

Managed Futures Market Commentary

Q2 2010 MANAGED FUTURES THEMATIC DRIVERS: The Euro, Interest Rates & Volatility

Figure 1
Managed Futures Performance vs Indices

	Q1 2010 Return	Q2 2010 Return	2010 YTD	2009 Return	2008 Return	10 Year Returns July 2000 - June 2010			
						Total Return	Ann ROR	Std Dev	Max DD
Altegris 40	2.33%	-0.53%	1.79%	-7.98%	15.47%	116.03%	8.01%	11.22%	-13.24%
HFRI Fund Weighted Composite	2.38%	-2.61%	-0.29%	20.01%	-19.03%	74.18%	5.71%	6.60%	-21.42%
S&P 500 TR	5.38%	-11.42%	-6.66%	26.45%	-36.99%	-14.80%	-1.59%	16.09%	-50.95%
Barclays Aggregate Bond	1.78%	3.49%	5.33%	5.93%	5.24%	87.16%	6.47%	3.79%	-3.82%
MSCI EAFE - Net	0.85%	-13.98%	-13.25%	31.78%	-43.39%	3.06%	0.30%	18.00%	-56.68%
NAREIT Composite Total Return	9.47%	-3.66%	5.46%	27.79%	-37.84%	144.67%	9.36%	23.90%	-68.17%
GSCI Total Return	-0.90%	-10.41%	-11.22%	13.67%	-46.49%	9.51%	0.91%	25.32%	-67.65%

SOURCE: International Traders Research (ITR). INDICES: Altegris 40: Altegris 40 Managed Futures Index; HFRI Fund: HFRI Fund Composite Index; S&P 500: S&P 500 Total Return Index; US Aggregate Bond: Barclays US Aggregate Composite Bond Index; MSCI EAFE: MSCI EAFE Composite Index; NAREIT Composite: NAREIT Composite Total Index; GSCI Total Return: GSCI Total Return Index. There is no guarantee that any investment product will achieve its objectives, generate profits or avoid losses. PAST PERFORMANCE IS NOT NECESSARILY INDICATIVE OF FUTURE RESULTS.

Over the course of Q2 2010, Managed Futures proved their resilience as an asset class. For Q2, the stock market, as represented by the S&P 500 Total Return Index, lost 11.42% while Managed Futures, as represented by the Altegris 40 Index, lost an estimated 0.53%, outperforming equities by 10.89%. On a year to date basis, Managed Futures is up 1.79%¹, while the stock market is down 6.66% (See Figure 1).

Trend Following is the largest component of the Managed Futures asset class, representing approximately 75% of the Altegris 40 Index as of June 30th, 2010. Over the second quarter, Trend Following managers in particular performed quite well, largely due to three predominant trends: the depreciating Euro, declining interest rates, and significant volatility across markets. These dominant trends were largely the result of the sovereign debt crisis in Greece and concern over economic contagion. The resulting sentiment vacillation influenced futures market prices markedly on a month-to-month basis.

In April, for example, the investment mood was semi-optimistic. U.S. consumer confidence was finally looking brighter, and there was general upside momentum in the energy complex as well as in commodities overall. The European Union (“EU”)/International Monetary Fund (“IMF”) 30 billion Euro bailout of Greece seemed plausible enough to send stock indices higher, although the Euro continued to depreciate versus other currencies. In essence, April was a continuation of Q1 2010, with stock indices, crude, and the Euro showing decent trends and Managed Futures performing positively on the whole.

Renewed concern over the EU/IMF bailout started May on uneasy footing. Particularly relevant for all futures markets was the May 6th ‘Flash Crash.’ Unrest in Greece caused European economic contagion fears, sending the VIX¹ to its largest single-day gain in three years and leading investors on a flight to quality (most notably to US treasuries, the US Dollar (“USD”²) and Gold). While the ultimate culprit of the Flash Crash is still up for debate, some postulate that the VIX spike triggered high frequency trading systems to rapidly submit sell orders. Trades reached 19 billion shares in 10 minutes, with the Dow Jones declining 9.8%.³ Commodities and stock indices dramatically reversed their gains from April, the Euro continued to decline, while the VIX spiked up and then down in an erratic fashion. Managed Futures strategies struggled in the midst of market turmoil, although not nearly as much traditional asset classes.

After May’s wild ride, Systematic and Discretionary managers alike reigned in risk across their programs in early June. Rangy trading markets and declining (although still erratic) volatility dominated the month. Later in the month, Eurozone optimism resumed, and it seemed as if commodities, stock indices, and even the Euro were on the rebound. Unfortunately, this optimism quickly turned to pessimism. The S&P 500 tumbled to an eight-month low on June 29th on weakened growth in China and a dismal US consumer confidence figure. Many Managed Futures managers fared well over June, with most managers we review either flat or slightly positive for the month.

Given this backdrop, let’s review each of the primary Managed Futures strategies and delve into their performance drivers for the second quarter of 2010.

SHORT-TERM SYSTEMATIC

Although the majority of Managed Futures strategies can be classified as Trend Following, Short-Term Systematic managers make up approximately 12% of the Managed Futures asset class, as represented by the Altegris 40 Index. One benefit of investing in short-term managers is their historically low correlation to longer-term trend followers. Short-Term Managed Futures programs also vary from each

¹ The CBOE Volatility Index[®] (VIX[®]) is a key measure of market expectations of near-term volatility conveyed by S&P 500 stock index option prices

² Representing the US Dollar Index and/or the US Dollar compared to another basket of currencies

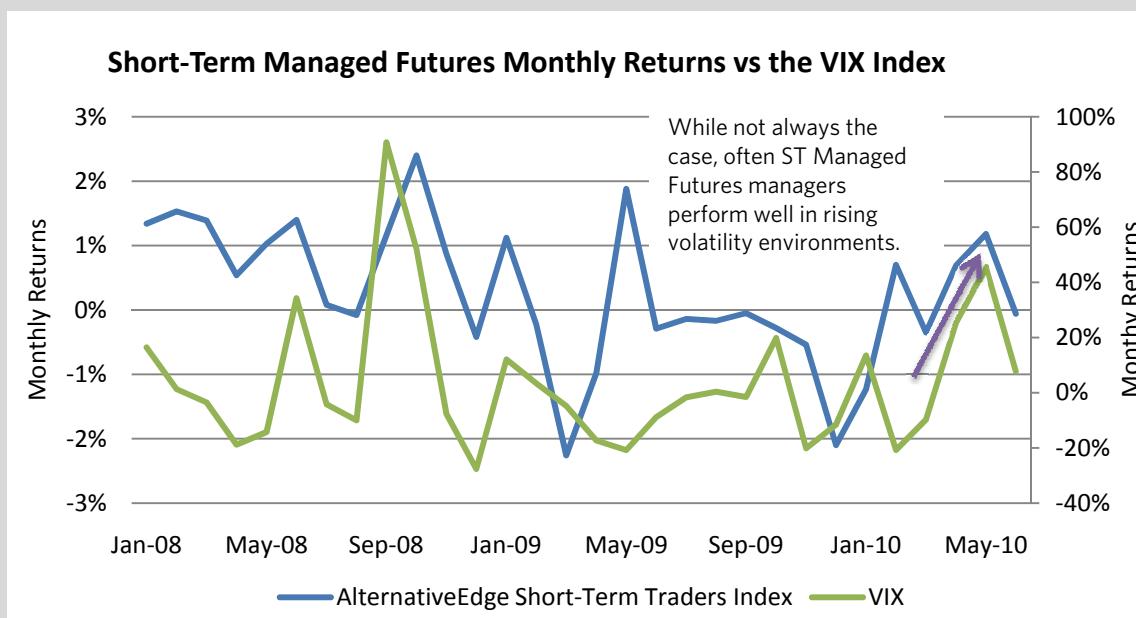
³ How the ‘Flash Crash’ Echoed Black Monday, WSJ, May 17, 2010

other considerably. For instance, one manager may focus on mean reversion models (models that assume prices will eventually move back towards their historical average), while another focuses on volatility breakouts (models that focus on capturing price moves, often after a contraction in volatility occurs). Additionally, some managers enter and exit trades over a 2-3 day period while others keep trades on for several weeks. There are innumerable permutations of styles and trade duration in the short-term space; yet in order to be successful, most Short-Term Systematic traders seek: 1) some degree of short-term price persistence in markets 2) rising volatility regimes.

The VIX is used as a proxy for overall market volatility, and markets during Q2 2010 were certainly volatile. The VIX steadily crept up over the course of April, starting the month around 17 and ending at 22.05. It then skyrocketed during May, hitting a high of over 45 on May 20, an increase of 120% from one month prior. Although volatility decreased throughout June, the VIX consistently averaged at around 30 for the month.

Using history as our guide, high volatility environments often suggest positive returns for short-term managers. This was indeed the case as the Alternative Edge Short-Term Traders Index⁴ gained 0.70% for April and 1.18% for May (See Figure 2).

Figure 2

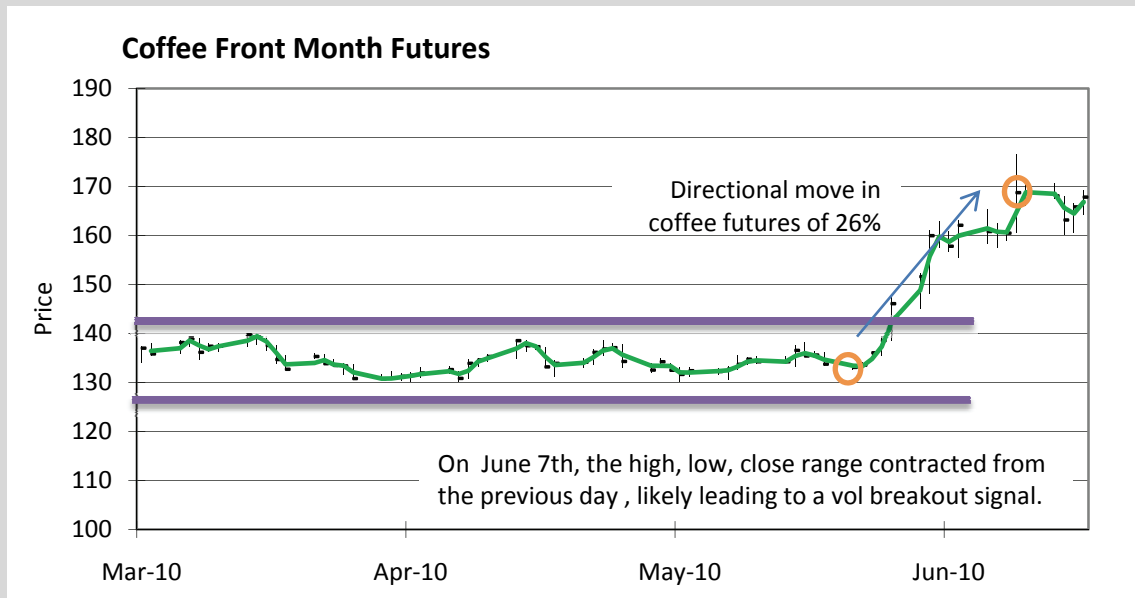


SOURCE: International Traders Research (ITR). INDICES: Alternative Edge Short-Term Traders: Alternative Edge Short-Term Traders; VIX: Chicago Board Options Exchange Volatility Index There is no guarantee that any investment product will achieve its objectives, generate profits or avoid losses. PAST PERFORMANCE IS NOT NECESSARILY INDICATIVE OF FUTURE RESULTS.

⁴ The Alternative Edge Short-Term Traders Index is designed to track the daily performance of a portfolio of CTAs and Global Macro managers executing diversified trading strategies with a less than 10-day average holding period.

Volatility breakout strategies in particular benefited nicely from the spike in volatility, as certain markets broke out of previously sideways trading ranges (where the spread between high and low prices across markets was fairly narrow). For example, coffee futures had been in a tight 10-cent band since January of this year. News that high quality beans from Vietnam, Columbia, and Central America were in short supply (possibly due to production issues and poor harvests) caused a volatility spike in coffee futures around June 7th. Aided by short covering, a 26% rally in coffee futures ensued through June 25th (See Figure 3). The short-term programs whose systems identified the volatility breakout pattern reaped significant profits as a result.

Figure 3



SOURCE: Bloomberg. There is no guarantee that any investment product will achieve its objectives, generate profits or avoid losses. PAST PERFORMANCE IS NOT NECESSARILY INDICATIVE OF FUTURE RESULTS.

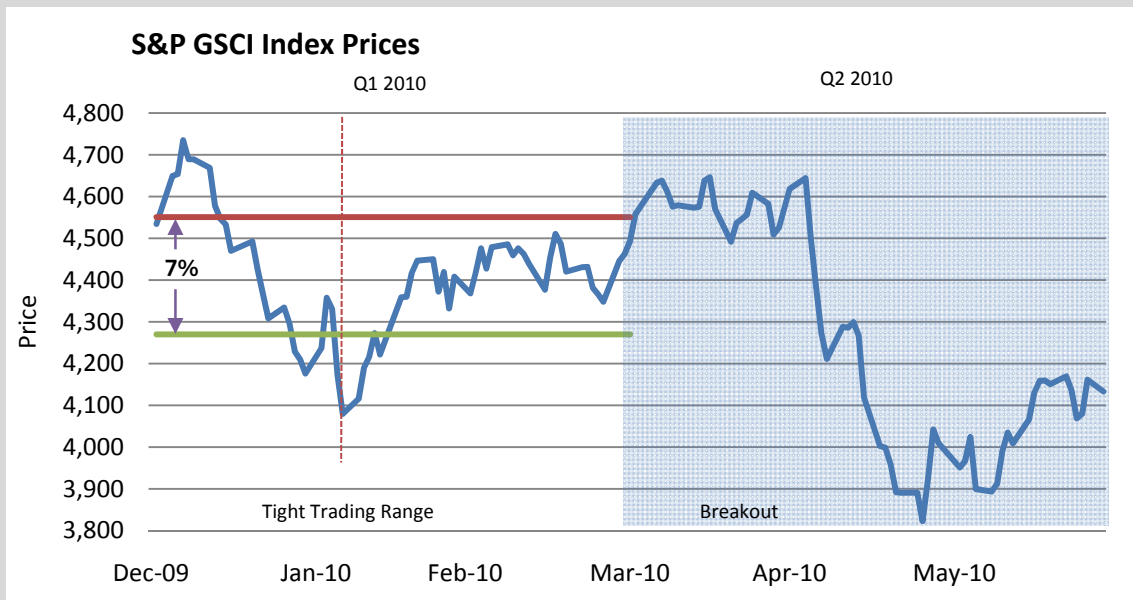
Given that short-term managers can be highly dissimilar from one another, you can imagine that not all managers fared as well as the index. While volatility rose from month end to month end, there were idiosyncratic pops in volatility in other markets that lasted anywhere from intraday (particularly during the Flash Crash) to several days, yet with little persistence. Consequently, erratic price action and lack of momentum intermonth made it difficult for some programs to capture short-term price fluctuations in certain markets.

DISCRETIONARY CTA

Discretionary CTAs are a smaller component of the Altegris 40 Index at approximately 2% and have struggled in recent years. Since early 2009, discretionary managers have found themselves in markets dominated by macro event risk, and mired in sideways price action. As we mentioned in our Q1 2010 summary, the S&P 500 GSCI Index has traded in a choppy 7% trading band since the end of 2008 (See Figure 4). Managers that upped risk and increased exposure often hit their stops (rule based sell order), and posted negative returns. Ostensibly, for the past two years, patient managers have reduced risk while producing uninspiring returns. After annualizing 8.33% from 2002-2008, the Barclay Discretionary Traders Index⁵ has annualized just over 1% from January 2009 to June 2010.

The good news is that commodities broke out of their Q1 2010 trading range in Q2 2010 (See Figure 4) as markets inched higher in April and then collapsed in May due to European economic contagion fears.

Figure 4

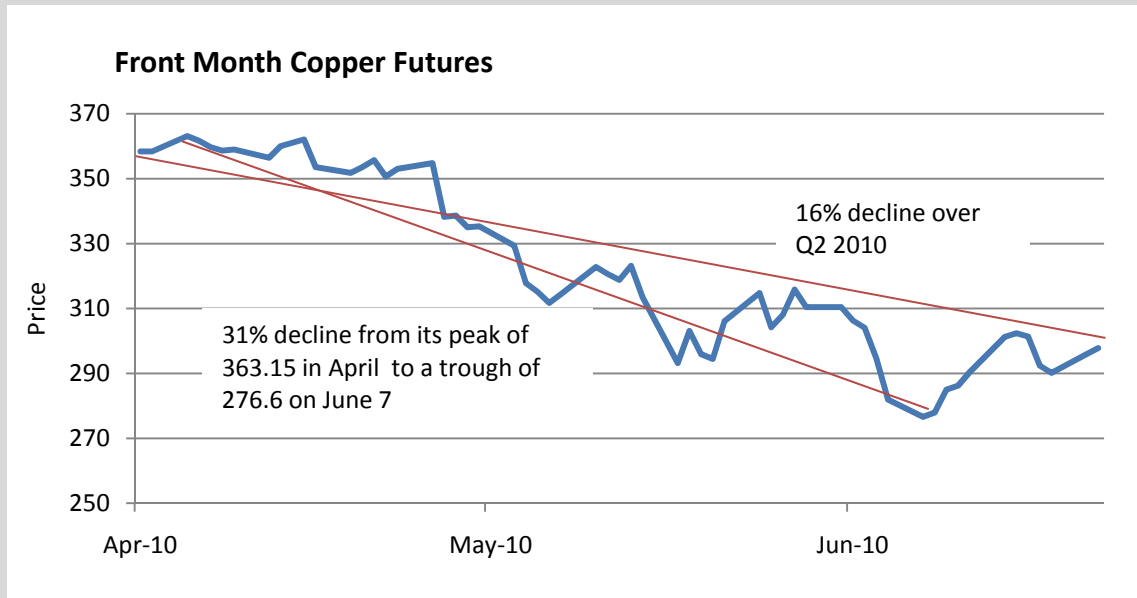


SOURCE: International Traders Research (ITR). INDEX: GSCI Total Return: GSCI Total Return Index. There is no guarantee that any investment product will achieve its objectives, generate profits or avoid losses. PAST PERFORMANCE IS NOT NECESSARILY INDICATIVE OF FUTURE RESULTS.

⁵ An equal weighted composite of managed programs whose approach is at least 65% discretionary or judgmental.

The USD rally exacerbated the sell off since a rising dollar makes commodities more expensive globally. In fact, since the beginning of the year, the USD and the S&P GSCI have moved in locked step – with the USD up just over 11% and the S&P GSCI Index down -11.29%. Despite the seemingly omnipresent macro cloud, we saw gains in several programs thanks to short positions in multiple contracts, particularly base metals like copper, which are highly reliant on economic growth for price appreciation (See Figure 5). Conversely, managers that were long these contracts were swiftly stopped out.

Figure 5



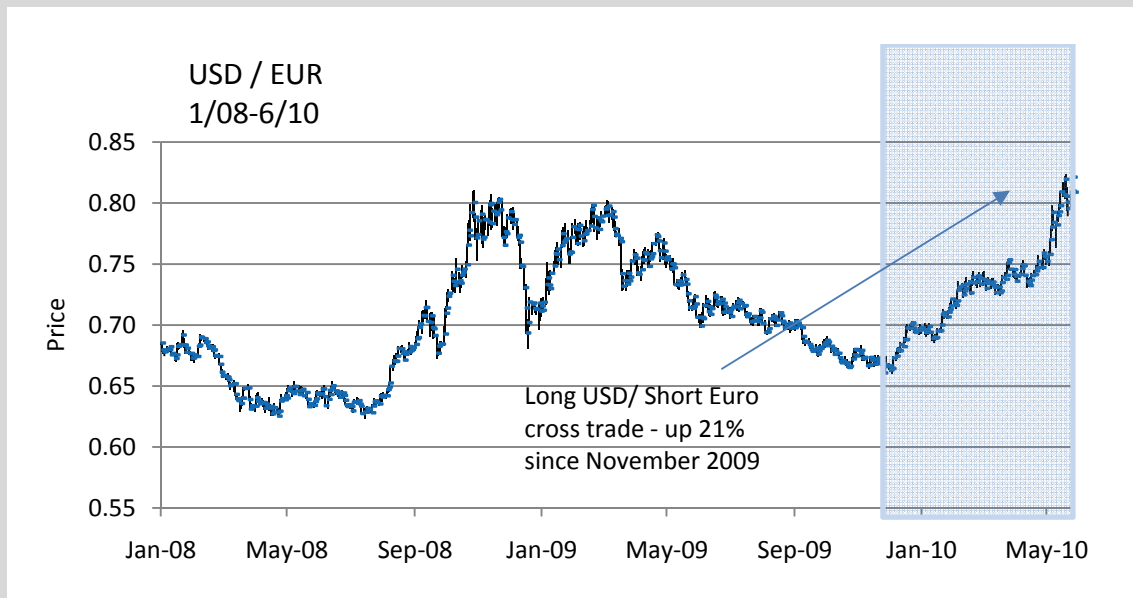
SOURCE: Bloomberg. There is no guarantee that any investment product will achieve its objectives, generate profits or avoid losses. PAST PERFORMANCE IS NOT NECESSARILY INDICATIVE OF FUTURE RESULTS.

TREND FOLLOWING

Markets during Q2 2010 were a continuation of Q1; essentially, the slow and steady development of trends including the rising USD, the depreciating Euro, and declining global interest rates. As a whole, this trifecta of trends made significant profits for the majority of Trend Following systems we follow.

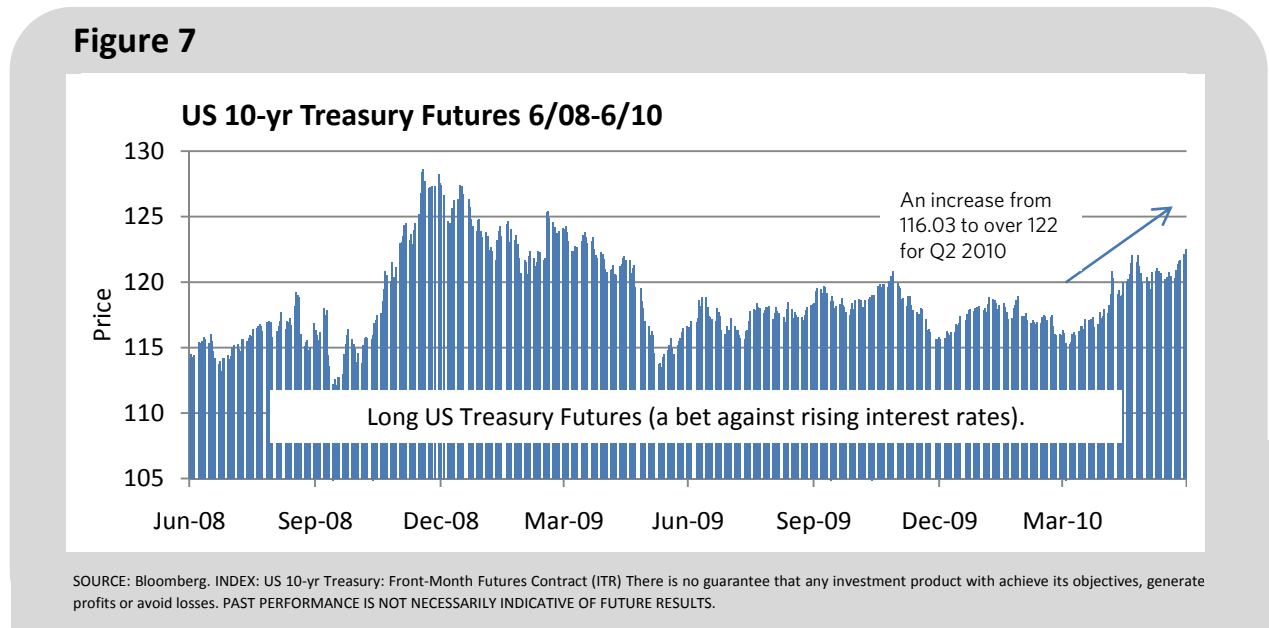
Since Greece waived its white flag in November of last year, the Euro has depreciated in a steady and unabated fashion. Versus the USD, the Swiss Franc and the Aussie Dollar in particular, the Euro cross trade has proven to be a very profitable trade thus far in 2010 for many programs. For example, the USD/Euro cross is up 21% since November through June 2010 (See Figure 6). Trend Following managers have also profited nicely from direct short Euro or short Pound futures as well as long USD and long Japanese Yen futures.

Figure 6



SOURCE: Bloomberg. INDEX: USD/EUR: USD/EUR X-Rate (USDEUR) There is no guarantee that any investment product will achieve its objectives, generate profits or avoid losses. PAST PERFORMANCE IS NOT NECESSARILY INDICATIVE OF FUTURE RESULTS.

A new, and perhaps more impactful trend over the second quarter, was the massive ascent of medium- and long-term interest rate futures, notably 10 and 30-year Treasury Futures contracts (See Figure 7).



Rising interest rate futures was the direct result of the flight to quality caused by continued concern over Eurozone contagion, as well as recent fears that the US recovery isn't going as smoothly as previously thought. Moreover, it appears that there may still be room for rates to decline given that concern over inflation is rapidly dissipating. Trend Following systems that signaled for long positions in medium-term and long-term interest rates benefitted immensely from this strategy.

IN SUM

During much of 2009, the US economy was at the mercy of a rapidly changing environment of government indebtedness. Policies aimed at fighting the Great Recession dominated the investment landscape, and as a result, correlations across markets were high. Trend Following Managed Futures strategies in particular were in very similar trades, most of which centered on being short the USD. If one market was to rise or fall, the others tended to rise or fall in lockstep.

However, in early 2010, cross-market correlations finally showed some signs of decoupling as demonstrated by the graph below (See Figure 8). While several markets remained highly correlated, others were decisively less so (see blue shaded area), including the USD and the S&P GSCI Index (a proxy for the commodity markets as a whole)⁶.

Figure 8

Q1 2010 Managed Futures Correlations vs Indices

	10-Year Treasury Note	Euro Spot Rate	USD Spot	Front Month Gold Futures	Front Month Copper Futures	Front Month Brent Crude Futures	S&P GSCI Index	S&P 500 Futures Index
10-Year Treasury Note	1.00							
Euro Spot Rate	-0.24	1.00						
Dollar Spot	0.17	-0.99	1.00					
Front Month Gold Futures	-0.43	0.37	-0.37	1.00				
Front Month Copper Futures	-0.70	0.12	-0.10	0.70	1.00			
Front Month Brent Crude Futures	-0.73	-0.02	0.06	0.69	0.83	1.00		
S&P GSCI Index	-0.73	0.28	-0.24	0.81	0.85	0.94	1.00	
S&P 500 Futures Index	-0.73	-0.04	0.07	0.56	0.83	0.89	0.79	1.00

*Euro spot rate is the conventional term for the number of USD per euro. The USD is the value against which all other spot rates are measured. The US Dollar Index Spot indicates the general international value of the USD by averaging the exchange rates between the USD and 6 major world currencies. SOURCE: Bloomberg. INDICES: 10 Year Treasury Note; Euro Spot Rate; Dollar Spot Rate; Front Month Gold Futures; Front Month Copper Futures; Front Month Brent Crude Futures; S&P GSCI Index; S&P 500 Futures Index. There is no guarantee that any investment product will achieve its objectives, generate profits or avoid losses. PAST PERFORMANCE IS NOT NECESSARILY INDICATIVE OF FUTURE RESULTS.

As we discussed in our Q1 Commentary, this was a good sign for the Managed Futures asset class because when cross-market correlations are high, Managed Futures tend to underperform and when they decouple, performance of the asset class can perform quite well.

⁶ The GSCI Total Return Index measures a fully collateralized commodity futures investment that is rolled forward from the 5th to the 9th business day of each month. Currently the GSCI includes 24 commodity nearby futures contracts. The GSCI Total Return Index is significantly different than the return from buying physical commodities.

During Q2 2010, market correlations reverted to their 2009 levels. Macro influences once again appeared to influence price movement, although this time it was Greece and its fellow PIGS⁷ taking their turn as the canary in the coalmine for the Eurozone and for the global economy as a whole. Sentiment regarding any EU and IMF plan to rescue Greece from its sovereign debt woes vacillated greatly. While a three-month period hardly constitutes statistical significance, the result was nonetheless a marked resumption of high short-term cross-market correlations across the board (See Figure 9).

Figure 9

Q2 2010 Managed Futures Correlations vs Indices

	10-Year Treasury Note	Euro Spot Rate	USD Spot	Front Month Gold Futures	Front Month Copper Futures	Front Month Brent Crude Futures	S&P GSCI Index	S&P 500 Futures Index
10-Year Treasury Note	1.00							
Euro Spot Rate	-0.93	1.00						
Dollar Spot	0.93	-1.00	1.00					
Front Month Gold Futures	0.84	-0.90	0.87	1.00				
Front Month Copper Futures	-0.93	0.96	-0.96	-0.88	1.00			
Front Month Brent Crude Futures	-0.90	0.90	-0.92	-0.71	0.84	1.00		
S&P GSCI Index	-0.91	0.90	-0.92	-0.70	0.86	0.99	1.00	
S&P 500 Futures Index	-0.90	0.92	-0.93	-0.75	0.88	0.96	0.95	1.00

*Euro spot rate is the conventional term for the number of USD per euro. The USD is the value against which all other spot rates are measured. The US Dollar Index Spot indicates the general international value of the USD by averaging the exchange rates between the USD and 6 major world currencies. SOURCE: Bloomberg. INDICES: 10 Year Treasury Note; Euro Spot Rate; Dollar Spot Rate; Front Month Gold Futures; Front Month Copper Futures; Front Month Brent Crude Futures; S&P GSCI Index; S&P 500 Futures Index. There is no guarantee that any investment product will achieve its objectives, generate profits or avoid losses. PAST PERFORMANCE IS NOT NECESSARILY INDICATIVE OF FUTURE RESULTS.


The good news is that the impact on Managed Futures returns was minimal, with high cross-market correlations not really impacting Managed Futures performance. With the exception of several discretionary commodities programs, the asset class performed extraordinarily well considering the highly correlated market environment, as trends in currencies and interest rates proved to be quite profitable.

One long standing advantage of Systematic Managed Futures programs is that they are entirely agnostic to this muddled macro picture. For instance, Trend Following systems don't care why the Euro has been falling; their role is to identify the fall and enjoy the ride. While correlations were high in Q2, there were more ample and persistent trends than in Q1 for systems to identify.

⁷ PIGS: Portugal, Italy, Greece and Spain

Moreover, while Managed Futures were positive over Q2, equity market returns were volatile and poor. May (-7.99%) and June (-5.23%) losses resulted in an 11.42% loss for Q2, wiping out gains enjoyed during the first quarter of the year. The outperformance of Managed Futures over the equity market this quarter is no small point. One of the key features of Managed Futures is their potential to reduce portfolio risk and enhance returns. For the year, Managed Futures outperformed equities by 8.45% with a standard deviation of 11.22%.

The investment landscape is still uncertain, although it appears that for now, negative sentiment is outweighing the positive. The good news is that multiple trends seem to be emerging, and while performance for the asset class is flat, several Managed Futures strategies are showing signs of a positive future.

As always, if you have any questions, please contact your Altegris Account Executive. 

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The risk of loss in trading commodities can be substantial. You should therefore carefully consider whether such trading is suitable for you in light of your financial condition. In considering whether to trade or to authorize someone else to trade for you, you should be aware of the following:

If you purchase a commodity option you may sustain a total loss of the premium and of all transaction costs.

If you purchase or sell a commodity future or sell a commodity option you may sustain a total loss of the initial margin funds and any additional funds that you deposit with your broker to establish or maintain your position. If the market moves against your position, you may be called upon by your broker to deposit a substantial amount of additional margin funds, on short notice, in order to maintain your position. If you do not provide the requested funds within the prescribed time, your position may be liquidated at a loss, and you will be liable for any resulting deficit in your account.

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As a result, there exists a conflict between Altegris' interest in maximizing the commissions and fees paid by you (in which it will participate) and your interest in minimizing those commission and fees.