

Why Vice Stocks Make Sense.

A conversation with Jeff Middleswart, Portfolio Manager of the Vice Fund (VICEX)

Q1: The Vice Fund invests in Tobacco, Alcohol, Gaming, and Defense companies, can you explain the investment merits of investing in vice stocks?

There are numerous potential benefits to investing in vice stocks beyond the widely held belief that are regardless of what happens to the economy people will drink, smoke, gamble and hunt. For example, vice stocks often pay higher dividends than the equity market, a lesser known fact, but one that is incredibly important in today's economy.

The most obvious advantage to many vice-related companies is great barriers to entry, thus many do not face crushing competition. That benefit has allowed them to boost prices in recent years and post revenue and income growth. Customers consume the products regardless of economic conditions, so results have historically been very stable. Costs for the combination of capital spending, research and development, marketing, and new product introductions are lower than many other industries, as they do not need to reinvent their product line every 6 to 18 months. It also means lower personnel training and consumer education. The net result of strong pricing power and lower costs is high cash flow. Additionally, these companies have benefited from industry consolidation that has further improved pricing and cost structure, and driven cash flow higher. And that cash flow is used for three things:

» Dividends. Vice stocks generally pay higher dividends than the market. Consider that dividends have historically

made up about half of a typical stock's total return, so vice-related investments are ahead of the game in that department. Also, dividends help to limit downside exposure when the market falls because an attractive yield can boost interested buyers for the stock.

- » Share repurchases. Buybacks can drive earnings-per-share (EPS) growth faster than actual net income, which, in turn, can boost the potential stock return for investors.
- » Industry consolidation. Excess cash may be used for acquisition growth, which could set off another round of cost cutting measures and pricing power enhancement, all of which may increase shareholder value.

Q2: With tobacco use in the United States falling, why is investing in vice stocks attractive?

Tobacco use in the United States is falling, but consumption is still rising in many emerging markets, such as China and Eastern Europe. Price increases and cost-cutting measures have more than offset domestic U.S. volume declines, and these companies have managed to produce higher income and cash flow.

In my view, tobacco stocks represent some of the most shareholder-friendly companies in the world. In fact, more than 70% of the industry's total cash flow is allocated directly to shareholders.

Also, consider that while the equity market has a current dividend yield of roughly 1.9%, tobacco companies are generally paying a 5% to 7% yield. These compa-



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nies are buying back outstanding shares and this has the effect of driving EPS growth higher.

And overall valuations are still attractive. The industry's price-to-earnings-growth (PEG) ratio, a convenient measurement of a stock's price-earnings ratio divided by the EPS growth rate, is currently 1.1x. A ratio of 1x is desired, as it indicates the relative trade-off between the market price of a stock, the earnings generated per share (EPS), and the company's expected growth is in line.

For all these reasons, we believe Tobacco remains an attractive area.

Q3: Are vice stocks in a growth mode or is the industry in a mature state?

Vice stocks, in general, are very mature and in established markets, such as the U.S., Canada, Japan, and Western Europe. However, in many of parts of the world, especially China, India, Brazil, Eastern Europe and Africa, vice stocks could be considered to be in a state of growth.

Whether you look at tobacco, alcohol, gambling, or defense/aerospace - vice companies are largely benefiting from replacement demand. Price increases and cost reductions have been made to offset steady volume declines. We believe the businesses in these areas are cash cows and have rewarded shareholders with dividends and repurchased shares.

In the aforementioned regions of growth, as people get richer and countries urbanize, those citizens trade up to name-brand cigarettes and fancy booze. Many start to gamble more for recreation, the developing countries benefit from more air travel, and many seek more sophisticated defense programs, which also leads to greater airplane purchases.

Q4: How should the Fund be positioned in client accounts? Is the Vice Fund an alpha generator or a defensive play?

We believe the Vice Fund should represent a core holding in a client's account. In fact, numerous academic studies show that companies with above-average dividends tend to outperform. Plus, we believe that these companies are not going to see their products undergo tremendous change (i.e. cigarettes and beer have been seemingly around forever, so these products are not fads). Their high barriers to entry prevent competition from impacting results in any material way and many have the cash flow to buy competitors as they see fit.

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The Fund is designed to generate alpha and be a defensive play. Alpha arises because the stocks tend to show strong and steady EPS growth.

The defensive nature of the Fund is attributed to the low P/E ratios of many vice-related stocks, as there is widespread belief that a number of these companies do not grow. Historically high dividend payouts also help to buffer return, which provides added protection. Consider these stocks are also real companies, many with household names, and products most consumers can identify. For that reason, when the dividend yield rises, the price declines and attracts more buyers.

Q5: Recently, the Fund's portfolio manager was changed. What is being done differently today than before?

You are correct. In early February, the Vice Fund ceased being sub-advised and is now being managed in-house. Changes with the new Fund Manager are several:

- » The Fund was taking minor short sale positions in 2008 and early 2009. Those actions have been eliminated and the Fund intends to be long-only going forward. The financial situations of these industries and their high dividend payouts make shorts sales tough, which can detract from performance.
- » The Fund has in the past been very overweight in some sectors and seriously underweight in others, among Tobacco, Defense/Aerospace, Gambling, and Alcohol. Going forward, while the Fund may never be 25% invested in a sector, as there will be better opportunities in one area than another at times, the weighting will be closer to equal, to take advantage of the historical results that show a balanced portfolio of these industries tends to outperform the market over time.
- » Dividends are being emphasized even more. The ideal would be to have 100% of the holdings generating cash dividends. That is not always possible, but we have reduced the non-dividend paying and short positions that would result in negative dividends paid on borrowed shares to about 10% of holdings at this point. Stocks not paying dividends in the 7%-8% range of total holdings is the realistic goal.

For additional information on the Vice Fund, please visit ViceFund.com or call 866.264.8783.

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Past performance does not guarantee future results.

The Fund's investment objectives, risks, charges and expenses must be considered carefully before investing. The statutory and summary prospectuses contain this and other information about the investment company, and they may be obtained by contacting 866.264.8783 or go to www.USAMutuals.com. Read it carefully before investing.

Mutual fund investing involves risk; principal loss is possible. The Vice Fund is non-diversified, meaning it may concentrate its assets in fewer individual holdings than a diversified fund. Therefore, the Fund is more exposed to individual stock volatility than a diversified fund. The Fund invests in foreign securities, which involve greater volatility and political, economic and currency risks and differences in accounting methods. The Fund invests in smaller companies, which involve additional risks, such as limited liquidity and greater volatility.

The Price to Earnings (P/E) Ratio is calculated by dividing current price of the stock by the company's trailing 12-month earnings per share.

Alpha is an annualized return measure of how much better or worse a fund's performance is relative to an index of funds in the same category, after allowing for differences in risk.

The Price to Earnings Growth Ratio (PEG) is calculated by dividing current price of the stock by the company's annual earnings per share growth.

Earnings per share (EPS) is calculated by taking the total earnings divided by the number of shares outstanding.

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