An Introduction to Alternative Investments

HOW NON-TRADITIONAL STRATEGIES MAY

BENEFIT PORTFOLIO PERFORMANCE

HATTERAS

Introduction

If you are reading this paper, you likely already have some knowledge of alternative investments. You may be interested in learning more about a subject that is both broad and extremely detailed. You may have heard that college endowments and institutions have been using hedge funds, private equity, and real estate with great success over the years. You may have also seen headlines about hedge funds that have "blown up." Much of what you've heard or read has some truth, but needs to be clarified and placed into context to be fully understood. This paper will introduce you to alternative investments: the advantages, potential risks, and which vehicles may be appropriate for various situations. Alternative investments, also called non-traditional investments, are investment strategies that utilize trading techniques generally unavailable through public markets. These strategies include hedge funds, private equity, real estate, natural resources, managed futures, and others typically offered only to sophisticated (knowledgeable) institutional and private investors. (Please reference the appendix of this document for a discussion on specific alternative investment strategies.) These strategies are usually structured as private partnerships and are not typically governed by the regulations placed on traditional investments. This offers alternative investment managers freedom to operate in a variety of markets and employ a broad range of investment strategies that are not available to traditional equity or fixed income portfolio managers.

What Are the Objectives of Alternative Investments?

Alternative investment managers have a greater range of strategies available, but what does that ultimately mean for the investor? Why have colleges, institutions, and high net worth individuals chosen to allocate assets to these strategies? The basic answer is that adding alternatives to a portfolio of traditional assets can lower risk while increasing returns. More specifically, alternative investments offer the following:

- Increased Diversification
- Lower Correlations
- Lower Portfolio Volatility
- Portfolio Performance
- Access to Talent

Increased Diversification

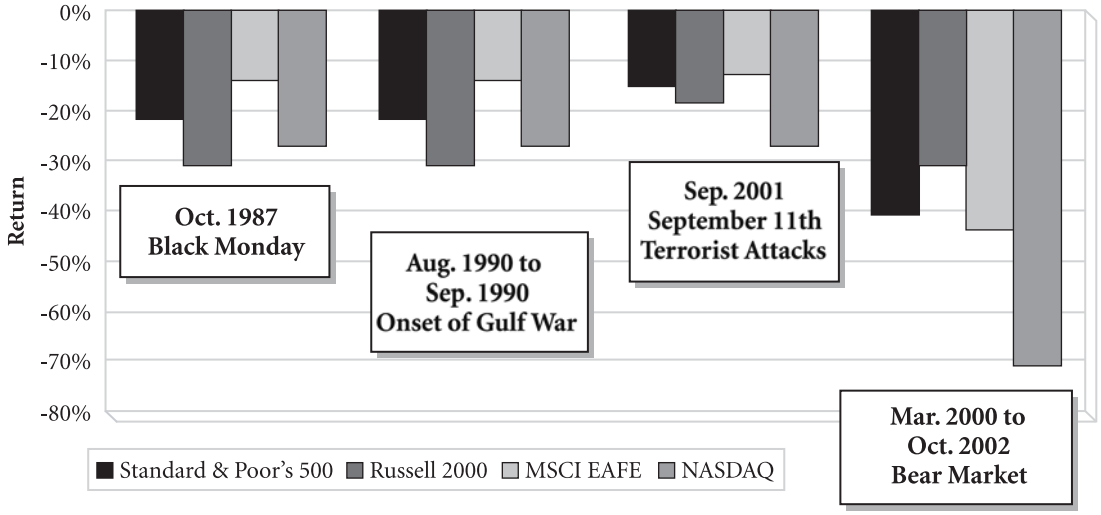
Although farmers, parents, and even investors have long understood the warning, "Don't put all your eggs in one basket," Harry Markowitz actually won the Nobel Prize for his work that quantified and explained this adage as it relates to portfolio management. Markowitz showed that combining assets which do not exhibit a high correlation to one another gives investors an opportunity to reduce risk without sacrificing return.

The measurement of a diversified portfolio's risk is not simply the weighted average of the individual volatility measurements. Instead, a diversified portfolio exhibits less risk than the weighted average of its underlying positions' individual risks. In *Pioneering Portfolio Management*, David Swensen, CIO of Yale University's $15 billion endowment, summarizes Markowitz's Nobel Prize-winning theory: "By combining assets that vary in response to forces that drive markets, more efficient portfolios provide higher returns than less well diversified portfolios. Conversely, through appropriate diversification, a given level of returns can be achieved at lower risk."[1]

For years, investors have attempted to create diversified portfolios by combining stocks with bonds and cash. Investors have sought further diversification by allocating capital to domestic and international stocks, growth and value stocks, and stocks of different capitalization ranges and different sectors. Unfortunately, these efforts do not combine assets that move independently of one another – one of Markowitz's requirements in constructing a diversified portfolio. Investors with capital allocated to various regions, sectors, and capitalization ranges are not necessarily getting the efficiency associated with a truly diversified portfolio. Chart 1 illustrates the high correlation of different equity indices in times of crisis over the past twenty years.

Through appropriate diversification, a given level of returns can be achieved at lower risk.

Chart 1: High Correlation of Equity Markets in Periods of Recent Crisis



Source: Standard & Poor's 500, MSCI EAFE and NASDAQ.

The above information is hypothetical and is meant as an illustration only. Unmanaged indices are for illustrative purposes only. An investor cannot invest directly in an index. Index performance does not reflect the deduction of fund fees and charges. Past performance is no guarantee of future results.

1 Swensen, David F., *Pioneering Portfolio Management*. The Free Press, New York, NY, 2000. page 62.

Investors seeking portfolio diversification may utilize fixed income in an effort to reduce the risk associated with equities. Over time, fixed income has not correlated highly with equities, therefore offering diversification benefits. However, a significant performance trade-off is associated with bonds and cash. A portfolio which includes both traditional and non-traditional investment strategies offers increased diversification and the opportunity for better returns (versus using fixed income as the portfolio's sole diversifier). Summing up the diversification benefits associated with alternative investments, Swensen offered:

"By identifying high-return asset classes, not highly correlated with domestic marketable securities, investors achieve diversification without the opportunity costs of investing in fixed income. Possibilities for institutions include real estate, venture capital, leveraged buyouts, oil and gas participations and absolute return strategies. If these asset classes provide high equity-like returns in a pattern that differs from the return pattern of the core asset (U.S. domestic equities), investors create portfolios that offer both high returns and diversification. Although on an asset-specific basis, higher expected returns come with the price of higher expected volatility, diversification provides investors with a mechanism to control risk."[2]

Lower Correlations

In order for diversification to realize its benefits, a portfolio's underlying asset classes must behave differently in varying market conditions. The measurement of this historical relationship, whether different or similar in behavior, is called correlation. A correlation coefficient of 1.0 indicates that two investments behave exactly the same – moving in the same direction with the same amplitude – in varying market conditions. A -1.0 correlation coefficient indicates that two assets will move inversely in lockstep.

Adding alternative investments to a portfolio increases diversification because, for the most part, alternative strategies are not highly correlated to one another or to traditional asset classes. Many alternative investment strategies are designed to minimize, or even eliminate, the role of overall market direction in determining return. These strategies isolate a manager's investment thesis and talent, decreasing the likelihood of significant correlation to general market indices such as the S&P 500 Index. Describing the ability of alternative investments to produce returns regardless of market direction, a study by BARRA RogersCasey concluded, "While traditional investments derive the majority of investment return from the capital markets, many hedge fund strategies are less affected by the direction of underlying capital markets."[3]

2 Swensen, David F., *Pioneering Portfolio Management*. The Free Press, New York, NY, 2000. pgs. 66–67.
3 BARRA RogersCasey. 2001. "An Introduction to Hedge Funds." The first in the *BRC Hedge Fund Series*, 16.

Alternative investment strategies (as represented by the respective HFRI indices) do not exhibit a strong correlation toward one another or toward traditional asset classes. The lack of correlation between alternative investment strategies offers investors the opportunity to create a truly diversified portfolio. If an investor's goal is to secure higher returns at a lower level of risk, then adding alternative investments to the traditional portfolio is an attractive option.

Table 1
Correlation Coefficient
(Jan 1994 - Dec 2007)

	Goldman Sachs Commodity Index	HFRI Equity Hedge Total Index	HFRI EH: Equity Market Neutral Index*	HFRI Fixed Income (Total)	HFRI Sector: Real Estate Index	Cambridge Private Equity Index	Lehman Aggregate Bond Index	Russell 2000 Index	S&P 500 Index
Goldman Sachs Commodity Index	1.00	-0.01	0.00	0.04	0.03	-0.03	-0.11	-0.14	-0.21
HFRI Equity Hedge Total Index	-0.01	1.00	0.49	0.52	0.25	0.71	-0.21	0.82	0.79
HFRI EH: Equity Market Neutral Index*	0.00	0.49	1.00	0.53	0.34	0.30	0.01	0.46	0.32
HFRI Fixed Income (Total)	0.04	0.52	0.53	1.00	0.54	0.37	-0.18	0.59	0.46
HFRI Sector: Real Estate Index	0.03	0.25	0.34	0.54	1.00	0.30	-0.01	0.52	0.32
Cambridge Private Equity Index	-0.03	0.71	0.30	0.37	0.30	1.00	-0.24	0.64	0.70
Lehman Aggregate Bond Index	-0.11	-0.21	0.01	-0.18	-0.01	-0.24	1.00	-0.25	-0.20
Russell 2000 Index	-0.14	0.82	0.46	0.59	0.52	0.64	-0.25	1.00	0.87
S&P 500 Index	-0.21	0.79	0.32	0.46	0.32	0.70	-0.20	0.87	1.00

Source: HFRI (Hedge Fund Research, Inc.)
* HFRI Relative Value was used for data preceding 1998

Lower Portfolio Volatility

By adding alternative investments to the traditional portfolio, an investor can reduce portfolio volatility and improve the opportunity to experience increased returns over the long term. Beyond their ability to reduce risk as portfolio diversifiers, many alternative strategies exhibit very low volatility when considered in isolation.

Table 2 compares the risk and return of various alternative investment classes (as represented by the respective HFRI's indices) to the S&P 500 Index and the Lehman Brothers Aggregate Bond Index. The table also shows the Sharpe ratio and the Sortino ratio for each asset class, which measure the return produced by an investment (above the risk-free rate) per unit of risk taken. The Sharpe measures return over any type of volatility, whereas the Sortino measures return over downside volatility only. Each alternative index exhibits lower risk, as represented by standard deviation, versus equities. Each alternative index exhibits higher Sharpe and Sortino ratios versus both equities and fixed income.

Table 2
Risk Table Annualized
(Jan 1994 - Dec 2007)

	Annualized ROR	Standard Deviation	Sharpe 5.00% [4]	Sortino 5.00% [5]
HFRI Equity Hedge Index	14.0%	8.6%	0.99	1.36
HFRI Equity Market Neutral Index	9.3%	3.1%	1.28	1.68
HFRI Fixed Income (Total)	8.6%	3.2%	1.05	1.55
HFRI Sector: Real Estate Index	9.5%	6.5%	0.67	1.23
Lehman Aggregate Bond Index	6.7%	4.0%	0.40	1.26
S&P 500	9.1%	15.2%	0.32	0.41

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4 The Sharpe ratio is a risk-adjusted measure of return that divides a portfolio's return in excess of the risk-free rate by the portfolio's standard deviation. Over this time period, the risk-free rate was assumed to be a constant of 5%.

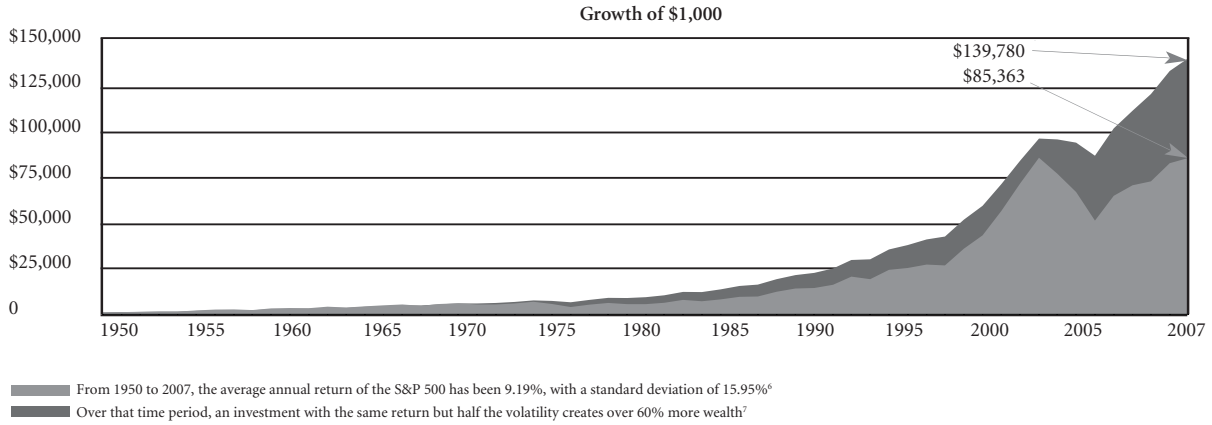
5 The Sortino ratio is the excess return over the risk-free rate divided by the downside semi-variance – in other words, it measures return divided by an asset's negative or "bad" volatility. As in the Sharpe ratio, the risk-free rate is assumed to be 5%.

How Non-Traditional Strategies Benefit Portfolio Performance

For years, endowments have enjoyed the benefits of lower volatility in their portfolios. How does reduced volatility help investors? Reducing the frequency and severity of losses in a portfolio creates an environment in which the portfolio may compound returns more efficiently. When an investor experiences negative returns in a volatile portfolio, subsequent monthly returns must first "catch up" for those prior losses before the investor can begin to enjoy growth on his initial investment. When an investor experiences consistently positive returns in a low volatility portfolio, each month's returns compound upon prior positive returns to offer growth and help preserve capital. The true power of compounding has its greatest impact when negative months are eliminated or reduced.

How valuable is lower portfolio volatility to an investor? A $1,000 investment in the S&P 500 Index from 1950 through 2007 would have produced an average return of 9.19% with a standard deviation of 15.95%.[6] At the end of that period, the $1,000 investment would have grown to $85,363. (That actually sounds fairly enticing.) However, if the investor could have utilized instruments that allowed him to earn the same [average] return (9.19%) with half the volatility, his $1,000 investment would have grown to $139,780. Lowering portfolio volatility by half created almost 60% more in additional wealth.[7]

Graph 1
Large Endowments Focus On Consistent Compounding



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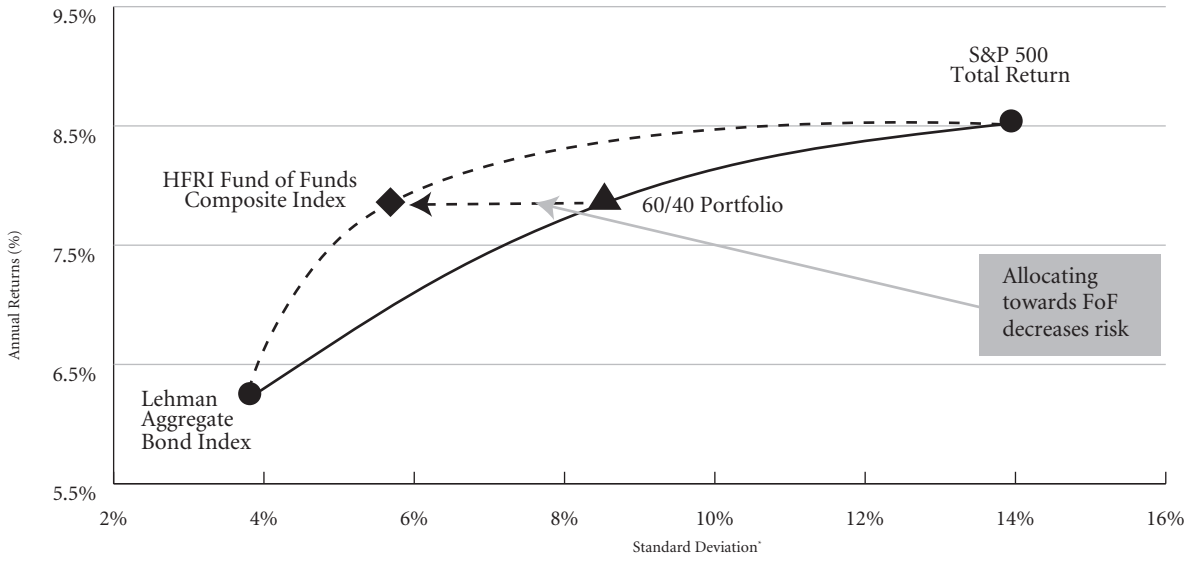
6 Source: Standard & Poor's.
7 Source: Morgan Creek Capital Management
Using future value function on financial calculators assumes half the standard deviation and results in $139,780.

An efficient frontier maps the possible risk and return relationships of a combination of asset classes over a chosen time period. In Graph 2, the solid line represents a continuum of asset allocations to the S&P 500 and Lehman Brothers Aggregate Bond Index. Moving from left to right ("northeast") on the graph, the portfolios allocate incrementally more assets to equities while fewer to bonds. A point on the line represents a discrete portfolio with a specific allocation towards stocks and bonds. For any point on the line, there is a measure of both return and risk (both are dependent upon the time series chosen). For example, the square located on the bold line represents a typical 60% equity/40% fixed income portfolio. Between January 1994 and December 2007, the 60/40 traditional portfolio generated a return of approximately 7.9% with a standard deviation of approximately 8.5%.

Between January 1994 and December 2007, the 60/40 traditional portfolio generated a return of approximately 8%

Graph 2: Efficient Frontier – Including Allocation to Alternatives (Jan 1994 – Dec 2007)



Source: Backstop Solutions Group

* Standard Deviation is a measurement of the investment's volatility.

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Using the HFRI (Hedge Fund Research, Inc.) Fund of Funds Index as a simplified proxy of alternative investments, an additional efficient frontier was created. This new efficient frontier includes stocks (S&P 500 Total Return), bonds (Lehman Brothers Aggregate Bond Index), and alternative investments (as represented by the HFRI Fund of Funds composite). Any chosen point along the new efficient frontier line represents a discreet portfolio that allocates to some combination of stocks, bonds, and alternative investments. With the x-axis as volatility and the y-axis as return, an investor would like a portfolio positioned in the upper left segment of the graph: high returns with low standard deviation over time. The dashed arrow indicates the direction and approximate risk/return characteristics that could be expected as an investor allocates assets toward alternatives and away from the traditional 60/40 portfolio. In a portfolio context, you can see that allocating assets to alternative investments increases return and reduces risk. Swensen describes how alternative investments affect a portfolio: "Alternative asset classes – absolute return, real estate, and private equity – contribute to the portfolio construction process by pushing back the efficient frontier, allowing the creation of portfolios with higher returns for a given level of risk or lower risk for a given level of returns. Investors treating alternative assets as legitimate tools in the portfolio allocation process reduce dependence on traditional marketable securities, facilitating the structuring of truly diversified portfolios."[8]

In a portfolio context, you can see that allocating assets to alternative investments increases return and reduces risk

Access to Talent

The finest investment professionals in the world gravitate to this sector in large part because their compensation is based on ability as demonstrated by returns, not merely the firm's ability to gather assets under management.[9] Sometimes referred to as the "brain drain," talented investment managers leave traditional equity and fixed income funds for hedge funds, private equity funds, or other types of alternative investment funds where they can enjoy:

- Incentive compensation
- Greater breadth of investment instruments and strategies
- Privacy of investment ideas associated with less transparency
- The ability to capitalize on the benefits of taking less liquid positions

Many would consider incentive fees the most significant reason that these talented professionals are leaving traditional investment management shops. However, the manager's ability to generate a return to earn an incentive fee is, at least partially, dependent upon the other three points. When a highly motivated manager can combine his expertise with the freedom to utilize an appropriate set of tools, he is more likely to generate the returns that investors expect. Because of the aligned interests associated with incentive fees, both sides are happy.

8 Swensen, David F., *Pioneering Portfolio Management*. The Free Press, New York, NY, 2000. pg. 204.

9 McKean, Paul F., CFA, "Absolute-Return Strategies" from proceedings of AIMR (Association for Investment Management and Research) CFA Continuing Education seminar, 1998. pg. 50.

What Are the Risks of Alternative Investments?

- Lack of Regulation
- Lack of Transparency
- Inappropriate Use of Leverage
- Fraud
- Manager Selection Risk

Lack of Regulation

While traditional managers are subject to federal regulation, alternative investment managers are not generally subject to regulation under U.S. federal securities laws. Hedge funds and private equity investments escape these regulations because alternative investments are private placements, meaning that they are able to take accredited and qualified investors without registering with the Securities and Exchange Commission. These investors have been determined by government and regulatory agencies to have enough capital to withstand loss and are generally thought of as sophisticated investors that are able to understand the risks of private investments. Without governmental or agency regulation and oversight, private investors must themselves focus significant resources on due diligence.

Alternative investment managers benefit from the flexibility afforded by the lack of regulation. However, this also makes it possible for some investment managers to benefit from unethical acts that cheat investors. Reports of these criminals and the aftermath of their actions create headlines that are far more interesting than news of an ethical manager who produces gains legally.

Without governmental or agency regulation and oversight, private investors must themselves focus significant resources on due diligence.

Some managers register their funds under the Investment Company Acts of 1940 and/or 1933. A registered fund will disclose its holdings to the public and to shareholders at least every six months.

Lack of Transparency

Transparency describes the amount of portfolio information that is provided to investors or potential investors. Portfolio transparency is variable, ranging from full to non-existent. Full transparency provides details that facilitate an investor's ability to analyze the underlying investment thesis, style, risk, and leverage. However, transparency is neither required nor commonplace among alternative investments.

Reduced transparency protects a fund manager's ideas from competitors. This issue is especially noticeable in hedge funds that utilize short investing techniques, as investment managers need to protect their positions from others who could take adversarial positions designed to "squeeze" (artificially inflating the price of) a portfolio's short positions.

Although managers have long protected their portfolios from public eyes, significant strides have been made toward finding an appropriate balance of disclosure. Funds of funds, consultants, and even third party risk management providers have prompted advances in the provision of greater leniency regarding portfolio "look-throughs."

Without full transparency, investors must depend upon the due diligence process to understand a manager's process and portfolio objectives. A lack of transparency can also be considered a benefit to current investors, as protection at the portfolio level reduces potential threats from non-investors.

Inappropriate Use of Leverage

Leverage means using borrowed funds for the pursuit of investment opportunities. Leverage magnifies an investment manager's performance; that magnification can be good or bad. Leverage has been associated with several "blow ups" in the hedge fund industry, most notably Long Term Capital Management. Leverage, like shorting, is simply a tool that alternative investment managers may use. Some use leverage appropriately, applying conservative levels to positions that exhibit moderate volatility. Some managers have applied excessive leverage to vehicles that exhibit significant volatility.

Leverage is typically used at the individual fund level; for example, in a specific hedge fund. However, some funds of funds now utilize leverage to amplify the overall fund's performance. It is important for investors to ask individual funds and funds of funds to explain their aggregate level of leverage and how its use is appropriate for that specific strategy. Investors should use care in their utilization of leverage, protecting a portfolio from levels of risk that are not appropriate.

Fraud

As with any investment, fraud may happen in the alternative investment arena. To combat potential fraud, investors must conduct significant due diligence by asking questions that specifically target a manager's ethics, experience, track record, and utilization of investment and business risk controls. The due diligence process can offer answers that give investors comfort and confidence. An investor must understand all disclosures and then address any questions that were not answered in fund provided documents. Second, an investor must conduct quantitative analysis to determine whether a fund's historical risk and return were plausible and explainable. Does a manager really have a seven year track record or is that record based on a back-tested model? Does the answer give you comfort with the manager? An important precaution against potential fraud is extensive use of background checks. While most managers will provide a list of professional and client references, use of industry contacts and even professional private investigators can increase an investor's ability to learn about a manager's past. Lastly, the in-person on-site interview should enable investors to cover any unanswered questions and determine whether it is appealing to do business with a specific person or group.

Manager Selection Risk

Currently, investors cannot allocate capital to alternative strategy indices; therefore, active investment managers must be chosen. How does an investor pick a manager? How can he know that he has found the best convertible arbitrage manager or the best long/short manager? Does an investor have the time, experience, resources, and access to reliable data necessary to make a confident choice?

One significant problem associated with choosing alternative investment managers is the large disparity among individual manager returns. The return difference between the best managers and the worst managers in a specific alternative investment strategy is typically much greater than the return disparity between the best and worst traditional investment managers. This puts greater pressure on an investor to find the best manager within a particular strategy.

Manager selection risk encompasses many of the potential pitfalls associated with choosing an investment partner. To mitigate manager selection risk, investors must address each of the following:

> *Does an investor have the time, experience, resources, and access to reliable data necessary to make a confident choice?*

PEOPLE: *Consider education, experience, cohesion, responsibilities, turnover, compensation and special skills.*

PHILOSOPHY: *Evaluate investment strategy, consistency, trading, client service and risk management.*

PROCESS: *Learn how the firm's investment philosophy is implemented.*

PERFORMANCE: *Assess attribution, calculation, consistency, repeatability, volatility, and dispersion among accounts.*[10]

10 Yoder, J. (1998). "A Primer on Alternative Investments: Free Lunches, Magic, and the Four Ps," *Business Officer*, 36(2), 21-25.

How Do Investors Access Alternatives?

- Individual Single Strategy Managers
- Fund of Funds

Individual Single Strategy Managers

Investors can allocate capital to individual hedge funds, private equity funds, or real estate funds. Depending upon an investor's size, sophistication, resources, and access to research, this can be an appropriate way to allocate portfolio assets to alternative investments. Alternative investment managers typically have investment minimums of $1 million to $5 million. Therefore, in order to achieve an appropriate level of diversification across strategies and managers, an investor would need to employ at least $25 million. That figure assumes that the investor is able to find 25 managers who maintain a $1 million investment minimum and who are open to new investors. That scenario does not take into account the additional costs associated with creating such a portfolio – such as paying an internal staff to conduct research and analysis, opportunity costs associated with the investor's time, or the cost of fees paid to outsourced professionals. If the investor also maintains that risk management is important, he will need to invest between $50–200 thousand in a third party risk management system.

Some investors, such as large state pension funds, have the expertise and resources in-house to make these decisions and implement the ongoing "portfolio management" processes necessary to successfully manage direct allocations to alternative strategies. Other investors assume that they do, but find out later that they were mistaken.

Some investors are not interested in crafting a diversified portfolio of alternatives to complement the traditional portfolio. These investors will direct their limited resources toward finding 2–3 very good individual alternative investment managers. For those investors, adding two hedge funds and a venture capital fund to their portfolios is simply an opportunistic foray into an exciting asset class. Unfortunately, those investors cannot achieve portfolio diversification and risk reduction by simply taking a "random walk" through the universe of alternative investment strategies and managers.

> *Some investors have the expertise and resources in-house to make these decisions (individual, single strategy managers) ...other investors assume that they do, but find out later that they were mistaken.*

Allocating assets across a portfolio of individual investment managers should be left to the largest, most sophisticated investors who can achieve an appropriate level of diversification with an efficient use of capital. Investors can benefit from guidance and experience when they consider these asset classes.

Fund of Funds

A fund of funds is a professionally managed investment vehicle that allocates investor capital toward multiple underlying managers. Some funds of funds utilize a multi-strategy, multi-manager approach, allocating capital across several investment strategies. Other funds of funds allocate capital to multiple managers within a single strategy, such as long/short investment strategies.

Funds of funds create target allocations designed to achieve an investment objective. Fund managers then make allocation decisions, overweighting or underweighting certain strategies or managers in an effort to increase the likelihood that the fund's objectives are met.

A fund of funds typically has an investment minimum in the $1–10 million range. An investment offers immediate diversified access to multiple strategies and managers. The number of managers underlying a fund of funds will differ, but typically is between 20 and 80.

An investor must do as much due diligence on a fund of funds as on an individual investment manager. An investor should seek a fund of funds with an investment objective that is aligned with his own portfolio investment objectives. Investors should seek experienced and ethical management teams who have demonstrated advantages within the strategy that they manage.

Detractors will cite that funds of funds maintain an extra layer of fees, above those of the individual funds. They do. An investor is paying for the experienced guidance, resources, risk management, access to talent, and daily fund management that a fund of funds offers. If a fund of funds reports its performance net of all fees – meaning net of all management and incentive fees at both the individual fund level and at the fund of funds level – then the investor can determine whether or not that fund's return and risk characteristics are worth paying for.

Conclusion

All alternative investment strategies are not the same. Investors should carefully research and understand how adding specific strategies – alone or in combination with other strategies – will affect a portfolio's return and risk characteristics. An investor should ensure that an alternative investment strategy's objective is congruent with his.

Considered in isolation, alternative investment strategies are attractive because they are designed to produce positive returns, with low standard deviation. Alternative investment strategies are often managed by talented, experienced investment managers who are compelled to achieve fund objectives through incentive compensation. Because alternative investments are not governed by the same level of regulation as traditional investments, alternative investment managers have access to a broader array of investment tools and opportunities.

When considered as a complement to traditional assets, prudently selected alternative investment strategies can reduce risk and increase return for the overall portfolio. Adding alternative investment strategies to a portfolio of traditional assets increases diversification and helps lower volatility, offering an opportunity to compound positive returns and avoid significant periods of loss. However, it should also be noted that diversification does not guarantee a profit or protection against loss.

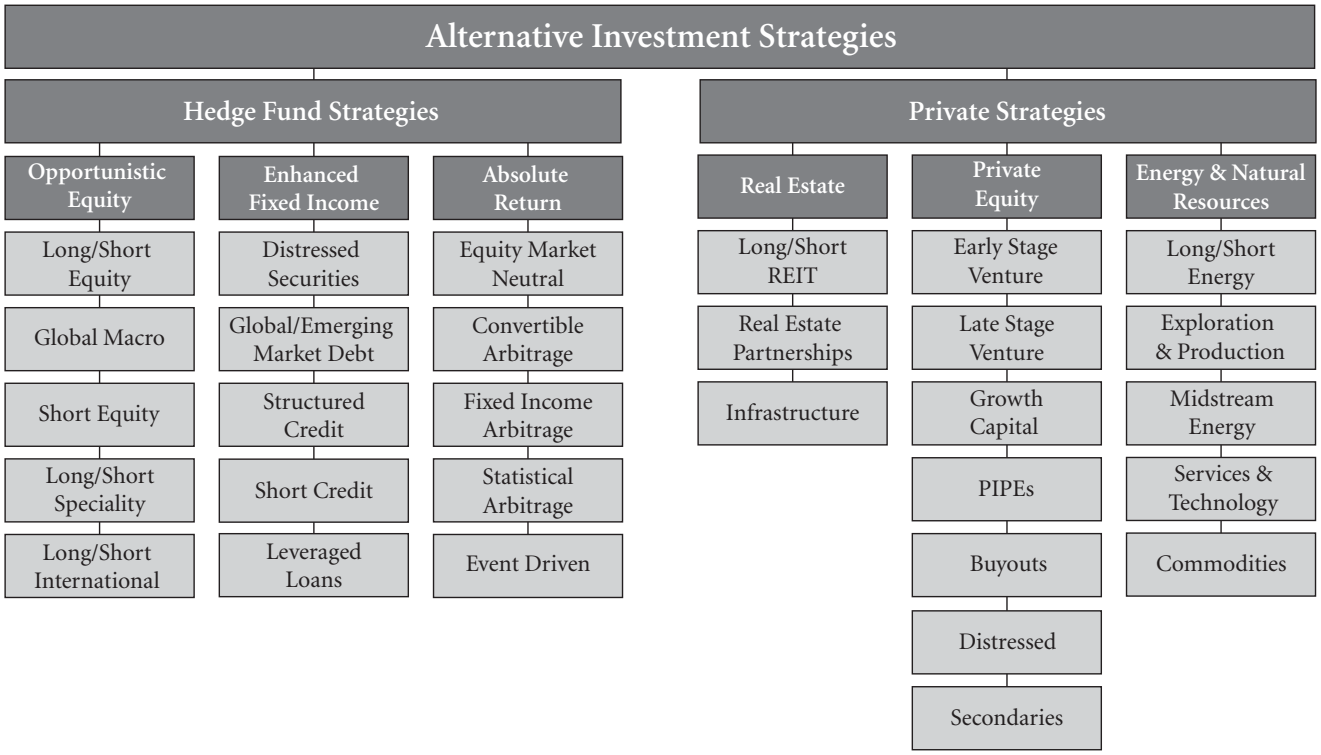
Appendix

- Strategies Explained
- Absolute Return
- Real Estate
- Private Equity

Specific Alternative Investment Strategies Explained

Alternative investments can be organized into two primary categories: Hedge Funds and Private Strategies. Absolute Return, Real Estate and some National Resources Strategies generally provide excellent diversification benefits because the strategies employed do not rely heavily upon market direction for returns. Opportunistic Equity and Private Equity have the potential to generate strong returns, but have fewer diversification benefits because returns can be influenced by the same factors that drive public equity market returns. Broadly speaking, any alternative investment strategy can be categorized as either a risk reducer (diversifier) or a return enhancer.

Below is a graphic representation of the different sub-classes of alternative investments:



Absolute Return

Through hedge funds, which allow techniques such as "short selling" and leverage, absolute return investors seek to generate positive returns that are independent of the overall market. Absolute return managers build portfolios comprised of "inefficiency-exploiting marketable securities positions exhibiting little or no correlation to traditional stock and bond investments."[11] Absolute return investments can be sub-categorized: Relative Value, Event Driven, Opportunistic, and Managed Futures. The risks associated with these investments are lack of liquidity, volatility and loss of investment value.

Relative value investing depends upon a manager's talent in recognizing both undervalued and overvalued securities. Traditional long-only equity managers seek to profit from finding companies whose value increases over time ("buy low, sell high"). Selling short is a technique that allows an investor to sell the stock of an overvalued company today, with an agreement to buy back the shares at a lower price in the future ("sell high, buy low").

A relative value manager will employ both long and short investments, seeking to profit from successfully predicting one company's future value relative to another related company's future value (or decline in value) – regardless of the direction of the overall market. For example, a relative value investor could buy shares of an undervalued beverage company and sell short the shares of an overvalued beverage company in an effort to profit from successfully assessing the value relationship between the two companies within the same sector. Regardless of whether beverage stocks are up or down, returns are driven by talent in determining valuation.

Event driven investing seeks to generate returns based on correctly anticipating corporate finance transactions such as mergers and the reorganizations associated with bankruptcies. The success of these investments is determined by the arbitrageur's ability to correctly assess the pending transaction's pricing, timing, and ultimate conclusion. For example, when a merger is announced, an event driven investor can buy the target company's stock and sell stock of the acquiring company. The investor seeks to profit from the typical price spread compression that occurs as the merger's conclusion approaches. Profits are event-dependent instead of market driven. Opportunistic investing is a broad grouping of different strategies and techniques that all have the similar trait of allowing the investment manager to seize an advantage in knowledge, research, temporary pricing anomalies, or market-specific inefficiencies to generate profit. One example of an opportunistic investor is the macro investor, who uses a top-down approach to predict how macroeconomic and geopolitical events will affect pricing relationships. Macro investors are able to use a broad range of strategies across a broad range of regions with the simple mandate of finding and taking advantage of pricing discrepancies.

Managed futures traders manage portfolios of futures contracts with the goal of profiting from movement in the prices of commodities, currencies, energy, and stock and bond indices. Managed futures investors seek profits in varying economic conditions – including down markets – by creating portfolios of non-correlated commodities diversified across regions, countries, and economies. A diversified portfolio of futures contracts is not correlated historically to traditional markets.

11 Swensen, David F., *Pioneering Portfolio Management*. The Free Press, New York, NY, 2000. pg. 205.

Real Estate

Real estate investments are unique in that they exhibit the characteristics of both debt and equity investments. Cash flows from leases resemble the income that bond holders receive from coupon payments. Real estate also possesses equity-like characteristics associated with variable property values. Some real estate holdings also offer an element of protection from unanticipated inflation.

Real estate investments can be public, in the form of REITs (Real Estate Investment Trusts), or private. Stock-market traded REITs are valued daily, while private real estate is valued periodically by appraisal until it is sold (which is the only true valuation point). REITs have offered higher returns than private real estate over time, but have exhibited higher standard deviation as well. While REITs possess higher volatility and a stronger correlation to stocks than private real estate, some investment managers take both long and short positions in REITs to reduce market exposure – while enjoying the liquidity associated with publicly marketable securities. The risks associated with real estate investing include lack of liquidity, volatility and loss of investment value.

Private Equity

Private equity investments made through leveraged buyouts, venture capital, and mezzanine debt have the potential for high returns, but also exhibit higher standard deviation versus other alternative asset classes. The volatility of these strategies is due in part to the operational risk associated with the underlying investments and in part to a greater sensitivity to the forces that drive the public equity markets. Most private equity strategies exhibit some degree of illiquidity and possess a potential for higher returns and higher volatility.

Venture investors offer early-stage capital in exchange for significant ownership stake in a private company. Venture capital investment funds seek to diversify their investments across several types of businesses, regions, management teams and especially over different time periods. Venture managers seek to sell their stake in a business at attractive multiples; however, the reality is that not all business ideas – no matter how carefully researched – succeed. If two out of ten investments are "home runs," a venture fund is likely to reward its investors with attractive returns.

Leveraged buyout firms borrow money to take control of target companies whose potential value can be unlocked through operational changes. Buyout specialists seek mature businesses with real revenue and predictable cash flow that can be used to pay off the debt used to purchase them. The ultimate goal of an LBO is to sell the company once it is more profitable. The time horizon on these types of investments is significantly longer, requiring a "lock up" of investor capital. The risks associated with investing in private equity include lack of liquidity, volatility and loss of investment value.

Important Information: Hedge funds are speculative investments and are not suitable for all investors, nor do they represent a complete investment program. The Funds are only open to qualified investors who are comfortable with the substantial risks associated with investing in hedge funds. The Funds investment program is speculative and entails substantial risks. Specific risks associated with underlying securities that populate the Hedge Funds in which the Funds invest include:

1) Risks inherent in an investment in securities: loss of money, illiquidity, volatility;
2) Specific risks associated with limited liquidity: underlying securities may not be available to sell for long periods of time thus limiting exit strategies and redemptions;
3) The use of leverage: leverage compounds returns by adding exposure which can enhance performance but also exacerbate losses;
4) Short Sales: risks are illiquidity, use of leverage and unlimited loss potential;
5) Options & Futures: risks are volatility, illiquidity and substantial loss of money beyond initial investment;
6) Derivative Instruments: risks are volatility, illiquidity and substantial loss of money beyond initial investment;
7) Investment in non-U.S. securities: risks are illiquidity, currency fluctuations, lack of transparent management and geopolitical;
8) "Junk" bonds and illiquid investments: loss of money, inability to sell securities, legal issues, corporate malfeasance, bankruptcy proceedings and volatility otherwise not associated with bonds.

Investors should recognize that they will bear asset-based fees and expenses at the fund level, and indirectly, fees, expenses and performance-based compensation of the investment funds in which these Funds invest. In addition, the overall performance of a fund of funds is dependent not only on the investment performance of individual managers, but also on the ability of the fund's Advisor to allocate the fund's assets amongst such managers on an ongoing basis. Investors should understand that they will likely be required to obtain extensions of the filing date for their income tax returns due to possible K-1 delays. Investors could lose some or all of their investments.

HATTERAS

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