All Returns Net of Fees	**Prime Long Only**	S&P 500 Including Dividends	**Prime Traditional Long/Short**	HFRX Equity Hedge Index (Long/Short)	**Prime Ultra Hedged 50% Cash Unlevered (50:40)**	HFRX Market Neutral Index
2009	74.86%	34.23%	40.72%	12.94%	36.16%	-5.09%
2010	106.71%	15.06%	95.91%	8.92%	34.56%	2.64%
2011	13.02%	2.11%	18.31%	-19.08%	7.54%	-2.92%
2012	23.70%	16.00%	16.18%	4.81%	5.38%	-4.66%
2013	115.06%	32.39%	56.86%	11.14%	20.85%	1.72%
2014	-1.86%	13.69%	-7.33%	1.42%	-4.04%	3.63%
Annualized Net Gain[1]	**48.37%**	**18.39%**	**32.89%**	**2.74%**	**15.77%**	**-0.84%**
Overall Net Gain[1]	**966.59%**	**175.34%**	**450.85%**	**17.60%**	**140.81%**	**-4.96%**

Dear Investors and Friends,

As you can see above, Prime just finished our first year in which we had negative performance. The long side of the book on a levered basis was down -1.86%, and on an unlevered basis was actually up 0.56%. Our Traditional Long/Short product was down -7.33%, while our Ultra Hedged Unlevered portfolio (90 gross) was down -4.04%.

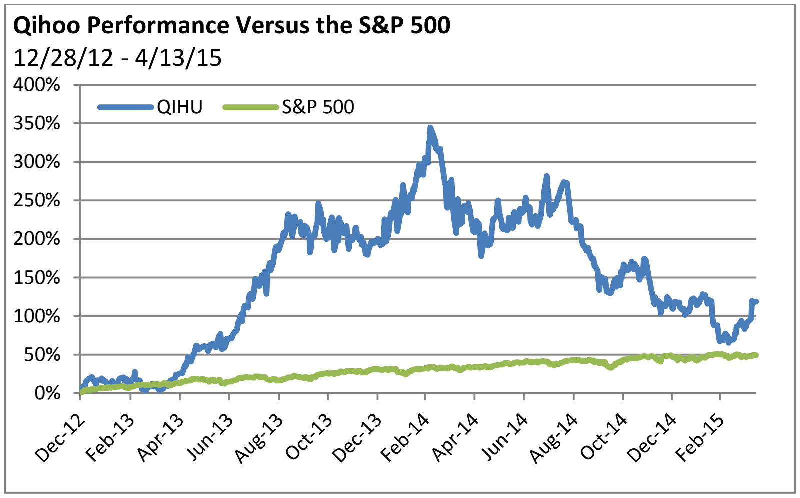
On the short side, Intel was our worst performer last year. Overall, since we bought it over three years ago, the stock has performed reasonably well as a short, underperforming the S&P 500 by approximately 5%. Underperformance, of course, is what you look for in a short. So far this year,[2] Intel's stock is already down -12.57%, while the S&P is up 1.63%, so it is doing well in 2015. In 2014, however, it *out*performed by 28%, but in the previous two years it underperformed as we envisioned (by about 4% in 2013 and 8% in 2012). This goes to illustrate why you can't pay too much attention to any one stock, especially over the short term.

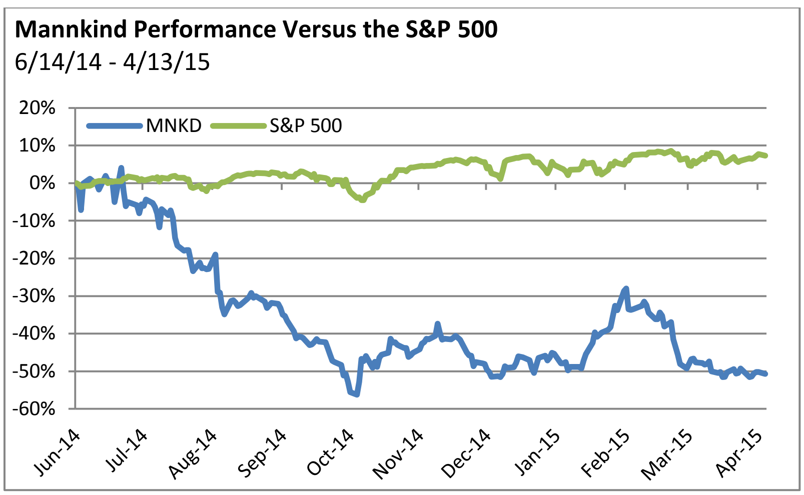
As for Intel's performance in 2014, we frankly didn't expect the company to do so well on the server side, as people were adapting to the Cloud. We also thought the PC business would continue its rapid decline in 2014, but a Windows update helped to slow that decline. Much of what also saved last year for Intel was Microsoft's ending of its technical support for its Windows XP operating system, which forced many large businesses to upgrade their computers. In another move, one that helped its stock but diminished its balance sheet, Intel spent a cumulative $15 billion on share buybacks and dividends last year. That was $5 billion more than it generated in free cash flow.

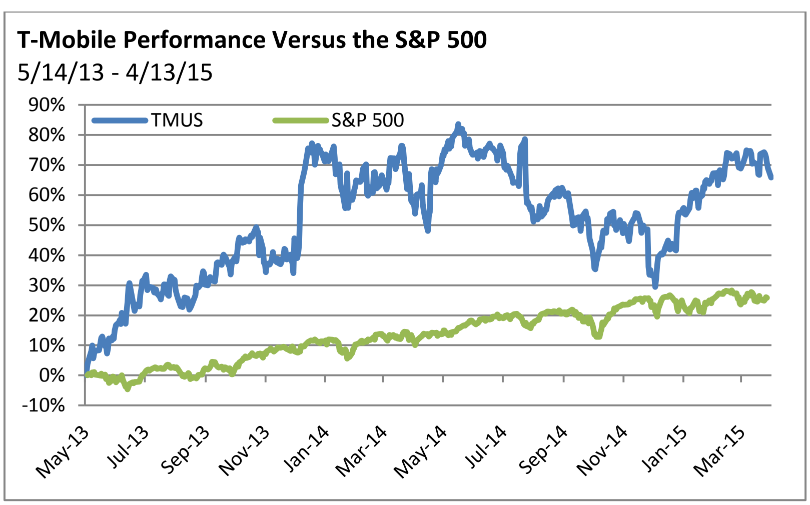
We still think our longer-term view of Intel holds water, and its performance in 2015 is starting to reflect that, in line with its own recent announcement revising its revenue guidance downward by approximately $800 million due to ongoing slippage in the PC side of the business. Worldwide computer shipments during the first quarter of 2015 dropped nearly seven percent from last year's first quarter, according to research firm IDC.

In another recent development, Amazon and others have begun rolling out desktop software that runs in the cloud. This is a scenario that simply was not practical or viable even two years ago. Now almost every software vendor has made its mission critical applications available on the cloud, including the Microsoft Windows 7 desktop and Office, and many software applications are now popping up as cloud-only. The significance of this is that users will now be able to access the equivalent of their desktop from any cell phone, tablet, or PC. Since all of the actual computing is done in the cloud, it may also make viable a transition from more expensive PCs to "dumb terminals" for many companies. Even if the latter does not come to fruition, just the migration to mobile devices, where Intel is far from being the dominant player, will further the trend of the downsizing of PCs and their pricing. At a $160 billion market cap, Intel has a lot of issues to contend with over the next five to ten years.

On the long side—where *out*performance is obviously what you look for—the largest underperformers last year were Qihoo, Mannkind, and T-Mobile.







We bought Qihoo at the end of 2012 (December, to be exact), and in 2013, Qihoo outperformed the S&P for us by 146.76%. In 2014, it underperformed the S&P by 41.60%. All in all, from the time we purchased it, Qihoo has been up 118.92%[2] as opposed to the S&P's 49.20%[2]—not a bad level of outperformance in just over two years.

What's really noteworthy here is that Qihoo has been behaving the way we expect individual stocks to behave—up, then down, then up, then down, but with an overall trend in the direction we anticipate. We believe stock market investing is all about understanding the complexities of the market and being patient.

We entered a relatively small biotech position in Mannkind in June 2014, and in 2014 Mannkind underperformed the S&P by 55.81%. This is a very volatile stock, and one of the smaller market caps in our portfolio at only $2 billion. We expect a lot of bumps in the road with this one due to the nature of the company, its industry, and its size, but do anticipate its doing well overall. We entered the position with about a 2% stake.

Our third biggest loser for 2014 was T-Mobile, which we wrote about last year. It was down -19.92% in 2014. But it's hard to be too critical about TMUS; it's up 65.91% versus 26.79% for the S&P from the time we bought it in May, 2013,[2] a number we find very favorable to our bottom line.

It's important to note that we still like the above investments, and we're still in them—however, we have no problem exiting positions when conditions change and they no longer appeal to us, as we'll discuss later.

As for positions that performed well, our top longs were, in order of best performing, Tesla, Chipotle, and American Railcar Industries, which were up 47.85%, 28.48%, and 12.57% for the year, respectively, and our best performing shorts were ArcelorMittal, TripAdvisor, and IBM, which were down -38.17%, -9.86%, and -14.46% for the year, respectively.

Perhaps the most important thing we did right though in 2014 was continue to follow our investment parameters. As you'll read below, this is the single most important practice we undertake. Long-term viability is always our goal. We will spend the next several pages discussing various aspects of our investment strategy, presenting the logic of some of our existing positions, and looking at our top holdings. But this is all done with a "big picture" outlook, because that is how we operate and how we invest your money. Yes, it is important to look at short-term performance, and we will put our short-term performance up against anyone's as you'll see, but when it comes to understanding the individual investments we make, and our company and portfolio as a whole, it is wise to take a longer view. We consider ourselves to be investors, not speculators.

The way we see it, the short-term fluctuation of our individual stocks is a microcosm of the securities industry as a whole. After all, 2014 was our worst-performing year, and it came right on the heels of our best year thus far, 2013, in which we were up 115.06% net of fees (154.40% gross) on the long side. This pattern is not uncommon in the market—a great year followed by a not-so-great year, and vice versa. The same thing happened after our previous best-performing year—we went from 106.71% in 2010 to our then-lowest performance of 13.02% in 2011. We then returned 23.7% in 2012, 115.06% in 2013, and then had the -1.86% year in 2014. Yet what changed between 2013 and 2014? Our strategy and our risk management remained the same, and our number of positions was almost identical across the two years (55 in 2014 and 53 in 2013). We had the same strict loss limits and portfolio concentration limits in place; our sector diversification was the same, with approximately seven sectors on both the long and short side; and, importantly, we maintained the same long-term fundamental value based approach we've employed since our inception.

If you look at it on an aggregate basis, our long performance over the past two years was a little above the average of our six-year track record, and, remember, a two-year minimum timeframe is how we've always suggested investors look at our performance (see Ground Rules). We had a huge up year in 2013 and a relatively small dip in 2014. This is to be expected from time to time—stocks don't move in a straight line. There is no need to look at 2014 as a panic year, in our view, but rather as part of the natural ebb and flow of the market.

In the big picture, our level of underperformance in 2014—especially considering this was our first down year ever—is not at all dramatic when you look at the volatility of the market itself and our peers' portfolios.

Beast Mode (with a nod to Seattle Seahawks fans)

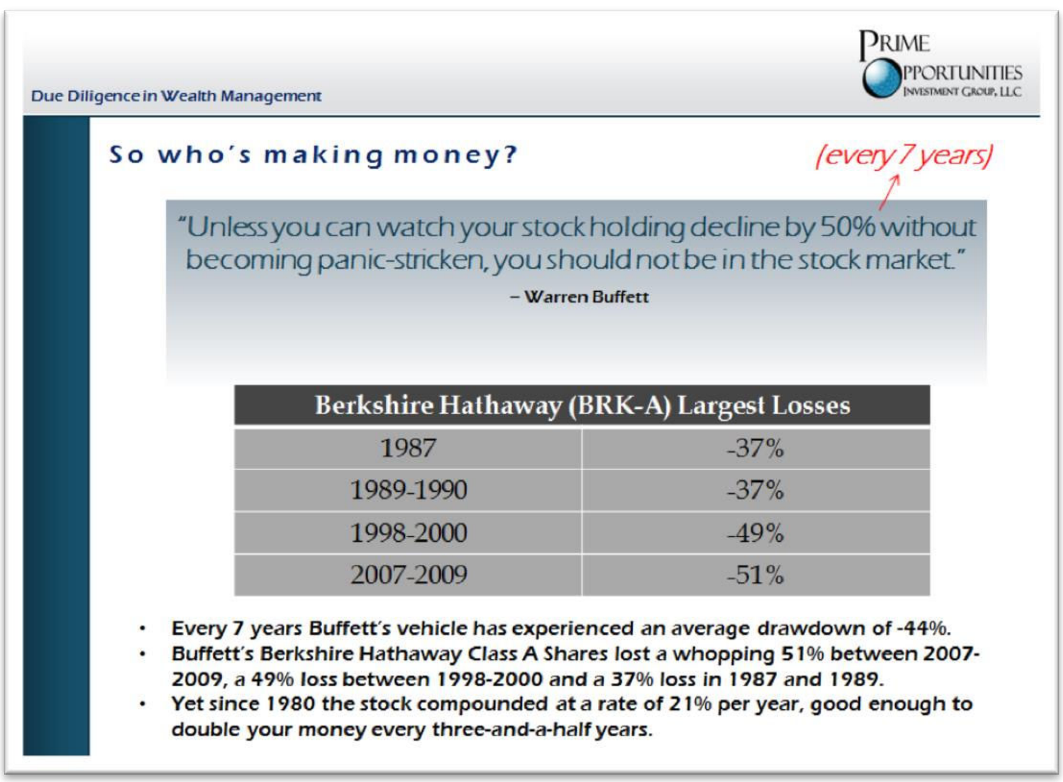
The market is a beast, you see. It does wild and crazy things. But we like irrational behavior. That is what creates the opportunities. And the way these opportunities often play out is short-term pain, but long-term gain. As you can see with our annual returns, though happily they have largely been up relative to the market, they are somewhat "lumpy" even in their upside performance. But at the end of the day, the direction has clearly been toward long-term gains... in a big way. The mere fact that our longs have been doing well in the up market of the past six years is not especially impressive—after all, many portfolios have been able to ride this rising tide. What *is* impressive is the *magnitude* of outperformance we've enjoyed compared to our benchmarks. We're doing substantially better than our peers, and our relevant benchmarks, across the board.

To tame a wild beast (the market), you need a systematic, cautious approach. And of course, a good understanding of value. There is no way to substantially outperform the market over the long run without finding inefficiencies in the market. Does that mean the entire market is inefficient? No. In our view, the vast majority of stocks are priced within reason, but there are some stocks that are wildly mispriced, and all we need to do is find about fifty of these (25 longs and 25 shorts), out of thousands, in order to outperform.

But it is important to realize that, just as businesses take years to develop, the value of those businesses often takes years to become clear. We like that famous quote by Benjamin Graham, "In the short run, the market is a voting machine, but in the long run, it is a weighing machine." People's *opinions* about stocks are what dominate in the short run, but in the long run what matters is the performance of the underlying companies. And that usually takes more than one year to play out.

I was recently invited to give the opening remarks at the Lido risk management event in Beverly Hills, and it gave me a chance to more formally gather my thoughts on the nature of the market. (The report is in our monthly update, "Risk Management Conference Presentation," if you want to take a look.) I thought I'd share this slide I used in the talk.

It starts with a quote from Warren Buffett, "Unless you can watch your stock holding decline by 50% without becoming panic-stricken, you should not be in the stock market." You'll see we added the phrase, "every 7 years."



As is clear in the graphic, even Berkshire Hathaway, that famous bastion of long-term value investing, has undergone several major dips over the short term.

The long term is what matters. US stocks, though they've had significant short-term dips (over the last century, the market has averaged an astonishing 26.9% decline every 5 years), have delivered a long-term average return of 8.9% going back to 1871. And *no* 15-year period has ever seen a loss. So if you had patiently invested in the stock market at any point in its history, you would have made money in the long term. If, however, you can go one step further, by intelligently picking stocks that *exploit the inefficiencies* in the market and employing risk management practices that help ensure that your investments have a chance to attain their true value, then logic says you should be able to do even better than the general market. That is the idea behind Prime's approach.

A Look at Our Peers

We are certainly not perfect. We will continue to make mistakes year in and year out. That is just the reality of the business; you are not going to get them all right. To do so would be impossible unless you had absolute knowledge of all things, and how everything mathematically interacted with everything else. But the good news is, you don't need to get them all right; you just need to get more right than wrong. And when you compare us to our peers, we believe we are doing a very good job of understanding, and executing on, value. Here is a table depicting our Traditional Long/Short portfolio compared to some of the largest and most liquid funds.

Fund Name	Overall Return	2009 Return	2010 Return	2011 Return	2012 Return	2013 Return	2014 Return
Prime Traditional Long/Short	**450.8%**	**40.7%**	**95.9%**	**18.3%**	**16.2%**	**56.9%**	**-7.3%**
Pine River Master Fund	221.1%	91.0%	13.9%	5.7%	21.8%	9.7%	4.6%
Value Partners High-Dividend Stocks	200.5%	82.7%	25.8%	-11.8%	25.0%	8.4%	9.5%
Taiyo Fund	170.6%	32.8%	4.2%	-15.8%	22.7%	66.5%	13.7%
Value Partners Classic Fund	161.5%	83.2%	20.1%	-17.3%	13.8%	11.1%	13.7%
Bay Resource Partners Offshore	146.6%	59.6%	17.4%	-6.9%	9.2%	22.2%	5.9%
Nordea 1 – European Value Fund	144.4%	43.7%	23.8%	-8.6%	23.1%	15.2%	6.1%
Platinum Asia Fund	126.6%	40.2%	4.4%	-19.6%	25.0%	26.3%	22.0%
Renaissance Inst'l Equities Fund	118.7%	-5.2%	16.4%	34.5%	9.3%	17.6%	14.5%
PIMCO Absolute Return Strategy IV	118.7%	63.3%	11.5%	1.8%	12.0%	-0.4%	5.9%
Visium Balanced Master Fund	116.0%	22.0%	24.5%	1.0%	10.3%	18.6%	7.7%
BlueMountain Credit Alt. Master	101.8%	37.0%	12.2%	3.6%	14.5%	7.9%	2.7%
Odey European Inc	84.1%	33.7%	-0.1%	-20.6%	30.7%	25.8%	5.5%
Adelphi Europe Fund	80.9%	18.7%	9.3%	-5.0%	14.2%	17.3%	9.5%
Macquarie Asian Alpha Fund	72.6%	14.2%	10.3%	9.1%	4.4%	9.0%	10.4%
RWC Global Convertibles Fund	68.0%	24.7%	7.6%	-3.3%	8.0%	13.9%	5.4%
Majedie Tortoise Fund	67.3%	28.0%	-1.7%	9.2%	5.6%	15.0%	0.3%
Passport Global Fund	58.2%	19.4%	18.3%	-18.7%	11.1%	23.0%	0.9%
Alphadyne Intl. Master Fund	52.9%	13.8%	4.4%	7.2%	6.0%	5.2%	7.8%
Zenit	51.4%	24.1%	4.7%	-4.0%	16.7%	3.5%	0.5%
GAM Star (Lux) - European Alpha	37.7%	0.3%	9.2%	2.0%	9.2%	10.0%	2.5%
S&P 500, Including Dividends	175.34%	34.23%	15.06%	2.11%	16.00%	32.39%	13.69%

All returns net of fees.

1) The simple fact is that the *best* performing fund on this top twenty list has had three underperforming years out of the last six years. By contrast, 2014 was Prime's first year of underperformance in the past six.

2) If you look at the level of our outperformance and our yearly ranking, our overall performance is best by a wide margin. Our overall returns are 450.8%, while the average return of the top twenty is 109.98%. If you recognize the nature of the market and its inherent volatility, you will see that one year of underperformance relative to our peers is a blip, and perhaps a long-term opportunity. As an investor, you don't want to focus on short-term gains or losses, in our opinion. You want to look for sustainable investment methodologies and parameters. And you want to pay attention to long-term returns of five years or more when evaluating a manager.

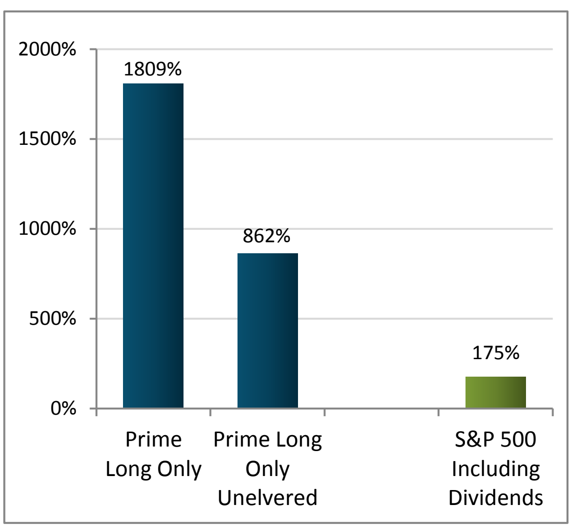
Overall Performance

Now that we have talked about our one-year performance, and our view that the market is best approached from a longer-term perspective, let's take a conceptual overview of the bigger picture—our performance over the past six years in aggregate.

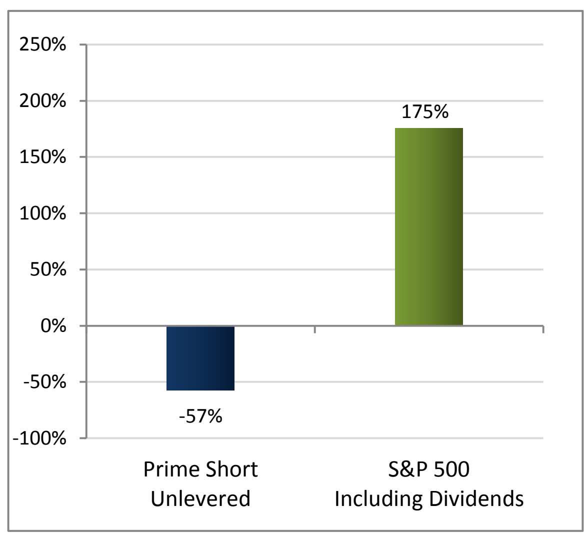
Since launching Prime, the long side of our portfolio has been up an annual rate of 48.37% net of fees, (62.32% gross) turning $1 million into $10.7 million since our inception, as compared to a $2.8 million return for the S&P over the same time period. What's amazing, though, is that our drawdown during that time period has actually been less than the S&P's. We believe this is attributable to Prime's track record of finding undervalued investments—which by our definition means companies with a relatively high upside and low downside.

Not only have our long positions been some of the best-performing companies in the S&P—outperforming by a wide margin—but also our short positions have been some of the worst-performing companies (on the short side we don't use indexes or ETFs, only individual companies). The short side of our portfolio has been up less than one third of what the S&P has been up since our inception. There is a perception that investment managers tend to be good with *either* longs or shorts. But in our view, if you truly understand the operating environment in which these businesses are functioning, and you know who is going to do well over the long term, you should also know who is *not* going to do well over the long term. The point is that we are creating alpha on both our long positions and our short positions—a rare feat in the investing world. This speaks volumes as to the long-term sustainability of our strategy.

Long Attribution
Gross of Fees



Unlevered Short Attribution
Gross of Fees



Sustainability Is the Thing

Successful investing is about producing a solid body of work, in a rational and sustainable manner, over a meaningful period of time. For that reason, I would like to explore a few ideas that are directly related to sustainability and value investing, and address a few of the common questions that come up regarding how we practice the art and science of investing. Understanding our thinking, and our practices, on these issues is critical to understanding our long-term thinking, and to putting 2014 in perspective.

Can You Excel While Avoiding Options and Practicing Good Risk Management?

Does an investment firm need to use day trading, options, and other fancy instruments, in order to invest successfully these days? Or can it still invest the old-fashioned way—looking at businesses from an operating perspective? The answer to the last question is yes. Remember, it is the performance of individual companies, within a given industry and within a given economy, that drives stock value. That's never going to change, whether you are evaluating stocks today, or seven years ago, or 25 years from now. Everything else is smoke and mirrors. If you do your homework, diligently and thoroughly, and are naturally good at evaluating companies, then ultimately picking good stocks is where you make your money.

Not only can you have good performance from picking the right stocks, but you can also have good performance while observing reasonable and sound risk-management practices. We have had an average annual performance of 48.37%, net of fees, on our long portfolio, but our best year ever was in 2013—when we were in full stride and following all of the risk management parameters shown below.

Risk Management Parameters	
Portfolio Composition	100% highly liquid publicly traded equities, both on the long and short side.
Number of Positions	Approximately 50 (25 long, 25 short).
Sector Diversification	Currently invested in seven sectors on both the long and the short side, with substantial overlap.
Options or Derivatives Used	None.
ETFs or Indexes Used	None, even on the short side; invested only in individual companies.
Market Capitalization and Liquidity	$500M minimum market cap, both on the long and the short side. Current weighted average market cap >$50 billion on both long and short portfolios.
Portfolio Rebalancing	New and existing positions are reviewed and rebalanced bimonthly at minimum, and additionally on an as-needed basis, in accordance with how much of their anticipated value has been realized. We don't let our positions run. Rather, we regularly trim according to strict guidelines and portfolio loss limits.
Separation of Duties	Separation of portfolio management and risk management in order to maintain objectivity and adherence to strict and transparent guidelines.
Geography	Predominantly large, multinational companies, with over 80% of our portfolio in US-based holdings.
Net Exposure	Average net exposure since inception of only 10% on our highly hedged fund.
Maximum Position Sizes	We have established ceilings whereby no long position will occupy more than 20% of the long portfolio and no short position more than 15% of the short portfolio. Currently, our largest long is 14.50% of the long portfolio, and our largest short is 7.75% of the short portfolio.[3]
Execution Risk on Short Portfolio	For every $2 billion of market cap valuation, short investments are limited to 1% of the short portfolio in order to reduce volatility and ensure position availability in a market downturn.
Adherence to Long-Term Value Principles	Expected holding period is 2+ years on our long positions and 1+ year(s) on our short positions; 78% of our long positions have been held for at least one year.

Our goal when designing our investment strategy was to try to get rid of a lot of the idiosyncratic risk, so that anyone, operating under our parameters, would generally achieve an outcome that approximates that of the markets, or their relative index, over the long term. The thinking was that with the right parameters it would actually be *hard* for someone to substantially underperform or outperform the market, and so the use of our risk parameters would, in essence be as much as a result of accurate stock picking as possible. If you chose enough companies, in enough sectors, and the companies themselves were generally representative of the overall market (weighted average market cap of $50 billion, well-known companies with established products, credible management, etc.), *and* you weren't using options or derivatives to create wild swings and thereby distort your short-term numbers, you would go a long way toward eliminating idiosyncratic risk, while ensuring that your long-term returns, relative to your benchmark, were more a result of good (or bad) stock picking than anything else.

But here is a critical point: not everybody can *pick* good stocks, which is the true heart of our long-term performance. So the more you can set up a system that effectively manages risk in a consistent, sustainable, and objective way, and then you add intelligent stock picking *on top* of that, *then* you can really drive value over the long term. We have endeavored to set up a risk-managed system in which the principal driving engine of growth is the ability to consistently pick a higher than average number of good stocks. Why did we do that? Because we have confidence in our ability to pick good stocks over the long term.

What is the benefit of this approach to you? Well, you won't wake up one morning and say, "Why were my stocks down 60% this month?" only to find out that the investment manager, knowing that he was going to get redemptions, put his foot on the options gas pedal and doubled or tripled down. We'd rather drive a car that goes 65 miles per hour and makes it to its destination than an Indy racecar that can go 265 miles per hour and can easily veer off the track at any moment.

In 2013 we had returns of 115%, even observing all the strict risk management parameters above and maintaining an incredibly diverse portfolio of about 25 positions on the short side and 25 on the long side. What's amazing is that we were doing all this while rebalancing our portfolio with strict position and portfolio size limits. We were not allowing any of our positions to run; as they were going up, we were trimming them back down. This means the attribution of our returns was incredibly diverse. *Fourteen* of our long positions were up 50% or more, while eight of them were up over 75%. This shows that it *can* be done, and done well. In truth, we don't even "need" to have the level of diversification we now have. Many of our peers have always maintained concentrated portfolios and have been able to grow nicely. The size or the number of positions is not the determinant; the point is that you need to be picking the right companies, while using sustainable risk management approaches.

Fund	Concentration in 15 top positions
Pershing Square	100.00%
Pabrai	99.97%
Brave Warrior	99.93%
ValueAct	99.62%
Fairholme	98.74%
Fairfax	97.25%
Baupost Group	94.72%
Berkshire Hathaway	94.53%
Owl Creek	88.66%
Elliott	88.07%
Third Point	81.76%
Paulson	76.61%
Greenlight	75.00%
Tiger	72.61%
Appaloosa	71.49%
Eton Park	70.51%
Fir Tree Partners	70.24%

When you realize that when using all of our above investment parameters in 2013, we outperformed the market by 82.67% net, and then you see that the following year we lost -1.86% on the long side, it helps keep that short-term loss in perspective. Long-term, we have been going up strongly, but growth happens in a nonlinear fashion. Dips are inevitable in a marketplace environment.

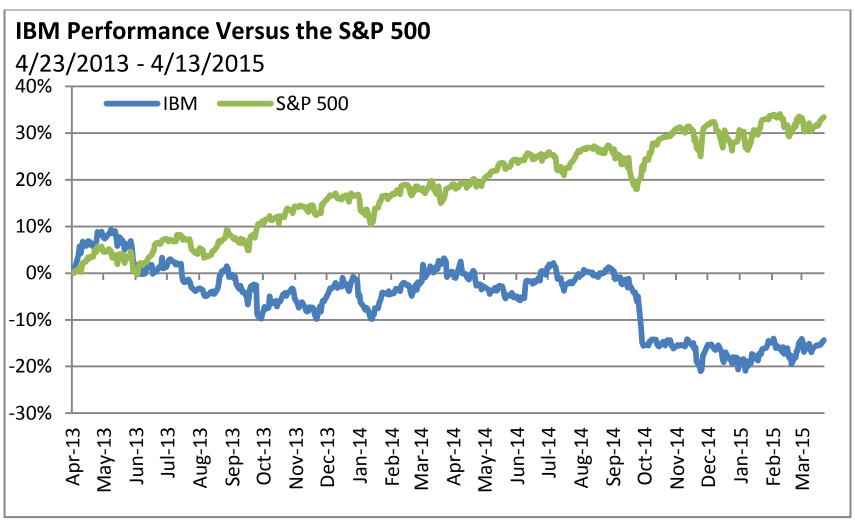
Value Investing – How We Differ

The ironic thing is that even though we consider ourselves value investors, it is by going *against* many of the traditional myths and mindsets of value investing that we have done well. Many people think, for example, that "value is value" and that all value companies look alike. Or that value investing is buy-and-hold, or either a top-down or bottom-up proposition. But we look at value from many different angles. We evaluate a variety of scenarios. We use both a top-down and a bottom-up perspective, we look in a wide variety of sectors, and we constantly re-examine our premises. We always strive to remain flexible, to make adjustments as needed, and to understand situations based on their merits. We look at things from a multidimensional angle.

Value investing for us means looking at companies over one-year, three-year, five-year, and ten-year periods (with the latter two being the most important), and comparing their expected value to what the stock is trading at today. We do own many traditional value companies such as FedEx, Rite Aid, Wells Fargo, American Railcar Industries, International Paper, and Disney, because they truly were undervalued, compared to their worth, when we bought them. But when we can find companies that are undervalued even more, but also require even more patience, those are even better. We have done exceptionally well with picks such as Tesla, Chipotle, Google, Clearwire, Activision, and Qihoo as well.

I will take the "traditional" value plays all day long, but when I find something that I believe has even higher upside and lower downside—i.e., greater value—I will grab it even if it doesn't fall into other peoples' view of value. Both types of investment are value plays in our book, because both are currently selling for substantially less than we think they will be worth in five to ten years.

The same non-traditional value definition applies to the short side. Most people, for example, would view IBM as a traditional value play, especially two years ago. But we took it as a short, and its performance over two years has been -14.34%, versus 33.43% for the S&P over the same time period. Without getting into too much detail, eleven straight quarters of revenue declines for IBM have served to validate many of our premises, indicating to us that there are structural problems with the company, the business environment it is operating in, and its new management team. IBM has actually been our biggest short position, at about 7.5% of our short portfolio for the past year. At a $160 billion market cap, we think it still has some distance to travel on the downside, and that's why we've continued to hold onto it. We don't look at things traditionally, but we do look at things from a value perspective, and that is what has enabled us to make so many exceptional risk-weighted returns over time.



A Popular Myth of Value Investing: Buy and Hold

I often talk about patience and long-term value, so people often wonder how much of a "buy and hold" operation we are. But just because we are committed to long-term value investing does *not* mean that we buy and hold no matter what. It means that we get the best of public equity liquidity, while maintaining a private equity mentality—that is, looking at the business from a holistic perspective and asking ourselves whether we would actually buy this company outright if we could. We combine a sustainable approach to investing with the ability to easily enter and exit positions whenever we feel we have made a mistake or as the trading value of a stock approaches its intrinsic value. That is the beauty of our working system. We have made, and will continue to make, mistakes with our picks. But that's why we're not married to any of our positions. As we've often said, at the right price any of our longs could be a short, and any of our shorts could be a long position.

That's not just whistling Dixie; it's the way we operate. A couple of the earliest shorts we got into were BlackBerry and Nokia, when we saw major destructive forces taking place in the phone industry. We started shorting BlackBerry at $70.18 a share and a market cap of $40B, and started shorting Nokia at $15.53 a share and a market cap of $58B. These were two of the biggest companies in that space, and the most precipitous fallers from their peaks. These were also two of our most successful short positions, with Nokia underperforming the S&P by about 100% (Nokia was down 58%, while the S&P was up 42% during that time). What's interesting, though, is that long after exiting these phone manufacturers, we noticed that BlackBerry, having dropped by over 90% from its peak and having gone through several CEOs, was starting to look interesting again. It had two new phones, a brand new operating system, dramatically reduced costs, and, finally, a CEO with a proven record of turning things around who was making the right decisions. We won't get into the details here, but at a $4.5 billion market cap, Blackberry looked like a completely different investment than it did at $40 billion. It not only had a higher upside, but, perhaps more importantly, a lower downside. We bought back into BlackBerry as a long in July of 2014.

The point is not to convince you that BlackBerry is a great investment, especially since most of the investing world has "put a fork in them." What I want to show you is that we are not emotionally attached to our ideas about any investment; it's all about maximizing profit. Quite honestly, I may be wrong on this play, and if I see things shaping up differently from my expectations, I will be the first one out. But my experience with our investments to date has been that when we check and recheck our premises, and then go against the naysayers, our analysis has generally prevailed.

Although 78% of our longs are held over a year, as you can see below, three out of our top ten holdings from a year and a half ago are no longer being held, and four out of our top ten shorts are no longer in the portfolio. If you look at our portfolio from month to month and year to year, you will also notice movement in position sizes. For example, Amazon was our second largest position at a $120B market cap but has dropped to number 17, owing to its current $177 BB market cap. We still love Amazon and may increase our position again in the future, when Jeff Bezos starts delivering more to the bottom line as we believe he will, but for now we see a greater upside with some of our other stocks. Disney at a $99B market cap was different from Disney at today's $181B market cap (we lowered its position from 5th to 18th). On the other hand, some of our investments have kept the same position, and some of these positions have been held for over three years. CMG is a stock we've held since our inception and is still our favorite position. In our 2012 annual report, we re-printed an excerpt of a letter I wrote to Buffett around the time of our firm's inception explaining why we believed the stock would go from $80 to $400 per share. This turned out to be a successful analysis, as CMG did indeed hit the $400 level, a fivefold increase in value, right around its four-year mark. We believe that stock continues to be mispriced—and many of the premises outlined in that report still hold true—so it is still our number one position. (Owing to the nature of the market, CMG, like most stocks, has had its shares of ups and downs, but we are still quite enthused about it.) The one thing that hasn't changed is our fundamental style of investing. We are using the same mindset of finding value as we did when we started.

Top 10 Long Positions

March 2013 Position Rank	September 2014 Position Rank	Ticker	Exit Date
1	1	CMG	-
2	17	AMZN	-
3	Exited	CLWR	05/13
4	7	ATVI	-
5	18	DIS	-
6	Exited	DE	12/13
7	16	GOOG	-
8	3	QIHU	-
9	Exited	DDD	05/14
10	25	1913	-

Top 10 Short Positions

March 2013 Position Rank	September 2014 Position Rank	Ticker	Exit Date
1	Exited	NOK[1]	09/13
2	Exited	FB[1]	07/13
3	5	Active	-
4	6	Active	-
5	3	Active	-
6	7	Active	-
7	Exited	GME[1]	09/13
8	Exited	JCP[1]	11/13
9	23	Active	-
10	9	Active	-

The Myth of Many Cooks

Many people believe that value investing requires a lot of personnel to run the shop. That's not really the case. To make a simple analogy, no matter how many women you put on the task of having a baby, it still takes nine months. That is the same concept in value investing. The "secret sauce" is how you, the manager, interpret the information. It has to be viewed and understood through your lens. Putting more people on the task doesn't necessarily help.

This can be seen in Buffett's operation. He has about twenty-five people at his headquarters, and they manage over $600 billion in assets. And not only do they invest in publicly traded companies, but about half their holdings are privately held companies, which are much harder to manage—if something goes wrong, one can spend up to 90% of one's time trying to fix problems and change management. By contrast, when holding only publicly traded, liquid companies as we do, if something goes wrong, or we don't like something we see, we can simply exit the position—as we have on numerous occasions. This allows us to efficiently spend our time looking for the next great investment, one with a good management team already in place.

Too many people on a team can actually create inertia or a "let's split the difference" mentality when it comes to making decisions. You often get the worst of both worlds—high turnover (of both stocks and employees) and low conviction. I simply would not expect anyone to agree with all of my stock picks—or even most of them—so aiming for team consensus would be a pointless exercise. The best of both worlds, as we see it, is to gather and read all the relevant information, review what outside analysts think and why, and then to ultimately rely on your own wisdom and deep analysis. And most importantly, to do this while following objective and transparent risk management guidelines. If you don't have those guidelines, then no matter how many people you put on the job—and we have seen this time and time again—you can fall far off track.

To help ensure transparency and oversight, we do partner with a number of top-notch service providers such as KPMG (a "Big Four" auditor), SS&C (administrator of over $500B in assets), Paul Hastings (a well-known and respected industry law firm), Bank of America Merrill Lynch (global leader in prime brokerage and custody services), and Ashland Partners (largest Global Investment Performance Standards verification firm in the world). These trustworthy stewards help us oversee your assets, so we're not operating in an intelligence vacuum, by any means, nor are we "rogue agents." But we *are* nimble from a decision-making perspective.

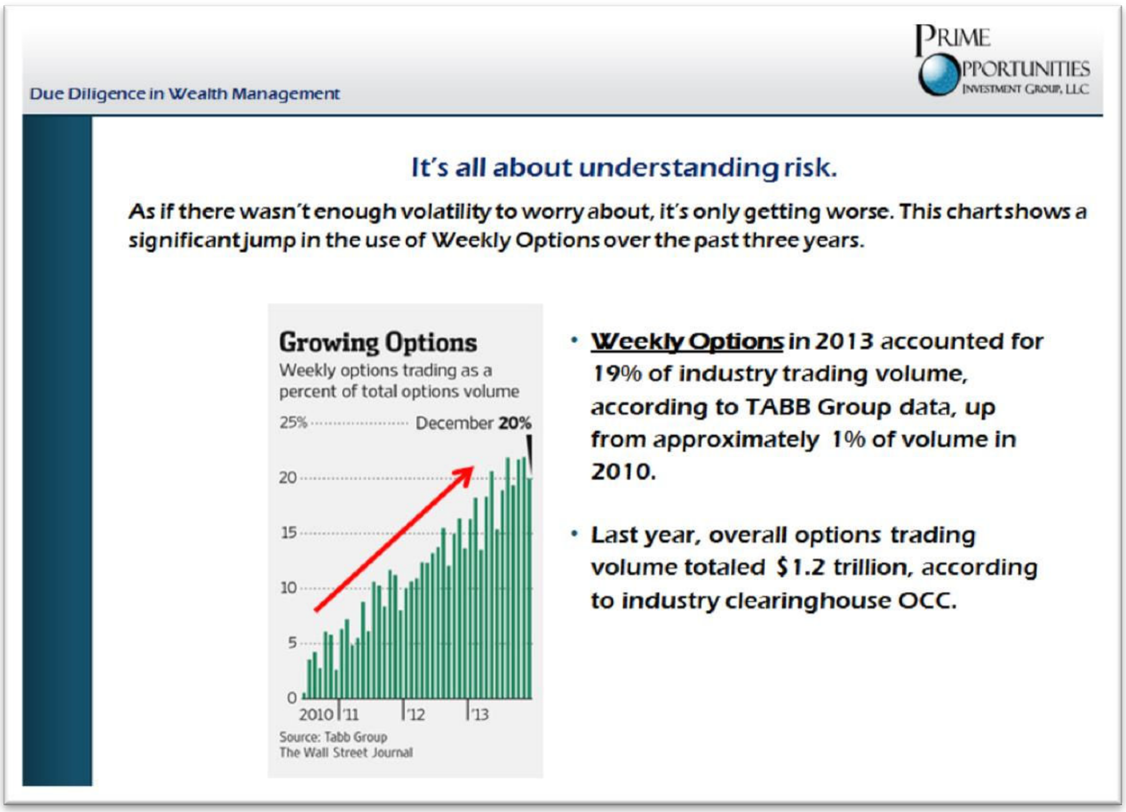
A Few Words About Options

There is one last concept I'd like to explore as it relates to sustainability and performance. We often speak of how we don't invest in options or derivatives—that's because we consider options the antithesis of sustainable, long-term value based investing. Despite their current popularity, the one suggestion I would give anyone willing to listen is not to buy options or invest with anyone that buys options. Yes, you may make large sums of money in a short time, but there is also a high likelihood that you will lose that money, plus much more, over the long run.

Full disclosure: We did at one point, approximately four years ago, purchase options on two short positions (Nokia and Garmin) in the only way that we thought sensible. We sought to reduce taxes through long-term, highly *un*levered options (which is far from the kind of options-gambling that is going on today). That one minor experiment with options had a relatively immaterial effect on our overall returns, but it did achieve our goal of adding slightly to our after-tax returns. The best part of the experiment, though, was that, despite its meeting our expectations, it reinforced the idea, early in our history, that we wanted to stay far away from options—both for the sake of maintaining rational behavior and for the sake of our own and our investors' long-term monetary interests. Sacrificing a little bit of tax efficiency in the short run is a small price to pay for peace of mind and sustainability. (Our portfolio already tends to be pretty tax-efficient, with 78% of our long positions being held for over a year.)

Buying and selling options just isn't smart. It is a constant guessing game about prices, where the only beneficiary is usually the Wall Street brokerage firm that facilitates the transaction. Options are vehicles that, in effect, magnify the already volatile nature of equity investing. And we say this knowing that our own past performance success might have been greatly amplified through the use of options, thanks to our good stock picks. But we feel that the dramatic increase in volatility that goes along with options is a foolish gamble that can cause catastrophic damage, and we'd rather not take that chance.

I cannot tell you how many individuals I have spoken with who have been burned by a too-risky investment and are now sitting on the sideline when it comes to the stock market and missing out on some great investment opportunities. The market is already volatile by its nature; the use of options only makes it vastly more so. Unfortunately, options are getting much more prevalent. Forget the fact that options trading volume has surpassed $1.2 trillion and is going through the roof; *weekly* options now account for 19% of the options market. And that is from a base that was almost non-existent a few years ago, as the chart below shows.



So, not only are many investment managers failing to create any alpha, as can be seen by the negative returns of the HFRX Market Neutral Index and the lukewarm 2.74% average annual returns of the HFRX Equity Hedge Index, but they are also investing in risk-laden securities that require managers to anticipate stocks' general direction and price fluctuations on a weekly basis. On top of that: even if option buyers do hit it right, on a whim, they will pay a substantial chunk of their "payoff" in taxes because of the way short-term gains are treated for ordinary investors, at least in the US.

Options, derivatives, and day trading are all areas we avoid. And we would advise you to do the same. You may not become your broker's best friend, but you will be your kids' (and grandkids') best friends when it comes to their inheritance.

I hope this brief discussion of the above topics has helped you to better understand our thinking as it relates to sustainable long-term value investing.

A Naïve Beginning

This might be a good time to share a little insight into how I formed my investment parameters as a fund manager. Warren Buffett, as you might have surmised by now, was a huge influence on me early in my career and helped shape some of my core thinking about investing. And although I've developed my own distinct investing philosophy since then, I still have large areas of overlap with him.

The reason I'd like to take a brief side trip down Memory Lane, though, is not for nostalgia's sake, but to briefly explain how my thinking began, and how it has evolved over the past six years, regarding Prime's three main product offerings. This will all make sense if you'll indulge me and let me share a little bit about my journey in the business.

I was relatively young when I started Prime and, perhaps because I didn't come from Wall Street, a little naïve in some ways. But before we get into that, let's climb into the Wayback Machine for a moment and go back to my preteen years. I remember sitting in bed when I was 12 or 13 years old and reading the annual reports of Berkshire Hathaway for fun. It's true. Even at that age, there was nothing more exciting to me—except girls and football—and I always knew this was what I wanted to do as a career. As I read those documents, I remember thinking, "Wow, these are all the business secrets in the world." I almost couldn't believe they were being revealed to me. More importantly, I *connected* to them and felt I understood them at their core. I devoured more and more of Buffett's work and the work of his teacher Benjamin Graham, such as *The Interpretation of Financial Statements*.

Fortunately, I was blessed to have a family that was successful in real estate. After college, I began my career in that field. I liked the real estate sector in general because it followed many of the same principles as long-term value investing. But still, my deeper passion was always on the securities side. After gaining some real-world experience, I wanted to combine my business background, my understanding of true intrinsic value, and the principles of long-term investing, but I wanted to do it in securities. Not only did I enjoy analyzing the complexities of the market, but I also learned that for every one person on the Fortune 500 list who was in real estate, there were about three who were in securities or the securities-related world. So, in addition to being the passion of my life, securities also seemed more lucrative, provided you had a knack for understanding complicated issues. Securities had more moving parts, and all of these moving parts resulted in more mispriced assets. I was able to find (and still am) companies that I believed were worth two to three times their current values. In real estate, although also a great investment venue, mispriced assets generally ran in the 20 to 30% range, and you were beholden more to the general direction of the market than the mispricing of the asset.

My dad, like many people I know, was wary of the securities world. To him, it was a high rollers' game to play. And after all, if in real estate we could enjoy not only a calm lifestyle, but also a very lucrative one, why not stick with that?

I did agree with my dad that the securities business was generally set up to be a speculative and dicey proposition. But I didn't believe it *had* to be that way. And, in fact, the most successful people in the business didn't operate that way. The upshot was that, right from the start, I made a firm decision to avoid the path of Wall Street's shortsighted methodology. I also vowed to devise a system that would keep me from falling into the speculation trap, even years down the road.

This idea of setting up an objectively based, well-thought-out investing system appealed to me from both a lifestyle perspective and a monetary perspective. First of all, I would not have to attend happy hour every day to relieve the daily stresses of investing short term. (Although long-term investing has its own share of stresses, trust me.) Second, this was the only way I could imagine to make substantial and sustainable returns. My belief was, and is, that nobody knows what is happening in the short term, but that over the long term, if you evaluate businesses not as ticker symbols to be traded like playing-cards in a high-stakes table game, but as operating companies that you can understand, you can do very well.

My premise was that investing in securities was very much like investing in real estate, as long as you take a long-term value based approach, rooted in facts and logic. As with real estate, if you evaluate and understand all the moving parts, and you operate from sound premises, your chances of success go up astronomically.

But there's a key difference between real estate and securities, and it is this difference that makes it hard to treat securities like a rational, long-term business. In both real estate and securities, prices fluctuate constantly. But with the stock market you *see* the movement of prices on a daily, or even a minute-by-minute, basis. In real estate, prices are also moving day by day (in theory), but because you don't *see* that happening, and because there is no way to get in and out of real estate on a daily or hourly basis, you don't fall into the trap of constantly moving your assets around or panicking like a cat on a hot tin roof whenever the winds change. Or worse yet, levering your short-term bets through options.

If you are not careful, and if you fail to set up the right speed-bumps ahead of time, the speculative trap can become your whole life. You forget about the underlying asset, and all the facts related to it. You become hooked on emotions, gambling, and unsustainable methodologies. It becomes very easy not to look past the end of your own nose.

But if you set up firm and intelligent investment parameters, you can invest in a calm, rational, and sustainable way, thus turning others' risky behavior to your advantage.

My approach, in essence was this:

I set out to find the companies that I thought would do the best over the next two to five-plus years and to go long with them. I also set out to find companies, based on the same investment premises, that would *not* do well over the next two to five years and to short those companies. I decided, for all the reasons mentioned above, to implement the strict risk management parameters outlined earlier. I also sought to offset, to the extent practically possible, susceptibility to market downturns, or even economic downturns.

My thinking was that if I kept a relative balance between my long and short books, all else being equal, this would help protect me against market gyrations, and my performance numbers would be a result of my picking the right stocks—which I believed I would be good at. I thought I had a good understanding of value, and of risk/reward, but I also made a decision to invest only in publicly traded companies, and, as a general rule, not to invest in anything with less than $500 million in market cap. That way, as I built out a track record over many years, investors couldn't look back and say, "He could only do this with small amounts of money because he was only investing in relatively illiquid investments."

Fast forward to today, six years later. We are one of the most liquid funds in the market. We have a weighted average market cap of over $50 billion, and are delivering substantial alpha-based returns both on the long and the short side of the portfolio.

Back to my naïveté, though. What I did not know when we started out is that market neutral funds that were operating similar strategies to ours were averaging *negative* returns, even if you went back twenty years, and therefore they represented less than 1% of the overall market. And it has always been important to me that I make Prime's portfolio of undervalued companies available and accessible to a wide sector of the investing public.

Three Ways to Invest With Prime

The important thing to understand about our products is that Prime manages a *single* portfolio of securities. The differences between the three product groups are twofold, based on investors' preferences: 1) the amount of desired hedging and 2) the amount of gross exposure desired (see comparison table below).

Although we have some long-range concerns regarding the economy, as reflected in our paper, "Sound Investing for Uncertain Times," we are not here to be economists or prognosticators on the global economy, we're here to invest in undervalued companies, and—to the extent a hedge is desired—to short overvalued companies. Experience has taught us that the best defense against any market environment is to pick the right stocks, period. If you are a bull, you can invest with us; if you are a bear, you can invest with us. And with our series structure, if you change your views or get concerned about the market or the economy, you don't have to leave our family, but rather you can move between one product and another.

The following brief overview is intended to help in your evaluation and understanding of Prime's offerings, and to share with you some insights we've gained about the market.

If you look at all of the products, there is commonality in terms of performance. As mentioned, the Long Only is outperforming the S&P by 29.98% net of fees, the Traditional Hedge is outperforming the HFRX Equity Hedge Index by 30.15% net of fees, and the Ultra Hedged 50% Cash Unlevered is outperforming the HFRX Market Neutral Index by 16.61% net of fees; these are all on an annualized basis. If you look at the other indices such as the alpha, beta, Sortino, and Sharpe, across all products, they also point to the same consistent outperformance on a risk-adjusted basis.

That is a testament to the good stock selection that underlies each of the products.

Long Only Portfolio

	Net Exposure	Correlation	Alpha	Beta	Maximum Drawdown	Sortino (0.1%)	Sharpe (0.1%)	Gross Average Annual Gain	Net Average Annual Gain	Prime Average Annual Outperformance	Net Overall Gain
Prime Long Only Portfolio	150%	0.42	2.42%	0.82	15.52%	3.43	1.56	62.32%	48.37%	+29.98%	966.59%
Benchmark: S&P 500 Incl Dividends	100%	1	0.00%	1	16.26%	2.17	1.25	-	18.39%	-	175.34%

As I mentioned previously, our long performance since inception is up an average annual 48.37% net of fees. So, a million dollars invested with us is worth $10.7 million vs. $2.75 million for the S&P. But the amazing thing is that our drawdown during that period is less than the S&P's. Also, the correlation of our Long Only book to the S&P is only 0.42. This is actually lower than the 0.79 of the HFRX Equity Hedge Index—the index that shows the average *long/short fund* correlation! That's something you don't normally see on a long-only book.

Traditional Long/Short Portfolio

	Net Exposure	Correlation	Alpha	Beta	Maximum Drawdown	Sortino (0.1%)	Sharpe (0.1%)	Gross Average Annual Gain	Net Average Annual Gain	Prime Average Annual Outperformance	Net Overall Gain
Prime Traditional Long/Short (125:60)	65%	0.06	2.46%	0.09	12.13%	3.14	1.42	40.97%	32.89%	+30.15%	450.85%
Benchmark: HFRX Equity Hedge Index (Long/Short)	60%	0.79	-0.31%	0.37	19.12%	0.62	0.42	-	2.74%	-	17.60%

Our traditional hedged product, operating at 65 net, is averaging 32.89% net returns, with a drawdown less than both the S&P and the HFRX Equity Hedge Index. In this case, a million dollars invested with us at inception would be worth $5.51M as opposed to $1.18M invested in the HFRX Equity Hedge Index. Perhaps the most important factor is that this product has a low correlation (which is the whole point of going long/short) of 0.06 and a beta of 0.09. By contrast, if you look at the Equity Hedge Index, the average correlation there is 0.79—and anything over 0.70 is considered highly correlated. So, many of the long/short funds out there are not really providing the downside protection one would traditionally associate with a long/short product. What is also remarkable, in my view, is that although the Equity Hedge Index's correlation to the S&P is high, its average annual return is only 2.74% net of fees. So you are not getting downside protection *and* you're underperforming the market by 15.65% per year! And remember, each 1% compounded over time makes a dramatic difference in the total value of your assets. The correlation rate of *our* Long/Short fund is actually even lower than the Market Neutral Index correlation of 0.22. And the Market Neutral Index has had a negative overall average annual return, as opposed to our 32.89% mentioned above.

I like all three subsets of our core portfolio, but from a net exposure and risk/reward perspective, a very strong case can be made for Traditional Long/Short as the leader of the pack.

Ultra Hedged (Low Net)

	Net Exposure	Correlation	Alpha	Beta	Maximum Drawdown	Sortino (0.1%)	Sharpe (0.1%)	Gross Average Annual Gain	Net Average Annual Gain	Prime Average Annual Out-performance	Net Overall Gain
Prime Ultra Hedged 50% Cash Unlevered (50:40)	10%	0.04	1.22%	0.03	6.20%	3.81	1.60	18.94%	15.77%	+16.61%	140.81%
Prime Ultra Hedged Unlevered (100:90)	10%	-0.10	2.12%	-0.14	14.63%	2.43	1.15	29.57%	23.31%	+24.15%	251.58%
Benchmark: HFRX Market Neutral Index	0%	0.22	-0.15	0.06	10.97%	-0.28	-0.22	-	-0.84%	-	-4.96%

Last but not least is our Ultra Hedged product. It is available in three levels of gross exposure: 50/40 (90 gross), 100/90 (190 gross), and 150/140 (290 gross).

Perhaps the clearest way to review this product’s performance is by starting with the 50/40 version. It’s a great option with a 6.2% Max drawdown, and a 15.77% average annual (net of fees) return on only a 0.04 correlation. This, again, shows the efficiency of our stock picking on a relative basis.

The 100/90 version has returned an average annual rate of 23.31% heading into our seventh year. That compares to a -0.84% average annual return for the HFRX Market Neutral Index.

While the overall performance has been very good, the low net product is probably the most challenging of our products for the casual investor to understand. And quite honestly, from a pure marketing perspective, we might be better off not even having it. After all, if you look at our Long Only, with its 48.37% return and a lower drawdown than the S&P, and our Traditional Hedged with its 32.89% average annual net return, drawdown of only 12.13%, and correlation to the S&P of only 0.06, there is a lot to like about these products.

We do think there is a place for such a low net product in an investment portfolio. We generally suggest that investors have a third of their Prime investment in this vehicle. That’s because the performance of our other products has been so good, and with very low relative correlations at the same time, and also because we think the low net product is a hard asset to understand and doesn't move in step (to say the least) with the market. But for those who are really concerned about the overall market, and/or those who are currently avoiding investing solely because they think the market is overvalued, or are in gold, we think this is a good option if you can have the patience.

What you have to understand is that, with the long book doing so well, while having a drawdown lower than the S&P’s, most of the volatility in our portfolio is coming from the short side of the book. It is much harder to get shorts rights; you have to hit a trifecta. You not only have to pick the right short, you have to time it right, and predict the upside. (Unlike a long position that can go up multifold, shorts have much less return potential because there is a limit to how far down they can go.) What this means is that you have to be much more patient on the short side and expect a lot more ups and downs.

We also have a 290 gross version of the product. We have found this 150/140 version to be too volatile for many investors, and we want people to invest in a style that keeps them around for the next twenty-plus years. So we suggest most people invest in the unlevered version of this product. The kinds of companies we are investing in are generally not moving at a slow pace, as you can infer from our 48.37% net annualized returns on the long side. So when you factor in 290 gross, you get a *lot* of ups and downs. And don't get us wrong, although since our inception you would have done better in aggregate *because* of those ups and downs, such a roller coaster is hard for most investors to stomach—especially when our other products are outperforming their benchmarks on a large scale with relatively low drawdowns.

As can be seen with the 50% cash version, the core stock selection has actually been delivering great returns, with low volatility and drawdowns on this product. Our primary goal is to keep investors around long enough to let our investment theses play out, regardless of what “the beast” does over the short term. And for many investors, if they can’t tolerate the volatility aspects, then what’s the point of investing in it? I get that. And that was part of my naïveté when I started.

Our Overall Suggestion:

We generally advise one-third in low net, and two-thirds either Traditional or Long Only. If we move into a more treacherous economic environment, you can modify this balance. We also are open to differing combinations. We believe the most important take-away, however—because of the level of relative outperformance we are achieving across the board—is to invest with us, regardless of the product you choose for your specific need.

Case Study: Airlines

Intro: Top-Down or Bottom-Up?

Now we come to the part of the annual report where I offer insights into some of the detailed decision-making that goes on “behind the scenes” at Prime. Now, as you know, I often encourage our investors not to look too hard at individual investments, but rather to think of the entire portfolio as a working whole. As we spoke about earlier, Prime can be in a stock today and out of it tomorrow, and we don't expect everyone to like all of our stock picks. In fact, if “everyone” liked them at their inception, then almost by definition there wouldn't be much of an opportunity there.

Keep in mind, too, that each investment is only one of approximately 25 longs or 25 shorts, and these investments can change at any time. It's the process and the risk management system that matter most. That said, I know that some of you are keenly interested in our thought processes and why we choose some stocks and not others. The following analyses are offered for you. For those not interested in drilling down into the individual investments, feel free to skip over this section.

We will go out on a limb here and give you our insight into an investment whose outcome won’t be known for a few years (but remember, we can always exit it if we don’t like what we’re seeing). As we mentioned, our overriding goal is to maximize profit on our investments, not necessarily to stick to any preconceived notions.

The case study I’m going to offer this year is an example of a “top-down” investment thesis. Often this is where we get great ideas—from global/macro changes in industries, policies, and technologies that trigger anticipated ripple effects in individual companies. But we also sometimes discover opportunities by using a bottom-up perspective.

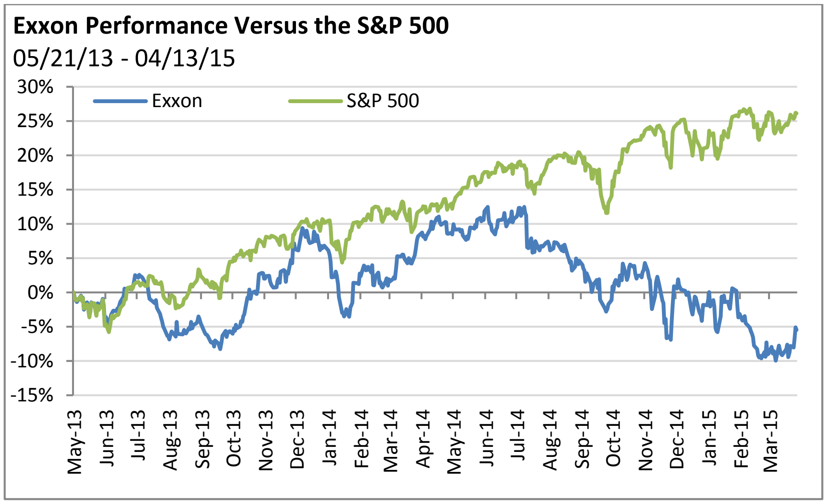
One example of a bottom-up read is Tesla, where it's the company’s position in one of the oldest industries in the world, its infrastructure, its vision, and the product itself that grabbed us more than anything else. We read the reviews, *saw* the car, and actually drove it. We got in at its relative infancy date and its early market cap of $4.5 billion. It is now valued at $21 billion and still, we believe, a bargain over the long run. Then there are companies like Rite Aid, Disney, and FedEx, where our interest was snagged by the management in an established, long-lasting industry but with good macro-economic overrides. That’s kind of a “middle-up” take. This is all a bit oversimplified, because there are overlaps in each case that transcend the buckets—in short, you need to be able to look at companies and industries bottom-up, middle-out, and top-down to be able to identify the true gems. And ultimately it’s a combination of all those approaches that cements the deal in our mind.

But here’s a “classic” top-down case for your perusal.

In 2014, we entered the airline industry. At first blush, you might consider the airlines a "boring” play, but I hope you’ll read on to explore our reasoning. It’s a move we made based mainly on how truly undervalued we believed the stocks to be. We thought this opportunity had much of the same low downside and high upside that we've seen in most of our investments—but with even a lower downside than we normally find.

What "Fueled" Our Investment Decision

A little background to start. About two years ago we took a short position in Exxon Mobile (XOM), for several reasons, which we will keep simple here. To date, the position on XOM has done us well. It is down about 8% since we bought it, while the S&P has been up around 25%.[2]



One of the reasons we shorted XOM was that, in our view, people were underestimating fracking technology and the effect new investments and additional efficiencies were having in the field, as well as the massive amounts of money being employed to bring fracking technology to fruition. From the US to China, from the Middle East to Canada and Africa, it seemed that anywhere people were punching a hole in the ground, using this technology, they were finding oil.

In short, world demand for oil was holding fairly still while supply was increasing.

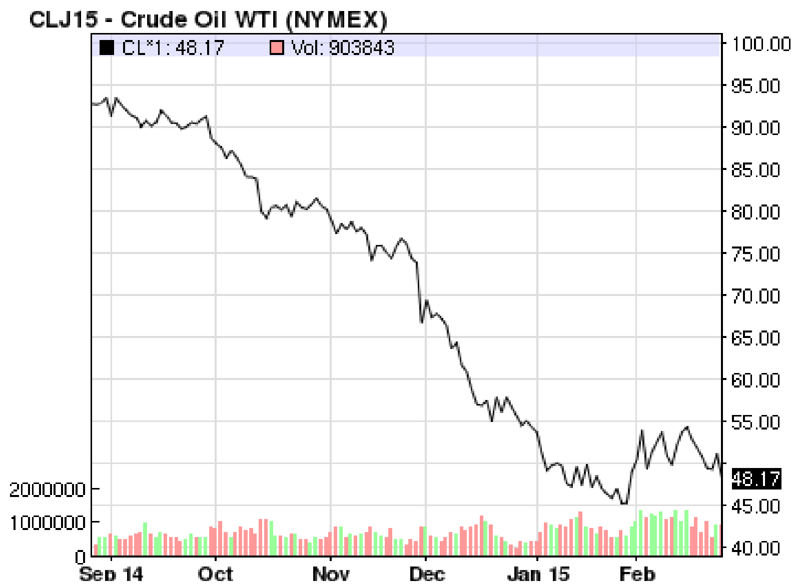
We won't dwell on this, but what made oil such an explosive opportunity as a short was the "price elasticity of demand" in these industries. As an illustration, in the apartment rental business, if the vacancy rate goes from 5% to 2% in a given market, the rental rates can oftentimes go up 15 to 20%. But conversely, if the vacancy rates go from 5% to 10%, rents can drop 20% or more. So, as time goes on you would see that the more fracking that is done—and this technology was now accessible not only to the larger players, but to smaller players with smaller parcels of land—the more rapidly prices could go down with the incremental increase of supply coming from around the world.

Adding to this effect is the inelastic supply/demand equation brought on by the accelerated development of electric cars. Fully 60% of all the gas used around the world goes into cars. So, an incremental percentage of that amount, over time, moving to electric cars will have a dramatic continued downward effect on oil prices.

Just as fracking technology has revolutionized oil production, some of the supply/demand balance of traditional oil has changed in ways that are hard to calculate and may lead to different equilibrium calculations than those used in the past. For example, many of the frackers are adapting a new strategy that allows them to quickly pump more crude from the ground as soon as prices begin to rise. They are drilling the actual wells, but are holding off on doing the next steps needed to free up the oil from the shale formations. In essence, they are using the ground for storage, but giving themselves unprecedented quick access to tap it whenever they wish. This can allow them to quickly increase supply as was never possible before. There are an estimated 3,000 wells in Texas and North Dakota alone that have been drilled but aren't yet pumping due to the downward pressure on oil prices. This is serving to keep a cap on prices from rising precipitously.

There were, of course, many other factors that led us to short XOM, including the change in its management team, acquisitions that we thought were irrational and overpriced, and its huge market cap of over $350 billion, which virtually ensured that no one was going to buy it out and cause its stock to jump exorbitantly in a short period of time. These factors limited the downside risk, helping to solidify it as a good short position.

And then oil prices began to fall. The recent unprecedented decision by the Organization of the Petroleum Exporting Countries (OPEC) not to reduce its output and to let prices sink was a purely rational and smart one in our opinion, for much of the reasoning we are outlining. If they cut output in order to maintain prices, other companies and nations would pick up the slack over the short- to mid-term, and the frackers would increase at a more and more rapid pace, causing long-term oil prices to eventually suffer even more. And so, what OPEC is doing, although unprecedented and a difficult decision, makes a lot of business sense considering the new operating environment they are working in, and is probably what we would do in OPEC's place. The alternative might be much larger price drops in the future. They are thinking long-term.



What does this have to do with the airlines? Well, even with the outlook we adopted two years ago, we weren't expecting our premise about declining oil prices to be borne out so dramatically. Oil prices, in about six months, dropped a little over 50% and went from almost $100 a barrel to less than $50! This is *oil*, mind you, one of the largest industries in the world—a well over 40-trillion-dollar enterprise. We knew most investors on the Street would not be looking at the long-term consequences of these moves, as they are focused more on what will happen today and tomorrow than on one-to-five years from now. We also knew that almost every "negative" in one part of the economy generates a potential "positive" somewhere else. We asked ourselves, "What industry, economy, or sector will this precipitous (and in our view, sustainable) plunge in oil prices affect, and how can we profit from it, either on the long or the short side of the equation?" Inherently, there *have* to be some beneficiaries, and losers, from such a huge and sudden change—and we wanted to find them.

On the benefit or long side, we knew that retailers would benefit because it would be cheaper for people to drive to their stores, and customers would have more discretionary capital available due to not spending so much at the pump. But we don't generally like retail these days, mainly because of what Amazon and others are doing, and the general direction and sustainability of e-tailing.

How about the package shipping industry? It is one of the largest consumers of gas, and gas represents a huge chunk of its operating costs. We considered increasing our FedEx position. After all, I already understand that business quite well, as we are already invested in it, and love the fact that it's relatively immune from China, operates in a virtual duopoly with UPS, and is relatively resistant to competitors. I also love the CEO, Fred Smith. He has been there since their inception, he knows how to keep costs down, and he's an entrepreneur who can deliver—a rarity. FedEx also has a huge tailwind building up from the massive shift toward e-commerce. These are all qualities I love to see in an investment. But mainly, I know fuel is a *huge* part of delivery companies' expenses, and savings in that line item should gush down to the bottom line.

But wait, not so fast. FedEx, it turns out, uses a surcharge on its deliveries, meaning that the party sending the package pays for increases in fuel charges. But when oil prices decrease, FedEx lowers the surcharge. So the sender of the package gets most of the benefit of lower fuel prices, not FedEx. Of course, this arrangement won't necessarily hold sway over the long term because I am sure FedEx (and UPS for that matter) will slowly figure out how to extract more of the fuel-cost savings for themselves. Still, the bottom line picture for now is: FedEx may get a short-term bump this quarter for the period immediately after oil prices plummeted and before FedEx had time to adjust its surcharges, but after that, the benefits will be more gradual and long-range.

So I liked FedEx, but given the dramatic scope of the drop in oil prices, I searched for a better play. And that led us to the airlines.

An Idea Takes Flight

I've never been a fan of the airline industry. In my view, it is a generally inefficient and highly fragmented industry. There is too much cutthroat competition, which has historically led to large headaches and lots of red ink.

But the oil-price situation demanded I take a fresh look.

The initial shock I had when looking into the airline stocks was that the forward P/E ratio for American and United was less than six! Today I rarely see a stock at five or six times P/E, when the market average is more like 18. The five-to six-times-range is usually reserved for tech companies that are well on their way toward obsolescence.

With five-to-six times earnings, you don't need much of a blip on net income to move the needle. Even if there weren't any continued benefits from their long term hedging against fuel prices, you would still be getting the equivalent of almost 20% on your money; that's without an increase in the stock price. The status quo, in this case, would not be a bad thing, and any semblance of additional profitability would be gravy, especially if there was good profitability ahead to boot. And these airlines were increasing their dividends and buybacks at a brisk clip.

At these P/Es I wanted to do a deep dive. I knew if I could find a premise missed by the investment community, there would be a huge upside potential here, along with low downside because of the relatively low P/E. As I began my research, I quickly discovered that my premises regarding the airline industry, while they *were* true years ago, had lost validity—and I suspected I was not alone in my misconception. In the past there were many, many carriers, all fighting tooth-and-nail with one another and constantly dropping prices and offering promotional airfares. They were all losing money in an extremely competitive "land grab" environment and each airline was getting funded to grow at all costs in hopes of becoming a profitable survivor.

But there has been massive consolidation from over 200 carriers thirty years ago. Owing to many recent mergers, bankruptcies, and other massive shifts, the airline industry has changed dramatically over just the past few short years...

Consolidation and Coordination

In December 2013, a huge merger took place between American Airlines and US Airways. With this acquisition happening on the heels of several important smaller ones—Delta acquiring Northwest in 2008, United and Continental merging in 2010, and Southwest acquiring Air Tran in 2011—we saw the last piece of a major tectonic shift in the airlines fall into place. Two hundred airlines had now been reduced to *four that controlled 85% of the business!* The enormity of that change cannot be overstated.

And now these four main surviving carriers don't even compete a great deal in the same markets (routes). It is often just one or two airlines operating in a market, especially on the non-stop routes. So, where competition used to be an airline-industry killer, actual competition in the airlines is now considerably lower than in most industries!

The Department of Justice had long been concerned about the effect that mergers and collusion amongst the airlines could have on competitiveness in the industry. The DOJ, in fact, filed suit to stop the American-US Airways merger from happening, on the grounds that it would lead to less competition and higher prices for consumers.

In its suit, the DOJ said that it saw the landscape changing and that in recent years major airlines have, in tandem, raised fares and imposed new and higher fees. According to a *Washington Post* article, the DOJ's position was that, "Big airlines have all sorts of ways to coordinate fares with each other. First, there are 'cross-market initiatives,' or CMIs. Essentially, the airlines threaten each other with destructive price wars in order to keep fares high. ... CMIs often cause an airline to withdraw fare discounts.

"The airlines *also* share real-time airfare data in order to coordinate prices."

This was true even back in 1992. At that time, the US government filed a lawsuit to stop several airlines, including US Airways and American, from engaging in that practice. But that prohibition has now expired:

"[A]ll airlines have complete, accurate, and real-time access to every detail of every airline's published fare structure on every route through the airline-owned Airline Tariff Publishing Company ("ATPCO"). ... The airlines use ATPCO to monitor and analyze each other's fares and implement strategies designed to coordinate pricing." The article further states, "The big remaining US airlines now try to avoid competing with each other**.** The complaint notes that three of the four remaining 'legacy carriers'—namely, Delta, America, and United—appear to have a gentleman's agreement not to undercut each other on pricing along certain routes..."

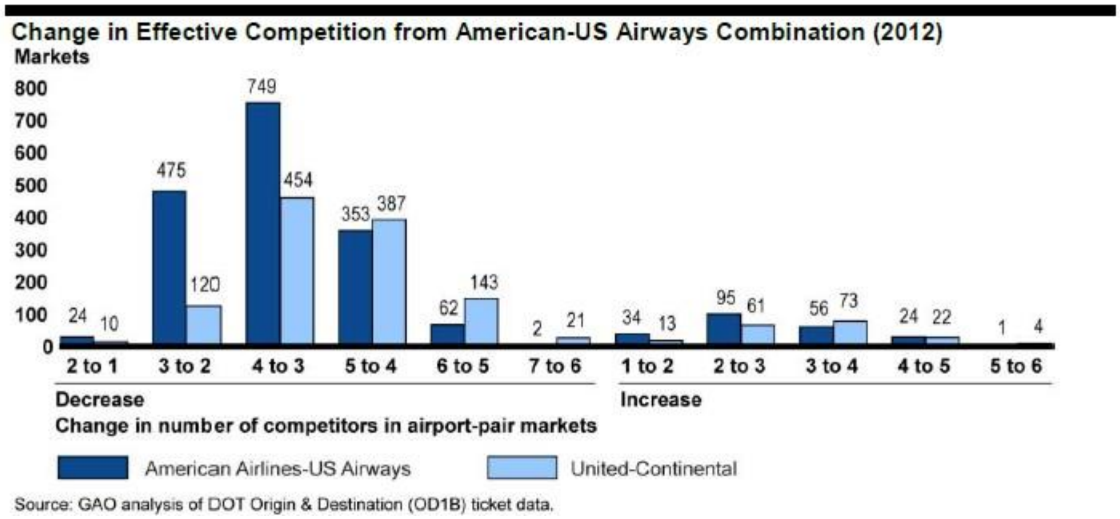
And if this sort of coordination in routing and pricing was happening *before* the big merger, it seemed only logical to assume that it would continue in the wake of the largest consolidation to date. (And that's exactly what has happened, and is continuing to happen, through the oil price drop.)

The DOJ also concluded that the merger was likely to result in continued higher ancillary fees, such as checked baggage fees and flight change fees. I think we are all seeing these today. These fees have, in fact, become huge profit centers for the airlines. As early as 2012, even before the largest merger had taken place, the domestic airlines generated $6 billion in fees from checked bags and flight changes alone. These fees weren't being charged until the last few years, for the most part, and the change seemingly came out of nowhere. Now we know why.

The only way the American-US Airways merger ultimately got greenlighted was for the new American to give up some of its gate spaces (a modest number) to the remaining few competitors. In finally letting the merger go through, the DOJ knew the pendulum could swing too far in the anti-competitiveness direction, but after years and years of red ink for the airlines during the land grab stage, and then the recession hitting, the DOJ approved all of these mergers at a rapid-fire pace.

And now many of the DOJ's fears are being realized. The end result is that, after years of land grabbing, there is not much land left to grab. Most of it has been left in the hands of the four major carriers, with a few others on the fringes, thereby effectively capping the potential for future competition for years or decades to come. But all of this has created an extraordinary investment opportunity.

The chart below by the GAO shows, to our point, that with the rapid reduction in the number of major airlines, the competition for routes between destinations has dropped *dramatically*. And it has all happened very fast. As each reduction continues forward in time, the effect (of the added business and the ability to avoid cutthroat pricing) is increased—this is not your grandmother's airline investment anymore.



The chart above shows that, for example, with the latest massive consolidation between American and US Airways, there were 749 instances where the competition dropped from four carriers offering a route to only three, and 475 routes that are now serviced by only two airlines as opposed to three before the merger. There was a similar raft of reductions with the prior merger of United and Continental. The bottom line is that there is now much less competition serving passengers between routes.

Out of 1,875 markets served in the United States, 26.6% of them are now served by two or fewer carriers, 66.5% by three or fewer, and a little over 85% of them by four or fewer. Perhaps even more astonishing is the corollary: that less than 15% of the markets are now served by five or more airlines—a dramatic shift from the intense competition that characterized the industry during its heyday growth.

2 or fewer	499	26.6%
3 or fewer	1248	66.5%
4 or fewer	1601	85.3%
5 or more…	275	14.7%

In 2014, some 197 million passengers boarded American's mainline and regional flights. The newly combined airline operated 983 mainline jets and 566 regional aircraft as of year-end, 2014. Including its subsidiaries and third-party regional carriers, such as American Eagle and US Airways Express, the carrier now operates an average of nearly 6,700 flights per day.

Remember, this latest merger was only finalized at the end of 2013. So the ramifications of this largest of all airline mergers have not even been fully felt yet. It takes time. But it all bodes very well for an even further reduction in competition, which augurs sustainable profit levels for the near future.

Again, four mergers since 2008 have led to the shrinking of the last eight remaining major airlines to four in just a few years' time. That is a *lot* of change, and it's very hard for analysts to project the long-term consequences of such change. Understanding it and unwinding it from a longer-term perspective creates tremendous opportunity.

With a P/E under six, consolidation was not the only compelling factor making the airlines tough to compete with...

Capacity

According to FAA estimates (2012), air travel is expected to double over the next twenty years. As supporting evidence for this projection, for the past thirty years there has been around a 5% annual increase. But flight capacity is on track to increase at a slower rate, which should only increase demand.

In the last year alone, United saw its profitability double, as these airlines are crushing it with unprecedented profits. Coming off a record $4.6 billion in 2014, they are expected to *double* and grow to $9.9 billion this year. But even in the face of that, United Airlines has said its strategy is to grow capacity "in a disciplined manner" and in line with GDP, as have the other major airlines. As proof, in the fourth quarter of 2014, United saw its available seat miles, or capacity, grow at a year-over-year rate of only .09%. Delta Airlines increased capacity at only a 3.7% pace. Perhaps more telling is that in 2011, after Southwest’s latest merger, combined capacity totaled 128.5 billion available seat miles, or ASMs. Three years later, in 2014, Southwest offered 131.0 billion ASMs—indicating that it increased capacity less than 2% in a three-year period.

Further evidence of a stall in the increase of capacity is that the number of planes in use over the past two years, and expected again for this year, has stayed about constant. Why is that? In most other industries, with this type of profitability, they would be blowing the doors off capacity, building out and expanding as fast as possible.

The fact is that the airlines can’t grow very quickly, even if they want to. Physical capacity is near maximum. Flight totals have not diminished with all the consolidation that has happened. The same routes, and many more that have become available, have filled up all the airports and their open hubs; it’s just that they are all consolidated with the four major carriers. There aren’t many routes, or gates, the airlines can add right now.

Gate Space

Limited gate space has become a major issue, and is having a dampening effect on any future competition. Especially within the primary markets, gate space is now a highly sought-after commodity.

There are simply very few spots left. In fact, gate space is such a scarcity that one of the biggest bargaining chips the regulators use to approve mergers is to force one or both of the merging airlines to give up, through concessions, some of their gate space.

Airport expansion is the only way to ease the space issue. But the most profitable routes are in the major gateways, and in those highly dense metropolitan areas, there is simply no real estate to expand airports without massive eminent domain initiatives, which would take many years. Even if they were to expand, they would need to raise bonds, and even if they wanted to do *that*, it would be *at least* a five-year process, with all the bureaucracies to be dealt with and the construction times involved. Almost all commercial service airports are owned and/or operated by units of local or state government, making potential airport growth even slower. And to move the needle in terms of affecting the other airlines’ operations on a large scale, expansion would need to happen simultaneously at many airports around the country. That’s just not feasible in today’s landscape. If only a few airports expanded, that would make only a small dent in the overall travel routes and the airlines’ business.

The important thing to remember, from a business perspective, is that with all of this consolidation, gate usage has not diminished. Essentially, there have been no vacant lots left for competitors to grow out of the weeds of destruction. Gates have simply been overtaken by the consolidating airlines, so it's very hard for a new or competing airline to find gate space in an airport for routes.

Airplane Backlog

Here’s another crucial point that compounds the difficulty of potential competition. Even if a couple of new airlines did start up, and they were able to get gate space in major routes, there is a huge backlog of new plane orders. There are no airplanes for them to buy!

There are only two main commercial airplane manufacturers, Boeing and Airbus, and they both have a four-year backlog on plane orders. Neither manufacturer is eager to expand capacity because investors like to see a lot of demand and a backlog of orders whenever quarterly earnings are reported, as a layer of protection against possible future economic downturns. Even if the two big manufacturers wanted to expand capacity, it would take a very long time to do so, owing to the intricacies of the business. And since there are only two major manufacturers, it's not a case where if they don't expand, the airlines will give their business to someone else.

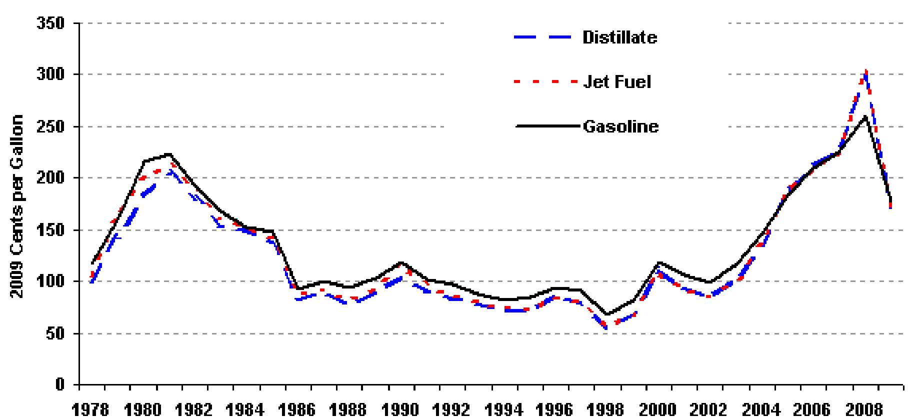
Jet airliner manufacturing is a highly sophisticated, complicated, and capital-intensive industry, and because safety issues are so important and the risk of bad publicity so extremely high, it is not easy for other entrants to get in. If they do, which they eventually will, it will take many, many years, and even then they will make only a small dent in overall capacity.

The number of airplanes currently in use and on order gives you a sense of the scale of competition in the airline industry. Virgin America, one of the few airlines that is now competing after years and years of effort, is presently operating 53 aircraft and expects to take delivery of six more by the end of 2015. By contrast, American Airlines has over 950 mainline jets and 566 regional aircraft in active use, with over 450 new planes on order. It is going to take years, if not decades, for emerging airlines to make any kind of substantial dent in the major carriers' business. And then, whichever few airlines do create a semblance of competition can easily be swallowed by the big players. For example, Delta has made recent overtures toward buying out Alaska Airlines, which has now grown to be the seventh largest airline. Virgin's relatively small fleet numbers show how far away Virgin, and by extension any other new entrant, is from entering the space in a competitive way with the major carriers. The big four hold a huge advantage for the foreseeable future.

Last but Not Least, Fuel Prices

And, of course, getting back to the advantage that led us to airlines in the first place, the airlines are intense users of fuel, and oil prices have dropped precipitously. (Jet fuel and oil prices are very highly correlated, as you can see in the chart below.)

Refiner Prices of Petroleum Products for Resale, 1978-2009



Any price reduction in fuel makes a *major* difference to an airline's costs. Its fuel charges are many times its net income. To give you an idea, American Airlines had total fuel expenses of $10.7 billion in 2014, versus a net income of $2.9 billion. Yes—wow! So a 30-50% reduction in fuel charges, over time, could have a massive effect on its profits. The full benefit, or even a very large benefit, from the cost drop hasn't been realized yet, because it happened so recently. It takes time for such things to play out. To the extent that the airlines have oil hedges in place, they will realize more and more benefits for years to come, as the hedges continue to expire over the next few years. So, a substantial, long-term reduction in fuel costs, which looks pretty likely, will continue to pour straight to the bottom line (fuel doesn't have any offsetting costs).

And the airlines, with their newfound competitive position, aren't presently planning to pass their cost savings on to customers.

Before the oil price drop even happened, US Airways CEO Doug Parker, in February of 2013, squelched any idea that American Airlines would cut fares simply because its costs were expected to go down (at that time because of the merger and an improving economy). "What we believe is that pricing is tied to demand, and that demand remains strong," he said. "And that's what we should base our pricing on, not based on our cost structure."

After the consolidation and the major plunge in oil prices, Parker reiterated his position in January of 2015, stating, "...we are going to continue to run [our airline] as though we are still operating with $100 per barrel oil." He was speaking to his investor base, but I'm sure the other three competitors were listening intently.

Sure enough, Delta Chief Executive Richard H. Anderson chimed in, saying, "These jet fuel savings are enormous, and we are diligent at maintaining those savings for the bottom line." Scott Kirby, president of the American Airlines Group added the comment, "In a strong demand environment, we don't plan to go off and proactively cut fares." And last but not least, Southwest Airlines repeated a similar message in its latest quarterly conference call.

With no fare wars on the horizon, you can do the math on the value of even a 10% drop in oil prices. This alone would seem to make the airlines good candidates for consideration as investments. But in the end, though oil prices were what drew us to this opportunity, the airline investment turned out to be a play that is not solely contingent upon oil price movements. And for all we know, oil prices could drop further, especially with Iran's massive supply hitting the market incrementally if and when the worldwide embargos are lifted. Even if oil goes up 20 to 25% beyond where it is today, the airlines would still a good investment. That is because of the companies' low P/E combined with the fundamental shifts in the industry described above.

In Summary, a Huge Moat and a Huge Tailwind

What this all boils down to is that the moat around the major airlines is incredibly robust. Any one of these competitive advantages by itself would be a huge factor...

- Four players now controlling 85% of all the industry's capacity, with many routes serviced by only two or three carriers
- Scarcity of gate space, routes and airports in which competitors could find room to grow
- Four year backlog of new aircraft orders, making planes very hard to get
- Coordination on pricing and routes between the big four
- Growing demand and limited capacity
- China-proof (which we will talk about below)
- 50% reduction in fuel costs, a dramatic expense component, over just the past six months.

But when you roll all these factors together, you get an industry that is one of the most competition-proof we've seen. On top of that you have the huge tailwinds (pun acknowledged) of good management, merger savings, and the massive decline in fuel costs. What this all adds up to is a situation in which the airlines are poised to do quite well in the foreseeable future.

This is not exactly a standard portrait of a company that is trading at less than six times next year's earnings! Many stocks that are currently trading at around the market's average of eighteen times P/E don't, in my view, contain nearly as many moats as these airline stocks—and the airlines are trading at a third of that price. How many other industries can you name with four players controlling this much of the market, huge obstacles for competitors in the foreseeable future, massive tailwinds from an unprecedented reduction in one of its primary costs, and consumer demand expected to increase by 50% within the next decade?

All told, this is the kind of opportunity you don't see very often—the kind of low downside/huge upside scenario that in our view has formed the backbone of our ability to generate hearty net returns on our long portfolio, with a drawdown less than the S&P. Bottom line: all of the signs were pointing in the same direction, and that direction was "buy."

And so the next question was which stocks to purchase. Usually we choose only one company in an industry that we love, but in this case, where several of the existing players have so many pluses, and we wanted to diversify against some of the volatility that we would undoubtedly see over the next year or so, we decided to spread the investment amongst three of them.

The reasons for choosing each individual airline pale in comparison to the overriding reasons for getting into the industry in general. In fact, as a result of the consolidation, unification of pricing, and close collaboration amongst the players, there isn't a lot separating one airline dramatically from another. That said, there are distinctive characteristics in all three of them that we like, and each has its individual risks and rewards from a peer comparison basis. We chose the three we did for the reasons I briefly explain below.

American Airlines (AAL)

Most of the major benefits coming from the merger are yet to be realized, and this merger just took place in December, 2013. Remember, the merger of American and US Airways was an enormous move, creating the largest airline in the world. With this kind of thing, it takes years to consolidate and to realize the cost benefits and savings from both the consolidation itself and the reduced competition (the two former rivals competed directly on more than a thousand routes, representing tens of billions of dollars in annual revenue).

Virgin (VA)

At only a $1.3 Billion market cap, Virgin not only has all benefits of the industry, but is the smallest of the airlines and therefore can act as a great hedge against the larger airlines. It can also act as a hedge against international competition (even though there is already legal price fixing allowed between these major carriers and their European counterparts for transatlantic flights, reducing the chances of international fare wars), and currency fluctuations, as it serves only the US market. Additionally, it may present a great buy-out opportunity for one of the larger airlines, which would pay out handsomely for it. Virgin will also be the likely beneficiary when regulators, in an attempt to increase competition in the post-merger landscape, will probably award any gate space that becomes available to smaller airlines. (American Airlines, for example, as a condition of its merger, was forced to give up two gates at Dulles. There was a fierce fight between Southwest and Delta for the spaces, but the FAA assigned the gates to Virgin.)

Virgin is doing amazingly well in customer feedback, for both its service and its airplanes. And I can personally attest to its appeal. After flying Virgin a few times, I am hooked and wouldn't travel with another airline unless the pricing was a lot cheaper—which it isn't.

The airline also gets a huge advertising advantage from its name recognition as part of Virgin brands, and has the ingenious and well-heeled Sir Richard Branson at the helm.

Virgin (as well as the other airlines we are invested in) is still at half the P/E of Southwest, which is now almost the largest in industry.

United (UAL)

We chose United as one of the three simply because it is cheap. The Price to Sales ratio of United is almost 2.5 times (yes, amazing) less than Southwest, and 25% lower than even American and Virgin. Its EBITDAR margin gap is about 500 bps less than its peers, which means it is operating much less efficiently than the others. It also has the highest fuel contracts and the most hedged fuel costs.

But we like its *in*efficiency because it bodes well for the future. If it gets its act together more—which it has already started to do by reducing head count, outsourcing where appropriate, etc.—it will eventually reap the greatest long-term benefit. And even if it doesn't get the operational efficiencies it's striving for, it should still be able to ride the benefits from the change within the industry in general, and its stock is trading at a substantial enough discount that any operational benefits will only be accretive to the bottom line—and we like that.

So, all in all, we have a nice mix of two industry leaders plus a smaller airline acting as a hedge and as a huge upside potential in case of a buyout. But, again, all of the airlines are poised to take advantage of the major premises we've outlined here.

Perhaps more telling than the airlines we chose is one we didn't choose. Our reasons for passing on this one offer a further glimpse into Prime's way of looking at things.

Southwest (LUV)

Southwest has grown to become one of the largest players, not only in the United States, but in all of the world. It has a $29 billion market cap, only a few billion shy of the largest airline in the world, American Airlines at $35 billion.

Southwest has a forward P/E that is about *twice* that of American and almost 50% higher than United, despite being a full-grown $30B airline. We think that here, again, investors may be running on a perception of how the airline industry *used* to be, and on Southwest's former image as a scrappy competitor trying to unseat the big boys. Southwest now *is* the big boy.

Symbol	Market Cap	P/E Next Year	Price/ Sales
AAL	33.3B	5.53	0.77
UAL	23.5B	5.84	0.6
VA	1.3B	7.19	0.87
LUV	28.3B	11.46	1.54

Southwest has good management and is already appreciating its reduced costs—and that is reflected in its stock price. We also see this in its P/E ratio and its Price/Sales. Though LUV is probably still a solid buy, we just think on a relative basis, we'd rather have the other airlines—although absent those opportunities we think Southwest could also do very well for all the same reasons. With the consolidation, many of the other remaining players have top-notch management as well. To pay this much—almost twice as much on all relevant matrices—for Southwest management, especially at LUV's large size already, isn't worth it on a relative basis to the other airlines, in our opinion. Again, it's all about value and trying to assess it properly. We're not just looking for well-run companies, we're looking for growth potential and low downside.

Our goal is to get a lot more picks right than wrong. In doing so, we want to make sure you know that our logic is sound and that if we see something we don't like moving forward, we can and will get out.

China-Proofing: Some Important Investment Criteria

When viewed from an "investment criteria" perspective, the airlines actually share a lot in common with most of the companies we've consistently invested in, due to their wide operating moats and other competitive factors. But here is the most critical point. The kinds of *problems* faced by the companies we like to invest in are much easier to deal with than the enormous threats that China currently presents. All of the businesses we invest in are, in many ways, "China-proof," and that's a huge advantage.

When making an investment decision, we are frankly scared to death of China from a competitiveness perspective. A big part of our evaluation process involves looking at how China could negatively or positively affect a business we are interested in investing in or shorting.

Before we get into why, let me just state categorically: we don't hate China. Far from it. In fact, we admire China. In many ways, the entire world can and will benefit from China's success. We love Chinese companies and often look for opportunities to invest in them. We know that, over the long run, in the areas where they can compete, they will be formidable. Not only are they getting a cost and labor advantage today, but they will also gain a "backyard" advantage tomorrow, in that their consumers are going to be coming, more and more, from their own backyard as China's emerging middle class continues to explode.

The problem is not that I dislike investing in China. The problem is that, in most cases, I can't get enough of an understanding of Chinese companies to feel comfortable about buying them. Before buying, I need to truly understand a company, its competitive position, its products, its competitors' products, and its sources of danger, as well as what's on its horizon from other companies, nations, new technologies, and so on. I need to use its products firsthand. For that reason, China is still shrouded in too much mystery for me. And besides, we are finding plenty of investment opportunities, with plenty of upside, that we feel we understand very well in the West right now, sticking to our knitting. In fact, we'd love to allocate *more* to each investment we are currently in, but the problem is that if we add more to one, we need to reduce from another. And we like all our investments. We also have a few good companies waiting on the sidelines, but we don't want to have more than about 25 positions on the long side. All in all, it's a good problem to have, but the point is that there's no need to stretch ourselves into situations where we don't have the same comfort level.

So I don't feel the pressing *need* to invest in Chinese companies that I don't truly understand. On the other hand, I wouldn't know how to compete *against* Chinese companies with their cost advantages, and so I would be very reluctant to invest in companies that are competing with them head-on or that are susceptible to them. I prefer companies with a wide moat against the very real challenge of China, which will only get tougher in the decades to come.

I believe China (and the whole emerging world to a lesser extent) is the number one threat to business as usual today. One reason, which we have been feeling the effects of for some time now, is that Chinese firms can create manufactured goods much more cheaply, over the long run, than US companies. Another reason is that China has more than 100,000 state-owned enterprises (SOEs), which tower over its economy. China's SOEs are even fiercer competitors to US-based companies than her private companies, because they are getting capital at lower costs and can afford to produce at lower efficiencies, since they are backed by the government. So it is even harder to compete with them because they can do irrational things like keep prices artificially low while advancing Chinese national interests. The intensity of competition from these SOEs is only getting greater as the Chinese economy has grown. Yet another reason China is such a threat is that the government and other interests make it difficult for US companies to go after Chinese consumers in their own market. And this is an absolutely massive market of over a billion consumers, with hundreds of millions currently moving into the new Chinese middle class.

But the biggest reason, by far, that China scares us derives from its sheer size and capabilities. China has a population of 1.4 billion—about 20% of the world's people—and it is young, eager, and fast growing. China's emerging dominance in multiple fields will be sustainable simply because it has so many people—we're talking about a huge scale here. Therefore, China's threat to worldwide competition from an operating perspective will continue. China will have gigantic pricing advantages over many individual industries, and there won't be equilibrium of prices and wages for a long, long time. China can presently operate on one-fifth the labor costs of the US. Its people have a fierce work ethic, are well educated, and are willing to work on low margins.

This is why companies that are *not* susceptible to China warrant *much* higher values than they are currently trading at. This is a factor that many analysts are not giving its due weight. If you look at all the companies we invest in, you will find this rule in common: they are generally much less vulnerable to China's economy, business acumen, and systemic advantages than the average company.

You can see from a quick glance, running up and down our portfolio, that being "China-proof" is at the forefront of our minds when choosing companies. If we can at least eliminate vulnerability to China as one of a company's main weak spots, that says a lot. If the company in question is able to actually *take advantage* of the changing global landscape, all the better.

In that light, let's look at some of our bigger long positions:

Note: As you know from our past annual reports, even when trying to condense our thoughts it often takes many pages of writing to explain our general views. These are very intricate companies and industries we're talking about, and every detail "counts in large amounts." It is often in understanding the details, and how they interrelate, that an investment premise comes to make sense—or not. But here I'll just offer the very broadest of summaries.

> **Activision.** This is a company that derives most of its value from intellectual property. If anything, I see it getting huge advantages from the Chinese adoption of US games, the growing interconnectedness of the world, and the huge thirst of the Chinese people for games in general (Chinese youngsters and adults play games for even more hours a day than people in the US, which is truly astonishing). And now the Chinese government is slowly opening up the gaming industry, which had been closed to US companies for so long. Major consoles, Sony's PlayStation and Microsoft's Xbox, which account for the majority of Activison game sales, are debuting their latest versions in China after a decade-plus ban on videogame consoles.

T-Mobile. We talked about TMUS last year at length. Not only is there insufficient spectrum and opportunity for a new *US* entrant to make a real play, but the chances of a Chinese company getting into the US retail telecom space are remote. (As a side note, although I didn't expect Wall Street to have so much patience for it, TMUS is right on schedule, adding 11.5 million net subscribers in the last 1.5 years, without any fierce competition or pants-dropping from Verizon or AT&T to get there. John Legere is doing an amazing job.)

FedEx. No way China is entering into the US package delivery system. That industry currently consists only of FedEx and UPS, and, secondarily, the US Postal Service. To illustrate how competition-resistant the industry is, DHL, which runs a tight ship and has a lot of experience in the worldwide shipping industry, tried to enter the market a few years ago. It spent well over $1 billion on infrastructure, then folded its tent and pretty much gave up (we're still keeping an eye on it relative to drone technology). That is an indication of how hard it is to break into the US shipping market. And not only is US door-to-door shipping a China-proof duopoly, but it is also a growth industry because of Internet shipping increasing at such a fast pace. FedEx is also expanding further into Europe and China with its industry-leading logistics know-how.

Chipotle Mexican Grill. It take years for a credible new entrant to get into the casual restaurant industry, as we have explained before, and the chances of a competitor coming from China, and being able to use any pricing or manpower advantage on US soil, are quite slim. I can even envision Chipotle growing into China eventually, either with its Mexican Grill or its ShopHouse Asian concept.

Disney. Disney is relatively immune from Chinese competition, with not only theme parks, cruise lines, and ESPN—and huge growth opportunities in many of those sectors—but also all of its extremely valuable intellectual rights for films, characters, etc. Disney should actually *benefit* from the opening up of the Chinese consumer market, and its collective wallet. The whole world loves Disney IP.

Google. If anything, Google can expand in China if it can break its deadlock with the Chinese government. I don't see the Chinese search engines breaking into the US market anytime soon.

Rite Aid. Pretty obvious. Its retail stores and pharmaceutical sales in the US are relatively immune to China's competitive forces. Health care reforms recently enacted in the United States, and the subsequent 13% year-over-year increase in prescription care, have given Rite Aid a nice jump that it is already appreciating.

You can go down the line to even the smaller players—Wells Fargo, Mannkind, Dish, Amazon, etc. All are predominately US-based and relatively China-proof in terms of their current revenue base. If anything, these companies will benefit by opening up their products to Chinese consumers.

As I said, I like Chinese companies, and although it is important to stretch ourselves beyond our comfort level, it is even more important to fully understand, on a personal level, the companies that we are investing in. That way we are able to see potential competitors and alternative products coming down the line, while also getting a good general business sense of the operating environment—on both a macro and micro level. This is the essence of the "low downside" portion of our "high upside/low downside" equation. And it's still hard for us to do this with Chinese companies.

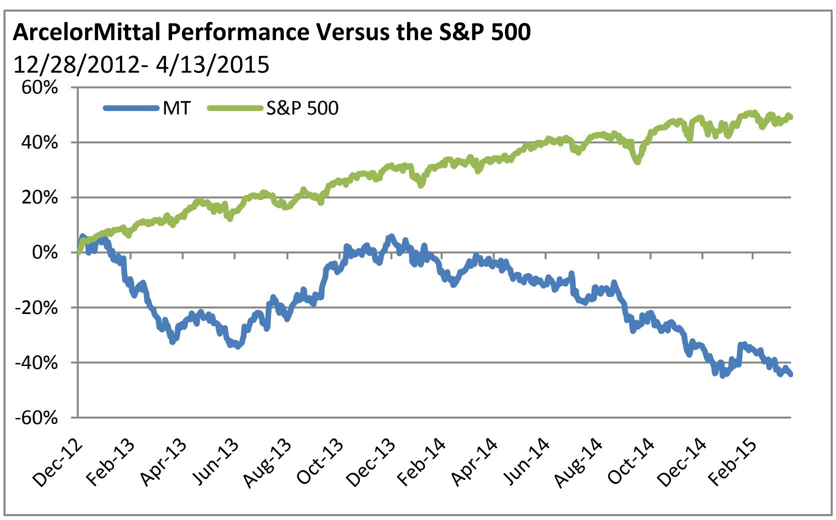
The only Chinese play we have been able to take advantage of to date is Qihoo (and, to a lesser extent, Baidu). And that is precisely because we can understand it. It doesn't have any manufacturing plants and doesn't sell a physical product. It is basically a search engine and gaming company, both of which we are familiar with from research of Google and Activision (and both are industries we like because of their moat and their rapidly growing user base). Qihoo has 25% of the Chinese market, which is vastly bigger than the US, but has a market cap of only about $7B, compared to $370B for Google. We have done quite well with that position, as we mentioned, although it was down in 2014 despite beating Wall Street's quarterly profit expectations each of the last four quarters. But it is a hard company for many people to understand and get used to.

Qihoo has an amazing story, but it's too rich to get into here, since we've already spent so much time discussing other investments. The very short version is that Qihoo is a relatively new player but has an amazing CEO with great vision, patience, and gumption, as well as a proven track record in the search engine space, having made over $100 million building out Yahoo's search engine in China. Qihoo will be a bumpy ride, but has tremendous upside that we believe it will be able to realize. It has already captured 25% of PC searches in China over the past two years alone. It operates in a market of 1.2 billion people who are rapidly moving onto the Internet, and we know how profitable the search industry can be. There are currently three players in China that control over 90% of searches, similar to the playing field in the US. And once you capture users' eyeballs, it is hard to lose them to competitors since they are never charged directly and users' loyalty to their preferred search engine is high. This is not a winner-take-all situation, but rather a case where the few Internet search companies that have been able to wrestle market share can all succeed and thrive. Qihoo could end up leading that pack eventually.

China-Vulnerable Shorts

Keeping our longs China-proof is not our only objective; we also look for shorts that have their heads right in the teeth of China's big appetite. An example of the confluence of factors that have made a great short play for us is ArcelorMittal in the steel Industry. As a steel producer, China gets a major advantage from lower labor costs, lower costs for raw materials such as coking coal used to make steel, synergies from the steel market being in its own backyard, and a push from the government owing to the fact that most of the major steel producers in China are state-owned. China produces more steel for domestic use than the rest of the world, combined! But with steel use in China growing by a mere 1% last year—and expected to slow down even more this year due to a cooling of the country's real estate boom—and Chinese steel production still going full-blast, China is exporting more and more of its excess steel capacity. China's exports to the US rose 63% in January from a year earlier. There was also a 49% increase to Europe, and a 200% increase to India over the same year.

China's steel exports over the past year were the most by any country in the past 100 years. Even with that, China is still exporting less than 10% of its domestic production. Therefore, one of our shorts that we have held for a while has been ArcelorMittal, which has been losing money for over three years now.



This stock has further decline ahead of it, in our view. In addition to the hammering it's taking from China, many other factors contribute to this story, such as the fact that ArcellorMittal is the largest producer of steel in the world, yet has less than 6% of all production. And nearly half of all steel is recycled, not even produced "fresh" each year, so it is very hard for any player to control prices. It is the opposite of a monopoly, since many countries, for pride's sake, want to have a vibrant domestic steel industry.

This is an example of how China's natural economic advantage, combined with the influence of its many State Owned Enterprises, can create opportunities on both sides of the equation, and cause major wreckage to other players.

Other Investment Criteria

Of course, China is only one of many criteria we use in finding, filtering, researching, and selecting stocks for our portfolio.

As a general rule, we migrate towards large cap companies because they have often built a wide moat, which includes pricing power and operating independence. Conversely, it is often harder (in general) to find smaller companies that have that competitive moat we love already in place. But it all comes down to the right company in the right position—because the *wrong* large-cap company, one that is *not* positioned properly, is actually even more vulnerable than smaller, more nimble companies. That's the kind of company we try to snag for our short portfolio—large companies that are out of date on their technology, product, leadership, or market positioning, and whose very size makes it hard to maneuver against the competitive forces that will be in play over the next five to ten years. XOM, IBM, and MT are examples of that type of company in our opinion.

When looking for stocks on the long side we also look for attributes such as:

- Significant increase in same-store sales or year over year revenue
- Substantially increasing market share for its products/services
- Company is well established in an industry with significant barriers to entry
- A significant "moat" surrounds the company, consisting of billions of dollars of needed investment (often combined with intellectual property rights that prevent competitors from easily entering the field)
- CEO has demonstrated entrepreneurial success, with a proven knack for "outside the box" thinking, which has generated a personal net worth that exceeds a certain target threshold

We use many additional criteria, some of which we purposely keep up our sleeve. As part of our extensive research process, we analyze factors such as:

- Is there substantial growth potential?
- Does the company have a strong and proven management team?
- Are the leverage levels appropriate for the company's long-term vision?
- What is the company's track record for growth and innovation?
- Have there been significant political, regulatory, or environmental changes affecting the industry?
- Are there emerging competitors?
- ROIC, ROA, profit margins, asset turnover, debt structure, cash flow, P/E ratios, book value, net asset value

And, of course, on the short side, we seek the inverse of most of these criteria.

Once we have completed intensive research and analysis of the stocks under review, we establish anticipated one-year, three-year, five-year, and (all important) ten-year target prices and only add to our portfolio the investments we believe provide the best risk/reward opportunity over the long term.

What Are Our Own Performance Expectations?

We hope you've enjoyed reading this year's analyses and commentaries.The message we'd like to leave you with is this:

When evaluating any investment—whether it's you looking for a vehicle or manager with which to entrust your money, or us looking for the best companies to invest in—it boils down to finding the best risk/reward scenario possible. And unfortunately, there is no way to feel 100% comfortable with any decision. There will always be lingering questions in the back of your mind. In the end, though, in both your case and ours, it's all about finding the best risk-adjusted return. As confidence builds in the performance and the sustainability of the strategy or company, the doubts begin to recede.

Toward that end, when Prime started, we set some ambitious performance goals for ourselves. We knew that 8% above the S&P was a nice stretch goal that had been achieved by a select group of individuals we highly respected in the business. So that was where we set our compass. We felt that if we could outperform the S&P by 8%, over time, then all parties involved would be very pleased.

How have we done against that goal? Starting our seventh year, we are *way* ahead of schedule. Had we attained “only” our 8% over the S&P goal since inception we would now have realized an overall gain of 308.27%. In fact, however, our overall gain, on a gross basis, has been 1,728.96%. As you can see, our actual performance has dwarfed our expected performance.

We tell you this because we hope our level of performance will help alleviate at least some of the nagging concerns you might have. We also tell you this because want to give you confidence and a sense of preparedness going forward into the future.

With a 62.32% gross average annual return, a drawdown less than the S&P’s thus far, and our worst loss to date being -1.86%, (+0.56% on an unlevered basis), you might think we would be tempted to let down our guard a bit when it comes to worrying about the market’s short-term irrationality. But in fact, we remain as vigilant as ever about it, and our risk management procedures remain durable and fully in force. We still think the market’s “temperamental” character is our biggest ongoing challenge, both from our own and our investors’ perspective. We want to make sure we put ourselves in the best position possible to let our longer-term investment theses play out, and we don’t want to get burned by the market’s short-term behavior before that happens.

Ultimately, the best defense against any market economy is excellent outperformance based on good stock picking—which we believe we have been achieving since day one. But in order to keep accomplishing that in a long-term, sustainable way, diligence, maturity, and temperance are needed. We understand that. So, just as we will continue aiming to pick the best stocks and maintain the best possible performance year in and year out, we will continue to do so with a healthy respect for the market’s inherent irrationality in order to help ensure that we can all reach our goals.

News and Wrap-up

Credit Where Credit is Due:

I'd like to thank my entire staff, especially Mariana, who has been with us since our inception, and Nicole who has been on the team for almost four years now. I am losing a lot of hair on the front of my head, and without Mariana and Nicole, I would have lost a lot more. They have made my life a relative breeze, and there is no way we would have been able to achieve the kind of success we have had, from both a performance and a peace-of-mind perspective, if it weren't for all their hard work, intelligence, and care. I like them both a lot and am grateful to them.

For many of the same reasons, I'd like to thank Andy Wolfendon, our editor. He has been helping us with our documents right from the start. I often hear people say they’re impressed with how clear and transparent my writing is, and I always feel guilty because most of that smoothness is attributable to Andy. If you tried to read my unedited work, or logic, you would probably get a bit lost, as my mind considers numerous perspectives at once. I like to cover all angles, and my brain doesn't necessarily work in a straight line. For those of you who don't know me, I am also headstrong about getting things done in a particular way, and I put a lot of emphasis on details I think are important (as you can see in my analyses). Andy has probably gone through, literally, 30+ revisions of some of these documents, and perhaps even more on some of our earlier ones. I haven't seen him physically for several years, so I wonder how much hair he has left. But I think, when all is said and done, he enjoys the work.

Last but not least, I thank my wife, who kindly reminds me that there that there is something I can do about my receding hairline. She is my other half, and I am immensely grateful to her, not only for dealing with me, but also for putting up with this crazy industry. She feels my stress, but, thankfully she understands the importance of this business and my goals, and has worked in finance herself, so she gets it. I love you, Honey, and I wouldn't change a second of our adventure together.

Our news section is brief this year. We'd like to inform you of our annual shareholders meeting to be held on June 4 at the Beverly Hills Hotel. Invitations will follow soon. You can coordinate with Nicole Hyman at 310-295-2212 or nhyman@primeopp.com.

We look forward to meeting you, if you can make it, but we take comfort in knowing that we have laid everything out for you in our written communications. We are confident that if you read our investment presentation, our annual reports (including all the stocks we have analyzed in them), “Sound Investing in Uncertain Times,” and our “Ground Rules,” you will get a very full understanding of what we do, how we do it, why we do it, and how we got to where we are today. It's all right there in black and white.

But you should also know that we take the same long-term perspective with our investor base as we do when analyzing companies. We look forward to building long-term relationships with you and being around for the next twenty-plus years. And so we are firmly committed to your doing well over the very long term, as well as to following the sustainable methodologies we’ve designed to help ensure we can get there.

Pouya Yadegar
Chief Investment Officer

April 15, 2015

[1]Performance through 12/31/2014. | Prime Opportunities Investment Group, LLC claims compliance with the Global Investment Performance Standards (GIPS®) and has been independently verified for the periods January 20, 2009 through December 31, 2013. Verification and performance examination reports are available upon request.

[2]YTD performance through 4/13/2015.

[3] Unlevered portfolio ratios.

IMPORTANT DISCLOSURES

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The strategies described represent Prime's intentions. However, Prime may pursue any objectives, employ any techniques, or purchase any type of financial investment that it considers appropriate. There are no limits on the number, size or liquidity of positions or the concentration or exposure of the portfolio. Prime has absolute discretion to change its targeted guidelines in response to changes in markets and other conditions.

Any information relating to the tax status of financial instruments discussed herein is not intended to provide tax advice or to be used by anyone to provide tax advice. Prime is not a legal or accounting firm. Investors are urged to seek tax advice based on their particular circumstances from an independent tax professional.

NO GUARANTEES OFFERED: Past performance is no guarantee of future results. All economic and performance information is historical and not indicative of future results. Different types of investments involve varying degrees of risk, and there can be no assurance that the future performance of any specific investment, investment strategy, or product made reference to directly or indirectly in this brochure, will be profitable, equal any corresponding indicated historical performance level(s), or be suitable for your portfolio. Moreover, you should not assume that any discussion or information provided here serves as the receipt of, or as a substitute for, personalized investment advice from Prime or any other investment professional. Further, the charts and graphs contained herein should not serve as the sole determining factor for making investment decisions. To the extent that you have any questions regarding the applicability of any specific issue discussed to your individual situation, you are encouraged to consult with Prime or your financial professional.

ONE STRATEGY DOES NOT FIT ALL: Our investment strategy is not necessarily suitable for ALL types of investors. Additionally, an investment strategy may be suitable for only a portion of a client’s total investable assets. When Prime does not manage all of a client’s investable assets, we recommend the client seek assistance from other financial professionals for the purpose of developing a fully diversified investment portfolio. It should be noted that Prime does not recommend specific financial professionals. For reasons including variances in account holdings, variances in the investment management fee incurred, market fluctuation, the date on which a client may engage our investment management services, and any account contributions or withdrawals, the performance of a specific client's account may vary substantially from the performance represented herein.

FIRM DEFINITION: Prime Opportunities Investment Group, LLC (“Prime”) is defined for GIPS purposes as an independent investment adviser, registered with the California Department of Business Oversight. Prime claims compliance with the Global Investment Performance Standards (GIPS®) and has been independently verified for the periods January 20, 2009 through December 31, 2013. Verification and performance examination reports are available upon request. Contact management@primeopp.com or call us at (800) 550-4188.

PERFORMANCE AND PORTFOLIO: Prime Opportunities Long/Short Composite performance results reflect time-weighted rates of return, the reinvestment of dividends and other account earnings, and are net of applicable account transaction and custodial charges, and Prime’s performance based allocation. The reinvestment of dividends and other earnings may have a material impact on overall returns. Valuation is computed and performance is reported in U.S. dollars.

Average net exposure since inception excludes gold related securities. Effective April 30, 2012, the portfolio no longer included gold investments, and Prime does not anticipate purchasing gold as a hedge going forward. Average net exposure including gold through Feb, 2015 is 21.84%. Returns and performance metrics are inclusive of gold investments.

Prime has never used options on our long positions. Options on our short positions were used in the past on two securities, but have not been purchased for over three years, and when bought were limited to Deep-in-the-Money LEAP puts for tax efficiency. Prime does not anticipate any use of options going forward.

"Long and Short Attribution” as illustrated in this report (see page 6) reflects the long and short stock contribution to return of the Prime Opportunities Long/Short Composite. It is calculated monthly as the total gains on long/short positions plus margin costs, divided by the total Average Capital Base, and compounded over time and is presented on a levered and unlevered basis for long positions and on an unlevered basis for short positions.

Returns for Prime’s Ultra Hedged Levered portfolio reflect the performance of the Prime Opportunities Long/Short Composite. Returns for subset products "Traditional Long/Short", "Ultra Hedged Unlevered", "Ultra Hedged 50% Cash Unlevered", "Long-only", "Unlevered Long-Only“ are illustrated net of fees and subject to a high water mark, and do not include cash or cash equivalents. Actual long exposure of the Prime Opportunities Long/Short Composite used for all products, with the following maximums: Ultra Hedged Unlevered and Long-Only Unlevered: 100% long exposure; Ultra Hedged 50% Cash Unlevered: 50% long exposure; Traditional Long/Short: 125% long exposure. Actual net exposures of the Prime Opportunities Long/Short Composite used for all Long/Short products with the following exception: Returns for Traditional Long/Short are illustrated using actual net exposures of the Prime Opportunities Long/Short Composite through July 2010, with 125% long exposure and 60% short exposure thereafter; the Prime Opportunities Long/Short Composite first surpassed 125% long exposure in July 2010. Floor for all products: 0% short exposure. Gross returns for subset product were calculated on a monthly basis using figures from the Prime Opportunities Long/Short Composite as follows: the *sum* of product’s long exposure divided by Prime Opportunities Long/Short Composite long exposure, multiplied by Prime Opportunities Long/Short Composite long stock contribution, *and* product’s short exposure divided by Prime Opportunities Long/Short Composite short exposure, multiplied by the Prime Opportunities Long/Short Composite short stock contribution. Net returns of subset products represent actual fees of the Prime Opportunities Long/Short Composite product, and were calculated using the Prime Opportunities Long/Short Composite gross return to net return ratio. "Long-only performance" as illustrated in this report represents the long only stock performance of the Prime Opportunities Long/Short Composite. Returns were reduced by a simulated incentive fee of 20% of all profits, charged quarterly through 12/31/13, and represent actual fees of the Prime Opportunities Long/Short Composite thereafter.

LIMITATIONS WITH PERFORMANCE BASED ALLOCATIONS: The nature of performance based allocations creates a potential conflict of interest between Prime and clients. For example, a performance allocation may encourage Prime to make riskier and more speculative investments. Prime does not represent that the amount or the manner of calculating the performance allocation is consistent with the amounts or methods used by other investment advisers under the same or similar circumstances.

LIMITATIONS WHEN COMPARING AGAINST BENCHMARKS: Prime's strategies may differ materially from the composition and performance of the S&P 500, HFRX Equity Hedge Index (Long/Short), and HFRX Equity Market Neutral Index, which have been used as benchmarks. These benchmarks are more widely known indices and are shown simply as references and not because Prime strategies are, or are likely to become, representative of past or expected benchmark performance. There may be other benchmarks that better correlate to our strategy and our performance against such strategies may be lower than performance compared to benchmarks used herein. The historical performance results of benchmarks may or may not include dividends and may or may not reflect the deduction of transaction and custodial charges, or the deduction of an investment management fee, the incurrence of which would have the effect of decreasing indicated historical performance results of the benchmarks. All information, including that used to compile charts, is obtained from sources believed to be reliable, but Prime does not guarantee its accuracy. How We Compare (page 11) is a comparison between Prime and the twenty largest long/short funds according to Preqin (fixed income funds excluded with the exception of PIMCO's Absolute Return Strategy product).

COMPOSITE DEFINITION AND RISKS: The Prime Opportunities Long/Short composite includes U.S. and international securities which utilizes a fundamentally based stock selection process. This process is combined with rigorous risk control to create an attractive return/risk product. The portfolio's value added is a function of the return spread between the long and short portfolios with the goal of providing long-term capital growth from a well-hedged strategy. Positions in the underlying portfolios are leveraged at a ratio up to, but not limited to, 2:1 for long positions and 2:1 for short positions.