



SEMI-ANNUAL UPDATE
FIRST HALF 2024

H1 2024 Results

During the first half of 2024, the Saga Portfolio (“the Portfolio”) increased 39.4% net of fees. This compares to the overall increase for the S&P 500 Index, including dividends, of 15.3%.

The cumulative return since inception on January 1, 2017, for the Saga Portfolio is 135.9% net of fees compared to the S&P 500 Index of 178.3%. The annualized return since inception for the Saga Portfolio is 12.1% net of fees compared to the S&P 500’s 14.6%. Please check your individual statement as specific account returns may vary depending on the timing of any contributions throughout the period.

Performance			
	Saga Portfolio (gross)	Saga Portfolio (net) ⁽¹⁾	S&P 500 Index ⁽²⁾
2017	16.0%	14.3%	21.8%
2018	2.1%	0.6%	-4.4%
2019	65.6%	63.2%	31.5%
2020	123.8%	120.5%	18.4%
2021	-9.6%	-10.9%	28.7%
2022	-84.7%	-84.9%	-18.1%
2023	209.2%	204.6%	26.3%
H1'24	40.4%	39.4%	15.3%
H2'24			
Cumulative	164.0%	135.9%	178.3%
Annualized	13.8%	12.1%	14.6%

(1) Saga Portfolio serves as a model for client accounts. Net returns assume 1.5% management fee.

(2) S&P 500 performance includes dividends. Please see disclaimer at the end of this letter regarding comparison to indices.

Interpretation of Results

During the first half of the year the share prices of our companies continued to rise as the market better appreciated their value. In the last letter I discussed the inherent conflict of interest between portfolio managers and their investors. As an investor, I love when the share prices of our companies go down...not up. I want share prices to be highly volatile, as long as the business continues to widen its moat and grow intrinsic value per share over the long-term. As a portfolio manager, I want nothing more than to provide consistent market-beating returns for the Saga Portfolio investors, i.e. I want our stocks to go up. It feels good to report big consistent returns. It does not feel good to report steep drawdowns.

However, it really does not matter what I want regarding something that I cannot control and what stock prices do in the short-term is something I cannot control or predict. What one considers short-term is also subjective. There are endless examples of stocks that continue to march higher and higher for years, only to crash and never recover because the underlying company was deteriorating unbeknownst to the market. During those interim years the market was providing superficial positive feedback that likely comforted shareholders, only for them to discover the castle they believed to have a wide moat was built on sand.

There are also countless examples of stocks that remain depressed for years despite the underlying company making strong progress. Then one day, for some apparent reason, the market begins to better appreciate the value

of the company with a rising stock price. Trying to guess what the market is thinking or when it will change its mind can be a fun game of speculation. What truly matters is trying to see what is really there, despite what the rest of the world may believe at the time.

If there is anything we can take away from the ups and downs in the stock market over the past few years, it is that the current price of a stock does not necessarily reflect its true value. In fact, it can be wildly off base. Therefore, we cannot use the current stock price or its recent movements as confirmation or disconfirmation of an investment thesis. We cannot pat ourselves on the back when a stock we own goes up, just as we cannot despair if it goes down. If we look to others for reassurance in any investment, we are setting ourselves up for failure.

Of course, eventually a stock will reflect the underlying earning power of the company. Therefore, we need to evaluate a company's earning power by analyzing its product/service, management, and long-term prospects, and then compare that outlook to the current stock price. If we are able to make good judgements when we have an insight into value that is not being fully appreciated and appears more attractive than anything else available in the market, then eventually the stock will better reflect that value.

While the Saga Portfolio's net returns since inception still lag the S&P 500 through H1'24, I find the valuations of our companies to be unusually attractive, hence why we own them. With a few exceptions over the past several years, the Saga Portfolio has pretty much owned the same group of companies. This has not been due to a lack of searching for other opportunities, but rather the relative attractiveness of our companies' current valuation compared to their prospects. Discovering the few companies that will be the long-term winners is challenging. When you find one, it's typically best to hold on for dear life which is much easier said than done.

The operating results of each of our companies through the second quarter continued to show fundamental gains. Most of our companies are on the path to report record results in 2024. While the financial metrics are trending positively, what has happened beneath the numbers is even more impressive. The operating environment since COVID has been extremely challenging to navigate, especially for companies that are in the part of their lifecycle where they are building out their infrastructure. When demand was fluctuating so erratically, it forced our companies to slow down, lean into their strengths, and cut the distractions as they emerged stronger on the other side.

In an alternate universe where COVID never happened, I would suspect that many of our companies would have continued growth trajectories off their 2019 base and revenues would have exceeded present levels. Even though 2024 revenues may be somewhat lower than they otherwise would have been, our companies now have a stronger foundation to scale more seamlessly. That should lead to even greater profitability going forward and therefore result in even higher intrinsic values.

In the last letter I dove into some of our investments in detail. For the rest of this letter, I want to take a step back to touch more on the overarching philosophy that guides decision making in the Saga Portfolio. I've discussed investing philosophy throughout past letters, but I think it will be helpful to put it in the context of three main topics; 1) how knowledge grows wealth, 2) the predictability of knowledge, and finally 3) how this influences the criteria I look for in an investment, highlighting Trupanion as an example. It will be obvious to those familiar with David Deutsch's books, *The Fabric of Reality* and *The Beginning of Infinity*, how much his ideas have influenced my thinking and how I apply these ideas to the investment process. For those who find these topics interesting or simply want to better understand the world, I highly recommend David Deutsch's books, [interviews](#), or the podcast [TokCast](#) where Brett Hall discusses Deutsch's ideas in more detail.

The Growth of Wealth (and Knowledge)

At its core, investing is exchanging wealth today with the expectation to get more wealth in the future. Growing wealth may seem like an inherently selfish goal, but in reality it provides a great benefit to society. One can invest in public companies, private companies, real estate, etc., but the expectation always is that one is deferring the consumption of capital today to be able to consume more in the future. During the interim period, the capital is serving others that are in need of capital. People face problems every day, and the economy attempts to solve those problems by allocating capital to the solutions people demand. Those that best solve other people's problems create wealth and help others live better lives.

Deutsch defines wealth not as the amount of money one has in their bank account, but rather the range of physical transformations one can bring about. Money is merely a medium of exchange that puts an approximate quantitative value on the wealth created. In the short-term, there is a rough correlation between the number of dollars one has and wealth. You can give dollars to others, such as a doctor, restaurant, or homebuilder for example, in exchange for products or services that they have better knowledge and resources than you to bring about. However, over the long run, the fundamental economic exchange is relative knowledge.

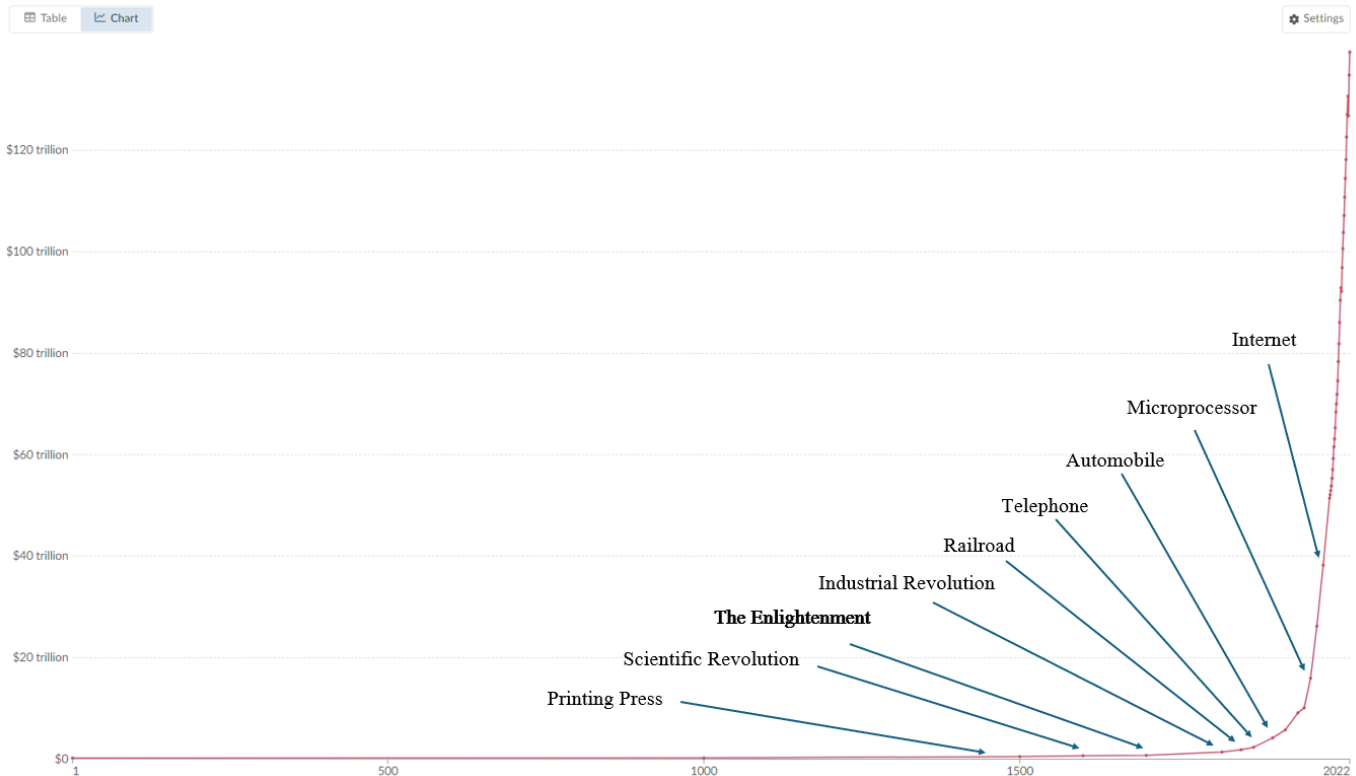
Wealth is a byproduct of knowing how to create physical transformations that solve people's problems. The economy consists of people trading the knowledge they are good at creating in exchange for money. Then they use that money to pay others that have better knowledge in bringing about physical transformations that solve their problems. As more of life's problems are solved through greater knowledge, people can then focus on solving new and even better problems. As society figures out how to make more and more physical transformations, everybody gets wealthier.

For nearly all of human history wealth remained stagnant. Innovations such as fire, clothing, or the wheel happened so rarely that over an individual's life living standards never improved. It wasn't that people did not want to make progress; they didn't know how to make progress. Then an inflection point was reached around three hundred years ago when wealth (using GDP as a rough proxy in the chart below) started to take off.

Global GDP over the long run

Total output of the world economy. These historical estimates of GDP are adjusted for inflation. We combine three sources to create this time series: the Maddison Database (before 1820), the Maddison Project Database (1820–1989), and the World Bank (1990 onward).

Our World
In Data



Source: World Bank (2023); Bolt and van Zanden – Maddison Project Database 2023; Maddison Database 2010

Note: This data is expressed in international-\$ at 2017 prices

The inflection point followed the Enlightenment. Prior to the Enlightenment, there was a widespread belief that all important knowledge was already discovered. People believed authorities retained all the prevailing knowledge, resulting in little to no innovation or progress and what Deutsch calls a static society. Then sometime between Galileo showing evidence for the heliocentric model of the solar system in 1616 and Newton publishing *Principia* in 1687, a cultural shift occurred. It led to a more widespread *culture of criticism*, or what Deutsch calls a dynamic society. People started to believe there were better explanations for how the world worked. They no longer accepted the world as it was, but rather searched for explanations for *why* things were the way they were. As better explanations were discovered, knowledge grew. With more knowledge, people were able to bring about more physical transformations to solve life's problems.

The economic model that embodies a culture of criticism is one that permits free trade, i.e. capitalism. The process starts when a problem exists. Through people conjecturing and testing potential solutions, new knowledge to solve a problem is created/invented that is better than existing solutions. Customers are then drawn to the better solution, which leads to big profits. Big profits signal to the market that people demand more of the solution. Capital then gravitates towards solutions that the market demands more of, and away from solutions that are less effective or become obsolete. As more capital is invested in supplying that solution, excess profits are competed

down until demand is saturated leading to ever-decreasing cost of production curves. This provides more and more goods and services available at decreasing prices. People spend less of their energy on solutions to their existing problems so that they can spend more of their energy on new and more interesting problems that arise. Everyone becomes wealthier as access to food, clothing, shelter, transportation and all the other solutions to life's problems becomes more accessible and cheaper.

The whole economic process of creating new explanatory knowledge/solutions, and therefore wealth, resembles biological evolution. In biological evolution, organisms experience problems within their ecological niche. Through random mutations, genes “conjecture” a variety of solutions given the environmental conditions. Natural selection favors the variants that most improve the ability of the organisms to reproduce, thus causing those variant genes to spread through the population. For example, food may be hard to reach in tall trees. A solution is a mutation in a gene that creates a longer neck that makes it easier for a giraffe to reach the leaves. Through mutation, nature's method of being creative, biological knowledge was created. Because the biological knowledge is useful in solving a problem, “product-nature fit,” it tends to replicate to the extent it fills the ecological niche.

The major difference is that economic evolution attempts solutions through purposeful conjecture while biological evolution attempts new solutions through blind random mutations. People understand the problems they face, purposefully conjecture possible solutions, then customers act as the natural selection process by either buying or not buying the solution. This difference makes the growth of explanatory knowledge exponentially faster than biological knowledge. How many random mutations did the giraffe species “attempt” and fail, most of which were harmful to survival, before its genes produced a long neck to reach food easier? Allegedly it took Thomas Edison thousands of attempts before he invented a workable light bulb, yet that was still many orders of magnitude faster than it took fireflies or glow worms to generate light. People, when free to pursue solutions to life's problems through conjecture and criticism, have the ability to grow knowledge at rates never experienced by any other species in history.

Predicting the Growth of Knowledge (and Companies)

All regularities in nature have explanations. Therefore, explanatory knowledge is able to predict those regularities. The more we understand, the better we can predict and perform the physical transformations that we prefer (i.e. grow wealth). Given the right set of circumstances, we know that an airplane will fly, a bridge will hold a certain weight, or a drug will cure a disease, based on our existing explanatory knowledge.

One thing that cannot be predicted is the growth of future knowledge. If we knew the contents of a future theory, then it would already exist. When you are trying to predict the economy or the behavior of a person, you are trying to predict what knowledge that system or person is going to create in the future which is inherently impossible. That is why those who state they can predict what stock prices will do in the future are prophesizing. A Wall Street analyst has no more insight into where a stock will trade in the next twelve months than your Uber driver with a hot stock tip. How a stock reacts at any point in the future depends on the choices people will make, and people buy and sell shares for an infinite number of reasons given an infinite number of potential future scenarios. Those choices that people will make in reaction to those scenarios are both fundamentally unpredictable which is why there is no “magic formula” to beat the market.

That does not eliminate the fact we still have to make decisions about where to invest our savings today, which is subject to the future state of knowledge. Although a scientific prediction cannot be made about the future of a company or its stock price, we can search for better (or good) explanations as opposed to using worse (or bad) explanations to guide our decision making.

Deutsch defines a bad explanation as one that can easily vary without changing its prediction. For example, many will attempt to “explain” why stocks may be up or down on any day depending on recent news. Sometimes positive economic news will be interpreted as good, but sometimes it will be interpreted as bad. Similarly, bad news can be interpreted as good or bad depending on how stocks react. This approach places reasoning behind the unpredictable and therefore creates a belief of control where none exists. It is more akin to a conspiracy theory than useful explanatory knowledge. An explanation (theory) that can explain anything explains nothing. They are bad explanations.

Alternatively, a good explanation is one that is hard to vary while still accounting for what it claims to account for. Like a good explanation, the determining factors that make a good company are hard to vary. A good company remains good regardless of interest rates, inflation, or general business conditions. There is a good, hard to vary reason for why it succeeds to a greater extent than other companies within its “ecological niche” despite what may happen in the economy. We may not be able to know the precise amount and timing of the cash that will be returned to owners (a stock’s intrinsic value), but we can understand why certain products/services may or may not solve a particular problem better than alternative solutions, or the capability of management, or the company’s ability to innovate, to help inform a thesis about a company’s prospects and its value.

In the Q2’22 Investor Letter, I discussed some of the theories (Clayton Christensen’s Jobs to Be Done, Conservation of Attractive Profits, and Theory of Disruption) that provide a framework for assessing the prospects of a business. Take the Theory of Disruption as an example. It attempts to explain why big incumbent companies can lose out to smaller ones. It is counterintuitive that a big company that has more resources could lose to a startup or another company from outside its industry. How does Walmart beat out Sears, Amazon beat Barnes & Noble, Microsoft beat IBM in the PC operating system, Apple beat Microsoft in the smartphone operating system? Companies seem to emerge from essentially nothing to become huge entities that serve markets one would think incumbent companies were best positioned to win.

Why have incumbent companies so frequently missed out on major disruptive innovations? They have the ability and far more resources, but often actively decide to not pursue new disruptive ideas/solutions at first because they appear unimportant from the perspective of their existing infrastructure, end-markets, and customer base. New technologies typically perform worse than existing solutions, may initially have a different use case, and therefore management often passes on a new idea that does not meet the needs of the existing customers. Eventually the lower quality disruptive innovation gets a foothold and through a series of sustaining disruptions is able to serve the needs of the incumbent customer base to a better extent, at which point it is too late for the incumbent to catch up.

In 1876, Alexander Graham Bell tried to sell his telephone patent for \$100,000 to Western Union, one of the largest corporations in the U.S. at the time. The management declined the offer believing the telephone was nothing more than a toy stating, “we feel that the device will never be capable of sending speech over a distance of several miles.” They thought the use case for the telephone would only be for special local circumstances and would never be able to serve Western Union’s large telegraph customers such as the railroads who required fast and reliable long-distance communication. Only a few years later customers started to replace Western Union’s telegraphs with telephones. By 1909, AT&T dwarfed Western Union and acquired a 30% stake to take control of the company.

Any theory that depends on future knowledge creation cannot scientifically predict the future. There is not a law of nature that says Western Union had to miss the telephone wave, or Sears miss the discount retailer wave, or Walmart miss the e-commerce wave. They missed it because their choices were influenced by motivations to serve existing customers and utilize existing infrastructure to rationally grow profitability. That is a better explanation for why many incumbent companies fail than a theory that management was not mission-driven or customer-focused enough. While The Theory of Disruption is not scientific, one can see how there are better and worse theories surrounding the future growth of knowledge to help form expectations surrounding a company's prospects.

Criterion for Investment

With any investment, I am looking for a company that is; 1) able to solve a problem better than alternative options available today and far into the future (durable competitive advantage), and 2) selling for an attractive price relative to its prospects (value). Since we can't predict knowledge that will be created in the future, neither criteria can be known. However, good explanations for whether a company has a durable competitive advantage and is selling at an attractive price relative to its prospects can guide decision making.

Investment theses are grounded in having a good idea for what the end state of an industry will look like far out into the future. For most companies, the future either looks so obvious to the rest of the world that current valuations appear more than fairly priced or is too foggy that I cannot form a clear enough picture about what I expect will happen. I think companies like Cintas, Costco, or Coca Cola have wide moats and the long-term outlooks appear clear, but that view seems to be well-recognized in their current valuations.

On the other end of the spectrum, companies like Nvidia, Snowflake, CrowdStrike, or Zoom Video may look like great companies today, but I have little idea about what they will look like in the year 2034 and beyond based on my current understanding. Capitalism is brutal to the majority of companies but can be very rewarding to the few that truly build a durable competitive advantage. Being able to pick the haves from the have nots without the benefit of hindsight is no easy task. Fortunately, I do not have to predict the rise or fall of every winner and loser. I just need to have a few long-term insights that are directionally correct to move the needle in the Saga Portfolio.

I have found that one of the most durable advantages frequently arises from companies that spent considerable time, effort, and resources investing in creating capabilities that solve hard problems. The company develops a series of interconnected solutions that are built upon each other. Each part of the solution works in conjunction with the other to provide what appears to be a seamless solution. This model demonstrates Christensen's Conservation of Attractive Profits which essentially states companies make the best profits when they integrate solutions around the hardest to solve problems.

A common characteristic among many of these companies, at least the ones that proved most resistant to competition, emphasized low prices. Jeff Bezos has said, "*there are two types of companies – those that work to raise prices and those that work to lower them. We will be the second.*" That does not mean the companies charged the lowest arbitrary price regardless of economic reality. Rather they had a philosophy to constantly keep price as low as possible while still providing the hard to solve solution.

Even if competitor's prices were far higher for comparable services, the company set the lowest possible price relative to its cost structure, leaving little room for new entrants or competition to catch up. It helped build a brand known for value that no others could match, attracting more demand and making it possible to scale its solution to a size that was difficult to initially imagine. Giving customers a lot of value even if it doesn't maximize short-

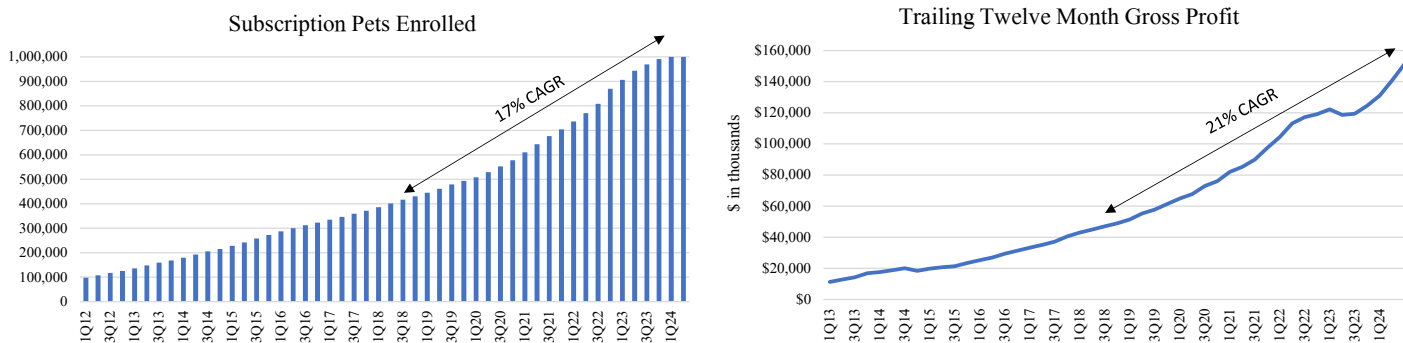
term profits turns out to be good business. It increases a company's durability and can be far more profitable in the long run.

These companies that built integrated solutions to challenging problems through years of trial and error are a rare species. They make the hard look easy. Their solution may look like it was a straightforward linear series of systematic decisions, but in reality, the process was indirect, messy, and only learned through relentless persistence to try to solve problems. This process of continual improvement can span the course of many years, or even decades, which often goes unnoticed. It was their learned processes and capital investments that built capability, resilience, and efficiency, which created huge value that would otherwise have been impossible. If a company has knowledge to solve an important problem that is very difficult for others to replicate, it provides durable earning power despite what may happen to inflation, interest rates, or business cycles. It is a good business.

The other great thing about integrated and seemingly complex companies is that they are often misunderstood and can be undervalued for much of their life. Traditional value investors understandably search for predictable, capital-light companies with high margins. They look to the past to extrapolate trends into the future and prefer cash flow today over cash flow tomorrow. That makes companies earlier in their life, pursuing an unconventional integrated solution while building out infrastructure look unattractive as an investment. Counterintuitively, the capital-light, seemingly more scalable business model has frequently been less lucrative when solving very large, complicated problems (e.g. eBay vs. Amazon). If one can discover an underappreciated company, building a hard to replicate solution with a long runway to reinvest capital at attractive rates of return, it has the right ingredients (good explanation) for an attractive long-term investment.

Trupanion

Trupanion is an example of a company that has approached a problem in an unconventional way and through persistent effort has built a solution that is extremely difficult to replicate. I have discussed Trupanion in past letters and the fundamental story since the Saga Portfolio first bought shares in 2018 has not changed as the company continues to scale.



Source: Company filings, Saga Partners

Historically, pet insurers in the U.S. pursued the easier route to shorter term profits as opposed to durable value creation. They tried to attract customers by selling policies with low monthly premiums. Lower price points meant offering limited coverage, making the claims process cumbersome, and dictating the treatments and prices animal hospitals charged. That strategy was an easy way to acquire unknowing new customers, but the low-value product created distrust amongst pet owners and veterinarians, giving pet insurance a bad reputation.

Trupanion approached the problem in a completely different way. Its mission is to deliver the best possible value to their customers. It sought to simplify the product by offering comprehensive coverage and a seamless experience. What else is the purpose of insurance other than to pay the unexpected expenses of the insured?

It targets a 71% payout ratio (the amount it pays in claims vs. premiums received) compared to other insurers that only payout ~50-60% of premiums. That does not mean Trupanion's product is necessarily the lowest monthly payment, just that it provides the best value proposition in the industry. It prices policies as a cost-plus model, letting veterinarians dictate the treatments and prices they charge. Such a high payout ratio is only possible by being the low-cost provider. Trupanion's cost to administer and to acquire new pets is by far the lowest in the industry. That is only possible through a relentless focus on controlling costs, vertical integration, and a unique distribution model that created an efficient avenue for generating customer leads.

A culture of frugality and attacking costs is part of Trupanion's DNA. Management even goes as far as discussing the need to lower spend on snail mail postage as it has proven to be a low-value investment. Costs are lowered further by underwriting their own policies, which they can do because of having years of claims data to provide more accurate pricing, often down to the neighborhood level. Pricing is a vital part of an insurance underwriter and getting it wrong can lead to big losses and a damaged brand. This past June, the second largest U.S. pet insurer announced they are going to cancel ~100,000 policies due to underpricing, leaving many pets that are likely older and have preexisting conditions without coverage.

Trupanion's nationwide salesforce of independent contractors called Territory Partners is the most cost-effective distribution in the industry. Trying to replicate it would be extremely difficult. It took considerable effort to develop, recruit, and then train Territory Partners before the strategy was more established and became successful. It can take years for a Territory Partner to develop a relationship with an animal hospital before they start actively recommending pets. Veterinarians will not recommend a bad insurance product to their client. Once they learn about Trupanion's value to both pet owners as well as to vets, they are the most effective channel to help pet owners understand the benefits of Trupanion's coverage and highest payouts in the industry. Further, when a hospital integrates Trupanion's automated claims processing software that pays hospitals directly, as opposed to the traditional reimbursement model, it strengthens Trupanion's relationship with hospitals and customers. It leads to more referrals, higher retention rates, increases the lifetime value of the pet, as well as providing a better experience for pet owners and veterinarians.

Such a seamless product might look like it was the result of a master plan but was in fact the result of years (decades) of ongoing trial and error where one solution was built off another as the company continued to tackle problem after problem. For example, comprehensive coverage requires sophisticated data insights and pricing methods, which leads to vertical integration, which requires additional capital and regulatory requirements. One can see how solving one problem leads to new problems, which require further solutions that eventually lead to the integrated company we see today. These challenges might explain why others rarely try to copy the strategy.

Businesses are complex entities and getting a clear picture of where a company is headed is hard. But there is a certain clarity in a company that continues to find ways to lower costs and share benefits of scale with its customers, which creates a virtuous cycle that is extremely difficult for competitors to match. With only ~3% of pets in the U.S. and Canada having pet medical insurance and the best value proposition in the industry, Trupanion has a long runway to reinvest in growing the number of covered pets. Its exact earning power and share price in the year 2034 may not be scientifically predictable, but there is a good explanation for why I expect both to be materially higher than recent levels. What the share price does tomorrow or even over the next year or two is anyone's guess.

Conclusion

Diving into the underlying philosophy of the Saga Portfolio can seem a little abstract, but I think it is important to explain what guides general decision-making as well as the reasoning behind specific decisions within the Portfolio. That helps you better understand what you own and why you own it when otherwise all you would see are yo-yoing stock prices in your statements.

The deep simplicity of the Saga Portfolio's strategy is trying to grow investors' wealth by owning a few companies whose long-term prospects appear undervalued by the market. Such a strategy will inevitably experience greater volatility in the short term compared to owning dozens or hundreds of different stocks. But if I am directionally correct about the long-term prospects of the handful of companies that we own, I expect the returns will more than make up for it in the fullness of time.

As always, it is a privilege to manage your capital. The Saga Portfolio's success is directly tied to an investor base that is aligned, stable, and thinks long-term. That is what makes it possible to navigate the inevitable ups and downs of the market.

Please reach out if you have any questions or comments!

Sincerely,

Joe Frankenfield

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