Non-Traditional Mutual Funds

For more than 20 years, alternative investments have become a part of the lexicon of the general investing public. They appear frequently in The Wall Street Journal and other financial publications and make up a significant portion of the endowments of prominent universities such as Yale and Harvard.[1] The discussion of alternatives has typically been confined to hedge funds, private equity, real estate and real assets such as gold. In the last several years, however, hedge fund-like strategies and other alternative investments have become much more available in mutual fund and exchange-traded fund (ETF) structures.

In this paper, GWM Investment Management & Guidance (IMG) seeks to help Financial Advisors and their clients make informed decisions and prudent investment choices in a relatively new investment strategy. We will attempt to:

- *Highlight the portfolio benefits of using alternative investments.*
- *Explain the growth of the non-traditional mutual fund (NTMF) market.*
- *Describe what non-traditional mutual funds are and what they are not.*
- *Explain the use of NTMFs in a portfolio and the value of fund selection.*

Portfolio Benefits of Using Alternative Investments

Investors have traditionally sought capital growth and current income through an appropriate mix of stocks and bonds. These investments have typically been long only and used no leverage or derivatives. The exposure in these portfolios is essentially to the market. Active management and successful stock-picking can mitigate this traditional dependence on the market, but only to a degree. If the markets go up, the portfolio will go up, more or less; likewise, if they go down the portfolio will go down.

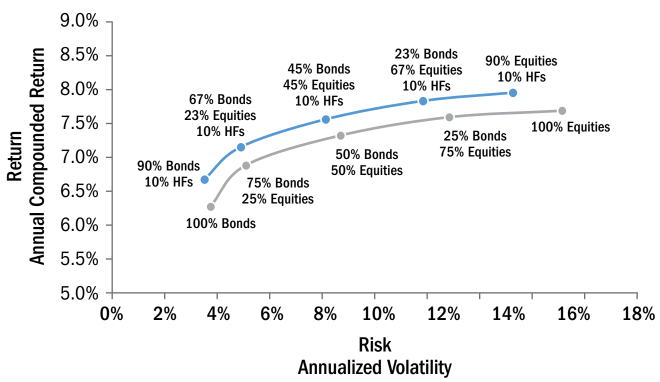
Alternative investments are, simply put, alternatives to traditional, long-only stock and bond investing. A specific, accepted definition of alternatives is difficult to come by, but consensus generally divides alternative investments into two different segments—alternative assets and alternative strategies. Alternative assets include gold, other physical commodities and real assets, real estate and similar asset classes. Alternative strategies are those generally associated with hedge funds and private equity funds and include selling securities short, using leverage and derivatives, concentrating in a small number of securities and using illiquid or private investments. Both of these groups of alternatives behave differently than traditional investments, providing the potential for diversification, and that is ultimately their appeal. More

[1] According to Russell Investments' *2012 Global Survey on Alternative Investing*, institutional investors are making significant allocations to alternatives (on average 22% of total assets). Importantly, up to one-third of respondents are expecting to increase their allocations to alternatives over the next one to three years.

specifically, hedge funds employ strategies ranging from simply picking stocks both long and short in a hedged portfolio to very sophisticated, model-driven derivatives investments. These strategies purport to control risk and emphasize return. While this is an attractive proposition, the true value of hedge fund strategies lies in their contribution to a traditional portfolio. Over a market cycle, these strategies do not act like traditional, long-only investments. Their returns are differentiated and so they can enhance the potential for diversification.

Diversification is the core tenet of modern portfolio theory. The basic concept is that combining different return streams that are not perfectly correlated to each other will lead to a more efficient portfolio. This is a portfolio that can provide the same returns for less risk or greater returns for the same risk as an undiversified portfolio. Therefore, if an investor were to add diversifying alternative strategies to traditional investments, the portfolio should require less risk to generate each unit of return, as Exhibit 1 demonstrates, using a hedge fund index as an example.

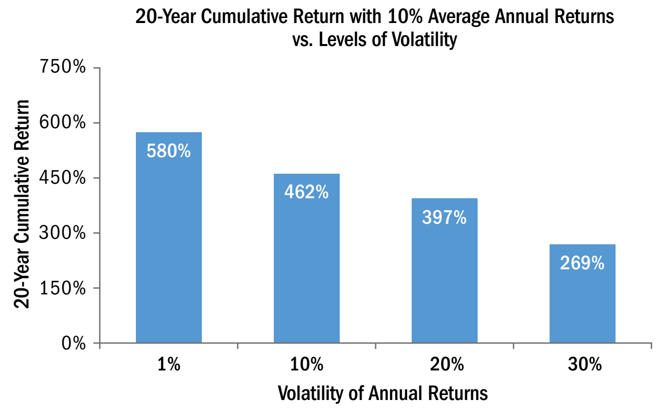
Exhibit 1*: Risk / Return – Jan 94 - Dec 13



Source: Hedge Fund Research. Data from Jan. 1994 - Dec 2013
Past performance is not indicative of future results. For illustrative purposes only. The 10% allocation is for indicative purposes only, not a recommended allocation level.

Reduced volatility by definition provides more certain outcomes. It should also lead to smaller drawdowns and more effective compounding of wealth (see Exhibit 2).

Exhibit 2: Volatility Matters: The Symmetry of Compounding



For illustrative purposes only.
Source: Carlson Capital.

There are a number of different sources of alternative returns and an increasing breadth of ways to invest in hedge fund strategies.

The Growth of the NTMF Market

For years, client portfolios consisted primarily of stocks and bonds. Diversification was achieved chiefly through duration or sector, market capitalization and geographic allocations. After the financial crisis of 2008, and the recession and market volatility that followed, many investors began to re-examine their investment approach. A number of investors in traditional asset classes were dissatisfied with their experience in 2008 and began looking for ways to protect their portfolios from such extreme market volatility. Long-only equity strategies fell out of favor: $234 billion was redeemed from equity mutual funds in 2009 alone.[2] While hedge funds as a group outperformed

[2] Morningstar

* Source: IMG Investment Analytics. Based on pro-forma quarterly data with semi-annual rebalancing from Jan. 1994 to Dec. 2013. **Asset allocation does not assure a profit or protect against a loss in declining markets.** Results shown are based on indexes and are illustrative; they assume reinvestment of income, no transaction costs or taxes, and that the allocation for each model remained consistent. Past performance is no guarantee of future results. 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 which 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.

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.

the equity indices during this period, many still experienced substantial losses and their sophisticated investors suffered their own form of disappointment. Many hedge fund investors were subjected to gating, side-pocketing of illiquid securities[3] or outright suspension of redemptions. In some cases, these liquidity impairments were a surprise to investors who did not have transparency to the underlying holdings, or otherwise had not focused on the broad flexibility hedge fund managers have in the event of severe market conditions. The lack of dependability around investors' redemption rights exacerbated the perception of an absence of uniformity in hedge fund structures and terms.

Post 2008, traditional investors began to look for ways to diversify their portfolios and reduce their dependence on the market directionality. At the same time, hedge fund investors began to express a stronger appetite for improved transparency, liquidity and structural uniformity. The result of these frustrations in both traditional and alternative strategies has led to a convergence of demand for liquid, more highly regulated alternatives broadly and non-traditional mutual funds in particular.

As seen in Exhibit 3, assets in mutual funds categorized by Morningstar as alternative have grown nine-fold between 2005 and the end of 2013. Moreover, alternative assets as a portion of the mutual fund universe, have risen from 0.5% in 2005 to 2.4% in late 2013.

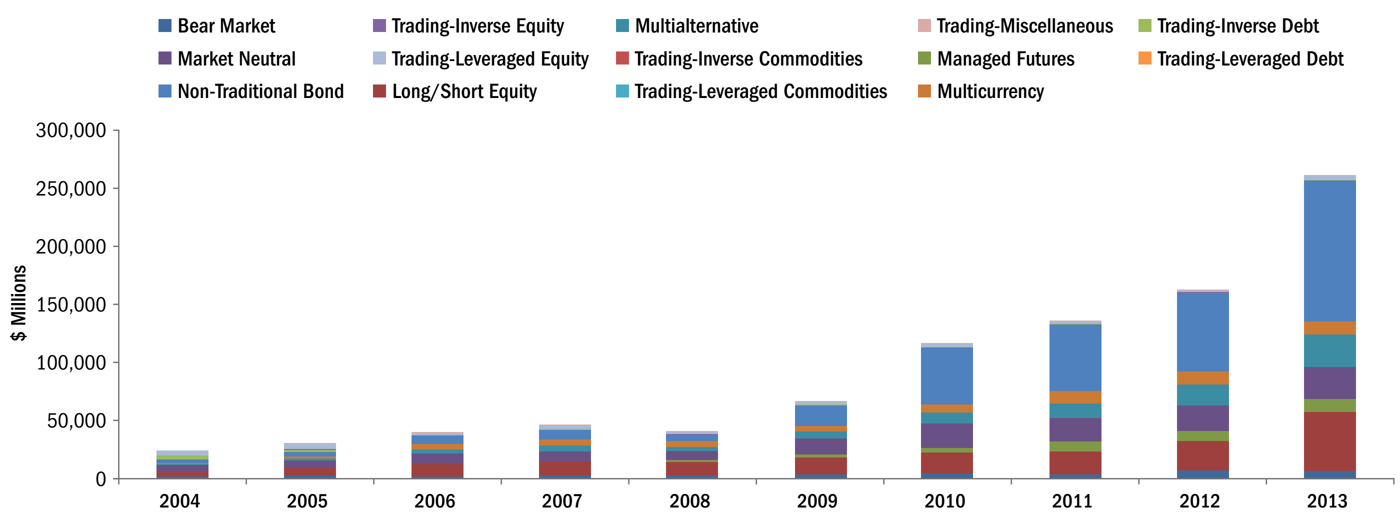
Comparing NTMFs and Hedge Funds

Non-Traditional Mutual Funds generally are mutual funds that pursue alternative strategies, subject to the limitations of the Investment Company Act Of 1940 (40 Act). They are a liquid, more highly regulated way to access strategies more commonly found in hedge funds. That said, NTMFs involve trade-offs. In fact, because of their liquid, regulated nature, NTMFs may not be able to take full advantage of some of hedge funds' sources of return—leverage (for short selling as well as buying securities long), illiquid securities and security level concentration. Funds registered under the 40 Act are subject to a range of asset coverage rules, depending on the types of securities used, which limit their use of leverage.

As an example, an equity-only NTMF cannot be more than $200 long and $100 short for every $100 of capital; equity market neutral hedge funds, meanwhile, sometimes have as much as $300 long and $300 short or more for the same $100 of capital. In addition to the logistical challenge of handling daily cash flows in and out, NTMFs must comply with liquidity rules in the 40 Act. These rules require the funds to have no more than 15% of their capital in illiquid securities, which are defined as securities that would take more than seven days to sell without meaningfully impacting their value. Hedge funds by contrast have no such limitations. In fact, many will invest in instruments that could easily take months or years to liquidate.

Finally, there are a number of rules pertaining to diversification

Exhibit 3: Alternative Mutual Fund Net Flows



Source: Morningstar.

[3] A type of account used in hedge funds to separate illiquid assets from other more liquid investments. Once an investment enters a side pocket account, only the present participants in the hedge fund will be entitled to a share of it. Future investors will not receive a share of the proceeds in the event the asset's returns get realized.

of fund assets, again, based on the types of securities used. For instance, for at least 75% of a fund's assets, the securities of an issuer held by the fund cannot be more than 10% of the outstanding voting stock of the issuer or more than 5% of the fund's total assets. Once again, hedge funds face no similar restrictions and there are those that invest substantially all of their assets in a very select few ideas. With a view toward this point, a 2009 study of hedged mutual funds concluded that hedge funds outperformed hedged mutual funds and that hedged mutual funds outperformed traditional mutual funds over a 10-year period.[4] One of the central observations of the study was that the different degrees of freedom permitted the portfolio manager in each structure was a material driver of the return differential between heavily constrained traditional mutual funds, less constrained NTMFs and unconstrained hedge funds.

In Exhibit 4, we compare NTMFs with traditional mutual funds and hedge funds across a number of variables. Specifically, the table summarizes the differences in investment mandates, structural considerations and regulatory constraints encountered in these three different investment vehicles.

The primary differentiating characteristics can be summarized as follows: NTMFs have much of the flexibility of mandate enjoyed by hedge funds, with the structural conveniences of mutual funds. It is worth noting again, however, that the regulatory constraints may impact NTMFs' return potential, particularly as they restrict the use of leverage (long and short), illiquidity and security level concentration, three meaningful sources of potential hedge fund

Exhibit 4: Typical Comparison of Traditional Hedge Funds and Non-Traditional Mutual Funds

			Alternative Investments	
		Traditional Mutual Funds	**Non-Traditional Mutual Funds**	**Hedge Funds**
Investment Mandate	Investment Style	Typically Long-Only	Typically Opportunistic and Flexible	Typically Opportunistic and Flexible
	Return Objective	Returns Relative to a Benchmark	Absolute Returns	Absolute Returns
	Leverage Use	Typically do not use leverage	Typically use some leverage	May use substantial leverage
	Derivatives Use	Limited use of derivatives	Frequent use of derivatives depending on strategy	Frequent use of derivatives depending on strategy
	Liquidity of Investments	Generally invest in highly liquid securities	Generally invest in highly liquid securities	Portfolios may contain private securities or other illiquid investments
Structural Considerations	Redemptions	Daily Liquidity (early redemption fees may apply)	Daily Liquidity (early redemption fees may apply)	Based on individual fund terms (monthly, quarterly, yearly). Suspension of redemptions / gating possible
	Transparency	Holdings available at least quarterly	Holdings available at least quarterly	Holdings available at the manager's discretion
	Tax Reporting Mechanism	1099	1099	Typically K-1
	Fees	Management Fees*	Management Fees*	Combination of Management and Incentive Fees*
	Investment Min./ Qualifications	Low Minimums, No Qualification Restrictions	Low Minimums, No Qualification Restrictions	High Minimums and Qualification Restrictions
Regulatory Constraints	Leverage	Require a 300% Asset Coverage Ratio and/or segregation of assets	Require a 300% Asset Coverage Ratio and/or segregation of assets	Some regulatory limits but managers may use substantial leverage depending on strategy
	Liquidity of Investments	No more than 15% of total assets in illiquid securities	No more than 15% of total assets in illiquid securities	Managers may use private securities and other illiquid investments
	Diversification	Minimum diversification requirements (e.g. limitations on position size, sector exposure etc)	Minimum diversification requirements (e.g. limitations on position size, sector exposure etc)	No pre-set diversification requirements

* Under 1940 Act and Internal Revenue Code, both mutual funds and hedge funds are subject to other fees and expenses. Generally, mutual funds don't charge performance fees.

4 Agarwal, Boyson and Naik, Journal of Financial and Quantitative Analysis. Data as of April 2009.

outperformance. Given the combination of traditional structures and flexible investment styles, it is not surprising that there is no broadly accepted definition of NTMFs. Each data vendor and mutual fund firm has applied their own criteria to the area. For example, Morningstar has gone from one category of alternative mutual funds (Bear Market) with 23 funds in 2004 to seven (Multialternative, Long/Short Equity, Nontraditional Bond, Bear Market, Market Neutral, Managed Futures and Multicurrency) with 453 funds. It is fair to expect that these will continue to evolve and expand over time. There is also relatively little data available to analyze this space. There are no widely accepted indices and many of the funds in this space have short track records.

The Morningstar alternative mutual fund categories provide a strong starting point for defining the available pool of NTMFs. However, one could expand the universe beyond these to include certain managers from other categories such as World Allocation. Mutual funds to consider would be those with certain characteristics that may include one or more of the following:

- Flexibility of asset class allocations.
- Ability to take short positions, and evidence of use.
- Ability to use derivatives and/or leverage, and evidence of use.
- Relatively significant investments in non-traditional asset classes such as commodities and/or currencies.
- Statistics that support a non-traditional profile, such as relatively low maximum drawdowns and/or relatively low correlations or betas with respect to traditional indices.
- Intent to provide a non-traditional return profile as indicated, for example, by an absolute return objective without adherence to a benchmark.

These funds are usefully comparable to hedge fund strategies, and from an analytical perspective, it is helpful to group them into the same broad strategy buckets as hedge funds. Exhibit 5 highlights each of the core hedge fund strategies and the ways in which they may behave in a portfolio. It is important to note that each of these strategies has a different set of risk exposures and primary return drivers.

Exhibit 5

Credit-Oriented AI Strategies—Seek stability and consistency of returns	
Credit Long / Short	Credit Long/Short strategies use an investment process designed to isolate attractive opportunities (on the long side) and deteriorating situations (on the short side) in fixed income securities; these include both senior and subordinated claims, bank debt and may also include exposure to government, sovereign, equity, convertible, credit default swaps or other obligations. Managers typically use fundamental credit analysis to evaluate the likelihood of an improvement or decline in the issuer's creditworthiness in order to capitalize on changes in the value of the securities.
Event Driven: Multi	Event-Driven funds attempt to profit when stock or bond prices change in response to certain corporate actions, such as bankruptcy, mergers, or acquisitions. Event-Driven Multi-Strategies have positions in companies currently or prospectively involved in a wide variety of corporate transactions including, but not limited to, mergers, restructurings, financial distress, tender offers, shareholder buybacks, debt exchanges, security issuance or other capital structure adjustments. Event-Driven exposure includes a combination of sensitivities to equity markets, credit markets and idiosyncratic company specific developments.
Merger Arbitrage	Merger Arbitrage strategies use an investment process primarily focused on opportunities in equity and equity-related instruments of companies that are currently engaged in a corporate transaction. Merger Arbitrage involves primarily announced transactions but can, at times, involve positioning in anticipation of a particular corporate event.
Relative Value	Relative Value funds exploit the pricing relationship between pairs of related securities. Managers take a long position in the security that appears to be underpriced and a short position in the security that appears to be overpriced. Some sub-sectors of Relative Value Strategies are credit long/short, equity market neutral and convertible arbitrage. • Credit long/short strategies use an investment process designed to isolate attractive opportunities (on the long side) and deteriorating situations (on the short side) in fixed income securities. • Equity market neutral strategies are defined by a low net exposure and are comprised of both long and short positions primarily in equity and equity derivative securities. • Convertible arbitrage includes strategies in which the investment thesis is based on the realization of a spread between a company's stock and its convertible bonds, taking into account multiple factors and often uses leverage.
Equity & Growth-Oriented AI Strategies—Seek growth and capital appreciation	
Emerging Markets Long/Short	Emerging Markets (EM) Long/Short strategies invest in Emerging Markets (or in developed market companies that have substantial exposure to EM), which can include parts of Asia, Latin America, Eastern Europe and the Middle East, through investments in equities, currencies, debt or other instruments. Strategies or regions of investments can be broadly diversified or narrowly focused and portfolios can differ substantially in terms of levels of net exposure, leverage, holding periods, concentrations of market capitalizations and valuations.

Exhibit 5 cont'd

Equity & Growth-Oriented AI Strategies—Seek growth and capital appreciation	
Equity Long/Short	Equity Long/Short strategies maintain both long and short positions primarily in equity and equity derivative securities. A wide variety of investment processes can be used to arrive at an investment decision, including both quantitative and fundamental factors; strategies can be broadly diversified or narrowly focused and portfolios can differ substantially in terms of levels of net exposure, leverage employed, holding periods, concentration of market capitalizations, geographical exposures and valuations.
Event Driven Equity & Distressed	Event-Driven funds attempt to profit when stock or bond prices change in response to certain corporate actions, such as bankruptcy, mergers, or acquisitions. Event-Driven Equity & Distressed strategies invest in companies currently or prospectively involved in corporate transactions of a wide variety including, but not limited to, mergers, restructurings, financial distress, bankruptcy, tender offers, shareholder buybacks, debt exchanges, security issuance or other capital structure adjustments. Security types can range from senior to junior debt, convertibles securities, equities and derivative securities.
Diversifying AI Strategies—Seek portfolio diversification and/or hedging inflation	
Global Macro	Global Macro strategies use a broad range of instruments in which the investment process is focused on movements in underlying economic variables and the impact these have on equity, fixed income, foreign exchange and commodity markets. Global Macro managers use a variety of techniques (primarily discretionary) based upon fundamental analysis of global macro economic data and trends. Managers have no preset band of how investments can be allocated across all the major asset classes and can use both systematic and fundamental approaches to portfolio construction and instrument selection.
Managed Futures	Managed Futures strategies have investment processes typically based upon mathematical, algorithmic and technical models. These managers trade liquid global futures, options, and foreign-exchange contracts largely according to trend-following strategies. Some managed futures strategies involve mean-reversion or counter-trend strategies rather than momentum or trend-following strategies. Strategies generally use an investment process designed to identify opportunities in markets with trending or momentum characteristics across individual instruments or asset classes. Strategies typically use a process that focuses on statistically robust or technical patterns in the return series of the asset, and typically focus on highly liquid instruments. Although some strategies seek to employ countertrend models, most strategies benefit from an environment characterized by persistent and discernible trending behavior.
Commodities	Commodities investments are direct or indirect exposure to raw materials, including energy, food, agricultural materials, industrial and precious metals. These investments are often accessed through commodity pools, non-traditional mutual funds (NTMFs), exchanged-traded funds (ETFs) and direct ownership (e.g., physical precious metals). Underlying investments are typically in commodity futures (or occasionally in the physical commodity, such as gold ETFs). The return of funds using futures depends on the change in spot commodity prices, the cost of rolling forward the futures contract, and short term interest rates.

* (Under 1940 Act and Internal Revenue Code), both mutual funds and hedge funds are subject to other fees and expenses. Generally, mutual funds don't charge performance fees.

It should be noted that not all of the hedge fund strategies translate perfectly into a mutual fund construct and some NTMF strategies tend to be closer to their hedge fund cognates than others.

For example, Equity Long/Short strategies can be expected to translate well from hedge funds into NTMFs because the underlying securities are generally liquid and the funds do not use substantial leverage. In addition there is a deep pool of skilled portfolio managers who are comfortable investing in equities.

Merger Arbitrage strategies that rely largely on equities and options will be similar regardless of regulatory structure. Distressed or bankruptcy related investments (often found in Event-Driven Equity & Distressed, Credit Long/Short, and Event-Driven Multi funds), however, are inherently illiquid and would be very difficult to pursue in a mutual fund format. Accordingly NTMFs in these areas will tend to focus on more liquid credit strategies.

Relative Value, likewise, will be more limited in scope in the mutual fund arena. Here the factor that will drive the difference is primarily leverage, as a number of the sub-strategies require the use of leverage to achieve an acceptable rate of return from very small spreads. Equity market neutral, for example, tends to translate well while fixed income arbitrage often does not.

With its typically liquid and diversified nature, Global Macro is a hedge fund strategy that one might expect to translate well to a mutual fund structure. However, to date there has been a somewhat limited number of NTMFs using a traditional hedge fund approach to Global Macro, although this space is growing.

There can be wide dispersion in returns from strategy to strategy and fund to fund in NTMFs just as there is for hedge funds; and there may be wide dispersion between the performance of NTMFs and hedge funds pursuing a similar strategy.

The Use of NTMFs in a Portfolio and the Value of Fund Selection

The broad range of potential risk and return drivers available in NTMFs suggest that modern portfolio theory's precept of diversification can be applied to a portfolio of NTMFs as well as to an investor's broader portfolio.

As discussed in Exhibit 5, different hedge fund strategies will respond to different market conditions. Equity Long/Short, for example does carry equity market exposure and will perform better in rising markets. It also tends to benefit from markets which differentiate between undervalued and overvalued stocks. Managed Futures will perform best in environments characterized by trending markets. In fact, each hedge fund strategy has a tendency to be cyclical in response to sets of market factors that vary from strategy to strategy. Using NTMFs in a portfolio made up of multiple funds across multiple hedge fund strategies can, therefore, generate a more stable return stream than selecting an individual fund or two and will likely provide diversification to traditional investments.

Any discussion of using hedge fund strategies in a portfolio naturally leads to the question of when an investor should choose to use a hedge fund and when she or he should invest in an NTMF. Importantly, the decision to use hedge funds or NTMFs is not an either/or decision. Clients may benefit from a combination of hedge funds and NTMFs. We must remember, however, that while a hedge fund and a NTMF may utilize a similar strategy, the funds may implement/execute that strategy differently. That said, when determining whether to utilize hedge funds, NTMFs or a combination of both, you, in consultation with your financial advisers, should consider a number of factors including:

- Eligibility to invest in hedge funds (i.e. does the investor meet the eligibility standards required by the fund's structure)
- The liquidity needs of the client (i.e., does the client need and does the particular fund provide daily, quarterly, semi-annual, or annual liquidity?)
- The performance of the fund, including diversification benefits and alpha (return due to manager skill as opposed to beta, or market exposure)
- The specific strategy and its implementation
- Any client preferences for registered products and transparency of registered funds
- Tax reporting preferences (e.g., Schedule K-1 versus Form 1099)
- Upfront fees, including front-end sales charges
- Ongoing fees, including the amount of the fee and the use of performance fees (sometimes over a hurdle rate) by hedge funds
- The ability to meet investment minimums which for traditional hedge funds may start at $100,000 and go up. For all but the highest net worth investors, it may be difficult to construct a diversified hedge fund portfolio given the high minimum investment requirements

Regardless of how an investor chooses to access hedge fund strategies, manager selection is central to investment outcomes. As with hedge funds, the fund manager's skill and flexibility is often what drives the value proposition for these funds but it can also lead to a wide range in performance between the best and worst in a given strategy. David Swensen, Yale University's Chief Investment Officer, expands upon this point and notes that selecting good managers of hedge fund strategies is not easy. *"Casual approaches to fund selection lead to almost certain disappointment. Absolute return investing belongs in the domain of sophisticated investors who commit significant resources to the manager evaluation process."*[5]
By inference, if investing in NTMFs and related skill-based strategies provides diversification to a traditional portfolio then it follows that time and energy expended performing due diligence on NTMFs are resources well spent.

The complexities of these funds can be best addressed by analysts who are specialized by strategy or asset class. It is preferable to have funds researched by professionals who are familiar with their investment strategy, the types of securities used and the various ways that both hedge fund and mutual fund competitors may be positioned.

This requires a disciplined and research intensive approach and argues for substantial resources to be committed in selecting managers in order increase the likelihood of successful outcomes.

Conclusion

Alternative investment strategies behave differently than traditional investments. They may hedge, concentrate, use leverage, or allocate freely across many markets all in an effort to generate returns that are not fully dependent on the broad markets. These potentially differentiated returns suggest that

[5] David Swensen, Pioneering Portfolio Management, 2007 pp 198-199

alternative investment strategies can provide diversification to a traditional portfolio. Portfolio diversification is one of the most powerful tools available to help manage investment risk and improve risk adjusted returns.

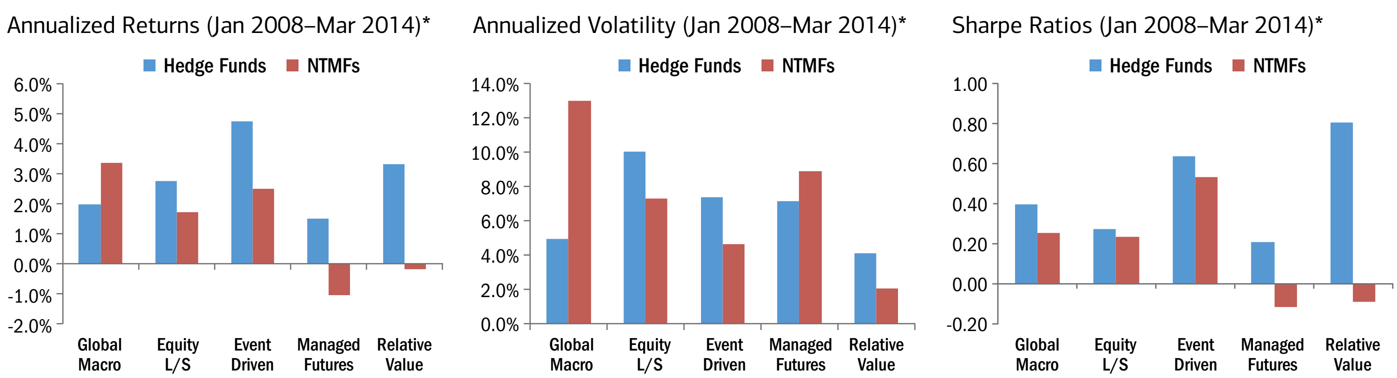
Traditional investors' demand for ways to diversify their portfolios has intersected with investor demands for improved transparency, liquidity, and structural uniformity. The apparent consequence of these developments is the growth in the size and number of registered alternative investment products, generally, and NTMFs in particular. Assets under management by NTMFs, using Morningstar's narrow classification (which does not include particular World Allocation funds) have grown from $20 billion in 2005 to $261 billion at the end of 2013.

These funds offer hedge fund strategies in a convenient format, and they seek to provide both diversification and risk control characteristics to a broader portfolio. However, as Exhibit 6 demonstrates, there are trade-offs inherent in gaining liquid regulated access to these strategies. Some of the drivers of hedge fund returns, namely illiquidity, leverage and position concentration, are limited in 40 Act registered funds. As a result, it is fair to assume that NTMFs may exhibit lower alpha and higher beta than their hedge fund siblings. This potential sacrifice is compensated for by structural benefits (such as daily liquidity, regular transparency, lower investment minimums and eligibility requirements, generally lower fees and more efficient tax reporting) as well as the ability of NTMFs to potentially reduce losses in down equity markets (as illustrated in Exhibit 7 on the following page). These variables and others must be taken into account when deciding whether to access alternative return streams through hedge funds, NTMFs, or other products.

Like the hedge funds they emulate, NTMFs come in many shapes and styles. Each strategy will provide different factor exposures and different risk and return profiles. Additionally, individual portfolio manager skill and experience take on greater import when funds have a more flexible mandate, so manager selection becomes even more integral to success. This reinforces the belief that a robust, professional approach to manager due diligence is critical. It also supports using a portfolio approach to investing in NTMFs, combining managers with different strategies into a diversified portfolio.

For those investors who have historically been unable to access the benefits of hedge funds, a well- constructed portfolio of

Exhibit 6: Performance of Hedge Fund and NTMF Strategies



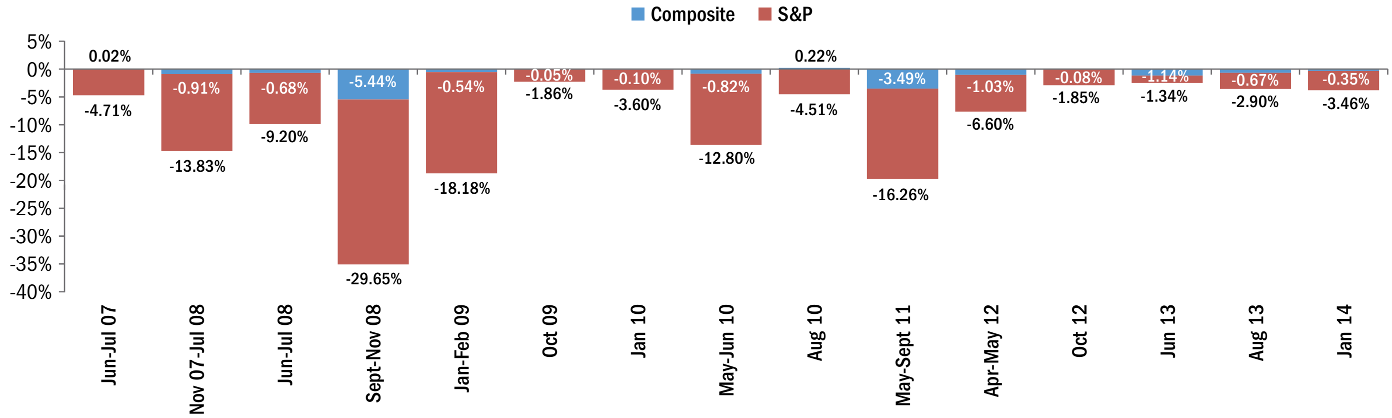
Source: IMG

IMG observations are based on the current state of maturation of the NTMF categories and may not represent a view of which approaches ultimately are best served by remaining in a private placement form versus a registered 40 Act fund.

* **Index sources:** The hedge fund and mutual fund indices used in these charts are as follows: **Global Macro** (HFRI Global Macro (Total) Index and Morningstar World Allocation Composite); **Equity Long/Short** (HFRI Equity Hedge (Total) Index and Morningstar Equity Long/Short Composite); **Event-Driven** (HFRI Event-Driven (Total) Index and Morningstar Non Traditional Bond Composite); **Managed Futures** (Newedge CTA Index and Morningstar Managed Futures Composite, and **Relative Value** (Average of HFRI Relative Value (Total) and HFRI Equity Market Neutral indices and Morningstar Market Neutral Composite); **Emerging Markets** is not shown because there is no NTMF composite available.

Direct investment cannot be made in the above indices. Both the hedge fund indices and the Morningstar composite indices are provided for illustrative purposes only. The hedge fund indices 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.

Exhibit 7: NTMF Performance in Down Markets*



* The performance of a composite of Morningstar alternative mutual fund categories during periods when the S&P 500 was down more than 1%.
Source: IMG and Morningstar. As of Jan. 31, 2014.

carefully selected NTMFs can provide this alternative exposure in a liquid, regulated, convenient fashion. Sophisticated investors are likely to find that detailed analysis of the underlying merits of individual funds and strategies, combined with thoughtful consideration of a range of structural variables will lead to NTMFs being used in conjunction with private placement hedge funds and other alternative vehicles to enhance their portfolios.

* Diversification does not ensure a profit or protect against loss in a declining market.

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Index Definitions

Indices are unmanaged and their returns do not include sales charges or fees, which would lower performance. It is not possible to invest directly in an index. They are included here for illustrative purposes. Performance represented by a hedge fund index is subject to a variety of material distortions, and investments in individual hedge funds involve material risks that are not typically reflected by an index, including the "risk of ruin." The indices referred to herein do not reflect the performance of any account or fund managed by Bank of America Corporation or its affiliates, or of any other specific fund or account, are unmanaged and do not reflect the deduction of any management or performance fees or expenses. One cannot invest directly in an index.

HFRI Relative Value Arbitrage Index is an asset-weighted index. It includes Relative Value Arbitrage funds from the HFR database that are open to new investments, have at least $50 million under management and have a 24-month track record. The index is rebalanced quarterly. Relative Value Arbitrage investment strategy approach is on making "spread trades" which derive returns from the relationship between two related securities rather than from the direction of the market. Generally, managers will take offsetting long and short positions in related securities when their values, which are mathematically or historically interrelated, are temporarily distorted. Profits are derived when the skewed relationship between the securities returns to normal. Relative value strategies may include fixed income arbitrage, merger arbitrage, convertible arbitrage, statistical arbitrage, pairs trading, options and warrants trading, capital structure arbitrage, index rebalancing arbitrage and Regulation D securities.

The Dow Jones Credit Suisse (ex Credit Suisse-Tremont) Event Driven Index is an asset-weighted index and includes only funds, as opposed to separate accounts. The Index uses the Credit Suisse-Tremont database and consists only of Event Driven funds with a minimum of US $50 million AUM, a 12-month track record, and audited financial statements. It is calculated and rebalanced monthly, and shown net of all fees and expenses. Event Driven funds invest in various asset classes and seek to profit from potential mispricing of securities related to a specific corporate or market event (e.g., mergers, bankruptcies, financial or operational stress, restructurings, asset sales, recapitalizations, spin-offs, litigation, regulatory and legislative changes etc.). Event Driven funds can invest in equities, fixed income instruments, options and other derivatives. Many managers use a combination of strategies and adjust exposures based on the opportunity sets in each sub-sector.

The Dow Jones Credit Suisse (ex Credit Suisse-Tremont) Global Macro Index is an asset-weighted index and includes only funds, as opposed to separate accounts. The Index uses the Credit Suisse-Tremont database and consists only of Global Macro funds with a minimum of US $50 million AUM, a 12-month track record, and audited financial statements. It is calculated and rebalanced monthly, and shown net of all fees and expenses. Global Macro funds focus on identifying extreme price valuations and leverage is often applied on the anticipated price movements in equity, currency, interest rate and commodity markets. Managers typically employ a top-down global approach to concentrate on forecasting how political trends and global macroeconomic events affect the valuation of financial instruments. Profits are made by correctly anticipating price movements in global markets and having the flexibility to use a broad investment mandate, with the ability to hold positions in practically any market with any instrument.

The Dow Jones Credit Suisse (ex Credit Suisse-Tremont) Long/Short Equity Index is an asset-weighted index and includes only funds, as opposed to separate accounts. The Index uses the Credit Suisse-Tremont database and consists only of Long/Short Equity funds with a minimum of US $50 million AUM, a 12-month track record, and audited financial statements. It is calculated and rebalanced monthly, and shown net of all fees and expenses. Long/Short Equity funds invest on both long and short sides of equity markets, generally focusing on diversifying or hedging across particular sectors, regions or market capitalizations. Managers have the flexibility to shift from value to growth; small to medium to large capitalization stocks; and net long to net short. Managers can also trade equity futures and options as well as equity related securities and debt or build portfolios that are more concentrated than traditional long-only equity funds.

The Dow Jones Credit Suisse (ex Credit Suisse-Tremont) Managed Futures Index is an asset-weighted index and includes only funds, as opposed to separate accounts. The Index uses the Credit Suisse-Tremont database and consists only of Managed Futures funds with a minimum of US $50 million AUM, a 12-month track record, and audited financial statements. It is calculated and rebalanced monthly, and shown net of all fees and expenses. Managed Futures funds (often referred to as CTAs or Commodity Trading Advisors) focus on investing in listed bond, equity, commodity futures and currency markets, globally. Managers tend to employ systematic trading programs that largely rely upon historical price data and market trends. A significant amount of leverage is employed since the strategy involves the use of futures contracts. CTAs do not have a particular bias towards being net long or net short in any particular market.

The Newedge CTA Index is equal-weighted and reconstituted annually and calculates the net daily rate of return for a pool of CTA's selected from the largest managers open to new investment.

HFRX Event Driven (Total) Index: HFRX Event Driven (Total) Index comprises Event-Driven Hedge Fund Managers that maintain positions in companies currently or prospectively involved in corporate transactions of a wide variety, including but not limited to mergers, restructurings, financial distress, tender offers, shareholder buybacks, debt exchanges, security issuance or other capital structure adjustments. Security types can range from most senior in the capital structure to most junior or subordinated, and frequently involve additional derivative securities. Event-Driven exposure includes a combination of sensitivities to equity markets, credit markets and idiosyncratic, company-specific developments. Investments are typically predicated on fundamental characteristics (as opposed to quantitative), with the realization of the thesis predicated on a specific development exogenous to the existing capital structure.

The indexes referred to in the paper do not reflect the performance of any account or any specific fund, and do not reflect the deduction of any management or performance fees, or expenses. One cannot invest directly in an index. The indexes shown are provided for illustrative purposes only. They do not represent benchmarks or proxies for the return of any particular investable product. The alternative universe from which the components of the indexes are selected is based on funds that 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 indexes, 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 indexes 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.

IMG assumes no responsibility for any of the foregoing performance information, which has been provided by the index sponsor. Neither IMG nor the index sponsor can verify the validity or accuracy of the self-reported returns of the managers used to calculate the index returns. IMG does not guarantee the accuracy of the index returns and does not recommend any investment or other decision based on the results presented.

Technical Terms

Alpha: The difference in return above or below the return of a target index.

Asset Allocation: The percentage breakdown of an investment portfolio. This shows how the investment is divided among different asset classes.

Bear Market: A market condition associated with widespread pessimism and declining prices of securities. Many consider a 20% or more downturn in multiple broad market indexes a bear market.

Beta: A measure of the sensitivity of the returns of the fund to the comparative index. For example, a Beta of 2.0 would indicate that for every 1% move up in the comparative index, the fund moved up 2% on average.

Bull Market: A condition marked by increased confidence and optimism in the market as reflected in the rising prices of securities.

Correlation: Measures the extent of linear association of two variables. It quantifies the extent to which the fund and a comparative index move together.

Currency Note: The currency market affords investors a substantial degree of leverage, which provides the potential for substantial profits or losses. Such transactions entail a high degree of risk and are not suitable for all investors. Currency fluctuations may also affect the value of an investment.

Commodities: There are special risks associated with an investment in commodities, including market price fluctuations, regulatory changes, interest rate changes, credit risk, economic changes, and the impact of adverse political or financial factors.

Derivatives: Derivative instruments may at times be illiquid, subject to wide swings in prices, difficult to value accurately and subject to default by the issuer. The risk of loss in trading derivatives, including swaps, OTC contracts, and futures and forwards, can be substantial. There is no guarantee that this objective will be achieved. The use of hedging strategies may, in certain circumstances, cause the value of a portfolio to appreciate or depreciate at a greater rate than if such techniques were not used, which in turn result in significant loss. Options involve risk and are not suitable for all investors. Before engaging in the purchase or sale of options, investors should understand the nature and extent of their rights and obligations and be aware of the risks involved in investing with options.

Diversification: Diversification does not ensure a profit or protect against loss in declining markets.

Efficient Frontier: 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, which 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. In addition, any comparison of actively managed strategies and passive securities indexes is itself subject to inherent material limitations, as is the selection of what index should be used as representative of alternative investment strategies.

Futures: A futures contract is an agreement to buy or sell an asset at some point in the future at a pre-determined price today. Futures contracts are standardized contracts that trade over an exchange.

Hedge Funds: 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. The characteristics discussed in this paper are typical attributes, as hedge funds and traditional funds vary. Other key characteristics such as fees, minimum investments and liquidity should also be carefully considered. A hedge fund generally uses more aggressive strategies than a traditional fund and entails a higher level of risk.

Max Drawdown: A term used to describe a peak to trough decline during a specific time period.

Short: The sale of a borrowed security with the expectation that the asset will fall in value and the borrower will be able to purchase the security at a lower price.

Small Cap: A term used to refer to companies with a market capitalization between $300 million and $2 billion.

Swap: Involves the exchange of one asset or liability for another of comparable value. Assets range from commodities, equities, and bonds to financial instruments such as interest rates, foreign exchange, cash flows from underlying investments, etc.

Sharpe Ratios and Standard Deviation of returns are commonly used measures of the risk-reward profile of traditional portfolios and broad market indexes. However, these statistics may materially understate the true risk profile of a fund because hedge funds are subject to a "risk of ruin" which may not be reflected in the standard deviation of returns. The markets in which hedge funds trade, the liquidity characteristics of the traded securities, the risks of leverage, the use of derivative securities with nonlinear risk sensitivities, the use of nonrepresentative historical data for estimating standard deviation, manager error, bad judgment and/or misconduct create the possibility of sudden, dramatic, and unexpected losses — losses that may not be adequately reflected in Sharpe Ratios or standard deviations. Prospective investors must recognize this risk of ruin, which is a material risk involved in investing in any alternative investment, and which may not be adequately reflected in such performance statistics as the Sharpe Ratio.

Trend-following: A trading method that utilizes mathematical models to make trading decisions based on the general direction/momentum of the market.

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