

Using a Directional Long/Short Fund as a Core Holding

Many people hear the term “long/short” and think of “alternative,” more complex or even riskier investments without understanding what long/short means and the differences within these strategies. Indeed, some long/short equity investment styles are actually lower risk than traditional long-only equity investing. The intent of this paper is to provide a background primer on long/short equity investing as well as to further explain the three major types of long/short equity mutual funds.

Long/short equity investment approaches were originally used by investors focused on risk management and capital preservation within their equity investments. These investors also desired flexibility to invest opportunistically in an attempt to make money during a variety of equity market conditions; e.g., bear markets. Through the addition of shorting to an investment portfolio, there was an opportunity to profit from investment research about both over- and under-valued securities. Since the 1930s, long/short equity products were typically available in the form of hedge funds or limited partnerships, and consequently were really only accessible to institutions and high net worth individuals. The term “hedge” fund, initially referred to the use of a hedged-equity, a portfolio of both long and short positions, as contrasted with a long-only equity investment approach. Today, there are wide ranges of strategies employed in the hedge fund world, many of which have nothing to do anymore with hedging or even equities. Indeed, the term “hedge” fund has become an adjective used in reference to a fund’s structure as a limited partnership, and it is no longer an accurate descriptor of fund strategy.

Investors interested in traditional hedged-equity investment strategies now are able to access such products through the more recent introduction of long/short equity mutual funds. Long/short equity is a term simply describing the fact that these funds have the ability to sell securities short in addition to the traditional long equity positions within the portfolio. Beyond that commonality, long/short equity mutual funds still can have some meaningful differences in objectives and risks. Some long/short funds are niche funds used to diversify your portfolio, while others can be appropriate as core portfolio holdings.

In general there are three distinct types of long/short equity funds: a) directional long/short funds, b) “market neutral” long/short funds, and c) leveraged long/short funds. We outline below the significant difference in objectives and risks among these three common types of long/short equity funds, and highlight the central role a directional long/short fund can play in your core investment portfolio.

THREE DIFFERENT TYPES OF LONG/SHORT FUNDS

1. Directional Long/Short Funds

OBJECTIVE: Capital appreciation and preservation (equity-like returns, but with less risk)

VOLATILITY/RISK: Medium (less than typical equity fund)

These funds are focused on risk-adjusted return and do not use leverage. They invest up to 100% of the fund's assets in long equities, while also taking varying short positions. Cash received from short sales is held in cash equivalents to cover the short sale liability.

The amount of securities sold short typically increases as the market rises in valuation and decreases as valuation falls. As such, the fund typically increases its use of short sales in an effort to preserve capital when the risk of a market decline increases. The fund seeks to avoid being hurt by its short sales in rising markets by picking securities for short sales that are believed to be overvalued regardless of market direction.

Using these strategies, the goal of directional Long/Short funds is to achieve capital appreciation while also providing capital preservation. The managers of such funds would expect to significantly outperform equities in down markets and to slightly lag equities in up markets. If successfully executed, directional Long/Short funds should modestly outperform equities over the long term, and do so with potentially less volatility and risk.

Note: This approach has been commonly used in the limited partnership space for decades, but only became available in the mutual fund space about 10 years ago after the Congressional repeal of the “short-short” rule.

2. “Market Neutral” Long/Short Funds

OBJECTIVE: Capital preservation (returns above T-bills, with limited upside and downside)

VOLATILITY/RISK: Low

These funds invest an equal amount in long and short positions. By doing so they are somewhat insulated from market moves up or down. The longs and shorts in the portfolio are expected to roughly balance each other, with the fund seeking to deliver small consistent gains through the quality of the fund's stock selection. A well run market neutral long/short fund has very low volatility. These funds generally use T-bills as their benchmark, and seek to consistently provide a return slightly above T-bills, since these funds are not risk-free. Within the limited partnership structure, leverage is commonly applied to this strategy in order to target greater returns.

3. Leveraged Long/Short Funds (e.g., 130/30 funds)

OBJECTIVE: Capital appreciation (greater risk and returns than equities)

VOLATILITY/RISK: High

These aggressive funds use leverage by re-investing the proceeds of their short sales. As a result these funds may have up to 130% of the fund's net assets invested in long equities, while simultaneously having 30% of the fund's assets at risk on the short side. If executed well the fund has the ability to capture increased returns because of this levered position—the gains on the long side are increased by 30%, plus any gains made on the short side. Of course with the upside potential comes increased volatility and risk. Additionally, this approach

does not offer the same potential for capital preservation many investors are seeking with a hedged-equity approach.

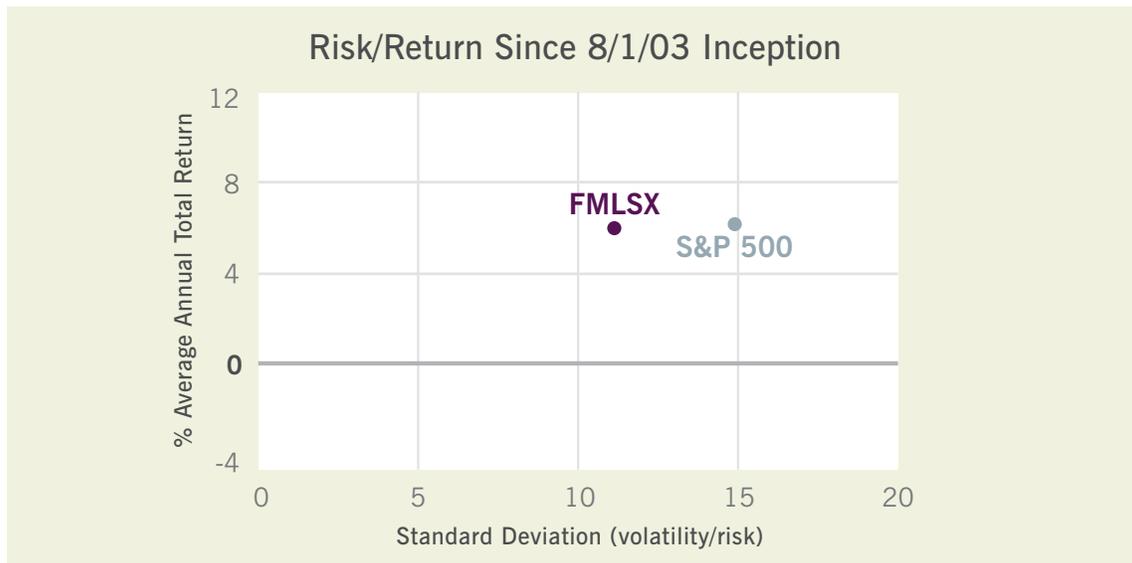
The Wasatch Long/Short Fund (FMLSX)

The Wasatch Long/Short Fund is an example of a directional long/short fund. We will use it here to help illustrate why this type of fund can be appropriate as a core holding in your portfolio.

FUND OVERVIEW

- The Wasatch Long/Short Fund’s objective is capital appreciation. We hope to deliver equity-like returns, but with less volatility and risk. The Fund invests primarily in equities (long and short), but does not use leverage as part of its strategy. It functions like a regular equity fund, but has the ability to sell short securities in order to potentially limit risk.
- The Fund has flexibility in the magnitude of its short positions, but the Fund has typically been 20% to 30% short. The Fund will not go over 100% long (i.e., it will not use leverage).
- The Fund also has the flexibility to invest in companies of all sizes, but has primarily invested in mid and large cap companies (both long and short).

FUND RESULTS — EQUITY-LIKE RETURNS WITH LESS VOLATILITY



Source: Russell/Mellon Analytical Services LLC, 12/31/12

Average Annual Total Returns For Periods Ended December 31, 2012

	1 Year	3 Years	5 Years	Since Inception (8/1/03)
FMLSX	8.67%	6.56%	4.47%	6.00%
S&P 500 Index	16.00%	10.87%	1.66%	6.10%
Citigroup 3-Mo. U.S. T-Bills Index	0.07%	0.09%	0.45%	1.72%

Source: Wasatch Funds

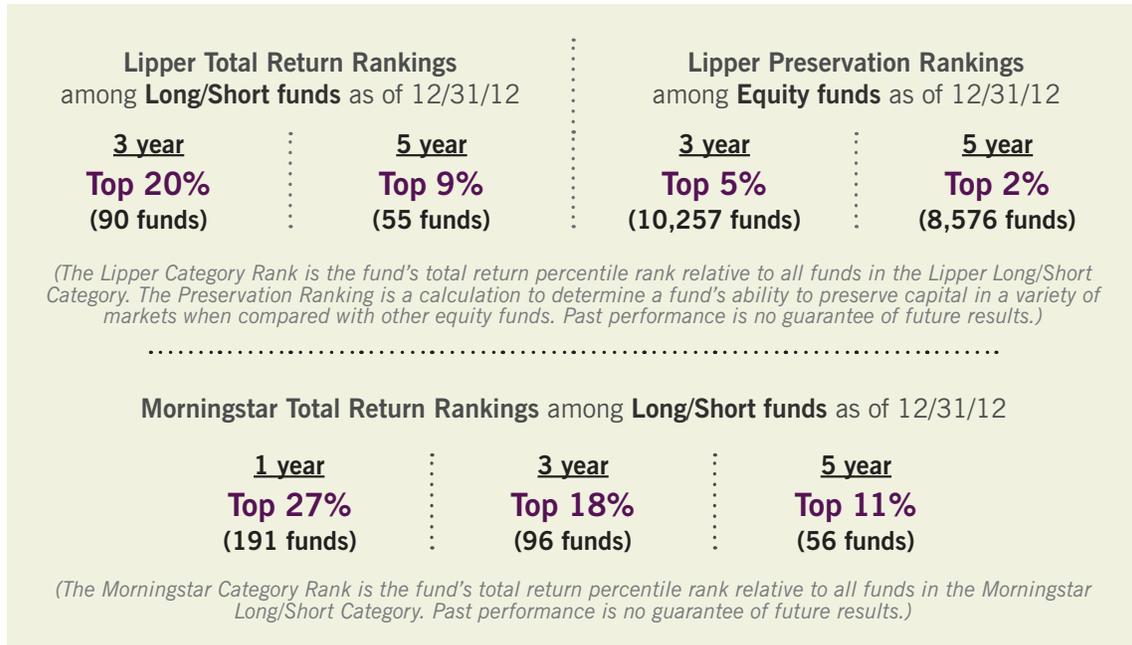
Data show past performance which is not indicative of future results. Current performance may be lower or higher than the performance quoted. For month-end performance, please visit www.WasatchFunds.com. Investment returns and principal value will fluctuate and shares, when redeemed, may be worth more or less than their original cost. Wasatch Funds deducts a fee of 2% from redemption proceeds on Fund shares held 60 days or less. Performance data does not reflect this fee or taxes. The Total Expense Ratio for FMLSX is 1.63% (1.30% excluding dividend expense on short sales).

- Keeping pace in the up years and historically outperforming in the down years



Source: Wasatch Funds

• **Doing it better than most:**



Note: Morningstar uses a broad definition of long/short funds which includes all three types of long/short funds described in this paper, as well as some flexible asset allocation funds. As a result, comparing a long/short fund within a Morningstar peer group requires additional analysis and understanding. Lipper uses a tighter definition of long/short focused on directional long/short funds and places market neutral strategies in a separate category.

FUND MANAGEMENT — STABLE AND EXPERIENCED PORTFOLIO TEAM

The Wasatch Long/Short Fund is one of the most seasoned funds in this space. Both portfolio managers have been with the Fund since its inception in 2003 and were involved in crafting the fund strategy and objectives prior to launch. Lead Portfolio Manager Michael Shinnick brings unique perspective and experience to the Fund and has been leading this Fund for as long, or longer, than 90% of long/short mutual fund managers. Co-manager Ralph Shive contributes over three decades of investment experience and proven success, as seen in his own large cap value fund (FMIEX).


MICHAEL SHINNICK FUND TENURE: 9 years

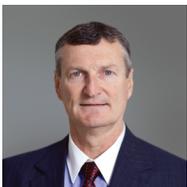
PREVIOUS INDUSTRY EXPERIENCE

- Vice President of 1st Source Corporation Investment Advisors
- Portfolio Manager, 1st Source Corporation Investment Advisors
- Partner and principal at Diamond Technology Partners (DTPI), a Chicago-based global management consulting firm
- Officer of Z-Cosm, global venture development group at Zurich Financial Services

EDUCATION: University of Notre Dame, B.A. in Economics

For someone who's spent much of his life in the Midwest, Michael Shinnick sure knows how to explore. His path has taken him from studies in political science and philosophy to jobs in high tech. He started his own business in health care software consulting, then found himself pulled toward finance. While employed with DTPI, Michael gained a better understanding of how companies are valued—and he found the process fascinating. He began to explore the investing world where a friend introduced him to Ralph Shive. Several lunches and many deep conversations later, Ralph ultimately invited Michael to join 1st Source Investment Advisors and start his own fund.

The result is the Wasatch Long/Short Fund (formerly Wasatch-1st Source Long/Short Fund), where Michael practices the philosophy of “make it, keep it, and just don't lose it.” One of the first 20 Long/Short funds created, the Wasatch Long/Short Fund has been acclaimed for its steady history and Michael's up-close-and-personal management. Michael also co-manages the Wasatch Large Cap Value Fund. When Michael is not investigating investment opportunities, his taste for exploring sticks around. Michael enjoys traveling the world for work and leisure and believes every experience can help people better understand that world.


RALPH SHIVE, CFA FUND TENURE: 9 years

PREVIOUS INDUSTRY EXPERIENCE

- Vice President and Chief Investment Officer, 1st Source Corporation Investment Advisors
- Portfolio Manager, 1st Source Corporation Investment Advisors
- Portfolio Manager of a private family portfolio in Dallas, Texas
- Named a Barron's Top 100 Fund Manager

EDUCATION: Southern Methodist University, B.S. in Business Administration

To Ralph Shive, investing is a “people business” in every sense. For starters, he's fascinated by the psychology of the market—the fears, passions, and hubris that can drive market trends. An avid reader of history, Ralph consumes stories about the rise and fall of businesses and how the human condition is expressed in them. This passion for history and an appetite for news give him a unique perspective when analyzing market and sector cycles. He put this into practice while developing the investment philosophy for 1st Source Corporation Investment Advisors. But it's his perspective of the individual investor that Ralph values most.

Before joining 1st Source, Ralph managed a private family investment portfolio where he experienced firsthand what it means to personally handle someone else's money. Although his career has since taken him to mutual fund management, Ralph has never stepped away from that personal style. He practices a work ethic that would allow him to look any shareholder in the eye and confidently answer their questions. It's paid off—Ralph has received numerous recognitions as one of the top portfolio managers in the United States by *The Wall Street Journal* (12/10/2002), *Barron's* (8/11/2008), and other publications over the past 10 years. When he's not examining a company or exploring the psyche of a sector, Ralph works to please his toughest crowd; his favorite pastime is relaxing with his daughters and wife.

FUND INVESTMENT PHILOSOPHY — FOCUS ON VALUE

- Key criteria for selecting Long positions—a value approach
 - Low valuation relative to sector/industry
 - Company positioned to benefit from a global theme/framework
 - Targeting securities that are at least 25% below intrinsic value
- Key criteria for selecting Short positions—fundamental and technical analyses
 - High valuation relative to sector/industry
 - Clear thesis for why valuation will come down or earnings will be hurt
 - Technical signs of distribution/breakdown

FUND FEES & OVERSIGHT — LOWER FEES AND GREATER OVERSIGHT THAN PRIVATE OPTIONS

Long/Short investing has been taking place in limited partnerships and hedge funds for years. Making this strategy available in mutual funds provides several key advantages in fees, liquidity, transparency, and oversight:

- **LOWER FEES** Typical hedge fund fees are 2.00% management fee plus 20% of the performance. The average Long/Short mutual fund total expense ratio is 2.16%, and the total expense ratio of the Wasatch Long/Short Fund is just 1.63%.
- **BETTER LIQUIDITY** Investing in hedge funds or limited partnerships generally involves long-term lock-ups for your investment. The mutual fund construct provides daily access to increase or redeem investments—of course the preferred mutual fund investor has a long-term horizon.
- **TRANSPARENCY** The fund's investments are in public securities. The portfolio value is priced on a daily basis, and the list of holdings is published quarterly. All holdings are held by an independent third party custodian.
- **GREATER OVERSIGHT** Mutual funds are tightly regulated by the SEC and by each state in which they are registered.

CONCLUSION

“Long/Short” funds can have very different objectives. Directional Long/Short funds seek to provide equity returns with an emphasis on capital preservation, thus making them an excellent component of your equity allocation. Market Neutral and 130/30 funds may appropriately fill niche opportunities within your asset allocation. It's worth clearly understanding the objectives and strategy of a Long/Short fund before investing. These funds can provide unique strategies and results to you and your clients' portfolios, but it is important to select a fund with strategies and results consistent with your goals.

For those interested in a directional Long/Short fund, the Wasatch Long/Short Fund (FMLSX) is worth considering as one of the most seasoned funds in the space. Michael Shinnick and Ralph Shive have run the Fund since its inception and have consistently delivered equity-beating results with lower volatility, and at expense levels well below the category average.

Wasatch Contacts

Individual Investors: 800.551.1700 • Financial Advisors: 800.381.1065
 Institutional Investors: 801.983.4119 • Retirement Plan Solutions: 801.983.4177

Wasatch Funds deducts a fee of 2% from redemption proceeds on Fund shares held 60 days or less. Performance data does not reflect this fee or taxes.

The Fund makes short sales of securities which involve the risk that losses may exceed the original amount invested. Mutual fund investing involves risks, including potential loss of the principal amount invested. Being non-diversified, the Wasatch Long/Short Fund can invest a larger portion of its assets in the securities of a limited number of companies than a diversified fund. Non-diversification increases the risk of loss to the Fund if the values of these securities decline. Investments in value stocks can perform differently from the market as a whole and other types of stocks and can continue to be undervalued by the market for long periods of time.

An investor should consider investment objectives, risks, charges and expenses carefully before investing. To obtain a prospectus, containing this and other information, visit www.WasatchFunds.com or call 800.551.1700. Please read it carefully before investing.

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The S&P 500 Index represents 500 of the United States' largest stocks from a broad variety of industries. The Index is unmanaged, and a common measure of common stock total return performance. The Citigroup 3-Month U.S. Treasury Bills Index tracks the performance of U.S. Treasury bills with a remaining maturity of three months. U.S. Treasury bills, which are short-term loans to the U.S. government, are full-faith-and-credit obligations of the U.S. Treasury and are generally regarded as being free of any risk of default. You cannot invest directly in these or any indices.

Intrinsic Value is the actual value of a company based on an underlying perception of its true value including all aspects of the business, in terms of both tangible and intangible factors.

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