Creating Hedge-like Mutual Funds

The Opportunity

Gemini Fund Services, LLC

The recent credit crunch and economic turndown is creating unique opportunities for alternative investment asset managers to tap into the retail demand for uncorrelated investments. With headlines screaming the death of asset allocation, many financial advisors (RIAs and brokers) are looking beyond traditional large, mid and small cap investments, and hedge strategies can be very appealing.

Morningstar tracks only 132 hedge fund-like mutual funds, which suggests the opportunities for new entrants with proven strategies are high. And recently Gemini Fund Services, LLC ("Gemini") has facilitated the creation of hedge fund-like mutual funds, which were motivated by several different factors.

One reason is to capitalize on potential distribution opportunities available to mutual funds, which can be made available on widely-known public platforms such as Schwab and Fidelity. Many hedge fund advisers have to turn down significant investments because the investors, individually, don't quite have the large minimum investment required to invest in a hedge fund.

Sometimes conversion requests are the result of an adviser's clients seeking the security of more regulated and more transparent investments such as mutual funds, while still wanting to invest in vehicles with hedge fund characteristics.

Another motivation is the fallout of the Madoff scandal and the likelihood of additional regulation of hedge funds in the near future; as long as added regulation is coming, why not take advantage of the broader distribution platform afforded by mutual funds?

Hedge funds often can outperform mutual funds, due to the lack of restrictions on investment liquidity and leverage in the hedge fund arena. One of our clients currently has a long-short hedge fund with superior performance. If it were a mutual fund, its performance would be near the top of its category. Once converted to a mutual fund, it will have an almost identical investment strategy to the original hedge fund, which will allow the mutual fund to retain the performance of the hedge fund. However, not all hedge funds can convert to mutual funds seamlessly.

Which strategies are suitable for 40 Act mutual funds?

While many strategies are suitable, there are a few limitations. For example, a hedge fund that uses significant leverage would have to change its strategy when converting to a mutual fund, because mutual funds are limited as to the amount of leverage allowed. Mutual funds also are limited in the amount of commodities they can use, as commodities generally do not qualify as passive income for a mutual fund. A mutual fund must have 90% of its income from passive investments under sub-Chapter M of the Internal Revenue Code in order to qualify as a Regulated Investment Company, which allows the fund to be a pass-through entity for tax purposes. Certain ETNs or ETFs that invest in commodities may qualify as passive income. Gemini has many clients that invest in commodities and we regularly assist our clients in navigating this compliance maze. An advisor of a hedge fund planning to start a mutual fund should consider the limitations placed on mutual funds when using leverage or investing in commodities, among other limitations, and should coordinate very closely with an experienced administrator and outside counsel. In the case of converting an existing hedge fund into a mutual fund, if its strategy has to be adjusted, it may impair the mutual fund's ability to retain its prior hedge fund performance.

That said, there are numerous strategies and asset classes that can work inside the regulations. These include, but are not limited to:

Example Strategies	Asset Classes
Global distressed	Commercial loans
Long/Short equity	Common stock
Market neutral	Convertible bonds
Arbitrage	ETFs
Absolute return	Futures
Real estate	Options
Quantitative	Real estate
Strategic Asia	SPACs
Strategic asset fund	US Treasury

Creating Hedge-like **Mutual Funds**

What options exist for illiquid strategies/assets?

Mutual funds are required by regulation to have daily liquidity, which might limit strategies investing in distressed and high yield bonds, for example. To conform to the regulations, the manager has the option of creating a mutual fund that mimics most of the unregulated strategy, but that leaves out any illiquid investments, or the manager might consider opening a closed-end fund.

What are the costs and timelines?

A typical 40 Act fund will take four months to create. This is driven largely by the SEC's review period.

Costs depend on several factors such as whether the manager wishes to self administer. Those wishing to minimize start up costs and provide the greatest transparency and confidence to investors could consider a suite of services from Gemini and our sister companies including fund administration, series trust and distribution services.

The costs of starting a mutual fund with $10 million in assets under management is approximately $35k to $50k.

What are the benefits of a shared trust?

A shared trust is comprised of independent mutual funds, all managed by separate investment advisors. Joining our series trust, the Northern Lights Fund Trust, provides a solution to the ever increasing costs of managing a mutual fund. These include operational efficiency through our management of corporate, board and regulatory governance; economies of scale through reduced auditor, fund counsel, trustee, insurance and registration expenses; and compliance and proper board oversight.

How does distribution work?

Gemini's sister company, Northern Lights Distributors, LLC, provides enhanced fund sales through our selling agreements with broker/dealers and other institutions. With over 200 selling agreements (i.e. investment platforms at leading advisors and brokers), we can provide you with the assistance and support to maximize your brand awareness and marketing. Our industry and regulatory knowledge also allows us to:

- Assist you in understanding applicable regulatory requirements
- Review and file all fund-related sales and advertising materials with FINRA
- Maintain records of all filed sales and advertising materials

Conclusion

The retail market demand for alternative investment strategies is expected to grow dramatically. Gemini and our affiliated sister companies and partners can provide you with turnkey, full service solutions to help ensure you benefit from this trend. Let Gemini help you:

- Create additional unregistered investment strategies and vehicles
- Create 1940 Act mutual and closed-end funds for these strategies
- Provide series trust and distribution services to keep costs low and maximize your marketing
- Convert hedge funds into mutual funds while retaining past performance track records

Gemini is a consultative partner providing pooled investment solutions, not only for mutual and hedge funds, but also for variable annuity funds, collective funds, and offshore funds.

1166-GFS-10/7/2009

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