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Some Differences Between Hedge Funds and Mutual Funds

More Investment Alternatives and Techniques

Hedge funds are less restricted in the techniques they may use and the types of investments they may hold. They generally have greater investment flexibility and employ alternative investment techniques, such as hedging to offset a potential market downturn, investing in less traditional asset classes such as currencies, private securities, or distressed securities, or using potential return-enhancing tools such as leverage, derivatives, and arbitrage.

Less Regulation

Mutual funds are regulated under the Investment Company Act of 1940 (the Act) and are open to all investors. Under the Act, they are regulated in their use of leverage and have required levels of liquidity and diversification. Mutual funds must value their portfolios and price their securities daily using fair value guidelines. Hedge funds face less regulation. They are not required to provide investors with periodic pricing or valuation, which allows them a great deal of flexibility but may increase the risks for investors.

Limited Availability

Only "accredited investors" or "qualified purchasers" within the meaning of U.S. securities laws can invest in hedge funds. This means investors must have a minimum level of income, assets, or net worth to be eligible. General qualifications are listed in the adjoining table. Typical investors include institutions, such as pension funds, universities, and insurance companies, as well as financially sophisticated investors. Each fund must take reasonable steps to verify its investors meet the qualifications.

Hedge funds and mutual funds each have unique risks and rewards. Before considering either, investors should carefully read a respective investment fund offering private placement memorandum or investment prospectus.

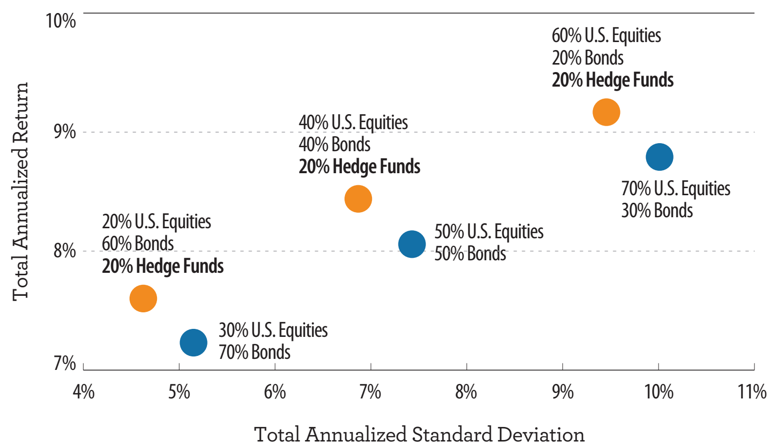
What Is a Hedge Fund?

Key Takeaways

- Hedge funds are private investment pools exempt from registration under federal securities laws because, among other things, they limit investors to those who are considered to be financially sophisticated
- They can be an important diversification tool for some investors and may complement an existing portfolio of stocks, bonds or other securities
- Hedge funds have a wide range of investment flexibility and can employ investment techniques and investment strategies that often aren't available to traditional investments
- They can help manage risk and may provide some downside protection
- Hedge funds consist of portfolios of underlying securities and can use a variety of investment strategies, from conservative to aggressive

Historically Better Risk-Adjusted Returns with Decreased Risk

Adding hedge funds to a traditional portfolio of stocks and bonds historically has increased return and decreased risk



Source: MPI Stylus. Hedge funds represented by the HFRI Fund Weighted Index. Bonds represented by the Bloomberg Barclays U.S. Aggregate Bond Index. U.S. equities represented by the S&P 500 Index. Data shown is from Jan. 1, 1990, (the inception of the HFRI Fund Weighted Composite Index) through Nov. 30, 2018. **This information is hypothetical and for illustrative purposes only; it does not represent any specific investment or represent the experience of individual investors.** An index is unmanaged and not available for direct investment. **Past and hypothetical performance is no guarantee of future results.** Please see page 4 for the descriptions of the risks associated with these asset classes and for definitions of the indices. Standard deviation is a statistical measure of the volatility of returns. The higher the standard deviation the higher the volatility.

Who Can Invest in Hedge Funds?

Depending on the structure of the hedge fund, there are two levels of qualifications for investors:

Accredited Investor	Qualified Purchaser
• An investor with either: – $1 million net worth (excluding primary residence) – Earned net income of $200,000 ($300,000 for couples) over the past two years and similar expectations for the current year • An institution or trust with more than $5 million in total assets that was not set up for the sole purpose of investing in a single fund	• An investor (single or joint with spouse) with more than $5 million in investable assets • A family trust that owns more than $5 million in investable assets • An institution or trust with more than $25 million in total assets that was not set up for the sole purpose of investing in a single fund

Note: To be considered an Accredited Investor or Qualified Purchaser other qualifications or requirements may apply.

Long and Short of Investing

One common technique employed by hedge funds is long/short equity investing. This strategy involves "going long" one security or sector, while "going short" another.

While going long is simply the act of buying a security, selling short involves borrowing shares from another investor and selling them in the hope that the market price goes down, so the fund can later buy shares at the lower price to replace those that were borrowed. The fund's profit is the difference between the initial selling price and the subsequent purchase price. The risk with short selling is the risk of potentially unlimited increase in the market value of the security sold short, which could result in potentially unlimited loss for the fund. Hedge funds seek to mitigate this risk and increase gains by going long and shorting similar securities simultaneously.

Ultimately, placing long and short trades together may help hedge fund managers isolate risk and execute their investment strategies more precisely.

Primary Hedge Fund Types

Hedge funds can be broken down into two primary types: single manager and fund of funds.

Single Manager

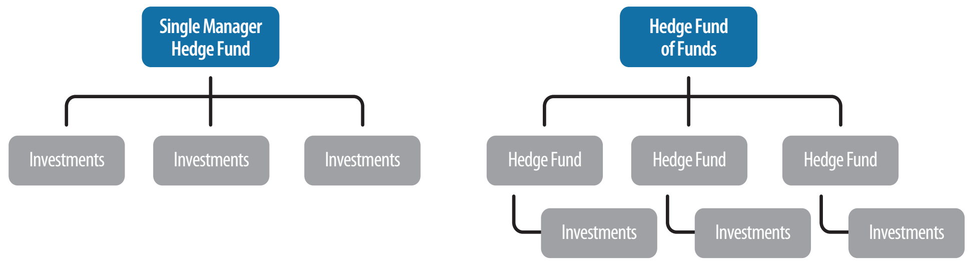
Invests directly in public or private securities. Employs a wide variety of investment techniques but can generally be classified into one of four different strategies.

- More than 8,300 industrywide*

Hedge Fund of Funds

Invests in multiple hedge fund managers in an effort to provide diversification and increase return potential. May provide access to managers with high investment minimums that investors may not otherwise be able to access.

- More than 1,300 industrywide*



*Source: Hedge Fund Research, Inc. As of September 30, 2018.

Investing in single manager hedge funds could lead to greater volatility, less diversification, and greater firm-specific risk. Investors in hedge fund of funds will incur asset-based fees and expenses at the fund level and indirect fees, expenses and asset based compensation of investment funds in which these funds invest.

Potential Benefits

Responsive: Since hedge funds typically have flexible investment mandates, they can often be more tactical and nimble than most traditional investments, enabling them to move quickly into and out of investment opportunities.

Illiquidity Premium: Because hedge funds are not required to provide daily liquidity, they can be longer term investors and access less liquid investment opportunities that are not typically available to traditional investment funds. These less liquid investment opportunities may be more profitable than more liquid investments because investors expect a greater profit to account for the illiquidity.

Diversification: Hedge funds can complement other investments in a portfolio, enhancing diversification by incorporating one or more alternative investment techniques including: using hedging to offset the potential of a market downturn, investing in less traditional asset classes such as currencies or distressed securities, or using potential return-enhancing tools such as leverage, derivatives, and arbitrage.

All-Market Strategies: Hedge funds typically strive to give investors the ability to participate in a rising market while reducing downside exposure against sharp market downside moves. Over the long term, this strategy strives to outperform more volatile traditional investments.

Flexible: Because hedge funds have fewer restrictions than traditional investments, they can employ advanced investment techniques to focus their investment in their best ideas—including both winners (longs) and losers (shorts). This investment freedom also helps hedge funds attract some of the investment industry's most creative and experienced managers.

Potential Risks

Leverage: Many hedge funds use leverage—or borrowed capital—to attempt to enhance returns. In general, the more leverage a fund uses, the more its gains or losses are amplified, so understanding a fund's leverage policy is an important component of understanding the fund's risks.

Transparency: Since hedge fund managers engage in proprietary trading strategies or may hold a significant portion of a thinly traded security, they are often reluctant to provide details about portfolio positions.

Liquidity: Hedge fund investors typically have limited rights to redeem and transfer fund interests (e.g., monthly, quarterly, or even annual liquidity), and there is generally no secondary market for these interests. Liquidity terms can vary considerably, so it is important for investors to understand them up front.

Valuations: Although hedge funds are required to adopt policies to determine their holdings' fair values, they are not required to offer investors periodic valuations. Also, funds may invest in less liquid instruments which could complicate portfolio valuation.

Tax Considerations: Hedge fund investors are often subject to complex tax structures, such as pass-through tax treatment of their investments. It is also possible that a hedge fund manager may not be able to distribute tax information in time for investors to file their returns without filing for an extension.

In evaluating hedge funds, Wells Fargo Investment Institute employs a review process and dedicated team of due diligence specialists focused on selecting and monitoring high quality hedge funds that we believe provide the best combination of maximizing hedge fund benefits while minimizing each of these risks.

Primary Hedge Fund Strategies

Hedge funds trade in diverse complex strategies that are affected in different ways and at different times by changing market conditions. See page 4 for the risks associated with using these strategies.

Equity Hedge or Long/Short Equity

Consists of a core holding of equities hedged with short sales of stocks and/or stock index options. It commonly employs leverage.

- Provides return opportunities from both long positions and short positions
- May help reduce volatility during market correction
- May accelerate portfolio growth and return

Macro

Involves making leveraged bets on anticipated price movements of stock markets, interest rates, currency foreign exchange, and/or physical commodities.

- Provides return opportunities from across the globe from a wide variety of investment types
- May help reduce a portfolio's exposure in prolonged bear markets
- May help balance portfolio growth and return

Event Driven or Corporate Life Cycle

Involves investing in opportunities created by significant transactional events, such as spin-offs, mergers and acquisitions, bankruptcy reorganizations, recapitalizations and share buybacks.

- Ability to capitalize on anticipation of corporate activity and events; can serve as a catalyst to that change
- Diversifies long-only equity and credit exposure
- Helps exploit opportunities throughout credit cycle

Relative Value Arbitrage

Attempts to take advantage of relative pricing discrepancies between securities, including equities, debt, options, and futures. Managers may use mathematical, fundamental, or technical analysis to determine misvaluations.

- Diversifies fixed income and credit exposure
- Has generally performed well in a rising-interest-rate environment and can invest in less- or non-interest-rate-sensitive instruments
- May help preserve capital and/or generate income

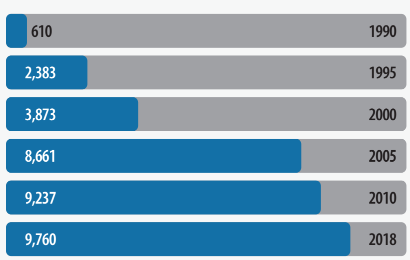
By the Numbers

Hedge Funds Assets Under Management[1]

$38.9 BILLION 1990

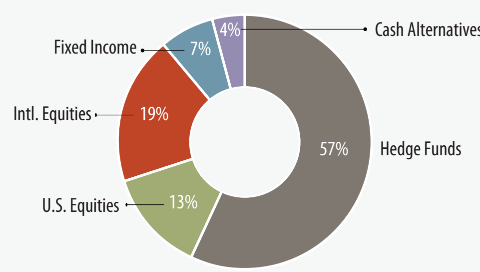
$3.24 TRILLION 2018

Number of Hedge Funds[2]



Institutional Use of Hedge Funds[3]

Asset allocation of university endowments with more than $1 billion in assets.



Sources: 1 & 2: Hedge Fund Research, Inc. As of September 30, 2018. 3: NACUBO-Communfund Study of Endowments 2015. Hedge funds in this category include absolute return, market neutral, long/short, 130/30, event driven and derivative strategies. As of September 30, 2018.

Risk Disclosures

Hedge funds are an alternative investment vehicle that are not suitable for all investors. Any offer to purchase or sell a specific hedge fund will be made by the product's official offering documents. Investors could lose all or a substantial amount investing in hedge funds. They are open to qualified investors only and carry high costs, substantial risks, and may be highly volatile. There is often limited (or even non-existent) liquidity and a lack of transparency regarding the underlying assets. They do not represent a complete investment program. There is no secondary market for the investor's interest in a hedge fund and there is no guarantee one will develop. In addition, there may be restrictions on transferring interests in a hedge fund.

Hedge fund strategy risk disclosures:

The Hedge strategies discussed above employ aggressive investment techniques, including short sales, leverage, swaps, futures contracts, options, forward contracts and other derivatives which can expose the investor to substantial risk. The use of 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 investment. In addition, taking short positions in securities is a form of leverage which may cause a portfolio to be more volatile. Engaging in futures, forwards, options, swap agreements or other derivative instruments can expose the investor to additional risk, including illiquidity and counterparty risk and could produce disproportionate gains or losses and may increase volatility and costs in the portfolio. Counterparty risk is the risk that the other party to the agreement will default at some time during the life of the contract. Derivatives can give rise to a form of leverage. Leverage creates special risks including potential interest rate risks and the likelihood of greater volatility of net asset value and market price of the fund's securities. The use of derivatives carries the risk of the underlying instrument as well as the derivative itself and may not be successful, resulting in losses to the fund, and the cost of such strategies may reduce the fund's returns. Purchasing and writing options are highly specialized activities and entail greater than ordinary investment risks. The successful use of options depends in part on the ability of the manger to manage future price fluctuations and the degree of correlation between the options and securities markets. No assurance can be given that such judgments will be correct. Options are subject to sudden price movements and are highly leveraged, in that payment of a relatively small purchase price, called a premium, gives the buyer the right to acquire an underlying security interest that may have a face value greater than the premium paid.

Successful hedging strategies may require a manager's skill in assessing corporate events, the anticipation of future movements in securities prices, interest rates, or other economic factors. No assurance can be given that a manager's view of the economy will be correct which may result in lower investment returns or higher return volatility. In addition, there can be no assurance that a manager that uses these strategies will be successful or that a manager will not deviate from its stated investment strategy and not employ other investment techniques in an effort to meet the fund's investment objective. All investing involves risk including the possible loss of principal.

Asset class risk disclosure

Stocks are subject to market risk which means that their value may fluctuate in response to general economic and market conditions, the prospects of individual companies, and industry sectors.

Bonds are subject to interest rate, credit/default, liquidity, inflation and other risks. Prices tend to be inversely affected by changes in interest rates.

Hedge funds are complex, speculative investment vehicles not suitable for all investors. An investment in a hedge fund involves the risks inherent in an investment in securities, as well as specific risks associated with limited liquidity, the use of leverage, short sales, options, futures, derivative instruments, investments in non-U.S. securities, which involves risks associated with currency fluctuation, political and economic instability, and different accounting standards, "junk" bonds which have lower ratings and are subject to greater volatility than other fixed income securities and specific risks associated with illiquid investments.

Index definitions

Bloomberg Barclays US Aggregate Bond Index is a broad-based measure of the investment grade, US dollar-denominated, fixed-rate taxable bond market.

S&P 500 Index is a market capitalization-weighted index composed of 500 widely held common stocks that is generally considered representative of the US stock market.

HFRI Fund Weighted Composite Index is a global, equal-weighted index of over 2,000 single-manager hedge funds that report to HFR Database. Because the HFR Indices are calculated based on information that is voluntarily provided, actual returns may be higher or lower than those reported.

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