Volume 6, Number 2 **Fall/Winter** 2014

Alternative Investments Observer

MORNINGSTAR®

How Alternative Asset Managers Work

Alternative asset managers are capitalizing on investor interest in alternative investments.

by
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We believe that the alternative asset management industry is structurally attractive and generally misunderstood by investors. The relative newness of the industry to the public markets, not to mention the complexity of its accounting, has kept many from looking at the group more closely. We also believe that investors do not fully appreciate the business quality or growth prospects for the biggest and best alternative asset managers, which have, in many cases, greatly expanded beyond their initial roots in private equity. In this report, we seek to answer some of the biggest questions that industry participants and investors might have about the group, including how alternative asset managers generate revenues and how best to evaluate the industry's competitive advantages.

What Is the Alternative Asset Management Industry?

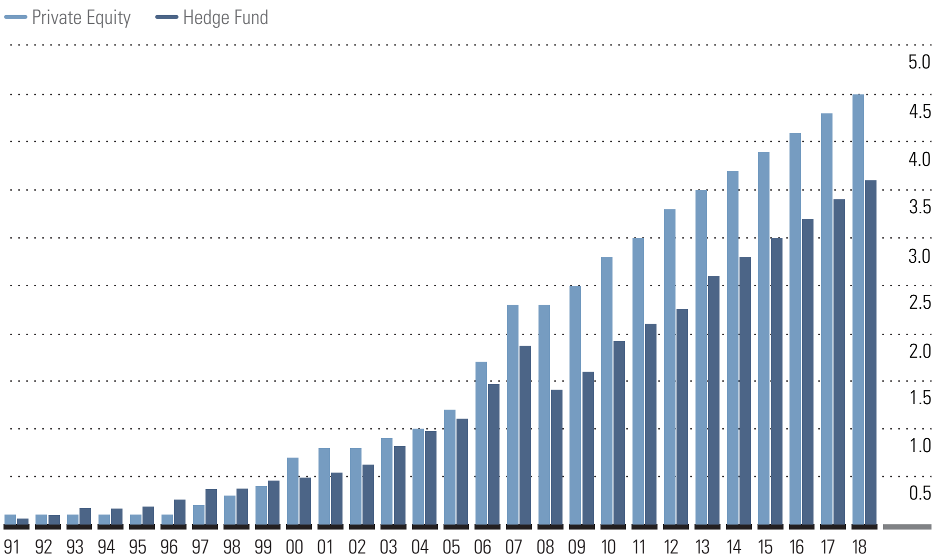
The publicly traded alternative asset managers are global institutions with decades of experience investing in nontraditional asset classes, primarily by managing money for private and public pension funds, endowments, foundations, and other institutions, as well as for high-net-worth individuals. Most of the industry's largest players—including Blackstone **BX**, Apollo **APO**, and Carlyle **CG**—started off in private equity but have expanded their reach over time to include credit, real estate, secondary funds, and funds of funds. Other players—like Oaktree **OAK** and Ares **ARES**—have focused almost exclusively on credit opportunities (distressed, high-yield, convertibles, and mezzanine) with great success. The industry has tended to follow the same business model for going public, structuring as partnerships (which file K-1s), with the investment managers themselves listed as the general partners, and investors in their funds designated as limited partners. Investor interest in the products being offered by the alternative asset managers has increased since the 2008–09 financial crisis, with pension funds—many of which have turned to riskier and higher-returning assets during the past 10 to 15 years in an attempt to close funding gaps—leading the way. In particular, we think that private equity performance has helped increase the level of interest in alternative assets. Returns for the top quartile of private equity funds at 26% and 29% during the past 10 and 20 years, respectively, versus single-digit returns for the MSCI World Index during the same time frame have contributed to a substantial increase in the assets under management for the industry overall during the past 20 years. Given the level of interest that still exists for alternatives, we expect continued healthy levels of growth in AUM for the industry overall going forward.

Editor's Note:

In the cover story of this issue of AIO, Stephen Ellis, director of financial services research in Morningstar's equity research department, discusses the trends driving growth and profitability in the major publicly traded alternative asset managers. This analysis is fascinating not only for the insight it offers into these firms' viability as investment opportunities, but the perspective it provides on the mechanics of the alternative investment industry as a whole.

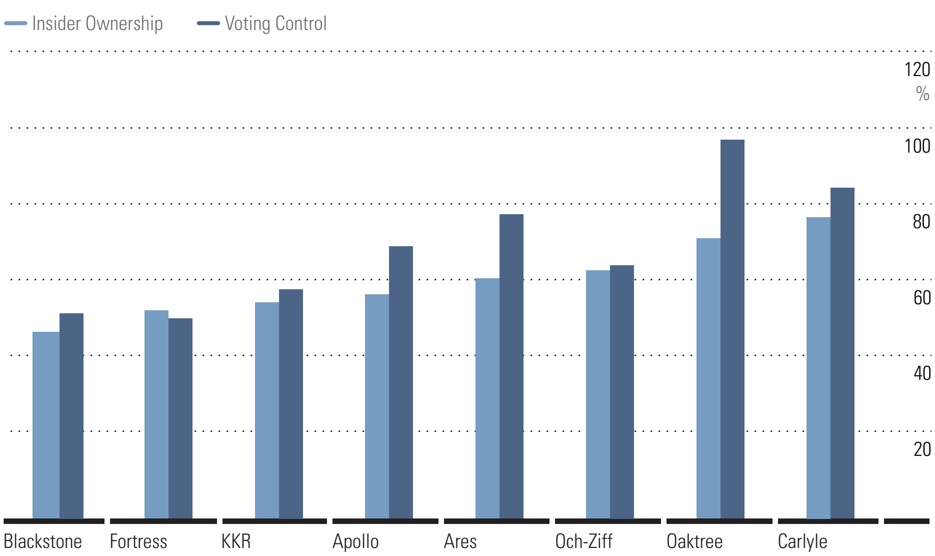
Ellis focuses on private equity as the primary engine driving the industry, while liquid alternatives barely register. Still, many of these firms have been dipping their toes into the liquid space—most notably Blackstone, with its multistrategy mutual fund, but also Carlyle and KKR, with varying degrees of success. Others have been actively investigating the space as well. The private equity business will likely remain hugely profitable, but private hedge funds have seen asset growth slow, so it's not surprising that these firms would seek ways to diversify their revenue streams over time. Whether any of these firms over the long term can successfully translate a "2 and 20" carried interest mentality to the far more price-competitive world of retail mutual funds—and which models of engagement are most promising—remains to be seen.

Exhibit 1 Alternative Assets Under Management Over Time (in $Trillions)



Source: Preqin, McKinsey, Hedge Fund Research, Morningstar.

Exhibit 2 Insider Ownership and Level of Voting Control by Asset Manager

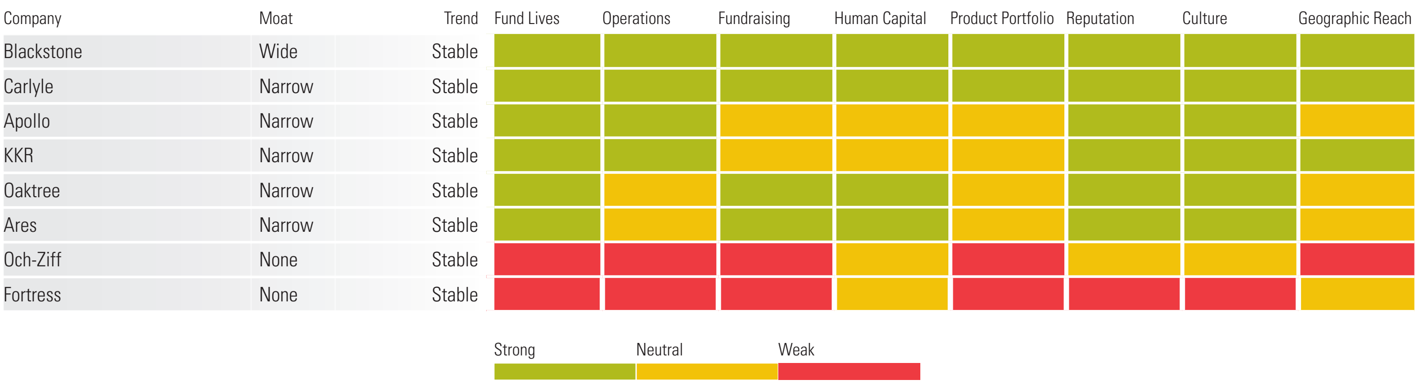


Source: Company reports, Morningstar.

The most recognizable fund structure used by the alternative asset managers is a closed-end fund model, which would describe the traditional private equity fund model, which typically lasts 10 to 11 years. In most cases, a general partner will identify a promising investment niche and engage in a 12- to 24-month fundraising period when potential limited partners (typically restricted to professional and wealthy investors) can subscribe to the fund. The fund can be considered a blind pool, as limited partners do not have any idea of the potential investments the fund could make, relying solely on the manager's track record and reputation when making their decision to invest in the fund. Once a limited partner has committed capital to a fund, it is required to contribute this capital on demand. The manager of the fund will then invest the capital over three to five years. The latter stages of a fund's life are when the manager sells off the company to a strategic acquirer or another private equity firm, or takes it public and earns incentive fees. Limited partners typically recycle their realized gains into the latest fund being offered by the manager, provided that the performance of the previous fund was satisfactory, making the timing and the size of any distributions to limited partners a critical consideration for the alternative asset manager.

Value creation within private equity typically comes from three sources: leverage, multiple expansion, and operational improvements. In the 1980s, the amount of equity that a private equity firm's general partners put into a transaction was typically less than 10% of the deal's value, with the rest of the acquisition price being funded by debt. The leverage, combined with modest operational changes, typically generated substantial returns. In the 1990s, as banks and limited partners grew more reluctant to fund highly leveraged deals after a series of failures, the equity contributions of the general partners increased to the 20%–40% range, reducing the amount of leverage-fueled gains that could be produced. In terms of multiple expansions, the private equity industry has typically seen the best returns when it has been able to put capital to work in a difficult environment (such as following the 2008–09 financial crisis). Blackstone, in particular, had great success buying highly cyclical companies during the trough, using leverage to multiply the gains on their investments as the industries and general economy recovered. By the late 2000s, the private equity industry had generally turned to operational improvements to drive intrinsic value creation at its investments. Carlyle, Blackstone, Apollo, and KKR & Co. **KKR**, among others, have built out substantial employee bases of in-house executives, consultants, and

Exhibit 3 Alternative Asset Manager Moat Framework Heat Map



Source: Morningstar.

advisors who have decades of industry experience and can successfully revitalize a company through cost-cutting, acquisitions, or other strategic maneuvers, increasing the chance of producing a successful investment.

What About Unitholders' Interests?

In 2007, the industry became publicly traded for the first time with the initial public offerings of Och-Ziff **OZM**, Fortress **FIG**, and Blackstone. KKR listed on the NYSE in 2010, Apollo began to trade on the NYSE in 2011, and Oaktree and Carlyle followed in 2012. Ares only recently became public, in early 2014. The main reasons for the pursuit of IPOs were increased liquidity for the partners' large stakes in the firms and the ability to pursue acquisitions. Now, unitholders entered the equation. Unitholders neither have a direct ownership stake in any of the funds in which the general partners invest, nor do they directly benefit from the returns that they generate. However, unitholders do retain partial ownership of the income generated by management and incentive fees through their ownership of the general partner. Unitholders are essentially receiving a piece of the management fees and carried interest that is taken in by these firms, after operating expenses (and the capital that management expects to reinvest back into the business) are deducted. However, insiders typically retain the majority of units held, as well as the majority of voting rights through different unit classes. The industry typically pays out the vast majority (80% to 90%) of its distributable (cash) earnings as distributions to unitholders.

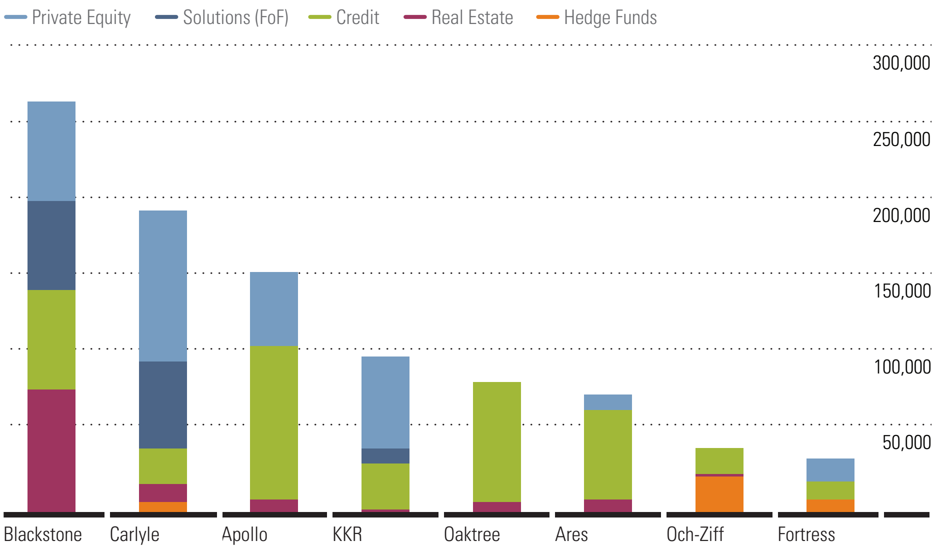
Despite the lack of control over the firms (and the loss of other related rights that typically accrue to unitholders), we still think unitholders are given a fair deal by the partnerships. Unitholders have placed tremendous pressure on the partnerships to diversify their revenue streams away from the volatile and more market-dependent private equity business, as they've emphasized the value they place on a steady stream of management fees earned from a diverse asset manager. In response, the industry has engaged in a fairly aggressive acquisition spree to expand the scope of the offerings to well beyond their traditional roots in private equity and credit to include real estate, funds of funds, and secondaries, among other offerings. In general, we think this is a positive move as it increases the stickiness of a partnership AUM (which we view as moat-enhancing), especially when a limited partner takes part in multiple strategies. This allows ROICs to be earned through an increasingly diverse business mix rather than on the strength of a given firm's particular franchise, insulating it from the potential for strategies to become commodified, as many hedge fund strategies have, in our view.

We think there are a few other factors that align unitholder, limited partner, and general partner interests. Many general partners take very limited or no compensation (Howard Marks of Oaktree takes no pay) other than the distributions they receive, thanks to their unit ownership. Their ownership aligns their interests with unitholders in terms of growing distributions over time. In 2008–09, the industry's leaders saw a substantial decline in the overall value of their units as well as sharply lower distributions alongside common unitholders. In addition, though the general partners in most firms typically contribute 1% to 2% of a manager's capital to a fund, insiders have been known to contribute as much as 2% to 3% (leading to situations like Apollo's $18.4 billion Fund VIII, to which insiders and the general partner committed roughly $900 million). This leaves a substantial part of insiders' compensation tied to fund-level returns, being locked up alongside the limited partners. Finally, senior managing directors and other key individuals are typically locked up under non-compete arrangements, which prohibit working for a competitor or soliciting clients for a year at minimum. Overall, we believe interests are generally aligned among unitholders, general partners, and limited partners.

How Do Alternative Asset Managers Make Money?

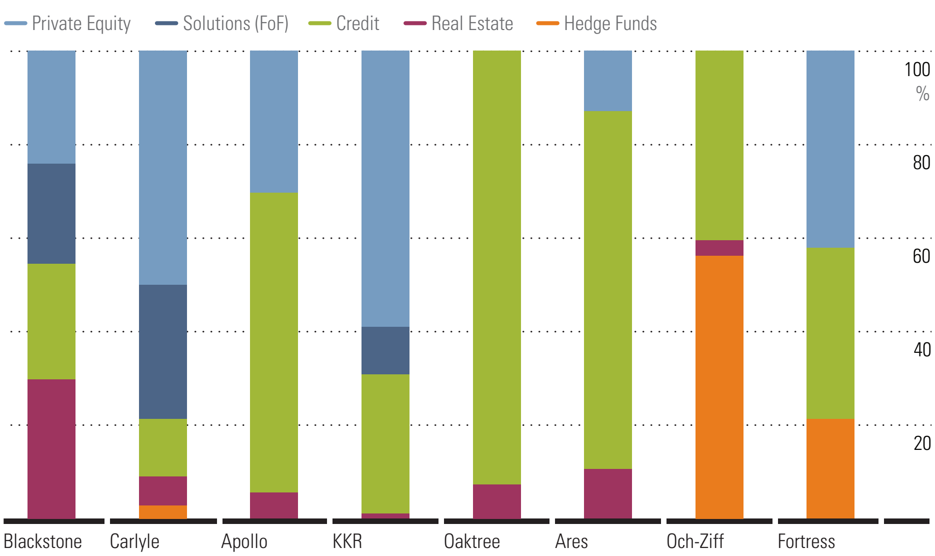
The publicly traded alternative asset managers generate revenue in three different ways:

Exhibit 4 Alternative Asset Managers' AUM Breakout by Strategy (in $ Millions)



Source: Morningstar.

Exhibit 5 Alternative Asset Managers' AUM Breakout by Composition in Percent



Source: Morningstar.

management fees, incentive fees, and investment income, which are then shared with employees and unitholders.

Management fees. These range between 0.3% and 2.0% and are commonly charged on committed capital, invested capital, or net asset value. Fees can vary greatly depending on the size of the fund, the current fundraising environment, the targeted investment opportunity, or the level of capital commitment made by the limited partner, among other items. Typically, we'd expect to see higher fees charged during the investment period for a fund, with rates stepping to a lower level as the fund enters the realization portion of its useful life when incentive income can be generated. Management fees are charged for the full life of the fund, which is usually 10 to 11 years. Lower fees are sometimes charged for strategies where the expected return is lower.

Incentive fees or carried interest. Hedge fund structures typically earn 20% of the fund's capital appreciation per year, subject to a high-water mark in the 5%–8% range. Carried interest applies to carry funds (such as private equity), where the range of incentive fees can vary depending on the strategy, but are typically between 10% and 30% of any realized profits on an investment, subject to a high-water mark in the 7%–10% range. If a fund does not achieve its preferred return over the life of the fund, managers are obligated to repay the amount in excess of the agreed-on split to the limited partners. This is known as a clawback obligation.

Investment income. To align their interests with the limited partners, the general partners typically contribute company capital, as well as their own capital, to a fund. The range varies depending on the size of the fund and manager, but is usually about 1% to 5% of a fund's AUM. These investments are typically held on the company's balance sheet.

Transaction, monitoring, and other advisory fees can also be charged on portfolio holdings, but thanks to limited-partner pressure during the past few years, 50% to 100% of these fees (at least for the major players) are generally rebated to limited partners through a reduction in their management fees.

How Do We Determine Alternative Asset Manager Moats?

Traditional asset managers such as BlackRock **BLK** have earned Morningstar Economic Moat Ratings, thanks to high levels of switching costs and strong intangible assets. Once AUM flows into the traditional managers, it tends to stay there, as annual redemption rates of around 30% demonstrate. The traditional asset managers can build on that switching-cost advantage by offering a diverse product mix, having greater geographic reach, being strong in multiple distribution channels, and having a reputation as a world-class investment manager. A niche focus on retirement accounts and tax-managed strategies creates even higher switching-cost advantages for the traditional asset managers. We also believe that a singular corporate culture dedicated to a common purpose, as well as a deep and wide product set across multiple asset classes, allows asset managers to hold on to assets even longer—making these some of the key differentiators between wide and narrow moats in the industry.

Alternative asset managers, in our view, have attributes that can make these moat sources—switching costs and intangible assets—even more indelible. We'd also note that from a financial perspective, putting 1% to 2% of their capital at risk within a fund in exchange for 20% of the profits and an ongoing management fee in the 1%–2% range is an extraordinarily lucrative deal for the alternative asset managers. Our moat framework for the alternative asset managers focuses on several key factors:

1. Fund lives. Unlike the products of most traditional asset managers, which have to rely on investor inaction to keep annual redemption rates low, the products offered by the alternative asset managers can have lockup periods, which prevent investors from redeeming part or all of their investment. Generally, we favor longer lockup periods for limited-partner capital because of the substantial switching costs. A long lockup period, such as the 10- to 11-year time frame for private equity funds, implies a great level of trust between the limited and general partner, as the limited partner cannot redeem its capital for years. In contrast, hedge fund redemptions can occur as frequently as quarterly.

2. Operational expertise. Large general partners such as KKR and Blackstone have increasingly provided operational and strategic expertise to their portfolio companies to create value. For example, we estimate that Blackstone employs more than 70 professionals (including ex-CEOs), and KKR has nearly 100 advisors and consultants who advise portfolio companies on strategic and operational insights. Duplicating these units would not only be expensive from a compensation perspective, but also would require a sizable and active private equity operation.

3. Fundraising expertise. While we believe that the top executives at alternative asset managers play a critical role in raising new funds because of strong and established relationships with limited partners, the largest alternative asset managers have substantial fundraising organizations at their disposal. Carlyle, for example, has about 80 professionals that segment the markets by region, by product line, and by distribution platform.

4. Human capital. Firms with a larger number of investment professionals operating across a broader range of asset classes will generally have more-extensive and deeper relationships with buyers and sellers, which will generate higher-quality investment opportunities. We also believe a higher number of investment professionals can drive a substantial increase in the number of limited-partner relationships that an alternative asset manager develops over time, lowering the implicit cost of acquiring incremental AUM. We think of this element as the "deal funnel," as it focuses on the size and scope of the human capital an asset manager retains. In short, the greater number of investment professionals in-house, the more opportunities the manager will have to land lucrative deals.

5. Product portfolio. Limited partners are increasingly looking to consolidate their assets with fewer managers that operate across a wider range of asset classes and strategies in an attempt to reduce oversight costs. Managers that can develop and source deal flow (and thus investment opportunities) across a wider range of strategies and asset classes are more likely to inbound incremental capital.

6. Reputation. Managers that have a long and successful track record of strong investment performance (preferably over decades), and also have a history of treating limited partners with respect, are better positioned, in our view, to attract incremental capital than a startup with a much more limited track record.

7. Culture. We think alternative asset managers that operate across a broad set of investment strategies and product offerings, and that incentivize these different teams to work together (either by compensation or through a common culture of sharing ideas), have an additional competitive edge. We believe Carlyle, Blackstone, and KKR have some of the strongest internal cultures and are actively working together to put more money behind their best ideas through idea sharing. For example, Blackstone put more than $10 billion to work across the firm supporting its improving housing thesis, which was based on insights gleaned from its private equity, credit, real estate, and solutions segments, and resulted in investments in single-family homes, home automation services, credit financing, nonperforming residential loans, mortgage servicing rights, and the purchase of homebuilder and related equities.

8. Geographic reach. The larger an alternative asset manager's base of global offices, investments, and overseas clients is, the further along it will be in developing relationships with the limited partners of tomorrow (which are increasingly sovereign wealth funds), as well as sourcing international deal flow. Carlyle is by far the leader here, with about 25% of its investments being made outside of North America and Europe during the past few years, versus 15% at its major peers. Carlyle also has the largest amount of region-specific funds, and investors are increasingly looking for emerging-markets funds.

How Do We Determine Moats for Each Manager?

Though all of the publicly traded alternative asset managers broadly operate under the same business model of collecting and retaining fee-earning AUM and making successful investments, we think investors should understand several key elements that differentiate each of these managers. We tend to award the industry narrow moats because of the explicit switching costs associated with carry funds' long lives, which are 10 to 11 years. We also award narrow moats based on the strong reputations and the scale needed to invest in the back-office systems required to meet increasingly tougher regulatory and limited-partner transparency and reporting requirements.

It also helps to look at the level of total AUM each of the alternative asset managers is managing, as well as the diversification that exists in their asset bases. Of the eight publicly traded alternative asset managers, Blackstone at $271 billion has the largest level of AUM dedicated to alternative assets and owns the only sizable real estate division, with Carlyle at $199 billion being a close second. Apollo stands out next with $158 billion in mostly credit AUM, while KKR, Oaktree, and Ares follow up with $102 billion, $86 billion, and $77 billion in AUM, respectively. Och-Ziff and Fortress are the two smallest players in the group at $42.6 billion and $36 billion (excluding its traditional fixed-income AUM), respectively.

Blackstone is also the most diverse of the alternative asset managers. It garners 30% of its AUM from real estate, 24% from private equity, 24% from credit, and 21% from solutions, where the firm directly allocates investor capital to hedge funds but offers options to others. Only Carlyle comes close to the same level of diversification as Blackstone, with 50% of its AUM devoted to private equity carry funds, 29% to solutions, where it primarily allocates investor capital to private equity funds, and 12% and 6% in credit and real estate, respectively. KKR is mostly split between private equity and credit, and Ares and Apollo are focused nearly entirely on credit AUM. Finally, Och-Ziff and Fortress are primarily weighted toward hedge funds and credit, with Fortress retaining a sizable but declining private equity franchise.

From a fundraising perspective, there are also differences in the quality of alternative asset managers. Scale is increasingly becoming more important in fundraising. We believe dedicated teams and global offices are needed, because the number of marketing channels is fragmenting across the industry. Inflows from pension funds and funds of funds are increasingly stagnating, while sovereign wealth funds and retail investor channels are growing in importance and demanding higher levels of marketing investment than in the recent past. At more than $150 billion from 2011 to 2013, Blackstone has raised more investor capital than its next four largest peers combined. The firm has accomplished this remarkable feat primarily through introducing new and innovative strategies that meet limited-partner needs. For example, Blackstone Tactical Opportunities, which seeks to invest in areas that might not fit within the firm's traditional private equity, credit, or real estate niches, quickly raised $5.6 billion, and the partnership is pursuing fundraising for a second fund this year.

Carlyle has also been very successful, pulling in more than $50 billion during the past few years, thanks to its broad and deep fund portfolio, which includes many region-specific funds, letting investors target specific strategies and geographies that meet their allocation requirements. Meanwhile, Oaktree and Ares have done well raising money for their credit funds, and at $33 billion and $27.5 billion ($34 billion including real estate and private equity for Ares), respectively, their inflows compare favorably against Blackstone's $55 billion in credit inflows and are stronger than their next-closest peer, Apollo, at $12 billion in credit fundraising. KKR and Apollo delivered $36 billion and $33 billion in AUM inflows, respectively, mostly weighted toward private equity. We think both partnerships can do more here to leverage their existing relationships with limited partners to bring in more AUM, and as both asset managers have been highly aggressive in acquiring new strategies and AUM, we think they will be able to leverage the newly expanded product portfolios and relationships to boost fundraising efforts going forward.

There are also substantial variations between asset managers in terms of the strength of their product offerings and geographic reach, and the depth of their human capital. Blackstone and Carlyle own some of the deepest product portfolios, which allow limited partners to invest in multiple funds and strategies, at a variety of price points, with varying levels of transparency, size, and time commitments. We also think the pair benefits from a substantially greater number of investment professionals and wider global reach (as measured by number of offices worldwide), where the relationships in place ensure access to the highest-quality investment opportunities and ensure that they are first in mind for any limited partner looking to increase its alternatives allocations. KKR also stands out from its peers, as it is rapidly expanding its product portfolio and adding investment talent, and we think it will be able to convince more clients to sign up for multiple strategies going forward. Apollo, Ares, and Oaktree have largely remained within their traditional niches within private equity and credit, and they have pursued only modest step-out strategies in recent years. Finally, Och-Ziff and Fortress have very limited product portfolios, geographic reach, and a small cadre of investment professionals, which we believe limit their ability to raise funds, develop new strategies, and inbound attractive investments.

Let Correlations Be Your Guide

A useful tool to help fine-tune your alternatives allocations.

by
Josh Charney
Team Lead, Alternative
Strategies Research

Investors have been plowing money into alternative mutual funds at an astounding rate. Last year, alternatives inflows shattered records, as investors poured in $95.4 billion, including non-traditional-bond funds, while total assets stood at $311 billion at the end of August. It's questionable whether all of the new investors in alternative funds understand how to properly allocate to alternatives. The allocation process can be counterintuitive when it comes to alternatives, leading to certain unintended consequences. The purpose of this article is not only to break certain misconceptions, but also to show which asset mixes are most appropriate when incorporating alternative strategies.

To understand how investors might be misusing alternatives, let's turn our attention to a rapidly growing category—non-traditional-bond funds. This group of funds aims to offer investors low correlations to traditional core fixed income by employing a mix of go-anywhere management and hedging techniques. JPMorgan Strategy Income Opportunities **JSOAX**, for instance, exhibits a near zero correlation to fixed income. Therefore, the fund makes for an excellent portfolio diversifier, right? Unfortunately, there's a problem with this assumption: This fund's correlation to equities is 0.77. If an investor had 80% of his money in equities, then diversifying his fixed-income allocation into this fund would probably create unintended consequences by potentially increasing his equitylike exposure.

Thus, the process of determining alternatives allocations hinges greatly on the asset-class composition of the existing portfolio. A heavy fixed-income allocation, for instance, will require a drastically different alternatives allocation than an equity-centric portfolio.

A Word on Alternatives Correlations

Correlations of alternative funds vary widely. Generally, long-short equity funds have the highest correlation to the S&P 500 (0.78 during the last five years). But correlations within the group vary widely—some funds such as Gateway **GATEX** and Wasatch **FMLSX** have exhibited a correlation in excess of 0.90 to equities over the last five years. Contrary to their name, even some market-neutral funds display extremely high correlations to the market. Calamos Market Neutral Income **CVSIX**, with the highest, stands at 0.95, but the category has averaged 0.28 during the last five years.

In order to simplify the analysis for the purposes of this article, we've decided to use the correlations of multialternative funds as a proxy for alternatives correlations, since these funds combine multiple alternatives strategies. During the last five years through September, the multialternative category has exhibited a correlation of 0.68 to the S&P 500, while exhibiting a negative 0.02 correlation to the Barclays U.S. Aggregate Bond Index (we'll discuss why that's important a bit later).

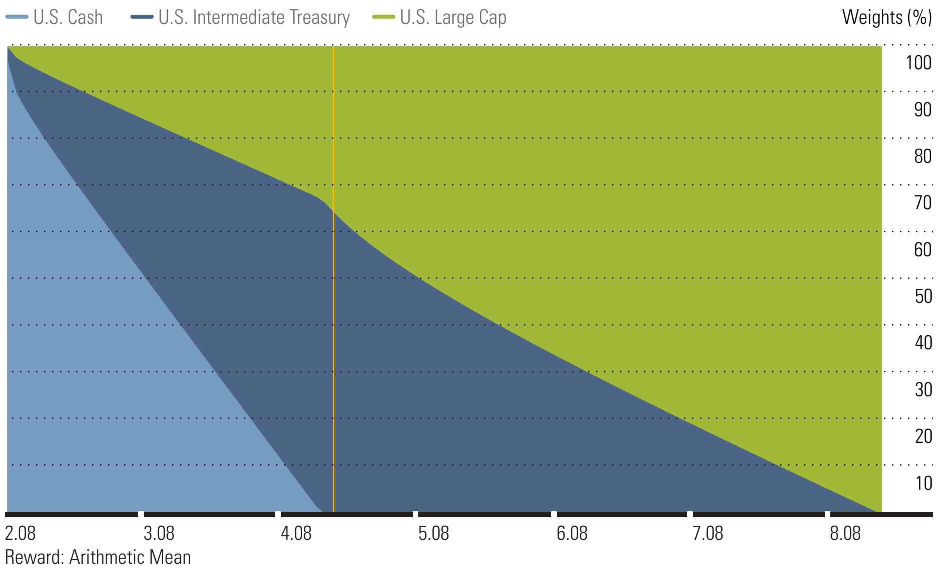
Finally, note that correlations of liquid 1940 Act mutual funds aren't that dissimilar to hedge funds. The correlation of the Morningstar MSCI Composite Asset Weighted Hedge Fund Index is 0.78 to the S&P 500. That index includes some long-only hedge funds and skews toward equity-based strategies, inflating its correlation slightly.

Creating a Model

One standard method of determining appropriate asset allocation is to use an optimizer. The optimizer generates portfolios at various points on an efficient frontier, seeking the asset mix that will provide the highest reward per unit of risk. The composition of each point along the frontier can be viewed on an allocation spectrum, which measures the unit of expected reward, on the x-axis, and the composition of each asset class, on the y-axis.

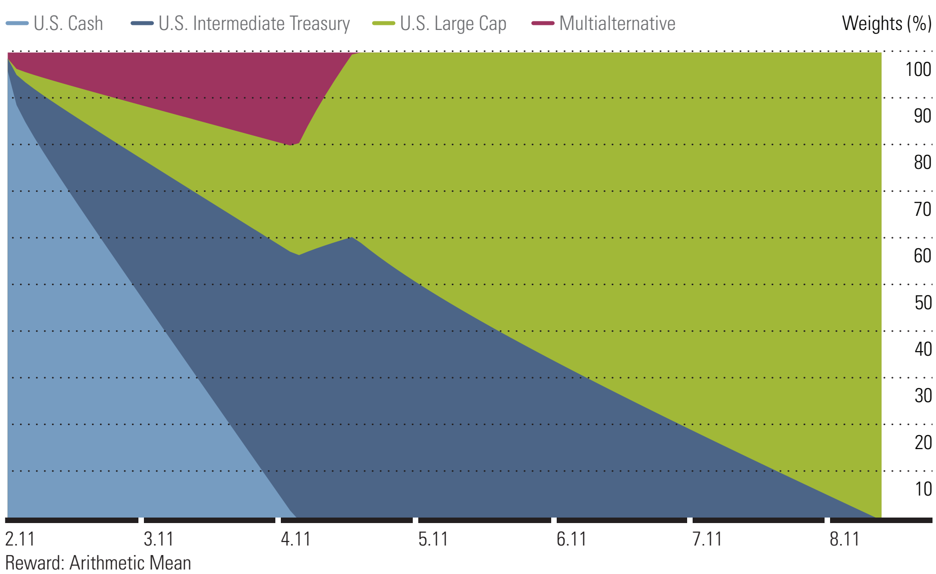
In order to create our model, we used forward-looking market assumptions from J.P. Morgan's 2014 Long-Term Capital Market Return Assumptions. (This should not be taken as Morningstar supporting J.P. Morgan's forecasts over other

Exhibit 1 Allocation Spectrum: No Alternatives



Source: Morningstar.

Exhibit 2 Allocation Spectrum: Alternatives 5.25% Return, 0.68 Correlation



Source: Morningstar.

providers, but simply the fact that the assumptions were comprehensive, reasonable, and available.) Because J.P. Morgan assumes cash will return 2.0% per annum, the expected Sharpe ratio for stocks is around 0.44 (for more information on assumptions, see appendix).

Let's start with a simple portfolio of cash, stock, and bonds. Exhibit 1 shows the asset mix of various points along the allocation spectrum. The line represents a portfolio with an expected return of 4.27%. Reward and risk both increase as you move from the left to the right side of the spectrum. As expected reward increases, the optimizer allocates away from safer asset classes in exchange for riskier ones. Thus, the portfolio on the far right side is a 100% stock portfolio with an expected return of 8.49%.

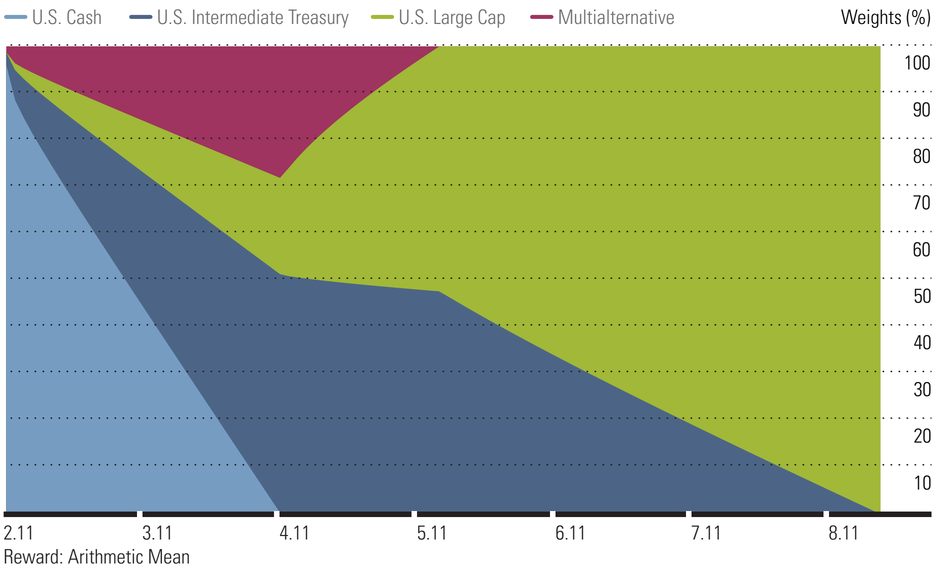
Adding Alternatives

Before we add alternatives, we have to make a few assumptions about their performance and correlation to other asset classes. Since many alternative strategies exhibit more equitylike characteristics, we're going to assume their returns will be more in line with stocks than bonds, extrapolating their average correlations of 0.68. Consequently, we've assumed alternatives will offer a Sharpe ratio more similar to stocks than bonds. This forecast assumes that stocks offer a Sharpe ratio of about 0.44, relatively close to J.P. Morgan's prediction that hedge funds will produce a Sharpe ratio around 0.53. To simplify matters, we assumed 1940 Act alternative mutual funds will offer a Sharpe ratio of around 0.50, or a return of 5.25% per year, and will exhibit similar historical standard deviation and correlation to other asset classes.

Key Takeaways

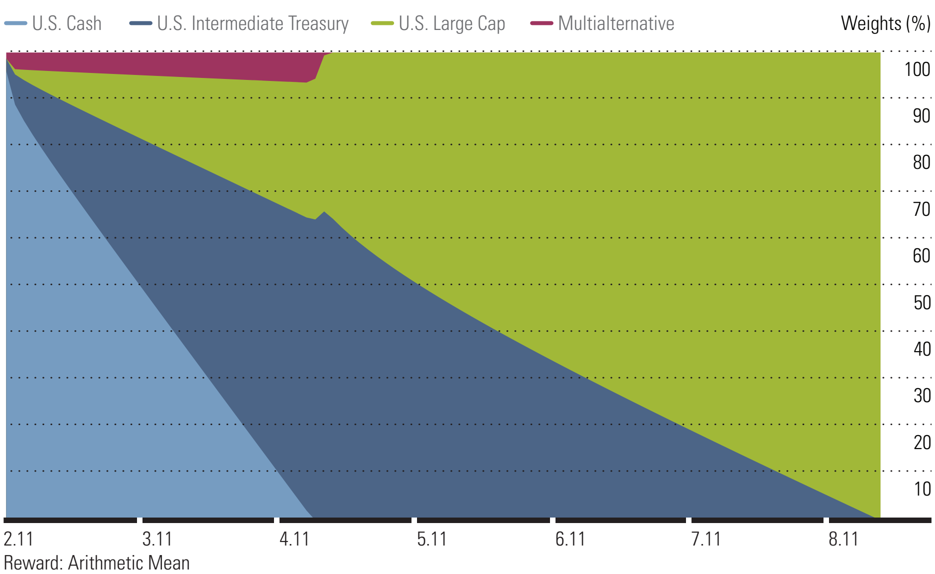
The optimizer shows that a modest 20% allocation to alternatives makes sense if a portfolio has a large exposure to fixed income, around 50%. In general, our research finds that alternatives are a much better diversifier for bonds than stocks. In our forecast, we assumed that stocks would exhibit a negative correlation to fixed income. Given that belief, the best diversifier for equities is actually fixed income. Even though we assumed that alternatives would have a higher Sharpe ratio than fixed income (0.50 versus 0.37) the optimizer justifiably allocates away from alternatives and into fixed income for any allocation that requires meaningful equity allotments. At most, the optimizer allocates around 20% to alternatives (Exhibit 2). But as one requires more return, that is moves further to the right on the x-axis of the allocation spectrum, the optimizer sheds alternatives. In our forecast, fixed income is such

Exhibit 3 Allocation Spectrum: Alternatives 5.25% Return, 0.5 Correlation



Source: Morningstar.

Exhibit 4 Allocation Spectrum: Alternatives 5.25% Return, 0.8 Correlation



Source: Morningstar.

a compelling equity diversifier that the optimizer allocates fully away from alternatives when large positions in equities are required.

Another key takeaway is that cash competes with alternatives. Exhibit 1 showed a basic three asset-class portfolio, while in exhibit 2, we added alternatives. Since we assumed that cash would generate 2% in the long run, the optimizer allocates mostly to cash at low levels of expected return. Cash could certainly be thought of as a competing asset class to alternatives. At a 2% return per year, and with a standard deviation of 0.5%, cash offers the best risk-adjusted returns among the assets. But if we lowered our assumption of cash's return, for instance, the optimizer would significantly ratchet up our allocation to alternatives.

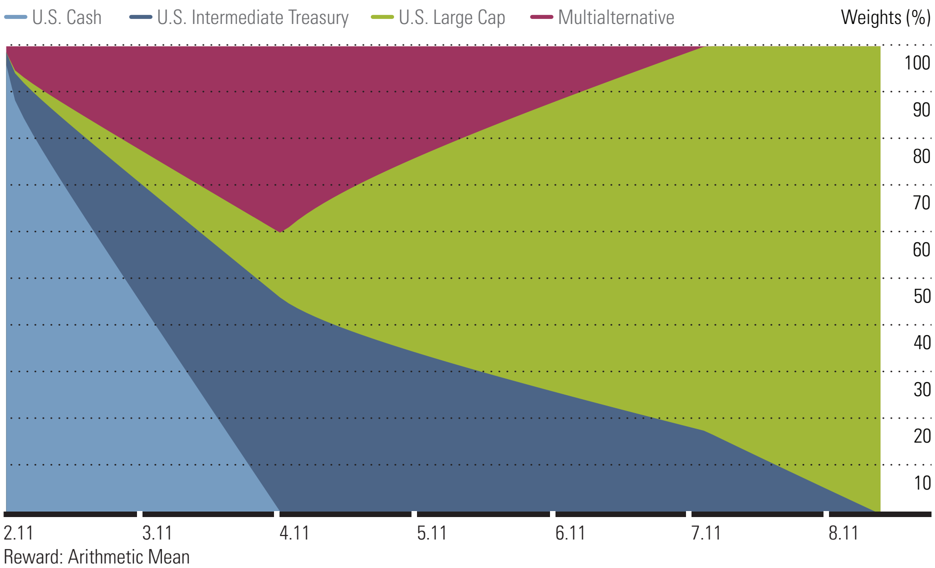
Varying Our Assumptions

An optimizer can be thought of as an extremely precise tool used in an inexact world. Although it relies on various simulations, its output is only as good as the assumptions. One remedy for this circumstance is to vary one's assumptions by using sensitivity analysis. The practice is more common in other areas of finance, such as equity valuation, but the same basic principles apply to asset allocation. The basic premise of sensitivity testing involves varying one's assumptions in order to test a broader range of possible outcomes. For the purpose of this exercise, we've varied the risk-adjusted returns of alternatives and their correlations to equities, holding all other assumptions constant. By not varying other asset-class assumptions, it's easier to diagnose how the group will behave one variable at a time.

We first examined how our allocation spectrum would change when we varied assumptions for alternative correlations. Although a 0.68 correlation of alternatives to stocks seems reasonable, there are alternative funds that offer much lower correlations. Exhibit 3 assumes that we can build a portfolio of alternative funds that exhibit a correlation of 0.50 to the S&P 500. In this case, the optimizer calls for higher allocations to alternatives (30% at its max). What hasn't changed, however, is that the asset class is still predominately incorporated when fixed-income allocations are large. Alternatives are almost useless for an investor who requires returns in excess of 6%.

Finally, we looked at what would happen if we raised the correlation to alternatives to 0.80. In this high-correlation case, alternatives become far less useful. As shown in Exhibit 4, the optimizer still relies on a small portion of alternatives when fixed-income levels are high, around 6% to alternatives, but finds

Exhibit 5 Allocation Spectrum: Alternatives 5.89% Return, 0.68 Correlation



Source: Morningstar.

them relatively unhelpful when alternatives exhibit a correlation of 0.80 to equities.

We can also vary the assumptions around the projected returns for alternatives. In the original model, we assumed alternatives would generate an annualized return of 5.25% and exhibit a Sharpe ratio of 0.50. In our scenario testing, we created a high-return and low-return case for alternatives. The high case exhibited a Sharpe ratio of 0.60 (with a 5.89% return), while the low case had a Sharpe ratio of 0.40 (4.60% return). For these test cases, we maintained the original assumption that alternatives' correlation to the market would be 0.68.

In the high-return scenario (Exhibit 5), alternatives make up a substantial portion (40%) of a portfolio at an expected return of about 5.44%. The same trend we saw in the other allocation spectrums still applies—alternatives work best with fixed-income allocations of around 50%. But in this example, we assume that alternatives carry a far more favorable Sharpe ratio. Therefore allocating to the group under these assumptions makes sense, even with large equity allocations because its risk/reward characteristics are so compelling.

Finally, in our low-return case, alternatives were completely rejected by the optimizer. Since equities offered better risk-adjusted returns than alternatives, the optimizer defaulted to equities. This is somewhat telling regarding the minimum threshold required to invest in alternatives. Generally, it's best to avoid alternatives that can't beat equities on a risk-adjusted basis. Although it's true that a moderately lower-returning fund could still add value if it's completely uncorrelated to stocks and bonds, in order to avoid forecasting errors, it's more prudent to focus solely on strategies that have a relatively higher probably of outperforming equities on a risk-adjusted basis.

The Big Picture

Taken all together, the results of our optimizer tests can provide guidance on how best to use alternatives. First, and perhaps most important, alternatives are best used in conjunction with large fixed-income allocations. The reason is simple: The group carries equitylike characteristics, and thus acts as a better diversifier for fixed income than equities. Even if alternatives were to exhibit a slightly better Sharpe ratio than fixed income and equities, the relatively low correlation between stocks and bonds overrides the incremental advantage of alternatives. This point may come as a surprise to investors who view alternatives primarily as an equity diversifier.

At the same time, Exhibit 4 also helps show why so many people view alternatives as such a compelling asset class. If you believe the group will exhibit a decent risk-adjusted return profile (in this case, a Sharpe ratio of 0.6), then allocating as much as 40% of your portfolio into alternatives makes sense. But this is an extremely tough sell, as identifying a basket of alternatives with those favorable characteristics could prove vexing.

Putting It All Together

Finally, it's equally as important to understand when not to use alternatives. In our forecast, we saw that when alternatives exhibited a Sharpe ratio of 0.40 or less, they were largely useless, because stocks offered more compelling risk-adjusted returns. With so many different variables, it's hard to draw a "use/don't use" line in the sand. But generally it's better to focus on alternatives that will exhibit better risk-adjusted returns than equities. This ensures that they will add value to your portfolio and reduces the risk of making errors. Also, correlations to equities of under 0.68 are preferred, because once correlations spike into the 0.7 range, they begin to lose their luster. Finally, the ideal candidate for alternatives is an investor with a heavy dose of fixed income. Alternatives make the most sense for someone who is expecting to have upward of 50% allocated to fixed income. Given that many alternative funds correlate highly with equities, and that alternatives exhibit more muted returns than equities, investors would be wise to look to alternatives to diversify their fixed-income exposure, especially given the abysmal outlook for fixed income.

Appendix:

Forward-looking assumptions and cross correlations were gathered from J.P. Morgan's 2014 Long-Term Capital Market Return Assumptions for cash, U.S. intermediate Treasury, and U.S. large cap. For alternatives, the multialternative category was used as a proxy for broad alternative exposure because the funds offer a diversified approach to investing in 1940 Act alternative mutual funds. The cross-correlation data were gathered from historical analysis, while the asset-class returns were based off historical Sharpe ratios. Its standard deviation was also gleaned from historical data.

Exhibit 6 Forward-Looking Assumptions: Returns

	Arithmetic Mean	Standard Deviation
U.S. Cash	2.00	0.50
U.S. Intermediate Treasury	4.45	6.5
U.S. Large Cap	8.49	14.75
Multialternative	5.25	6.49

Exhibit 7 Forward-Looking Assumptions: Cross Correlations

	U.S. Cash	U.S. Intermediate Treasury	U.S. Large Cap	Multialternative
U.S. Cash	1.00	-0.30	0.08	-0.12
U.S. Intermediate Treasury	-0.30	1.00	-0.26	0.04
U.S. Large Cap	0.08	-0.26	1.00	0.68
Multialternative	-0.12	0.04	0.68	1.00

Let's Make a Deal

Rising deal activity boosts merger-arbitrage funds.

by
A.J. D'Asaro
Alternative Investments Analyst

This year has so far been an investment banker's dream, buoyed by some of the biggest mergers and acquisitions since 2007. The second quarter of 2014 brought exceptionally strong deal flow, with $501 billion of announced deals globally, including multiple mega-deals such as Comcast's **CMCSA** $45 billion acquisition of Time Warner Cable **TWC** and AT&T's **T** $48.5 billion acquisition of DirectTV **DTV**. From the year-ago quarter, the global value of announced mergers skyrocketed 129% and represents the most single-quarter activity in the past seven years.[1] Third-quarter deal flow also represented a substantial growth at $324 billion, an increase of 121% from the year-ago quarter. As merger activity continues to pick up, a relatively obscure subset of the fund industry—merger arbi-trage— stands poised to reap the benefits.

Merger arbitrage is a niche strategy in which managers buy the stock of an acquisition target, profiting from the spread between the target's buyout price and its current price. For instance, as of Sept. 3, acquisition target DirectTV's share price was $86.50, while its announced buyout price is approximately $95.00 in cash and AT&T stock. A merger arbitrager placing a trade would invest long in DirectTV stock, hedging out market risk in the cash portion of the deal with options, and hedging out market risk in the stock portion of the deal by selling AT&T stock. A merger-arbitrage investor stands to collect the spread between the two prices, about 10% in 90 days, if federal regulators approve the transaction. However, if the merger fails, DirectTV's share price could fall substantially and an investor could lose money.

Managers attempt to cash in on the risk premium associated with a potential "deal break," also known as event risk (in the case of DirectTV/AT&T, its 10% merger spread, or potential return, reflects a higher degree of risk than typical transactions). Managers are willing to assume selected event risk, but typically hedge all other types of risk. By using option techniques, and by shorting the acquisitor in stock-for-stock transactions, skilled managers are able to hedge their stock market risk, minimizing their funds' reaction to broad market declines. Because of this, merger-arbitrage strategies are categorized as market-neutral strategies. Indeed, the two largest merger-arbitrage mutual funds, Merger Fund **MERFX** and Arbitrage Fund **ARBFX**, delivered positive returns in the second half of 2008 (0.98% and 2.10%, respectively), while equities and many other asset classes plummeted.

A Brief History of Merger-Arbitrage Mutual Funds

Merger arbitrage was exclusively the domain of hedge funds until Westchester Capital Management debuted Merger Fund as the first merger-arbitrage mutual fund in 1989. Water Island Capital followed with Arbitrage Fund in 2000. Neither fund took off, however, until 2008, when merger arbitrage, because of its hedged nature, outperformed most traditional strategies by a wide margin. As a result, assets in the two funds combined jumped from $1.5 billion to $2.9 billion by 2009, and they have continued to grow at a break-neck pace ever since. With a combined $8.2 billion under management today, the Merger and Arbitrage funds control an estimated 89% of mutual fund merger-arbitrage assets, and approximately 20% of assets in dedicated merger-arbitrage strategies across both mutual and hedge funds, according to data provided by Barclays.[2]

Merger arbitrage's rapid growth has paralleled the rise in alternative investments in general. Post-2008, investors sought out uncorrelated investments that could generate positive long-term returns. Merger arbitrage fit that bill well. Additionally, merger arbitrage has more recently begun to gain popularity as a floating-rate-yield alternative to bonds, because of its positive correlation with short-term interest rates. Because of the risk of investing in an M&A deal, merger investors shy away from deals unless they promise to deliver returns in excess of the risk-free rates of Treasury bills. Under normal circumstances, merger-arbitrage deals tend to produce annualized returns of Treasury yields plus 4 percentage points.

The success of Merger Fund and Arbitrage Fund has encouraged new merger-arbitrage entrants in the mutual fund arena. Many are long-time merger-arbitrage hedge fund operators, such as Glenfinnen and Longfellow, which have partnered with mutual fund distributors SilverPepper and Touchstone, respectively, to offer their strategies to a retail audience. Others, like Kellner Capital, have effectively straddled both worlds by carving out a merger-arbitrage sleeve of their broader event-driven hedge fund strategy for use within a mutual fund.

One advantage that new entrants may have is a lower asset base, which gives funds more flexibility to invest across the market-capitalization spectrum. While smaller, nimbler funds can easily load up to 10% of fund assets in their favorite deals, larger funds aren't always so fortunate. Smaller-cap deals are often far too illiquid to build any meaningful position size, which could take weeks for a multibillion dollar fund. Larger funds must adapt by investing in better trading infrastructure to avoid front-running by other parties, by expanding their scope to more complex situations such as spin-offs and split-offs, and by altering their strategy to invest in a broader universe of deals. Other funds may need to close early to preserve their small asset bases, as was the case with Touchstone Merger Arbitrage **TMGAX**, whose management favors small-cap deals. The fund closed at $700 million after less than two years.

Rising 2014 Deal Flow Lifts Performance Expectations

The deal flow experienced in the second quarter of 2014 represents a major boon for merger-arbitrage managers. Fund managers have been anticipating the latest spike in deal flow for some time because of high levels of cash on corporate balance sheets. In addition to cash, companies have as available financing options record-low interest rates and their own appreciated stock prices. In the third quarter, cash and debt financing was the favored financing method, with 55% of announced deals financed solely by cash and debt, according to Dealogic. Additionally, controversial tax-inversion deals have recently become popular, providing a further boost to merger activity. Taken together, it is clear that highly favorable conditions exist for new deal flow.

The increased deal flow stands to benefit merger-arbitrage mutual funds in two ways. First, with so much supply in the marketplace, funds should have no problem deploying new capital as deals mature (a deal usually closes in 90 days). This is especially important for large, capacity-constrained funds such as Merger Fund and Arbitrage Fund, which have large amounts of capital maturing each month that must be deployed into new deals. Moreover, spreads have widened in many deals from about 3% annualized to around 5% in straightforward transactions. One possible reason is that the greater supply of deals has left the market with fewer arbitragers—whose trades tend to force spreads to narrow—as a percentage of market participants.

The increased deal flow has already led returns to trend higher. In the second quarter, Merger Fund posted its best quarterly return since 2011, as did Arbitrage Fund. In the second quarter, Arbitrage gained 1.44%, while Merger gained 2.36%, which is considerable compared with their five-year annual average returns of 2.22% and 3.71%, respectively. The benefits seem to have flowed only to larger merger-arbitrage funds for now. Smaller players in the space, including Kellner Merger **GAKAX** and Silver-Pepper Merger Arbitrage **SPAIX**, gained a modest 0.39% and 0.59%, respectively, in the second quarter, which is within typical ranges. Touchstone Merger Arbitrage fell 1.22% in the second quarter, likely because of a broken deal. Part of the reason for the bifurcation is that the recent surge in deal volume has been fueled almost exclusively by large-capitalization deals. As reported by *The New York Times*, 46 deals worth more than $5 billion had been announced by the middle of 2014, 130% more than last year. The difference is even starker on a dollar basis: These announced mega-deals were worth $740.7 billion, up nearly 231% from the first half of 2013.

For capacity-constrained funds, this presents a clear benefit. Merger Fund, the largest and most capacity-constrained merger-arbitrage fund, invested only 85% of assets on average from 2011 to 13, because of the lack of available liquid deals. As of March 31, 2014, the fund had invested more than 93% of assets, and in recent discussions, management estimated that the fund had reached 98% of assets invested. Based purely on the increase in percentage of capital invested, holders of this fund can expect a small but material bump (around 15%) in expected return going forward, as long as deal flow remains elevated at current levels.

Widening Spreads

Merger spreads may have also widened for reasons besides increased deal flow. In the fourth quarter, a controversial tax inversion deal—the largest of the year—between AbbVie **ABBV** and Shire **SHPG** broke on political pressure from the U.S. Treasury. An equal-weighted basket of the five merger arbitrage funds tracked by Morningstar fell 3.0% from Oct. 8 through Oct. 17 in the runup to and aftermath of the deal break. In addition to the losses from Shire, spreads widened in virtually all deals (causing temporary losses), reflecting the greater uncertainty in merger arbitrage as a whole.

Greater perceived risk in the merger-arbitrage market causes merger spreads to widen, which creates an opportunity to reinvest at greater rates of return. In 2008, for example, market anxiety caused spreads to widen but led to increased returns in the following year. After falling 0.6% and 2.3%, respectively, in 2008, the Arbitrage and Merger funds returned 10.0% and 8.5% in 2009 because of widened spreads.

While the market has seemingly panicked following AbbVie-Shire, history suggests this may be a good time to invest. Some funds, including Kellner Merger, have opportunistically increased gross exposure, based on management's positive outlook.

An Attractive Strategy

With wider spreads, the result of both elevated deal flow and an uptick in perceived risk, merger arbitrage appears relatively attractive at this time. If the supply of deals continues to remain high, which is likely in the near term, there should be more opportunities for managers to fully invest and add alpha. The risks of merger arbitrage tend to be uncorrelated to those of the stock and bond markets, an attribute that could prove valuable given that many consider traditional asset prices to be artificially high at this time.

Tax-inversion legislation, however, presents an ongoing risk, although one that may already be priced in to current spreads. Because of the increased uncertainty over inversion deals, the merger-arbitrage market is undervalued at this time. For investors seeking to gain access to this strategy, Silver-rated Merger and Bronze-rated Arbitrage are solid choices with experienced management and long track records of success. Concerns over capacity issues with these large funds should be eased for now, considering strong deal flow this year. Bronze-rated Touchstone Merger Arbitrage is closed to new investors, but offers a less-capacity constrained mid-cap version of its strategy in Touchstone Arbitrage **TMAYX**. Two new entrants, Kellner Merger and SilverPepper Merger Arbitrage, are unrated by Morningstar but possess prior hedge fund track records. M

1. Dealogic and William Blair's mergers and acquisitions market analysis.

2. http://www.barclayhedge.com/research/indices/ghs/mum/HF_Money_Under_Management.html

Exhibit 1 Merger Arbitrage Funds, Selected Statistics

Name	Morningstar Analyst Rating	Inception Date	5-Year Annualized Return %	5-Year Annualized Std Dev %	5-Year Sharpe Ratio	Quarterly Return % 2014–Q1
Merger	Silver	1/31/89	3.3	2.51	2.19	-1.65
Arbitrage	Bronze	9/18/00	1.95	2.72	0.48	-0.79
Touchstone Merger Arbitrage	Bronze	8/9/11	—	—	-2.33	-1.14
Kellner Merger	Not Rated	6/29/12	—	—	1.96	-1.72
SilverPepper Merger Arbitrage	Not Rated	10/31/13	—	—	1.09	-0.49

Medalist Spotlight: Merger Fund

by
A.J. D'Asaro
Alternative Investments Analyst

Process

With the help of four analysts, portfolio managers Roy Behren and Michael Shannon consider all merger and acquisition opportunities available in the marketplace and select about 80 transactions for inclusion in the portfolio. The team will research the strategic rationale behind each deal, and analyze financial, legal, and regulatory obstacles to completion. Merger Fund also spends a significant sum on outside experts, law firms, and industry consultants to gain a greater understanding of the deal and its likelihood of closing.

The fund's risk system calculates each merger deal's expected return and risk in real time, which helps make portfolio allocation decisions as positions change in price. Position weights are determined within this framework but are also subject to strict liquidity requirements. The fund uses options to isolate event risk and eliminate market risk. When merger activity is light, the fund's cash stake can increase rapidly until deal flow resumes. During these periods, the fund can invest in short-term corporate bonds and other corporate events.

People

In 2007, Westchester Capital Management founder Fred Green promoted two longtime analysts, Roy Behren and Michael Shannon, to take over the reins as comanagers. Behren joined the firm in 1994 after working as an attorney with the Securities and Exchange Commission, and Shannon joined two years later after working in mergers and acquisitions and equity research at J.P. Morgan. Shannon left his role as director of research in 2005 to work at a hedge fund but returned in 2006.

Behren and Shannon have remained true to their core principles despite supervising a period of massive asset growth for Merger Fund. Their style is patient and focused on risk mitigation; the duo excels at avoiding broken merger deals (the bane of merger-arbitrage funds) and at getting out of those deals as conditions change for the worst. Both managers invest more than $1 million alongside fundholders, showing commendable commitment.

Performance

Like other merger-arbitrage funds, this fund delivers a modest level of absolute returns that are uncorrelated to the S&P 500 and the Barclays U.S. Aggregate Bond Index, with 10-year correlations of 0.56 and 0.19, respectively. For the 10 years ended September 2014, performance for this fund has outpaced the market-neutral category, with annualized returns of 3.8% and a 3.6% standard deviation, versus 1.9% annualized returns and a 5.0% standard deviation for the broad market-neutral Morningstar Category.

An event that causes a sectorwide cancellation of existing merger deals is this fund's biggest risk. For example, in 2002, the Enron utility merger fallout precipitated both the fund's biggest drawdown and annual loss in the past

Kudos

One of the cheapest alternative funds with a 1.26% expense ratio.

Experienced management with little turnover and large investments in the fund.

Low beta to the S&P 500. (When the S&P 500 cratered 54.9% during the financial crisis, Merger slipped only 5.0%.)

Can act as a hedge for rising interest rates (the duration of most deals is 90 days, allowing constant reinvestment at higher rates).

Low $2,000 minimum investment.

Cautions

Broad pullbacks across an entire sector could cause this fund to lose more than expected, such as in 2002, when the fund suffered from the post-Enron utility merger fallout (returns fell 14.0% from January 2002 through November 2002).

The fund grew from $1.6 billion in mid-2009 to a whopping $5.0 billion by late 2011, and although the pace of growth has slowed, capacity continues to be an issue to watch.

20 years. The fund declined 14.0% from January 2002 through November 2002 and recovered substantially in December to end the year down 5.7%. Aside from the occasional merger meltdown, the fund has navigated difficult periods for the stock market with ease. When the S&P 500 cratered 54.9% during the financial crisis (Oct. 9, 2007, to March 9, 2009), Merger Fund slipped only 5.0%.

Parent

Westchester has proved itself to be an above-average steward of shareholder capital. Behren serves as chairman of the board, and the remaining three trustees are independent. The board has consistently demonstrated a commitment to shareholders by keeping fees low as the fund has grown and closing the fund several times in the past to preserve the strategy's integrity. Behren and Shannon are majority owners of the firm. The advisor currently employs 13 professionals, six on the investment management team and eight who manage operations.

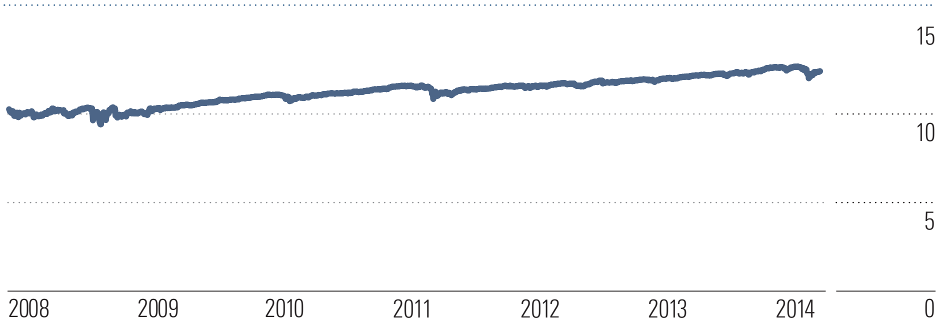
Westchester encourages investment in the funds by employees and mandates it for the investment team.

Price

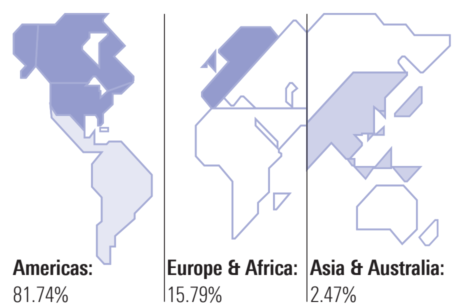
The Investor shares' net expense ratio of 1.26% falls in the category's cheapest quintile and is priced below average relative to other no-load alternative funds. The newly launched Institutional share class charges even less, at a 1.00% net expense ratio.

Exhibit 1 The Merger Fund

Growth of 10K



Regional Exposure



Stats

Morningstar Catgory	**Market Neutral**
Expense Ratio	**1.26%**
Fee Level	**Low**
Morningstar Analyst Rating	**Silver**
Morningstar Rating	★★★★
5-Yr. Annualized Return	**3.30%**
5-Yr. Annualized Std Dev	**2.51%**

Top 10 Holdings 9/30/2014

Stock	Weight (%)
Covidien PLC	4.22
Time Warner Cable Inc	4.13
DirecTV	4.05
Allergan Inc	3.84
TRW Automotive Holdings Corp	3.55
Shire PLC ADR	3.17
Medtronic Inc	-2.89
Comcast Corp Class A	-2.86
American International Group Inc	2.77
Lamar Advertising Co Class A	2.58

Fund Reports

AllianceBernstein Select US Long/Short

by **Jason Kephart**

Advisor
AllianceBernstein

Advisor Location
New York, New York

Assets Under Management
$1.7 billion

Inception Date
Dec. 12, 2012

Investment Type
Mutual fund

Morningstar Category
Long-short equity

People
Kurt Feuerman, chief investment officer of the Select Equity Portfolios, is the fund's lead portfolio manager. He's also the lead manager for AllianceBernstein Select US Equity AUUAX.

Feuerman spent 12 years as a managing director and portfolio manager at hedge fund shop Caxton Associates before joining AllianceBernstein in mid-2011. At Caxton, the strategy's assets peaked at close to $1 billion in 2007, before withdrawals in 2008 and 2009 reduced it to $238 million. AllianceBernstein acquired Feuerman's team as well as his long-short hedge fund as part of the move. He is supported on this fund by eight sector-specific research analysts (four of whom were part of the team at Caxton, with an average of 10 years of experience on the team), two trading experts (one of whom has been with the team for 10 years), and one portfolio specialist.

Manager investment in this fund is disappointing. Feuerman has more than $1 million invested alongside shareholders in the long-only version of this strategy, but none invested in this fund.

Purpose
Like other long-short equity funds, this offering seeks to give investors a smoother ride to returns that are similar to the U.S. stock market over a full cycle by limiting drawdowns. To achieve that, the fund's net long exposure to stocks will typically range from 30% to 70%, but it can go as low as zero. Investors could use this fund to diversify their existing U.S. equity allocation.

Process
Manager Kurt Feuerman has run this long-short strategy since 1998, although from inception through December 2012 it was only available as a hedge fund. The strategy allows up to 130% gross long exposure and 30% gross short exposure; however, it has rarely been near those limits. The fund's overall gross exposure has typically landed below 100%. Exposure decisions are based partly on Feuerman's top-down macroeconomic views, which he derives from fundamental data like credit spreads and the level of the VIX, as well as the number of individual company opportunities he sees in the market. Net exposure has ranged from 95% long to 5% long, the latter of which occurred in 2008, but typically ranges from 70% to 30%. For long positions, Feuerman looks for large- and mid-cap companies that he thinks can outperform earnings estimates over a three- to five-year period, have growing cash flows, and a short-term catalyst that could move the stock price up during the next couple of quarters. The short positions are companies that have the opposite characteristics but with greater emphasis placed on the short-term catalyst. The average holding period for a short position has been three to six months, whereas the average holding period of a long position is around one year. Ideas are generated by Feuerman and the eight sector analysts on his team.

Portfolio
As of June 30, 2014, the fund's net long exposure was 50.3%. Its gross long exposure was 58.1% while its gross short exposure stood at 7.8%. Feuerman is most bullish on the financial services sector, as he believes it will benefit most from an economic recovery. Financials were the fund's largest sector weighting, with 11.7% net long exposure, and its two largest holdings, American Express AXP (3.74%) and Wells Fargo WFC (2.79%), each hail from the sector. He's betting that both companies will see earnings grow faster than expected if the improving economy leads to higher interest rates. Consumer discretionary is the next largest weighting, with 10.5% net long exposure, as it should also benefit from an improving economy. The largest position in that sector was Home Depot HD (2.11%).

Price
This fund is offered in six share classes, all of which charge above-average fees relative to similarly distributed peers. The majority of assets are in the Advisor share class, which charges 2.06%, a more expensive price tag than almost 80% of similar funds. The A shares charge 2.31% and are also more expensive than roughly 80% of similar funds.

AllianceBern Select US L/S Portfolio Adv ASYLX

Investment Summary

Data as of	Currency	Benchmark 1	Benchmark 2
10/31/2014	USD	S&P 500 TR USD	—

Trailing Return

	Total Return %	+/- BM1	+/- BM2	Cat % Rank
1 Mo	-0.33	-2.77	—	74
3 Mo	0.99	-4.05	—	48
6 Mo	2.60	-5.62	—	42
YTD	2.35	-8.65	—	46
1 Yr	6.46	-10.81	—	36
3 Yr	—	—	—	—
5 Yr	—	—	—	—
10 Yr	—	—	—	—
15 Yr	—	—	—	—

Ratings

	Overall	3 Year	5 Year	10 Year
Rating	—	—	—	—
Risk	—	—	—	—
Return	—	—	—	—
# Investments Rated	—	—	—	—

Risk/Reward

vs Benchmark 1	3 Year	5 Year	10 Year
Alpha	—	—	—
Beta	—	—	—
R-Squared	—	—	—
Tracking Error	—	—	—
Information Ratio	—	—	—
Excess Return	—	—	—

Miscellaneous	3 Year	5 Year	10 Year
Standard Deviation	—	—	—
Sharpe Ratio	—	—	—
Sortino Ratio	—	—	—

Manager Information

Kurt Feuerman. Since 12/2012. M.A. 1980 Syracuse University. B.A. 1977 McGill University. M.B.A. 1982 Columbia University.

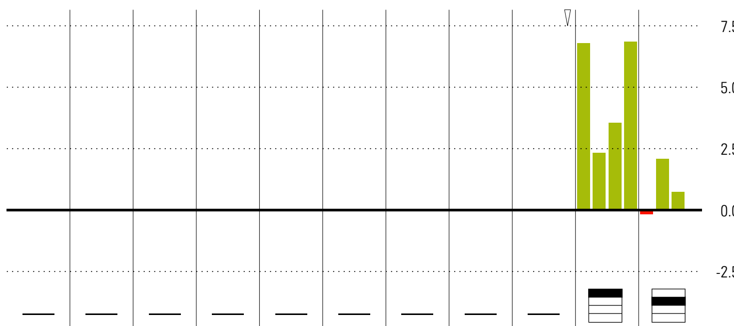
Investment Strategy

The investment seeks long-term growth of capital. Under normal circumstances, the fund invests at least 80% of its net assets in equity securities of U.S. companies, short positions in such securities, and cash and U.S. cash equivalents. Its investments will be focused on securities of companies with large and medium market capitalizations, but it may also take long and short positions in securities of small-capitalization companies. The fund is non-diversified.

Operations

Minimum Initial Investment	0
Inception Date	12/12/2012
Management Fees	Actual: 1.70% Max: 1.70%
Sales Fees	—
Firm Name	AllianceBernstein
Telephone	800-221-5672
Web Address	www.AllianceBernstein.com

Performance



Manager Change
Partial Mgr Change

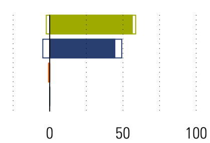
Investment Performance
Quarterly Return

Category
—
US OE Long/Short Equity

Performance Quartile (within category)

2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	10/2014	History
—	—	—	—	—	—	—	—	—	20.95	2.35	Total Return %
—	—	—	—	—	—	—	—	—	-11.43	-8.65	+/- Benchmark 1
—	—	—	—	—	—	—	—	—	—	—	+/- Benchmark 2
—	—	—	—	—	—	—	—	—	282.00	581.00	Turnover Ratio %
—	—	—	—	—	—	—	—	0	383	1,217	Share Class Assets (mil)
—	—	—	—	—	—	—	—	—	1.95	2.06	Expense Ratio
—	—	—	—	—	—	—	—	51.56	71.72	45.59	Stock %
—	—	—	—	—	—	—	—	0.00	0.00	0.00	Bond %

Holding Analysis as of 9/30/2014



	Net %	#
Cash	56.4	—
Stock	44.5	91
Bond	-0.8	0
Other	0.0	—
Total	**100.0**	**95**

Equity Style %

Val	Core	Gr	
29	23	35	Lg
3	6	3	Mid
0	0	1	Sm

Market Cap	%
Giant	57.4
Large	28.5
Mid	12.3
Small	1.5
Micro	0.2
Avg Market Cap (mil)	70,977.6

Value Factors	%	Growth Factors	%
Price/Earnings	16.99	LT Earn Gr	10.63
Price/Book	2.39	Hist Earn Gr	17.26
Price/Sales	1.56	Book Val Gr	7.70
Price/Cash Flow	7.07	Sales Gr	3.21
Dividend Yield	1.92	Cash Flow Gr	10.67

Fixed Income Style

Ltd	Mod	Ext	
			High
			Med
			Low

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

[1] as of —

Credit Rating Breakdown	%	Maturity Breakdown	%
AAA	—	1-3	—
AA	—	3-5	—
A	—	5-7	—
BBB	—	7-10	—
BB	—	10-15	—
B or Below B	—	15-20	—
Not Rated	—	20-30	—
		30+	—

Top Holdings as of 8/31/2014

	Style Box	Sector	Mkt Cap USD (mil)	% Mkt Val
Wells Fargo & Co			268,538	3.84
American Express Co			93,720	2.58
American Tower Corp			39,060	1.92
EMC Corp			59,906	1.91
Verizon Communications Inc			206,515	1.78
Comcast Corp Class A			142,655	1.35
Apple Inc			613,756	1.31
Johnson & Johnson			292,548	1.27
CVS Health Corp			92,013	1.26
Home Depot Inc			125,844	1.26
Wyndham Worldwide Corp			10,131	1.10
Gilead Sciences Inc			162,595	1.08
U.S. Bancorp			76,185	1.08
Union Pacific Corp			94,472	1.04
CBS Corp Class B			31,235	1.04
Microsoft Corp			374,336	0.99
Google Inc Class C			386,626	0.96
Health Care Select Sector S...		—	—	0.96
PepsiCo Inc			139,363	0.89
Pfizer Inc			186,358	0.88
Top 20 holdings				28.5

Top 3 Equity Sectors	%	Rel BM1%	Rel BM2%
Financial Svcs	19.77	24.14	—
Cons Cyclical	18.44	44.84	—
Healthcare	13.95	-5.62	—

Top 3 Fixed Income Sectors	%	Rel BM1%	Rel BM2%
Cash	100.00	—	—
Derivative	0.00	—	—
Securitized	0.00	—	—

Fund Reports

AQR Style Premia

by **Jason Kephart**

Advisor
AQR Capital Management LLC

Advisor Location
Greenwich, Connecticut

Assets Under Management
$300 million

Inception Date
Oct. 30, 2013

Investment Type
Mutual fund

Morningstar Category
Multialternative

People
Ronen Israel, Jacques Friedman, Andrea Frazzini, and Michael Katz have been the named managers for this fund since its inception. They are supported by more than 100 analysts on AQR's portfolio management and research, global asset-allocation, and global stock-selection teams. Israel, who runs AQR's 12-person Global Alternative Premiums Group, oversees the strategy's portfolio construction. He also oversees portfolio construction of Neutral-rated AQR Multi-Strategy ASAIX. He has been with AQR for 15 years. Friedman is the head of AQR's global stock-selection team. Frazzini is a senior member of that team. Katz oversees the firm's macro strategies.

Friedman and Israel have between $50,001 and $100,000 invested alongside shareholders.

Purpose

This fund attempts to capture a diversified array of alternative betas that correspond to factors present in active alternative strategies. As such, it could be suitable as an investor's entire alternatives allocation or as a core piece of an alternatives sleeve.

Process

This fund is built around AQR's expertise in factor research. Factors are simply different sources of risk and return; the most well-known is probably value, which is the belief that over time, cheap assets will outperform expensive ones. This fund offers investors a market-neutral exposure to four factors AQR has found most reliable—value, momentum, carry, and defensive (or quality)—across the four major asset classes: equities, fixed income, commodities, and currencies. Value and momentum, however, are the only factors present in all four asset classes. Carry, for example, isn't applied to equities because the factor, which bets that higher-yielding securities will outperform lower-yielding securities, isn't well-defined in the equity space, according to AQR. The defensive factor is likewise excluded from commodities and currencies. Value and momentum are present in all four asset classes.

Management uses a long-short strategy within each asset class to isolate the relevant factor and fully hedge out any market exposure. For example, the strategy will go long undervalued stocks (as measured by traditional valuation metrics like price/book) and short overvalued stocks to isolate the value factor. The same is done for momentum (for example, long high-momentum commodities versus short low-momentum commodities), carry (long higher-yielding bonds or currencies versus short lower-yielding bonds or currencies), and defensive (long high-quality companies versus short low-quality companies).

Portfolio

Management first sets a target risk allocation to each asset class. The asset classes with the greatest perceived investment opportunities and liquidity get the highest risk weightings, which are measured by standard deviation. The fund's overall volatility target is 10%. Equities have a target risk allocation of 50% (30% in individual stocks and industries and 20% in equity indexes) and fixed income has a target of 20%, while both currencies and commodities have a 15% target. Fixed income, currencies, and commodities are all accessed through derivatives. The target-risk asset weightings lead to a 34% exposure to value strategies, 34% to momentum, 18% to defensive, and 14% to carry. Management does not make tactical tilts to the different factors. Management will make adjustments to maintain its target correlation of 0.2 or less to the S&P 500.

Price

This fund is offered in three share classes. The Institutional share class, which has 93% of assets, has an expense ratio of 1.50%, which is average compared with similarly distributed alternative funds, but it is more expensive than roughly 55% of institutionally distributed multialternative funds. It is cheap compared with multistrategy funds that offer access to hedge fund managers; such funds charge 2.00% or more.

AQR Style Premia Alternative I QSPIX

Investment Summary

Data as of	Currency	Benchmark 1	Benchmark 2
10/31/2014	USD	S&P 500 TR USD	—

Trailing Return

	Total Return %	+/- BM1	+/- BM2	Cat % Rank
1 Mo	3.09	0.64	—	2
3 Mo	2.59	-2.46	—	6
6 Mo	4.82	-3.40	—	4
YTD	6.88	-4.11	—	1
1 Yr	11.24	-6.03	—	1
3 Yr	—	—	—	—
5 Yr	—	—	—	—
10 Yr	—	—	—	—
15 Yr	—	—	—	—

Ratings

	Overall	3 Year	5 Year	10 Year
Rating	—	—	—	—
Risk	—	—	—	—
Return	—	—	—	—
# Investments Rated	—	—	—	—

Risk/Reward

vs Benchmark 1	3 Year	5 Year	10 Year
Alpha	—	—	—
Beta	—	—	—
R-Squared	—	—	—
Tracking Error	—	—	—
Information Ratio	—	—	—
Excess Return	—	—	—

Miscellaneous	3 Year	5 Year	10 Year
Standard Deviation	—	—	—
Sharpe Ratio	—	—	—
Sortino Ratio	—	—	—

Manager Information

Ronen Israel. Since 10/2013. B.S. University of Pennsylvania (Wharton). B.S. University of Pennsylvania. M.A. Columbia University.

Jacques Friedman. Since 10/2013. Ph.D. University of Washington. M.S. University of Washington. B.S. Brown University.

Andrea Frazzini. Since 10/2013. Ph.D. Yale University. B.S. University of Rome III.

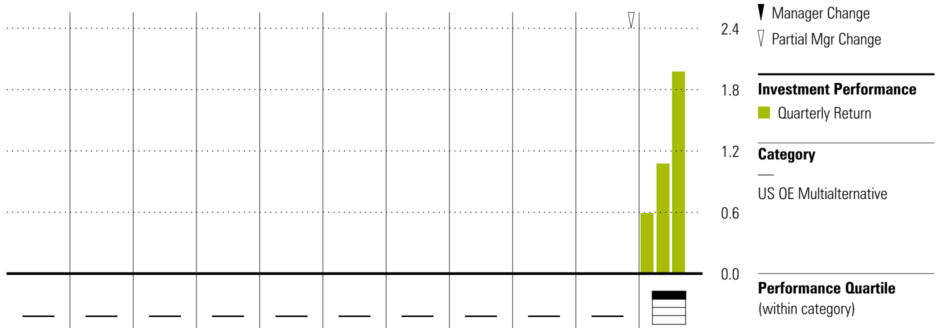
Investment Strategy

The investment seeks positive absolute returns. The fund pursues its investment objective by aiming to provide exposure to four separate investment styles ("Styles"): value, momentum, carry and defensive, using both "long" and "short" positions within the following asset groups ("Asset Groups"): equities, bonds, interest rates, commodities and currencies. It may achieve its exposure to any of the Asset Groups by using derivatives rather than holding those assets directly. The fund is non-diversified.

Operations

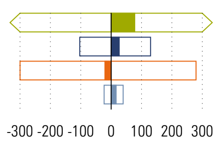
Minimum Initial Investment	5000000
Inception Date	10/30/2013
Management Fees	Actual: 1.35% Max: 1.35%
Sales Fees	—
Firm Name	AQR Funds
Telephone	866-290-2688
Web Address	www.aqrfunds.com

Performance



2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	10/2014	History
—	—	—	—	—	—	—	—	—	—	6.88	Total Return %
—	—	—	—	—	—	—	—	—	—	-4.11	+/- Benchmark 1
—	—	—	—	—	—	—	—	—	—	—	+/- Benchmark 2
—	—	—	—	—	—	—	—	—	133.00	133.00	Turnover Ratio %
—	—	—	—	—	—	—	—	—	362	348	Share Class Assets (mil)
—	—	—	—	—	—	—	—	—	1.50	1.50	Expense Ratio
—	—	—	—	—	—	—	—	—	11.62	15.68	Stock %
—	—	—	—	—	—	—	—	—	47.78	33.77	Bond %

Holding Analysis as of 9/30/2014



	Net %	#
Cash	77.6	—
Stock	26.4	840
Bond	-20.4	9
Other	16.3	—
Total	**100.0**	**942**

Equity Style %

	Val	Core	Gr
Lg	—		—
Mid	—	—	—
Sm	—	—	—

Market Cap	%
Giant	—
Large	—
Mid	—
Small	—
Micro	—
Avg Market Cap (mil)	—

Value Factors	%	Growth Factors	%
Price/Earnings	14.12	LT Earn Gr	10.84
Price/Book	1.49	Hist Earn Gr	7.74
Price/Sales	0.86	Book Val Gr	6.35
Price/Cash Flow	5.06	Sales Gr	-1.18
Dividend Yield	2.35	Cash Flow Gr	5.00

Fixed Income Style

	Ltd	Mod	Ext
High			
Med			
Low			

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

[1] as of —

Credit Rating Breakdown	%	Maturity Breakdown	%
AAA	—	1-3	0.0
AA	—	3-5	0.0
A	—	5-7	0.0
BBB	—	7-10	0.0
BB	—	10-15	0.0
B or Below B	—	15-20	0.0
Not Rated	—	20-30	0.0
		30+	0.0

Top Holdings as of 9/30/2014	Style Box	Sector	Mkt Cap USD (mil)	% Mkt Val
3mo Euro Euribor 15/06/15	—	—	—	109.16
Long Gilt 12/29/2014	—	—	—	42.80
3mo Euro Euribor Sep15	—	—	—	37.72
3mo Euro Euribor 16/03/15	—	—	—	33.49
90day Euro$ 16/03/15	—	—	—	28.59
Aqr Style Premia Alt Off	—	—	—	16.91
Euro-Bund 12/08/2014	—	—	—	14.09
10 Year Government of Cana...	—	—	—	11.59
S&P Canada 60 Index Future ...	—	—	—	10.83
Hang Seng Idx 10/30/2014	—	—	—	8.80
Hang Seng Idx 10/30/2014	—	—	—	5.98
TOPIX Index Future Dec14	—	—	—	5.79
Lme Copper 12/15/2014	—	—	—	4.68
Natural Gas 10/29/14	—	—	—	3.82
Lme Copper 10/16/14	—	—	—	3.49
Wti Crude 10/21/14	—	—	—	2.82
AEX Index Future Oct14	—	—	—	2.22
Lme Copper 10/10/14	—	—	—	1.89
Euro-Bobl 12/08/2014	—	—	—	1.39
Ibex 35 Indx 10/17/2014	—	—	—	1.18
Top 20 holdings				347.2

Top 3 Equity Sectors	%	Rel BM1%	Rel BM2%
Basic Matls	—	—	—
Cons Cyclical	—	—	—
Financial Svcs	—	—	—

Top 3 Fixed Income Sectors	%	Rel BM1%	Rel BM2%
Derivative	42.56	—	—
Government	33.58	—	—
Cash	23.80	—	—

Fund Reports

Balter Long/Short Equity

by **Josh Charney**

Advisor
Balter Liquid Alternatives LLC

Advisor Location
Boston, Massachusetts

Assets Under Management
$121.7 million

Inception Date
Dec. 31, 2013

Investment Type
Mutual fund

Morningstar Category
Long-short equity

People
Balter Capital Management was founded by Brad Balter, CFA, in 2006 for the purpose of performing hedge fund research and building customized hedge fund products. He is also CEO and portfolio manager of the fund's advisor, Balter Liquid Alternatives, which currently oversees one mutual fund. Previously, Balter was a managing director at Citigroup Global Markets and a member of the hedge fund coverage program at PaineWebber, focusing on early-stage hedge fund investing. Jay Warner, CFA, is the firm's CIO and a portfolio manager at Balter. Before co-founding Balter, he was an analyst at Citigroup Global Markets and also served on the investment committee of a Connecticut-based hedge fund, The Segalas Group.

Purpose

Balter Long/Short Equity is a multimanager long-short equity fund of hedge fund managers, with an emphasis on small-cap equities. The fund can be used as a means to access boutique hedge fund managers. Similar to other long-short equity funds, this fund offers investors upside participation in equity markets, while limiting downside risks through short positions. It also seeks lower correlations and volatility than traditional equity funds.

Process

This fund of boutique hedge fund firms allocates to between two and five managers. The hedge fund firms it selects are generally small, between $100 million and $300 million in assets. The small size is due to this fund's small-cap bias as well as Balter Capital Management's preference to steer clear of firms that may be exposed to "crowded" hedge fund trades. The selection process relies on Balter Capital's database of roughly 3,000 hedge fund firms, as well as annual on-site due-diligence visits to screen for managers.

The firm seeks a mix of subadvisors whose portfolios have low correlations with one another and who use differing strategies. Each subadvisor runs a sleeve for the mutual fund that is pari passu, or identical to the firm's hedge fund strategy. The strategies therefore must meet the guidelines of the 1940 Act mutual fund structure for liquidity and leverage. Balter selects strategies that carry multiyear track records, and all subadvisory track records can be found in the prospectus. Generally, the advisor doesn't intervene in manager trades, but it does monitor the portfolio and ensure the fund stays within its individual position limits (5.0% for long and 2.5% for shorts).

Portfolio

The fund's portfolio currently consists of four subadvisors—Apis Capital Advisors (30.1%), Madison Street Partners (23.4%), Midwood Capital Partners (23.3%), and Millrace Asset Group (23.2%). Balter determines manager allocations based on relative market opportunities and conversations with subadvisors. Management has deviated from an equal-weighting by about 7% on average. The fund also prefers managers with more-concentrated portfolios, although the total portfolio is somewhat more diversified with 271 total positions (164 long, 107 short). Net exposure ranges between 40% and 60% and is generally a product of the managers' bottom-up decision-making process. The advisor doesn't usually override its managers' process in order to adjust net exposure. It does, however, maintain position limits (5.0% for longs and 2.5% for shorts) to avoid the over-concentration that might result from multiple managers' betting on the same security.

At the end of September 2014, the fund's net exposure was 39.3%, with 67.5% long and 28.2% short. The portfolio also tilted toward small caps (62.5%) and predominantly held domestic equities (81.4%).

Price

The fund has an expense cap of 2.19% for the Institutional shares and 2.54% for the Investor share class. Both the Institutional and Investor share classes rank in the most expensive quartile of alternative funds. The expenses also compare unfavorably with the fund's long-short equity peers, which cost 1.82% on average.

Balter Long/Short Equity Institutional BEQIX

Investment Summary

Data as of	Currency	Benchmark 1	Benchmark 2
10/31/2014	USD	S&P 500 TR USD	—

Trailing Return

	Total Return %	+/- BM1	+/- BM2	Cat % Rank
1 Mo	0.40	-2.04	—	58
3 Mo	0.40	-4.64	—	58
6 Mo	1.52	-6.70	—	53
YTD	-0.10	-11.09	—	74
1 Yr	—	—	—	—
3 Yr	—	—	—	—
5 Yr	—	—	—	—
10 Yr	—	—	—	—
15 Yr	—	—	—	—

Ratings

	Overall	3 Year	5 Year	10 Year
Rating	—	—	—	—
Risk	—	—	—	—
Return	—	—	—	—
# Investments Rated	—	—	—	—

Risk/Reward

vs Benchmark 1	3 Year	5 Year	10 Year
Alpha	—	—	—
Beta	—	—	—
R-Squared	—	—	—
Tracking Error	—	—	—
Information Ratio	—	—	—
Excess Return	—	—	—

Miscellaneous	3 Year	5 Year	10 Year
Standard Deviation	—	—	—
Sharpe Ratio	—	—	—
Sortino Ratio	—	—	—

Manager Information

Ross DeMont. Since 12/2013.
Brad Balter. Since 12/2013.
Jay Warner. Since 12/2013.

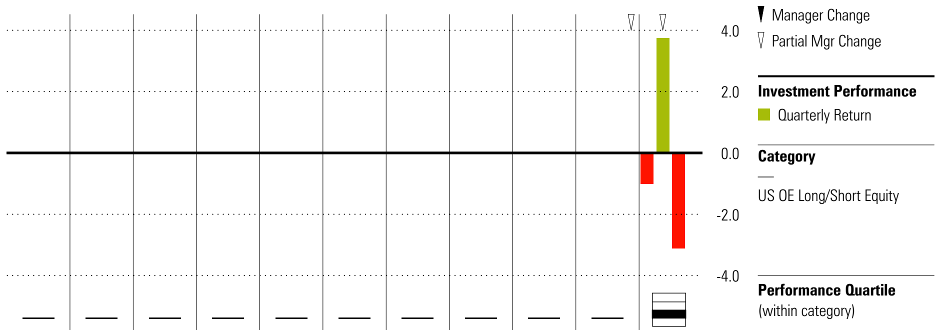
Investment Strategy

The investment seeks to achieve long-term capital appreciation plus income. The fund employs a "long/short" investment strategy to attempt to achieve capital appreciation and manage risk by purchasing stocks believed to be undervalued and selling short stocks believed to be overvalued. It invests at least 80% of its net assets, plus any borrowings for investment purposes, in equity securities. The fund may also invest up to 20% of its net assets in fixed income securities, including sovereign debt, corporate bonds, exchange-traded notes ("ETNs") and debt issued by the U.S. government and its agencies. It is non-diversified.

Operations

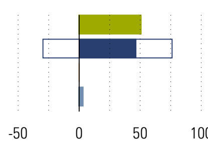
Minimum Initial Investment	50000
Inception Date	12/31/2013
Management Fees	Actual: 1.95% Max: 1.95%
Sales Fees	1R
Firm Name	Balter
Telephone	855-854-7258
Web Address	www.balterliquidalts.com

Performance



	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	10/2014	History
	—	—	—	—	—	—	—	—	—	—	-0.10	Total Return %
	—	—	—	—	—	—	—	—	—	—	-11.09	+/- Benchmark 1
	—	—	—	—	—	—	—	—	—	—	—	+/- Benchmark 2
	—	—	—	—	—	—	—	—	—	—	—	Turnover Ratio %
	—	—	—	—	—	—	—	—	—	100	128	Share Class Assets (mil)
	—	—	—	—	—	—	—	—	—	—	—	Expense Ratio
	—	—	—	—	—	—	—	—	—	—	58.52	Stock %
	—	—	—	—	—	—	—	—	—	—	0.00	Bond %

Holding Analysis as of 6/30/2014



	Net %	#
Cash	50.6	—
Stock	46.5	159
Bond	0.0	0
Other	2.9	—
Total	**100.0**	**173**

Equity Style %

	Val	Core	Gr
Lg	1	5	8
Mid	1	3	16
Sm	8	22	37

Market Cap	%
Giant	5.9
Large	7.6
Mid	20.0
Small	31.1
Micro	35.4
Avg Market Cap (mil)	1,660.6

Value Factors	%	Growth Factors	%
Price/Earnings	22.66	LT Earn Gr	17.29
Price/Book	2.42	Hist Earn Gr	17.48
Price/Sales	1.04	Book Val Gr	7.48
Price/Cash Flow	9.27	Sales Gr	1.70
Dividend Yield	0.53	Cash Flow Gr	4.90

Fixed Income Style

	Ltd	Mod	Ext
High			
Med			
Low			

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

[1] as of —

Credit Rating Breakdown	%	Maturity Breakdown	%
AAA	—	1-3	—
AA	—	3-5	—
A	—	5-7	—
BBB	—	7-10	—
BB	—	10-15	—
B or Below B	—	15-20	—
Not Rated	—	20-30	—
		30+	—

Top Holdings as of 6/30/2014	Style Box	Sector	Mkt Cap USD (mil)	% Mkt Val
Constant Contact Inc			1,017	2.18
InterMune Inc			4,544	2.15
Saba Software Inc	—		354	1.82
GenCorp Inc			1,121	1.82
Agilysys Inc			318	1.81
Aegean Marine Petroleum N...			487	1.76
COM DEV International Ltd			307	1.64
Xtreme Drilling and Coil Servi...			397	1.51
Information Services Group I...			178	1.36
Pain Therapeutics Inc			262	1.35
OSI Systems Inc			1,331	1.34
Medivation Inc			5,912	1.19
Sierra Wireless Inc			636	1.17
Brightcove Inc			340	1.06
Amerco Inc			5,701	1.05
Apple Inc			556,574	1.05
Alexion Pharmaceuticals Inc			30,922	0.99
Qualcomm Inc			132,898	0.94
Enanta Pharmaceuticals Inc	—		800	0.94
West Holdings Corporation			410	0.91
Top 20 holdings				28.0

Top 3 Equity Sectors	%	Rel BM1%	Rel BM2%
Technology	37.60	52.51	—
Healthcare	16.97	13.18	—
Industrials	13.96	19.96	—

Top 3 Fixed Income Sectors	%	Rel BM1%	Rel BM2%
Cash	100.00	—	—
Derivative	0.00	—	—
Securitized	0.00	—	—

Fund Reports

Franklin K2 Alternative Strategies

by **Jason Kephart**

Advisor
Franklin Templeton Investments

Advisor Location
San Mateo, California

Assets Under Management
$456 million

Inception Date
Oct. 11, 2013

Investment Type
Mutual fund

Morningstar Category
Multialternative

People
This fund is managed by K2 Associates, a hedge funds-of-funds provider that was acquired by Franklin Templeton in September 2012. K2 runs approximately 50 different funds of funds with about $10 billion in assets combined. William Douglass and David Saunders, co-founders of K2, have managed this fund since its October 2013 inception. Prior to founding K2 in 1994, Douglass was comanager of Tiedemann International Research's U.S. business and Saunders was a senior managing director at ABN Amro. Robert Christian, head of manager research, and John Brooks Ritchey, head of portfolio construction, were added as named managers in October 2014. They are supported by 25 analysts on the manager research team, five analysts on the portfolio construction team, and three people on the operational due-diligence team.

Purpose

This fund offers investors access to multiple alternative investment strategies, including long-short equity, event-driven, and relative value. Its goal is to offer positive risk-adjusted returns that have a low correlation to long-only stocks and bonds and lower volatility than stocks.

Process

K2's portfolio construction team uses the same basic process to build this portfolio as its hedge funds, but this fund takes on more of a one-size-fits-all approach. The majority of the team's hedge funds are custom-built for specific clients. The team works closely with Franklin's Global Solutions group to set return expectations for global assets. Management uses those projections to make allocation decisions among four core alternative strategies: long-short equity, event-driven, relative value, and global macro within strategic bands based on each strategy's weighting in the HFRI Global Hedge Fund Index. The fund will have its biggest tilt to long-short equity, for example, when management is most bullish on equities. The subadvisors are drawn from K2's approved manager list, which has about 100 hedge fund managers on it. The list is culled from K2's proprietary database of about 500 hedge fund managers. Managers on the list have to get approved by both the management research team, which focuses on portfolio managers' process and performance, and the operational due-diligence team, which focuses on back-office capabilities, like trading practices and reviews of financial statements. Strategy allocations are reviewed monthly. Management doesn't target specific correlations or betas to the market.

Portfolio

The fund currently has 12 subadvisors, but as the fund's assets grow, management expects that number to reach high as 20. The fund has strategic-allocation bands of 25% to 40% for long-short equity, 20% to 35% for event-driven, 30% to 45% for relative value, and 0% to 20% for global macro. The strategic targets are based on each strategy's weighting in the HFRX Global Hedge Fund Index, the fund's secondary benchmark. As of June 30, the fund had a 35% allocation to long-short equity (split between five managers), a 33% allocation to event-driven (split between two managers), a 23% allocation to relative value (split between four managers), and a 9% allocation to global macro (managed solely by Graham Capital Management). The fund's gross long exposure was 122% and its gross short exposure was 42%.

Price

Investors in this fund aren't getting any breaks on price. The fund is offered in five share classes, all of which have either above-average or high expense ratios compared with similarly distributed funds in the broad alternatives universe. The fund's board did initiate a new fee cap for the Advisor and Retirement share classes in October that lowers the price of those shares to 1.95%, down from 2.15%. Those two share classes hold approximately 75% of the fund's assets. It's an encouraging move, but even at the reduced levels the fund's fees are just average compared with other multialternative funds.

Franklin K2 Alternative Strategies A FAAAX

Investment Summary

Data as of	Currency	Benchmark 1	Benchmark 2
10/31/2014	USD	S&P 500 TR USD	—

Trailing Return

	Total Return %	+/- BM1	+/- BM2	Cat % Rank
1 Mo	-0.19	-2.63	—	68
3 Mo	0.38	-4.67	—	46
6 Mo	1.33	-6.89	—	43
YTD	2.70	-8.29	—	39
1 Yr	—	—	—	—
3 Yr	—	—	—	—
5 Yr	—	—	—	—
10 Yr	—	—	—	—
15 Yr	—	—	—	—

Ratings

	Overall	3 Year	5 Year	10 Year
Rating	—	—	—	—
Risk	—	—	—	—
Return	—	—	—	—
# Investments Rated	—	—	—	—

Risk/Reward

vs Benchmark 1	3 Year	5 Year	10 Year
Alpha	—	—	—
Beta	—	—	—
R-Squared	—	—	—
Tracking Error	—	—	—
Information Ratio	—	—	—
Excess Return	—	—	—

Miscellaneous	3 Year	5 Year	10 Year
Standard Deviation	—	—	—
Sharpe Ratio	—	—	—
Sortino Ratio	—	—	—

Manager Information

William Douglass,III. Since 11/2013.
David Saunders. Since 11/2013. B.S. 1981 University of Maryland.
John Ritchey. Since 10/2014. 1982 Franklin and Marshall College.

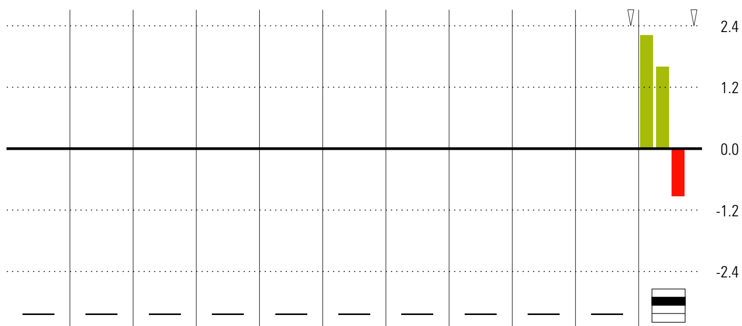
Investment Strategy

The investment seeks capital appreciation with lower volatility relative to the broad equity markets. The fund seeks to achieve its investment goal by allocating its assets across multiple non-traditional or "alternative" strategies, including, but not limited to, some or all of the following strategies: Long Short Equity, Relative Value, Event Driven and Global Macro.

Operations

Minimum Initial Investment	1000
Inception Date	11/18/2013
Management Fees	Actual: 2.05% Max: 2.05%
Sales Fees	6F
Firm Name	Franklin Templeton Investments
Telephone	800-632-2301
Web Address	franklintempleton.com

Performance



Manager Change
Partial Mgr Change

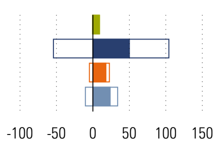
Investment Performance
Quarterly Return

Category
—
US OE Multialternative

Performance Quartile
(within category)

2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	10/2014	History
—	—	—	—	—	—	—	—	—	—	2.70	Total Return %
—	—	—	—	—	—	—	—	—	—	-8.29	+/- Benchmark 1
—	—	—	—	—	—	—	—	—	—	—	+/- Benchmark 2
—	—	—	—	—	—	—	—	—	—	181.06	Turnover Ratio %
—	—	—	—	—	—	—	—	—	36	94	Share Class Assets (mil)
—	—	—	—	—	—	—	—	—	—	2.27	Expense Ratio
—	—	—	—	—	—	—	—	—	51.44	61.35	Stock %
—	—	—	—	—	—	—	—	—	18.92	13.31	Bond %

Holding Analysis as of 9/30/2014



	Net %	#
Cash	8.6	—
Stock	50.0	480
Bond	17.8	357
Other	23.6	—
Total	**100.0**	**1097**

Equity Style %

Val	Core	Gr	
7	18	36	Lg
3	12	14	Mid
2	2	6	Sm

Market Cap	%
Giant	17.7
Large	42.8
Mid	28.2
Small	8.4
Micro	3.0
Avg Market Cap (mil)	17,894.2

Value Factors	%	Growth Factors	%
Price/Earnings	20.87	LT Earn Gr	12.36
Price/Book	2.77	Hist Earn Gr	27.23
Price/Sales	1.49	Book Val Gr	0.30
Price/Cash Flow	9.79	Sales Gr	0.99
Dividend Yield	1.31	Cash Flow Gr	3.57

Fixed Income Style

Ltd	Mod	Ext	
			High
			Med
			Low

Avg Eff Duration	—
Avg Eff Maturity	—
Avg Credit Quality	—
Avg Wtd Coupon	5.07%
Avg Wtd Price	109.99

[1] as of —

Credit Rating Breakdown	%	Maturity Breakdown	%
AAA	—	1-3	11.1
AA	—	3-5	46.4
A	—	5-7	18.9
BBB	—	7-10	11.6
BB	—	10-15	2.2
B or Below B	—	15-20	2.7
Not Rated	—	20-30	6.3
		30+	0.9

Top Holdings as of 9/30/2014

	Style Box	Sector	Mkt Cap USD (mil)	% Mkt Val
K2 Investments Holding Co	—	—	—	13.44
Recv Ibox Hi Yld 12/20/14	—	—	—	1.67
Time Warner Cable Inc			40,235	1.35
Actavis PLC			63,939	1.28
Allergan Inc			53,032	1.21
Covidien PLC			39,081	1.17
Time Warner Inc			63,327	1.11
Shire PLC			51,820	1.07
Anheuser-Busch Inbev SA A...			178,092	1.06
Directv			43,454	1.02
Paris Las Vegas Hldg 144A 1...	—	—	—	0.99
Union Pacific Corp			96,590	0.99
NXP Semiconductors NV			15,790	0.97
Roc Fin Llc / Roc Fin 144A 12...	—	—	—	0.91
W R Grace & Co			6,748	0.88
HCA Holdings Inc			30,562	0.84
Tyco International Ltd			19,767	0.81
Air Products & Chemicals Inc			27,730	0.81
Affinion Grp 7.875%	—	—	—	0.79
Pay Ishares 2000 Swp	—	—	—	0.78
Top 20 holdings				33.2

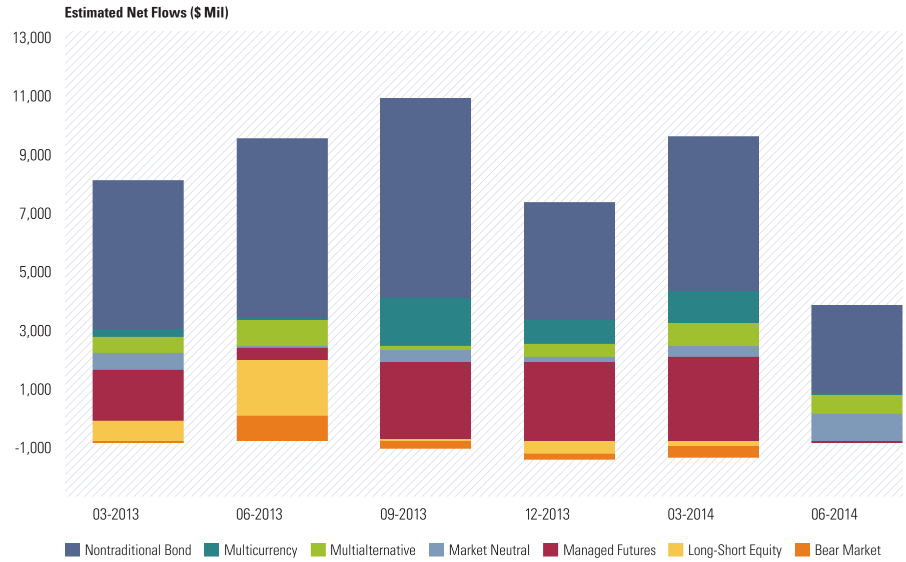
Top 3 Equity Sectors	%	Rel BM1%	Rel BM2%
Healthcare	20.90	29.48	—
Industrials	19.29	42.07	—
Cons Cyclical	16.47	38.24	—

Top 3 Fixed Income Sectors	%	Rel BM1%	Rel BM2%
Corporate	76.06	—	—
Cash	15.54	—	—
Securitized	4.31	—	—

Flows and Assets Under Management: Alternative Mutual Funds

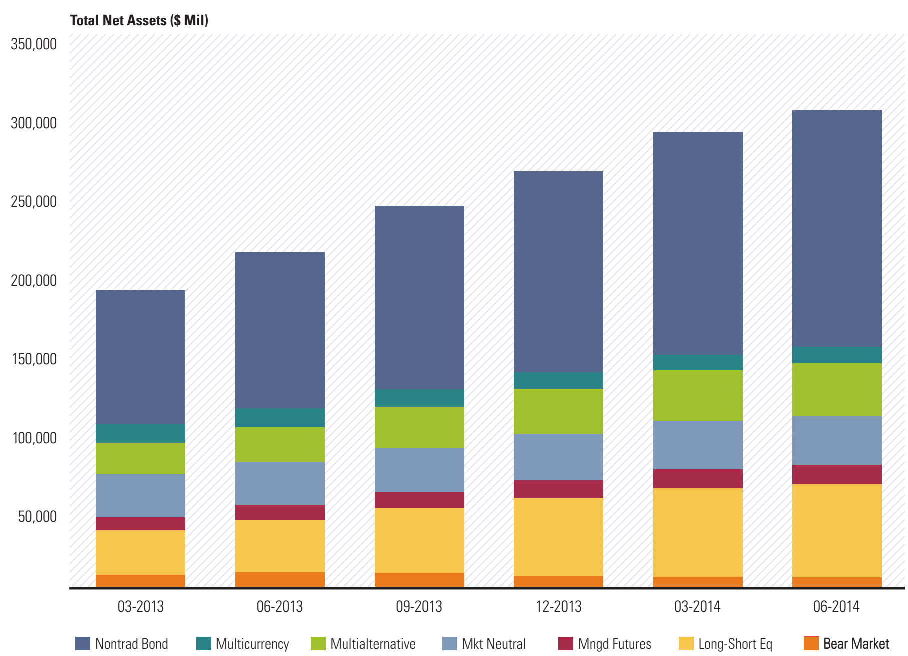
Quarterly Alternative Mutual Fund Flows

During the second quarter of 2014, alternative mutual funds' net inflows amounted to nearly $11.3 billion, a decrease from last quarter's inflows of roughly $24.5 billion. The non-traditional-bond category led with the largest inflows ($7.5 billion), consistent with the previous six quarters. The long-short equity category also had a notably high influx, with net inflows equal to about $2.3 billion, followed by the multialternative category with smaller but still significant net inflows of slightly more than $1.5 billion. More inflows were captured among multicurrency ($148 million) and managed-futures ($32 million) funds, while the market-neutral category declined, with net modest outflows totaling $153 million. The bear-market category continued its decline for a third consecutive quarter with outflows of $106 million.



Quarterly Alternative Mutual Fund Assets Under Management

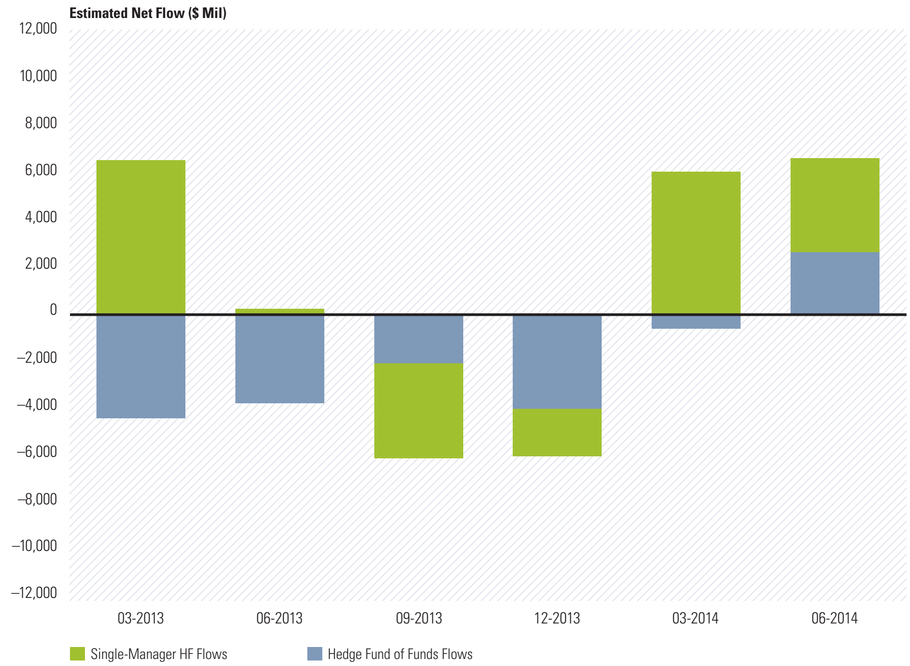
Assets under management for all alternative mutual funds increased 4.69% quarter over quarter, totaling more than $302 billion at the end of June 2014. Six of the seven alternative mutual fund categories gained assets in the second quarter. Long-short equity funds experienced the largest growth in assets during the last three quarters (78.39%), followed by multi-alternative funds, which increased by 52.61%. The bear-market category still remains the smallest among all the alternative mutual fund categories at just under $6 billion as of June 30, 2014. Nontraditional bond, the largest alternative mutual fund category in terms of assets, also experienced a significant increase in total assets of nearly 51.5% for the previous three quarters. Bear-market funds lost 6.0% this quarter, and market-neutral funds were flat.



Flows and Assets Under Management: Hedge Funds

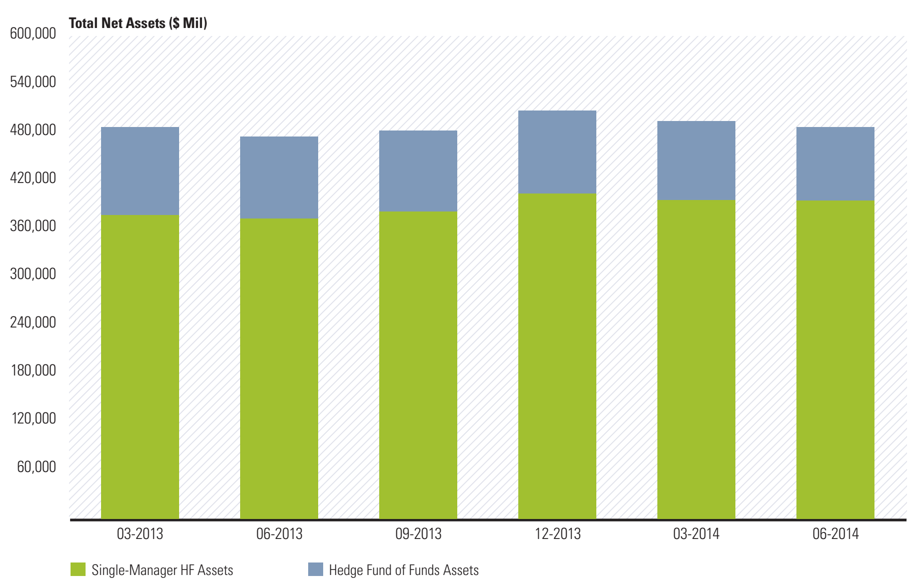
Quarterly Hedge Fund Flows

During the second quarter of 2014, single-manager hedge funds in Morningstar's database experienced inflows for a second consecutive quarter, totaling more than $2.6 billion, and funds of hedge funds recorded inflows of just more than $4 billion. Interestingly, the inflows in the funds of hedge funds universe occurred after five consecutive quarters of losses. Multistrategy (single-manager) hedge funds continued their positive flow trend for the sixth consecutive quarter, with nearly $1.9 billion. Long-short debt (single manager) experienced the second-highest inflows, with $1.7 billion. Systematic-futures and global-macro (single-manager) hedge funds experienced the largest outflows at $2.5 billion and $1.7 billion, respectively. For funds of hedge funds, the multistrategy category led the pack with inflows of $3.7 billion, following five quarters of consecutive outflows. Debt and equity funds of funds also experienced net inflows of $680 million and $166 million, respectively. Macro-systematic funds of funds displayed the largest outflows at $482 million, followed by event-driven and relative-value funds of funds, with respective outflows of $73 million and $36 million.



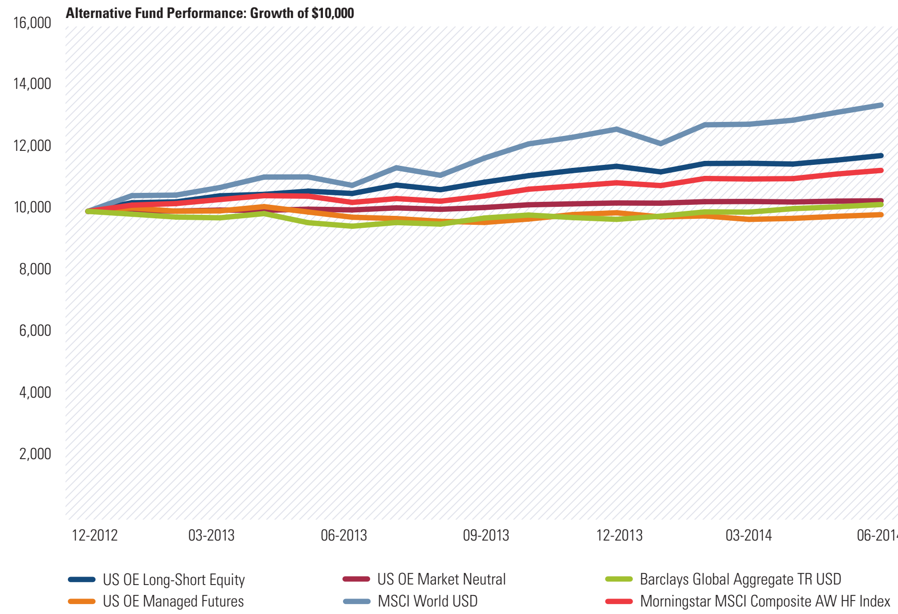
Quarterly Hedge Fund Assets Under Management

In the second quarter of 2014, single-manager hedge fund assets under management in Morningstar's database decreased slightly by 0.21% to $396.6 billion. During the last year, assets under management of single-manager hedge funds increased by a total margin of just under 6% despite some outflows over the past three quarters. Hedge funds of funds in Morningstar's database managed 6.9% fewer assets than in the prior quarter, with $91.5 billion assets recorded as of June 30, 2014. Surprisingly, assets under management of hedge funds of funds decreased 10.17% year over year (from June 2013).



Alternative Investment Performance

Growth of a $10,000 Alternative Investment
Global stocks, as represented by the MSCI World NR Index, gained 4.86% in the second quarter. All other alternative investment categories recorded positive returns between 0.22% and 2.53%. Over the 18 months ended June 30, 2014, the MSCI World NR Index continued to outperform all other categories, with a 24.05% return. During the same period, long-short equity funds gained 11.62%, while the Morningstar MSCI Composite Hedge Fund Index saw an overall gain of 10.10%. The Barclays Global Bond Index still gained 7.39%, and the market-neutral and managed-futures category averages gained 2.96% and 0.84%, respectively, during the past 18 months.



*Morningstar no longer publishes proprietary hedge fund indexes. Morningstar now uses the Morningstar MSCI series of indexes, including the Morningstar MSCI Composite AW, a currency-hedged asset-weighted index of 1,000 hedge funds, or the applicable category averages.

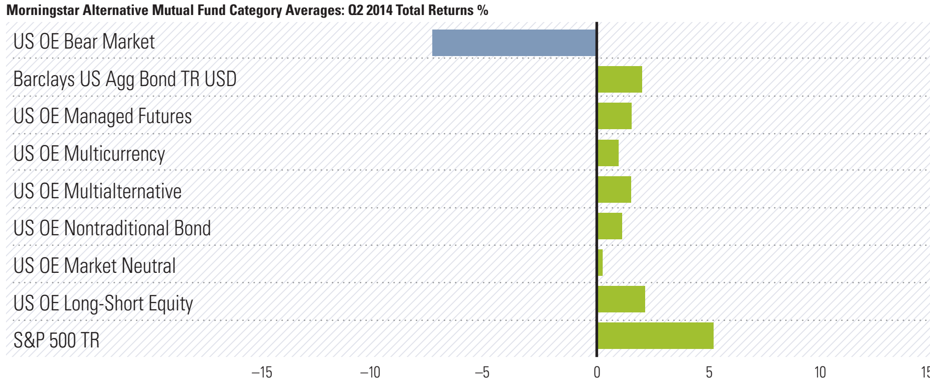
Performance of Alternative Investments Over Time
Global stocks, as represented by the MSCI World NR Index, steadily outperformed all other alternative investments during the past quarter, one-year, three-year, and five-year time frames (ended June 30). Long-short equity funds had the second-highest returns over the one-, three-, and five-year periods but were slightly outpaced by hedge funds, as represented by the Morningstar MSCI Composite Hedge Fund Index, this quarter. Global bonds, hedge funds, long-short equity funds, and market-neutral funds all displayed positive returns over the one-, three-, and five-year periods, in addition to this past quarter. Managed futures displayed negative returns over the past one-, three-, and five-year periods, yet posted positive returns this past quarter.

Second-Quarter 2014 Performance by Category

Alternative Mutual Funds

Equities managed to post modest gains during the second quarter of 2014. The S&P 500 gained 5.23%, and long-short equity mutual funds, which aim to protect against stock market downdrafts, gained 2.16%. The average bear-market fund, which aims to profit during weak equity markets, did not fare quite as well, with returns of negative 7.39% in the second quarter, yet the Barclays U.S. Aggregate Bond TR Index gained 2.04%. Managed-futures, multicurrency, market-neutral, and non-traditional-bond funds all displayed positive returns this quarter of under 2.00%.

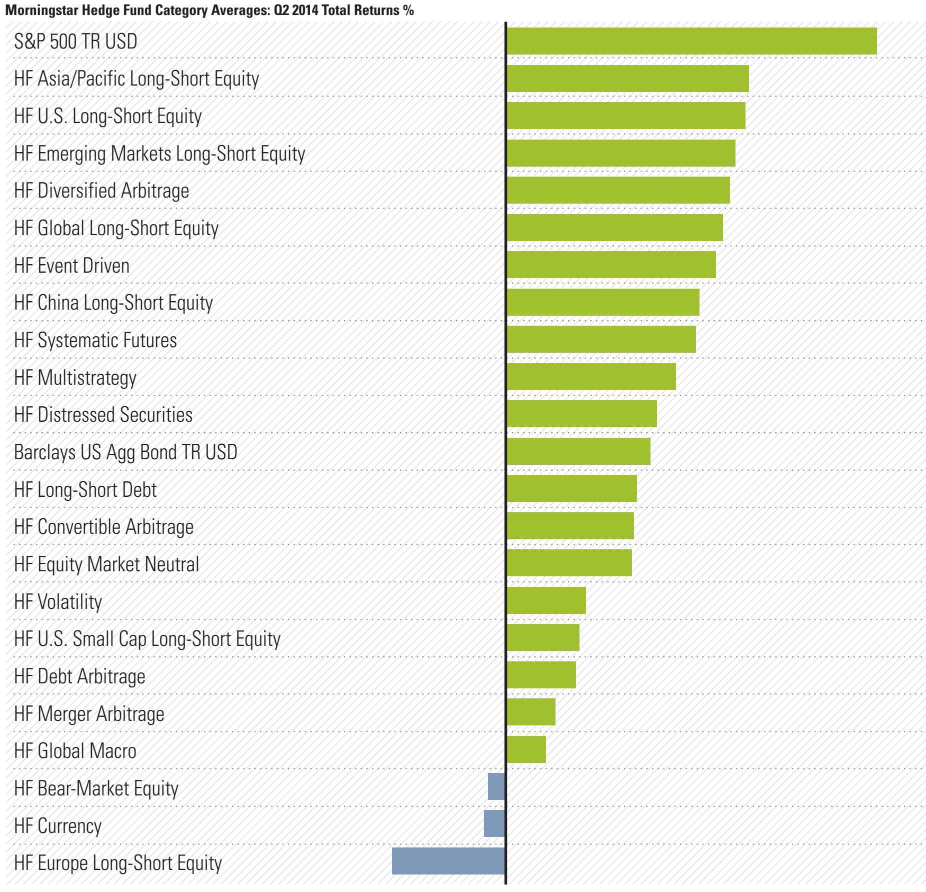
Morningstar Alternative Mutual Fund Category Averages: Q2 2014 Total Returns %



Hedge Funds

Hedge funds saw relatively consistent gains across categories in the second quarter of 2014. All hedge fund categories except European long-short equity, bear-market equity, and currency posted gains. Asia/Pacific and U.S. long-short equity funds gained the most, with returns of 3.43% and 3.38%, respectively. None of the 21 hedge fund categories beat the S&P 500, which increased 5.23% this quarter. The worst-performing hedge fund categories included European long-short equity, currency, and bear-market equity, which decreased by 1.6%, 0.31%, and 0.25%, respectively.

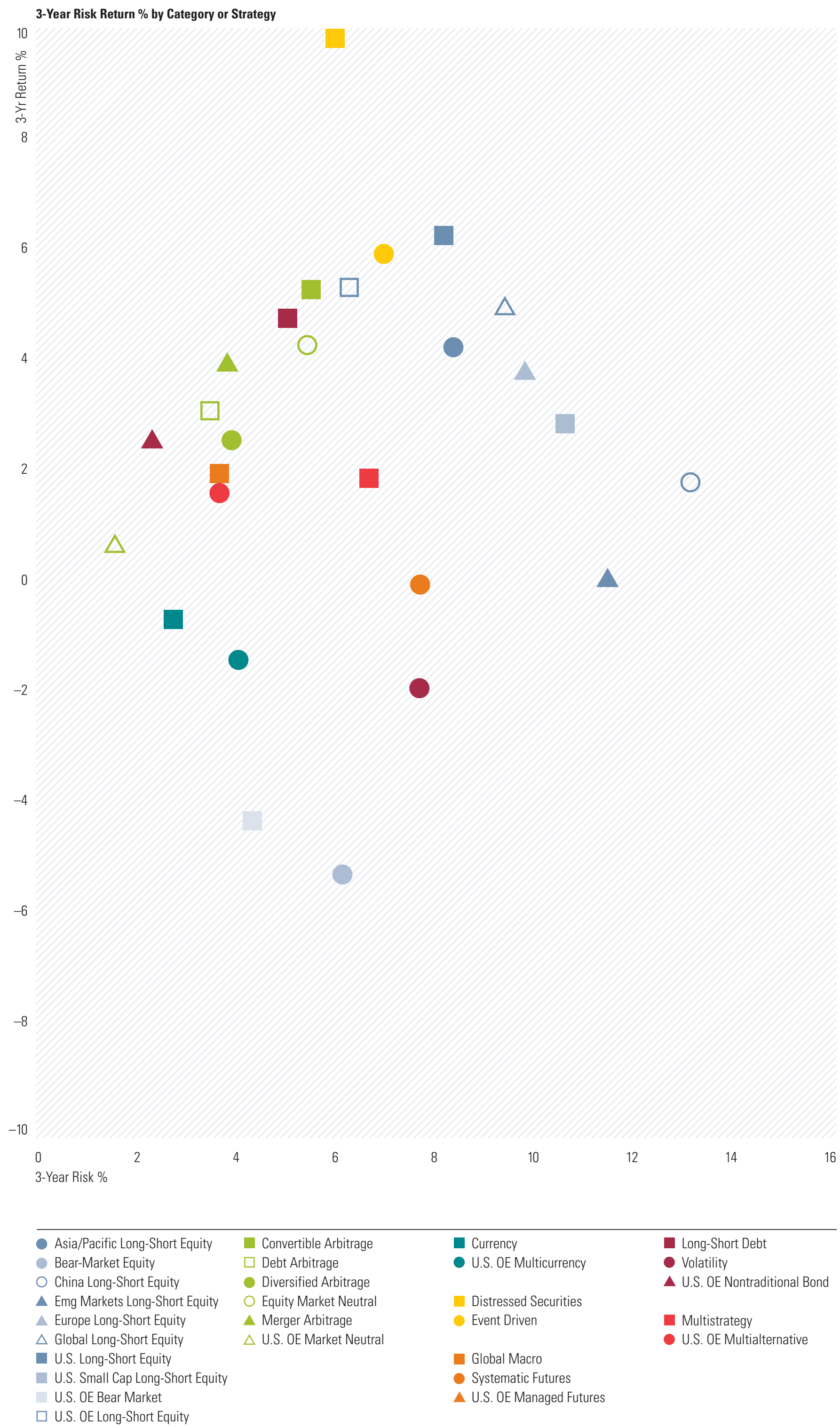
Morningstar Hedge Fund Category Averages: Q2 2014 Total Returns %



Risk Versus Return: Alternative Mutual Funds and Hedge Funds

Three-Year Standard Deviation and Return

Of the 28 alternative mutual fund and hedge fund category averages, 23 exhibited positive returns over the three years ended June 30, 2014. Hedge funds in the distressed securities, long-short equity, and event-driven categories produced the best three-year total returns, of 9.96%, 6.36%, and 6.01%, respectively. Distressed-securities hedge funds also posted the highest risk-adjusted returns at 1.65%, followed by non-traditional-bond mutual funds and merger-arbitrage and convertible-arbitrage hedge funds. In contrast, the U.S. bear-market mutual fund category experienced a 22.8% annualized decline over the three-year period ended June 2014, while also exhibiting the highest (17.13% annualized) standard deviation. Managed-futures mutual funds and bear-market hedge funds displayed the second-lowest risk-adjusted returns at negative 0.96% and negative 0.84%, respectively.



Correlations by Alternative Fund Strategy

Three–Year Correlations: Alternative Mutual Fund Categories	1	2	3	4	5	6	7
1 US OE Bear Market	1.00						
2 US OE Long-Short Equity	-0.96	1.00					
3 US OE Managed Futures	0.05	-0.04	1.00				
4 US OE Market Neutral	-0.79	0.86	0.06	1.00			
5 US OE Multialternative	-0.90	0.92	0.16	0.82	1.00		
6 US OE Multicurrency	-0.82	0.77	-0.12	0.62	0.84	1.00	
7 US OE Nontraditional Bond	-0.64	0.66	0.13	0.63	0.84	0.76	1.00

Three–Year Correlations: Hedge Fund Categories	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20	21
1 HF Asia/Pacific Long-Short Equity	1.00																				
2 HF Bear-Market Equity	-0.31	1.00																			
3 HF China Long-Short Equity	0.39	-0.45	1.00																		
4 HF Convertible Arbitrage	0.78	-0.32	0.46	1.00																	
5 HF Currency	0.44	-0.24	0.10	0.32	1.00																
6 HF Debt Arbitrage	0.80	-0.30	0.37	0.93	0.33	1.00															
7 HF Distressed Securities	0.77	-0.30	0.53	0.84	0.37	0.82	1.00														
8 HF Diversified Arbitrage	0.66	-0.22	0.48	0.73	0.28	0.74	0.70	1.00													
9 HF Emerging-Markets Long-Short Equity	0.85	-0.44	0.54	0.90	0.49	0.88	0.85	0.66	1.00												
10 HF Equity Market Neutral	0.78	-0.38	0.39	0.86	0.23	0.89	0.71	0.72	0.86	1.00											
11 HF Europe Long-Short Equity	0.80	-0.43	0.42	0.91	0.31	0.92	0.84	0.72	0.90	0.90	1.00										
12 HF Event Driven	0.79	-0.45	0.52	0.89	0.35	0.87	0.87	0.68	0.95	0.89	0.92	1.00									
13 HF Global Long-Short Equity	0.87	-0.45	0.46	0.90	0.33	0.92	0.83	0.74	0.92	0.93	0.94	0.94	1.00								
14 HF Global Macro	0.77	-0.37	0.33	0.76	0.45	0.79	0.67	0.66	0.76	0.77	0.76	0.73	0.80	1.00							
15 HF Long-Short Debt	0.85	-0.24	0.38	0.92	0.34	0.94	0.79	0.80	0.88	0.89	0.90	0.85	0.90	0.83	1.00						
16 HF Merger Arbitrage	0.68	-0.49	0.44	0.78	0.15	0.78	0.71	0.55	0.77	0.82	0.82	0.84	0.82	0.62	0.74	1.00					
17 HF Multistrategy	0.83	-0.37	0.43	0.92	0.34	0.94	0.78	0.73	0.92	0.93	0.92	0.92	0.96	0.84	0.95	0.80	1.00				
18 HF Systematic Futures	0.49	-0.23	0.18	0.31	0.29	0.33	0.27	0.37	0.32	0.34	0.28	0.25	0.38	0.69	0.44	0.23	0.42	1.00			
19 HF U.S. Long-Short Equity	0.80	-0.50	0.43	0.86	0.33	0.88	0.81	0.68	0.91	0.91	0.92	0.95	0.97	0.72	0.82	0.84	0.92	0.24	1.00		
20 HF U.S. Small-Cap Long-Short Equity	0.70	-0.47	0.46	0.81	0.20	0.82	0.76	0.61	0.84	0.87	0.86	0.92	0.91	0.66	0.77	0.84	0.88	0.17	0.94	1.00	
21 HF Volatility	-0.41	0.16	-0.05	-0.26	-0.43	-0.31	-0.53	-0.21	-0.42	-0.21	-0.39	-0.45	-0.36	-0.12	-0.26	-0.24	-0.24	0.09	-0.44	-0.33	1.00

1.00 to 0.76 0.75 to 0.51 0.50 to 0.26 0.25 to 0.00
0.00 to -0.24 -0.25 to –0.49 -0.50 to -0.74 -0.75 to -1.00

Correlations of Alternative Funds to Traditional Asset Classes

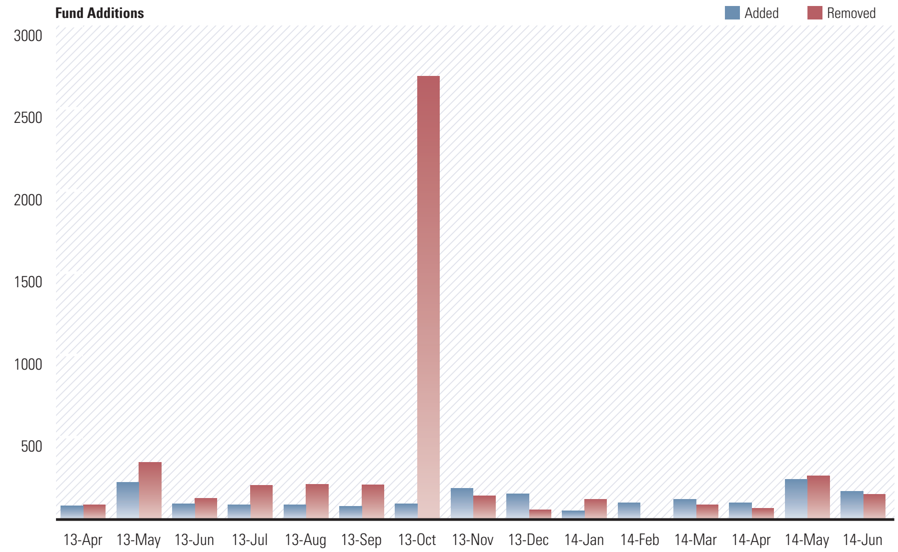
Correlation of Mutual Funds to U.S. Stocks and Bonds	S&P 500 Correlation (USD)			Barclays US Agg Correlation (USD)		
	3-Year	5-Year	10-Year	3-Year	5-Year	10-Year
US OE Bear Market	-0.95	-0.96	-0.96	0.21	0.19	-0.08
US OE Long-Short Equity	0.98	0.96	0.93	-0.28	-0.25	-0.02
US OE Managed Futures	-0.05	0.31		0.28	0.07	
US OE Market Neutral	0.85	0.40	0.18	-0.19	-0.07	-0.10
US OE Multialternative	0.90	0.92	0.92	0.03	-0.02	0.15
US OE Multicurrency	0.77	0.68	0.42	0.06	0.05	0.01
US OE Nontraditional Bond	0.69	0.58	0.69	0.19	0.23	0.21

Correlation of Hedge Funds to U.S. Stocks and Bonds	S&P 500 Correlation (USD)			Barclays US Agg Correlation (USD)		
	3-Year	5-Year	10-Year	3-Year	5-Year	10-Year
Morningstar MSCI Composite AW	0.75	0.79	0.69	0.10	0.02	0.02
HF Asia/Pacific Long-Short Equity	0.74	0.79	0.75	0.00	-0.07	0.13
HF Bear-Market Equity	-0.53	-0.50	-0.48	0.20	0.15	0.09
HF China Long-Short Equity	0.30	0.34	0.25	-0.13	-0.08	-0.03
HF Convertible Arbitrage	0.77	0.76	0.71	-0.21	-0.03	0.19
HF Currency	0.26	0.49	0.36	0.08	0.08	0.07
HF Debt Arbitrage	0.82	0.78	0.73	-0.08	0.05	0.19
HF Distressed Securities	0.71	0.75	0.77	-0.22	-0.18	-0.06
HF Diversified Arbitrage	0.60	0.60	0.59	-0.16	0.02	0.17
HF Emerging-Markets Long-Short Equity	0.83	0.74	0.72	-0.13	-0.05	0.08
HF Equity Market Neutral	0.86	0.82	0.71	-0.15	-0.10	0.10
HF Europe Long-Short Equity	0.85	0.84	0.78	-0.25	-0.15	0.06
HF Event Driven	0.85	0.87	0.83	-0.21	-0.13	0.02
HF Global Long-Short Equity	0.89	0.90	0.81	-0.17	-0.13	0.05
HF Global Macro	0.67	0.67	0.52	0.11	0.12	0.13
HF Long-Short Debt	0.75	0.74	0.74	-0.02	0.09	0.25
HF Merger Arbitrage	0.81	0.79	0.77	-0.15	-0.05	0.19
HF Multistrategy	0.83	0.84	0.74	-0.03	0.00	0.11
HF Systematic Futures	0.22	0.45	0.17	0.34	0.20	0.06
HF U.S. Long-Short Equity	0.93	0.94	0.89	-0.25	-0.24	-0.05
HF U.S. Small-Cap Long-Short Equity	0.82	0.85	0.85	-0.23	-0.23	-0.06
HF Volatility	-0.42	-0.09	0.14	0.32	0.28	0.39

Morningstar Hedge Fund Database Overview as of 06-30-2014

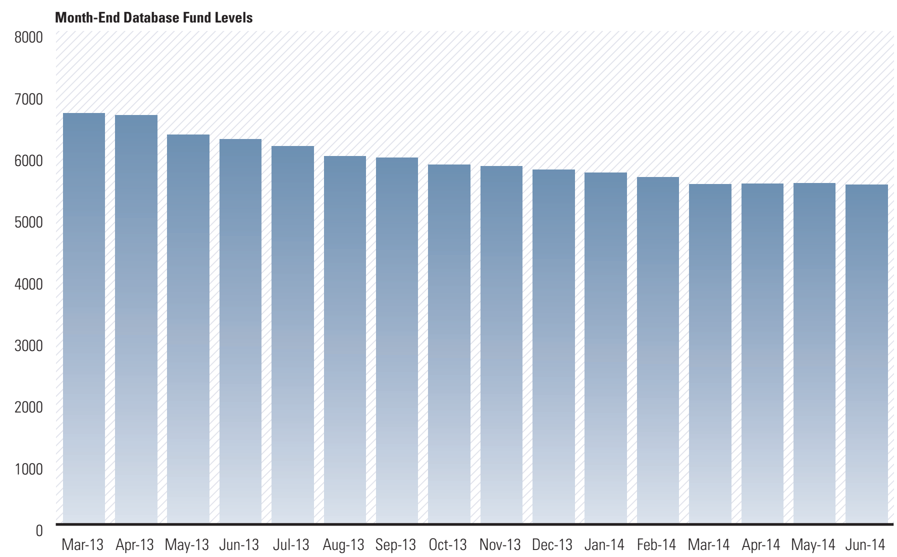
Net Fund Additions by Month

Morningstar's hedge fund database experienced a net addition of 34 funds during the second quarter of 2014. The database saw 516 additions and 482 fund withdrawals during the quarter. Funds drop out because they have liquidated or because they cease sharing performance data, typically because of poor performance. Fund additions occur as a result of new fund launches or a recent decision to supply data to Morningstar.



Month-End Database Fund Levels

As of June 30, 2014, the Morningstar hedge fund database contained 5,593 funds that actively report performance and assets-under-management data. This figure includes about 3,647 single-manager hedge funds, about 1,425 funds of hedge funds, and 5,492 CTAs and managed futures. As of quarter-end, the number of funds in the database had dropped approximately 11.89% from June 2013 levels.

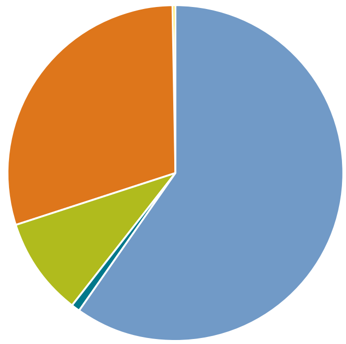


Morningstar Hedge Fund Database Overview as of 06-30-2014

Hedge Funds by Region

Approximately 59.75% of hedge funds in the Morningstar database are legally domiciled in the North American/Caribbean region, primarily in the Cayman Islands and United States. A large percentage of U.K. hedge funds are also domiciled in the Cayman Islands for tax and regulatory purposes. Approximately 29.93% of funds in Morningstar's database are domiciled in Europe, including both European Union and non-EU jurisdictions, and 9.39% of funds are domiciled in Asia and Australia, primarily in China (95%). All figures are as of June 30, 2014.

Morningstar Hedge Fund Database by Region



Region	# Funds
N. America/Caribbean	3,342
Africa	51
Asia/Australia	525
Europe	1,674
South America	1
Other	0
Total	**5,593**

Hedge Funds by Location

Approximately 78% of the hedge funds in Morningstar's database are domiciled in the United States, the Cayman Islands, China, the British Virgin Islands, Bermuda, and Luxembourg. Switzerland, France, and Ireland continue to domicile a large portion of European hedge funds, trailing Luxembourg.

North America and Caribbean	**3,241**
Cayman Islands	1,351
United States	1,128
British Virgin Islands	300
Bermuda	207
Canada	199
Curaçao	44
Bahamas	10
Barbados	1
St. Kitts and Nevis	1

Africa	**51**
South Africa	24
Mauritius	23
Seychelles	2
Swaziland	1
United Arab Emirates	1

Asia and Australia	**525**
China	497
Australia	14
Israel	4
Hong Kong	3
Japan	2
Bahrain	2
Christmas Island	1
Marshall Islands	1
Vanuatu	1

Europe	**1,674**
Luxembourg	819
Ireland	235
Switzerland	146
France	107
Guernsey	103
Italy	53
Jersey	35
Spain	33
Liechtenstein	29
United Kingdom	26
Netherlands	25
Malta	21
Gibraltar	7
Germany	6
Isle of Man	6
Sweden	5
Norway	4
Macedonia	4
Finland	2
Channel Islands	2
Cyprus	2
Portugal	2
Belgium	1
Austria	1

South America	**1**
Chile	1

Morningstar Hedge Fund Database Overview as of 06-30-2014

Service Providers

Morgan Stanley and Goldman Sachs are the largest prime brokerage-service providers to hedge funds in Morningstar's database, serving just over a 27% share combined. The big four accounting firms are employed by approximately 75% of the hedge funds listed in Morningstar's database, with PricewaterhouseCoopers leading the pack. Credit Suisse provides administration services to 6.27% of funds in Morningstar's database, in comparison with the next-largest administrator, Citco, which services about 6.25% of funds in the database. Maples & Calder, Walkers, and Elvinger, Hoss & Prussen are the three largest legal-counsel-service providers to hedge funds in the database, with a combined 26% market share. This data is as of September 2014.

Type	Rank	Service Provider	% of Database
Prime Broker	1	Morgan Stanley	14.32
	2	Goldman Sachs	13.05
	3	Credit Suisse AG	9.88
	4	UBS	9.29
	5	J.P. Morgan	7.88
	6	Deustche Bank	6.78
	7	Newedge Group Inc.	4.72
	8	Bank of America	2.65
	9	BNP Paribas	2.13
	10	Citigroup	2.03
Legal Counsel	1	Maples & Calder	11.26
	2	Walkers	8.31
	3	Elvinger, Hoss & Prussen	7.06
	4	Seward & Kissel LLP	5.33
	5	Dechert LLC	4.77
	6	Sidley Austin LLP	3.70
	7	Simmons & Simmons	3.45
	8	Schulte Roth & Zabel LLP	3.39
	9	Ogier	2.92
	10	Conyers Dill & Pearman	2.29
Auditor	1	PriceWaterhouseCoopers	23.49
	2	KPMG	21.42
	3	Ernst & Young	17.23
	4	Deloitte	15.63
	5	Rothstein Kass	4.66
	6	BDO	2.67
	7	McGladrey LLP	2.11
	8	Grant Thornton	1.87
	9	Eisner Amper	1.21
	10	Arthur Bell	0.84
Administrator	1	Credit Suisse	6.27
	2	Citco	6.25
	3	State Street	4.16
	4	BNY	4.00
	5	Citi	3.19
	6	Fund Partner Solutions	2.71
	7	UBS	2.63
	8	Northern Trust	2.03
	9	HSBC	1.98
	10	CACEIS Fastnet	1.67

Alternative Investments Observer

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