

# GaveKal Knowledge Leaders Fund

## A Template for the Taper





## Summary



***Please consider the Fund's investment objectives, risks, charges and expenses before investing. The prospectus or summary prospectus that contains this and other information about the Fund, is available by calling 888.998.9890 and should be read carefully.***

### Investment Objective

The Fund's investment objective is to seek long-term growth of capital and to exceed the performance of the MSCI World Index.

### Fund Investment Strategy

The GaveKal Knowledge Leaders Fund seeks to identify global companies that are utilizing a deep reservoir of intangible capital to generate earnings growth and shareholder value. Intangible rich companies often possess some competitive advantages such as a strong brand, proprietary knowledge or a unique distribution mechanism. The Fund manager has developed a methodology to measure and analyze intangible capital investments, and this methodology forms the backbone of the Fund's investment process.

### Risks

The value of the securities held by the Fund will change due to general market and economic conditions and industry perceptions. Investments in non-US issuers may involve unique risks. Currency fluctuation, adverse political, economic or social developments could undermine the value of the Fund's investments. The securities of mid-cap companies may be subject to more abrupt or erratic market movements and may have lower trading volumes.



## Performance as of 12/31/13



### GaveKal Knowledge Leaders Fund

	1 Year		3 Years		Since Inception (9/30/2010)	
	GAVIX	MSCI World Index	GAVIX	MSCI World Index	GAVIX	MSCI World Index
Performance	19.04	26.68	12.17	11.49	11.32	13.52
Beta	0.60	1.00	0.38	1.00	0.35	1.00
Alpha (%)	3.16	0.00	7.18	0.00	6.17	0.00
Standard Deviation (%)	6.78	9.26	6.56	13.73	1.77	13.84
Sharpe Ratio	2.80	2.87	1.84	0.83	1.77	0.97

	As of 12/31/13	
	GAVIX	MSCI World Index
Active Share	92.64	0.00

The total annual operating expenses of the Fund are 1.53% and 1.28% and net expenses are 1.50% and 1.25% for the Advisor and Institutional Classes, respectively. The inception date for the GaveKal Knowledge Leaders Fund is 9/30/10.

*The performance data quoted here represents past performance. Past performance is no guarantee of future results. Investment return and principal value will fluctuate, so that an investor's shares, when redeemed, may be worth more or less than their original cost. Current performance may be lower or higher than the performance information quoted. To obtain performance information current to the most recent month-end please call 888.998.9890 or visit our website at [www.gavekalfunds.com/mutualfund.php](http://www.gavekalfunds.com/mutualfund.php). A redemption fee of 2.00% will be imposed on redemptions or exchanges of shares you have owned for 90 days or less. Please see the prospectus for more information.*

*The Fund's advisor has contractually agreed to waive its fees and/or pay for operating expenses of the Fund to ensure that total annual fund operating expenses (excluding any taxes, leverage interest, brokerage commissions, dividend expenses on short sales, acquired fund fees and expenses (as determined in accordance with SEC Form N-1A), expenses incurred in connection with any merger or reorganization, and extraordinary expenses such as litigation expenses) do not exceed 1.50% and 1.25% of the average daily net assets for Advisor Class and Institutional Class shares of the Fund, respectively. This agreement is in effect until December 31, 2014, and it may be terminated before that date only by the Trust's Board of Trustees. The Fund's advisor is permitted to seek reimbursement from the Fund, subject to limitations, of fees waived for payments made to the Fund for a period of three years from the date of the waiver or payment.*



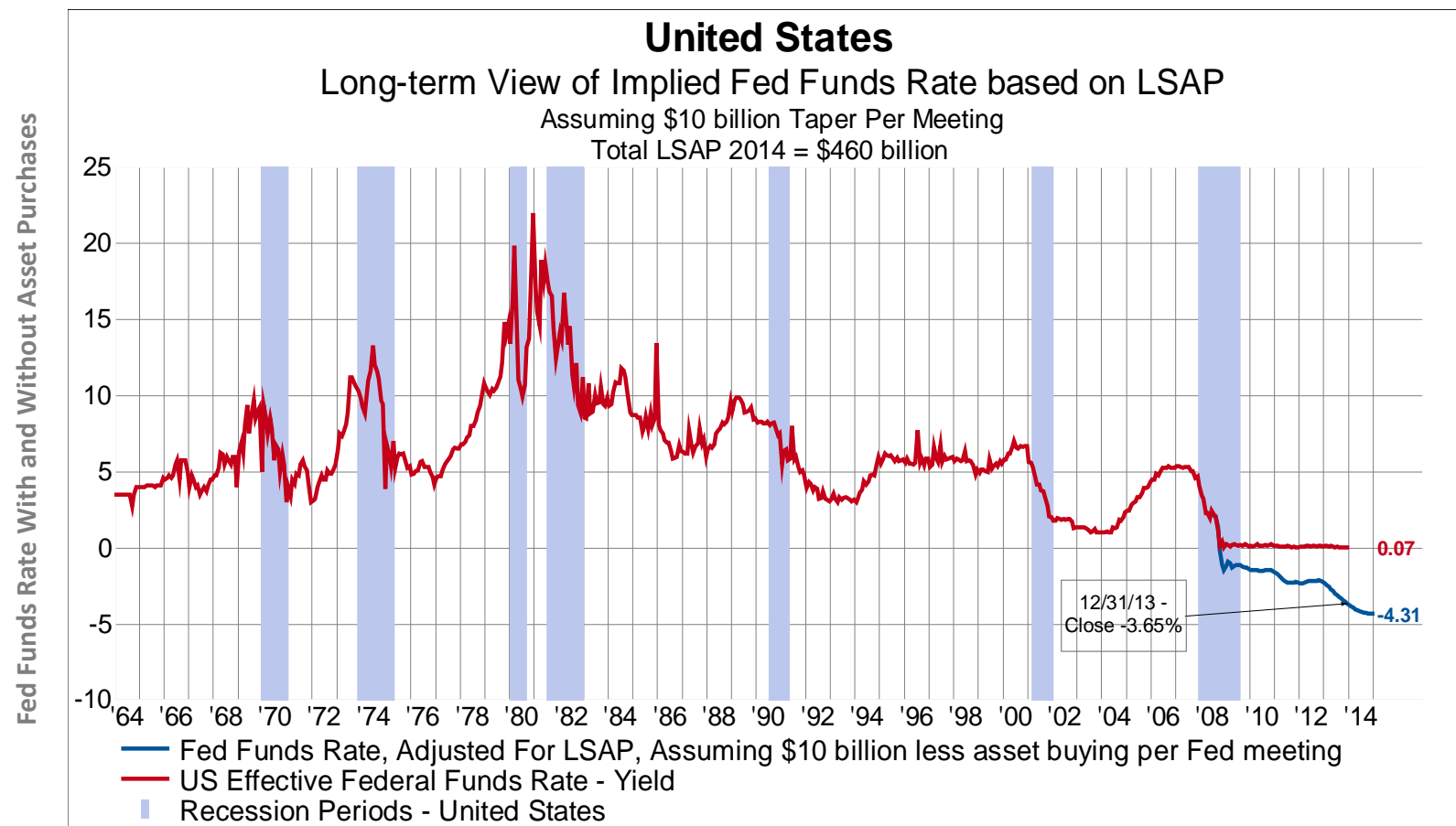
# Introduction



- Large scale asset purchases have effectively lowered the federal funds rate to -3.65% and, when they end, short rates will be -4.31%, according to our models.
- Bonds already seem to be incorporating tapering expectations.
- Quantitative Easing (QE) has led to 13 important outcomes. A coming reduction in asset purchases calls into question whether the QE-induced trends will continue or reverse.
  - 1) Stocks rose
  - 2) Interest rates rose
  - 3) Corporate bond spreads narrowed
  - 4) Stocks outperformed bonds
  - 5) Cyclical stocks outperformed counter-cyclicals
  - 6) Relative volatility of cyclicals vs. counter-cyclicals declined
  - 7) Stocks stayed in overbought territory
  - 8) Small caps outperformed large caps
  - 9) Downside volatility was reduced
  - 10) Stocks went on major statistical “runs”
  - 11) Leading indicators and growth expectations rose
  - 12) Funding conditions in the US improved
  - 13) Global macro risk indicators declined
- The average stock is at elevated valuations. We find large numbers of stocks at valuation extremes.
- On a sectoral basis, opportunities appear to be mostly in bond and commodity related groups like Telecom, Utilities or Basic Materials, and Energy. Risk appears to be in the Industrial, Consumer Discretionary, and Financial sectors.
- European Consumer Staples and North American Technology appear to be the exceptions and look attractive too.

## Large-scale asset purchases (LSAP) in perspective.

Research suggests that each \$800bn in Fed asset purchases equates to a 100bps reduction in the fed funds rate. We expect purchases will be reduced by \$10bn per meeting throughout 2014, terminating in Dec. 2014. The Federal Reserve will likely purchase \$460bn in assets in 2014, taking our simulated short rates to -4.3% by the end of this year vs. -3.65% currently.



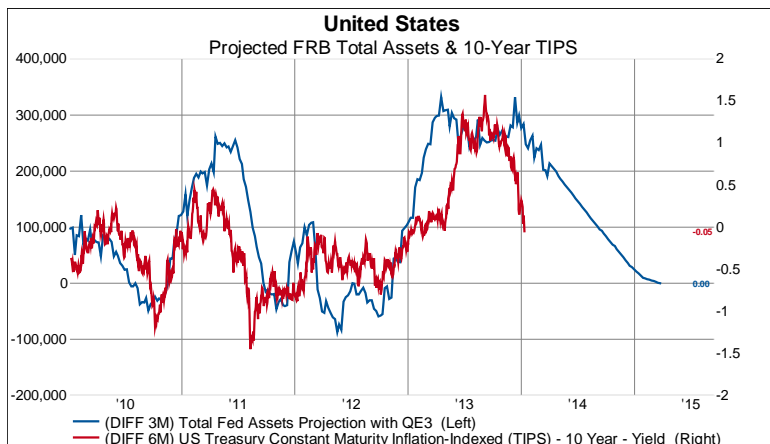
Source: Gavekal Capital, FactSet

As of 12/31/13



# Bonds already seem to be incorporating the taper.

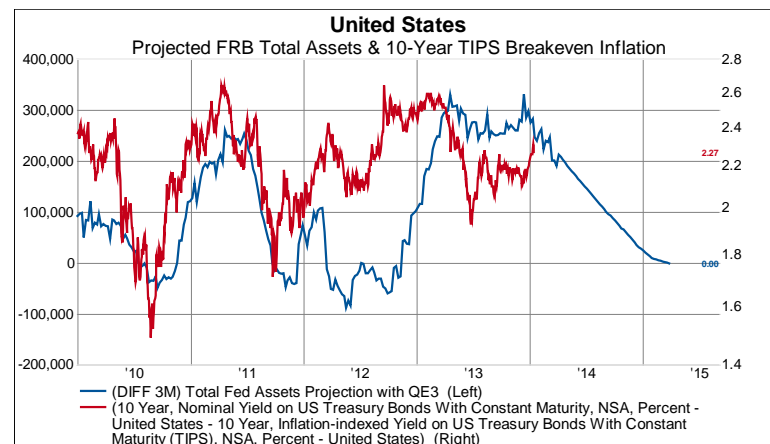
3-Month Change in Total Fed Assets



10-Year TIPS Yield

TIPS seem to be responding already to the taper as the 6-month rate of change has fallen to zero.

3-Month Change in Total Fed Assets

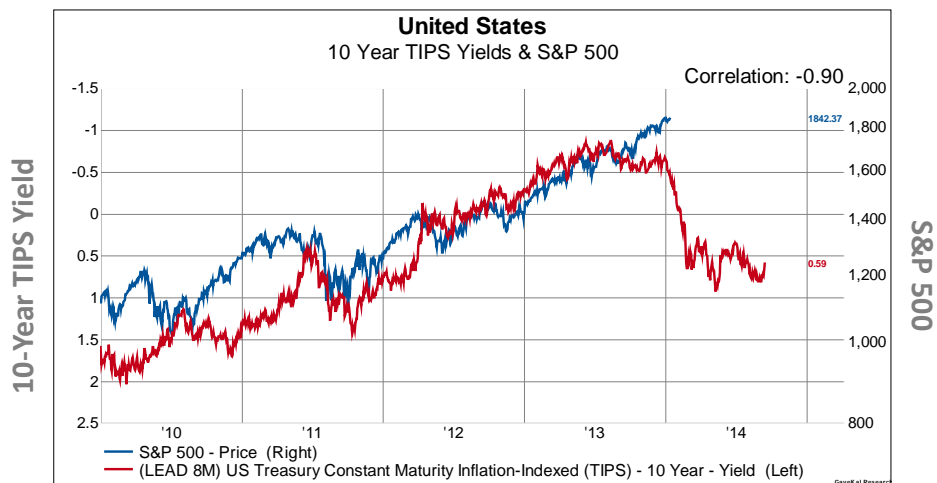


10-Year Breakeven Inflation

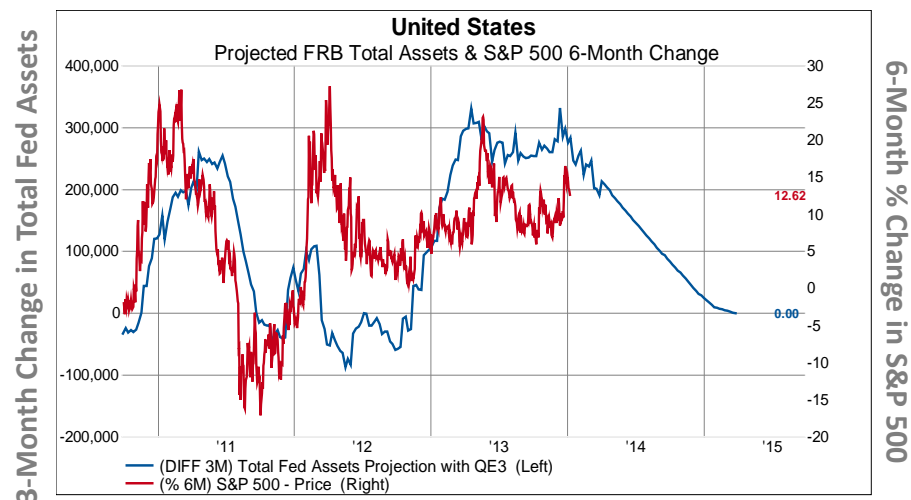
A taper scenario would seem to suggest a more bullish perspective for long bonds.

# #1 - Asset purchases have driven stock prices higher. Will tapering put an end to that?

The main effect of large scale asset purchases was to lower interest rates. During the course of all phases of quantitative easing, TIPS rates declined by almost 4% peak to trough.

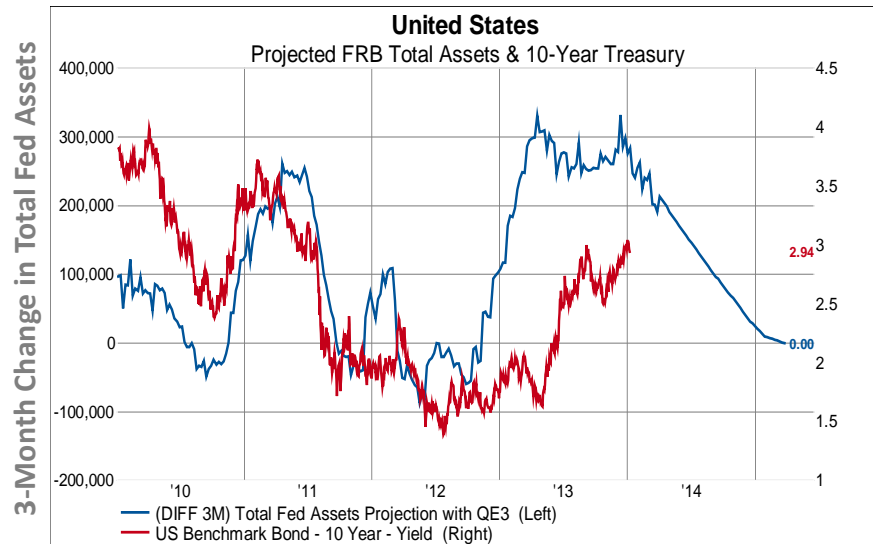


Large scale asset purchases have steadily driven down TIPS rates. This decline in real rates has had a 90% correlation with rising stock prices.

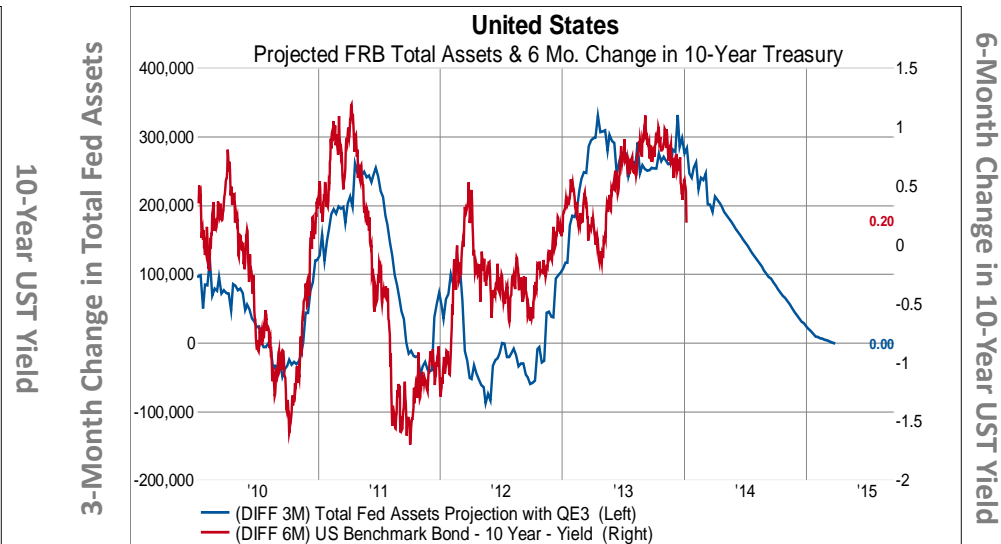


The 3-month change in total Fed assets has correlated well with changes in the price level of the S&P 500.

## #2 - Asset purchases have driven rates higher. Will tapering lead to lower rates?



Treasury yields have been pushed higher as a delayed reaction to Fed asset purchases. The 3-month change in total Fed assets has correlated well with the level of 10-year UST yield.

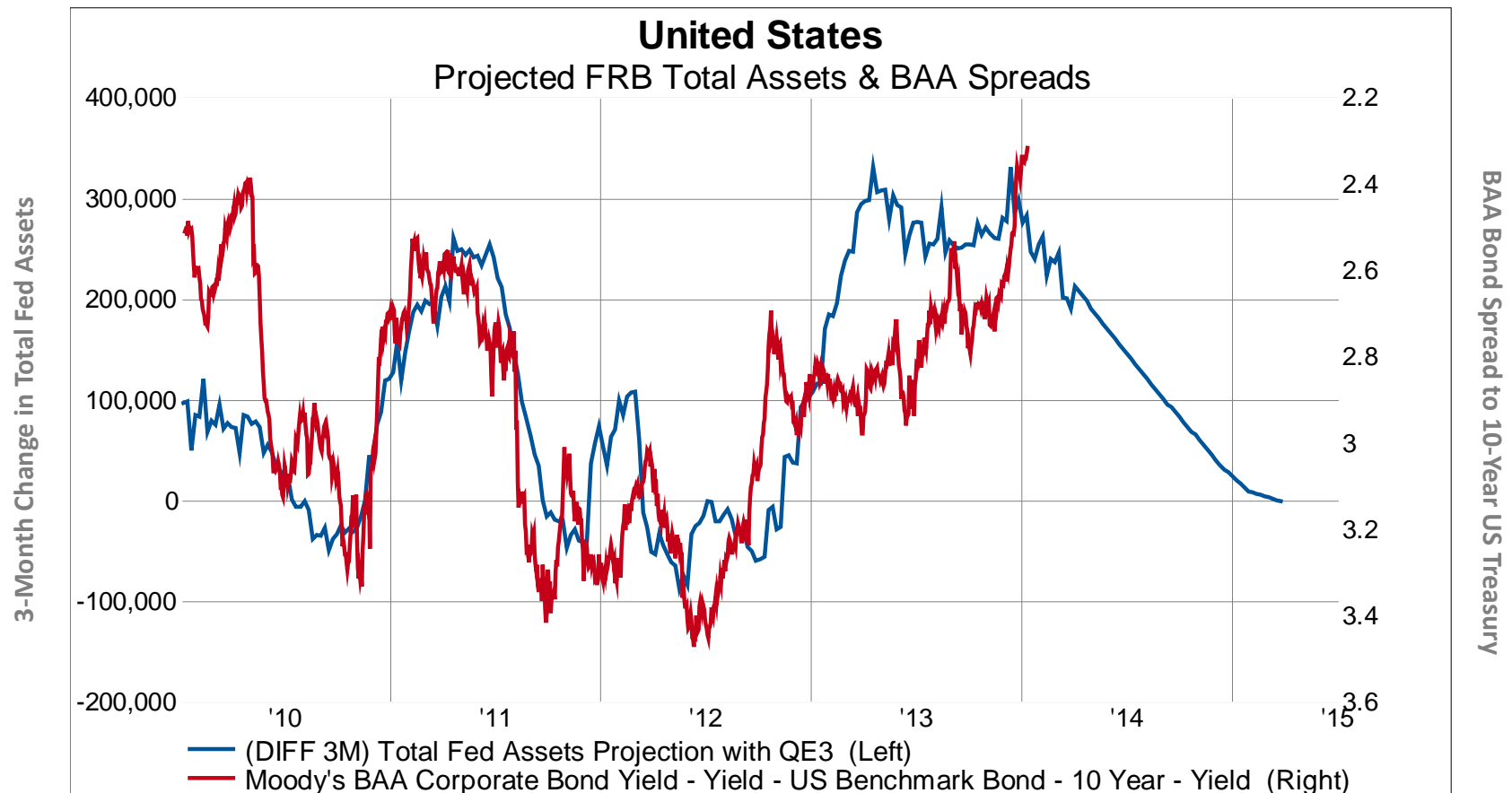


The 3-month change in total Fed assets has correlated well with the 6-month change in the 10-year UST yield as well.



### #3 - Large scale asset purchases have led to the narrowing of corporate bond spreads. Will they widen as taper commences?

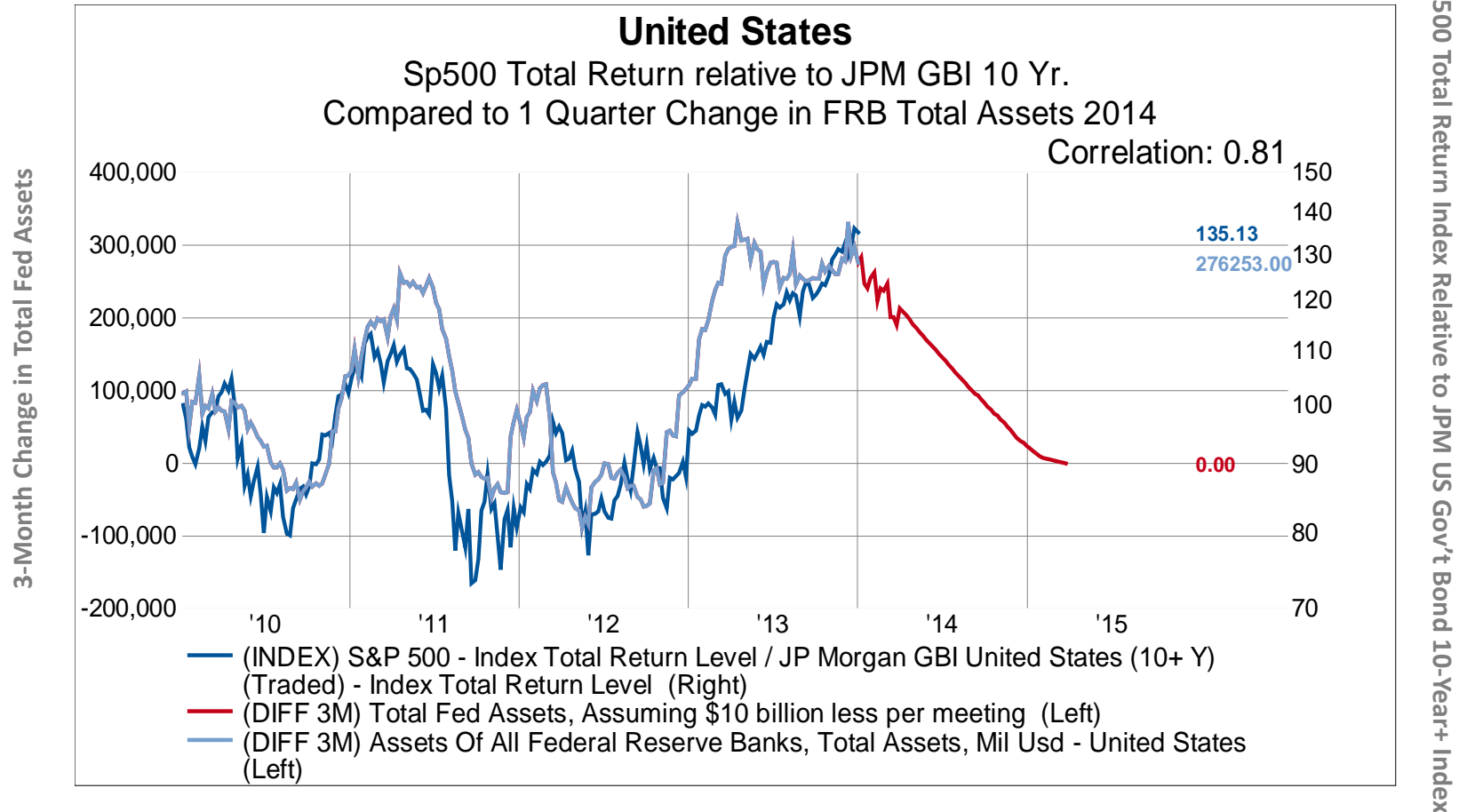
Moody's BAA corporate bond spread to 10-year US Treasury bonds could widen by almost 1% if the taper is completed by late 2014.



Source: Gavekal Capital, FactSet

## #4 - Large scale asset purchases have led to the relative outperformance of stocks vs. bonds. Will bonds outperform during taper?

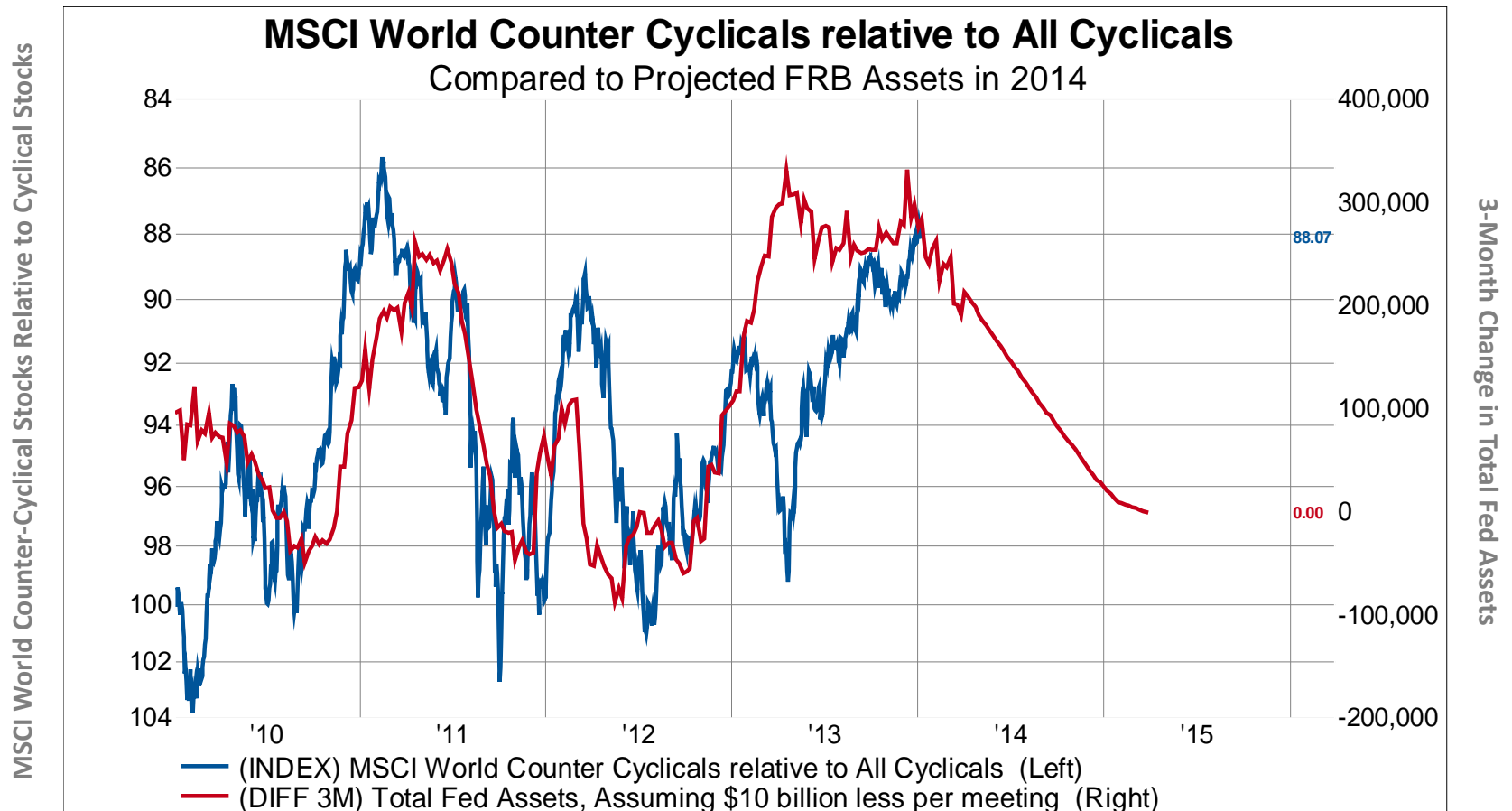
With Fed purchases resulting in both higher stock prices and higher bond yields, stocks have outperformed bonds by a wide margin over the last several years.



Source: Gavekal Capital, FactSet

## #5 - Asset purchases have led to outperformance by cyclical stocks. Will taper lead to counter-cyclical outperformance?

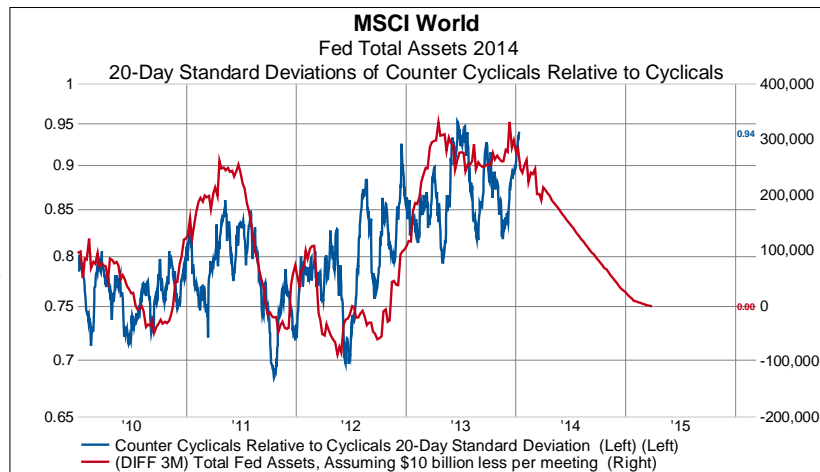
Cyclical stocks have historically benefitted more than counter-cyclicals when the Fed is expanding its balance sheet. Now that the Fed has laid out a relatively clear path for the reduction in the pace of purchases, it could be time for counter-cyclicals to make a relative performance comeback.



Source: Gavekal Capital, MSCI

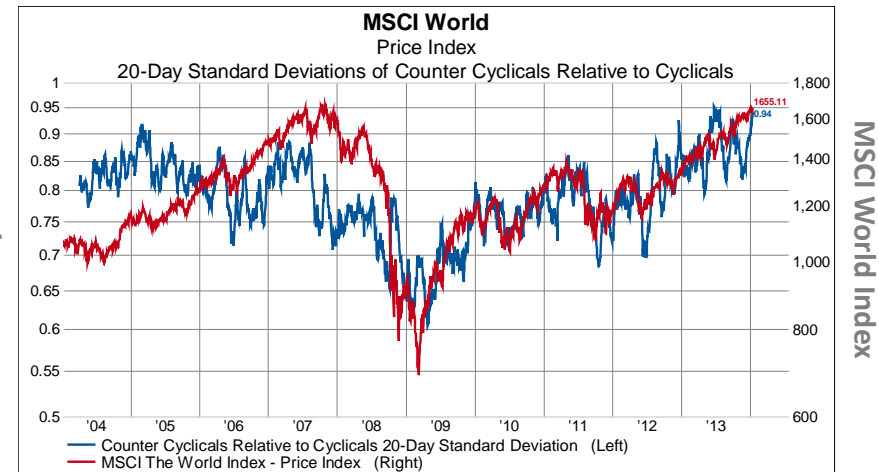
## #6 - Asset purchases have driven down the volatility of cyclicals and counter-cyclicals. Will the relative volatility of cyclicals revert when taper begins?

Relative 20-Day Standard Deviation



3-Month Change in Total Fed Assets

Relative 20-Day Z-Score



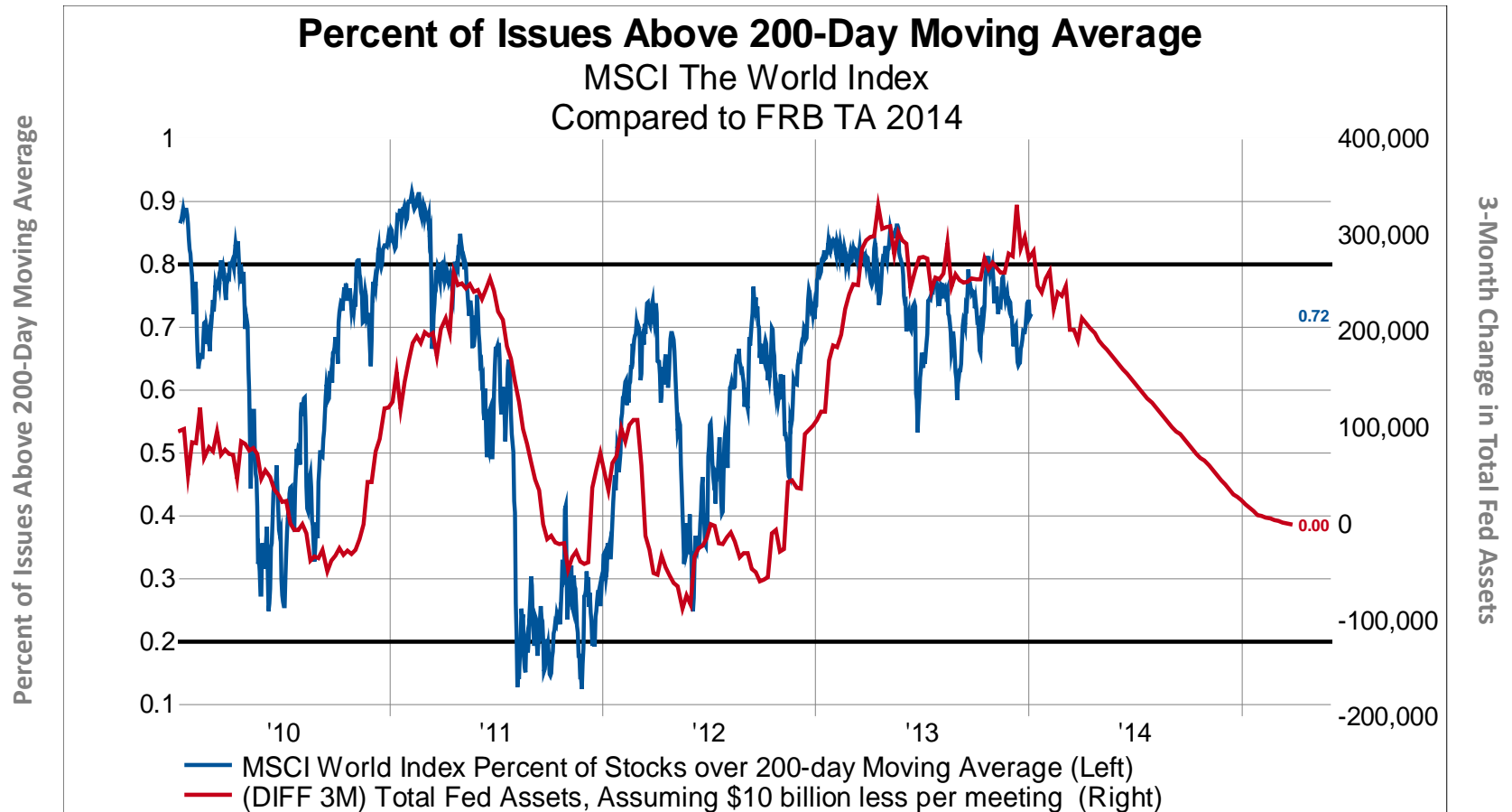
MSCI World Index

The relative volatility of counter-cyclicals to cyclicals has increased as more asset purchases were made.

At 94%, the relative volatility of the counter-cyclicals to cyclicals is at the highest level in a decade.

## #7 - Asset purchases moved stocks into overbought territory and kept them there. Will taper release some of this pressure?

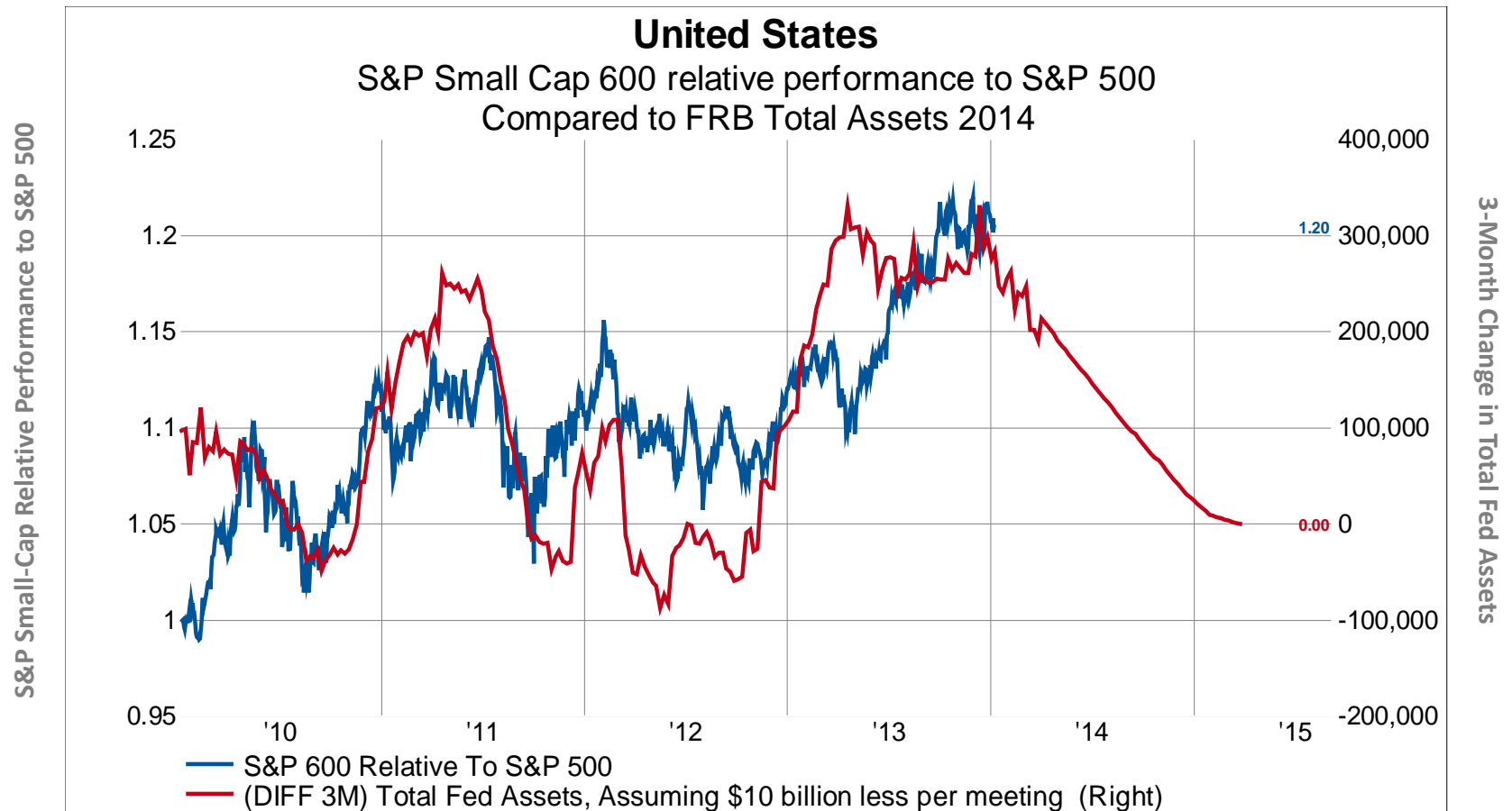
At no point in 2013 were less than 50% of stocks trading below their 200-day moving average.



Source: Gavekal Capital, MSCI

## #8 – Asset purchases have caused small caps to outperform large caps.

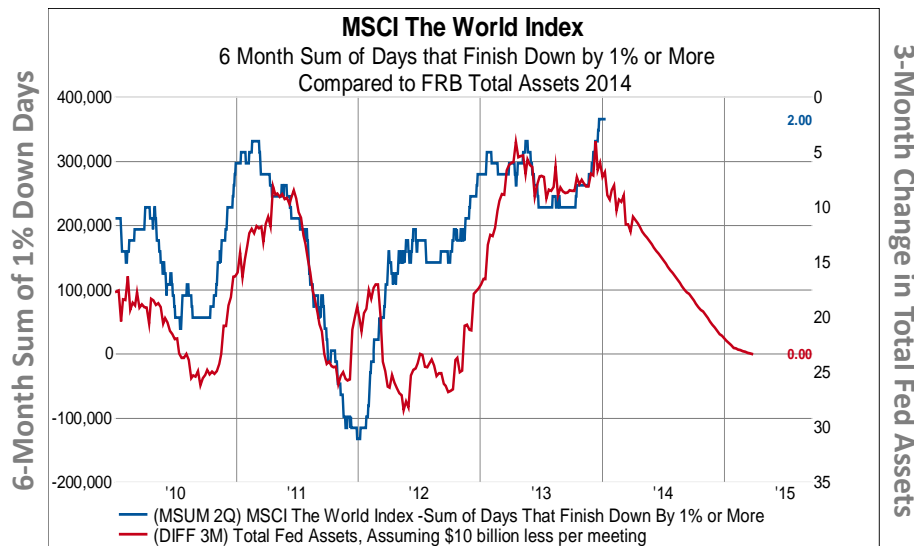
Small-cap stocks consistently outperformed large-cap stocks in 2013.



Source: Gavekal Capital, FactSet



## #9 - Asset purchases have eliminated downside volatility. Will the taper lead to more, bigger down days?

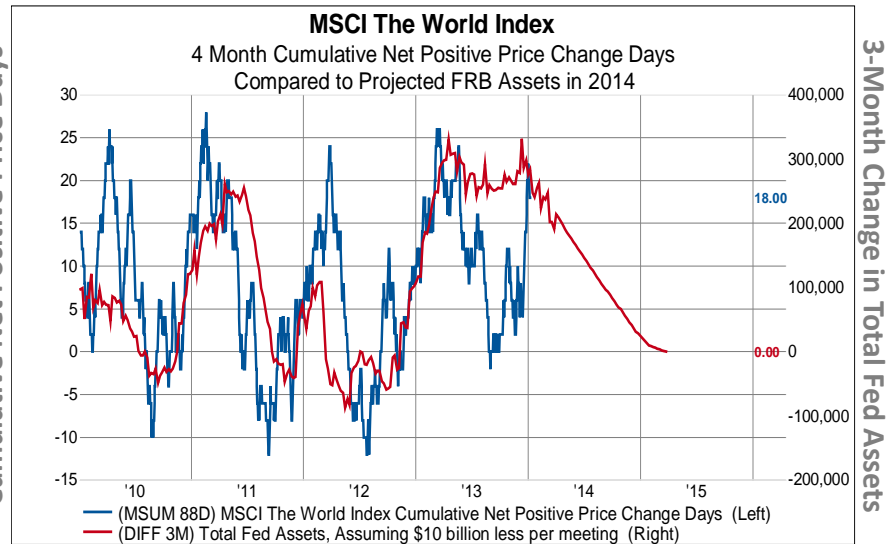


There have only been 2 days where the market has declined by 1% or more over the past 6 months.

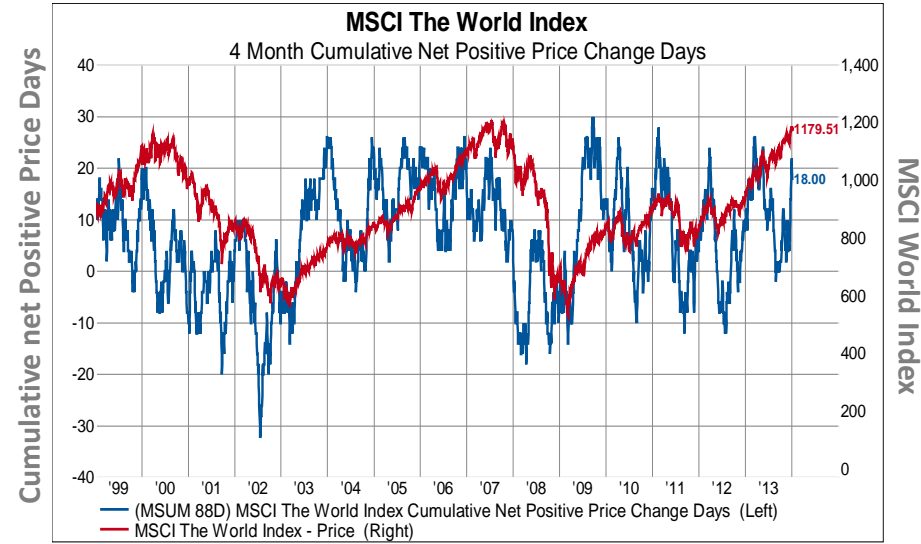


At market lows, you expect to see around 45 days, over the previous 6 months, where the market closes down at least 1%.

## #10 - Asset purchases have led to statistical “runs” in stocks. Will taper lead to “slumps”?

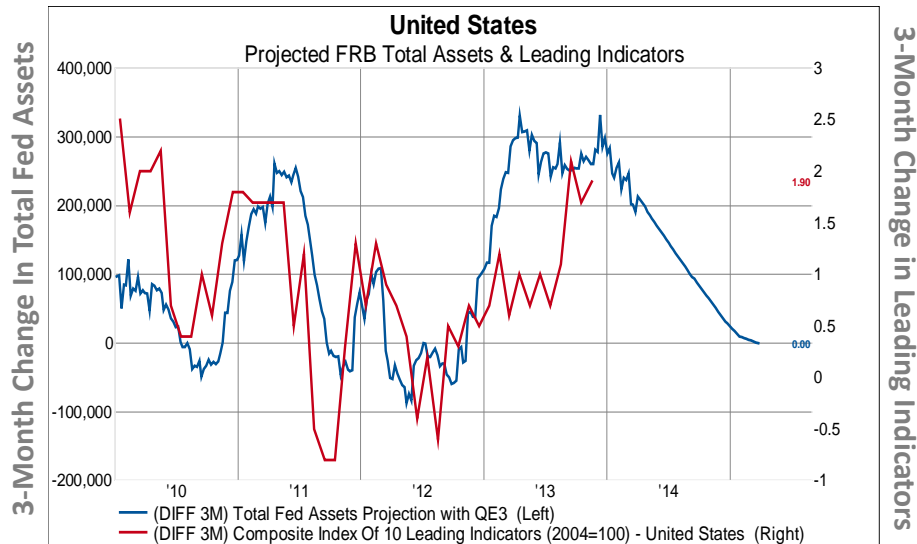


We calculate the net number of days out of the last 88 trading days where stocks were up. Net up days tends to be a mean reverting stat.

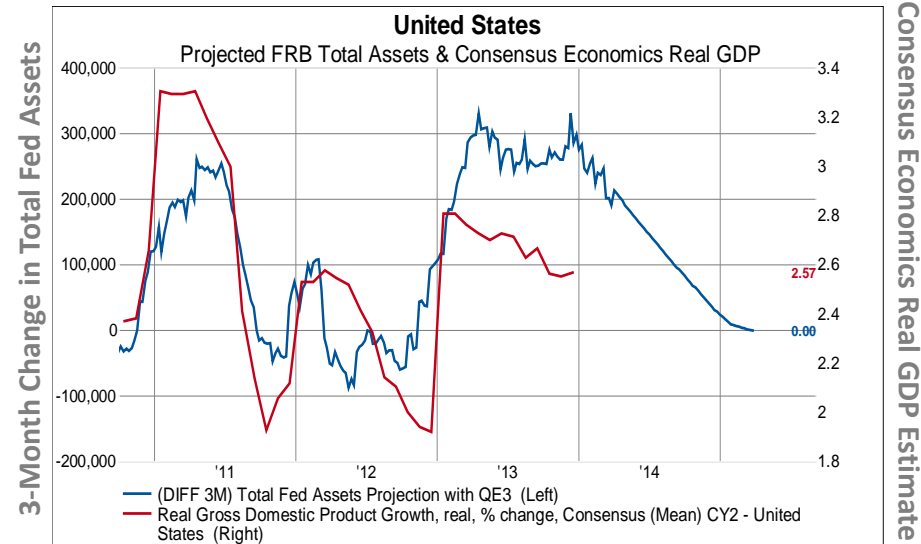


As asset purchases increased, stocks tended to have many more positive days than negative days.

## #11 - Asset purchases have clearly helped the economy. Will tapering lead to faltering expectations?



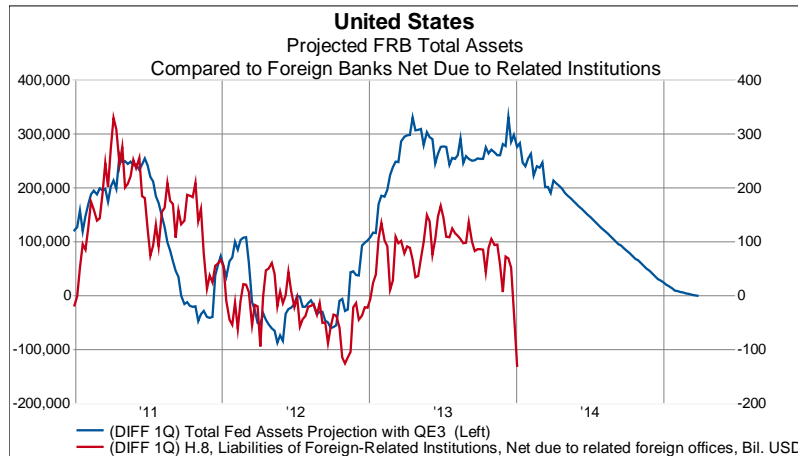
The 3-month change in leading indicators has generally moved in line with the 3-month change in total fed assets.



GDP expectations have been influenced by asset purchases. As more asset purchases were made, the more GDP expectations increased.

## #12 - Asset purchases have helped funding conditions. Recent contraction in funding sources indicates stress.

3-Month Change in Total Fed Assets



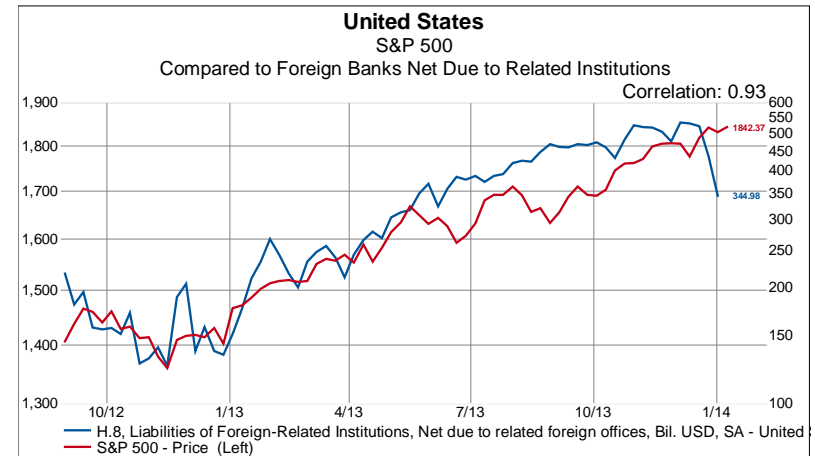
Change in Foreign Bank Net Claims on Related Parties

Foreign banks represent roughly half of excess reserves deposited at the FRB via their net claims on related institutions in the US. There has been a swift recent contraction.

FRB= Federal Reserve Board

Source: Gavekal Capital, FactSet

005 D&S

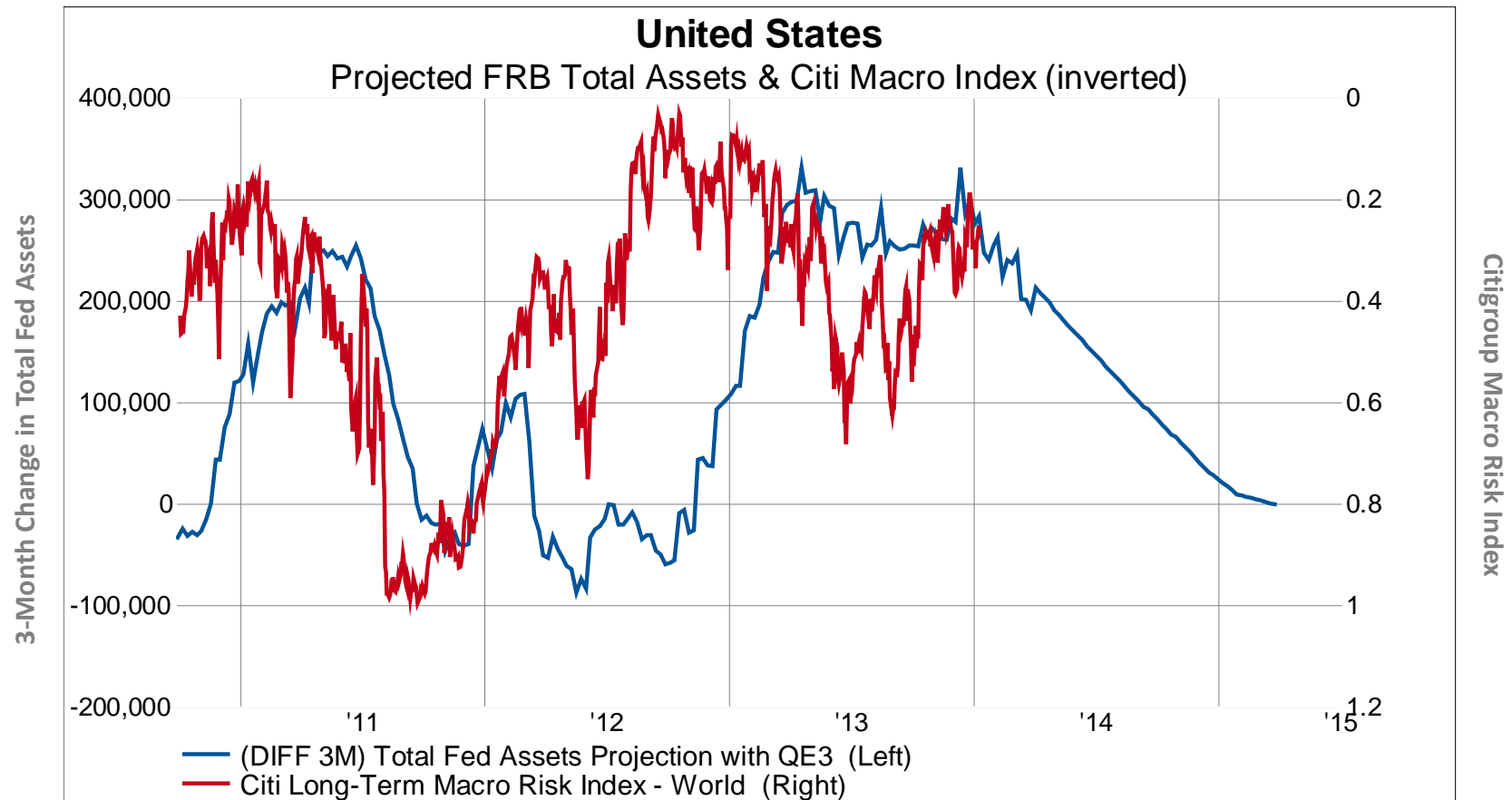


Foreign Bank Net Claims on Related Parties

The increase in claims on US branches by foreign related institutions (think Credit Suisse) has been highly correlated with rising stock prices. These deposits in the US banking are retreating as the taper begins.

## #13 - Global macro risk has oscillated around FRB asset purchases.

A coming tapering of asset purchases suggests a rise in global macro risk, which would include widening sovereign spreads and weakening currencies.



Source: Gavekal Capital, FactSet

The median stock has doubled in valuation over the last five years.



How has QE influenced the average stock in the MSCI World Index? The median P/S ratio has risen from less than 1.0 in early 2009 to 1.8 in 2013.

P/S ratio= Price-to-Sales Ratio

P/CF ratio= Price-to-Cash Flow Ratio

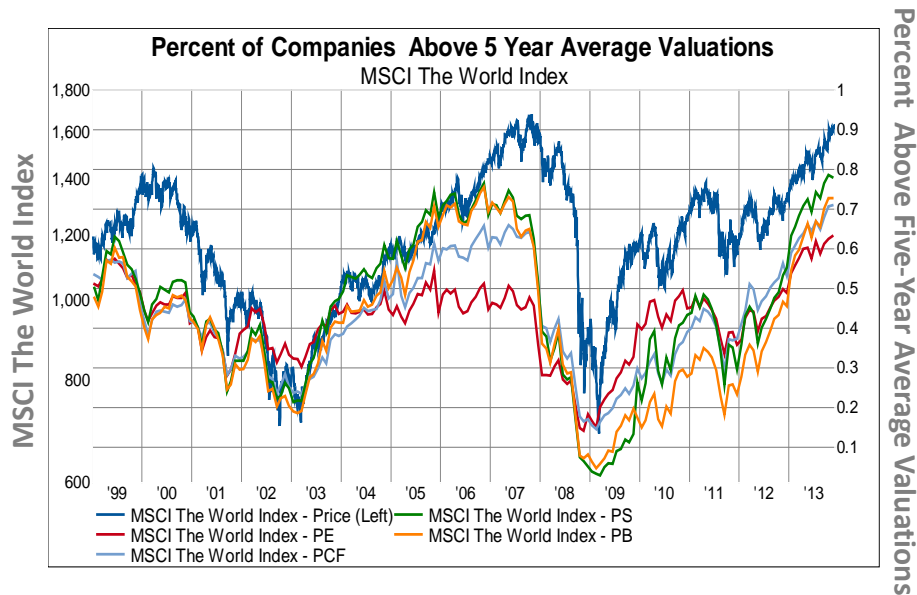
Source: Gavekal Capital, MSCI



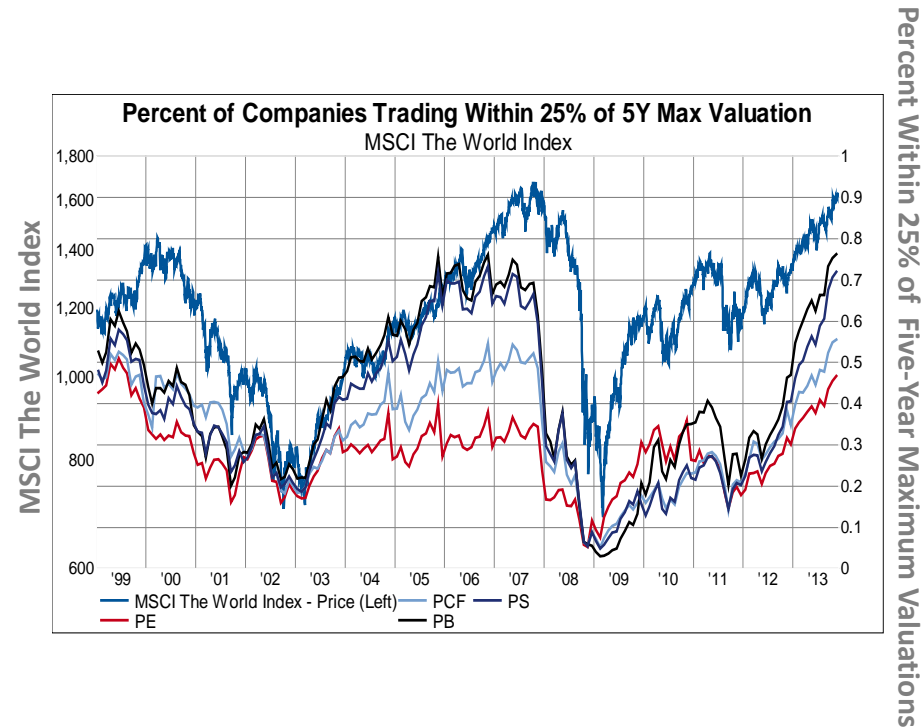
At the same time, the median P/CF ratio has increased from less than 6.0 to nearly 12.5 today.



## The broad cross section of stocks are at elevated valuations from many perspectives.

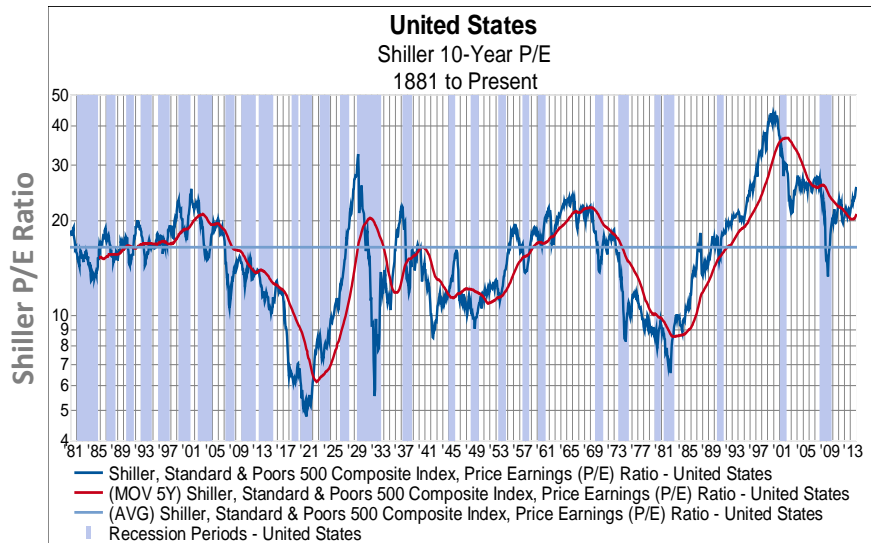


By any valuation metric, the vast majority of companies in the MSCI World Index are well above average...

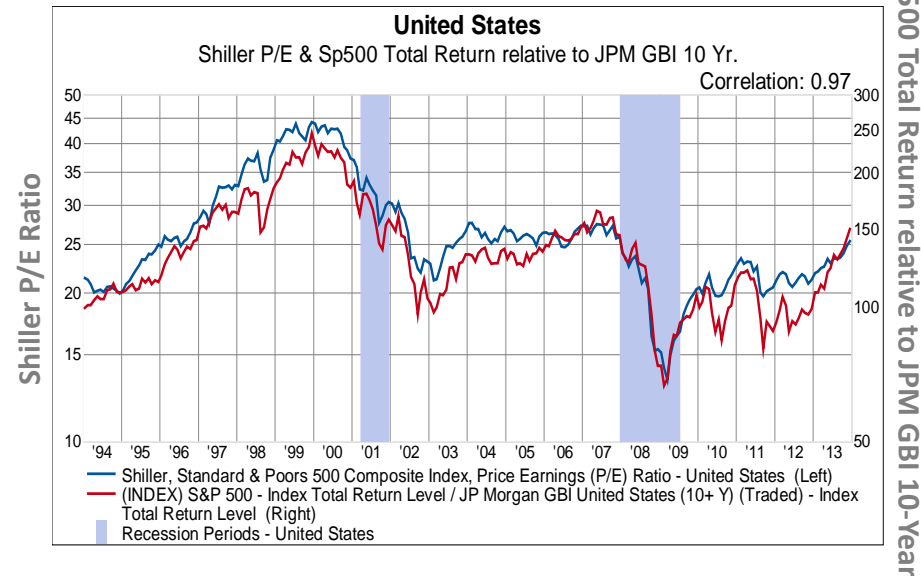


...and many are currently trading within 25% of the highest valuation recorded over the last five-year period— levels not seen since 2007.

# Valuations and the relative performance of stocks vs. bonds are highly correlated.



The Shiller P/E is quite a bit above its historical average—and approaching levels that preceded the last financial crisis.

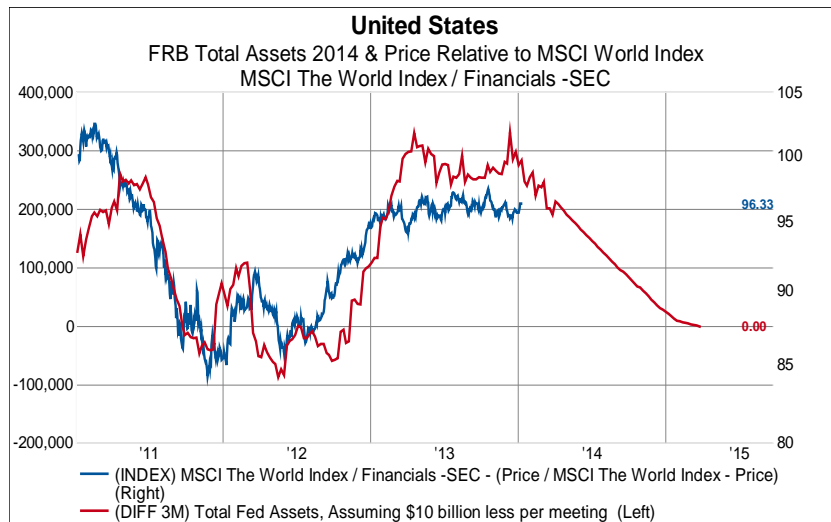


Given the high degree of correlation between the two variables, it does not seem unreasonable to anticipate that the outperformance of equities versus bonds could suffer a setback if the Shiller P/E were to return to more average levels.

## Some areas of the MSCI World Index seem at risk.

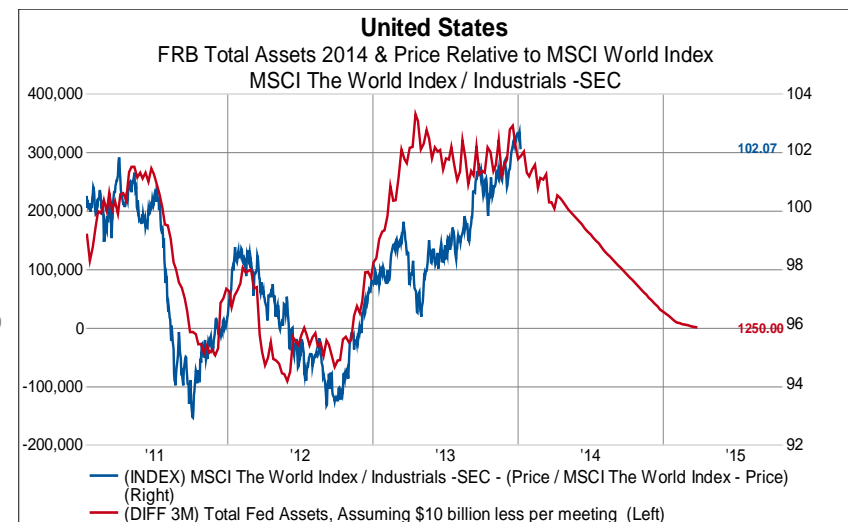
A few sectors seem particularly vulnerable to the tapering of Fed asset purchases: Financials, Consumer Discretionary, and Industrials. Can these groups continue to rise as stimulus is withdrawn? Here we model taper expectations vs. the relative performance of the MSCI World Financial and Industrial sector.

3-Month Change in Total Fed Assets



MSCI World Index relative to MSCI World Financials

3-Month Change in Total Fed Assets



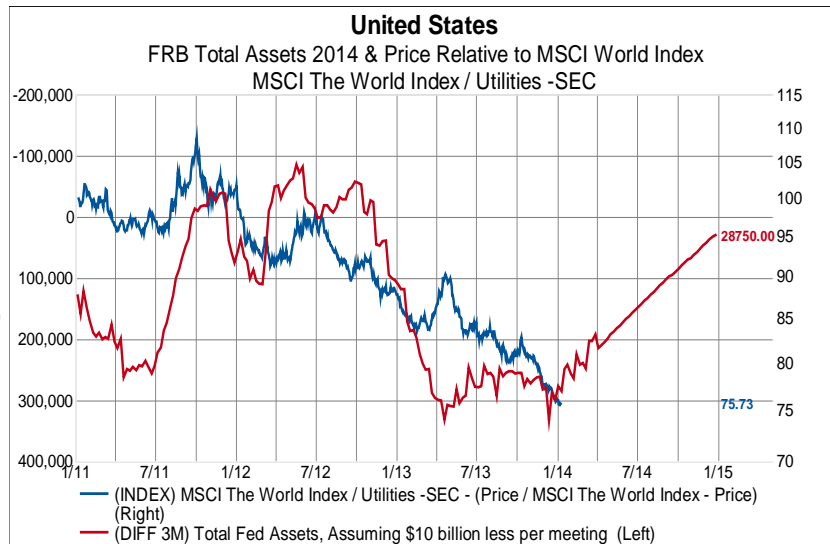
MSCI World Index relative to MSCI World Industrials

## Bond related groups look interesting.

In contrast to Financials, Consumer Discretionary, and Industrials—those sectors that exhibit a positive correlation with QE—the Utilities and Telecommunication Services sectors could benefit from the tapering of asset purchases. Here we invert our model of expected FRB asset purchases to illustrate the positive relationship for these sectors.

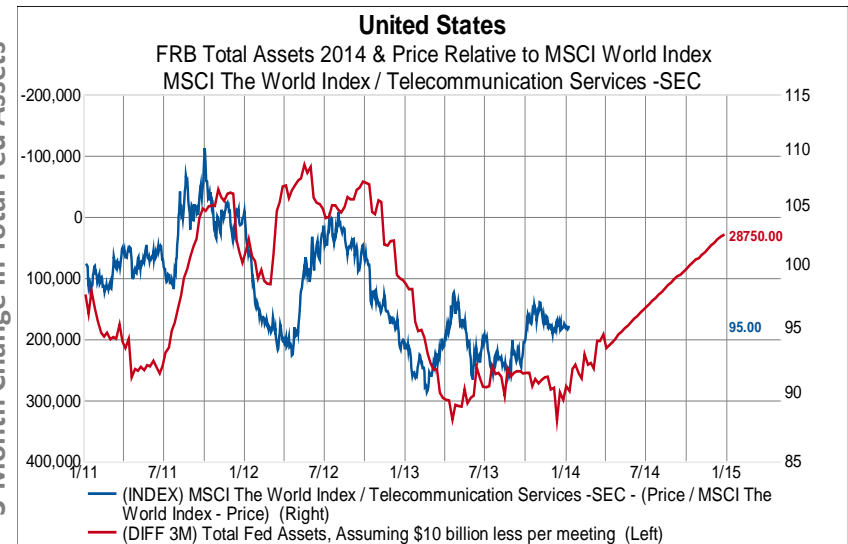
MSCI World Index relative to MSCI World Telecom Services

3-Month Change in Total Fed Assets



MSCI World Index relative to MSCI World Utilities

3-Month Change in Total Fed Assets

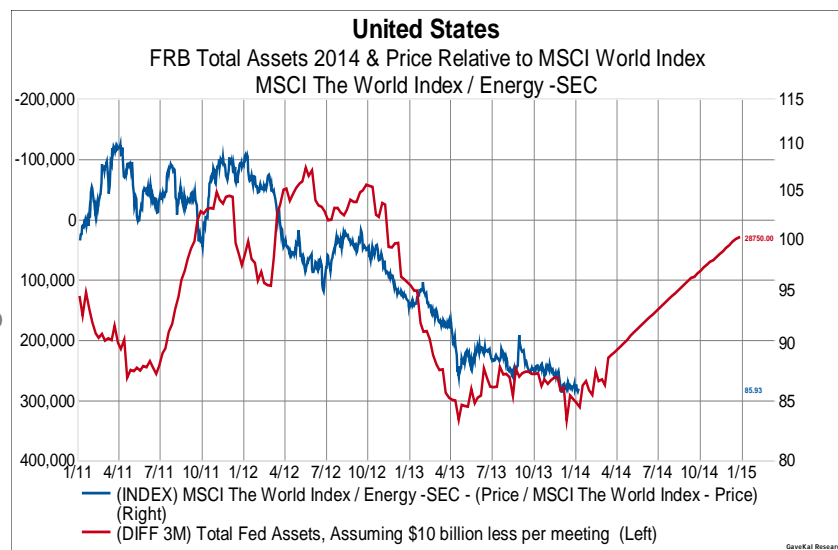


## As do commodity related groups.



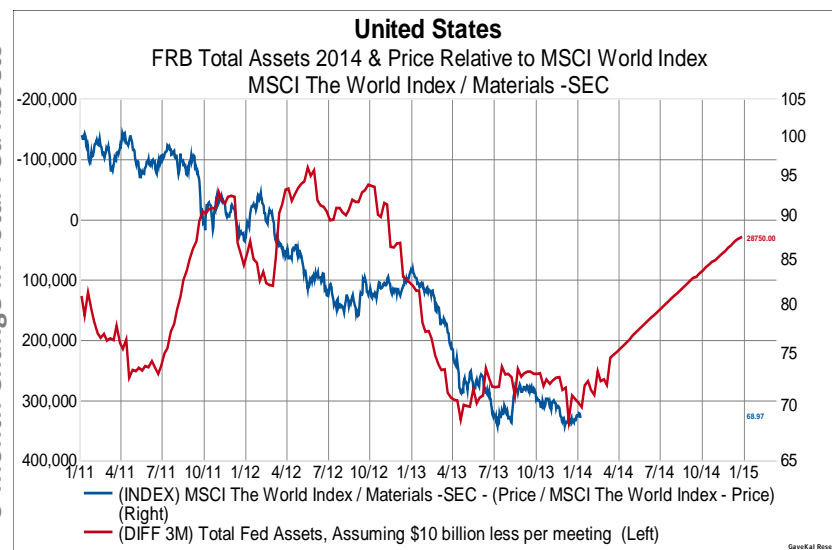
Energy and Materials have also underperformed in the current environment. If the relationship to Fed asset purchases holds, these groups may begin to outperform as the taper gets underway.

3-Month Change in Total Fed Assets



MSCI World Index relative to MSCI World Energy

3-Month Change in Total Fed Assets



MSCI World Index relative to MSCI World Materials

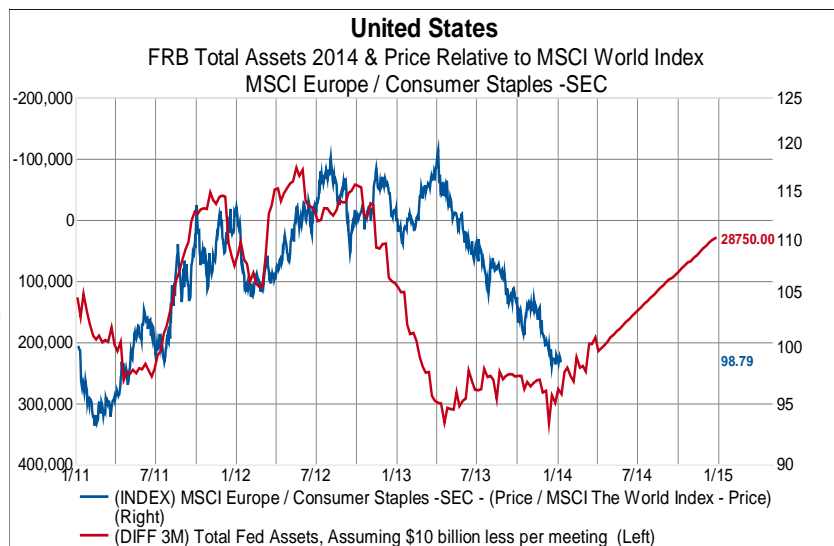
# With some exceptions.



European Consumer Staples and North American Information Technology sectors seem to be bucking the broader sector trends and look interesting also. Here again, we model relative performance vs. an inverted layout of Fed asset purchase estimates.

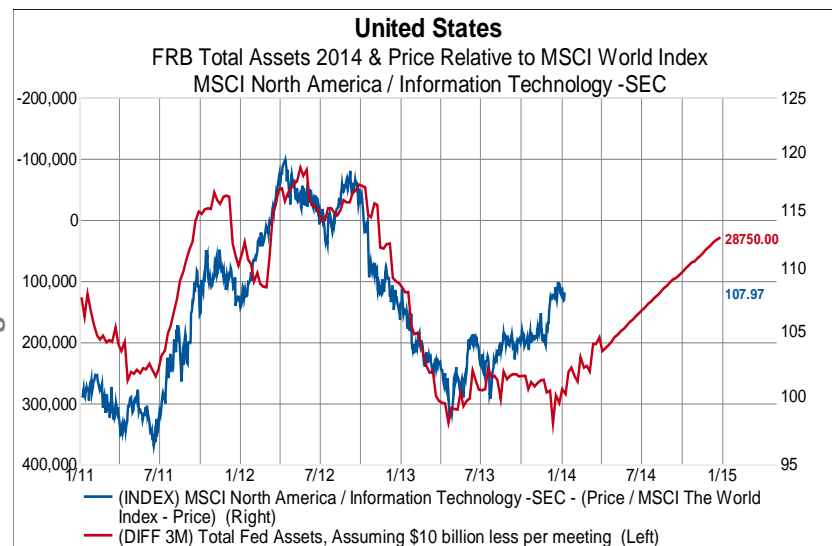
MSCI World Index relative to MSCI World Information Technology

3-Month Change in Total Fed Assets



MSCI World Index relative to MSCI World Consumer Staples

3-Month Change in Total Fed Assets



MSCI World Index relative to MSCI World Information Technology





## To sum up, we think the tendencies may be different in 2014 than they were in 2013.



If the tapering of asset purchases commences as planned, the markets may exhibit the following tendencies in 2014 that will shape our investment strategy:

- 1) Bonds outperform stocks
- 2) Large cap stocks outperform small cap
- 3) Corporate bond spreads widen
- 4) Counter-cyclical stocks outperform cyclicals
- 5) The relative volatility of counter-cyclicals declines, leading to superior risk-adjusted performance for counter-cyclicals
- 6) Bond-like sectors outperform (utilities and telecom)
- 7) Commodity related industries outperform (energy and materials)
- 8) European consumer staples and US technology outperform



## Glossary of Definitions

**Beta** is a measure of the funds sensitivity to market movements. A portfolio with a beta greater than 1 is more volatile than the market and a portfolio with a beta less than 1 is less volatile than the market.

**Alpha** is a measure of the portfolio's risk adjusted performance. When compared to the portfolio's beta, a positive alpha indicates better-than-expected portfolio performance and a negative alpha worse than-expected portfolio performance.

**Sharpe Ratio** uses a fund's standard deviation and its excess return (the difference between the fund's return and the risk-free return of 90-day Treasury Bills) to determine reward per unit of risk.

**Standard Deviation** is a calculation used to measure variability of a portfolio's performance.

**Treynor Ratio** is a risk-adjusted measure of return based on systematic risk. It is similar to the Sharpe ratio, with the difference being that the Treynor ratio uses beta as the measurement of volatility.

**Correlation** is the extent to which the returns of different types of investments move in tandem with one another in response to changing economic and market conditions. Correlation is measured on a scale of  $-1$  (negatively correlated) to  $+1$  (completely correlated). Low correlation or negative correlation to traditional stocks and bonds may help reduce risk in a portfolio and provide downside protection.

**MSCI World Index** is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed markets.

**Active Share** is the percentage of stock holdings in a portfolio that differ from the benchmark index. Active Share determines the extent of active management being employed by mutual fund managers: the higher the Active Share, the more likely a fund is to outperform the benchmark index. Researchers in a 2006 Yale School of Management study determined that funds with higher Active Share will tend to be more consistent in generating high returns against the benchmark indexes.



## Important Disclosures



The value of the securities held by the Fund will change due to general market and economic conditions and industry perceptions. Investments in non-US issuers may involve unique risks including, foreign securities that trade in, and receive revenues in, foreign currencies are subject to the risk that those currencies will decline in value relative to the US dollar. Currency fluctuation, adverse political, economic or social developments could undermine the value of the Fund's investments. The securities of mid-cap companies may be subject to more abrupt or erratic market movements and may have lower trading volumes.

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For investors interested in the GaveKal Knowledge Leaders Fund,  
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at [spaulk@gavekal-usa.com](mailto:spaulk@gavekal-usa.com) or 704.844.6844.

