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# Hatteras Funds

## An Introduction to Long/Short Debt

OCTOBER 2011

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*Defining Alternatives*



Long-short debt is an alternative investment approach developed to take advantage of opportunities across an array of fixed-income instruments. At its core, it allows managers to take “long” positions in securities that seem likely to appreciate and to “short” securities that seem likely to decline in price. Although many clients are now gaining access to this strategy for the first time through mutual funds employing hedged strategies, long-short debt is not a new or untested approach. In fact, institutional investors and high-net-worth individuals have long benefited from long-short debt funds, which have recorded a two-decade track record of strong investment performance.

Rather than a single investment strategy, long-short debt encompasses a series of sub-strategies that a particular manager may pursue either as a sole focus or in various combinations. The following list includes the primary strategies comprising the long-short debt category.

### **Trading Strategies of Long/Short Debt**

Value long – in this most basic sub-strategy, a manager who believes a security is cheap from a credit perspective or a yield perspective buys it long, seeking either to realize a capital gain by selling the security after its price has appreciated or to receive abnormally high coupon payments by holding the security in the portfolio.

Value short – believing a bond or loan is overvalued, a manager sells it short in the

expectation that the price decline in the short- to medium-term will more than offset the cost of shorting the bond.

Hedged long – a manager purchases a security long and hedges out (removes) some aspect of the transaction, such as the credit risk or interest-rate risk. Typically the manager is seeking to isolate the mispricing within the specific security while removing a broader market risk. An investment can be hedged directly by purchasing a credit default swap (CDS) on the security itself or indirectly by purchasing a CDS on the issuer’s industry group or on the market as a whole. A long position in a loan or bond can also be hedged by taking a short position in the issuer’s equity.

Event-driven -this resembles a value long or value short sub-strategy, but anticipates a specific catalyst – such as a merger or restructuring – that the manager believes will alter an issuer’s creditworthiness and ultimately the value of the position.

Relative value- a simultaneous long and short approach designed to profit from differences in the performance of two related securities, such as the bonds of two auto manufacturers or the bonds and convertible securities of the same issuer.

Stressed/distressed debt - involves purchasing debt that is trading at a discounted value because the issuer is at risk for bankruptcy.

Yield curve trading - a manager who anticipates a change in the slope of the yield

curve may be able to capitalize on this opportunity by, for example, acquiring a long position at one end of the curve and a short position at the other.

Through these sub-strategies and others, long-short debt managers strive to generate attractive total returns, using their fundamental analysis, understanding of market complexities, and flexibility to take advantage of inefficiencies in the fixed-income markets.

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### **Information Age**

Drawing on extensive credit expertise, long/short debt managers typically depend upon independent research and analysis of bonds, loans and other fixed-income instruments to reach conclusions that may differ from those of the credit-rating agencies. The largest owners of bonds – institutions, mutual funds and endowments are often restricted on the amount of low rated credit securities they are able to hold. –Thus, when a bond is downgraded, some investors may be forced to sell it. A long/short debt manager who believes a downgrade was unmerited may then be able to purchase the security at an attractive price.

### **Flexibility**

In addition to their specialized fixed-income research capabilities, long/short debt managers also benefit from working with a very broad set of investment tools. They can choose from a full range of fixed-income assets: sovereign debt, corporate bonds, municipal bonds, asset-backed securities, and bank loans of any duration or credit quality. They can also buy and sell derivative instruments of many kinds, take long positions, short positions, both, or neither.

### **What role can long/short debt play in an investment portfolio?**

As illustrated in the graph on the following page, the long/short debt strategy, as represented by the HFRI RV Fixed Income - Corporate Index has exhibited low correlation with both equity benchmarks and with long-only fixed-income benchmarks. In other words, long/short debt funds have responded differently than stocks and bonds to the factors that drive investment performance. Low correlations are the essence of effective diversification. Adding the long/short debt strategy to a portfolio may help reduce risk without sacrificing return – or, put another way, may enhance returns without increasing investment risk. Please see the chart on the following page that illustrates Long/Short Debt's low correlation to traditional equity markets.

**Correlation Matrix**  
10 Year period ending September 2011

	Barclays Aggregate Bond Index	ML High Yield Master II Index	S&P 500 TR Index	HFRI RV Fixed Income- Corp. Index
Barclays Capital U.S. Aggregate Bond Index	1			
ML High Yield Master II	0.19	1		
S&P 500 TR Index	-0.07	0.70	1	
HFRI RV Fixed Income- Corp. Index	0.01	0.81	0.66	1

Source: Bloomberg

For clients who have dedicated a specific portion of their portfolio to alternative investments, long/short debt could serve as one of their more conservative alternative asset allocations. For clients who hold a long/short debt fund within their fixed-income allocation, the investment could help to stabilize overall fixed-income performance through all phases of the interest-rate cycle.

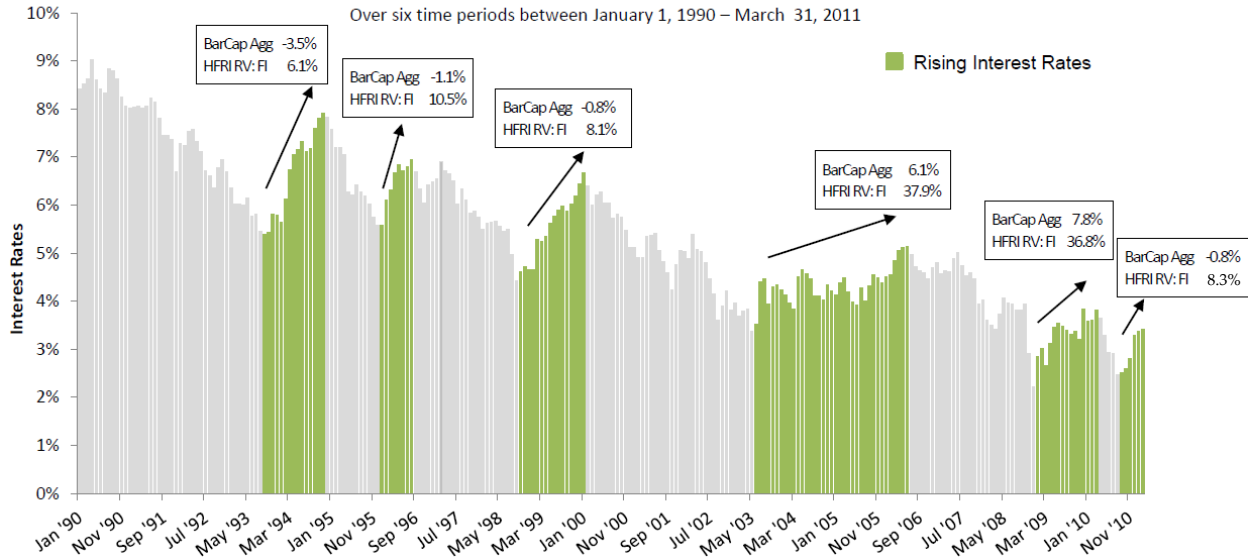
**How does the long/short debt strategy perform?**

Over the recent 10-year period ending September 2011, the long/short debt strategy delivered average annual gains of 6.49% as measured by the HFRI Relative Value Fixed Income - Corporate Index. This compares quite favorably to long-only fixed-income investments. For example, Barclays Capital U.S. Aggregate Bond Index delivered gains of 5.67% for the same period. Based on this record, a long/short debt fund may be a sound long-term holding for many of your clients. There can, of course, be no assurance that future returns will remain at the level of the past.

A closer look at performance patterns suggests that long/short debt may be especially relevant in the current market environment. Historically, long/short debt funds have outperformed long-only fixed-income funds in rising interest rate environments. Currently, most fixed-income observers agree that a 30-year bull market for bonds will reach an end and that the Federal Reserve's zero-interest-rate policy, predicted to last for the next two to three years, will result in rising yields. Fixed-income experts are no longer asking *whether* interest rates will rise but *when, for how long and by how much*.

When interest rates rise, traditional long-only fixed-income funds tend to decline in net asset value (NAV). In these periods, fixed-income investors face the dual challenges of preserving their investment principal and profiting from the market turn as seen in the graph on the following page. By investing in a long/short debt fund, they may be able to accomplish both of these objectives at once.

## LONG/SHORT DEBT HAS SIGNIFICANTLY OUTPERFORMED FIXED INCOME IN THE LAST 6 RISING INTEREST RATE ENVIRONMENTS



Source: Bloomberg

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

In addition to the likelihood of rising rates, another salient feature of today's credit markets is the high level of uncertainty, particularly with respect to sovereign debt. Periods of uncertainty typically generate volatility in the fixed-income markets, and this, in turn, often creates pockets of opportunity that flexible, experienced managers may be able to exploit.

While the above trends are favorable for long/short debt funds, advisors and prospective investors should also be aware of a caveat. In periods of serious dislocations in the fixed-income markets, such as 2008, long/short debt funds have underperformed traditional bond funds. During a severe credit crisis, even sub-strategies that employ hedging cannot assure complete preservation of principal.

### Investment risks

The long/short debt strategy exposes investors to risks that are also inherent in long-only fixed-income investments, namely:

**Credit risk:** the possibility that an issuer will not keep its promise regarding repayment of the debt.

**Interest-rate risk:** the possibility that a security will lose value because of an increase in interest rates.

Long/short debt funds also expose investors to additional risk, such as:

**Basis risk:** the danger that differences in the performance of two positions, such as a bond and a stock, may undermine the effectiveness of a hedge.

Counterparty risk: the possibility that the party on the other side of a derivative transaction will not live up to its obligation.

Manager risk: the risk that a chosen manager will make poor investment decisions. A diversified fund-of-funds structure that limits exposure to any single manager can help reduce manager risk.

### **Benefits of a liquid fund-of-funds structure**

Historically, long/short debt funds were offered only in private partnership structures that could require minimum investments of \$1 million or more. This placed them beyond the reach of many investors. Liquidity has also been a concern, since long/short debt partnerships have typically accepted investments only once a month and allowed redemptions just once a quarter following a 45 or 60-day notification period. Furthermore, investors seeking to build a diversified portfolio of managers and sub-strategies may find it difficult to do so in an area where manager search, selection and monitoring require so much experience, expertise and time. A long/short debt fund-of-funds mutual fund can help you and your clients meet all of these challenges by providing a lower minimum investment level, daily liquidity, full transparency, active manager search and selection, and diversification of styles and sub-strategies.

An alternative fund-of-funds differs importantly from the “unconstrained” bond funds with which it may be confused. While

both kinds of funds may at times hold similar securities, the unconstrained fund represents the thinking of a single investment management team, which may consist of generalists, whereas the fund-of-funds incorporates a diversified portfolio of specialized managers across multiple long-short debt sub-strategies. Most of these are sub-strategies that require high-level skills and specialized market knowledge. The fund-of-funds structure also introduces another layer of risk control in the form of the managing firm, which can allocate and re-allocate capital to appropriate sub-managers based on extensive interviewing, due diligence and ongoing monitoring. As a result, unlike an unconstrained bond fund, the multi-manager fund-of-funds structure can offer protection against manager risk.

### **Conclusion**

Funds specializing in long/short debt have, for two decades, delivered attractive risk-adjusted returns in comparison to long/only fixed-income investments. With the development of an alternative mutual fund devoted to long-short debt, your clients can now access this strategy, which was previously available predominantly to institutions and high-net-worth individuals. If, as seems probable, interest rates rise in the near or medium term, this investment may be especially rewarding, as long/short debt strategies have typically outperformed in periods of rising rates.

The long/short debt strategy encompasses a series of sub-strategies pursued in different

proportions by different fund managers. In a multi-manager fund-of-funds structure, a diversified mix of carefully selected funds can offer your clients an optimal blend of these sub-strategies while avoiding overconcentration in any one fund.

We believe an alternative long/short debt mutual fund represents an important innovation in the financial marketplace, offering your clients the ability to remain invested and take advantage of changes in the fixed-income market while maintaining daily liquidity and full transparency.

***The Funds' investment objectives, risks, charges, and expenses must be considered carefully before investing. The summary prospectus and prospectus contain this and other important information about the investment company, and may be obtained by calling 1.877.569.2382 or visiting [www.hatterasmutualfunds.com](http://www.hatterasmutualfunds.com). Read it carefully before investing.***

#### **Risk Disclosure**

Alternative investments involve a high degree of risk. Certain hedging techniques and leverage employed in alternative investments may accelerate the velocity of possible losses. Short selling involves the risk of potentially unlimited increase in the market value of the security sold short, which could result in potentially unlimited loss for the funds. Derivatives involve investment exposure that may exceed the original cost and a small investment in derivatives could have a large potential impact on fund performance. Options held may be illiquid and the fund manager may have difficulty closing out a position. The cost of investing in fund-of-funds will generally be higher than the cost of investing directly in the shares of the mutual funds in which it invests.

Mutual fund investing involves risk; loss of principal is possible. Please consult an investment professional for advice regarding your particular circumstances. An investment in the alternative investments may not be suitable for all investors.

#### **SAFE HARBOR AND FORWARD-LOOKING STATEMENTS DISCLOSURE**

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## **Glossary**

**Barclays Capital U.S. Aggregate Bond Index** – The Index represents securities that are SEC-registered, taxable, and dollar denominated. It covers the U.S. investment grade fixed rate bond market, with index components for government and corporate securities, mortgage pass-through securities, and asset-backed securities. These major sectors are subdivided into more specific indices that are calculated and reported on a regular basis.

**ML High Yield Master II** – The Index is a commonly used benchmark for high yield corporate bonds. It measures the broad high yield market.

**S&P 500 Index** – The Index consists of 500 stocks chosen for market size, liquidity and industry group representation, among other factors. The S&P 500 is designed to be a leading indicator of U.S. equities and is meant to reflect the risk/return characteristics of the large cap universe. Companies included in the index are selected by the S&P Index Committee, a team of analysts and economists at Standard & Poor's. It is a market value weighted index, with each stock's weight in the index proportionate to its market value.

**HFRI RV Fixed Income - Corporate Index** - Includes strategies in which the investment thesis is predicated on realization of a spread between related instruments in which one or multiple