



HATTERAS
Funds

HATTERAS FUNDS
INVESTMENT PERSPECTIVE

HEDGED EQUITY
June 2010



KEY POINTS

- Historically, hedge funds have outperformed traditional long-only equities during flat or bear markets. Over the last two decades, the HFRI Equity Hedge Index has outperformed the S&P 500 Total Return Index by 194%.
- By reducing the frequency and magnitude of drawdowns, investors can improve their potential to preserve and grow capital.
- Historically, hedge funds have been helpful in creating a more diversified portfolio as they have exhibited low correlation to traditional markets.
- The variability of returns has been lower for hedge funds as compared to equities. Hedge funds have provided approximately 60% of the volatility of the S&P 500 Total Return Index.

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I. INTRODUCTION AND OVERVIEW

In 1949, A.W. Jones created the first hedge fund with the hopes of remaining exposed to markets, but with much less volatility. He employed leverage and short-selling with the intention to produce a less volatile, more conservative return pattern. In specific bull market periods, the strategy was likely to lag long-only equity market exposure. He was, however, willing to forego some upside because of the protection that a truly hedged strategy strives to offer when markets lose ground. More than sixty years ago, Mr. Jones created a model that enabled stronger wealth creation through compounding positive returns consistently.

We believe that investments in strategies employing hedging techniques will outperform long-only investments over the next five to ten years and that hedged investments should be a meaningful allocation within investor portfolios. We believe that long-only stock returns could disappoint versus historical expectations, and that the markets will exhibit significant volatility. In such an environment, hedged strategies could provide protection on volatile downside moves and offer some upside participation driven by stock selection and trading strategies.

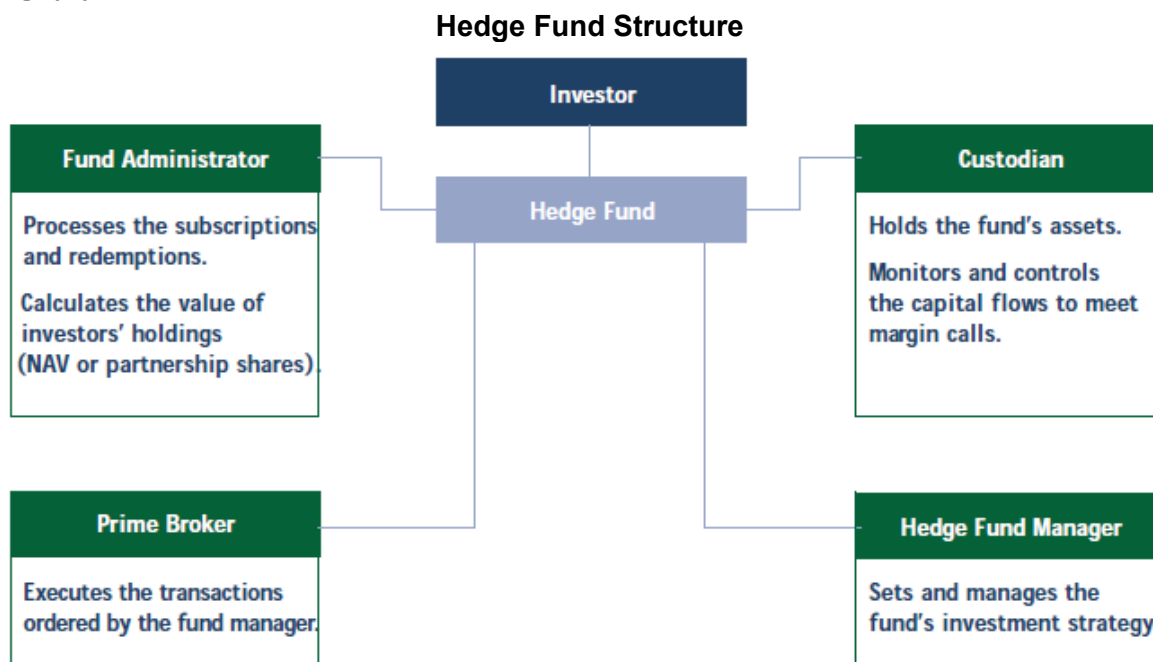
Navigating the hedge fund universe can be daunting and confusing for even the most

seasoned investors. While many investors may recognize the benefits of hedged investment strategies, relatively few have the time, resources, or industry knowledge to effectively research this asset class. The purpose of this paper is to define what hedge funds are, explain how they differ from long-only investments, and assess the benefits of introducing hedged investments into a traditionally allocated portfolio of stocks, bonds, and cash.

What is a Hedge Fund?

Although there are many different opinions of what exactly a hedge fund is, at its most basic level, it is merely a vehicle for holding and investing the money of its investors. While traditional long-only investment funds compare results to a benchmark (relative returns), hedge funds seek *absolute returns*. A hedge fund is managed by an investment manager with employees, including the portfolio manager(s), research analysts, middle and back office personnel, and salespeople. Although the fee structure can vary, typical hedge fund management fees range from 1-3% per year and include a percentage of the positive performance of the fund (typically 10-20%).

Chart 1



Sources AIMA

As seen in Chart 1, in addition to the investment manager that makes the investment decisions, there are other key contributors to a hedge fund's operation. These typically include a number of third-party service providers, the first and most important of which is the administrator. Although most hedge funds typically employ third-party administrators, some are internally administered. The administrator is responsible for calculating the net asset value ("NAV") of the fund, performing back office functions (trade reconciliation, performance reporting, and investor reporting), and dealing with new investments into and redemptions out of the fund. In certain funds, some of these functions may be performed by the manager itself, giving rise to a potential conflict of interest that stems from having the manager determine the NAV and thus,

benefit from its potential increase through performance fees.

Prime brokerage services include lending money, acting as counterparty to derivative contracts, lending securities for the purpose of short-selling, trade execution, clearing, and settlement. Many prime brokers also provide custody services. Prime brokers are typically parts of large investment banks.

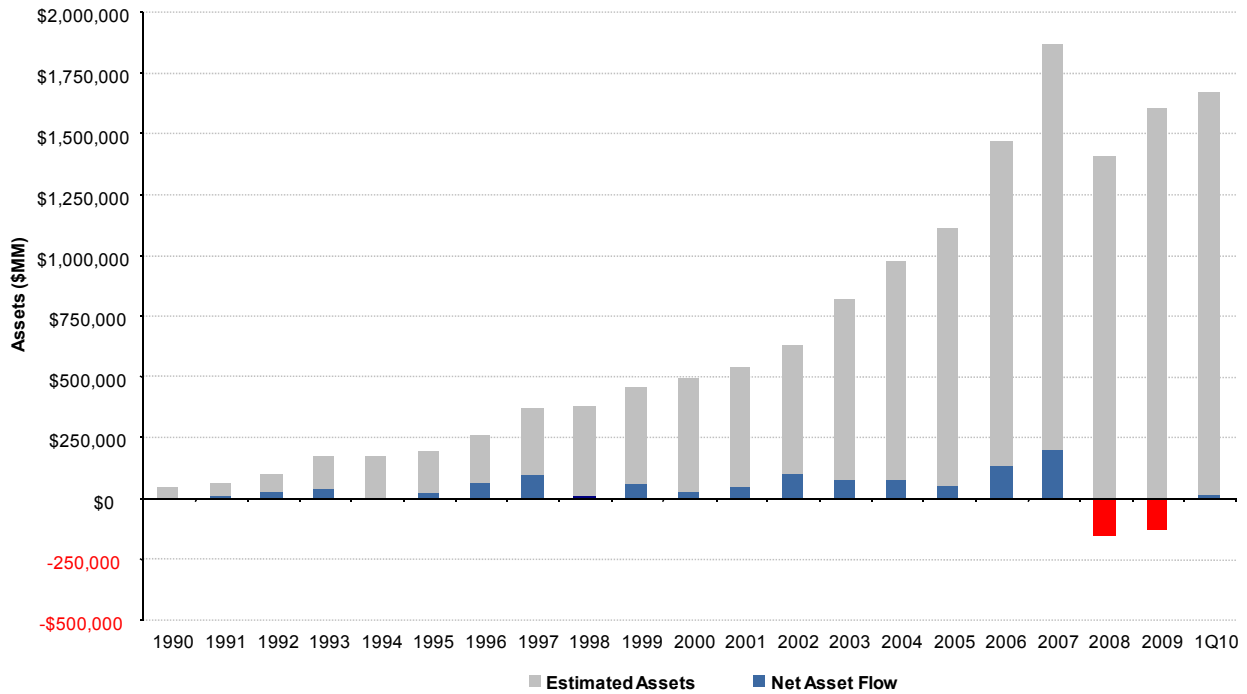
The Hedge Fund Market

Over the past ten years, the hedge fund industry has experienced explosive growth, increasing from 3,873 hedge funds and fund of funds with \$490 billion in assets in 2000 to more than 9,000 funds and \$1.6 trillion in assets at the end of 2009, a compound annual growth rate in assets of 12.5% per year.¹

1 HFRI Industry Reports, © HFR, Inc. 1Q 2010, www.hedgefundresearch.com

Chart 2

Hedge Fund Industry Assets Under Management¹
1990-2009

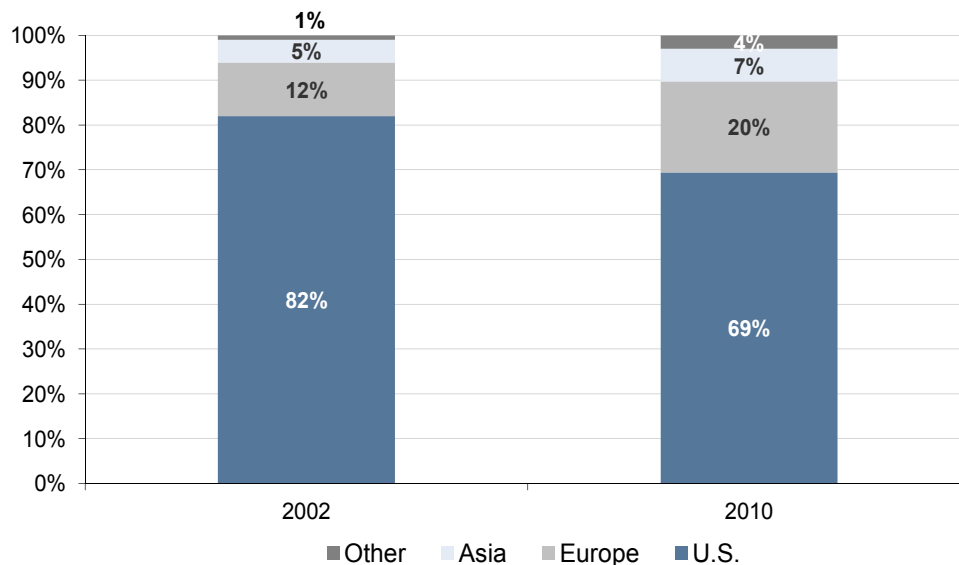


The percentage of hedge fund assets outside of the U.S. has also grown over the past ten years, showing the global expansion of the industry. In fact, in January 2010, hedge

fund assets in Europe and Asia accounted for almost 30% of the industry total compared to only 17% just five years earlier.

Chart 3

Global Hedge Fund Assets²
2002 vs. 2010



1 HFRI Industry Reports, © HFR, Inc. 1Q 2010, www.hedgefundresearch.com

2 International Financial Services London estimates and Hedge Fund Intelligence

Types and Strategies of Hedge Funds

Hedge funds employ different trading strategies that are classified in many different ways with no standard system used. A hedge fund will typically commit itself to a particular strategy and investment type and will include details of the strategy and investment methodology in its offering documentation. Although the most common hedge fund strategy is “long/short equity,” meaning that the fund takes both long and short positions in shares traded on public stock exchanges, there are many different strategies, markets, and investment types that hedge funds utilize. We’ve focused on what we believe are the four primary strategies listed below:

Opportunistic equity. This strategy considers trade opportunities within equity markets (domestic and international) involving both sides of trades (long and short) and possibly sector specific.

- Long/short equity – Also called equity hedge, this sub-strategy buys equity positions it expects to increase in value. These “long” positions are hedged by selling short stocks or stock market index options expected to decrease in value.
- Emerging markets – This sub-strategy specializes in markets in emerging economies such as China, India, Brazil, etc.
- Sector funds – This sub-strategy features an expertise in niche areas such as technology, energy, or healthcare.
- Fundamental – This sub-strategy invests in undervalued companies or companies with best prospects for earnings growth.
- Quantitative – This is an equity trading sub-strategy that uses quantitative techniques.
- Short bias – This sub-strategy uses short positions to take advantage of overvalued securities.

Event driven. This strategy attempts to identify special situations or exploit pricing inefficiencies that develop as a result of potential corporate events.

- Distressed – This sub-strategy specializes in companies that may trade at a discount to fair value because of potential debt default or bankruptcy.
- Merger arbitrage – Also called risk arbitrage, this sub-strategy buys the stock of a company being acquired and sells short the stock of the acquirer in order to exploit pricing inefficiencies between the two companies.
- Special situations – This sub-strategy focuses on securities of restructuring companies or companies engaged in a corporate transaction.
- Credit arbitrage – This sub-strategy specializes in corporate fixed income securities.
- Activist – This sub-strategy takes large positions in companies and attempts to influence management decisions or strategic direction.

Relative value. This strategy, typically involving arbitrage or market neutral approaches, attempts to exploit pricing inefficiencies between assets that appear to be mispriced.

- Fixed income arbitrage – This sub-strategy takes positions in related fixed income securities to exploit pricing inefficiencies.
- Equity market neutral – This sub-strategy attempts to maintain a close balance between long and short positions in the portfolio.
- Convertible arbitrage – This sub-strategy attempts to exploit pricing inefficiencies between convertible securities (long) and corresponding equities (short).
- Structured credit. This long/short or fixed income arbitrage sub-strategy uses asset-backed securities.
- Opportunistic credit – This sub-strategy takes long/short positions in credit markets.
- Statistical arbitrage – This market neutral sub-strategy uses statistical and quantitative models.
- Volatility arbitrage – This sub-strategy exploits the change in implied volatility instead of the change in price.

Global macro. Often called trading strategies, global macro approaches try to anticipate global macroeconomic events and typically use many markets and multiple investment instruments to generate absolute returns.

- Discretionary macro – This sub-strategy involves macro trading by managers selecting securities.
- Systematic macro – This sub-strategy, involving macro trading using quantitative or statistical models, is sometimes referred to as “black box” as there is typically no human interaction except for development of the software or models.
- Commodity Trading Advisors (CTA or managed futures) – This sub-strategy trades in futures (or options) in commodity markets.
- Systematic diversified – This sub-strategy involves quant model trading in diversified markets.
- Systematic currency – This sub-strategy involves quant model trading in currency markets

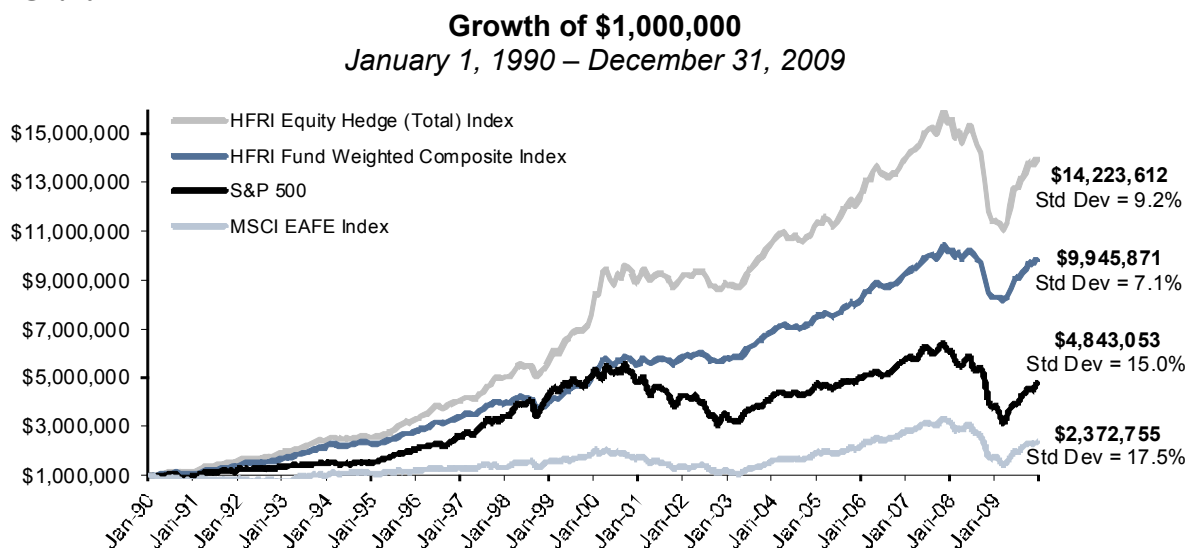


II. ENHANCED RETURNS, CAPITAL PRESERVATION, AND LOW CORRELATION

Hedged investments have historically outperformed traditional long-only investments. In fact, over the past decade, by reducing correlation to equity indices in down markets, these investments have mitigated the size and duration of drawdowns and effectively preserved capital while growing wealth. By losing less, the strategy is able to depend upon the

“magic” of compounding to generate greater wealth from a larger base each period. As seen in Chart 4, a basket of hedge fund strategies (HFRI Equity Hedge Total Index) outperformed domestic and international stocks from 1990-2009.

Chart 4



Since hedge funds cannot hedge all risks, most still have exposure to a certain market, either long or short. Hence, while hedge funds have experienced better returns compared to long-only investments during bear markets (see Charts 5-6), in bull

markets hedged investments tend to lag the overall market (Charts 7-8). This can be seen clearly by hedge fund outperformance during the market downturn over the past ten years and the lag in performance during the two most recent market rallies.

CHART SOURCES: Morningstar Direct, Hedge Fund Research, Inc., and Hatteras Funds

Index returns are provided for illustrative purposes only to demonstrate a hypothetical investment vehicle using unmanaged broad-based indices of securities. Returns do not represent any actual investment. An investor cannot invest directly in an index. Index performance does not reflect the deduction of fund fees and charges. Past performance does not guarantee future results.

Chart 5

Hedge Fund Performance During Down Markets
November 1, 2007 – February 28, 2009

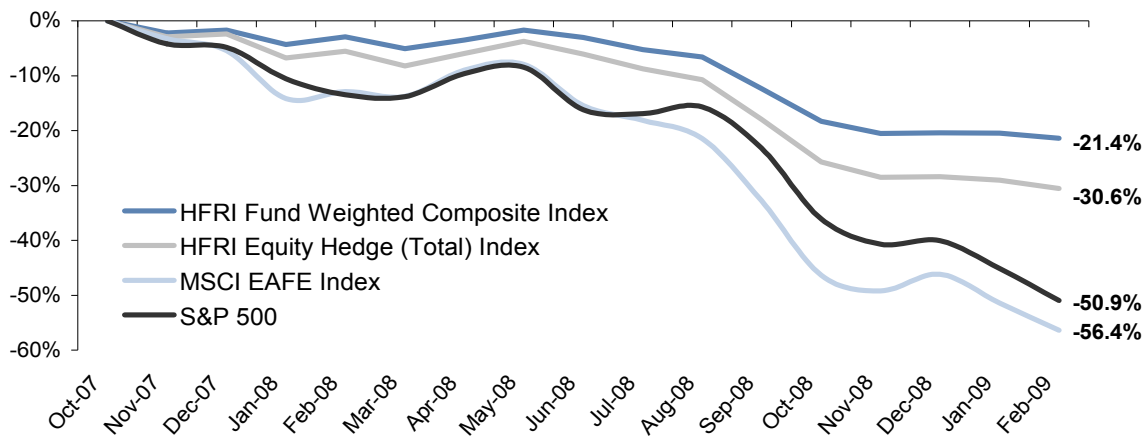


Chart 6

Hedge Fund Performance During Down Markets
January 1, 2000 – February 28, 2003

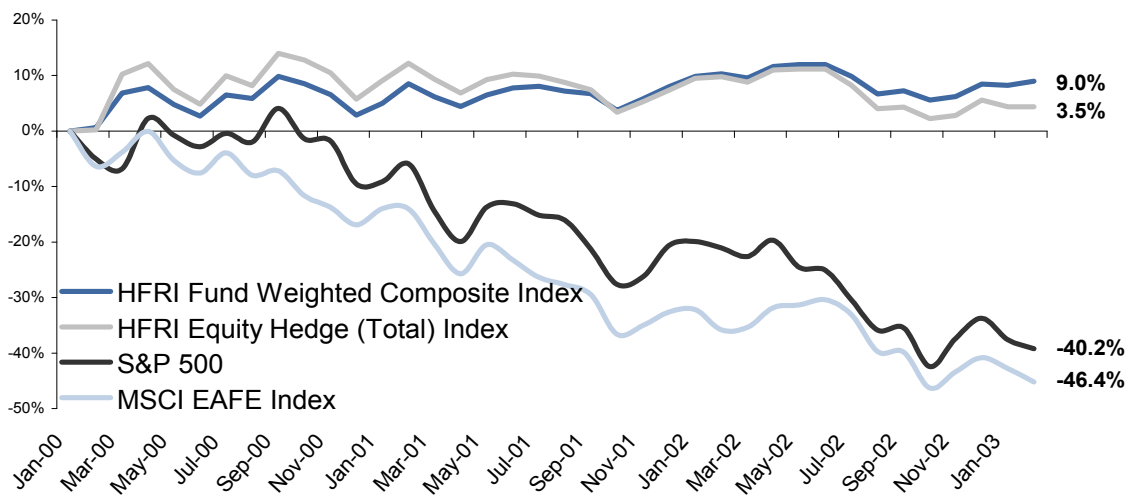


CHART SOURCES: Morningstar Direct, Hedge Fund Research, Inc., and Hatteras Funds

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Chart 7

Hedge Fund Performance During Market Rallies
March 1, 2003 – October 31, 2007

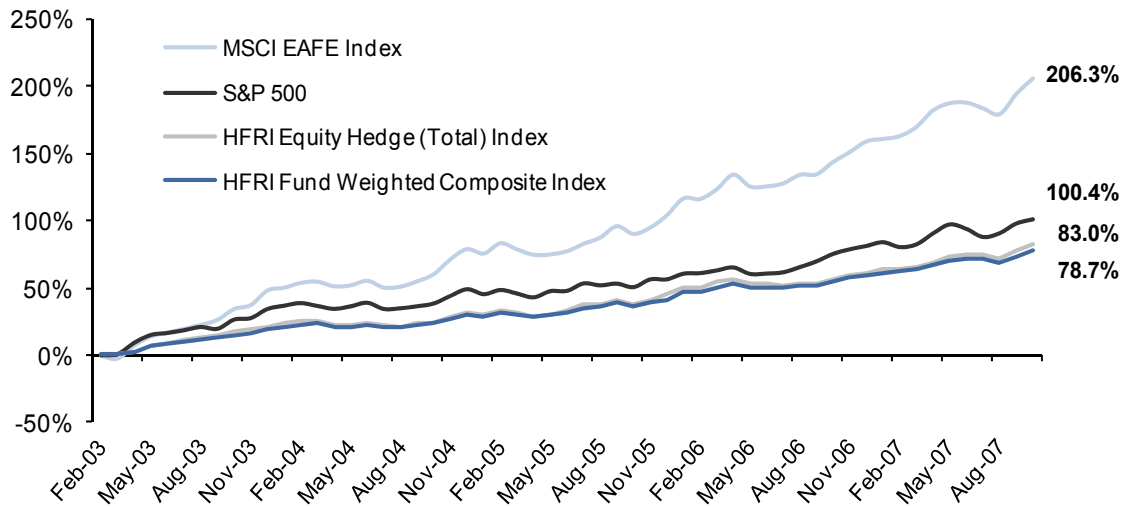


Chart 8

Hedge Fund Performance during Market Rallies
March 1, 2009 – December 31, 2009

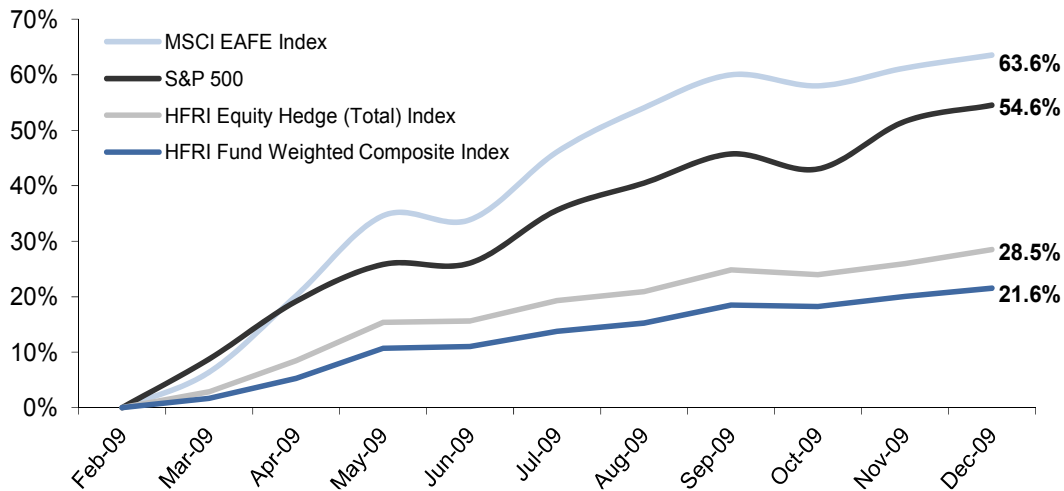


CHART SOURCES: Morningstar Direct, Hedge Fund Research, Inc., and Hatteras Funds

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III. REDUCED VOLATILITY

One misconception regarding hedge funds is that they are much riskier than long-only investments. Given the inherent nature of hedging, however, volatility has historically been much lower for hedge funds than for traditional long-only investments that track

broad indices. Over the past twenty years, hedge funds (as measured by the HFRI Equity Hedge Index) have had a volatility (as measured by annualized standard deviation) of 600 basis points less than the S&P 500 Total Return Index.

Chart 9

Hedge Fund Volatility versus Long-Only Indices

	Return				Volatility			
	3-Year	5-Year	10-Year	20-Year	3-Year	5-Year	10-Year	20-Year
HFRI Equity Hedge Index	0.3%	4.5%	5.4%	14.3%	11.5%	9.7%	9.2%	9.2%
HFRI Emerging Markets Index	3.2%	10.6%	10.8%	14.2%	16.4%	13.9%	12.7%	14.2%
HFRI Event Driven Index	1.4%	5.2%	7.9%	12.5%	9.1%	7.6%	7.0%	7.0%
HFRI Relative Value Index	3.9%	6.0%	7.3%	10.7%	8.0%	6.4%	4.7%	4.5%
HFRI ED: Merger Arbitrage Index	4.2%	6.5%	6.3%	9.5%	4.2%	4.0%	3.6%	4.2%
HFRI EH: Equity Market Neutral Index	0.1%	2.7%	4.2%	3.2%	3.5%	3.0%	3.1%	3.2%
HFRI Macro Index	6.7%	7.0%	7.6%	7.8%	5.5%	4.9%	5.5%	7.8%
S&P 500 Total Return Index	-5.6%	0.4%	-1.0%	8.2%	19.9%	16.1%	16.1%	15.0%
MSCI EAFE Index	-5.6%	4.0%	1.6%	4.4%	24.0%	19.7%	17.9%	17.5%
MSCI Emerging Markets Index	5.4%	15.9%	10.1%	10.6%	32.8%	28.0%	24.9%	24.3%

Sources: Hedge Fund Research, Inc. and Morningstar Direct; Return is average annual total return



IV. OTHER RISKS OF HEDGE FUND INVESTING

There are other risks to investing in hedge funds, including:

Liquidity. Hedge funds will typically have limited liquidity versus publicly traded long-only counterparts. Funds can have lock-up provisions of up to three years, and may provide only annual, semi-annual, quarterly, or monthly liquidity. Mutual funds and exchange traded funds (“ETFs”), on the other hand, provide daily liquidity to investors.

Leverage. A hedge fund will sometimes borrow money or trade on margin in addition to the money raised from investors. Certain funds may borrow sums many times greater than the equity invested. If a hedge fund has borrowed multiples of the money raised from investors and experiences a substantial loss in the value of investments, a greater portion of investors’ money could be lost once creditors call their loans. Leverage simply amplifies performance – whether up or down.

Short-selling. Due to the inherent nature of short-selling, the losses that can be incurred on a losing bet are, in theory, limitless, unless the short position directly hedges a corresponding long position.

Appetite for risk. Hedge funds are more likely than other types of funds to take on underlying investments that carry high degrees of risk, such as high yield bonds,

distressed securities, and collateralized debt obligations based on sub-prime mortgages.

Transparency. Because hedge funds are private entities with fewer public disclosure requirements than listed funds, investors may have difficulty assessing trading strategies, diversification of the portfolio, and other factors relevant to an investment decision. Since the market crisis of 2008, however, many funds have enhanced transparency to provide more accessibility to portfolio metrics and positions.

Lack of regulation. Hedge fund managers are, in some jurisdictions, not subject to as much oversight from financial authorities as regulated funds and therefore, may carry undisclosed structural risks.

Investors in hedge funds are, in most countries, required to be sophisticated investors who are assumed to be aware of and willing to take on the risks because of the potential rewards: Leverage can amplify profits as well as losses; short-selling opens up new investment opportunities; riskier investments typically provide higher returns or losses; secrecy helps to prevent imitation by competitors; and being unregulated reduces costs and allows the investment manager more freedom to make decisions on a purely commercial basis.

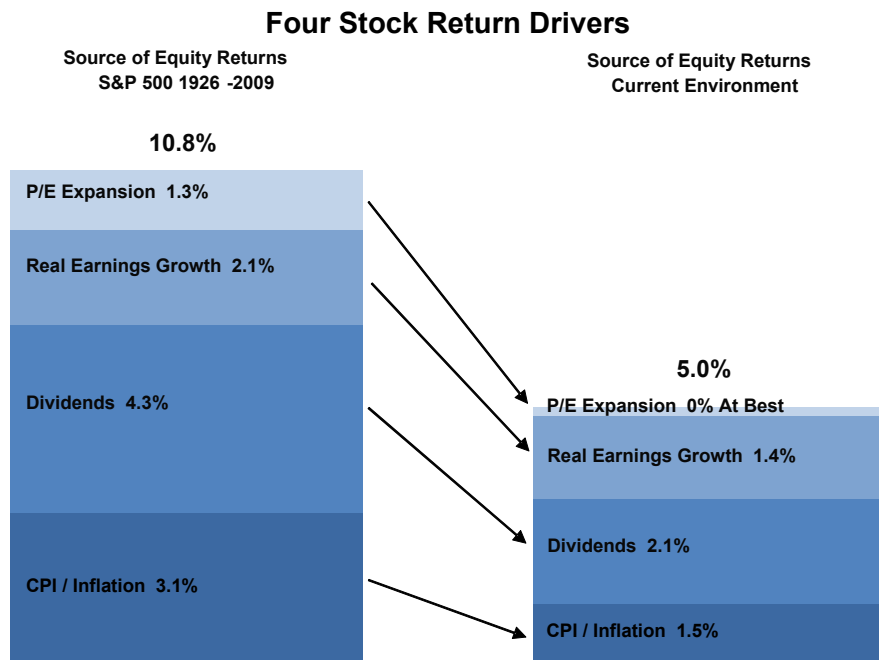


V. CURRENT ENVIRONMENT

Historically, stock returns have been driven by four factors: inflation, dividends, real earnings growth, and P/E expansion. In the period 1926-2009, equity returns averaged 10.8%. Going forward, it may be difficult to match the returns that domestic equities generated – especially the returns over the past twenty years. Considering that inflation is currently lower than the

historical average, dividends are at historically low levels, real earnings growth is expected to be below normal, and P/E multiples are at or near historically high levels, we believe equity returns for the next decade will disappoint. See Chart 10 for our expectations for the four sources of equity returns in the current environment.

Chart 10

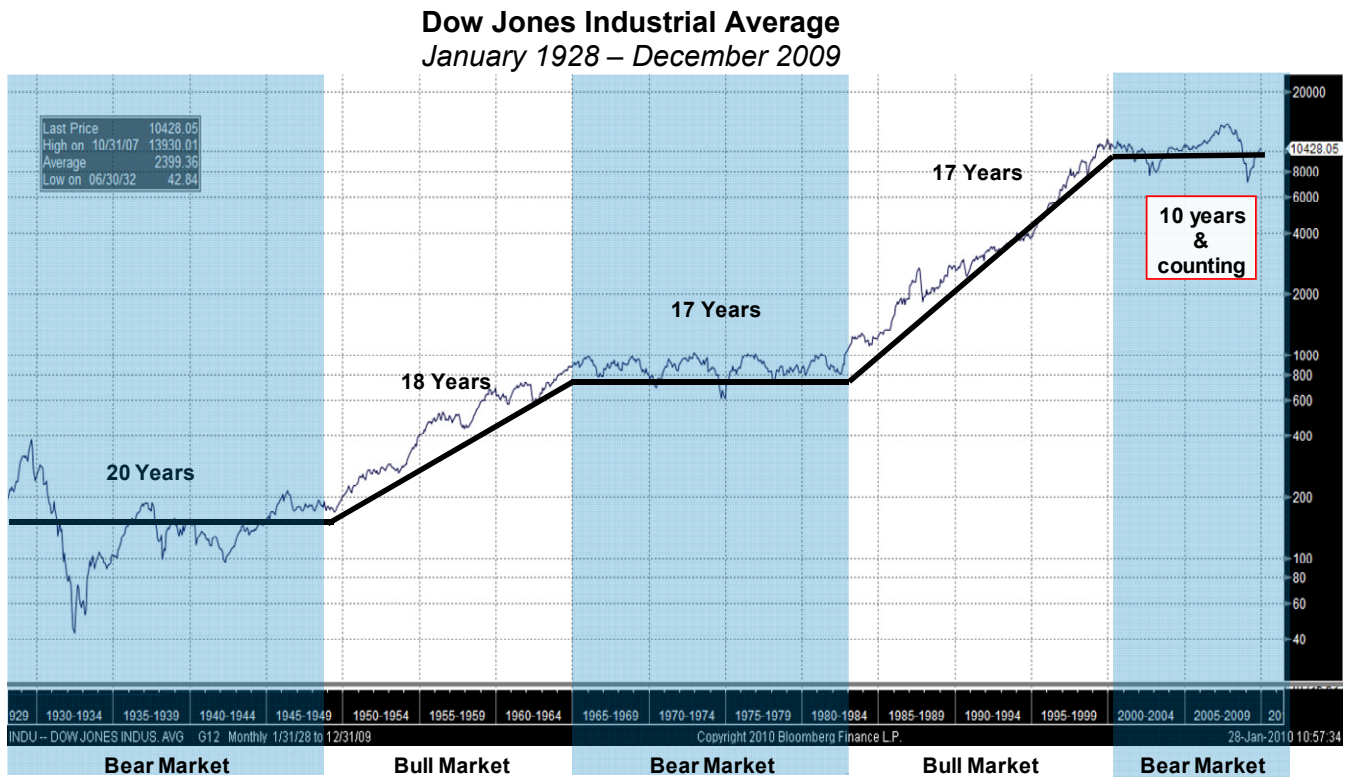


Source: Based on research study conducted by Ibbotson & Chen. Research Report dated 2000. Study has not been replicated since 2000. Dividends represent dividend yield of Standard & Poor's 500. Inflation rate reflects CPI as of 12/31/09 (information from Bureau of Labor Statistics).

Over the same time period, an interesting “stair step” trend can be seen in equity markets. In Chart 11, alternating bear and bull markets last for approximately twenty years. Within the “sideways” bear market periods, significant volatility still exists. We

believe domestic equity markets are currently mired in another extended bear market period, during which long-only equities will have a difficult time meeting investors’ expectations.

Chart 11



Source: Bloomberg; Past performance is no guarantee of future results.

During periods of range bound, volatile markets, managers who depend upon market directionality will suffer. Long-only managers whose performance depends upon steadily upward trending equity markets could face a difficult bear market head wind. In this type of market, we believe managers with hedging tools will be able to generate above market returns. In

the hedge fund industry, managers often refer to “alpha,” which is simply defined as the extra return (over what general markets provide) that is attributed to manager skill. During a range bound, bear market, we believe that hedged managers will be able to enhance return versus a long-only equity portfolio.

VI. CONCLUSION

All hedge fund strategies are not the same. Investors should carefully research and understand how adding specific hedge funds may affect a portfolio's return and risk characteristics.

Considered in isolation, hedge funds are attractive because they are designed to produce more consistent returns with lower standard deviation than long-only investment strategies. Because they are not governed by the same level of regulation, they often have access to a broader array of investment tools and opportunities. When considered as a complement to traditional investments, hedge funds can potentially reduce risk and enhance return for the overall portfolio. By reducing the magnitude and duration of drawdowns, portfolios with hedged investments can potentially grow wealth more effectively

and benefit from the opportunity to compound positive returns.

We believe that the current market environment will offer disappointing equity returns. We believe that domestic markets are mired in a secular bear market trend and that long-only investments have the potential to exhibit low returns and high volatility for another decade. In this environment, we believe that diversified hedged investments, as managed by talented and experienced managers, will outperform broad equity markets. We believe that hedged investments should comprise a significant role within an overall portfolio and further that their risk reducing behavior merits consideration as a core element within the asset allocation framework.



The Hatteras Perspective

- We believe that the current market environment will offer disappointing equity returns and the markets will exhibit significant volatility.
- When considered as a complement to traditional investments, hedge funds can potentially reduce risk and enhance return for the overall portfolio.
- We believe that diversified hedged investments, as managed by talented and experienced managers will outperform long-only investments and broad equity markets over the next five to ten years.
- We believe that hedged investments should be a meaningful allocation within investor portfolios.



GLOSSARY

Alpha: Often referred to as a measurement of "manager skill," alpha measures a manager's return that cannot be attributed to the market. It shows the difference between a fund's actual returns and its expected performance given its level of risk.

Absolute return: Absolute return investors seek to produce positive returns regardless of the direction of general markets. Hedge funds target absolute returns versus mutual funds, which typically target returns relative to a benchmark.

Correlation: A statistical measure of how two securities move in relation to each other. A correlation coefficient is a measure of the interdependence of two random variables that ranges in value from -1 to +1, indicating perfect negative correlation at -1, absence of correlation at zero, and perfect positive correlation at +1.

Drawdown: The number of months of a peak to trough decline of an investment. The maximum drawdown is the maximum loss (compounded, not annualized) that the manager ever incurred during any sub-period of the entire time period. Conceptually, the calculation looks at all sub-periods of the time period in question and calculates the compound return of the manager over that period. The maximum drawdown is the minimum of zero and all these compound returns.

Liquidity: An asset's ability to be sold without causing a significant movement in the price and with minimum loss of value. Money, or cash on hand, is the most liquid asset. Liquidity also refers both to a business's ability to meet its payment obligations, in terms of possessing sufficient liquid assets, and to such assets themselves.

Lock-up: The time period for which investors are precluded from withdrawing or redeeming their investments in a fund.

Long-only: The buying of a security such as a stock, commodity or currency with the expectation that the asset will rise in value.

Performance fee: A fee that an investment fund may be charged by the investment manager that manages its assets, calculated by reference to the increase in the fund's net asset value (or "NAV"), which represents the value of the fund's investments. Performance fees are widely used by the investment managers of hedge funds, which typically charge a performance fee of 20% of the increase in the NAV of the fund.

Short-selling: The practice of selling assets, usually securities, that have been borrowed from a third party with the intention of buying identical assets back at a later date to return to the lender. The short seller hopes to profit from a decline in the price of the assets between the sale and the repurchase, as the seller will pay less to buy the assets than the seller received on selling them. The short seller will incur a loss if the price of the assets rises.

Standard deviation: A measurement of the investment's volatility, standard deviation is a statistical measure of dispersion. The larger the standard deviation, the greater the likelihood that a security's performance will fluctuate from the average return.

Volatility: A statistical measure of the dispersion of returns for a given security or market index. Volatility can either be measured by using the standard deviation or variance between returns from that same security or market index. The higher the volatility, the riskier the security.

SAFE HARBOR AND FORWARD-LOOKING STATEMENTS DISCLOSURE

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