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Executive Summary

As we emerge from the global financial crisis, Financial Advisors and their clients have a new and profound appreciation for liquidity. At a time when investors should have been actively rebalancing to manage remarkable volatility, those with traditional alternative investment portfolios were constrained by lock-ups, gates and other restrictions that kept investors from accessing their investments.

The case for alternative investments didn’t suddenly go away. If anything, their longstanding benefits—diversification through non-correlated assets and enhanced risk mitigation—we believe are needed now more than ever given growing concerns about lofty equity markets, the resumption of interest rate hikes, and the increasingly cozy relationship between the prices of many traditional assets.

If anything, we believe these benefits are needed now more than ever given growing concerns. Today, Financial Advisors and their clients are looking for a new alternative—one that blends those traditional advantages of alternatives in a simple, easy to implement mutual fund product that provides greater liquidity and the flexibility to rebalance and make investment decisions as market conditions warrant.

Demand for liquid alternative mutual funds is surging, but there is still plenty of confusion about the various strategies, how best to access them and how they fit within an overall asset allocation.

Financial Advisors cannot completely take their clients’ emotions out of the picture, but they can influence investing decisions by providing greater diversification and better choices for weathering any market environment. At times of increased volatility, clients want to know they have sound options, along with a strong guiding hand to choose what’s right for them. Those options have been dramatically expanded with the emergence of liquid alternative investments, which could yield more durable portfolios and more durable advisory practices in the years to come.

This paper provides a blueprint for Financial Advisors and their clients seeking to diversify their portfolios with liquid alternative investments.

In the pages that follow, we examine:

1 | The roles that liquid alternatives can play in investor portfolios;
2 | The numerous choices among alternative strategies and the advantages of each; and
3 | The variety of ways to access alternative strategies through daily liquid funds.

Financial Advisors cannot completely take their clients’ emotions out of the picture, but they can influence investing decisions by providing greater diversification and better choices for weathering any market environment. At times of increased volatility, clients want to know they have sound options, along with a strong guiding hand to choose what’s right for them. Those options have been dramatically expanded with the emergence of liquid alternative investments, which could yield more durable portfolios and more durable advisory practices in the years to come.
The Rise of Alternatives

Financial Advisors have always been retail investors’ best defense against themselves. Even during the most sanguine times, it can be hard for investors to take their emotions out of their investing decisions.

Should I rebalance now? Should I reduce my allocations? Is it time to add to my investments during this time of underperformance? Financial Advisors have regularly answered these questions along with many more. Clients may not always heed the advice, but those who do have typically benefited enormously.

For years, traditional asset allocations to stocks and bonds gave Financial Advisors the means to build diversified and durable portfolios for their clients. When the dot-com bubble burst in 2000, the lack of access to alternative investments left investor portfolios exposed when stock and bond investments moved lower en masse.

By contrast, high-net worth clients whose asset allocations included a healthy dose of alternative investments had a dramatically different experience than those that relied on traditional investing strategies alone. In fact, from 2000 to 2002, the S&P 500 total return (TR) index declined for three consecutive years, generating a cumulative return of –38%. During the same period, the HFRI Fund of Funds Composite Index—an index comprising more than 650 constituent hedge funds of funds investing across a broad range of alternative strategies—posted slight gains in all three years and produced a cumulative gain of 8%, as shown in Chart 1.

**CHART 1: 2000–2002, S&P 500 TOTAL RETURN PERFORMANCE WAS NEGATIVE; FUND OF FUNDS COMPOSITE INDEX WAS POSITIVE**

![Chart showing growth of $1 million initial investment from 2000 to 2002, comparing S&P 500 TR Index and HFRI Funds of Funds Composite Index.](chart)

Source: Pertrac. *Past performance is not a guarantee of future results.* Index returns are provided for illustrative purposes only. Returns do not represent any particular investment. The unmanaged indexes do not reflect fees and expenses and are not available for direct investment.
For decades, hedge funds, private equity, funds of funds and tactical trading (i.e., global macro and managed futures) funds had been a staple of institutional investors such as family offices, ultra high-net-worth individuals, endowments and foundations. Between 2002 and 2007, the alternative industry experienced unprecedented inflows. For instance, over that span, assets invested in hedge funds surged from $625 billion to $1.87 trillion, an increase of almost 300% (see Chart 2). Funds of hedge funds were particularly attractive as they offered a single investment solution for immediate diversified exposure. Growth accelerated in the later years of this time span, as total global alternative assets under management nearly doubled from $2.9 trillion to $5.7 trillion.¹

Institutional investors and high-net worth clients increasingly recognized in the dot-com market fallout that alternative fund managers had three portfolio tools available to them that couldn’t be found elsewhere:

1 | Ability to Invest Long and Short
2 | Use of Leverage
3 | Risk/Return characteristics that differ from traditional investments


1 | Ability to Invest Long and Short

The ability to express market views through both long and short positions provides increased flexibility to take advantage of any economic environment within the same asset classes. Combining both long and short positions within an overall investment strategy is a valuable tool for potentially mitigating losses and benefiting from market volatility. By evaluating all of the positions in the portfolio, it is possible to manage the portfolio’s net exposure to express a directional (>60% long), non-directional (20% – 60% long), or market neutral (<20%) view. While popularly thought of as a more aggressive approach than a traditional long-only equity strategy, a long/short hedge fund strategy can actually be more conservative. Such a strategy enables portfolio managers to hedge volatility and potentially profit, not just from companies that are doing well, but also from those that are struggling. In addition, a hedge fund manager’s ability to lower net exposure—the difference between long exposures and short exposures—grants them the ability to reduce broad-based market volatility and increase exposure to the manager’s best ideas, emphasizing the importance of security selection.

**CHART 2: ASSETS IN HEDGE FUNDS AND FUNDS OF FUNDS INCREASES SIGNIFICANTLY (1990 – 2013)**

<table>
<thead>
<tr>
<th>Year</th>
<th>Assets in Hedge Funds (in Billions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1990</td>
<td>$38.310</td>
</tr>
<tr>
<td>1991</td>
<td>$58.370</td>
</tr>
<tr>
<td>1992</td>
<td>$95.720</td>
</tr>
<tr>
<td>1993</td>
<td>$167.790</td>
</tr>
<tr>
<td>1994</td>
<td>$167.560</td>
</tr>
<tr>
<td>1995</td>
<td>$185.750</td>
</tr>
<tr>
<td>1996</td>
<td>$256.720</td>
</tr>
<tr>
<td>1997</td>
<td>$374.770</td>
</tr>
<tr>
<td>1998</td>
<td>$456.410</td>
</tr>
<tr>
<td>1999</td>
<td>$490.580</td>
</tr>
<tr>
<td>2000</td>
<td>$539.060</td>
</tr>
<tr>
<td>2001</td>
<td>$520.009</td>
</tr>
<tr>
<td>2002</td>
<td>$625.554</td>
</tr>
<tr>
<td>2003</td>
<td>$920.009</td>
</tr>
<tr>
<td>2004</td>
<td>$1,105.385</td>
</tr>
<tr>
<td>2005</td>
<td>$1,464.526</td>
</tr>
<tr>
<td>2006</td>
<td>$1,868.419</td>
</tr>
<tr>
<td>2007</td>
<td>$2,073.325</td>
</tr>
<tr>
<td>2008</td>
<td>$2,160.156</td>
</tr>
<tr>
<td>2009</td>
<td>$1,600.156</td>
</tr>
<tr>
<td>2010</td>
<td>$1,470.095</td>
</tr>
<tr>
<td>2011</td>
<td>$1,917.385</td>
</tr>
<tr>
<td>2012</td>
<td>$2,252.378</td>
</tr>
<tr>
<td>2013</td>
<td>$2,628.329</td>
</tr>
</tbody>
</table>
2 | Use of Leverage

Alternative fund managers can enhance risk-adjusted returns with the use of leverage, which refers to borrowed capital (a loan) that can be used to amplify the impact of an investment through return enhancement. The use of leverage allows a manager to extend exposure by adding to the long side of the portfolio or reduce exposure by adding to the short side. For strategies that seek to capture the spread (difference) between higher risk and lower risk securities, leverage may be used to increase exposures to each, generating increased return potential through security selection.

Of course, it is important for investors to understand that leverage works in both directions; while it can be used to enhance returns, it can also magnify losses should the underlying asset decline. In addition, there are margin requirements and other costs associated with borrowing capital, and positions are only accretive after they cover the loan cost.

3 | Risk/Return Characteristics that Differ from Traditional Investments

Alternative investments by definition offer risk/return characteristics that are different from those of traditional long-only stock or bond investments, which have not offered nearly as much diversification in recent years as they have historically. Over the past 15 years, a 60% stock/40% bond portfolio (stocks represented by the S&P 500 TR index and bonds by the BarCap U.S. Aggregate Bond index) had a near-perfect 0.98 correlation to the S&P 500 TR Index. This means the portfolio’s value moved almost in lock step with the S&P 500’s performance over this time.

Adding alternative strategies that use traditional assets in both long and short positions can effectively delink their prices and offer investors downside protection.

CHART 3: ALTERNATIVE STRATEGIES EXHIBIT LOW CORRELATIONS TO TRADITIONAL LONG-ONLY ASSETS

15-YEAR CORRELATION COEFFICIENT AS OF DECEMBER 31, 2013

<table>
<thead>
<tr>
<th></th>
<th>S&amp;P 500 Total Return Index</th>
<th>Barclays Capital U.S. Aggregate Bond Index</th>
<th>HFRI Equity Hedge Index</th>
<th>HFRI Relative Value Multi-Strategy Index</th>
<th>HFRI Fund Weighted Composite Index</th>
<th>Goldman Sachs Commodity Index</th>
<th>Barclay CTA Index</th>
<th>60% S&amp;P 500/40% BarCap</th>
</tr>
</thead>
<tbody>
<tr>
<td>S&amp;P 500 Total Return Index</td>
<td>1.00</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Barclays Capital U.S. Aggregate Bond Index</td>
<td>-0.08</td>
<td>1.00</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>HFRI Equity Hedge Index</td>
<td>0.76</td>
<td>-0.04</td>
<td>1.00</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>HFRI Relative Value Multi-Strategy Index</td>
<td>0.57</td>
<td>0.13</td>
<td>0.74</td>
<td>1.00</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>HFRI Fund Weighted Composite Index</td>
<td>0.75</td>
<td>-0.02</td>
<td>0.98</td>
<td>0.77</td>
<td>1.00</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Goldman Sachs Commodity Index</td>
<td>0.30</td>
<td>-0.01</td>
<td>0.47</td>
<td>0.44</td>
<td>0.47</td>
<td>1.00</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Barclay CTA Index</td>
<td>-0.14</td>
<td>0.21</td>
<td>0.05</td>
<td>0.07</td>
<td>0.11</td>
<td>0.24</td>
<td>1.00</td>
<td>-</td>
</tr>
<tr>
<td>60% S&amp;P 500/40% BarCap</td>
<td>0.98</td>
<td>0.09</td>
<td>0.76</td>
<td>0.59</td>
<td>0.75</td>
<td>0.29</td>
<td>-0.09</td>
<td>1.00</td>
</tr>
</tbody>
</table>

Source: PerTrac, 12/31/2013. *Past performance is no guarantee of future results* and there is no guarantee that future correlations between the indexes presented will remain the same. It is not possible to invest directly in an index.
Chart 3 shows how various alternative investment strategies are correlated to one another, the S&P 500 TR Index and the Barclays Capital U.S. Aggregate Bond Index. Diversification benefits increase as correlations decrease.

In recent years, these three tools gave alternative fund managers greater flexibility and enabled them to better manage an increase in market volatility. As shown in Chart 4, two portfolios with the same average annual return, but one with half the volatility of the other, will produce very different results over time.

Yet, despite the flood of interest in alternative strategies, retail investors’ access to them continued to be constrained by a number of factors:

- **Investor qualifications**: Private equity and hedge funds typically have highly regulated standards regarding the financial standing of their investors, including minimum thresholds for investable assets
- **Investment minimums**: These funds also usually require investors to fund initial purchases of at least $1 million and sometimes more
- **Cost**: Hedge funds have historically charged a “2 & 20” fee structure, a 2% annual fee plus 20% of any of the profits
- **Transparency**: Private equity and hedge funds typically offer little insight into portfolio holdings and the investment decisions behind them
- **Liquidity**: Traditional alternative funds typically mandate long lock-up periods for investments
- **Tax reporting**: Private equity and hedge fund investments require the filing of time-consuming Schedule K-1 tax forms along with annual income tax returns

Investors across the wealth spectrum may have been struggling with some of these issues leading up to 2008, but it wasn’t until the global financial crisis hit that the alternative fund landscape experienced major upheaval—and transformative innovation.

**Chart 4: Same Return—Different Investor Outcome**

Source: Hatteras Funds. The above information is hypothetical and is meant as a mathematical illustration only. The illustration does not represent performance of any Hatteras Funds security and there can be no assurance that any Hatteras Funds security will achieve the performance of the hypothetical example. *Past performance is no guarantee of future results.*
The Emergence of Liquid Alternatives

When the global financial crisis began in the middle of 2008, investors couldn’t sell assets across their portfolios fast enough. After all was said and done, the selling spree sent the S&P 500 TR Index down 57% from the peak reached in May 2008 to the trough in March 2009.

During this time, hedge fund and private equity clients might have taken comfort from the alternative investment industry’s historic outperformance during periods of uncertainty, but their fears were only stoked after the Madoff fraud came to light in December 2008. Traditional funds of funds, which declined an average 23% from peak-to-trough, saw their assets plunge 28% to about $571 billion by the close of 2009. The exodus from traditional alternative funds structured as limited partnerships might have been greater but for one problem: the exits were barred. In many cases, investors’ money was locked up or gated as many of alternative funds suspended or restricted redemptions. Overnight, illiquidity had become the most important risk. Suddenly, the interests of retail investors, institutional investors and high-net worth clients were aligned: they all wanted the benefits that alternative investments provided—diversification through non-correlated investments and enhanced risk mitigation—with the ability to liquidate or shift their investment capital around at a moment’s notice.

Investor attention began to shift toward liquid alternative investments in a big way.

Investor attention began to shift toward liquid alternative investments in a big way. Liquid alternative mutual funds—or so-called alternative ’40 Act funds—are pooled investment vehicles offered by a registered investment company pursuant to the Investment Company Act of 1940 that apply an investment strategy that doesn’t purely pursue long-only investments in stocks or bond instruments. These funds deliver hedge fund strategies in an easy-to-use mutual fund structure that

CHART 5: ASSETS UNDER MANAGEMENT HAVE INCREASED SIGNIFICANTLY SINCE 2008

In the wake of the global financial crisis, these attributes helped spark a surge in liquid alternative mutual fund assets under management, which jumped from just $32 billion in 2008 to $244 billion in 2013, according to Morningstar.

Source: Morningstar. Categories represent the six largest tracked by Morningstar, out of the 13 categorized as liquid alternative strategies.
offers daily liquidity, competitive pricing, low investment minimums, no investor requirements, increased transparency and simplified tax reporting.

In the wake of the global financial crisis, these attributes helped spark a surge in liquid alternative mutual fund assets under management, which jumped from just $32 billion in 2008 to $244 billion in 2013, according to Morningstar (see Chart 5). Strategies seeing the biggest inflows between 2012 and 2013 included nontraditional bond (+$53 billion), long/short equity (+$20 billion), multialternative (+$9 billion) and market neutral (+$4 billion). Asset managers have introduced over 325 liquid alternative funds since 2008, bringing the total today to more than 420 liquid alternative funds from which to choose (see Chart 6).

Liquid alternative investments are likely to grow even further, not only in terms of assets under management, but also in terms of their importance in portfolio construction and risk mitigation. As the charts above show, investor demand for liquid alternatives continues to increase, even now that the global financial crisis is firmly behind us. According to one study, projected growth of the alternative industry could create a $2.4 trillion market by 2020, representing a six-year growth rate of 376%.²

The logic behind such forecasts is straightforward: investors want all the potential advantages of alternative investment strategies—diversification, risk mitigation, low-correlation and enhanced risk-adjusted portfolio profile—but they are far less willing to tolerate traditional limited partnership structures. Instead, investors are demanding daily liquidity and transparency so they will have the ability to rebalance easily, the opportunity to make strategic allocation decisions without any constraints, the flexibility to make frequent tactical changes, and the comfort of knowing that their assets can be converted to cash each day. To many investors, the advantages of liquidity are well worth forgoing the average 0.98% return difference between traditional private and liquid alternatives.³

This desire is only being strengthened by the near-term outlook for equity and fixed income markets. Over the last 14 years, investors have been on an equity market roller-coaster ride where bull and bear markets have fluctuated by 50 – 150%.

---


Liquid Alternative Mutual Funds are subject to risk.
within a few years. With equity markets near all-time highs (see Chart 7), investors are reminded that markets don’t rise forever, particularly those investors who are nearing retirement and don’t have the time to rebound from significant losses again.

Meanwhile, nominal interest rates are approaching zero and real rates are even lower, as seen in Chart 8. With Federal Reserve officials telegraphing future interest rate hikes, fixed income markets may be nearing the end of a 32-year bull market.

**CHART 7: WHAT’S NEXT FOR EQUITY MARKETS?**

With equity markets currently near all-time highs, investors are reminded that markets don’t rise forever, particularly those investors who are nearing retirement and don’t have the time to rebound from significant losses again.

**CHART 8: TRADITIONAL FIXED INCOME YIELDS REACHED RECORD LOWS IN 2012**

Meanwhile, nominal interest rates are approaching zero and real rates are even lower.
Allocating to Liquid Alternatives

Today’s “rebalancing conundrum” is well-known to Financial Advisors and highlights a predicament particularly acute for investors looking to lower their risk profile and replace income within their nest eggs. Should they invest or rebalance into equities at all-time highs or into fixed income securities that are subject to the question of when, not if, interest rates will rise?

In light of this dilemma, it should cause little surprise that investment management firms and other advisors are increasingly introducing their clients to another option: rebalancing their portfolios to include a greater percentage of alternatives. Chart 9 shows the current model portfolios of three major investment firms whose recommended allocations to alternative investments range from 24% to 30%.

Financial Advisors and their clients may assert that they already own alternative investments because of their holdings in gold or other precious metals, real estate investments trusts (REITs) and tactical trading strategies such as managed futures. But the universe of alternative strategies designed to offer equity, fixed income and overall portfolio diversification is much larger. What is more, for those that own traditional alternative investment structures in their portfolios, they may not offer the liquidity necessary to make strategic allocation decisions and tactical or opportunistic moves.

CHART 9: RESEARCH TEAMS RECOMMEND ALTERNATIVES IN ASSET ALLOCATION MODELS

The illustration above should not be considered a recommendation by the Advisor or Distributor.
Defining Alternative Investment Strategies

We recognize that there are several ways to define and classify alternative investment strategies and many research institutions have used different methodologies to do so. Hedge Fund Research (HFR) the prominent hedge fund data and research firm, has identified five main strategies with 38 sub-strategies. Morningstar has formally identified 13 strategies as alternative, yet it also breaks out several other categories such as commodities, sector equity, tactical allocation as well as nontraditional bond funds, which many would also consider alternative investments.

Cliffwater LLC, a provider of alternative advisory services to institutional investors, splits alternative strategies into two camps: “alpha driven” and “beta driven.” Alpha driven strategies promise high value-added returns produced by a manager’s active decisions. Beta driven alternatives focus on less well-known asset classes—e.g., real estate investment trusts, commodities, infrastructure—whose returns are also less correlated to stock returns.

*At Hatteras Funds, we define an alternative investment product as one that delivers an alternative investment strategy.*

At Hatteras Funds, we define an alternative investment product as one that delivers an alternative investment strategy. And, an alternative investment strategy as a strategy that derives a meaningful component of its total return from nontraditional management techniques. The alternative strategies are then classified into two primary categories: hedge fund strategies and private investments (see Chart 10). Each has a number of sub-strategies and categorizations that can be further defined.

While each of these strategies is an important component in building a complete, diversified, core alternative investment allocation, not all of them can be implemented with daily liquidity. In order to achieve the strategies’ objectives, some require asset control for one to three years and others up to 10 years. Below are definitions for each of the alternative strategies.

**Long/Short Equity** strategies primarily invest in public equity markets. These equity-diversifying strategies are centered on a manager’s ability to invest long in equities they believe will increase in value, while simultaneously selling short equities they believe will decrease in value. This increased flexibility over a long-only manager enables long/short equity managers to potentially generate profit in all market environments, and to provide risk management through hedging techniques. Due to the large universe of equities and daily trading volume, public equity markets allow a manager to enter into and exit positions easily each day.

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chart 10: defining alternative investment strategies

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**ALTERNATIVE INVESTMENT STRATEGIES**

**HEDGE FUND STRATEGIES**

- Long/Short Equity
- Market Neutral
- Long/Short Debt
- Event Driven
- Tactical Trading

**PRIVATE INVESTMENTS**

*Source:* Hatteras Funds.
Market Neutral strategies are designed to achieve capital appreciation by exploiting equity market inefficiencies. They involve being simultaneously invested in long- and short-paired equity portfolios that are generally of the same size and usually in the same market. These strategies are a close relative of long/short equity strategies because they take offsetting long and short positions in similar mispriced securities. However, this strategy differs from most long/short equity strategies in that managers are taking positions not based on a directional read, but rather to simply generate alpha through relative changes in the prices of the positions held. This strategy therefore tends to minimize market and sector risk.

Long/Short Debt strategies and nontraditional bonds diverge in one or more ways from traditional fixed income strategies in that they are often “unconstrained” and thus have more flexibility to invest tactically across a wide range of fixed income sectors, including high-yield, global sovereign, emerging market, corporate credit and stressed bonds, as well as bank loans. These strategies also attempt to manage duration through derivative instruments such as interest rate swaps. To implement their strategy, long/short debt managers may use assets such as corporate and municipal bonds, interest rate and currency swaps or residential and commercial mortgage-related assets, loans and securities, and supplement them with more liquid U.S. government bills, bonds or notes.

Due to the managers’ increased flexibility, long/short debt strategies are designed to generate returns independent of interest rates and may provide protection from rising and falling rates.

In addition to the advantages of nontraditional bond funds, long/short debt strategies have the ability to take both long and short positions in bonds. While traditional long-only fixed income managers have the ability to generate returns from two sources—yield and bond price appreciation—long/short debt managers have the ability to generate returns from four sources—yield, price appreciation, price depreciation through shorting and alternative trading strategies. Due to the managers’ increased flexibility, long/short debt strategies are designed to generate returns independent of interest rates and may provide protection from rising and falling rates.

Event-Driven strategies seek to exploit pricing inefficiencies that may occur before or after a corporate event, such as a bankruptcy, merger, acquisition or spinoff. The strategy may be executed by using public equities or bonds, or the strategy may use less liquid investments like swaps, corporate bonds or derivatives. Because of the length of time needed for some events to occur and recognize value, the strategy is viewed as less liquid than other equity-oriented strategies.

Tactical Trading strategies are, generally speaking, highly liquid and cover both global macro and managed futures strategies. A futures contract is a standardized contract between two parties to buy or sell a specified asset of standardized quantity and quality for a price agreed on today, with delivery and payment occurring at a specified future date. Futures are traded for a wide range of commodities, including agricultural goods, metals and precious metals, as well as financial securities, currencies and intangibles such as interest rates and indexes. These portfolio-diversifying strategies generally speculate on the direction of market prices. Tactical trading strategies are highly technical and typically utilize proprietary, model-based trading systems to identify market trends.

Private investments are primarily designed to offer return enhancement through investments in privately negotiated transactions. For that reason, private equity investments are often referred to as “illiquid,” or without a readily accessible market for buying and selling securities. Once an investment is made, the private equity team typically works with the target company’s management team to improve the financial standing of the company through initiatives such as new product development, restructuring of operations, or new management. In practice, private equity investors often hold (or are required to hold) investments for several years. Because private investments are less liquid than traditional equity investments or even other equity based alternative strategies, investors expect a return premium, often referred to as the illiquidity premium. The buyout sector of private investments is the most commonly known and refers to a transaction in which the ownership (or control) of a company is acquired. The new owner essentially “buys out” the equity owners with the goal of increasing the value of the company either through management changes, restructuring or new product development.
Alternative Mutual Funds

Not all alternative mutual funds are created equal. In accessing the strategies enumerated above, as well as others, Financial Advisors and their clients can choose from more than 420 liquid alternative mutual funds. These funds are structured in a variety of ways and many also vary in the number of strategies and managers investors can access. Alternative mutual fund structures can be broken down into four main categories; each has specific benefits and challenges.

1 | Single-Strategy/Single-Manager

**Benefits:** A single strategy fund managed by a single manager is designed to leverage the experience, expertise and conviction of the manager. By design, the manager has identified a specific strength in an alternative strategy and has developed a fund in order to leverage that strength. The single/single structure allows the investor to take advantage of the manager’s best ideas.

**Challenges:** A single strategy fund managed by a single manager has the idiosyncratic risk of both the strategy and the manager. It is inherently a less diversified approach to portfolio construction and relies heavily on the manager’s ability to take advantage of an investment opportunity. The manager’s skill will be reflected in the performance of the fund.

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**CHART II: SINGLE-STRATEGY/SINGLE-MANAGER FUND EXAMPLE**

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**Source:** Hatteras Funds.
2 | Single-Strategy/Multi-Manager

Benefits: A single strategy fund, such as long/short equity fund or long/short debt fund, may allocate assets to multiple managers to achieve its goal. Each underlying manager may have expertise in a specific sub-strategy or sector and when combined may be non-correlated to each other. This approach allows an investor to add the benefits of the strategy, while mitigating the idiosyncratic, manager-specific risk.

This approach allows an investor to add the benefits of the strategy, while mitigating the idiosyncratic, manager-specific risk.

Challenges: The allocation and rebalancing decisions to each underlying manager are outsourced to the investment manager. The investment manager must have deep expertise, due diligence and oversight into manager selection, as well as an understanding of the impact of combining sub-strategies in a single portfolio.

Source: Hatteras Funds.
3 | Multi-Strategy/Single-Manager

**Benefits:** A multi-strategy fund run by a single manager is typically offered by large financial institutions with many independent portfolio management teams in-house. This allows the parent investment management firm to control risk and monitor all positions internally, accounting for any potential overlapping positions. In addition, the associated fees and expenses may be lower.

**Challenges:** The most commonly articulated challenge for multi-strategy/single-manager funds is that financial institutions may have limited in-house expertise in multiple alternative strategies. They may not be able to combine a full spectrum of strategies to provide a complete investment solution. This may result in the investor needing to allocate to additional funds to achieve full breadth of desired strategy exposures. In addition, large financial institutions often have centralized research that can result in shared investment ideas. While multi/single funds reduce strategy risks, they typically have a single investment decision maker which keeps the manager idiosyncratic risks high.

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**CHART 13: MULTI-STRATEGY/SINGLE-MANAGER FUND EXAMPLE**

**ALTERNATIVE MUTUAL FUND**

<table>
<thead>
<tr>
<th>LONG/SHORT EQUITY</th>
<th>MARKET NEUTRAL</th>
<th>LONG/SHORT DEBT</th>
<th>EVENT DRIVEN</th>
<th>TACTICAL TRADING</th>
</tr>
</thead>
</table>

Manager 1

**Source:** Hatteras Funds.
4 | Multi-Strategy/Multi-Manager

**Benefits:** A multi-strategy/multi-manager fund provides immediate access to a complete, turnkey solution of alternative investments. The portfolio management team of a multi-strategy/multi-manager fund is responsible for making all allocation decisions—overweighting or underweighting strategies based on the opportunity—conducting manager search and selection, and for conducting constant risk management on the combined portfolio. The broad diversification of this kind of strategy not only spreads the idiosyncratic risk of individual managers, but also uses a wide variety of alternative strategies to offer a risk/return profile that is stabilizing and reduces volatility.

**Challenges:** While some detractors will point out that multi-strategy/multi-manager funds maintain an extra layer of fees above those of the individual funds, the investor is paying for the experience, guidance, resources, risk management, and due diligence of the investment manager. Since all mutual fund performance is reported net of all fees—after all management and advisory fees—the investor can determine if the fund’s return and risk characteristics justify the increased expense. In order for this structure to be successful, the team must exhibit expertise in analyzing multiple alternative strategies and in portfolio implementation on both a strategy and manager level.

**Chart 14: Multi-Strategy/Multi-Manager Fund Example**

**Source:** Hatteras Funds.
Multi-Strategy Investment Approaches

Multi-strategy funds employ different approaches when it comes to fund structure and access, and it is important to distinguish between them.

Multi-Strategy Replicators

Replication strategies aim to deliver returns similar to those of another vehicle, typically an index, with the added benefits of improved liquidity and transparency. Alternative mutual fund replicators seek to identify the underlying exposures of hedge fund strategies by performing linear regression analysis of their historical monthly returns. Studies have shown that sophisticated multi-factor regression models can explain 80% of the returns of a diversified index of hedge funds. One fundamental concern of replication strategies is that they are inherently backward-looking, and depend on analysis of historical returns to predict future investment trends.4

Alternative mutual fund replicators seek to identify the underlying exposures of hedge fund strategies by performing linear regression analysis of their historical monthly returns.

Multi-Strategy Using Third-Party Mutual Funds

A financial institution may create a multi-strategy/multi-manager fund by combining independent mutual funds offered by non-associated investment firms in a single investment vehicle. This approach may provide a diversified portfolio of alternative strategies and managers and is designed to reduce the portfolio’s risks, manage volatility and offer non-correlated assets to the overall portfolio.

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However, this structure adds an additional layer of fees on top of the third-party mutual funds’ underlying costs. Firms who offer this structure assert that they perform due diligence on the funds selected and then manage the portfolios, adjusting the asset allocations as needed. Managers who use this approach believe that their investment oversight more than pays for itself, and the result can be a managed, well-diversified fund of funds.

Multi-Strategy Using Third-Party Hedge Fund Managers

Multi-strategy alternative mutual funds may establish a separately managed account with several true hedge fund managers that otherwise are not accessible in a mutual fund structure. By design, each manager implements the hedge fund strategy in an independent account. The fund company provides trading authority to the hedge fund manager, but maintains full control of the assets. In the event of a change of manager, security blow-up or other crisis, the assets of the separately managed account can be liquidated or the trading authority can be removed instantly. This provides an additional level of risk management inherently built into the structure.

An added benefit of the separately managed account structure that was not historically available to traditional funds of hedge funds is the complete position level transparency that is available each day. The portfolio management team is able to see all trading activity, evaluate overlapping positions, and review sector, market-cap, and geographical exposures for the total portfolio. Performance information is also available each day on an individual manager level, at the strategy level and for the total portfolio.

This structure can be a more expensive approach when compared to other mutual funds, however it is often much less expensive than a traditional fund of funds structure. In addition, this structure does not pay incentive fees to the underlying hedge fund managers.
Implementing Liquid Alternatives

Which alternative investment strategies are suitable for each investor depends on the role alternatives are meant to fulfill in the portfolio. To determine the right fit, Financial Advisors and their clients must determine the overall investment objective. For instance, are they seeking protection from changes in interest rates? Are they concerned about managing equity volatility? Or are they generally looking to mitigate risk within their overall portfolio? Broadly speaking, alternative investments can fulfill one or more of three roles within an investment portfolio.

1 | Fixed Income Diversifier

Liquid alternative investments designed as fixed income diversifiers seek to provide a complement to existing fixed income holdings. They may offer protection against changing interest rates, offer an alternative source of yield, and/or generate enhanced risk-adjusted returns.

There are three primary strategies of fixed income diversifiers to consider:

- Long/short debt
- Nontraditional bonds
- Multi-strategy/multi-manager

As discussed earlier, long/short debt and nontraditional bonds offer more flexibility to seek diversification by investing tactically across a wide range of fixed income sectors, and also managing duration (interest rate risk) through derivative instruments and shorting. Some may wonder how a multi-strategy/multi-manager fund could be considered a diversifier to a long-only fixed income allocation. The answer is that a multi-strategy/multi-manager portfolio may offer a return profile different from that of traditional fixed income, albeit with similar volatility characteristics. This diversified alternative solution may offer low correlation to traditional long-only stock and bond investments and, when added to a portfolio, can potentially enhance returns and reduce risk.
Equity Diversifier

Equity diversifying strategies are designed to complement an existing equity allocation, allowing an investor to maintain their market exposure, but through solutions that offer greater consistency, hedge against losses, and mitigate portfolio volatility. Equity diversifying strategies can be driven by quantitative or fundamental analysis, be broadly diversified or narrowly focused on specific sectors or market capitalizations, and can range broadly in terms of net exposure, leverage employed, and holding period.

There are four sub-strategies of equity diversifiers for consideration:

- Long/short equity
- Market neutral
- Short bias
- Event-driven

Long/short equity strategies, the most popular liquid alternative mutual fund category, seek to participate on the upside while providing non-correlation benefits and enhanced risk-adjusted returns. As of December 31, 2013, there were 106 long/short equity funds in Morningstar’s category representing over $58 billion, yet only 50% have a three-year track record. It’s important to point out that many long/short equity managers have not yet managed through a full market cycle, so manager selection can make a big difference in performance. Market neutral strategies can offer similar diversification benefits without taking directional stands, therefore minimizing market and sector risk. Short bias funds are designed to generate alpha when the market is going down—often by tracking a particular market index in reverse—and to at least break-even when valuations are rising.

Finally, event-driven strategies offer further equity diversification by seeking to exploit pricing inefficiencies stemming from corporate actions such as buybacks, acquisitions and initial public offerings. Due to the longer time horizon typically associated with these investments, multi-strategy funds offer a way for investors to obtain event-driven exposure while still maintaining daily liquidity.

Portfolio Diversifier

Portfolio diversifiers offer the potential to diversify an overall asset allocation. Historically, these strategies have provided non-correlated returns to both equities and fixed income securities. Recently, some investors have been disappointed with portfolio diversifying strategies such as managed futures, but this is to be expected during bull markets; when the prices of stocks and bonds are both increasing, the non-correlated attributes of tactical trading are expected to result in negative performance. These strategies should be viewed as a long-term allocation in order to provide the diversification benefits for which they are designed. Historically, in times of great market stress, these strategies provide substantial downside protection.

Historically, in times of great market stress, these strategies provide substantial downside protection.

There are five main strategies of portfolio diversifiers for consideration:

- Multi-strategy/multi-manager
- Managed futures
- Commodities
- REITs
- Currency

Multi-strategy/multi-manager funds can serve as a complete turnkey solution for Financial Advisors and their clients because they provide immediate access to a complete, diversified set of alternative investments. Managed futures funds seek to achieve positive returns in both rising and falling equity markets with generally lower volatility. Commodities, real estate investment trusts (REITs) and currencies have historically shown low correlation to stocks and bonds, and have outperformed them at times.
Strategy Liquidity Needs

Today, advisors and their clients are carefully attuned to concerns about being able to access their capital, make allocation changes based on their perceptions of where the markets are heading and rebalance easily. In the aftermath of the crisis, the question for asset managers became: Which alternative strategies can be implemented successfully within a liquid structure and which cannot?

Asset liquidity can be defined on three levels:

**Level 1** | These assets have quoted prices and active markets, and include equities, futures—including currencies and commodities—and Treasury bills. These securities have the most verifiable and reliable fair value measurement. Strategies that primarily use these securities to effectuate their strategy are generally available with daily liquidity.

**Level 2** | These assets do not have regular market pricing but their fair value can be readily determined or approximated based on over-the-counter prices. Level 2 assets may include corporate and municipal bonds, interest rate and currency swaps or residential and commercial mortgage-related assets, loans and securities. While strategies that utilize these securities as their primary investment vehicle may have more liquidity limitation, they can often be made available with daily liquidity by limiting the percentage allocation to the less liquid investments.

**Level 3** | These assets are the most unobservable and include instruments that may involve assumptions and estimates. Examples may include infrequently traded asset backed securities or investments in privately owned companies. Strategies that rely on Level 3 assets to implement their strategy are not currently available with daily liquidity.

Certain strategies employ less liquid assets and require more time in the market, reducing their ability to be implemented with daily liquidity, as shown in Chart 15. In general, strategies which rely on Level 3 securities are too illiquid for alternative mutual fund structures, but mutual funds are able to allocate up to 15% of an overall portfolio to Level 3 securities. Strategies focused on distressed securities, venture capital, or structured credit typically rely on Level 3 assets. These types of strategies generally require time to become profitable, and thus may be unavailable to investors with short time horizons. Private real estate, private equity, and activist strategies are also illiquid due to their structure and investment horizon measured across multiple years.

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**Chart 15: Alternative Strategies Vary Widely in Liquidity**

<table>
<thead>
<tr>
<th>STRATEGY</th>
<th>ASSET</th>
<th>SECURITY EXAMPLE</th>
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<tbody>
<tr>
<td>Global Macro</td>
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<td>Managed Futures</td>
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<td>Verifiable Daily Pricing</td>
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<td>Market Neutral</td>
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<td>REITs</td>
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<td></td>
<td></td>
<td>BDCs</td>
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<tr>
<td>Event Driven: Merger Arb</td>
<td>LEVEL 2</td>
<td>Corporate Bonds</td>
</tr>
<tr>
<td>Multi-Strategy</td>
<td>No Regular Market Pricing</td>
<td>Municipal Bonds</td>
</tr>
<tr>
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<td>Fair Value Based on OTC Prices</td>
<td>Interest Rate Swaps CMBS</td>
</tr>
<tr>
<td>Nontraditional Bond</td>
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<td>Long/Short Debt</td>
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<tr>
<td>Event Driven Activist</td>
<td>LEVEL 3</td>
<td>Private Companies</td>
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<tr>
<td>Private Equity Buyout</td>
<td>Non-Exchange Traded</td>
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<td>Event Driven: Distressed</td>
<td>Most Unobservable</td>
<td>Distressed Securities</td>
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<td>Venture Capital</td>
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<tr>
<td>Private Real Estate</td>
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</table>
Finding the Right Fit

At Hatteras, we find it helpful to consider three approaches when implementing alternative investments. These approaches—opportunistic, dedicated and integrated—weigh the purported role of alternative investments against their strategic fit within an asset allocation.

**OPPORTUNISTIC**

This approach is generally appropriate for investors who are looking for a return enhancer. Investments included in this approach may act more as a “bet” to address expected market conditions or to profit from a specific opportunity, as opposed to a more permanent part of an overall strategic asset allocation. Each investment is selected separately, whether it is an individual stock, a hedge fund, a private equity deal or a REIT. Some may be liquid while others are illiquid. Since the allocation remains separate from the equity and fixed income asset class decisions, alternatives are not being used exclusively to mitigate volatility. Daily liquid alternative investments allow investors to implement and change opportunistic positions with relative ease.

**DEDICATED**

This approach is typically best for those investors who are strategically implementing alternatives as a portfolio diversifier. A dedicated portion of the portfolio is set aside for alternative investments. Ideally, each investment selected contributes a unique risk/return profile that will add to the portfolio’s diversity and stability over the long term. Investors who use this approach are likely to be focused on evaluating and measuring their alternative investments versus other alternative options and benchmarks. Daily liquidity enables rebalancing and allocation adjustments.

**Multi-Strategy** funds may be a good fit for a dedicated portfolio allocation, as they can provide immediate access to several strategies, and may provide a complete, turnkey, alternatives allocation.
INTEGRATED

Investors looking to implement alternatives as part of an overall strategy to integrate asset classes often use this approach, which aims to fully complement portfolio exposures by seeking alternative investments that increase diversification, mitigate risks and enhance returns. The alternatives allocation is built into each asset class and also maintains a separate allocation for overall portfolio diversification strategies. The integrated approach addresses all three portfolio roles by providing equity, fixed income and portfolio diversification. Daily liquid alternative mutual funds allow for greater flexibility to rebalance and manage the portfolio from a risk-focused perspective.

**Single-Strategy/Multi-Manager** funds may serve as an optimal solution for Financial Advisors and clients who are using an integrated approach to implementing alternatives because they complement existing asset class exposures and fit easily within the current asset allocation. Such funds may also allow Financial Advisors to better manage asset class risk exposures by including hedged, volatility-mitigating investments alongside traditional long-only positions.
Building a Durable Portfolio

With market uncertainty at all-time highs, we believe investors need to evaluate their overall portfolio allocations in conjunction with personal long-term investment goals and risk tolerances. As Financial Advisors help their clients consider portfolio rebalancing or the implementation of new strategies, liquid alternative investment strategies have earned their way into that conversation.

We believe that allocating to liquid alternative investments enables Financial Advisors to build more durable portfolios for clients by helping them mitigate volatility and steer clear of rash decisions that could diminish their desired outcomes.

Innovative yet easy-to-use liquid alternative mutual funds enable investors to utilize advanced risk-adjusted strategies without the constraints typically associated with hedge funds, private equity and other traditional alternative investment vehicles.

Increased access to liquid alternatives could not have come at a more opportune time. High correlations between standby portfolio options are eroding the diversification benefits of traditional allocation approaches at a time when more savers are approaching retirement and have less room to recover from losses. Those once able to hold their emotions in check during past market swings may be less successful in the future given the higher stakes for preserving their wealth. They need the comfort to know not only that they will be sufficiently diversified to weather such episodes, but that they will have the flexibility to make adjustments if conditions warrant them.

We believe that allocating to liquid alternative investments enables Financial Advisors to build more durable portfolios for clients by helping them mitigate volatility and steer clear of rash decisions that could diminish their desired outcomes. With a wide variety of options to meet each client’s individual needs, we believe liquid alternative investments should be a cornerstone of any durable portfolio.
DEFINITIONS

**Alpha**
Measures excess return relative to the market; often referred to as a measurement of “manager skill.”

**Barclays Capital U.S. Aggregate Bond Index**
An unmanaged index of investment-grade, U.S. dollar-denominated fixed income securities of domestic issuers having a maturity greater than one year.

**Barclay CTA Index**
A leading industry benchmark of representative performance of commodity trading advisors. There are currently 551 programs included in the calculation of the Barclay CTA Index for the year 2014, which is unweighted and rebalanced at the beginning of each year.

**Correlation**
A statistical measure of how two securities move in relation to each other.

**HFRI Fund of Funds Composite Index**
An equal weighted index of over 650 constituent hedge funds of funds that invest over a broad range of strategies.

**HFRI Equity Hedge Index**
These strategies maintain positions both long and short in primarily equity and equity derivative securities. A wide variety of investment processes can be employed to arrive at an investment decision, including both quantitative and fundamental techniques; strategies can be broadly diversified or narrowly focused on specific sectors and can range broadly in terms of levels of net exposure, leverage employed, holding period, concentrations of market capitalizations and valuation ranges of typical portfolios. Equity hedge managers would typically maintain at least 50% in equities, and may in some cases be entirely invested in equities, both long and short.

**HFRI Fund Weighted Composite Index**
This index is a global, equal-weighted index of over 2,000 single-manager funds. Constituent funds report monthly net of all fees performance in U.S. dollars and have a minimum of $50 million under management or a 12-month track record of active performance. The index does not include funds of hedge funds.

**HFRI RV Fixed Income Corporate Index**
The index includes strategies in which the investment thesis is predicated on realization of a spread between related instruments in which one or multiple components of the spread is a corporate fixed income instrument. Fixed Income–Corporate strategies differ from Event Driven–Credit Arbitrage in that the former more typically involve more general market hedges which may vary in the degree to which they limit fixed income market exposure, while the latter typically involve arbitrage positions with little or no net credit market exposure, but are predicated on specific, anticipated, idiosyncratic developments.

**HFRI RV: Multi-Strategy Index**
This index employs an investment thesis predicated on realization of a spread between related yield instruments in which one or multiple components of the spread contains a fixed income, derivative, equity, real estate, MLP or combination of these or other instruments. Strategies are typically quantitatively driven to measure the existing relationship between. Multi-strategy is not intended to provide broadest-based mass market investors appeal, but are most frequently distinguished from other arbitrage strategies in that they expect to maintain >30% of portfolio exposure in two or more strategies meaningfully distinct from each other.
Goldman Sachs Commodity Index
A composite index of commodity sector returns which represents a broadly diversified, unleveraged, long-only position in commodity futures.

Russell 2000 Index
The index measures the performance of the small-cap segment of the U.S. equity universe. It includes approximately 2,000 of the smallest securities based on a combination of their market capitalization and current index membership.

S&P 500 Total Return (TR) Index
This is an index of 500 stocks chosen for market size, liquidity, and industry grouping, among other factors. The S&P 500 is designed to be a leading indicator of U.S. equities and is meant to reflect the risk/return characteristics of the large cap universe.
Safe Harbor and Forward-Looking Statements Disclosure: The opinions expressed in this report are subject to change without notice. This material has been prepared or is distributed solely for informational purposes and is not a solicitation or an offer to buy any security or instrument or to participate in any trading strategy. The opinions discussed are solely those of Hatteras and may contain certain forward-looking statements about the factors that may affect the performance of the illustrative examples in the future. These statements are based on Hatteras’ predictions and expectations concerning certain future events and their expected impact, such as performance of the economy as a whole and of specific industry sectors, changes in the levels of interest rates, the impact of developing world events, and other factors that may influence the future performance of the illustrative examples. Hatteras believes these forward-looking statements to be reasonable, although they are inherently uncertain and difficult to predict. Actual events may cause adjustments in portfolio management strategies from those currently expected to be employed. It is intended solely for the use of the person to whom it is given and may not be reproduced or distributed to any other person. The information and statistics in this report are from sources believed to be reliable, but are not warranted by Hatteras to be accurate or complete. Past performance does not guarantee future results.

Key Risks and Important Information about hedge funds and private equity: Diversification does not assure a profit or protect against a loss. Liquid alternative mutual funds are subject to market risk and may not be suitable for all investors. No investment is risk free. Loss of principal is possible. Equities are subject to the risk of decline due to adverse company or industry news or general economic decline. Foreign investments present additional risks due to currency fluctuations, economic and political factors, government regulations, differences in accounting standards and other factors. Commodities present certain risks, including adverse weather, geological and environmental factors, economic events, interest rates, government regulation, and taxation. Bonds are subject to interest-rate risk and can lose principal value when interest rates rise. Bonds are also subject to credit risk, in which the bond issuer may fail to pay interest and principal in a timely manner or that negative perception of the issuer’s ability to make such payments may cause the price of that bond to decline. There can be no assurance that any investment will meet its performance objectives or that substantial losses will be avoided.

Hedge funds and private equity funds are speculative investments and are not suitable for all investors, nor do they represent a complete investment program. By investing in a fund of funds, investors will be subject to a dual layer of fees, both at the fund and the underlying private equity fund levels. In addition, the overall performance of a fund of funds is dependent not only on the investment performance of individual managers, but also on the ability of the fund’s advisor to allocate the fund’s assets among such managers on an ongoing basis. The use of leverage compounds returns by adding exposure that can enhance performance but also exacerbate losses. Short selling involves the risk of potentially unlimited increase in the market value of the security sold short, which could result in potentially unlimited loss.

If used in connection with the sale or promotion of an investment company product, this material must be preceded or accompanied by a prospectus for the respective product.

Securities offered through Hatteras Capital Distributors, LLC, member of FINRA/ SIPC.

Investors should consider the Funds’ investment objectives, risks, charges and expenses carefully before investing. The prospectus, or if applicable, summary prospectus, contains this and other important information about the Funds and may be obtained by visiting hatterasfunds.com or calling 866.388.6292. Read it carefully before investing.
About Hatteras Funds

Hatteras Funds provides unique alternative investment solutions for financial advisors and their clients.

We believe that all investors should have access to the same sophisticated investment approach and superior portfolio management talent as the largest institutions.

A boutique alternative investment specialist founded in 2003, Hatteras Funds offers a suite of innovative products designed to help financial advisors allocate to alternative investments.