

# THE WALL STREET TRANSCRIPT

Connecting Market Leaders with Investors

## The Endowment Model of Investing



**MARK W. YUSKO** is the CEO and CIO of Morgan Creek Capital Management, LLC, a registered investment adviser formed in July 2004 to provide investment management and advisory services based on the University Endowment Model of Investing. Additionally, Mr. Yusko serves as the CIO for the Hatteras Multi-Strategy funds, offered through a joint venture formed in 2004 between Morgan Creek Capital Management and Hatteras Funds. Previously, Mr. Yusko was President, CIO and Founder of UNC Management Company Inc., the endowment investment office for The University of North Carolina at Chapel Hill, from 1998 to 2004. Throughout his tenure at UNCMC, Mr. Yusko directly oversaw strategic and tactical asset-allocation recommendations to the investment fund board, investment manager selection, manager performance evaluation, spending policy management and performance reporting. The total assets under management were \$1.5 billion — \$1.2 billion in endowment assets and \$300 million in

working capital. Until 1998, Mr. Yusko was the Senior Investment Director for the University of Notre Dame's Investment Office, which he joined as the Assistant Investment Officer in October 1993. He worked with the CIO in all aspects of endowment management. Mr. Yusko earned his B.S., with honors, in biology and chemistry from the University of Notre Dame, and he earned an MBA in accounting and finance from the University of Chicago.

**TWST: Please share with us the background of Morgan Creek, Hatteras, the Hatteras Multi-Strategy funds and the Endowment Model of Investing.**

**Mr. Yusko:** Morgan Creek Capital Management was formed after I left the University of North Carolina at Chapel Hill, UNC, where I served as Chief Investment Officer of the UNC Endowment Fund for seven years. Morgan Creek grew out of the consulting activities that I was involved in while at UNC. The idea was to bring the Endowment Model of investing to other types of investors, be they smaller institutions that don't have dedicated staff, high net worth families or individuals. Morgan Creek was designed to perform three functions well: asset allocation, manager selection and portfolio construction. These are essentially the same functions that we performed at UNC and Notre Dame. They are the key tenets of endowment investing.

My relationship with Hatteras Funds' Chairman David Perkins began when David was looking for some help finding alternative investment solutions. We formed a relationship that evolved into the Hatteras Multi-Strategy funds.

Morgan Creek has a joint venture with Hatteras to deliver the full spectrum of alternative investments within a single investment offering. Morgan Creek assists in the asset allocation, manager selection and portfolio construction expertise, and Hatteras provides risk management, distribution, client services and compliance. Hatteras provides a multi-

strategy fund which combines hedge fund strategies and private investment strategies in a single multi-manager fund. It is designed to replicate the alternative investment portfolios seen at some of the largest, most successful university endowments. The core idea is that these funds allow smaller institutional investors and individual investors to get access to the same type of portfolio as the large university endowments. Essentially, it offers investors who are somewhere downstream from billion-dollar endowments a chance to invest in strategies and managers that would otherwise be unavailable to them.

**TWST: How do the Hatteras Multi-Strategy funds differ from the typical hedge funds?**

**Mr. Yusko:** Everything that we do within the Hatteras Multi-Strategy funds, is modeled after what I did for years at the Universities of Notre Dame and North Carolina. We built a team and constructed a process similar to the most successful university endowments. These organizations focus on building a diversified portfolio across multiple asset classes.

There are a lot of single asset class fund of funds in the world, and there are also a lot of single hedge fund or private asset managers. But what was missing was a single solution that combined marketable alternatives, or hedge funds, with private investment strategies — real estate, private equity, and private energy and natural resources. Hatteras and Morgan Creek built the Hatteras Multi-Strategy funds to address that need in the market. In addition to delivering a uniquely structured product, we

are excited to be able to offer a wider range of investors access to the best managers around the globe.

You hear the term “fund of funds” in the marketplace — private equity fund of funds, real estate fund of funds. We prefer the term “manager of managers.” To me, a fund of funds is a static portfolio. You take 10 good hedge funds for 10% each, and you rebalance quarterly. I’m not quite sure why you pay somebody one and 10 to do that. A manager of managers, on the other hand, actively allocates between and among the managers, continually looking for the best themes in which to invest. As opposed to just investing in the underlying managers and letting them take care of where to invest, a manager of managers focuses on asset allocation first, manager selection second and portfolio construction third.

The other difference is that a classic fund of funds is usually a single investment strategy or single asset class. For example, a hedge fund of funds that invests in long/short equity or long/short debt funds, a hedge fund of funds that focuses on absolute return or arbitrage, a private equity fund of funds, venture capital fund of funds, or a real estate fund of funds. What the Hatteras Multi-Strategy funds do is take all six alternative investment strategies: the three public or marketable alternatives — long/short equity, long/short credit and arbitrage; and the three private strategies — private equity, private real estate and private energy — and put it all into one vehicle, creating a one-stop solution to get a full allocation to alternative investments, as opposed to having to piece together six different single fund of funds.

**TWST: Would you explain your investment process?**

**Mr. Yusko:** Everything we do within the Hatteras Multi-Strategy funds is derived from the Endowment Model of Investing, which has several principal tenets. The first is that diversification wins, and Harry Markowitz was right. He proved that when you start with a low-risk asset class, such as bonds, and you add a non-correlated risky asset, such as equities, then the risk of the overall portfolio falls. If you add real estate and venture capital to that portfolio, the risk of the overall portfolio continues to fall. He was awarded the Nobel Prize for this very innovative and counterintuitive construct that adding risky uncorrelated assets to a portfolio actually reduces the risk of the overall portfolio.

The second tenet is that integrating alternative investments into traditional asset classes is very important. We don’t think of hedge funds, private equity or real estate as asset classes. To us, there are only four asset classes — equity, fixed income, currencies and commodities. Real estate and private equity are just other forms of equity or fixed income, depending on how you structure the transaction. Hedge funds are really just a legal structure that enables investment in different asset classes. Some

hedge funds focus on currencies and commodities; others focus only on fixed income or equity. Many people think of alternatives as an asset class to which they allocate only 5% or 10%. The problem with that size allocation is that it doesn’t allow the power of these strategies to complement or offset the traditional long-only portfolio. So our process is to look first at being diversified across our six investment strategies: opportunistic equity, enhanced fixed income, absolute return, private equity, private real estate, and energy and natural resources. Across those six strategies, we will allocate capital in a diversified manner.

We will also have multiple managers within each strategy. Generally speaking, we believe specialty managers have an edge over generalist managers. For example, if you invest in health care only, technology only, Europe only or Japan only, you have an edge versus somebody who is broadly based across U.S. or global equities. Then, we look to diversify by geography, sector, as well as stage and vintage on the private side. We’ll do some venture capital, some growth capital, buyouts and distressed. In the energy and natural resources strategy, we will invest in reserve acquisition, as well as long/short securities. So we’re looking for lots of diversification within each strategy, as well as across strategies.

The last tenet is that talent wins. People manage money, not institutions, and therefore you’ve got to be with the best talent in order to produce the best returns long term. We’ve built relationships over time with managers we believe are the most talented. We’ve negotiated capacity with managers that don’t take new money or are closed to new investors. There’s a great Mark Twain quote, “I’d never join a club that would have me as a member.” It’s true of investments, too. If someone desperately wants your money, you should think twice about giving it to

them, and you should work hard to get access to the people who really don’t need additional capital but are fantastic as managers.

Our investment process is quite disciplined. We have a strategic target and a tactical range for each of our six strategies. We have to stay within those ranges, which forces us to buy into weakness and sell into strength. For example, when we have underperformance in a particular segment of the portfolio, we’ll have to buy more. On the flip side, when we have outperformance, we become overweight and must trim into that strength. So that disciplined process is guided by the overall fundamental principles of diversification, integrating alternatives and talent. Then it’s a discipline of meeting on a weekly basis to talk about which strategies we’re going to allocate new capital to, which managers we think are doing the best, which new managers we want to integrate into the portfolio and which managers we want to trim from the portfolio.

### Highlights

*Mark W. Yusko provides an in-depth overview of his investment strategy and philosophy. Mr. Yusko uses the Endowment Model of Investing, and he says his firm does primarily three things: asset allocation, manager selection and portfolio construction. He says the firm’s funds differ from the competition because they combine hedge funds with private investment strategies, incorporating real estate, private equity, private energy and natural resources. He calls this combination “manager of managers,” a deviation of the fund of funds construct, and he says this approach allows the firm to play different themes. Some of the principles that guide Mr. Yusko’s investments are a positive view of diversification, the integration of alternative investments to traditional asset classes, using multiple specialized managers within each investment strategy and the constant search for investment talent. Looking forward, Mr. Yusko looks to energy and natural resources to hedge against inflation in the developing world, and he looks to have 25% of investments in illiquid assets. Companies include: General Motors Company (GM) and International Business Machines Corp. (IBM).*

**TWST: What type of outcome from a return and risk perspective do large endowments seek?**

**Mr. Yusko:** An endowment has to cover its spending in real terms. Most spending rates are between 4.5% and 5.5%. Then you add on 1% for the cost of running the organization. Thus, most endowments are targeting to achieve 5.5% to 6.5% in real returns. As we have always tried to do better than that to foster a bit of growth, our target has always been 7% real returns in the universities at which I have worked. Furthermore, we wanted to do that with volatility that approximates half the volatility of equities, which is approximately the volatility of fixed income. So you are trying to achieve long-term equity returns over multiple market cycles, not every quarter or every 12 months, but over a long period of time and do it with the volatility of 7% to 8% as opposed to the 16% to 17% volatility of equity returns.

*“The real risk for an endowment, a foundation, a wealthy individual or a pension fund, however, is not standard deviation. The real risk is having your purchasing power eroded by inflation or the risk of permanent loss of capital, disappearance of your asset through a bankruptcy, or confiscation or theft. Those are things you are really trying to avoid. Volatility is really not the best measure of true risk.”*

**TWST: How does this apply to other investors? How may pension funds or even wealthy individuals incorporate the endowment methodology through an investment in the Hatteras Multi-Strategy funds?**

**Mr. Yusko:** The way you have to think about it is like this: Most investors are using 70-year-old technology, the capital asset-pricing model, CAPM, the upward sloping security market line (SML). I am a University of Chicago grad, so I love those guys, they were great — Milton Friedman, Gene Fama and all those guys, Nobel laureates and the like, all much smarter than I. It’s a wonderful model, except that it is now old technology. What an upward-sloping SML says is that stocks will always outperform bonds, because you are taking more risk measured by standard deviation. The real risk for an endowment, a foundation, a wealthy individual or a pension fund, however, is not standard deviation. The real risk is having your purchasing power eroded by inflation or the risk of permanent loss of capital, disappearance of your asset through a bankruptcy, or confiscation or theft. Those are things you are really trying to avoid. Volatility is really not the best measure of true risk. People looked at the capital asset pricing model and said, “Okay, if I overweight equities relative to fixed income, then I will outperform over long periods of time.” That old model might have worked for certain periods, it certainly worked in the fourth quarter of last year — stocks have outperformed bonds — but over a long period of time, we have had a transition we can’t ignore. As the developed world became more and more leveraged, the CAPM started to break down.

Today investors have to think about their models. The Endowment model says, “Look, I am not just bound to United States. I am going to look globally. I am not going to be bound to just investing in one type of security, public equities or public fixed income. I am going to invest in the places where I think I can make the best return per unit of risk. Sometimes that will be the private markets; sometimes that will be the public markets.” So we have a value-oriented global perspective, and take advantage of illiquid assets in addition to liquid assets to give us a better long-term return.

If you draw a security market line today with cash at 0%, bonds at 3% and stocks — according to the pundits — maybe making 5%, the straight line that would be upward sloping. However, if your target is to make 8% to 10%, you can mix it up anyway you want — e.g. 60/30/10, 90/10/0, 0/40/60. You can’t get 8% to 10% with 0%, 3% and 5% as your options. So what you have to do is add uncorrelated assets. This was the genius of Markowitz. You add truly uncorrelated assets to your portfolios of stocks, bonds and cash, and your risk declines and your long-term return rises.

So what’s an uncorrelated asset? Think of your house and your neighbor’s house. I know your house is nicer, but the houses will go up and down in value together. They are going to be perfectly correlated because they are in the same neighborhood. If you move across town, the houses will be less correlated. If you move to another state,

they will be even less correlated. If you move to Shanghai, where they need to build 4,000 houses an hour for the next 30 years, the value of your house is probably going to go north because of demand. It will be totally uncorrelated with what goes on in the U.S. So when you add Chinese real estate or Brazilian land aggregation or a Serbian dry cleaner, you are getting uncorrelated performance from your assets, and therefore lower risk. What Markowitz found was that when you add those seemingly risky assets to a diversified portfolio, you actually lower the volatility.

The Hatteras Multi-Strategy funds create a one-stop solution of uncorrelated assets. When you allocate 20% to 25%, adding it to a traditional portfolio of stocks, bonds and cash, you have the potential to lower your risk and volatility. There is no magic in what we do. We just constantly look for the highest and best use for capital. We don’t rely on one asset class to drive returns. We seek assets that are unlinked to the economy. For traditional portfolios of stocks, bonds and cash — which most individuals or pension funds have — they must have economic growth in order to succeed. To have some of your assets in non-economically linked assets or non-U.S.-economy-linked assets that are truly uncorrelated, you can get a better long-term return.

**TWST: Would you describe your strategic allocation to private assets such as private equity, real estate and natural resources? Why do endowments allocate to these illiquid strategies?**

**Mr. Yusko:** As discussed earlier, there are four ways to make money. You can take credit risk, equity risk, illiquidity risk and you can use structure. Long-term historical numbers are 4% for the risk-free rate, 6% for bonds, 11% for equities and 16% for private investments. If you use leverage, you can increase those returns. That was in the past, but we have to buy the future. The future says that the current risk-free rate in the developed world is zero. The best indicator of your 10-year return on bonds is the current yield. If you buy bonds that are yielding 3% and you hold to maturity, you’re going to make 3% per year. We think the return on fixed income may be lower than the long-term average because yields are still low and interest rates could rise.

The second way to make money is by taking equity risk. In the developed world, equity risk is a little dodgy because, we believe, valuations are quite high, especially when you look at the trailing 10-year price-to-earnings ratio, or Shiller p/e for the S&P 500. It doesn't mean the market is going to crash, but when you start from this level of p/e we believe equity returns over the next 10 years are likely to be in the low-single-digits.

The reason endowments embraced illiquidity is because they are never going to touch the bulk of their assets, as they can only spend the gains and the income. That is actually true for most pension funds and many wealthy individuals. Therefore, large endowments will typically build a portfolio that focuses on taking advantage of that illiquidity premium. Since many people are reluctant to take illiquidity risk, investors may be amply rewarded if they do. Endowments allocate to less-illiquid strategies to gain the illiquidity premium. Going forward, because we just came out of the worst recession since the Great Depression, we think the illiquidity premiums could double the long-term average. We believe you could make 10% above equities in private strategies. Thus our strategic allocation to private investments starts from the perspective of wanting to have a quarter of our assets in illiquid assets to capture that illiquidity premium. On a tactical basis we would be overweight private strategies relative to our long-term goals today, versus what our outlook was five years ago. Where five years ago we may have allocated 10% to 15% of our portfolio to illiquid strategies, today we want to be close to our 25% target allocation.

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**TWST: Please tell us about the specific opportunity set that your team sees for private investments today.**

**Mr. Yusko:** You can break down private assets into four buckets: private equity — including venture capital, buyouts and growth capital — private real estate, private energy and private debt. Venture capital is quite interesting to us for the first time in a decade and half. We believe there is a 14-year cycle in venture. The year 1954 brought us the mainframe. In 1968 it was the microchip. In 1982 it was the personal computer. The Internet was in 1996. In 2010 it is the mobile Internet. This trend might be bigger than the last two put together. If you asked people in 1982 if they wanted a personal computer, they'd say, “Why would I ever want that?” If you ask people today if they want a cell phone, they will say, “I already have two.”

While not a lot of debt is available for buyouts, small buyouts are particularly interesting. We have shied away from large buyouts for almost 10 years. They too may become a bit more interesting if banks start lending more, because prices for businesses are cheap. There is a lot of cash on company balance sheets, and prices for strategic assets may be attractive. So buyouts, in general, are reasonably interesting now, and we believe there are nice returns to be made there.

Growth capital, particularly outside of the U.S., for companies that are growing incredibly fast is very interesting. In China today we see the possibility of high returns without taking as much risk, since funds are buying companies for five, six or seven times EBITDA (earnings before interest, taxes, depreciation and amortization), versus multiples in

excess of 20 times EBITDA for some of the big tech companies in the public markets in the U.S. Thus, I believe you can get a big discount to public market valuations with these companies when they are private and later sell them into the public markets.

We particularly like private real estate outside of the U.S., where housing is affordable and an extraordinary number of people are moving into the middle class. The world has never seen anything like this effect before, and housing is going to be an interesting play in specific markets. Moreover, land will be affected. As agricultural land has been converted to residential and commercial property, we've seen volatility in agricultural prices at their highest in four years, and there may not be enough arable land to grow the crops to support a world of nine billion people. Barring a third world war or a plague, there will be nine billion people in 40 years on the planet who will likely have to eat a lot of soybeans. Thus, bean prices in the teens might be around for a while.

We also like private energy, especially energy and natural resources in the ground, oil reserves, gas reserves, gas gathering facilities, oil processing and oil services companies. We want to own anything related to energy and natural resources, as we see unlimited demand and very limited supply. Moreover, there are problems in mining and materials — platinum, palladium, copper. All the easy stuff has been found. Since many banks won't lend to these companies, private debt and mezzanine lenders can make high returns. These coupons compare pretty favorably to munis, corporate and agencies.

**TWST: Is your team positioning for inflation or deflation moving forward? How does your energy and natural resources allocation play into that?**

**Mr. Yusko:** We believe that the world is in a state of biflation. We see inflation in the developing world, primarily through food prices. There are riots related to food in five countries around the world. Inflation is causing increased stress, but demographics also play a role. When a significant portion of the population is younger than 25 years old, we can expect inflation because people are not as productive at 25 as they are at 35, 45 and 55. This is one of the reasons inflation declined in the U.S. from the 1980s into the 2000s. The U.S. became more productive because the Baby Boomers turned 45 and then 55.

On the other hand, we see deflation in the U.S., Japan and Europe. While there has been much talk of inflation in these countries, we haven't seen it. With the GDP deflator still around 1%, we have only experienced deflation. I agree with the view that deflation is still a problem, but there is a threat of rising inflation because of the monetary stimulus created by Quantitative Easing, QE, which is now nearing an end. As more liquidity is pumped into the system the potential for inflation rises only if the banking system is operational. If the banking system doesn't function properly, banks won't lend despite reserve creation. Thus, the stimulus may just go into the reserve system. If there are no loans, there will be no money multiplier, no velocity of money and thus no inflation.

Energy and natural resources is our potential hedge against inflation in the developing world. The demand for raw materials and

commodities is skyrocketing. China in particular realizes this as 400 million Chinese will be joining the ranks of the middle class over the next few years. China will require a lot of raw materials, and so they are beginning to stockpile, leading to investment opportunities. They also can control the price of commodities. If the Chinese let the renminbi float, that could pressure the dollar, change the price of commodities and make it easier for them. They could push the dollar higher, which would hurt commodity prices, allowing them to buy cheaper commodities. So we like the ebb and flow of energy and natural resources today as a hedge against long-term inflation. It presents an opportunity to take advantage of supply/demand imbalances.

**TWST: What about credit opportunities? Is that a big focus for the Hatteras Multi-Strategy funds?**

**Mr. Yusko:** Yes. We believe we did a really good job overweighting credit at the end of 2008. When credit was obliterated in September, October and November, when short selling was banned, and convertible bonds and senior secured debt were massacred — an unintentional byproduct of the ban of short selling of equities — credit strategies were hurt because you couldn't hedge your credits. When there were big mark-to-market losses, we were able to step up at the end of 2008 into 2009 to make really nice returns in distressed debt, convertible bonds and other credit strategies.

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In 2010 a lot of the debt had been kicked down the road due to “extend and pretend.” That debt will start to mature. Companies have started to fail. As that occurs debt will become the new equity, leaving the potential to make a lot of money on the other side. This year, with the announcement of QE2, debt maturities were pushed back even further. Certain companies, particularly those in the REIT market, had negative equity value but still managed to raise new equity from investors. That hurt us a bit, but it's not that we lost money. We just made single- to low-double-digit returns as investors stopped buying the credit and began buying the equity. We believe that in the long term the equity will be worthless, and therefore we will end up owning the companies. We don't, however, expect that will happen until 2012 or 2013.

We also missed how strongly the government would respond to the slowdown in the economy and the breadth of QE. One thing we've learned over the last couple of years is that one of the biggest risks that we all face as investors is government-intervention risk. When the government can change the rules, like they did with **General Motors** (GM) and the unions, and not pay back senior debt holders, or when they can ban short selling, or whether they can print money and buy bad assets from the banks, those things affect the outcome.

We like credit in the long term. In an uncertain world you want to be senior in the capital structure, which means you want to own credit over equity. In the short run, however, the spoils have gone to the equity holders over the last four months of 2010 and into 2011. When we look out into 2012, when the stimulus expires, GDP growth is likely to fall back to 1%, which could be disastrous for

equities but quite good for credit. While we have not yet given up on credit, we have favored equity and hedged equity a bit more, taking our foot off the accelerator on credit.

**TWST: Diversification helps to temper volatility in certain strategy-specific and manager-specific risk. Are there other means by which you seek to measure and manage risk in the portfolio?**

**Mr. Yusko:** Yes. I think this is a really important question, and I love that you used both the words “measure” and “manage” in talking about risk. Most people, when they say the words “risk management,” actually mean “risk measurement.” Often when people measure some form of risk, they measure standard deviation and downside volatility. They think about some quantitative measure of risk and do very little to actually manage risk.

You have to think about the risk of permanent loss and the risk of default, and those risks have to be managed. For example, I think some of the biggest risks are in the municipal bond world. If you have a lot of municipal bonds, there is a lot of risk in your portfolio. You can't measure that the same way you do for traditional equities or investments in diversified portfolios in Asia. Certainly you can manage the risk through diversification. You can hold many different bonds. Yet the better way to manage the risk is to avoid it. Perform good credit analysis. Focus on gaining exposure where you think there is a lower likelihood

of default. Thus, as we think about measuring and managing risk, we try to consider the true risks an investor faces.

We believe that one of the big risks is loss of purchasing power. If you own assets that appreciate at a low rate in this 0%, 3%, 5% world, and if you have a diversified portfolio that's going to compound at 2% or 3% while inflation ends up at 2%, 3% or 4%, you've made no real return or you have a negative real return. So your risk is the erosion of the purchasing power of your assets. Another risk you face as a dollar-denominated investor with most of your assets in dollars is currency erosion. This is a big risk, as the Federal Reserve and the U.S. government enact Quantitative Easing. Therefore, if I have a choice between investing in risk-free rate in China today denominated in renminbi or investing in the risk-free rate in the U.S. in dollars. Not only do I make more — 3% or 4% risk-free in China versus 0% in U.S. — but the likelihood is that renminbi will appreciate versus the dollar, earning another 6% to 8% from the renminbi appreciation. So I can make a much better return because I'm not eroding the purchasing power of my asset as the dollar devalues.

In terms of measuring risk and managing risk, it is one thing to look at Value at Risk, or VaR of X, another thing to calculate the standard deviation of Y and yet another thing entirely to actively manage the risk in my portfolio by owning more of what I call “un-dollars” and less dollars. Or more assets that are not denominated in dollars, assets such as foreign currencies, foreign stocks, foreign bonds and commodities that are priced currencies other than dollars. That is one way to manage the risk of dollar devaluation.

We manage risk both through diversification and due diligence. Our team has 4,000 manager interactions a year. We believe that the way to make fewer mistakes is to have more interaction with the managers, see and interview more people, improve upon interviewing skills and to get better at sourcing. If you put all of your eggs in one basket and that basket falls on the ground, many of your eggs will break. Thus, we tend to be more diversified. We put fewer eggs in any one basket. We watch those baskets closely. We manage the risk in the portfolio by ensuring that the managers, people, process and philosophy remain consistent. If anything changes, we make a change. We actively manage the risk that can come from changes in an organization, changes in philosophy or change in process. As I said, there is a big difference in measurement of risk and management of risk, and I think this was a very important question.

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**TWST: Can a fund such as yours reduce risk too much?**

**Mr. Yusko:** There are really only three broad types of risk. The risk of absolute loss, meaning someone steals your money or the company disappears. You can't recover from that permanent loss of capital. Therefore, nobody wants exposure to that type of risk. Secondly, there is risk in the form of volatility of returns, stemming from mark-to-market valuations. For example, in 2008 we bought many credit assets that were senior in the capital structure and very secure at \$0.80 on the dollar, thinking they should be at par or in some cases par-plus accrued interest, so \$1.03 or \$1.04. Then the changes in short-selling rules and mark-to-market enforcement rules appeared. Suddenly those assets got marked down to \$0.60, \$0.50, \$0.40. So in the fourth quarter of 2008 the risk looked terrible. It looked like there was a lot of risk and losses in the portfolio. Yet the losses weren't true losses. Rather, they were mark-to-market losses. We didn't sell most of those assets, which are now maturing at par, or in many cases par-plus accrued interest. Therefore, if we paid \$0.80 and we sell at \$1.00, how much did we lose? Nothing. We actually made money, but it sure looked like there was a loss. It sure looked like there was risk in the short run in 2008.

To assess the third type of risk, you can ask yourself if you have too much exposure to any single factor — equity, fixed income, default risk. Equities are a contingent claim as opposed to a contractual claim, meaning if there is no money left over at the end of the day, you don't get paid and you lose your investment. That is what happened with **General Motors** and **Chrysler**. The equity disappeared despite the fact that the company didn't disappear, and the bond holders became the new equity holders.

One of the things we tend to hear in the marketplace is that we have dialed down our volatility or risk too much. The point, in fact, is that the whole idea of investing is to minimize the volatility of returns, keeping exposure to the positive risk factors that create long-term returns — credit risk, equity risk, liquidity risk and structure. If you can create the same return profile with lower volatility, you achieve more wealth over the long term. Therefore the answer to your question is that I don't think that you can dial down risk too much. I think what you have to remember, as we talked about in the last ques-

tion, measuring risk versus managing risk. If your idea of risk is just standard deviation of returns, you are missing the point. The true risk for investors is loss of capital and the destruction of their assets through inflationary devaluation of the currency.

**TWST: How much do you think investors should allocate to alternative investment strategies within their overall portfolios?**

**Mr. Yusko:** Often, certain people don't like alternative things — alternative medicine, alternative education and alternative music. So they are hesitant to put money into alternative things because they want to invest money in traditional vehicles. In the end, I don't believe alternative investments actually exist. I believe there are only four types of investments we can own: equity, debt, currency and commodities. Derivatives draw value from the stocks, bonds, currency or commodity, and therefore are a mechanism to gain exposure to one of the four investment classes

rather than a separate classification. In comparing hedge funds to mutual funds, some people think of mutual funds as traditional and hedge funds as alternative. Regardless of how investors own shares of **IBM** (IBM) stock — i.e. in a mutual fund, a hedge fund, a separate account or private partnership — they still own stock. Different investors may pay different fees and have different lockup or liquidity terms, but it doesn't change the fact that they still own stock. Alternatives, therefore, merely have a different structure. They represent different ways to access one of the four investment types.

What I believe is truly alternative is the correlation pattern of different investment strategies. There will be different return patterns across the strategies — e.g. long/short strategy versus a long-only strategy — regardless of the instrument — equity, credit, currency or commodities. There will be lower correlation to traditional investments, which, as discussed earlier, lowers the risk of the overall portfolio by lowering the volatility. Thus, if the question posed is, “How much of a portfolio should you allocate to alternatives?,” and since I believe that alternatives merely provide structure to access the four different types of investments, then my answer is “all of it” as an alternative just provides better access to stocks, bonds, currencies and commodities.

We want to manage a portfolio such that it has low expenses, traditional equities, traditional fixed income, a large portion of low volatility strategies, hedged strategies and a large position in private strategies that take advantage of illiquidity premium. I'd recommend that every portfolio should have three buckets. First, each portfolio should have a liquidity bucket of 10% to 15% in cash and short-duration fixed income to cover your lifestyle expenses. This bucket should cover two years of spending. If you spend 5%, this bucket should encompass 10%; if you spend 7%, make the bucket 14%. I would recommend between 10% and 15% in pure liquidity. The second bucket we suggest is a speculative bucket, comprised of 10% to 15% in concentrated stock positions of a friend's venture capital deal or a cousin's real estate deal. Keep it small. The final bucket is a core bucket that encompasses 70% to 80% of the portfolio. This bucket, I believe, should be half traditional long-biased assets that are more dependent on the economy, and half strategies that are not as dependent on the economy and are dependent on the manager's

skills — hedged strategies, private strategies, etc. Therefore, if you put all of that in context, believing that an average portfolio is 60% stocks, 30% bonds and 10% cash, I would argue that an average portfolio should consist of 5% cash, 10% bonds, 40% in less-correlated alternative strategies similar to that of the Hatteras Multi-Strategy funds and 45% equities.

**TWST: Your team seeks opportunity globally. What regions or strategies are the most exciting over the next five years?**

**Mr. Yusko:** I think global investing is critical today. We are all interconnected. Interest rates in the U.S. don't just affect the U.S. Bond yields in Brazil don't just affect Brazil. Equity returns in China don't just affect China. You have to think globally, consider opportunity cost, and contemplate upside and downside from a truly global perspective. If you take a value discipline or value approach to investing, you will seek to allocate capital on a global basis where there is a high margin of safety, where you will pay low prices rather than high prices and where you can capitalize on structural advantages of different marketplaces. If you are investing for growth, go where there is growth. We expect most of the growth over the next 40 years to come from South America, the Middle East, Northern Africa and China/India. We don't expect much economic growth in the U.S., Europe and Japan. If you're investing for low volatility, safety and security, seek places where there is less debt. The component with the highest weighting in a bond index is the company or the country that has most debt, but you want to buy debt of companies or countries that don't have a lot of debt, that use debt appropriately. You want less debt of companies or countries facing bankruptcy, where there is risk of default.

*“Unless there is a third world war or a plague, there will be nine billion people on the planet in the next 40 years, and those people will eat soybeans. So let's own some exposure to soybeans by owning land in places where you can have four times the growing season. In fact, many farmers from Illinois are moving down to Brazil to grow soybeans.”*

As we look around the world today, we couldn't be more excited. While I often hear it said that I am quite bearish, I'm only bearish on the things that most people love. I'm bearish long term on prospects for the U.S., Europe and Japan. I think these countries have a huge demographic headwind, as well as pricing headwind. I don't believe there is an imminent crash, but I do think we will have dead money for another decade. Therefore we must look elsewhere. Look at growth capital businesses in China, where we can buy private Chinese businesses that are growing rapidly and pay lower multiples of earnings instead of much higher multiples in the public markets.

As discussed earlier, I believe that unless there is a third world war or a plague, there will be nine billion people on the planet in the next 40 years, and those people will eat soybeans. So let's own some exposure to soybeans by owning land in places where you can have four times the growing season. In fact, many farmers from Illinois are moving down to Brazil to grow soybeans.

We are seeing opportunities in mining, materials, and other real assets — e.g. oil, gas, platinum, etc. Palladium is an interesting opportunity, as it is estimated that China could put 18 million cars and trucks on the road this year. In fact we estimate that China will put more cars and trucks on the road over the next 30 years than did the entire automotive industry in the U.S. throughout history. China will use catalytic converters. Also, in 2014, the new U.S. Clean Air Act will go into effect. Trucks in the U.S. will also have to use new catalytic converters, which are bigger and have more platinum and palladium. We think of

gold, silver and other precious metals as a store of value, but you don't just have to own gold. Rather, you can own mining companies in Chile, processing plants in South Africa or natural gas gathering facilities or power plants that produce electricity to mine the silver and gold in Argentina. There are many of ways to invest in these strategies.

Thinking broadly, we favor credit in the developed world. We recommend moving up the capital structure, avoiding equity and owning credit where there is bank debt, secured debt and mezzanine lending. Buy distressed assets from the bank as they come into market. There are plenty distressed assets, particularly real estate assets, on the books at the banks that will have to be sold over next few years. We will buy those. We like equity in the developing world, as we expect growth there. We look at public market selectively. As it appears a bit pricey to us, we've been selective, looking for better prices and a higher margin of safety. The long-term view in places like Russia, where the bulk of the public assets are in the commodity space, is positive because we like commodities. Overall, thinking of the four ways to make money — taking credit risk, equity risk, illiquidity risk and using structure — we like illiquidity risk best. We want to be overweight in less-liquid investments.

One of the nice things about the Hatteras Multi-Strategy funds strategy is that you can gain access to a fully diversified private portfolio plus all of the new deals that our managers are going to do. You don't have to lock your money up for a decade. So thinking about opportunities today, go senior in the capital structure in places there is too much debt, move down in the capital structure and equity markets

— and particularly private equity markets — where there is lot of expected growth, own commodities as a hedge against future inflation and devaluation of the major currencies, and stay broadly diversified. Build a portfolio with three buckets: liquidity, a small “get rich” bucket, and put most of your money in the “stay rich” bucket. That is how we look at the world.

**TWST: Thank you. (MJW)**

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*The Hatteras Multi-Strategy Fund, L.P.; the Hatteras Multi-Strategy TEI Fund, L.P.; the Hatteras Multi-Strategy Institutional Fund, L.P.; and the Hatteras Multi-Strategy TEI Institutional Fund, L.P. (collectively referred to herein as the “Hatteras Multi-Strategy Funds” or the “Funds”) are Delaware limited partnerships that are registered under the Investment Company Act of 1940 (the “1940 Act”), as amended, as non-diversified, closed-end management investment companies whose units are registered under the Securities Act of 1933, as amended. The Hatteras Multi-Strategy Funds are funds of alternative investments. As such, the Funds invest in private hedge funds and private equity investments. Hedge funds are speculative investments and are not suitable for all investors, nor do they represent a complete investment program. A hedge fund can be described generally as a private and unregistered investment pool that accepts investors’ money and employs hedging and arbitrage techniques using long and short positions, leverage and derivatives, and investments in many markets.*

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*Key Risk Factors: The Funds, through an investment in the Master Fund, will invest substantially all of their assets in underlying funds that are generally not registered as investment companies under the 1940 Act and, therefore, the Funds will not have the benefit of various protections provided under the 1940 Act with respect to an investment in those underlying funds. The Funds can be highly volatile, carry substantial fees, and involve complex tax structures. Investments in the Funds involve a high degree of risk, including loss of entire capital. The underlying funds may engage in speculative investment strategies and practices, such as the use of leverage, short sales, and derivatives transactions, which can increase the risk of investment loss. The Funds provide limited liquidity, and units in the Funds are not transferable. Liquidity will be provided only through repurchase offers made by the Funds from time to time, generally on a quarterly basis upon prior written notice.*

*The success of the Funds is highly dependent on the financial and managerial expertise of its principals and key personnel of the Funds’ investment managers. Although the investment managers for the Funds expect to receive detailed information from each underlying fund on a regular basis regarding its valuation, investment performance, and strategy, in most cases the investment managers have little or no means of independently verifying this information. The underlying funds are not required to provide transparency with respect to their respective investments. By investing in the underlying funds indirectly through the Funds, investors will be subject to a dual layer of fees, both at the Funds and underlying fund levels. Certain underlying funds will not provide final Schedule K-1s for any fiscal year before April 15th of the following year. Those funds, however, will endeavor to provide estimates of taxable income or losses with respect to their investments.*

*Please see the Prospectus for a detailed discussion of the specific risks disclosed here and other important risks and considerations.*

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