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Q3 2010 Managed Futures Market Commentary

MANAGED FUTURES PERFORMANCE HIGHLIGHTS

Diversification is one of the key benefits of the Managed Futures asset class within an investor's portfolio. While past performance is never a guarantee of future results, we have seen a pattern of low correlation between traditional asset class returns (stocks, bonds, currencies, commodities, etc) and Managed Futures returns (as represented by the Altegris 40 Index[i]) for the past ten years. Even though Managed Futures underperformed versus traditional asset classes for this particular quarter, the argument remains the same (see Figure 1).

Further, traditional asset class returns have been significantly more volatile this year. Through the third quarter of 2010, the standard deviation of returns for the stock market was 19.95% with a worst drawdown of -12.80%. Conversely, the standard deviation of returns for Managed Futures was 8.05% thus far in 2010, with a worst drawdown of only -3.31% Managed Futures have significantly outperformed for the year on a risk adjusted basis.

Figure 1: Managed Futures Performance vs. Indices

						10 Year Returns Oct 2000 - Sep 2010			
	Q2 2010 Return	Q3 2010 Return	2010 YTD	2009 Return	2008 Return	Total Return	Ann ROR	Std Dev	Max DD
Altegris 40 Index	-0.54%	4.70%	6.56%	-7.98%	15.47%	129.55%	8.66%	11.24%	-13.24%
HFRI Fund Weighted Comp.	-2.68%	4.96%	4.58%	20.01%	-19.03%	79.27%	6.01%	6.56%	-21.42%
S&P 500 TR Index	-11.42%	11.30%	3.89%	26.45%	-36.99%	-4.25%	-0.43%	16.34%	-50.95%
Barclays Aggregate Bond	3.49%	2.49%	7.95%	5.93%	5.24%	86.20%	6.41%	3.79%	-3.82%
MSCI EAFE-Net	-13.98%	16.48%	1.05%	31.78%	-43.39%	30.57%	2.70%	18.39%	-56.68%
NAREIT Composite TR	-3.66%	12.34%	18.48%	27.79%	-37.84%	155.59%	9.84%	23.89%	-68.17%
GSCI Total Return	-10.41%	8.27%	-3.88%	13.67%	-46.49%	12.83%	1.21%	24.99%	-67.65%

PAST PERFORMANCE IS NOT NECESSARILY INDICATIVE OF FUTURE RESULTS. There is no guarantee that any investment product with achieve its objectives, generate profits or avoid losses. SOURCE: Altegris. INDICES: Altegris 40 Index: 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.

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Q3 2010 MANAGED FUTURES PERFORMANCE DRIVERS

Fixed Income & Precious Metals Trend, Stock Indices Fluctuate

Returns across strategies during Q3 were significantly “news-driven” as markets reacted to a variety of data from Fed Policy statements indicating further quantitative easing to improved durable goods orders. While some news was encouraging (particularly in September), the majority of information pointed towards a continued lackluster recovery or even a double dip recession. Consequently, fixed income as well as precious metal futures rallied as investors flocked to safety. We saw these strong trends develop in early Q2 and they have shown no sign of abating.

Trend Following managers, which represent the largest component of the Managed Futures asset class at approximately 75% of the Altegris 40 Index[ii], benefited the most from the fixed income and precious metal rally (notably gold futures and more recently, silver as well). Most Trend Following systems identified these trends, and added significant long positions in fixed income and precious metals over the last several months.

“Managed Futures have significantly outperformed for the year on a risk adjusted basis.”

Pockets of positive economic news throughout the quarter were not enough to convince the bearish fixed income investors towards riskier assets; however, many equity investors took the bait. Stock indices rose significantly when good news hit the tape, and declined at the hint of poor economic data. The equity market ebbed and flowed with investor sentiment, causing wide dispersions in equity market volatility.

Thankfully, clear directional trends emerged in other markets, particularly commodities (with the exception of Energy futures). In prior quarters we discussed the macroeconomic impacts on commodity prices. This quarter, it became clear that tried and true fundamental variables were the primary drivers for commodity price movement. Directional upward price moves particularly catapulted wheat and corn due to fires and drought conditions in Russia.

Given this backdrop, let’s review the performance drivers for each of the primary Managed Futures strategies.

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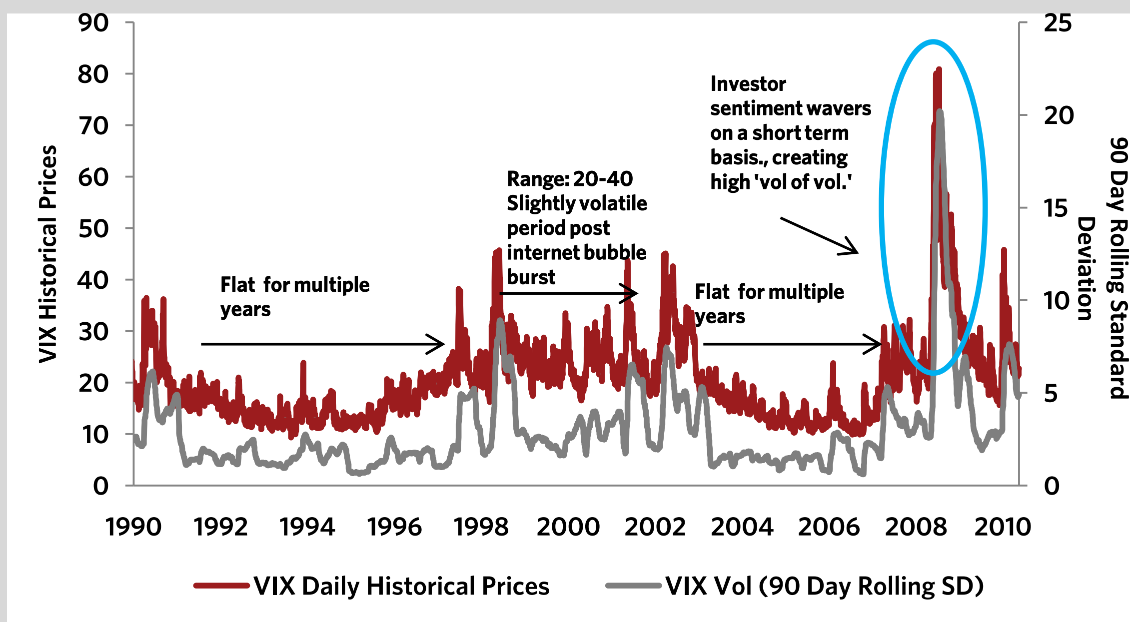
SHORT-TERM SYSTEMATIC

Although the majority of Managed Futures strategies are classified as Trend Following, Short-Term Systematic managers comprise approximately 11% of the Managed Futures asset class, as represented by the Altegris 40 Index. Short-Term Systematic managers are like snowflakes; no two managers are exactly the same. However, while their strategies vary, the markets in which they invest are often similar. In fact, most Short-Term Systematic managers we review often have significant exposure to stock indices. This quarter was an exception for some Short-Term Systematic managers as programs reduced stock index exposure due to erratic equity volatility patterns.

The VIX Index[iii] measures implied volatility for options on the S&P 500 Index and is generally regarded as a "fear index" insofar as it measures expected stock market volatility. If we use history as our guide, we observe that when equity market volatility is high, it's high for a contained period of time as investor fears peak and then fall. Conversely, when volatility is low, it can remain low for several months if not years. Investors tend to feel sanguine about future returns for longer periods of time.

The red line in the Figure 2 represents the VIX Index's historical prices. Since 1990, the VIX was flat over three long time periods, with intermittent peaks representing high S&P 500 volatility. Since early 2008, we observed an interesting phenomenon develop as 'volatility of equity market volatility' has risen significantly. The grey line represents the volatility (standard deviation of prices) of the VIX itself over a rolling ninety day period in Figure 2.

Figure 2: VIX Historical Prices vs. VIX 90-Day Rolling Volatility (Jan 1990 – Sep 2010)



PAST PERFORMANCE IS NOT NECESSARILY INDICATIVE OF FUTURE RESULTS. There is no guarantee that any investment product with achieve its objectives, generate profits or avoid losses. SOURCE: Altegris. INDICES VIX: Chicago Board Options Exchange Volatility Index.

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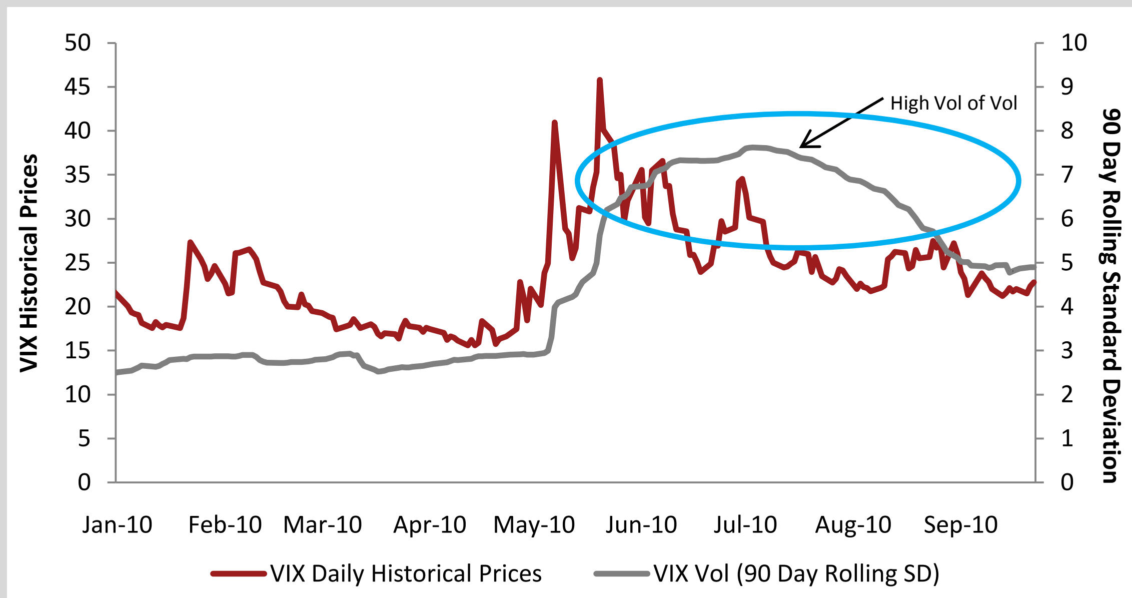
The volatility of the VIX has been inconsistent. This has been particularly true for the 2nd and 3rd quarters of 2010. As represented in Figure 3, the VIX went from a low of 15.58 in April to a high of 45 in May due to sovereign debt concerns, representing a nearly 200% move. The VIX averaged in the mid 20s in June and moved to the low 20s in July, picking up to near 30 in August over fears of a US double dip recession. It then declined back to the low 20s in September as equity investors were swayed by positive economic news and stock markets enjoyed their largest September rally since 1939.

Figure 3: VIX vs. VIX 90 Day Rolling Volatility (Jan 2010 - Sep 2010)



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What this means is that equity market prices are moving fast and are highly subject to investor temperament. For some Short-Term Systematic managers, it appears that erratic volatility patterns may have impacted trade sizing in stock indices. Given that equity market volatility has gone from high to low to high and back to low, it appears that many short term managers that we reviewed reduced stock index exposure and did their best to mitigate although not entirely avoid whipsaws as well. While stock index futures have been a significant contributor to P/L in previous quarters, its impact in Q3 was diminutive due to the fact that programs simply had fewer positions on in stock index futures.

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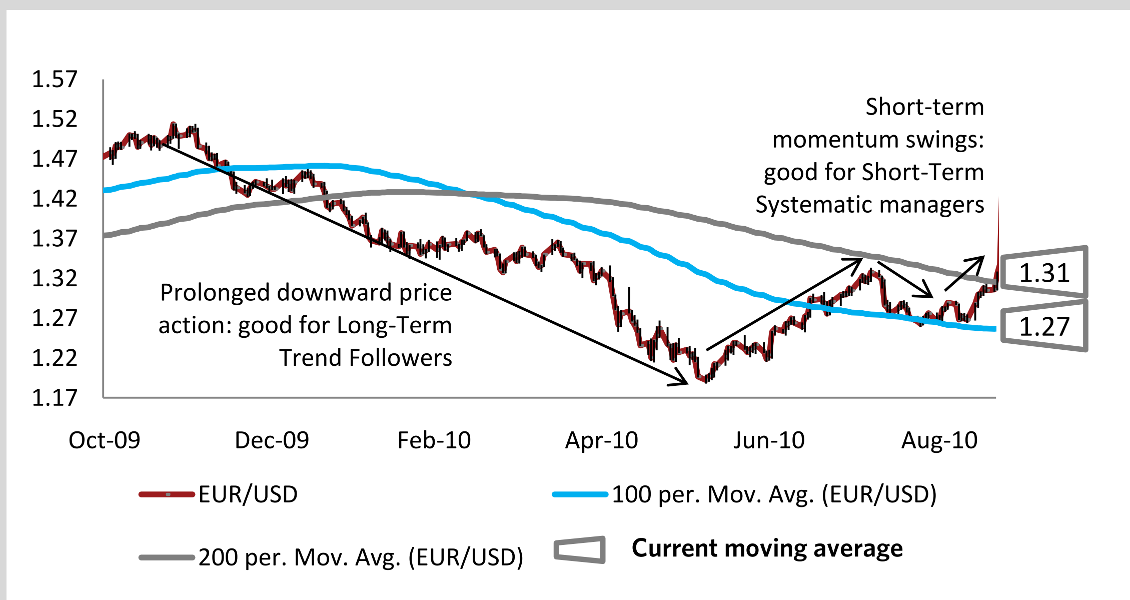
While stock index returns were muted if not negative, several managers profited from upward momentum across commodity markets, interest rate markets, as well as the currency markets. For example, trading the EUR/USD[iv] cross was profitable for several short term systems. If you recall, Trend Following managers have been largely short the EUR/USD since a strong downward price trend began emerging at year end 2009. Since the end of May / early June of 2010, this prevailing trend showed signs of reversing as European sovereign debt concerns began to fade. Figure 4 shows how the contract's 100 and 200 day moving average were breached in Q3, and EUR/USD contract prices bullishly inched higher. Many Trend Following systems which were short the EUR/USD trade were eventually stopped out. On the other hand, several Short-Term Systematic programs which have momentum systems recognized the reversal and ensuing short-term momentum rally. They were thus able to profit nicely from long EUR/USD positions. Likewise, since their systems are typically quick to go from long to short, many short-term programs reversed the trade and shorted the EUR/USD cross, only to reestablish a long in September.

Figure 4: EUR/USD Spot (Oct 2009 – Aug 2010)



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

The AlternativeEdge Short-Term Traders Index returned 0.67% for the quarter and 1.54% in 2010[v]. Returns for the year have modestly profitable across the board for Short-Term Systematic managers, although it should be noted that returns on a manager by manager basis vary widely.

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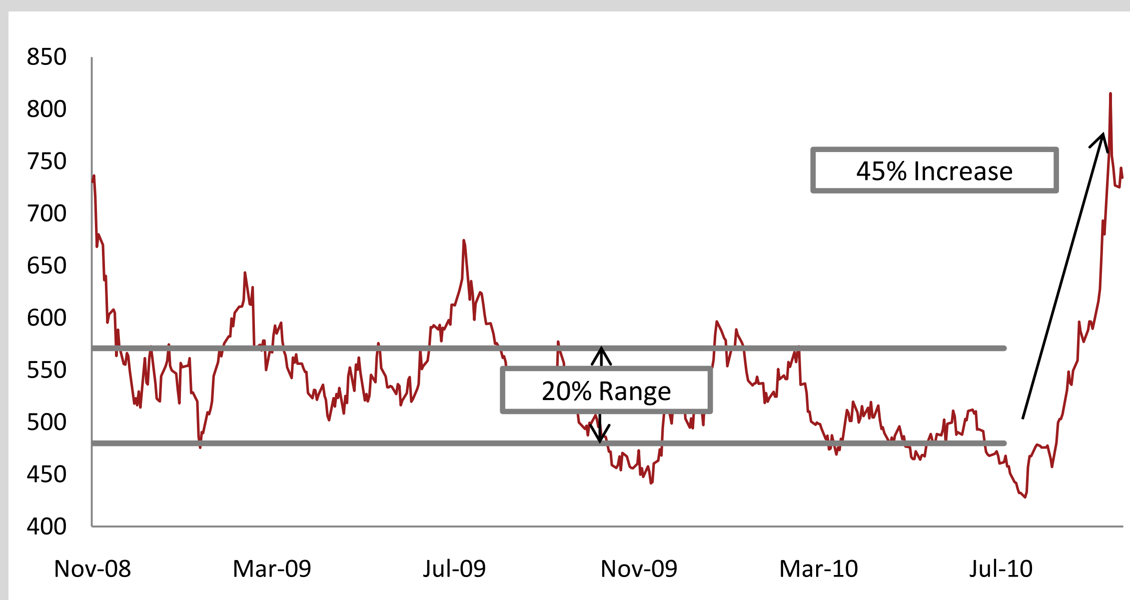
DISCRETIONARY COMMODITY TRADING

After nearly two years of a trading environment dominated by macro risk, choppy sideways price action and substantial speculative flows moving in and out of commodities, economic fundamentals are regaining influence across commodity markets. Consequently, Discretionary Commodity managers breathed a collective sigh of relief as several favorable opportunities presented themselves over the quarter.

The grains markets are a great example of how fundamentals have driven price movement. As delineated in Figure 5, wheat traded in a choppy 20% range from November of 2008 through July 2010. In early August, the market broke out of its trading range, and then shot up exponentially.

Figure 5: Front Month Wheat Futures (Nov 2008 – Sept 2010)



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

A confluence of factors led to this impressive reversal of fortune, chief among them relates to a significant decline in supply. For the grains markets, Russia's current drought coupled with raging wildfires has diminished supplies of wheat markedly. Worldwide wheat supplies were expected to drop by more than 15 million tons, with more than half of the reduction coming from Russia[vi]. Note that other agricultural commodities ("Ags") showed similar price patters for the quarter. For example, corn has rallied alongside wheat since corn is often viewed as a feed substitute.

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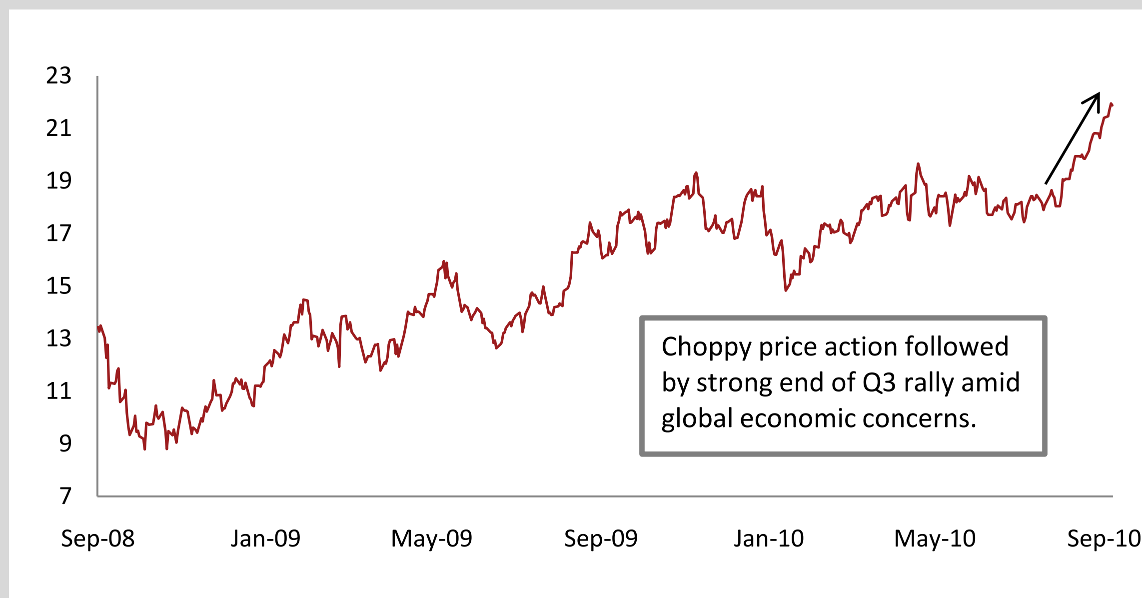
Pakistani floods are also culpable for slashing commodity supplies. According to Bloomberg, Pakistan lost 10.4 million tons of standing sugar cane. Rice and cotton production suffered staggering losses as well. Concerns over further monsoonal weather in Pakistan as well as India have fueled speculation that supply will remain tight. Softs and Ags have been easy pickings for Discretionary Commodity Traders; however, other commodity markets have proven to be more complicated.

Silver, for example, has been trending up since the end of 2008, but in a very choppy fashion as demonstrated in Figure 6.

Figure 6: Front Month Silver Futures (Sep 2008 – Sep 2010)



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Managers are aware of technical drivers in commodity markets; however, the goal of their analysis is to also understand the fundamental and macro drivers related to commodity price movements. Silver has rallied alongside other precious metals and has shown considerable upside momentum in September. It is also an industrial component used in electronics, photography, and paint. A potential economic recovery or a double dip recession will significantly impact industrial demand and therefore the price of silver. With macro, technical and fundamental variables all materially influencing price movement, navigating the choppy silver market has been a challenge for many managers. Nonetheless, several managers had the foresight to purchase silver futures and participate in the upward price movement in September. Further, most markets in general presented ripe opportunities for Discretionary Commodity Managers. The vast majority of managers we follow were up nicely for the quarter.

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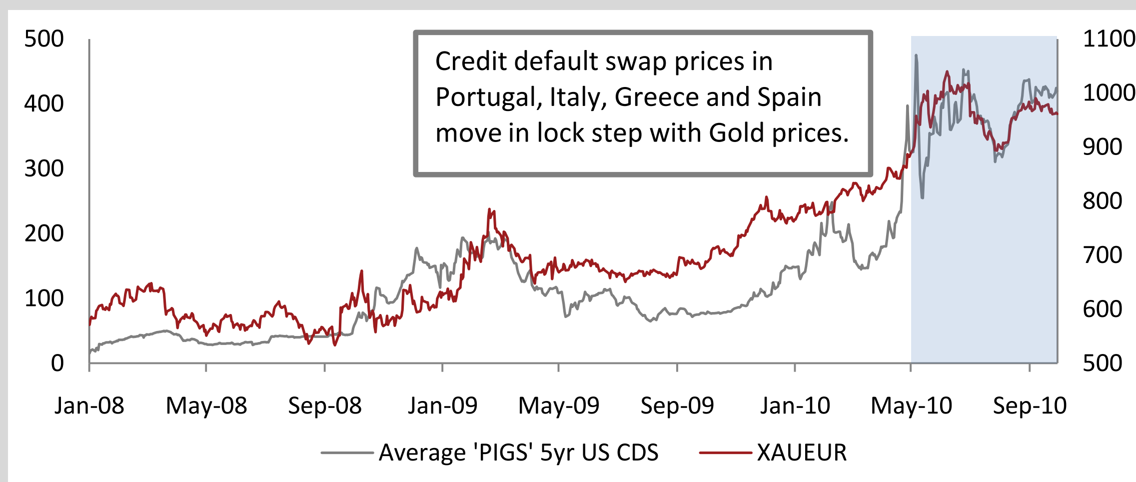
TREND FOLLOWING

Continuing on the precious metals theme, Gold futures[vii] sustained their rally throughout Q3. Gold is trading almost entirely on macro influences, most of which is related to monetary easing expectations and uncertainly around inflation or deflation. As the U.S. government adds more stimulus, the US Dollar ("USD")[viii] becomes more devalued, and investors logically demand an alternative store of value to fiat currency. Another key contributor to the Gold rally is sovereign risk aversion.

> *"As the U.S. government adds more stimulus, the US Dollar becomes more devalued, and investors logically demand an alternative store of value to fiat currency."*

While concerns over sovereign risk have vacillated over the quarter, there are ample risk-adverse investors who do not think we are out of the woods yet. Since May of 2010, the correlation between the average 'PIGS'[ix] five year credit default swaps ("CDS") and Gold (EUR denominated) is nearly one. Since sovereign CDS prices reflect the riskiness of owning sovereign debt, the increase in PIGS CDS prices demonstrates the continued concern regarding the solvency of these four countries. Figure 7 shows how PIGS' CDS pricing has moved nearly lock step with Gold priced in Euros as sovereign debt fears in Europe rise and fall.

Figure 7: Gold and Sovereign Risk Aversion (Jan 2008 – Sep 2010)



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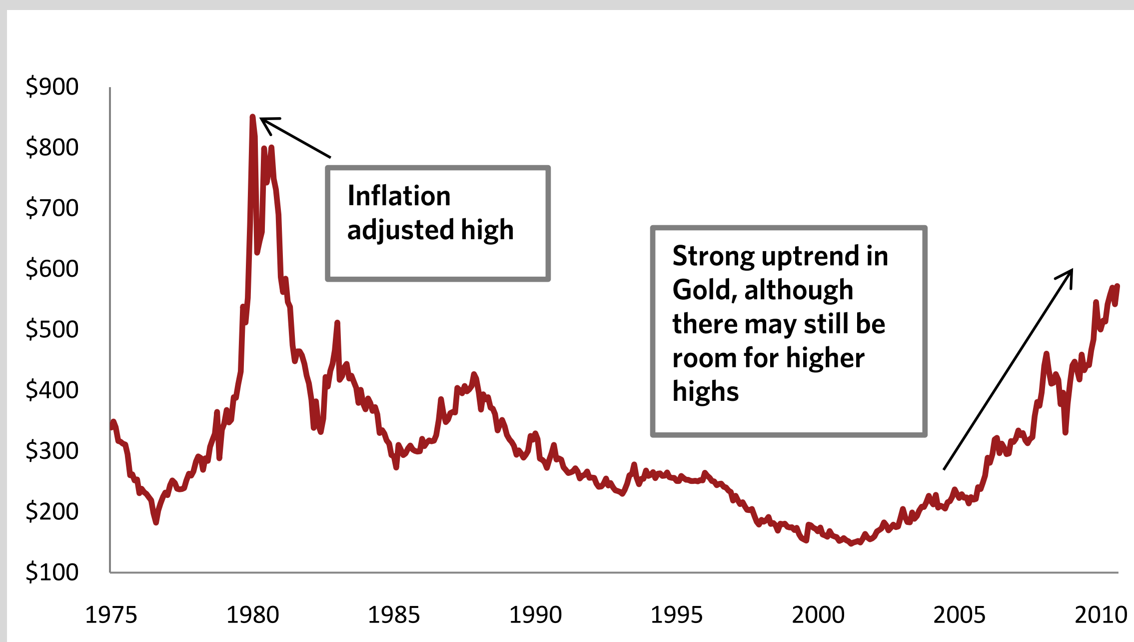
As a result of U.S. government stimulus and sovereign debt risk, Gold has risen past $1300 oz and is up approximately 20% through the 3rd quarter of 2010. The clear question remains whether Gold is overbought, although two key factors may mitigate this risk: the strength of the uptrend and the fact that Gold prices are nowhere near their inflation adjusted highs.

"Clearly there is strong momentum behind the trend in Gold prices."

Clearly there is strong momentum behind the trend in Gold prices. Additionally, Gold is far from its inflation adjusted highs. According to Bloomberg, Gold reached $873/oz in January 1980. In real terms, the current price per ounce is in the $500/oz range. As you can see Figure 8, to get back to its 1980 highs, Gold would need to rise above $2000 an ounce to exceed its 1980 high[x].

Figure 8: Inflation Adjusted Gold (Base Year 1982-1984)



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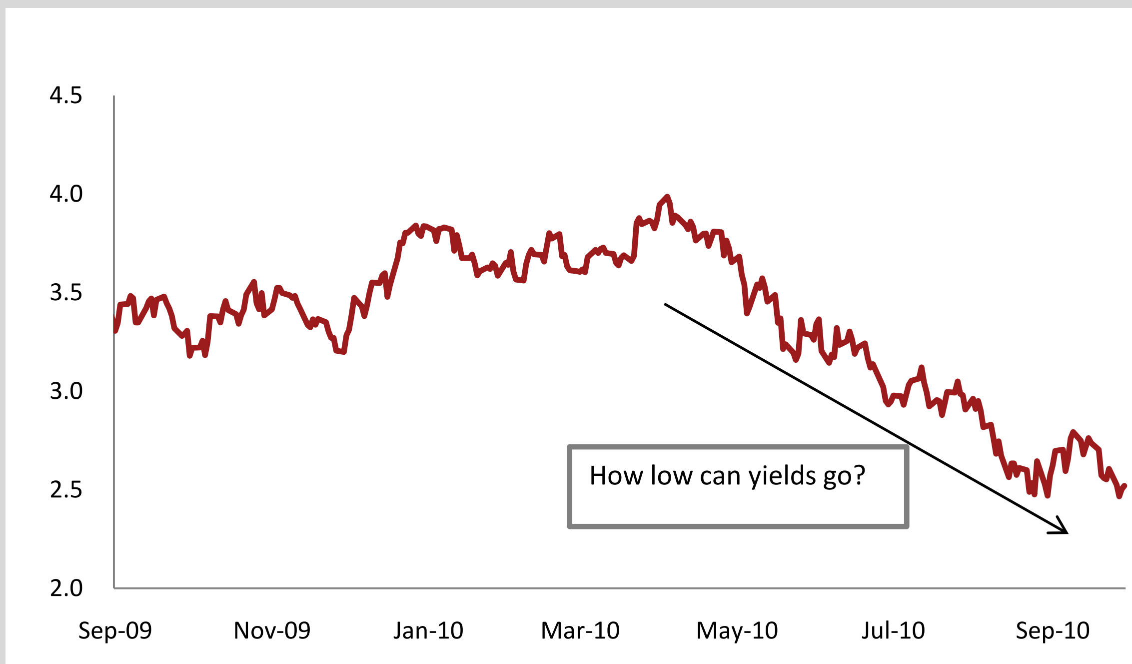
As a continuation from the previous two quarters, following the trend of declining Global interest rates has been worth its weight in Gold (pun intended), see Figure 9. On September 21st, the FOMC met and indicated their willingness to introduce additional stimulus if needed, likely through the purchase of Treasury bonds. With inflation below expectations and the economy limping along, the recovery is not anywhere near where many hoped it would be, and Bernanke is keeping an accommodative mandate.

> *"Following the trend of declining Global interest rates has been worth its weight in Gold (pun intended)."*

The result has been a strong and sustained trend in fixed income. Unlike Gold, this trend has a limited upside. Rates can only go so low, although they can remain low for a long period of time. It is possible that rates may squeeze lower and lower, but at some point the trend will plateau. We anticipate that Trend Following systems may possibly scale out of long rates positions at some point in the future but not necessarily the near-future.

Figure 9: 10-Year Treasury Yields (Sep 2009 – Sep 2010)



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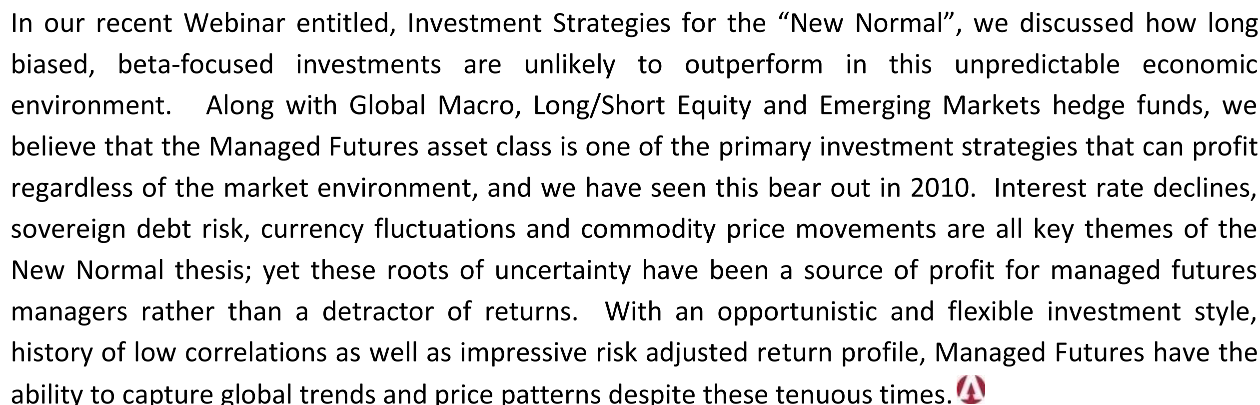
IN SUM

Put two economists in a room and they could argue both sides of the recovery/double dip recession debate until you physically separated them. The fact of the matter is that no one knows exactly where this economy is headed, or how the markets will react. For the third quarter, good news sent the equity market rallying and supply concerns lead to strong upward commodity prices moves. Yet, the recovery is still in doubt leading to quantitative easing and hence a fixed income rally.


In our recent Webinar entitled, Investment Strategies for the "New Normal", we discussed how long biased, beta-focused investments are unlikely to outperform in this unpredictable economic environment. Along with Global Macro, Long/Short Equity and Emerging Markets hedge funds, we believe that the Managed Futures asset class is one of the primary investment strategies that can profit regardless of the market environment, and we have seen this bear out in 2010. Interest rate declines, sovereign debt risk, currency fluctuations and commodity price movements are all key themes of the New Normal thesis; yet these roots of uncertainty have been a source of profit for managed futures managers rather than a detractor of returns. With an opportunistic and flexible investment style, history of low correlations as well as impressive risk adjusted return profile, Managed Futures have the ability to capture global trends and price patterns despite these tenuous times.

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[i] Based on the top 40 CTA program assets as reported to the Altegris Managed Futures Database.
[ii] As of September 30, 2010
[iii] The VIX represents the CBOE Market Volatility Index, which measures implied volatility for options on the S&P 500 Index.
[iv] Cash / spot foreign exchange market pair.
[v] The AlternativeEdge 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 holding period.
[vi] Russian drought devours world wheat supplies: US, Seeddaily.com
[vii] Gold futures or "Gold" refer to gold price per troy ounce available for immediate delivery in USD unless otherwise denoted.
[viii] Representing the US Dollar Index and/or the US Dollar compared to another basket of currencies
[ix] J.P. Morgan Securities Ltd. Metals Michael J. Jansen Global Commodity Research.
[x] Bloomberg.com, Gold Far from Real Record: Chart of the Day, September 17, 2010

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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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