MainStay Investments®

MARKETFIELD ASSET MANAGEMENT

December 2013

MainStay Marketfield Fund

Fund Overview

Objective

The investment objective of the Fund is capital appreciation. We endeavor to accomplish this by seeking low-volatility absolute returns in excess of broad equity indexes.

Strategy & Process

The Fund attempts to provide returns on capital substantially in excess of the risk-free rate rather than matching any particular index or external benchmark. The Fund has a broad investment charter that allows it to utilize equity securities, fixed-income instruments, commodities, futures and options. Additionally, with respect to 50% of the Fund's net assets, the Fund may engage in short sales of index-related and other equity securities to reduce its equity exposure or to profit from an anticipated decline in the price of the security sold short. The use of short selling could result in increased volatility of returns.

Fund Facts

Fund Statistics

CUSIP:........................Class A: 56064B878
..................................Class I: 56064B852
................................Class R2: 56064B845
Inception Date.............................7/31/07
Benchmark...........................S&P 500 Index
Net Assets .... $19,341 M
Number of Holdings 121

Top Ten Long Holdings (Excluding Cash) (As of 12/31/13)

Tokyo Price Index Futures* 1.9%
Bank of Ireland... 1.8%
SPDR S&P Regional Banking ETF................ 1.6%
Sumitomo Mitsui Financial Group, Inc. (Japan) 1.5%
iShares MSCI Mexico ETF......................... 1.5%
Facebook, Inc. 1.4%
ABB Ltd. (Switzerland)............................... 1.3%
Continental AG (Germany)....................... 1.3%
Bank of Ireland Trust-Preferred Security 1.3%
Alcoa, Inc... 1.2%
TOTAL: 14.8%

Notional Value

Portfolio Allocation (As of 12/31/13)

Equity Long 80%
Futures Long*...................................... 2%
Equity Short 30%
Futures Short* 14%

Option delta not reflected.
Notional Value

★★★★★ OVERALL MORNINGSTAR RATING™ (CLASS I)
AMONG 139 LONG-SHORT EQUITY FUNDS AS OF 12/31/13

Ratings are based on risk-adjusted return. The Overall Morningstar Rating for a fund is derived from a weighted average of the performance figures associated with its 5 year Morningstar Rating metrics. *Class I shares received 5 stars among 139 Long-Short Equity Funds for the three-year period and 5 stars among 75 Long-Short Equity Funds for the five-year period.*

Fund Performance

Quarterly Average Annual Total Returns as of 12/31/13

	Tickers	One Year	Three Year	Five Year	Inception
Class A (Max. 5.5% load) (10/08/2012)	MFADX	10.20%	8.90%	14.00%	8.96%
Class A (NAV) (10/08/2012)	MFADX	16.62%	10.97%	15.30%	9.92%
Class I (07/31/2007)	MFLDX	16.93%	11.23%	15.58%	10.19%
Class R2 (10/08/2012)	MFRDX	16.58%	10.85%	15.18%	9.80%
S&P 500 Index	N/A	32.39%	16.18%	17.94%	6.11%*

*Inception date used was for Class I (07/31/07)

Total Annual Fund Operating Expenses: Class A: 4.15%, Class R2: 3.91%, and Class I: 2.94%; Effective October 5, 2012, New York Life Investment Management LLC ("New York Life Investments") has contractually agreed to waive fees and/or reimburse expenses so that Total Annual Fund Operating Expenses (excluding taxes, interest, litigation, extraordinary expenses, brokerage and other transaction expenses relating to the purchase or sale of portfolio investments, and acquired (underlying) fund fees and expenses) for Class I shares do not exceed 1.56% of its average daily net assets. This agreement will be in effect for a two-year period unless extended by New York Life Investments and approved by the Board of Trustees.

Average annual total returns include the change in share price and reinvestment of capital gains and distributions. Effective 10/8/12, Marketfield Fund was renamed MainStay Marketfield Fund. At that time, the Fund's existing no-load shares were redesignated Class I shares. Performance for Class A and R2 shares, first offered 10/8/12, includes the historical performance of Class I shares from inception through 10/8/12, adjusted to reflect the applicable sales charge and fees and expenses for such shares. Class I shares are generally available only to corporate and institutional investors.

Performance reflects the reinvestment of dividends and other earnings and is net of advisory fees. 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 to the most recent month end may be obtained by calling 800–MAINSTAY (624–6782).

The S&P 500 Index (SPX) is a broad-based unmanaged index of 500 stocks, which is widely recognized as representative of the equity market in general. The securities holdings and volatility of the Fund differ significantly from the stocks that make up the SPX.

Equity allocations may include fixed-income exposure.

Top Five Sectors–Net

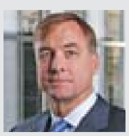
Industrials.. 15.2%
Materials 14.2%
Consumer Discretionary 10.7%
Financials.. 9.8%
Energy 5.6%

Fund holdings and/or sector allocations are subject to change at any time and are not recommendations to buy or sell any security. Current and future portfolio holdings are subject to risk. There can be no guarantee that investment objectives will be met.

Management Team

Michael C. Aronstein
President, Chief Investment Officer, and Portfolio Manager

Michael C. Aronstein is Portfolio Manager of MainStay Marketfield Fund. In 2004, Mr. Aronstein joined Oscar Gruss & Son Incorporated, where he held the position of Chief Investment Strategist. Prior to joining Oscar Gruss, Mr. Aronstein was Chief Investment Strategist at Preservation Group, a provider of independent macroeconomic and strategic advice to professional investors. Mr. Aronstein began his investment career in 1979 at Merrill Lynch, serving positions as Senior Market Analyst, Senior Investment Strategist, and Manager of Global Investment Strategy. Mr. Aronstein spent six years as President of Comstock Partners, a diversified investment advisor, and left to found West Course Capital, a discretionary commodity management firm. Mr. Aronstein graduated from Yale College with a Bachelor of Arts in 1974. His views on macroeconomic and strategic issues are regularly sought by and disseminated through the financial print and visual media. Mr. Aronstein manages $19,341 million in MainStay Marketfield Fund, $341 million in MainStay VP Marketfield Portfolio & $740 million in Marketfield Fund Dublin; total assets under management are $20,422 million.

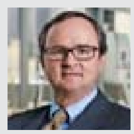


David C. Johnson, Jr.
Principal, Director of Research

Mr. Johnson joined Marketfield Asset Management LLC as Director of Research in April 2011. Mr. Johnson is a graduate of the University of North Carolina at Chapel Hill. He received his MBA in 1984 from Darden School of Business, University of Virginia. Prior to joining Marketfield, Mr. Johnson was an investment analyst, portfolio manager, and head of business development at Wilkinson O'Grady & Co., Inc. He spent the first 10 years of his career in the fixed-income department of Salomon Brothers, where he managed one of its primary sales groups. Mr. Johnson was president of Preservation Group, where he worked closely with Mr. Aronstein.

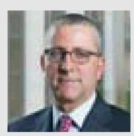
Michael Shaoul
Chairman and CEO

Michael Shaoul also serves as Chief Executive Officer of Oscar Gruss and Son Incorporated, a position he has held since December 2001. He joined Oscar Gruss in 1996 as Chief Operating Officer. Between 1992 and 1996, Mr. Shaoul ran Park Square Associates, a Manhattan-based real estate investment and management company. He was awarded a Ph.D. in Accounting and Finance in 1992 from Manchester University (UK). Mr. Shaoul has written articles on behalf of *Barron's* and has been regularly quoted in *The Wall Street Journal* and Dow Jones Newswires regarding his opinions on the investment markets.



Myles D. Gillespie
Principal, Senior Trader

Myles D. Gillespie joined Marketfield Asset Management in 2007. Myles is a graduate of The Hotchkiss School and holds a Bachelor of Arts degree from Franklin and Marshall College (Class of 1983). From 1983 to 1986, he worked as a stock index futures trader with Henderson Brothers and in 1986 became a NYSE Specialist at Quick & Reilly. He was appointed Executive Vice President of JCC Specialist Corp., the successor firm to Quick & Reilly, in 1989. In 1999 he became President of Fleet Specialist, Inc., the successor firm to JCC Specialist Corp., retiring from this position in 2004. During his time at the NYSE, Myles served as a NYSE floor Official (1993-1999) and NYSE floor Governor (2001-2004).



Andrew Lyss
Principal, Senior Trader

Mr. Lyss joined Marketfield Asset Management LLC in 2012. He was previously Executive Vice President at Oscar Gruss, which he re-joined in 1997. Mr. Lyss previously worked for Oscar Gruss from 1993 to 1995. Mr. Lyss specializes in special situations, including merger arbitrage, spinoffs, bankruptcy, and post-bankruptcy valuations. He has twenty-three years of securities industry experience. Prior to re-joining Oscar Gruss in 1997, Mr. Lyss was employed by Arnhold & S. Bleichroeder from 1995 to 1997 in institutional sales and by Prudential Securities from 1983 to 1989 in varied positions. Mr. Lyss received a BS/BA from the University of Denver in 1982.

Before You Invest

Mutual fund investing involves risk. Principal loss is possible. The Fund invests in smaller companies, which involve additional risks such as limited liquidity and greater volatility. The Fund invests in foreign securities which involve greater volatility, political, economic and currency risks, and differences in accounting methods. These risks are greater for investments in emerging markets. Investments in debt securities typically decrease in value when interest rates rise. This risk is usually greater for longer-term debt securities. Investment by the Fund in lower-rated and non-rated securities presents a greater risk of loss to principal and interest than higher-rated securities. Investments in asset-backed and mortgage-backed securities involve additional risks such as credit risk, prepayment risk, possible illiquidity and default, and increased susceptibility to adverse economic developments.

The Fund regularly makes short sales of securities, which involve the risk that losses may exceed the original amount invested. The Fund may also use options and futures contracts, which have the risks of unlimited losses of the underlying holdings due to unanticipated market movements and failure to correctly predict the direction of securities prices, interest rates and currency exchange rates. However, a mutual fund investor's risk is limited to the amount invested in a fund. Investments in absolute return strategies are not intended to outperform stocks and bonds during strong market rallies.

The Fund involves the risk that the macroeconomic trends identified by portfolio management will not come to fruition and their advantageous duration may not last as long as portfolio management forecasts. The Fund may invest in derivatives, which often involve leverage, may increase the volatility of the Fund's NAV, and may result in a loss to the Fund.

 For each fund with at least a three-year history, Morningstar calculates a Morningstar Rating™ (based on a Morningstar Risk Adjusted Return measure that accounts for variation in a fund's monthly performance, including the effects of sales charges, loads, and redemption fees), placing more emphasis on downward variations and rewarding consistent performance. The top 10% of funds in each category receive 5 stars, the next 22.5% receive 4 stars, the next 35% receive 3 stars, the next 22.5% receive 2 stars and the bottom 10% receive 1 star. (Each share class is counted as a fraction of one fund within this scale and rated separately, which may cause slight variations in the distribution percentages.)

MainStay Marketfield Fund is subadvised by Marketfield Asset Management LLC and distributed by NYLIFE Distributors LLC, 169 Lackawanna Avenue, Parsippany, NJ 07054, a wholly owned subsidiary of New York Life Insurance Company. NYLIFE Distributors LLC is a Member FINRA/SIPC.

MainStay Investments® is a registered service mark and name under which New York Life Investment Management LLC does business. MainStay Investments, an indirect subsidiary of New York Life Insurance Company, New York, NY 10010, provides investment advisory products and services.

Neither New York Life Investment Management LLC, its representatives or affiliates provide tax, legal or accounting advice. Please consult your own advisors on these matters.

The risk-free rate represents the interest an investor would expect from an absolutely risk-free investment over a specified period of time.

Notional is the total value of a leveraged position's assets.

Obtain the Prospectus

For more information, call 800-MAINSTAY (624-6782) for a prospectus or summary prospectus. Investors are asked to consider the investment objectives, risks, and charges and expenses of the investment carefully before investing. The prospectus or summary prospectus contains this and other information about the investment company. Please read the prospectus or summary prospectus carefully before investing.

Commentary

Year End Letter 2013

During the last quarter, our monthly commentaries have begun to explore the question of inflation as a significant macroeconomic factor over the course of the next year. Our interest in this possibility is an outgrowth of a strong feeling that the Federal Reserve Board (FRB) is maintaining a radically expansive policy long past the point of propriety.

To the extent that we are correct in doubting the need for additional monetary stimulus, the consequences will be manifest in an environment that shows evidence of over-stimulation in the forms of excess activity and accelerating nominal prices. On the other hand, if the popular view that rates deflation as the main macroeconomic risk is correct, then the FRB is entirely justified in its current policy path and we are wrong.

At the earliest stages of change in macroeconomic conditions, empirical evidence of the new, emergent regime is scant. The process of discernment is entirely theoretical. It is a function of human reason and the logical, scientific structures that derive from rational consideration.

Economic science and its related forecasting protocols, which we employ as a basis of our investment process, are logical, not empirical in form. Just as there is no need to measure thousands of triangles in order to prove the Pythagorean Theorem, we do not need studies to demonstrate that raising legal minimum wages above market rates reduces total employment or that subsidies provoke surpluses.

A reliance on theoretical processes to forecast economic change makes certain that we will spend a great deal of time defending views that most commentators find far-fetched or nonsensical.

From a practical, portfolio management standpoint, it is imperative that these theoretical musings about large-scale trend changes not be implemented before conditions are actually beginning to change. The risks of portfolio adjustments that are years too early outweigh any potential benefits of utilizing macroeconomic inputs in the asset allocation process. That said, it is important to act when markets are still incorporating the longer-term, macroeconomic factors that one believes to be on the way out. The difference in timing between insight and error comes out in the form of performance.

In the current cycle, plenty of intelligent commentators and managers made the point in 2009-2011 that the relentless monetary expansion undertaken by the FRB was bound to result in inflation. To the extent that they reacted by allocating funds to typical inflation sensitive assets e.g., mining stocks, precious metals, commodity indices, emerging market mineral exporters and inflation-indexed bonds, performance has been disastrous.

Now that these views have been fully discredited and customers have pulled a great deal of capital away from those who held and acted on them, conditions are ripe for change.

The early conflation of FRB policy and the consequent likelihood of inflation were not conceptually incorrect but incorrectly timed. We have said for decades that implementation of macroeconomic views that are several years in advance of market recognition is not a matter of too early but simply another way of being wrong.

Popular media presents an endless stream of heroic commentators who “called,” ex post, every great market dislocation since the 1929 crash. What is never mentioned is that these calls were generally three or four years before the actual event and thus useless in application. By the time such a long-touted event unfolds (if ever), the narrative behind the opinion has been so fully discredited by poor investment performance that clients have moved their assets elsewhere and the manager has become emotionally impaired.

The process of discrediting worries about inflation has been gathering momentum for the past three years. It appears to us to have reached full force with central bankers now uniformly anxious about their ability to create nominal price increases. This is somewhat the obverse of the sentiment that prevailed in 2008-2010, when we had countless discussions with advisors, analysts and business leaders who were concerned that the Fed could not muster enough firepower to prevent a tidal surge of default across fixed income markets and the entire banking system.

Now that nearly every measure of credit distress in the domestic financial system is at record lows, arguments for monetary impotence continue in different form. The fact that five years of balance sheet expansion by the Federal Reserve has not resulted in consumer price acceleration is taken as an indication that they are powerless to affect such an outcome. Prices of non-financial, “main street” goods and services did not respond quickly to the surge in dollar liquidity because the transmission mechanism within the economy was broken.

Commentary Cont.

Households, governments and the banking systems that financed their credit adventures have been in the throes of secular balance sheet restructurings since the panic of 2008. Parallel restructurings and rationalizations in the elements of the real economy i.e., property markets and construction activity have likewise been in process.

The monetary pipeline was blocked by a full blown depression in U.S. home construction and the deflationary policies of the European Central Bank, which presided, ineptly, over the largest economic bloc in the world and did not change policy until the end of 2011. The Bank of Japan was similarly recalcitrant.

The combination of inappropriately tight monetary policy in two of the major developed world central banks, serious rationalization of government finances in the European periphery, U.S. states and municipalities and the draconian restructuring of the majority of the multinational banking system prevented the expansion of central bank liquidity from provoking more than spectacular asset inflation.

The main defects in the transmission mechanism through the real economy are now largely healed. The question is how the inflationary process can migrate from assets' prices to prices of consumers' goods and services.

In order to address the question, one must begin with the morphology of asset inflations and central banks' roles in provoking them.

We come at the issue from a perspective that considers inflationary processes to be monetary in origin. Our working definition of inflation is an inappropriately large (in relation to real economic activity) increase in money and credit.

Once such an increase has, as in the present case, come to pass, the discussion is entirely about consequences. The main focus of this letter is on the symptoms deriving from the inflation of money and credit that has already come to pass. We assume the impropriety of current FRB policy and will not further argue that point. Time and markets will tell if that basic assumption is correct.

Inflations are pernicious aspects of economies mainly because their effects are so uneven, or, in more popular parlance, unequal.

There would be little to object to in a circumstance where prices, wages and asset values were suddenly revised higher by 20%. Assuming this process was applied to bank balances and credit instruments, the resulting distortions would be manageable.

Unfortunately, the actual effects of monetary inflation are manifest throughout the global economy in highly uneven fashion. The process produces clear groups of winners and losers. The characteristics of the members in those categories vary from cycle to cycle. Beneficiaries range widely from owners of raw land (Japan 1980s, U.S. 2001-2007), to oil producers (1970s) and owners of residential property in financial centers (2010-present). Each of these episodes has countless subcategories comprising beneficiaries.

The main burdens in each case fall upon those who are not involved in the parts of the economy that are enjoying the boost from inflationary policy but are still in need of goods and services, the real cost of which continues to rise. There is a real transfer of wealth from the second group to the first. If it persists long enough, the disparity becomes extreme.

We can recall the height of the oil boom and the depth of the bond bear market in the early 1980s, when a two bedroom apartment in Manhattan cost less than a two bedroom starter home in Houston. Petroleum geologists, not fixed income managers, expected helicopter transport to work sites.

The effects of monetary inflations within the real economy arise in accordance with the different pathways of credit expansion at work in each cycle. At the outset of every inflationary cycle, there is always a collateral form that enjoys good fundamental supply/demand characteristics available to transmit the monetary impulse. It is never the asset type that the central bank is attempting to repair.

Expansive monetary policy always follows periods of distress, when policymakers see something that needs to be rescued. The distressed assets are normally those that were the focus of enthusiasm in the prior cycle. As monetary conditions are eased in response to the distress in a dying mania as took place in housing and housing finance in 2008-2009, that sector is never the beneficiary of the increased availability of credit. Bankers and investors will not willingly return to the collateral types that have just caused them the most extreme pain.

Commentary Cont.

With the credit spigots open, there is always some unimpaired sector that can serve as collateral with no apparent risks. In the current cycle, emerging market economies gathered a disproportionate share of the global credit excess that began after the Panic of 2008. They were not involved in the U.S. and European property mania, had been growing steadily since 2002 and were, as a result, regarded as pristine borrowers.

The remarkable cycle of issuance in emerging market credit since 2009 strikes us as the primary locus of the inflation engendered by Federal Reserve policy.

It is difficult for observers to put the process in context because it is, like every important macroeconomic cycle, unique and without direct precedent. The inflationary mechanism utilized by the Fed in the present circumstance relies less upon the traditional avenue of expanding bank credit and more on the direct stimulation of fixed income markets.

By supporting bond prices at above market levels, the Fed is, in essence, maintaining a massive subsidy for issuers. There is little difference in form between QE 3 and the various agricultural price support programs undertaken by governments around the world. Their end result is always the same—a surplus of the item that is being held at above market prices.

All artificially elevated prices eventually provoke surplus production. The bond markets since the beginnings of QE have been no exception. Because the Fed has confined its purchases largely to high quality government and mortgage bonds, the field has been cleared for other issuers of lesser quality to jump into the void.

And jump they have.

We will not recapitulate the statistics regarding global fixed income issuance during the past three years. Suffice it to say that despite the Fed's absorption of more than three trillion dollars of bonds from the open markets, the corpus of outstanding issues has still managed to grow.

In response to price declines in cotton and distress in the farm sector, the Chinese government introduced cotton price supports in 2011 and 2012. These were above world market levels. Today China is warehousing enough surplus cotton to supply more than half of the world's annual needs. Unless wearing four pairs of underwear at once becomes the new fashion, the Chinese have a major problem.

The Federal Reserve has painted itself into a similar corner. Fixed income issuance since the onset of QE 2 has comprised a variety of overvalued and lesser quality instruments of little practical use. The old Wall Street admonition about learning the difference between eating sardines and trading sardines (which are never meant to be opened or consumed, merely passed back and forth among traders) is particularly apt as pertains to contemporary fixed income markets.

A ten-year bond with a 1.5% coupon is about as useful as teats on a bullfrog. It is a trading sardine with no practical, fundamental output value to the investor. It does not hold up next to cash as a safe haven. The only hope in owning it is to make a trading gain, which, on the heels of a 31-year bull market, is a dangerous business.

More egregious overvaluations were evident in the offerings from emerging market sovereign and corporate issuers. Their dollar bonds had the dual features of extraordinarily low rates and questionable credit fundamentals. Like Chinese cotton, Thai rice or U.S. sugar, price supports (by the FRB) have created a bond glut.

The inflationary aspect of the bond glut is the extraordinary flow of cash to issuers. For the past three years, it seemed as though anyone able to spell 'bond' was considered qualified to issue them.

The distortions in prices enabled by unprecedented and nearly unlimited access to credit markets have been profound. The most straightforward has been the corporate balance sheet arbitrage whereby companies have issued overpriced bonds and used the proceeds to buy back their own stock. This has been an obvious method of taking advantage of the implicit price supports offered by the Federal Reserve.

The capital structure arbitrage employed by developed market companies has been a meaningful factor in propelling equity prices and provoking resentment among those not enjoying the benefits.

Commentary Cont.

The liquidity flood emanating from the fixed income markets has had the most striking effects within the developing world. The hyperinflationary spirals of property in Western financial centers, bad art and luxury goods are celebrated in ever-grander gatherings and heavier magazines.

The question at hand is whether this liquidity flood will now make its presence known in more prosaic aspects of the global economy.

An easy first look can be had directly within emerging market economies. Broad and accelerating inflation has become the norm. In China, Brazil, Russia, Indonesia and India, among others, wages and prices are increasing at between 10 and 20% per annum. A portion of the increases in goods' costs is attributable to the weakening currencies and the withdrawal of subsidies that have held prices of fuels, power and certain staples at artificially suppressed levels. The costs to central governments of maintaining payments to producers and importers to hold prices below market levels have exacerbated current account shortfalls and further weakened currencies and local bond markets. As these are withdrawn, costs of living increase rapidly for the lower and middle classes, and demands for legislated wage increases intensify. The process is self-reinforcing.

To the extent that these governments have sufficient reserves and are inclined to support their currencies in the face of current account shortfalls, that activity has the effect of tightening local capital markets' liquidity (withdrawing local currency by purchasing it for dollars) and placing more stress on internal debtors.

The inflation, credit distress and capital outflows are consequences of the liquidity booms that proceeded in the aftermath of 2008. That process was and continues to be supported by the flood of dollar liquidity induced by the Federal Reserve.

The inflationary response to inflationary policy appears first in the developing world because they did not have the deflationary sinkholes opening in their economies between 2007 and 2010 that prevented anything other than asset inflation in the U.S. and Western Europe.

In order to consider the possible domestic influences of the inflation underway in emerging markets, we will go back four decades to look at a potential line of transmission.

During the explosive growth of the American consumer economy during the decades following the Second World War, a key input factor was an apparently limitless supply of cheap energy from domestic discoveries and from newly acquired allies in the Middle East.

In many regards, the repressed price of hydrocarbons was a crucial factor (along with our returning military personnel and the destruction of the rest of the world's industrial capacity) in allowing the U.S. to vastly outperform every other economy on Earth. The development of a far-flung, suburban consumer infrastructure was enabled by the very low cost of automobile travel.

A generation after the end of World War II, the presence of inexpensive fuel was taken as a given throughout our economy.

The first oil shock in the early 1970s set the stage for a long, disruptive cycle of inflation and recession. It culminated with record high interest rates and a near collapse of the dollar. The oil supply shock, while real, was simply the proximate trigger for the generalized acceleration of inflation. The enabling fundamental was the Federal Reserve's effort to head off a countervailing deflation in the non-energy related portions of the economy by inflating the money supply sufficiently to accommodate rising energy prices without that increase coming out of some other price.

Recall that in a stable monetary environment, a rise in the price of item A will be counterbalanced by falls in other prices. This is what the FRB of the early 1970s wished to prevent. In its stead, it provoked a much more serious and destabilizing trend, where rising prices and falling real incomes spread across all corners of the economy.

At present, there is a somewhat analogous system of external dependence and fears of deflationary chimera at work in the U.S. economy, although they do not involve OPEC and oil scarcity.

For more than two decades, we have come to rely on the extraordinarily inexpensive manufactured goods produced in the developing world. China is a particularly clear example of this. The trend of relocating global manufacturing capacity outside the developed world accelerated in the aftermath of the 1997-1998 Asian currency crisis. Their abrupt, involuntary devaluations further lowered costs and prices from the perspective of Western manufacturers and consumers.

Commentary Cont.

The long migration of manufacturing capacity to Asia was abetted by the very loose monetary policy maintained by the Federal Reserve between 2001 and 2005. The process was then turbocharged by the radically accommodative policy measures arising in the aftermath of 2008 and continuing to this day.

The initial macroeconomic effects of the mass movement of capacity to low cost regions were deflationary for Western economies. These effects were particularly glaring in regions of the U.S. that had been devoted to traditional industrial processes. Wages, standards of living and overall measures of prosperity were relentlessly depressed.

The bankruptcies of two of the three remaining U.S. automobile manufacturers and the city in which they were headquartered probably marked the nadir. Readers should keep in mind that in 1926, the most expensive commercial property on the planet was on Dearborn Avenue in Detroit. Things change.

The processes by which labor unions and their legislative allies raised the costs of labor well beyond the growth of productivity created the basic incentive structure for companies (and consumers) to look overseas for greater value. The inevitable readjustment of wage levels from their artificially elevated heights two generations ago has been taken up by the mainstream economics community and much of the financial press as proof that there are fundamental flaws in labor markets that need administrative remedy.

The fact is that wage rates in the U.S. have finally adjusted back to levels at which they are well supported by productivity, and without political interference, should begin a cycle of real growth.

A similar cycle of wage deflation has been evident in parts of Europe since the onset of their crisis, and in much of the periphery, private labor costs are approaching levels where they are competitive on an international scale.

The extraordinary largess of the Federal Reserve has not, with some limited exceptions, raised U.S. wages, commodity prices or costs of retail goods, and in light of these facts the consensus view of the economy now holds deflation as a much more worrisome probability. Nearly every mainstream forecaster dismisses the possibility of a serious inflationary trend out of hand.

Price shocks that would undermine the accepted picture of economic risks in the U.S. and Europe have already progressed well beyond the embryonic stages in the parts of the emerging world that we have come to rely on for an endless supply of inexpensive manufactured goods.

Wage rates in China and most of developing Asia are continuing to grow at double-digit rates. Inadequate power and transportation infrastructure further undermines any cost advantages that have characterized the region since the mid 1990s.

Asia is the present day OPEC of manufactured products. We in the West have provided access to our robust consumer demand and manufacturing expertise in exchange for a generation of remarkably inexpensive consumer and intermediate goods. A sustained rise in prices from this corner will catch the investment community and central banks completely unprepared.

Most observers are discounting the risks inherent in inflationary processes now underway because their focus is on commodity prices and developed market wage rates. Both have been very subdued. In addition, anyone who has sounded the alarm regarding inflation since 2009 has been made to look quite foolish by markets and economic data flows. Most in that camp appear to have surrendered, a normal sign of trend change.

Commodity prices are still being depressed by the withdrawal of institutional investment capital that was sold the fiction of a "commodity super-cycle" right as it was ending some five years ago. The influx of passive capital to the strategy of owning large stocks of commodity inventory helped to create the final peak in prices. Large increases in productive capacity were the normal industry response to the price spikes. Both are being unwound and keeping most index contained commodities relatively docile.

Commentary Cont.

Wages in the developed economies are in the midst of a long correction from unsustainably elevated levels. The process is complete in the vast majority of the private sector, particularly in manufacturing. The correction of unsustainably elevated public sector employment cost is underway, having progressed much farther in Greece and Detroit than in New York City. This is part of a long process of global cost rationalization that has made its way through the private sector and is just taking hold among governments.

Price rises at the emerging economy end of the global supply chain would seem a natural prompt to capital and capacity migration back to the developed world. To some extent this is already underway. An important surprise will develop when it becomes clear that there is a great deal less spare capacity in developed economies than statistics would indicate.

Pressures on corporate managers to conserve equity capital (the apparent, real costs of which are high and difficult to determine) are substantial. There is a large cadre of analysts and "activists" leaning on managers to close, sell, reduce and rationalize capacity. Marginal facilities that are counted by statisticians as unused capacity may, in actuality, have no real productive value.

We suspect that the same is true in the labor force, where the skills mismatch between the unemployed and those needing workers capable of participating in modern manufacturing processes is insurmountable.

It is becoming quite clear that the popular imperative among central bankers in the developed world is to make monetary inflation manifest in prices and wages. The choruses of academia and politics are supporting them in this endeavor. A form of militant altruism has arisen as the new intellectual fashion among the very rich and powerful. Davos 2014 has become the Woodstock of guilt.

Present efforts to speed the migration of price increases from assets to goods and wages are not just superfluous but harmful. The tragic harm consists in the fact that the burdens of policy error will fall most heavily on those at the bottom of the economic ladder.

If there is just one thing about the relationship between economics and society that readers of this letter take away, it should be this; economic inefficiency kills prospects of the poor. Always and everywhere and in spite of good intentions (which are indeed pavement on the road to Hell).

In every cycle comprising unusual macroeconomic features, there are clear beneficiaries and victims. This one will be no different.

Companies with capacity that is difficult to replicate or substitute for will be at great advantage, assuming that they are able to compete for the labor required to satisfy additional demand.

Businesses that depend upon price advantages from emerging market inputs will begin to see cost pressures. Some will be able to pass these through, but few will have the ability to continue to take costs from their domestic labor force. Real wages at all points in the domestic economy look set to begin a long advance.

Commodities prices should be widely dispersed, with local supply/demand conditions playing a much larger role than institutional capital flows. Real costs of production in certain parts of the world will rise dramatically as the phenomenon of absurdly low wage rates in developing markets begins to abate.

In past cycles, equity valuations have not responded well to unanticipated increases in reported inflation. The negative response often takes time. At present, it is clear in the case of Emerging Market equities, where we have just entered year three of the bear market. Investors seem to be noticing, but there is still a stubborn adherence to the idea that the future of global economic progress will be led by the developing world. We continue to believe otherwise.

Commentary Cont.

As 2013 drew to a close, our portfolio was continuing to move toward those companies that would fare better in a world where prices in the real economy started to catch up with prices of investment media. Our short portfolio remains concentrated in emerging market assets, where the benefits of the radical largess of Western central banks have been most profound and fundamentally unsupported.

As many of you are aware, the fund has experienced remarkable asset growth during the past year. We are acutely aware that this is not a good portend for ensuing performance. Our style and methods of execution remain deliberate and long-term, as they have been from day one. They are now matters of necessity as well as inclination, but the day-to-day processes within the firm have not changed. Results will continue to depend upon our ability to gain some differentiable insight into the complex macroeconomic processes that drive changes in capital assets' pricing and output.

As always, we are extraordinarily grateful for your support and welcome your questions.

January 27, 2014

Michael C. Aronstein
President, CIO & Portfolio Manager

The information provided herein represents the opinion of the Portfolio Manager and is not intended to be a forecast of future events, a guarantee of future results, nor investment advice.