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BDCs Deconstructed

What every investor should know about Business Development Companies.

by
Morningstar Analysts

With investors searching for yield just about anywhere they can find it, business development companies have suddenly come up on the radar screen. Business development companies are closed-end investment companies that provide equity and debt capital to small private companies or listed public companies. Essentially, they are a private equity or debt vehicle whose investors do not need to be accredited. Even better, listed business development companies provide liquidity to investors, just like any publicly traded equity. What attracts most investors to BDCs, however, is the yield. The highest-yielding listed BDC, for example, is Saratoga Investment Corp., with a 16.93% 12-month yield, and the average yield is about 8.00%.[1]

Despite the potential appeal of BDCs, investors don't know much about them. They are rarely covered by analysts, and most databases lump them together with financial stocks. One of the reasons is that the market is still tiny. According to the SEC, there were 137 business development companies that had filed registration statements as of June 14, 2013.[2] Only about 45 of those are publicly traded (there is no definitive database of BDCs), with a collective market cap of $33 billion. The top 10 comprise most of the market, about $20 billion.

Another reason BDCs have stayed out of mainstream investing is the complex nature of their legal structure and underlying investments, both of which are very different than that of open-end mutual funds. Lack of knowledge often leads to unfortunate investor results, which is why FINRA warned against BDCs in early 2013.[3] As most investments are not categorically good or bad, however, this article is intended to shed light on BDC investing and to steer investors toward what might be some of the better options.

Legal Structure

The unique legal structure of a BDC offers investors the opportunity set of a private equity fund with the accessibility of a publicly traded stock. In 1980, Congress passed the Small Business Investment Incentive Act (the BDC Act), establishing a new type of closed-end fund subject to some of the provisions under the Investment Company Act of 1940 (1940 Act). The goal was to make capital more readily available for smaller companies, as the economic crisis of the 1970s created a dearth of financing. The BDC Act requires that most of a BDC's assets (70%) must be invested in companies that are not investment companies, that are not funds of funds, and that have a market capitalization of less than $250 million.[4] The management of a BDC must offer significant managerial assistance to its portfolio companies, similar to a private equity fund.[5]

BDCs are highly regulated, which makes them attractive relative to their unregulated private equity counterparts. BDCs must register under the Securities Exchange Act of 1934 and are therefore subject to annual and quarterly reporting requirements. If a BDC choses to go public under the Securities Act of 1933, it can be offered to retail investors without limitations. Similar to other stocks, a listed BDC must also comply with the rules of the exchanges—an independent audit committee, executive compensation oversight, a code of ethics, and corporate governance guidelines, to name few.[6]

The 1940 Act requires of BDCs many of the same things required of mutual funds.

1 Van Eck Global. *Growth and Income Potential with Business Development Companies.* Sept. 30, 2013.
2 U.S. Securities and Exchange Commission. *Business Development Company Report.* June 14, 2013. http://www.sec.gov/open/datasets.shtml#bdc
3 Financial Industry Regulatory Authority. *Business Conduct and Sales Practice Priorities.* Jan. 11, 2013. http://www.finra.org/web/groups/industry/@ip/@reg/@guide/documents/industry/p197649.pdf
4, 5 Ropes & Gray LLP. *Overview of Organization and Structuring of BDCs.* Aug. 27, 2013. http://meetings.abanet.org/meeting/tax/FALL13/media/im-overview-doherty-slides.pdf
6 Sutherland Asbill & Brennan LLP. *Overview of the Business Development Company.* Aug. 17, 2006.

For example, the board of directors must be largely independent, the assets must be held by a qualified custodian, and provisions must be in place to protect against fraud (code of ethics, fidelity bond, and the inability to indemnify its officers). Also like mutual funds, most BDCs become registered investment companies (RIC) in order to avoid taxation at the corporate level (Subchapter M of the IRS code). RIC status means that a BDC must meet diversification and income distribution (at least 90% annually) rules. A BDC can leverage more than an open-end mutual fund, but leverage is capped at 100% of assets.

Exhibit 1: Top 10 Listed BDCs by Market Cap

Listed BDC Name	Ticker	Inception Date	Market Cap ($mil)	12-month Yield	Management
Ares Capital Corporation	ARCC	10/5/04	5,138.37	8.32	External
American Capital Ltd.	ACAS	8/29/97	4,256.94	N/A	Internal
Prospect Capital Corporation	PSEC	7/27/04	3,174.43	11.83	External
Apollo Investment Corp	AINV	4/6/04	1,984.47	9.06	External
Fifth Street Finance Corporation	FSC	6/12/08	1,304.14	12.27	External
Main Street Capital Corporation	MAIN	10/5/07	1,277.47	5.79	Internal
Hercules Technology Growth Capital Inc.	HTGC	6/9/05	1,038.41	6.60	Internal
Solar Capital Ltd.	SLRC	2/9/10	1,016.51	9.58	External
Triangle Capital Corporation	TCAP	2/15/07	819.83	7.26	Internal
Pennant Park Investment Corporation	PNNT	4/19/07	793.90	9.39	External

Traded Versus Nontraded

It's important to note that there are both traded (or listed) and nontraded (or unlisted) versions of BDCs. Traded BDCs gathered a critical mass after Apollo Investment Corporation's nearly $1 billion capital raise in 2004, but nontraded BDCs have only recently come into vogue. In 2008, FS Investment Corporation (in conjunction with GSO, Blackstone's credit arm) launched the first unlisted BDC and several have followed. Some names include Business Development Corporation of America (American Realty Capital), Corporate Capital Trust (CNL and KKR), and Keating Capital.[7]

Nonlisted BDCs are entirely different animals. Often, they are higher yielding than listed BDCs, but the yield does not usually compensate for the drawbacks. The biggest downside is the cost. Up-front sales charges for nontraded BDCs can be gut-wrenching—in the 11%–15% range.[8] Besides cost, the lack of accessibility, the uncertainty of their underlying investments, the illiquidity, and the high costs should give investors much pause. Nontraded BDCs can only be offered to accredited investors (the definition varies state by state) through broker/dealers and must be approved in each state they are sold.[9] Instead of a one-time initial public offering, nontraded BDCs are continuously offered for a period of time (a blind pool of assets), after which they must invest their cash. They must complete a liquidity event (an IPO, a sale of assets, or a merger) at the end of a specified period of time, up to 10 years. (Fortunately, nontraded BDCs are still required to mark to fair value quarterly).

Internal Versus External Management

Whether one chooses a traded or nontraded BDC, an investor must scrutinize the management. Prior to 2003, most BDCs were internally managed.[10] Internal management means that the managers of the BDC are employees of a wholly owned subsidiary of the fund, and salaries and other operating costs (office space, etc.) are paid directly by the BDC. External management means the BDC pays a management and incentive fee (unlike other 1940 Act funds, BDCs are allowed to charge performance fees) to a third party (typically large asset-management firms).

It can be argued that internal management better aligns management incentives with those of shareholders, because internal management fees are paid at cost, while external management fees build in a profit margin.[11] Typical external management fees are high: 1.5%–2.5% of gross assets (including leverage), with a 100% performance fee on performance between 7.0%–8.5% annualized, and a 20% share of the profits thereafter.[12] Furthermore, the livelihood of the internal manager depends on the success of the BDC, whereas an external manager typically manages other products.

Six of the 10 largest publicly traded BDCs are externally managed, however. See Exhibit 1. External management does come with some benefits. The management may be more experienced in a particular asset class, and as external managers are required to be SEC-registered investment advisors, they are subject to another layer of regulatory oversight.[13] As with most matters, investors must weigh the benefits with the costs.

Underlying Investments

The financial crisis of 2008 created a paradigm shift in the way companies are financed. Whereas banks used to lend to a wide variety of businesses, stringent regulatory capital requirements have closed the purse strings to all but the largest, most creditworthy clients. The Financial Stability Board (FSB) is currently watching 29 global financial institutions that are "too big to fail," and more than half

7, 8 Boehm, Steven B. and Krus, Cynthia M. Sutherland Asbill & Brennan LLP. *The ABCs of Non-Listed BDCs*. June 2011. http://www.sutherland.com/portalresource/lookup/wosid/cp-base-4-49844/media.name=/ABCsOFNON-LISTEDBDCs.pdf
9 Investment Program Association. *Portfolio Construction Using Non-Traded Business Development Companies.* 2013. http://www.ipa.com/wp-content/uploads/IPA_BDCs_whitepaper.pdf
10 Main Street Capital Corporation. *Introduction to Business Development Companies ("BDCs") and Main Street Capital Corporation.*
11, 12, 13 http://www.mofo.com/files/Uploads/Images/FAQ-Business-Development-Companies.pdf

are still undercapitalized relative to FSB standards[14] despite efforts to beef up balance sheets during the past five years.

In come the BDCs. The first BDCs were private equity investors, but the tide has decidedly shifted toward private debt. Private debt, whether senior and secured or mezzanine and unsecured, is not issued by banks and is not freely tradable over the counter. All 10 of the top-traded BDCs focus on private debt, according to their prospectuses. See Exhibit 2. According to Fitch, the 11 BDCs it rates held approximately 85% of their portfolios in debt, with 58% in senior debt. Fitch states that equity allocations are down relative to those before the financial crisis.[15]

Before the financial crisis, it was widely believed that the companies that borrowed in the private markets were more risky.[16] This is still largely true. Fitch Ratings' 2012 special report on traded BDCs rates only two, Apollo Investment **AINV** and Ares Capital **ARCC**, just at investment grade (BBB).[17] But the tightly regulated capital markets of today have thrown some potentially creditworthy borrowers into that mix.

Exhibit 2: Top 10 BDC Investment Strategies

Listed BDC Name	Strategy Per Prospectus
Ares Capital Corporation	Makes $10 million to $50 million investments in senior and senior subordinated debt, and mezzanine debt, which sometimes includes an equity component, to middle-market companies. Acquired Allied Capital in April 2010.
American Capital Ltd.	Offers senior debt, mezzanine debt and equity to fund growth, acquisitions, recapitalizations and securitizations. Invests from $5 million to $800 million per company.
Prospect Capital Corporation	Senior and subordinated debt and equity in private and micro-cap public businesses. Offers private mezzanine debt, senior secured debt, senior unsecured debt, publicly traded high-yield debt, bridge loans and private equity. Acquired Patriot Capital Funding in December 2009.
Apollo Investment Corp	Secured, unsecured, and mezzanine debt in companies with revenues up to $2 billion. Also some equity and collateral loan obligations.
Fifth Street Finance Corporation	Invests in first-lien and second-lien senior-secured debt and subordinated below-investment-grade debt, which may also include an equity component, for small and midsized companies with private equity sponsors.
Main Street Capital Corporation	Secured-debt investments, equity investments, warrants, and other securities of lower-middle-market and middle-market US companies.
Hercules Technology Growth Capital, Inc.	Provides primarily structured debt with warrants to technology and life sciences companies at all stages of development, mostly privately held startups backed by leading venture capital and private equity firms.
Solar Capital Ltd.	Offers senior secured loans, mezzanine loans, and equity investments in leveraged middle market firms.
Triangle Capital Corporation	Offers customized debt (primarily subordinated note) and sometimes equity financing to companies with $20 million to $75 million revenues.
Pennant Park Investment Corporation	Senior secured loans, mezzanine debt, and equity investments, in the range of $10 million to $50 million, in the securities of middle-market firms ($50 million to $1 billion in annual revenues) with maturities from three to 10 years.

The $33 Billion Question

The most important question an investor can ask when investing in a BDC is: Can the net investment income (NII) meet the expected dividend? Just because a BDC has paid a dividend in the past doesn't mean it can pay it in the future. Only four of the 11 BDCs that Fitch rates had NII dividend coverage ratios of 100% or more. American Capital and FS Investment Corp, have the lowest ratios, of 65% and 67%, respectively. American Capital hasn't paid a quarterly dividend (it paid two special ones in 2012) since 2009, and FSIC didn't pay one in 2008.[18]

Perhaps the most notorious BDC financial disaster was Allied Capital, which David Einhorn, founder of hedge fund firm Greenlight Capital, brought to light in a speech to a charity organization in May 2002. He then wrote a book about it, *Fooling Some of the People All of the Time*. Allied Capital was a mezzanine debt and private equity BDC that attracted many investors with its 8% yield (at the time of Einhorn's speech), and its stock price traded at a premium to net asset value. According to Einhorn, even though BDC rules required Allied to mark everything to fair value, the company was fleecing investors by marking down assets only when they became permanently impaired (after the loans defaulted or companies went bankrupt). It also was inflating its income statement with transfer payments between its subsidiaries.[19] Despite all of the red flags waived by Einhorn, the SEC waited until 2007 to investigate Allied's accounting practices. Even then, however, the SEC did not levy any

14 Touryalai, Halah. "The World's 29 Too Big To Fail Banks, JPMorgan at the Top." Forbes. Nov. 11, 2013. http://www.forbes.com/sites/halahtouryalai/2013/11/11/the-worlds-29-too-big-to-fail-banks-jpmorgan-at-the-top/
15 Fitch Ratings. *Business Development Companies: A comparative analysis: 2012 Special Report.* May 6, 2013. www.fitchratings.com
16 Arena, Matteo. Marquette University. *The Corporate Choice between Public Debt, Bank Loans, Traditional Private Debt Placements, and 144A Debt.* May 25, 2010.
http://epublications.marquette.edu/cgi/viewcontent.cgi?article=1028&context=fin_fac
http://citeseerx.ist.psu.edu/viewdoc/download?doi=10.1.1.8.1181&rep=rep1&type=pdf
17, 18 Fitch Ratings. Ibid.
19 Einhorn, David. 2010. *Fooling Some of the People All of the Time: A Long Short Story.* http://foolingsomepeople.com/main/

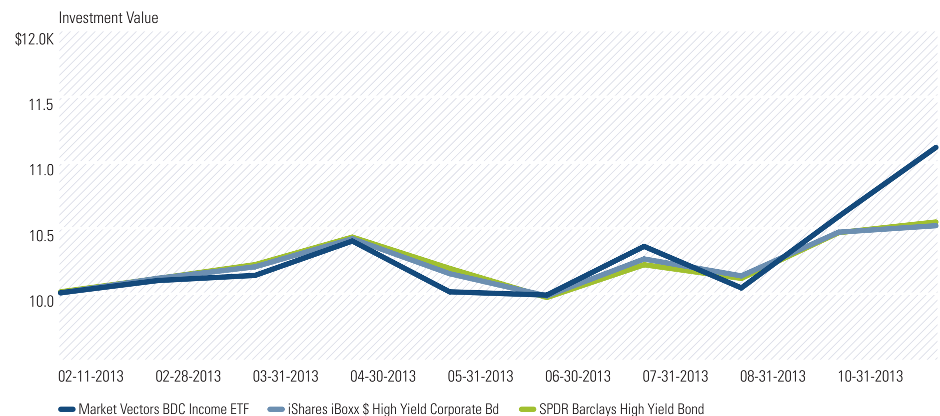
fines or require admission of wrongdoing.[20] Finally, between September 2008 and January 2009, the stock plummeted from $16 to less than $2, as one of its portfolio companies filed for bankruptcy and as Allied's management implied that it wouldn't be able to meet its dividend.[21] Allied was bought by Ares Capital for $4.99 a share in April 2010.[22]

What Is an Investor to Do?

Short of spending all day with an expert accountant, how is a typical investor supposed to access the benefits of BDCs without all of the risks? The answer to most investment riddles is diversification. UBS launched the UBS E-TRACS Wells Fargo Business Development Company ETN **BDCS** (as well as a two-times leveraged version) in mid-2011. Van Eck Global launched MarketVectors BDC Income ETF **BIZD** in February 2013. These products combine the top 26 listed BDCs by market cap and yield about 7%. By combining 26 BDCs, investors are getting exposure to both private equity and private debt, and they are limiting their risk to any one particular BDC blowup. (Of course, ETNs come with counterparty credit risk.) From its early February inception through the end of November 2013, MarketVectors BDC Income ETF returned 11.2%, more than double that of the two major high-yield bond exchange-traded funds (iShares iBoxx $ High Yield Corporate Bond **HYG** and the SPDR Barclays High Yield Bond **JNK**) for a slightly lower yield. See Exhibit 3.

Investors should be aware of two things related to these exchange-traded products, however. For one, they both add on another layer of fees to the already expensive BDC portfolio. MarketVectors BDC Income ETF tacks on about 0.40% after waivers, for a grand total of 8.33%, while UBS E-TRACS Wells Fargo Business Development Company ETN charges 85 basis points and doesn't include the underlying BDC costs in its expense ratio.

Exhibit 3: MarketVectors BDC Income ETF Growth of $10,000



Second, because of the illiquid and leveraged nature of the BDCs' underlying investments, it's highly possible that BDCs as a group will take a big hit during the next financial crisis. In 2008, for example, only one BDC made money (Prospect Capital Corporation **PSEC**) and some lost more than 80% (American Capital **ACAS** and MCG Capital **MCGC**). Therefore, investors seeking to invest in illiquid investments for a higher yield should be able to hold their investments for a very long time, long enough to recover from any potential crisis.

More Competition

For accredited investors, there are more-interesting private-debt options than BDCs—more specifically, those that buy short-term loans originated by a direct-lending platform. High-tech platforms like IOU Central make small- business lending fast and efficient; the application process takes about 10 minutes, and investors can get cash in a matter of days. IOU Central uses an algorithm, which looks at sources such as bank statements, the owner's personal credit history, and social media data to prequalify the loan.[23] From an investor's perspective, these loans are risky, but not as risky as they first appear. The approval rate is low, and the average term of the loan is less than one year, paid back on a daily basis. If the borrower defaults for just one day, the firm can take legal action. The reward, or interest paid, is also much higher—a stated interest rate of about 15%—because small businesses can't always get loans from banks and often need more than their credit card can offer. The borrowers are also charged a guarantee fee which amounts to another 10% yield in order to buffer against prepayment risk.[24]

With a $100,000 minimum, investors can access firms like Direct Lending Investments, which partner with platforms such as IOU Central to choose a geographically diversified portfolio of small-business loans that are somewhat seasoned. The fees for these types of private-debt limited partnership investments are slightly better than nontraded BDCs, with preferred return before which no management or performance fees are levied.[25] As with any limited partnership investment, investors are more at risk for fraud.

The Inefficient Frontier

Private debt, whether accessed through BDCs or other means, is not for everyone. Because the underlying investments are private and illiquid, they are prone to risks that public, regulated investments are not. Those that are willing to take on these risks, however, may reap larger rewards—especially before other investors pile in. M

20 "Allied Capital Settles S.E.C. Inquiry." Reuters. June 21, 2007. http://www.nytimes.com/2007/06/21/business/21allied.html
21 Morgenson, Gretchen. "Following Clues the S.E.C. Didn't." The New York Times. Jan. 31, 2009. http://www.nytimes.com/2009/02/01/business/01gret.html?pagewanted=1&_r=0
22 Switzky, Bryant Ruiz. "Allied Capital completes sale to Ares Capital." Washington Business Journal. April 1, 2010. http://www.bizjournals.com/washington/stories/2010/03/29/daily62.html
23, 24 www.ioucentral.com and discussions with the company management
25 http://www.dirlend.com/about-us/ and discussions with company management.

Quant Corner: Option-Selling Is Not Income

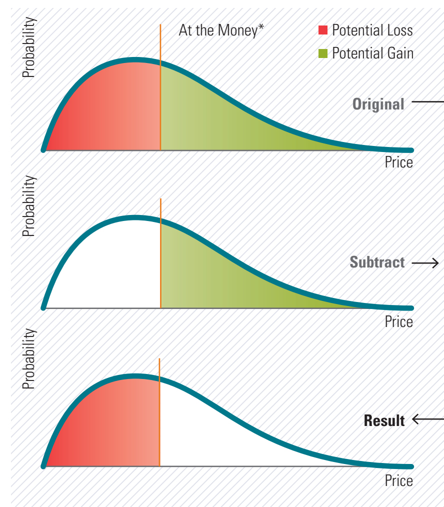
by
Philip Guziec, CFA

These days, income is the name of the game. A slew of covered-call mutual funds have emerged recently, advertising their option-selling strategies as ways to enhance the dividend income from an equity portfolio. Investors are often seduced by this idea, believing that the premium generated by covered calls is "free money" to spend on daily living needs, particularly in retirement. Investors who fall victim to this fallacy, however, may unwittingly be depleting their principal nest egg.

Covered-Call Characteristics

To understand why covered-call strategies are not sustainable income strategies, one must first understand the ins and outs of covered calls. A covered call is the simultaneous purchase of common stock and the sale of a call option on the same stock or index. If the underlying asset's price falls below the strike price of the option at expiration, the investor keeps the money he or she received for selling the option. If the underlying asset's price is above the strike of the option, the asset is called away, and the investor is paid the strike price. Thus, when the option expires, the covered-call position is worth, at most, the strike price of the option, plus the amount of premium received for the option. But it could be worth much less. The stock or index price could end up far below the strike price of the call option at expiration, meaning the investor has lost money (even after adding back the call premium received). It is this potential for loss of principal that makes a covered-call strategy a poor substitute for a retirement income strategy.

Exhibit 1



*Strike is the stock price

Depicting a covered call graphically can help add some insight. Exhibit 1 shows how an investor who owns a stock is exposed to both the red downside and the green upside of the stock price. A covered-call investor sells the upside for a cash payment, leaving only downside exposure. (Cash-secured short put options work the same way.)

Some investors also believe that, besides generating income, a covered-call strategy is useful for exiting a fully valued or overvalued stock position; they sell the call option in order to generate current income, and they don't mind if the underlying stock is called away. Such a belief reflects a lack of understanding of the covered call's risk profile, however. A covered call is a bullish strategy that an investor should use when he or she expects the position to rise in value to the strike price or, at the very least, to not decline below the strike price. If one believes a stock is fully valued or overvalued, a better decision is to sell the stock and look for another undervalued investment opportunity.

The Fallacy of Option Income

In theory, if stocks only rose and never fell, covered-call strategies could be fantastic income strategies. But in practice, the downside is frequently realized. When an investor sells an at-the-money covered call and spends all of the premium income, the "principal" is only safe when the underlying stock or index has risen

at expiration. If the underlying stock or index has fallen, the covered-call portfolio value effectively "ratchets down" because a new call option will be sold on the lower-priced asset that prevents any value recapture when the asset rebounds. This problem compounds when there are frequent or dramatic drawdowns.

Exhibit 2 below illustrates the problem with viewing covered calls as income. The exhibit shows the growth of $10,000 invested in both the S&P 500 Total Return and S&P 500 Price Return Indexes, as well as the CBOE S&P 500 BuyWrite Index (BXM)—a strategy that sells at-the-money call options on the S&P 500 every month and reinvests the premium—between June 2004 and April 2010 (the period of available data from the CBOE). It also shows a theoretical portfolio, labeled BXM Ex-Call Premium, in which the call-option premium is removed from the portfolio each month as if an investor were spending the income.

The S&P 500 and BXM generate similar levels of return, and the covered-call strategy reduces the magnitude of the peaks and valleys in the S&P 500 returns. However, the BXM Ex-Call Premium strategy clearly illustrates the ratcheting-down effect of spending the entire option premium. The portfolio value declined by 72% over this time period, whereas the BXM increased 3.3% because the return of capital prevented the BXM Ex-Call Premium strategy from capturing the upside of the market when it recovered in early 2009.

Exhibit 2: Growth of $10,000 of the S&P 500 and the BXM Indexes, With and Without Income Return

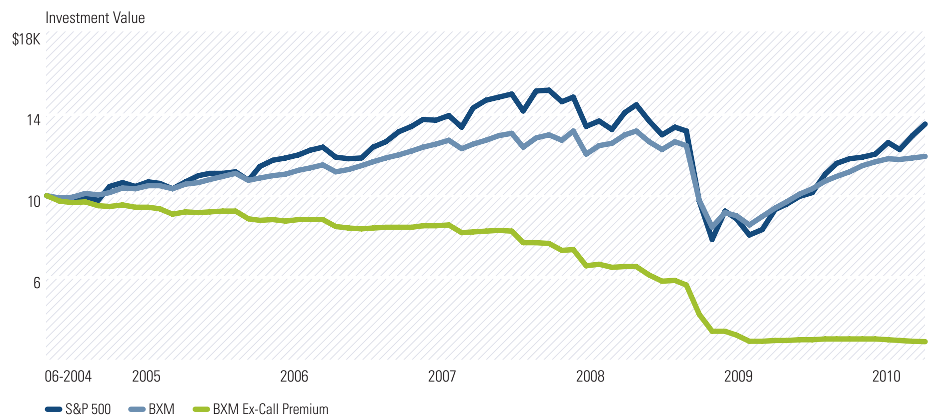


Exhibit 3: BXM Call Premium as a Percentage of Portfolio Assets, June 2004 to April 2010

Spending a Little of the Upside

The amount of premium generated by a covered-call strategy can be adjusted simply by adjusting the strike price. As the call's strike price increases relative to the underlying price, the amount of premium falls, as does the probability of producing a lower total return than holding the underlying index or stock outright. According to a Goldman Sachs report, selling one-month at-the-money S&P 500 Index options from January 1996 to December 2011 would have generated an annualized 27.6%, while a 5% out-of-the-money strategy would have generated 6.4% per month relative to the S&P 500's 6.6% return.[1] The out-of-the-money strategy's 6.4% return is still well in excess of the 4.0% value that is used as a rule of thumb for retirement planners. If one wanted to target 4.0% annualized option premium, one-month covered calls on the S&P 500 Index as of Sept. 18, 2013, would have to be struck approximately 12% out of the money.

However, option premium is highly variable, and always writing at-the-money or a certain percentage out-of-the-money call options doesn't guarantee a consistent income stream or total return, because even investors selling far out-of-the-money options are still giving up exposure to big rallies. Exhibit 3 below shows the monthly option premium as a percentage of portfolio value generated by BXM's at-the-money from June 2004 to April 2010. The high premiums seen in December 2008 may have seemed appealing, but consistently writing at-the-money options at that point would have meant missing the entire 2009 rally. Therefore, any covered-call strategy that spends even a little of the option premium still reduces the long-run total value of the portfolio. There is no free lunch.

The Income Obsession

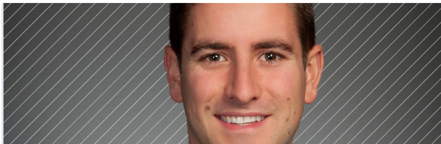
In fact, the very concept of an income-producing security is a fallacy. A dollar of return is a dollar of return, whether that return comes from capital gains, coupons, dividends, or option

1 Goldman Sachs Options Research. "Finding alpha: A 16 year study of S&P 500 index overwriting." Feb. 6, 2012.

premium. Christine Benz, Morningstar's director of personal finance, strongly advocates total-return strategies as opposed to income strategies and discusses http://news.morningstar.com/articlenet/article.aspx?id=577595 how to set up a retirement plan based on total return. That said, covered-call strategies may have their place in a total-return portfolio because they modestly reduce the volatility of a portfolio. For example, from its January 2004 inception until August 2013, the CBOE S&P 500 BuyWrite Index's standard deviation was 11.2% compared with 14.8% for the S&P 500 Index. For retired investors who withdraw a fixed and growing income stream from a portfolio, reducing volatility means reducing the risk of running out of funds. The National Association of Personal Financial Advisors has determined that reducing the volatility of a portfolio with a 10% expected return and a withdrawal rate equal to 6% of the starting value showed that reducing portfolio volatility from 20% to 10% reduces the risk of running out of money over 30 years from 23% to 1%!

Options are powerful tools for creating a desirable risk/return profile. The risk/return profiles created by option strategies can be useful for supporting withdrawal rates in retirement, but they should never be used for the sole purpose of generating income.

Morningstar Product Spotlight: Benchmarking Alternative Investments



by
A.J. D'Asaro
Alternative Investments Analyst

Widely accepted and easily accessible benchmarks make traditional stock- and bond-fund analysis relatively straightforward. Alpha, or manager skill, and beta, or market risk, are very easy to calculate. In alternatives, however, alpha is very difficult to measure, because the betas, and thus the benchmarks, are exotic and difficult to find. Take the common alternatives strategy of merger arbitrage, for example. This strategy earns a premium for taking on deal risk, or the risk that a merger will fail. A good merger-arbitrage benchmark would represent all of the target stocks in announced merger deals, with short positions in the related acquisitor stocks. Unfortunately, this benchmark does not exist. A few sponsors have created exchange-traded products tracking such a benchmark index (IQ Hedge, Credit Suisse, and ProShares, to name a few), but each index is different, and none are widely accepted.

So for alternatives investors, it's back to the Wild West. Until benchmarking technology catches up with the times, here are some best practices that can help one find an appropriate benchmark.

The Good

The good news is that not all alternatives funds have a benchmark problem. If a fund's R-squared (coefficient of determination) to a Morningstar Best Fit Index or prospectus benchmark is high, and the fund's holdings are similar to that benchmark, then the fund generally can be judged against it, using a risk-adjusted measure such as alpha or Sharpe ratio. The Morningstar Best Fit Index data point runs a series of simple regressions using about 150 different asset-class index benchmarks and selects the one with the highest R-squared over the past three years. Users of Morningstar Direct℠ can also pull up alpha and beta data points relative to this index.

For example, the GMO Global Asset Allocation III Fund **GMWAX** exhibits a 93% three-year R-squared to the MSCI All Country World Index, the fund's Morningstar Best Fit Index. This fund is not an alternatives fund because it doesn't take substantial short positions, but it is a tactical asset-allocation fund, which is sometimes just as difficult to benchmark as an alternatives fund. Looking at its holdings, its historical equity allocations are high (around 60%), with a leaning toward non-U.S. equity (up to about 50%) and its fixed-income allocations are low (10% or less). Therefore, a global-stock index benchmark makes some sense. The fund's alpha relative to the index is 4.0%, meaning it has outperformed the index on a risk-adjusted basis by 4 percentage points annualized.

There are three alternatives categories that are relatively easy to benchmark: long-short equity, nontraditional bond, and market neutral. Most long-short equity funds have a relatively high R-squared to the S&P 500 or other long-only equity-market indexes (if the fund is a small-cap fund, investors could use the Russell 2000, for example). Many nontraditional bond funds have a very high R-squared to high-yield-bond benchmarks. Most currency funds can be compared with the inverse U.S. Dollar Index, which tracks a long basket of five foreign currencies against the U.S. dollar. And finally, market-neutral funds generally can be benchmarked to the risk-free cash rate (three-month Treasuries or Libor, for example).

Investors must be aware, however, that non-market-neutral alternatives funds often list cashlike benchmarks, even if they are taking on significant market risk. In this case, it helps to check the correlation to the primary prospectus benchmark of a peer in the category, or the category benchmark itself. This can be found in Morningstar Direct℠ by going to "Global Databases" / "Funds/Managed Products" / "Category/Sector Avg" / "US Open-End

Categories", selecting "Edit Data," and finding the data point by name containing "MPT Benchmark." Users can save the alternatives category benchmarks to an investment list. More specific than the MPT Benchmark is the Analyst Assigned Benchmark, which can be found by selecting a fund in an investment list, clicking "Edit Data" and selecting the "Analyst Assigned Benchmark" data point. See Exhibit 1.

Exhibit 1: Morningstar Benchmarks for Alternatives Mutual Fund Categories

My Lists › MPT Benchmarks for Alts Categories

Action ▾ View Untitled | Save | Add | Edit Data | Sort | Locate | Export ▾ | PDF

Refresh

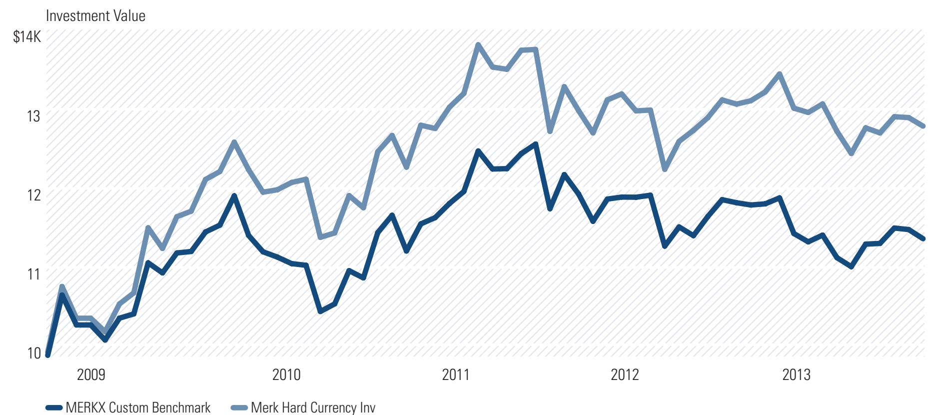
	Name	MPT Benchmark	Analyst Assigned Benchmark
1	US OE Bear Market	S&P 500 TR USD	S&P 500 TR USD
2	US OE Long/Short Equity	S&P 500 TR USD	S&P 500 TR USD
3	US OE Managed Futures	Credit Suisse Mgd Futures Liquid TR	Credit Suisse Mgd Futures Liquid TR
4	US OE Market Neutral	Barclays US Agg Bond TR USD	USTREAS T-Bill Auction Ave 3 Mon
5	US OE Multialternative	Morningstar Moderate Target Risk	Morningstar Moderate Target Risk
6	US OE Multicurrency	BofAML USD LIBOR 3 Mon CM	Morningstar Gbl Long/Short Currency
7	US OE Nontraditional Bond	Barclays US Agg Bond TR USD	BofAML USD LIBOR 3 Mon CM

The Bad

The bad news is that, just because a fund exhibits a high R-squared to a known benchmark, and it produces alpha relative to that benchmark, doesn't mean the manager has necessarily outperformed because of skill. It could mean that the benchmark is incomplete. For example, some leveraged-loan funds strategically allocate 10% of their portfolios to AAA rated corporate bonds, which have significantly less default and liquidity risk. This deviation allowed them to significantly outperform peers in 2008.
If the bond allocation is strategic (more or less a constant part of the portfolio), then those bank-loan funds should be judged against a benchmark that includes an allocation to investment-grade corporate bonds. A blended benchmark can be constructed in Morningstar Direct[SM] by going to "Portfolio Management" / "Custom Benchmarks."

To illustrate, Merk Hard Currency **MERKX** has a high R-squared (0.88) to its prospectus benchmark, the JPMorgan Global Bond Index, because the fund takes long positions in foreign currencies and short-term non-U.S. government bonds in the more stable currency markets. But the fund also holds a strategic allocation to gold that isn't reflected in its benchmark. Upon examining the fund's asset allocation or holdings over time, we find that a gold allocation has been permanent since inception, with allocations ranging from 8% to 15%. So we can roughly assume the fund's strategic allocation to gold is 10%. Reading the fund's literature and speaking with the fund's

Exhibit 2: MERKX Versus Custom Benchmark (90% UDN, 10% GLD)



management back up this observation.
Based on the strategy, we can create a custom benchmark of 90% PowerShares DB US Dollar Index Bearish Fund **UDN** and 10% SPDR Gold Shares **GLD** (rebalanced monthly), a benchmark that is both investable and exhibits a much higher correlation to the fund (92% over the past five years). Even after creating a better benchmark, we still find that this fund has outperformed over the past five years. See Exhibit 2.

The Ugly

Perhaps the funds most difficult to benchmark are in the multialternative category.
These funds are all over the map in terms of investment strategy. Some are multi-manager funds, and some are single manager. Some combine multiple long and short investment strategies, while others are long and short asset classes. Some are highly tactical, while others are less so. Yet, despite the heterogeneity, there is a single tie that binds—the traditional 60/40 portfolio. Essentially, multialternative funds all serve one purpose: to diversify a traditional portfolio—more specifically, the client's existing traditional portfolio. The problem is that, like many client portfolios, most multialternative funds have very high correlations to stocks. More than half of the 46 multialternative funds with a three-year track record registered a correlation to the S&P 500 of 0.80 or higher (through November), which means they are not really providing much in the way of diversification benefits. In that case, they are only beneficial if they can outperform a traditional or existing portfolio on a risk-adjusted basis (Morningstar Risk-Adjusted Return, Sharpe ratio, or Sortino ratio, for example). Unfortunately, during the past three years, only a couple of the 46 funds came close to outperforming the Sharpe ratio of a traditional 60% S&P 500 and 40% Barclays Aggregate Bond Index portfolio (rebalanced quarterly). High cost may be one of the causes; the average multiaternative fund

charges more than 2%.

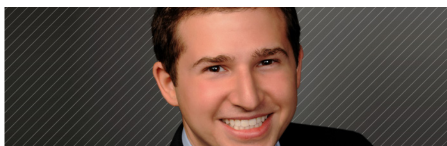
Conclusion

To summarize, here are some guidelines for benchmarking alternatives strategies:

1. If a fund exhibits a high R-squared to an asset-class index (0.80 or higher, for example), and the fund invests in assets similar to the index, then this index is a useful comparison benchmark on a risk-adjusted basis (alpha or Sharpe ratio, for example).
2. If a fund consistently deviates from a benchmark by underweighting or overweighting certain sectors, it's more accurate to construct a custom benchmark that includes those strategic deviations.
3. Multialternative funds should be benchmarked against the client's own portfolio or a 60/40 portfolio.

Industry Trends: Alternative Mutual Funds

What inning are alternative funds in, and what's the hedge fund advertising holdup?



by
By Josh Charney
Alternative Investments Analyst

Alternative Mutual Funds

The alternative mutual fund landscape is more mature and vastly more competitive than ever before. New players are desperately trying to break in as the assets keep growing. Just in 2013 (through November), 60 new funds launched. Not all can be winners. In the more developed categories such as long-short equity, the game is in the late innings, and investors have already decided who has won, as a few big players are soaking up the bulk of new money.

In order to attract attention, new entrants will have to advertise their distinctiveness. This presents a tricky situation, akin to standing out at a costume party on Halloween. The long-short equity category alone has almost 100 distinct mutual funds totaling approximately $47 billion in assets, up from $25 billion at the end of 2012. But almost all of the new assets landed in only 10 funds, most of which have three-year track records. So launching a similar "plain-vanilla" long-short equity fund (if the term exists) will not likely turn heads.

Take AQR Long-Short Equity **QLENX**, for example. A few short years ago, investors would have salivated over AQR, but not in this environment. The firm's new long-short equity mutual fund has received a lukewarm reception since its July 2013 opening; it stands at less than $6 million in assets, despite the strong category tailwinds. Calamos Long/Short **CALSX** is facing similar headwinds. Although Calamos is best known for convertibles, last year it acquired Gary Black's long-short hedge fund firm, Black Capital (Black is the former CEO of Janus). Since the new fund's June launch, it has fared somewhat better than the AQR fund, gaining $54 million in assets.

There is also a problem with bringing products to market that are too distinct, such as sector-focused funds. The more niche a fund's strategy is, the narrower its appeal. CBRE Clarion Long/Short **CLSIX** is one of the more successful sector-focused funds. It specializes in real estate and converted its long-short real estate hedge fund to a mutual fund in 2011, along with its decent track record.

In contrast with the long-short equity category, it is still early in the game for the multialternative category, and there are no clear market leaders. Over the last two years, 41 multialternative funds have launched, almost half of which have already passed the $100 million mark. In late 2011, John Hancock launched JHancock2 Global Absolute Return Strategies **JHAAX**, a fund subadvised by well-known U.K. multiasset manager Standard Life. That fund has raised $4.4 billion so far. In late 2012, Arden Alternative Strategies **ARDNX**, the first fund of big-name hedge fund managers, debuted and quickly catapulted to $1 billion. And in August 2013, Blackstone Alternative Multi-Manager **BXMMX** came out with a similar fund of better-known hedge fund managers and promptly raised $1 billion. Fund companies continue trying to one-up each other. The latest example, Franklin K2 Alternative Strategies **FAAAX**, launched in late 2013. As a result, pack leaders may quickly find themselves trailing a competitor's fiercer lineup.

Name recognition is paramount in the nontraditional bond category, even more so than in the multialternative category. The PIMCOs, JPMorgans, and Blackrocks of the world have a tight hold on assets. Other players are struggling to boost fanfare. Even Guggenheim, a firm recognized in the institutional fixed-income world, is struggling to break the $1 billion barrier after two years with Guggenheim Macro Opportunities **GIOAX**, despite its top-quartile return rank. In contrast, similarly ranked PIMCO Mortgage Opportunities **PMZAX** has raised $867 million in one year. It seems that firms like PIMCO are in the bottom of the ninth inning, while others are still trying to find the stadium. M

Fund Reports

Litman Gregory Masters Alternatives Strategies

by **Morningstar Analysts**

Advisor
Litman Gregory Fund Advisors LLC

Advisor Location
Larkspur, California

Assets Under Management
$676.1 million

Inception Date
Sept. 30, 2011

Investment Type
Mutual fund

Morningstar Category
Multialternative

Management
This fund is managed by Jeremy DeGroot, chief investment officer of Litman Gregory, and Ken Gregory, a trustee of the mutual fund trust. DeGroot joined Litman Gregory in 1999 and was promoted to partner in 2003. Previously, he worked for KPMG Peat Marwick as their economic consulting services manager and for the Law and Economics Consulting Group as a senior economist. Gregory co-founded Litman Gregory in 1987 and serves as president of the mutual fund advisor. Prior to founding his own firm, he was president of Williams Asset Management and a financial advisor for Bank of America's executive financial counseling group.

Strategy
This fund is intended to be a substitute for a traditional 60/40 traditional portfolio, with lower risk and better returns. This fund has four subadvisors and underlying strategies, which are similar to existing mutual funds: DoubleLine Opportunistic Income, managed by Jeffrey Gundlach; FPA Contrarian Opportunity, managed by Steven Romick, Brian Selmo, and Mark Landecker; Loomis Sayles Strategic-Alpha Fixed-Income, managed by Matt Eagan, Kevin Kearns, and Todd Vandam; and Water Island Capital Arbitrage Strategy, managed by John Orrico, Todd Munn, Roger Foltynowicz, and Gregg Loprete. The DoubleLine strategy focuses on nonagency RMBS (including alt-A securities) and agency MBS. The FPA strategy holds cash as a way to reduce risk in the portfolio of bottom-up, primarily large-capitalization U.S. stock picks. The Loomis Sayles strategy invests in high-yield bonds, bank loans, investment-grade corporates, securitized credits, sovereign bonds, and currencies. Finally, the Water Island Capital strategy incorporates some event-driven and credit arbitrage strategies (about 25%) into its flagship merger-arbitrage strategy.

Process
The strategic allocation is an equal weight to each of the four managers. Management has flexibility to tactically overweight or underweight this strategy by plus or minus 10 percentage points. The fund had an overweighting in DoubleLine (by 5 percentage points) from its inception through mid-2013 because of the firm's positive outlook in the mortgage sector. The team's macroeconomic outlook is informed by several outside resources, including Ned Davis Research.

There are seven research personnel dedicated to investment research at the firm, and two analysts are assigned to each subadvisor (one is the lead analyst). Most analysts are generalists, but one focuses more on international and emerging-markets equities. Any analyst can come up with an idea for a fund, and all decisions are vetted by the team. DeGroot makes the final decisions.

If the team is interested in a fund, they will contact the manager and send a request for proposal. Then the analysts will have a one-hour call with the manager. If the team approves the manager, they will conduct an onsite visit. The focus is a transparent, repeatable process and an investment edge. The team prefers managers who are more active and concentrated.

Risk Management
Once selected, the managers' performance is monitored against several benchmarks (market indexes, 60/40 portfolios, similar hedge fund strategies, and the managers' returns in other vehicles), and the portfolios are monitored for changes. For this fund, the team focuses on a manager's downside risk and drawdowns. M

Litman Gregory Master Alt Strats Instl (USD)

Standard Index	Category Index	Morningstar Cat
— US OE Multialternative	Morningstar Moderate Target Risk	Morningstar Moderate Target Risk

Performance 12-31-2013

Quarterly Returns	1st Qtr	2nd Qtr	3rd Qtr	4th Qtr	Total %
2011	—	—	—	3.41	—
2012	4.07	-0.19	3.58	1.69	9.41
2013	3.00	-0.18	0.98	2.41	6.32

Trailing Returns	1 Yr	3 Yr	5 Yr	10 Yr	Incept
Load-adj Mthly	6.32	—	—	—	8.55
Std 12-31-2013	6.32	—	—	—	8.55
Total Return	6.32	—	—	—	8.55
+/- Std Index	-7.98	—	—	—	—
+/- Cat Index	-7.98	—	—	—	—
% Rank Cat	32	—	—	—	
No. in Cat	268	—	—	—	

	Subsidized	Unsubsidized
7-day Yield	—	—
30-day SEC Yield	—	—

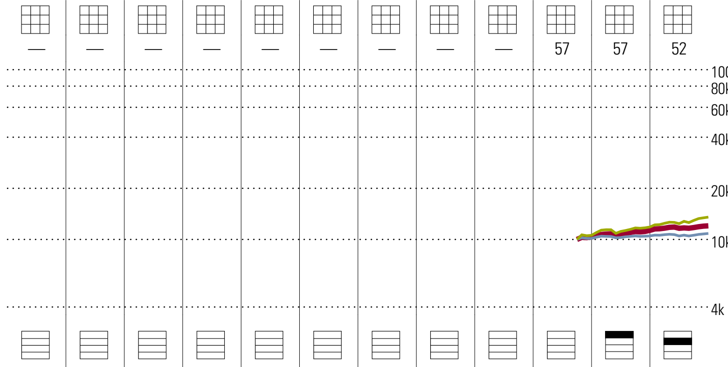
Performance Disclosure

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

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

Current performance may be lower or higher than return data quoted herein. For performance data current to the most recent month-end, please call 800-960-0188 or visit www.mastersfunds.com.

Investment Style	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	12-13
Fixed-Income Bond %	—	—	—	—	—	—	—	—	—	57	57	52



Performance Quartile (within category)

History	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	12-13
NAV/Price	—	—	—	—	—	—	—	—	—	10.32	11.01	11.42
Total Return %	—	—	—	—	—	—	—	—	—	—	9.41	6.32
+/- Standard Index	—	—	—	—	—	—	—	—	—	—	-2.63	-7.98
+/- Category Index	—	—	—	—	—	—	—	—	—	—	-2.63	-7.98
% Rank Cat	—	—	—	—	—	—	—	—	—	—	15	32
No. of Funds in Cat	—	—	—	—	—	—	—	—	—	—	203	268

Fees and Expenses

Sales Charges

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

Fund Expenses

Management Fees %	1.40
12b1 Expense %	NA
Net Expense Ratio %	**1.49**
Gross Expense Ratio %	**1.91**

Risk and Return Profile

	3 Yr 140 funds	5 Yr 92 funds	10 Yr 5 funds
Morningstar Rating™	—	—	—
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	—
Potential Cap Gains Exp	5.63%

Portfolio Analysis 09-30-2013

Asset Allocation %	Net %	Long %	Short %
Cash	2.58	2.58	0.00
US Stocks	24.42	30.62	6.20
Non-US Stocks	10.94	11.75	0.81
Bonds	50.80	60.82	10.02
Other/Not Clsfd	11.26	11.51	0.25
Total	100.00	117.29	17.29

Equity Style (Value Blend Growth; Large Mid Small)

Portfolio Statistics	Port Avg	Rel Index	Rel Cat
P/E Ratio TTM	20.1	1.24	1.22
P/C Ratio TTM	10.6	1.12	1.04
P/B Ratio TTM	2.1	1.03	1.01
Geo Avg Mkt Cap $mil	8554	0.35	0.39

Fixed-Income Style (Ltd Mod Ext; High Med Low)

Avg Eff Maturity	—
Avg Eff Duration	—
Avg Wtd Coupon	—
Avg Wtd Price	88.36

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

Regional Exposure	Stock %	Rel Std Index
Americas	77.7	1.08
Greater Europe	19.0	1.20
Greater Asia	3.3	0.27

Share Chg since 06-2013	Share Amount	Holdings: 681 Total Stocks , 476 Total Fixed-Income, 161% Turnover Ratio	% Net Assets
☼	139,446	Sourcefire, Inc.	2.06
☼	10 mil	B12 Cds Usd R V 00mevent	1.98
☼	10 mil	B12 Cds Usd P F 5.00000	-1.98
☼	10 mil	B5 Cds Usd P F 1.00000	-1.87
☼	10 mil	B5 Cds Usd R V 00mevent	1.85
⊕	220,522	NYSE Euronext, Inc.	1.80
⊕	98,792	Life Technologies Corp	1.44
⊕	37,559	IntercontinentalExchange, Inc.	-1.32
⊖	60,043	M&T Bank Corp	-1.31
⊖	714,486	Hudson City Bancorp, Inc.	1.26
☼	126,376	Harris Teeter Supermarkets Inc	1.21
⊕	395,942	Elan Corp PLC ADR	1.20
⊕	180,409	Lender Processing Services, Inc.	1.17
⊕	175,654	Microsoft Corporation	1.14
⊕	7 mil	FNMA CMO 3%	1.12

Sector Weightings	Stocks %	Rel Std Index
Cyclical	**33.0**	**0.84**
Basic Materials	1.4	0.25
Consumer Cyclical	10.4	0.90
Financial Services	19.4	1.07
Real Estate	1.9	0.50
Sensitive	**38.4**	**1.02**
Communication Services	5.3	1.36
Energy	4.2	0.47
Industrials	7.7	0.61
Technology	21.2	1.72
Defensive	**28.6**	**1.23**
Consumer Defensive	10.1	1.15
Healthcare	18.2	1.77
Utilities	0.3	0.07

Operations

Family:	Litman Gregory Masters Funds	Ticker:	MASFX	Incept:	09-30-2011
Manager:	Multiple	Minimum Initial Purchase:	$100,000	Type:	MF
Tenure:	2.3 Years	Min Auto Investment Plan:	$2,500	Total Assets:	$713.94 mil
Objective:	Growth and Income	Minimum IRA Purchase:	$5,000		
Base Currency:	USD	Purchase Constraints:	—		

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MORNINGSTAR®

Fund Reports

361 Managed Futures Strategy

by **Morningstar Analysts**

Advisor
361 Capital LLC

Advisor Location
Denver, Colorado

Assets Under Management
$476.6 million

Inception Date
Dec. 20, 2011

Investment Type
Mutual fund

Morningstar Category
Managed futures

Management
This fund is managed by Brian Cunningham, president and chief investment officer of 361 Capital. Cunningham founded 361 Capital in 2001 (then Trail Ridge Capital) and at that time ran a multistrategy hedge fund of funds and a market-neutral fund. Between 1996 and 2007, Cunningham worked for Innovest Portfolio Solutions, an investment consultant and wealth management firm. Cunningham is supported by Blaine Rollins, senior portfolio manager and member of the investment committee; Tom Florence, chief executive officer and member of the investment committee; Jeremy Frank, head of quantitative analysis; and two analysts. Rollins helped manage several funds at Janus.

Strategy

This systematic, price-driven fund follows a counter-trend mean-reversion strategy using futures contracts on the Nasdaq-100, S&P 500, and Russell 1000 Indexes. This strategy works best in oscillating markets. If the model determines there is enough volatility to trade, it will take a long or short 100% notional position in equity futures contracts. If the market is not volatile enough, the fund is invested in money market funds and fixed-income exchange-traded funds. The fund is 100% invested in cash and fixed income 75% of the time. The average trade lasts 2.5 days.

Process

First, a filter looks at pricing extremes in Nasdaq-100 futures contracts over the last few weeks. If the dispersion is high enough (typically if a correction has occurred), the model will look at two different signals to determine a long or short position. The first signal determines if the current price is below (above) the mean closing price over two short-term periods (several days and a few weeks). If this is the case, the fund will take a long (short) position in equity futures. The second looks at the medium-term performance (several months) versus the short-term performance (a few weeks). If the return over the medium-term period is higher (lower) than the return over the short-term period, the model predicts that the upward (downward) trend is ending and it will take a short (long) contrarian position. Both signals must agree on the direction in order to take a position. All trades are done at the close of the day, because that's when the liquidity is the highest.

Risk Management

In order to diversify against liquidity risk, the firm may also trade S&P 500 and Russell 1000 equity-index futures contracts, which are highly correlated to the Nasdaq-100 futures contracts. Management does not use stop losses, as it believes stop losses detract from this strategy's returns more than they protect against risk.

Release date 12-31-2013

361 Managed Futures Strategy A (USD)

Standard Index	Category Index	Morningstar Cat
—	Credit Suisse Mgd Futures Liquid TR USD	Credit Suisse Mgd Futures Liquid TR USD
US OE Managed Futures		

Performance 12-31-2013

Quarterly Returns	1st Qtr	2nd Qtr	3rd Qtr	4th Qtr	Total %
2011	—	—	—	—	—
2012	-0.41	8.04	0.38	2.92	11.17
2013	-1.28	5.74	0.26	-1.78	2.80

Trailing Returns	1 Yr	3 Yr	5 Yr	10 Yr	Incept
Load-adj Mthly	-3.12	—	—	—	3.01
Std 12-31-2013	-3.12	—	—	—	3.01
Total Return	2.80	—	—	—	6.05
+/- Std Index	-4.69	—	—	—	—
+/- Cat Index	-4.69	—	—	—	—
% Rank Cat	30	—	—	—	
No. in Cat	134	—	—	—	

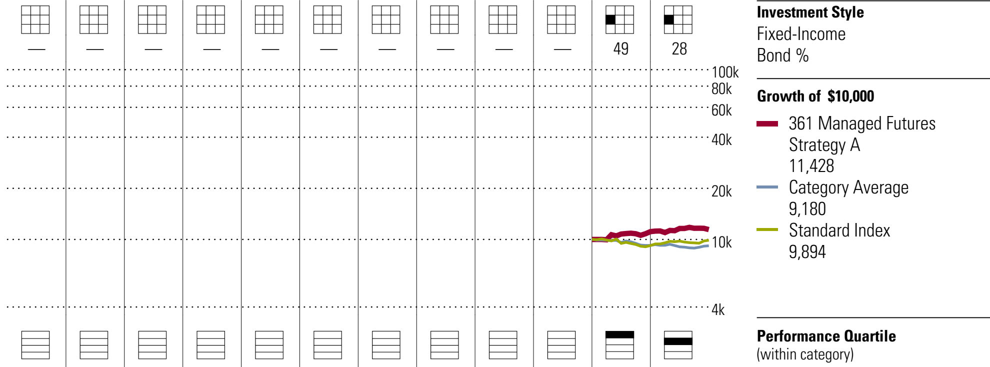
	Subsidized	Unsubsidized
7-day Yield	—	—
30-day SEC Yield	—	—

Performance Disclosure

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

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

Current performance may be lower or higher than return data quoted herein. For performance data current to the most recent month-end, please call 888-736-1227 or visit www.361funds.com.



Investment Style
Fixed-Income
Bond %

Growth of $10,000
361 Managed Futures Strategy A
11,428
Category Average
9,180
Standard Index
9,894

Performance Quartile
(within category)

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	12-13	History
	—	—	—	—	—	—	—	—	—	*9.86*	10.95	10.86	NAV/Price
	—	—	—	—	—	—	—	—	—	—	11.17	2.80	Total Return %
	—	—	—	—	—	—	—	—	—	—	19.12	-4.69	+/- Standard Index
	—	—	—	—	—	—	—	—	—	—	19.12	-4.69	+/- Category Index
	—	—	—	—	—	—	—	—	—	—	2	30	% Rank Cat
	—	—	—	—	—	—	—	—	—	—	100	134	No. of Funds in Cat

Fees and Expenses

Sales Charges

Front-End Load %	**5.75**
Deferred Load %	**NA**

Fund Expenses

Management Fees %	1.50
12b1 Expense %	0.25
Net Expense Ratio %	**2.40**
Gross Expense Ratio %	**2.69**

Risk and Return Profile

	3 Yr *40 funds*	5 Yr *4 funds*	10 Yr —
Morningstar Rating™	—	—	—
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	—
Potential Cap Gains Exp	0.92%

Portfolio Analysis 10-31-2013

Asset Allocation % 07-31-2013	Net %	Long %	Short %
Cash	58.50	58.79	0.29
US Stocks	0.00	0.00	0.00
Non-US Stocks	0.00	0.00	0.00
Bonds	40.72	40.72	0.00
Other/Not Clsfd	0.78	0.80	0.01
Total	100.00	100.30	0.30

Equity Style

Value Blend Growth / Large Mid Small

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

Fixed-Income Style

Ltd Mod Ext / High Med Low

Avg Eff Maturity	1.26
Avg Eff Duration	1.88
Avg Wtd Coupon	—
Avg Wtd Price	102.71

Credit Quality Breakdown 10-31-2013	Bond %
AAA	80.66
AA	3.61
A	6.97
BBB	6.36
BB	0.12
B	0.01
Below B	0.00
NR	2.26

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

Share Chg since 07-2013	Share Amount	Holdings: 0 Total Stocks , 1,813 Total Fixed-Income, 2% Turnover Ratio	% Net Assets
	656,540	iShares 1-3 Year Treasury Bond	11.95
	461,220	PIMCO Enhanced Short Maturity ETF	10.08
	200,633	iShares 1-3 Year Credit Bond	4.56
	109,781	iShares MBS	2.52
	104,797	iShares 0-5 Year TIPS Bond	2.29
	92,000	PIMCO 1-5 Year US TIPS Index ETF	1.05

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	—	—

Operations

Family:	361 Funds	Base Currency:	USD	Purchase Constraints:	—
Manager:	Multiple	Ticker:	AMFQX	Incept:	12-20-2011
Tenure:	2.1 Years	Minimum Initial Purchase:	$2,500	Type:	MF
Objective:	Income	Minimum IRA Purchase:	$2,500	Total Assets:	$499.91 mil

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MORNINGSTAR®

Fund Reports

Crow Point Hedged Global Equity Income

by **Morningstar Analysts**

Advisor
Crow Point Partners LLC

Advisor Location
Hingham, Massachusetts

Assets Under Management
$9.3 million

Inception Date
June 4, 2012

Investment Type
Mutual fund

Morningstar Category
Long-short equity

Management
This fund is managed by Timothy O'Brien and Peter DeCaprio, who co-founded Crow Point Partners in 2006. O'Brien serves as the co-chief investment officer, along with Amit Chandra, who joined the firm in 2012. O'Brien currently subadvises the Wells Fargo Advantage Utility and Telecommunications Fund **EVUAX** and has worked on utilities funds for Eaton Vance and Gabelli. DeCaprio is the firm's chief risk officer and head of trading. He previously worked at Evergreen Investments and Thomas Weisel Partners as a senior equity analyst. Prior to joining Crow Point, Chandra was the chief investment officer of Golden Capital Management, a subsidiary of Wells Fargo, and a senior portfolio manager for Evergreen Investments.
Jay Hickman, formerly of Absolute Investment Advisors, joined in 2013.

Strategy

This fund writes index and single-name calls and puts to generate income, and buys index and single-name puts to hedge a portfolio of approximately 60 to 80 large-cap high-dividend-yield stocks in the U.S., other developed markets, and emerging markets. Up to 20% of the portfolio can be invested in preferred stocks and closed-end funds. The goal is an annual yield of 5% to 7% net of fees, with a 5% to 7% annualized standard deviation.

Process

The underlying portfolio is optimized to have a 4% tracking error to the MSCI ACWI. The portfolio is selected according to a quantitative model, which first screens out the smaller, less liquid, low-yielding stocks from the MSCI ACWI. Then the model seeks the stocks with the highest alpha score, which is a combination of valuation, sentiment, quality (which according to management means high payout ratios, growing dividends, high return on equity, high profit markets, and high debt-service ratios), and momentum factor weights. The investment team then qualitatively reviews those stocks.

The portfolio is always hedged, typically with at-the-money puts. The firm attempts to buy longer-dated puts, typically six months to expiration, when the price is right. Management sometimes engages in put spreads to reduce the hedging costs. Calls and puts are sold beyond the dividend date for the underlying stocks about 50% of the time. Calls are sold more frequently to protect gains after the underlying stocks have rallied (to minimize taxes) and when there are higher premiums. When the portfolio rallies, management moves the put hedges such that the strike prices are set higher and the maturity date is extended. Most long put positions are offset prior to expiration.

Management attempts to reduce transaction costs through commission recapture credits, which management does not use to buy research, but rather to help reduce the fund's expenses.

Risk Management

Management sells stocks in the portfolio if they are contributing a disproportionate amount of risk, or if their alpha scores are declining. Management may also sell if there is an extreme event (the fund sold out of its positions in Turkish stocks, for example, in reaction to the riots).

The fund may also hedge out other risks from time to time. In May 2013, for example, the fund had a small position in the ProShares Short 7–10 Year Treasury TBX exchange-traded fund.

Crow Point Hedged Global Equity Inc A (USD)

Standard Index	Category Index	Morningstar Cat
— US OE Long/Short Equity	S&P 500 TR USD	S&P 500 TR USD

Performance 12-31-2013

Quarterly Returns	1st Qtr	2nd Qtr	3rd Qtr	4th Qtr	Total %
2011	—	—	—	—	—
2012	—	—	0.80	0.80	—
2013	1.69	-0.98	1.95	2.02	4.74

Trailing Returns	1 Yr	3 Yr	5 Yr	10 Yr	Incept
Load-adj Mthly	2.38	—	—	—	2.61
Std 12-31-2013	2.38	—	—	—	2.61
Total Return	4.74	—	—	—	4.10
+/- Std Index	-27.65	—	—	—	—
+/- Cat Index	-27.65	—	—	—	—
% Rank Cat	86	—	—	—	
No. in Cat	241	—	—	—	

	Subsidized	Unsubsidized
7-day Yield	—	—
30-day SEC 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 855-754-7940 or visit www.crowpointpartners.com.

Fees and Expenses

Sales Charges

Front-End Load %	**2.25**
Deferred Load %	**NA**

Fund Expenses

Management Fees %	0.88
12b1 Expense %	0.25
Net Expense Ratio %	**1.27**
Gross Expense Ratio %	**5.01**

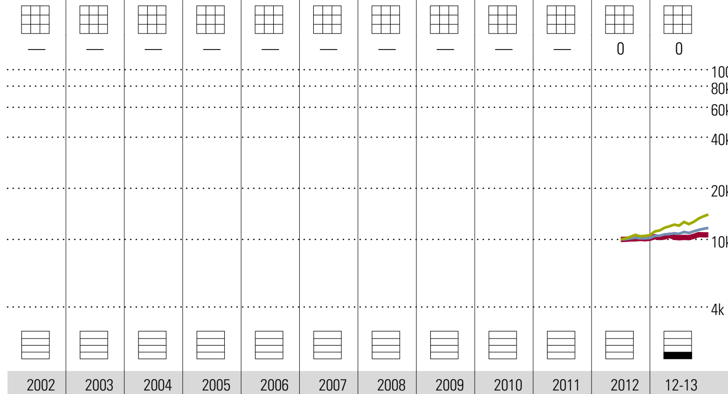
Risk and Return Profile

	3 Yr 139 funds	5 Yr 75 funds	10 Yr 26 funds
Morningstar Rating™	—	—	—
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	—
Potential Cap Gains Exp	0.14%



Investment Style
Fixed-Income
Bond %

Growth of $10,000
- Crow Point Hedged Global Equity Inc A 10,643
- Category Average 11,692
- Standard Index 14,027

Performance Quartile (within category)

2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	12-13	History
—	—	—	—	—	—	—	—	—	—	10.03	10.21	NAV/Price
—	—	—	—	—	—	—	—	—	—	—	4.74	Total Return %
—	—	—	—	—	—	—	—	—	—	—	-27.65	+/- Standard Index
—	—	—	—	—	—	—	—	—	—	—	-27.65	+/- Category Index
—	—	—	—	—	—	—	—	—	—	—	86	% Rank Cat
—	—	—	—	—	—	—	—	—	—	—	241	No. of Funds in Cat

Portfolio Analysis 08-31-2013

Asset Allocation %	Net %	Long %	Short %
Cash	2.43	2.43	0.00
US Stocks	34.28	34.28	0.00
Non-US Stocks	39.43	39.43	0.00
Bonds	-0.02	0.00	0.02
Other/Not Clsfd	23.88	24.66	0.78
Total	100.00	100.80	0.80

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

Portfolio Statistics	Port Avg	Rel Index	Rel Cat
P/E Ratio TTM	11.9	0.64	0.67
P/C Ratio TTM	5.8	0.52	0.55
P/B Ratio TTM	1.5	0.57	0.65
Geo Avg Mkt Cap $mil	15135	0.23	0.37

Fixed-Income Style (Ltd / Mod / Ext; High / Med / Low)

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

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

Regional Exposure	Stock %	Rel Std Index
Americas	49.4	0.50
Greater Europe	34.2	19.13
Greater Asia	16.3	—

Share Chg since 05-2013	Share Amount	Holdings: 59 Total Stocks , 32 Total Fixed-Income, 160% Turnover Ratio	% Net Assets
⊕	3,050	Eli Lilly and Company	2.53
⊕	6,200	Ashford Hosptlty Tr Pfd	2.53
⊕	5,900	Newcastle Invt Corp New Pfd	2.47
⊕	4,600	CenturyLink Inc	2.46
⊕	8,800	R.R. Donnelley & Sons Company	2.37
⊖	2,900	Reynolds American Inc	2.23
☼	5,350	Vanguard Nat Res Pfd	2.21
☼	306,100	Bank Of China Ltd. H Shares	2.08
☼	1,700	Novartis AG ADR	2.00
⊕	1,430	WellPoint Inc	1.96
⊕	4,200	National Australia Bank Limited	1.96
⊕	10,500	VimpelCom Ltd ADR	1.82
⊖	900	Lockheed Martin Corporation	1.78
☼	38,455	Fisher & Paykel Healthcare Corpora	1.72
⊕	21,000	Resolution Ltd	1.67

Sector Weightings	Stocks %	Rel Std Index
Cyclical	**25.2**	**0.80**
Basic Materials	1.4	0.42
Consumer Cyclical	5.3	0.47
Financial Services	16.1	1.05
Real Estate	2.4	1.38
Sensitive	**41.0**	**0.97**
Communication Services	14.4	4.03
Energy	6.4	0.62
Industrials	15.5	1.33
Technology	4.7	0.28
Defensive	**33.7**	**1.30**
Consumer Defensive	3.0	0.29
Healthcare	16.5	1.29
Utilities	14.2	5.00

Operations

Family:	Crow Point Partners, LLC	Base Currency:	USD	Purchase Constraints:	—
Manager:	Multiple	Ticker:	CGHAX	Incept:	06-04-2012
Tenure:	1.6 Years	Minimum Initial Purchase:	$2,500	Type:	MF
Objective:	Equity-Income	Min Auto Investment Plan:	$250	Total Assets:	$9.99 mil

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MORNINGSTAR®

Flows and Assets Under Management: Alternative Mutual Funds

Quarterly Alternative Mutual Fund Flows

During the second quarter of 2013, alternative mutual funds net inflows amounted to nearly $26.4 billion, an increase of $4.4 billion over the previous quarter and $25 billion over the second quarter of 2012. The nontraditional bond category led the second quarter with the largest inflows of $15.8 billion, adding to the previous inflow of $12.6 billion in the first quarter of 2013. The long-short equity and multialternative categories also saw substantial net inflows of $4.4 and $2.3 billion, respectively. All categories saw inflows, but the multicurrency category received the least—only $97 million.

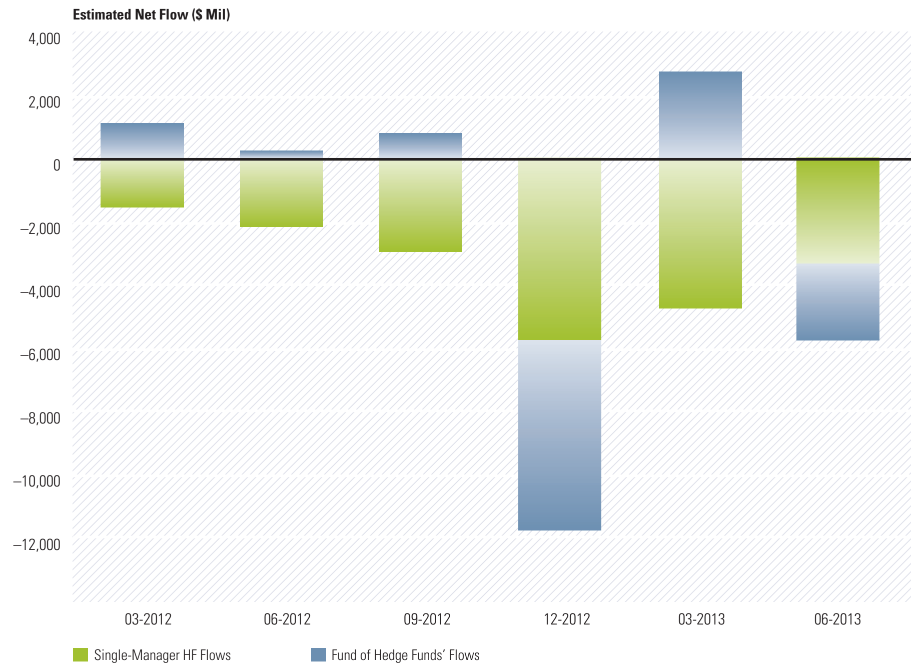
Quarterly Alternative Mutual Fund Assets Under Management

Assets under management for all alternative mutual funds increased 14% quarter over quarter, totaling more than $205 billion at the end of June 2013. All alternative mutual fund categories gained assets in the first quarter, with the exception of multicurrency. Nontraditional bond funds experienced the largest quarter-over-quarter percentage increase in assets (18%). The nontraditional bond category is the largest alternative mutual fund category by far, with $90.6 billion as of June 2013, while the bear-market category remains the smallest, at $9.3 billion.

Flows and Assets Under Management: Hedge Funds

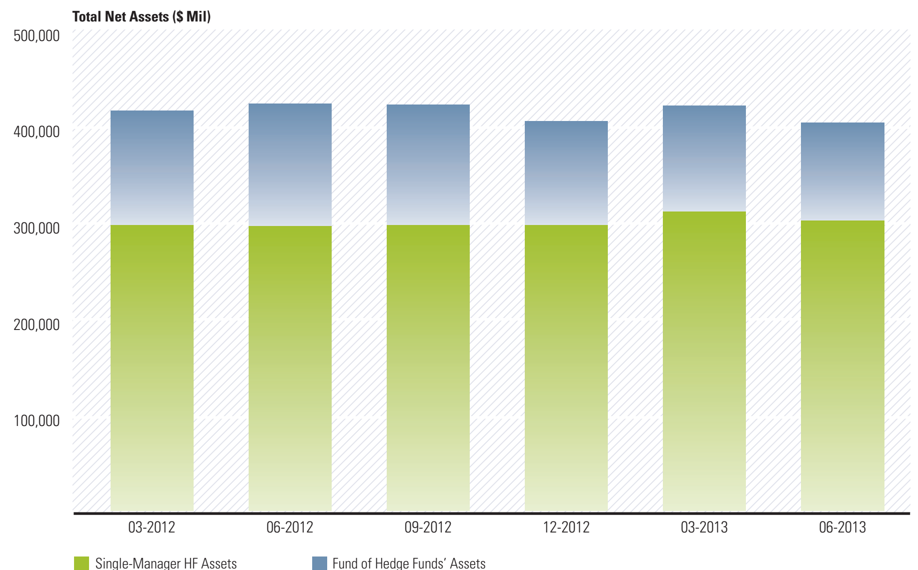
Quarterly Hedge Fund Flows

During the second quarter of 2013, single-manager hedge funds in Morningstar's database experienced outflows totaling $2.4 billion, and funds of hedge funds recorded outflows of almost $3.3 billion. Funds of hedge funds' outflows over the past six consecutive quarters have amounted to more than $24 billion. Over the past six quarters, multistrategy and global macro single-manager hedge funds received the most inflows ($4.2 and $3.3 billion, respectively), while systematic futures single-manager hedge funds have experienced the largest outflows of $7.6 billion. Debt arbitrage single-manager hedge funds experienced the greatest inflows ($0.6 billion) in the second quarter of 2013. The long-short debt hedge fund category is the only one with six consecutive quarters of inflows through June 2013.



Quarterly Hedge Fund Assets Under Management

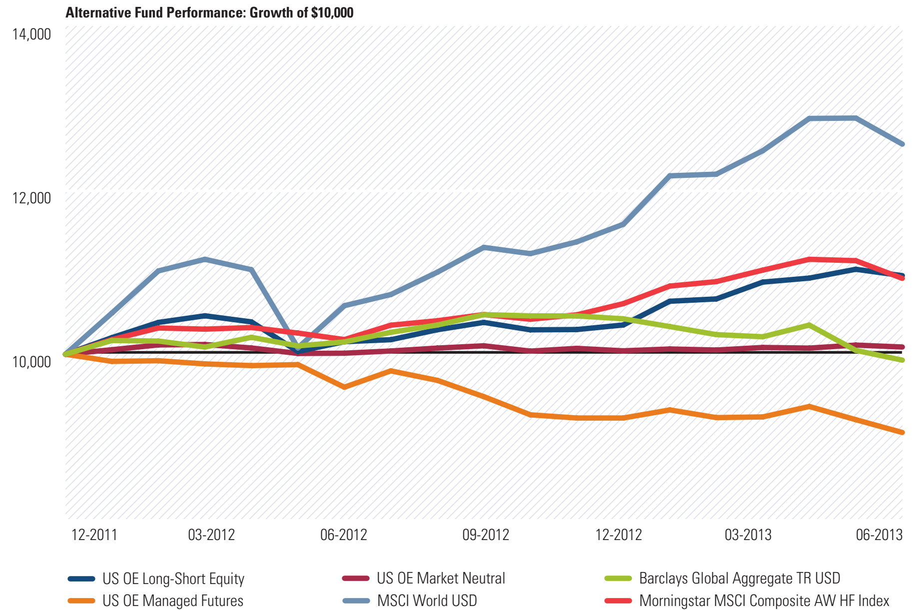
In the second quarter of 2013, single-manager hedge fund assets under management in Morningstar's database decreased 3% quarter over quarter, to $302 billion. During the last year (through June 30, 2013), single-manager assets under management have increased by a small margin (1.8%). Funds of hedge funds in Morningstar's database managed 7.3% fewer assets than in the prior quarter, with $102 million in assets recorded as of June 30, 2013. Assets under management of funds of hedge funds have dropped nearly 20% year over year (through June).



Alternative Investment Performance

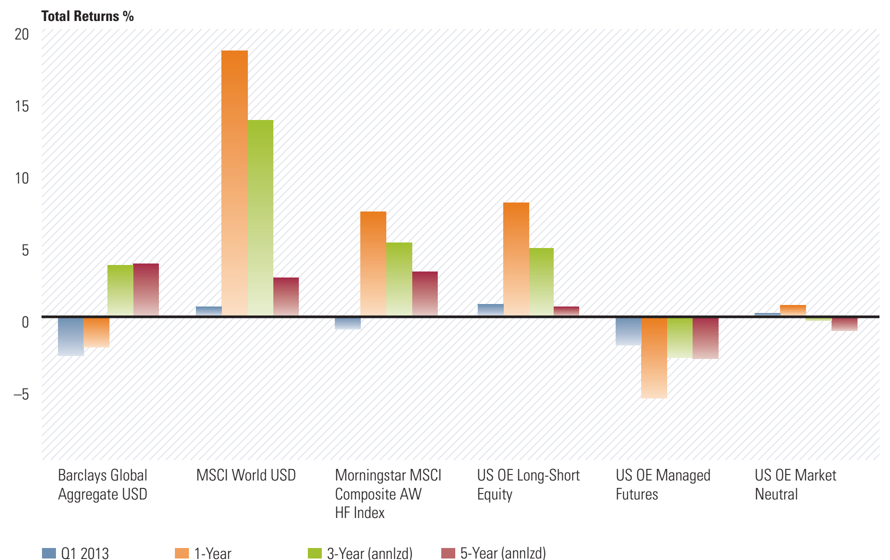
Growth of a $10,000 Alternative Investment

Hedge funds, as proxied by the Morningstar MSCI Composite AW Hedge Fund Index, lost 2.2% in the second quarter of 2013, while global stocks, as represented by the MSCI World NR Index, gained 0.65%. Global bonds, as tracked by the Barclays Global Aggregate TR Index, recorded a loss of 2.8%. Over the 18 months ended June 2013, the MSCI World NR Index substantially outperformed both global bonds and hedge funds with a 16.4% climb. Over the same period, the Barclays Global Aggregate TR USD Index fell 0.5%, while the Morningstar MSCI Composite AW Hedge Fund Index jumped 6.1%. The average long-short equity mutual fund slightly outperformed the hedge fund index over the same 18-month period, while managed-futures mutual funds saw dramatic losses on average (6.5%).



Performance of Alternative Investments Over Time

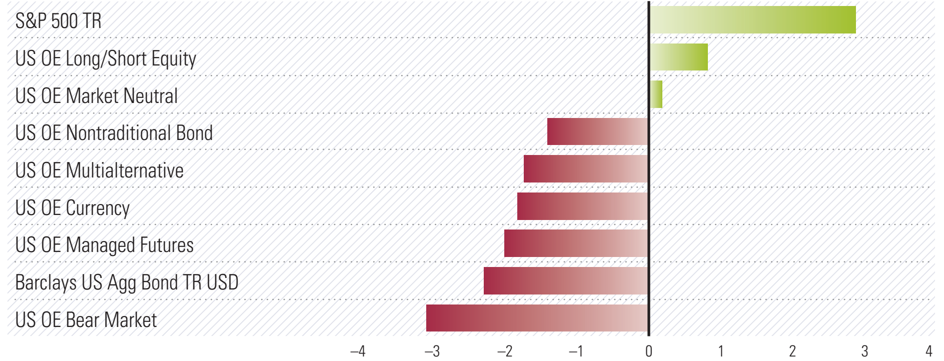
Hedge funds, as represented by the Morningstar MSCI Composite AW Hedge Fund Index, outperformed global bonds (as represented by the Barclays Global Aggregate TR Index) over the past one- and three-year time frames (ended June 30, 2013). Hedge funds have outperformed stocks over the past five years, but not over the past one- and three-year periods. Managed-futures mutual funds landed in the red in the second quarter of 2013 (down 2.0%) and have lost money on average over the past one, three, and five years, underperforming the long-short equity and market-neutral mutual fund category averages. Market-neutral mutual funds have underperformed bonds over the past three and five years, but have outperformed over the past quarter and 12-month periods (ended June 30, 2013).



Q2 Performance by Category

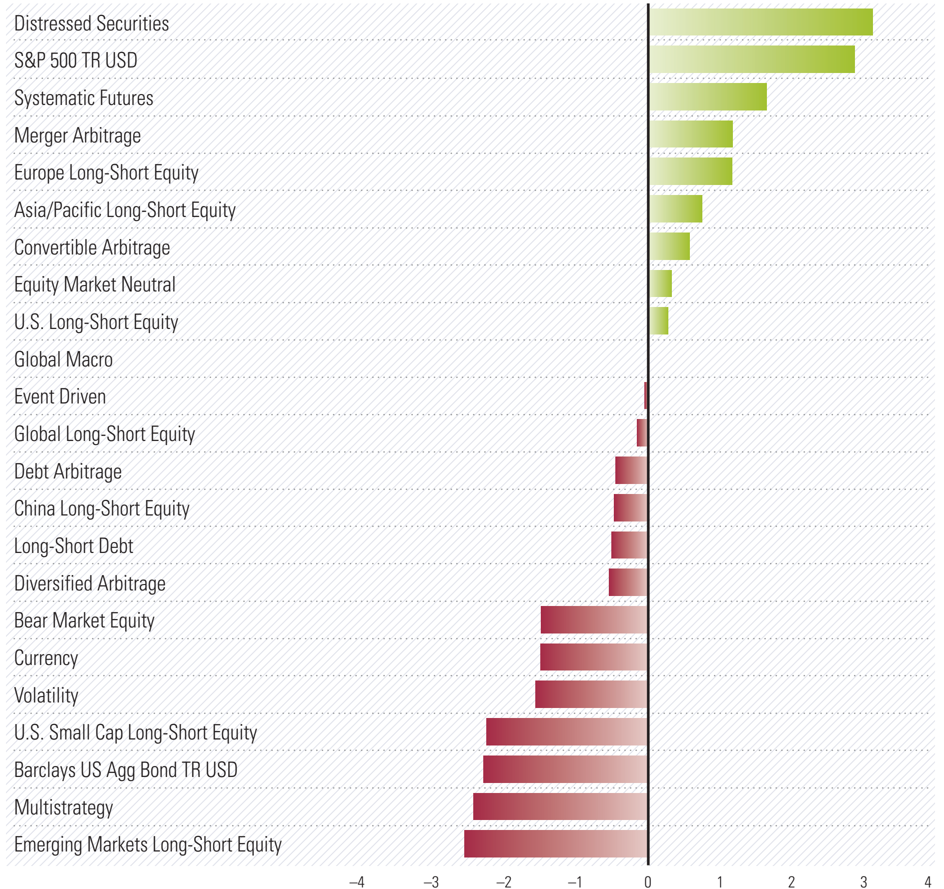
Alternative Mutual Funds

U.S. equities, as represented by the S&P 500, rallied 2.9% during the second quarter of 2013. Long-short equity mutual funds, which hedge out some stock-market exposure, gained 0.8% on average in the second quarter, the biggest gain among all the U.S. open-end mutual fund category averages. The average bear-market mutual fund, which aims to profit during weak equity markets, saw a significant loss of 3.1% in the second quarter of 2013. The Barclays U.S. Aggregate Bond Index saw a large decline (2.3%) in the second quarter because of rising interest rates, but nontraditional bond funds, which hedge interest-rate risk, managed smaller losses on average (1.4%). Multicurrency funds, which generally short the U.S. dollar, lost 1.9% on average. Multialternative mutual funds lost an average of 1.76% in the second quarter.



Hedge Funds

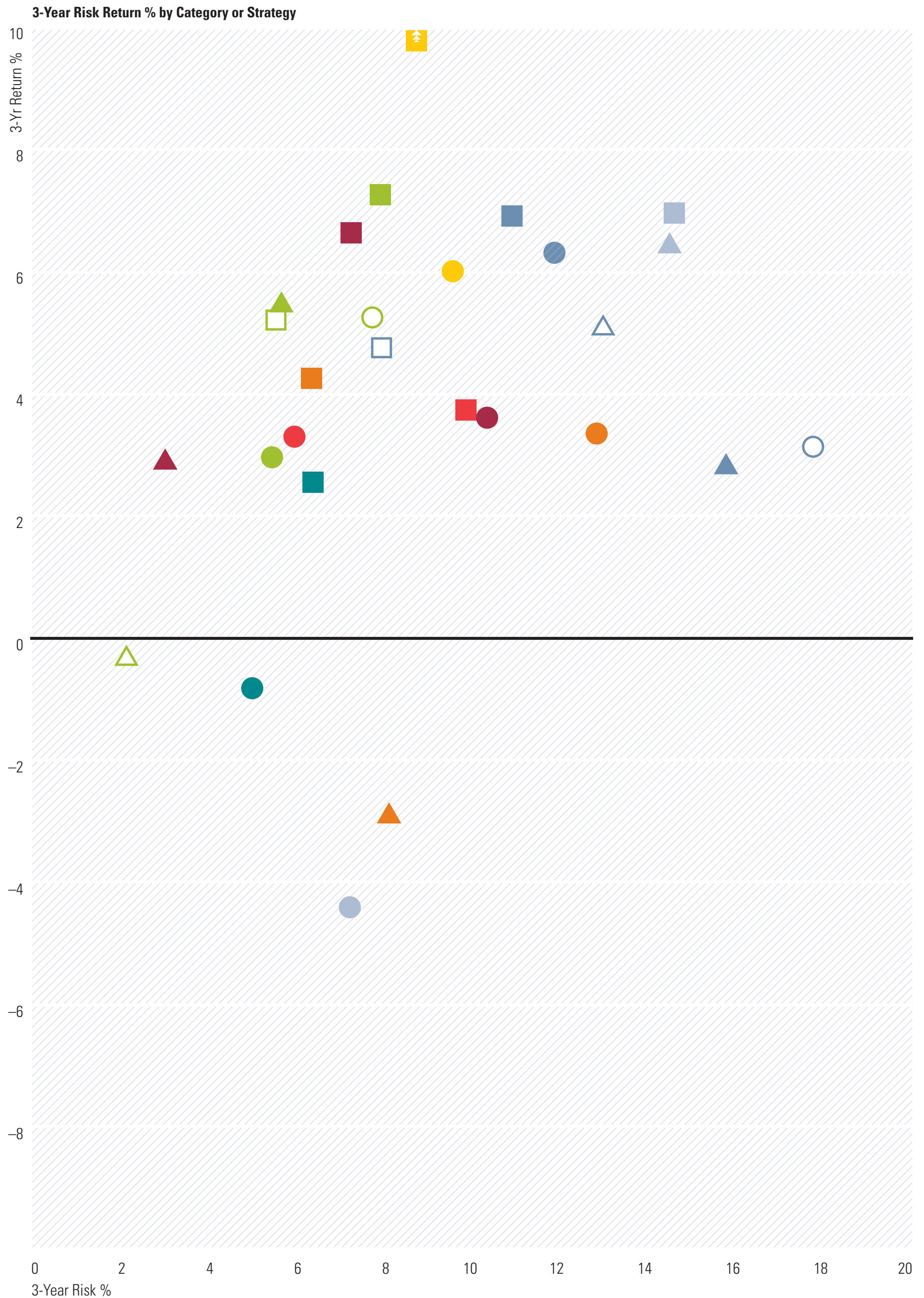
Hedge fund performance was mixed in the second quarter of 2013. The distressed securities and systematic futures categories earned the most, 3.2% and 1.7%, respectively. Thirteen of the 21 hedge fund categories posted losses in the second quarter. Emerging-markets long-short equity and multistrategy categories fared the worst, down 2.6% and 2.5% on average, respectively.



Risk Versus Return: Alternative Mutual Funds and Hedge Funds

Three-Year Standard Deviation and Return

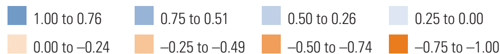
Of the 28 alternative mutual fund and hedge fund category averages, 23 exhibited positive returns over the three years ended June 30, 2013. For the fifth quarter in a row, funds in the distressed-securities, convertible-arbitrage, and U.S. small-cap long-short equity hedge fund category averages produced the best three-year total returns, of 10.4%, 7.3%, and 7.0%, respectively. Distressed-securities and merger-arbitrage hedge funds provided the best risk-adjusted returns, however. In contrast, the U.S. bear-market mutual fund category average fell 23.4% annualized over the three-year period ended June 30, 2013, with the highest (17.4% annualized monthly) standard deviation. Bear-market equity hedge funds performed better, losing 4.4% on average with a 5.8% annualized standard deviation.



Correlations by Alternative Fund Strategy

Three–Year Correlations: Alternative Mutual Fund Categories	1	2	3	4	5	6	7
1 US OE Bear Market	1.00						
2 US OE Long-Short Equity	–0.95	1.00					
3 US OE Managed Futures	–0.07	0.14	1.00				
4 US OE Market Neutral	–0.61	0.64	–0.14	1.00			
5 US OE Multialternative	–0.89	0.87	0.38	0.49	1.00		
6 US OE Multicurrency	–0.84	0.80	0.14	0.56	0.82	1.00	
7 US OE Nontraditional Bond	–0.63	0.67	0.18	0.46	0.72	0.73	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	–0.28	1.00																			
3 HF China Long-Short Equity	0.37	–0.33	1.00																		
4 HF Convertible Arbitrage	0.76	–0.19	0.50	1.00																	
5 HF Currency	0.50	–0.07	0.30	0.44	1.00																
6 HF Debt Arbitrage	0.76	–0.17	0.39	0.92	0.56	1.00															
7 HF Distressed Securities	0.84	–0.26	0.52	0.87	0.50	0.83	1.00														
8 HF Diversified Arbitrage	0.66	–0.19	0.47	0.72	0.36	0.77	0.70	1.00													
9 HF Emerging-Markets Long-Short Equity	0.74	–0.28	0.66	0.86	0.53	0.79	0.82	0.58	1.00												
10 HF Equity Market Neutral	0.79	–0.19	0.40	0.87	0.52	0.91	0.80	0.73	0.81	1.00											
11 HF Europe Long-Short Equity	0.84	–0.20	0.40	0.91	0.63	0.93	0.90	0.75	0.82	0.94	1.00										
12 HF Event Driven	0.81	–0.35	0.50	0.87	0.49	0.84	0.91	0.63	0.89	0.89	0.90	1.00									
13 HF Global Long-Short Equity	0.89	–0.30	0.45	0.90	0.57	0.92	0.91	0.72	0.86	0.94	0.95	0.94	1.00								
14 HF Global Macro	0.76	–0.10	0.38	0.75	0.74	0.80	0.71	0.59	0.70	0.80	0.81	0.73	0.82	1.00							
15 HF Long-Short Debt	0.84	–0.15	0.39	0.92	0.53	0.95	0.85	0.79	0.81	0.91	0.92	0.85	0.93	0.82	1.00						
16 HF Merger Arbitrage	0.71	–0.31	0.42	0.82	0.51	0.86	0.75	0.64	0.75	0.87	0.86	0.83	0.85	0.72	0.81	1.00					
17 HF Multistrategy	0.85	–0.18	0.42	0.92	0.62	0.94	0.87	0.73	0.84	0.94	0.96	0.91	0.96	0.86	0.95	0.86	1.00				
18 HF Systematic Futures	0.59	–0.03	0.30	0.48	0.62	0.49	0.45	0.39	0.41	0.49	0.49	0.39	0.51	0.82	0.54	0.44	0.58	1.00			
19 HF U.S. Long-Short Equity	0.83	–0.35	0.44	0.83	0.47	0.84	0.88	0.64	0.85	0.90	0.90	0.96	0.95	0.70	0.82	0.81	0.90	0.36	1.00		
20 HF U.S. Small-Cap Long-Short Equity	0.78	–0.30	0.46	0.80	0.50	0.79	0.82	0.58	0.84	0.87	0.86	0.93	0.92	0.70	0.78	0.80	0.89	0.38	0.97	1.00	
21 HF Volatility	–0.23	0.22	–0.01	–0.05	–0.02	–0.01	–0.30	–0.03	–0.25	–0.05	–0.12	–0.27	–0.18	0.12	–0.05	–0.01	–0.01	0.25	–0.28	–0.16	1.00



Correlations of Alternative Funds to Traditional Asset Classes

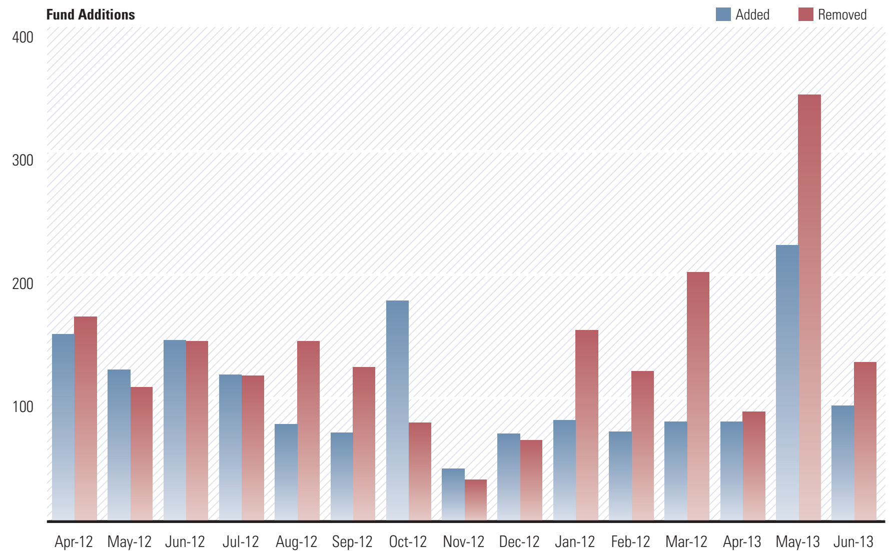
Correlation of Mutual Funds to U.S. Stocks and Bonds	S&P 500 Correlation (USD)			Barclays US Agg Correlation (USD)		
	3-Year	5-Year	10-Year	3-Year	5-Year	10-Year
US OE Bear Market	–0.96	–0.96	–0.96	0.23	-0.21	–0.09
US OE Long-Short Equity	0.97	0.96	0.93	–0.33	0.09	0.03
US OE Managed Futures	0.09	–0.24	N/A	0.11	–0.25	N/A
US OE Market Neutral	0.60	0.27	0.14	–0.17	0.06	0.05
US OE Multialternative	0.90	0.93	0.92	–0.02	0.26	0.14
US OE Multicurrency	0.78	0.56	0.37	–0.02	0.03	0.17
US OE Nontraditional Bond	0.63	0.71	0.64	0.19	0.28	0.36

Correlation of Hedge Funds to U.S. Stocks and Bonds	S&P 500 Correlation (USD)			Barclays US Agg Correlation (USD)		
	3-Year	5-Year	10-Year	3-Year	5-Year	10-Year
Morningstar MSCI Composite AW HF Index	0.72	0.73	0.69	–0.01	0.22	0.05
HF Asia/Pacific Long-Short Equity	0.80	0.81	0.72	–0.11	0.28	0.15
HF Bear-Market Equity	–0.40	–0.46	–0.48	0.13	0.02	0.06
HF China Long-Short Equity	0.34	0.34	N/A	–0.13	0.08	N/A
HF Convertible Arbitrage	0.78	0.75	0.70	–0.16	0.29	0.21
HF Currency	0.46	0.47	0.37	0.02	0.24	0.19
HF Debt Arbitrage	0.84	0.79	0.74	–0.02	0.31	0.21
HF Distressed Securities	0.82	0.81	0.78	–0.32	0.01	–0.05
HF Diversified Arbitrage	0.65	0.68	0.60	–0.17	0.26	0.18
HF Emerging-Markets Long-Short Equity	0.75	0.77	0.71	–0.11	0.21	0.10
HF Equity Market Neutral	0.88	0.80	0.70	–0.13	0.25	0.15
HF Europe Long-Short Equity	0.89	0.85	0.78	–0.24	0.19	0.09
HF Event Driven	0.89	0.86	0.83	–0.24	0.15	0.05
HF Global Long-short Equity	0.92	0.89	0.81	–0.19	0.22	0.07
HF Global Macro	0.68	0.65	0.52	0.09	0.34	0.17
HF Long-Short Debt	0.77	0.80	0.72	0.01	0.35	0.28
HF Merger Arbitrage	0.84	0.80	0.78	–0.11	0.38	0.20
HF Multistrategy	0.85	0.81	0.74	–0.04	0.25	0.12
HF Systematic Futures	0.34	0.20	0.18	0.25	0.19	0.12
HF U.S. Long-Short Equity	0.95	0.92	0.88	–0.32	0.07	–0.04
HF U.S. Small-Cap Long-Short Equity	0.89	0.89	0.86	–0.30	0.08	–0.05
HF Volatility	–0.24	0.28	0.17	0.38	0.53	0.31

Morningstar Hedge Fund Database Overview as of 06-30-2013

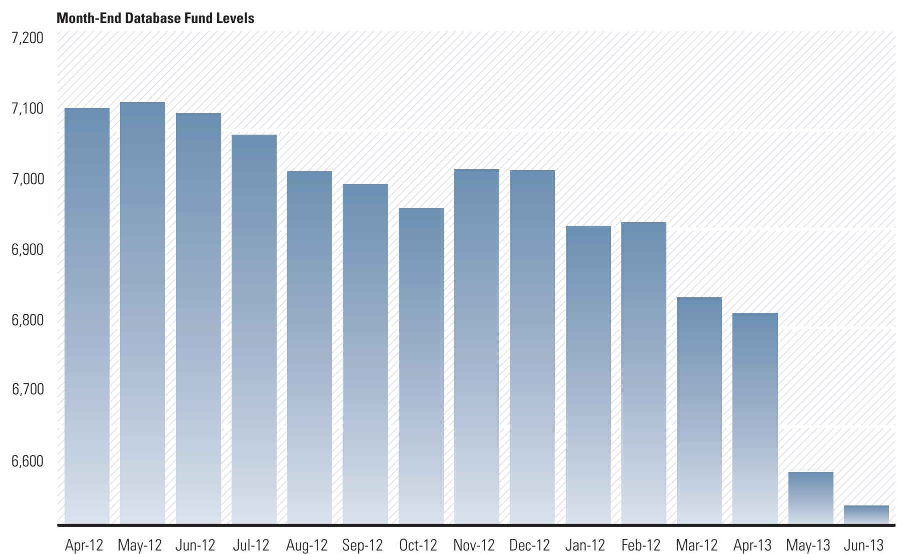
Net Fund Additions by Month

Morningstar's hedge fund database experienced a net withdrawal of 165 funds during the second quarter of 2013. The database saw 399 additions and 564 fund withdrawals during the quarter. Funds drop out of the database because they have liquidated or because they cease sharing performance data, typically because of poor performance.



Month-End Database Fund Levels

As of June 30, 2013, the Morningstar hedge fund database contained 6,240 funds that actively reported performance and assets-under-management data. This figure includes about 4,450 single-manager hedge funds and about 1,800 funds of hedge funds. As of quarter-end, the number of active funds in the database had dropped approximately 12% from December 2011 levels.

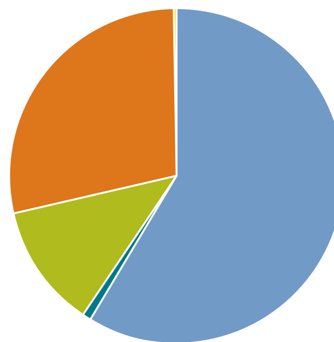


Morningstar Hedge Fund Database Overview as of 06-30-2013

Hedge Funds by Region

Approximately 60% of hedge funds in the Morningstar database are legally domiciled in the North American/Caribbean region, primarily in the Cayman Islands and United States. A large percentage of U.K. hedge funds are also domiciled in the Cayman Islands for tax and regulatory purposes. Approximately 28% of funds in Morningstar's database are domiciled in Europe, including both European Union (EU) and non-EU jurisdictions, and 12% of funds are domiciled in Asia and Australia, primarily in China. All figures are as of June 30, 2013.

Morningstar Hedge Fund Database by Region



Region	# Funds
N. America/Caribbean	3,674
Africa	45
Asia/Australia	744
Europe	1,771
South America	6
Other	0
Total	**4,845**

Hedge Funds by Location

Approximately 55% of the hedge funds in Morningstar's database are domiciled in the United States and the Cayman Islands, British Virgin Islands, and Bermuda. Luxembourg, Ireland, Switzerland, and France continue to domicile a large portion of European hedge funds. China houses most of the Asian hedge funds in Morningstar's database.

North America and Surrounding	**3,674**
Cayman Islands	1,573
United States	1,244
British Virgin Islands	359
Bermuda	268
Canada	159
Curaçao	52
Bahamas	17
Anguilla	0
Barbados	1
Panama	0
St Kitts and Nevis	1

Africa	**45**
South Africa	24
Mauritius	19
Swaziland	1
United Arab Emirates	1

Asia/Australia	**744**
China	716
Australia	16
Hong Kong	3
Japan	2
Bahrain	2
Christmas Island	1
Marshall Islands	1
Singapore	0
Vanuatu	1
Israel	2

Europe	**1,771**
Luxembourg	685
Ireland	216
Switzerland	161
France	146
Guernsey	130
Italy	83
Sweden	62
Jersey	52
Malta	54
Liechtenstein	31
Netherlands	31
Spain	33
United Kingdom	24
Finland	16
Germany	10
Norway	6
Austria	5
Isle of Man	6
Macedonia	5
Denmark	4
Gibraltar	4
Cyprus	3
Portugal	2
Andorra	1
Belgium	1

South America	**6**
Brazil	5
Chile	1

Morningstar Hedge Fund Database Overview as of 06-30-2013

Service Providers

Morgan Stanley and Goldman Sachs are the largest prime brokerage-service providers to hedge funds in Morningstar's database, serving a 25% share combined. The big four accounting firms are employed by approximately 75% of the hedge funds listed in Morningstar's database, with PricewaterhouseCoopers leading the pack. Citco Fund Services provides administration services to more than 8% of funds in Morningstar's database, significantly more than the next-largest administrator, StateStreet/IFS, which services about 3.5% of funds in the database. Walkers, Maples & Calder, and Dechert are the three largest legal-counsel service providers to hedge funds in the database, with a combined 24% market share.

Type	Rank	Service Provider	% of Database
Prime Broker	1	Morgan Stanley	13.47
	2	Goldman Sachs	11.43
	3	Credit Suisse	7.06
	4	Deutsche Bank	6.43
	5	UBS	6.38
	6	J.P. Morgan	5.25
	7	Newedge	3.27
	8	Guosen Securities	2.83
	9	BNP	2.12
	10	Citigroup	1.62
Legal Counsel	1	Walkers	9.01
	2	Maples & Calder	8.72
	3	Dechert LLP	5.92
	4	Seward & Kissel	4.66
	5	Sidley Austin	3.32
	6	Elvinger, Hoss & Prussen	3.19
	7	Schulte Roth & Zabel	2.96
	8	Ogier	2.75
	9	Simmons & Simmons	2.72
	10	Appleby	1.94
Auditor	1	PricewaterhouseCoopers	22.74
	2	Ernst & Young	20.85
	3	KPMG	18.28
	4	Deloitte	13.38
	5	Rothstein Kass	5.18
	6	BDO	2.74
	7	RSM / McGladrey	2.03
	8	Grant Thornton	1.80
	9	Eisner	1.28
	10	Arthur Bell	0.47
Administrator	1	Citco	8.46
	2	HSBC	3.45
	3	UBS	3.19
	4	BNY	3.17
	5	Citi	3.10
	6	Northern Trust	2.75
	7	Credit Suisse	2.69
	8	State Street	2.38
	9	Apex Fund Services	2.19
	10	SS&C	2.09

Alternative Investments Observer

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