Dear Investor,

The Vice Fund (VICEX) is a defensive growth strategy focused on the alcoholic beverages, tobacco, gaming and defense sectors. These four sectors, in aggregate, are defensive in nature and have tended to outperform when the U.S. economy was stressed and the broad market was struggling.[1] In other words, we're focused on *economically independent growth*.

Of our four target sectors, gaming is the most growth oriented and is the most sensitive to the business cycle, unexpected changes in inflation, and investor confidence (though not as sensitive as other growth sectors). That being the case, it comes as no surprise that recent market turbulence had a magnified impact on the gaming sector.

This was covered recently in the major media outlets, but we'd thought we'd take the opportunity to share our thoughts, particularly as it relates to arguably one of the most exciting growth opportunities for the sector: Asian gaming.

The Missing Piece of the Macau Story

By Charles L. Norton, CFA

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An interesting column appeared in *Wall Street Journal* a few weeks ago called "U.S. Casinos Hit Cold Streak in Asia." It essentially posits that gaming stocks tied to Macau – namely, **Las Vegas Sands (LVS)** and **Wynn Resorts (WYNN)** – have tanked lately because "investors are nervous about the long-term prospects of the Asian market."

That's a simple answer, but it doesn't entirely explain what's really happening in Macau. In fact, it misses the most important piece of information.

First, let's first take a look at Macau's booming story. Last year, gaming revenue there totaled $6.95 billion, with around $6.84 billion of that coming from games of fortune and the rest from gaming activities such as sports wagering and lottery. For comparison's sake, the Vegas Strip generated $6.69 billion in revenue.[2]

So gaming revenue in Macau surpassed that of the Vegas Strip last year – only two years after the Sands Macau, the first casino outside the 40-year-old monopoly, opened up. And Macau is merely in its infancy. By 2010, total revenue from games of fortune could exceed $14 billion as gaming capacity balloons.

To put the capacity increase in perspective, consider this: At year-end 2006, more than 6,500 slot machines and nearly 2,800 gaming tables were operating in Macau. By 2010, that's expected to grow to 30,000 slot machines and more than 9,000 gaming tables.

Travel Trends

Visitation, too, is thriving. Back in 1991, the first year of available data, over 82% of the 7.5 million visitors to Macau came from Hong Kong; fewer than 8% of visitors resided in mainland China. By 2006, nearly 22 million visitors arrived in Macau, about 54% from mainland China and another 32% from Hong Kong. The easing of travel restrictions to allow more Chinese citizens to visit Macau and a strong and growing Chinese middle class are driving factors of the growth.

An estimated 460 million people in China live within a two-hour flight of Macau, and at least 1.1 billion live within a three-hour flight, and more of these people are now able to afford such excursions. Therefore, visitation trends in Macau are likely to remain off-the-charts for some time to come.

Let’s compare this with Las Vegas. In 2006, 38.9 million people visited Las Vegas. Of the respondents to a 2005 Las Vegas visitor profile questionnaire, 12% were from a foreign country. Assuming the same proportion of international visitors last year, that leaves 34.2 million U.S.-based visitors to Las Vegas out of a population of just over 300 million. So the penetration rate of U.S. residents visiting Las Vegas is about 11%.

Meanwhile, of China’s population of more than 1.3 billion, only about 12 million visited Macau last year, or less than 1%. Because travel restrictions in China are relatively onerous, it’s unrealistic to assume an 11% penetration rate is ever achievable. But if even 2% or 3% of China’s population were to visit Macau in 2010, that’s serious growth over the next few years. The number of visitors to Macau could conceivably hit 40 million by then, up from 22 million last year.

However, there is one important risk factor related to numerous visitors flocking to tiny Macau: infrastructure. Macau has a number of entry and exit points by land, air and sea. Unfortunately, they are almost all at or nearing capacity, and the number of travelers will only be increasing. During the recent Chinese New Year, when visitation is much higher than normal, there were reportedly major bottlenecks. Plans are under way to increase capacity at the airport, add a new ferry terminal and expand several bridges. Infrastructure development is essential for growth in Macau, and any delays to these plans could damage the gaming industry there.

Aside from that potential stumbling block, the trend of tens of millions of annual visitors to Macau bodes well for the casino operators and, in particular, points to rampant growth in so-called mass-market play, which is traditional, Vegas-like gambling on the main casino floor.

Adding to the move toward mass-market play is the development of the Cotai Strip, which is expected to include hotels, exhibition and conference facilities, showrooms, shopping malls, spas, world-class restaurants and entertainment facilities, in addition to casinos. Clearly, then, most Macau watchers believe the future is heavily tilted toward mass-market play, with this segment widely expected to contribute at least two-thirds of total gaming revenue in the next four to five years. That’s good news, because it also happens to be high-margin business.

Today, however, the vast majority of gaming revenue in Macau is so-called VIP play, which resembles Las Vegas high-rollers on steroids. VIP wagering takes place in private gaming rooms and is mostly conducted on credit.

Casino operators use middlemen called junkets to bring in VIP customers, because junket operators – not casinos – have the high-roller relationships. In addition, the junkets often provide credit lines to customers and, in some cases, even operate the gaming room. In return, the casino operator pays a commission to the junket. The bottom line is that even though a VIP table generates significant revenue, it’s a much lower-margin business because of the junket. While EBITDA margins for mass-market gaming are typically in the 35%-to-40% range, VIP margins are closer to 10% to 15%, on average.[3]

What has happened, though, is what *The Wall Street Journal* piece missed – and what I believe to be one culprit behind the recent pullback in shares of Macau-related casino operators.

Margins in the Mix

Recently, the Macau government drastically revised its previously reported 2006 gaming statistics. The total gaming revenue did not change for any month or quarter, but the mix between mass-market and VIP revenue was significantly restated in favor of VIP. Most Macau watchers were operating under the belief that mass-market growth was booming; in fact, after the modifications, mass-market growth was a tepid 6% in the second half of the year. Meanwhile, the real driver of growth was VIP play, with much lower margins.

There are two implications of adjusting the mix of VIP and mass-market revenue. First and most obviously is that the lower margins associated with VIP gaming mean lower EBITDA for the industry. Second is a change in the demand story. Before, there was the seemingly limitless possibility of 1.3 billion Chinese people flooding into Macau. But the VIP market is more limited; there is a finite number of gamblers of that size. The VIP demand story is one of rotational growth, with super high-rollers coming to Macau from other international gaming centers.

So my sense is that the market is adjusting to this by reducing the valuations of Macau-centric gaming companies such as Las Vegas Sands, Wynn Resorts and **Melco PBL Entertainment (MPEL)**. That's the element that *The Wall Street Journal* left out.

Meanwhile, the Asian gaming market's potential is much bigger than Macau and certainly much more important than the mix of one type of gaming vs. another. Regardless of the nature of the gaming, Macau remains a tremendous growth story in its infancy.

Singapore is next, and it could be a multibillion-dollar market itself. Las Vegas Sands is expected to open the first casino there in 2009. Thailand is studying whether to allow casino gaming, and Japanese officials are also considering legislation to approve casinos. India, too, is expected to issue several riverboat casino licenses as early as this year.

The Macau government's restatement of the way in which the $6.8 billion was generated is important. Models need to be adjusted and valuations lowered to account for the lower-margin, VIP-driven growth. There are also great risks, not the least of which is whether the infrastructure will be ready to accommodate millions more visitors.

But Macau is still one of the market's greatest, most underappreciated growth stories. High-margin, Vegas-style gaming such as slot machines and mass-market tables will continue to proliferate as more properties open. And, bigger picture, Macau is only the first chapter in the Asian gaming epic.

Sources:
[1] QED International
[2] Macau Gaming Inspection and Coordination Bureau; Nevada Gaming Commission and State Gaming Control Board
[3] UBS, Morgan Stanley

Please see the following page for important disclosure information.

The fund's investment objectives, risks, charges and expenses must be considered carefully before investing. The prospectus contains this and other important information about the investment company, and it may be obtained by calling toll free at (866) 264-8783, or visiting www.vicefund.com. Read it carefully before investing.

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

Past performance is no guarantee of future results.

As of 02/28/07, Las Vegas Sands (LVS) comprised 3.24% of the Vice Fund, while Wynn Resorts (WYNN) and Melco PBL Entertainment (MPEL) comprised 3.11% and 0.90% of the Vice Fund, respectively.

Fund holdings and sector weightings are subject to change. References to specific securities or industries should not be considered a recommendation to buy or sell any security.

EBITDA margin is a company's earnings before interest, taxes, depreciation, and amortization divided by its sales.

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