

October 2007

Emerald Mutual Fund Advisers Trust

Third Quarter Economic Commentary

The markets in 2007 are going to be remembered by the record amount of deals transacted by private equity funds and cash-rich corporations. The other outstanding aspect of early 2007 was the lack of risk awareness in individual balance sheets as speculation ran amok in personal as well as speculative real estate investing. Subprime lending became the norm for mortgage brokers as underwriting standards or lack thereof caused a real estate bubble in many of the hot markets, like the Inland Empire of California, Phoenix, Las Vegas, and of course the condo market, as well as high-priced second homes and condos across the South, especially Florida.

After many red flags, the credit markets reached a breaking point seizing up first in Europe and then domestically. The issuance of asset-backed commercial paper came to a stand still and word of hedge funds losses spread across Wall Street, igniting comparisons to 1998 when Long Term Capital collapsed and started the world currency crisis.

As the credit markets convulsed, equity market investors began aggressively eliminating risk, which meant wholesale selling. Surprisingly, technology stocks held up and maintained their attractiveness. As of quarter end, technology stocks were the best-performing sector in the Russell 2000 Growth Index (more on this later). Faced with deteriorating growth prospects for the rest of 2007 and possibly 2008, the Fed stepped forward and, under Chairman Bernanke, reduced the little used and mostly forgotten discount rate. Then to cap off the quarter, the Fed reduced the Fed Funds rate by a surprising 50 basis points, restoring confidence and propelling the market higher. Emerald believes the slowing economy gave the Fed cover as their inflationary war was being won. The latest report since the Fed's rate cut shows inflation increased by only 1.9% on a year-over-year basis, below their target rate of 2%. The Fed's focus on the headline number can also be won. With crude at a mid-1980s number we could see a lower price if the hurricane season ends without a major disruption and the war on Iraq or tensions in Iran don't accelerate.

The negative to providing the market with the necessary liquidity to fund private equity deals already announced, provide relief to the commercial paper markets, and encourage banks to lend is a weaker dollar. The weaker dollar could soon see a bottom if the dollar is once again seen as a storehouse of value and the lowering of rates restores growth to the economy in 2007 and 2008.

The dollar started to fall in early 2002 and, so far, there has not been much if any inflationary pressure since many foreign producers have not raised prices in order to maintain market share. Intense global competition and low utilization rates, productivity increases embedded across almost all industries and technological advances occurring to increase worldwide supplies of goods and services, all remain as inhibitors to inflation.

A positive development late in the quarter was the revolutionary labor agreement between General Motors and the United Auto Workers. This could make the U.S. competitive in the auto industry—an outcome which had been considered a lost cause by most economists.

What Helped Results

Performance within the producer durables and technology sectors drove the better-than-index performance during the quarter. Within producer durables, aerospace holdings Ladish and Triumph Group have remained strong drivers of return. We have been bullish on the opportunities within aerospace for the last 12 months as international carriers upgrade and expand their fleets. Despite Boeing's well-publicized delays with the 787 Dreamliner, we believe demand remains strong and has continued unabated. Outside of aerospace, holdings within producer durables are diversified with names including TASER International, Smith & Wesson and Varian Semiconductor contributing to the outperformance within the sector.

Technology was a strong second as returns within software, electronics and semiconductors solidly outpaced the index. Following a very strong back-to-school period, increasingly strong notebook shipments, and the continued ramp in flat

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panel TVs, most semiconductor manufacturers are experiencing better-than-normal seasonal demand in Q3, and current expectations are for this demand strength to extend into the fourth quarter and the first quarter of 2008. Although U.S. economic concerns could pressure near-term performance, we believe there are sufficient underlying growth opportunities in the U.S., and globally, to support a continued over-weight position in semiconductors, especially in applications such as LED (light emitting diode) backlighting for televisions and next generation handsets.

In the computer software and services industry, Emerald benefited from strong gains in shares of design analysis software companies Ansys and Ansoft and on-demand software provider, Ultimate Software, and upside from the acquisition of Opware by Hewlett Packard. We remain optimistic on the computer software and services industry, based on our belief that there are signs of solid corporate IT spending, the growing adoption of the subscription software model, the continued trend toward offshore outsourcing of IT services, and a fertile market for merger and acquisition activity. In addition, the fourth quarter has historically been a seasonally strong period for the software and services industry, and we are optimistic this will again be the case in 2007.

Outside producer durables and technology, the portfolio experienced better-than-index returns in transportation and healthcare due to solid stock selection. Healthcare remained a positive contributor to return in the quarter as it has on a year-to-date basis. Performance was particularly strong within biotechnology and medical and dental instruments.

What Hurt Results

Concerns over a consumer led recession mounted during the quarter as investors became increasingly concerned over the degree to which the consumer would pull in its reins. Spending had slowed from the pace witnessed earlier this year, and with oil prices continuing their ascent, mortgage defaults rising and the unknown impact of the pending adjustable rate mortgage resets, the consumer discretionary sector proved to be one of the worst-performing sectors of the Russell 2000 Growth during the third quarter. Further, stock selection across the board was disappointing, with weakness within retail, cosmetics, rental and leasing services, and commercial services, with the most notable underperformance in the shares of Coldwater Creek and NutriSystem. While disappointed by the stock selection within this sector this year, we believe through better stock selection, there are opportunities for Emerald to outperform even in the face of a weakening macroeconomic environment. In aggregate, however, Emerald has been gradually reducing the exposure to consumer in favor of opportunities within other economic sectors, such as technology and healthcare.

To a lesser degree negative contributions from financials and consumer staples also detracted from returns during the quarter. Financials have remained challenging as a result of broader credit market and economic concerns. Emerald has maintained its underweight position in light of the aforementioned, but remains optimistic regarding performance within certain regions of the United States, specifically Texas.

Market Outlook

Since Chairman Bernanke's actions at the last meeting, volatility has moderated slightly and even bad news is starting to seem not so bad now that the Federal Reserve has proved its willingness to step up to the plate. The market applauded Citigroup, UBS and Credit Suisse for worse-than-expected earnings results because the general consensus was that each had "kitchen-sinked" the numbers by assuming the worst case scenario in the write-down of their credit instruments—a sign that slowly but surely credit concerns are easing. However, the same thing cannot be said for the consumer. After the disappointing August jobs report, we believe all eyes will be fixed on the upcoming September jobs report due out later this week.

While consumers may continue to struggle, we believe technology will continue to flourish. After multiple years of woeful underperformance, the technology sector of the Russell 2000 Growth has been the best-performing sector on a year-to-date basis. Given the growth indexes bias toward technology, it is no coincidence that Growth stocks have also outperformed during this time period. We believe that the current change in leadership is sustainable and look for growth stocks (both large and small) to continue to lead the market.

Funds that concentrate in a particular industry will involve a greater degree of risk than a fund with a more diversified portfolio. Small company stocks are generally riskier than large company stocks due to greater volatility and less liquidity.

The Russell 2000 Growth Index, measures the performance of those Russell 2000 Index companies with higher price-to-book ratios and higher forecasted growth value. The index figures do not reflect any deduction for fees, expenses or taxes. It is not possible to invest directly in an index.

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