ALPHAStream® PORTFOLIOS, INC.

Frequently Asked Questions
The Stock Market and AlphaStream® Investment Models

Has this volatile a stock market and steep decline ever been experienced before?

There have been many periods where steep declines occurred. The most recent have been:

- In 1987, the S&P 500 declined over 20% in one day (October 19th). From August 25th through October 20th that year the S&P declined over 35%.
- In 1990, the S&P 500 declined over 20% in three months (July 13th through October 11th).
- In 1998, the S&P 500 declined over 22% in three months (July 20th through October 8th).

In each case the market produced many days with dramatic changes in value, both up and down. In each case the S&P 500 went on to make new highs, but the time of recovery varied.

How have other investment opportunities compared to common stocks?

Investors that ran to the "safety" of gold at $913 an ounce on October 8th had a 24% decline in value only 16 days later (Gold has been down as much as 32% from its March 2008 high). The highly touted and diversified Berkshire Hathaway stock experienced a 36% decline in seven days beginning October 3rd (and has been down as much as 52% since December 2007). Oil is down 65% in just over two months.

The overall market of the last two months is rare in that virtually every asset class declined in tandem be it related to finance, manufacturing, services, real estate, oil & gas, agricultural commodities, precious metals. Many of the traditional theories of certain asset classes moving counter to one another have not held in the initial stages of this deflationary environment.

The Chart to the right, published by Bloomberg.com, depicts the dramatic decline in commodities indexes.

<u>Experts are comparing this stock market to that of the Great Depression. Is that a valid comparison?</u>

Today many experts suggest that our current market is like that at the beginning of the Great Depression in 1929. Actually, our current conditions draw closer comparisons to late 1937 – early 1938. Remember, as of November 2008 the US stock market is 8 ½ years removed from its all-time high in early 2000. In October 2007 the S&P 500 finally recovered to its previous all-time high, only to draw down below that former high once again.

The 50% decline in the S&P 500 from March 2000 through October 2002 in the S&P 500 took 2 ½ years. It took the S&P 500 five years to regain all the lost ground, without the economy even being in recession. Clearly, this market recovery will occur in a more challenging economy.

Few popular accounts of the Great Depression reveal that in January 1937 small-cap stocks briefly exceeded by almost 20% the all time high established in November 1928, much like the way the S&P recovered its lost value and posted new highs by October 2007. The small-cap stocks would fall below the recovery high of 1937 and not climb to that level again until April 1943.

<u>How quickly might lost stock market value be recovered?</u>

While there can be no accurate assessment or guarantee of the time to recover lost value, it is instructive to look at a comparable period of market volatility and economic uncertainty. In the 1930s, small cap stocks required a four year rally to recover all lost value from November 1928. The consecutive annual returns for 1933 through 1936 were 143%, 24%, 40% and 65%. Scattered amongst the declining years and the recovery years were **<u>monthly</u>** total returns of 21%, 26%, 18%, 35% and 73% (back-to-back), 50% and 64% and 26% (back-to-back-to-back), 39%, 30% and 35%. Make no mistake – there were some significant declining months as well that challenged the emotional fortitude of investors that stayed the course. But, if investors did not stick with their investment in stocks, the opportunity to recover value in these months was lost.

<u>Given today's economy, does it make sense to remain invested in the stock market?</u>

While no one can predict where the markets will go from here, probabilities suggest that there is more downside to this market over the long term. Our analysis suggests that it will likely be 2017 before investors see sustained record highs on the popular stock market indexes.

Despite that potential, there will be market rallies and opportunities for wealth building in the stock market. What is definite is that certain segments of the overall economy are performing and the corresponding stocks will ultimately reflect that positive dynamic. However, no one can ever predict when and to what degree investors will begin to see that value and propel the stock market higher.

For investors that have lost value in the stock market since October 2007, the best statistical opportunity at this time to recover some of that value is to remain in the stock market, recognizing that there is a small probability of further declines in the short-term. No other class of assets seems to have anywhere near the same upside potential as common stocks at this moment.

<u>When stock market value is recovered, how will AlphaStream Portfolios protect those gains?</u>

Since 2002, AlphaStream Portfolios has researched the optimum method for protecting the investment potential of the Decile Model when these protracted declines in the market are encountered. Since the objective of the Decile Model is to outperform the S&P 500 with regularity, when the need to hedge arises it is logical to remove the S&P 500 risk component from the holdings of an investment portfolio. When the Hedge Model identifies the potential for a protracted decline in the S&P 500, the model will trigger the purchase of assets that inversely track the performance of the S&P 500 Index. Up to 100% of the value of the long positions can be hedged.

Effective December 1, 2008, investors that choose the long-only Decile Model will be able to incorporate the hedge Model in their portfolio strategy. The AlphaStream® Special Strategy Fund (formerly known as the Special Equity Fund) will begin incorporating the hedge Model on December 1, 2008. (This is not a solicitation for the Fund. Please obtain a prospectus at www.alphastreamfunds.com)

<u>Why did the Decile Model lose so much value in September and October?</u>

Through August the net year-to-date return of the Decile Model was down approximately 6% and the S&P was down approximately 12.6%. So, at the beginning of September the Decile Model had more than a six percentage point advantage over the S&P for 2008. By the end of October, the Model had given up that margin of superiority. The reasons for this are two-fold.

First, the Decile Model is set to a time component that allows the model to adapt to changes in an orderly market or a market with somewhat heightened volatility. The purpose for this constraint is to avoid a lot of unnecessary trading in and out of industry groups (and associated trading expenses). The stock market decline in September and October will go down in history as one of the sharpest declines in the shortest time frames. The market decline was analogous to a one hundred year storm, but the Decile Model is simply not designed to respond to such a statistical outlier.

Second, the market of the last two months is rare in that virtually every asset class declined in tandem be it related to finance, manufacturing, services, real estate, oil & gas, agricultural commodities, precious metals. Thus, there was little opportunity for the Decile Model to identify industry groups with positive dynamics.

<u>Did the collapse of financial stocks affect the performance of the Decile Model?</u>

While the Decile Model has not held any bank or finance-related stocks (in fact, the Model has not recommended such a group since March 2007) the adverse impact of those industry groups on others has been pronounced. Much of the disparity between the daily performance of the Model and the S&P 500 is due to the fact that the Index has heavy exposure to banks and financials which may rise or fall 20, 30, 0r 40% a day.

<u>What industry groups did contribute to the decline in the Decile Model's value?</u>

At the end of July 2008, the Model did specify heavy exposure to commodity-based groups associated with agriculture, oil & gas, and metals. At the time that was where investor psychology and investment dollars were focused. This coincided with the highs for many commodity indexes. The Model did begin in August to reduce exposure to most of the commodity groups, but not at a rate that was sufficiently rapid enough to avoid the adverse impact of one of the most dramatic declines in commodity prices in US history, as evidenced by the following Bloomberg chart.

Again, it is worth noting that the overall market of the last two months is rare in that virtually every asset class declined in tandem be it related to finance, manufacturing, services, real estate, oil & gas, agricultural commodities, precious metals. There were virtually no safe harbors.