

## **HUSSMAN INVESTMENT TRUST DUE DILIGENCE INFORMATION**

### **What is Dr. Hussman's investment background?**

Dr. Hussman holds a Ph.D. in Economics from Stanford University (1992), and two degrees from Northwestern University: a Masters degree in Education and Social Policy (1985) and a Bachelors degree in Economics (1983, Phi Beta Kappa). Dr. Hussman is the president and sole shareholder of Hussman Strategic Advisors (formerly known as Hussman Econometrics Advisors), the investment advisory firm that manages the Hussman Funds. He is also the President of Hussman Investment Trust.

Prior to managing the Hussman Funds, Dr. Hussman was a professor of Economics and International Finance at the University of Michigan. His academic research centers on market efficiency and information economics. Of particular interest is the potential for the market to be inefficient even when traders hold "rational expectations", and the ability of price movements to convey the private information held by disparately informed traders even in the presence of "noise."

Dr. Hussman has been active in the financial markets since 1981. In the mid-1980's, he worked as an options mathematician for Peters & Company at the Chicago Board of Trade. In 1988, he began publishing the Hussman Econometrics newsletter. He has been active in portfolio management since 1993.

### **Why are the Funds termed "Strategic"?**

The essential objective of the Hussman Funds is to take those investment risks that we expect to be rewarded, on average, and to avoid, hedge or diversify away those risks not associated with a satisfactory expected return. The approach is strategic in the sense that we do not believe that any specific type of investment risk (such as market risk) is always worthwhile. Depending on the specific market environment, the Funds may employ hedging techniques to minimize the impact of fluctuations in the overall stock or bond markets, and may also take positions in individual securities that differ substantially from their weights in aggregate stock or bond market averages.

### **What criteria does the manager use to determine whether market conditions are favorable or unfavorable?**

We use an ensemble of evidence to classify investment conditions, with **valuation** and **market action** being the most important considerations. Each unique combination of valuation, market action and other factors produces a specific "Market Climate" with its own average historical characteristics of expected return and risk. Our approach is not to "predict" market direction. All of the Market Climates that we define may experience short-term returns which are both positive and negative. Rather the intent of the approach is to classify prevailing investment conditions with those historical instances having the greatest similarity, and to accept those investment risks which are expected to be

compensated by high returns, on average, while attempting to systematically avoid those risks which have historically not been compensated.

Valuations and market action significantly influence our willingness to take risk, both at the overall market level and at the individual stock level. In stocks, **favorable valuation** means that stock prices appear reasonable in view of the stream of earnings, dividends, and cash flows expected in the future. We also use a variety of information from financial statements relating to capital structure, inventories, receivables, book value, and other factors that influence the stability and quality of financial results. In bonds, favorable valuation means that yields on long-term bonds appear reasonable in relation to inflation, short-term interest rates, economic growth, and yields available on competing assets such as utility stocks and foreign bonds.

**Market action** considers the behavior of a wide range of securities and industry groups, in an attempt to assess the economic outlook of investors and their willingness to accept market risk. **Market action involves more than just obvious trends in the major averages.** We are not trying to measure the extent or duration of various trends, and we don't expose ourselves to risk just because, say, the S&P crosses its 50-day moving average. Rather, we are interested in the quality of market action – for example, whether stocks are advancing broadly or narrowly, whether trading volume is active or dull as stock prices change, whether corporate bonds are diverging from Treasuries, and so forth.

Market action conveys an enormous amount of information. Most of this is conveyed not simply by obvious trends, but in more subtle ways - particularly how various elements of market action diverge from how they would be expected to behave, given the surrounding context.

A few examples may be useful. Suppose you are given a series of numbers and are asked to calculate the average. If the current average is 25, and the next number you are given is 25, there is no new information in that (other than slightly strengthening your confidence in the existing average). But if the next number is 30, now you've got new information and your average changes. This new information appears because the new data diverged from what your previous information would have anticipated. Statistically, new information is only found in the difference between actual data and expected data.

Similarly, suppose that Treasury bond yields are falling, and corporate bond yields are also falling. In this case, the uniform decline in yields is a fairly pure interest rate signal. But suppose instead that Treasury yields are falling but corporate yields are rising. That divergence contains important and useful information - generally about oncoming economic weakness and a rising probability of corporate debt problems. Likewise, if manufacturing stocks are advancing but transportation stocks are declining, the divergence could be a signal that inventories are building without an improvement in final demand, or perhaps that market participants are concerned about energy prices.

We strongly believe that market action conveys information held by millions of other traders – not only about broad economic trends, but also about their own personal situations (income improvements, job losses, risk preferences, etc). Market action distills all of this

information in ways that cannot possibly be conveyed by government statistics. Our objective is to gauge the quality of market action, not simply to chase raw and obvious market trends that may or may not have run their course.

At the individual stock level, favorable market action involves price and volume action that suggests accumulation by other traders. Favorable market action often conveys information about potentially favorable news and earnings surprises. Such market action should not be confused with momentum or relative strength approaches. The information content of price and volume action is revealed through more subtle characteristics than raw price strength.

**Can you explain in detail exactly what factors and calculations are incorporated into your valuation models and measures of market action?**

No. While we believe that it is important for shareholders to understand the general basis of our investment decisions, an exhaustive description of Dr. Hussman's investment considerations would force the Fund to compete with other investors in pursuing its own investment approach. In most cases, detailed exposition of specific factors and calculations would be useful only to competitors.

**Can you provide a complete historical record of shifts in the Market Climate, and a monthly listing of stocks selected in historical tests of your investment approach?**

No. This would invite attempts at reverse engineering and compromise the value of our historical research to our own shareholders. Also, from a regulatory standpoint, historical tests do not represent actual investment results. Finally, while ongoing historical research is an important part of our work, the management of the Funds is based on a broad, ongoing evaluation of market conditions, including both quantitative and non-quantitative judgments.

**Does Dr. Hussman have a prior track record relevant to the Funds?**

Rule 206(4) of the Investment Advisers Act places a number of restrictions on performance advertising. Except for a similar approach to stock selection, the Funds' strategies, objectives and investment policies differ substantially from those applied prior to the inception of the Funds. These investment policies include much wider diversification than is feasible for private accounts, as well as prohibitions on the use of margin and net short positions. We are enthusiastic about our real-time stock selection record, as well as the results of extensive historical tests (both in and out of sample) of our Market Climate approach. But we believe that it would be misleading to combine a real-time security selection record with the record of hedging strategies and investment policies that did not, in fact, exist prior to the inception of the Funds, or to present performance figures as if they were representative of how the Funds would have performed, despite substantially different restrictions. For this reason, we have chosen to let the Funds' real-time records stand on their own merits.

**Does Dr. Hussman have any personal investments in the Hussman Funds?**

Yes. Virtually all of Dr. Hussman's liquid assets are invested in the Hussman Funds. Depending on individual circumstances, this allocation may not be suitable for all investors. The Hussman Funds are designed to be well-diversified "core" holdings for investors pursuing a disciplined, long-term saving and investment plan. Using these Funds, investors can achieve a diversified portfolio that includes U.S. and foreign stocks as well as U.S. Treasury securities. When investment conditions are viewed as appropriate, the Funds may also include exposure to U.S. agency securities, investment grade corporate bonds and foreign government bonds, Treasury inflation protected securities, utilities, and precious metals shares.

### **Does Dr. Hussman manage private accounts?**

The only investment vehicles under Dr. Hussman's management are Hussman Strategic Growth Fund, Hussman Strategic Total Return Fund and Hussman Strategic International Equity Fund. Dr. Hussman is a Trustee of the Hussman Foundation, Inc., a private foundation organized to provide life-changing assistance through medical research, education, and direct aid to vulnerable individuals having urgent needs or significant disabilities. Dr. Hussman is also a Trustee of Genome Sciences Foundation, Inc., a charitable organization formed to advance the field of personalized medicine by providing genetic testing and counseling related to disease risk and pharmacogenomics. Dr. Hussman also oversees the investments of a few charitable organizations, without direct compensation. Such investments are restricted to money market securities, cash equivalents and mutual funds (primarily long-term investments in the Hussman Funds). Transactions for these organizations follow the same Code of Ethics restrictions as Dr. Hussman's personal investments.

### **Does Dr. Hussman attempt to time the market by identifying bottoms, tops, or short-term market movements?**

No. The essence of our Market Climate approach is not to forecast, but to identify. We do not believe that it is possible to forecast specific market movements, but we do believe that the Market Climates we identify have substantially different return/risk characteristics on average. So instead of trying to forecast future direction (particularly short-term movements), we attempt to align our investment position with the specific Market Climate that we identify at any given point in time.

It is important to understand that all of the Market Climates we identify may include substantial market advances or declines. Even the most favorable Market Climate we identify includes some periods of sharply falling prices. Even the most negative Market Climate includes some periods of sharply rising prices. We are interested only in the average return/risk for each Market Climate. We generally have no prediction of how long a given Market Climate will persist, or when it will shift. Once we have identified a particular Market Climate, we do not believe that we have the additional ability to forecast short-term advances or declines within that Market Climate.

We simply do not react or attempt to "correct" our position when the market declines in a favorable Market Climate or advances in an unfavorable Market Climate. This is because

we believe that attempting to forecast short-term market movements is useless and counterproductive. Shifts in the Market Climate generally prompt shifts in our investment position. But market fluctuations within a particular Market Climate generally do not provoke a significant change in our stance.

Our objective is long-term capital appreciation and total return with added emphasis on protecting capital during unfavorable market conditions. This objective does expose us to certain risks that are different than a buy-and-hold approach, or a forecasting approach for that matter. Notably, we will simply fail to "track" short-term rallies that occur in unfavorable Market Climates. This "tracking risk" isn't of particular concern for long-term investors. Indeed, if an investor hopes to defend capital during substantial market declines, the willingness to follow a strategy that doesn't always track the market is essential. Still, certain investors may find this tracking risk unacceptable, and for those investors, our approach is inappropriate. It is also inappropriate for investors who believe that all movements in the market should be "timed." We do not have any confidence at all that our approach will consistently align itself with short-term market movements.

**How do the Funds choose brokers to execute its trades? What are the typical trading costs paid by the Funds? Do the Funds receive any soft-dollar benefits?**

We choose brokers on the basis of competitiveness of commissions, quality of service, ability to effectively execute orders per trade instructions, and timeliness of order executions. Competitiveness of commissions includes per-share charges as well as minimum commission levels. Service and effectiveness is evaluated on the basis of phone-waiting times to place orders, speed of confirmation for completed trades, resolution of customer service inquiries, and the ability of trading staff to handle complex orders. Timeliness of order executions is evaluated on criteria including the time-delay between entry of limit orders and their appearance on real-time data feeds, and the ability of brokers to match trades against bids and offers appearing on real-time data feeds.

The average cost of trading for the Funds is approximately 1.3 cents per share and \$1.30 per option contract. The Funds do not accept "soft dollar" research or other payments as compensation for directing trades to brokers.

**What would happen in the event that Dr. Hussman is incapacitated or otherwise unable to manage the Funds?**

While Hussman Strategic Advisors may add and train additional financial analysts as the Funds grow, no individual can fully replicate the decisions of another. It is an asset to the Funds that Dr. Hussman's skills are not easily replicated, but this is also a risk factor. As is typical for investment managers who follow unique investment approaches, there is no way to fully hedge this risk.

Nevertheless, we believe that the combined investment and finance experience of the Board of Trustees is outstanding, and that in the event of Dr. Hussman's incapacitation, the Board would take sure action as it deems to be in the best interest of the Funds'

shareholders, which could include either overseeing the adherence of each Fund with the investment approach contained in the Prospectus, or alternatively, overseeing a return of capital to shareholders at the prevailing net asset value. Nelson Freeburg is a nationally recognized expert in the development of disciplined and quantitative trading systems. He has offered significant expertise to the Funds. William Vanover is the head of Planning Alternatives, a financial planning firm with an active money management practice. David Anderson has substantial experience in computer applications and investment analysis, and worked with Dr. Hussman on trading systems and option valuation methods as early as 1986.

**Does Dr. Hussman have any intention of selling his investment company or retiring in the foreseeable future?**

No.

**What roles do analysts play in the research process?**

Dr. Hussman is solely responsible for security selection, investment decisions and order placement for the Strategic Growth Fund and the Strategic Total Return Fund. He is also the lead portfolio manager for the Strategic International Equity Fund and is responsible for the day-to-day investment decisions of the Fund and continuously reviews, supervises and administers the Fund's investment program. As co-portfolio manager of the Strategic International Equity Fund, William J. Hester, CFA, collaborates with Dr. Hussman in research, market analysis and security selection for the Fund. Mr. Hester also provides research articles, industry analysis, portfolio attribution, and shareholder communications. A number of staff members assist with statistical analysis, computer programming, optimization and other quantitative research.

**Dr. Hussman's background indicates that he was a professor of economics and international finance prior to managing the Funds. Why doesn't he accept the widespread academic view that financial markets are efficient?**

The focus of Dr. Hussman's academic research was market efficiency and information economics. We fully accept (and rely on) the premise that market action conveys information. But there are additional assumptions on expectation formation and preferences that are required by theoretical models that assert market efficiency. Two of Dr. Hussman's papers may be useful in understanding these views: Time variation in market efficiency; a mixture of distributions approach (1998 – available on the Research & Insight page of the Fund website, [www.hussmanfunds.com](http://www.hussmanfunds.com)), and Market efficiency and inefficiency in rational expectations equilibria; dynamic effects of heterogeneous information and noise, *Journal of Economic Dynamics and Control* 16 (1992) 665-680.

**Who receives the 1.5% redemption fee paid by investors who hold the Funds for less than 60 days?**

All redemption fees are retained as part of the applicable Funds' assets, and are a direct

benefit to the remaining shareholders of that Fund. The fee does not go to the Fund's investment manager. In the interest of our long-term shareholders, the Funds also have the right to refuse any investment that the investment manager determines may not be in the Funds' best interest (for example, in the case of investments by market timers and other short-term traders).

### **How do the Funds vote proxy ballots?**

Proxies are voted in a manner intended to maximize the value of investments to shareholders, subject to reasonable standards of social responsibility. Any conflict between shareholder interests and the business interests of the Advisor must be resolved in the way that will most benefit the shareholders of the Funds.

When voting proxy ballots, we give substantial weight to the recommendation of management, in an attempt to give the company broad flexibility to operate as it believes is appropriate. However, we will consider each issue on its own merits, and the position of a company's management will not be supported in any situation where it is found not to be in the best interests of shareholders (for example, dilution of shareholder interests through option grants), or against reasonable standards of ethical conduct and social responsibility (for example, marketing certain products to minors, and insufficient controls or oversight with respect to foreign workplace standards).

We strongly favor incentive compensation plans based on increases in "economic value added" (EVA): after-tax operating profits minus capital costs (debt service plus the risk-adjusted cost of equity capital). In contrast, we generally view stock and option incentive plans as hostile to the interests of shareholders, dilutive, subject to windfalls unrelated to financial performance, ineffective in enhancing the market value of equities, and poorly suited to increasing the long-term cash flows available to shareholders.

We will generally vote against stock and option incentive plans in any form. We support expensing the full value of option grants on an accrual basis (for more information, please see "How and why stock options should be expensed from corporate earnings" on the *Research & Insight* page of our website at [www.hussmanfunds.com](http://www.hussmanfunds.com)).

In contrast to option incentive plans, we will generally vote in favor of employee stock *purchase* plans (i.e., availability of stock purchase by employees at a fixed discount to market value). Though we see such plans as less effective than EVA plans, they are acceptable as a legitimate employment benefit, provided that shares purchased under the plan are acquired for no less than 85% of their market value.

While we do not specifically restrict investments against particular industries such as tobacco, defense, nuclear power or other areas, we believe that corporate policy should adhere to reasonable standards of social responsibility. Proxy matters in this category, initiated primarily by shareholders, typically request that the company disclose or amend certain business practices. We believe that the marketing to minors of violent media, explicit material, or potentially addictive substances (alcohol, tobacco), or unrestricted availability having similar effect, is unethical and socially irresponsible. We will generally vote in favor

of resolutions to reasonably restrict such practices, provided that the actions required by the resolutions are sufficiently targeted and quantifiable.

We believe that companies with substantial manufacturing activities in developing countries can substantially limit risks to reputation, reduce legal liability, and enhance financial stability by adopting well-articulated human rights policies. We will generally vote in favor of adopting such policies, particularly with regard to safety and workplace conditions, provided that they do not include restrictive provisions that unduly limit the ability of the company to operate competitively, or the flexibility of the company to determine the size and compensation of its labor force.

We believe that shareholders should have voting power equal to their equity interest in the company and will generally vote for proposals to lower barriers to shareholder action (e.g., limited rights to call special meetings, limited rights to act by written consent). We will generally vote against proposals for a separate class of stock with disparate voting rights.

We will generally vote for proposals to subject shareholder rights plans ("poison pills") to a shareholder vote. In evaluating these plans, we will be more likely to support arrangements with short-term (less than 3 years) sunset provisions, qualified bid/permitted offer provisions ("chewable pills") and/or mandatory review by a committee of independent directors at least every three years (so-called "TIDE" provisions).

A complete summary of our proxy voting policies and procedures for the Trust can be found in the most recent Statement of Additional Information for each Fund, available on our website at [www.hussmanfunds.com](http://www.hussmanfunds.com).

### **Do the Funds attempt to minimize tax distributions to shareholders?**

The intent of the Funds is to maximize after-tax returns to shareholders rather than minimizing taxes per se. If a Fund has the opportunity to take a short-term gain on a lower ranked holding that has advanced strongly, we will typically do so even though there is a tax consequence. To do otherwise would risk losing the gain, and the accompanying opportunity to reinvest the proceeds into a more favorable candidate.

With regard to annual distributions of income and capital gains, the Funds do attempt from time to time to take tax losses in order to reduce distributions to shareholders. However, the Funds also make an attempt to avoid the accumulation of large, undistributed gains. In our view, excessive deferral of gains is hostile to new shareholders when those gains are ultimately paid.

We believe that except when purchasing shares immediately prior to a distribution, concern about tax consequences is generally unwarranted. When a Fund pays a distribution, the share price declines by the amount of the distribution, which reduces the amount of future capital gains on the eventual liquidation. Since distributions may include both long- and short-term gains, the ill-advised practice of selling a Fund prior to a distribution may actually result in higher taxes than taking that distribution.

## **Can you explain the Funds' accounting process?**

The Funds are priced daily and net asset value is calculated at the close of regular trading on the NYSE (generally 4 PM EST) on each day that the exchange is open for business. The Funds value their securities and other investments at current market value determined on the basis of market quotations. In rare instances when such quotations are not available, securities may be priced at fair value in accordance with procedures adopted by the Board of Trustees. The Prospectus and Statement of Additional Information (SAI) contain more detailed information on Fund pricing policies.

With respect to the Strategic International Equity Fund, the value of foreign securities may be materially affected by events occurring before the Fund's pricing time but after the close of the primary markets or exchanges on which the securities are traded. Portfolio securities of the Fund that trade in foreign markets will typically be priced at their fair value as determined by an independent pricing service approved by the Board of Trustees. Foreign securities are translated from the local currency into U.S. dollars using current exchange rates supplied by an independent pricing service.

Portfolio transactions are recorded on a trade-date-plus-one basis. Interest and dividend income is accrued as it is earned. Cost is relieved on a first-in-first-out basis unless a given lot is specifically identified by the investment manager.

## **STRATEGIC GROWTH FUND**

### **How does the Strategic Growth Fund "hedge" its stock positions?**

Typically, the Fund uses option combinations. Buying a put option on a stock index, and simultaneously selling short the call option having the same strike price and expiration, is equivalent to an interest-bearing short sale valued at \$100 times the underlying index. So for example, if the S&P 100 Index is at 500, buying a put option and selling short the corresponding call option (regardless of the specific strike price or expiration chosen for the pair) is equivalent to selling short  $\$100 \times 500 = \$50,000$  worth of S&P 100 stocks.

The most defensive position held by the Fund is a fully hedged stance where the entire value of stocks held by the Fund is offset by a short sale of equal value in major market indices. So for example, if the market falls by 10% and the stocks held by the Fund fall by 5%, a fully hedged position would result in a positive return of about 5%. In contrast, if the market falls by 10% and the stocks held by the Fund fall by 15%, the Fund would experience a loss of about 5% despite being fully hedged. Similar examples apply to market advances. In either case, the return of a fully hedged position is driven by the difference in performance between the stocks we own and the indices we use to hedge, not by absolute market direction.

The Fund may experience a loss even when it is "fully hedged", if the returns of the stocks held by the Fund fall short of the returns of the securities and financial instruments used to hedge, or if the exercise prices of the Fund's call and put option differ, so that the combined

loss on these options during a market advance exceeds the gain on the underlying stock index. The Fund's hedging positions are intended to provide a hedge against general movements in the stock market as they might impact the overall portfolio. Because the Fund does not necessarily invest in the securities included in any index or invest in industry sectors in the same proportion as such sectors may be represented in any index, the hedging strategy used by the Fund does not eliminate market risk or provide complete protection against adverse changes in the prices of individual securities or securities within particular industry sectors. When options are owned by the Fund, it is possible that they may lose value over time, even if the securities underlying such options are unchanged.

### **Does the Strategic Growth Fund use leverage?**

The Fund holds a short-term line of credit to assist with day-to-day management of cash balances, but does not borrow money for investment purposes. During particularly favorable Market Climates, however, the Fund has the ability to invest a limited percentage of assets in call options. This ability is specifically restricted in the Prospectus, such that the maximum amount of stock controlled by the Fund, either directly through purchase, or indirectly through call options, may not exceed 150% of net assets at the time of investment.

For example, if IBM is at 90 and the Fund purchases an out-of-the-money March 120 call option on IBM, that call option counts as \$9,000 (\$90 per share times 100 "shares" per option) toward that 150% position limit. In general, this position limit implies that call options will rarely represent more than a modest percentage of Fund assets even in the most favorable Market Climates.

### **Investors have heard a lot about derivatives. Aren't they dangerous?**

A derivative is simply a security whose value is linked to (or "derived from") the value of some other security. As with any financial instrument, the risk depends on how it is used. The main risk of derivatives is the ability to use them in a highly leveraged way (for example, a hedge fund might use futures contracts to control ten times the value in stocks as the fund would be able to own if those stocks were purchased with cash).

In our view, there are three features involved in derivatives-related debacles such as Long Term Capital Management, Orange County, and Barings Bank:

1. Extreme leverage.
2. Large mismatches in the characteristics of assets and liabilities.
3. Lack of disclosure.

For example, Long Term Capital Management held a portfolio that was leveraged 40to-1, holding a large portfolio of illiquid securities in developing countries, as well as derivatives positions both long and short, in the belief that the assets and liabilities were sufficiently matched to produce low overall risk. The problem is that it is excruciatingly difficult to properly match assets and liabilities at 40 times leverage. During the 1998 Asian Crisis, a very small deviation in the behavior of the securities held by LTCM resulted in extreme losses. At 40 times leverage, it only takes a 2.5% performance gap between assets and

liabilities to completely wipe out portfolio equity. Poorly disclosed, highly leveraged portfolio mismatches are invariably at the root of derivatives-related debacles.

The Hussman Funds use options primarily for hedging risk. To the extent that the Funds use options to reduce the impact of market fluctuations, the market value protected by these options does not exceed the fully paid value of securities owned by the Funds. In other words, the Funds cannot establish net short positions. To the extent that the Strategic Growth Fund can use leverage, this ability is limited to the outright purchase of call options. The maximum amount of stock controlled by the Fund, either directly through purchase, or indirectly through call options, may not exceed 150% of net assets at the time of investment. In practice, this means that options will rarely represent more than a few percent of Fund assets. The potential loss in purchased call options is limited to the premium paid for them.

All of the options used by the Hussman Funds are exchange traded and backed by the Options Clearing Corporation (OCC). The OCC is in turn backed by the creditworthiness of its Clearing Members (major U.S. financial institutions) and carries a lien on securities, margin deposits and funds maintained in Clearing Members accounts to the extent specified in the OCC's rules (see [www.optionclearing.com](http://www.optionclearing.com) for details). The OCC requires margin deposits by its Clearing Members, and carries a separate Clearing Fund. We believe that an OCC default is highly improbable. Even if it were to occur, the potential loss to the Hussman Funds would be limited to the extent that the Fund's options were "in-the-money," which rarely represents more than a few percent of Fund assets.

### **What is the Strategic Growth Fund's beta with respect the S&P 500?**

The Fund's correlation with the major indices will vary depending on the Market Climate we identify. During Market Climates characterized by both unfavorable valuation and market action, the Fund will generally be fully hedged, and we would anticipate a near-zero correlation with overall market fluctuations. In contrast, in a Market Climate characterized by both favorable valuations and market action, the Fund will typically hold an unhedged investment position, and may even invest a small percentage of assets in call options. In such a Market Climate, we would expect that the beta of the Fund could approach 1.5. It is important to note, however, that even in the Fund's most aggressive position, any leverage taken by the Fund is restricted to owning a few percent of assets in call options, so in the event of a market decline, the additional risk of loss resulting from that leverage would be limited to that few percent of assets.

### **Is it reasonable to assume that the Strategic Growth Fund will generally outperform the stock market during bear markets, and will generally lag the stock market during bull markets?**

No. It is probably accurate to assume that the Fund may be partially hedged during very overvalued portions of bull markets, but the extent to which the Fund might lag or outperform the market when it is hedged depends on the performance of our stock holdings relative to the performance of the market indices we use to hedge.

Though bull and bear markets can only be identified in hindsight, most bull market periods are characterized both by favorable market action and favorable valuation in their early portions. In such Market Climates, the Fund will typically take an aggressive investment stance. Indeed, most bull markets have started from price/earnings ratios below 9 on the S&P 500 Index, and rarely above the historical norm of 14. The bull-bear cycle typically moves gradually through each of the Market Climates that we identify. The performance of the Fund (relative to the market) at any point in time is dependent both on the prevailing Market Climate and on the performance of our favored stocks relative to the overall market.

In general, the approach used by the Strategic Growth Fund has an inherent "bullish" bias - the only market condition that warrants a fully hedged position is when both valuations and market action are unfavorable. Historically, this has occurred in less than 30% of the long-term market record.

The historical record does include a certain number of periods in which the measures we use to identify the Market Climate were completely opposed to the major trend (as identified in hindsight). These account for about 10% of historical periods. Examining bullish periods from 1940 through 2002 (bull markets and advances of 20% or more during bear markets), 8.6% of such periods were characterized both by unfavorable valuations and unfavorable market action on the measures we use, indicating a defensive position. During 14.6% of bear market periods, both valuations and market action were favorable, indicating an aggressive position.

We have no expectation that our investment position will always be profitable over the short term. However, we attempt to avoid investment positions that rely on a particular stance being correct, at the risk of unacceptable losses otherwise. This is why we have included certain investment restrictions into the Prospectus of the Strategic Growth Fund, such as limiting the notional value of our hedges and accepting leverage only using limited-risk call options.

**Is the Strategic Growth Fund best classified as small cap, large cap, value, growth, bear, market neutral, or some combination of these?**

The Hussman Strategic Growth Fund is a no-load, diversified U.S. equity growth fund. The investment objective of the Fund is long-term capital appreciation, with added emphasis on capital preservation during unfavorable market conditions. The Fund is very emphatically a growth fund - not a bear fund, hedge fund or market-neutral fund. While there is certainly an important value emphasis on our work, we define "value" as a price that is attractive in relation to the present discounted value of expected future cash flows. Depending on the price, the stock of a very rapidly growing company can be an outstanding "value" as well. Accordingly, we see the traditional distinction between "value" and "growth" as artificial.

Our selection of investment positions is driven by the set of opportunities available at any given time. While the Fund typically holds a fully invested position in favored stocks, the specific holdings may overweight or underweight particular industry groups relative to their overall market weightings, and the characteristics of our holdings may appear weighted toward mid cap, or large cap, growth or value (as traditionally defined). None of these

should be considered “standard” investment styles.

Investors using the Fund in an asset allocation approach should consider how the Fund is likely to perform over the complete market cycle, not simply how it performs in a particular Market Climate. Though the Fund hedges its market risk in unfavorable Market Climates and leverages its market risk in favorable ones, we do not believe that the Fund should be classified as particularly conservative or aggressive overall. The Fund is probably best classified as a “multi-cap blend” Fund, reflecting a mix of market capitalizations, including both “value” and “growth” holdings as traditionally defined.

### **How much discretion does the investment manager have in choosing the specific stock holdings of the Strategic Growth Fund?**

Because the Fund is not restricted to any capitalization or security type, and does not attempt to minimize “tracking risk” against any benchmark stock index, the investment manager has broad discretion as to the individual stocks held by the Fund. However, the stocks chosen for investment are chosen because they display some combination of favorable valuation and favorable market action on various measures. While our investment universe contains all stocks on the NYSE, AMEX and NASDAQ exchanges, the set of stocks satisfying these criteria typically represent less than 10% of actively traded stocks at any point in time. The investment manager focuses primarily on these candidates.

Once a stock is admitted as a candidate by satisfying certain quantitative criteria, the investment manager applies further analysis, which may include examination of information such as financial statements, earnings estimates, news releases, research reports, and internal due diligence research by staff members.

### **What is the typical level of diversification in the Strategic Growth Fund?**

The Fund typically holds 100 or more individual securities at any given time. Highly favored stocks are often allocated a weight of about 2% of portfolio value, while most holdings range between 0.5% - 1% of portfolio value. A portion of the Fund’s performance is driven by the ability to hold a portfolio that differs from major indices to some extent, so the industry concentration of the Fund may not closely mirror that of the major indices. Except where we view valuations to be unusually favorable, the Fund generally avoids investing more than 10% of assets in any specific industry.

### **Does the Strategic Growth Fund invest in illiquid securities?**

The Fund invests primarily in securities listed on the NYSE, AMEX and NASDAQ exchanges. These may include foreign stocks listed on U.S. exchanges. In addition, the Fund typically uses listed stock and index options to manage the market risk of its portfolio. These securities are considered to be liquid, and generally have readily available price quotations. Strictly speaking, the Fund has the ability to purchase illiquid securities (e.g. private placements, over-the-counter options and repurchase agreements not terminable within seven days) in an amount up to 15% of net assets. In practice, such securities

generally fall outside of our investment strategy, and we do not anticipate making such investments in the foreseeable future.

### **Does the Strategic Growth Fund use stop-loss techniques?**

No. In historical research of our stock selection approach using historical data since the late 1950's, we were unable to find a single stop-loss approach which, applied consistently, resulted in an increase in long-term returns. Many stop loss approaches (both raw percentage rules, and variants such as relative-strength stops, volatility stops, and so forth) did result in a reduction of volatility, but always at the cost of reduced returns.

There was, however, an exit strategy that was found to reduce portfolio volatility while increasing long-term returns. This strategy involves liquidating lower ranked holdings on short-term strength, and replacing them with higher ranked candidates on (relative) short-term weakness, where "rank" is determined by both valuation and market action. This is an important daily discipline in our management approach. We certainly encounter individual cases where a stop loss rule would have been more effective in one situation or another, but applied consistently, the habit of selling lower ranked holdings on strength and buying higher ranked candidates on weakness dominates all other exit strategies we have tested.

It is important to note, however, that past results do not ensure future performance, and that the historical tests noted above do not reflect the performance of an actual investment account.

### **What is the portfolio turnover rate of the Strategic Growth Fund?**

To-date, the turnover rate of the Fund has varied from 55% to 199% annualized. In general, when stocks experience a strong upward move following a period of depressed valuations, there are often excellent opportunities to buy the stocks of growth companies at very reasonable P/E multiples. In such environments, prices can increase on the basis of earnings growth alone, without P/E multiples or other valuation measures becoming extreme. This in turn tends to result in lower turnover rates.

In contrast, when valuations are high and economic growth is stagnant, long-term holding periods are less typical for us. Lacking substantial growth in fundamentals, increases in price generally make our holdings less favorable from a valuation perspective, and we typically respond by replacing them with new, more favorably valued candidates.

That said, we always welcome the opportunity to sell lower ranked holdings on strength and buy higher ranked candidates on weakness. In a sense, more opportunities are better in this regard.

### **Does the Strategic Growth Fund intend to close investments to new investors in the foreseeable future?**

In general, mutual funds close only after their largest holdings in specific stocks begin to represent 3-5 days of average daily trading volume of those stocks (in some cases as much as 14 days). Even the largest holdings in the Strategic Growth Fund generally represent only a modest fraction of a single day's average trading volume.

There are many instances in which mutual funds have experienced reduced performance after strong growth in assets. However, it is important to understand the source of this reduced performance. Typically, these "hot" funds invest in a very narrow range of industries or market capitalizations (for example, micro-cap funds or internet funds). If you closely examine their portfolios at the peak of their popularity, you will generally find a large number of highly correlated stocks that are simultaneously overextended in price. We strongly believe that it is this feature – overextended stocks in a narrow selection group – not fund size per se, that causes "hot" funds to suffer a subsequent deterioration in performance.

As studies by Morningstar have noted, "funds usually close at about the time their favorite sectors and strategy are overheated." Morningstar examined funds that closed at any point between 1980 and June 1996: "For every fund that saw its relative performance improve, three more suffered a decline in the three years after they closed. The performance slump probably has little to do with closing. The explanation is simply that hot funds usually cool off." Morningstar attributed this effect to strategies "sensitive to asset size such as high-turnover momentum investing, or that focus on a less liquid asset class such as small caps or REITs."

The Hussman Strategic Growth Fund is not restricted to stocks in any particular capitalization range, and is a diversified fund that invests in a wide variety of industries. A specific feature of our investment approach is the attempt to sell lower ranked holdings on short-term strength, and to purchase higher ranked candidates on short-term weakness. For this reason, it is unusual for the Fund to have a large number of holdings that are simultaneously overextended. In contrast and by design, it is fairly common for the Fund to have a large number of holdings that are in the low or moderate portions of their typical range of valuation and price movement.

To a large extent, investment returns are compensation for making trades that make the market more efficient. This generally involves providing buying support for undervalued stocks that might otherwise be pressured lower, or providing selling resistance for overvalued stocks that might otherwise be pressured higher. In a U.S. stock market valued at trillions of dollars, there generally is no scarcity of such opportunities.

At the point where the largest holdings of the Strategic Growth Fund become significant relative to the average daily trading volume of these stocks, or we believe that additional investments from new shareholders would materially reduce the prospective returns of our existing shareholders, we do expect to close the Fund to new investors. Our ongoing evaluation of these factors is generally discussed in the shareholder letter of the Fund's Annual Report.

## **STRATEGIC TOTAL RETURN FUND**

### **What is the appropriate benchmark for the Strategic Total Return Fund?**

The Strategic Total Return Fund invests the majority of its assets in fixed-income securities issued or guaranteed by the United States Government, its agencies, or instrumentalities. These include U.S. Treasury bonds, notes and bills, Treasury inflation-protected securities, U.S. Treasury Strips, and U.S. Government agency securities. When market conditions favor wider diversification in the view of the investment manager, the Fund may invest in investment grade corporate debt rated AA or higher by Standard & Poor's Ratings Group, Moody's Investors Service, Inc., or having an equivalent rating from another independent rating organization. The Fund may also invest up to 30% of its net assets in securities outside of the U.S. fixed-income market (foreign government bonds, precious metals shares, and utilities). The investment return and principal value of the Fund may fluctuate or deviate from overall market returns to a greater degree than in other funds that do not employ these strategies. While the Lehman Brothers Aggregate Index is the most appropriate benchmark for comparative purposes, it should be understood that the Fund may not closely track this index in certain Market Climates.

## **STRATEGIC INTERNATIONAL EQUITY FUND**

### **What is the appropriate benchmark for the Strategic International Equity Fund?**

The MSCI Europe, Australasia, and Far East Index ("MSCI EAFE Index") is perhaps the most widely recognized index of stock prices in foreign markets. We believe it to be an appropriate broad-based securities market index against which to compare the Fund's long-term performance. The Fund may invest in securities that are not included in the MSCI EAFE Index, and may vary its exposure to market fluctuations depending on market conditions. As a result, the Fund's investment returns may differ from the performance of major stock market indices, particularly over the short term, and from the performance of U.S. stock markets.

### **Are total expenses in the Strategic International Equity Fund still capped at 2%?**

Due to the smaller size of the Fund, we have agreed to reduce our advisory fees and reimburse other operating expense until at least December 31, 2012 to the extent necessary to limit the Fund's total ordinary operating expenses to the annual rate of 2.00% of average net assets. As the Fund continues to grow, economies of scale will allow the Fund to operate at a lower expense ratio and the expense cap will no longer be needed.

### **Where can I obtain more information about the Hussman Funds?**

For Prospectus containing more complete information, including charges and expenses, please call us at 1-800-HUSSMAN (1-800-487-7626), or visit our website at [www.hussmanfunds.com](http://www.hussmanfunds.com). Please read the Prospectus carefully before you invest or send

money. The Distributor of the Hussman Funds is Ultimus Fund Distributors, LLC. Account application forms may also be downloaded from the website.

Past performance is not predictive of future results, and there is no assurance that the Hussman Funds will achieve their investment objectives. Investment results and principal value will fluctuate so that shares of the Funds, when redeemed, may be worth more or less than their original cost. The Hussman Funds have the ability to vary their exposure to market fluctuations depending on overall market conditions, and they may not track movements in the overall stock and bond markets, particularly over the short-term. While the intent of this strategy is long-term capital appreciation, total return, and protection of capital, the investment return and principal value of each Fund may fluctuate or deviate from overall market returns to a greater degree than other funds that do not employ these strategies. For example, if a Fund has taken a defensive posture and the market advances, the return to investors will be lower than if the portfolio had not been defensive. Alternatively, if a Fund has taken an aggressive posture, a market decline will magnify the Fund's investment losses.

The Hussman Strategic Growth Fund has the ability to hedge market risk by selling short major market indices in an amount up to, but not exceeding, the value of its stock holdings. The Fund also has the ability to leverage the amount of stock it controls to as much as 1 1/2 times the value of net assets, by investing a limited percentage of assets in call options.

The Hussman Strategic Total Return Fund has the ability to hedge the interest rate risk of its portfolio in an amount up to, but not exceeding, the value of its fixed income holdings. The Fund also has the ability to increase the interest rate exposure of its portfolio through limited purchases of Treasury zero-coupon securities and STRIPS. The Fund may also invest up to 30% of assets in alternatives to the U.S. fixed income market, including foreign government bonds, utility stocks, and precious metals shares.

The Hussman Strategic International Equity Fund invests primarily in equities of companies that derive a majority of their revenues or profits from, or have a majority of their assets in, a country or country other than the U.S., as well as shares of exchange traded funds ("ETFs") and similar investment vehicles that invest primarily in the equity securities of such companies. The Fund has the ability to hedge market risk by selling short major market indices using swaps, index options and index futures in an amount up to, but not exceeding, the value of its stock holdings. These may include foreign stock indices, and indices of U.S. stocks such as the Standard and Poor's 500 Index. Foreign markets can be more volatile than U.S. markets, and may involve additional risks.