

THE FBR FUNDS

FBR Pegasus FundTM Investor Class (FBRPX) and I Class (FBPIX)
FBR Pegasus Mid Cap FundTM Investor Class (FBRMX) and I Class (FBPMX)
FBR Pegasus Small Cap FundTM Investor Class (FBRYX) and I Class (FBPYX)
FBR Pegasus Small Cap Growth FundTM Investor Class (FBRCX), I Class (FBPGX) and R Class (FBPSX)

FBR Focus Fund Investor Class (FBRVX), I Class (FBRIX) and R Class (FBRRX)
FBR Large Cap Financial Fund Investor Class (FBRFX)
FBR Small Cap Financial Fund Investor Class (FBRSX), I Class (FBRUX) and R Class (FBRWX)
FBR Technology Fund Investor Class (FBRTX) and I Class (FBRQX)
FBR Gas Utility Index Fund Investor Class (GASFX) and R Class (GASSX)

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STATEMENT OF ADDITIONAL INFORMATION February 26, 2010

This Statement of Additional Information is not a Prospectus. It should be read in conjunction with the Funds' Prospectuses, dated February 26, 2010. A copy of the Funds' Prospectuses may be obtained without charge by contacting the Funds at the above telephone number.

The audited financial statements of the Funds for the fiscal year ended October 31, 2009, are included in the Funds' 2009 Annual Report to Shareholders, which has been filed with the Securities and Exchange Commission and is incorporated herein by reference. A copy of the Funds' 2009 Annual Report is available, without charge, by request by contacting the Funds at the telephone number shown above.

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FUND ORGANIZATION

The FBR Funds (the “Trust”) is an open-end management investment company organized as a statutory trust under the laws of Delaware. The Trust currently consists of nine series of units of beneficial interest (“shares”). The series described in this SAI are the FBR Pegasus FundTM, FBR Pegasus Mid Cap FundTM, FBR Pegasus Small Cap FundTM, FBR Pegasus Small Cap Growth FundTM, FBR Focus Fund, FBR Large Cap Financial Fund, FBR Small Cap Financial Fund, FBR Technology Fund and FBR Gas Utility Index Fund, each of which is a non-diversified fund (together, the “Funds”). Much of the information contained in this SAI expands on subjects discussed in the Investor Class, I Class and R Class Prospectuses. Capitalized terms not defined herein are used as defined in the Prospectuses. No investment in shares of the Funds should be made without first reading the applicable Prospectus.

Prior to February 27, 2004, the Funds, except for the FBR Pegasus FundTM, FBR Pegasus Mid Cap FundTM, FBR Pegasus Small Cap FundTM and FBR Gas Utility Index Fund, were series of the FBR Family of Funds, a Delaware statutory trust (“FoF”). Prior to February 27, 2004, the FBR Gas Utility Index Fund, Inc. was organized as a Maryland corporation (“AGI”). On February 27, 2004, each of the portfolios of FoF and AGI were reorganized as separate series of the Trust. As of February 28, 2004, the following Funds changed their names as follows: FBR Financial Services Fund (to FBR Large Cap Financial Fund), FBR Small Cap Value Fund (to FBR Small Cap Fund), and FBR Technology Fund (to FBR Large Cap Technology Fund). The portfolios of FoF and AGI that were reorganized into series of the Trust are referred to in this SAI collectively as the “Predecessor Funds.” All data and information in this SAI with respect to a Fund includes information from the periods covered by such Fund’s corresponding Predecessor Fund, as applicable. The FBR Pegasus FundTM commenced operations on November 15, 2005, the FBR Pegasus Mid Cap FundTM and FBR Pegasus Small Cap FundTM commenced operations on February 28, 2007 and therefore were not part of the reorganization in February 2004.

The Funds offer three separate classes of shares: all of the Funds offer Investor Class shares; certain of the Funds offer I Class and R Class shares. Consult the separate Investor Class, I Class and R Class Prospectuses to see which of the Funds are currently offered in those classes. The shares of the Funds’ represent an interest in the same assets of the Funds, have the same rights and are identical in all material respects except that: (i) each class of shares may bear different (or no) distribution fees; (ii) certain other class specific expenses will be borne solely by the class to which such expenses are attributable, including transfer agent fees attributable to a specific class of shares, printing and postage expenses related to preparing and distributing materials to current shareholders of a specific class, registration fees incurred by a specific class of shares, the expenses of administrative personnel and services required to support the shareholders of a specific class, litigation or other legal expenses relating to a class of shares, Trustees’ fees or expenses incurred as a result of issues relating to a specific class of shares and accounting fees and expenses relating to a specific class of shares; (iii) each class has exclusive voting rights with respect to matters relating to its own distribution arrangements; and (iv) certain classes offer different features and services to shareholders. The Board of Trustees may classify and reclassify the shares of the Funds’ into additional classes of shares at a future date.

INVESTMENTS AND RISKS

The following are the investment strategies and risks associated with investing in the Funds. The Funds’ principal investment strategies are detailed in the Funds’ Prospectuses. The following paragraphs detail other investment strategies the Funds may pursue and the risks associated therewith.

SPECIAL NOTE REGARDING RECENT MARKET EVENTS

Events in the financial sector over the past few years have resulted in reduced liquidity in the credit and fixed income markets and an unusually high degree of volatility in the financial markets, both domestic and international. While entire markets have been impacted, issuers that have exposure to the real estate, mortgage and credit markets have been particularly affected. These events and the potential for continuing market turbulence may have an adverse effect of the Funds’ investments. It is uncertain how long these conditions will continue.

The instability in the financial markets led the U.S. Government to take a number of unprecedented actions designed to support certain financial institutions and certain segments of the financial markets. Federal, state, and other governments, regulatory agencies, and self regulatory organizations may take actions that affect the regulation of the

instruments in which the Funds invest, or the issuers of such instruments, in ways that are unforeseeable. Such legislation or regulation could limit or preclude a Fund's ability to achieve its investment objective.

Governments or their agencies may also acquire distressed assets from financial institutions and acquire ownership interests in those institutions. The implications of government ownership and disposition of these assets are unclear, and such ownership or disposition may have positive or negative effects on the liquidity, valuation and performance of the Funds' portfolio holdings.

Short-Term Debt Obligations. The Funds may invest in short-term instruments which may include high grade liquid debt securities such as variable amount master demand notes, commercial paper, certificates of deposit, bankers' acceptances, repurchase agreements which mature in less than seven days and obligations issued or guaranteed by the U.S. Government, its agencies and instrumentalities. Bankers' acceptances are instruments of the U.S. banks which are drafts or bills of exchange "accepted" by a bank or trust company as an obligation to pay on maturity. Money market instruments may carry fixed, variable, or floating interest rates. A security's credit may be enhanced by a bank, insurance company, or other entity. Some money market securities employ a trust or other similar structure to modify the maturity, price characteristics, or quality of financial assets so that they are eligible investments for money market funds. If the structure does not perform as intended, adverse tax or investment consequences may result. With respect to each Fund, there may be times when, in the opinion of the Adviser, adverse market conditions exist, and it believes that the return on certain money market type instruments would be more favorable than that obtainable through a Fund's normal investment programs. Accordingly, for temporary defensive purposes, each Fund may hold up to 100% of its total assets in cash and/or short-term obligations. To the extent that a Fund's assets are so invested, they will not be invested so as to meet its investment objective.

U.S. Treasury Securities. U.S. Treasury securities are direct obligations of the U.S. Government and are backed by the full faith and credit of the U.S. Treasury. U.S. Treasury securities differ only in their interest rates, maturities, and dates of issuance. Treasury Bills have maturities of one year or less. Treasury Notes have maturities of one to ten years, and Treasury Bonds generally have maturities of greater than ten years at the date of issuance. Yields on short-, intermediate-, and long-term U.S. Treasury securities are dependent on a variety of factors, including the general conditions of the money and bond markets, the size of a particular offering, and the maturity of the obligation.

Government Agency Securities. Government agency securities, often called agencies, are indirect obligations of the U.S. government, and are issued by federal agencies and government-sponsored corporations under authority from Congress. Government agency securities may be backed by the full faith and credit of the federal government, which is the case with Government National Mortgage Association and Small Business Administration certificates, but are more often issued or guaranteed by the sponsoring agency. Examples of government agency securities include Export-Import Bank of the United States, the Federal Home Loan Banks, and the Federal Farm Credit System Banks.

Government-Sponsored Enterprises. Government-sponsored enterprises are characterized as being privately owned and publicly chartered. These enterprises were created by the U.S. Government to help certain important sectors of the economy reduce their borrowing costs. The U.S. Government does not directly back government-sponsored enterprise securities, although in some instances, government-sponsored enterprise securities may benefit from indirect support. Freddie Mac and Fannie Mae are examples of government-sponsored enterprise securities.

On September 6, 2008, the Federal Housing Finance Authority ("FHFA"), an agency of the U.S. government, placed Fannie Mae and Freddie Mac into conservatorship under its authority with the stated purpose to preserve and conserve each entity's assets and property, and to put each entity in a sound and solvent condition. The effect that this conservatorship will have on these entities' debt and equities is unclear and no assurance can be given that any steps taken by the FHFA or the U.S. Treasury or any other agency of the U.S. government with respect to Fannie Mae or Freddie Mac will succeed. Fannie Mae and Freddie Mac have each been and remain the subject of investigations by federal regulators over certain accounting matters. Such investigations, and any resulting restatements, may adversely affect these entities and, as a result, the payment of principal or interest on securities they issue.

Risks Associated with Investing in U.S. Government Securities. The U.S. Government is considered to be the best credit-rated issuer in the debt markets. Since Treasury securities are direct obligations of the U.S. Government, there is minimal credit risk. While most other government-sponsored securities are not direct obligations of the U.S. Government (although some are guaranteed by the U.S. Government), they also offer little credit risk.

However, another type of risk that may affect the Fund is market and/or interest rate risk. For example, debt securities with longer maturities tend to produce higher yields and are generally subject to potentially greater capital appreciation and depreciation than obligations with shorter maturities and lower yields. The market value of U.S. Government securities generally varies inversely with changes in market interest rates. An increase in interest rates, therefore, would generally reduce the market value of any U.S. Government security held by the Fund, while a decline in interest rates would generally increase the market value of such investment.

Bank Money Market Instruments. Bank money market instruments are short-term obligations of depository institutions which provide high liquidity and a relatively risk-free way to earn interest on cash reserves.

Risks of Bank Money Market Instruments. Bank deposits and CDs are insured to \$100,000 per depositor by the Bank Insurance Fund and the Savings Association Insurance Fund, units of the Federal Deposit Insurance Corporation ("FDIC"), and by the National Credit Union Administration ("NCUA"). The FDIC and NCUA are federally sponsored agencies.

Repurchase Agreements. A repurchase agreement is an agreement where the Funds acquire a debt security from a commercial bank or broker/dealer with the understanding that the Fund will sell the instrument back at an agreed-upon price and date (normally, the next business day). Essentially, a repurchase agreement may be considered a loan backed by securities. The resale price reflects an agreed-upon interest rate effective for the period the instrument is held by the Funds. In these transactions, the value of the securities acquired by the Fund (including accrued interest earned) must be greater than the value of the repurchase agreement itself. The securities are held by the Funds' custodian bank until repurchased.

Reasons to Use Repurchase Agreements. The Fund may invest in repurchase agreements secured by securities issued or guaranteed by the U.S. Government, its agencies and government-sponsored enterprises: (i) for defensive purposes due to market conditions; or (ii) to generate income from the Fund's excess cash balances. The Funds will only enter into repurchase agreements with member banks of the Federal Reserve system or primary dealers of U.S. Government securities.

Risks of Repurchase Agreements. The use of repurchase agreements involves certain risks. For example, if the other party to the agreement defaults on its obligations to repurchase the underlying security at a time when the value of the security has declined, the Funds may incur a loss when the security is sold. If the other party to the agreement becomes insolvent and subject to liquidation or reorganization under the Bankruptcy Code or other laws, a court may determine that the underlying security is collateral for a loan by the Funds not within the control of the Funds. Consequently, the Funds may not be able to substantiate its interest in the underlying security and may be deemed an unsecured creditor of the other party to the agreement. While the Funds' investment adviser acknowledges these risks, it is expected that these risks can be controlled through monitoring procedures. These procedures include effecting repurchase transactions only with large, well-capitalized and well-established financial institutions whose condition will be continually monitored. In addition, the value of the collateral underlying the repurchase agreement will always be at least equal to the repurchase price, including any accrued interest earned in the repurchase agreement.

Reverse Repurchase Agreements. Each Fund may borrow funds for temporary purposes by entering into reverse repurchase agreements in accordance with the Fund's investment restrictions. Pursuant to such agreements, a Fund would sell portfolio securities to financial institutions such as banks and broker-dealers, and agree to repurchase the securities at the mutually agreed-upon date and price. The Funds intend to enter into reverse repurchase agreements only to avoid otherwise selling securities during unfavorable market conditions to meet redemptions. At the time a Fund enters into a reverse repurchase agreement, it will place in a segregated custodial account assets consistent with the Fund's investment restrictions having a value equal to the repurchase price (including accrued interest), and will subsequently monitor the account to ensure that such equivalent value is maintained. Such assets will include U.S. Government securities or other liquid, high-grade debt securities.

Risks of Reverse Repurchase Agreements. Reverse repurchase agreements involve the risk that the market value of the securities sold by a Fund may decline below the price at which the Fund is obligated to repurchase the securities. Reverse repurchase agreements are considered to be borrowing by a Fund under the Investment Company Act of 1940, as amended (the "1940 Act").

Foreign Investments. The Funds may invest in securities issued by foreign branches of U.S. banks, foreign banks, or other foreign issuers, including American Depositary Receipts ("ADRs"), European Depositary Receipts ("EDRs") and Global Depositary Receipts ("GDRs") and securities purchased on foreign securities exchanges and over-the-counter.

Depositary receipts are not usually denominated in the same currency as the securities into which they may be converted. Generally, ADRs, in registered form, are designed for use in U.S. securities markets and EDRs and GDRs, in bearer form, are designed for use in European and global securities markets. ADRs are receipts typically issued by a U.S. bank or trust company evidencing ownership of the underlying securities. EDRs and GDRs are European and global receipts, respectively, evidencing a similar arrangement.

Other permissible investments include: Eurodollar Certificates of Deposit ("ECDs"), which are U.S. Dollar-denominated certificates of deposit issued by branches of foreign and domestic banks located outside the United States; Yankee Certificates of Deposit ("Yankee CDs"), which are certificates of deposit issued by a U.S. branch of a foreign bank denominated in U.S. Dollars and held in the United States; Eurodollar Time Deposits ("ETDs"), which are U.S. Dollar-denominated deposits in a foreign branch of a U.S. bank or a foreign bank; and Canadian Time Deposits ("CTDs"), which are U.S. Dollar-denominated certificates of deposit issued by Canadian offices of major Canadian Banks. Such investments may subject the Funds to significant investment risks that are different from, and additional to, those related to investments in obligations of U.S. domestic issuers or in U.S. securities markets.

Risks of Foreign Investments. The value of securities denominated in or indexed to foreign currencies, and of dividends and interest from such securities, can change significantly when foreign currencies strengthen or weaken relative to the U.S. dollar. Foreign securities markets generally have less trading volume and less liquidity than U.S. markets, and prices on some foreign markets can be highly volatile. Many foreign countries lack uniform accounting and disclosure standards comparable to those applicable to U.S. companies, and it may be more difficult to obtain reliable information regarding an issuer's financial condition and operations. In addition, the costs of foreign investing, including withholding taxes, brokerage commissions, and custodial costs, are generally higher than for U.S. investments.

Foreign markets may offer less protection to investors than U.S. markets. Foreign issuers, brokers, and securities markets may be subject to less government supervision. Foreign branches of U.S. banks and foreign banks may be subject to less stringent reserve requirements than those applicable to domestic branches of U.S. banks. Foreign security trading practices, including those involving the release of assets in advance of payment, may involve increased risks in the event of a failed trade or the insolvency of a broker-dealer, and may involve substantial delays. It may also be difficult to enforce legal rights in foreign countries.

Investing abroad also involves different political and economic risks. Foreign investments may be affected by actions of foreign governments adverse to the interests of U.S. investors, including the possibility of expropriation or nationalization of assets, confiscatory taxation, restrictions on U.S. investment or on the ability to repatriate assets or convert currency into U.S. Dollars, or other government intervention. There may be a greater possibility of default by foreign governments or foreign government-sponsored enterprises. Investments in foreign countries also involve a risk of local political, economic, or social instability, military action or unrest, or adverse diplomatic developments. There is no assurance that the Adviser will be able to anticipate these potential events or counter their effects.

The considerations noted above generally are intensified for investments in developing countries. Developing countries may have relatively unstable governments, economies based on only a few industries, and securities markets that trade a small number of securities.

The Funds may invest in foreign securities that impose restrictions on transfer within the U.S. or to U.S. persons. Although securities subject to transfer restrictions may be marketable abroad, they may be less liquid than foreign securities of the same class that are not subject to such restrictions.

Illiquid Investments and Restricted Securities. Each Fund may invest up to 15% of its net assets in illiquid investments, including restricted securities which do not meet the criteria for liquidity established by the Trust's Board of Trustees. Illiquid investments are investments that cannot be sold or disposed of in the ordinary course of business, within seven days, at approximately the prices at which they are valued. Under the supervision of the Board of Trustees, the Adviser determines the liquidity of each Fund's investments and, through reports from the Adviser, the Board of Trustees monitors investments in illiquid instruments. In determining the liquidity of a Fund's investments, the Adviser may consider various factors, including: (1) the frequency of trades and quotations; (2) the number of dealers and prospective purchasers in the marketplace; (3) dealer undertakings to make a market; (4) the nature of the security (including any demand or tender features); and (5) the nature of the marketplace for trades (including the ability to assign or offset a Fund's rights and obligations relating to the investment). Investments currently considered by the Funds to be illiquid include repurchase agreements not entitling the holder to payment of principal and interest within seven days. Also, the Adviser may determine some over-the-counter options, restricted securities and loans and other direct debt instruments, and swap agreements to be illiquid. In the absence of market quotations, illiquid investments are priced at fair value as determined in good faith in accordance with procedures established by the Board of Trustees. If through a change in values, net assets, or other circumstances, a Fund were in a position where more than 15% of its net assets were invested in illiquid securities, it would seek to take appropriate steps to protect liquidity.

Restricted securities are securities which cannot be sold to the public without registration under the Securities Act of 1933. Unless registered for sale, these securities can only be sold in privately negotiated transactions or pursuant to an exemption from registration. The ability of the Trustees to determine the liquidity of certain restricted securities is permitted under a position of the staff of the Commission set forth in the adopting release for Rule 144A under the Securities Act of 1933 ("Rule 144A"). Rule 144A is a nonexclusive safe-harbor for certain secondary market transactions involving securities subject to restrictions on resale under federal securities laws. Rule 144A provides an exemption from registration for resales of otherwise restricted securities to qualified institutional buyers. Rule 144A was expected to further enhance the liquidity of the secondary market for securities eligible for resale under Rule 144A. The Trustees determine the liquidity of certain restricted securities, including Rule 144A securities and foreign securities.

The Trustees consider the following criteria in determining the liquidity of certain restricted securities: the frequency of trades and quotes for the security; the number of dealers willing to purchase or sell the security and the number of other potential buyers; dealer undertakings to make a market in the security; and the nature of the security and the nature of the marketplace trades. The Trustees have delegated to the Adviser the daily function of determining and monitoring the liquidity of restricted securities pursuant to the above criteria and guidelines adopted by the Trustees. The Trustees will continue to monitor and periodically review the Adviser's selection of Rule 144A securities as well as any determinations as to their liquidity.

Securities Lending. Each Fund may lend its portfolio securities to broker-dealers, banks or institutional borrowers of securities. A Fund must receive a minimum of 100% collateral, plus any interest due in the form of cash or U.S. Government securities. This collateral must be valued daily and should the market value of the loaned securities increase, the borrower must furnish additional collateral to the Fund. During the time portfolio securities are on loan, the borrower will pay the Fund any dividends or interest paid on such securities plus any interest negotiated between the parties to the lending agreement. Loans will be subject to termination by the Fund or the borrower at any time. While a Fund will not have the right to vote securities on loan, it will terminate the loan and regain the right to vote if that is considered important with respect to the investment. A Fund will only enter into loan arrangements with broker-dealers, banks or other institutions which the Adviser has determined are creditworthy under guidelines established by the Trustees. Each Fund will limit its securities lending to 33 1/3% of total assets, except for the FBR Gas Utility Index Fund which will limit its securities lending to 30% of total assets.

Risks of Securities Lending. Each Fund will enter into securities lending and repurchase transactions only with nationally recognized brokers, banks, dealers or other financial institutions. In the event of a default or bankruptcy by a seller or borrower, the Fund will promptly liquidate collateral. However, the exercise of the Fund's right to

liquidate such collateral could involve certain costs or delays and, to the extent that proceeds from any sale of collateral on a default of the seller or borrower were less than the seller's or borrower's obligation, the Fund could suffer a loss.

Borrowing. Each Fund may enter into commitments to purchase securities in accordance with their investment programs, including when-issued securities and reverse repurchase agreements, provided that the total amount of any such borrowing does not exceed 33 1/3% of each Fund's total assets. Additionally, each Fund may borrow money for temporary or emergency purposes in an amount not exceeding 5% of the value of each Fund's total assets at the time when the loan is made.

THE FOLLOWING INVESTMENTS AND RISKS APPLY TO ALL FUNDS EXCEPT THE FBR GAS UTILITY INDEX FUND.

Convertible Securities. The Funds may invest in all types of common stocks and equivalents (such as convertible debt securities and warrants) and preferred stocks. The Funds may invest in convertible securities which may offer higher income than the common stocks into which they are convertible. The convertible securities in which the Funds may invest consist of bonds, notes, debentures and preferred stocks which may be converted or exchanged at a stated or determinable exchange ratio into underlying shares of common stock. A Fund may be required to permit the issuer of a convertible security to redeem the security, convert it into the underlying common stock or sell it to a third party. Thus, a Fund may not be able to control whether the issuer of a convertible security chooses to convert that security. If the issuer chooses to do so, this action could have an adverse effect on the Fund's ability to achieve its investment objectives.

Asset-Backed Securities. Asset-backed securities include pools of mortgages, loans, receivables or other assets. Payment of principal and interest may be largely dependent upon the cash flows generated by the assets backing the securities, and, in certain cases, supported by letters of credit, surety bonds, or other credit enhancements. The value of asset-backed securities may also be affected by the creditworthiness of the servicing agent for the pool, the originator of the loans or receivables, or the financial institution(s) providing the credit support.

Mortgage-Backed Securities. The Funds may invest in securities that directly or indirectly represent participations in, or are collateralized by, payable from, mortgage loans secured by real property ("Mortgage-Backed Securities").

Mortgage-Backed Securities represent pools of mortgage loans assembled for sale to investors by various governmental agencies such as the Government National Mortgage Association ("Ginnie Mae") and government-related organizations such as Fannie Mae and Freddie Mac, as well as by nongovernmental issuers such as commercial banks, savings and loan institutions, mortgage bankers, and private mortgage insurance companies. Although certain Mortgage-Backed Securities are guaranteed by a third party or otherwise similarly secured, the market value of the security, which may fluctuate, is not so secured. If the Adviser purchases a Mortgage-Backed Security at a premium, that portion may be lost if there is a decline in the market value of the security whether resulting from changes in interest rates or prepayments in the underlying mortgage collateral. As with other interest-bearing securities, the prices of such securities are inversely affected by changes in interest rates. However, though the value of a Mortgage-Backed Security may decline when interest rates rise, the converse is not necessarily true since in periods of declining interest rates the mortgages underlying the securities are prone to prepayment. For this and other reasons, a Mortgage-Backed Security's stated maturity may be shortened by unscheduled prepayments on the underlying mortgages and, therefore, it is not possible to predict accurately the securities' return to a Fund. In addition, regular payments received in respect of Mortgage-Backed Securities include both interest and principal. No assurance can be given as to the return a Fund will receive when these amounts are reinvested.

There are a number of important differences among the agencies and instrumentalities of the U.S. Government that issue Mortgage-Backed Securities and among the securities that they issue. Mortgage-Backed Securities issued by Ginnie Mae include Ginnie Mae Mortgage Pass-Through Certificates which are guaranteed as to the timely payment of principal and interest by Ginnie Mae. This guarantee is backed by the full faith and credit of the United States. Ginnie Mae is a wholly-owned U.S. Government corporation within the Department of Housing and Urban Development. Ginnie Mae certificates also are supported by the authority of Ginnie Mae to borrow funds from the U.S. Treasury to make payments under its guarantee. Mortgage-Backed Securities issued by Fannie Mae include

Fannie Mae Guaranteed Mortgage Pass-Through Certificates (also known as “Fannie Maes”) which are guaranteed as to timely payment of the principal and interest by Fannie Mae. Fannie Maes are solely the obligations of Fannie Mae and are not backed by or entitled to the full faith and credit of the United States. Fannie Mae is a government-sponsored organization owned entirely by private stockholders. Mortgage-Backed Securities issued by Freddie Mac include Freddie Mac Mortgage Participation Certificates (also known as “Freddie Mac PC’s”). Freddie Mac is a corporate instrumentality of the United States, created pursuant to an Act of Congress, which is owned entirely by Federal Home Loan Banks. Freddie Macs are not guaranteed by the United States or by any Federal Home Loan Bank and do not constitute a debt or obligation of the United States or any Federal Home Loan Bank. Freddie Macs entitle the holder to timely payment of interest, which is guaranteed by Freddie Mac. Freddie Mac guarantees either ultimate collection or timely payment of all principal payments on the underlying mortgage loans. When Freddie Mac does not guarantee timely payment of principal, Freddie Mac may remit the amount due on account of its guarantee of ultimate payment of principal at any time after default on an underlying mortgage, but in no event later than one year after it becomes payable.

The Funds may also invest in Mortgage-Backed Securities which are collateralized mortgage obligations structured on pools of mortgage pass-through certificates or mortgage loans (“CFOs” and “REMICs”) and derivative multiple-class mortgage-backed securities (“Stripped Mortgage-Backed Securities” or “SMBSs”).

Recently, rating agencies have placed on credit watch or downgraded the ratings previously assigned to a large number of mortgage-related securities (which may include certain of the mortgage-related securities in which certain of the Funds may have invested or may in the future invest), and may continue to do so in the future. If a mortgage-related security in which the Fund is invested is placed on credit watch or downgraded, the value of the security may decline and the Fund may experience losses.

Further, the recent and unprecedented disruption in the residential mortgage-related securities market (and in particular, the “subprime” residential mortgage market), the broader mortgage-related securities market and the asset-backed securities market have resulted in downward price pressures and increasing foreclosures and defaults in residential and commercial real estate. Concerns over inflation, energy costs, geopolitical issues, the availability and cost of credit, the mortgage market and a declining real estate market have contributed to increased volatility and diminished expectations for the economy and markets going forward, and have contributed to dramatic declines in the housing market, with falling home prices and increasing foreclosures and unemployment, and significant asset write-downs by financial institutions. The continuation or worsening of this general economic downturn may lead to further declines in income from, or the value of, real estate, including the real estate which secures the mortgage-related securities held by certain of the Funds. Additionally, a lack of credit liquidity and decreases in the value of real property have occurred and may continue to occur or worsen, and potentially prevent borrowers from refinancing their mortgages, which may increase the likelihood of default on their mortgage loans. These economic conditions may also adversely affect the amount of proceeds the holder of a mortgage loan or mortgage-related securities would realize in the event of a foreclosure or other exercise of remedies. Moreover, even if such mortgage-related securities are performing as anticipated, their value in the secondary market may fall or continue to fall as a result of deterioration in general market conditions for such securities or other asset-backed or structured products. Trading activity associated with market indices may also drive spreads on those indices wider than spreads on mortgage-related securities, thereby resulting in a decrease in the value of such mortgage-related securities. Mortgage loans backing non-agency mortgage-related securities are more sensitive to economic factors that could affect the ability of borrowers to pay their obligations under the mortgage loans backing these securities.

These economic conditions may reduce the cash flow that a Fund investing in such mortgage-related securities receives from such securities and increase the incidence and severity of credit events and losses in respect of such securities. In addition, interest rate spreads for mortgage-backed securities have widened and are more volatile when compared to the recent past due to these adverse changes in market conditions. In the event that interest rate spreads for mortgage-related securities continue to widen following the purchase of such assets by a Fund, the market value of such securities is likely to decline and, in the case of a substantial spread widening, could decline by a substantial amount. Furthermore, these adverse changes in market conditions have resulted in a severe liquidity crisis in the market for mortgage-backed securities (including the mortgage-related securities in which certain of the Funds may invest) and increasing unwillingness by banks, financial institutions and investors to extend credit to servicers, originators and other participants in the mortgage-related securities market for these securities and other

asset-backed securities. As a result, the liquidity and/or the market value of any mortgage-related securities that are owned by a Fund may experience further declines after they are purchased by such Fund.

The recent rise in the rate of foreclosures of properties has resulted in legislative, regulatory and enforcement actions seeking to prevent or restrict foreclosures. Actions have also been brought against issuers and underwriters of residential mortgage-backed securities collateralized by such residential mortgage loans and investors in such residential mortgage-backed securities. Future legislative or regulatory initiatives by federal, state or local legislative bodies or administrative agencies, if enacted or adopted, could delay foreclosure or the exercise of other remedies, provide new defenses to foreclosure, or otherwise impair the ability of the loan servicer to foreclose or realize on a defaulted residential mortgage loan included in a pool of residential mortgage loans backing such residential mortgage-backed securities. The nature or extent of any future limitations on foreclosure or exercise of other remedies that may be enacted is uncertain. Governmental actions that interfere with the foreclosure process, for example, could increase the costs of such foreclosures or exercise of other remedies, delay the timing or reduce the amount of recoveries on defaulted residential mortgage loans and securities backed by such residential mortgage loans owned by a Fund, and could adversely affect the yields on the mortgage-related securities owned by the Funds and could have the effect of reducing returns to the Funds that have invested in mortgage-related securities collateralized by these residential mortgage loans.

In addition, the U.S. Government, including the Federal Reserve, the Treasury, and other governmental and regulatory bodies have recently taken or are considering taking actions to address the financial crisis, including initiatives to limit large-scale losses associated with mortgage-related securities held on the books of certain U.S. financial institutions and to support the credit markets generally. The impact that such actions could have on any of the mortgage-related securities held by the Funds is unknown.

Structured Securities. Structured securities employ a trust or other similar structure to modify the maturity, price characteristics or quality of financial assets. For example, structural features can be used to modify the maturity of a security or interest rate adjustment features can be used to enhance price stability. If the structure does not perform as intended, adverse tax or investment consequences may result. Neither the Internal Revenue Service (“IRS”) nor any other regulatory authority has ruled definitively on certain legal issues presented by structured securities. Future tax or other regulatory determinations could adversely affect the value, liquidity or tax treatment of the income received from these securities or the nature and timing of distributions made by a Fund. The payment of principal and interest on structured securities may be largely dependent on the cash flows generated by the underlying financial assets.

Variable or Floating Rate Securities. Variable or floating rate securities provide for periodic adjustments of the interest rate paid. Variable rate securities provide for a specific periodic adjustment in the interest rate, while floating rate securities have interest rates that change whenever there is a change in a designated benchmark rate. Some variable or floating rate securities have put features.

Swap Agreements. Swap agreements can be individually negotiated and structured to include exposure to a variety of different types of investments or market factors. Depending on their structure, swap agreements may increase or decrease a Fund’s exposure to long- or short-term interest rates (in the United States or abroad), foreign currency values, mortgage securities, corporate borrowing rates, or other factors such as security prices or inflation rates. Swap agreements can take many different forms and are known by a variety of names. The Funds are not limited to any particular form of swap agreement if the Adviser determines it is consistent with a Fund’s investment objective and policies.

In a typical cap or floor agreement, one party agrees to make payments only under specified circumstances, usually in return for payment of a fee by the other party. For example, the buyer of an interest rate cap obtains the right to receive payments to the extent that a specific interest rate exceeds an agreed-upon level, while the seller of an interest rate floor is obligated to make payments to the extent that a specified interest rate falls below an agreed-upon level. An interest rate collar combines elements of buying a cap and selling a floor.

Swap agreements will tend to shift a Fund’s investment exposure from one type of investment to another. For example, if a Fund agreed to exchange payments in dollars for payments in foreign currency, the swap agreement would tend to decrease the Fund’s exposure to U.S. interest rates and increase its exposure to foreign currency and

interest rates. Caps and floors have an effect similar to buying or writing options. Depending on how they are used, swap agreements may increase or decrease the overall volatility of a Fund's investments and its share price.

The most significant factor in the performance of swap agreements is the change in the specific interest rate, currency, or other factors that determine the amounts of payments due to and from a Fund. If a swap agreement calls for payments by a Fund, the Fund must be prepared to make such payments when due. In addition, if the counterparty's creditworthiness declined, the value of a swap agreement would be likely to decline, potentially resulting in losses. Each Fund expects to be able to eliminate its exposure under swap agreements whether by assignment or other disposition, or by entering into an offsetting swap agreement with the same party or a similarly creditworthy party.

Each Fund will maintain appropriate liquid assets in a segregated custodial account to cover its current obligations under swap agreements. If a Fund enters into a swap agreement on a net basis, it will segregate assets with a daily value at least equal to the excess, if any, of the Fund's accrued obligations under the swap agreement over the accrued amount the Fund is entitled to receive under the agreement. If a Fund enters into a swap agreement on other than a net basis, it will segregate assets with a value equal to the full amount of the Fund's accrued obligations under the agreement.

Indexed Securities. The Funds may purchase securities whose prices are indexed to the prices of other securities, securities indices, currencies, precious metals or other commodities, or other financial indicators. Indexed securities typically, but not always, are debt securities or deposits whose value at maturity or coupon rate is determined by reference to a specific instrument or statistic. Gold-indexed securities, for example, typically provide for a maturity value that depends on the price of gold, resulting in a security whose price tends to rise and fall together with gold prices. Currency-indexed securities typically are short-term to intermediate-term debt securities whose maturity values or interest rates are determined by reference to the values of one or more specified foreign currencies, and may offer higher yields than U.S. dollar-denominated securities of equivalent issuers. Currency-indexed securities may be positively or negatively indexed; that is, their maturity value may increase when the specified currency value increases, resulting in a security that performs similarly to a foreign-denominated instrument, or their maturity value may decline when foreign currencies increase, resulting in a security whose price characteristics are similar to a put on the underlying currency. Currency-indexed securities may also have prices that depend on the value of a number of different foreign currencies relative to each other.

The performance of indexed securities depends to a great extent on the performance of the security, currency, or other instrument to which they are indexed, and may also be influenced by interest rate changes in the United States and abroad. At the same time, indexed securities are subject to the credit risks associated with the issuer of the security, and their values may decline substantially if the issuer's creditworthiness deteriorates. Recent issuers of indexed securities have included banks, corporations, and certain U.S. Government agencies. Indexed securities may be more volatile than the underlying instruments.

Stripped Securities. The Funds may purchase separately traded interest and principal component parts of such obligations that are transferable through the Federal book entry system, known as Separately Traded Registered Interest and Principal Securities ("STRIPS") and Coupon Under Book Entry Safekeeping ("CUBES"). These instruments are issued by banks and brokerage firms and are created by depositing U.S. Treasury notes and U.S. Treasury bonds into a special account at a custodian bank; the custodian holds the interest and principal payments for the benefit of the registered owner of the certificates or receipts. The custodian arranges for the issuance of the certificates or receipts evidencing ownership and maintains the register. Receipts include Treasury Receipts ("TRs"), Treasury Investment Growth Receipts ("TIGRs") and Certificates of Accrual on Treasury Securities ("CATS").

STRIPS, CUBES, TRs, TIGRs and CATS are sold as zero coupon securities, which mean that they are sold at a substantial discount and redeemed at face value at their maturity date without interim cash payments of interest or principal. This discount is amortized over the life of the security, and such amortization will constitute the income earned on the security for both accounting and tax purposes. Because of these features, these securities may be subject to greater interest rate volatility than interest-paying U.S. Treasury obligations. Bonds issued by the Resolution Funding Corporation ("REFCORP") can also be stripped in this fashion. REFCORP Strips are eligible investments for the Funds.

Zero Coupon Bonds. The Funds may purchase zero coupon bonds. Zero coupon bonds are purchased at a discount from the face amount because the buyer receives only the right to receive a fixed payment on a certain date in the future and does not receive any periodic interest payments. The effect of owning instruments which do not make current interest payments is that a fixed yield is earned not only on the original investment but also, in effect, on all discount accretion during the life of the obligations. This implicit reinvestment of earnings at the same rate eliminates the risk of being unable to reinvest distributions at a rate as high as the implicit yields on the zero coupon bond, but at the same time eliminates the holder's ability to reinvest at higher rates in the future. For this reason, zero coupon bonds are subject to substantially greater price fluctuations during periods of changing market interest rates than are comparable securities which pay interest currently, whose fluctuation increases the longer the period of maturity. Although zero coupon bonds do not pay interest to holders prior to maturity, U.S. federal income tax law requires a Fund to recognize as interest income a portion of the bond's discount each year and this income must then be distributed to shareholders along with other income earned by the Fund. To the extent that any shareholders in a Fund elect to receive their dividends in cash rather than reinvest such dividends in additional shares, cash to make these distributions will have to be provided from the assets of the Fund or other sources such as proceeds of sales of Fund shares and/or sales of portfolio securities. In such cases, the Fund will not be able to purchase additional income producing securities with cash used to make such distributions and its current income may ultimately be reduced as a result.

Real Estate-Related Investments. Real estate-related instruments include real estate investment trusts, commercial and residential mortgage-backed securities, and real estate financings. Real estate-related instruments are sensitive to factors such as real estate values, property taxes, interest rates, cash flow of underlying real estate assets, overbuilding, and the management skill and creditworthiness of the issuer. Real estate-related instruments may also be affected by tax and regulatory requirements, such as those relating to the environment.

Lower-Rated Debt Securities. The Funds may purchase lower-rated debt securities, commonly referred to as "junk bonds" (those rated below the fourth highest grade by a nationally recognized statistical ratings organization ("NRSRO") and non-rated securities judged by the Adviser to be of equivalent quality), that have poor protection with respect to the payment of interest and repayment of principal, or that may be in default. These securities are often considered to be speculative and involve greater risk of loss or price changes due to changes in the issuer's capacity to pay. The market prices of lower-rated debt securities may fluctuate more than those of higher-rated debt securities and may decline significantly in periods of general economic difficulty, which may follow periods of rising interest rates.

The market for lower-rated debt securities may be thinner and less active than that for higher-rated debt securities, which can adversely affect the prices at which the former are sold. If market quotations are not available, lower-rated debt securities will be valued in accordance with procedures established by the Board of Trustees, including the use of outside pricing services. Judgment plays a greater role in valuing high-yield corporate debt securities than is the case for securities for which more external sources for quotations and last-sale information are available. Adverse publicity and changing investor perceptions may affect the ability of outside pricing services to value lower-rated debt securities and the Fund's ability to sell these securities.

Since the risk of default is higher for lower-rated debt securities, the Adviser's research and credit analysis are an especially important part of managing securities of this type held by the Funds. In considering investments for the Funds, the Adviser will attempt to identify those issuers of high-yielding debt securities whose financial condition are adequate to meet future obligations, have improved, or is expected to improve in the future. The analysis focuses on relative values based on such factors as interest or dividend coverage, asset coverage, earnings prospects, and the experience and managerial strength of the issuer.

A Fund may choose, at its expense or in conjunction with others, to pursue litigation or otherwise exercise its right as security holder to seek to protect the interests of security holders if it determines this to be in the best interest of the Fund's shareholders.

Loans and Other Debt Instruments. Loans and other direct debt instruments are interests in amounts owed by a corporate, governmental, or other borrower to another party. They may represent amounts owed to lenders or lending syndicates (loans and loan participation), to suppliers of goods or services (trade claims or other

receivables), or to other parties. Direct debt instruments involve a risk of loss in case of default or insolvency of the borrower and may offer less legal protection to the Funds in the event of fraud or misrepresentation. In addition, loan participations involve a risk of insolvency of the lending bank or other financial intermediary. Direct debt instruments may also include standby financing commitments that obligate the Funds to supply additional cash to the borrower on demand.

Foreign Currency Transactions. Each Fund may conduct foreign currency transactions on a spot (i.e., cash) basis or by entering into forward contracts to purchase or sell foreign currencies at a future date and price. A Fund will convert currencies on a spot basis from time to time, and investors should be aware of the costs of currency conversion. Although foreign exchange dealers generally do not charge a fee for conversion, they do realize a profit based on the difference between the prices at which they are buying and selling various currencies. Thus, a dealer may offer to sell a foreign currency to a Fund at one rate, while offering a lesser rate of exchange should the Fund desire to resell that currency to the dealer. Forward contracts are generally traded in an interbank market conducted directly between currency traders (usually large commercial banks) and their customers. The parties to a forward contract may agree to offset or terminate the contract before its maturity, or may hold the contract to maturity and complete the contemplated currency exchange.

Each Fund may use currency forward contracts for any purpose consistent with its investment objective. The following discussion summarizes the principal currency management strategies involving forward contracts that could be used by the Funds. The Funds may also use swap agreements, indexed securities, and options and futures contracts relating to foreign currencies for the same purposes.

When a Fund agrees to buy or sell a security denominated in a foreign currency, it may desire to “lock in” the U.S. Dollar price of the security. By entering into a forward contract for the purchase or sale, for a fixed amount of U.S. Dollars, of the amount of foreign currency involved in the underlying security transaction, a Fund will be able to protect itself against an adverse change in foreign currency values between the date the security is purchased or sold and the date on which payment is made or received. This technique is sometimes referred to as a “settlement hedge” or “transaction hedge.” The Funds may also enter into forward contracts to purchase or sell a foreign currency in anticipation of future purchases or sales of securities denominated in foreign currency, even if the specific investments have not yet been selected by the Adviser.

The Funds may also use forward contracts to hedge against a decline in the value of existing investments denominated in foreign currency. For example, if a Fund owned securities denominated in Euro, it could enter into a forward contract to sell Euro in return for U.S. Dollars to hedge against possible declines in the Euro’s value. Such a hedge, sometimes referred to as a “position hedge,” would tend to offset both positive and negative currency fluctuations, but would not offset changes in security values caused by other factors. A Fund could also hedge the position by selling another currency expected to perform similarly to the Euro. This type of hedge, sometimes referred to as a “proxy hedge,” could offer advantages in terms of cost, yield, or efficiency, but generally would not hedge currency exposure as effectively as a simple hedge into U.S. Dollars. Proxy hedges may result in losses if the currency used to hedge does not perform similarly to the currency in which the hedged securities are denominated.

A Fund may enter into forward contracts to shift its investment exposure from one currency into another. This may include shifting exposure from U.S. Dollars to a foreign currency, or from one foreign currency to another foreign currency. For example, if a Fund held investments denominated in Euro, the Fund could enter into forward contracts to sell Euro and purchase Japanese Yen. This type of strategy, sometimes known as a “cross-hedge,” will tend to reduce or eliminate exposure to the currency that is sold, and increase exposure to the currency that is purchased, much as if the Fund had sold a security denominated in one currency and purchased an equivalent security denominated in another. Cross-hedges protect against losses resulting from a decline in the hedged currency, but will cause a Fund to assume the risk of fluctuations in the value of the currency it purchases.

Under certain conditions, Commission guidelines require mutual funds to set aside appropriate liquid assets in a segregated custodial account to cover currency forward contracts. As required by Commission guidelines, the Funds will segregate assets to cover currency forward contracts, if any, whose purpose is essentially speculative. The Funds will not segregate assets to cover forward contracts entered into for hedging purposes, including settlement hedges, position hedges, and proxy hedges.

Successful use of currency management strategies will depend on the Adviser's skill in analyzing and predicting currency values. Currency management strategies may substantially change a Fund's investment exposure to changes in currency exchange rates, and could result in losses to the Fund if currencies do not perform as anticipated. For example, if a currency's value rose at a time when the Adviser had hedged a Fund by selling that currency in exchange for U.S. Dollars, the Fund would be unable to participate in the currency's appreciation. If a Fund hedges currency exposure through proxy hedges, the Fund could realize currency losses from the hedge and the security position at the same time if the two currencies do not move in tandem. Similarly, if the Adviser increases a Fund's exposure to a foreign currency, and that currency's value declines, the Fund will realize a loss. There is no assurance that the use of currency management strategies will be advantageous to a Fund or that it will hedge at an appropriate time.

Futures Contracts. The Funds may enter into futures contracts, options on futures contracts and stock index futures contracts and options thereon for bona fide hedging purposes. Futures contracts provide for the future sale by one party and purchase by another party of a specified amount of a specific security, class of securities, or an index at a specified future time and at a specified price. A stock index futures contract is a bilateral agreement pursuant to which two parties agree to take or make delivery of an amount of cash equal to a specified dollar amount times the difference between the stock index value at the close of trading of the contracts and the price at which the futures contract is originally struck. Futures contracts which are standardized as to maturity date and underlying financial instrument are traded on national futures exchanges. Futures exchanges and trading are regulated under the Commodity Exchange Act by the Commodity Futures Trading Commission ("CFTC"), a U.S. Government agency.

Although futures contracts by their terms call for actual delivery and acceptance of the underlying securities, in most cases the contracts are closed out before the settlement date without the making or taking of delivery. Closing out an open futures position is done by taking an opposite position ("buying" a contract which has previously been "sold," or "selling" a contract previously "purchased") in an identical contract to terminate the position. A futures contract on a securities index is an agreement obligating either party to pay, and entitling the other party to receive, while the contract is outstanding, cash payments based on the level of a specified securities index. The acquisition of put and call options on futures contracts will, respectively, give the Funds the right (but not the obligation), for a specified price, to sell or to purchase the underlying futures contract, upon exercise of the option, at any time during the option period. Brokerage commissions are incurred when a futures contract is bought or sold.

Futures traders are required to make a good faith margin deposit in cash or U.S. Government securities with a broker or custodian to initiate and maintain open positions in futures contracts. A margin deposit is intended to assure completion of the contract (delivery or acceptance of the underlying security) if it is not terminated prior to the specified delivery date. Minimal initial margin requirements are established by the futures exchange and may be changed. Brokers may establish deposit requirements that are higher than the exchange minimums. Initial margin deposits on futures contracts are customarily set at levels much lower than the prices at which the underlying securities are purchased and sold, typically ranging upward from less than 5% of the value of the contract being traded.

After a futures contract position is opened, the value of the contract is marked to market daily. If the futures contract price changes to the extent that the margin on deposit does not satisfy margin requirements, payment of additional "variation" margin will be required. Conversely, a change in the contract value may reduce the required margin, resulting in a repayment of excess margin to the contract holder. Variation margin payments are made to and from the futures broker for as long as the contract remains open. A Fund expects to earn interest income while its margin deposits are held pending performance on the futures contract.

When interest rates are expected to rise or market values of portfolio securities are expected to fall, a Fund can seek, through the sale of futures, contracts to offset a decline in the value of its portfolio securities. When interest rates are expected to fall or market values are expected to rise, a Fund, through the purchase of such contracts, can attempt to secure better rates or prices for the Fund than might later be available in the market when it effects anticipated purchases.

A Fund's ability to effectively utilize futures trading depends on several factors. First, it is possible that there will not be a perfect price correlation between the futures contracts and their underlying stock index. Second, it is possible that a lack of liquidity for futures contracts could exist in the secondary market, resulting in an inability to

close a futures position prior to its maturity date. Third, the purchase of a futures contract involves the risk that the Fund could lose more than the original margin deposit required to initiate a futures transaction.

Restrictions on the Use of Futures Contracts. A Fund will only sell futures contracts to protect securities it owns against price declines or purchase contracts to protect against an increase in the price of securities it intends to purchase. Pursuant to claims for exemption filed with the CFTC and/or the National Futures Association on behalf of the Funds, the Funds are not deemed to be a “commodity pool” or “commodity pool operator” under the Commodity Exchange Act and are not subject to registration or regulation as such under the Commodity Exchange Act.

In addition to the margin restrictions discussed above, transactions in futures contracts may involve the segregation of funds pursuant to requirements imposed by the Commission. Under those requirements, where a Fund has a long position in a futures contract, it may be required to establish a segregated account (not with a futures commission merchant or broker, except as may be permitted under Commission rules) containing cash or certain liquid assets equal to the purchase price of the contract (less any margin on deposit). For a short position in futures or forward contracts held by a Fund, those requirements may mandate the establishment of a segregated account (not with a futures commission merchant or broker, except as may be permitted under Commission rules) with cash or certain liquid assets that, when added to the amounts deposited as margin, equal the market value of the instruments underlying the futures contracts (but are not less than the price at which the short positions were established). However, segregation of assets is not required if a Fund “covers” a long position. For example, instead of segregating assets, a Fund, when holding a long position in a futures contract, could purchase a put option on the same futures contract with a strike price as high or higher than the price of the contract held by the Fund. In addition, where a Fund takes short positions, or engages in sales of call options, it need not segregate assets if it “covers” these positions. For example, where the Fund holds a short position in a futures contract, it may cover by owning the instruments underlying the contract. A Fund may also cover such a position by holding a call option permitting it to purchase the same futures contract at a price no higher than the price at which the short position was established. When a Fund sells a call option on a futures contract, it may cover either by entering into a long position in the same contract at a price no higher than the strike price of the call option or by owning the instruments underlying the futures contract. A Fund could also cover this position by holding a separate call option permitting it to purchase the same futures contract at a price no higher than the strike price of the call option sold by the Fund.

In addition, the extent to which a Fund may enter into transactions involving futures contracts may be limited by the Internal Revenue Code’s requirements for qualification as a registered investment company and the Fund’s intention to qualify as such.

Risk Factors in Future Transactions. Positions in futures contracts may be closed out only on an exchange which provides a secondary market for such futures. However, there can be no assurance that a liquid secondary market will exist for any particular futures contract at any specific time. Thus, it may not be possible to close a futures position. In the event of adverse price movements, a Fund would continue to be required to make daily cash payments to maintain the required margin. In such situations, if the Fund has insufficient cash, it may have to sell portfolio securities to meet daily margin requirements at a time when it may be disadvantageous to do so. In addition, the Fund may be required to make delivery of the instruments underlying futures contracts it holds. The inability to close options and futures positions also could have an adverse impact on the ability to effectively hedge them. A Fund will minimize the risk that it will be unable to close out a futures contract by only entering into futures contracts which are traded on national futures exchanges and for which there appears to be a liquid secondary market.

The risk of loss in trading futures contracts in some strategies can be substantial, due both to the low margin deposits required, and the extremely high degree of leverage involved in futures pricing. Because the deposit requirements in the futures markets are less onerous than margin requirements in the securities market, there may be increased participation by speculators in the futures market which may also cause temporary price distortions. A relatively small price movement in a futures contract may result in immediate and substantial loss (as well as gain) to the investor. For example, if at the time of purchase, 10% of the value of the futures contract is deposited as margin, a subsequent 10% decrease in the value of the futures contract would result in a total loss of the margin deposit, before any deduction for the transaction costs, if the account were then closed out. A 15% decrease would result in a loss equal to 150% of the original margin deposit if the contract were closed out. Thus, a purchase or sale of a futures

contract may result in losses in excess of the amount invested in the contract. However, because the futures strategies engaged in by a Fund are only for hedging purposes, it is expected that the Fund is generally not subject to risks of loss exceeding those that would be undertaken if, instead of the futures contract, it had invested in the underlying financial instrument and sold it after the decline.

Utilization of futures transactions by a Fund involves the risk of imperfect or no correlation where the securities underlying futures contract have different maturities than the portfolio securities being hedged. It is also possible that a Fund could both lose money on futures contracts and also experience a decline in value of its portfolio securities. There is also the risk of loss by a Fund of margin deposits in the event of bankruptcy of a broker with whom the Fund has an open position in a futures contract or related option.

Options. The Funds may purchase and sell put and call options on their portfolio securities to enhance investment performance and to protect against changes in market prices.

Covered Call Options. A Fund may write covered call options on its securities to realize a greater current return through the receipt of premiums than it would realize on its securities alone. Such option transactions may also be used as a limited form of hedging against a decline in the price of securities owned by the Fund.

A call option gives the holder the right to purchase, and obligates the writer to sell, a security at the exercise price at any time before the expiration date. A call option is “covered” if the writer, at all times while obligated as a writer, either owns the underlying securities (or comparable securities satisfying the cover requirements of the securities exchanges), or has the right to acquire such securities through immediate conversion of securities.

In return for the premium received when it writes a covered call option, a Fund gives up some or all of the opportunity to profit from an increase in the market price of the securities covering the call option during the life of the option. The Fund retains the risk of loss should the price of such securities decline. If the option expires unexercised, the Fund realizes a gain equal to the premium, which may be offset by a decline in price of the underlying security. If the option is exercised, the Fund realizes a gain or loss equal to the difference between the Fund’s cost for the underlying security and the proceeds of sale (exercise price minus commissions) plus the amount of the premium.

A Fund may terminate a call option that it has written before it expires by entering into a closing purchase transaction. A Fund may enter into closing purchase transactions in order to free itself to sell the underlying security or to write another call on the security, realize a profit on a previously written call option, or protect a security from being called in an unexpected market rise. Any profits from a closing purchase transaction may be offset by a decline in the value of the underlying security. Conversely, because increases in the market price of a call option will generally reflect increases in the market price of the underlying security, any loss resulting from a closing purchase transaction is likely to be offset in whole or in part by unrealized appreciation of the underlying security owned by the Fund.

Covered Put Options. A Fund may write covered put options in order to enhance its current return. Such options transactions may also be used as a limited form of hedging against an increase in the price of securities that the Fund plans to purchase. A put option gives the holder the right to sell, and obligates the writer to buy, a security at the exercise price at any time before the expiration date. A put option is “covered” if the writer segregates cash and high-grade short-term debt obligations or other permissible collateral equal to the price to be paid if the option is exercised.

In addition to the receipt of premiums and the potential gains from terminating such options in closing purchase transactions, a Fund also receives interest on the cash and debt securities maintained to cover the exercise price of the option. By writing a put option, a Fund assumes the risk that it may be required to purchase the underlying security for an exercise price higher than its then current market value, resulting in a potential capital loss unless the security later appreciates in value.

A Fund may terminate a put option that it has written before it expires by a closing purchase transaction. Any loss from this transaction may be partially or entirely offset by the premium received on the terminated option.

Purchasing Put and Call Options. A Fund may also purchase put options to protect portfolio holdings against a decline in market value. This protection lasts for the life of the put option because the Fund, as a holder of the option, may sell the underlying security at the exercise price regardless of any decline in its market price. In order for a put option to be profitable, the market price of the underlying security must decline sufficiently below the exercise price to cover the premium and transaction costs that the Fund must pay. These costs will reduce any profit the Fund might have realized had it sold the underlying security instead of buying the put option.

A Fund may purchase call options to hedge against an increase in the price of securities that the Fund wants ultimately to buy. Such hedge protection is provided during the life of the call option since the Fund, as holder of the call option, is able to buy the underlying security at the exercise price regardless of any increase in the underlying security's market price. In order for a call option to be profitable, the market price of the underlying security must rise sufficiently above the exercise price to cover the premium and transaction costs. These costs will reduce any profit the Fund might have realized had it bought the underlying security at the time it purchased the call option.

A Fund may also purchase put and call options to attempt to enhance its current return.

Options on Foreign Securities. The Funds may purchase and sell options on foreign securities if the Adviser believes that the investment characteristics of such options, including the risks of investing in such options, are consistent with the Fund's investment objectives. It is expected that risks related to such options will not differ materially from risks related to options on U.S. securities. However, position limits and other rules of foreign exchanges may differ from those in the U.S. In addition, options markets in some countries, many of which are relatively new, may be less liquid than comparable markets in the U.S.

Risks Involved in the Sale of Options. Options transactions involve certain risks, including the risks that the Adviser will not forecast interest rate or market movements correctly, that a Fund may be unable at times to close out such positions, or that hedging transactions may not accomplish their purpose because of imperfect market correlations. The successful use of these strategies depends on the ability of the Adviser to forecast market and interest rate movements correctly.

An exchange-listed option may be closed out only on an exchange which provides a secondary market for an option of the same series. There is no assurance that a liquid secondary market on an exchange will exist for any particular option or at any particular time. If no secondary market were to exist, it would be impossible to enter into a closing transaction to close out an option position. As a result, a Fund may be forced to continue to hold, or to purchase at a fixed price, a security on which it has sold an option at a time when the Adviser believes it is inadvisable to do so.

Higher than anticipated trading activity or order flow or other unforeseen events might cause The Options Clearing Corporation or an exchange to institute special trading procedures or restrictions that might restrict a Fund's use of options. The exchanges have established limitations on the maximum number of calls and puts of each class that may be held or written by an investor or group of investors acting in concert. It is possible that the Trust and other clients of the Adviser may be considered such a group. These position limits may restrict the Funds' ability to purchase or sell options on particular securities.

Options which are not traded on national securities exchanges may be closed out only with the other party to the option transaction. For that reason, it may be more difficult to close out unlisted options than listed options. Furthermore, unlisted options are not subject to the protection afforded purchasers of listed options by The Options Clearing Corporation.

Government regulations, particularly the requirements for qualification as a "regulated investment company" under the Internal Revenue Code, may also restrict the Funds' use of options.

Special Expiration Price Options. The Funds may purchase over-the-counter ("OTC") puts and calls with respect to specified securities ("special expiration price options") pursuant to which the Funds in effect may create a custom index relating to a particular industry or sector that the Adviser believes will increase or decrease in value generally as a group. In exchange for a premium, the counterparty, whose performance is guaranteed by a broker-dealer, agrees to purchase (or sell) a specified number of shares of a particular stock at a specified price and further agrees

to cancel the option at a specified price that decreases straight line over the term of the option. Thus, the value of the special expiration price option is comprised of the market value of the applicable underlying security relative to the option exercise price and the value of the remaining premium. However, if the value of the underlying security increases (or decreases) by a prenegotiated amount, the special expiration price option is canceled and becomes worthless. A portion of the dividends during the term of the option are applied to reduce the exercise price if the options are exercised. Brokerage commissions and other transaction costs will reduce a Fund's profits if the special expiration price options are exercised. A Fund will not purchase special expiration price options with respect to more than 25% of the value of its net assets, and will limit premiums paid for such options in accordance with state securities laws.

LEAPS. The Focus Fund may purchase certain long-term exchange-traded equity options called Long-Term Equity Anticipation Securities ("LEAPs"). LEAPs provide a holder the opportunity to participate in the underlying securities' appreciation in excess of a fixed dollar amount. The Focus Fund will not purchase these options with respect to more than 25% of the value of its net assets.

LEAPs are long-term call options that allow holders the opportunity to participate in the underlying securities' appreciation in excess of a specified strike price, without receiving payments equivalent to any cash dividends declared on the underlying securities. A LEAP holder will be entitled to receive a specified number of shares of the underlying stock upon payment of the exercise price, and therefore the LEAP will be exercisable at any time the price of the underlying stock is above the strike price. However, if at expiration the price of the underlying stock is at or below the strike price, the LEAP will expire worthless.

Short Sales. Each Fund may seek to hedge investments or realize additional gains through the use of short sales. Short sales are transactions in which a Fund sells a security it does not own, in anticipation of a decline in the market value of that security. To complete such a transaction, the Fund must borrow the security to make delivery to the buyer. The Fund then is obligated to replace the security borrowed by purchasing it at the market price at or prior to the time of replacement. The price at such time may be more or less than the price at which the security was sold by the Fund. Until the security is replaced, the Fund is required to repay the lender any dividends or interest that accrue during the period of the loan. To borrow the security, the Fund also may be required to pay a premium, which would increase the cost of the security sold. The net proceeds of the short sale will be retained by the broker (or by the Fund's custodian in a special custody account), to the extent necessary to meet margin requirements, until the short position is closed out. A Fund also will incur transaction costs in effecting short sales.

Until the Fund replaces a borrowed security, it is required to maintain a segregated account of cash or liquid assets with a broker or custodian to cover the Fund's short position. Securities held in a segregated account cannot be sold while the position they are covering is outstanding, unless they are replaced with other liquid assets. The Fund's ability to access the pledged collateral may also be impaired in the event the broker fails to comply with the terms of the contract, due to, for instance, its insolvency or bankruptcy. In such instances the Fund may not be able to substitute or sell the pledged collateral. Additionally, the Fund must maintain sufficient liquid assets (less any additional collateral pledged to the broker), marked-to-market daily, to cover the short sale obligation. This may limit the Fund's investment flexibility, as well as its ability to meet redemption requests or other current obligations.

A Fund will incur a loss as a result of the short sale if the price of the security increases between the date of the short sale and the date on which the Fund replaces the borrowed security. The Fund will realize a gain if the security declines in price between those dates. The amount of any gain will be decreased, and the amount of any loss increased, by the amount of the premium, dividends, interest or expenses the Fund may be required to pay in connection with a short sale.

Investment Company Securities. The Funds may invest in other investment companies to the extent permitted by the 1940 Act, other applicable law or SEC exemption. Investment companies include other open-end investment companies, closed-end investment companies, unit investment trusts, and exchange-traded funds ("ETFs") which may be organized as either open-end investment companies or unit investment trusts, all of which are professionally managed portfolios. As a shareholder of another investment company, a Fund would bear along with other shareholders, its pro rata portion of the investment company's expenses, including advisory fees. These expenses would be in addition to the advisory and other expenses that the Funds incur directly in connection with their own operations. Shareholders would also be exposed to the risks associated not only to the investments of the Fund but

also to the portfolio investments of the underlying investment companies. Certain types of investment companies, such as closed end investment companies, issue a fixed number of shares that typically trade on a stock exchange or over-the-counter at a premium or discount to their net asset value. Others are continuously offered at net asset value but also may be traded in the secondary market.

When-Issued Securities. Each Fund may purchase securities on a when-issued or delayed delivery basis. These transactions are arrangements in which a Fund purchases securities with payment and delivery scheduled for a future time. When a Fund agrees to purchase securities on a when-issued basis, the Fund's custodian must set aside cash or liquid portfolio securities equal to the amount of that commitment in a separate account, and may be required to subsequently place additional assets in the separate account to reflect any increase in the Fund's commitment. Prior to delivery of when-issued securities, their value is subject to fluctuation and no income accrues until their receipt. A Fund engages in when-issued and delayed delivery transactions only for the purpose of acquiring portfolio securities consistent with its investment objective and policies, and not for investment leverage. In when-issued and delayed delivery transactions, a Fund relies on the seller to complete the transaction; its failure to do so may cause the Fund to miss a price or yield considered to be advantageous.

Rights and Warrants. The Technology Fund and the Pegasus Small Cap Growth Fund may purchase warrants, which are privileges issued by corporations enabling the owners to subscribe to and purchase a specified number of shares of the corporation at a specified price during a specified period of time. Subscription rights normally have a short life span to expiration. The purchase of warrants involves the risk that the Technology Fund and the Pegasus Small Cap Growth Fund could lose the purchase value of a warrant if the right to subscribe to additional shares is not exercised prior to the warrant's expiration. Also, the purchase of warrants involves the risk that the effective price paid for the warrant added to the subscription price of the related security may exceed the value of the subscribed security's market price such as when there is no movement in the level of the underlying security.

Discussion of Index Methodology – FBR Gas Utility Index Fund. The American Gas Association Stock Index (the "Index") is comprised of the common stock of approximately 70 publicly traded companies whose securities are traded on a United States stock exchange (exclusive of treasury stock), and are members of the American Gas Association ("AGA"). While securities in such companies will be domestic U. S. securities, they may include foreign securities, such as ADRs, EDRs or GDRs. These companies are engaged in the distribution and/or transmission of natural gas. The actual computations required to produce the Index are performed by AUS Consultants Utility Services ("AUS") for AGA pursuant to a contractual agreement between AGA and AUS. AGA has ultimate responsibility to ensure that AUS's calculations are performed according to its Administrative Services Agreement with Fund.

The Index is computed by multiplying the number of outstanding shares of common stock of each AGA member company by the closing market price per share at the Index date. This product then is multiplied by the percentage of each company's assets devoted to natural gas distribution and transmission. This process, completed at least annually, is done to recognize the natural gas component of the company's asset base. The result is each company's "gas market capitalization value". The sum of all the companies' "gas market capitalization values" is totaled. This summation results in a base number called the "industry's gas market capitalization value". Each company's stock percentage within the Index is determined by dividing the company's "gas market capitalization value" by the "industry's gas market capitalization value". The "gas market capitalization value" for each company will be recalculated at least quarterly. In computing the Index, individual stocks will be limited to no more than 5% of the Index. Therefore in calculating the Index, any representation in the Index exceeding 5% will be reallocated. FBR Fund Advisers, Inc. (the "Adviser") seeks to purchase sufficient shares of each company's stock such that its proportion of the Fund's assets will substantially equal that stock's proportion of the Index. The Adviser will monitor the Fund's securities holdings so that those holdings reflect the composition of the Index. As market conditions dictate, and as significant shareholder purchases and redemptions occur, the Adviser will buy or sell stocks to maintain holdings of each stock to reflect proper weightings within the Index. In both rising and falling markets, the Fund attempts to achieve a correlation of approximately 95% or better between its total return and that of the Index. One-hundred percent correlation would mean the total return of the Fund's assets would increase and decrease exactly the same as the Index. For the fiscal year ended October 31, 2009, the Fund achieved a 99.2% correlation. Since the Index weightings change in very small amounts during the trading day, continual small adjustments would be needed to track the Index exactly. Furthermore, purchases and sales of every stock within the Index would be necessary as contributions and redemptions to the Fund are made. To minimize brokerage and

transaction expenses, the Adviser will make adjustments to the Fund in accordance with the following methodology. Comparison of the actual composition of the Fund to the theoretical target will be made daily. Generally, adjustments to the holdings of any single stock will be made at least weekly whenever the actual proportion of that stock in the Fund varies by more than 0.5% of the weighting of that stock in the Index. The percentage of each stock holding is based on the Fund's net asset value. For example, if Stock A represented 3% of the total weighting in the Index at the close of business, adjustments to the holdings of Stock A will be made if the value of Stock A is greater than 3.5% or less than 2.5% of the net assets. Adjustments may be made at other times even though these tolerances are not exceeded if the adjustment can be made without incurring unreasonable transaction expenses.

INVESTMENT LIMITATIONS AND RESTRICTIONS

The following investment limitations are fundamental with respect to the Funds and may not be changed without prior approval of a majority of the Funds' outstanding voting shares. As defined in the 1940 Act, the term "majority" means the vote of the lesser of (a) 67% of the shares of the Fund at a meeting where more than 50% of the outstanding shares are present in person or by proxy; or (b) more than 50% of the outstanding shares of the Fund.

The Funds, except for the FBR Gas Utility Index Fund, May Not:

1. Purchase or sell physical commodities unless acquired as a result of ownership of securities or other instruments (but this shall not prevent a Fund from purchasing or selling options and futures contracts or from investing in securities or other instruments backed by physical commodities).
2. Purchase or sell real estate unless acquired as a result of ownership of securities or other instruments (but this shall not prevent a Fund from investing in securities or other instruments backed by real estate or securities of companies engaged in the real estate business). Investments by a Fund in securities backed by mortgages on real estate or in marketable securities of companies engaged in such activities are not hereby precluded.
3. Issue any senior security as defined in the 1940 Act, except that (a) a Fund may engage in transactions that may result in the issuance of senior securities to the extent permitted under applicable regulations and interpretations of the 1940 Act or an exemptive order; (b) a Fund may acquire other securities, the acquisition of which may result in the issuance of a senior security, to the extent permitted under applicable regulations or interpretations of the 1940 Act; (c) subject to the restrictions set forth below, a Fund may borrow money as authorized by the 1940 Act.
4. Borrow money, except that as a temporary measure a Fund may borrow money to facilitate redemptions. Such a borrowing may be in an amount not to exceed 33 1/3% of the value of the Fund's total assets at the time of borrowing or such other percentage permitted by law.
5. Lend any security or make any other loan if, as a result, more than 33 1/3% of its total assets would be lent to other parties, but this limitation does not apply to purchases of publicly issued debt securities or to repurchase agreements.
6. Underwrite securities issued by others, except to the extent that a Fund may be considered an underwriter within the meaning of the Securities Act of 1933, as amended (the "1933 Act") in the disposition of restricted securities.
7. With respect to 50% of its total assets, purchase the securities of any issuer (other than securities issued or guaranteed by the U.S. Government or any of its agencies or instrumentalities) if, as a result, (a) more than 5% of the Fund's total assets would be invested in the securities of that issuer, or (b) the Fund would hold more than 10% of the outstanding voting securities of that issuer.
8. Purchase the securities of any issuer if, as a result, more than 25% of the total assets would be invested in the securities of one or more conducting their principal business activities in the same industry, except that
 - (a) with respect to the Financial Services Funds, purchase the securities of any issuer if, as a result, less than 25% of a Fund's total assets would be invested in the securities of issuers principally engaged in the financial services group of industries; and

- (b) with respect to the Technology Fund, purchase the securities of any issuer if, as a result, less than 25% of the Fund's total assets would be invested in the securities of issuers principally engaged in the technology group of industries.

These limitations do not apply to securities issued or guaranteed by the U.S. Government or any of its agencies or instrumentalities.

The Gas Utility Index Fund May Not:

1. Issue senior securities.
2. Make short sales of securities or purchase securities on margin.
3. Borrow money except as a temporary measure to facilitate redemptions. Such borrowing may not exceed 30% of the Fund's total assets, taken at current value, before such borrowing. The Fund may not purchase securities if a borrowing by the Fund is outstanding.
4. Underwrite securities of any other issuer, nor purchase or sell restricted securities.
5. Purchase or sell real estate or real estate mortgage loans.
6. Buy or sell commodities or futures contracts.
7. Invest in oil, gas or other mineral leases.
8. Make loans except through repurchase agreements provided the borrower maintains collateral equal to at least 100% of the value of the borrowed security, and marked to market daily.
9. Purchase securities of any issuer if, as a result of such a purchase, such securities would account for more than 5% of the Fund's assets.
10. Purchase the securities of any issuer if, as a result, less than 25% of the Fund's total assets would be invested in the securities of issuers principally engaged in the utilities industry.

Non-Fundamental Restrictions of the Funds, except for the Gas Utility Index Fund:

The following restrictions with respect to the Funds are not fundamental and may be changed by the Board of Trustees without the approval of shareholders:

1. No Fund will invest more than 15% of its net assets in illiquid securities. Illiquid securities are securities that are not readily marketable or cannot be disposed of promptly within seven days and in the usual course of business at approximately the price at which a Fund has valued them. Such securities include, but are not limited to, time deposits and repurchase agreements with maturities longer than seven days. Securities that may be resold under Rule 144A, securities offered pursuant to Section 4(2) of, or securities otherwise subject to restrictions on resale under the 1933 Act ("Restricted Securities"), shall not be deemed illiquid solely by reason of being unregistered. The Adviser determines whether a particular security is deemed to be liquid based on the trading markets for the specific security and other factors.
2. No Fund will purchase securities on margin except for short-term credits necessary for clearance of portfolio transactions, provided that this restriction will not be applied to limit the use of options, futures contracts and related options, in the manner otherwise permitted by the investment restrictions, policies and investment program of the Fund.

Non-Fundamental Restrictions of the Gas Utility Index Fund:

The following restrictions are not fundamental and may be changed by the Board of Trustees without the approval of shareholders:

1. The Fund may not invest in warrants;
2. The Fund may not invest more than 15% of the Fund's net assets in illiquid securities.

General. The policies and limitations listed above supplement those set forth in the Prospectuses. Unless otherwise noted, whenever an investment policy or limitation states a maximum percentage of a Fund's assets that may be invested in any security or other asset, or sets forth a policy regarding quality standards, such standard or percentage limitation will be determined immediately after and as a result of the Fund's acquisition of such security or other asset except in the case of borrowing (or other activities that may be deemed to result in the issuance of a "senior

security” under the 1940 Act). Accordingly, any subsequent change in values, net assets, or other circumstances will not be considered when determining whether the investment complies with the Fund’s investment policies and limitations. If the value of a Fund’s holdings of illiquid securities at any time exceeds the percentage limitation applicable at the time of acquisition due to subsequent fluctuations in value or other reasons, the Trustees will consider what actions, if any, are appropriate to maintain adequate liquidity.

Portfolio Turnover. The portfolio turnover for each Fund for the 2008 and 2009 fiscal years is:

Fund	2008	2009
Pegasus Fund	39%	60%
Pegasus Mid Cap Fund	93%	128%
Pegasus Small Cap Fund	207%	226%
Pegasus Small Cap Growth Fund	139%	102%
Focus Fund	17%	5%
Large Cap Financial Fund	509%	220%
Small Cap Financial Fund	147%	118%
Technology Fund	175%	211%
Gas Utility Index Fund	27%	26%

VALUATION OF PORTFOLIO SECURITIES

Portfolio securities are valued at the last sale price on the securities exchange or national securities market on which such securities primarily are traded. Securities not listed on an exchange or national securities market, or securities in which there were no transactions, are valued at the average of the most recent bid and asked prices, except in the case of open short positions where the asked price is used for valuation purposes. Bid price is used when no asked price is available. Short-term investments are carried at amortized cost, which approximates value. Any securities or other assets for which recent market quotations are not readily available are valued at fair value as determined in good faith by the Trust’s Board of Trustees. Expenses and fees, including the management fee and distribution and service fees, are accrued daily and taken into account for the purpose of determining the net asset value (“NAV”) of the Funds’ shares.

Restricted securities, as well as securities or other assets for which market quotations are not readily available, or are not valued by a pricing service approved by the Board of Trustees, are valued at fair value as determined in good faith by the Board of Trustees. The Board of Trustees will review the method of valuation on a current basis. In making their good faith valuation of restricted securities, the Trustees generally will take the following factors into consideration: restricted securities which are, or are convertible into, securities of the same class of securities for which a public market exists usually will be valued at market value less the same percentage discount at which purchased. This discount will be revised periodically by the Board of Trustees if the Trustees believe that it no longer reflects the value of the restricted securities. Restricted securities not of the same class as securities for which a public market exists usually will be valued initially at cost. Any subsequent adjustment from cost will be based upon considerations deemed relevant by the Board of Trustees.

Determination of Net Asset Value. Each Fund’s NAV is determined as of the end of trading on the New York Stock Exchange (“NYSE”) (normally 4:00 p.m., Eastern time) on days the NYSE is open for business. In computing a Fund’s NAV, all liabilities incurred or accrued are deducted from net assets. The resulting net assets are divided by the number of shares outstanding at the time of the valuation and the result (adjusted to the nearest cent) is the NAV per share.

NYSE Closings. The holidays (as observed) on which the NYSE is closed currently are: New Year’s Day, Martin Luther King Jr. Day, Presidents’ Day, Good Friday, Memorial Day, Independence Day, Labor Day, Thanksgiving Day and Christmas Day.

CALCULATION OF PERFORMANCE DATA

Average Annual Total Return Quotations

For purposes of quoting and comparing the performance of the Funds to that of other mutual funds and to other relevant market indices in advertisements or in reports to shareholders, performance may be stated in terms of total return. Under rules adopted by the Securities and Exchange Commission (the "Commission"), Fund advertising stating performance must include total return quotes calculated according to the following formula:

$$P(1+T)^n = ERV$$

Where: P = a hypothetical initial payment of \$1,000.
T = average annual total return.
n = number of years.
ERV = ending redeemable value of a hypothetical \$1,000 payment made at the beginning of the 1-, 5-, or 10-year periods at the end of the 1-, 5-, or 10-year periods (or fractional portion thereof).

Under the foregoing formula, the time periods used in advertising will be based on rolling calendar quarters, updated to the last day of the most recent quarter prior to submission of the advertising for publication, and will cover 1-, 5-, and 10-year periods or a shorter period dating from the Fund's inception. In calculating the ending redeemable value, all dividends and distributions by the Funds are assumed to have been reinvested at net asset value as described in the Prospectuses for the Funds on the reinvestment dates during the period. Total return, or "T" in the formula above, is computed by finding the average annual compounded rates of return over the 1-, 5-, and 10-year periods (or fractional portion thereof) that would equate the initial amount invested to the ending redeemable value.

The Funds, from time to time, also may include in such advertising a total return figure that is not calculated according to the formula set forth above in order to compare more accurately the performance of the Fund with other measures of investment return. For example, in comparing the total return of the Fund with the performance of the S&P 500 or Russell 2000, the Funds calculate their aggregate total return for the specified periods of time by assuming the investment of \$10,000 in the Funds' shares and assuming the reinvestment of each dividend or other distribution at net asset value on the reinvestment date. Percentage increases are determined by subtracting the initial value of the investment from the ending value and by dividing the remainder by the beginning value. Such alternative total return information will be given no greater prominence in such advertising than the information prescribed under rules adopted by the SEC.

Average Annual Total Return After Taxes on Distributions Quotations

The Funds compute their average annual total return after taxes on distributions by determining the average annual compounded rates of return during specified periods that equate the initial amount invested to the ending redeemable value of such investment after taxes on fund distributions but not after taxes on redemptions. This is done by dividing the ending redeemable value after taxes on fund distributions of a hypothetical \$1,000 initial payment by \$1,000 and raising the quotient to a power equal to one divided by the number of years (or fractional portion thereof) covered by the computation and subtracting one from the result. This calculation can be expressed as follows:

$$\text{Average Annual Total Return After Taxes = } \left[\frac{\text{ATV}_D}{P} \text{ to the } 1/n \text{th power} - 1 \right]$$

(after taxes on distributions)

Where: P = a hypothetical initial payment of \$1,000.
n = number of years.
ATV_D = ending value of a hypothetical \$1,000 payment made at the beginning of the 1-, 5-, or 10-year periods at the end of such periods after taxes on fund distributions but not after taxes on redemption.

Average Annual Total Return After Taxes on Distributions and Redemption Quotations

The Funds compute their average annual total return after taxes on distributions and redemption by determining the average annual compounded rates of return during specified periods that equate the initial amount invested to the ending redeemable value of such investment after taxes on fund distributions and redemption. This is done by dividing the ending redeemable value after taxes on fund distributions and redemption of a hypothetical \$1,000 initial payment by \$1,000 and raising the quotient to a power equal to one divided by the number of years (or fractional portion thereof) covered by the computation and subtracting one from the result. This calculation can be expressed as follows:

$$\text{Average Annual Total Return After Taxes} = \left[\frac{\text{ATV}_{\text{DR}}}{P} \text{ to the } 1/n\text{th power} - 1 \right]$$

(after taxes on distributions and redemption)

Where:

- P = a hypothetical initial payment of \$1,000.
- n = number of years.
- ATV_{DR} = ending value of a hypothetical \$1,000 payment made at the beginning of the 1-, 5-, or 10-year periods at the end of such periods, after taxes on fund distributions and redemption.

After-tax returns are calculated using the historical highest individual federal marginal income tax rates and do not reflect the impact of state and local taxes. Actual after-tax returns depend on an investor's tax situation and may differ from those shown, and after-tax returns shown are not relevant to investors who hold their Fund shares through tax-deferred arrangements, such as 401(k) plans or individual retirement accounts.

ADDITIONAL PURCHASE AND REDEMPTION INFORMATION

Investor Class shares may be purchased or redeemed through FBR Investment Services, Inc., ("FBR Services" or "Distributor") account executives, other authorized dealers or directly through the Trust's transfer agent, JPMorgan Chase Bank N.A. ("JPMorgan" or "Transfer Agent"), P.O. Box 5354, Cincinnati, Ohio 45201-5354. The minimum initial investment for each Fund is \$2,000. The minimum initial investment for Individual Retirement Accounts ("IRAs"), or pension, profit-sharing or other employee benefit plans is \$1,000. There is no subsequent minimum investment requirement.

I Class shares are intended only for purchase by institutional investors such as corporations, foundations, any organization authorized to act in a fiduciary, advisory, custodial or agency capacity and Fund Trustees, employees, and other employee relatives of the Trust, Adviser or affiliates of the Adviser. The minimum initial investment is \$1,000,000. There is no minimum requirement for subsequent investments.

R Class shares are available only for purchase through certain broker-dealers and third-party intermediaries to 401(k) plans, 457 plans, employee sponsored 403(b) plans, defined benefit pension plans, profit sharing plans, nonqualified deferred compensation plans and other similar employee sponsored retirement plans (collectively "Retirement Plans") whereby the Retirement Plan or Retirement Plan's financial services firm has an agreement with the Funds or the Distributor to utilize R Class shares in certain investment products or programs. You may buy shares of the Funds on any Business Day. There is no minimum requirement for initial or subsequent investments. The Funds reserve the right to reject any purchase order or change the initial and subsequent investment minimum requirements at any time.

Shares may be purchased at a price equal to their next determined NAV. The value of shares on redemption or repurchase may be more or less than the investor's cost, depending upon the market value of the portfolio securities at the time of redemption or repurchase.

Redemption In-Kind. Although each Fund intends to redeem shares in cash, each Fund reserves the right under certain circumstances to pay the redemption price in whole or in part by a distribution of securities from a Fund. To the extent available, such securities will be readily marketable. Redemption in-kind will be made in conformity with applicable SEC rules, taking such securities at the same value employed in determining NAV and selecting the securities in a manner the Trustees determine to be fair and equitable. The Funds have elected to be governed by

Rule 18f-1 of the 1940 Act under which each Fund is obligated to redeem shares for any one shareholder in cash only up to the lesser of \$250,000 or 1% of a Fund's NAV during any 90-day period. A shareholder will incur brokerage costs in disposing of securities acquired when the redemption price is paid in whole or in part by a distribution of securities.

Suspension of Redemptions. The right of redemption may be suspended or the date of payment postponed: (a) during any period when the New York Stock Exchange is closed (other than customary weekend and holiday closings); (b) when trading in the markets a Fund ordinarily utilizes is restricted, or when an emergency exists as determined by the SEC so that disposal of the Fund's investments or determination of its NAV is not reasonably practicable; or (c) for such other periods as the SEC by order may permit to protect Fund shareholders.

DIVIDENDS AND DISTRIBUTIONS

Each Fund, except the Gas Utility Index Fund, ordinarily declares and pays dividends from its net investment income annually. The Gas Utility Index Fund ordinarily declares and pays dividends from its net investment income on a calendar quarterly basis. Each Fund distributes substantially all of its net investment income and net capital gains, if any, to shareholders within each calendar year as well as on a fiscal year basis to the extent required for the Fund to qualify for favorable federal tax treatment. The amount of distributions may vary from time to time depending on market conditions and the composition of a Fund's portfolio.

For this purpose, the net income of a Fund, from the time of the immediately preceding determination thereof, shall consist of all interest income accrued on the portfolio assets of the Fund, dividend income, if any, income from securities loans, if any, and realized capital gains and losses on the Fund's assets, less all expenses and liabilities of the Fund chargeable against income. Interest income shall include discount earned, including both original issue and market discount, on discount paper accrued ratably to the date of maturity. Expenses, including the compensation payable to the Adviser, are accrued each day. The expenses and liabilities of a Fund shall include those appropriately allocable to the Fund.

TAXES

The following summarizes certain additional federal income tax considerations generally affecting the Funds and their shareholders that are not described in the Funds' Prospectuses. No attempt is made to present a detailed explanation of the tax treatment of the Funds or their shareholders, and the discussion here and in the applicable Prospectus is not intended as a substitute for careful tax planning. This discussion is based upon present provisions of the Internal Revenue Code, the regulations promulgated thereunder, and judicial and administrative ruling authorities, all of which are subject to change, which change may be retroactive. Prospective investors should consult their own tax advisers with regard to the federal tax consequences of the purchase, ownership and disposition of Fund shares, as well as the tax consequences arising under the laws of any state, foreign country, or other taxing jurisdiction.

General. The Funds intend to elect and qualify annually to be taxed as a regulated investment company under Subchapter M of the Internal Revenue Code. As a regulated investment company, the Funds generally are exempt from Federal income tax on its net investment income and realized capital gains which it distributes to its shareholders, provided that it distributes an amount equal to the sum of (a) at least 90% of its investment company taxable income (net investment income and the excess of net short-term capital gain over net long-term capital loss), if any, for the year and (b) at least 90% of its net tax-exempt interest income, if any, for the year ("Distribution Requirement") and satisfies certain other requirements of the Internal Revenue Code that are described below. Distributions of investment company taxable income and net tax-exempt interest income made during the taxable year or, under specified circumstances, within twelve months after the close of the taxable year will satisfy the Distribution Requirement.

In addition to satisfying the Distribution Requirement, the Funds must derive with respect to a taxable year at least 90% of its gross income from dividends, interest, certain payments with respect to securities loans and gains from the sale or other disposition of stock or securities or foreign currencies, net income derived from investments in qualified publicly traded partnerships, or from other income derived with respect to its business of investing in such stock, securities, or currencies ("Income Requirement").

In addition to the foregoing requirements, at the close of each quarter of its taxable year, at least 50% of the value of the Fund's assets must consist of cash and cash items, U.S. Government securities, securities of other regulated investment companies, and securities of other issuers (as to which the Fund has not invested more than 5% of the value of its total assets in securities of such issuer and as to which the Fund does not hold more than 10% of the outstanding voting securities of such issuer) and no more than 25% of the value of a Fund's total assets may be invested in the securities of any one issuer (other than U.S. Government securities and securities of other regulated investment companies), in two or more issuers which the Fund controls and which are engaged in the same or similar trade or business or one or more qualified publicly traded partnerships.

Distributions of net investment income received by a Fund from investments in debt securities and any net realized short-term capital gains distributed by a Fund will be taxable to shareholders as ordinary income and will not be eligible for the dividends-received deduction for corporations.

The Funds intend to distribute to shareholders any excess of net long-term capital gain over net short-term capital loss ("net capital gain") for each taxable year. Such gain is designated and distributed as a capital gain dividend and is taxable to shareholders as gain from the sale or exchange of a capital asset held for more than one year, regardless of the length of time a shareholder has held his or her Fund shares and regardless of whether the distribution is paid in cash or reinvested in shares. The Funds expect that capital gain dividends will be taxable to shareholders as long-term gain. Capital gain dividends are not eligible for the dividends-received deduction for corporations.

In the case of corporate shareholders, distributions of a Fund for any taxable year generally qualify for the dividends-received deduction to the extent of the gross amount of "qualifying dividends" received by such Fund for the year and if certain holding period requirements are met. Generally, a dividend will be treated as a "qualifying dividend" if it has been received from a domestic corporation.

Current tax law generally provides for a maximum tax rate for individual taxpayers of 15% on long-term capital gains from sales and on certain qualifying dividend income. The rate reductions do not apply to corporate taxpayers. The Funds will be able to separately designate distributions of any qualifying long-term capital gains or qualifying dividends earned by the Funds that would be eligible for the lower maximum rate. A shareholder would also have to satisfy a more than 60-day holding period with respect to any distributions of qualifying dividends in order to obtain the benefit of the lower rate. Distributions from funds investing primarily in bonds and other debt instruments will not generally qualify for the lower rates.

The favorable treatment for qualifying dividends and the 15% maximum tax rate for individuals on long-term capital gains is scheduled to expire after 2010. After such expiration, qualifying dividends would be taxed as ordinary income and the rate on long-term capital gains for individuals would generally increase to 20%.

If for any taxable year a Fund does not qualify as a regulated investment company, all of its taxable income will be subject to tax at regular corporate rates without any deduction for distributions to shareholders. In such event, all distributions (whether or not derived from exempt-interest income) would be taxable as ordinary income and would be eligible for the dividends-received deduction in the case of corporate shareholders to the extent of the Fund's current and accumulated earnings and profits.

Shareholders will be advised annually as to the Federal income tax consequences of distributions made by the Funds each year.

Amounts not distributed on a timely basis in accordance with a calendar year distribution requirement are subject to a nondeductible 4% excise tax. To prevent imposition of the excise tax, the Funds must distribute during each calendar year an amount equal to the sum of (1) at least 98% of its ordinary income (not taking into account any capital gains or losses) for the calendar year, (2) at least 98% of its capital gains in excess of its capital losses (adjusted for certain ordinary losses, as prescribed by the Internal Revenue Code) for the one-year period ending on October 31 of the calendar year, and (3) any ordinary income and capital gains for previous years that was not distributed during those years. A distribution will be treated as paid on December 31 of the current calendar year if it is declared by the Funds in October, November or December with a record date in such a month and paid by the

Funds during January of the following calendar year. Such distributions will be taxable to shareholders in the calendar year in which the distributions are declared, rather than the calendar year in which the distributions are made. To prevent application of the excise tax, the Funds intend to make their distributions in accordance with the calendar year distribution requirement.

The Funds will be required in certain cases to withhold and remit to the United States Treasury at the current rate of 28% (currently scheduled to increase to 31% after 2010) of taxable distributions, including gross proceeds realized upon sale or other dispositions paid to any shareholder (i) who has provided either an incorrect tax identification number or no number at all, (ii) who is subject to backup withholding by the Internal Revenue Service for failure to report the receipt of taxable interest or dividend income properly, or (iii) who has failed to certify that he or she is not subject to backup withholding or that he or she is an “exempt recipient.”

Disposition of Shares. Upon the redemption or sale of shares of a Fund, a shareholder generally may realize a capital gain or loss depending upon his or her basis in the shares. Such gain or loss will be treated as capital gain or loss if the shares are capital assets in the shareholder’s hands and will be long-term or short-term, generally, depending upon the shareholder’s holding period for the shares. Any loss realized on a redemption, sale or exchange will be disallowed to the extent the shares disposed of are replaced (including shares acquired pursuant to a dividend reinvestment plan) within a period of 61 days beginning 30 days before and ending 30 days after the disposition of the shares. In such a case, the basis of the shares acquired will be adjusted to reflect the disallowed loss. Any loss realized by a shareholder on the disposition of Fund shares held by the shareholder for six months or less will be treated as a long-term capital loss to the extent of any distributions of net capital gains received by the shareholder with respect to such shares and treated as long-term capital gains.

Although the Funds expect to qualify as a “regulated investment company” and to be relieved of all or substantially all Federal income taxes, depending upon the extent of its activities in states and localities in which its offices are maintained, in which its agents or independent contractors are located or in which it is otherwise deemed to be conducting business, the Fund may be subject to the tax laws of such states or localities.

Taxation of Certain Financial Instruments. Special rules govern the Federal income tax treatment of financial instruments that may be held by the Funds. These rules may have a particular impact on the amount of income or gain that a Fund must distribute to its shareholders to comply with the Distribution Requirement, on the income or gain qualifying under the Income Requirement, all described above.

Original Issue Discount. The Funds may purchase debt securities with original issue discount. Original issue discount represents the difference between the original price of the debt instrument and the stated redemption price at maturity. Original issue discount is required to be accreted on a daily basis and is considered interest income for tax purposes and, therefore, such income would be subject to the distribution requirements applicable to regulated investment companies.

Market Discount. The Funds may purchase debt securities at a discount in excess of the original issue discount to the stated redemption price at maturity (for debt securities without original issue discount), and this discount is called market discount. If the amount of market discount is more than a de minimis amount, a portion of such market discount must be included as ordinary income (not capital gain) by the Funds in each taxable year in which the Funds own an interest in such debt security and receives a principal payment on it. In particular, the Funds will be required to allocate that principal payment first to the portion of the market discount on the debt security that has accrued but has not previously been included in income. In general the amount of market discount that must be included for each period is equal to the lesser of (i) the amount of market discount accruing during such period (plus any accrued market discount for prior periods not previously taken into account) or (ii) the amount of the principal payment with respect to such period.

Hedging Transactions. The taxation of equity options and over-the-counter options on debt securities is governed by Internal Revenue Code Section 1234. Pursuant to Internal Revenue Code Section 1234, the premium received by a Fund for selling a put or call option is not included in income at the time of receipt. If the option expires, the premium is short-term capital gain to the Fund. If a Fund enters into a closing transaction, the difference between the amount paid to close out its position and the premium received is short-term capital gain or loss. If a call option written by a Fund is exercised, thereby requiring the Fund to sell the underlying security, the premium will increase

the amount realized upon the sale of such security and any resulting gain or loss will be a capital gain or loss, and will be long-term or short-term depending upon the holding period of the security. With respect to a put or call option that is purchased by a Fund, if the option is sold, any resulting gain or loss will be a capital gain or loss, and will be long-term or short-term, depending upon the holding period of the option. If the option expires, the resulting loss is a capital loss and is long-term or short-term, depending upon the holding period of the option. If the option is exercised, the cost of the option, in the case of a call option, is added to the basis of the purchased security and, in the case of a put option, reduces the amount realized on the underlying security in determining gain or loss.

Any regulated futures and foreign currency contracts and certain options (namely, nonequity options and dealer equity options) in which the Funds may invest may be “Section 1256 contracts.” Gains or losses on Section 1256 contracts are generally considered 60% long-term and 40% short-term capital gains or losses; however, foreign currency gains or losses arising from certain Section 1256 contracts may be treated as ordinary income or loss. Also, Section 1256 contracts held by the Fund at the end of each taxable year (and, generally, for purposes of the 4% excise tax, on October 31 of each year) are “marked to market” (that is, treated as sold at fair market value), with the result that unrealized gains or losses are treated as though they were realized.

Generally, hedging transactions, if any, undertaken by the Funds may result in “straddles” for U.S. Federal income tax purposes. The straddle rules may affect the character of gains (or losses) realized by a Fund. In addition, losses realized by a Fund on positions that are part of a straddle may be deferred under the straddle rules, rather than being taken into account in calculating the taxable income for the taxable year in which the losses are realized. Because only a few regulations implementing the straddle rules have been promulgated, the tax consequences to a Fund of engaging in hedging transactions are not entirely clear. Hedging transactions may increase the amount of short-term capital gain realized by a Fund which is taxed as ordinary income when distributed to shareholders.

The Funds may make one or more of the elections available under the Internal Revenue Code, which are applicable to straddles. If a Fund makes any of the elections, the amount, character and timing of the recognition of gains or losses from the affected straddle positions will be determined under rules that vary according to the election(s) made. The rules applicable under certain of the elections may operate to accelerate the recognition of gains or losses from the affected straddle positions.

Because application of the straddle rules may affect the character of gains or losses, and may defer losses and/or accelerate the recognition of gains or losses from the affected straddle positions, the amount which must be distributed to shareholders, and which will be taxed to shareholders as ordinary income or long-term capital gain, may be more than or less than the distributions of a Fund that did not engage in such hedging transactions.

Certain hedging activities may cause a dividend that would otherwise be subject to the lower tax rate applicable to a “qualifying dividend,” to instead be taxed at the rate of tax applicable to ordinary income.

The diversification requirements applicable to a Fund’s assets may limit the extent to which the Fund will be able to engage in transactions in options, futures or forward contracts.

Constructive Sales. IRS rules may affect the timing and character of gain if the Funds engage in transactions that reduce or eliminate its risk of loss with respect to appreciated financial positions. If a Fund enters into certain transactions in property while holding substantially identical property, the Fund would be treated as if it had sold and immediately repurchased the property and would be taxed on any gain (but not loss) from the constructive sale. The character of gain from a constructive sale would depend upon a Fund’s holding period in the property. Loss from a constructive sale would be recognized when the property was subsequently disposed of, and its character would depend on a Fund’s holding period and the application of various loss deferral provisions of the Internal Revenue Code.

Foreign Shareholders. The tax consequences to a foreign shareholder of an investment in the Funds may be different from those described herein. Taxation of a shareholder who, as to the United States, is a nonresident alien individual, foreign trust or estate, foreign corporation, or foreign partnership (“foreign shareholder”), depends on whether the income from a Fund is “effectively connected” with a U.S. trade or business carried on by such shareholder. If the income from a Fund is not effectively connected with a U.S. trade or business carried on by a foreign shareholder, ordinary income dividends (including distributions of any net short-term capital gains) will

generally be subject to U.S. withholding tax at the rate or 30% (or, if applicable, lower treaty rate) upon the gross amount of the dividend. Such a foreign shareholder would generally be exempt from U.S. federal income tax on gains realized on the sale of shares of a Fund, and distributions of net long-term capital gains that are designated as capital gain dividends. If the income from the Fund is effectively connected with a U.S. trade or business carried on by a foreign shareholder, then ordinary income dividends, capital gain dividends and any gains realized upon the sale of shares of a Fund will be subject to U.S. federal income tax at the rates applicable to U.S. citizens or domestic corporations. Note that the 15% rate of tax applicable to certain dividends (discussed above) does not apply to dividends paid to foreign shareholders. Foreign shareholders are advised to consult their own tax advisers with respect to the particular tax consequences to them of an investment in the Funds.

Other Taxation. The foregoing discussion relates only to U.S. Federal income tax law as applicable to U.S. persons (i.e., U.S. citizens and residents and domestic corporations, partnerships, trusts and estates). Distributions by the Funds and dispositions of Fund shares also may be subject to other state and local taxes, and their treatment under state and local income tax laws may differ from the U.S. Federal income tax treatment. Shareholders should consult their tax advisers with respect to particular questions of U.S. Federal, state and local taxation. Future legislative or administrative changes or court decisions may significantly change the conclusions expressed herein, and any such changes or decisions may have a retroactive effect with respect to the transactions contemplated herein.

TRUSTEES AND OFFICERS

Board of Trustees. Overall responsibility for management of the Trust rests with the Board of Trustees (“Trustees” or “Board”). Subject to the Trust’s Trust Instrument, its By-Laws and Delaware law, the Trustees have all powers necessary and convenient to carry out their responsibilities, including the appointment and removal of the Trust’s officers. There are currently five Trustees, four of whom are not “interested persons” of the Trust within the meaning of that term under the 1940 Act (“Independent Trustees”). The Trustees, in turn, elect the officers of the Trust to actively supervise its day-to-day operations.

Information about the Trustees of the Trust is included in the following table. The address for each Trustee is 1001 Nineteenth Street North, Arlington, VA 22209.

Name, Address and Age	Term of Office* and Length of Time Served**	Principal Occupation During Past 5 Years	Portfolios Overseen in the Trust and Fund Complex***	Other Directorships
<i>Independent Trustees</i>				
Michael A. Willner, 53	Since June 1997	President AlphaGrip, Inc. January 2001 to present.	9	None
Reena Aggarwal, 52	Since July 2006	Professor, Georgetown University, 2000 to present; Deputy Dean, McDonough School of Business, Georgetown University, 2006-2008; Interim Dean, 2004-2005; Visiting Professor MIT Sloan School of Management, 2005-2006.	9	IndexIQ Trust
William E. Cole, Jr., 60	Since July 2006	Retired, 2006. Partner, Ernst & Young LLP, 1972-2006.	9	None
Charles O. Heller, 74	Since September 2003	President, Annapolis Capital Group, since 2005; Athlone Global Security (venture	9	None

capital firm), 2006-2008;
Beacon Global LLC
(venture capital firm), 2003-
2005.

Interested Trustee⁺

David H. Ellison, 51 100 Federal Street Boston, MA 02110	Since September 2003	Director, CIO and President, FBR Fund Advisers, Inc., since December 1999; and Portfolio manager for Equity Funds since October 1996.	9	None
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* Trustees serve until their resignation, removal, or death.

** Length of time served is measured from the earliest date of service as a Trustee of any of the Funds or the Predecessor Funds.

*** The “Fund Complex” consists of all mutual funds advised by FBR Capital Markets Holding Group, Inc. (“FBR Capital Markets”) and its affiliate advisers.

+ Mr. Ellison is considered to be an “Interested Trustee” of the Trust due to his position with FBR Fund Advisers.

The Trustees presently have an audit committee, a valuation committee, and a nominating committee, each of which are comprised of all of the Independent Trustees of the Trust: Ms. Aggarwal and Messrs. Willner, Cole and Heller. The function of the audit committee is to recommend independent auditors, pre-approve audit and certain non-audit services to be provided by the independent auditors to the Funds, and review and report on accounting and financial matters. The Board has adopted a written charter for the Audit Committee. The function of the valuation committee is to determine and monitor the value of the Funds’ assets pursuant to the Trust’s Valuation Procedures. The function of the nominating committee is to nominate persons to serve as Independent Trustees and to serve on committees of the Board. The Board does not have a policy related to considering nominees recommended by shareholders. There was no meeting of the valuation or nominating committee during the Funds’ most recent fiscal year end. The audit committee met twice during the period.

Remuneration of Certain Trustees and Executive Officers. Each Independent Trustee receives an annual retainer of \$25,000 and a fee of \$2,500 for each regular meeting and \$1,000 for each committee meeting attended, plus expenses, and \$1,000 for each telephonic meeting attended. The Trust Chairman receives an additional fee of \$2,000 for each meeting and the Audit Committee Chairman receives \$1,000 for each committee meeting attended. Officers of the Funds and Trustees who are interested persons of the Funds (if any) do not receive any compensation from the Funds or any other funds managed by the Adviser. The following table sets forth information regarding compensation of each of the Trustees by the Trust for the fiscal year ended October 31, 2009.

Compensation Table

Name of Trustee	Aggregate Compensation from Trust	Pension or Retirement Benefits Accrued as Part of Fund Expenses	Estimated Annual Benefits Upon Retirement	Total Compensation from the Fund and Fund Complex Paid to Trustees*
Michael A. Willner ⁺	\$51,500	N/A	N/A	\$51,500
Reena Aggarwal	\$39,000	N/A	N/A	\$39,000
William E. Cole, Jr. ⁺⁺	\$42,500	N/A	N/A	\$42,500
Charles O. Heller	\$41,500	N/A	N/A	\$41,500
David H. Ellison	None	None	None	None

* “Fund Complex” consists of all mutual funds advised by FBR Capital Markets Holding Group, Inc. (“FBR Capital Markets”) and its affiliate advisers.

+ Mr. Willner serves as the Chairman of the Board.

++ Mr. Cole serves as the Chairman of the Audit Committee.

Officers of the Trust

The officers of the Trust, their ages, addresses and principal occupations during the past five years, are as follows:

Name, Address and Age	Position(s) Held With the Trust and Term of Office*	Principal Occupation During Past 5 Years
David H. Ellison, 51 100 Federal Street Boston, MA 02110	President Since 2001; Trustee Since 2003	Director, CIO and President, FBR Fund Advisers, Inc., since December 1999; and Portfolio Manager, FBR Fund Advisers, Inc., since October 1996.
Winsor H. Aylesworth, 62 100 Federal Street Boston, MA 02110	Executive Vice President Since 1999	Portfolio Manager, FBR Fund Advisers, Inc. since September 1998.
William B. Sanders III, 45 1001 Nineteenth Street North Arlington, VA 22209	Executive Vice President Since 1999	Senior Vice President of Fund Operations, FBR Fund Advisers, Inc. since August 1999; and Head Trader for FBR Fund Advisers, Inc., since January 1997.
Guy F. Talarico, 54 800 Third Avenue 11 th Floor New York, NY 10022	Chief Compliance Officer Since 2006	CEO of Alaric Compliance Services, LLC since January 2006. Co-Chief Executive Officer of EOS Compliance Services, LLC June 2004 - December 2005. Senior Director of Investors Bank & Trust Institutional Custody Division February 2001- June 2004.
Kimberly J. Bradshaw, 35 1001 Nineteenth Street North Arlington, VA 22209	Secretary Since 2003 and Treasurer Since 2006	Employee of FBR since August 1998 serving in various capacities, including Senior Vice President Fund Administration, Chief Compliance Officer of FBR Investment Services, Inc., Transfer Agent Operations Manager and Fund Accounting Supervisor. Vice President and Secretary of Money Management Advisers, Inc., November 2003-March 2006.
Kristin E. Stelljes, 33 1001 Nineteenth Street North Arlington, VA 22209	Assistant Treasurer Since 2006	Employee of FBR since February 2002, serving in various capacities including Assistant Vice President Fund Administration, Supervisor Fund Administration, Accountant, and Customer Service Representative.

* The officers of the Trust serve at the pleasure of the Trustees.

As of January 31, 2010, the Trustees and officers of the Trust, as a group, owned approximately 38% of the outstanding shares of the Pegasus Fund, 27% of the outstanding shares of the Pegasus Mid Cap Fund, 18% of the outstanding shares of the Pegasus Small Cap Fund, 27% of the outstanding shares of the Pegasus Small Cap Growth Fund, 8% of the outstanding shares of the Large Cap Financial Fund, and less than 1% of the outstanding shares of the Focus Fund, Small Cap Financial Fund, Technology Fund and Gas Utility Index Fund.

Trustees' Ownership of Fund Shares as of December 31, 2009

	Dollar Range of Equity Securities owned in:	Aggregate Dollar Range of Equity Securities in All Registered Investment Companies Overseen By Trustee in Family of Investment Companies*	
Michael A. Willner	Pegasus Fund	None	\$10,001 - \$50,000
	Pegasus Mid Cap Fund	None	
	Pegasus Small Cap Fund	None	
	Pegasus Small Cap Growth Fund	\$10,001 - \$50,000	
	Focus Fund	None	
	Large Cap Financial Fund	\$1 - \$10,000	
	Small Cap Financial Fund	\$1 - \$10,000	
	Technology Fund	None	
	Gas Utility Index Fund	\$1 - \$10,000	
Reena Aggarwal	Pegasus Fund	None	\$10,001 - \$50,000
	Pegasus Mid Cap Fund	None	
	Pegasus Small Cap Fund	None	
	Pegasus Small Cap Growth Fund	None	
	Focus Fund	\$10,001 - \$50,000	
	Large Cap Financial Fund	\$1 - \$10,000	
	Small Cap Financial Fund	\$1 - \$10,000	
	Technology Fund	None	
	Gas Utility Index Fund	None	
William E. Cole, Jr.	Pegasus Fund	\$1 - \$10,000	\$10,001 - \$50,000
	Pegasus Mid Cap Fund	None	
	Pegasus Small Cap Fund	None	
	Pegasus Small Cap Growth Fund	\$1 - \$10,000	
	Focus Fund	None	
	Large Cap Financial Fund	None	
	Small Cap Financial Fund	None	
	Technology Fund	\$1 - \$10,000	
	Gas Utility Index Fund	\$1 - \$10,000	
Charles O. Heller	Pegasus Fund	\$10,001 - \$50,000	\$50,001 - \$100,000
	Pegasus Mid Cap Fund	None	
	Pegasus Small Cap Fund	\$10,001 - \$50,000	
	Pegasus Small Cap Growth Fund	None	
	Focus Fund	None	
	Large Cap Financial Fund	None	
	Small Cap Financial Fund	None	
	Technology Fund	\$10,001 - \$50,000	
	Gas Utility Index Fund	None	
David H. Ellison	Pegasus Fund	Over \$100,000	Over \$100,000
	Pegasus Mid Cap Fund	Over \$100,000	
	Pegasus Small Cap Fund	Over \$100,000	
	Pegasus Small Cap Growth Fund	Over \$100,000	
	Focus Fund	Over \$100,000	
	Large Cap Financial Fund	Over \$100,000	
	Small Cap Financial Fund	Over \$100,000	

Technology Fund	None
Gas Utility Index Fund	None

* “Family of Investment Companies” consists of all mutual funds advised by FBR Capital Markets Holding Group, Inc. (“FBR Capital Markets”) and its affiliate advisers.

TRUST MANAGEMENT AND ADMINISTRATION

Investment Adviser. FBR Fund Advisers, Inc. (the “Adviser”), located at 1001 Nineteenth Street North, Arlington, Virginia 22209, serves as the investment adviser to the Funds. The Adviser oversees the investment of each Fund’s assets, subject at all times to the supervision of the Trustees of the Funds. The Adviser continually conducts investment research and supervision for the Funds and is responsible for the purchase and sale of each Fund’s investments.

The Adviser was organized as a Delaware corporation in 1996 and is registered with the Securities and Exchange Commission as an investment adviser. The Adviser is a subsidiary of FBR Capital Markets, Inc. (“FBR Capital Markets”). As of January 31, 2010, the Adviser managed approximately \$1.26 billion of net assets on behalf of the Funds.

The Investment Advisory Agreement. The Investment Advisory Agreement between the Adviser and the Trust on behalf of the Funds (the “Investment Advisory Agreement”) provides that it will continue in effect as to each Fund for an initial two-year term and for consecutive one-year terms thereafter, provided that such continuance is approved at least annually by the Trustees or by vote of a majority of the outstanding shares of a Fund (as defined under “Additional Information”), and, in either case, by a majority of the Trustees who are not parties to the Investment Advisory Agreement or interested persons (as defined in the 1940 Act) of any party to the Investment Advisory Agreement, by votes cast in person at a meeting called for such purpose.

The Investment Advisory Agreement is terminable as to a Fund at any time on 60 days’ written notice without penalty by the Trustees, by vote of a majority of the outstanding shares of the Fund, or by the Adviser. The Investment Advisory Agreement also terminates automatically in the event of any assignment, as defined in the 1940 Act.

The Investment Advisory Agreement provides that the Adviser shall not be liable for any error of judgment or mistake of law or for any loss suffered by a Fund in connection with the performance of services pursuant to the Investment Advisory Agreement, except a loss resulting from a breach of fiduciary duty with respect to the receipt of compensation for services or a loss resulting from willful misfeasance, bad faith, or negligence on the part of the Adviser in the performance of its duties, or from reckless disregard by it of its duties and obligations thereunder.

Under the Investment Advisory Agreement, the Adviser may delegate a portion of its responsibilities to a sub-adviser. In addition, the Investment Advisory Agreement provides that the Adviser may render services through its own employees or the employees of one or more affiliated companies that are qualified to act as an investment adviser of a Fund and are under common control with FBR Capital Markets as long as all such persons are functioning as part of an organized group of persons, managed by authorized officers of the Adviser.

For its services, the Adviser receives a fee at an annual rate based on the Funds’ net assets as follows:

<u>Fund</u>	<u>Rate</u>
Pegasus Fund	0.90%
Pegasus Mid Cap Fund	0.90%
Pegasus Small Cap Fund	0.90%
Pegasus Small Cap Growth Fund	0.90%
Focus Fund	0.90%
Large Cap Financial Fund	0.90%
Small Cap Financial Fund	0.90%
Technology Fund	0.90%
Gas Utility Index Fund	0.40%

Effective May 30, 2008, FBR Fund Advisers, Inc. has agreed in writing to waive a portion of its investment advisory fees and assume certain expenses of the Investor Class shares of each Fund, except the Gas Utility Index Fund, to the extent annual fund operating expenses exceed 1.25%, 1.35%, 1.45% and 1.45% of the Pegasus Fund, Pegasus Mid Cap Fund, Pegasus Small Cap Fund and Pegasus Small Cap Growth Fund, respectively and 1.95% of the Focus Fund, Large Cap Financial Fund, Small Cap Financial Fund and Technology Fund's average daily net assets (excluding interest, taxes, brokerage commissions, dividend expenses, acquired fund fees and expenses, extraordinary legal expenses, or any other extraordinary expenses) With respect to the Gas Utility Index Fund, the Adviser has agreed in writing to waive a portion of its investment advisory fees and assume certain expenses of the Fund's Investor Class to the extent annual fund operating expenses exceed 0.85% of the Fund's average daily net assets (excluding interest, taxes, brokerage commissions, dividend expenses, acquired fund fees and expenses, extraordinary legal expenses, or any other extraordinary expenses). FBR Fund Advisers, Inc. has agreed in writing to waive a portion of its investment advisory fees and assume certain expenses of the I Class shares of each Fund to the extent annual fund operating expenses exceed 1.00%, 1.10%, 1.20% and 1.20% of the Pegasus Fund, Pegasus Mid Cap Fund, Pegasus Small Cap Fund and Pegasus Small Cap Growth Fund, respectively and 1.70% of the Focus Fund and Small Cap Financial Fund's average daily net assets (excluding interest, taxes, brokerage commissions, dividend expenses, acquired fund fees and expenses, extraordinary legal expenses or any other extraordinary expenses). FBR Fund Advisers, Inc. has agreed in writing to waive a portion of its investment advisory fees and assume certain expenses of the R Class shares of each Fund to the extent annual fund operating expenses exceed 1.70% of the Pegasus Small Cap Growth Fund, 2.20% of the Focus Fund and Small Cap Financial Fund, and 1.35% of the Gas Utility Index Fund's average daily net assets (excluding interest, taxes, brokerage commissions, dividend expenses, acquired fund fees and expenses, extraordinary legal expenses or any other extraordinary expenses). The Adviser has agreed to maintain these expense limitations with regard to each Fund through February 28, 2013.

For the fiscal year ended October 31, 2009, each Fund paid investment advisory fees and received fee waivers and reimbursements of expenses as follows:

Fund	Gross Advisory Fees	Advisory Fee Waivers	Net Advisory Fees	Expense Reimbursements
Pegasus Fund	\$112,281	\$(112,281)	\$-	\$(11,680)
Pegasus Mid Cap Fund	56,505	(56,505)	-	(54,342)
Pegasus Small Cap Fund	66,439	(66,439)	-	(37,530)
Pegasus Small Cap Growth Fund	38,063	(38,063)	-	(83,085)
Focus Fund	6,876,176	(10,825)	6,865,351	-
Large Cap Financial Fund	221,101	-	221,101	-
Small Cap Financial Fund	1,594,107	(10,554)	1,583,553	-
Technology Fund	62,228	(62,228)	-	(10,061)
Gas Utility Index Fund	719,637	(10,559)	709,078	-

For the fiscal year ended October 31, 2008, each Fund paid investment advisory fees and received fee waivers and reimbursements of expenses as follows:

Fund	Gross Advisory Fees	Advisory Fee Waivers	Net Advisory Fees	Expense Reimbursements
Pegasus Fund	\$ 81,035	\$ (76,144)	\$ 4,891	\$ -
Pegasus Mid Cap Fund	37,788	(37,788)	-	(48,874)
Pegasus Small Cap Fund	41,334	(41,334)	-	(42,270)
Pegasus Small Cap Growth Fund	35,828	(35,828)	-	(65,950)
Focus Fund	9,965,909	(709)	9,965,200	-
Large Cap Financial Fund	145,196	(21,380)	123,816	-
Small Cap Financial Fund	1,232,316	(687)	1,231,629	-
Technology Fund	192,240	(16,622)	175,618	-
Gas Utility Index Fund	1,051,470	(900)	1,050,570	-

For the fiscal year ended October 31, 2007, each Fund paid investment advisory fees and received fee waivers and reimbursements of expenses as follows:

Fund	Gross Advisory Fees	Advisory Fee Waivers	Net Advisory Fees	Expense Reimbursements
Pegasus Fund	\$ 117,714	\$ (31,699)	\$ 86,015	\$ —
Pegasus Mid Cap Fund ¹	20,497	(20,497)	—	(30,166)
Pegasus Small Cap Fund ¹	23,428	(23,428)	—	(24,112)
Pegasus Small Cap Growth Fund	41,238	(41,238)	—	(44,311)
Focus Fund	13,230,756	—	13,230,756	—
Large Cap Financial Fund	206,760	(8,361)	198,399	—
Small Cap Financial Fund	2,135,115	—	2,135,115	—
Technology Fund	352,020	—	352,020	—
Gas Utility Index Fund	1,143,082	—	1,143,082	—

¹ From commencement of operations on February 28, 2007 until October 31, 2007.

Effective May 30, 2008, the Adviser may recoup any waived amount from a Fund pursuant to this agreement if such reimbursement does not cause the Fund to exceed existing expense limitations and the reimbursement is made within three years after the year in which the Adviser incurred the expense. As of October 31, 2009 the Funds had the following amounts (and year of expiration) subject to repayment to the Adviser:

Fund	Year Fees Waived	Repayment Expires	Balance
Pegasus Fund – Investor Class	2008	2011	\$ 42,645
	2009	2012	112,398
Pegasus Fund – I Class	2008	2011	1,153
	2009	2012	11,563
Pegasus Mid Cap Fund – Investor Class	2008	2011	37,881
	2009	2012	99,322
Pegasus Mid Cap Fund – I Class	2008	2011	1,295
	2009	2012	11,525
Pegasus Small Cap Fund – Investor Class	2008	2011	36,709
	2009	2012	92,582
Pegasus Small Cap Fund – I Class	2008	2011	1,298
	2009	2012	11,387
Pegasus Small Cap Growth Fund – Investor Class	2008	2011	44,078
	2009	2012	98,547
Pegasus Small Cap Growth Fund – I Class	2008	2011	1,436
	2009	2012	11,301
Pegasus Small Cap Growth Fund – R Class	2008	2011	1,450
	2009	2012	11,300
Focus Fund – R Class	2008	2011	709
	2009	2012	10,825
Small Cap Financial Fund – R Class	2008	2011	687
	2009	2012	10,554
Technology Fund – Investor Class	2008	2011	7,400
	2009	2012	72,289
Gas Utility Index Fund – R Class	2008	2011	823
	2009	2012	10,559

During the year ended October 31, 2009, the Large Cap Financial Fund – Investor Class and the Gas Utility Index Fund – Investor Class repaid Fund Advisers \$104 and \$78, respectively, for fees waived during the fiscal year ended October 31, 2008. During the year ended October 31, 2008, the Large Cap Financial Fund – Investor Class, Small Cap Financial – I Class, Technology Fund – Investor Class and Gas Utility Index Fund – Investor Class repaid Fund

Advisers \$7,218, \$391, \$125 and \$680, respectively, for fees waived during the fiscal year ended October 31, 2008.

Distributor. FBR Investment Services, Inc. (the “Distributor”), located at 1001 Nineteenth Street North, Arlington, VA 22209, is an affiliate of the Adviser and serves as principal underwriter and distributor of the Funds’ shares pursuant to an agreement with the Trust which is renewable annually. The Distributor promotes and sells shares of the Funds on a continuous, best efforts basis.

Distribution Plan. The Trust’s Board of Trustees has adopted a Distribution Plan (the “Plan”) on behalf of the Investor Class shares of each Fund, except the Gas Utility Index Fund, pursuant to Rule 12b-1 under the 1940 Act (the “Plan”). Pursuant to the Investor Class Plan, each Fund pays the Distributor a fee for distributing Fund shares at the annual rate of up to 0.25% of the average daily net assets of the Fund shares for which it is the distributor of record. The Trust has also adopted a Distribution Plan for R Class shareholders of certain Funds that pays the Distributor a fee for distributing Fund shares at the annual rate of up to 0.50% of the average daily net assets of the Fund shares for which it is the distributor of record. Under the Plan, the Distributor may pay third parties in respect of these services such amount as it may determine. The fees paid to the Distributor under the Plans are payable without regard to actual expenses incurred. The Trust understands that these third parties also may charge fees to their clients who are beneficial owners of Fund shares in connection with their client accounts. These fees would be in addition to any amounts which may be received by them from the Distributor under the Plans.

Distribution fees may be used by the Distributor for: (a) costs of printing and distributing a Fund’s prospectus, statement of additional information and reports to prospective investors in the Funds; (b) costs involved in preparing, printing and distributing sales literature pertaining to a Fund; (c) an allocation of overhead and other branch office distribution-related expenses of the Distributor; (d) payments to persons who provide support services in connection with the distribution of a Fund’s shares, including but not limited to, office space and equipment, telephone facilities, answering routine inquiries regarding a Fund, processing shareholder transactions and providing any other shareholder services not otherwise provided by a Fund’s transfer agent; (e) accruals for interest on the amount of the foregoing expenses that exceed the distribution fee; and (f) any other expense primarily intended to result in the sale of a Fund’s shares, including, without limitation, payments to salesmen and selling dealers who have entered into selected dealer agreements with the Distributor, at the time of the sale of shares, if applicable, and continuing fees to each such salesmen and selling dealers, which fee shall begin to accrue immediately after the sale of such shares. In addition to the above, R Class distribution fees may be used by the Distributor for: (a) costs related to account maintenance and personal service provided to shareholders; (b) costs attributable to activities related to retirement plan programs and the sponsors of such retirement plan programs which invest in the Funds; (c) costs attributable to activities related to administrators of retirement plan programs, including recordkeeping and other similar administrative support services provided to participants in retirement plan programs which invest in the Funds; and (d) costs attributable to the support of retirement plan programs including educational and other related information services provided to retirement plans and their participants which invest in the Funds.

In approving the Plans in accordance with the requirements of Rule 12b-1 under the 1940 Act, the Trustees (including the independent Trustees, being Trustees who are not “interested persons,” as defined by the 1940 Act, of the Trust and who have no direct or indirect financial interest in the operation of the Plans or in any agreements related to the Plans) considered various factors and determined that there is a reasonable likelihood that the Plans will benefit the shareholders. The Plans will continue in effect as to a Fund from year to year if specifically approved annually (a) by the majority of such Fund’s outstanding voting shares or by the Board of Trustees and (b) by the vote of a majority of the independent Trustees. While the Plans remain in effect, the Trust shall prepare and furnish to the Board of Trustees a written report setting forth the amounts spent by each Fund under the Plans and the purposes for which such expenditures were made. The Plans may not be amended to increase materially the amount to be spent for distribution without shareholder approval and all material amendments to the Plan must be approved by the Board and by the Independent Trustees cast in person at a meeting called specifically for that purpose. While the Plans are in effect, the selection and nomination of the Independent Trustees shall be made by those Independent Trustees then in office.

For the fiscal year ended October 31, 2009, the following amounts were paid by each Fund with respect to Investor Class shares:

Fund	Amount Paid
Pegasus Fund	\$31,004
Pegasus Mid Cap Fund	15,514
Pegasus Small Cap Fund	18,266
Pegasus Small Cap Growth Fund	10,183
Focus Fund	1,846,767
Large Cap Financial Fund	61,417
Small Cap Financial Fund	436,613
Technology Fund	17,286

For the fiscal year ended October 31, 2009 the following amounts were paid by each Fund with respect to R Class shares :

Fund	Amount Paid
Pegasus Small Cap Growth Fund	\$364
Focus Fund	598
Small Cap Financial Fund	547
Gas Utility Index Fund	354

For the fiscal year ended October 31, 2009, the Distributor incurred the following expenses with respect to Investor Class shares:

	Sales Material and Advertising	Printing and Mailing Prospectuses to other than Current Shareholders	Compensation to Sales Personnel and Broker- Dealers	Other*	Approximate Total Amount Spent With Respect to Each Fund
Pegasus Fund	\$ 1,618	\$ 177	\$ 34,144	\$ 1,118	\$ 37,057
Pegasus Mid Cap Fund	810	46	17,007	560	18,423
Pegasus Small Cap Fund	953	55	20,087	659	21,754
Pegasus Small Cap Growth Fund	531	87	11,205	367	12,190
Focus Fund	96,386	11,200	2,024,943	66,634	2,199,163
Large Cap Financial Fund	3,205	601	67,550	2,216	73,572
Small Cap Financial Fund	22,789	3,062	478,487	15,755	520,093
Technology Fund	902	131	18,939	624	20,596

* Other expenses include administrative, overhead and consulting fees.

For the fiscal year ended October 31, 2009 the Distributor incurred the following expenses with respect to R Class shares:

	Sales Material and Advertising	Printing and Mailing Prospectuses to other than Current Shareholders	Compensation to Sales Personnel and Broker- Dealers	Other*	Approximate Total Amount Spent With Respect to Each Fund
Pegasus Small Cap Growth Fund	\$10	\$1	\$380	\$ 7	\$398
Focus Fund	16	2	627	11	656
Small Cap Financial Fund	14	3	572	10	599
Gas Utility Index Fund	9	2	371	6	388

* Other expenses include administrative, overhead and consulting fees.

Fund Administration. JPMorgan Chase Bank N.A. (“JPMorgan”) serves as the administrator to the Funds and provides pursuant to an Administration Agreement (“Agreement”) day-to-day administrative services including monitoring portfolio compliance, determining compliance with provisions of the Internal Revenue Code and preparing the Funds’ registration statements. Pursuant to the Agreement, JPMorgan receives a fee of 0.02% of the first \$2.5 billion of average daily net assets of the Trust, 0.0175% of the next \$1.0 billion of average daily net assets of the Trust and 0.015% of the Trust’s average daily net assets in excess of \$3.5 billion.

Pursuant to the Administrative Services Agreement, the Adviser also provides administrative services to the Funds including oversight of service providers. For the period ended October 31, 2009, the Adviser received 0.02% of average daily net assets of the Trust. Effective November 1, 2009, the Adviser receives 0.04% of average daily net assets of the Trust. The Adviser also provides the Funds with office space, facilities and business equipment and generally administers the Funds’ business affairs and provides the services of executive and clerical personnel for administering the affairs of the Funds. The Adviser compensates all personnel, Officers, and Trustees of the Funds if such persons are employees of the Adviser.

For the fiscal years ended October 31, 2007, 2008 and 2009, the following fees were paid to FBR Fund Advisers, Inc. pursuant to the Agreement for each Fund:

Fund	Amount Paid		
	2007	2008	2009
Pegasus Fund	\$7,695	\$1,801	\$2,495
Pegasus Mid Cap Fund	1,328	840	1,256
Pegasus Small Cap Fund	1,519	918	1,476
Pegasus Small Cap Growth Fund	2,690	796	846
Focus Fund	862,285	221,445	152,791
Large Cap Financial Fund	13,512	3,226	4,913
Small Cap Financial Fund	139,775	27,382	35,415
Technology Fund	23,004	4,272	1,383
Gas Utility Index Fund	319,102	157,716	107,943

For the fiscal years ended October 31, 2008 and 2009, the following fees were paid to JPMorgan pursuant to the Agreement for each Fund:

Fund	Amount Paid	
	2008	2009
Pegasus Fund	\$1,911	\$2,314
Pegasus Mid Cap Fund	828	1,017
Pegasus Small Cap Fund	928	990
Pegasus Small Cap Growth Fund	818	574
Focus Fund	232,429	122,013
Large Cap Financial Fund	2,864	4,060
Small Cap Financial Fund	26,796	34,485
Technology Fund	4,721	838
Gas Utility Index Fund	54,048	33,246

Custodian. JPMorgan Chase Bank, N.A. (“JPMorgan”), 303 Broadway, Suite 900, Cincinnati, Ohio 45202, serves as the Custodian of the Funds’ investments. The Custodian acts as each Fund’s depository, safe keeps its portfolio securities, collects all income and other payments with respect thereto, disburses funds at the Fund’s request and maintains records in connection with its duties.

Transfer Agent and Fund Accountant. JPMorgan, 303 Broadway, Suite 900, Cincinnati, OH 45202 acts as the Funds’ transfer agent and fund accountant. In its capacity as transfer agent, JPMorgan maintains the records of each shareholder’s account, answers shareholder inquiries concerning their accounts, processes purchases and redemptions of Fund shares, acts as dividend and distribution disbursing agent and performs other accounting and shareholder service functions. In its capacity as fund accountant, JPMorgan is responsible for calculating the daily net asset value of the Funds in accordance with the Funds’ current prospectuses and statement of additional

information and maintains the general ledger for the Funds and records all income, expenses, capital share activity and security transactions.

American Gas Association. The American Gas Association (“AGA”) also provides administrative services to the FBR Gas Utility Index Fund pursuant to an Administrative Services Agreement between the Fund and AGA. These administrative services include overseeing the calculation of the Index. AUS performs the actual computations required to produce the Index and receives a fee for such calculations pursuant to a contractual arrangement with AGA. AGA does not furnish other securities advice to the Fund or the Adviser or make recommendations regarding the purchase or sale of securities by the Fund. Under the terms of an agreement approved by the Board of Trustees, AGA provides the Adviser with current information regarding the common stock composition of the Index no less than quarterly but may supply such information more frequently. In addition, AGA provides the Fund with information on the natural gas industry. Effective March 1, 2007, the Fund pays AGA in its capacity as administrator a fee at an annual rate of 0.04% of the average daily net assets of the Fund. For the fiscal years ended October 31, 2009, 2008 and 2007, the Fund paid the following administration fees to AGA:

2007	2008	2009
\$151,178	\$105,147	\$71,964

Expenses. Except for expenses paid by the Adviser and the Distributor, each Fund bears all costs of its operations. Expenses attributable to a class (“Class Expenses”) shall be allocated to that class only. Class Expenses with respect to the R Class shares must include payments made pursuant to the distribution plan relating to that Class. In the event a particular expense is not reasonably allocable by class to a particular class, it shall be treated as a Fund expense or a Trust expense. Trust expenses directly related to a Fund are charged to the Fund; other expenses are allocated proportionately among all the portfolios of each Trust in relation to the net asset value of the portfolios.

Chief Compliance Officer. The Trust has contracted with Alaric Compliance Services, LLC to provide the services of Guy F. Talarico to serve in the capacity of Chief Compliance Officer of the Trust under Rule 38a-1 of the 1940 Act. For these services, the Trust pays fees on a monthly basis, plus any out of pocket expenses. Each Fund pays a portion of the fees based on average net assets and number of funds in the Trust.

Independent Registered Public Accounting Firm. The financial statements of the Funds (or their corresponding Predecessor Funds) have been audited by Tait, Weller & Baker LLP, the Trust’s independent registered public accounting firm, as indicated in their report with respect thereto, and are incorporated by reference hereto in reliance upon the authority of said firm as experts in giving said report.

BROKERAGE ALLOCATION AND OTHER PRACTICES

Portfolio Transactions. Pursuant to the Investment Advisory Agreement, the Adviser determines, subject to the general supervision of the Trustees of the Trust, and in accordance with each Fund’s investment objective and restrictions, which securities are to be purchased and sold by a Fund, and which brokers are to be eligible to execute its portfolio transactions. Purchases from underwriters and/or broker-dealers of portfolio securities include a commission or concession paid by the issuer to the underwriter and/or broker-dealer and purchases from dealers serving as market makers may include the spread between the bid and asked price. While the Adviser generally seeks competitive spreads or commissions, a Fund may not necessarily pay the lowest spread or commission available on each transaction, for reasons discussed below.

Allocation of transactions to broker-dealers is determined by the Adviser in its best judgment and in a manner deemed fair and reasonable to shareholders. The primary consideration is prompt execution of orders in an effective manner at the most favorable price. Subject to this consideration, broker-dealers who provide supplemental investment research to the Adviser may receive orders for transactions by the Trust. Information so received is in addition to and not in lieu of services required to be performed by the Adviser and does not reduce the investment advisory fees payable to the Adviser by a Fund. Such information may be useful to the Adviser in serving both the Trust and other advisory clients and, conversely, such supplemental research information obtained by the placement of orders on behalf of other clients may be useful to the Adviser in carrying out its obligations to the Trust.

In selecting broker-dealers to execute a particular transaction, and in evaluating the best overall terms available, the Adviser is authorized to consider the brokerage and research services (as those terms are defined in Section 28(e) of the Securities Exchange Act of 1934, as amended) provided to the Fund and/or other accounts over which the Adviser or its affiliates exercise investment discretion. The Adviser may cause the Fund to pay a broker-dealer or that furnishes brokerage and research services a higher commission than that which might be charged by another broker-dealer for effecting the same transaction, provided that the Adviser determines in good faith that such commission is reasonable in relation to the value of the brokerage and research services provided by such broker-dealer, viewed in terms of either the particular transaction or the overall responsibilities of the Adviser to the Fund. Such brokerage and research services might consist of reports and statistics on specific companies or industries, general summaries of groups of bonds and their comparative earnings and yields, or broad overviews of the securities markets and the economy.

The Commission has published proposed interpretive guidance that would tighten existing standards concerning the types of expenses that qualify for the Section 28(e) safe harbor and set forth certain steps that investment advisers would need to take in order to ensure such qualification.

Supplementary research information so received is in addition to and not in lieu of services required to be performed by the Adviser and does not reduce the investment advisory fees payable to the Adviser by the Fund. Such information may be useful to the Adviser in serving both the Fund and other advisory clients and, conversely, such supplemental research information obtained by the placement of orders on behalf of other clients may be useful to the Adviser in carrying out its obligations to the Fund.

In accordance with procedures adopted by the Board, the Funds may place portfolio transactions with broker-dealers who sell fund shares only if such brokerage is not direct or indirect compensation for the promotion or sale of shares of the Funds or any other investment company.

The Trustees have authorized the allocation of brokerage to FBR Capital Markets & Co. ("FBR & Co."), an affiliated broker-dealer, to effect portfolio transactions on an agency basis. The Trustees have adopted procedures incorporating the standards of Rule 17e-1 under the 1940 Act, which require that the commission paid to affiliated broker-dealers must be "reasonable and fair compared to the commission, fee or other remuneration received, or to be received, by other brokers in connection with comparable transactions involving similar securities during a comparable period of time." At times, a Fund may also purchase portfolio securities directly from dealers acting as principals, underwriters or market makers. As these transactions are usually conducted on a net basis, no brokerage commissions are paid by the Fund.

Investment decisions for a Fund are made independently from those made for the other Funds of the Trust or any other investment company or account managed by the Adviser. Such other funds, investment companies or accounts may also invest in the same securities in which a Fund invests. When a purchase or sale of the same security is made at substantially the same time on behalf of a Fund and another advisory client, the transaction will be averaged as to price, and available investments allocated as to amount, in a manner which the Adviser believes to be equitable to the Fund and such other advisory client. In some instances, this investment procedure may affect the price paid or received by a Fund or the size of the position obtained by the Fund in an adverse manner relative to the result that would have been obtained if only the Fund had participated in or been allocated such trades. To the extent permitted by law, the Adviser may aggregate the securities to be sold or purchased for a Fund with those to be sold or purchased for the other Funds of the Trust or for other advisory clients in order to obtain best execution. In making investment recommendations for a Fund, the Adviser will not inquire or take into consideration whether an issuer of securities proposed for purchase or sale by the Fund is a customer of the Adviser, or its parent or affiliates, and, in dealing with commercial customers, the Adviser or its affiliates will not inquire or take into consideration whether securities of such customers are held by the Trust.

For the fiscal year ended October 31, 2009, each Fund paid brokerage commissions as follows:

Fund	Total Brokerage Commissions Paid	Commissions Paid to FBR & Co.	% of Aggregate Commissions Paid to FBR & Co.	% of Aggregate Dollar Amount of Transactions Effected through FBR & Co.
Pegasus Fund	\$10,819	\$-	-	-
Pegasus Mid Cap Fund	7,291	-	-	-
Pegasus Small Cap Fund	22,180	-	-	-
Pegasus Small Cap Growth Fund	5,334	-	-	-
Focus Fund	225,106	-	-	-
Large Cap Financial Fund	78,411	3,410	4.3%	1.5%
Small Cap Financial Fund	896,776	52,942	5.9%	4.0%
Technology Fund	11,077	-	-	-
Gas Utility Index Fund	34,435	-	-	-

For the fiscal year ended October 31, 2008, each Fund paid brokerage commissions as follows:

Fund	Total Brokerage Commissions Paid	Commissions Paid to FBR & Co.	% of Aggregate Commissions Paid to FBR & Co.	% of Aggregate Dollar Amount of Transactions Effected through FBR & Co.
Pegasus Fund	\$ 2,924	\$--		
Pegasus Mid Cap Fund	3,637	--		
Pegasus Small Cap Fund	8,196	--		
Pegasus Small Cap Growth Fund	4,160	--		
Focus Fund	551,334	--		
Large Cap Financial Fund	68,409	2,400	3.5%	1.4%
Small Cap Financial Fund	482,333	43,731	9.1%	6.4%
Technology Fund	26,966	--		
Gas Utility Index Fund	45,190	--		

For the fiscal year ended October 31, 2007, each Fund paid brokerage commissions as follows:

Fund	Total Brokerage Commissions Paid	Commissions Paid to FBR & Co.	% of Aggregate Commissions Paid to FBR & Co.	% of Aggregate Dollar Amount of Transactions Effected through FBR & Co.
Pegasus Fund	\$ 7,528	\$--	--	--
Pegasus Mid Cap Fund ¹	4,196	--	--	--
Pegasus Small Cap Fund ¹	4,272	--	--	--
Pegasus Small Cap Growth Fund	6,292	--	--	--
Focus Fund	261,418	--	--	--
Large Cap Financial Fund	17,487	--	--	--
Small Cap Financial Fund	271,480	25,786	9.5%	6%
Technology Fund	62,132	--	--	--
Gas Utility Index Fund	41,833	--	--	--

¹ Commissions paid from commencement of operations on February 28, 2007 until October 31, 2007.

FINANCIAL STATEMENTS

The financial statements for the fiscal year ended October 31, 2009, with respect to the Funds, including notes thereto and the report of Tait, Weller & Baker LLP thereon, are herein incorporated by reference. A copy of the Funds' Annual Report to shareholders, with respect to the FBR Pegasus FundTM, the FBR Pegasus Mid Cap FundTM,

the FBR Pegasus Small Cap FundTM, the FBR Pegasus Small Cap Growth FundTM, the FBR Focus Fund, the FBR Large Cap Financial Fund, the FBR Small Cap Financial Fund, the FBR Technology Fund and the FBR Gas Utility Index Fund must accompany the delivery of this SAI. Copies of the Funds' most recent annual report may be obtained without charge upon request by writing to The FBR Funds, 1001 Nineteenth Street North, Arlington, Virginia 22209 or by calling toll free 888.888.0025.

DESCRIPTION OF SHARES

The Trust is a Delaware statutory trust formed on September 26, 2003. The Trust Instrument authorizes the Trustees to issue an unlimited number of shares, which are units of beneficial interest, without par value. The Trust presently is authorized to issue ten series of shares, which represent interests in the FBR Pegasus FundTM, the FBR Pegasus Mid Cap FundTM, the FBR Pegasus Small Cap FundTM, the FBR Pegasus Small Cap Growth FundTM, the FBR Focus Fund, the FBR Large Cap Financial Fund, the FBR Small Cap Financial Fund, the FBR Technology Fund, the FBR Gas Utility Index Fund and the FBR Fund for Government Investors. The Trust Instrument authorizes the Trustees to divide or redivide any unissued shares of the Trust into one or more additional series by setting or changing in any one or more aspects their respective preferences, conversion or other rights, voting power, restrictions, limitations as to dividends, qualifications, and terms and conditions of redemption.

Shares have no subscription or preemptive rights and only such conversion or exchange rights as the Trustees may grant in their discretion. When issued for payment as described in the Prospectuses and this SAI, the Trust's shares will be fully paid and non-assessable. In the event of a liquidation or dissolution of the Trust, shares of a Fund are entitled to receive the assets available for distribution belonging to the Fund, and a proportionate distribution, based upon the relative asset values of the respective Funds of the Trust, of any general assets not belonging to any particular Fund which are available for distribution.

Shares of the Trust are entitled to one vote per share (with proportional voting for fractional shares) on such matters as shareholders are entitled to vote. On any matter submitted to a vote of the shareholders, all shares are voted separately by individual series (Funds), and whenever the Trustees determine that the matter affects only certain series, may be submitted for a vote by only such series, except: (1) when required by the 1940 Act, shares are voted in the aggregate and not by individual series; and (2) when the Trustees have determined that the matter affects the interests of more than one series and that voting by shareholders of all series would be consistent with the 1940 Act, then the shareholders of all such series shall be entitled to vote thereon (either by individual series or by shares voted in the aggregate, as the Trustees in their discretion may determine). There will normally be no meetings of shareholders for the purpose of electing Trustees unless and until such time as less than a majority of the Trustees have been elected by the shareholders, at which time the Trustees then in office will call a shareholders' meeting for the election of Trustees. In addition, Trustees may be removed from office by a vote of the holders of at least two-thirds of the outstanding shares of the Trust. A meeting shall be held for such purpose upon the written request of the holders of not less than 10% of the outstanding shares. Upon written request by ten or more shareholders meeting the qualifications of Section 16(c) of the 1940 Act, (i.e., persons who have been shareholders for at least six months, and who hold shares having a NAV of at least \$25,000 or constituting 1% of the outstanding shares) stating that such shareholders wish to communicate with the other shareholders for the purpose of obtaining the signatures necessary to demand a meeting to consider removal of a Trustee, the Trust will provide a list of shareholders or disseminate appropriate materials (at the expense of the requesting shareholders). Except as set forth above, the Trustees shall continue to hold office and may appoint their successors.

Rule 18f-2 under the 1940 Act provides that any matter required to be submitted to the holders of the outstanding voting securities of an investment company such as the Trust shall not be deemed to have been effectively acted upon unless approved by the holders of a majority of the outstanding shares of each Fund of the Trust affected by the matter. For purposes of determining whether the approval of a majority of the outstanding shares of a Fund will be required in connection with a matter, a Fund will not be deemed to be affected by a matter unless it is clear that the interests of each Fund in the matter are identical, or that the matter does not affect any interest of the Fund. Under Rule 18f-2, the approval of an investment advisory agreement or any change in investment policy would be effectively acted upon with respect to a Fund only if approved by a majority of the outstanding shares of such Fund. However, Rule 18f-2 also provides that the ratification of independent public accountants, the approval of principal underwriting contracts, and the election of Trustees may be effectively acted upon by shareholders of the Trust voting without regard to series.

SHAREHOLDER AND TRUSTEE LIABILITY

The Delaware Statutory Trust Act provides that a shareholder of a Delaware statutory trust shall be entitled to the same limitation of personal liability extended to shareholders of Delaware corporations, and the Delaware Trust Instrument provides that shareholders of the Trust shall not be liable for the obligations of the Trust. The Delaware Trust Instrument also provides for indemnification out of the Trust property of any shareholder held personally liable solely by reason of his or her being or having been a shareholder. The Delaware Trust Instrument also provides that the Trust shall, upon request, assume the defense of any claim made against any shareholder for any act or obligation of the Trust, and shall satisfy any judgment thereon. Thus, the risk of a shareholder incurring financial loss on account of shareholder liability is considered to be extremely remote.

The Delaware Trust Instrument states further that no Trustee, officer, or agent of the Trust shall be personally liable in connection with the administration or preservation of the assets of a Fund or the conduct of the Trust's business; nor shall any Trustee, officer, or agent be personally liable to any person for any action or failure to act except for his own bad faith, willful misfeasance, gross negligence, or reckless disregard of his duties. The Trust Instrument also provides that all persons having any claim against the Trustees or the Trust shall look solely to the assets of the Trust for payment.

DISCLOSURE OF PORTFOLIO HOLDINGS

The Board has adopted policies and procedures for the public and nonpublic disclosure of the Fund's portfolio securities ("Disclosure Procedures"). On a quarterly basis, the Funds disclose on the Trust's website, www.fbrfunds.com, each Fund's entire portfolio holdings, including a description of each security and the percentage such security represents of the Fund's total investments as of that date. The information will be available no later than the 10th business day following the end of each calendar quarter and shall remain on the website until the next calendar quarter's information is made publicly available. The Funds also make available certain additional information regarding their portfolios (*e.g.* top-10 holdings, asset allocation, sector breakdown) on their website on a quarterly basis by the 15th of the month following the calendar quarter-end. A complete list of the Funds' portfolio holdings is also publicly available on a quarterly basis through filings made with the SEC on Forms N-CSR and N-Q.

As a general matter, no information concerning the portfolio holdings of the Funds may be disclosed to any unaffiliated third party except (1) to service providers that require such information in the course of performing their duties (such as the Funds' custodian, fund accountants, investment adviser and sub-advisers (if applicable), administrator, independent public accountants, attorneys, officers and trustees and each of their respective affiliates and advisors) and are subject to a duty of confidentiality, and (2) pursuant to enumerated exception that serve a legitimate business purpose. These exceptions include (1) disclosure of portfolio holdings only after such information has been publicly disclosed, as provided in the previous paragraph, and (2) to third-party vendors such as Morningstar and Lipper Analytical Services that (a) agree to not distribute the portfolio holdings or results of the analysis to third parties, other departments or persons who are likely to use the information for purposes of purchasing or selling the Funds before the portfolio holdings or results of the analysis become publicly available; and (b) signs a written confidentiality agreement. The confidentiality agreement must provide, among other things, that the recipient of the portfolio holdings information agrees to limit access to the portfolio information to its employees (and agents) who, on a need to know basis, are (1) authorized to have access to the portfolio holdings information and (2) subject to confidentiality obligations, including duties not to trade on non-public information, no less restrictive than the confidentiality obligations contained in the confidentiality agreement.

Any exceptions to the policies and procedures may only be made consent of the Trust's chief compliance officer and will be reported to the Board at the Board's next regularly scheduled meeting.

SHAREHOLDER SERVICES AGREEMENTS

The Funds are authorized to enter into certain Shareholder Services Agreements pursuant to which the Funds are entitled to make payments to certain entities which may include investment advisers, brokers, dealer, banks, trust companies and other types of organizations ("Authorized Service Providers") for providing administrative services

with respect to shares of the Funds attributable to or held in the name of the Authorized Service Provider for its clients or other parties with whom they have a servicing relationship. Under the terms of each Shareholder Services Agreement, a Fund is authorized to pay an Authorized Service Provider (which may include affiliates of the Funds) a shareholder services fee at the rate of up to 0.25% on an annual basis of the average daily net asset value of the shares of the Fund attributable to or held in the name of the Authorized Service Provider for providing certain administrative services to Fund shareholders with whom the Authorized Service Provider has a servicing relationship. Among the types of shareholder services that may be compensated under these types of Agreements are: (1) answering customer inquiries of a general nature regarding the Funds; (2) responding to customer inquiries and requests regarding statements of additional information, reports, notices, proxies and proxy statements, and other Fund documents; (3) delivering prospectuses and annual and semi-annual reports to beneficial owners of Fund shares; (4) assisting the Funds in establishing and maintaining shareholder accounts and records; (5) sub-accounting for Fund share transactions at the shareholder account level; and (6) assisting customers in changing account options, account designations, and account addresses, and providing such other shareholder administrative services as may be reasonably requested.

PROXY VOTING POLICIES AND PROCEDURES

The Board of each Fund has approved proxy voting policies and procedures for the Fund that delegate the authority to vote proxies related to Fund portfolio securities to the Adviser. The Adviser's proxy voting policies and procedures address the responsibility of the Adviser to ensure that proxies received for portfolio securities held by the Fund are voted in the best interest of the Fund, including in those situations involving a conflict of interest between the Fund on the one hand, and the Adviser, Distributor, and certain of their affiliated persons on the other. Such voting responsibilities will be exercised in a manner that is consistent with the general antifraud provisions of the Investment Advisers Act of 1940, as well as the investment adviser's fiduciary duties under the federal and state law to act in the best interest of its clients.

Voting Proxies. Proxies solicited for items of business with respect to issuers whose voting securities are owned by the Fund must be voted in the best interests of the Fund. Proxies are voted on a case-by-case basis in the best economic interest of the client or shareholder taking into consideration all relevant contractual obligations and other circumstances at the time of the vote. Proxies are also voted with the objective of fostering good corporate governance practices, including the fair and equal treatment of shareholders together with the reasonable disclosure of company policies, activities and returns. The Adviser may abstain from voting a client proxy when the effect on shareholders' economic interests or the value of the portfolio holding is indeterminable or insignificant; or when the cost of voting the proxies outweighs the benefits, *e.g.*, when voting certain non-U.S. securities.

Conflicts of Interest. The Adviser generally insulates itself from conflicts of interests between the Fund and itself, the Fund's Distributor and/or certain affiliated persons of the Adviser or Distributor by voting proxies in accordance with the Adviser's proxy voting policies and procedures. Where a conflict of interest arises, the Adviser may pursue one of the following courses of action: (1) convene an ad-hoc committee to assess and resolve the conflict; (2) vote in accordance with the instructions of a client or shareholder after providing notice to that client or shareholder of the conflict; (3) vote the proxy in accordance with the recommendation of an independent third-party service provider; or (4) delegate the vote to an independent third-party service provider. The Board of Trustees of the Fund has appointed a committee of the Board for the purpose of providing the Fund's consent to vote in matters where the Adviser seeks such consent because of a conflict of interest that arises in connection with a particular vote or for other reasons.

Each portfolio manager of the Adviser and/or Proxy Designate (a representative designated by the portfolio manager to vote proxies) is encouraged to own shares in the Fund over which he oversees the proxy process as to align his voting interest with other Fund shareholders. The portfolio manager and/or Proxy Designate is required to review each proxy issue and make a voting decision in a timely manner that, in his/her best judgment, is in the best interests of the client.

The Funds have filed with the SEC their proxy voting record on Form N-PX for the most recent 12-month period ended June 30. Form N-PX must be filed by the Funds each year by August 31. Once filed, the most recent Form N-PX will be available without charge, upon request, by calling 888.888.0025 or the Securities and Exchange Commission's website at <http://www.sec.gov>.

PORTFOLIO MANAGERS

Portfolio Managers. David H. Ellison, Winsor H. Aylesworth, Robert C. Barringer, Ryan C. Kelley, David S. Rainey, Brian E. Macauley, and Ira Rothberg are the portfolio managers of the Funds. The following table lists the number and type of accounts managed by each individual as of October 31, 2009.

Portfolio Manager	Registered Investment Company Accounts	Assets Managed (\$ millions)*	Pooled Investment Vehicle Accounts	Assets Managed (\$ millions)*	Other Accounts	Assets Managed (\$ millions)*	Total Assets Managed (\$ millions)*
David H. Ellison	3	\$243.9	0	-	0	-	\$243.9
Winsor H. Aylesworth	2	202.2	0	-	0	-	202.2
Robert C. Barringer	3	35.3	0	-	0	-	35.3
Ryan C. Kelley	2	25.9	0	-	0	-	25.9
David S. Rainey	1	794.2	0	-	0	-	794.2
Brian E. Macauley	1	794.2	0	-	0	-	794.2
Ira Rothberg	1	794.2	0	-	0	-	794.2

* If an account has a co-portfolio manager, the total number of accounts and assets have been allocated to each respective manager. Therefore, some accounts and assets have been counted twice.

As indicated in the table above, portfolio managers may manage numerous accounts for multiple clients. These accounts may include registered investment companies, other types of pooled accounts (e.g., collective investment funds), and separate accounts (*i.e.*, accounts managed on behalf of individuals or public or private institutions). Portfolio managers of the Adviser make investment decisions for each account based on the investment objectives and policies and other relevant investment considerations applicable to that portfolio. Even where multiple accounts are managed by the same portfolio manager within the same investment discipline, the Adviser may take action with respect to one account that may differ from the timing or nature of action taken, with respect to another account. Accordingly, the performance of each account managed by a portfolio manager will vary.

Conflicts of interest also may arise where some accounts managed by a particular portfolio manager have higher fees than the fees paid by other accounts. Because a portfolio manager's compensation may be affected by revenues earned by the Adviser, the incentives associated with any given account may be significantly higher or lower than those associated with other accounts.

In addition, to the extent that trade orders are aggregated, which typically occurs in limited circumstances involving participation in initial public offerings or secondary offerings, conflicts may arise when aggregating and/or allocating aggregated trades. The Adviser may aggregate multiple trade orders for a single security in several accounts into a single trade order, absent specific client directions to the contrary. When a decision is made to aggregate transactions on behalf of more than one account, the transactions will be allocated to all participating client accounts in a fair and equitable manner.

The Adviser has adopted and implemented policies and procedures, including brokerage and trade allocation policies and procedures, which it believes address the conflicts associated with managing multiple accounts for multiple clients. In addition, the Adviser monitors a variety of areas, including compliance with account investment guidelines and/or restrictions, the allocation of initial public offerings, and compliance with the Adviser's Code of Ethics and compliance program under the 1940 Act and Investment Advisers Act of 1940. Furthermore, senior personnel of the Adviser periodically review the performance of all portfolio managers.

The compensation package for portfolio managers of the Adviser is a combination of base salary, annual bonuses based on merit and asset based fees. The asset based fees are paid quarterly and are calculated on the average net assets for the quarter of the respective Fund. Mr. Ellison's compensation is comprised of a base salary, and a percentage of assets in the Trust. Mr. Aylesworth's compensation is comprised of a base salary, periodic bonus arrangements based on merit and a percentage of assets in the FBR Technology Fund. Mr. Barringer's compensation is comprised of a base salary, periodic bonus arrangements based on merit and a percentage of assets

in the FBR Pegasus FundTM, FBR Pegasus Small Cap FundTM and FBR Pegasus Small Cap Growth FundTM. Mr. Kelley is compensated with a base salary, periodic bonus arrangements based on merit and a percentage of assets in the FBR Pegasus FundTM and FBR Pegasus Mid Cap FundTM. Mr. Rainey's compensation is comprised of a percentage of assets in the FBR Focus Fund. Mr. Macauley's compensation is comprised of a percentage of assets in the FBR Focus Fund. Mr. Rothberg's compensation is comprised of a percentage of assets in the FBR Focus Fund. In addition, each of the portfolio managers are eligible for equity grants in FBR Capital Markets Corp. based on a number of factors determined by FBR Capital Markets Corp.

The following table shows the dollar range each portfolio manager owns of the Funds which they manage, as of October 31, 2009:

Portfolio Manager	Fund	Dollar Range of Amount Owned in Fund
David H. Ellison	FBR Large Cap Financial Fund	Over \$1,000,000
	FBR Small Cap Financial Fund	Over \$1,000,000
	FBR Technology Fund	None
Winsor H. Aylesworth	FBR Technology Fund	\$50,001-\$100,000
	FBR Gas Utility Index Fund	\$50,001-\$100,000
Robert C. Barringer	FBR Pegasus Fund TM	\$10,001 - \$50,000
	FBR Pegasus Small Cap Fund TM	\$100,001 - \$200,000
	FBR Pegasus Small Cap Growth Fund TM	\$10,001 - \$50,000
Ryan C. Kelley	FBR Pegasus Fund TM	\$10,001-\$50,000
	FBR Pegasus Mid Cap Fund TM	\$10,001-\$50,000
David S. Rainey	FBR Focus Fund	\$100,001 - \$500,000
Brian E. Macauley	FBR Focus Fund	\$50,001-\$100,000
Ira Rothberg	FBR Focus Fund	\$50,001-\$100,000

CONTROL PERSONS AND PRINCIPAL HOLDERS OF SECURITIES

As of January 31, 2010, the following persons held beneficially or of record 5% or more of the outstanding shares of the Funds.

Name and Address	Number of Shares	Percentage of Ownership*
FBR PEGASUS FUNDTM – Investor Class		
National Financial Services LLC For the Exclusive Benefit of Our Customers 200 Liberty Street 1 World Financial Center New York, NY 10281	983,383.867	48.02%
Charles Schwab & Co. Inc. Special Custody Account for Benefit of Customers 101 Montgomery Street San Francisco, CA 94104	613,779.114	29.97%
FBR Fund Advisers, Inc. 1001 Nineteenth Street North Arlington, VA 22209	116,857.658	5.71%
FBR PEGASUS FUNDTM – I Class		
FBR Fund Advisers, Inc. 1001 Nineteenth Street North Arlington, VA 22209	10,168.468	80.87%
Merrill Lynch Pierce Fenner & Smith	2,405.593	19.13%

For the Sole Benefit of Customers
4800 Deer Lake Drive East
Jacksonville, FL 32246

FBR PEGASUS MID CAP FUND™ – Investor Class

FBR Fund Advisers, Inc. 234,149.517 37.01%
1001 Nineteenth Street North
Arlington, VA 22209

National Financial Services LLC 192,834.788 30.48%
For the Exclusive Benefit of Our Customers
200 Liberty Street 1 World Financial Center
New York, NY 10281

Charles Schwab & Co. Inc. 150,576.934 23.80%
Special Custody Account for Benefit of Customers
101 Montgomery Street
San Francisco, CA 94104

FBR PEGASUS MID CAP FUND™ – I Class

FBR Fund Advisers, Inc. 10,275.002 100%
1001 Nineteenth Street North
Arlington, VA 22209

FBR PEGASUS SMALL CAP FUND™ – Investor Class

National Financial Services LLC 662,500.027 57.58%
For the Exclusive Benefit of Our Customers
200 Liberty Street 1 World Financial Center
New York, NY 10281

FBR Fund Advisers, Inc. 258,238.595 22.44%
1001 Nineteenth Street North
Arlington, VA 22209

Charles Schwab & Co. Inc. 117,021.736 10.17%
Special Custody Account for Benefit of Customers
101 Montgomery Street
San Francisco, CA 94104

FBR PEGASUS SMALL CAP FUND™ – I Class

FBR Fund Advisers, Inc. 10,382.188 100%
1001 Nineteenth Street North
Arlington, VA 22209

**FBR PEGASUS SMALL CAP GROWTH FUND™ –
Investor Class**

National Financial Services LLC 225,864.288 37.66%
For the Benefit of Customers
200 Liberty Street 1 World Financial Center
New York, NY 10281

Charles Schwab & Co. Inc. 190,678.289 31.79%
Special Custody Account for Benefit of Customers
101 Montgomery Street
San Francisco, CA 94104

FBR Fund Advisers, Inc. 1001 Nineteenth Street North Arlington, VA 22209	77,441.397	12.91%
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FBR PEGASUS SMALL CAP GROWTH FUND™ – I Class

National Financial Services LLC For the Benefit of Customers 200 Liberty Street 1 World Financial Center New York, NY 10281	11,208.131	49.37%
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FBR Fund Advisers, Inc. 1001 Nineteenth Street North Arlington, VA 22209	10,000.000	44.05%
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Merrill Lynch Pierce Fenner & Smith For the Sole Benefit of Customers 4800 Deer Lake Drive East Jacksonville, FL 32246	1,494.314	6.58%
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FBR PEGASUS SMALL CAP GROWTH FUND™ – R Class

FBR Fund Advisers, Inc. 1001 Nineteenth Street North Arlington, VA 22209	10,000.000	100%
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FBR FOCUS FUND – Investor Class

National Financial Services LLC For the Benefit of Customers 200 Liberty Street 1 World Financial Center New York, NY 10281	7,933,462.767	43.48%
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Charles Schwab & Co. Inc. Special Custody Account for Benefit of Customers 101 Montgomery Street San Francisco, CA 94104	4,993,420.116	27.37%
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FBR FOCUS FUND – I Class

National Financial Services LLC For the Benefit of Customers 200 Liberty Street 1 World Financial Center New York, NY 10281	8,467,241.883	60.82%
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First Clearing LLC 2801 Market Street St. Louis, MO 63103	3,128,376.967	22.47%
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Charles Schwab & Co. Inc. Special Custody Account for Benefit of Customers 101 Montgomery Street San Francisco, CA 94104	1,527,162.836	10.97%
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FBR FOCUS FUND – R Class

FBR Fund Advisers, Inc. 1001 Nineteenth St. North Arlington, VA 22209	41,728.157	50.16%
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Charles Schwab & Co. Inc. Special Custody Account for Benefit of Customers 101 Montgomery Street San Francisco, CA 94104	41,233.224	49.57%
FBR LARGE CAP FINANCIAL FUND – Investor Class Charles Schwab & Co. Inc. Special Custody Account for Benefit of Customers 101 Montgomery Street San Francisco, CA 94104	1,257,268.554	47.87%
National Financial Services LLC For the Benefit of Customers 200 Liberty Street 1 World Financial Center New York, NY 10281	611,372.594	23.28%
Ameritrade Inc. For the Exclusive Benefit of Customers P.O. Box 2226 Omaha, NE 68103	159,265.076	6.06%
FBR SMALL CAP FINANCIAL FUND – Investor Class National Financial Services LLC For the Benefit of Customers 200 Liberty Street 1 World Financial Center New York, NY 10281	4,228,637.190	39.58%
Charles Schwab & Co. Inc. Special Custody Account for Benefit of Customers 101 Montgomery Street San Francisco, CA 94104	3,798,718.884	35.56%
Ameritrade Inc. For the Exclusive Benefit of Customers P.O. Box 2226 Omaha, NE 68103	574,761.669	5.38%
FBR SMALL CAP FINANCIAL FUND – I Class Pershing LLC P.O. Box 2052 Jersey City, NJ	444,283.131	38.97%
National Financial Services LLC For the Benefit of Customers 200 Liberty Street 1 World Financial Center New York, NY 10281	373,937.887	32.80%
Post Co. 112948 c/o Bank of New York P.O. Box 1066 Wall Street Station New York, NY 10268	129,974.118	11.40%
SEI Private Trust Co. One Freedom Valley Drive Oaks, PA 19456	89,238.624	7.83%

FBR SMALL CAP FINANCIAL FUND – R Class		
FBR Fund Advisers, Inc.	10,210.545	81.62%
1001 Nineteenth Street North Arlington, VA 22209		
National Financial Services LLC	1,972.302	15.77%
For the Benefit of Customers 200 Liberty Street 1 World Financial Center New York, NY 10281		
FBR TECHNOLOGY FUND – Investor Class		
National Financial Services Corp.	611,701.688	57.70%
For the Benefit of Customers 200 Liberty Street 1 World Financial Center New York, NY 10281		
Charles Schwab & Co. Inc.	206,882.379	19.51%
Special Custody Account for Benefit of Customers 101 Montgomery Street San Francisco, CA 94104		
FBR GAS UTILITY INDEX FUND – Investor Class		
Charles Schwab & Co. Inc.	3,070,292.405	23.31%
Special Custody Account for Benefit of Customers 101 Montgomery Street San Francisco, CA 94104		
National Financial Services Corp.	1,891,625.239	14.36%
For the Benefit of Customers Church St. Station New York, NY 10281		
FBR GAS UTILITY INDEX FUND – R Class		
FBR Fund Advisers, Inc.	12,310.928	85.01%
1001 Nineteenth St. North Arlington, VA 22209		
National Financial Services Corp.	2,170.491	14.99%
For the Benefit of Customers Church St. Station New York, NY 10281		

* A party holding in excess of 25% of the outstanding voting securities of a Fund may be deemed to control the Fund based on the substantial ownership interest held and the party's resultant ability to influence voting on certain matters submitted to shareholders for their consideration and approval.

ADDITIONAL INFORMATION

As used in the Prospectuses and in this SAI, "assets belonging to a Fund" means the consideration received by the Trust upon the issuance or sale of shares of a Fund, together with all income, earnings, profits, and proceeds derived from the investment thereof, including any proceeds from the sale, exchange, or liquidation of such investments, and any funds or payments derived from any reinvestment of such proceeds and any general assets of the Trust, which general liabilities and expenses are not readily identified as belonging to a particular Fund that are allocated to that Fund by the Trustees. The Trustees may allocate such general assets in any manner they deem fair and equitable. It is anticipated that the factor that will be used by the Trustees in making allocations of general assets to a particular

Fund of the Trust will be the relative NAV of each respective Fund at the time of allocation. Assets belonging to a particular Fund are charged with the direct liabilities and expenses in respect of that Fund, and with a share of the general liabilities and expenses of each of the Funds not readily identified as belonging to a particular Fund, which are allocated to each Fund in accordance with its proportionate share of the net asset values of the Trust at the time of allocation. The timing of allocations of general assets and general liabilities and expenses of the Trust to a particular Fund will be determined by the Trustees and will be in accordance with generally accepted accounting principles. Determinations by the Trustees as to the timing of the allocation of general liabilities and expenses and as to the timing and allocable portion of any general assets with respect to a particular Fund are conclusive.

As used in the Prospectuses and in this SAI, a “vote of a majority of the outstanding shares” of a Fund means the affirmative vote of the lesser of (a) 67% or more of the shares of the Fund present at a meeting at which the holders of more than 50% of the outstanding shares of the Fund are represented in person or by proxy, or (b) more than 50% of the outstanding shares of the Fund.

Code of Ethics. Pursuant to Rule 17j-1 under the 1940 Act, the Trustees have adopted a Code of Ethics for the Trust and approved this same Code of Ethics for the Adviser and Distributor based on a determination that the Code of Ethics contains provisions reasonably necessary to prevent access persons from violating Rule 17j-1 under the 1940 Act. The Code of Ethics permits access persons to invest in securities that may be purchased or held by a Fund, subject to a number of restrictions and controls including blackout periods, pre-approval of trades, and reporting requirements.

The Prospectuses and this SAI are not an offering of the securities herein described in any state in which such offering may not lawfully be made. No salesman, dealer, or other person is authorized to give any information or make any representation other than those contained in the Prospectuses and this SAI.

APPENDIX A

DESCRIPTION OF SECURITY RATINGS.

The nationally recognized statistical rating organizations (individually, an “NRSRO”) that may be utilized by the Adviser with regard to portfolio investments for the Fund include Moody’s Investors Service, Inc. (“Moody’s”), Standard & Poor’s Ratings Services (“S&P”), Duff & Phelps, Inc. (“Duff”), Fitch Investors Service, Inc. (“Fitch”), IBCA Limited and its affiliate, IBCA Inc. (collectively, “IBCA”), and Thompson BankWatch, Inc. (“Thompson”). Set forth below is a description of the relevant ratings of each such NRSRO. The NRSROs that may be utilized by the Adviser and the description of each NRSRO’s ratings is as of the date of this SAI, and may subsequently change.

Long-Term Debt Ratings (may be assigned, for example, to corporate and municipal bonds).

Description of the five highest long-term debt ratings by Moody’s (Moody’s applies numerical modifiers (e.g., 1, 2, and 3) in each rating category to indicate the security’s ranking within the category):

Aaa. Bonds which are rated Aaa are judged to be of the best quality. They carry the smallest degree of investment risk and are generally referred to as “gilt edged.” Interest payments are protected by a large or by an exceptionally stable margin and principal is secure. While the various protective elements are likely to change, such changes as can be visualized are most unlikely to impair the fundamentally strong position of such issues.

Aa. Bonds which are rated Aa are judged to be of high quality by all standards. Together with the Aaa group, they comprise what are generally known as high grade bonds. They are rated lower than the best bonds because margins of protection may not be as large as in Aaa securities or fluctuation of protective elements may be of greater amplitude or there may be other elements present which make the long-term risk appear somewhat larger than in Aaa securities.

A. Bonds which are rated A possess many favorable investment attributes and are to be considered as upper-medium-grade obligations. Factors giving security to principal and interest are considered adequate, but elements may be present which suggest a susceptibility to impairment some time in the future.

Baa. Bonds which are rated Baa are considered as medium grade obligations, I.E., they are neither highly protected nor poorly secured. Interest payments and principal security appear adequate for the present but certain protective elements may be lacking or may be characteristically unreliable over any great length of time. Such bonds lack outstanding investment characteristics and in fact have speculative characteristics as well.

Ba. Bonds which are rated Ba are judged to have speculative elements, I.E., their future cannot be considered as well assured. Often the protection of interest and principal payments may be very moderate and thereby not well safeguarded during both good and bad times in the future. Uncertainty of position characterizes bonds in this class.

Description of the five highest long-term debt ratings by S&P (S&P may apply a plus (+) or minus (-) to a particular rating classification to show relative standing within that classification):

AAA. Debt rated AAA has the highest rating assigned by S&P. Capacity to pay interest and repay principal is extremely strong.

AA. Debt rated AA has a very strong capacity to pay interest and repay principal and differs from the higher rated issues only in small degree.

A. Debt rated A has a strong capacity to pay interest and repay principal although it is somewhat more susceptible to the adverse effects of changes in circumstances and economic conditions than debt in higher rated categories.

BBB. Debt rated BBB is regarded as having an adequate capacity to pay interest and repay principal. Whereas it normally exhibits adequate protection parameters, adverse economic conditions or changing circumstances are more likely to lead to a weakened capacity to pay interest and repay principal for debt in this category than in higher rated categories.

BB. Debt rated BB is regarded, on balance, as predominately speculative with respect to capacity to pay interest and repay principal in accordance with the terms of the obligation. While such debt will likely have some quality and protective characteristics, these are outweighed by large uncertainties or major risk exposure to adverse conditions.

Description of the three highest long-term debt ratings by Duff:

AAA.- Highest credit quality. The risk factors are negligible being only slightly more than for risk-free U.S. Treasury debt.

AA+, AA, AA-. High credit quality protection factors are strong. Risk is modest but may vary slightly from time to time because of economic conditions.

A+, A, A-. Protection factors are average but adequate. However, risk factors are more variable and greater in periods of economic stress.

Description of the three highest long-term debt ratings by Fitch (plus or minus signs are used with a rating symbol to indicate the relative position of the credit within the rating category):

AAA. Bonds considered to be investment grade and of the highest credit quality. The obligor has an exceptionally strong ability to pay interest and repay principal, which is unlikely to be affected by reasonably foreseeable events.

AA. Bonds considered to be investment grade and of very high credit quality. The obligor's ability to pay interest and repay principal is very strong, although not quite as strong as bonds rated "AAA." Because bonds rated in the "AAA" and "AA" categories are not significantly vulnerable to foreseeable future developments, short-term debt of these issues is generally rated "[-]."

A. Bonds considered to be investment grade and of high credit quality. The obligor's ability to pay interest and repay principal is considered to be strong, but may be more vulnerable to adverse changes in economic conditions and circumstances than bonds with higher ratings.

IBCA's description of its three highest long-term debt ratings:

AAA. Obligations for which there is the lowest expectation of investment risk. Capacity for timely repayment of principal and interest is substantial. Adverse changes in business, economic or financial conditions are unlikely to increase investment risk significantly.

AA. Obligations for which there is a very low expectation of investment risk. Capacity for timely repayment of principal and interest is substantial. Adverse changes in business, economic, or financial conditions may increase investment risk albeit not very significantly.

A. Obligations for which there is a low expectation of investment risk. Capacity for timely repayment of principal and interest is strong, although adverse changes in business, economic or financial conditions may lead to increased investment risk.

Short-Term Debt Ratings (may be assigned, for example, to commercial paper, master demand notes, bank instruments, and letters of credit).

Moody's description of its three highest short-term debt ratings:

Prime-1. Issuers rated Prime-1 (or supporting institutions) have a superior capacity for repayment of senior short-term promissory obligations. Prime-1 repayment capacity will normally be evidenced by many of the following characteristics:

- Leading market positions in well-established industries.

- High rates of return on funds employed.
- Conservative capitalization structures with moderate reliance on debt and ample asset protection.
- Broad margins in earnings coverage of fixed financial charges and high internal cash generation.
- Well-established access to a range of financial markets and assured sources of alternate liquidity.

Prime-2. Issuers rated Prime-2 (or supporting institutions) have a strong capacity for repayment of senior short-term debt obligations. This will normally be evidenced by many of the characteristics cited above but to a lesser degree. Earnings trends and coverage ratios, while sound, may be more subject to variation. Capitalization characteristics, while still appropriate, may be more affected by external conditions. Ample alternate liquidity is maintained.

Prime-3. Issuers rated Prime-3 (or supporting institutions) have an acceptable ability for repayment of senior short-term obligations. The effect of industry characteristics and market compositions may be more pronounced. Variability in earnings and profitability may result in changes in the level of debt protection measurements and may require relatively high financial leverage. Adequate alternate liquidity is maintained.

S&P's description of its three highest short-term debt ratings:

A-1. This designation indicates that the degree of safety regarding timely payment is strong. Those issues determined to have extremely strong safety characteristics are denoted with a plus sign (+).

A-2. Capacity for timely payment on issues with this designation is satisfactory. However, the relative degree of safety is not as high as for issues designated "A-1."

A-3. Issues carrying this designation have adequate capacity for timely payment. They are, however, more vulnerable to the adverse effects of changes in circumstances than obligations carrying the higher designations.

Duff's description of its five highest short-term debt ratings (Duff incorporates gradations of "1+" (one plus) and "1-" (one minus) to assist investors in recognizing quality differences within the highest rating category):

Duff 1+. Highest certainty of timely payment. Short-term liquidity, including internal operating factors and/or access to alternative sources of funds, is outstanding, and safety is just below risk-free U.S. Treasury short-term obligations.

Duff 1. Very high certainty of timely payment. Liquidity factors are excellent and supported by good fundamental protection factors. Risk factors are minor.

Duff 1-. High certainty of timely payment. Liquidity factors are strong and supported by good fundamental protection factors. Risk factors are very small.

Duff 2. Good certainty of timely payment. Liquidity factors and company fundamentals are sound. Although ongoing funding needs may enlarge total financing requirements, access to capital markets is good. Risk factors are small.

Duff 3. Satisfactory liquidity and other protection factors qualify issue as to investment grade. Risk factors are larger and subject to more variation. Nevertheless, timely payment is expected.

Fitch's description of its four highest short-term debt ratings:

F-1+. Exceptionally Strong Credit Quality. Issues assigned this rating are regarded as having the strongest degree of assurance for timely payment.

F-1. Very Strong Credit Quality. Issues assigned this rating reflect an assurance of timely payment only slightly less in degree than issues rated F-1+.

F-2. Good Credit Quality. Issues assigned this rating have a satisfactory degree of assurance for timely payment, but the margin of safety is not as great as for issues assigned F-1+ or F-1 ratings.

F-3. Fair Credit Quality. Issues assigned this rating have characteristics suggesting that the degree of assurance for timely payment is adequate, however, near-term adverse changes could cause these securities to be rated below investment grade.

IBCA's description of its three highest short-term debt ratings:

A+. Obligations supported by the highest capacity for timely repayment.

A1. Obligations supported by a very strong capacity for timely repayment.

A2. Obligations supported by a strong capacity for timely repayment, although such capacity may be susceptible to adverse changes in business, economic or financial conditions.

SHORT-TERM DEBT RATINGS. Thompson BankWatch, Inc. ("TBW") ratings are based upon a qualitative and quantitative analysis of all segments of the organization including, where applicable, holding company and operating subsidiaries.

TBW Ratings do not constitute a recommendation to buy or sell securities of any of these companies. Further, TBW does not suggest specific investment criteria for individual clients. The TBW Short-Term Ratings apply to commercial paper, other senior short-term obligations and deposit obligations of the entities to which the rating has been assigned. The TBW Short-Term Ratings apply only to unsecured instruments that have a maturity of one year or less. The TBW Short-Term Ratings specifically assess the likelihood of an untimely payment of principal or interest.

TBW-1. The highest category; indicates a very high degree of likelihood that principal and interest will be paid on a timely basis.

TBW-2. The second highest category; while the degree of safety regarding timely repayment of principal and interest is strong, the relative degree of safety is not as high as for issues rated "TBW-1."

TBW-3. The lowest investment grade category; indicates that while more susceptible to adverse developments (both internal and external) than obligations with higher ratings, capacity to service principal and interest in a timely fashion is considered adequate.

TBW-4. The lowest rating category; this rating is regarded as non-investment grade and, therefore, speculative.

Definitions of Certain Money Market Instruments

Commercial Paper. Commercial paper consists of unsecured promissory notes issued by corporations. Issues of commercial paper normally have maturities of less than nine months and fixed rates of return.

Certificates of Deposit. Certificates of Deposit are negotiable certificates issued against funds deposited in a commercial bank or a savings and loan association for a definite period of time and earning a specified return.

Bankers' Acceptances. Bankers' acceptances are negotiable drafts or bills of exchange, normally drawn by an importer or exporter to pay for specific merchandise, which are "accepted" by a bank, meaning, in effect, that the bank unconditionally agrees to pay the face value of the instrument on maturity.

U.S. Treasury Obligations. U.S. Treasury Obligations are obligations issued or guaranteed as to payment of principal and interest by the full faith and credit of the U.S. Government. These obligations may include Treasury bills, notes and bonds, and issues of agencies and instrumentalities of the U.S. Government, provided such obligations are guaranteed as to payment of principal and interest by the full faith and credit of the U.S. Government.

U.S. Government Agency and Instrumentality Obligations. Obligations issued by agencies and instrumentalities of the U.S. Government include such agencies and instrumentalities as the Government National Mortgage Association, the Export-Import Bank of the United States, the Tennessee Valley Authority, the Farmers Home Administration, the Federal Home Loan Banks, the Federal Intermediate Credit Banks, the Federal Farm Credit Banks, the Federal Land Banks, the Federal Housing Administration, the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, and the Student Loan Marketing Association. Some of these obligations, such as those of the Government National

Mortgage Association are supported by the full faith and credit of the U.S. Treasury; others, such as those of the Export-Import Bank of the United States, are supported by the right of the issuer to borrow from the Treasury; others, such as those of the Federal National Mortgage Association, are supported by the discretionary authority of the U.S. Government to purchase the agency's obligations; still others, such as those of the Student Loan Marketing Association, are supported only by the credit of the instrumentality. No assurance can be given that the U.S. Government would provide financial support to U.S. Government-sponsored instrumentalities if it is not obligated to do so by law. A Fund will invest in the obligations of such instrumentalities only when the investment adviser believes that the credit risk with respect to the instrumentality is minimal.