Emerging Markets

Now is the Time For a Hedged Approach

December 2010

Executive Summary

Altegris believes the best way to capture investment opportunities in Emerging Markets ("EM") is through a multi-strategy, hedged investment approach which emphasizes long and short positioning across multiple EM asset classes. Traditionally, most EM investors have pursued a long-only, equity focused strategy, largely because they had little choice if they wanted EM exposure in their portfolios. However, an equity focused investment strategy relies heavily upon market beta, leaving investors exposed to steep losses during periods of increased volatility and EM market declines. Now, as EM countries join the economic mainstream, their investment opportunities have become broader and deeper. As a result of the growing availability of liquid asset classes within EM, investors can now express both bullish and bearish views and have the potential to earn profits across a variety of market environments. In our view, a nimble and hedged investment approach is the superior method for EM investors to capitalize on manager skill, or alpha, as well as achieve potentially higher risk-adjusted returns in both up and down markets.

	Beta-Driven Emerging Markets Investing	Hedged Emerging Markets Investing
Markets Traded	Equity focus	Equities, currencies, interest rates, credit
Strategy	Long only	Long and short
Return Profile	Beta/market dependent	Alpha/manager skill dependent
Risk Profile	High volatility/market dependent	Lower volatility versus market benchmarks
Drawdown Potential	High/market dependent	Lower versus market benchmarks

SOURCE: Altegris Advisors

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Today's Emerging Markets

The phrase "Emerging Markets" refers to about 24% of the 195 countries in the world. **(See Figure 1.)** No one definition fits all the EM countries, but in general EM countries:

- Have a lower per capita income than developed countries
- Are transitional societies in the process of adopting domestic and political reforms

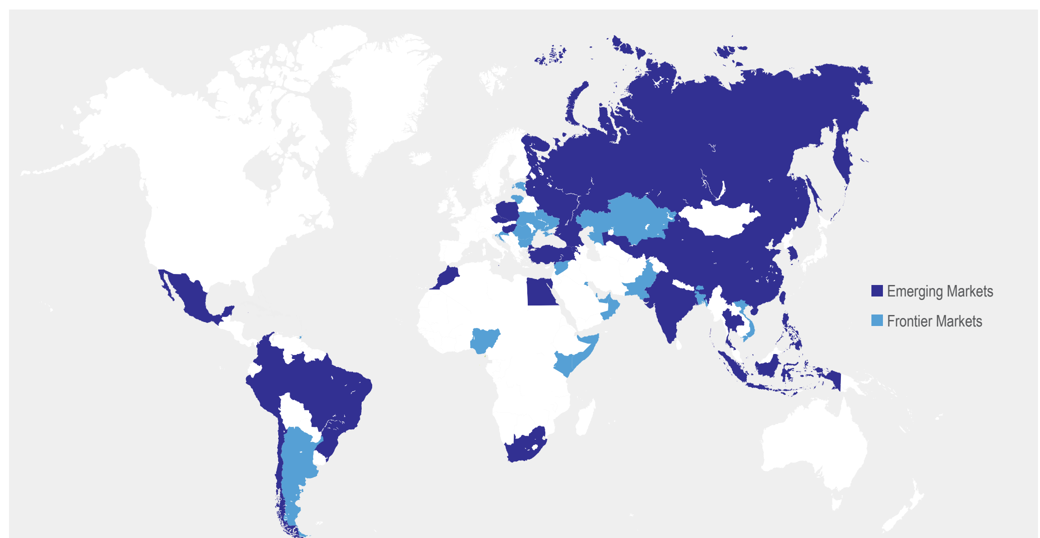
KEY POINT

With increased liquidity and the presence of multiple asset classes, EM countries are beginning to more closely resemble the "developed" financial markets in Europe and the US.

Though small in number, the potential impact of these economic powerhouses is enormous. More than 70% of the world's population lives in EM countries, creating an engine of growth for years to come. Indeed, a May 2010 Goldman Sachs report on EM forecasts that Brazil's economy will be larger than Italy's by 2020 and that India's will exceed Spain, Canada and Italy's in the coming decade. The most liquid and "developed" EM economies are Brazil, China, and India.[1] With increased liquidity and the presence of multiple asset classes, these countries are beginning to more closely resemble the "developed" financial markets in Europe and the US.

With the development of EM economies and financial markets over the past decade, the EM category has expanded to now include "frontier" destinations as well. The frontier label describes countries with smaller, less liquid financial markets like Croatia, Kazakhstan and Cambodia. While these frontier markets resemble the exciting EM arena of 15 years ago, their investment menu is still largely restricted to long-only equity strategies, and investors run the same greater potential risks of losing capital during inevitable market swoons. Still young and evolving, frontier markets lack the size and liquidity to pursue a multi-strategy approach that the developed EM space now allows. Our focus, therefore, is on the most developed EM countries which allow for a multi-strategy, hedged investment approach across multiple asset classes.

Figure 1: Map of Emerging and Frontier Markets



Emerging Markets and Frontier Markets based on MSCI definitions

[1]**Athough Russia is part of the BRIC acronym that has ruled EM investing since 2001, its current economic uncertainty makes it a less compelling investment opportunity than Brazil, India, and China.**

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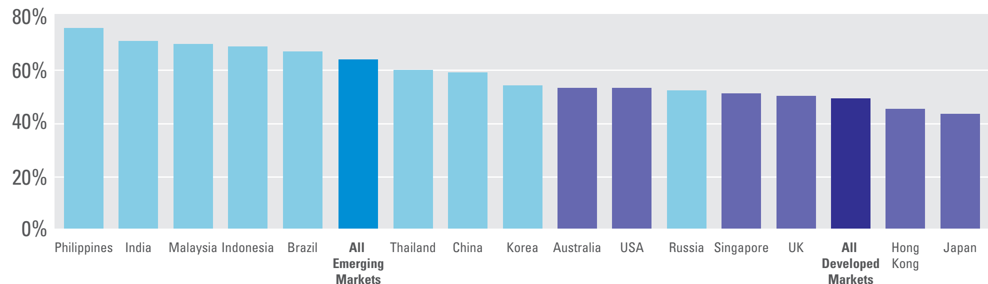
The Case for Emerging Markets

While the EM growth story is widely acknowledged, it is worth recounting why, in some cases, EM countries are financially fitter and leaner than developed countries. The main drivers propelling Emerging Market growth are:

- Large and young populations, skilled labor and expanding educational opportunities.

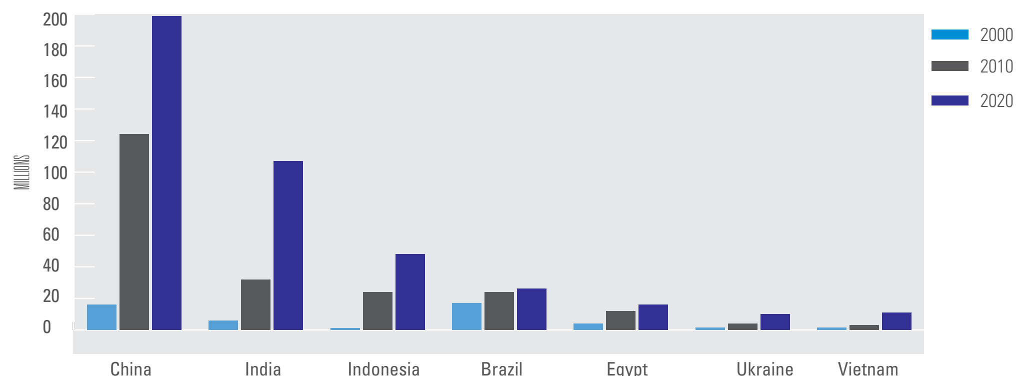
Figure 2: Proportion of Population Under 40 Years Old in Selected Countries



SOURCE: Goldman Sachs, Sep-10.

- A burgeoning middle class that is bolstered by rising incomes and is eager to purchase more of its own manufactured goods and services.

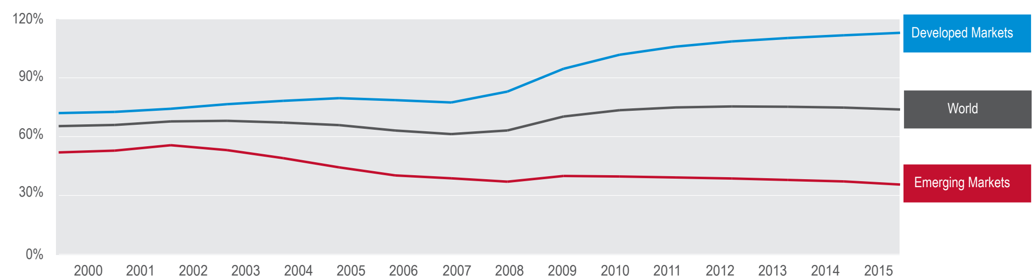
Figure 3: Number of households with annual disposable income of US $5,000-15,000 in selected economies: 2000-2020



SOURCE: Euromonitor International from national statistics, Mar-10. Note: Data for 2010 and 2020 are forecasts.

- Strong domestic growth and manageable debt levels.

Figure 4: Debt as Percentage of GDP



SOURCE: IMF, Apr-10. Based on real GDP growth 2000-2007 and projected GDP Growth 2008-2015

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Importantly, this economic independence enables EM countries to fuel growth internally rather than relying heavily on foreign investors as they have done in the past. While EM countries were affected by the 2008 worldwide credit crisis, it was short-lived, and they have quickly returned to a more normal growth path that is being driven by strong domestic demand. Having largely avoided the housing bubbles, bad bank loans, and government bailouts, EM countries are less burdened than their developed market counterparts. With their relatively strong domestic growth and more manageable debt levels, EM economies have a tailwind for strong future growth prospects.

KEY POINT

Investors are no longer restricted to an "equity-only" universe, and this expansion of investment options is the key factor that enables a truly hedged investment approach.

Evolving EM Financial Markets Parallel Evolving EM Economies

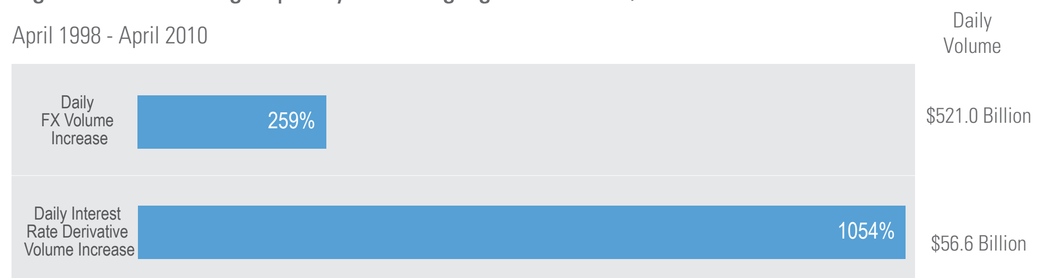
While investors are aware of EM economic growth, there has been an even more significant development and transformation within EM financial markets that has been less widely accepted. The result of this financial progress means investors are no longer restricted to an "equity-only" universe, and the expansion of investment options is the key factor that enables a truly hedged investment approach. The growing sophistication in the EM's most "developed" financial markets can be measured by the growth of their asset classes, including not only equities and credit, but also foreign exchange and interest rate derivatives.

Economists project that most advanced economies will experience only modest financial asset growth in the wake of the 2008 credit crisis. By contrast, EM financial markets have grown significantly over the past decade and are expected to continue their growth trajectory in the coming years. To illustrate,

- EM equities' market cap has soared from $2 trillion in 2000 to an estimated $14 trillion in 2010.
- Economists project EM to account for more than half of the global equity market cap by 2030.
- China's equity market cap may surpass the U.S. by 2030.
- Since 1998, trading volume in the EM Foreign Exchange ("FX") market has more than tripled (increasing by 259%), and daily trading volume of EM interest rate derivatives has experienced a more than ten-fold increase (growing by 1054%). **(See Figure 5.)**
- The Asia-Pacific region overtook North America as the world's largest derivatives market for the first time in October 2010.

Figure 5: Increasing Liquidity in Emerging Markets FX/Interest Rate Markets

April 1998 - April 2010



SOURCE: Bank for International Settlements

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The Pitfalls of a Long-Only Approach to EM Investing

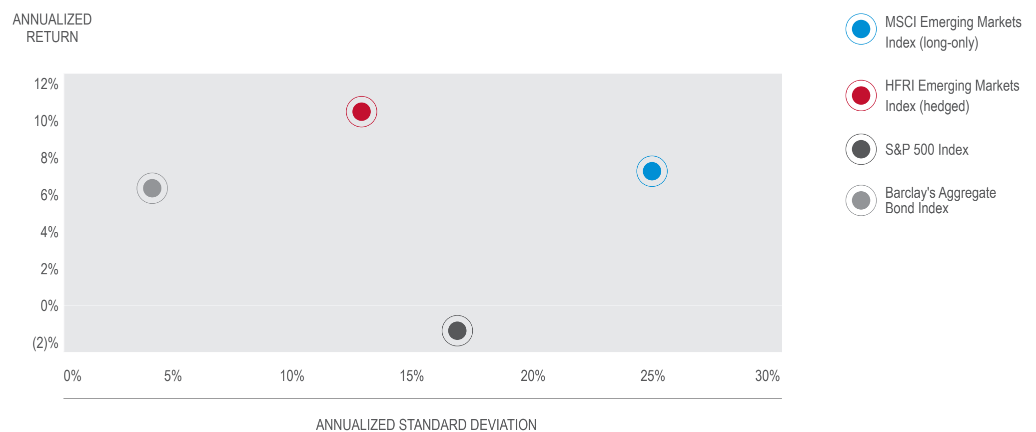
EM financial markets have a history of boom and bust cycles, with extended periods of prosperity and robust returns that are often followed by extreme volatility and sharp market declines. Indeed, investors still have fresh memories of the Mexican crisis in 1994, the "Asian Contagion" in 1997 and the Russian "Ruble Crisis" in 1998. Despite the history of erratic and highly volatile returns, most EM investors still pursue a long-only, equity-biased approach. This is a difficult proposition, however, as EM equity markets frequently exhibit sharp downturns in which strong investment profits can be wiped out in relatively brief periods. While not possible in the 1980s or even the late 1990s, the development of multiple asset classes within EM now allows for a hedged investment approach that may have significant diversification benefits compared to a long-only strategy and the potential to withstand, and even profit from, future market volatility. **(See Figure 6.)**

KEY POINT

The varied opportunity sets within each of the four major EM asset classes provides skilled multi-strategy managers with the opportunity to trade profitably during all market conditions.

Figure 6: Superior Risk/Reward Proposition of Hedged vs. Long-only EM Investing

January 2000 - September 2010



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SOURCE: MSCI

Emerging Markets Multi-Strategy Investing: An Overview

Unlike long-only, equity focused managers, EM multi-strategy managers trade in a hedged, top-down approach across the four major asset classes, the largest of which is equities, but also includes foreign exchange, interest rates (primarily swaps and futures) and credit. As indicated in the following sections, the varied opportunity sets within each of the four major EM asset classes provides skilled multi-strategy managers with the opportunity to trade profitably during all market conditions.

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Equities

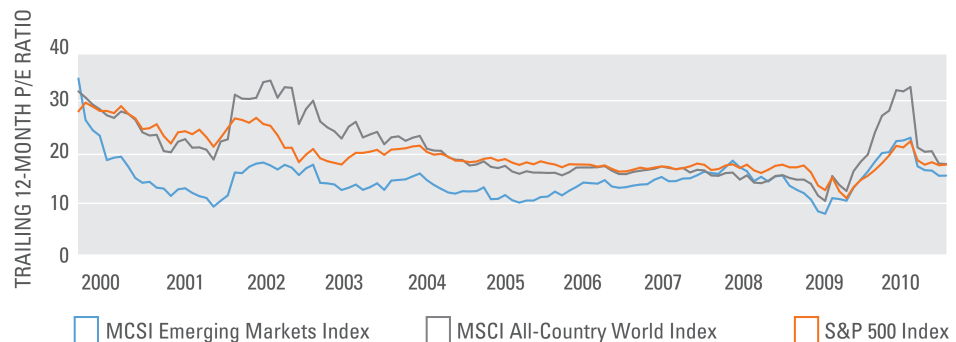
Equities are the most familiar instruments in which EM managers can invest, and also represent the area in which a long / short, hedged approach can have the most obvious advantage. When outside investors first invested in EM countries, the opportunity was long-only because equity valuations were low (reflecting the higher uncertainty of the markets), volatility was very high, and the ability to short equities was extremely limited. EM investors had the potential for outsized returns, but often suffered large performance swings in down equity markets. In recent years, EM companies have attracted enough capital that (1) liquidity has significantly increased, and (2) valuations have richened and now more closely track developed markets. The result has been that the risk of volatility is no longer balanced by the opportunity of significantly outsized returns. Fortunately, the same EM markets have also seen an expansion in hedging tactics, such as options, futures, and shorting techniques. EM multi-strategy managers utilize these hedging techniques to manage and even take advantage of the same volatility that is the nemesis of long-only managers. As a result, multi-strategy managers have the potential to generate alpha via a hedged approach as opposed to market-driven returns. As EM equity valuations are now more in line with their developed market counterparts **(See Figure 7)**, managers' ability to pick the right stocks and successfully trade both long and short will be, in our opinion, the critical factor to achieving excess returns within the EM equity space.

KEY POINT

Multi-strategy managers have the potential to generate alpha via a hedged approach as opposed to market-driven returns.

Figure 7: Graph of Relative Regional P/Es

January 2000 - September 2010



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SOURCE: MSCI

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Foreign Exchange (FX)

Currencies represent the largest, most active, and thus the most liquid market in the world. FX trading is the most direct way to potentially benefit from differences between economies, and investors can capture the increasing EM opportunity set by taking views against currencies of developed countries or other EM countries. For example, an EM multi-strategy manager might express a view that Brazilian economic growth will exceed US growth by buying the Brazilian Real and shorting the US Dollar. Managers can also enter relative value trades among EM countries by shorting one EM currency against another (i.e. buying the Indian Rupee and shorting the Brazilian Real to express a positive economic view on the Indian economy versus the Brazilian economy). In the hands of a skilled and nimble manager, FX can be an effective vehicle for translating macro views into profit opportunities. While many market experts anticipate significant strengthening of EM currencies against their developed market counterparts in the coming years, skilled managers have the potential to profit from both rallies and declines in EM currencies if the investment horizon becomes less sanguine.

KEY POINT

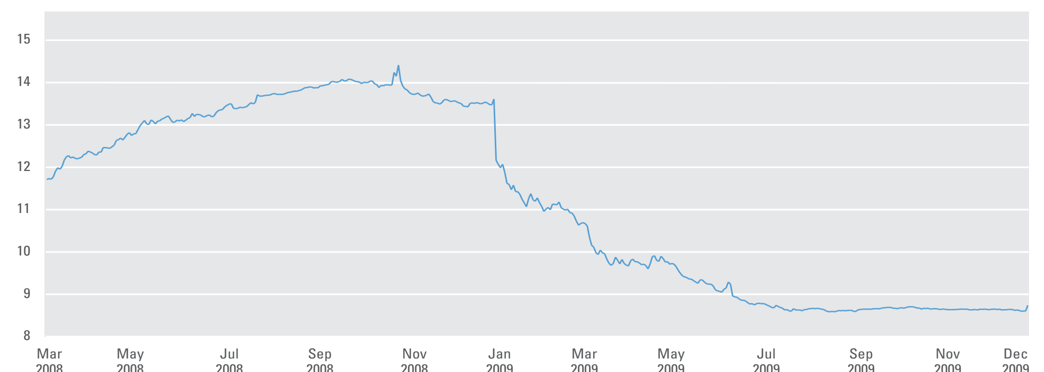
FX trading is the most direct way to potentially benefit from differences between global economies.

Interest Rates

Interest rates are another investment vehicle used by managers to express views on macro-economic trends within EM countries. In the coming years, we believe underlying economic fundamentals and government policies should cause interest rates in EM countries to diverge from those of developed countries and provide a strong opportunity set to dynamically trade across EM countries' yield curves. Trading within this asset class also has potential diversification benefits, as interest rates typically produce strong gains as economies weaken. Similar to FX, managers can utilize EM interest rate trading to take views against their developed market counterparts or other EM countries. This again provides for profit opportunities throughout a market cycle and enables managers to take a bullish or bearish view on EM as opposed to a simple long-only approach. As an example of the uncorrelated opportunity set within this asset class, interest rate trading was particularly fruitful during the 2008 crisis as managers found significant profit opportunities by being long fixed income while central banks slashed interest rates to stimulate economic growth (prices go up as yields go down, and vice versa). **(See Figure 8.)**

Figure 8: Falling Short-Term Interest Rates in Response to Global Credit Crisis Presents Uncorrelated Investment Opportunity

March 2008 - December 2009



SOURCE: Bloomberg

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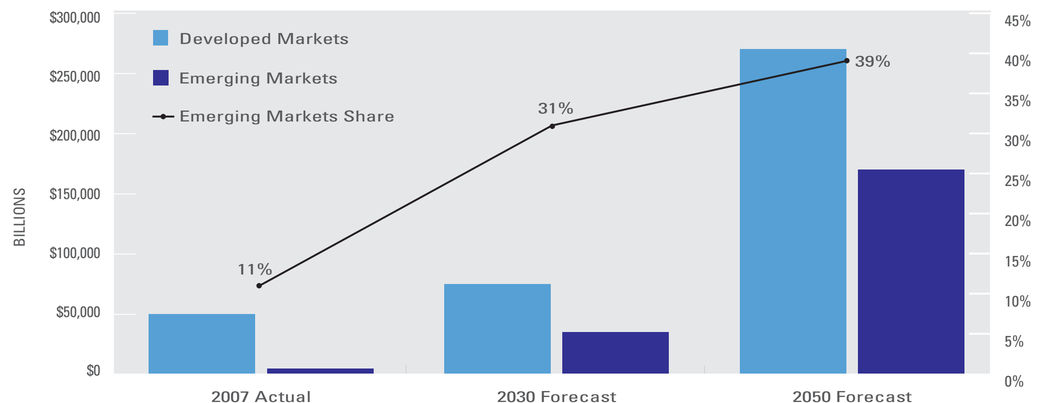
Credit

Another traditional vehicle for profiting from the EM space exists within credit instruments – bonds issued by large EM corporations. In the past, the primary benefit of this asset class was the additional yield that EM bonds carried in comparison to developed countries' bonds. While those differences have diminished as EM corporations have improved in terms of credit quality and liquidity, there are still significant opportunities for managers to profit within EM credit. As credit spreads narrow between developed and Emerging Markets issuers, the prices commanded by the latter will go up (prices go up as yields go down, and vice versa) and offer EM managers the chance to profit from both capital appreciation and current yield. Finally, credit markets offer increasing opportunities for hedging, shorting, and active trading using credit derivative instruments such as credit default swaps. **(See Figure 9.)** As elsewhere, finding the managers with the necessary insight, skill and discipline to profit from these strategies is key.

KEY POINT

The ability to trade both long and short throughout various market conditions offers what we believe to be a superior investment proposition than a one-directional, equity focused strategy.

Figure 9: Projected Evolution of Debt Market



SOURCE: Goldman Sachs, Apr-2010

An All-Weather Approach

In contrast to a long-only investment strategy, a multi-strategy approach to EM investing promotes a nimble, hedged trading stance across multiple asset classes that has the potential to generate significant alpha and produce profits throughout both "boom" and "bust" periods. While long exposure to the equity and credit markets can be expected to provide the most robust returns during an economic expansion, long equity and credit exposure can lead to protracted negative returns as markets decline. However, multi-strategy managers have more tools in their tool kit. For example, interest rate trading has the potential to deliver a strong and uncorrelated return stream compared to equities, and the development of an active market to short credit and equities allows for further opportunities during periods of market turmoil. Foreign currency trading can also be profitable in up, down or flat markets, as active managers can produce alpha by taking long or short views on EM currencies. Despite strong economic drivers and maturing capital markets, Emerging Markets still remain susceptible to periods of elevated volatility and market losses. However, we believe the ability to trade both long and short throughout various market conditions may offer a superior investment proposition than a one-directional, equity focused strategy.

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Conclusion

In the post-2008 environment, developed market economies are facing uneven recoveries. In contrast, Emerging Markets offer more growth potential and thus greater opportunities for directional trading profits. However, Emerging Markets are still subject to sharp reversals, and their history of boom-bust cycles has revealed traditional beta-focused strategies to be a simplistic and often unfavorable approach to trading these regions. We believe it is imperative that EM investors seek managers who can take a more nimble approach and utilize long and short trading strategies across multiple asset classes to achieve persistent levels of alpha. While we believe it is likely that EM equities and bonds will outperform equities and bonds in the developed markets over the coming years, successful EM investing requires significant manager skill (alpha) rather than simply replicating market returns (beta). Combining hedging strategies in equities and bonds with opportunities in the FX and interest rate markets offers EM investors the ability to grow and protect capital through the ups and downs of a market cycle.

KEY POINT

While it is likely that EM equities and bonds will outperform equities and bonds in the developed markets in the coming years, successful EM investing requires significant manager skill (alpha) rather than simply replicating market returns (beta).

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GLOSSARY

Alpha - A measure of performance on a risk-adjusted basis. Alpha is often considered to represent the value that a portfolio manager adds to or subtracts from a fund's return. A positive alpha of 1% means the fund has outperformed its benchmark index on a risk-adjusted basis by 1%. Correspondingly, a similar negative alpha would indicate an underperformance of 1%.

Beta - The tendency of a security's returns to respond to swings in the market. A beta of 1 indicates that the security's price will move with the market. A beta of less than 1 means that the security will be less volatile than the market. A beta of greater than 1 indicates that the security's price will be more volatile than the market.

Derivative - A financial instrument, traded on or off an exchange, for which the price is directly dependent upon the value of one or more underlying securities, equity indices, debt instruments, commodities, other derivative instruments, or any agreed upon pricing index or arrangement.

Developed Markets - Nations that are industrialized, have high levels of per capita income, and maintain developed and liquid financial markets. Currently, there are 24 developed markets in the world.

Emerging Markets - Nations with social or business activity in the process of rapid growth and industrialization. Currently, there are 21 emerging markets in the world, with the economies of China and India considered to be the two largest.

Frontier Markets - Nations that are generally considered to be at a much earlier stage of economic and financial market development than the emerging markets. Frontier nations typically have underdeveloped, smaller-sized, and often illiquid financial markets. Currently, there are 26 frontier markets in the world.

Hedging - The practice of taking a position to reduce the risk of adverse price movement in another investment. The goal of hedging is minimizing one's exposure to unwanted market or position-level risk. Hedging strategies can be implemented across a variety of asset classes, the most prominent of which include the equity, interest rate, currency, and credit markets.

Liquidity - A characteristic of a security or commodity market that allows assets to be converted into cash quickly without a substantial change in price.

Volatility - A measurement of the change in price over a given time period. Typically, higher volatility is associated with an elevated level of risk.

An investor cannot invest directly in an index. Moreover, indices do not reflect commissions or fees that may be charged to an investment product based on the index, which may materially affect the performance data presented.

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- Returns from some alternative investments can be volatile
- There may be a substantial risk of loss: you may lose all or portion of your investment
- The high degree of leverage often attainable in alternative investments can work against you as well as for you. The use of leverage can lead to large losses as well as gains
- With respect to single manager products, the manager has total trading authority. The use of a single manager could mean a lack of diversification and higher risk
- Many alternative investments are subject to substantial expenses that must be offset by trading profits and other income. A portion of these fees includes payments to Altegris
- Trading may take place on foreign exchanges that may not offer the same regulatory protection as US exchanges. Such trading may also entail exchange rate risk
- Past results are not necessarily indicative of future results

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About Altegris

Altegris has one core mission – to find the best alternative investments for our clients. Our unique platform connects financial professionals and sophisticated individual investors to, what we believe are, premier alternative investment managers, often at lower minimums. Altegris offers what we believe are a straightforward and efficient solution for investors seeking to improve portfolio diversification with historically low correlated investments.

With one of the leading research and investment groups focused solely on alternative investments, Altegris follows a disciplined process for identifying, evaluating, and monitoring investment talent across the spectrum of hedge funds, managed futures funds, and other alternative investments.

Veteran experts in the art and science of alternatives, Altegris guides our investors through the complex and often opaque universe of alternative investing.

Alternatives are in our DNA. Our very name, Altegris, highlights our singular focus on alternatives, the highest standards of integrity, and a process that constantly seeks to minimize investor risk while maximizing potential returns.

The Altegris Group of Companies includes Altegris Investments, Altegris Advisors, and Altegris Funds. Altegris and its affiliates currently have approximately $2.1 billion in client assets, and provide clearing services to accounts representing $800 million in institutional assets.

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