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Alternative Investments Observer

MORNINGSTAR®

Illuminating the Murky World of Hedge Fund Investing

How Morningstar's new transparency tool can help investors avoid hedge fund blowups.

by
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Hedge Fund Analyst

The media love a good story about a seedy hedge fund manager, one who takes off with investors' millions or one who loses a fortune over a few bad trades. In the last several years, some very large hedge fund frauds have plastered the news: James Nicholson of Westgate Capital Management, Stephen Walsh and Paul Greenwood of WG Trading Investors, Samuel Israel of Bayou Capital, and, of course, the infamous Bernard Madoff. But let's not forget the massive hedge fund failures not caused by fraud—Amaranth and LTCM, to name a few. In these cases, investors lost billions of hard-earned capital because a lack of transparency prevented them from understanding the underlying risk of these hedge funds.

Investors are outraged, and governments are calling for greater transparency and oversight of hedge funds. Senators Chuck Grassley and Carl Levin introduced a hedge fund transparency bill in January 2009, and the G-20 attempted to introduce global regulation of hedge funds in April. Both of these efforts have so far proved fruitless, and hedge funds still maintain the same freedoms as they did prior to all of these failures and scandals. Morningstar believes that, while we may never be able to agree on an effective regulatory structure for hedge funds in the United States or elsewhere, and while hedge funds may never be legally held to transparency standards, hedge fund investors can and should force transparency upon them.

In an effort to promote transparency, Morningstar will soon debut new functionality into the Morningstar® Altvest℠ research platform designed specifically for hedge funds (and eventually Morningstar Direct℠) that will allow investors to screen hedge funds in four areas of operational transparency—a fund's auditor, administrator, registration status, and serial correlation of returns. These tests are designed to assist investors screening the hedge fund database for potential investments, and to identify areas requiring above-average caution or more-thorough research. The goal is to help investors more easily avoid a hedge fund blowup. An alert in any of the four test areas results in a recommendation for a higher level of due diligence in that area. This new functionality is not intended as a substitute for a comprehensive due diligence investigation or ongoing monitoring of hedge funds, but rather serves as a first-alert screen for hedge fund investors.

The first test requires a hedge fund firm to list auditor information for its funds and the listed auditor to provide services to at least five different hedge fund firms in the Morningstar database. The second test, a screen of the administrator, uses the same criteria, except that firms choosing to self-administer are also flagged for carrying higher operational risk. The third test spotlights whether the fund or its management firm reports to a well-known regulatory body. Morningstar currently tracks nine regulatory bodies in six jurisdictions (the United States, United Kingdom, France, Canada, Hong Kong, and Australia) and has begun to survey newly participating hedge funds on their registration in an additional 12 jurisdictions, including Japan and Germany. Morningstar believes that funds avoiding registration in a major jurisdiction are under less operational scrutiny and therefore justify a higher level of due diligence than funds operating under some supervision.

The fourth and final test of operational risk scrutinizes hedge funds' reported returns, specifically the presence of positive serial correlation. Positive serial correlation means that a fund's returns are positively correlated to prior-month returns, a characteristic not typically found in financial market returns.

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A fund whose returns exhibit high positive serial correlation could be trading in highly illiquid markets such as distressed securities, where frequent market prices are unavailable.
Less commonly, but more drastically, it could be outright misrepresenting its numbers.
The risk in funds with positive serial correlation is that the returns suddenly take a turn for the worse, either because a fraud is uncovered (for example, in the case of WG Trading) or because the riskiness of the fund's investments had been understated. Morningstar will flag hedge funds that lack sufficient return history to test for positive serial correlation (38 months is required) or that show statistically significant positive serial correlation.

Investors familiar with hedge fund databases are well aware of the shortcomings of voluntary reporting. Many perfectly legitimate and highly regarded hedge funds either don't report to hedge fund databases, choose not to report all data points requested, or fail to update stale information. While lack of information will initially trigger operational risk indicators for many hedge funds, Morningstar expects that this will prompt hedge funds to demonstrate more transparency going forward.

Backtesting and Current Results
In developing these tests, Morningstar evaluated all active and inactive funds (those that have subsequently stopped reporting returns to our database) in our database for the 10 years ended June 30, 2009, using fund information reported as of July 31, 2009. The test for each year includes all funds active in the Morningstar database as of June 30 of the tested year. The following table outlines the percentage of funds that would have received an operational risk indicator in each of the four test areas.

The auditor test finds that 49% of funds were flagged for operational risk in 2009, with most of these funds, 47%, failing to report an auditor and only a handful of firms, 2%, using lesser-known auditing firms. It is notable that after the Madoff, Stanford, and WG Trading scandals, the percentage of funds failing to report an auditor declined in 2009, and Morningstar hopes this trend continues.

The same issue of nonreporting is prevalent in the area of administrators. Of the 58% of funds that received an administrator operational risk indicator in 2009, 52% either failed to report a third party or self-administered, while the remaining 6% failed to reporta known, independent administrator. Prior to 2009, many investors had been comfortable investing in funds operating their own back office, or self-administration. With more and more institutions demanding independent administration, the recent uptick in funds using an experienced administration firm is not surprising. Although many fund families have strong back offices and internal controls, Morningstar feels that the lack of independence justifies more thorough due diligence even for the largest, most-trusted hedge fund firms.

	Auditor %	Administrator %	Registration %	Serial Correlation %	Statistically Signif. Serial Correlation %*	Insufficient Returns History %*	Total Active Funds
2009	49	58	74	72	15	57	8,505
2008	60	68	79	53	3	50	10,571
2007	63	71	79	60	5	55	10,925
2006	64	72	77	65	4	61	10,219
2005	64	73	77	72	5	67	8,784
2004	63	73	77	73	6	67	7,171
2003	62	73	75	70	3	67	5,498
2002	61	73	74	71	4	67	4,276
2001	60	72	72	71	5	66	3,236
2000	61	74	72	71	5	66	2,573

*This statistic is a subset of the serial correlation column.

In the registration test, 74% of funds were noted as operationally risky in 2009, highlighting the use of nonstandard legal jurisdictions by hedge funds or the failure to report regulatory registration information. Currently, the registration test checks registration with the SEC, FINRA, CFTC, and NFA (all U.S. bodies), as well as the FSA (U.K.), AMF (France), OSC (Canada), ASIC (Australia), and SFC (Hong Kong). We continue to evaluate the evolving regulation regimes of other countries, as well as "offshore" locales. Encouraging regulatory changes in recent years, particularly in the Cayman Islands, are of particular interest in our re-evaluation as the jurisdiction continues to improve its investor protection efforts.

The serial correlation test highlights an increase in illiquidity and valuation issues during the market downturn that caused many hedge funds severe losses—many were even forced to shutter. While 50% of all hedge funds reported an insufficient return history to calculate serial correlation in 2008, this number jumped to 57% in 2009.

Of greater import is the dramatic increase in the number of funds exhibiting significant, positive serial correlation. For the three years ended June 30, 2009, 15% of all active funds

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exhibited statistically significant serial correlation, while in all prior three-year periods this figure hovered around 5% of all active funds. As investments became more illiquid, the number of funds flagged for positive serial corrections increased almost 400% from 2008 to 2009 even as the pool of active funds declined nearly 20%. Convertible arbitrage and distressed securities funds were affected the most. Of the 34 convertible arbitrage funds with a sufficient return history as of June 2009, 29 exhibited positive serial correlation. This compares with 20 of 76 funds one year earlier. In 2009, 31 of 45 distressed securities funds with sufficient returns showed statistically significant positive serial correlation, an increase from 25 of 93 in 2008.

Known Frauds and Failures

In addition to backtesting funds in our database for indications of operational risk, Morningstar also looked at confirmed cases of operational risk—frauds and fund failures of recent years. Our review of news stories, articles, and SEC actions identified approximately 125 hedge fund firm failures or frauds in the last 10 years—not a comprehensive list, but a good start. Of these 125 firms, only 20 firms participated in Morningstar's database, running 142 legally distinct share classes. This data is telling in and of itself—that the most risky hedge funds tended to circumvent transparency and regulation. Only four of 142 funds completely avoided an operational risk alert. Three of these funds are managed by Austin Capital, which had some, but limited, "Madoff" exposure, and the fourth fund was managed by Fairfield Greenwich Group, but has not been specifically tied to any "investment" in Madoff. More than 80% of the 142 funds received operational risk indicators on the auditor, administrator, and registration tests, while 50% of funds received an indicator in the serial correlation test.

WG Trading Investors, whose managers were charged with $550 million fraud in February 2009, clearly received an alert in all four operational risk areas for each year from 2000 through 2008. WG Trading's returns exhibited the highest serial correlation of all funds toward the end of its life, and it didn't report an auditor or administrator because it simply fabricated financial statements.

Funds associated with the Madoff fraud, the biggest hedge fund fraud in history, show more murky operational risk indicator results, primarily due to Bernard Madoff's efforts in hiding the fraud. The returns of various feeder funds and funds of funds, such as Tremont's Rye funds and Fairfield's Sentry funds, tended to mean revert rather than display positive serial correlation, remaining under our operational risk radar. Additionally, these funds reported well-known, large audit firms that simply failed to do their job. Very few of the Madoff-related funds, however, reported outside administrators or registration with regulators, which may have tipped off some investors to do more homework.

While not perfect, the implications of our operational risk indicator are clear. Performing proper research in all four of the operational areas we highlight is a critical, common-sense step in selecting a hedge fund. Morningstar's operational risk indicators are not a replacement for thorough due diligence, but a signal that using extra caution in areas we've highlighted will help. Had hedge fund investors and consultants followed this common sense, the Bernie Madoffs of the world wouldn't have been so successful.

Quant Corner: One and a Quarter Centuries of Stock Market Drawdowns

Real stock market returns reveal the true frequency of "once-in-a-century" crashes.

by
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Vice President,
Quantitative Research

When former Federal Reserve chairman Alan Greenspan characterized the financial crisis of 2008 as a "once-in-a-century credit tsunami," I was stunned. Being familiar with long-term data on the U.S. capital markets, I thought a more apropos statement was the one made by Leslie Rahl (founder of Capital Market Risk Advisors) more than year before the crisis when she said, "We seem to have a once-in-a-lifetime crisis every three or four years."[1] The contrast between Greenspan's and Rahl's perspectives inspired me to write an article for *Morningstar Advisor* on the history of market meltdowns, "Déjà Vu All Over Again."[2] In that article, I illustrate the frequency and severity of the major drawdown for various countries using time series of stock market total returns. For the U.S., I naturally used the series on the S&P 500 that Morningstar publishes in the Ibbotson® SBBI® Yearbooks and makes available in its EnCorr® software and data package that starts in 1926. The results clearly demonstrate that Greenspan was in need of a history lesson.

I have recently expanded the analysis into a complete study on global equity market history upon the request of Larry Siegel, director of research at the CFA Institute, as a contribution to his forthcoming book on the global history of market crashes.[3] Larry asked me to use monthly *real* total returns[4] and to go back into history as far as it was possible with reasonably reliable data. The benefit of using real returns is to make meaningful return comparisons, as our study spans such a long period of time. The benefit of going further back in history is, of course, to give us a longer-term and more robust historical perspective on market crashes, in terms of frequency, length, and magnitude.

To complete the study, I needed to find monthly data from before 1925 on both stock returns and inflation, and calculate real returns. Since there was no such return series in existence, I would have to create one out of readable available data.

Professor Robert Shiller of Yale posts a monthly history of U.S. stock market returns and inflation on his Web site that goes back to 1871. Unfortunately, Professor Shiller's stock data is based on monthly average prices rather than month-end prices. So I could use his inflation data, but not his stock market data. Separately, Roger Ibbotson and some colleagues created an annual price and total return series for the NYSE that goes back to 1825.[5] However, annual returns are at too low a frequency to measure the largest drawdowns of the period, such as the large drop in the stock market during the panic of 1907. Fortunately, Larry had a book that contained daily price data on the Dow Jones Averages going back to 1885.[6] He advised me to estimate the monthly price returns in the broader NYSE price index from the monthly price returns on the Dow Jones Averages and then interpolate the total returns by assuming that the level dividends remained constant during each year.

Following Larry's advice, and soliciting the help of Morningstar intern Kailin Liu, I produced a time series of real total returns for the U.S. stock markets that runs from 1871 through the present. While for the first 15 years we only have annual returns, we now have more than 123 years of monthly total real returns. This data will appear in future editions of the Ibbotson SBBI Yearbooks, beginning in 2010.

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Exhibit 1: Real Index and Peak Values of the U.S. Stock Market

Exhibit 2: Largest Declines in U.S. Stock Market History (in real total return terms, from January 1871 to June 2009)

Peak	Trough	Decline %	Recovery	Event(s)
August 1929	May 1932	79.00	November 1936	Crash of 1929, 1st part of Great Depression
August 2000	February 2009	54.00	TBD	Dot-Com Bubble Burst (2000–02), Crash of 2007–09
December 1972	September 1974	51.86	December 1984	Inflationary Bear Market, Vietnam, Watergate
June 1911	December 1920	50.96	December 1924	World War I, Postwar Auto Bubble Burst
February 1937	March 1938	49.93	February 1945	2nd part of Great Depression, World War II
May 1946	February 1948	37.18	October 1950	Postwar Bear Market
November 1968	June 1970	35.46	November 1972	Start of Inflationary Bear Market
January 1906	October 1907	34.22	August 1908	Panic of 1907
April 1899	June 1900	30.41	March 1901	Cornering of Northern Pacific Stock
August 1987	November 1987	30.16	July 1989	Black Monday—Oct. 19, 1987
October 1892	July 1893	27.32	March 1894	Silver Agitation
December 1961	June 1962	22.80	April 1963	Height of the Cold War, Cuban Missile Crisis
November 1886	March 1888	22.04	May 1889	Depression, Railroad Strikes
April 1903	September 1903	21.67	November 1904	Rich Man's Panic
August 1897	March 1898	21.13	August 1898	Outbreak of Boer War
September 1909	July 1910	20.55	February 1911	Enforcement of the Sherman Anti-Trust Act
May 1890	July 1891	20.11	February 1892	Baring Brothers Crisis

Truth in Numbers

The significance of this data is in the lessons that we can learn from it. Over the entire 138½-year period, the Real US Stock Market Index grew from $1 to $5,179 in 1869 dollars. This is a compound annual real total of just under 6.4%, almost the same as the post-1925 period. However, as Exhibit 1 shows, it was a very bumpy ride with a number of major drawdowns, some of which can be linked with specific economic and political events.

Exhibit 1 shows the growth of $1 invested in the U.S. stock market at the end of 1869 through June 2009 in real terms, along with a line that shows the highest level that the index had achieved as of that date. Wherever this line is above the cumulative value line, the index was amid a decline relative to its most recent peak. The bigger the gap, the more severe the decline; the wider the gap, the longer the time until the index returned to its peak. Wherever this line coincides with the index line, the index was climbing to a new peak.

Exhibit 2 lists all of the drawdowns that exceeded 20%. In total, there were 17 such declines, including the present one from which we have yet to recover. Not surprisingly, the granddaddy of all market declines started just before the Crash of 1929 and did not recover until toward the end of 1936. The U.S. stock market lost 79% of its real value in less than three years, and it took more than five years to recover. What may be more sobering, however, is that not only are we currently in the second-greatest decline, but it started nine years ago! The combined effect of the crash of the Internet bubble in 2000 and the financial crisis of 2008 caused the U.S. stock market to lose 54% of its real value from August 2000 to February 2009. Who knows how long it will take to recover from that and when our next crisis will occur?

The history of stock market drawdowns presented here shows that investing in stocks can be very risky business, indeed, and that the current crisis is hardly a "once-in-a-century" event. But to more than just state the obvious, we should use this data to better gauge the potential risks and long-term rewards of investing in risky assets such as stocks. Specifically, we should supplement our traditional measures of risk, such as standard deviation, which relies on a normal distribution, by measures that better capture the fat-tailed nature of the historical returns and drawdowns as presented here. Incorporating fat-tailed distributions into risk measures has become a focus of my research. Stay tuned for more. M

References

1 As quoted by Christopher Wright, "Tail Tales," *CFA Institute Magazine*, March/April 2007.

2 February/March 2009. Available at http://www.nxtbook.com/nxtbooks/morningstar/advisor_20090203/.

3 This study will appear in the CFA Institute's forthcoming book, *Voices of Wisdom: Understanding the Global Financial Crisis*, Laurence B. Siegel, editor.

4 That is, returns that include the reinvestment of dividends and are adjusted for inflation.

5 Goetzmann, William N., Roger G. Ibbotson, and Liang Peng, "A New Historical Database for the NYSE 1815 to 1925: Performance and Predictability," *Journal of Financial Markets*, December 2000. The data appear in the *Ibbotson SBBI Yearbooks*.

6 Pierce, Phyllis, ed. 1982. *The Dow Jones Averages 1885–1980*. Dow Jones Irwin, Homewood, Illinois.

Morningstar Product Spotlight: Morningstar Direct℠

Showing the real price of drawdowns, to hedge fund investors and managers alike.

by
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The term drawdown is a common one in the hedge fund industry. A drawdown is a measure of cumulative loss, or a historical decline from a fund's peak to trough net asset value. Often, hedge fund investors look at a fund's maximum drawdown since inception as a proxy of the maximum risk they may face. Or, investors can look at a drawdown over a particular time period—for example, over the same time period as an equity market crash—as a form of historical stress testing. Besides using maximum drawdown to gauge how much one may lose in a hedge fund, one can also look at the length of a fund's recovery from a prior drawdown. Some investors, and even some hedge fund managers, may not be willing to wait. In this article, we explore the cost of drawdowns to both hedge fund investors and managers and how Morningstar Direct℠ can help investors decide if they want to take the hedge fund plunge.

Investors can use Morningstar Direct to calculate maximum drawdown, adjusting the calculation period and the return frequency (monthly or weekly). By going to the **Global Databases** tab in Direct, selecting the **Hedge Funds** universe, and clicking on the list of **Single Strategy** hedge funds, we can **Edit Data** to select the following custom data points: **Maximum Drawdown, Maximum Drawdown Months, Maximum Drawdown Peak, Maximum Drawdown Valley, Maximum Drawdown Recovery Months**, and **Maximum Drawdown Recovery Date**.

Using the Morningstar 1000 Hedge Fund Index (an asset-weighted index of approximately the largest 1,000 distinct hedge funds in Morningstar's database) as a proxy of the typical hedge fund experience, we see that hedge fund investors drew down 25.2% between November 2007 and February 2009. Although the index recovered 14% through July 2009, a simple calculation reveals that hedge funds must recover another 17.3% to break even, for a total return of 33.6%, because only $0.75 of each original $1 is still invested. It took slightly more than two years prior to the crash to make this kind of return.

Investors in emerging-markets hedge funds fared worse than the average hedge fund investor in the 2007–09 credit crisis. Funds in this category's index drew down almost 50% through February 2009. Even though the index has recovered 38% through July, it requires another 43% return to break even. It took 2.5 years, during a commodity bubble, prior to the crash to make this kind of return in emerging-markets hedge funds.

Another way to estimate how long it takes to recover from a drawdown is to look at recovery periods from a prior market crash. We looked at all of the Morningstar hedge fund category indexes' drawdowns over the eight years ended Dec. 31, 2006, in order to capture any drawdowns related to the tech-bubble burst or any major event affecting hedge funds prior to the credit crisis of 2007, such as the convertible arbitrage meltdown of 2005. We set the return frequency to monthly (hedge funds report monthly), and sorted this list by maximum drawdown. We found that out of 602 single-manager hedge funds, the average fund experienced drawdowns of 24.1%, and the average time to recover was 12.8% months. But we also see that 87 of those 602 funds never recovered—meaning, the hedge fund manager closed up shop. Looking at the drawdowns of the current crisis, the situation seems direr. This time, 2,427 funds experienced drawdowns since the beginning of 2007. The average drawdown was 29.8%, significantly worse than before.

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Only 576 of those 2,427 funds have since recovered, and of those, the average recovery time was 4.9 months. But the drawdowns of the recovered funds averaged only 14%, less than half that of most hedge funds.

In the case of extreme drawdowns, such as those experienced in 2008, hedge fund managers often voluntarily shut down and start anew. The fee structure of most hedge funds requires that the standard 20% performance fee may be charged only once the fund has recovered from a drawdown. A hedge fund manager may not find it profitable to operate after a large drawdown, charging only a 2% management fee on a now much smaller asset base. Instead, a new fund can be launched, and performance fees can be charged as soon as any profits are made, leaving the closed fund's investors out of luck.

Hedge fund manager John Meriwether is a classic example of this tactic, first with the collapse of his first hedge fund, LTCM, then the launch and subsequent liquidation of his second fund this year, which experienced a significant drop in 2008. Meriwether attempted to launch a third fund in February but was unable to raise the assets. Dwight Anderson of Ospraie Management proved luckier. He announced the liquidation of his primary fund in September 2008 after a substantial loss in August and launched two new hedge funds in July 2009.

Let's look at a simple example of why this strategy of closing and reopening has appeal. If a hedge fund shop ran $1 billion of assets prior to a 24.1% drawdown, it would be left with $759 million in assets, assuming no redemptions (which is a very bold assumption considering the $116 billion in hedge fund outflows in Morningstar's database between October 2008 and February 2009). Over the next three years, assuming the fund makes 10% each year with no inflows, management would receive only $57 million in fees, versus $139 million had the fund avoided a drawdown, or started a new $1 billion fund. Looking at it from the perspective of an investor, investors would have paid almost $82 million less in fees had the hedge fund attempted to recoup their lost profits.

We have shown here that drawdowns are costly, both to hedge fund investors and hedge fund managers. When looking to invest in a hedge fund or hedge fund strategy, investors can use Morningstar Direct℠ to look at historical maximum drawdowns of specific hedge funds and hedge fund indexes to better determine their risk of loss and if, in fact, they are willing to face it.

Hedge Fund Indexes Maximum Drawdowns 01-01-07 through 07-31-09

Indexes	Max Drawdown %	Peak Date	Valley Date	Recovery Return% through 07-31-09	Remaining Recovery %
Morningstar 1000 HF USD	25.17	11-01-2007	02-28-2009	13.97	17.26
Morningstar Hedge Fund of Funds	24.65	11-01-2007	02-28-2009	9.06	21.69
Morningstar Convtbl Arbitrage HF USD	31.30	11-01-2007	11-30-2008	29.75	12.18
Morningstar Corporate Actions HF USD	30.57	11-01-2007	11-30-2008	20.85	19.18
Morningstar Debt Arbitrage HF USD	18.28	11-01-2007	11-30-2008	14.45	6.93
Morningstar Distressed Sec HF USD	29.81	11-01-2007	03-31-2009	9.52	30.08
Morningstar Dvlp Asia Equity HF USD	29.03	11-01-2007	02-28-2009	19.76	17.66
Morningstar EM Equity HF USD	49.49	11-01-2007	02-28-2009	38.33	43.13
Morningstar Equity Arbitrage HF USD	12.37	07-01-2008	11-30-2008	6.36	7.29
Morningstar Europe Equity HF USD	24.95	07-01-2008	02-28-2009	12.64	18.30
Morningstar Global Debt HF USD	30.96	11-01-2007	02-28-2009	16.34	24.49
Morningstar Global Equity HF USD	34.61	11-01-2007	02-28-2009	18.45	29.11
Morningstar Global Non Trend HF PUSD	8.80	07-01-2008	10-31-2008	8.27	1.27
Morningstar Global Trend HF USD	10.99	07-01-2008	09-30-2008	3.61	8.44
Morningstar Multi-Strategy HF USD	24.28	11-01-2007	11-30-2008	14.68	15.16
Morningstar Short Equity HF PUSD	6.22	11-01-2008	12-31-2008	4.28	2.25
Morningstar US Equity HF USD	31.49	11-01-2007	02-28-2009	20.41	21.23
Morningstar US Small Cap Eqty HF USD	39.16	11-01-2007	02-28-2009	29.48	26.94

Effects of Drawdowns on Hedge Fund Fees

	Fund A	Fund B
Prior Drawdown	24.10	0
Remaining Assets $	759,000,000	1,000,000,000
Year 1		
Return	10	10
End NAV $	834,900,000	1,100,000,000
Mgmt Fee $	16,698,000	22,000,000
Perf Fee $	—	20,000,000
Year 2		
Return	10	10
End NAV $	834,900,000	1,100,000,000
Mgmt Fee $	16,698,000	22,000,000
Perf Fee $	—	20,000,000
Year 3		
Return	10	10
End NAV $	834,900,000	1,100,000,000
Mgmt Fee $	16,698,000	22,000,000
Perf Fee $	—	20,000,000
Total Fees	**57,316,180**	**139,020,000**

Mgmt and performance fees are calculated annually on ending net assets. Assumes no inflows or outflows.

Industry Trends: Alternative Mutual Funds

New mutual funds offer diversification options.

by
Nadia Papagiannis, CFA
Hedge Fund Analyst

Hedge fund firm AQR is at it again. It launched three new mutual funds in July: AQR Momentum, AQR Small Cap Momentum, and AQR International Momentum. AQR's founder Clifford Asness, Ph.D., has long invested in quantitative value-plus-momentum strategies and has published research showing the lack of correlation of momentum to value across geography and market capitalization. These new mutual funds make his momentum strategies available to the masses, although, unlike his related hedge fund strategies, these retail mutual funds do not short. Investors need only $5,000 to invest in these funds, which charge low expense ratios (between 0.49% and 0.65%).

In August, Natixis Global Associates launched ASG Diversifying Strategies **DSAFX**, a strategy run by Andrew Lo, Ph.D., founder of AlphaSimplex and publisher of numerous academic papers on hedge funds. Previously, the firm launched ASG Global Alternatives, which is intended to replicate hedge fund betas through the use of liquid derivatives. The new multistrategy fund, by contrast, follows proprietary AlphaSimplex strategies intended to produce low or negative correlations to the equity markets, also using liquid futures and currency forwards. This strategy is quantitative and combines trend following models, macroeconomic factor models, and relative value models. Minimum investments are $2,500 for A shares, which carry a 5.75% sales load and charge a net expense ratio of 1.74%.

Van Eck Multi-Manager Alternatives **VMAAX** launched in June 2009. This fund invests in open-end mutual funds, as well as hedge fund firms and closed-end fixed-income funds, both of which are used primarily for credit strategies. Expenses for this fund, excluding dividends on short sales, are capped at 2.4% for A shares. The fund's management fee comprises a large portion of the expenses, at 1.6%, but this figure includes fees of underlying subadvisors.

Also in June, the Collar Fund **COLLX** gave retail investors more alternative options. This fund, managed by Summit Portfolio Advisors, buys collars (short call and long put) on individual stocks when management feels the call premium is rich and the put premium is relatively cheap, creating an upper and lower bound on the stock return. This strategy's closest cousin is Gateway **GATEX**, which writes S&P 500 Index calls and buys index puts on less than 100% of the portfolio. The Collar fund sports a low expense ratio (0.99%) and a low minimum investment of $2,500.

Finally, Rydex came out with Rydex Long/Short Commodities Strategy **RYLBX** in June. This fund is similar to Rydex/SGI Managed Futures Strategy **RYMTX**, except that this fund focuses only on price trends in commodities, specifically the 14 components of the S&P GSCI Index, and each commodity receives an equal weighting, up to seven long and seven short. The fund charges a net expense ratio of 1.83% and requires an investment of $2,500 in nonretirement accounts.

Flows into alternative mutual funds have been strong since the beginning of the year, with almost $7.75 billion coming into these funds through July. The Morningstar long-short mutual fund category alone has seen $5.25 billion flow in. For the year to date through July, the funds are up 4.4%, much lower than the Morningstar 1000 Hedge Fund Index, but mutual fund strategies have limited use of leverage, which also damps returns. M

Fund Reports

Aston/Lake Partners LASSO Alternatives I

by **Nadia Papagiannis,** CFA

Advisor
Lake Partners, Inc.

Advisor Location
Greenwich, Connecticut

Assets Under Management
$1.4 million (fund)

Inception Date
April 1, 2009

Investment Type
U.S. open-end mutual fund

Morningstar Category
Long-Short

Management
Ron and Rick Lake founded Lake Partners in 1989, specializing in hedge funds and alternative investing. Prior to founding their own firm, which now advises more than $5 billion, Ron consulted institutional investors in nontraditional investments. He authored "Evaluating and Implementing Hedge Fund Strategies," published by *Euromoney Institutional Investor*, and served as director of the Illinois Commission of Public Pension Investment Policies to modernize the state's $5 billion pension system. Prior to Lake Partners, Rick Lake started his investment career at Prudential Securities. In 2003, he was invited to the SEC Hedge Fund Roundtable to present his whitepaper entitled, "The Democratization of Hedge funds: Hedge Fund Strategies in Open-End Mutual Funds."

Strategy

LASSO stands for Long and Short Strategic Opportunities, and the strategy has been available in separate-account format since 1999 as well as through a bank collective trust for qualified retirement plans. The mutual fund version launched in 2009 through a partnership with Aston Asset Management. The fund is a fund of all alternative 1940 act mutual funds, which the firm categorizes in four buckets: hedged equity, long/short bonds, futures/commodities/FX, and multi-strategy funds. Management aims to add value through strategic and tactical asset allocation, risk management, and manager selection. Asset-allocation and risk-exposure decisions are driven by management's macroeconomic research and discussions with hedge fund industry contacts. The fund typically invests in between 10 and 15 mutual funds, based on the strategy's correlation to the existing portfolio and other managers, and the managers' skill and tenure in a particular strategy. The largest allocations as of Aug. 31, 2009, were JP Morgan US Large Cap Core Plus Select **JLPSX** (19.5%), FPA Crescent **FPACX** (15.1%), and Needham Growth **NEEGX** (10.2%), reflecting a more directional equity strategy.

Process

The investment process begins with a top-down perspective. Opportunities in asset classes and strategies are discovered through extensive discussions with hedge fund and mutual fund managers, with which the firm has long-term relationships. Similarly, these discussions help the firm shape the overall market-risk exposure of the portfolio. Next, managers are selected through both quantitative analysis and qualitative analysis. Quantitative analysis looks at performance relative to peers, historical portfolios, statistics such as betas and R-squareds to various risk factors, return volatility, and stress testing. Qualitative analysis includes discussions with the managers about added value, risk controls, and strategy capacity. Verification of the data with the manager's story is crucial, and the firm constantly monitors for style or strategy shifts. The firm also conducts standard operational due diligence, visiting managers on-site, and looking at background checks and regulatory filings. The right mix of managers is key, with the goal of providing diversification of various traditional and alternative risk factors and strategies as well as maintaining low volatility. This fund charges a 1.0% management fee as part of a total 2.85% expense ratio (encompassing all funds' expenses) by prospectus.

Risk Management

Management models the portfolio with a strict daily volatility parameter of plus or minus 1%. Between September and December 2008, however, big market swings caused the strategy's daily losses to approach 3% on a few occasions. The maximum monthly drawdown allowed is 4%, and when the fund reaches negative 3%, net equity exposure is reduced. The separate-account version of the strategy breached a 4% monthly loss during October 2008 (negative 5%) and February 2009 (negative 4.7%), its worst losses. Net equity exposure of the strategy ranges between 20% and 50% net long. Historically, the strategy has reached a maximum month-end net exposure of 54% in June 2003, and a minimum of 17% in December of 1998. The strategy's largest drawdown occurred between October and February 2009, when it drew down 22.3%. In terms of position limits, individual funds are allocated a maximum of 20%, but an initial position is 5%, with special situations allowed between 2% and 5%. A full position is 10%–15% in any one fund.

Aston/Lake Partners LASSO Alternatives I (USD)

Incept	Type	Total Assets	Morningstar Cat
01-04-2009	MF	$1.36 mil	Long-Short

Performance 31-08-2009

Quarterly Returns	1st Qtr	2nd Qtr	3rd Qtr	4th Qtr	Total %
2007	—	—	—	—	—
2008	—	—	—	—	—
2009	—	—	—	—	—

Trailing Returns	1 Yr	3 Yr	5 Yr	10 Yr	Incept
Std Monthly	—	—	—	—	9.40
Std Quarterly	—	—	—	—	4.90
Total Return	—	—	—	—	9.40
+/- ML USD LIBOR 3 Mon	—	—	—	—	—
+/- S&P 500 TR	—	—	—	—	—
% Rank Cat	—	—	—	—	
No. in Cat	—	—	—	—	
7-day Yield	—				

Performance Disclosure

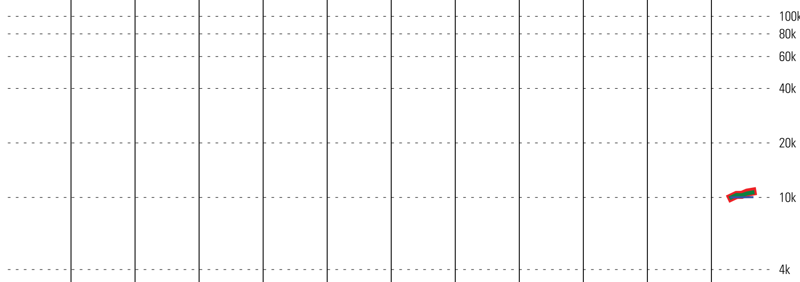
The Overall Morningstar Rating is based on risk-adjusted returns, derived from a weighted average of the three-, five-, and 10-year (if applicable) Morningstar metrics.

The performance data quoted represents past performance and does not guarantee future results. The investment return and principal value of an investment will fluctuate; thus an investor's shares, when sold or redeemed, may be worth more or less than their original cost.

Current performance may be lower or higher than return data quoted herein. For performance data current to the most recent month-end, please call 800 992 8151 or visit www.astonfunds.com.

Investment Style
Equity
Stock %

1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	08-09
—	—	—	—	—	—	—	—	—	—	—	50



Growth of $10,000
- Aston/Lake Partners LASSO Alternatives I 10,778
- Cat Avg: Long-Short 10,657
- Index: ML USD LIBOR 3 Mon CM 10,037

Performance Quartile (within category)

History	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	08-09
NAV	—	—	—	—	—	—	—	—	—	—	—	*10.94*
Total Return %	—	—	—	—	—	—	—	—	—	—	—	—
+/- ML USD LIBOR 3 Mon	—	—	—	—	—	—	—	—	—	—	—	—
+/- S&P 500 TR	—	—	—	—	—	—	—	—	—	—	—	—
% Rank Cat	—	—	—	—	—	—	—	—	—	—	—	—
No. of Funds in Cat	—	—	—	—	—	—	—	—	—	—	—	—

Fees and Expenses

Sales Charges

Front-End Load %	**NA**
Deferred Load %	**NA**

Fund Expenses

Management Fees %	1.00
12b1 Expense %	NA
Gross Expense Ratio %	**3.10**

Risk and Return Profile

	3 Yr	5 Yr	10 Yr
	—	—	—
Morningstar Rating™	—	—	—
Morningstar Risk	—	—	—
Morningstar Return	—	—	—

	3 Yr	5 Yr	10 Yr
Standard Deviation	—	—	—
Mean	—	—	—
Sharpe Ratio	—	—	—

MPT Statistics	Standard Index ML USD LIBOR 3 Mon	Best Fit Index
Alpha	—	—
Beta	—	—
R-Squared	—	—

12-Month Yield	—
30-day SEC Yield	—
Potential Cap Gains Exp	—

Portfolio Analysis 31-08-2009

Composition % 31-08-2009	Net %	Long %	Short %
Cash	21.79	26.07	4.28
US Stocks	39.55	56.34	16.79
Non-US Stocks	5.85	6.70	0.85
Bonds	23.87	28.35	4.49
Other/Not Clsfd	8.94	9.36	0.42
Total	100.00	126.83	26.83

Equity Style
Value Blend Growth
Large
Mid
Small

Portfolio Statistics	Port Avg	Rel Index	Rel Cat
P/E Ratio TTM	14.0	—	0.91
P/C Ratio TTM	5.6	—	0.73
P/B Ratio TTM	1.6	—	0.72
Geo Avg Mkt Cap $mil	9822	—	0.51

Fixed-Income Style
Short Int Long
High
Med
Low

Avg Eff Duration	2.95
Avg Eff Maturity	6.24
Avg Credit Quality	BB
Avg Wtd Coupon	5.99
Avg Wtd Price	90.52

Credit Analysis 30-06-2009	Bond %
AAA	13.80
AA	11.10
A	2.39
BBB	10.88
BB	24.24
B	16.00
Below B	21.59
NR/NA	0.00

Regional Exposure	Stocks %	Rel ML USD LIBOR 3 Mon
Americas	93.0	—
Greater Europe	3.7	—
Greater Asia	3.3	—

Top Holdings 31-07-2009

Share Chg since 07-2009	Share Amount	6,052 Total Stocks 8,831 Total Fixed-Income — Turnover Ratio	% Net Assets
⊕	10,166	JPMorgan US Large Cap Core Plus Sel	16.41
⊕	6,800	FPA Crescent	15.54
☼	3,962	Needham Growth	10.30
⊕	4,397	Caldwell & Orkin Market Opportunity	9.32
⊕	4,516	BlackRock Global Allocation I	7.65
⊕	7,061	AQR Diversified Arbitrage N	7.61
☼	5,189	Driehaus Active Income	6.25
☼	6,025	MainStay 130/30 High Yield A	6.23
☼	5,421	JPMorgan Strategic Income Opps Sel	6.13
⊕	3,791	Hussman Strategic Growth	5.08
⊕	3,244	Merger	4.96
⊕	2,635	Highbridge Statistical Mkt Neutral	4.34
⊖	1,862	BlackRock Liquidity TempCash Instl	0.19
⊖	0	Hussman Strategic Total Return	0.00
⊖	0	Rydex Managed Futures Strategy H	0.00

Sector Weightings	Stocks %	Rel ML USD LIBOR 3 Mon
Information Economy	**27.5**	**—**
Software	3.9	—
Hardware	12.9	—
Media	3.2	—
Telecommunication	7.5	—
Service Economy	**45.8**	**—**
Healthcare Services	14.1	—
Consumer Services	11.1	—
Business Services	3.9	—
Financial Services	16.7	—
Manufacturing Economy	**26.7**	**—**
Consumer Goods	6.3	—
Industrial Materials	8.2	—
Energy	10.5	—
Utilities	1.7	—

Operations

Family:	Aston	Base Currency:	USD
Manager:	Multiple	Ticker:	ALSOX
Tenure:	0.4 Year	Minimum Initial Purchase:	$100,000
Objective:	Asset Allocation	Purchase Constraints:	

Fund Reports

The Collar Fund

by **Nadia Papagiannis** CFA

Advisor
Summit Portfolio Advisors, LLC

Advisor Location
Denver, Colorado

Assets Under Management
$5.4 million (fund)

Inception Date
June 29, 2009

Investment Type
U.S. open-end mutual fund

Morningstar Category
Long-Short

Management
Thomas Schwab started Summit Portfolio Advisors, a registered investment advisor, in 2005 with his son and daughter, Joseph M. Schwab and Elizabeth Uhl, who now act as portfolio managers to the firm's collar strategy (also available in separate accounts). Schwab started his career in 1968 as an NYSE examiner, and then worked as a financial analyst for Goldman Sachs. Thirty years of his career, however, was spent at Smith Barney, where he moved from a retail stock broker to consulting large pension clients. He also established his own asset-management division, specializing in dynamic style investing inspired by the work of William Sharpe.

Strategy

The fund takes listed, collared option positions on individual equities, writing a call and a put with the same expiration simultaneously on the same underlying security. The goal is to collar the stock's returns, by capping both the upside and downside, to achieve a particular risk/return profile, about 1.5 to 2 times risk. Risk in this particular case means a 10% total loss in the fund, if all stocks drop to zero, and return means the upside potential of the stock the collar has locked in. Expirations of collars recently initiated are farther out, close to 500 days, because the longer-term optimism of the market is reflected in more expensive call premiums and less expensive put premiums at these expirations. As new flows come into the fund, the expirations will become more staggered. Every equity position in the portfolio is collared. Often, the premium received from the call option offsets most or all of the put option's premiums and required dividend payments, resulting in "zero cost" collars.

Process

Management looks at the risk/return profile of collaring equities with listed options, whose expirations stretch up to two years. Schwab manages the portfolio from a risk perspective, ensuring that the portfolio assets never take on more than 10% risk of loss. If a particular position takes on greater than a 10% risk profile—for example, when a collar is unwound—the additional risk will be offset by cash. The spread of the collars and the amount of risk taken depend on the market environment. Before the 2007 market crash, for example, when risk was priced cheaply, collars in management's separate accounts were narrower, whereas now they tend to be wider. The best market environment for this strategy is when stock prices are increasing. Therefore, this is generally a momentum strategy, although the strategy can also profit in a sideways market. The fact that this strategy is largely momentum-driven also means that the fund can become more concentrated in the "hot" sectors. For example, as of the end of July, materials comprised 20% of the fund's assets. The fund may also, however, invest in a stock that is temporarily beaten down due to negative news, in the expectation of a rebound. The underlying stock is chosen for the pricing of its traded options and for the stability of the dividend (which is a cost in the collar strategy). The fund currently holds around 60 positions but can hold up to 100 or more. The target cash position in the fund is 15%–20%.

Risk Management

The worst market environment for this strategy is one we have experienced most recently, when stock prices can drop suddenly or take a downward trend. Typically, if stock prices drop by 30%, the fund will recollar the stock rather than remain in the current unprofitable collar. If no collars are found with an appropriate risk/return profile, the fund will sit in cash, preferring to take on less risk rather than bolster returns. Management will also take on a greater cash position rather than sell a position in the event of illiquidity. Therefore, this strategy tends to be very conservative, and investors looking for equitylike returns should not invest in this fund. Management intends this fund to exhibit a beta of 0.25–0.30, although it may be even lower over periods when the fund experiences gains while the market is losing. This fund is inherently tax-inefficient due to the treatment of option premiums received as income, so it is more appropriate for tax-deferred accounts.

The Collar (USD)

Incept	Type	Total Assets	Morningstar Cat
29-06-2009	MF	$5.39 mil	Long-Short

Performance 31-08-2009

Quarterly Returns	1st Qtr	2nd Qtr	3rd Qtr	4th Qtr	Total %
2007	—	—	—	—	—
2008	—	—	—	—	—
2009	—	—	—	—	—

Trailing Returns	1 Yr	3 Yr	5 Yr	10 Yr	Incept
Std Monthly	—	—	—	—	2.20
Std Quarterly	—	—	—	—	0.00
Total Return	—	—	—	—	2.20
+/- ML USD LIBOR 3 Mon	—	—	—	—	—
+/- S&P 500 TR	—	—	—	—	—
% Rank Cat	—	—	—	—	
No. in Cat	—	—	—	—	
7-day Yield	—				

Performance Disclosure

The Overall Morningstar Rating is based on risk-adjusted returns, derived from a weighted average of the three-, five-, and 10-year (if applicable) Morningstar metrics.

The performance data quoted represents past performance and does not guarantee future results. The investment return and principal value of an investment will fluctuate; thus an investor's shares, when sold or redeemed, may be worth more or less than their original cost.

Current performance may be lower or higher than return data quoted herein. For performance data current to the most recent month-end, please call 888-526-5527.

Fees and Expenses

Sales Charges

Front-End Load %	**NA**
Deferred Load %	**NA**

Fund Expenses

Management Fees %	0.95
12b1 Expense %	NA
Gross Expense Ratio %	**0.99**

Risk and Return Profile

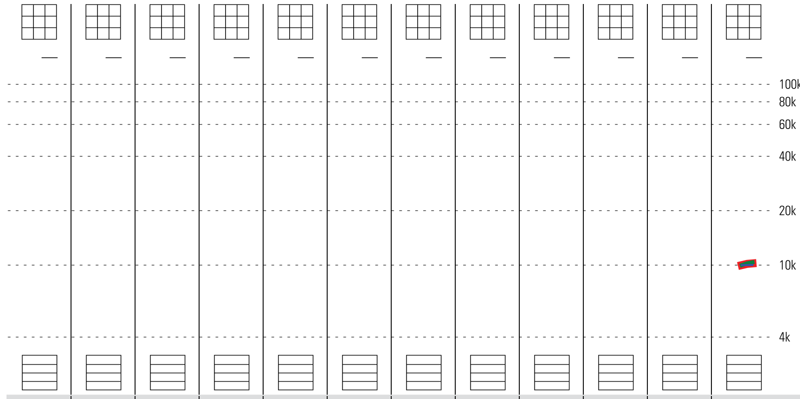
	3 Yr	5 Yr	10 Yr
	—	—	—
Morningstar Rating™	—	—	—
Morningstar Risk	—	—	—
Morningstar Return	—	—	—

	3 Yr	5 Yr	10 Yr
Standard Deviation	—	—	—
Mean	—	—	—
Sharpe Ratio	—	—	—

MPT Statistics	Standard Index ML USD LIBOR 3 Mon	Best Fit Index
Alpha	—	—
Beta	—	—
R-Squared	—	—

12-Month Yield	—
30-day SEC Yield	—
Potential Cap Gains Exp	—

Investment Style
Equity
Stock %



Growth of $10,000
- The Collar 10,220
- Cat Avg: Long-Short 10,360
- Index: ML USD LIBOR 3 Mon CM 10,014

Performance Quartile (within category)

1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	08-09	History
—	—	—	—	—	—	—	—	—	—	—	*10.22*	NAV
—	—	—	—	—	—	—	—	—	—	—	—	Total Return %
—	—	—	—	—	—	—	—	—	—	—	—	+/- ML USD LIBOR 3 Mon
—	—	—	—	—	—	—	—	—	—	—	—	+/- S&P 500 TR
—	—	—	—	—	—	—	—	—	—	—	—	% Rank Cat
—	—	—	—	—	—	—	—	—	—	—	—	No. of Funds in Cat

Portfolio Analysis —

Composition %	Net %	Long %	Short %
Cash	—	—	—
US Stocks	—	—	—
Non-US Stocks	—	—	—
Bonds	—	—	—
Other/Not Clsfd	—	—	—
Total	—	—	—

Equity Style (Value / Blend / Growth; Large / Mid / Small)

Portfolio Statistics	Port Avg	Rel Index	Rel Cat
P/E Ratio TTM	—	—	—
P/C Ratio TTM	—	—	—
P/B Ratio TTM	—	—	—
Geo Avg Mkt Cap $mil	—	—	—

Fixed-Income Style (Short / Int / Long; High / Med / Low)

Avg Eff Duration	—
Avg Eff Maturity	—
Avg Credit Quality	—
Avg Wtd Coupon	—
Avg Wtd Price	—

Credit Analysis	Bond %
AAA	—
AA	—
A	—
BBB	—
BB	—
B	—
Below B	—
NR/NA	—

Regional Exposure	Stocks %	Rel ML USD LIBOR 3 Mon
Americas	—	—
Greater Europe	—	—
Greater Asia	—	—

Top Holdings

Share Chg since —	Share Amount	0 Total Stocks 0 Total Fixed-Income — Turnover Ratio	% Net Assets

Sector Weightings	Stocks %	Rel ML USD LIBOR 3 Mon
Information Economy	**—**	**—**
Software	—	—
Hardware	—	—
Media	—	—
Telecommunication	—	—
Service Economy	**—**	**—**
Healthcare Services	—	—
Consumer Services	—	—
Business Services	—	—
Financial Services	—	—
Manufacturing Economy	**—**	**—**
Consumer Goods	—	—
Industrial Materials	—	—
Energy	—	—
Utilities	—	—

Operations

Family:	TheCollarFund	Base Currency:	USD	Minimum IRA Purchase:	$2,500
Manager:	Multiple	Ticker:	COLLX	Purchase Constraints:	
Tenure:	0.3 Year	Minimum Initial Purchase:	$2,500		
Objective:	Growth	Min Auto Investment Plan:	$2,500		

MORNINGSTAR®

Fund Reports

Wasatch-1st Source Long/Short

by **Nadia Papagiannis,** CFA

Advisor
Wasatch Advisors

Advisor Location
South Bend, Indiana

Assets Under Management
$143 million (fund)

Inception Date
Aug. 1, 2003

Investment Type
U.S. open-end mutual fund

Morningstar Category
Long-Short

Management
Portfolio managers Mike Shinnick and Ralph Shive teamed up in 2003. Shinnick had been running a personal long-short equity portfolio when he was introduced to Shive, after years in technology, business strategy, and private equity consulting at Diamond Technology Partners and Zurich Financial Services. Shive had worked for 1st Source for 20 years as chief investment officer and portfolio manager of Wasatch-1st Source Income Equity **FMIEX** since its inception in 1996. Shive's fund is a large-capitalization value equity fund with a 5-star rating.

Strategy

The fund uses both fundamental and technical analysis. It takes long positions in companies trading at a reasonable discount to intrinsic value that can benefit from the current macroeconomic environment and business cycle, that have strong competitive positions, and that have near-term price-appreciation catalysts. For example, management believes that Wal-Mart **WMT**, due to its information systems and its revenues from groceries, has the ability to price and grow in both inflationary and deflationary environments. Furthermore, management believes higher energy prices are driving consumers to do more one-stop shopping. On the short side, management sells short overpriced stocks with price-decline catalysts. For example, the fund has shorted ExxonMobil **XOM** because, unlike its competitors, it has not yet announced an overstatement of reserves, and it has been using excess cash to buy back stock rather than exploration and production. The stock has also been trading below its 200-day moving average. The portfolio typically remains 50%–70% net long, although it can turn net short. The fund charges a 1.44% expense ratio net of dividend expenses.

Process

Shive and Shinnick work very closely together in generating investment ideas and trading. The strategic partnership with Wasatch, which was completed in December 2008, now also forces management to rationalize every trade with the rest of Wasatch's team of portfolio managers, which may also help to generate investment ideas. For example, this process led the fund to invest in CNA Financial **CNA**, which is majority-owned by Loews **L**, the original investment idea. The Wasatch team believed that the market was not pricing in the new CEO's underwriting turnaround. The duo primarily works with outside, non-Wall-Street research. For example, management uses Ned Davis Research, which is known for macroeconomic analysis combining fundamental and technical factors, and 13-D Research, which attempts to identify outperforming asset classes or industry groups. Management first takes a top-down approach to the portfolio, determining which industries and which particular companies within those industries can benefit from the current macroeconomic environment. Management also uses this macroeconomic data to determine the fund's net equity position. For individual stock selection, management has a value bent, although it considers growth-at-a-reasonable-price and special situations.

Risk Management

The fund's short positions are directional bets rather than hedges. If the size of management's short portfolio falls short of the desired net exposure, the fund will take a larger cash stake, as it did in the fourth quarter of 2008, or write call options on the fund's long stocks, as it did in the second quarter of 2009, taking advantage of volatility in a generally rising market. Management avoids crowded shorts and sector ETFs, as it prefers to control the risk of individually selected shorts. Shorts are covered when intrinsic value is reached, or to minimize losses due to an adverse technical price move. Management uses technical analysis to select entry and exit points for short positions. Initial positions are 50 to 100 basis points, up to a maximum of 5% for shorts, but few short positions exceed 2% of portfolio assets. Long positions can reach a maximum of 6% of assets and are covered when intrinsic value is reached, a better idea is generated, or to protect capital in the event of a loss.

Wasatch-1st Source Long/Short (USD)

Overall Morningstar Rtg™	Incept	Type	Total Assets	Morningstar Cat
★★★ 108 Long-Short	01-08-2003	MF	$142.57 mil	Long-Short

Performance 31-08-2009

Quarterly Returns	1st Qtr	2nd Qtr	3rd Qtr	4th Qtr	Total %
2007	0.16	6.08	-0.70	-0.50	4.98
2008	-2.36	1.81	-5.37	-15.94	-20.93
2009	-1.46	16.00	—	—	22.41

Trailing Returns	1 Yr	3 Yr	5 Yr	10 Yr	Incept
Std Monthly	-5.81	—	4.58	—	5.01
Std Quarterly	-9.08	—	3.03	—	3.95
Total Return	-5.81	2.26	4.58	—	5.01
+/- ML USD LIBOR 3 Mon	-8.01	-1.79	0.77	—	—
+/- S&P 500 TR	12.45	8.04	4.09	—	—
% Rank Cat	48	22	13	—	
No. in Cat	186	108	63	—	
7-day Yield	—				

Performance Disclosure

The Overall Morningstar Rating is based on risk-adjusted returns, derived from a weighted average of the three-, five-, and 10-year (if applicable) Morningstar metrics.

The performance data quoted represents past performance and does not guarantee future results. The investment return and principal value of an investment will fluctuate; thus an investor's shares, when sold or redeemed, may be worth more or less than their original cost.

Current performance may be lower or higher than return data quoted herein. For performance data current to the most recent month-end, please call 800-551-1700 or visit www.wasatchfunds.com.

Fees and Expenses

Sales Charges

Front-End Load %	**NA**
Deferred Load %	**NA**

Fund Expenses

Management Fees %	1.10
12b1 Expense %	NA
Gross Expense Ratio %	**1.67**

Risk and Return Profile

	3 Yr	5 Yr	10 Yr
	108 funds	63 funds	*21 funds*
Morningstar Rating™	3★	4★	—
Morningstar Risk	+Avg	Avg	—
Morningstar Return	+Avg	+Avg	—

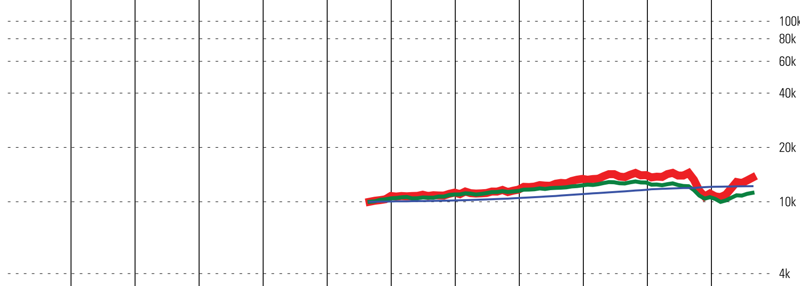
	3 Yr	5 Yr	10 Yr
Standard Deviation	14.45	11.71	—
Mean	2.26	4.58	—
Sharpe Ratio	0.04	0.18	—

MPT Statistics	Standard Index ML USD LIBOR 3 Mon	Best Fit Index DJ Moderate Portfolio TR USD
Alpha	10.10	1.93
Beta	-7.28	0.91
R-Squared	6.02	83.43

12-Month Yield	—
30-day SEC Yield	—
Potential Cap Gains Exp	-4.06% Assets

Investment Style
Equity
Stock %

—	—	—	—	—	48	59	72	67	68	76	67



Performance Quartile (within category)

1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	08-09	History
—	—	—	—	—	*10.63*	10.79	10.85	11.62	11.57	8.88	10.87	NAV
—	—	—	—	—	—	4.47	3.82	14.72	4.98	-20.93	22.41	Total Return %
—	—	—	—	—	—	3.17	0.68	9.63	-0.67	-24.75	21.53	+/- ML USD LIBOR 3 Mon
—	—	—	—	—	—	-6.41	-1.09	-1.07	-0.52	16.07	7.44	+/- S&P 500 TR
—	—	—	—	—	—	—	—	11	47	67	2	% Rank Cat
—	—	—	—	—	—	—	—	98	143	152	200	No. of Funds in Cat

Portfolio Analysis 30-06-2009

Composition %	Net %	Long %	Short %
Cash	33.75	33.75	0.00
US Stocks	58.39	74.55	16.16
Non-US Stocks	3.00	3.00	0.00
Bonds	0.00	0.00	0.00
Other/Not Clsfd	4.87	4.87	0.00
Total	100.00	116.16	16.16

Equity Style (Value Blend Growth; Large Mid Small)

Portfolio Statistics	Port Avg	Rel Index	Rel Cat
P/E Ratio TTM	11.4	—	0.74
P/C Ratio TTM	6.3	—	0.82
P/B Ratio TTM	1.5	—	0.68
Geo Avg Mkt Cap $mil	10130	—	0.52

Fixed-Income Style (Short Int Long; High Med Low)

Avg Eff Duration	—
Avg Eff Maturity	—
Avg Credit Quality	—
Avg Wtd Coupon	—
Avg Wtd Price	—

Credit Analysis	Bond %
AAA	—
AA	—
A	—
BBB	—
BB	—
B	—
Below B	—
NR/NA	—

Regional Exposure	Stocks %	Rel ML USD LIBOR 3 Mon
Americas	98.9	—
Greater Europe	0.0	—
Greater Asia	1.1	—

Top Holdings

85 Total Stocks
0 Total Fixed-Income
71% Turnover Ratio

Share Chg since 03-2009	Share Amount		% Net Assets
⊕	125,000	Wal-Mart Stores, Inc.	5.25
☼	200,000	Loews Corporation	4.75
	185,000	Republic Services, Inc. A	3.91
☼	250,000	CNA Financial Corporation	3.35
⊖	50,000	Cerner Corporation	2.70
	110,000	Waste Management, Inc.	2.68
☼	90,000	Noble Corporation	2.36
⊖	125,000	Oracle Corporation	2.32
⊕	120,000	Electronic Arts, Inc.	2.26
	150,000	eBay, Inc.	2.23
⊖	60,000	Energen Corporation	2.07
	100,000	Sysco Corporation	1.95
⊕	32,000	ExxonMobil Corporation	-1.94
	70,000	Bed Bath & Beyond, Inc.	-1.86
	50,000	Plains All American Pipeline, L.P.	1.84

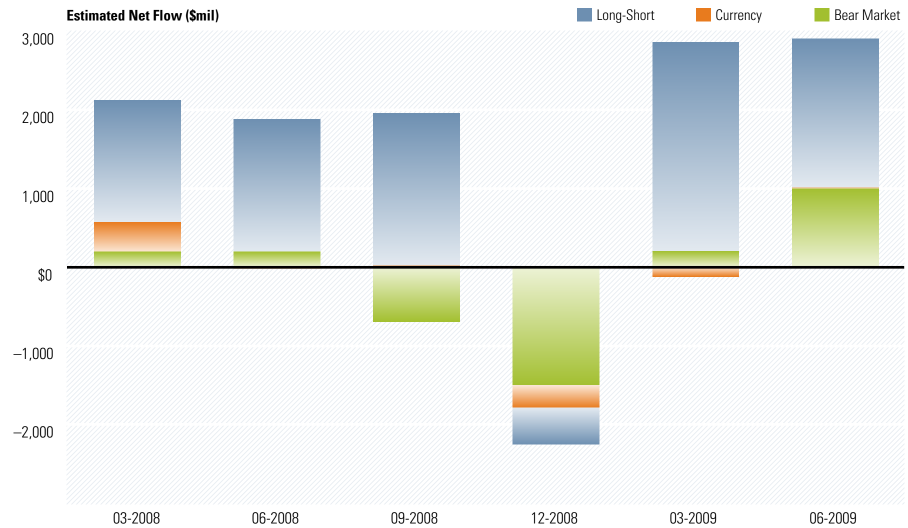
Sector Weightings	Stocks %	Rel ML USD LIBOR 3 Mon
Information Economy	**23.1**	**—**
Software	13.0	—
Hardware	1.8	—
Media	0.0	—
Telecommunication	8.2	—
Service Economy	**33.9**	**—**
Healthcare Services	6.2	—
Consumer Services	14.8	—
Business Services	0.0	—
Financial Services	12.9	—
Manufacturing Economy	**43.0**	**—**
Consumer Goods	2.8	—
Industrial Materials	18.0	—
Energy	18.0	—
Utilities	4.1	—

Operations

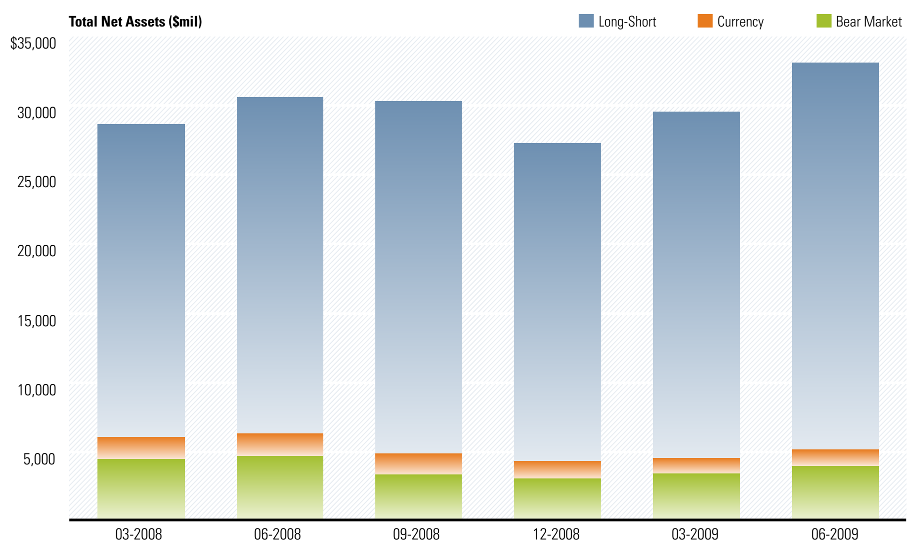
Family:	Wasatch	Base Currency:	USD	Minimum IRA Purchase:	$1,000
Manager:	Multiple	Ticker:	FMLSX	Purchase Constraints:	
Tenure:	6.1 Years	Minimum Initial Purchase:	$2,000		
Objective:	Aggressive Growth	Min Auto Investment Plan:	$1,000		

Flows and Assets Under Management: Alternative Mutual Funds

Quarterly Alternative Mutual Fund Flows
Investors directed more assets—about $2.9 billion—into alternative mutual funds during the second quarter of 2009 than in the previous five quarters. Unlike the previous three quarters, no alternative fund category experienced outflows between April and June 2009. Funds in the long-short category again attracted the most assets, about $1.9 billion, with overall net inflows of $9.2 billion into the category over the 18 months ended June 2009.



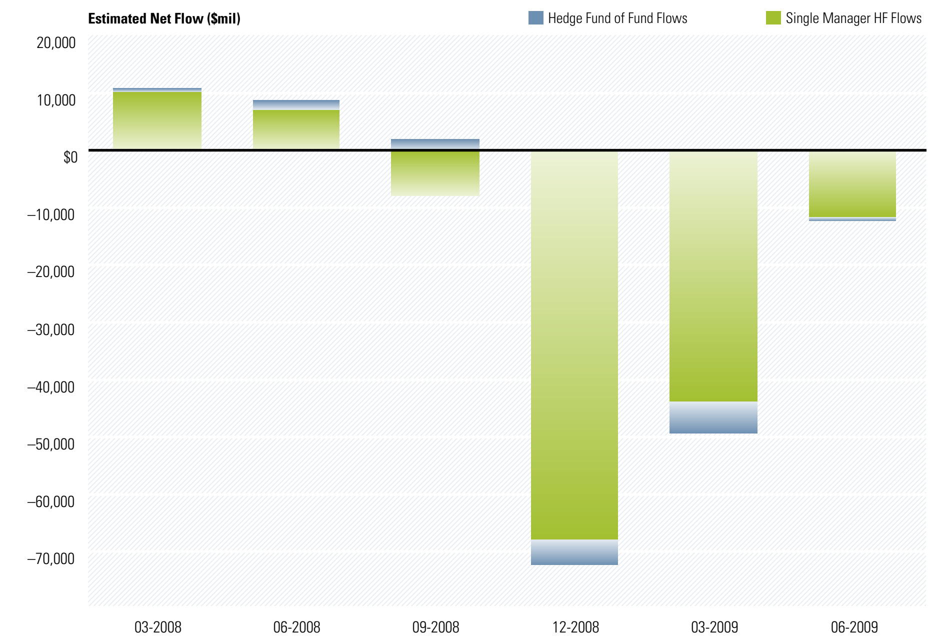
Quarterly Alternative Mutual Fund Assets Under Management
Long-short mutual funds' assets under management increased 11.6% in the second quarter of 2009 to almost $28 billion, helped by both positive performance and new inflows. Currency mutual funds experienced a 5.5% increase in assets, while bear market mutual fund assets jumped 16.4% in the second quarter, due to inflows from nervous investors who didn't anticipate a stock market recovery.



Flows and Assets Under Management: Hedge Funds

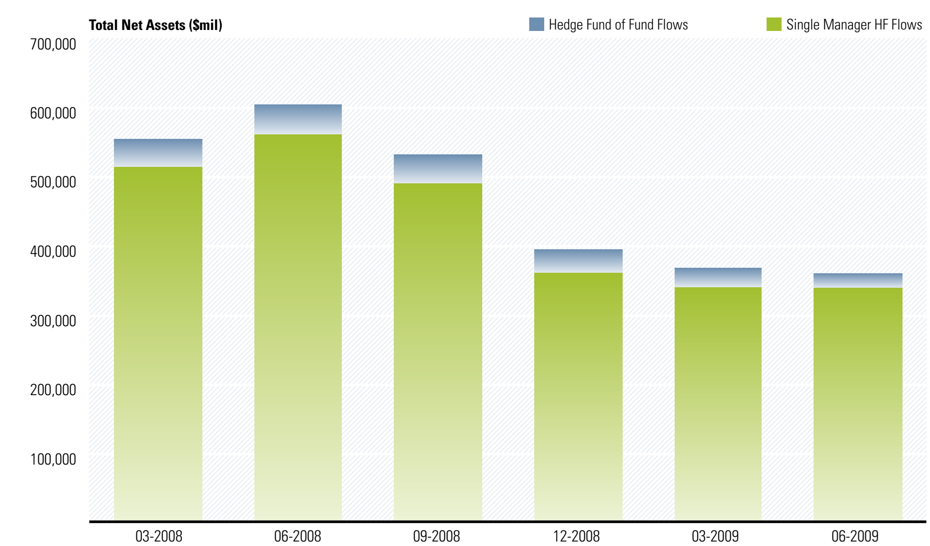
Quarterly Hedge Fund Flows

Hedge funds still suffered from outflows in the second quarter of 2009, about $11.7 billion in total. Multistrategy and corporate actions hedge funds saw the bulk of this outflow, at $3.3 billion and $2.2 billion, respectively. Certain hedge fund categories, however, received inflows, namely trend-following hedge funds (global trend) with $0.9 billion of new funds. Overall, hedge fund outflows declined significantly from the previous two quarters.



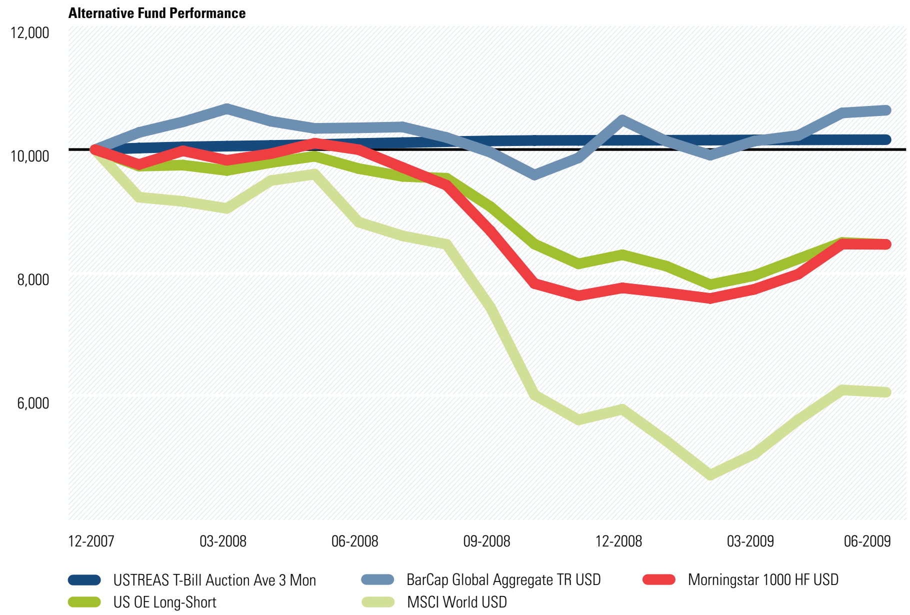
Quarterly Hedge Fund Assets Under Management

Single-manager hedge fund assets dropped in the second quarter by less than 1%, as the result of continued outflows offsetting generally positive performance. But this drop dwarfs the asset declines of the previous two quarters, indicating that assets are stabilizing. Hedge fund of fund assets, however, are still declining, dropping 26% between the first and second quarters of 2009, more than in the previous two quarters.

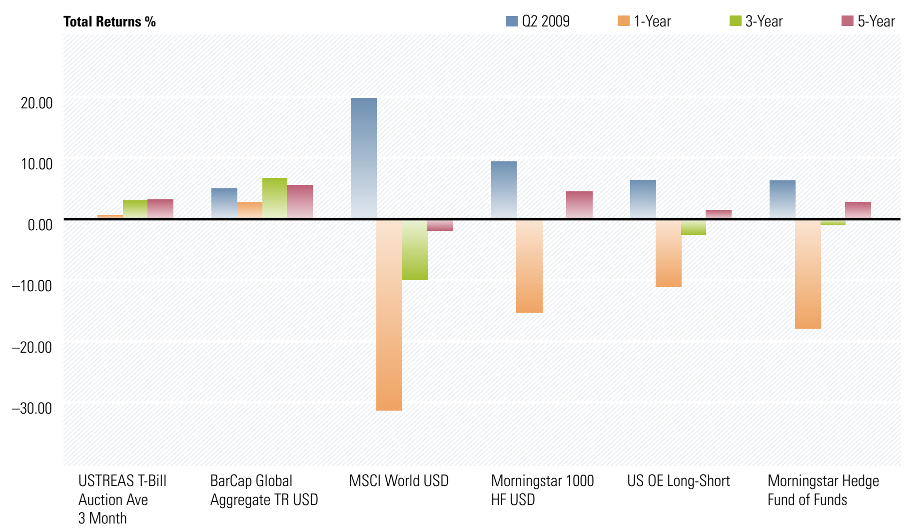


Alternative Investment Performance

Growth of a $10,000 Alternative Investment
Hedge funds and long-short mutual funds rallied along with the markets in 2009's second quarter but are still down 15% on average since the beginning of 2008. As the global equities are still off more than 39% in the 18 months ended June 2009, alternative investments successfully hedge much of the equity markets' losses. Investors, however, would have still fared significantly better in a risk-free or cash investment over this time period.



Performance of Alternative Investments Over Time
The Morningstar 1000 Hedge Fund Index increased by 9.4% in the second quarter, about double that of bonds and half that of equities. Long-short mutual funds increased by less than hedge funds on average, but these strategies do not employ the levels of leverage that hedge funds do. Lower leverage helped the long-short mutual fund category lose less than the Morningstar 1000 Hedge Fund Index over the last year, but hedge funds outperformed over the last three and five years.

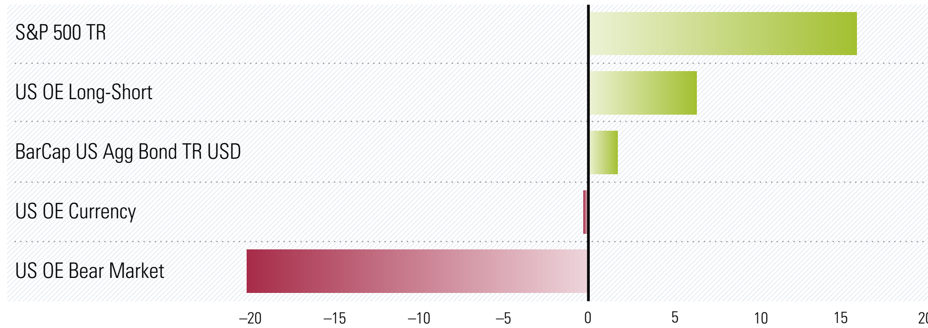


Q1 Performance by Category

Alternative Mutual Funds

Because of the tremendous rally in equity markets, U.S. bear-market mutual funds saw a sizeable 20.3% decline. Currency funds remained virtually flat in the second quarter, dropping only 0.3%, as currency volatility remained low. U.S. long-short mutual funds participated in some of the stock market gains, returning 6.4% versus the S&P 500's 15.9%.

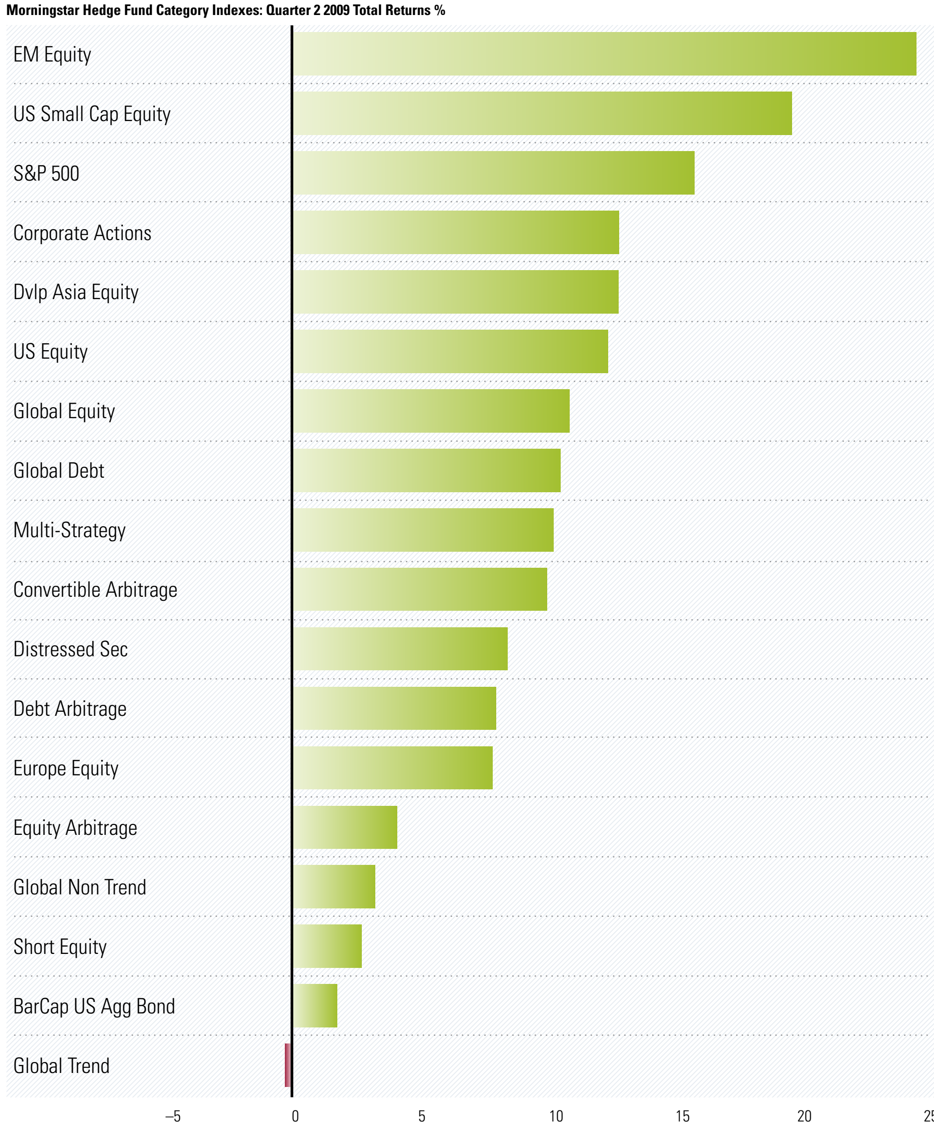
Morningstar Alternative Mutual Fund Category Averages: Quarter 2 2009 Total Returns %



Hedge Funds

Hedge funds also benefited from the equity market rebound, especially hedge funds trading in the higher-beta, less liquid markets. The Morningstar Emerging Markets Equity and US Small Cap Equity Hedge Fund Indexes sported the biggest gains, at 24.7% and 19.8%, respectively, while the Morningstar Global Trend Hedge Fund Index lost 0.3%. Trend-following hedge fund strategies struggled as many futures markets lacked sustainable trends in the second quarter.

Morningstar Hedge Fund Category Indexes: Quarter 2 2009 Total Returns %

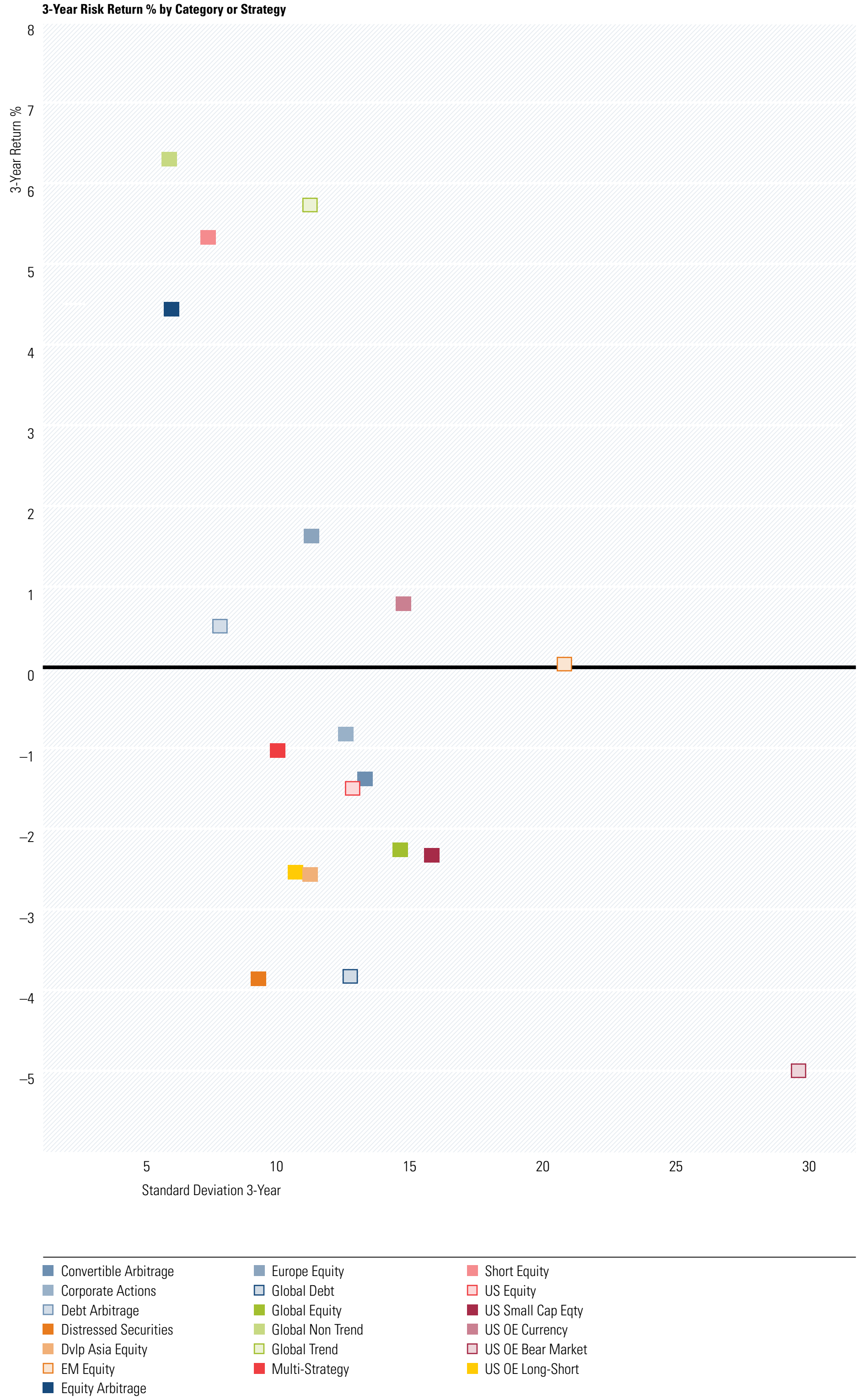


Risk versus Return: Alternative Mutual Funds and Hedge Funds

Three-Year Standard Deviation and Return

Eight alternative investment category indexes and averages provided positive returns over the three years ended June 2009: global trend hedge funds (5.7%), global non-trend hedge funds (6.3%), short equity hedge funds (5.3%), equity arbitrage hedge funds (4.4%), Europe equity hedge funds (1.6%), currency mutual funds (0.8%), debt arbitrage hedge funds (0.5%), and emerging-markets equity hedge funds (0.04%). Europe equity, emerging-markets equity, and debt arbitrage hedge funds fell into the black after strong performance in the second quarter. Funds in the Morningstar Global Non-Trend Hedge Fund Index provided the best risk-adjusted return, with a low three-year annualized standard deviation of 5.7%, while funds in the bear-market mutual fund category provided one of the worst, with a three-year return and annualized standard deviation of –5.0% and 29.3%, respectively.

3-Year Risk Return % by Category or Strategy



Correlations by Alternative Fund Strategy

Three-Year Correlations: Alternative Mutual Fund Categories

		1	2	3	4
1	US OE Long-Short Cat Avg	1.00			
2	US OE Bear Market Cat Avg	–0.90	1.00		
3	US OE Currency Cat Avg	0.39	–0.19	1.00	
4	Morningstar 1000 HF Index	0.90	–0.73	0.44	1.00

Three-Year Correlations: Hedge Fund Category Indexes

		1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16
1	Morningstar Convtbl Arbitrage HF USD	1.00															
2	Morningstar Corporate Actions HF USD	0.88	1.00														
3	Morningstar Debt Arbitrage HF USD	0.95	0.91	1.00													
4	Morningstar Distressed Sec HF USD	0.74	0.86	0.82	1.00												
5	Morningstar Dvlp Asia Equity HF USD	0.81	0.87	0.86	0.70	1.00											
6	Morningstar EM Equity HF USD	0.82	0.93	0.87	0.82	0.91	1.00										
7	Morningstar Equity Arbitrage HF USD	0.80	0.85	0.83	0.67	0.83	0.83	1.00									
8	Morningstar Europe Equity HF USD	0.83	0.91	0.86	0.75	0.87	0.93	0.94	1.00								
9	Morningstar Global Debt HF USD	0.94	0.90	0.94	0.86	0.79	0.85	0.82	0.88	1.00							
10	Morningstar Global Equity HF USD	0.86	0.94	0.89	0.78	0.92	0.95	0.92	0.97	0.87	1.00						
11	Morningstar Global Non Trend HF PUSD	0.62	0.72	0.69	0.52	0.76	0.74	0.87	0.81	0.63	0.83	1.00					
12	Morningstar Global Trend HF USD	0.03	0.23	0.08	0.08	0.24	0.23	0.50	0.37	0.07	0.34	0.68	1.00				
13	Morningstar Multi-Strategy HF USD	0.91	0.97	0.93	0.87	0.88	0.92	0.88	0.92	0.92	0.95	0.76	0.29	1.00			
14	Morningstar Short Equity HF PUSD	–0.47	–0.30	–0.44	–0.16	–0.23	–0.19	–0.44	–0.34	–0.40	–0.29	–0.30	–0.03	–0.31	1.00		
15	Morningstar US Equity HF USD	0.86	0.93	0.87	0.89	0.83	0.90	0.76	0.85	0.88	0.91	0.62	0.12	0.94	–0.17	1.00	
16	Morningstar US Small Cap Eqty HF USD	0.83	0.91	0.87	0.86	0.89	0.93	0.79	0.86	0.85	0.93	0.68	0.19	0.94	–0.14	0.96	1.00

1.00 to 0.75 | 0.75 to 0.50 | 0.50 to 0.25 | 0.25 to 0.00
0.00 to –0.25 | –0.25 to –0.50 | –0.50 to –0.75 | –0.75 to –1.00

Correlations of Alternative Funds to Traditional Asset Classes

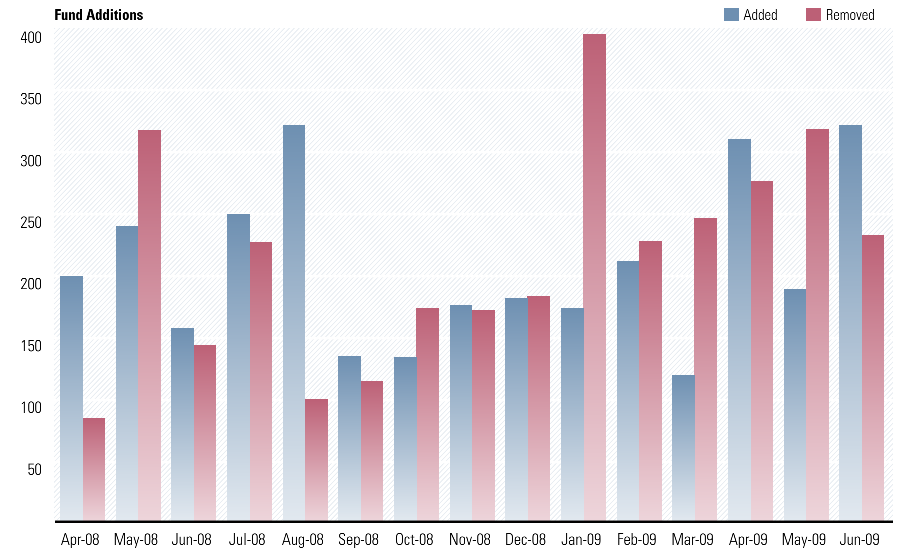
Correlation of Hedge Funds to U.S. Stocks and Bonds	S&P 500 Correlation (USD)			BarCap US Agg Correlation (USD)		
	2006-07-01 to 2009-06-30 3-Year	2004-07-01 to 2009-06-30 5-Year	1999-07-01 to 2009-06-30 10-Year	2006-07-01 to 2009-06-30 3-Year	2004-07-01 to 2009-06-30 5-Year	1999-07-01 to 2009-06-30 10-Year
US OE Long-Short	0.94	0.92	0.70	0.26	0.14	0.13
US OE Bear Market	–0.96	–0.96	–0.94	–0.39	–0.27	0.02
US OE Currency	0.27	0.24	0.09	0.18	–0.01	0.29

Correlation of Hedge Funds to U.S. Stocks and Bonds	S&P 500 Correlation (USD)			BarCap US Agg Correlation (USD)		
	2006-07-01 to 2009-06-30 3-Year	2004-07-01 to 2009-06-30 5-Year	2003-01-01 to 2009-06-30 Since Index Inception	2006-07-01 to 2009-06-30 3-Year	2004-07-01 to 2009-06-30 5-Year	2003-01-01 to 2009-06-30 Since Index Inception
Morningstar 1000 HF USD	0.75	0.76	0.75	0.29	0.15	0.21
Morningstar Convtbl Arbitrage HF USD	0.69	0.66	0.62	0.46	0.34	0.31
Morningstar Corporate Actions HF USD	0.71	0.71	0.71	0.24	0.12	0.15
Morningstar Debt Arbitrage HF USD	0.71	0.68	0.66	0.42	0.28	0.34
Morningstar Distressed Sec HF USD	0.74	0.73	0.73	–0.02	–0.10	–0.03
Morningstar Dvlp Asia Equity HF USD	0.74	0.71	0.67	0.40	0.21	0.17
Morningstar EM Equity HF USD	0.77	0.75	0.74	0.23	0.12	0.20
Morningstar Equity Arbitrage HF USD	0.57	0.56	0.54	0.42	0.22	0.28
Morningstar Europe Equity HF USD	0.71	0.68	0.69	0.35	0.18	0.22
Morningstar Global Debt HF USD	0.74	0.72	0.71	0.37	0.27	0.31
Morningstar Global Equity HF USD	0.75	0.75	0.76	0.30	0.16	0.17
Morningstar Global Non Trend HF USD	0.40	0.44	0.42	0.30	0.14	0.32
Morningstar Global Trend HF USD	–0.07	0.07	0.10	–0.06	–0.11	0.10
Morningstar Multi-Strategy HF USD	0.72	0.72	0.70	0.25	0.11	0.19
Morningstar Short Equity HF PUSD	–0.09	–0.04	–0.07	–0.53	–0.45	–0.29
Morningstar US Equity HF USD	0.85	0.85	0.85	0.15	0.05	0.08
Morningstar US Small Cap Eqty HF USD	0.86	0.86	0.86	0.19	0.07	0.08

Morningstar Hedge Fund Database Overview as of 08-31-09

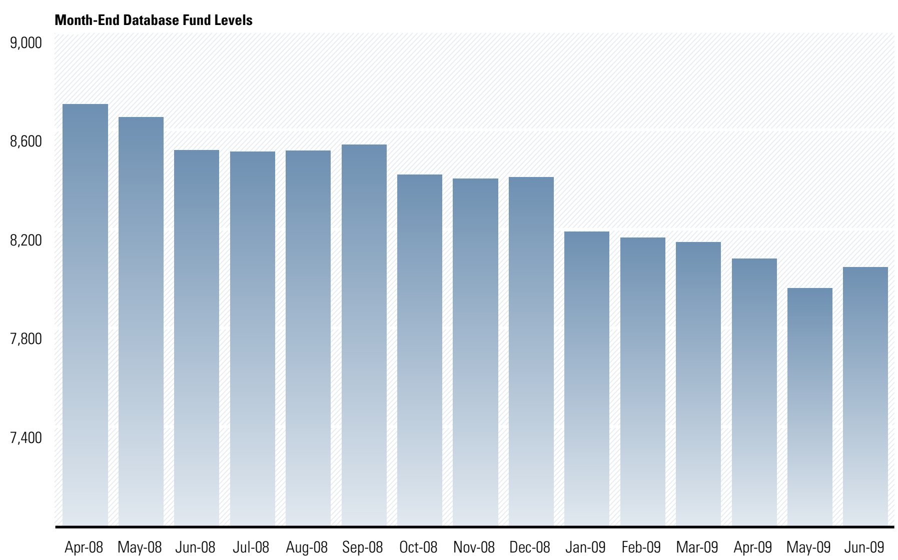
Fund Additions by Month

In the second quarter of 2009, Morningstar's hedge fund database experienced a small net drop of seven funds, as additions in April and June were outweighed by dropouts in May. This small net drop, however, sharply contrasts with the previous quarter, when a substantial number of funds left the database in January and March 2009. Funds drop out because they have liquidated or because they are unwilling to share performance data, typically due to poor performance.



Month-End Database Fund Levels

As of June 30, 2009, Morningstar's hedge fund database reached 8,052 funds. This figure includes both single-manager hedge funds and funds of hedge funds, which account for approximately 3,000 and 5,000 funds, respectively. May 2009 marked the lowest level of hedge funds in more than 12 months, as the fall out from insurmountable 2008 losses continued.

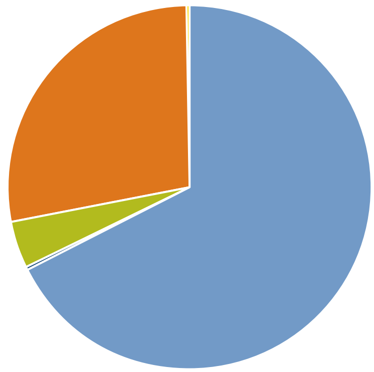


Morningstar Hedge Fund Database Overview as of 08-31-09

Hedge Funds by Region

Most hedge fund advisors in Morningstar's database are located in North America or the Caribbean, because many U.S. hedge funds follow a master-feeder structure. In this structure an offshore feeder is set up for U.S. tax-exempt institutions to retain their tax status. In Europe, many hedge funds are located in Luxembourg, which provides tax-haven status similar to Caribbean jurisdictions. In Asia, the majority of hedge funds in the database are located in China.

Morningstar Hedge Fund Database by Region



Region	# Funds
North America/Carribbean	5,488
Africa	15
Asia/Australia	348
Europe	2,250
South America	12
Total	**8,113**

Hedge Funds by Location

The Cayman Islands houses a large number of hedge funds, more than in the United States, according to Morningstar's database. The Cayman Islands Monetary Authority requires registration of hedge funds, as long as there are more than 15 investors, and the mandatory filing of certain statistics, such as assets under management, investment strategy, and holdings by asset class.

North America & Surrounding	**5,488**
Cayman Islands	2,093
British Virgin Islands	670
Canada	191
Netherlands Antilles	55
Belize	1
United States	1,897
Bermuda	498
Bahamas	76
St. Vincent & the Grenadines	6
Barbados	1

Africa	**15**
Mauritius	11
South Africa	3
Botswana	1

Asia & Australia	**348**
China	269
Hong Kong	6
Malaysia	2
Marshall Islands	1
Australia	65
Singapore	2
Bahrain	2
Samoa	1

Europe	**2,250**
Luxembourg	785
France	267
Switzerland	175
Sweden	88
Spain	40
Liechtenstein	35
Finland	19
Germany	22
Denmark	10
Cyprus	6
Norway	4
Andorra	2
Ireland	258
Guernsey	195
Italy	96
Jersey	94
Netherlands	44
Isle of Man	29
United Kingdom	24
Austria	12
Malta	37
Belgium	4
Portugal	2
Gibraltar	2

South America	**12**
Brazil	12

Morningstar Hedge Fund Database Overview as of 08-31-09

Service Providers

Morgan Stanley and Goldman Sachs account for the largest percentage of prime brokerage service providers in Morningstar's database, with almost a 31% share combined. The big four accounting firms are used by nearly 74% of the database. Citco Fund Services provides administration services to the largest number of funds in Morningstar's database, accounting for more than 15%. Seward and Kissel LLP, is the largest legal service provider to hedge funds in the database.

Type	Rank	Service Provider	% of Database
Prime Broker	1	Morgan Stanley	16.48
	2	Goldman Sachs	14.24
	3	UBS	6.91
	4	Banc of America Securities LLC	5.88
	5	JP Morgan	5.75
	6	Deutsche Bank AG	5.42
	7	Crédit Suisse	3.02
	8	Citigroup	2.69
	9	Merrill Lynch	2.60
	10	Credit Suisse	2.27
Auditor	1	Pricewaterhouse Coopers	24.01
	2	Ernst & Young	18.74
	3	KPMG	16.21
	4	Delloite & Touche	14.99
	5	Rothstein Kass	5.49
	6	Grant Thornton LLP	2.87
	7	McGladrey & Pullen LLP	1.62
	8	BDO Seidman Financial Services	1.22
	9	Eisner LLP	1.10
	10	Cabinet Patrick Sellam	1.06
Administrator	1	Citco Fund Services	15.42
	2	Bank of New York Mellon	6.76
	3	HSBC Financial Services	8.33
	4	Fortis Fund Services	3.67
	5	Citi	5.65
	6	Northern Trust	2.39
	7	UBS	2.15
	8	JP Morgan	2.07
	9	Apex Fund Services Ltd.	2.01
	10	SEI Investments	1.69
Legal Counsel	1	Seward & Kissel LLP	7.43
	2	Walkers Group	5.61
	3	Maples & Calder	5.19
	4	Dechert LLC	4.50
	5	Simmons & Simmons	4.31
	6	Schulte Roth & Zabel LLP	4.14
	7	Elvinger, Hoss & Prussen	3.91
	8	Sidley Austin LLP	2.97
	9	Conyers Dill & Pearman	2.35
	10	Akin Gump Strauss Hauer & Feld LLP	2.07

Alternative Investments Observer

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