acceptance of a substantially weaker US dollar over the long term. Apparently, the Fed is content with the notion that such a downward adjustment at an orderly pace will have to be part of the global-adjustment process.

We also shun companies that use stock-option compensation as a means to over-compensate executives without the necessary transparency that accompanies cash compensation. As a consequence, we have found better and more responsible companies in places like Canada and Europe, where it is our view that the interests of shareholders are still paramount. We have great confidence in the companies we own in the light of how these broad themes, mentioned above, are playing out, even though news headlines are currently contradicting such optimism.

Emerging Markets The *MSCI Emerging Market* index dropped a stunning 43% in October. However, emerging markets still hold a gain of 86% from their 2002 low, while the S&P500 was only 14% above its October 2002 bear market low. According to *The Lex Column (Financial Times, October 29, 2008)*, emerging markets seem far better positioned to weather the current global crisis than in past crises. We quote, “Massive official reserves accumulated during the boom and financial institutions that are partial insulated from the developed market credit crisis are two reasons for this. And while developed markets look tempting, emerging markets are at their lowest trailing earnings multiple ever... Much of the discount comes from a lack of a large local investor base in certain countries and the impact of hedge fund liquidations that had little regard for value.”

For the week ending November 5, 2008, there was a net inflow of \$413 million into emerging market stock funds, compared to net redemptions of \$1.6 billion the previous week, and outflows of \$750 million two weeks earlier. Year-to-date, the outflows are estimated at \$45 billion, nearly 40% of the cumulative inflows from 2003 through 2007. Much of this explains the decline in the stock markets of emerging economies. It is worth noting that the *MSCI EM* has still outperformed the S&P500 by more than 200% since 1998. We are confident that the index should continue to show this type of long-term performance, although we do not invest in indices. Rather, we believe that our due diligence allows us to identify the best stocks in an index, which if successful leads to above-average returns over the long-term.

Since the turn of the century, there has been a gradual increase in trading between emerging nations, which lowers their exposure to a slowdown in the US. In fact, the US portion of emerging market exports has declined by a third since 2000. Measured in terms of the last 12 months' exports to the US as a percentage of the BRIC countries'

Total 2007 GDP, the ratios for Brazil, Russia, India, and China are only 2%, 2%, 3% and 5%, respectively.

One of the ways we tap into the growth of consumerism in emerging markets is through our investments in telecommunications companies, which together serve more than a billion mobile phone subscribers. These companies tend to have high profit margins and, consequently, produce huge amounts of cash flow, the lifeblood of any investment.

Urbanization Over the past 30 years, the world's urban population has risen from 1.6 billion to 3.3 billion, and it is believed that over the next 30 years cities in the developing world are set to grow by an extra 2 billion. The average population of the world's 100 largest cities now exceeds 6 million. In 1900, it was only 700,000. Between 1985 and 2005, the urban share of the population of developing countries rose by 8% points. Urbanization is accelerating, turning emerging countries from agricultural to industrial base economies.

The US has 9 cities with populations exceeding one million. India has 23 and China 160 (30 with more than 2 million).

Urbanization has been one of the driving forces behind China's growth. For example, the speed of China's motorization is stunning – some 30,000 miles of expressway were built the past decade as part of a plan to extend the system to 53,000 miles compared to the US interstate roads comprising 47,000 miles. China has roughly the same land area as the continental US. The US Interstate Highway System radically altered the American economy. The US has 898 automobiles per highway mile. The statistics in China and India are only 136 and 138, respectively.

Urbanization requires infrastructure investments, including highways, railroads, airports, telecommunications, water and electricity works, etc. This means ongoing demand for metals such as steel, copper and aluminum. The fund has invested in companies that produce copper, steel, specialty metals and other materials that are crucial to urbanization in the emerging economies. Currently, these investments are hugely out of favor, but we see this as a temporary phenomenon.

Energy The energy sector embraces more than oil and gas, but these two sources of energy still dominate the energy landscape. In November 2008, the International Energy Agency (IEA) issued a report predicting that the price of oil will be \$200 per barrel by 2030. Under-investment in exploration will cause an oil supply crunch between now and 2015. The era of cheap oil is over. The current oil price, now below \$60 per barrel, is a temporary effect of the economic crisis, according to the IEA. Crude oil was \$147 per barrel in July 2008. This dropped to \$56 per barrel in November 2008.

The world faces escalating energy costs as companies scramble to find new oil fields and extract more production from aging fields. The current global trends in energy supply and consumption are patently unsustainable. Companies will have to invest \$26 trillion between now and 2030 – this includes \$350 billion a year on new oil and gas projects – to

keep abreast of rising energy demand, with about half going towards exploration and developing new sources of oil and gas. (The industry spent a total of \$390 billion during the period 2000 to 2007.) The other half will be spent on increased power generation and distribution. Rising demand and production declines in existing fields will require oil companies to add 64 million barrels a day in capacity over the next 22 years, more than 6 times Saudi Arabia's current production and representing a growth rate of 2.98% p.a. (per annum). The average annual decline rate of the world's existing oil fields that are past peak production is 6.7%. The world's oil fields (not including unconventional energy sources such as tar sands, ethanol, oil from coal, etc) currently produce 70.4 billion barrels per day. The world consumes 87 million barrels a day.

The fund owns oil and gas companies, oil and gas drillers, gas pipeline companies, and other companies that are closely related to the oil industry, such as Tenaris, a Luxembourg-based company, that supplies specialized piping to oil and gas companies. Shell is currently installing the world's deepest offshore floating oil rig 200 miles out in the Gulf of Mexico in water starting at 7,500 feet deep, with the oil lying another mile below the seabed. This trend to drill deeper is a huge positive for Tenaris.

Commodities October was the worst month on record for commodity markets, with the *Reuter-Jeffries CRB Index* falling off almost 24% – the largest monthly decline since the index was created in 1956. On October 31, 2008, the *Financial Times* reported that the brutality of the reversal over the past six months has left the most seasoned mining executive in a state of shock. The fall in the price of metals such as copper, platinum and aluminum has been exaggerated by the forced-selling by hedge funds that had to liquidate positions in commodities to cover losses elsewhere. As an example of the indiscriminate selling that took place, Xstrata, the Switzerland-based diversified mining group, has lost 78% of its value. At October month-end, the price of aluminum at \$2,094 per tonne is down 37% from its 2008 peak, copper (\$4,498 per tonne) down 49%, nickel (\$12,807 per tonne) down 62%, platinum (\$841 per troy oz.) down 63% and zinc (\$1,216 per tonne) down 57%. Since October, prices have dropped even further.

In the commodities space, we mainly own copper, steel and aluminum. Our stocks have borne the brunt of this sell-off. Again, we believe the current situation is not driven by fundamentals. Accordingly, we do not believe there is need for concern.

BRIC In terms of the Decoupling Theory, emerging nations are being weaned off US economic dependence and, thus, should cope better with a US recession than in the past. The slide in global stock markets seems to contradict this notion. This is certainly the case in the short-term, but we believe the Decoupling Theory is still very much in place. Stock markets tend to overreact. They sell on rumors and ask questions later. Over the long-term, economic fundamentals should prevail. Despite downward revisions in the growth rate of the BRIC countries, the IMF still expects Brazil, Russia, India and China to grow in 2009 at 3.0%, 4.0%, 6.3% and 8.5%, respectively. This means that the size of the US economy relative to the global economy will shrink. If this occurs economic distress in the US could have a diminishing impact on world economies, although this might not be too evident today.

The stocks of companies in these markets are trading at compelling values. The current trailing P/E multiples for Brazil, Russia, India and China companies are 7.3, 4.1, 11.1 and 8.2, respectively. The 12-month forward P/E multiples are lower at 6.5, 4.0, 9.9 and 7.7, respectively, demonstrating that these economies are still growing and should grow in 2009, although not at 2008 levels. Estimated dividend yields for companies in the indices of these four countries are 4.9%, 4.2%, 2.0% and 4.3%, respectively.

China In November China unveiled a \$586 billion (four trillion Yuan) economic stimulus program to bolster domestic demand and help avert a global recession. The plan includes spending in housing, infrastructure, agriculture, healthcare and social welfare and tax incentives or capital spending. This amount represents about 16% of China's economic output last year, and is roughly equal to the total of all central and local government spending in 2006 and a substantial commitment against China's six trillion Yuan annual budget. This would be equal to the US spending \$2.3 trillion on a similar package. The US pushed through a \$168 billion stimulus package earlier this year, equal to about 1% of GDP. The Chinese government also cut taxes on a large number of export items. China's biggest banks announced that they will increase their lending as part of the effort to encourage economic growth.

The money China intends spending will come out of the government's \$2 trillion treasury. The stimulus packages that US politicians crow about are nothing of the sort. The US Treasury sits with \$10 trillion in debt. To stimulate the US economy, the government has to borrow the money and that means higher interest costs for taxpayers to absorb and heavy debt repayment burdens on future generations. On November 17, 2009, Bank of America, a recipient of the Treasury's largesse towards US banks, announced its intention to increase its stake in China Construction Bank from 10.75% to 19.1%, by exercising options it currently owns – so much for helping the beleaguered domestic banking community.

The decline in the price of gas from \$4.14 a gallon in July 2008 to \$2.26 in October amounts to an annual saving of \$282 billion – a *de facto* tax cut that doesn't need Congressional approval and does not increase the budget deficit.

Nobody questions the fact that China's economy is slowing down. For example, China's *National Bureau of Statistics* announced in November that monthly electricity output declined 4% in October 2008 from a year earlier, the first such monthly decline in four years. On the other hand, value-added industrial production rose 8.2% in October from a year earlier, which was far slower than September's 11.4% gain. The comparisons are really difficult because production grew nearly 18% in October 2007. Chinese merchandise exports rose 19.2% in October year-over-year, compared to a 21.3% growth rate reported in September. The October trade surplus was a record \$35.24 billion. China's *National Bureau of Statistics* also reported that consumer prices rose 4% in October from a year ago, below 4.6% in September, and down from February's peak of 8.7%.

Against this backdrop came the news on November 14, 2008 that Chinese automobile sales and production figures showed that October 2008 production of passenger vehicles rose by 10% year-on-year. Experts are predicting auto sales in the world's second largest car market to be in 5.8 million units in 2008 and 2009. Annualized car sales in the US are now 10.5 million units – the lowest since 1983. The median American car is 9.3 years old, 50% older than in 1990. There are 981 vehicles per 1,000 driving-age people on the road in the US. The same statistics for China, Brazil and Russia are 24, 138 and 230.

The Chinese economy grew at double-digit rates in each of the past five years. This has been the cause of the run up in commodity, energy, food prices and the like. A slowdown – obviously not a recession or sharp decline – in growth in China is actually a welcome development.

Experts believe that China's exports may suffer much less damage than first thought in a global recession because of their price competitiveness. The country is comparatively well-placed to deal with a slowdown. The boom years allowed China to clean up its banking system, return state enterprises to profitability and shore up government finances. The country's financial system remains largely unscathed by the global credit squeeze.

India Our fund has no exposure to India, but economic growth in India is very important in the context of the BRIC analysis and what happens in commodity markets, including oil and gas. India's industrial production increased 4.8% in September, which is well below the 9.5% recorded a year earlier, but nonetheless strong growth by international standards.

India's infrastructure deficit is greater than most countries. After five years of average economic growth of 9%, its national networks of highways and power plants are overwhelmed, choking growth.

The Indian government is forecasting a growth rate of 7% and has promised public expenditures to help buoy growth. Goldman Sachs has pared its forecast for the Indian economy to 6.7% in 2008-2009 from an earlier 7.5%.

Brazil Brazil is the largest and most populated country in South America, and the fifth most populated country in the world. Brazil is the world's tenth largest economy and the ninth largest in purchasing power. In 2007, Brazil launched a four-year plan to spend \$300-billion to modernize its roads, power plants, and ports.

Brazil's economy has grown strongly since the turn of the century. It has brought its financial house in order. It is a stable democracy that has seen the standard of living of its people rise significantly in recent years as the global economy has expanded. Despite the current turmoil in the global markets, the IMF is still projecting a healthy growth rate for the country's economy in 2009, in the 3.7%-range, which is down from the previous 4.5% estimate. It has \$250 billion in foreign currency reserves, which means it has

become a creditor nation, quite a change from the old regime that was chronically in debt and financial turmoil.

Brazil has a wide range of exports that include aircraft, coffee, automobiles, soybean, steel, ethanol, textiles, footwear, electrical equipment, and of course commodities, especially iron ore.

Anecdotally, *The Economist* (November 15, 2008), reported on Casa Bahai, a Brazilian furniture and electrical goods retailer. The company with 550 stores in Brazil dismissed the global economic slowdown and projected revenues of \$ \$6.1 billion in 2008, up from \$5.6 billion in 2007, an 8.9 % increase, with more to come in 2009.

Our exposure in Brazil is mainly in telecommunications, through our investment in Telefónica, the Spanish telecom giant.

Russia Russia's current woes stem from its excursion into Georgia and the sharp decline in oil prices. It is evident that there are still many in the media fighting the Cold War, which makes it difficult to obtain unbiased reports on Russia. The Economic Intelligence Unit of *The Economist* predicts that Russia's economy will grow 6.8% in 2009.

A recent letter in the *Financial Times* points out that Russian's foreign exchange reserves at \$515 billion exceed the total dollar value of all ruble deposits in the banking system (roughly equivalent to \$390 billion). No other country in the world is as well protected.

Our direct exposure to Russia is limited to our investment in the second largest mobile phone operator in Russia. However, if growth in Russia, together with the other BRIC countries continues to be positive, the global economy should benefit and with that many of the stock we own, especially in the energy and commodities sectors.

Be Positive Warren Buffett contributed an op-ed piece to the *New York Times* on October 17, 2008: "Buy American. I Am." Buffett acknowledges that fear is widespread, gripping even seasoned investors, but companies will again, as in the past, deliver "new profit records." The current setback is not unique in US history. While past performance is not an indicator of future results it is worth noting that following each setback, the country's economy recovered and investors did well with the DOW climbing from 66 to 11,497 during the past century, despite periods of deep despair. Still, many investors lost money during this time period. Who were these investors? "The hapless ones bought stocks only when they felt comfort in doing so and then proceeded to sell when the headlines made them queasy," according to Buffett.

He highlights a very important investment principle, so much so that he mentions it twice, namely that he cannot predict the short-term movement of the stock market. "I haven't the faintest idea as to whether stocks will be higher or lower a month – or a –year – from now," he writes. Again, "I have no idea what the market will do in the short term."

In other words, he does not buy stocks in May to sell them in August. He buys for the long-term. We, too, are buy-and-hold investors.

These are unusual times, but we are confident that the market will stabilize. Just as stocks fall to ridiculous levels, they also tend to rise to ridiculous levels. We have thoroughly researched the stocks that we own. We know them well and we have great confidence in their future. There are many variables that impact the value of a stock and influence the failure or success of a company's business strategy. We believe that thorough due diligence goes a long way to avoid investment failure. It is our opinion that the fund's portfolio is well-placed to benefit once economic growth recovers in the world's major economies.

Historically, stocks rise long before economic activity picks up. Equities tend to lead the economy out of a recession. Since 1893, there were 11 periods when the US economy contracted by 2.5% or more. On each occasion, the stock market recovered before the economy picked up. If you had bought the S&P500 at the end of 1932, when things looked their bleakest, you would have gained 86% after five years, 120% after 10 years and 926% after 20 years. It is time in the market that matters, not market timing.

*"We... [did not] let fear of unknowns cause us to defer or alter the deployment of capital. Indeed, we have usually made our best purchases when apprehensions about some macro event were at a peak. **Fear is the foe of the faddist, but the friend of the fundamentalist** [our emphasis]."*

Stock prices will continue to fluctuate – sometimes sharply – and the economy will have its ups and downs. Over time, however, we believe it is highly probable that the sort of businesses we own will continue to increase in value at a satisfactory rate." – Warren Buffett, 1994 Letter to Shareholders.

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