



HATTERAS
Funds

HATTERAS FUNDS
INVESTMENT PERSPECTIVE

PRIVATE EQUITY
June 2010



KEY POINTS

- Private equity has outperformed public equity over three, five, and ten year periods as the illiquidity premium ranged from 6.7%-9.3% annualized.
- Over the past two decades, private equity has created substantially more wealth than the public markets.
- Historically, private funds raised during recessionary periods have yielded higher returns than those raised during strong economic times. Thus, we believe the current environment provides an attractive opportunity for investors to gain access to private investments. Due to the recession, fewer private equity dollars are available to bid for stakes in companies, driving down entry prices.
- Due to the globalization of capitalistic economies over the last fifteen years, the opportunity set in private equity is growing rapidly outside the United States and Europe.

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I. INTRODUCTION AND OVERVIEW

Investors build portfolios by allocating to varying asset classes that have historic attributes and behaviors. A specific set of goals, liquidity needs, return expectations and risk tolerances drive which asset classes are considered and how heavily each will be represented. Investors choose certain specific asset classes – based on historic or expected behavior – for return enhancement, others for risk mitigation, and some for portfolio diversification. Traditionally, investors counted upon public “long-only” equities for growth (return) and allocated to bonds for yield and stability (risk mitigation).

Unfortunately, long-only public equity (or stocks) disappointed asset allocators recently, providing a negative return over the past decade (1999-2009). For the coming decade, both individual and institutional investors alike are left without an easily identifiable return driver for their investment, retirement, or pension portfolios.

Historically, private equity has provided strong return enhancement, outperforming public equities over the trailing 5, 10, and 20 year periods. Traditionally, private equity has been an attractive portfolio allocation tool for large institutions and ultra high net worth individuals. Unfortunately, private investing has been difficult to access for average wealthy clients because of large investment minimums, high investor qualification standards, and the illiquidity of long lock-up periods.

Recently however, market developments and product innovation are creating an opportunity for smaller investors to consider the attractive return potential of an allocation tool that was heretofore “off limits.” We believe that private equity is

likely to offer greater returns than public, long-only equities; and that the return premium (the difference between private returns and public returns) has the potential to be larger than usual because of the lack of capital availability today. Today, investors have opportunities to participate in far greater number of markets, countries, regions, companies, etc. because of growing global reach. Lastly, we believe that product innovation is making it far easier for a broader investor segment to enjoy the return enhancement features of adding private equity to a traditional portfolio of stocks, bonds, and cash.

For these reasons – greater return potential, a global opportunity set, and improvements in the ease of allocating – we believe investors should allocate a portion of their long-term assets to private equity.

Private Equity Defined

Pprivate Equity can be defined as “investing in equity-oriented securities through a privately negotiated process.” Typically, there are a limited number of buyers negotiating with a seller. The vast majority of transactions take place in companies whose equity is not publicly traded, although in some cases investors will inject private equity into public companies.

Almost all private equity funds and private equity fund of funds are structured as limited partnerships under Section 3c1 or 3c7 of the Investment Company Act of 1940, which limits the number of investors and therefore, implicitly forces the general partners (fund managers) to establish high minimum investments, typically between \$1 million to \$10 million per commitment. For many investors, high minimums make it

very difficult to invest on a prudent asset allocation basis.

Investors do not fund their investment in a private equity fund all at once. Instead, investors “commit” capital to a fund and later, over a three to four year period, deploy actual capital only when portions of the initial pledge are “called” (by the fund manager). Since the practice of “called” versus “committed” capital is unfamiliar to many investors and operationally cumbersome for financial advisors, some firms have established registered investment vehicles that invest in private equity funds. These funds usually carry lower minimums (between \$100,000 and \$1 million) because they can accept an unlimited number of investors.

Additionally, some registered funds accept all committed capital upfront at the time of investment, which eliminates the need for investors and advisors to track the committed versus called capital ratio.

The Private Equity Market

Over the last twenty years, the private equity market has grown tremendously. Money raised for private equity investments has increased from \$11.4 billion in 1990 to \$245.6 billion in 2009, and the number of funds grew from 101 to 482 during the same time period.*

Private equity fundraising and investing, however, has experienced a sharp retraction since mid-2008 as the impacts of the global financial meltdown and excessive investment activity by mega-sized private equity funds in the U.S. and Europe took their toll.

We view the private equity market as an aggregation of multiple sectors, each exhibiting different risk and return profiles. A critical understanding of these differences is important when investing in this asset class. Chart 1 provides a brief overview of the different sectors within the asset class.

Chart 1

	Risk / Return	Manager Role	Duration
Venture capital	Greatest return potential with highest risk Risk of total loss is high	Very active, emphasis on business development and strategy Minority ownership	Tends to be long with multiple rounds of financing expected for most investments Typical hold is 5-7 years
Growth capital	High returns Moderate to high risk	Active participation Minority ownership	Average hold is 3-5 years Target relatively mature companies, often resulting in shorter holds than venture capital investments
Buyouts	High returns Moderate to high risk	Emphasis on financial structuring / retaining strong management teams Majority ownership	Average hold is 3-5 years Potential for early return of some capital via financing events
Mezzanine debt	Moderate returns Moderate risk	Little active management / Emphasis on financial structuring Minority ownership, if any	Average hold is 3-5 years Some capital is returned early from cash coupon payments
Distressed debt	Moderate to high returns High risk	Skilled at bankruptcy proceedings and restructuring businesses Often seeking control	Average hold is 3-5 years Potential for early return of capital via financing events

* 2010 Preqin Global Private Equity Report

II. ILLIQUIDITY PREMIUM AND WEALTH CREATION

We believe private equity is an attractive investment due to its potential to generate returns in excess of the public markets and to offer portfolio diversification. Chart 2 demonstrates that over the last decade, the return premium over public equity, commonly referred to as the illiquidity premium, ranged from 6.7-9.3% annualized.

This illiquidity premium is the excess return that investors demand for “locking up” their capital for 5-12 years. The illiquidity premium generated by private equity investments over the last two decades has resulted in significant wealth creation (as seen in Chart 3).

Chart 2

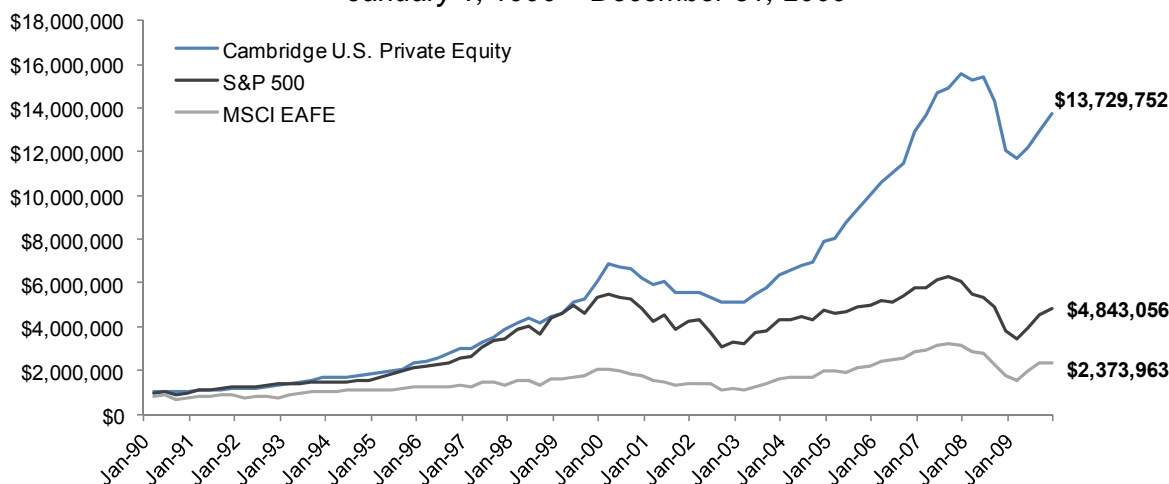
Investment Performance As of December 31, 2009

Investment Type	3-year	5-year	10-year
Russell 2000	-6.1%	0.5%	3.5%
S&P 500	-5.6%	0.4%	-1.0%
U.S. Private Equity	1.1%	9.7%	7.8%
U.S. Private Equity outperformance over S&P 500	6.7%	9.3%	8.8%

Sources: Morningstar: Russell 2000 TR USD Index and S&P 500 Total Return Index; Cambridge Associates LLC U.S. Private Equity Index. Private equity returns are net management fees, carried interest, and expenses.

Chart 3

Growth of \$1,000,000 Cambridge Private Equity vs. S&P 500 vs. MSCI EAFE January 1, 1990 – December 31, 2009



SOURCES: Morningstar, S&P 500, Cambridge Associates LLC U.S. Private Equity Index; Private equity returns are net to investors after management fees, carried interest, and expenses. 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.

III. RECESSIONARY PRICING

Turbulence in global capital markets has affected all investable asset classes around the world. Private equity is no exception as valuations have trended downward in line with public market declines.

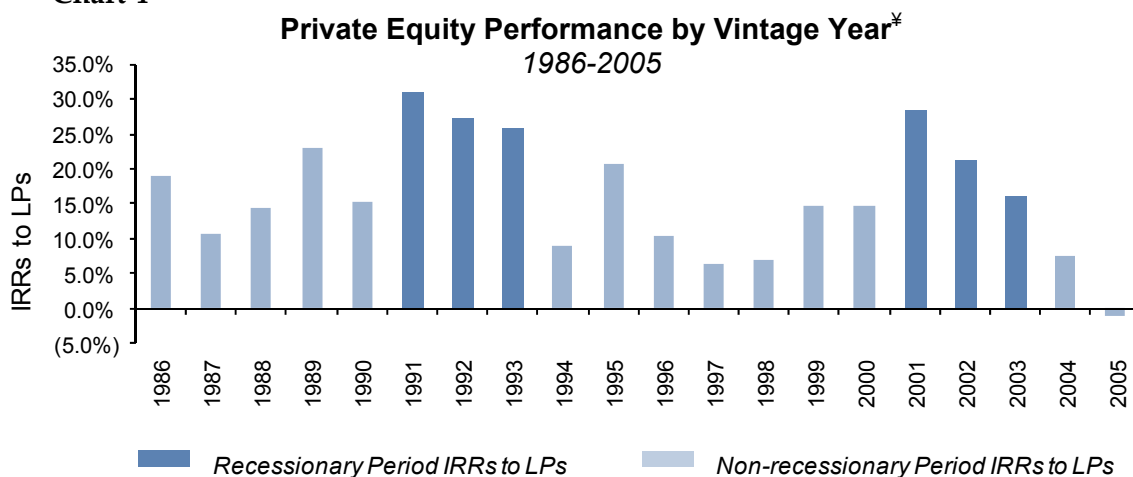
According to an analysis of private equity returns over the past 23 years, private equity investments made during recessionary periods have an average net return of more than 25.1%, compared to non-recessionary period average returns of just 12.3% (which is still above long-term public equity market returns).^{*} Although the data set represents only U.S. private equity trends, it may serve as a representative proxy for other, more mature economies such as in Europe.

The pattern that emerges is not surprising. When entry valuations are low, such as in 1991-1993 and 2001-2003, the return to investors, for those vintage years tended to be higher than the 23-year average. This trend falls in line with the first of two critical rules of investing: buy low. In this case, investors in recessionary periods are

buying well below average valuations. Further review helps validate the second rule of investing: sell high. Typically, private equity investors hold investments for three to five years and then sell their stakes to other investors or list them on public markets via IPOs (Initial Public Offerings). Therefore as seen in Chart 4, investments made in 1991-1993, on average, were sold in 1996-1998, when valuations were above the 23-year average. The same pattern emerges again between years 2001-2003 (buy low) and 2005-2007 (sell high).

There is a declining trend in valuations from 2007 through today. This is not surprising given the tumultuous financial environment of the last few years. Private equity valuations often lag the public market valuations and thus, we believe valuations could either continue to fall or stabilize at current levels. Under either scenario, however, current entry valuations are attractive and patterns from historical market cycles suggest that they could reach or rise above the historical average.

Chart 4



^{*} Source: Cambridge Associates, LLC U.S. Private Equity Index and Benchmark Statistics as of December 31, 2009. Pooled mean net IRR to limited partners by vintage year. Based on data compiled from 815 U.S. Private equity funds, including fully liquidated partnerships, formed between 1986 and 2009. Returns are net of fees, expenses, and carried interest. Analysis and comparison of partnership returns to benchmark statistics may be irrelevant. **Past performances is no guarantee of future results.** The illustrations are not intended to predict the performance of any specific investment or security. The past performances figures do not represent any Hatteras security and there can be no assurance that any Hatteras security will achieve the past returns of the illustrative examples. Vintage year funds since 2006 are immature and have not produced meaningful returns.

IV. GLOBALIZATION

As is the case in many industries, due to the globalization of capitalistic economies over the last 15 years, the opportunity set in private equity is global. Private equity in its current form was developed in the U.S. in the late 1970s, grew rapidly in the 1980s, spread to Europe in the mid to late 1980s, and finally surfaced in Asia at the beginning of this century. Consistent with our core investment beliefs and perspective at Hatteras Funds, we believe investors are best suited to allocate to private equity on a global basis for return potential and diversification purposes.

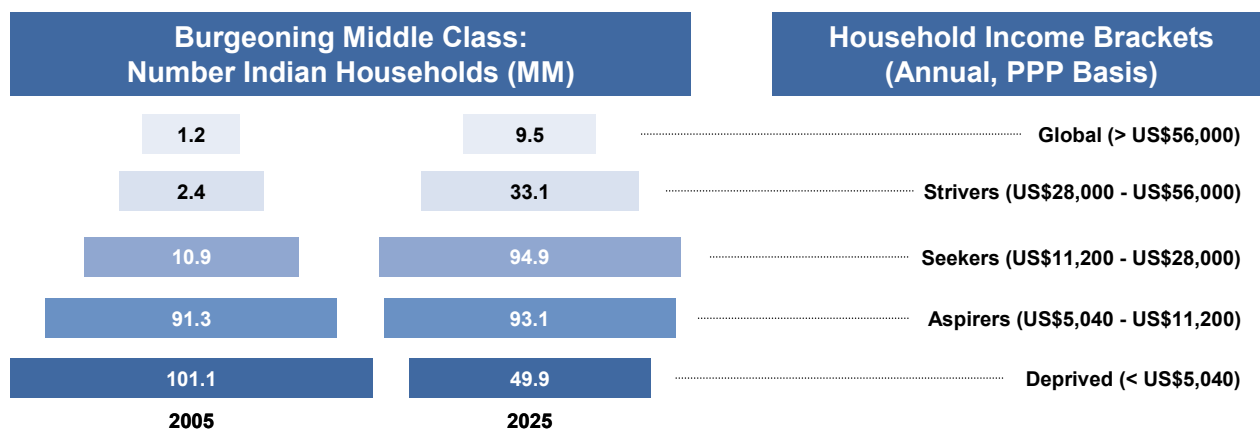
Emerging Asia

Currently, China and India dominate this market region and we believe represent the majority of the opportunity over the next 3-

5 years. These countries are two of the three largest economies in Asia, have the largest population centers, and have embraced globalization, capitalistic market practices, and economic development. Most of the private equity activity in India is in the form of growth capital, while in China it is in the form of growth capital and venture capital, with limited buyout activity. We believe that small and mid-size companies represent the most compelling opportunities in this region. We favor companies targeting infrastructure, educational, agricultural, and technological development. Continued growth of the middle class, as well as urbanization of the population will drive the need for large investments into these industries over the next 10-20 years (see Chart 5).

Chart 5

Changing Demographics in India



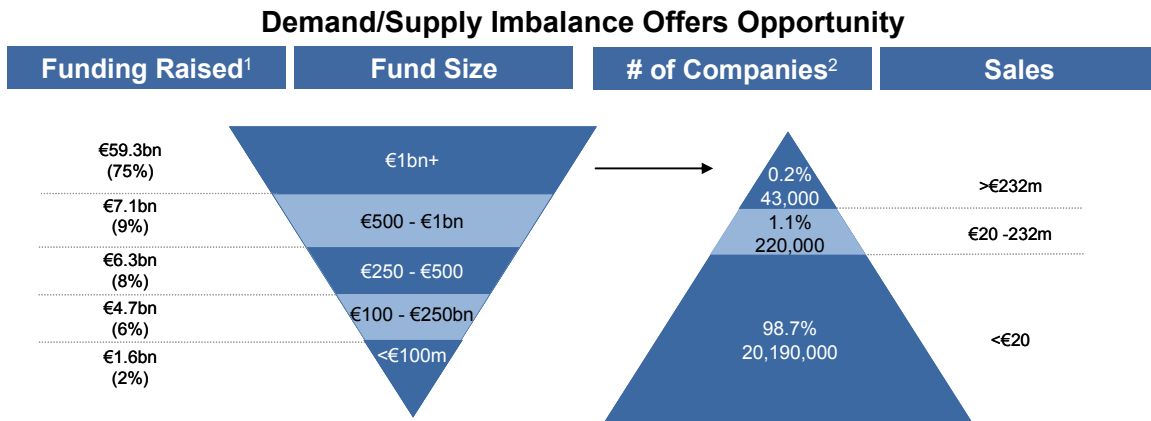
Source: McKinsey Global Institute

Europe

We view Europe still as a collection of disparate markets, not a single entity, and therefore, believe that most private equity opportunities need local presence, knowledge, and access. We believe France, Germany, Italy, Sweden, and the United Kingdom offer the most compelling private equity opportunities as they are the largest markets in Europe. While there are a large number of experienced private equity firms in Europe with long-term track records of success, private equity as a percentage of the overall economy is still much smaller than that of the U.S. (0.42% in Europe versus 1.41% in the U.S.) and therefore, is not as competitive, especially in the small and mid-size markets.[±]

Buyouts represent 70% of the private equity activity in Europe. Furthermore, within private equity, the mid-market sector represents 47% of the buyouts. Based on a report by EIM Business Policy & Research, there are more than 220,000 companies in Europe with revenues between €20 million and €232 million. While the larger sized segment is well-served by private equity, the small and mid-sized segment offers a large number of opportunities but has been undercapitalized. Finally, on an historical basis, the small and mid-size segments have produced higher returns than the large buyout segment (see Chart 6).

Chart 6



Current entry multiples, meaning how much an investor pays to acquire a company, are attractive versus higher multiple levels in 2007 and 2008 (see chart 7). We believe the

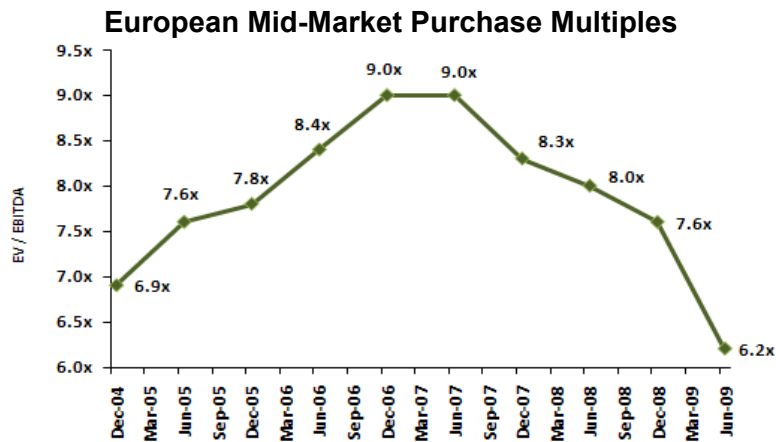
factors and themes discussed above will drive the opportunity set in the small and mid-size sector.

[±] Zero2IPO, World Band, and Capvent

¹ Unquote, Private Equity Insight Report; data as of 2008, funds raised based on total number of funds raised (as determined by PEREP Analytics) multiplied by percent breakout

² EIM Business & Policy Research, 2007

Chart 7



Source: Argos Mid-Market Index/Epsilon Research

U.S.

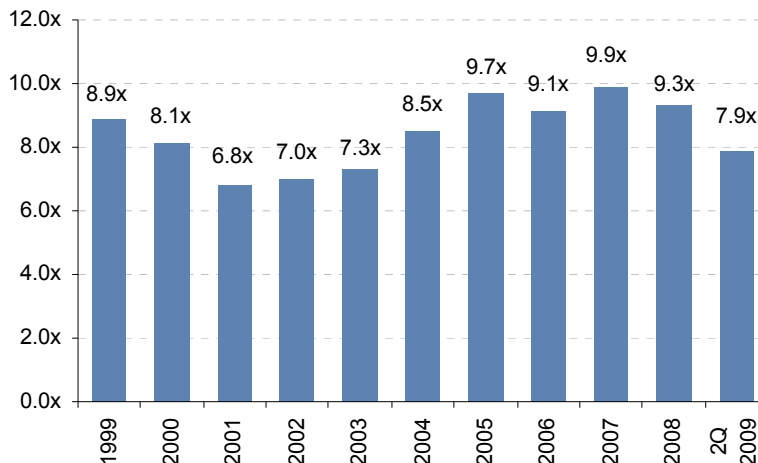
The U.S. represents the largest, most mature private equity market in the world. The significant amount of capital raised during the buyout boom years of 2006 through 2008 still reverberates through the industry and has resulted in a large overhang of un-invested capital, especially in the large and mega-cap sectors. Financing is still difficult and therefore, larger equity commitments are required to close transactions. As seen in Chart 8, median entity valuations for middle market companies have declined 20% since peaking in 2007. While less debt

can reduce risk in the transaction, it will also have an impact on the potential return.

Venture capital fundraising was also dramatically impacted in 2008 and 2009, and has hit a six year low. The IPO market has been dormant up until early this year. The most attractive areas in this market are small-mid buyouts with specialty focused expertise in particular sectors or geographical locations, where the combination of strong operating experience and in-depth knowledge bring competitive advantages over generalists.

Chart 8

Entry Valuations Declining
U.S. Middle Market Enterprise Value to Median EBITA Multiples
 1999-2Q09



Source: Standard & Poor's 2Q09 Leveraged Buyout Review; Capital IQ, Robert W. Baird; Capvent

V. RISKS

For all the benefits of private equity, there are challenges associated with accessing the asset class, including:

- Large dispersion of returns between best and worst performers (much greater than public market investments)
- Creating a diversified portfolio by sub-strategy, geography, and vintage year
- Historically high minimum investments
- Unpredictability of capital calls and distributions
- Since most investments are not publicly traded, valuations using benchmarks or comparable market multiples are used to determine net asset values

We typically see a wide dispersion of returns in markets and investment strategies, such as private equity, with structural inefficiencies. We believe private equity is an inefficient asset class due to

limited availability of information on the industry, managers, and investment opportunities in the market. This limited information creates challenges for asset allocators to select the best private equity managers, and creates an environment that may allow private equity managers with a competitive advantage or unique strategy to significantly outperform their peers. Additionally, some private equity investors actively monitor and influence their investments through board participation and oversight, which can result in performance uncorrelated to general markets and ultimately add to the dispersion of returns among funds.

In today's marketplace, there are more viable options to help investors alleviate or even eliminate some of these difficulties. For example, many asset allocators hire experienced teams of private equity specialists or funds of funds to research, evaluate, and select private equity funds that offer the best opportunities and put them together in a diversified portfolio.



VI. CONCLUSION

Historically, private equity has generated higher returns than public investments. The additional return, generally called the “illiquidity premium,” compensates investors for making less liquid investments. Investors seeking return generation may be disappointed by long-only public equities. Over the past two decades, broad-based private equity has generated greater returns and created substantially more wealth than long-only stocks. Because of the recession, fewer private equity dollars are available to bid on small, private companies. This leads to lower entry prices, which offers investors better growth potential and some risk mitigation. Investors have an opportunity today to access far more diverse private companies, focused on different industries, sectors, regions, and vintages. Globalization has improved the private

equity opportunity set which now offers access to attractive growth rates and diverse industries in places such as emerging Asia, Europe, and even South America. However, investing in these locales requires the experience, access, and knowledge of investment managers “on the ground” in a particular market. Lastly, product innovation in the private equity market is reducing the traditional barriers that either prevented broad access or made this investment class too opaque and confusing to consider. Today, investors are finding lower minimum investments, more diversified investments, lower qualification standards, and in some cases, shorter lock-up periods. For these reasons, we believe investors should consider an allocation to private equity for the return enhancement and diversification features it offers.

The Hatteras Perspective

- We believe that private equity is an attractive investment due to its potential to generate returns in excess of the public markets.
- We believe that the private equity return premium has the potential to be larger than usual because the difficult economic environment of the last two years has resulted in reduced capital available for investment.
- We believe investors should allocate to private equity on a global basis to maximize return potential and diversification, and that the Emerging Asia economies present compelling private equity investment opportunities.
- We believe that, in the current environment, small and mid-sized funds with operating expertise present better opportunities.
- We believe that product innovation is making it easier for a broader investor segment to enjoy the return enhancement features of adding private equity to a traditional portfolio of stocks, bonds, and cash.

GLOSSARY

Buyout: An investment transaction by which the ownership equity of a company or a majority share of the stock of a company is acquired. The acquirer thereby gains control of the target company.

Called capital: Represents investment capital that the private equity manager has requested from limited partners and used to fund investments or pay fees and expenses. Typically, the private equity manager can only “call” investment capital up to the amount committed by investors.

Committed capital: A legally binding pledge, or commitment, for a certain amount of money that investors have made to the private equity fund. When a private equity fund “raises” \$100 million, it has basically accumulated legally binding commitments totaling \$100 million from a number of investors, which would include limited partners and the general partner.

Distributions: Capital that is returned from the private equity fund to the investors. A fund typically distributes capital to investors upon selling one or more underlying investments.

Growth capital: A sub-strategy of private equity investing in which the private equity manager makes minority equity investments into private or public companies. Companies that receive growth capital investments are usually well established businesses that are seeking additional money to accelerate the growth and execution of their business plans.

Illiquidity premium: The value a private equity investor is capable of earning from assuming the risk of owning securities that are not publicly traded and taking longer periods of time to actively improve a portfolio company.

Qualification standards: Minimum investable net worth, which can often be as high as \$5 million.

Venture capital: A sub-strategy of private equity investing in which the manager, a venture capital firm, makes minority equity investments into small, private companies. Typically, venture capital is the money used to help emerging companies finance their growth and development into a larger, more mature company.

Vintage year diversification: Exposure to private equity funds that were formed and make investments during different periods of time. The year in which a private equity fund is formed is called its vintage year.

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