Hedge Fund Investing: Manager Selection and Due Diligence

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Hedge fund investments[1] may have the potential to add significant value to an investor's portfolio because they have historically provided strong risk-adjusted returns with low correlations to traditional investments. To gain the benefits of hedge fund investing, however, requires skillful manager selection and careful due diligence. This is because the dispersion of hedge fund manager returns is so wide. The wide dispersion in manager performance creates both opportunity and risk for an investor—selecting the right managers may add significant value to a portfolio while poor manager selection could materially impair investment performance.

To assist Financial Advisors and qualified clients in making hedge fund investment decisions, this paper provides a review of the:

- Importance of hedge fund manager selection
- Challenges involved in hedge fund manager selection
- Elements of an effective hedge fund investment due diligence process
- Elements of an effective hedge fund business due diligence process
- Potential benefits of using a professional intermediary for manager selection and due diligence

THE CRITICAL IMPORTANCE OF HEDGE FUND MANAGER SELECTION

Including hedge funds in a traditional investment portfolio may add significant value (see "Review of Hedge Funds in a Portfolio Context," p. 4).

For the analysis shown in "Review of Hedge Funds in a Portfolio Context" and in similar analyses, hedge fund index returns are shown as representative of an average investor's

The Wealth Allocation Framework

The Wealth Allocation Framework helps you put your goals and aspirations at the center of decisions about allocating your financial resources. **This paper focuses on strategies that may be appropriate for the Market asset category.**

Market: Investors seek to maintain their lifestyle. A well-diversified portfolio may provide risk and return in line with efficient market performance—very efficient, but also uncertain.

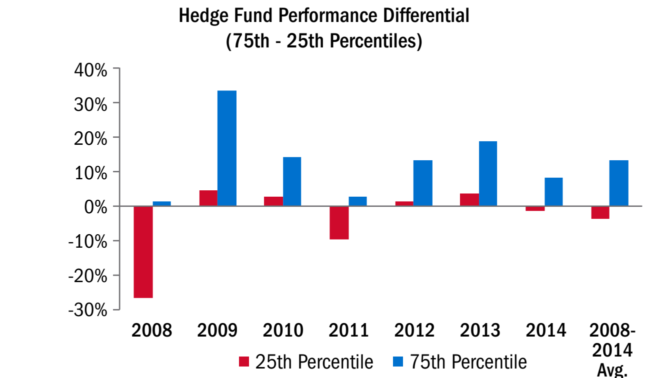
To learn more, read the whitepaper, *Investing in a Transforming World: The Wealth Allocation Framework*

Past performance not indicative of future results

[1] You should be aware that most AI products are sold on a private placement basis and eligible clients must typically be Qualified Purchasers ($5 million net investments). Alternative Investments are speculative and subject to a high degree of risk. Although risk management policies and procedures can be effective in reducing or mitigating the effects of certain risks, no risk management policy can completely eliminate the possibility of sudden and severe losses, illiquidity and the occurrence of other material adverse effects. The term "hedge fund investments" refers to single-manager hedge funds. Data used in performance dispersion analysis and on industry growth is focused on single-manager hedge funds.

experience in hedge funds. While this assumption makes sense in the aggregate, there is a big caveat—for an individual investor there is a substantial risk that his or her hedge fund investments will perform differently than the index.

Exhibit 1: Dispersion of Hedge Fund Returns, 2008 - 2014



	2008	2009	2010	2011	2012	2013	2014	2008-2014 Avg.
Dispersion (75th-25th):	27.9%	28.5%	11.6%	12.6%	11.9%	15.5%	9.5%	16.8%

Source: Morgan Stanley. Data as of Dec. 31, 2014.
Past performance not indicative of future results.

Exhibit 1 provides data on the dispersion of hedge fund returns from 2008 through 2014. Hedge funds have had a very wide dispersion of returns. For example, the simple average return difference between a manager in the 75th percentile of performance and the 25th percentile is approximately 17% per year. This holds true both in aggregate for hedge funds as well as within different hedge fund strategies. *In fact, manager performance differentials can be so wide within strategies that it can often overshadow performance differentials between very different investment strategies.*

This wide dispersion of manager returns creates both significant opportunity and risk for investors. Identifying and investing in superior hedge fund managers may add substantial value to a portfolio. However the costs of poor manager selection could be severe, leading not only to underperformance but potentially a significant loss of principal.

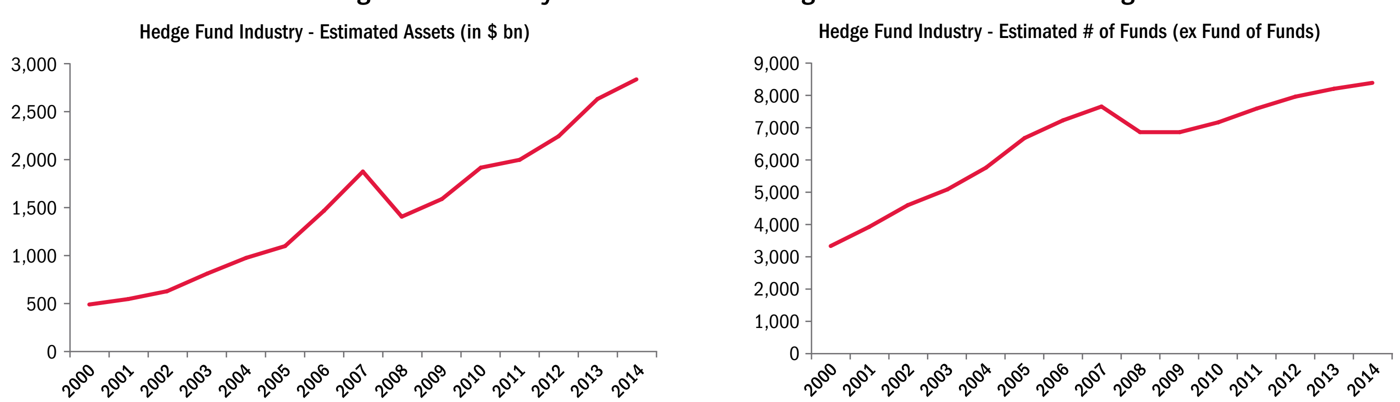
CHALLENGES IN HEDGE FUND MANAGER SELECTION AND DUE DILIGENCE

While investing in the right managers is essential, skillful hedge fund manager selection and due diligence is extremely difficult for a variety of reasons.

First, there are thousands of hedge funds available to investors, and this number has grown dramatically over the past decade (Exhibit 2). The sheer number of hedge funds means that significant value can be added simply by taking the time to meet with many hedge fund managers. The industry's growth is partly due to an increased acceptance and interest in hedge funds from high-net-worth and institutional investors. Part of the growth is also likely due to the attractive economics of running a hedge fund, which has attracted managers with varying levels of investment talent. Hedge fund managers have increasingly employed experienced service providers (prime brokers, consultants, third-party marketing firms) that often help managers refine their marketing pitches to potential investors, thereby making it even more difficult to distinguish the good from the bad without a comprehensive, in-depth due diligence process.

Second, few investors have the expertise necessary to properly evaluate these funds because hedge funds span an incredibly broad range of asset classes, investment strategies and

Exhibit 2: Growth of the Hedge Fund Industry - assets under management and number of hedge funds



Source: HFR. Data as of Q4 2014

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sub-strategies, geographies and instruments. For example, the expertise necessary to evaluate a U.S. convertible bond arbitrage manager may differ greatly from the expertise needed to evaluate a global macro manager or an Asia-focused equity long/short manager. Beyond having a deep understanding of instruments, strategies and markets, a potential hedge fund investor needs to have the qualitative and quantitative investment skills specific to evaluating managers, their backgrounds and their teams.

Third, few hedge fund investors have the expertise necessary to thoroughly evaluate all the business or operational aspects of a hedge fund organization. This includes evaluating a fund's operations, regulatory framework, its legal documents, business structure and history. Evaluating these aspects is crucial as many fund failures and investor losses are due to operational failures or business issues that were not directly investment related but increased risk in subtle and complex ways.

Compounding these challenges, it can be difficult for investors to get enough time with the senior investment professionals at top hedge funds to perform thorough due diligence as these professionals need to balance the demands of managing their portfolios with investor demands on their time. Additionally, hedge funds are often reluctant to provide the level of portfolio transparency needed to thoroughly evaluate a fund.

With these challenges in mind, the next two sections address an important question: What does an effective manager selection and due diligence process look like?

ELEMENTS OF AN EFFECTIVE INVESTMENT DUE DILIGENCE PROCESS

An effective investment due diligence process is essential to successful hedge fund investing. The term "investment due diligence" can be confusing because it is used in a variety of contexts to describe a scope of activities, both narrow and broad. We use the term "investment due diligence" broadly to include all facets of investment-related work and analysis. If done thoroughly, the investment due diligence process can often take three to six months, if not longer. We divide investment due diligence into three steps: manager sourcing, initial due diligence and manager monitoring.

- **Manager Sourcing:**
  Sourcing is the first step in the due diligence process. When sourcing, an investor must work hard to ensure that: 1) they review enough managers to have a framework for meaningful comparison and evaluation, and 2) the quality of new idea flow is high. Having an *active and continuous* manager sourcing effort is crucial. It helps avoid the risk of negative sourcing bias in which investors are not exposed to the highest quality managers. This can occur when investors mostly receive new investment ideas *passively*—typically directly from managers' solicitations or from service providers that may have a vested economic interest to market a particular manager, e.g. a third party marketing firm or a prime broker. There may be an inverse relationship between a fund's level of marketing outreach and fund quality because many top managers do not need to actively seek out investors. Additionally the available manager opportunity set changes over time. This includes new fund launches as well as managers who may have been closed to new capital but may periodically and selectively re-open. Accordingly, experienced hedge fund investors have built out their own sourcing network and are constantly in the market looking for new investment ideas in order to fill needs in their portfolio as well as to compare to their existing manager holdings and upgrade if the opportunity arises.

- **Initial Due Diligence:**
  Initial due diligence is the area that many investors think of when the term "due diligence" is used and includes a broad range of activities, analyses and evaluations. Initial due diligence should be a thorough, time-intensive process if an investor is to proceed with a new investment in a manager. Initial fund due diligence can be broken down into four steps:

  <u>Preliminary Review</u> – In this first phase, a review is typically based on the fund's materials and documents, and one or two meetings with the manager. The goal is to identify those managers worthy of the time and expense of the full due diligence process and to screen out the rest. An investor should begin by evaluating several factors including: 1) team pedigree, experience and talent, 2) investment strategy and performance, and 3) organization, structure and terms. Typically only a select group of managers that pass both a quality assessment and fit the investor's needs (strategy fit, portfolio fit, liquidity, etc.) will make it through the preliminary review process and proceed on to full due diligence.

Qualitative Review – This is typically the most exhaustive and time-consuming part of the initial due diligence process, and in many ways the most crucial. Here an investor is evaluating the investment aspects of a hedge fund manager in-depth. These can be grouped into the "Four P's":

1. People — The quality, depth and experience of the fund's investment team.
2. Investment Philosophy — The manager's investment strategy, approach and style.
3. Investment Process — The manager's research process, how positions or themes are added to the portfolio, monitored and removed from the portfolio.
4. Portfolio Construction and Risk Management — How the manager constructs the portfolio and manages risk at both the position and portfolio level.

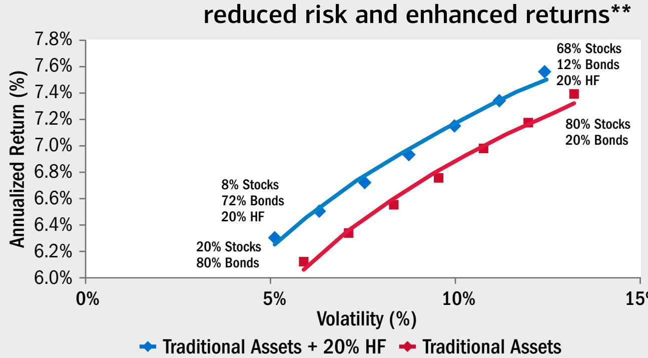
The qualitative review should involve multiple meetings, calls, and at least one on-site visit with the manager. An important part of this process is meeting with multiple members of the fund's investment team in order to better evaluate the team and the quality of their work. Transparency and an open dialogue are essential to enable a thorough analysis of the fund's portfolio and positions, both past and present. Detailed work should be done to investigate a manager's investment process, with an emphasis on analyzing detailed investment examples. This includes independently testing and checking the work at the individual position-level and reviewing managers' models to ensure the rigor of the investment process. The

REVIEW OF HEDGE FUNDS IN A PORTFOLIO CONTEXT

Most investors are familiar with traditional investments, such as stocks and bonds that are generally held long. These investments make up the bulk of the typical investor's portfolio and provide exposure to the markets. Alternative Investments are intended to generate returns that are far less dependent on market exposure. Alternative Investments are generally divided into three categories: hedge funds, private equity and real assets.

Hedge funds are often recommended as a complement to traditional portfolios because their returns have historically had relatively low correlations with the returns of traditional assets. This is important because, according to Modern Portfolio Theory, combining non-correlated investments helps create a diversified portfolio that has a better expected risk-adjusted return than the underlying investments alone. This diversification benefit is a primary reason investors seek alternative investments. For example, a portfolio that includes hedge funds may have the same returns as a traditional stock and bond portfolio but with less risk, as illustrated in Presentation 1. Presentation 2 provides data on the historical return, standard deviation, drawdown, and correlation for hedge funds, equities, and bonds.

Presentation 1: Portfolios including *all HF strategies* reduced risk and enhanced returns**



Source Indices: Credit Suisse Hedge Fund Index, S&P 500 Total Return Index, and Barclays US Aggregate Total Return Index. Source: IMG Investment Analytics. Based on data from Jan. 1994 - Dec. 2014. **Past performance not indicative of future results.**

Note: Please note that a 20% allocation to AI may not be appropriate for all investors, as allocations vary with the risk profiles and liquidity needs of individual investors.

Presentation 2: Risk/Return Statistics Jan 1994 - Dec 2014

	Annual Compound Return	Total Return	Standard Deviation	Max Drawdown	Correlatoin to DJ CS Hedge Fund
CS Hedge Fund Index	8.2%	422.7%	7.4%	-19.7%	N/A
S&P 500 TR	9.4%	563.4%	15.0%	-51.0%	0.57
Barclays US Agg TR	5.8%	223.6%	3.6%	-5.2%	0.14

Index sources: Equities: Standard & Poor's 500® Total Return; Bonds: BarCap US Aggregate TR; Hedge Funds: Dow Jones/Credit Suisse Hedge Fund. Direct investment cannot be made in an index. The hedge fund indices shown are provided for illustrative purposes only. They do not represent benchmarks or proxies for the return of any particular investable hedge fund product. The hedge fund universe from which the components of the indices are selected is based on funds which have continued to report results for a minimum period of time. This prerequisite for fund selection interjects a significant element of "survivor bias" into the reported levels of the indices, as generally only successful funds will continue to report for the required period, so that the funds from which the statistical analysis or the performance of the indices to date is derived necessarily tend to have been successful. There can, however, be no assurance that such funds will continue to be successful in the future. Merrill Lynch assumes no responsibility for any of the foregoing performance information, which has been provided by the index sponsor. Neither Merrill Lynch nor the index sponsor can verify the validity or accuracy of the self-reported returns of the managers used to calculate the index returns. Merrill Lynch does not guarantee the accuracy of the index returns and does not recommend any investment or other decision based on the results presented.

**Hypothetical portfolios for illustrative purposes only. Asset allocation does not assure a profit or protect against a loss in declining markets. Results shown are based on indexes; they assume reinvestment of income, no transaction costs or taxes, and that the allocation for each model remained consistent

The "efficient frontier" tracks the relationship of rate of return and performance volatility (as measured by standard deviation). While performance volatility is one widely-accepted indicator of risk in traditional investment strategies, in the case of alternative investment strategies, performance volatility is an indicator of only one dimension of the risk to which these actively-managed, skill-based strategies are subject. There is a "risk of ruin" in these strategies that has historically had a material effect on long-term performance but which is not reflected in performance volatility. From time to time, extremely low volatility alternative investments have incurred sudden and material losses. Consequently, any comparison of the "efficient frontiers" of traditional and alternative investments is inherently limited.

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investment positions and models selected to be analyzed should be chosen by the investor, not the manager.

Quantitative Review – Concurrent with the qualitative review, a quantitative review of the manager's performance is important. This review includes analyzing the manager's track record at his current fund and any prior performance records if available. The quantitative review is much more than just a review of performance and certain commonly used statistics (standard deviation, Sharpe ratio, etc.)

A thoughtful investor needs to dig into the performance history and use data gained from the manager to triangulate the sources of return and the risks taken to generate the track record. With the wide number of managers available it can be difficult to gauge skill versus luck. Questions to try to answer include:

- What was the level of risk taken to generate these returns? (This may or may not show up in common risk measures such as standard deviation)
- Have the returns been broad-based with contribution from a wide variety of different positions, sectors/asset classes and themes, or have returns been driven by a few "big bets" that went in the manager's favor?
- Was the manager structurally a beneficiary of pursuing a sub-strategy/having a particular expertise that was in favor in the markets during this time period?
- How has the manager navigated difficult periods in the markets?
- How dependent were returns on leverage?

Unfortunately investors do not have the opportunity to benefit from a historical return stream—they are buying into a future return stream that is by definition unknown. While some managers have been able to outperform over time, it is difficult to gauge whether a manager's strong returns are likely to continue. A thoughtful investor needs to combine the evidence from a manager's past performance with an understanding of how that performance was generated and a qualitative assessment of the investment process. This may help to determine whether that manager has an "investment edge" that is likely to replicate superior performance *in the future.*

Final Evaluation – The final evaluation is primarily qualitative in nature and is the last step in the decision-making process for a potential new investment. Reference checks on the firm and its senior staff are of critical importance. Experienced investors will call the official references listed by the manager, and ask tough, probing questions, while listening carefully to a reference's nuance and tone. Experienced investors will also have worked during the due diligence process to develop a range of "informal" references that have not been chosen by the manager. These informal references often include people who worked with the manager at a prior firm, industry peers of the manager and other investors in the fund (either current investors or ones who have redeemed). The goal is to find people who know the manager well but were not handpicked to serve as references and do not have a direct incentive to provide a positive view. References should be asked not only about a manager's investment acumen, but also his or her overall ability to run a hedge fund business, ability to manage a team, and ethics and character.

To help guide them to a decision on whether to invest, experienced investors write up their investment evaluations, carefully documenting and summarizing their due diligence work. This furthers the evaluation by helping to identify any remaining unanswered questions, open items, or areas of concern that may need to be researched further. The written analysis should lay bare the pros and cons of a manager and risks to an investment, helping to facilitate final investment decision-making. It also provides a summary document that can be referenced at a later date to help guide future decisions (e.g. if an invested manager begins to deviate from a strategy or risk parameters.) Professional hedge fund investors often formally present their written manager evaluations to investment committees, comprised of seasoned investment staff, for review, debate and a final vote.

- **Investment Monitoring / Ongoing Due Diligence:** Experienced investors realize that the date of first investment is not the end of the process of learning about a manager. Rather it is the crossing of an initial threshold of knowledge—specifically obtaining enough knowledge to have conviction to invest. Learning more about a manager and monitoring the portfolio and organization over time is an on-going task that should continue for as long as one holds the investment.

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The importance of closely monitoring investments cannot be overstated yet many investors underestimate both its importance and the commitment in time and resources needed to do it properly. Many investors have been stung by existing manager investments that they have not followed closely or have grown complacent with, thereby missing important changes or early warning signs that often presage performance difficulties. Hedge funds often have broad mandates and managers have considerable latitude in managing their portfolios. The success of many hedge funds can be driven by a few talented staff members whose departures could have a material effect. Accordingly, savvy hedge fund investors regularly talk with their hedge fund managers to get an update on the portfolio, performance and organization. They also visit managers on-site periodically and meet with multiple members of the team.

The goal of monitoring is to re-validate the original investment decision and understand any changes to the strategy, portfolio and team. Monitoring thus provides a basis for ongoing evaluation and review of hedge fund investments. It allows an investor to thoughtfully determine if the manager is still the best investment choice. A manager that appeared to be the most compelling choice a few years back may not be so today, perhaps due to changes in the manager, the team, strategy or the markets in which they invest. Perhaps there are now simply stronger managers available. The decision about whether and when to redeem from a manager can be as important as the original decision to invest.

ELEMENTS OF AN EFFECTIVE BUSINESS DILIGENCE PROCESS

An equally important component of successful hedge fund investing is an effective business due diligence process. Business due diligence, also commonly referred to as "operational due diligence," includes evaluating all aspects of a potential hedge fund investment that are *non-investment related*. This typically includes reviewing a fund's operational processes and procedures, legal structure and organization, staffing, valuation of underlying securities, compliance policies and procedures, and use of third-party service providers (e.g. its administrator, counterparties, auditor, law firm, etc.).

The importance of thorough business due diligence to successful hedge fund investing cannot be overstated. It is not uncommon for a talented hedge fund portfolio manager who may have developed his or her investment skills in a large organization to have little to no experience with setting up the operational infrastructure needed to execute his or her investment strategy or with the potential operational and business issues that come with running a hedge fund. Historically, many hedge fund failures have occurred not because of poor investment decisions, but because a hedge fund had material operational deficiencies. By some estimates, many hedge fund failures can be solely attributed to operational risk.

A business due diligence review typically focuses on evaluating risk in three broad areas:

- **Operational Risk**
  Operational risk is generally defined as the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. To evaluate operational risk at a hedge fund, it is important to review a fund's trade execution, settlement and reconciliation processes, its cash controls and its valuation procedures used to price the fund's holdings. A review of the quality of a fund's operational staff and the capabilities of the fund's third-party service providers is essential. The fund's policies and operating procedures should be reviewed to ensure they are appropriate relative to the investment strategy the fund employs. Further, it is important to ensure that the policies and procedures are consistently applied and that there is a proper segregation of duties among staff.

- **Legal and Regulatory**
  This area includes understanding: the regulatory framework in which a hedge fund is operating, the culture of compliance in the fund's organization and the potential risks posed by a hedge fund's conflicts of interest. Conflicts of interest tend to be present in hedge fund organizations and can be problematic in the absence of adequate disclosure to investors and strong compliance policies and procedures. Further areas to review include: fund structure, fund expenses, practices around the use of soft dollars, trade allocation policy and personal trading policy. In addition to performing a detailed review of all fund documents themselves, experienced hedge fund investors will also have external counsel provide an independent legal review of all documents. Savvy investors also employ third-

party background services to perform formal background checks on the key principals of a fund to verify education, employment history and search for possible civil or criminal records or current litigation.

- **Business Risk**
  Business risk is a broad area that incorporates evaluating the hedge fund organization as a business with a focus on business viability. Topics that should be addressed during a business due diligence review include: the hedge fund organization's history and business plan, history of assets under management, investor base and level of investor concentration, key person risk on the fund's investment and operations teams, redemption and liquidity terms versus the underlying liquidity of the portfolio and other structural features of the organization.

Similar to the investment due diligence process, visiting a hedge fund on-site and spending time with multiple members of its operations team is a critical part of the business due diligence process. A thorough business due diligence review of a prospective hedge fund should also include independent verification of the services provided by a fund's administrator and prime brokers, as well as an analysis of the fund's audited financial statements.

The expertise required to perform business due diligence properly is very different than that of investment due diligence. A business due diligence analyst typically has previously worked in the financial services industry, specifically in areas such as accounting, law, operations, risk and compliance.

Given the detailed nature of this type of review and the cost of conducting an external legal review and a third-party background check, business due diligence on a prospective new investment typically occurs after a substantial portion of the investment due diligence is complete. Regular business due diligence monitoring, including periodic on-site visits, is essential.

COMMON MANAGER SELECTION AND DUE DILIGENCE MISTAKES

- Chasing performance
- Being seduced by manager's pedigree or "exclusivity"
- Confusing manager marketing prowess with investment prowess
- Ignoring or minimizing operational or structural concerns
- Not carefully analyzing liquidity and a fund's assets under management/size
- Not spending enough time on ongoing due diligence / investment monitoring

PROFESSIONAL APPROACH TO INVESTING IN HEDGE FUNDS

Because of the critical importance, complexities and risks involved in hedge fund manager selection as well as the time and cost-intensive nature of the work, Merrill Lynch recommends that Financial Advisors and clients use a professional intermediary to provide investment and business due diligence on hedge fund investments.

Using a professional intermediary to provide investment and business due diligence on hedge funds may provide significant benefits to a potential hedge fund investor. Hedge fund manager selection is a high-stakes endeavor as the performance dispersion between managers is wide and the cost of poor manager selection could be substantial. The time and cost involved in performing proper hedge fund due diligence should not be underestimated. Using a professional intermediary allows a Financial Advisor or client to leverage the expertise and resources of a larger organization and benefit from economies of scale.

We believe that the characteristics of a strong professional intermediary include:

- **Deep and Experienced Team**
  Hedge funds can be complex and difficult to evaluate, and hedge fund organizations are dynamic and often fragile. Accordingly, it is essential to have senior, experienced people evaluating and monitoring all aspects of an investor's hedge fund investments.

  The investment due diligence team should be staffed by people with significant buy-side experience who are students of both the markets and managers. The investment team should be broad and include people with complementary and diverse investment backgrounds (e.g. expertise in equity, credit, and derivatives) to be able to thoroughly evaluate and monitor all hedge fund strategies, instruments, and geographies. Similarly, the business due diligence team should be staffed with experienced people with complementary and diverse backgrounds relevant for business due diligence. If built and managed properly, the

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team should have the experience and breadth to carefully select and monitor hedge fund managers across all hedge fund strategies globally.

- **Organization and Resources**
  A top professional intermediary should have the organizational commitment and resources to support a strong hedge fund investment process. This includes making the significant financial commitment necessary to hire and retain an experienced and sizable investment and business due diligence team. It also means a commitment to supporting an intensive research process, including providing resources to travel to visit managers on-site regularly, to support analytic tools for quantitative and qualitative assessment of managers and to hire quality service providers integral to top-notch business due diligence reviews (e.g. law firms and third-party background check services). Additionally, a professional intermediary should have strong governance and oversight to ensure the integrity of the due diligence process and investment decisions.

- **Information and Transparency**
  A strong professional intermediary can take advantage of its size and reputation to gain better portfolio transparency and more frequent access to senior investment staff at hedge funds. Thus a professional investor may have better information to make investment decisions.

- **Access to Top Hedge Fund Managers**
  A quality professional intermediary should be able to offer access to top-tier hedge fund managers including some that are closed to new investors more broadly. Long-standing business relationships and a reputation for expertise and staying power in hedge fund investing allow strong professional intermediaries the ability to access some top hedge fund managers that are only selectively open to capital.

- **Ethos of always trying to do better and constantly striving to improve**
  A top professional intermediary should have a continuous commitment to improving and refining its investment and business due diligence process and team. This is essential in the competitive and continually evolving hedge fund marketplace.

CONCLUSION

At Merrill Lynch, we have a long history with alternative investments. We believe that manager selection is essential to successful hedge fund investing because the dispersion of returns across managers is so wide. We believe that effective investment and business due diligence are critical to selecting hedge fund investments. Because of the challenges, complexities, and risks involved in hedge fund investing, in addition to the time and cost-intensive nature of due diligence, we believe that clients and Financial Advisors may benefit from using a professional intermediary for hedge fund manager selection and due diligence.

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INDEX DEFINITIONS

The indexes referred to herein are unmanaged, include the reinvestment of dividends, do not reflect the impact of transaction, management or performance fees. They do not represent benchmarks and are included here for illustrative purposes.

Barclays Aggregate Bond Index: Composed of the Government Corporate Bond Index, the Asset-Backed Securities Index and the Mortgage-Backed Securities Index and includes U.S. Treasury issues, agency issues, corporate bond issues and mortgage-backed issues.

The Dow Jones Credit Suisse Hedge Fund Index is compiled by Credit Suisse Hedge Index LLC and CME Group Index Services LLC. It is an asset-weighted hedge fund index and includes only funds, as opposed to separate accounts. The index uses the Credit Suisse Hedge Fund Database (formerly known as the "Credit Suisse/Tremont Hedge Fund Database"), which tracks approximately 8,000 funds and consists only of funds with a minimum of $50 million under management, a 12-month track record, and audited financial statements. The index is calculated and rebalanced on a monthly basis, and reflects performance net of all hedge fund component performance fees and expenses.

S&P 500 Index: A market-capitalization weighted index that measures the market value of 400 industrial stocks, 60 transportation and utility company stocks and 40 financial issues.

RISKS OF HEDGE FUND INVESTMENTS

- Hedge funds are speculative and involve a high degree of risk.
- Hedge funds may trade on a leveraged basis and may engage in short sale strategies which may increase the risk of loss.
- Hedge fund performance can be volatile.
- An investor could lose all or a substantial amount of his or her investment.
- There is no secondary market for interests in hedge funds and none is expected to develop.
- Hedge fund interests are subject to restrictions on transfers and on liquidity, which may include lock-ups and redemption gates.
- High fees and expenses may offset the underlying manager's trading profits.
- A substantial portion of the trades executed by the underlying managers may take place on non-US exchanges.
- Certain funds may take concentrated bets in particular sectors or strategies.
- There is less investment transparency than for registered funds.
- Hedge funds are subject to less regulatory oversight than traditional investments.
- Tax implications: Hedge fund investors receive a tax report on form K-1 for each fund in which they invest. This most likely will require filing a tax extension.

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IMPORTANT DISCLOSURE INFORMATION

The report was prepared by GWM IMG and is not a publication of BofA Merrill Lynch Global Research. The views expressed are those of GWM IMG only and are subject to change. This report is not an offer to purchase any security. An offer to purchase interests in any alternative investment fund may be made only pursuant to the fund's private placement memorandum, which contains important information concerning risk factors, performance and other material aspects of the fund.

Hedge funds are speculative and involve a high degree of risk. An investor could lose all or a substantial amount of his or her investment. There is no secondary market nor is one expected to develop for investments in hedge funds and there may be restrictions on transferring fund investments. Hedge funds may be leveraged and performance may be volatile. Hedge funds have high fees and expenses that reduce returns.

Alternative Investment products are only available to AI-qualified Financial Advisors and may only be sold to pre-qualified clients. Most alternative investment products are sold on a private placement basis and eligible clients must typically be Qualified Purchasers ($5 million net investments).

No assurance can be given that any alternative investment's investment objectives will be achieved. In addition to certain general risks, each product will be subject to its own specific risks, including strategy and market risk.

This material is for informational purposes only and does not constitute investment advice or an offer to sell or buy any security. An offer to purchase interests in any alternative investment fund may be made only pursuant to the fund's private placement memorandum, which contains important information concerning risk factors, performance and other material aspects of the fund. This must be carefully read before any decision to invest is made.

Alternative investments are intended for qualified and suitable investors only. Alternative Investments such as hedge funds, private equity funds, and funds of funds can result in higher return potential but also higher loss potential. Changes in economic conditions or other circumstances may adversely affect your investments. Before you invest in alternative investments, you should consider your overall financial situation, how much money you have to invest, your need for liquidity, and your tolerance for risk. Alternative Investments are speculative and involve a high degree of risk.

- Alternative Investments are speculative and involve a high degree of risk.
- Alternative investments may trade on a leveraged basis which increases the risk of loss.
- Performance can be volatile.
- An investor could lose all or a substantial amount of his or her investment.
- The use of one or a small number of fund managers applying one set of allocation procedures could mean lack of diversification and, consequently, higher risk.
- There is no secondary market for investor's interest in alternative investments and none is expected to develop.
- There may be restrictions on transferring interests in the alternative investments.
- High fees and expenses, including performance fees payable to the manager, may offset trading profits.
- Fund managers have broad authority to suspend redemptions, defer payment of redemption proceeds and establish illiquid side pockets to segregate illiquid investments.
- A substantial portion of the trades executed by the underlying managers may take place on non-US exchanges.
- In addition to the foregoing risks, each alternative investment fund is subject to its own strategy-specific or other risks. You must carefully review the offering memorandum for any particular fund and consider your ability to bear these risks before any decision to invest.
- **Past performance is not indicative of future results.**

In addition to the foregoing risks, private equity fund investments are subject to the following additional risks:

- Private equity investments involve significant risks and are typically illiquid on a long-term basis and may require a holding period of at least 8 to 12 years. Underlying private investments may be difficult to value.
- Private equity managers typically take several years to invest a fund's capital. Investors will not realize the benefits of their investment in the near term and there will likely be little or no near-term cash flow distributed by the fund during the commitment period. Interests may not be transferred, assigned or otherwise disposed of without the prior written consent of the manager.
- Private equity funds may make a limited number of investments, and such investments generally will involve a high degree of risk, such as start-up ventures with little or no operating histories. In addition, funds may make minority equity investments where the fund may not be able to protect its investment or control or influence the business of such entities. The performance of a fund may be materially impacted by a single investment.
- A private equity fund may obtain rights to participate in, or to influence, the management of certain portfolio companies, including the ability to designate directors. This or other measures could expose the assets of the fund to claims by a portfolio company, its security holders, creditors and others.
- Private equity fund investors are subject to periodic capital calls. Failure to make required capital contributions when due will cause severe consequences to the investor, including possible forfeiture of all investments in the fund made to date.

Investing in Emerging Markets may involve greater risks than investing in more developed countries. In addition, concentration of investments in a single region may result in greater volatility. Any reference to a specific company or security does not constitute a recommendation to buy, sell, hold or directly invest in the company or its securities. It should not be assumed that the recommendations made in the future will be profitable or will equal the performance of the securities discussed in this document.

This material may contain statements regarding plans and expectations for the future that constitutes forward-looking statements. All statements other than statements of historical fact are forward-looking and can be identified by the use of words such as "may," "will," "expect," "anticipate," "estimate," "believe," "continue" or other similar words. Such forward-looking statements are based on current plans and expectations, and are subject to risks and uncertainties that could cause actual results to differ materially from those described in the forward-looking statements.

Please refer to the last page of this document for additional important disclosure and risk information.

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