ALTERNATIVE INVESTMENTS: An Educational Guide

RISK FACTORS
Investments in these alternative products may involve significant risks including, but not limited to, various investment risks, illiquidity, leverage, multiple levels of expense and regulatory risk.

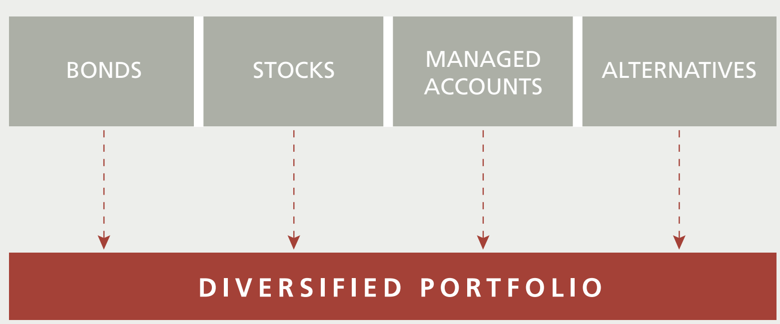
Open the door to alternatives

Why are many high net worth and institutional investors adjusting their portfolio allocations to include alternative investments? The answer is straightforward: for many sophisticated investors, alternatives make sense.

Investments in hedge funds and managed futures can complement traditionally structured portfolios by improving diversification and reducing volatility, while offering access to top investment managers and strategies. Private equity funds can provide investment access to companies that are not publicly traded. Exchange funds can add diversification along with the opportunity to realize superior returns while minimizing current federal capital gains tax liability.

Open the door to alternative investments and explore the potential benefits of hedge funds, private equity, exchange funds and managed futures in your portfolio.

Alternatives can help you meet your goals by improving portfolio diversification.



Intended only for clients with $1 million+ net investable assets.

Key definitions

Hedge funds: Investment funds that use one or more of a broad range of skill-based strategies to allocate their investment capital to publicly listed equities. Many use derivatives, long and short positions, and leverage to seek returns that are not correlated to the overall equity and fixed income markets.

Private equity funds: Investment funds that hold equity securities of private companies. Funds may specialize by industry, stage of company development or region. Private equity funds may also invest in private company convertible securities or other fixed-income hybrids.

Exchange funds: Pooled investment funds that allow the deposit of appreciated stock, often including restricted stock, in a portfolio with other stocks to achieve immediate diversification. Because the stock is exchanged rather than sold, investors incur no current federal capital gains tax liability upon deposit.

Managed futures funds: Pooled investment funds that seek trading opportunities in the world's currency, metals, interest rate and commodities futures markets.

Funds of funds: Investment pools that allow a single investment amount to be allocated by a professional money manager to multiple underlying funds. These funds can add diversification, and are common among hedge fund and private equity products.

Hedge funds

Performance and diversification through a range of skill-based investment strategies

Today, hedge funds invest more than $400 billion in thousands of securities across the United States and around the world. The industry has grown rapidly in recent years, as institutional and high net worth investors, foundations and endowments seek opportunities not otherwise available through traditional stock and bond investing.

Hedge funds are gaining attention and assets due to their potential benefits as part of an overall portfolio strategy – for example, in conjunction with a privately managed account or traditional stock and bond portfolio.

Investment strategies

A number of strategies operate within the hedge fund universe, including:

Long/short equity: Purchases ("goes long") stocks perceived to be undervalued, and sells ("shorts") stock perceived to be overvalued. The research-intensive methods used to identify promising stock to hold may also uncover short-sale opportunities. For this reason, many directional equity funds often maintain both long and short portfolios.

Event-driven: Seeks to capitalize on price movements resulting from anticipated events such as mergers, spin-offs, bankruptcies, earnings surprises or credit upgrades. For example, the manager might purchase the target company's rising stock on a merger announcement, and sell short the acquiring company's declining stock. Thus, the hedge fund profits from both sides of the transaction.

Convertible arbitrage: Involves taking long positions in convertible bonds or warrants, hedged with short positions, typically in the underlying stock. Since convertible bonds and warrants are derivatives, their prices reflect the price of the underlying stock, expected future volatility of returns, risk-free interest rates and the issuer-specific corporate/Treasury yield spread.

Key benefits

Diversification

Investors may gain additional portfolio diversification by participating in the many strategies available within the hedge fund universe. Several hedge fund investment strategies offer returns with low correlation to the stock and bond markets – this means that investors may reduce their overall portfolio risk by allocating a portion of their investments to hedge funds.

Performance

As a group over the last five years, hedge funds have outperformed the S&P 500® Index and the MSCI World Index℠ with less volatility.*

Access

Hedge funds can offer access to specialized investment managers who are not available otherwise.

Absolute return strategies

Many hedge funds and managed futures funds seek absolute returns regardless of the direction of broader financial markets.

* Source: CSFB/Tremont Hedge Fund Index, S&P 500 Index and MSCI World Index as of September 30, 2002.

The S&P 500® Index is a market-capitalization weighted index, which measures price movements of the common stock of 500 large U.S. companies within leading industries. S&P 500 is a registered trademark of The McGraw-Hill Companies, Inc.

The Morgan Stanley Capital International (MSCI) World Index℠ is a market value-weighted index composed of companies representative of developed countries in North America, Europe and the Pacific Region. MSCI World Index is a service mark of Morgan Stanley Capital International.

The Credit Suisse First Boston/Tremont Hedge Fund Index is an asset-weighted benchmark of hedge fund performance, and is based solely on information and data supplied by the investment managers composing the Index.

This comparison does not necessarily account for fees and expenses incurred with respect to investments in the underlying securities.

Past performance is no guarantee of future results.

Global macro: Gives a manager very broad investment discretion in an attempt to take advantage of changing economic and political conditions and market movements. Investments can cross international borders, traditional securities markets, interest rates, currencies, commodities and futures markets.

Market neutral: Is the closest to the original concept of the hedge fund. Essentially, this approach seeks to balance long and short equity positions to minimize exposure to market risk and emphasize the stock selection skills of the manager.

Fixed income arbitrage: This approach involves taking both long and short positions in closely related fixed income markets or securities. For example, a manager could attempt to capitalize on the interest rate spread between corporate and government bonds. The strategy of leveraging – borrowing capital such as margin – is often used to enhance returns.

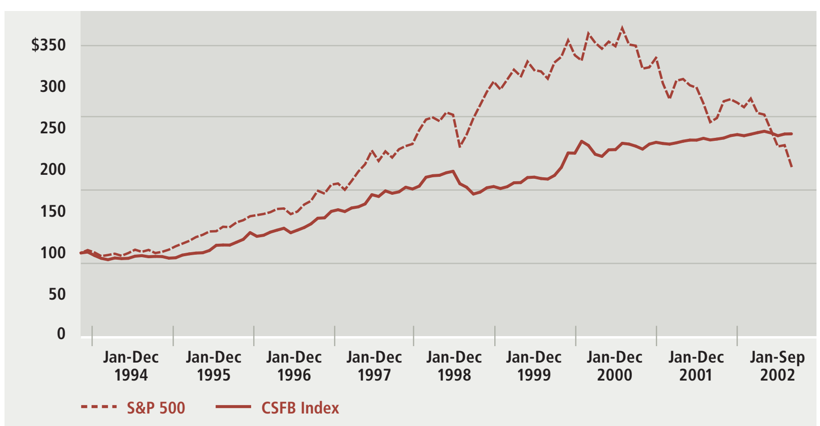
Hedge funds

Annualized total returns through September 30, 2002†

Index	1-Year	3-Year	5-Year	5-Year annualized standard deviation
S&P 500	-20.49%	-12.89%	-1.63%	18.31%
CSFB/Tremont Hedge Fund Index	3.12%	8.81%	6.85%	8.73%

As measured by the CSFB/Tremont Hedge Fund Index over a five-year period, hedge funds have outperformed the S&P 500 Index with less volatility.†

Value of $100 invested on January 1, 1994†



† Source: S&P 500 Index and CSFB/Tremont Hedge Fund Index as of September 30, 2002. Past performance is no guarantee of future results.

Private equity

Investment opportunities in privately held companies

Private equity funds allow investors to participate in growth opportunities available through privately held companies, that is, those not listed on a public exchange such as the New York Stock Exchange. Some of these companies may be newly formed or undergoing significant expansion, and their plans for rapid growth require capital input from new investors. However, companies of interest need not be new, nor necessarily very small.

Rather than focusing on a single market, private equity covers a wide range of investment situations and styles. Typically, investments fall into five categories:

- **Venture capital:** Includes "seed money" or funding for start-up and early-stage companies
- **Expansion capital:** For mature companies bringing new products to market or expanding through acquisitions
- **Buyout capital:** For management or leveraged buyouts, or for refinancing of larger companies
- **Restructuring capital:** For distressed companies undergoing reorganizations
- **Mezzanine (subordinated) debt:** Commonly used in leveraged buyouts, often in the form of convertible bonds, which allows the lender access to equity appreciation through rights, warrants or options

To realize the potential benefits of private equity investing while mitigating the risks through diversification, many investors choose to participate through professionally managed products, usually structured as a "fund of funds."

Generally, successful private equity vehicles do not generate positive returns until several years after the initial investment is made. In spite of this period of negative performance, investors focused on growth potential often choose private equity because, over the long term, private equity investing has generated returns greater than those of public equity, with similar levels of volatility.* You can also gain valuable portfolio diversification with appropriate allocations of private equity, because returns tend to have a low correlation to public equity markets.

Exchange funds

Exchange funds can provide the opportunity to realize superior returns, and they may offer significant tax advantages if you hold large positions in a small number of appreciated securities. If so, an exchange fund allows you to exchange those holdings for a diversified portfolio of securities, without generating currently taxable income or gain.

For example, executives and company founders frequently find themselves holding concentrated stock positions that are restricted or too expensive (from a tax perspective) to sell. By depositing this highly appreciated stock in a pooled portfolio with other stocks – an exchange fund – they achieve immediate diversification, and because the stock is not sold, they incur no current federal capital gains tax liability.

Exchange funds are typically most attractive to those with investment time horizons of at least seven years. At that time, investors can receive a diversified selection of the fund's stock, equal in value to their interest in the fund.

Managed futures

Managed futures funds are pooled vehicles that invest in metals, commodities, energies, stock index, interest rate and currency markets. With the growth in international trade over the last decade, managed futures funds have become increasingly important risk management tools. They offer investors seeking portfolio diversity exposure to a range of markets around the world, and they may produce non-correlation in your equity portfolio, as commodities prices can rise while equity markets fall.

Managed futures investing involves the commitment of funds to one or more commodity trading advisors or managers (CTAs or CTMs). In turn, they invest in various global futures markets on a discretionary basis, purchasing futures, options and other derivatives contracts. They may use fundamental or technical information when making trading decisions.

Managed futures funds offer several benefits, with some strategies focused on specific objectives including return enhancement, risk reduction and broad participation in global markets.

When included in a balanced portfolio, managed futures funds have the potential to improve efficiency, resulting in higher returns for a lower overall level of risk.

*Source: Thomson Financial Venture Economics/NVCA summary performance report for the 5-, 10- and 20-year periods ended December 31, 2001. Public market returns are typically stated as time- weighted returns, while Private Equity returns are stated as internal rates of return (IRR), or dollar- weighted returns. Thus, care must be taken when making direct comparisons of public and private market performance. Past performance is no guarantee of future results.

Alternative investments Q&A

How do I determine if alternative investments are suitable for my portfolio?

Together with your Financial Advisor, you should consider whether an investment in alternatives is consistent with your long-term objectives and risk tolerance level. Most alternative investments require investors to meet substantial income or net worth requirements. In addition, most AI products require minimum investment amounts of between $250,000 and $1 million.

How much should I invest in alternative investments?

Investments in alternatives should fit with an overall portfolio allocation plan determined by your investment profile. Merrill Lynch Investment Managers believes that the diversification benefits of alternative investments are best achieved with an allocation of between 5% and 10% of the investor's portfolio.

What are some of the special risks associated with alternative investments?

Alternative investment products often limit the amount and frequency of redemptions or provide no liquidity at all. Those investors may receive less information about the investment as compared with that provided with publicly traded securities or mutual funds. Hedge funds may employ trading strategies that rely on leverage, the extensive use of derivatives and options, and short investing. Like other market-based investments, alternative investments can lose value, up to your entire investment. You should carefully review the terms of any alternative investment fund, including the risk factors for the fund, prior to making any investment decisions.

How do I manage the risk of investing in alternatives?

As an individual investor, a professionally managed fund of funds that fits with your investment objective may offer the best blend of diversification and risk management. Such funds typically research many single-strategy managers and select the most promising for investment. By diversifying in this way, funds of funds reduce the risk of underperformance, however, they often include a management fee in addition to that charged by the underlying hedge funds.

You may also consider investing directly in single-strategy funds with established track records, or in exchange-traded funds that invest in alternative strategies.

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The views expressed herein are not necessarily the views of Merrill Lynch Investment Managers and are subject to change. Investment in alternative funds involves certain special risks. Like all investments, alternative funds are subject to the risk of loss of all of the capital invested. These investments may be highly speculative and may involve a high degree of business and investment risk. Also, they may be highly leveraged and utilize various hedging techniques such as options and derivatives, which increases the risk of investment losses. Investments in alternative funds are often illiquid, and are frequently subject to restrictions or prohibitions on sale of or withdrawal from the investment. Alternative funds investments are not registered under the securities laws of the United States and other countries and are subject to far less regulation than publicly offered investments and so do not offer investors the same protections provided by public registration. There is little publicly available information about the nature and performance of alternative fund investments that would allow investors to evaluate such investments. Because such funds often have incentive fees based on the fund's performance, management may have a greater incentive to make risky investments in pursuit of higher performance. Potential investors should obtain professional advice before taking any action. Past performance is not a guarantee of future performance.

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