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Investors Enthusiastic About Alternatives but No Longer Giddy

A closer look at Morningstar's 2011 alternatives survey.



by
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Advisors and institutional investors remain interested in alternative investments, but their fervor has cooled from the level of previous years, revealed *Morningstar and Barron's 2011 Alternative Investment Survey of U.S. Institutions and Financial Advisors*.

The survey, sixth in an annual series, examines investor attitudes toward a wide variety of alternative investments. It also measures cash flows into U.S. mutual funds and exchange-traded funds that follow alternative strategies. The figures show that after peaking at approximately \$45 billion in 2009 (for ETFs) and 2010 (for mutual funds), net inflows into alternative mutual funds and ETFs slid to \$23 billion and \$12 billion, respectively, in 2011. For ETFs, this figure matched what the industry managed in 2006 before entering into its boomlet. For mutual funds, the 2011 flows were still higher than in any preboom year. (See Exhibits 1 and 2.)

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Exhibit 1: Alternative Mutual Fund Flows

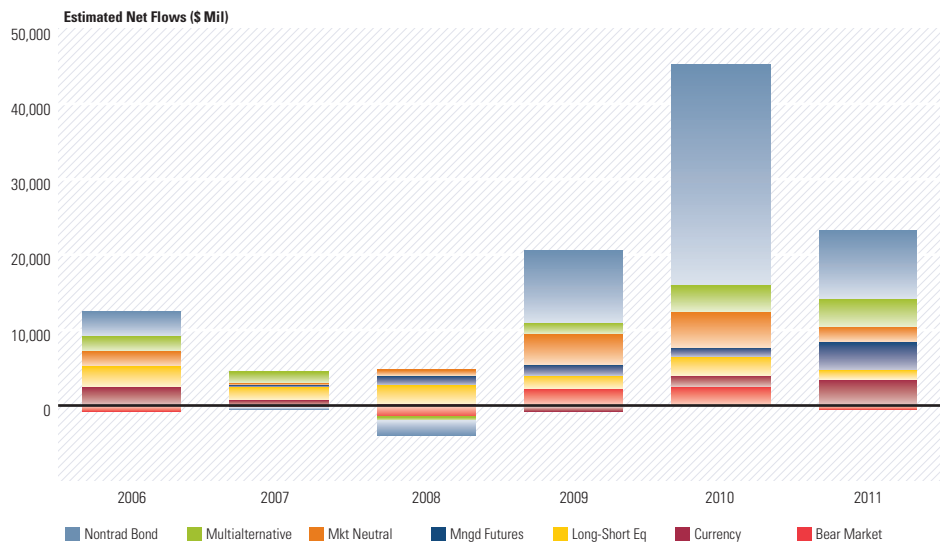
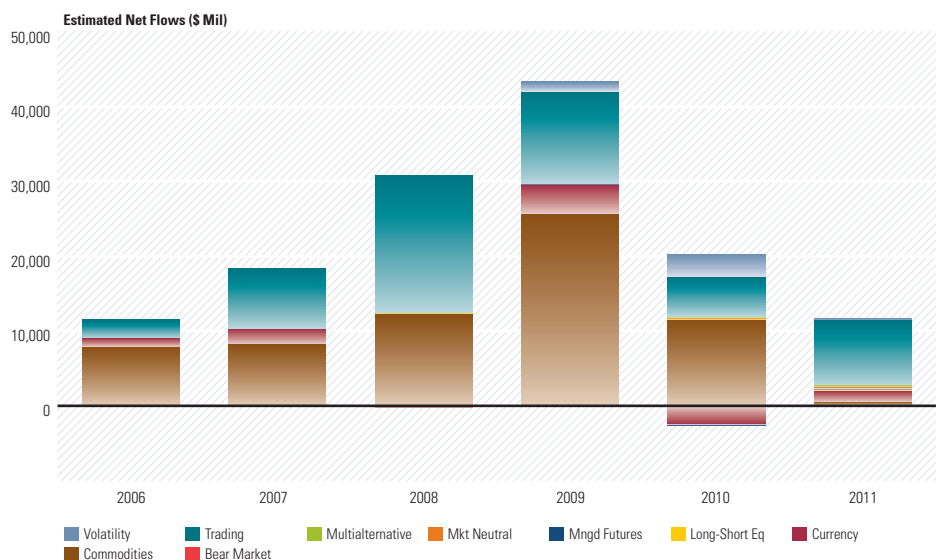


Exhibit 2: Alternative ETF Flows



Following the Money

While disappointing when compared to the torrid rate of the previous two years, the inflows remain impressive by other measures. Total assets in mutual fund and ETF alternatives total approximately \$260 billion, so the 2011 inflows represent a healthy 13% of the area’s accumulated assets. (See Exhibits 3 and 4.) And at least the figure is positive. In contrast, U.S. equity mutual funds suffered \$80 billion in net outflows on the year.

Mutual funds and ETFs compete directly in some market segments, but not with alternative investments. Last year, the vast majority of mutual-fund flows among alternatives went into nontraditional-bond, currency, and managed-future funds. However, among ETFs, only currency funds attracted assets, as nontraditional-bond and managed-future funds are typically actively managed and thus not structured as ETFs. The biggest seller among alternative ETFs

was what Morningstar calls “trading” funds—leveraged and inverse versions of market indexes. (See Exhibit 4.)

A similar pattern holds true for overall alternative fund assets. ETFs have the slightly larger market share, at just over \$140 billion. Of these monies, more than \$100 billion are in commodity funds (SPDR Gold Shares **GLD** held 65% of those assets), which investors backed away from last year but which were hugely popular in the preceding five years. (Even after being shunned in 2011, commodity funds make up almost 40% of all assets devoted to alternative mutual funds and ETFs.) Nearly everything else is in trading funds.

The allocation is very different with the \$120 billion devoted to alternative mutual funds. Nontraditional bond funds make up almost half of the assets, followed by long/short equity and market-neutral funds. A small but growing category of open-end alternatives consists of what Morningstar terms “multialternative” funds—that is, funds that attempt to offer a one-stop solution for alternative investing. These are often, but not always, organized as funds of funds.

Exhibit 3: Alternative Mutual Fund Assets

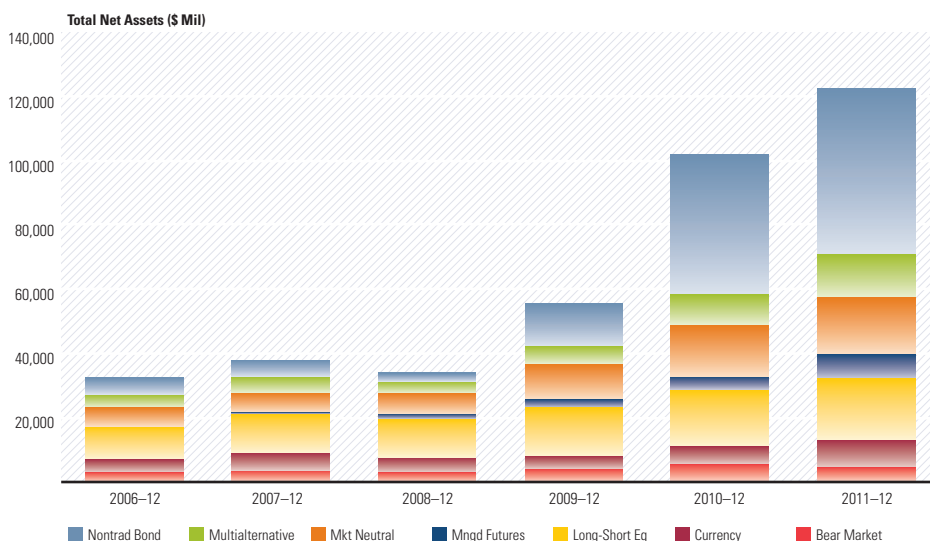
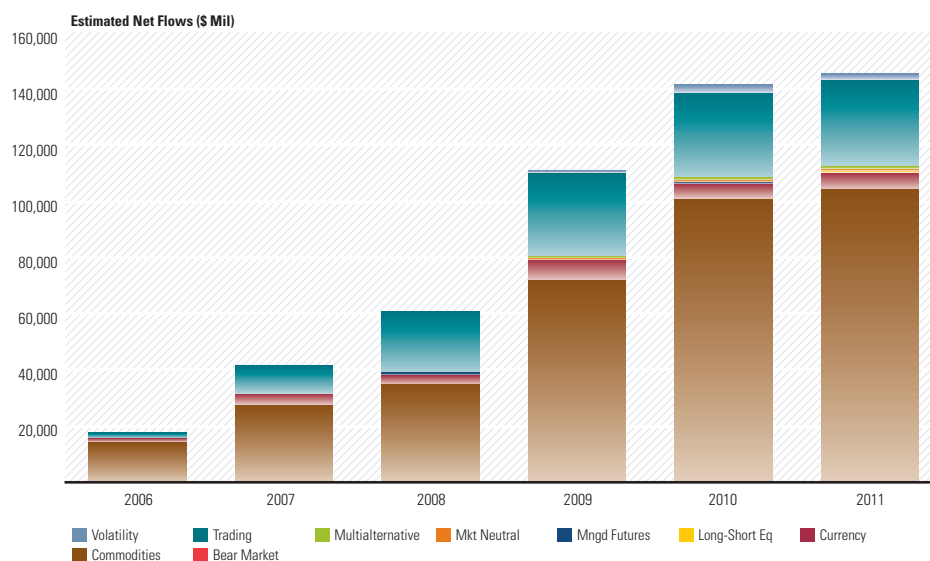


Exhibit 4: Alternative ETF Assets



To Be, or Not to Be, Alternative

Of course, this discussion of flows into alternative funds presupposes the definition of alternative—a moving target that is a constant source of debate. Although advisors and institutions as a whole answered the survey in much the same way, opinions differed sharply. Even though the 629 respondents were mostly likely to deem private equity, long/short equity, long/short debt, market-neutral, and managed-futures as being alternatives, those areas were not unanimously agreed upon, as indicated by 10%–15% of answers being either “not sure” or “no.”

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As evidenced by the above list, today's investors tend to define alternative investments as possessing one (or both) of two characteristics: illiquidity and long/short strategies. Examples of illiquidity include private equity, private real estate, distressed securities, private debt, collectibles, and infrastructure. Pretty much anything that was traded long/short met their approval, including equity, debt, futures, options, commodities, and currencies. Long-only commodity strategies, though, were still deemed alternative by a large group of institutional and advisor participants.

Other publicly traded, long-only strategies were consistently characterized as mainstream by the survey participants. The respondents felt that all varieties of foreign securities, including frontier markets, failed to qualify as alternative. TIPS, public real estate, commodity equities, and "go-anywhere" tactical-allocation funds were also nixed. The most controversial items were funds following 130/30 strategies and those employing leverage in a single direction. By a slim margin, those institutions surveyed felt that 130/30 funds were more alternative than leveraged funds, while advisors thought the opposite.

The Ebbing Flows

The decreased flow into alternative funds is consistent with the words of both advisors and institutions. When asked about their allocation to alternatives over the next five years, both parties backed away from their beliefs of the previous years. Among advisors, significantly more stated that they expected to see 1%–10% average annual growth in alternatives in their clients' portfolios, and fewer expected to see high growth rates of 21% or more. Indeed, the number of advisors forecasting the higher growth rates hit a four-year low, down from a peak of 23% in 2008 to 16% in the 2011 survey.

Institutions were asked a slightly different question about their plans for alternatives. Rather than the expected growth in alternatives, they were asked to forecast what their overall allocation would be five years out. Their answer was consistent with that of the advisors; that is, the institutions moved down from their more aggressive answers of the past toward more moderate ground. Whereas 36% of institutions in 2010 expected to invest more than one fourth of assets in alternatives, the figure dropped to 25% in the most recent survey.

While their definitions of alternatives and future investment plans are similar, advisors and institutions differ in their clients' current positioning. Institutions have a distinctly barbelled approach to alternatives. Half of all institutions have either a very large allocation in alternatives of more than 40%, or a negligible allocation of less than 5%. Clearly, there is a wide divergence of thought about alternatives in the institutional community. In contrast, the advisors answering the survey were of a like mind on the use of alternatives, with three fourths of them having moderate allocations ranging from 6% to 25%.

The Case for Alternatives

Both parties strongly concur that diversification is the most important attribute of alternatives. Almost 80% of respondents stated that diversification/low correlation is a critical reason to invest in alternatives. The next two most important rationales were to enhance the portfolio's risk-adjusted profile and to pursue absolute returns, with only 50%–60% of respondents agreeing, these items were clearly of lower priority than was diversification. The additional motivations of offering clients investments that they wouldn't find on their own, a poor outlook for the stock market (the so-called New Normal), and to enhance yield received paltry support.

In this instance at least, investors' actions matched their words. Whereas most early flows into alternatives funds went into categories that had moderately high correlations with the conventional stock market—that is, into long/short equity funds, 130/30 investment strategies, and commodities that tended to rise in price as the global economic news improved—the 2011 flows found distinctly noncorrelated assets. Managed-futures and currency funds have highly idiosyncratic returns. And nontraditional bond funds, another 2011 winner in asset flows, typically carry the promise that they will outperform if other bond funds are hurt by rising interest rates.

Unusually, the flows came while the assets were performing poorly. All three categories of managed-futures, currency, and nontraditional bond funds saw losses last year, on average. For managed futures, 2011 was the second down year in three tries. Currency has fared even worse, finishing in the red in every calendar year since 2007. Typically, fund asset flows are positively correlated with intermediate-term performance, such that fund categories with good five-year numbers receive inflows, and those that have performed badly suffer redemptions. For the customary pattern to be strongly reversed suggests that investors are indeed buying alternatives for diversification rather than returns.

If they are selling them, the reasons primarily are cost and liquidity. Advisors and institutions agree that high fees and a lack of liquidity are the main drawbacks for alternative investments. That said, concern about liquidity has declined sharply since 2008, in part as memories of the 2008 lockups fade and in part because of the launch of so many easily traded mutual funds and ETFs. Nevertheless, liquidity remains one of two major drawbacks of alternatives in the eyes of the respondents.

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Transparency also has slipped in importance, again due to the launch of so many publicly available funds. Institutions are more worried about transparency than are advisors, likely because institutions use more private funds, while advisors mostly use public mutual funds and ETFs.

The survey's institutions have only modest ability to negotiate price and liquidity terms with their alternative investments. After the 2008 market crash, the poor showing of hedge funds and the anger from investors who had been locked into declining assets led some to speculate that institutional investors would demand better terms from hedge funds in the future. That has not happened. By and large, the "2 and 20" pricing scheme remains intact, whereby hedge funds collect an annual management fee of 2% of assets and 20% of fund profits (usually over a hurdle rate). Institutions report that they can sometimes push the alternatives provider to get better liquidity terms, but only 22% of institutions were able to achieve even a single price concession. Advisors get neither.

No Longer Succumbing to Gimmicks

Only one third of the surveyed institutions report doing some form of tail-risk hedging, that is, explicitly structuring their portfolios to be protected against extreme market events. These strategies popped up post-2008, playing on investor's fears of a double-dip. Purchasing out-of-the-money puts was a popular option among those who proactively hedged tail risk; some also mentioned using volatility strategies. Most respondents, though, have not implemented tail-risk hedging due to cost concerns. The consensus believes that cash plus diversification should ease the effects of an extreme market event, and that any extra benefit from a tail-risk hedging

strategy would be fully consumed by the cost of implementation. Many also cited their clients' long time horizons as reasons not to spend on such a policy.

In summary, the sixth annual Morningstar Barron's Alternative Investment Survey of U.S. Institutions and Financial Advisors reveals that use of alternatives by institutions and advisors has moved into the second stage. The first stage was marked by rapid, enthusiastic adoption and the hope that portfolios that added alternatives would outgain portfolios that did not. (An example would be the 2007 adoption of 130/30 funds, which were sold to advisors explicitly on the promise of higher gains, not lower risk.) In contrast, the second stage swaps performance for diversification. Today's investors look to alternatives first and foremost to smooth portfolios, not to increase their returns. ■■■

Quant Corner: How Normal Is Your Fund?

Examining the non-normal characteristics of mutual fund and hedge fund returns.



by
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Introduction

Over the years, different practitioners and academics' studies have shown that the distribution of returns of most of the asset classes cannot be accurately described by the normal distribution and its parameters mean and variance. Much of the more recent research has therefore focused on developing more-robust portfolio optimization processes, which take into consideration other measures of risk. Xiong and Idzorek (2011), for example, found that mean-conditional value at risk optimization more adequately accounts for the "tail-risk" associated with traditional asset classes such as global high-yield bonds, commodities, and U.S. REITs than does mean-variance optimization.

Not as much research has been done on the distribution of returns of managers, however. While most institutional investors create a strategic asset allocation based on some form

of mean-variance optimization, which they generally review infrequently (every three to five years, for example), most institutions prefer to revisit their manager structure far more frequently (such as quarterly or annually). Even if institutions chose to incorporate the non-normality of the distribution of returns of many asset classes in their strategic asset allocation, they rarely do so in their manager selection.

The preferred scientific framework for combining investment managers into a portfolio to implement a target policy benchmark is best represented by the "manager structure optimization" procedure in Castille et al. (2000) and to a slightly lesser extent by Baierl and Chen (2000). Other names for a manager structure optimization include fund-of-funds optimization, alpha/tracking error optimization, and active return/active risk optimization. These powerful approaches still work best when the underlying managers' returns fit distributions that can be completely described by the first two moments (the mean and the variance). When the returns are skewed or fat-tailed, however, these optimized solutions can be suboptimal.

In this article we will examine the distributions of returns of open-end (mutual) funds and hedge funds to verify whether they can be described by the normal distribution. Our hypothesis was that many could not for a

variety of reasons, although none of them would necessarily be sufficient a priori. First, institutions seek active managers who add alpha. Managers who attempt to produce alpha must necessarily have a portfolio that is different and often more concentrated than the index representing their asset class. This divergent portfolio will likely produce a different return profile than that of the index. Second, many traditional funds have started to implement more advanced investment strategies that use derivatives, instruments with optionlike, non-normal returns. Third, as alternative investments are becoming a larger and larger part of the portfolios of institutional investors, many studies (Malkiel and Saha 2005, for example) have highlighted the non-normal characteristics of these products.

Data Description

We used monthly returns from January 1972 to February 2012 for the more than 39,000 open-end funds domiciled in the U.S. with at least 20 months of returns in Morningstar's database. The data set is survivorship bias-free (we included dead funds). An upward survivorship bias occurs when funds with poor performance are closed by management and subsequently fall out of any aggregate statistics.

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Similarly, we use a survivorship bias-free data set of more than 17,000 hedge funds with at least 20 months of returns in Morningstar's database, including all live and dead funds, from January 1972 to February 2012. Survivorship bias for hedge funds is even more pronounced because hedge funds tend to have a shorter lifespan than mutual funds (on average), and when their recent performance has been poor, many simply stop reporting returns (and are considered "dead").

There is a natural trade-off between the number of observations necessary to calculate certain statistics and survivorship bias. Limiting the data set to only those funds with a large number of observations (more than 30 for example) would exclude most of the funds with the extreme return characteristics we are trying to identify.

Skewness and Kurtosis

For each of the mutual funds and hedge funds in our sample, we calculated the third and fourth moments of the returns distribution, or the skewness and kurtosis. Skewness describes asymmetry and can be negative or positive depending on whether data points are skewed to the left (negative skew) or to the

right (positive skew) of the data average. A distribution with negative skewness indicates that the frequency of returns below the mean is higher than what is suggested by the normal distribution. The normal or Gaussian distribution, of course, has a skewness of zero.

Excess kurtosis describes the degree of peakedness or flatness in a return distribution relative to the normal distribution with the same variance. A normal distribution has a kurtosis of 3. Therefore a kurtosis larger than 3 indicates that the probability of extreme returns (positive or negative) is higher than what is suggested by the normal distribution. The tables below report excess-kurtosis, i.e., the level of kurtosis in excess to the level expected on the basis of the normal distribution. The combination of negative skewness and high kurtosis is the least desirable scenario for the investor because it suggests the presence of frequent negative extreme observations.

CVaR

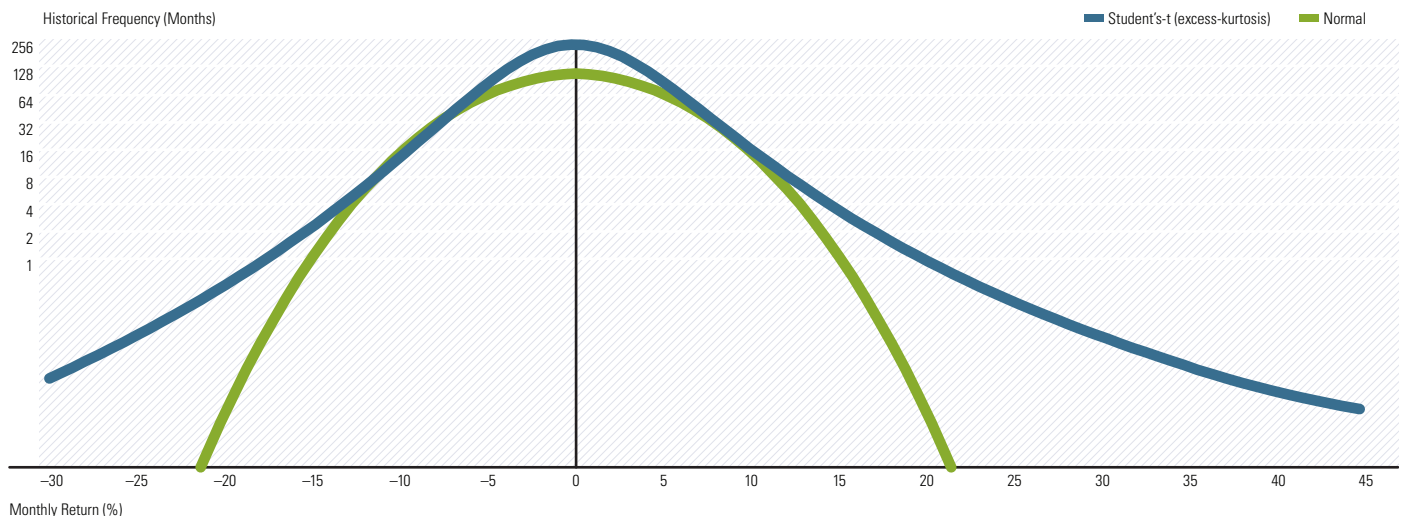
We also calculated the 5% confidence level CVaR for each fund in our sample. CVaR is related to the better-known measure, value at risk, or VaR, which estimates the loss

that is expected to be exceeded with a given level of probability over a specified period. Whereas VaR is a statement about only one particular point on the distribution, CVaR takes a probability-weighted average of all of the possible losses, conditional on the losses being equal to or exceeding the specified VaR. Other terms for CVaR include mean shortfall, tail VaR, and expected tail loss. Because CVaR is a comprehensive measure of the entire part of the tail risk of a distribution, it is the preferred measurement of downside risk for many.

Studies have shown that CVaR has more attractive properties than VaR (see, for example, Rockafellar and Uryasev 2001; Pflug 2000). Therefore, asset-allocation optimization frameworks that use a risk input, such as CVaR, that accounts for non-normal return properties are preferable. Our preferred definition of risk is CVaR and our preferred approach for setting asset-allocation policy is mean-CVaR optimization as developed in Xiong and Idzorek (2011). However, because it is very difficult to interpret CVaR in isolation, we must also calculate the excess-CVaR—a fund's CVaR in excess of the implied CVaR with a normal distribution.

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Normal Versus Fat-tailed (excess-kurtosis) Distribution



Results

Mutual Funds

Table 1 shows the risk parameters for our entire sample of open-end funds, sorted by return percentile. The median fund, at the 50th percentile, shows a higher negative skewness than what is suggested by the normal distribution, meaning the number of returns below the average is higher. Similarly the excess kurtosis, or the number of extreme returns, is higher than what is predicted by the normal distribution. Neither of these results is surprising because academic literature has shown a similar tendency for most asset classes, and the average fund is likely to closely track its asset class.

More active funds, those having portfolio holdings that diverge from the median fund in an attempt to outperform, show even more non-normal characteristics. For example, the fifth-percentile fund shows a very high level of kurtosis, more than 3 times that of a normal distribution. Even funds with less extreme returns, the 25th percentile fund for example, exhibit non-normal characteristics. The excess-CVaR results, which in some ways summarize the four moments, support the previous findings. Up until the 75th percentile fund, the excess CVaR (the historical CVaR less the CVaR assuming a normal distribution) is large and negative.

These statistics have important implications for investors who use a mean-variance optimization approach to create a portfolio of active managers. Investors are not accounting for and most likely underestimating the probability of extreme negative events in their portfolios.

Hedge Funds

Similar to our mutual fund results, the median hedge fund's return distribution is skewed to the left, indicating a higher frequency of returns below the average than what is suggested by the normal distribution.

Table 1: Return and Risk Statistics of Open-End Mutual Funds (January 1972 to February 2012)

Percentile	Mean	Standard Deviation	Skewness	Excess Kurtosis	Excess 5% CVaR
1st	-1.87	0.42	-2.53	15.68	-5.75
5th	-0.46	0.91	-1.45	6.66	-3.66
25th	0.28	2.27	-0.8	2.44	-2.08
50th	0.46	4.62	-0.56	1.35	-1.27
75th	0.7	5.83	-0.27	0.55	-0.39
95th	1.22	8.29	0.25	-0.44	0.79
99th	1.82	11.67	0.86	-0.87	2.79

Table 2: Return and Risk Statistics of Hedge Funds (January 1972 to February 2012)

Percentile	Mean	Standard Deviation	Skewness	Excess Kurtosis	Excess 5% CVaR
1st	-1.44	0.36	-4.99	3.30	-8.81
5th	-0.50	0.81	-2.58	1.84	-4.44
25th	0.20	1.65	-0.94	0.90	-1.51
50th	0.53	2.68	-0.28	0.53	-0.46
75th	0.90	4.51	0.28	0.20	0.20
95th	1.84	9.00	1.47	-0.50	1.96
99th	3.30	14.21	3.26	-0.86	5.27

Table 3: Return and Risk Statistics of Selected Mutual Fund Categories 5th Percentile (January 1972 to February 2012)

Open-End Category	Mean	Standard Deviation	Skewness	Excess Kurtosis	Excess 5% CVaR
Large Blend	-0.53	2.98	-1.17	-0.59	-3.27
Foreign Large Blend	-0.59	4.15	-0.96	-0.55	-3.42
Intermediate Government	0.27	0.74	-0.91	-0.12	-0.58
Latin America Stock	0.21	7.23	-1.26	0.4	-9.32
Emerging Markets Bond	0.18	2.21	-3.76	0.85	-6.08
Natural Resources	-0.44	4.96	-1.16	0.2	-6.08
Bank Loan	-0.04	1.1	-3.86	3.91	-5.03
High Yield Muni	0.15	1.35	-1.89	1.32	-2.72
Diversified Emerging Mkts	-0.33	5.49	-1.09	-0.24	-5.76

(See Table 2.) Likewise, the 50th percentile hedge fund's kurtosis is higher than a normal distribution's. Intuitively, those hedge funds with more extreme return characteristics display negative skewness and excess kurtosis. (For the fifth-percentile fund, these figures are negative 2.5 and 1.8, respectively.) The CVaR calculated using a normal distribution underestimates the historical realized CVaR by 4.4 percentage points.

Open-End Funds Versus Hedge Funds

Overall, the results are consistent between open-end funds and hedge funds. Managers' returns in both vehicles show a clear deviation from normality. Surprisingly, though, the data suggest that hedge fund returns are less extreme than those of mutual funds (as implied by their lower excess-kurtosis levels). This could be due to the fact that many hedge fund strategies are absolute or quasi-absolute returns, while most of the open-end funds are

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total return and benchmark-oriented strategies. However, more research is necessary to arrive at such a conclusion.

In our analysis we compared all the dead and alive open-end and hedge funds available in Morningstar's database since 1972. Because we saw an exponential increase in the number of hedge funds over the past decade, it is possible that our sample is time-dependent, making comparisons between open-end and hedge funds more difficult. An analysis of the different subperiods would be necessary to derive a more meaningful comparison between the two universes.

Using the monthly category average return for mutual fund categories over the January 1972–February 2012 time period, we calculated mean, standard deviation, skewness, kurtosis, and excess 5% CVaR (selected results for the fifth percentile are reported in Table 3). The results varied across the board, but one clear trend did emerge. Funds in more inefficient asset classes exhibited returns with higher deviations from normality. For example, the domestic large blend category's excess 5% CVaR was negative 3.27 percentage points, which is less extreme than the same statistic for the emerging-markets stock category (negative 5.76%). Similarly, while government bonds' third and fourth moments are relatively similar to those expected on the basis of the normal distribution (a small negative excess 5% CVaR), emerging-markets bonds as well as bank loans are very different (these categories exhibited large negative excess 5% CVaR).

The implication of these results is that investors using active managers in less efficient asset classes could experience returns that significantly deviate from normality. Many investors use a mix of active and passive managers. Often investors use passive managers for those asset classes that are

believed to have fewer alpha opportunities (like domestic government bond or domestic and foreign developed large-capitalization stocks) while they use active managers for asset classes believed to be more inefficient (like emerging-markets bond and stock as well as high-yield municipals). Therefore, investors who selectively use active managers may seriously underestimate the risk of their portfolios.

Conclusions

We investigated the third and fourth moments of the distribution of returns of a large survivorship bias-free data set of open-end funds and hedge funds and discovered that managers' returns can be far from normal, especially among the more active open-end funds as well as nontraditional strategies in hedge funds. Our analysis implies that investors using mean-variance optimization to select managers, or more generally, investors who don't take into account the non-normal qualities of investment products, may underestimate the probability of negative extreme events and may allocate too much to these managers. To resolve this situation, we recommend using a manager structure optimization technique that incorporates non-normal return qualities. ■■■

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Morningstar Product Spotlight: Investor Return

Gauging the real investor experience in alternative funds.



by
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Alternative Investments Analyst

The return an investor gets from a mutual fund does not only depend on the fund's published total return, but also on the timing of the investor's buy and sell decisions. To better gauge the real experience of average investors, Morningstar introduced the Investor Return data point in 2006, and it is now found in all major Morningstar products—Morningstar.com[®], Morningstar OfficeSM, and Morningstar DirectSM. The data point usually resides near the standard (total) return data points in most products. Investor Returns can be calculated for funds with complete monthly total net asset (TNA) data over trailing one-, three-, five-, and 10-year periods and for each calendar year time period.

Our studies on Investor Returns, conducted in 2007 and 2010, have shown that Investor Returns generally fall short of total returns in most traditional mutual funds, some more than others. Typically, investors' experience in gimmicky or niche strategies, such as

technology and natural resources, tend to lag the Investor Returns in more core holdings. With the rapid growth of alternative mutual funds in recent years, we are now examining investor behavior and returns in these nontraditional investments to see if they are any better or worse than in traditional investments.

What Is Investor Return?

Morningstar's Investor Return datapoint is designed to examine a fund's past performance from a different angle than its published total return. The traditional total return calculation measures the change in a fund's net asset value, or NAV, over a given time frame. This methodology assumes that investors hold the fund throughout the entire period without any additions or redemptions. In reality, however, this is hardly the case, as mutual funds allow daily subscriptions or redemptions.

Morningstar's Investor Return datapoint attempts to tackle this issue by taking into account a fund's total net assets at each month end. Returns achieved during months with larger asset bases will be overweighted relative to those months with large redemptions. For example, suppose a fund with beginning net assets of \$50 million returned 10%, 1%, and negative 5% in three consecutive months, respectively. Also, suppose the fund received \$10 million, \$100 million, and \$20 million of inflows over

those three months, respectively. The fund's Investor Return will be the constant monthly rate of return (or internal rate of return) that makes the beginning assets equal to the ending assets with all monthly flows accounted for. The result will be a 2.9% loss over the three-month period, a far cry from the 5.6% total return.

A fund's Investor Return can also be higher than its total return (although this is very rare), which is a sign that investors managed to buy low and sell high during the measured period.

Morningstar often cites Investor Return figures as evidence that investors tend to time their purchases and sales of traditional stock and bond funds badly. Do investors handle alternative mutual funds better? Our research shows that alternative mutual funds have achieved poorer Investor Returns compared to long-only stock and bond funds. In other words, a typical alternative mutual fund investor has a worse investment experience than a traditional stock- or bond-fund investor.

Our Findings for Alternative Funds

In our study, we examined funds in six of the seven alternative mutual fund categories. We excluded funds with incomplete net asset data, funds with less than one-year track records, and bear-market funds. The small asset bases and the leveraged nature of bear-market funds make investor returns highly sensitive

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to asset flows. The gaps between their total returns and Investor Returns are abnormally large (the gap can easily go up to 20% or 30%), and are off-the-chart outliers when compared with other alternative categories.

We then calculated Investor Returns on funds in the six categories over one-, three-, five-, and 10-year periods (as of June 30, 2012), based on monthly returns and TNA data for the oldest share classes of each fund in each category (so as to obtain a larger sample of funds with five- and 10-year returns). We equally weighted the returns of each fund in a category to reach category averages. The total numbers of alternative mutual funds we studied are shown below.

Table 1: Total Number of Alternative Funds by Period

	1-Yr	3-Yr	5-Yr	10-Yr
Sample Size	213	110	57	17

A positive return gap in a fund indicates that Investor Return is worse than total return, while a negative gap suggests that investors actually made more than the fund's total return over a particular period of time.

Worse Investor Returns

We selected the large blend and intermediate-term bond to represent traditional stock and bond categories, respectively. We found that alternative fund investors behaved roughly the same as traditional stock and bond fund investors over the one-year period ended June 30, 2012. Over a longer time frame, however, alternative investors fell behind significantly. For example, over the past 10 years, the gap between total return and Investor Return for alternative funds increased to 2.13 percentage points (annualized), while the gaps for the large blend and intermediate-term bond categories were 0.48 and 1.45 percentage points, respectively. (See Exhibit 1).

Exhibit 1: Investor Returns for Alternative Mutual Funds Compared to Traditional Mutual Funds

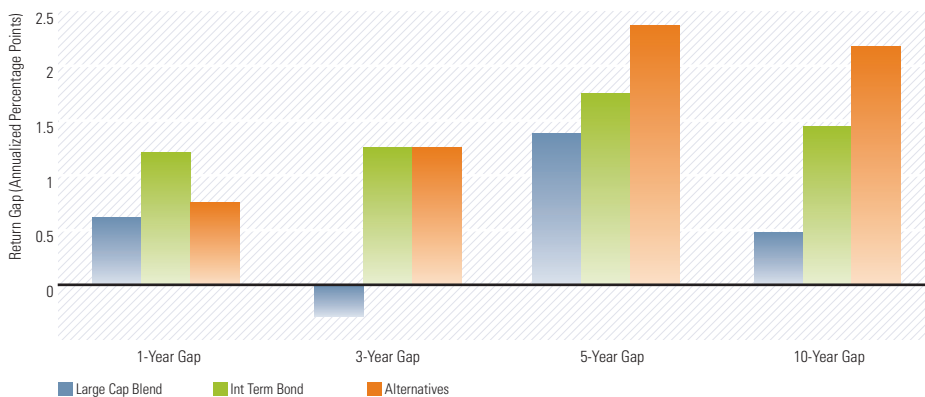


Exhibit 2: Investor Returns for Alternative Categories



Within the alternative categories, long/short equity and nontraditional bond funds exhibited the worst Investor Returns in most of the time frames measured. Market-neutral and multialternative funds had relatively narrow and consistent gaps. (See Exhibit 2).

Our results show that alternative mutual funds have worse Investor Returns compared with traditional stock and bond funds most likely because alternative funds have much shorter histories marked by a very volatile market environment. Massive inflows to alternative funds occurred after the 2008 financial crisis, when the performance of many of these strategies lagged. Investors poured almost \$90 billion into alternative mutual funds between 2009 and 2011, when total assets in these funds stood at only \$34 billion

at the end of 2008. On the contrary, flows into traditional stock and bond funds have been smoother and less reactive to category performance over the long run.

Link with Volatility

Our studies seem to indicate that one important determinant factor of Investor Returns is a fund's volatility. We ranked all alternative funds based on their monthly standard deviation in descending order and divided them into four quartiles. Funds in the first quartile have the highest standard deviation, while funds in the fourth quartile have the lowest. As Exhibit 3 demonstrates, funds in the most volatile quartile almost always have the largest Investor Return gaps. The gaps are particularly

CONTINUED ON NEXT PAGE

1 For the three-year period, the least volatile quartile surprisingly got the highest investor return gap (1.77%). The primary reason is that the least volatile quartile has a good number of nontraditional bond funds. Some of these funds (launched in the second half of 2008) had extraordinary performance during the 2009 "junk rally" when they had small asset bases, but most investors flew into these funds after 2010 and thus missed the majority of the three-year returns.

Exhibit 3: Strong Links between Alternative Mutual Funds' Investor Return Gaps and Volatility

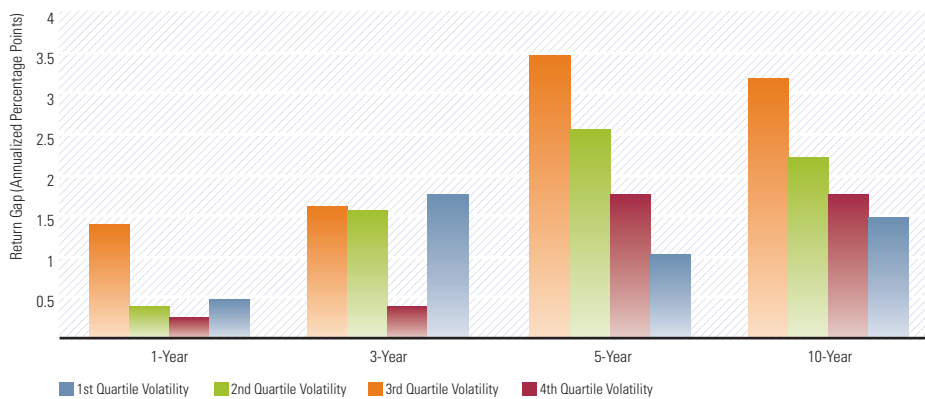
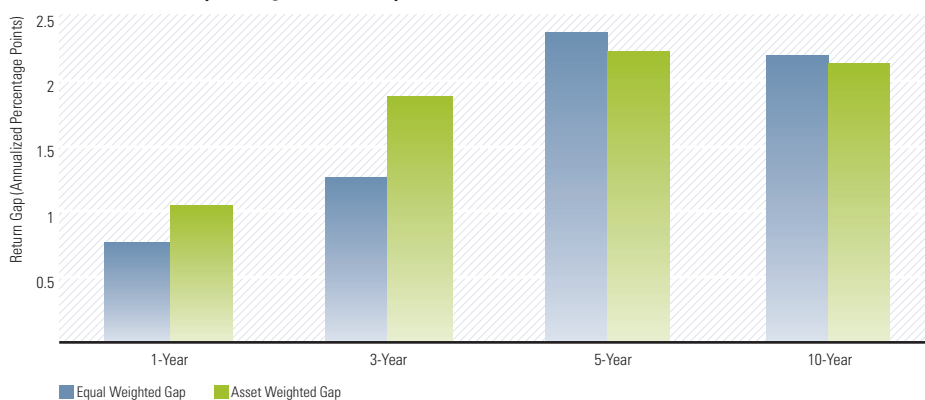


Exhibit 4: Asset- versus Equal-Weighted Return Gaps in Alternative Funds



prominent over the last five- and 10-year periods. For example, over a 10-year period, although the first quartile alternative funds achieved a total return of 3.82% (annualized), the average investor in these funds only made a dismal 0.64% (annualized), a 3.18 percentage point return gap.

There are a couple of reasons investor returns could be worse in more volatile funds. First, assuming an investor is rational and does not attempt to time his investment, he still must enter and exit the fund at some point in time. In a more volatile fund, these entry and exit points are more likely to coincide with peaks and troughs than in a less volatile fund, making investor return worse. Second, more volatile funds are more likely to attract irrational behavior and timing, as the potential for profits is larger.

Asset-Weighted Investor Returns

We also tested whether investors behave differently in large versus small alternative funds. Larger funds are likely to have drawn more assets due to better performance and are also more likely to survive over the long run. But is it easier for investors to deal with larger investments than smaller offerings?

To address this problem, we asset-weighted all alternative funds, which means that large funds, such as Gateway **GATEX** (with \$5.9 billion in assets as of June 30) and Merger **MERFX** (\$4.8 billion), will carry more weight in the calculation than small funds such as ICON Long/Short **IOLCX** (\$17 million). Exhibit 4 demonstrates that the gaps between total returns and investor returns are virtually the same for large and small funds over the five- and 10-year periods but different over one- and three-year periods.

The reason for asset-weighted gaps to be wider than equal-weighted gaps in the past one- and three-year periods is most likely because of the massive inflows into nontraditional bond funds (more than \$48 billion from 2009 to 2011). Unfortunately, these giant funds had worse investor returns than other alternative funds in the past three years. Over a long time frame, it becomes apparent that investors exhibit similar behavior regardless of fund sizes.

Mind the Gap

It is helpful for investors to keep an eye on investor returns, which demonstrate how other investors have been handling the fund historically. A large gap between investor returns and total returns should serve as a red flag—if so many investors failed to buy and sell the fund at right times, chances are you could make a similar mistake. **MI**

2 We averaged the beginning fund size and ending fund size over the examined time period and assigned weights based on the averaged fund sizes.

Industry Trends: Alternative Mutual Funds

More multistrategy mutual fund solutions.



by
Mallory Horejs
Alternative Investments Analyst

Alternative Mutual Funds

Fourteen new alternative mutual funds came to market during the second quarter of 2012, bringing the universe up to 322 offerings. Although the new products launched were fewer in number than in previous quarters, the total number of liquid alternative mutual funds has more than doubled over the past three years. The second quarter's 14 new products (three long/short equity funds, two managed-futures funds, two market-neutral funds, and seven multialternative funds) aren't vastly different from what exists already, but their strategies boast some unique qualities.

For example, Catalyst Insider Long/Short **CIAAX** invests solely in a portfolio of companies experiencing substantial insider buying and sells short stocks with large clusters of insider trading. And Palmer Square SSI Alternative Income **PSCAX**, a new addition to the market-neutral category, is the first mutual fund dedicated solely to convertible arbitrage.

Finally, Longboard Managed Futures Strategy **WAVIX** represents the latest in a new breed of managed-futures funds, which invest directly in a single commodity trading advisor, or CTA.

All of these new alternative products and their nuances have advisors confused. It's no surprise, then, that the greatest product proliferation in the second quarter happened in the multialternative category, a category of one-stop-shop alternative solutions. In total, seven new funds came to the market: WOA All Asset **WOAIX**, Stadion Trilogy **STTGX**, Orinda SkyView Macro Opportunities **OMOAX**, Neuberger Berman Absolute Return Multi-Manager **NABAX**, Collins Alternative Solutions **CLLIX**, Bridgehampton Value Strategies **BVSFX**, and Active Portfolio Multi-Manager Alternative Strategies **CPASX**. This brings the category's constituent count up to 83, making multialternative the largest alternative category tracked by Morningstar. The majority of these new products employed multimanager structures, which result in hefty fees—more than half have prospectus net expense ratios of more than 2.00%.

So far this year, no new currency or bear market funds have joined the alternative mutual fund ranks. With 21 and 28 funds, respectively, these two categories remain the smallest alternative mutual fund buckets. While three new nontraditional bond funds appeared in the first quarter of the year, the constituent

list did not expand in the second quarter. Furthermore, dismal flow data show that investors have steadily shied away from these funds, which short credit or duration risk, over the past year. More recently, the category leaked \$685 million in the second quarter and \$2.8 billion for the year to date.

While overall flows into alternative mutual funds remain healthy (the seven alternative categories have received net inflows of \$2.8 billion year-to-date through June), there's no denying the sharp decline in flows relative to last year. Alternative mutual funds netted a staggering \$24 billion in new assets in the first half of 2011. This slowdown isn't startling given the recent headwinds alternatives have faced. Many alternative strategies' performance struggled in 2011, as managed-futures funds were stung by strong momentum reversals, and equity-based strategies, such as long/short equity and market-neutral, were hindered by record high correlations among stocks. Inflows of last year's magnitude are unlikely moving forward, but considering the steady string of fund launches and overall positive inflows, it's safe to say that the alternatives story continues to resonate well with both investors and advisors. ■■■

Fund Reports

Grant Park Managed Futures Strategy

by **Nadia Papagiannis, CFA**

Advisor

Knollwood Investment Advisors, LLC

Advisor Location

Chicago, Illinois

Assets Under Management

\$106.2 million

Inception Date

March 4, 2011

Investment Type

Mutual fund

Morningstar Category

Managed futures

Management

David Kavanagh, chairman of Knollwood Investment Advisors, is the fund's portfolio manager. Kavanagh has more than 30 years of experience in the managed-futures and fixed-income markets. Since 1989, he and his investment team have operated the Grant Park Futures Fund, a publicly available managed-futures fund, registered under the Securities Act of 1933.

The mutual fund follows the same investment process and manager due diligence as does the limited partnership but is managed to a lower volatility level.

Strategy

This fund invests in commodity trading advisors, or CTAs, which seek to profit from price trends in the commodity, equity, interest-rate, and currency markets. While the firm's long-established hedge fund relies primarily on systematic (automated) price trend following, the mutual fund is constructed to offer wider diversification across investment strategies (including discretionary and nontrend), and price-trend time frames. The mutual fund targets an annualized volatility of 7%–10%.

This offering has a lower volatility profile than does the firm's related limited partnership and therefore does not incorporate all the same underlying managers. As of June 30, 2012, the fund was invested in five CTAs, and that number is expected to grow over time. The fund's 3.55% net expense ratio includes all management and performance fees paid to the underlying managers.

Management does not disclose the names of the fund's underlying managers and trading programs. Rather it describes their strategies, which include arbitrage, countertrend, global macro, predictive modeling, and trend-following. As of June 30, the portfolio was allocated to both commodity (30%) and financial futures (70%) and long futures/forwards sector exposures were as follows: grains/foods (9%), currencies (19%), equities (32%), and fixed income (19%). Short sector positions were held in energy (–10%) and metals (–11%).

Process

The investment process begins with a quantitative screening of the CTA universe (roughly 3,000 programs, according to management). Screening parameters include performance during up equity markets, drawdown statistics, alpha net of fees and expenses, as well as correlation characteristics. When selecting managers, Kavanagh and his team look specifically for traders with long track records who have avoided or have quickly recovered from any significant drawdowns. Grant Park prefers to invest in larger commodity trading advisors that have access to more resources—three of the five subadvisors manage more than \$1 billion. Overall, the manager selection process requires roughly six to nine months of due diligence. After selecting the subadvisors, management uses a five-factor proprietary model to make the portfolio allocations. The model is run daily and considers diversification, momentum, reversal, historical performance, and qualitative factors.

Risk Management

Management reviews daily portfolio risk management reports that track margin/equity ratios and VaR breaches for potential strategy deviations. There are no sector or net exposure limitations on the overall portfolio, but management does have full daily transparency with each of its subadvisors. The fund's seven-person investment committee meets twice per month to discuss which CTAs may out- or underperform given the current market environment. Based on these discussions and the recommendations of the portfolio allocation model, Kavanagh tweaks the allocations every two weeks and intends to make one or two larger shifts in allocation on an annual basis. Because futures contracts are leveraged, 75% of the fund's assets are allocated to a fixed-income strategy. Kavanagh does not use leverage or take significant duration risk with the fund's collateral. Approximately 75% of the fixed-income portfolio is invested in U.S. government and agency obligations and the weighted average duration is approximately one year (as of June 30). ■■■

Grant Park Managed Futures Strategy A (USD)

Standard Index
S&P 500 TR

Category Index
Morningstar
Diversified Futures
TR USD

Morningstar Cat
US OE Managed
Futures

Performance 07-31-2012					
Quarterly Returns	1st Qtr	2nd Qtr	3rd Qtr	4th Qtr	Total %
2010	—	—	—	—	—
2011	—	-4.14	3.49	-1.29	—
2012	-2.72	0.83	—	—	-1.11
Trailing Returns					
	1 Yr	3 Yr	5 Yr	10 Yr	Incept
Load-adj Mthly	-6.32	—	—	—	-5.27
Std 06-30-2012	-5.56	—	—	—	-6.18
Total Return	-0.61	—	—	—	-1.21
+/- Std Index	-9.74	—	—	—	—
+/- Cat Index	8.60	—	—	—	—
% Rank Cat	15	—	—	—	—
No. in Cat	57	—	—	—	—
7-day Yield	—	—	—	—	—

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

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

Current performance may be lower or higher than return data quoted herein. For performance data current to the most recent month-end, please call 855-501-4758 or visit www.grantparkstrategy.com.

Fees and Expenses	
Sales Charges	
Front-End Load %	5.75
Deferred Load %	NA

Fund Expenses	
Management Fees %	1.40
12b1 Expense %	0.25
Gross Expense Ratio %	4.83

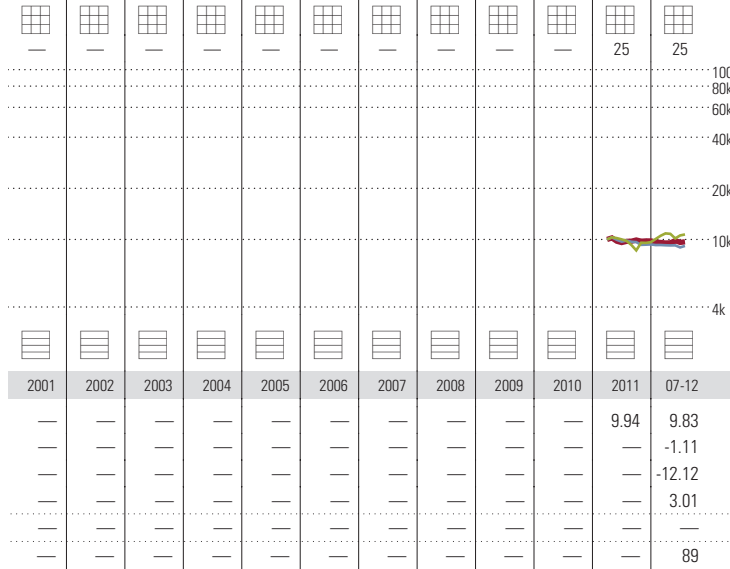
Risk and Return Profile			
	3 Yr	5 Yr	10 Yr
Morningstar Rating™	15 funds	4 funds	—
Morningstar Risk	—	—	—
Morningstar Return	—	—	—

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

MPT Statistics	Standard Index	Best Fit Index
Alpha	—	—
Beta	—	—
R-Squared	—	—

12-Month Yield	—
30-day SEC Yield	—
Potential Cap Gains Exp	-0.08%

Operations	
Family:	Grant Park
Manager:	David Kavanagh
Tenure:	1.4 Years
Objective:	Growth and Income



Investment Style	Equity	Stock %
25	25	100k
Growth of \$10,000		
Grant Park Managed Futures Strategy A	9,685	—
Category Average	9,159	—
Standard Index	10,702	—
Performance Quartile (within category)		
History		
NAV/Price	9.94	9.83
Total Return %	—	-1.11
+/- Standard Index	—	-12.12
+/- Category Index	—	3.01
% Rank Cat	—	—
No. of Funds in Cat	89	—

Portfolio Analysis 04-30-2012

Asset Allocation %	Net %	Long %	Short %
Cash	61.09	61.09	0.00
US Stocks	0.00	0.00	0.00
Non-US Stocks	24.66	24.66	0.00
Bonds	14.24	14.24	0.00
Other/Not Clsfd	0.00	0.00	0.00
Total	100.00	100.00	0.00

Share since 01-2012	Share Amount	Holdings:	% Net Assets
—	—	1 Total Stocks, 8 Total Fixed-Income, 16% Turnover Ratio	—
⊕	20 mil	Invesco Short Term Inv Treasury Pr	25.55
⊕	214,278	Grant Park Mfs Fund Ltd	24.66
⊗	8 mil	FHLBA 0.2%	10.39
—	3 mil	US Treasury Note 0.25%	3.85
⊖	0	US Treasury Bill	0.00

Equity Style	Portfolio Statistics	Port Avg	Rel Index	Rel Cat
Value Blend Growth	P/E Ratio TTM	—	—	—
Large Mid Small	P/C Ratio TTM	—	—	—
	P/B Ratio TTM	—	—	—
	Geo Avg Mkt Cap \$mil	—	—	—

Fixed-Income Style	Avg Eff Maturity	Avg Eff Duration	Avg Wtd Coupon	Avg Wtd Price
Ltd Mod Ext	—	—	—	—
High Mid Low	—	—	0.21	99.98

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

Regional Exposure	Stock %	Rel Std Index
Americas	—	—
Greater Europe	—	—
Greater Asia	—	—

Sector Weightings	Stocks %	Rel Std Index
Cyclical	—	—
Basic Materials	—	—
Consumer Cyclical	—	—
Financial Services	—	—
Real Estate	—	—
Sensitive	—	—
Communication Services	—	—
Energy	—	—
Industrials	—	—
Technology	—	—
Defensive	—	—
Consumer Defensive	—	—
Healthcare	—	—
Utilities	—	—

Fund Reports

QuantShares U.S. Market Neutral Momentum ETF

by **Josh Charney**

Advisor
FFCM LLC

Advisor Location
Boston, Massachusetts

Assets Under Management
\$5.3 million

Inception Date
Sept. 7, 2011

Investment Type
Exchange-traded fund

Morningstar Category
Market neutral

Management

This quantitative fund is overseen by Bill DeRoche, CFA, chairman and chief executive officer; Kishore Karunakaran, president and chief operating officer; and Chuck Martin, CFA, chief investment officer and chief financial officer. DeRoche joined FFCM from State Street Global Advisors, where he headed the U.S. enhanced equities team. Karunakaran previously worked at Platinum Grove Asset Management, LP, where he directed the quantitative equities stock selection group. Prior to that, he was a vice president in AQR Capital Management's global stock selection team. Martin served as a vice president at State Street Global Advisors and as a senior portfolio manager in the global enhanced equities group.

Strategy

This U.S. market neutral equity momentum fund provides investors with the return differential between stocks with positive momentum and those with negative momentum, attempting to capture the momentum factor risk premium. The ETF takes long positions in primarily large-capitalization equities that have exhibited a strong upward price trend and takes short positions in an equal number of large-capitalization stocks that have exhibited a downward price trend. The strategy is meant to offer investors a return stream that is neutral to broad equity market risk exposure. The benchmark index's correlation to the Dow Jones U.S. Index has been negative 0.45 (using 10 years of weekly data through June) as the index tends to move counter to the market. This strategy has also registered a negative 0.50 beta during the last 10 years.

Process

This fund tracks the Dow Jones U.S. Thematic Market Neutral Momentum Index. The index's calculation starts with the approximately 1,350 stocks in the Dow Jones U.S. Index. It then filters out stocks with less than \$10 million in average daily trading volume (leaving about 1,200 names) and selects the top 1,000 names by market capitalization. From this investable universe, the index calculates the best and worst trailing 12-month total returns and sorts them by quintiles in each of the 10 sectors. The fund takes long positions in the top 20% of stocks in each sector and short positions in the bottom 20%. The index's constituent changes are announced one day before month-end trading occurs, and the ETF is rebalanced the following day.

There are at least 10 authorized participants that can create and redeem shares. Short positions are redeemed and created through cash.

Risk Management

Even though the fund can rebalance throughout the last trading day of the month, it typically trades in the last 30 minutes of the day to minimize tracking error. Also to minimize tracking error, the fund may gain exposure to certain stocks (approximately 10% in assets) through swaps. Though swaps tend to be more expensive relative to direct security purchases, the cash collateral serves as a buffer for short stock coverage rules. Because counterparty risk is a concern for swaps, management spreads the contracts across three large institutions: JPMorgan, Morgan Stanley, and UBS.

If the ETF experiences severe losses, meaning the short stock positions rise in value and/or the long positions fall in value, management could be forced cover short positions in order to comply with regulations requiring full collateralization of short positions. Because the index is not bound by this trading restriction, in times of severe strain, the ETF could fail to track the index. The cost to borrow short positions also could cause the ETF to imperfectly track the index. This ETF is relatively illiquid. That means it could trade at a wide bid-ask spread, which could increase trading costs for investors (who should use limit orders to trade this ETF). ■■

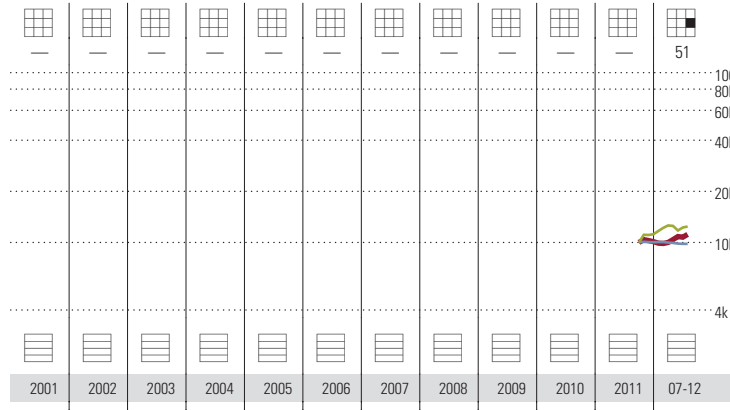
QuantShares US Market Neut Momentum ETF (USD)

Overall Morningstar Rtg™ — Market Neutral

Standard Index S&P 500 TR

Category Index BofAML USD LIBOR Market Neutral 3 Mon CM

Performance 07-31-2012					
Quarterly Returns	1st Qtr	2nd Qtr	3rd Qtr	4th Qtr	Total %
2010	—	—	—	—	—
2011	—	—	—	1.01	—
2012	-1.02	7.40	—	—	10.40
Trailing Returns	1 Yr	3 Yr	5 Yr	10 Yr	Incept
Std Mkt 06-30-12	—	—	—	—	3.77
Std NAV 06-30-12	—	—	—	—	4.06
Mkt Total Ret	—	—	—	—	7.86
NAV Total Ret	—	—	—	—	8.07
+/- Std Index	—	—	—	—	—
+/- Cat Index	—	—	—	—	—
% Rank Cat	—	—	—	—	—
No. in Cat	—	—	—	—	—



Investment Style	
Equity	100k
Stock %	80k
Growth of \$10,000	
QuantShares US Market Neut Momentum ETF	11,152
Category Average	9,810
Standard Index	12,413
Performance Quartile (within category)	
History	
Mkt Total Ret %	19.83
NAV Total Ret %	10.40
+/- Standard Index	-0.61
+/- Category Index	10.07
% Rank Cat	—
No. of Funds in Cat	12
Avg Prem/Discount %	-1.21

Performance Disclosure

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

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

Current performance may be lower or higher than return data quoted herein. For performance data current to the most recent month-end, please call 202-551-8090.

Fees and Expenses

Fund Expenses	
Management Fees %	0.50
12b1 Expense %	0.00
Expense Ratio %	2.79

Risk and Return Profile

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

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

MPT Statistics	Standard Index	Best Fit Index
NAV	—	—
Alpha	—	—
Beta	—	—
R-Squared	—	—
12-Month Yield	—	—
30-day SEC Yield	—	—
Potential Cap Gains Exp	—	—
Leveraged	—	No
Leverage Type	—	—
Leverage %	—	100.00
Primary Prospectus Benchmark	DJ US Thematic Market Neut Momen TR USD	—

Portfolio Analysis 08-01-2012

Asset Allocation % 07-26-2012	Net %	Long %	Short %	Share Chg since 07-2012	Share Amount	Holdings: 0 Total Stocks, 0 Total Fixed-Income, — Turnover Ratio	% Net Assets
Cash	94.51	95.38	0.87	—	—	—	—
US Stocks	5.30	85.05	79.75	—	—	—	—
Non-US Stocks	0.19	11.31	11.12	—	—	—	—
Bonds	0.00	0.00	0.00	—	—	—	—
Other/Not Clsfd	0.00	0.00	0.00	—	—	—	—
Total	100.00	191.74	91.74	—	—	—	—

Equity Style			Portfolio Statistics		
Value	Blend	Growth	Port Avg	Rel Index	Rel Cat
—	—	—	19.2	1.30	1.28
—	—	—	12.1	1.36	1.48
—	—	—	3.0	1.40	5.63
—	—	—	8086	0.14	0.71

Fixed-Income Style		
Ltd	Mod	Ext
—	—	—
—	—	—
—	—	—
—	—	—

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

Regional Exposure	Stock %	Rel Std Index
Americas	98.0	0.99
Greater Europe	2.0	2.56
Greater Asia	0.0	—

Sector Weightings

	Stocks %	Rel Std Index
Cyclical	40.1	1.48
Basic Materials	6.5	2.40
Consumer Cyclical	15.4	1.64
Financial Services	10.1	0.78
Real Estate	8.1	4.05
Sensitive	36.4	0.80
Communication Services	3.5	0.74
Energy	6.6	0.59
Industrials	14.3	1.26
Technology	12.1	0.66
Defensive	23.5	0.85
Consumer Defensive	8.0	0.67
Healthcare	9.9	0.85
Utilities	5.5	1.49

Operations

Family:	FQF TRUST	Ticker:	MOM	Prem/Discount:	—
Manager:	Multiple	Incept:	09-07-2011	Mkt Price:	26.35
Tenure:	0.9 Year	Expiration Date:	—	Base Currency:	USD
Total Assets:	\$5.3 mil	Exchange:	NYSE ARCA	Legal Structure:	Open Ended Investment Company
Shares Outstanding:	200.00k	NAV:	26.34	Backing Bank:	FFCM LLC

Fund Reports

QuantShares U.S. Market Neutral Anti-Beta ETF

by **Josh Charney****Advisor**
FFCM LLC**Advisor Location**
Boston, Massachusetts**Assets Under Management**
\$30.6 million**Inception Date**
Sept. 13, 2011**Investment Type**
Exchange-traded fund**Morningstar Category**
Market neutral

Management

This quantitative fund is overseen by Bill DeRoche, CFA, chairman and chief executive officer; Kishore Karunakaran, president and chief operating officer; and Chuck Martin, CFA, chief investment officer and chief financial officer. DeRoche joined FFCM from State Street Global Advisors, where he headed the U.S. enhanced equities team. Karunakaran previously worked at Platinum Grove Asset Management, LP, where he directed the quantitative equities stock selection group. Prior to that, he was a vice president in AQR Capital Management's global stock selection team. Martin served as a vice president at State Street Global Advisors and as a senior portfolio manager in the firm's global enhanced equities group.

Strategy

This U.S. market neutral equity anti-beta fund provides investors with the return differential between low-beta and high-beta stocks. The ETF takes long positions in primarily large-capitalization stocks with low market betas and shorts an equal dollar amount of equities with high betas. The strategy is meant to offer investors the factor risk premium from low-beta stocks outperforming high-beta stocks without exposure to the general market. Low-beta stocks exhibit less volatility to the market than high-beta stocks and can deliver better risk-adjusted returns over the long term. This strategy is likely to perform well during down markets, as was the case in 2008, but it may also perform poorly during a high-beta rally. The benchmark index has exhibited a negative 0.81 correlation to the Dow Jones U.S. Index during the last 10 years (using weekly data through June 30) as the index tends to move counter to the market. Because the strategy bets against beta, the index's beta is also negative, registering at negative 0.90 during the last 10 years.

Process

The ETF tracks the Dow Jones U.S. Thematic Market Neutral Anti-Beta Index, which is constructed by taking the approximately 1,350 stocks in the Dow Jones U.S. Index and weeding out names with less than \$10 million in average daily trading volume (leaving about 1,200 stocks). Then, the index calculates beta for the top 1,000 names by market capitalization and sector. Beta is calculated using weekly data for the trailing 52 weeks relative the Dow Jones U.S. Index. The index will take long positions in the bottom 20% and short positions in the top 20% of each 10 sectors, equally weighting each position. The index is rebalanced and reconstituted at the end of each month. The index provider will announce the new constituents one day before the changes are made so that the ETF has one full day to trade. To minimize tracking error, however, it typically trades in the last 30 minutes of that day. The ETF is fully invested primarily in individual stocks. Some of its equity exposure is gained through swaps, which are more expensive, but the cash collateral serves as a buffer for short-stock coverage rules.

There are at least 10 authorized participants that can create and redeem shares. Short positions are created and redeemed through cash.

Risk Management

To manage the tracking error and shorting risks, management allocates roughly 10% of its available cash to swaps. Because counterparty risk is a concern for swaps, management spreads the contracts across three large institutions: JPMorgan, Morgan Stanley, and UBS. If the ETF experiences severe losses, meaning the short stock positions rise in value and/or the long positions fall in value, management could be forced to cover short positions in order to comply with regulations requiring full collateralization of short positions. Because the index is not bound by this trading restriction, in times of severe strain, the ETF could fail to track the index. The cost to borrow short positions could also cause the ETF to imperfectly track the index. This ETF is relatively illiquid, meaning it could trade at a wide bid-ask spread, which could increase trading costs for investors (who should use limit orders to trade this ETF). ■■■

QuantShares US Market Neut Anti-Beta ETF (USD)

Overall Morningstar Rtg™

Standard Index
S&P 500 TR

Category Index
BofAML USD LIBOR
Market Neutral
3 Mon CM

— Market Neutral

Performance 07-31-2012

Quarterly Returns	1st Qtr	2nd Qtr	3rd Qtr	4th Qtr	Total %
2010	—	—	—	—	—
2011	—	—	—	-8.58	—
2012	-9.76	11.70	—	—	2.00
Trailing Returns	1 Yr	3 Yr	5 Yr	10 Yr	Incept
Std Mkt 06-30-12	—	—	—	—	-2.47
Std NAV 06-30-12	—	—	—	—	-2.19
Mkt Total Ret	—	—	—	—	-1.55
NAV Total Ret	—	—	—	—	-1.02
+/- Std Index	—	—	—	—	—
+/- Cat Index	—	—	—	—	—
% Rank Cat	—	—	—	—	—
No. in Cat	—	—	—	—	—

Performance Disclosure

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

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

Current performance may be lower or higher than return data quoted herein. For performance data current to the most recent month-end, please call (617) 292-9801.

Fees and Expenses

Fund Expenses	
Management Fees %	0.50
12b1 Expense %	0.00
Expense Ratio %	1.92

Risk and Return Profile

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

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

MPT Statistics	Standard Index	Best Fit Index
NAV	—	—
Alpha	—	—
Beta	—	—
R-Squared	—	—

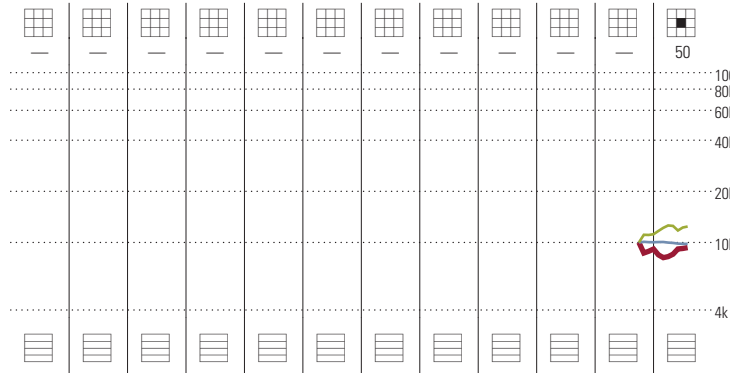
12-Month Yield	—
30-day SEC Yield	—
Potential Cap Gains Exp	—

Leveraged	No
Leverage Type	—
Leverage %	100.00

Primary Prospectus Benchmark	DJ US Thematic Mkt Neut Anti-Beta TR USD
------------------------------	--

Operations

Family:	FQF TRUST
Manager:	Multiple
Tenure:	0.9 Year
Total Assets:	\$30.6 mil
Shares Outstanding:	1.25 mil



Investment Style	Equity	Stock %
QuantShares US Market Neut Anti-Beta ETF	9,326	—
Category Average	9,810	—
Standard Index	12,413	—

Performance Quartile (within category)	History
0.97	Mkt Total Ret %
2.00	NAV Total Ret %
-9.01	+/- Standard Index
1.68	+/- Category Index
—	% Rank Cat
12	No. of Funds in Cat
-0.42	Avg Prem/Discount %

Portfolio Analysis 08-01-2012

Asset Allocation % 07-26-2012	Net %	Long %	Short %	Share Chg since 07-2012	Share Amount	Holdings: 0 Total Stocks, 0 Total Fixed-Income, — Turnover Ratio	% Net Assets
Cash	97.57	97.69	0.12	—	—	—	—
US Stocks	3.06	85.96	82.90	—	—	—	—
Non-US Stocks	-0.63	10.97	11.60	—	—	—	—
Bonds	0.00	0.00	0.00	—	—	—	—
Other/Not Clsfd	0.00	0.00	0.00	—	—	—	—
Total	100.00	194.62	94.62	—	—	—	—

Equity Style	Portfolio Statistics	Port Avg	Rel Index	Rel Cat
Value Blend Growth	P/E Ratio TTM	16.4	1.11	1.10
Large Mid Small	P/C Ratio TTM	9.4	1.05	1.14
	P/B Ratio TTM	2.1	0.98	3.94
	Geo Avg Mkt Cap \$mil	9936	0.18	0.87

Fixed-Income Style	Avg Eff Maturity	Avg Eff Duration	Avg Wtd Coupon	Avg Wtd Price
Ltd Mod Ext	—	—	—	—
High Mid Low	—	—	—	—

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

Regional Exposure	Stock %	Rel Std Index
Americas	98.5	0.99
Greater Europe	1.5	1.90
Greater Asia	0.0	—

Sector Weightings	Stocks %	Rel Std Index
Cyclical	33.5	1.24
Basic Materials	6.0	2.20
Consumer Cyclical	8.9	0.95
Financial Services	11.6	0.89
Real Estate	7.0	3.50
Sensitive	35.0	0.77
Communication Services	3.0	0.63
Energy	6.0	0.54
Industrials	15.9	1.41
Technology	10.0	0.55
Defensive	31.5	1.15
Consumer Defensive	16.0	1.33
Healthcare	9.5	0.81
Utilities	6.0	1.62

Fund Reports**Ziegler Lotsoff Long/Short Credit Fund**by **Mallory Horejs**

Advisor

Ziegler Lotsoff Capital Management

Advisor Location

Chicago, Illinois

Assets Under Management

\$26.5 million (fund)

Inception Date

Jan. 31, 2012

Investment Type

Mutual fund

Morningstar Category

Nontraditional bond

Management

This fund is run by Paula Horn, Stephen Bossu, and Jon Thomas. Horn serves as the firm's chief investment officer, and Bossu and Thomas serve as senior portfolio managers, specializing in macro/government trading and fundamental credit analysis, respectively. The management team is supported by two analysts: Michael Sanders, who assists with statistical screening, and Michael Hurley, who focuses on the portfolio's risk management. Management has run this long/short credit strategy in a hedge fund since 2006 but converted it to a mutual fund in January 2012.

Strategy

This fund can take both long and short positions in a wide range of credit securities, including corporate bonds, convertibles, preferred stock, floating-rate debt, and hedging instruments (treasuries, futures, and ETFs), but it concentrates in corporate bonds. Management invests opportunistically based on a top-down macroeconomic assessment of the market environment and a bottom-up fundamental security selection process. When bullish, management increases credit market exposure and moves toward higher-yielding securities. In bearish environments, it decreases exposure and focuses on investment-grade. The team also adjusts the fund's interest rate exposure based upon their macroeconomic outlook—portfolio duration typically ranges from 0 to 2.5 years and cannot exceed five years. The fund typically holds 40–60 positions with an average holding period of three to nine months. Managers Horn, Bossu, and Thomas target an annualized return of 6%–10% with half of the volatility of the S&P 500 Index. They expect two thirds of the return to come from the portfolio's yield component and one third to come from capital appreciation.

As of June 30, 2012, the portfolio held 75 individual positions and duration was 1.9 years. Net market exposure (including both credit and equity) was 64.6%, and the portfolio's long asset allocation was as follows: corporate bonds (48.2%), preferred securities (19.3%), high-yielding equities/REITs (5.7%), convertible securities (3.8%), and index ETFs and CEFs (1.2%). Management hedged a small portion of the equity exposure in convertible bonds and chose to hedge approximately half of the fund's interest rate duration by shorting Treasury notes (negative 13.1% position).

Process

Management begins the portfolio construction process with a macroeconomic assessment, looking at interest rates, default rates, spreads, and credit quality levels, as well as overall flows. Next comes quantitative screening (performed weekly), during which the team screens the universe of credit securities (roughly 800 securities from 600 companies) to identify those most likely to outperform in the current macro environment. Based on relative movement within the list (rather than on an absolute ranking), management selects 10–15 securities each week for further fundamental research. This analysis includes a full company valuation and restructuring analysis. In the final stage, management selects which securities to add to the portfolio.

Risk Management

Risk exposures are evaluated on both an individual security and aggregate portfolio basis, and unintended risk exposures are hedged whenever possible. Management limits industry exposures to 25%, and individual positions generally range from 3% to 5%. Net leverage exposure is capped at 140%, and gross leverage cannot exceed 200%. Portfolio hedges help to maintain optimal credit market exposure, sector exposure, and single-name exposure, as well as the duration target of the overall fund. To hedge, management uses listed options, equities, ETFs, single-name corporate bonds, or Treasuries. To monitor liquidity risk, management assigns an internal liquidity rating to each position in the portfolio based on a ratio of average daily trading volume divided by total volume outstanding for the issue. ■■■

Ziegler Lotsoff Cptl Mgmt L/S Crdt (USD)

Standard Index	Category Index	Morningstar Cat
Barclays US Agg Bond TR USD	Barclays US Govt/Credit 5-10 Yr TR USD	US OE Nontraditional Bond

Performance 07-31-2012					
Quarterly Returns	1st Qtr	2nd Qtr	3rd Qtr	4th Qtr	Total %
2010	—	—	—	—	—
2011	—	—	—	—	—
2012	—	0.47	—	—	—
Trailing Returns					
	1 Yr	3 Yr	5 Yr	10 Yr	Incept
Load-adj Mthly	—	—	—	—	3.20
Std 06-30-2012	—	—	—	—	2.08
Total Return	—	—	—	—	3.20
+/- Std Index	—	—	—	—	—
+/- Cat Index	—	—	—	—	—
% Rank Cat	—	—	—	—	—
No. in Cat	—	—	—	—	—
7-day Yield	—	—	—	—	—

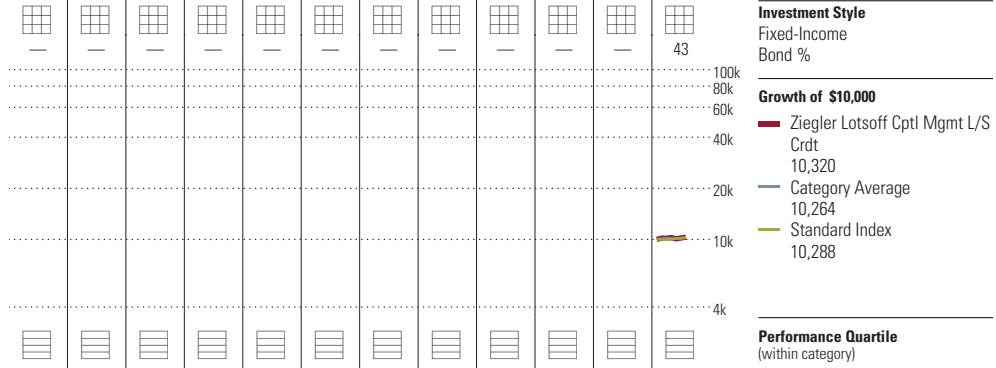
Performance Disclosure
 The Overall Morningstar Rating is based on risk-adjusted returns, derived from a weighted average of the three-, five-, and 10-year (if applicable) Morningstar metrics.
 The performance data quoted represents past performance and does not guarantee future results. The investment return and principal value of an investment will fluctuate; thus an investor's shares, when sold or redeemed, may be worth more or less than their original cost.
 Current performance may be lower or higher than return data quoted herein. For performance data current to the most recent month-end, please call 877-568-7633 or visit www.zieglerlotsoff.com.

Fees and Expenses	
Sales Charges	
Front-End Load %	NA
Deferred Load %	NA
Fund Expenses	
Management Fees %	0.65
12b1 Expense %	NA
Gross Expense Ratio %	2.77

Risk and Return Profile			
	3 Yr	5 Yr	10 Yr
Morningstar Rating™	70 funds	29 funds	5 funds
Morningstar Risk	—	—	—
Morningstar Return	—	—	—
	3 Yr	5 Yr	10 Yr
Standard Deviation	—	—	—
Mean	—	—	—
Sharpe Ratio	—	—	—
MPT Statistics	Standard Index	Best Fit Index	
Alpha	—	—	—
Beta	—	—	—
R-Squared	—	—	—

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

Operations	
Family:	Ziegler Lotsoff Capital Management
Manager:	Multiple
Tenure:	0.6 Year
Objective:	Income



Year	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	07-12	History
NAV/Price	—	—	—	—	—	—	—	—	—	—	—	10.17	NAV/Price
Total Return %	—	—	—	—	—	—	—	—	—	—	—	—	Total Return %
+/- Standard Index	—	—	—	—	—	—	—	—	—	—	—	—	+/- Standard Index
+/- Category Index	—	—	—	—	—	—	—	—	—	—	—	—	+/- Category Index
% Rank Cat	—	—	—	—	—	—	—	—	—	—	—	—	% Rank Cat
No. of Funds in Cat	—	—	—	—	—	—	—	—	—	—	—	—	No. of Funds in Cat

Portfolio Analysis 06-30-2012									
Asset Allocation %	Net %	Long %	Short %	Share Chg since 03-2012	Share Amount	Holdings:	10 Total Stocks , 1,025 Total Fixed-Income, — Turnover Ratio	% Net Assets	
Cash	35.72	35.88	0.15						
US Stocks	5.44	5.70	0.26						
Non-US Stocks	-0.13	0.00	0.13	✱	6 mil	Money Market Fiduciary		26.61	
Bonds	36.60	49.74	13.14	⊕	3 mil	US Treasury Note 2%		-13.14	
Other/Not Clsfd	22.36	23.13	0.76	⊕	700,000	Seitel 9.75%		2.94	
Total	100.00	114.45	14.45	⊕	530,000	Apria Healthcare Grp 11.25%		2.29	
				✱	500,000	Kratos Defense & Sec Solutions 10%		2.25	
Equity Style	Value	Blend	Growth	Port Avg	Rel Index	Rel Cat			
				11.5	—	0.80	⊕	500,000	Hca 5.875%
				—	—	—	⊕	500,000	Chrysler Grp Llc / Cg Co-Iss 8%
				1.0	—	0.52	⊕	500,000	Saratoga Res Inc Tex 12.5%
				2162	—	0.05	✱	500,000	Nortek 8.5%
							✱	500,000	Niska Gas Strge Us Llc/Fin Cp 8.87
Fixed-Income Style	Ltd	Mod	Ext	Avg Eff Maturity					
							⊕	500,000	Atkore Intl 9.875%
							✱	500,000	Forbes Engy Svcs 9%
							✱	452,748	First Data 10.55%
							✱	450,000	Norcraft Cos Lp / Norcraft Fin 10.
							⊕	16,902	Dupont Fabros Tech Pfd

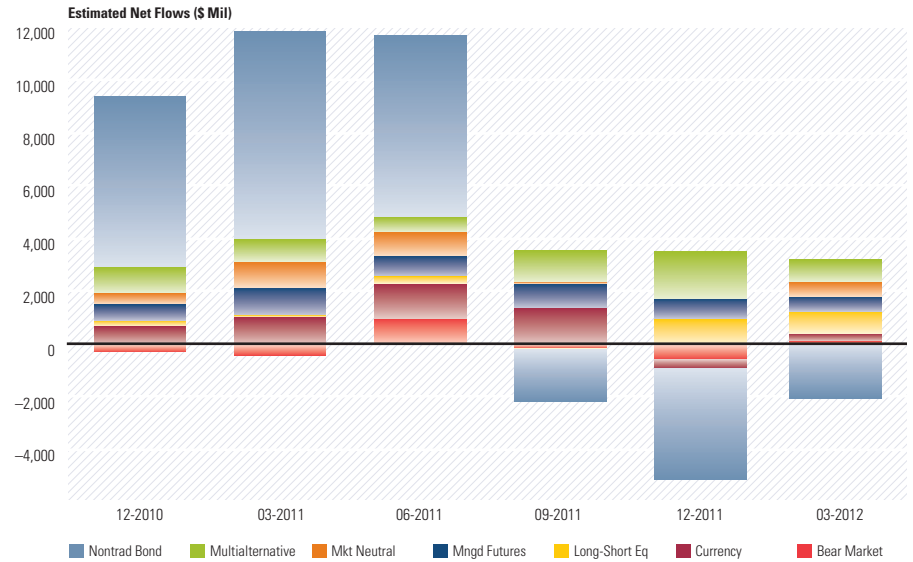
Sector Weightings			Stocks %	Rel Std Index
Cyclical			100.0	—
Basic Materials			0.0	—
Consumer Cyclical			0.0	—
Financial Services			43.6	—
Real Estate			56.4	—
Sensitive			0.0	—
Communication Services			0.0	—
Energy			0.0	—
Industrials			0.0	—
Technology			0.0	—
Defensive			0.0	—
Consumer Defensive			0.0	—
Healthcare			0.0	—
Utilities			0.0	—

Base Currency:	USD	Purchase Constraints:	—
Ticker:	ZLSCX	Incept:	01-31-2012
Minimum Initial Purchase:	\$2,500	Type:	MF
Min Auto Investment Plan:	\$1,000	Total Assets:	\$26.45 mil

Flows and Assets Under Management: Alternative Mutual Funds

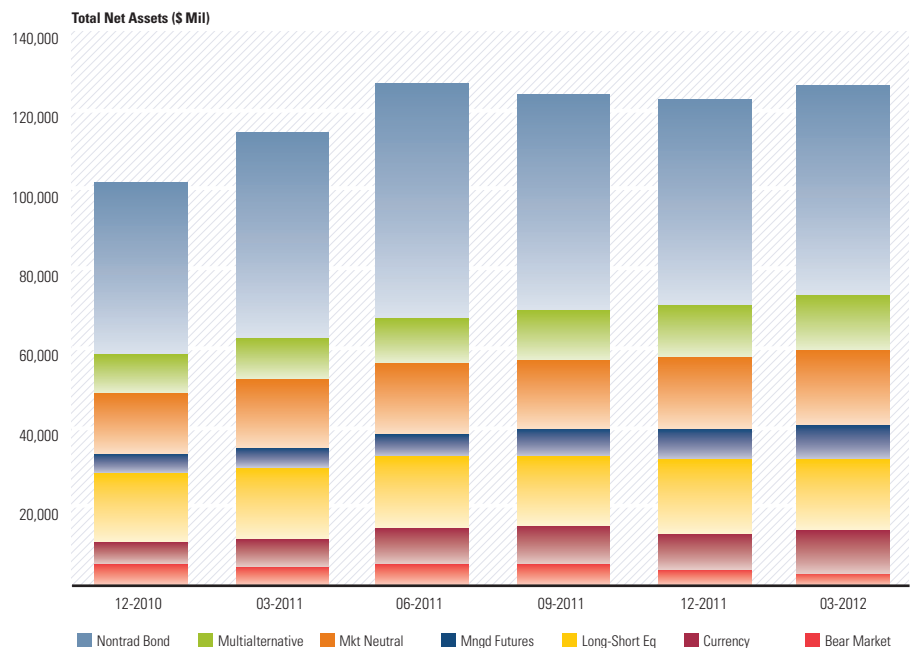
Quarterly Alternative Mutual Fund Flows

During the first quarter of 2012, alternative mutual funds experienced net inflows of more than \$1.1 billion, a significant turnaround from the \$1.6 billion in outflows seen in the fourth quarter of last year. The inflows were strong across all alternative categories, except for the nontraditional-bond category, which bled \$2.1 billion in the first quarter after losing almost \$4.2 billion in the fourth quarter. Two other alternative mutual fund categories, bear-market and currency, also experienced sharp reversals in flows from the previous quarter. These categories gathered \$141 million and \$273 million, respectively, in the first three months of the year. Funds in the long/short equity, multialternative, and market-neutral categories saw substantial net inflows of \$853 million, \$820 million, and \$599 million, respectively.



Quarterly Alternative Mutual Fund Assets Under Management

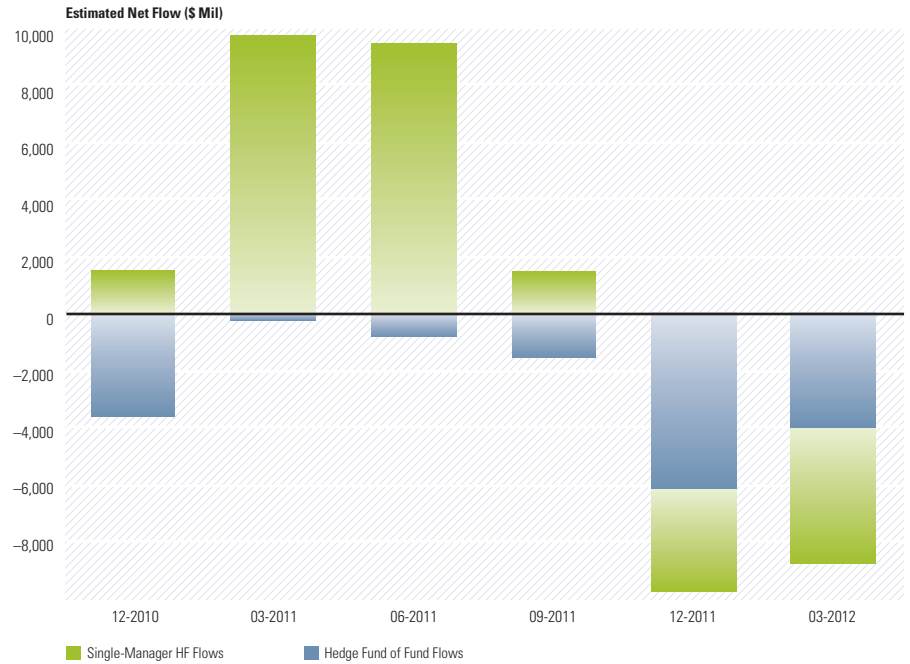
Assets under management of all alternative mutual funds increased by 2.6% during the first quarter of 2012 to \$126 billion. Five of the seven alternative mutual fund categories gained assets during the first quarter. Currency and multialternative funds experienced the most significant percentage gains in assets (8.2% and 7.4%, respectively) due to inflows and strong performance. Bear-market equity funds saw the largest percentage drop in assets during the first quarter (8.7%), and total assets in this category remain the smallest of all the alternative mutual fund categories at \$3.6 billion as of March 31. The largest alternative mutual fund category, nontraditional bond, lost 1.1% of its total assets quarter over quarter.



Flows and Assets Under Management: Hedge Funds

Quarterly Hedge Fund Flows

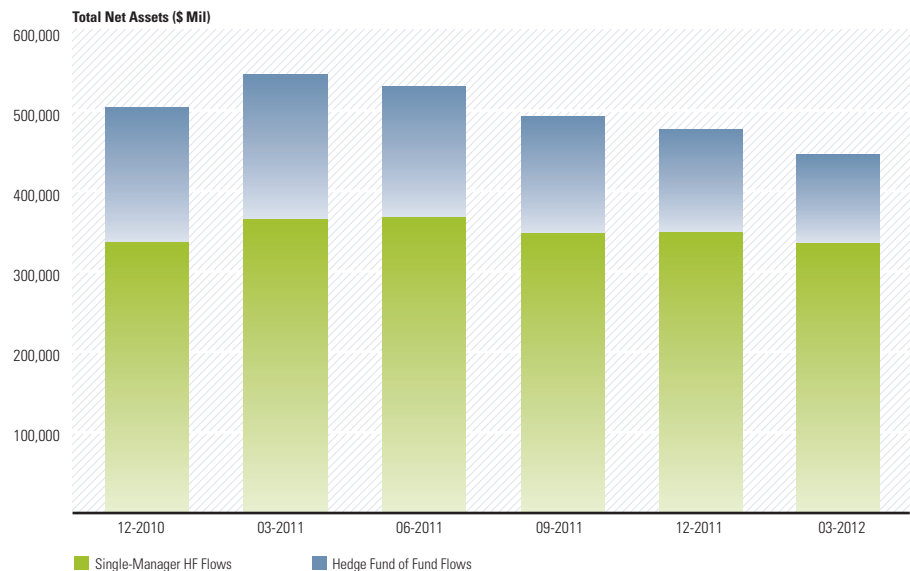
During the first quarter of 2012, single-manager hedge funds in Morningstar’s database experienced outflows of \$4.9 billion, more than double the \$2.1 billion of inflows gathered in all of 2011. Global macro and U.S. long/short equity hedge funds in the database bled more than any other category during the first quarter, suffering outflows of \$1.9 billion and \$1.7 billion, respectively. The majority of the global macro outflows can be attributed to a few funds with very large asset bases. Diversified arbitrage and long/short debt hedge funds experienced the largest inflows in the first three months of the year: \$883.5 million and \$734.9 million, respectively. Hedge funds of funds in Morningstar’s database leaked \$4.0 billion in the first quarter, continuing their multiquarter losing streak.



Quarterly Hedge Fund Assets Under Management

Single-manager hedge fund assets under management in Morningstar’s database decreased 2.7% during the first quarter. Over the past year (through March 31, 2012) assets under management of single-manager hedge funds fell by 7.2%, primarily because of outflows. In the first quarter, hedge funds of funds in Morningstar’s database managed 14.3% fewer assets than in the prior quarter and are down 30.7% from one year ago.

Morningstar does not report total hedge fund industry flows or assets, as these figures are based on estimates and projections of voluntarily reported information.

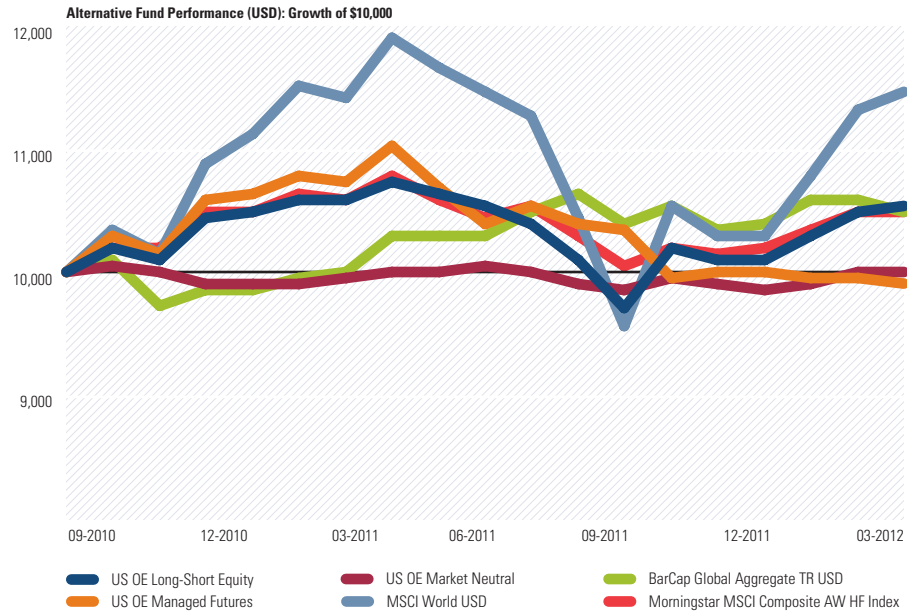


Alternative Investment Performance

Growth of a \$10,000 Alternative Investment

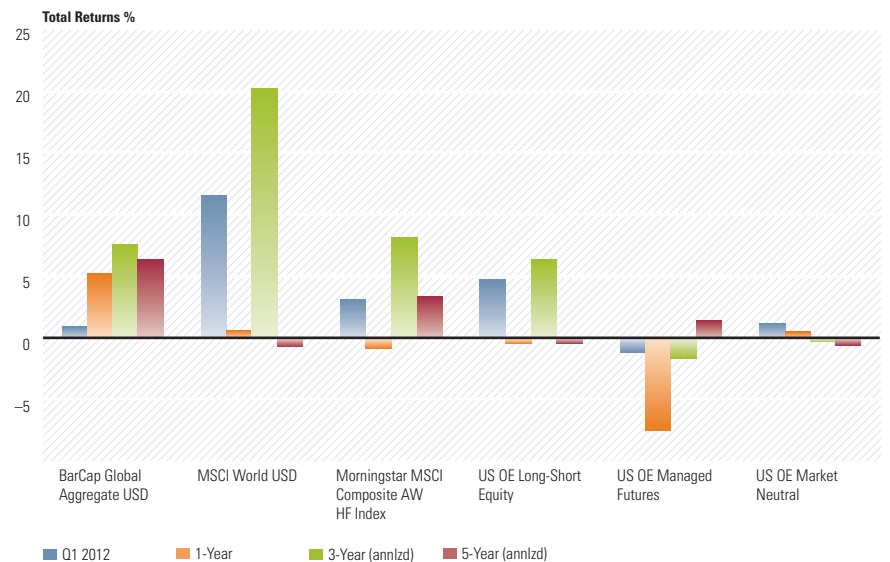
Hedge funds, as proxied by the Morningstar MSCI Composite AW Hedge Fund Index, grew 3.1% in the first quarter, while global stocks, as represented by the MSCI World NR Index, jumped 11.6%. The MSCI World NR Index surged 14.8% over the 18 months ended March 31, while the Morningstar MSCI Composite AW Hedge Fund Index lagged over the same period with a 5.1% increase. Long-short equity mutual funds outperformed the average hedge fund during the first quarter of 2012 and over the past 18 months. Managed futures mutual funds have lost money on average over the past 18-month period.

Morningstar calculates the Morningstar MSCI series of indexes, which includes the Morningstar MSCI Composite AW, a currency-hedged assets-weighted index of almost 1,000 single-manager hedge funds.



Performance of Alternative Investments Over Time

Global stocks, as represented by the MSCI World NR Index, significantly outperformed the average hedge fund (as proxied by the Morningstar MSCI Composite AW Hedge Fund Index) in the quarter ended March 31. Hedge funds have provided better returns than equities, however, over the past one and five years. Global bonds (per the Barclays Global Aggregate index) have fared better than both stocks and hedge funds have over the past one and five years. Alternative mutual funds (as represented by the long-short equity, managed-futures, and market-neutral category averages) underperformed hedge funds over the past three and five years ended March 31.

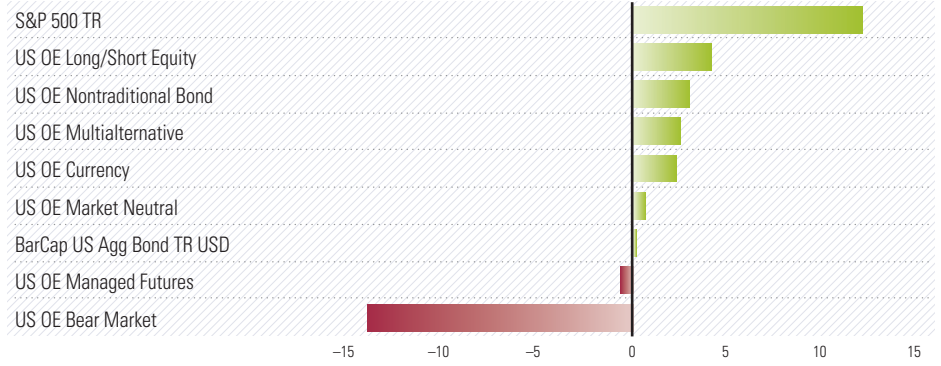


Q1 Performance by Category

Alternative Mutual Funds

The average managed-futures mutual fund lost 1.2% in the first quarter of 2012 due to price-trend reversals in several markets. The average bear-market fund plunged 14.0%, in sharp contrast to the S&P 500's 12.6% advance. Long-short equity mutual funds underperformed the broad stock market but still posted relatively strong results, of 4.7%. Currency mutual funds ended the quarter up on average as the U.S. dollar depreciated. These funds tend to take bets against the dollar.

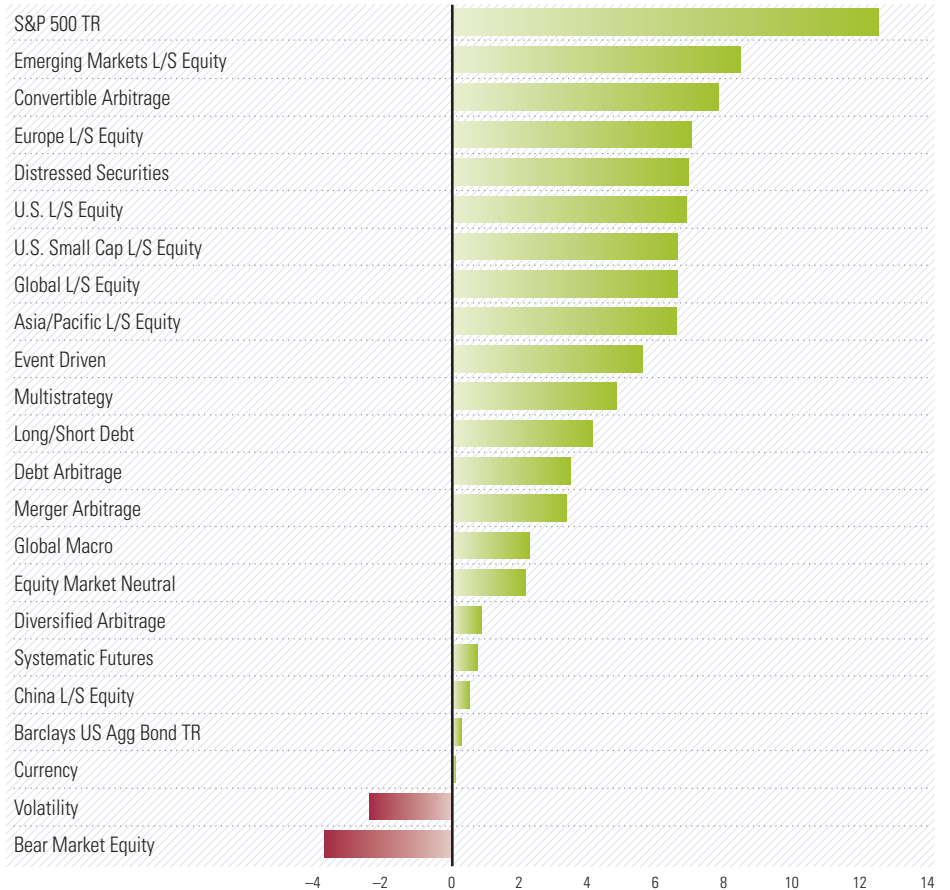
Morningstar Alternative Mutual Fund Category Averages: Q1 2012 Total Returns %



Hedge Funds

In the first quarter of 2012, every hedge fund category average rose, except volatility and bear market. Funds in the emerging-markets long-short equity and convertible arbitrage categories experienced the largest gains, averaging returns of 8.5% and 8.0%, respectively. Funds in Morningstar's distressed securities and Europe long/short categories also posted substantial gains of 7.3% and 7.2%, respectively.

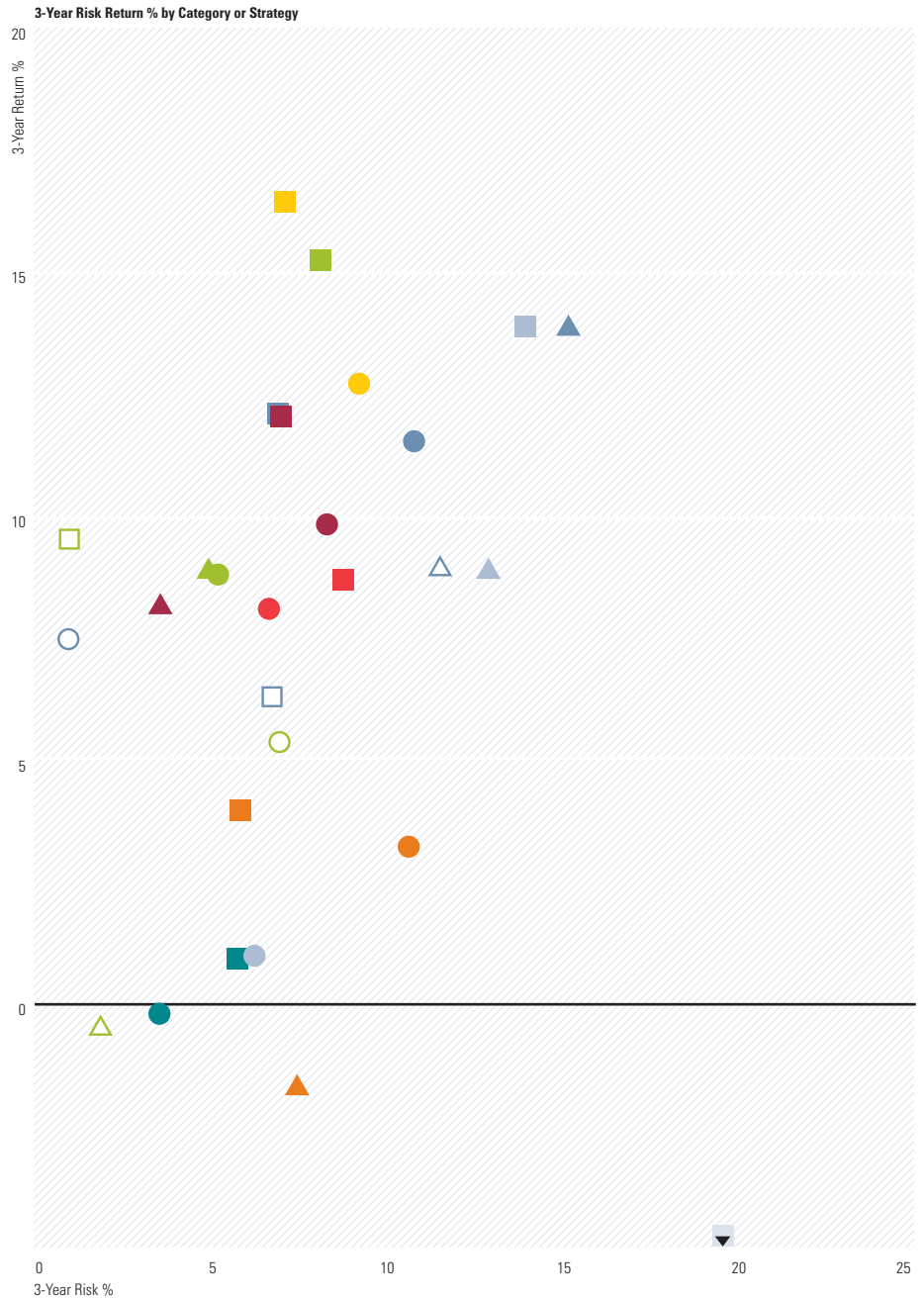
Morningstar Hedge Fund Category Averages: Q1 2012 Total Returns %



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 March 31. Funds in the convertible arbitrage, distressed securities, and U.S. small-cap long-short equity hedge fund categories showed the best annualized three-year total returns on average of 15.2%, 16.5%, and 19.1%, respectively. In terms of risk-adjusted returns, however, distressed securities hedge funds and nontraditional bond mutual funds averaged the best results over the past three years. In contrast, funds in the U.S. bear-market mutual fund category saw a 30.4% annualized decline on average over the three-year period ended March 31 while also exhibiting the highest standard deviation of all alternative mutual fund and hedge fund categories (19.3% annualized). The average managed-futures mutual fund also exhibited a poor three-year risk-adjusted return profile as well, losing 1.7% annualized with an 7.5% annualized standard deviation.

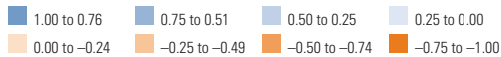


- Asia/Pacific Long/Short Equity
- Bear Market Equity
- China Long/Short Equity
- ▲ Emg Markets Long/Short Equity
- ▲ Europe Long/Short Equity
- ▲ Global Long/Short Equity
- U.S. Long/Short Equity
- U.S. Small Cap Long/Short Equity
- U.S. OE Bear Market
- U.S. OE Long/Short Equity
- Convertible Arbitrage
- Debt Arbitrage
- Diversified Arbitrage
- Equity Market Neutral
- ▲ Merger Arbitrage
- ▲ U.S. OE Market Neutral
- Currency
- U.S. OE Currency
- Long/Short Debt
- Volatility
- ▲ U.S. OE Non-traditional Bond
- Multistrategy
- U.S. OE Multialternative
- Global Macro
- Systematic Futures
- ▲ U.S. OE Managed Futures

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 Currency	-0.70	1.00					
3	US OE Long/Short Equity	-0.95	0.76	1.00				
4	US OE Managed Futures	-0.29	0.30	0.33	1.00			
5	US OE Market Neutral	-0.21	0.43	0.35	-0.16	1.00		
6	US OE Multialternative	-0.94	0.64	0.92	0.45	0.15	1.00	
7	US OE Nontraditional Bond	-0.66	0.43	0.71	0.13	0.14	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	-0.07	1.00																				
3	HF China Long/Short Equity	0.40	-0.31	1.00																			
4	HF Convertible Arbitrage	0.82	-0.11	0.49	1.00																		
5	HF Currency	0.62	0.13	0.33	0.53	1.00																	
6	HF Debt Arbitrage	0.81	-0.05	0.42	0.92	0.65	1.00																
7	HF Distressed Securities	0.85	-0.17	0.38	0.87	0.56	0.83	1.00															
8	HF Diversified Arbitrage	0.70	-0.07	0.48	0.76	0.42	0.77	0.70	1.00														
9	HF Emer Markets Long/Short Equity	0.79	-0.20	0.73	0.84	0.57	0.79	0.78	0.65	1.00													
10	HF Equity Market Neutral	0.82	-0.04	0.43	0.81	0.64	0.89	0.75	0.67	0.78	1.00												
11	HF Europe Long/Short Equity	0.88	-0.08	0.36	0.88	0.73	0.93	0.86	0.70	0.78	0.94	1.00											
12	HF Event Driven	0.89	-0.21	0.46	0.89	0.58	0.85	0.92	0.70	0.88	0.86	0.90	1.00										
13	HF Global Long/Short Equity	0.92	-0.13	0.46	0.89	0.67	0.91	0.89	0.69	0.86	0.93	0.96	0.96	1.00									
14	HF Global Macro	0.75	0.12	0.39	0.68	0.86	0.77	0.61	0.48	0.68	0.83	0.83	0.71	0.81	1.00								
15	HF Long/Short Debt	0.85	0.05	0.43	0.93	0.68	0.96	0.83	0.77	0.81	0.91	0.94	0.87	0.91	0.81	1.00							
16	HF Merger Arbitrage	0.83	-0.20	0.39	0.87	0.60	0.90	0.82	0.70	0.78	0.93	0.95	0.90	0.94	0.75	0.89	1.00						
17	HF Multistrategy	0.89	-0.04	0.45	0.89	0.73	0.93	0.85	0.70	0.82	0.95	0.98	0.91	0.98	0.87	0.95	0.92	1.00					
18	HF Systematic Futures	0.61	0.22	0.30	0.49	0.80	0.59	0.50	0.35	0.47	0.62	0.65	0.52	0.65	0.87	0.63	0.54	0.72	1.00				
19	HF U.S. Long/Short Equity	0.89	-0.26	0.48	0.85	0.54	0.80	0.90	0.65	0.86	0.84	0.87	0.97	0.95	0.68	0.80	0.87	0.88	0.52	1.00			
20	HF U.S. Small Cap Long/Short Equity	0.88	-0.21	0.51	0.83	0.55	0.78	0.88	0.64	0.86	0.83	0.84	0.95	0.94	0.70	0.79	0.84	0.88	0.56	0.98	1.00		
21	HF Volatility	0.05	0.31	0.09	0.13	0.16	0.23	-0.05	0.19	0.01	0.23	0.17	0.01	0.12	0.35	0.24	0.16	0.23	0.41	-0.02	0.05	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)			BarCap US Agg Correlation (USD)		
	3-Year	5-Year	10-Year	3-Year	5-Year	10-Year
US OE Bear Market	-0.98	-0.97	-0.97	0.22	-0.20	-0.02
US OE Currency	0.66	0.50	0.19	-0.07	0.01	0.26
US OE Long/Short Equity	0.96	0.95	0.84	-0.27	0.11	0.07
US OE Managed Futures	0.29	-0.24	N/A	-0.05	-0.33	N/A
US OE Market Neutral	0.24	0.13	-0.18	-0.04	0.05	0.17
US OE Multialternative	0.92	0.94	0.87	-0.12	0.21	-0.03
US OE Nontraditional Bond	0.63	0.73	0.60	0.05	0.22	0.32

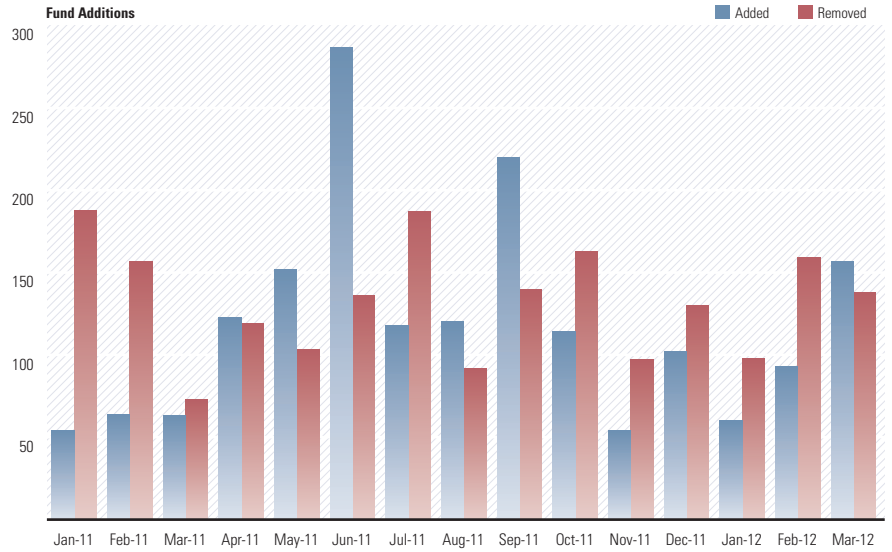
Correlation of Hedge Funds to U.S. Stocks and Bonds	S&P 500 Correlation (USD)			BarCap US Agg Correlation (USD)		
	3-Year	5-Year	10-Year	3-Year	5-Year	10-Year
Morningstar MSCI Composite AW HF Index	0.80	0.70	0.65	-0.12	0.08	0.04
HF Asia/Pacific Long/Short Equity	0.80	0.80	0.67	-0.14	0.24	0.13
HF Bear Market Equity	-0.46	-0.50	-0.52	0.22	0.03	0.08
HF China Long/Short Equity	0.42	0.34	N/A	-0.05	0.05	N/A
HF Convertible Arbitrage	0.79	0.74	0.65	-0.02	0.32	0.23
HF Currency	0.51	0.38	0.22	0.07	0.18	0.24
HF Debt Arbitrage	0.77	0.77	0.63	0.02	0.29	0.25
HF Distressed Securities	0.82	0.81	0.73	-0.24	0.03	-0.02
HF Diversified Arbitrage	0.60	0.63	0.52	0.02	0.26	0.22
HF Emerging Markets Long/Short Equity	0.75	0.75	0.72	-0.06	0.15	0.10
HF Equity Market Neutral	0.79	0.73	0.59	-0.08	0.21	0.20
HF Europe Long/Short Equity	0.85	0.81	0.72	-0.13	0.19	0.13
HF Event Driven	0.90	0.85	0.79	-0.15	0.13	0.06
HF Global Long/Short Equity	0.90	0.84	0.75	-0.14	0.17	0.09
HF Global Macro	0.64	0.54	0.46	0.10	0.25	0.20
HF Long/Short Debt	0.72	0.77	0.65	0.06	0.35	0.32
HF Merger Arbitrage	0.86	0.82	0.75	-0.11	0.31	0.19
HF Multistrategy	0.83	0.77	0.72	-0.04	0.20	0.10
HF Systematic Futures	0.47	0.12	0.03	0.11	0.04	0.17
HF U.S. Long/Short Equity	0.94	0.90	0.87	-0.27	0.04	-0.04
HF U.S. Small Cap Long/Short Equity	0.90	0.88	0.85	-0.25	0.04	-0.06
HF Volatility	0.02	0.27	0.13	0.23	0.47	0.32



Morningstar Hedge Fund Database Overview as of 03-31-2011

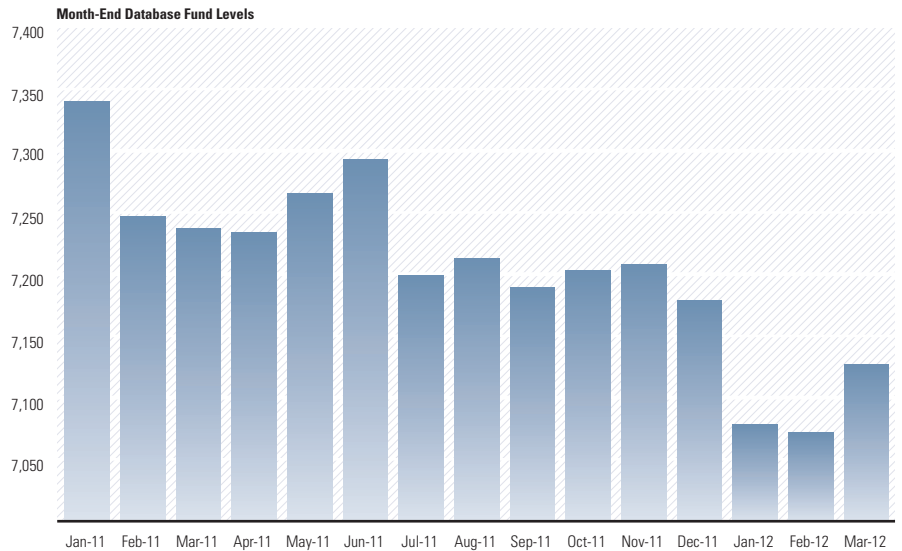
Net Fund Additions by Month

Morningstar's hedge fund database experienced a net withdrawal of 85 funds during the first quarter of 2012. The database saw 310 additions and 395 fund removals 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 March 31, the Morningstar hedge fund database contained 7,127 funds that actively report performance and assets-under-management data. This figure includes approximately 5,000 single-manager hedge funds and 2,000 funds of hedge funds. As of quarter-end, the number of funds in the database had dropped approximately 3.1% from December 2010 levels.

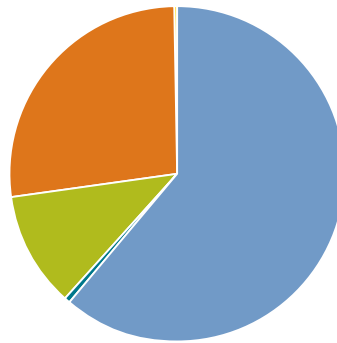


Morningstar Hedge Fund Database Overview as of 12-31-2011

Hedge Funds by Region

Approximately 61.3% of hedge funds in the Morningstar database are legally domiciled in the North American/Caribbean region, primarily in the U.S. and the Cayman Islands. A large percentage of United Kingdom hedge funds are also domiciled in the Cayman Islands for tax and regulatory purposes. Approximately 27.1% of funds in Morningstar's database are domiciled in Europe, including both European Union and non-EU jurisdictions, and 11.0% of funds are domiciled in Asia and Australia, primarily in China.

Morningstar Hedge Fund Database by Region



Region	# Funds
N. America/Caribbean	4,370
Africa	35
Asia/Australia	781
Europe	1,931
South America	7
Other	0
Total	7,124

Hedge Funds by Location

Approximately 78.0% of the hedge funds in Morningstar's database are domiciled in the U.S., the Cayman Islands, China, the British Virgin Islands, Bermuda, and Luxembourg. Both France and Ireland continue to domicile a large portion of European hedge funds, trailing Luxembourg. China is one of the largest and fastest-growing hedge fund domiciles.

Region	# Funds	Region	# Funds
North America and Surrounding	4,370	Europe	1,931
Cayman Islands	1,946	Luxembourg	726
United States	1,354	France	196
British Virgin Islands	461	Ireland	177
Bermuda	328	Guernsey	143
Canada	201	Switzerland	124
Curacao	46	Italy	121
Bahamas	27	Sweden	75
St. Vincent & the Grenadines	3	Jersey	69
Panama	1	Malta	66
Barbados	1	Liechtenstein	50
Anguilla	1	Netherlands	48
St. Kitts & Nevis	1	Spain	35
		United Kingdom	22
Africa	35	Finland	16
Mauritius	19	Germany	11
South Africa	15	Channel Islands	10
Swaziland	1	Austria	9
		Denmark	9
Asia and Australia	781	Isle of Man	7
China	737	Gibraltar	5
Australia	30	Cyprus	3
Hong Kong	7	Norway	3
Japan	2	Portugal	2
Christmas Island	1	Macedonia	1
Singapore	1	Belgium	1
Bahrain	1	Andorra	1
Marshall Islands	1	Greece	1
Vanuatu	1		
		South America	7
		Brazil	7

Morningstar Hedge Fund Database Overview as of 12-31-2011

Service Providers

Morgan Stanley and Goldman Sachs are the largest prime brokerage-service providers to hedge funds in Morningstar’s database, serving a 33.8% share combined. The big four accounting firms are employed by approximately 75.5% of hedge funds listing auditors in the database, with PricewaterhouseCoopers leading the pack. Citco Fund Services provides administration services to 8.4% of funds in Morningstar’s database, significantly more than the next-largest administrator, State Street/IFS. Walkers, Maples & Calder, and Dechert are the three largest legal-counsel providers to hedge funds in the database, with a combined 27.0% market share.

Type	Rank	Service Provider	% of Database
Prime Broker	1	Morgan Stanley	17.67
	2	Goldman Sachs	16.13
	3	Deutsche Bank	8.69
	4	UBS	8.66
	5	Credit Suisse	7.68
	6	JPMorgan	6.32
	7	Bank of America / Merrill Lynch	4.11
	8	Newedge	3.96
	9	Citigroup	2.78
	10	BNP Paribas	2.66
Legal Counsel	1	Walkers	10.37
	2	Maples & Calder	10.19
	3	Dechert LLP	6.42
	4	Seward & Kissel	6.29
	5	Elvinger, Hoss & Prussen	5.44
	6	Simmons & Simmons	4.48
	7	Schulte Roth & Zabel	3.62
	8	Sidley & Austin	3.17
	9	Ogier	2.79
	10	Conyers Dill & Pearman	2.16
Auditor	1	Pricewaterhouse Coopers	23.45
	2	Ernst & Young	21.28
	3	KPMG	17.12
	4	Deloitte	13.62
	5	Rothstein Kass	5.39
	6	RSM / McGladery & Pullen	2.67
	7	Grant Thornton	2.17
	8	BDO	2.17
	9	Eisner	0.98
	10	Arthur Bell	0.75
Administrator	1	Citco	8.37
	2	State Street / IFS	3.86
	3	Citigroup / BISYS	3.83
	4	HSBC	3.54
	5	CIBC / BNY Mellon	3.15
	6	Credit Suisse / Fortis	2.58
	7	UBS	2.47
	8	CACEIS Fastnet	2.43
	9	Northern Trust	2.06
	10	Apex	1.96

Alternative Investments Observer

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