Investment Primer: Alternative Mutual Funds

Global Investment Management Analysis

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Evaluating Alternative Mutual Funds

Following a six-year bull-run in equities and an unprecedented decline in interest rates, investors are increasingly considering alternative investments as a way to help diversify the risks in their portfolios. The proliferation of alternative mutual funds now offer this option to the mass affluent as well as to high net worth investors. This has created a need for education with regard to the opportunities and limitations these funds present as compared to traditional hedge funds.

In this primer, we discuss the recent growth of alternative mutual funds and our approach to selecting alternative mutual funds and private hedge funds for Morgan Stanley Wealth Management clients. We will also share our insights as to how clients, depending on the investment strategy and eligibility, could utilize both alternative mutual funds and traditional hedge funds.

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What Are Alternative Mutual Funds?

During the last few years, the proliferation of alternative mutual funds has sparked much discussion within the asset management industry on a range of issues from fund structures to the quality of managers when compared with traditional private hedge fund offerings. Within Global Investment Management Analysis (GIMA), we have keenly observed this debate and have examined a variety of managers in both private and mutual fund vehicles. Based on our evaluation of managers in either structure, we have discovered like most investment options, there are tradeoffs. As such, there are a variety of considerations ranging from investment, operational and regulatory factors when evaluating a particular structure for clients (see Exhibit 1).

The potential benefits from alternative mutual funds are similar to those of private hedge funds even though mutual funds operate under the Investment Company Act of 1940 while hedge funds are exempt from registration and subject to less regulation. Alternative mutual funds seek to deliver differentiated returns compared with traditional long-only investments with potentially lower volatility and correlation to the broader capital markets. Returns are ordinarily sought through some combination of beta, or exposure to the market, and alpha, or manager skill. This can be accomplished through long and short investments, leverage and less-conventional investment strategies. Alternative mutual funds generally seek to limit market volatility, drawdowns and provide the potential for a smoother return stream when compared with long-only strategies.

New Demand for Alternatives

In the years since the baby boomers have begun to retire, there has been large growth in the mass affluent class, those with $100,000 to $1 million in liquid assets. Investors from the two groups, retirees and the mass affluent, previously sought to diversify their portfolio with the relative stability of fixed income investments, but due to ultra-low interest rates in place since the financial crisis, they are looking to reallocate within their portfolios. History shows that alternatives can increase return potential and reduce the risk of a balanced stock-and-bond portfolio. However, implementing alternatives was not always easy as hedge fund strategies have typically been restricted to high net worth and institutional investors who can meet high minimum-investment and net-worth eligibility requirements as well as being subject to liquidity restrictions. Alternative mutual funds allow access to a range of hedge fund strategies without specific net worth requirements and with daily liquidity.

Asset managers recognize the opportunity, and are launching alternative mutual funds. In 2014, there were 493 alternative mutual funds, up from 171 in 2008, according to Morningstar. Assets under management (AUM) in these funds were $170 billion at year-end 2014 (see Exhibit 2, page 3). In 2013, only 7% of retirement plans offered alternative mutual funds, according to Aon Hewitt, a benefits consulting firm. However, the firm reported that 25% of plan sponsors are looking to add alternative mutual funds. Given the demographic shift and concerns with traditional long-only asset classes after a multi-year bull market in equities and the historically low interest rate back-drop, we expect this growth to continue as established asset managers continue to put alternative investments in mutual fund structures.

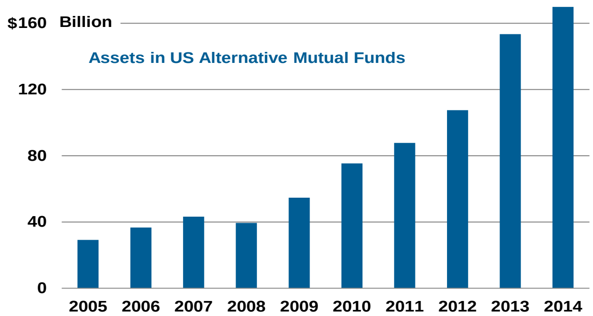
Despite the headline growth as a mutual fund category, alternative mutual funds are still relatively young—as only 55% of the funds have track records of three or more years according to Morningstar. Similar to flows seen in hedge funds, most of the growth within the industry has been top heavy, with larger

Exhibit 1: Comparing Alternative Mutual funds and Private Hedge Fund Offerings

		Alternative Mutual Funds	Private Hedge Fund Offerings
Investment	**Style**	Varies by Strategy	Varies by Strategy
	Flexibility	Limited Investment Flexibility	Greater Investment Flexibility
	Derivatives	Limited Use of Derivatives	Greater Ability to Use Derivatives
	Leverage	Limited Use of Leverage	Greater Ability to Use Leverage
	Transparency	High	Generally Low
	Liquidity	Generally Liquid Securities	Generally Liquid and Less-Liquid Securities
Operations	**Minimums**	Low	High/Private Investors Qualifications
	Fees	Typically Asset-Based Management Fees	Typically Management and Performance Fees
	Tax Reporting	IRS Form 1099	Typically IRS Form K-1
	Redemptions	Generally Daily	Limited Opportunity to Redeem
Regulatory	**Oversight**	1940 Act Restrictions	Limited SEC Oversight
	Diversification Requirements	Position Sizes, Sector Exposure, etc.	None—Diversification Varies Widely

Source: Morgan Stanley Wealth Management, Global Investment Management Analysis

Exhibit 2: Strong Asset Growth in US Alternative Mutual Funds



Source: Morningstar as of Dec. 31, 2014
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managers garnering the bulk of the inflows. Just 14% of the funds have more than $500 million in AUM.

Outcomes-Oriented Framework

In 2014, the Global Investment Committee (GIC) introduced an outcomes-oriented approach to alternatives in order to help align various asset class strategies with client objectives (see Exhibit 3). In its due diligence role, GIMA works to identify appropriate managers for actual implementation. The GIC outlined five primary client goals: capital preservation, income, balanced growth, market growth and opportunistic growth. Most traditional hedge fund and alternative mutual fund strategies aim at one of the middle three primary client goals—income, balanced growth and market growth—which we believe can act as an attractive addition to purely fixed income investments, 60% equity/40% fixed income mixes and equities, respectively, especially in the current low rate environment.

When comparing alternative mutual funds and private hedge funds, factors such as leverage and illiquidity can impact specific manager classification with each of the objectives. It is important to recognize that not all alternative investment managers are alike within strategy categories, particularly as mutual funds have leverage and liquidity restrictions that traditional hedge funds do not have.

Vehicle Selection: Mutual Fund or Hedge Fund?

The debate surrounding alternative mutual funds typically focuses on the quality of the managers themselves compared with their traditional hedge fund peers. In the open-end fund world, this argument is most often settled by evaluating fund performance versus a benchmark or peer group. With traditional alternatives, benchmarking is less definitive. From an analytical standpoint, GIMA strives for an objective assessment to determine manager quality and evaluate a variety of factors before making a decision as to what may be the more favorable fund. Regardless of the investment vehicle, we aim to find managers who we believe have

Exhibit 3: The GIC's Framework for Using Alternative Investments

Client Goals	Primary Traditional Assets	Alternatives' Portfolio Main Purpose	Recommended Alternative Assets	Strategy	Client Goal Suggested Benchmark
Capital Preservation	Cash, Money Market Fund Short Duration Bonds	Inflation Protection	Real Assets	TIPs, REITs, MLPs, Commodities	CPI Plus
Income	Bonds, High Yield, Equity, Convertibles, Preferred Stocks	Income/Cash-Flow Preservation	Total Return Assets	Equity Market Neutral, Relative Value, Low Duration, Credit Long/Short	T-Bill or LIBOR Plus
Balanced Growth	60%/40% Equities/Bonds	Volatility Reduction	Equity Hedge Assets	Global Macro, Managed Futures, Hedge Fund of Funds, Multistrategy	Risk-Adjusted 60%/40%
Market Growth	S&P 500 Plus	Equity Diversification	Equity Return Assets	Equty Long/Short, Event Driven	Risk-Adjusted S&P 500 Plus
Opportunistic Growth	80% Plus Equities	Growth Amplification	Opportunistic Assets	Private Real Estate, Private Equity, Venture Capital, Impact, Collectibles	Customized

Source: Morgan Stanley Wealth Management, Global Investment Management Analysis
The Global Investment Committee's Outcomes Framework for Alternatives is not provided as part of an investment advisory service offered by Morgan Stanley Wealth Management, is not available to be directly implemented as part of an investment advisory service and should not be regarded as a recommendation of any Morgan Stanley Wealth Management investment advisory service.

the ability to deliver alpha.

For some clients, eligibility barriers[1], liquidity, tax treatment and fund transparency make mutual funds the only alternatives option. When the client is eligible to purchase traditional hedge funds as well as alternative mutual funds, a number of factors should be considered.

Many private hedge funds typically charge a 1.5%-to-2.0% annual management fee plus a performance fee, usually 20% of the profits. In contrast, alternative mutual funds charge fees for management and other expenses, which generally range between 1.0% and 2.0% annually[2]. Certain structures such as funds of hedge funds and managed futures may also involve additional fees. Traditional hedge funds allow for only monthly, quarterly or annual redemptions—sometimes even longer—and often they have an initial lock-up period. A primary reason to restrict liquidity is to allow fund management to execute its investment strategy and meet redemptions in a manner that does not adversely impact the investment strategy. With alternative mutual funds, investors can redeem shares daily so fund managers have to adjust their investment strategy to be able to satisfy daily redemptions.

The more subjective reasons for higher fees and illiquidity center on the perceived manager skill—can the manager deliver returns and more specifically, generate enough alpha to justify limited liquidity and higher fees? As the argument goes, there are few managers so altruistic as to shun higher fees if they can rightfully justify them with their performance. Accordingly, we always evaluate performance net of fees and believe higher fees can be justified in some cases.

Not surprisingly, investors are likely to demand a higher return if they're going to cede the ability to access their capital at will—this is what we refer to as the "illiquidity premium." The illiquidity premium can vary across the alternatives landscape from hedge funds to private equity. Assuming an equal amount of risk, the longer the illiquidity of the investment, the higher this premium should be.

A 2013 Cliffwater LLC study of managers who ran both traditional hedge funds and alternative mutual funds suggested that the cost of liquidity was, on average, approximately 100 basis points per year. The study determined that the illiquidity premiums varied from roughly 40 basis points for more-liquid strategies such as managed futures to more than 200 basis points for less-liquid strategies such as multistrategy funds.

[1] In order to be eligible for private funds investors need to meet certain requirements which may include income or net worth qualifications.
[2] An investor in a brokerage account will pay a sales charge while an investor in an advisory account will pay advisory fees.

Strategy and Manager Selection

Liquidity and manager skill should inform the choice of investment vehicle. With more liquid strategies such as those trading equities, commodities or options, the illiquidity premium should be relatively low. On the other hand, strategies that bear illiquidity or leverage risk such as event driven and relative value may be more effective in a hedge fund structure. Regardless of the vehicle, GIMA believes the manager-selection decision to be paramount in finding alternative investment funds that can deliver alpha and meet client objectives.

To find offerings for our advisory platform, we perform an extensive evaluation of both investment managers and their strategies. However, when simplifying the comparison of alternative mutual funds and traditional hedge funds, we focus on the illiquidity premium and manager skill. This informs the manager selection decision in several ways. For alternative investment managers who run liquid strategies in both a mutual fund and private investment structure, the key determinant is manager skill as the underlying strategies could typically fit in either investment vehicle.

However, less-liquid strategies rely on manager skill and the illiquidity premium. As such, we contend there is more overlap in peer group analysis, when considering liquid strategies in alternative mutual funds and traditional hedge funds, such as comparing two equity long/short or managed futures funds. For less-liquid or more-leveraged strategies, we prefer to primarily focus on manager selection in traditional hedge funds as it would be difficult to make an apples-to-apples comparison of a credit-focused hedge fund and a credit-focused alternative mutual fund because of the differences in the underlying investments and use of leverage.

By way of example, let's consider two long/short equity funds focused on large-to-mid-cap stocks, which are running 150% gross exposure and 30% net long exposure[3]. Given the low leverage and inherent liquidity of mid-to-large-cap stocks, we believe this strategy could in all likelihood be run in either a mutual fund or hedge fund structure. From a manager selection perspective, we believe the strategy would need to deliver an illiquidity premium if it was in a hedge fund structure. This should inform the manager selection decision when comparing strategies in each format as we should expect a long/short equity hedge fund manager to maintain a higher return than an alternative mutual fund with a similar risk level.

[3]Gross exposure calculated as 90% long plus 60% short equals 150% gross exposure. Net exposure calculated as 90% long minus 60% short equals 30% net long.

Exhibit 4: Comparing Performance of Alternative Mutual Funds and Hedge Funds

Funds/Index	Number of Funds	Annualized Performance (%)	Difference*	Annualized Standard Deviation (%)	Difference*	Return/Risk**	Difference*
Morningstar Long/Short Equity* **	54	6.91		4.85		1.42	
HFRI Equity Hedge Index	802	7.72	0.81	5.81	0.96	1.33	-0.10
Morningstar Managed Futures* **	19	0.10		4.96		0.02	
HFRI Macro Systematic Diversified Index	157	2.27	2.17	6.29	1.33	0.36	0.34
Morningstar Multialternative* **	50	2.77		3.04		0.91	
HFRI Fund of Funds Composite Index	385	5.68	2.91	3.18	0.14	1.79	0.87

*Hedge fund less mutual fund returns. **Performance divided by standard deviation. ***Simple average of reported fund returns.
Source: HFRI, Morningstar, Morgan Stanley Wealth Management GIC as of Dec. 31, 2014
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By comparison, an event-driven credit fund focused on distressed investments could not be placed in a mutual fund structure as there would be an inherent asset/liability mismatch in trying to offer daily liquidity. In addition, regulatory restrictions generally make holding illiquid assets in a liquid vehicle prohibitive. As such, the manager selection decision for this type of strategy would be confined to traditional hedge funds. A comparison of a credit fund in the two formats would be difficult because it is unlikely those funds would hold similar assets and risk levels.

Performance of Alternative Mutual Funds

Given the lack of long-term performance data for many alternative mutual funds, it is challenging to compare their longer-term returns and risk with those of traditional hedge funds. In addition, given the leverage and liquidity constraints imposed on mutual funds, it would not be a fair comparison when analyzing certain strategies versus one another without considering these differences. Further complicating comparison is differences in fee structures between alternative mutual funds and traditional hedge funds mentioned earlier.

Caveats aside, we compared the three-year performance and volatility (January 2012 through December 2014) using Morningstar averages for mutual funds and HFRI indexes for hedge funds (see Exhibit 4). In the long/short equity category, the performance of the Morningstar long/short equity average was 6.91% annualized versus 7.72% for the HFRI Equity Hedge Index; the volatility of the Morningstar average was 4.85% versus 5.81% for the HFRI Index. In managed futures, the Morningstar managed futures fund average returned 0.10% versus 2.27% for the HFRI Macro Systematic Diversified Index, our benchmark for futures funds; for volatility, the two indexes were 4.96% and 6.29%, respectively. Finally, we looked at the multimanager/fund-of-funds categories: the Morningstar Multialternative average returned 2.77% versus 5.68% from the HFRI Fund of Funds Composite Index. Volatility of the two multimanager indexes was similar at 3.04% and 3.18%, respectively.

In each of the three examples, the hedge fund index beat the Morningstar peer group. In the case of the Morningstar long/short equity and Morningstar managed futures averages, the underperformance came with less volatility. We also observe in anecdotal manager reviews that alternative mutual funds employing equity long/short and managed futures strategies tend to use less leverage or target lower volatilities than hedge funds. One needs to evaluate each manager, regardless of the fund format, on return per unit of risk. As such, when accounting for the illiquidity premium and increased risk typically associated with private hedge funds, the absolute and risk-adjusted returns for liquid strategies may be more similar over time.

In the case of the Morningstar multialternative fund average, the underperformance could be attributed to a variety of factors. We believe this performance gap should exist, as a fund comprised of hedge funds has less liquid and more leveraged strategies than mutual funds. So long as clients are not constrained by liquidity, we believe that private fund-of-funds offerings may be able to deliver superior returns over time as they are able to capture both the illiquidity premium and the premium associated with investing in the top hedge fund managers.

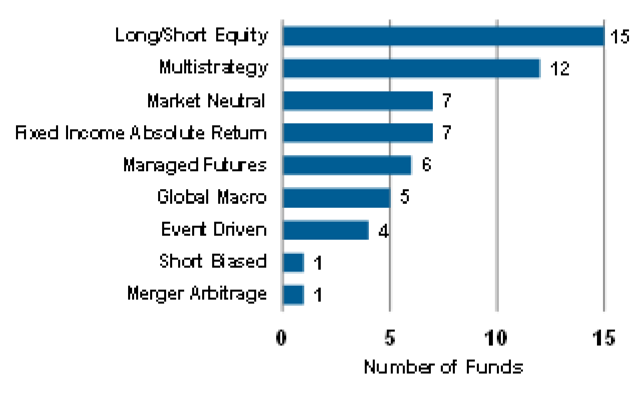
Can this large gap persist? After all, less-liquid strategies such as credit and event-driven and more-leveraged, relative-value strategies have performed well during the past few years, which has helped hedge fund-of-funds outperform multimanager alternative mutual funds. To the extent liquid strategies such as equity long/short outperform less liquid strategies, we might expect to see multimanager mutual funds compete better with private offerings.

Growth of the Advisory Platform

Given the growth in alternative mutual funds during the past few years, the numbers of funds offered through Morgan Stanley Wealth Management's advisory platform has increased. GIMA evaluates mutual fund managers through the same lens we evaluate private hedge funds and fund of funds, and divides managers into two broad categories, "Single Manager," those managers investing directly in the markets and "Multimanager," those who select third-party managers. Funds are also segmented by their respective strategy classifications. Although track records of alternative mutual fund managers are generally shorter than those of private funds, in many cases, managers entering the alternative mutual fund arena have run similar strategies in other vehicles, giving us relevant track records to evaluate.

Since June 2014, the roster of approved alternative mutual funds has increased to 58 from 30 managers (see Exhibit 5, page 6). In large part, this increase is due to a large number of what we believe to be high-quality managers entering the business. Despite the growth, we believe there is room for the continued addition of high-quality alternative mutual funds, especially in the categories in which leverage and liquidity constraints are low. In an effort to better align benchmarks for alternative mutual funds, GIMA changed the benchmarks of various alternative mutual funds that we use in our analysis. For a majority of the funds, GIMA has elected to the use the relevant HFRX hedge fund index as a more representative comparison. GIMA believes the newly assigned benchmark would generally be a better comparison of the fund's strategy, performance and risk characteristics with other managers having similar objectives and liquidity profiles.

Exhibit 5: Categories of Alternative Funds on the MSWM Advisory Platform



Source: Morgan Stanley Wealth Management as of May 13, 2015

Conclusion

Growth in the number of available alternative mutual funds has presented investors with more options to diversify their portfolios. This should benefit mass-affluent clients who now have a way to access alternative investment strategies traditionally available for only high net worth or institutional investors. In addition, larger investors who have certain liquidity, transparency, tax and other preferences now have an easier way to incorporate alternative investments in their portfolios. We anticipate the roster of approved alternative mutual fund managers will continue to grow as we expect more skilled managers will adapt their strategies for mutual funds. We believe in a format-agnostic approach to selecting funds that can potentially achieve specific investment outcomes, not in an either/or decision prefaced by the vehicle itself. ■

Index Definitions

CONSUMER PRICE INDEX This index examines the weighted average of prices of a basket of consumer goods and services.

HFRI EQUITY HEDGE INDEX This index tracks 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% exposure to, and may in some cases be entirely invested in, equities, both long and short.

HFRI FUND OF FUNDS INDEX This index tracks investment managers who trade a broad range of strategies in which the investment process is predicated on movements in underlying economic variables and the impact these have on equity, fixed income, hard currency and commodity markets. Managers employ a variety of techniques, both discretionary and systematic analysis, combinations of top down and bottom up theses, quantitative and fundamental approaches and long and short term holding periods. Although some strategies employ relative value techniques, macro strategies are distinct from relative value strategies in that the primary investment thesis is predicated on predicted or future movements in the underlying instruments, rather than realization of a valuation discrepancy between securities. In a similar way, while both macro and equity hedge managers may hold equity securities, the overriding investment thesis is predicated on the impact movements in underlying macroeconomic variables may have on security prices, as opposed to equity hedge, in which the fundamental characteristics on the company are the most significant are integral to investment thesis.

HFRI MACRO SYSTEMATIC DIVERSIFIED INDEX The strategies in this index have investment processes typically based on mathematical, algorithmic and technical models, with little or no influence of individuals over the portfolio positioning. Strategies which employ an investment process designed to identify opportunities in markets exhibiting trending or momentum characteristics across individual instruments or asset classes. Strategies typically employ quantitative process which focus on statistically robust or technical patterns in the return series of the asset, and typically focus on highly liquid instruments and maintain shorter holding periods than either discretionary or mean reverting strategies. Although some strategies seek to employ countertrend models, strategies benefit most from an environment characterized by persistent, discernable trending behavior. These strategies typically would expect to have no greater than 35% of portfolio in either dedicated currency or commodity exposures over a given market cycle.

S&P 500 INDEX this capitalization-weighted index includes a representative sample of 500 leading companies in leading industries in the US economy.

Glossary

ALPHA measures the difference between a portfolio's actual returns and its expected performance, given its level of risk as measured by Beta. A positive Alpha figure indicates the portfolio has performed better than its Beta would predict. A negative Alpha indicates the portfolio's underperformance given the expectations established by the Beta. The accuracy of the Alpha is therefore dependent on the accuracy of the Beta. Alpha is often viewed as a measurement of the value added or subtracted by a portfolio's manager.

BETA Measures a portfolio's volatility relative to its benchmark. A portfolio with a Beta higher than 1.0 has historically been more volatile than the benchmark, while a portfolio with a Beta lower than 1.0 has been less volatile. The accuracy of the Beta is dependent on R-Squared.

CORRELATION This is statistical measure of how two securities move in relation to each other. This measure is often converted into what is known as correlation coefficient, which ranges between -1 and +1.Perfect positive correlation (a correlation coefficient of +1) implies that as one security moves, either up or down, the other security will move in lockstep, in the same direction. Alternatively, perfect negative correlation means that if one security moves in either direction the security that is perfectly negatively correlated will move in the opposite direction. If the correlation is 0, the movements of the securities are said to have no correlation; they are completely random. A correlation greater than 0.8 is generally described as strong, whereas a correlation less than 0.5 is generally described as weak.

EXCESS RETURN This term represents the average quarterly total return of the portfolio relative to its benchmark. A portfolio with a positive excess return has on average outperformed its benchmark on a quarterly basis. This statistic is obtained by subtracting the benchmark return from the portfolio's return.

SHARPE RATIO Measures a portfolio's rate of return based on the risk it assumed and is often referred to as its risk-adjusted performance. Using Standard Deviation and returns in excess of the returns of T-bills, it determines reward per unit of risk. This measurement can help determine if the portfolio is reaching its goal of increasing returns while managing risk.

STANDARD DEVIATION This statistical quantifies the volatility associated with a portfolio's returns by measuring the variation in returns around the mean return. Unlike beta, which measures volatility relative to the aggregate market, standard deviation measures the absolute volatility of a portfolio's return.

VOLATILITY This is a statistical measure of the dispersion of returns for a given security or market index. Volatility can either be measured by using the standard deviation or variance between returns from that same security or market index. Commonly, the higher the volatility, the riskier the security.

ALTERNATIVE FUND CATEGORIES

Diversified Arbitrage strategies employ a number of different types of arbitrage strategies, including merger arbitrage, convertible arbitrage, and fixed income arbitrage.

Equity Market Neutral strategies attempt to reduce investors' exposure to equity market risk factors by being simultaneously long and short stocks in matched equity portfolios. The portfolios attempt to be beta or currency neutral, or both. Leverage may be used to potentially enhance returns.

Event Driven (includes Merger Arbitrage) strategies attempt to benefit from pricing inefficiencies that are a result of a corporate event, such as a merger, acquisition, spinoff, or bankruptcy.

Fixed Income Absolute Return invests in fixed income securities (long, short or both) and/or fixed income arbitrage (exploiting pricing anomalies in similar fixed income securities) opportunities, usually along with the use of leverage.

Global Macro, Tactical Asset Allocation, Global Tactical Asset Allocation strategies base their investment decisions on macro views of various markets around the globe. These strategies often consider how various economic and political forces could affect markets, and may invest long and short in equities, fixed income, currencies, and futures. Similarly, global tactical asset allocation strategies take a top-down view in an attempt to add value; however, they tend to be more diversified and have greater risk controls.

Long/Short Equity Long/short strategies invest both long and short to benefit from rising stock prices on the long side and declining stock prices on the short side. Ideas are typically sourced through security analysis, although also may use top down macro analysis of sectors, industries, countries, etc. Some strategies focus on certain sectors or industries or in style categories, as well long term or short term trading styles. Long/short strategies often try to mitigate volatility by diversifying and/or hedging positions across various sectors, industries, regions, and/or market capitalization. These strategies may also hedge against market risk or attempt to be market neutral.

Managed Futures strategies invest long and short in futures and forward contracts on equities and fixed income securities, currencies, and commodities. The strategies typically utilize proprietary trading strategies designed to provide long or short trading signals. Trades may be short, medium, or long term. Managed futures funds have been one of the fastest growing sub-segments over the past few years.

Merger Arbitrage strategies employ an investment process primarily focused on opportunities in equity and equity related instruments of companies which are currently engaged in a corporate transaction.

Multi-alternative (or Multi-Strategy) strategies invest in a number of different types of alternatives. Allocations to different types of strategies may change over time and may include both traditional and alternative assets.

IMPORTANT NOTICE REGARDING COMPLEX PRODUCTS

The type of mutual funds and ETFs discussed in this paper utilize nontraditional or complex investment strategies and/ or derivatives. Examples of these types of funds include those that utilize one or more of the below noted investment strategies or categories or which seek exposure to the following markets:

- Commodities (e.g., agricultural, energy and metals), Currency, Precious Metals
- Managed Futures
- Leveraged, Inverse or Inverse Leveraged
- Bear Market, Hedging, Long-Short Equity, Market Neutral
- Real Estate
- Volatility (seeking exposure to the CBOE VIX Index)

You should keep in mind that while mutual funds and ETFs may at times utilize nontraditional investment options and strategies, they should not be equated with unregistered privately offered alternative investments. Because of regulatory limitations, mutual funds and ETFs that seek alternative-like investment exposure must utilize a more limited investment universe. As a result, investment returns and portfolio characteristics of alternative mutual funds and ETFs may vary from traditional hedge funds pursuing similar investment objectives. Moreover, traditional hedge funds have limited liquidity with long “lock-up” periods allowing them to pursue investment strategies without having to factor in the need to meet client redemptions and ETFs trade on an exchange. On the other hand, mutual funds typically must meet daily client redemptions. This differing liquidity profile can have a material impact on the investment returns generated by a mutual or ETF pursuing an alternative investing strategy compared with a traditional hedge fund pursuing the same strategy. Nontraditional investment options and strategies are often employed by a portfolio manager to further a fund’s investment objective and to help offset market risks. However, these features may be complex, making it more difficult to understand the fund’s essential characteristics and risks, and how it will perform in different market environments and over various periods of time. They may also expose the fund to increased volatility and unanticipated risks particularly when used in complex combinations and/or accompanied by the use of borrowing or “leverage.”

ADDITIONAL COMMENTS – 1940 ACT LIMITATIONS

- GIMA recognizes that both 1940 Act-registered open-end mutual funds that seek alternative-like exposure and traditional hedge funds seek investment returns that have lower correlation to traditional markets in an attempt to increase diversification in an overall portfolio.
- Unlike traditional hedge funds, SEC registered open-end mutual funds that seek alternative-like exposure do not require investor pre-qualifications, enable efficient tax reporting, are subject to lower investment minimums and lower fees, provide portfolio transparency, daily liquidity, and are required to provide daily NAV pricing.
- Because of 1940 Act limitations, mutual funds that seek alternative-like exposure generally must utilize a more limited investment universe and, therefore, will have relatively higher correlation with traditional market returns. Registered open-end funds are statutorily limited in their use of leverage, short sales and the use of derivative instruments.
- Hedge funds typically charge an asset-based fee and a performance fee. Potential benefits to hedge funds include greater flexibility in terms of seeking enhanced returns through the use of leverage, exposure to less liquid investments, and the more flexible use of complex instruments such as derivatives.
- As a result of these differences, performance for a mutual fund that seeks alternative-like exposure and its portfolio characteristics may vary from a traditional hedge fund that is seeking a similar investment objective.

Risk Considerations

Alternative investments which may be referenced in this report, including private equity funds, real estate funds, hedge funds, managed futures funds, and funds of hedge funds, private equity, and managed futures funds, are speculative and entail significant risks that can include losses due to leveraging or other speculative investment practices, lack of liquidity, volatility of returns, restrictions on transferring interests in a fund, potential lack of diversification, absence and/or delay of information regarding valuations and pricing, complex tax structures and delays in tax reporting, less regulation and higher fees than mutual funds and risks associated with the operations, personnel and processes of the advisor.

Managed futures investments are speculative, involve a high degree of risk, use significant leverage, have limited liquidity and/or may be generally illiquid, may incur substantial charges, may subject investors to conflicts of interest, and are usually suitable only for the risk capital portion of an investor's portfolio. Before investing in any partnership and in order to make an informed decision, investors should read the applicable prospectus and/or offering documents carefully for additional information, including charges, expenses, and risks. Managed futures investments are not intended to replace equities or fixed income securities but rather may act as a complement to these asset categories in a diversified portfolio.

Master Limited Partnerships (MLPs) are limited partnerships or limited liability companies that are taxed as partnerships and whose interests (limited partnership units or limited liability company units) are traded on securities exchanges like shares of common stock. Currently, most MLPs operate in the energy, natural resources or real estate sectors. Investments in MLP interests are subject to the risks generally applicable to companies in the energy and natural resources sectors, including commodity pricing risk, supply and demand risk, depletion risk and exploration risk.

Private Real Estate: Risks of private real estate include: illiquidity; a long-term investment horizon with a limited or nonexistent secondary market; lack of transparency; volatility (risk of loss); and leverage.

Investing in **commodities** entails significant risks. Commodity prices may be affected by a variety of factors at any time, including but not limited to, (i) changes in supply and demand relationships, (ii) governmental programs and policies, (iii) national and international political and economic events, war and terrorist events, (iv) changes in interest and exchange rates, (v) trading activities in commodities and related contracts, (vi) pestilence, technological change and weather, and (vii) the price volatility of a commodity. In addition, the commodities markets are subject to temporary distortions or other disruptions due to various factors, including lack of liquidity, participation of speculators and government intervention.

Physical precious metals are non-regulated products. Precious metals are speculative investments, which may experience short-term and long term price volatility. The value of precious metals investments may fluctuate and may appreciate or decline, depending on market conditions. If sold in a declining market, the price you receive may be less than your original investment. Unlike bonds and stocks, precious metals do not make interest or dividend payments. Therefore, precious metals may not be suitable for investors who require current income. Precious metals are commodities that should be safely stored, which may impose additional costs on the investor. The Securities Investor Protection Corporation ("SIPC") provides certain protection for customers' cash and securities in the event of a brokerage firm's bankruptcy, other financial difficulties, or if customers' assets are missing. SIPC insurance does not apply to precious metals or other commodities.

Bonds are subject to interest rate risk. When interest rates rise, bond prices fall; generally the longer a bond's maturity, the more sensitive it is to this risk. Bonds may also be subject to call risk, which is the risk that the issuer will redeem the debt at its option, fully or partially, before the scheduled maturity date. The market value of debt instruments may fluctuate, and proceeds from sales prior to maturity may be more or less than the amount originally invested or the maturity value due to changes in market conditions or changes in the credit quality of the issuer. Bonds are subject to the credit risk of the issuer. This is the risk that the issuer might be unable to make interest and/or principal payments on a timely basis. Bonds are also subject to reinvestment risk, which is the risk that principal and/or interest payments from a given investment may be reinvested at a lower interest rate. **Bonds rated below investment grade** may have speculative characteristics and present significant risks beyond those of other securities, including greater credit risk and price volatility in the secondary market. Investors should be careful to consider these risks alongside their individual circumstances, objectives and risk tolerance before investing in high-yield bonds. High yield bonds should comprise only a limited portion of a balanced portfolio.

Treasury Inflation Protection Securities' (TIPS) coupon payments and underlying principal are automatically increased to compensate for inflation by tracking the consumer price index (CPI). While the real rate of return is guaranteed, TIPS tend to offer a low return. Because the return of TIPS is linked to inflation, TIPS may significantly underperform versus conventional U.S. Treasuries in times of low inflation.

An investment in an **exchange-traded fund** involves risks similar to those of investing in a broadly based portfolio of equity securities traded on an exchange in the relevant securities market, such as market fluctuations caused by such factors as economic and political developments, changes in interest rates and perceived trends in stock and bond prices. Investing in an international ETF also involves certain risks and considerations not typically associated with investing in an ETF that invests in the securities of U.S. issues, such as political, currency, economic and market risks. These risks are magnified in countries with emerging markets, since these countries may have relatively unstable governments and less established markets and economics. For specifics and a greater explanation of possible risks with ETFs¸ along with the ETF's investment objectives, charges and expenses, please consult a copy of the ETF's prospectus. Investing in sectors may be more volatile than diversifying across many industries. The investment return and principal value of ETF investments will fluctuate, so an investor's ETF shares (Creation Units), if or when sold, may be worth more or less than the original cost. ETFs are redeemable only in Creation Unit size through an Authorized Participant and are not individually redeemable from an ETF.

Equity securities may fluctuate in response to news on companies, industries, market conditions and general economic environment.

REITs investing risks are similar to those associated with direct investments in real estate: property value fluctuations, lack of liquidity, limited diversification and sensitivity to economic factors such as interest rate changes and market recessions.

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