



HATTERAS  
*Funds*

HATTERAS FUNDS  
INVESTMENT PERSPECTIVE

EVOLUTION OF ALTERNATIVES

*October 2011*



## KEY POINTS

- Historically, hedged strategies have produced return enhancement and volatility mitigation. Hedge funds have outperformed versus the S&P 500 Total Return Index over the last two decades.
- The investment management industry introduced new products to meet the investor demand for increased transparency and liquidity in alternative investment offerings.
- Liquid alternatives offer hedge fund characteristics to a much broader set of investors while providing the mutual fund benefits of daily liquidity and complete transparency.
- The liquidity features make it easier to implement asset allocation decisions, enabling active and model-based portfolio rebalancing without waiting for pre-defined entry and exit points.

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## I. INTRODUCTION

Historically, alternative investments, such as hedge funds, have offered return enhancement, risk mitigation, and correlation benefits to a diversified investment portfolio. Adding hedge funds to a portfolio has enabled investors to protect capital more effectively when markets fall, which, over time, could lead to the creation of more wealth.

Unfortunately, these benefits have come only to investors who could meet certain high minimum investment hurdles and high qualification standards. Even investors who meet these hurdles face subsequent illiquidity, special tax procedures, and opaque investment reporting. Advisors have been forced to prescribe the benefits of alternatives only to a select sub-set of their client base.

In response, the investment management industry developed structures that enable exposure to hedge fund strategies and techniques with the liquidity and ease of use associated with mutual funds. Today, “liquid alternatives” enable advisors to prescribe the benefits of hedge fund strategies to a broader set of clients. Additionally, advisors are able to increase

investors’ allocation to alternatives, without negatively affecting the liquidity profile of the overall portfolio. Liquid alternative mutual funds offer liquidity, low investment minimums, no investor qualification standards, and the general ease and familiarity of mutual fund structures.

The growth and availability of liquid alternative mutual funds not only enable advisors to prescribe alternative investment strategies, but also rebalance client portfolios at appropriate intervals determined by the investment policy statement. Efficient rebalancing offers advisors the flexibility to use alternatives within model-based portfolios as well.

Liquid alternative mutual funds give a broader set of clients the ability to enjoy the benefits of adding alternative investment strategies to their portfolios. Investors benefit from the liquidity, low minimums, and general ease of use. Advisors benefit from newfound flexibility, which enables broader application of alternative investment strategies across their client base.



## II. PERFORMANCE AND RISK

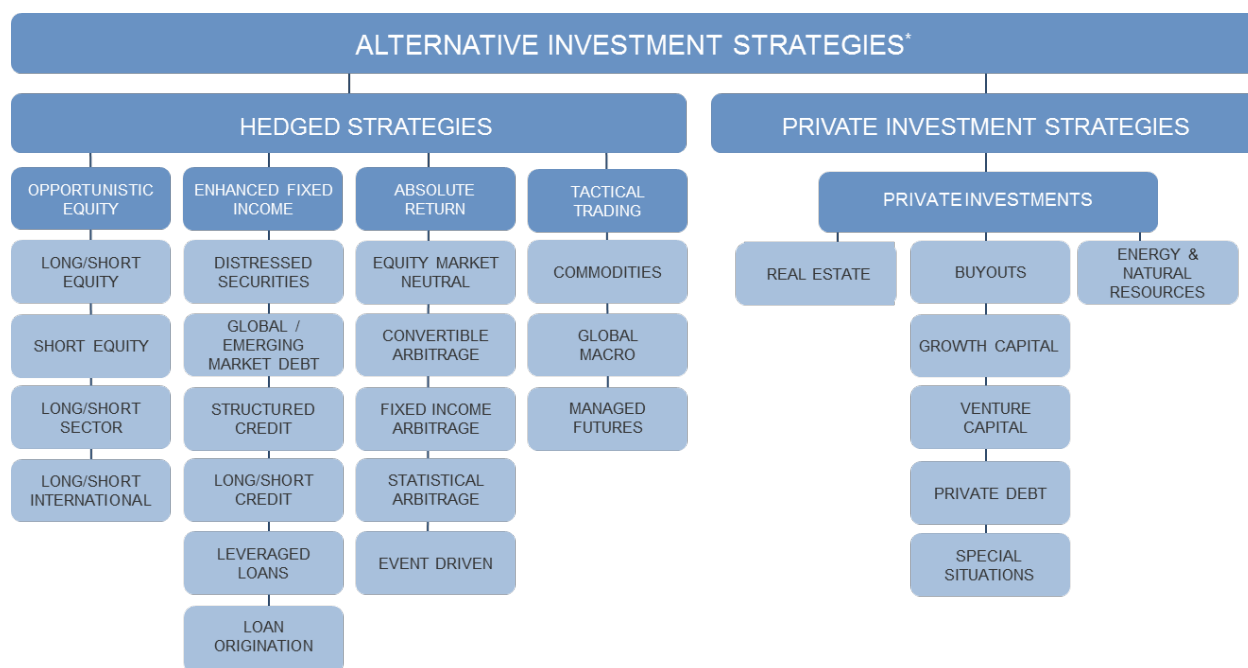
Alternative investments, and more specifically hedge funds, offer investors a tool to potentially reduce portfolio risk and enhance return. These strategies often seek to temper market volatility through various hedging techniques. The combination of various alternative investment strategies along with traditional investments enables advisors to craft diversified portfolios of non-correlated assets.

Alternative investments can be organized into different categories according to their structure, liquidity, security focus, and trading style. Chart 1 organizes alternative

investments by strategy types. Large institutional investors, ultra high net worth investors, endowments, and foundations utilize many of these strategies to create diversified investment portfolios. Part of that “diversification” stems from the way alternative investment strategies behave versus traditional investments (stocks, bonds, and cash) typically found in a portfolio. Many of these alternative investment strategies bear low correlation both to traditional investments and to one another.

**Chart 1**

**Alternative Investments Include Hedge Funds and Private Investments**



*\*As defined by Hatteras Funds*

Historically, hedged investments have outperformed traditional long-only investments. Through reduced volatility and lower correlation to equity indices during down markets, these investments have mitigated the size and duration of drawdowns and effectively preserved

capital. By losing less, these strategies are able to depend upon the power of compounding (from a larger base each period) to outperform. As seen in Chart 2, hedge funds have outperformed the S&P 500 Total Return Index over the last two decades.

Chart 2

**Growth of \$1,000,000**  
January 1, 1990 – September 30, 2011

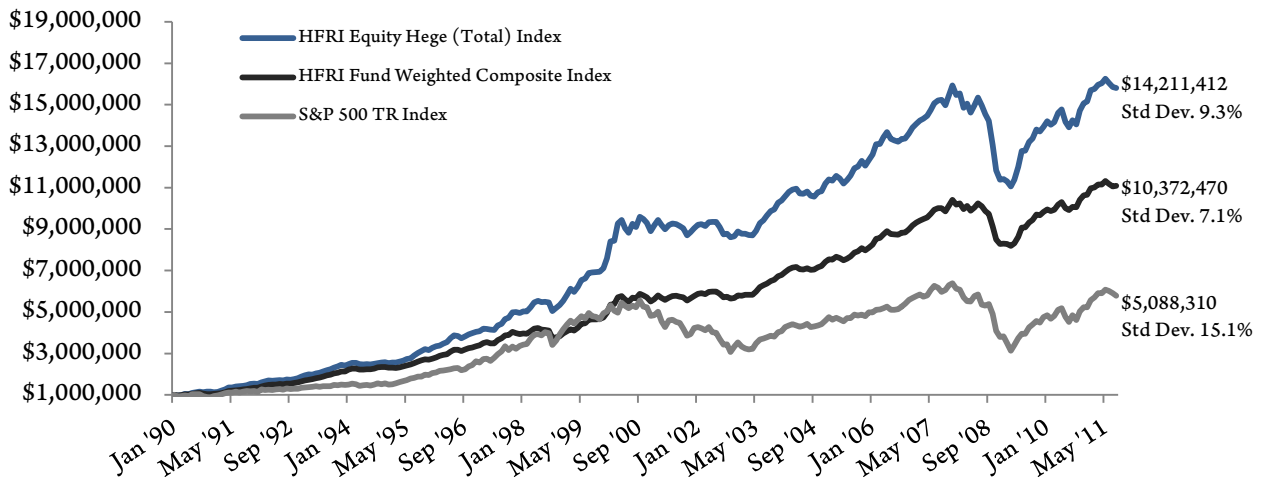


CHART SOURCES: Morningstar, Hedge Fund Research, Inc., and Hatteras Funds

Index returns are provided for illustrative purposes only to demonstrate a hypothetical investment vehicle using unmanaged broad-based indices of securities. Returns do not represent any actual investment. An investor cannot invest directly in an index. Index performance does not reflect the deduction of fund fees and charges. **Past performance does not guarantee future results.**



Sources: Morningstar Direct, Hedge Fund Research, Inc., and Hatteras Funds

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### III. TRANSPARENCY, LIQUIDITY, AND ACCESS

Advisors and investors face the challenge of constructing an appropriate portfolio asset mix that aligns long-term growth goals and short-term liquidity needs. While protecting and building wealth is the goal of most investors, real life liquidity needs alter the types of investments that can be utilized to achieve these goals. A well structured investment plan generally starts with a determination of short, intermediate, and long-term goals, followed by an assessment of risk tolerance and tax constraints. This study enables an advisor to “prescribe” an appropriate strategic asset allocation and monitoring program that takes into account each specific investor’s goals and limitations.

Within such a program, financial advisors have come to understand and appreciate the potential diversification, risk mitigation, and return enhancement benefits of alternative investments. Unfortunately the benefits of alternative strategies typically came with a

price, as these investments were not known for their liquidity, ease of use, or tax efficiency.

These barriers made allocation to alternative investments difficult – or impossible - for many investors. Until recently, financial advisors faced the difficult balancing task of maximizing portfolio efficiency while maximizing portfolio liquidity.

Unfortunately, not all alternative strategies or categories offer the same ease of use, liquidity, or investor access. Many of the strategies on the right side of Chart 1 offer investors attractive returns, but require a capital lock-up for 8-12 years. So, as investors consider allocating to alternative strategies, perhaps one of the most important ways to organize the investments is along a continuum of liquidity, as illustrated in Chart 3.

Chart 3

Continuum of Liquidity to Investors

Most Liquid	Same day to T+3		Monthly, Quarterly, Semi-Annual	3+Years	Most Illiquid
	Cash	Publicly traded stocks, bonds, mutual funds, ETFs	Most hedge fund strategies	Private investments	

The categories depicted in Chart 1, “hedge fund strategies” and “private investments,” are general descriptive terms that encompass many sub-strategies. The primary distinction between the two general categories (hedge funds and private investments) can be attributed to the degree to which the underlying strategy depends upon trading publicly offered securities. The more liquid the securities within a portfolio, the more likely the drivers of the strategy’s success resemble those of traditional, long-only, publicly traded investments. This does not mean that the return profiles must be similar, just that the nature of the liquidity of the underlying investments is similar. The success of the strategy should be determined by some combination of market opportunities and investment manager skill. Hedge fund strategies tend to be more trading-oriented and therefore, tend to occupy the more liquid end of the alternative investment liquidity continuum.

#### **LIQUID INVESTMENT**

*Of, relating to, or being an asset that may be bought or sold in a short period of time with relatively small price changes engendered by the transaction.*

*A U.S. Treasury bill is an example of a very liquid asset.*

Dictionary.com: Wall Street Words,  
Houghton Mifflin Company

According to Hedge Fund Research, Inc. estimates, assets under management in the hedge fund industry have grown to more than \$2 trillion within more than 9,000 hedge funds and fund of hedge funds by the end the second quarter, 2011. While the growth has been impressive, many investors lack access

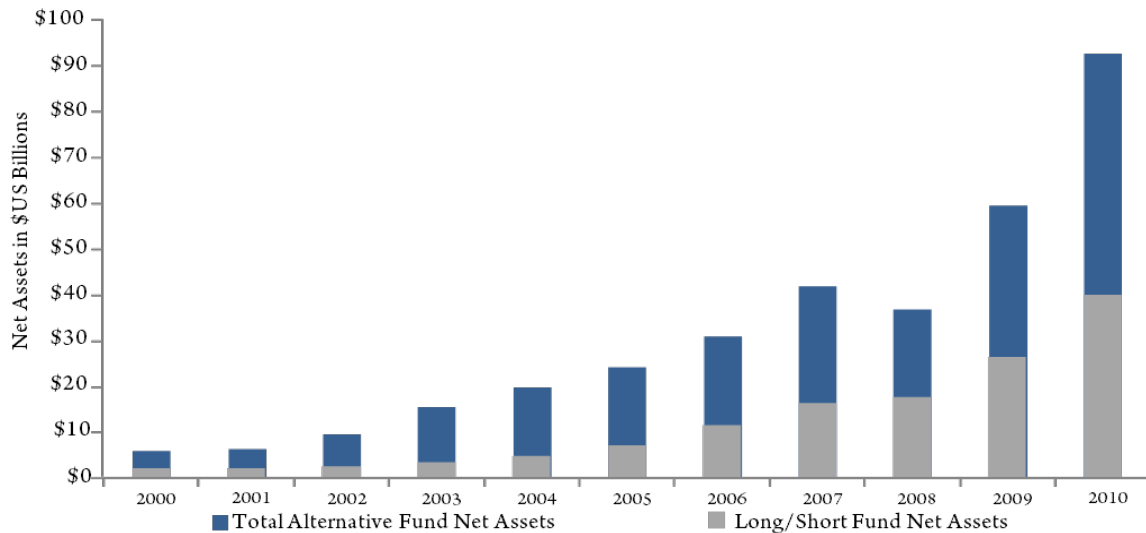
to traditional hedge fund vehicles due to high investor accreditation standards and high investment minimums. In addition, lock-up requirements (usually one year), limited redemption opportunities (usually once a quarter), and tax reporting issues (K-1s versus 1099s) have caused some investors to shy away from typically structured hedge fund investments. Additionally, the longer redemption and periodic investment periods of traditional hedge funds may limit opportunities for complete portfolio rebalancing activities.

#### **Alternative Mutual Funds**

In response, the investment management industry introduced new products to meet the investor demand for both access to alternative investments and better asset-liability matching. These comparably newer products have been generally labeled as “liquid alternatives” and are characterized by hedging-oriented investment strategies, daily valuation, daily liquidity, and 1099 tax reporting. Not long ago, the phrase “liquid alternatives” might have been considered an oxymoron. Yet today, advisors and investors alike have the ability to allocate to daily liquid mutual funds that offer hedge fund strategies, hedge fund managers and, by extension, the potential portfolio benefits of hedge fund investing: risk mitigation, return enhancement, and reduced correlation among assets. The mutual fund structure addresses not only the liquidity issue that often prevented investors from using these strategies, but also lowers the minimum investment amount and qualification standards. The growth of such “alternative mutual funds” is depicted in Chart 4.

**Chart 4**

**Alternative Mutual Funds  
2003 – 2010**



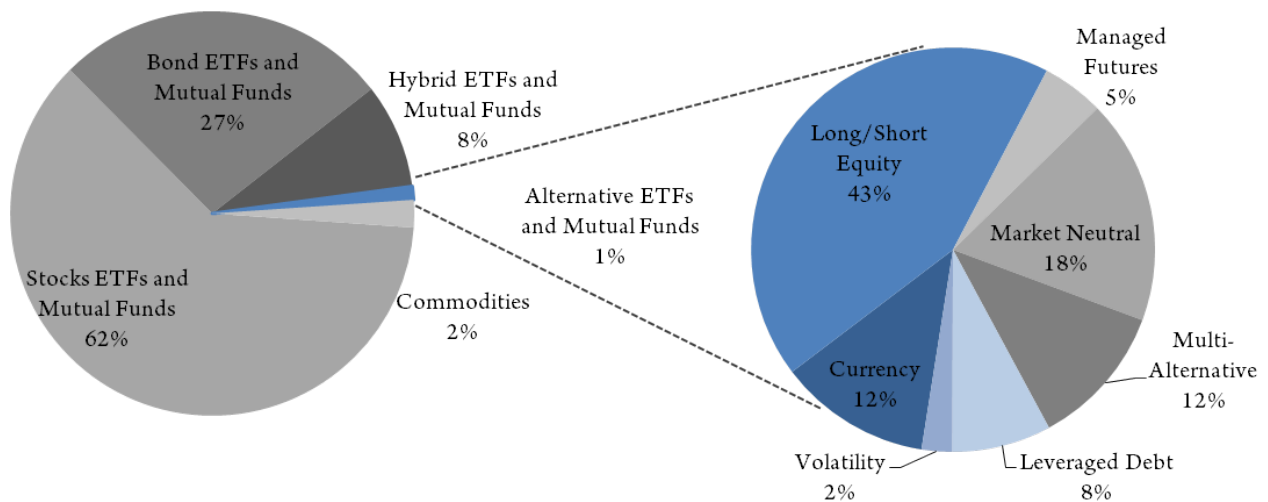
Source: Morningstar Direct, Fortigent

Within the context of the broad mutual fund and ETF landscape, liquid alternatives represent a small, but quickly growing segment comprised of a wide range of asset classes and strategies. A majority of these

liquid alternatives focus on separate asset classes – such as natural resources, precious metals, and commodities – that are not actual hedge fund strategies (please see Chart 5).

**Chart 5**

**Mutual Fund and ETF Landscape  
as of August 2011**



Source: Morningstar Direct



## IV. ASSET ALLOCATION AND REBALANCING FLEXIBILITY

### The Challenge

The challenge is how to introduce hedge fund behavior – such as risk mitigation and increased diversification – into a “liquid” portfolio of traditional asset classes. If the decision is made to achieve this through the use of liquid alternatives, many of the existing (truly hedged) choices are single strategy, single manager mutual funds. When an investor considers a core allocation to the broad range of hedge fund strategies, selecting appropriate single strategy hedge fund managers is a labor intensive process. Hedge fund manager search, selection, diligence, and monitoring

activities are time consuming and require a high level of experience and expertise.

In lieu of investing in only one specific hedge fund strategy, some advisors and investors have chosen to create a basket of multiple, different single strategy hedge fund-like mutual funds. Additionally, over the last few years, funds have been developed to incorporate multiple managers within one fund/portfolio. Regardless of which direction investors pursue, rigorous due diligence is required. Some of the factors that should be considered are outlined in Chart 7.

Chart 7

#### What to Look for in an Alternative Mutual Fund Structure

- ▶ Experienced hedge fund managers and proven hedge fund strategies
  - Active management
  - Significant hedging of market exposures
- ▶ Multi-Strategy
  - Diversification of styles and strategies
  - Correlation benefits across hedged strategies
  - More consistent return profile
- ▶ Multi-Manager
  - Thorough due diligence
  - Written and repeatable process
  - Dedicated risk management
  - Experienced allocators

## The Result

Allocating to a liquid alternatives fund that allocates to a broad range of hedge fund strategies offers the potential for diversification and return enhancement similar to that of traditional hedge funds. Allocating to liquid alternatives provides exposure to various underlying hedge fund strategies in a structure that provides the daily liquidity and portfolio transparency of mutual funds registered with the Securities and Exchange Commission (the "SEC"). In a multi-manager or "fund of funds" setting,

managers also add value through active strategy and manager allocation decisions in a defined, repeatable process. Experienced, proven managers will exhibit the ability to actively allocate and rebalance capital across a range of hedge fund strategies, rather than being limited to one specific strategy mandate. This is particularly noteworthy given the dramatic year-to-year results of different hedge fund strategies (please see Chart 8).

Chart 8

### Hedge Fund Strategy Performance

1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	YTD Q2 2011
S&P 500 28.59%	HFRI Emerging Markets 55.86%	HFRI ED: Merger Arb 18.02%	HFRI RV: ConvertArb 13.37%	Barclays Gov't/Credit 12.10%	HFRI Emerging Markets 39.36%	HFRI ED: Distressed 18.89%	HFRI Emerging Markets 21.04%	HFRI Emerging Markets 24.26%	HFRI Emerging Markets 24.92%	Barclays Gov't/Credit 6.09%	HFRI RV: ConvertArb 60.17%	S&P 500 15.08%	S&P 500 6.01%
HFRI Equity Hedge 15.98%	HFRI Equity Hedge 44.22%	HFRI EH: Eq Mkt Ntrl 14.56%	HFRI ED: Distressed 13.28%	HFRI RV: ConvertArb 9.05%	HFRI ED: Distressed 29.56%	HFRI Emerging Markets 18.42%	HFRI Equity Hedge 10.60%	HFRI ED: Distressed 15.94%	HFRI Macro 11.11%	HFRI Macro 4.83%	HFRI Emerging Markets 40.24%	HFRI RV: ConvertArb 13.07%	HFRI ED: Distressed 4.09%
Barclays Gov't/Credit 12.00%	HFRI Fund Wghtd Comp 31.29%	HFRI RV: ConvertArb 14.50%	HFRI Event-Driven 12.18%	HFRI Macro 7.44%	S&P 500 28.67%	HFRI Event-Driven 15.01%	HFRI Fund Wghtd Comp 9.30%	S&P 500 15.78%	HFRI Equity Hedge 10.48%	HFRI ED: Merger Arb -5.36%	HFRI ED: Distressed 28.13%	HFRI Emerging Markets 11.96%	HFRI Relative Value 3.12%
HFRI EH: Eq Mkt Ntrl 8.30%	HFRI FOF Composite 26.47%	HFRI Relative Value 13.41%	HFRI Emerging Markets 10.36%	HFRI Relative Value 5.44%	HFRI Event-Driven 25.33%	S&P 500 10.86%	HFRI ED: Distressed 8.27%	HFRI Event-Driven 15.33%	HFRI FOF Composite 10.25%	HFRI EH: Eq Mkt Ntrl -5.93%	S&P 500 26.47%	HFRI Relative Value 11.73%	HFRI Event-Driven 2.99%
HFRI RV: ConvertArb 7.77%	HFRI Event-Driven 24.33%	Barclays Gov't/Credit 13.27%	Barclays Gov't/Credit 9.40%	HFRI ED: Distressed 5.28%	HFRI Macro 21.42%	HFRI Fund Wghtd Comp 9.03%	HFRI FOF Composite 7.49%	HFRI ED: Merger Arb 14.24%	HFRI Fund Wghtd Comp 9.96%	HFRI Relative Value -18.04%	HFRI Relative Value 25.80%	HFRI Event-Driven 11.53%	Barclays Gov't/Credit 2.75%
HFRI ED: Merger Arb 7.23%	S&P 500 21.03%	HFRI Equity Hedge 9.09%	HFRI Relative Value 8.92%	HFRI Emerging Markets 3.70%	HFRI Equity Hedge 20.54%	HFRI Equity Hedge 7.68%	HFRI Event-Driven 7.29%	HFRI Fund Wghtd Comp 12.89%	HFRI Relative Value 8.94%	HFRI Fund Wghtd Comp -19.02%	HFRI Event-Driven 25.04%	HFRI ED: Distressed 11.26%	HFRI ED: Merger Arb 2.19%
HFRI Macro 6.19%	HFRI Macro 17.62%	HFRI Event-Driven 6.74%	HFRI Macro 6.87%	HFRI FOF Composite 1.02%	HFRI Fund Wghtd Comp 19.55%	HFRI FOF Composite 6.86%	HFRI Macro 6.79%	HFRI Relative Value 12.37%	Barclays Gov't/Credit 7.75%	HFRI FOF Composite -21.36%	HFRI Equity Hedge 24.55%	HFRI Equity Hedge 10.58%	HFRI EH: Eq Mkt Ntrl 1.61%
HFRI Relative Value 2.81%	HFRI ED: Distressed 16.94%	HFRI Fund Wghtd Comp 4.98%	HFRI EH: Eq Mkt Ntrl 6.71%	HFRI EH: Eq Mkt Ntrl 0.98%	HFRI FOF Composite 11.61%	HFRI Relative Value 5.58%	HFRI ED: Merger Arb 6.25%	HFRI RV: ConvertArb 12.17%	HFRI ED: Merger Arb 7.05%	HFRI Event-Driven -21.82%	HFRI Fund Wghtd Comp 19.98%	HFRI Fund Wghtd Comp 10.49%	HFRI Equity Hedge 1.07%
HFRI Fund Wghtd Comp 2.62%	HFRI Relative Value 14.73%	HFRI FOF Composite 4.07%	HFRI Fund Wghtd Comp 4.62%	HFRI ED: Merger Arb -0.87%	HFRI RV: ConvertArb 9.93%	HFRI ED: Merger Arb 4.63%	HFRI EH: Eq Mkt Ntrl 6.22%	HFRI Equity Hedge 11.71%	HFRI Event-Driven 6.61%	HFRI ED: Distressed -25.20%	HFRI ED: Merger Arb 11.63%	HFRI Macro 8.61%	HFRI RV: ConvertArb 0.80%
HFRI Event-Driven 1.70%	HFRI RV: ConvertArb 14.41%	HFRI ED: Distressed 2.78%	HFRI FOF Composite 2.80%	HFRI Fund Wghtd Comp -1.45%	HFRI Relative Value 9.72%	Barclays Gov't/Credit 4.54%	HFRI Relative Value 6.02%	HFRI FOF Composite 10.39%	S&P 500 5.49%	HFRI Equity Hedge -26.65%	HFRI FOF Composite 11.46%	Barclays Gov't/Credit 6.99%	HFRI Fund Wghtd Comp 0.77%
HFRI ED: Distressed -4.23%	HFRI ED: Merger Arb 14.34%	HFRI Macro 1.97%	HFRI ED: Merger Arb 2.76%	HFRI Event-Driven -4.30%	HFRI ED: Merger Arb 7.47%	HFRI EH: Eq Mkt Ntrl 4.15%	S&P 500 4.91%	HFRI Macro 8.15%	HFRI RV: ConvertArb 5.33%	HFRI RV: ConvertArb -33.71%	Barclays Gov't/Credit 4.81%	HFRI FOF Composite 5.60%	HFRI Emerging Markets -0.16%
HFRI FOF Composite -5.11%	HFRI EH: Eq Mkt Ntrl 7.09%	S&P 500 -9.09%	HFRI Equity Hedge 0.40%	HFRI Equity Hedge -4.71%	Barclays Gov't/Credit 5.07%	HFRI ED: Merger Arb 4.08%	Barclays Gov't/Credit 2.55%	HFRI EH: Eq Mkt Ntrl 7.32%	HFRI EH: Eq Mkt Ntrl 5.29%	S&P 500 -36.99%	HFRI Macro 4.37%	HFRI ED: Merger Arb 4.60%	HFRI FOF Composite -0.33%
HFRI Emerging Markets -32.96%	Barclays Gov't/Credit -2.40%	HFRI Emerging Markets -10.71%	S&P 500 -11.85%	S&P 500 -22.09%	HFRI EH: Eq Mkt Ntrl 2.44%	HFRI RV: ConvertArb 1.18%	HFRI RV: ConvertArb -1.86%	Barclays Gov't/Credit 4.07%	HFRI ED: Distressed 5.08%	HFRI Emerging Markets -37.26%	HFRI EH: Eq Mkt Ntrl 1.43%	HFRI EH: Eq Mkt Ntrl 3.16%	HFRI Macro -2.25%

Source: HFR Industry Reports, ©HFR, Inc. Second Quarter 2011, www.hedgefundresearch.com. Index returns are provided for illustrative purposes only to demonstrate a hypothetical investment vehicle using broad-range indices of securities. Returns do not represent an actual investment.

Well constructed, diversified investment programs can now include alternative investments regardless of an investor's near-term liquidity constraints. The diversification and potential return enhancement benefits of hedge funds are available to appropriately match asset accumulation with asset needs in short, intermediate and long-term time periods.

Advisors will appreciate that rebalancing activities may occur when desired. In traditional, liquid portfolios, advisors have been able to offer periodic rebalancing to ensure adherence to a predetermined asset allocation mix. The constraints of longer lock-up periods and less frequent liquidity periods (both for investment and redemption) made timely and appropriate portfolio rebalancing quite difficult for advisors who had prescribed traditionally structured alternative investments. The introduction of hedge fund strategies in a mutual fund structure allows for such benefits.

Additionally, many advisors utilize model-based investment programs for certain types

of clients. Within such a model, centralized asset allocation and manager decisions are made that automatically alter a whole group of investors' portfolio allocations. In these programs, traditionally structured alternative investments are unwieldy and inefficient because of the aforementioned liquidity constraints. Today, liquid alternative mutual funds offer a solution whereby model-based investing can still offer its efficiency and broad scale, while also delivering the benefits of hedge fund investing.

So, liquid alternatives enable advisors to rebalance frequently or utilize the efficiency of model-based programs, while delegating the associated search, selection, diligence, portfolio construction, and risk management activities to full-time, experienced professionals.

Today, a fund of hedge funds investing in experienced hedge fund managers utilizing true hedged investment strategies may serve as a core, liquid investment within a well constructed investment program.



## V. CONCLUSION

The use of a diversified portfolio of hedge fund strategies in a daily liquid, daily valued mutual fund format allows investors to either access hedged strategies (where they could not before) or increase their allocation to hedged strategies. Doing so may offer further risk/return benefits without compromising liquidity for that portion of the portfolio.

In addition, liquid alternatives allow the advisor to offer a more dynamic rebalancing approach to portfolio management. Investors can rebalance quickly and efficiently based on an investor's predetermined "investment policy statement," rather than being forced to wait for quarterly (or longer) redemption processes.

We believe that investors should use a diversified pool of liquid alternative strategies in conjunction with exposure to more traditional hedge fund structures as a core element to an overall asset allocation program. We believe advisors will appreciate the opportunity to offer access to hedge fund characteristics across a much broader set of client types. Hedged strategies have offered superior risk-adjusted returns versus long-only strategies over the last two decades and therefore, we believe should play an important role in portfolio allocation. We feel the growing universe of liquid alternative strategies gives investors the opportunity to increase their exposure to hedged strategies and receive many of the potential risk/return benefits without compromising liquidity.

***The Funds' investment objectives, risks, charges, and expenses must be considered carefully before investing. The summary prospectus and prospectus contain this and other important information about the investment company, and may be obtained by calling 1.877.569.2382 or visiting [www.hatterasmutualfunds.com](http://www.hatterasmutualfunds.com). Read it carefully before investing.***

#### **Risk Disclosure**

Alternative investments involve a high degree of risk. Certain hedging techniques and leverage employed in alternative investments may accelerate the velocity of possible losses. Short selling involves the risk of potentially unlimited increase in the market value of the security sold short, which could result in potentially unlimited loss for the funds. Derivatives involve investment exposure that may exceed the original cost and a small investment in derivatives could have a large potential impact on fund performance. Options held may be illiquid and the fund manager may have difficulty closing out a position. The cost of investing in fund-of-funds will generally be higher than the cost of investing directly in the shares of the mutual funds in which it invests.

Mutual fund investing involves risk; loss of principal is possible. Please consult an investment professional for advice regarding your particular circumstances. An investment in the alternative investments may not be suitable for all investors.

#### **SAFE HARBOR AND FORWARD-LOOKING STATEMENTS DISCLOSURE**

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## **Glossary**

### **HFRI Equity Hedge Index**

Funds included in the Index include investment managers who maintain positions both long and short in primarily equity and equity derivative securities. A wide variety of investment processes can be employed to arrive at an investment decision, including both quantitative and fundamental techniques; strategies can be broadly diversified or narrowly focused on specific sectors and can range broadly in terms of levels of net exposure, leverage employed, holding period, concentrations of market capitalizations, and valuation ranges of typical portfolios. Equity hedge managers would typically maintain at least 50%, and may in some cases be substantially entirely invested in equities, both long and short.

### **HFRI Fund Weighted Composite Index**

The Index includes more than 2,000 domestic and offshore funds that are equally weighted. All funds report assets in USD, and report net of all fees returns on a monthly basis. There are no funds of funds included in the Index, and the fund must have at least \$50 million under management or have been actively trading for at least twelve months.

### **S&P 500 Index**

The Index consists of 500 stocks chosen for market size, liquidity and industry group representation, among other factors. The S&P 500 is designed to be a leading indicator of U.S. equities and is meant to reflect the risk/return characteristics of the large cap universe. Companies included in the index are selected by the S&P Index Committee, a team of analysts and economists at Standard & Poor's. It is a market value weighted index, with each stock's weight in the index proportionate to its market value.



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