Managed Futures

Q4 2010 Market Commentary

Overview

With returns just shy of 5%, managed futures (represented by the Altegris 40 Index℠)[1] as an asset class had a very profitable fourth quarter. By comparison, equities (represented by the S&P 500 Total Return Index) were up 10.74%, while bonds (represented by the Barclays US Aggregate Bond Index) were down -1.29%. For the year, managed futures returned 11.49% while equities and bonds returned 15.05% and 6.56% respectively (Figure 1).

Figure 1.

MANAGED FUTURES PERFORMANCE VERSUS INDICES

Quarterly, Annual and 10-Year Returns through December 2010

	Quarterly Returns 2010				Yearly Returns			10-Year Returns January 2001–December 2010			
	Q1 Return	Q2 Return	Q3 Return	Q4 Return	2010 Return	2009 Return	2008 Return	Total Return	Ann ROR	Std Dev	Max DD
Altegris 40 Index	2.33%	-0.54%	4.67%	*4.66%**	*11.49%**	-7.98%	15.47%	*104.56%**	*7.42%**	*11.03%**	-13.24%
HFRI Fund Weighted Composite Index	2.38%	-2.67%	5.02%	*5.52%**	*10.43%**	20.01%	-19.03%	*95.65%**	*6.94%**	*6.45%**	-21.42%
S&P 500 Total Return Index	5.38%	-11.42%	11.30%	10.74%	15.05%	26.45%	-36.99%	15.03%	1.41%	16.31%	-50.95%
Barclays US Aggregate Composite Bond Index	1.78%	3.49%	2.49%	-1.29%	6.56%	5.93%	5.24%	76.36%	5.84%	3.79%	-3.82%
MSCI EAFE Index (Net)	0.85%	-13.98%	16.48%	6.62%	7.74%	31.78%	-43.39%	43.05%	3.64%	18.55%	-56.68%
NAREIT Composite Index	9.47%	-3.66%	12.34%	7.66%	27.55%	27.79%	-37.84%	165.72%	10.27%	23.83%	-68.17%
GSCI Total Return Index	-0.90%	-10.41%	8.27%	13.41%	9.02%	13.67%	-46.49%	19.35%	1.79%	25.00%	-67.65%

** Estimates as of January 7, 2011. 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.*

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QE2, China, and You

Throughout the quarter, we received many questions regarding the impact of QE2 (a second round of quantitative easing by the US Federal Reserve) on managed futures and specifically your investments with managed futures managers. To address this question adequately, let us discuss the roots of QE2 and then recap its impact on the futures markets thus far.

The Roots of QE2

Our interpretation of QE2's goal is to aid price stability and ensure that unemployment does not worsen. Officially announced in November, the Fed's plan of attack is to purchase hundreds of billions in government bonds, with the intent of keeping longer-term interest rates low in order to incite spending and investment by consumers and business alike. While not explicitly stated by the Fed, the knock-on effect is undoubtedly a weaker US dollar (USD), which is a benefit to US exporters and hence GDP. The problem is that recent economic indicators, such as the narrowing trade gap, have shown some improvement in the US economic landscape. This, coupled with the extension of the Bush-era tax cuts, has left many investors feeling optimistic, perhaps indicating that the US does not need additional stimulus after all. As a result, Treasury yields have gone up and the dollar has strengthened. While many argue the economy will remain weak despite stimulus measures, others believe we are on a crash course with inflation. Accommodative policy measures from the European Central Bank, only modest monetary tightening from China and commodity prices rallying to new highs have fueled the concern that QE2 might do more harm than good.

While many argue the economy will remain weak despite stimulus measures, others believe we are on a crash course with inflation.

For nearly two years, futures markets reacted to the tug of war between inflation (due to accommodative monetary stimulus and emerging market/Chinese demand for commodities) and the fact that clear deflationary pressures still exist, such as high unemployment in the US and European sovereign debt risk. For most of the fourth quarter, it appeared that the macro environment might be shifting, with the likelihood of global asset reflation as the victor.

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Q4 2010 managed futures returns were largely derived from inflationary forces, including rallies in gold, commodity and stock index futures.

Impact on the Futures Markets

As a result, Q4 2010 managed futures returns were largely derived from inflationary forces, including rallies in gold, commodity and stock index futures (as shown in Figure 3 on page 6). This was mainly evident in October. With QE2's announcement imminent, markets in October experienced broad based rallies. Optimism over a global economic recovery shifted capital to riskier assets, and notably away from government bonds. The long-standing fixed income rally gave way as bullish investors piled into commodities (gold in particular) and stocks. Strong trends led to overall gains in managed futures. The Altegris 40 Index gained nearly 4% for the month, with the majority of managers we review posting strong returns.

While rallies in futures extended from October through year-end, there were some hiccups along the way. In November, futures markets were a mixed bag; the stock market rose and then fell, as if in a waiting pattern for some significantly better or worse news to hit the tape. Ireland's debt woes fueled concerns over European sovereign debt risk. Perhaps more significantly, Chinese regulators forced Shanghai banks to halt loans for fixed-asset investments for 2010, and enact a quota for 2011, in an effort to curb lending practices that have helped accelerate inflation.[2] China's central bank also announced it planned to raise the reserve requirement in December. While China's measures to curb inflation were modest, they were nonetheless a signal that the country is concerned about their economy overheating. China's higher-than-expected October inflation figures and subsequent government policies cooled the commodity futures' rally in mid-November, leading to a reversal in many futures markets. Last but not least, escalating tensions and outright hostility between North and South Korea led to increased fear and risk aversion. All this combined created an atmosphere of disquiet and, therefore, choppy price action over the second half of November. Led by trend following programs, managed futures managers were collectively down for the month, with the Altegris 40 Index down -3.59%.

In December, all volatility was to the upside, and all news seemed to be interpreted as good news. Futures markets drifted higher and higher, erasing November losses and allowing for strong asset class performance. As a whole, managed futures were up substantially on the month, with the Altegris 40 Index returning 4.5%.

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Strategy Summary

While managed futures as represented by the Altegris 40 Index were up for the quarter, returns for both trend following and specialty (short-term systematic and discretionary commodity) managers varied based on markets traded and program specifics. A synopsis highlighting return drivers is as follows:

Specialized: Short-Term Systematic

Although the majority of managed futures strategies are classified as trend following, short-term systematic programs comprise just under 10% of the managed futures asset class, as represented by the Altegris 40 Index. Short-term systematic programs vary considerably. For example, one program may focus on short-term momentum systems (capturing some degree of short-term price persistence in markets). Another program's emphasis may be on volatility breakout systems (models that focus on capturing price moves often after a contraction in volatility occurs.

While representing a choppy minefield for managed futures in Q3, trades in stock index futures were profitable for several managers in Q4.

Generally, short-term systematic programs consist of several different systems that trade over varied time periods. What constitutes "short-term" may be three weeks for one program while another program may trade intraday. Over the quarter, several markets presented both ripe and rotten opportunities for short-term systematic programs.

While representing a choppy minefield for managed futures in Q3, trades in stock index futures were profitable for several managers in Q4. With momentum in global stock markets gaining steam, several short-term systematic programs once again added exposure to stock index futures in size.

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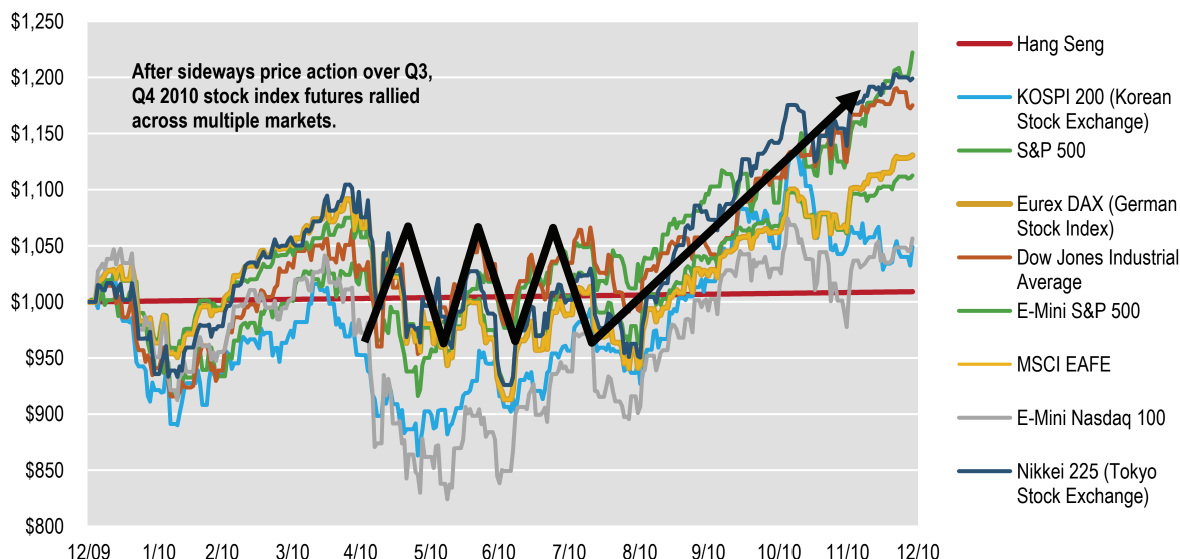
Despite a very profitable year as a whole for stock index futures, the ride up was not as smooth as it may appear on the year-to-date VAMI[3] chart (Figure 2). Short-term systematic programs were susceptible to intraday stock index swings and as a result, programs with narrow stop loss limits (systematic method for exiting a trade when a loss threshold has been breached) performed the worst as intraday reversals led to whipsaws and hence losses. Short-term momentum programs with wider stop loss limits (wider threshold for exiting trades) performed very well, as several stock index futures contracts rallied interday (from one day to the next) despite intraday (during the same trading day) hiccups. Intraday reversals were present in October, but overall, the month ended on a high note.

In November, Chinese inflation fears made the trading environment more challenging. Markets rocked back and forth throughout the day—a negative for programs that require several days of persistence for their programs' momentum trading models to profit.

Figure 2.

STOCK INDEX FRONT MONTH FUTURES VAMI CHART

December 2009–December 2010



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With markets inching higher throughout the trading day, December presented the best momentum based opportunities for the quarter.

Intraday movements on a per month basis are demonstrated below of S&P 500 front month futures (Figure 3).

Figure 3.

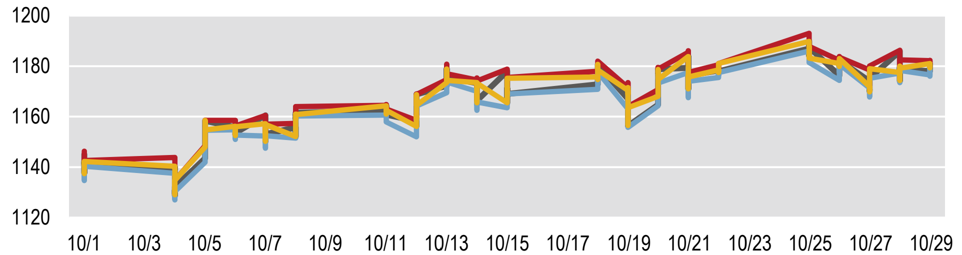
S&P 500 FRONT MONTH FUTURES

October 2010–December 2010

Open
High
Low
Last Price

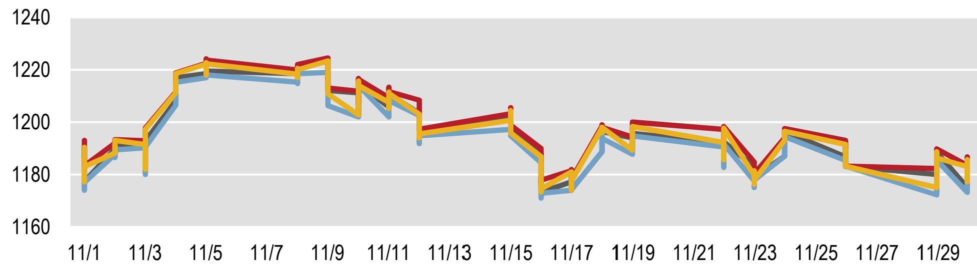
OCTOBER

Short-term price persistence despite intraday and interday reversals



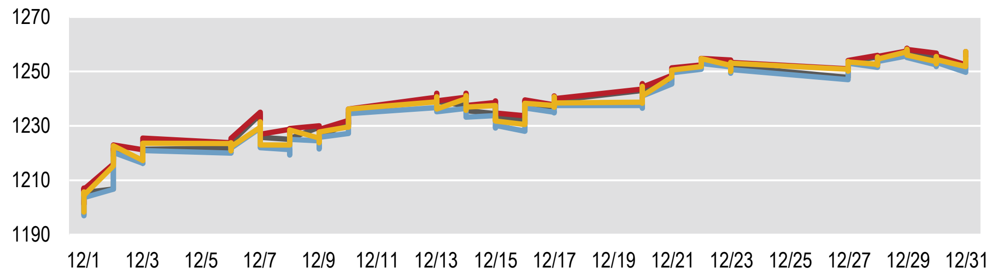
NOVEMBER

Macroeconomic and geopolitical concerns lead to choppy price action



DECEMBER

A smooth ride up…



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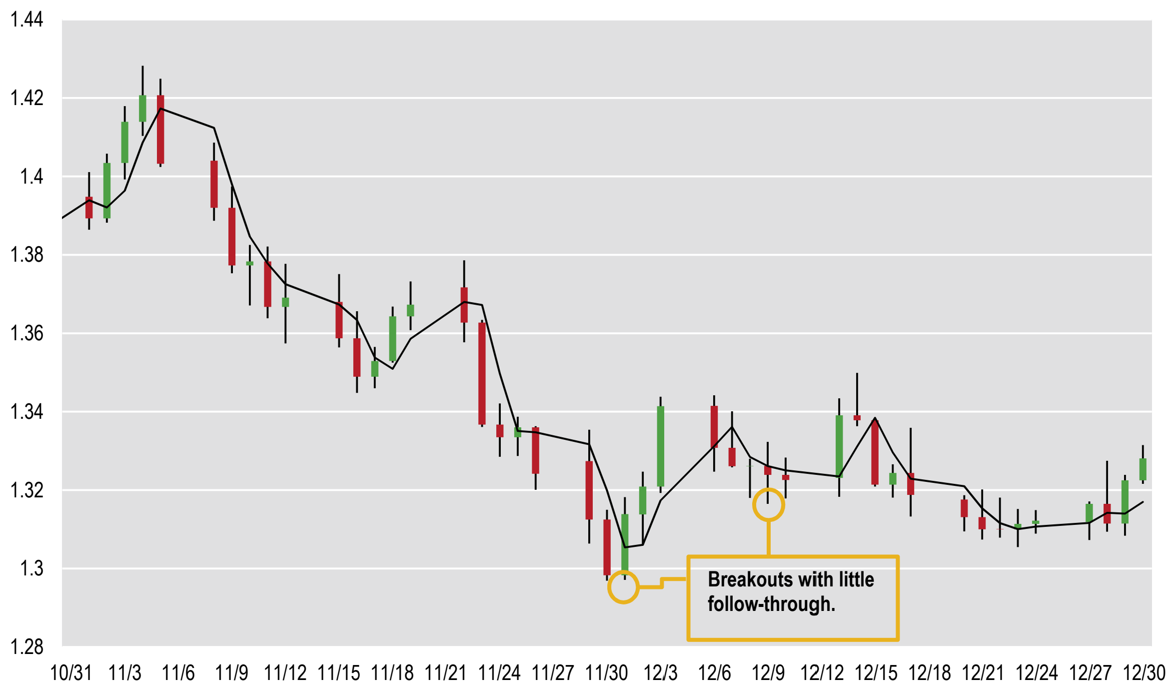
While momentum trades presented opportunities over the fourth quarter and most prominently in December, volatility breakout systems proved to be the Achilles heel of many short-term programs, chiefly in the currency markets. FX traders seemed to change their minds at breakneck speeds. Nowhere was this more present than in the EUR/USD (how many US dollars it takes to buy one euro) cross trade during several points in December. Shown in the graph below, from a technical perspective it looked as if the euro might breakout against the USD in both early and mid-December. The high, low, close range contracted several times (as represented by the gold circles), only to sputter after one or two days, rather than gain traction. This lack of follow-through made false breakouts difficult for several short-term systematic managers (Figure 4). Many programs were unprofitable as a result.

Figure 4.
EURO/USD SPOT
October 2010–December 2010



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Although returns on a manager-by-manager basis vary widely, short-term systematic managers as a group had a difficult fourth quarter, The AlternativeEdge Short-Term Traders Index returned -1.05% for the quarter and an uninspiring 0.42% in 2010.[4]

Specialized: Discretionary Commodity Trading

In the discretionary commodity trading universe, the trading environment was quite favorable. The Barclay Discretionary Traders Index[5] was up 2.63% for the quarter and 4.71% for 2010. Driven by fundamental (tightening supply, increased emerging market demand) as well as macroeconomic factors (primarily inflationary forces as the result of QE2), the commodity bull was charging and everyone was chasing after it. In November alone, commodity futures volume averaged a record 1.3 million contracts per day, up 47% compared with November 2009, and up 13% from October 2010.[6] Agricultural commodities, precious metals, base metals, softs and even energy all rallied into year-end, all despite a sharp China-induced reversal in November.

In our recent white paper, *Emerging Markets: Now is the Time for a Hedged Approach*, we discuss the transition of emerging markets from export focused to demand-driven economies. More than 70% of the world's population lives in emerging market countries, creating an engine of growth and consumption for years to come. For example, the soybean futures market has moved steadily higher since the third quarter of this year, as soybean production was not able to meet insatiable emerging market demand. Cotton, sugar, corn, rice, copper, and wheat, among others also rallied over the fourth quarter.

More than 70% of the world's population lives in emerging market countries, creating an engine of growth and consumption for years to come.

Prices have rallied not only as the result of fundamental supply and demand variables, but also because of increased market speculation. According to a long-standing commodity manager, there are only two commodities that speculators were net short in Q4: natural gas and cocoa. Based on a recent report by Bank of America/Merrill Lynch, large speculative positions in corn, soybean and wheat futures were also purchased by hedge funds toward the end of the year. Speculators bought copper and palladium, and added long positions to crude and heating oil as well.[7] Commodity futures trades were crowded in 2010 and we expect markets to continue to be volatile as speculators enter and exit the market. Opportunities are abundant in these markets; however, overbought conditions often lend themselves to short-term market corrections.

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Trend Following

Whether it was QE2, tax break extensions, or old-fashioned supply and demand factors, futures markets have quietly reached new highs. In a time where the Fed is concerned about the lack of inflation, 32 out of 52[8] markets reached 2-year highs in the fourth quarter of 2010, while eight markets reached 20-year highs, including sugar, cotton, copper, silver, gold, the Australian dollar (AUD), 5-year treasury futures and 2-year treasury futures (Figure 5).

Figure 5.
FUTURES MARKETS REACH NEW HIGHS IN Q4 2010

2-YEAR HIGHS
January 1, 2009–December 31, 2010

Market	Q4 High Price
Copper	12/31/2010
Silver	12/31/2010
Gold	12/31/2010
Australian Dollar	12/31/2010
Live Cattle	12/31/2010
Soybeans	12/31/2010
Gasoline	12/31/2010
Corn	12/31/2010
Soybean Oil	12/31/2010
KOSPI 200 (Korean Stock Exchange)	12/30/2010
Crude Palm Oil	12/30/2010
S&P 500 Futures	12/29/2010
Dow Jones Futures	12/29/2010
E-Mini S&P 500	12/29/2010
Sugar	12/28/2010
Coffee	12/28/2010
Orange Juice	12/27/2010
Crude Oil	12/23/2010
Nasdaq Futures	12/22/2010
E-Mini Nasdaq 100	12/22/2010
Eurex Dax (Deutscher Aktien Index, aka German Stock Index)	12/22/2010
Cotton	12/21/2010
Palladium	12/3/2010
Platinum	11/9/2010
Hang Seng	11/8/2010
New Zealand Dollar	11/5/2010
5-Year US Treasury	11/4/2010
10-Year US Treasury	11/4/2010
Ethanol	11/4/2010
E-Mini MSCI EAFE	11/4/2010
2-Year US Treasury Note	11/3/2010
3-Year US Treasury	11/1/2010

(2-year highs continued)

20-YEAR HIGHS
January 1, 1991–December 31, 2010

Market	Q4 High Price
Copper	12/31/2010
Silver	12/31/2010
Gold	12/31/2010
Australian Dollar	12/31/2010
Sugar	12/28/2010
Cotton	12/21/2010
5-Year US Treasury	11/4/2010
2-Year US Treasury Note	11/3/2010

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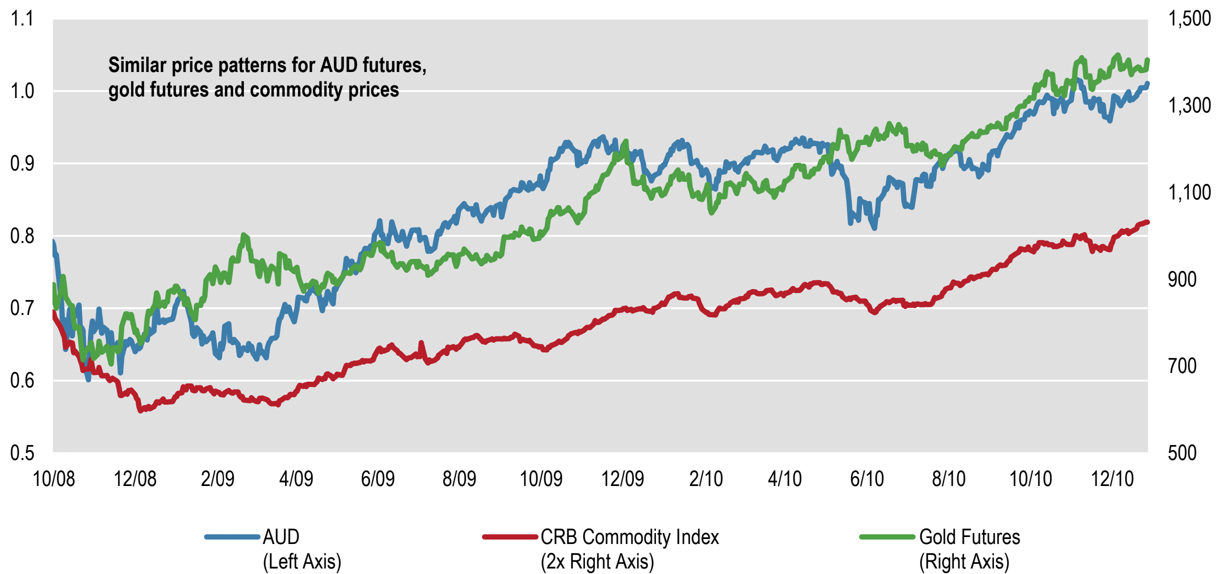
The most newsworthy trend was the near 30% ascent of gold futures. However, other sustained trends, such as the appreciation of both the Japanese yen and the AUD garnered much less attention. The AUD has rallied over 65% after reaching a low of 0.61 in November of 2008 (1.0 AUD could buy you 0.61 USD). Over the second half of 2010, it rallied nearly 20%. The AUD is now just above parity with the USD for the first time since 1983. The root of the AUD rally lies in the fact that it is what is known as a "commodity currency." Economies of countries like Australia, New Zealand, South Africa and Canada are heavily tied to raw material exports. In the case of Australia, goods such as coal and iron ore have proven particularly lucrative as emerging market countries continue to buy raw materials in size. The country's robust mining industry has also added luster to its currency as investors flee fiat currency and buy gold. In fact, if we take a closer look at the AUD rally since Q4 2008, the correlation between AUD, gold futures[9] and commodities[10] is profound. We compared AUD futures, front month gold futures, and the CRB Index[11] and found that the three track each other nearly in lock step (Figure 6). In fact, the AUD has a 0.92 correlation to commodities and a 0.88 correlation to gold futures over the same time period.

Figure 6.
AUD FUTURES, GOLD FUTURES AND COMMODITY PRICES
October 2008-December 2010



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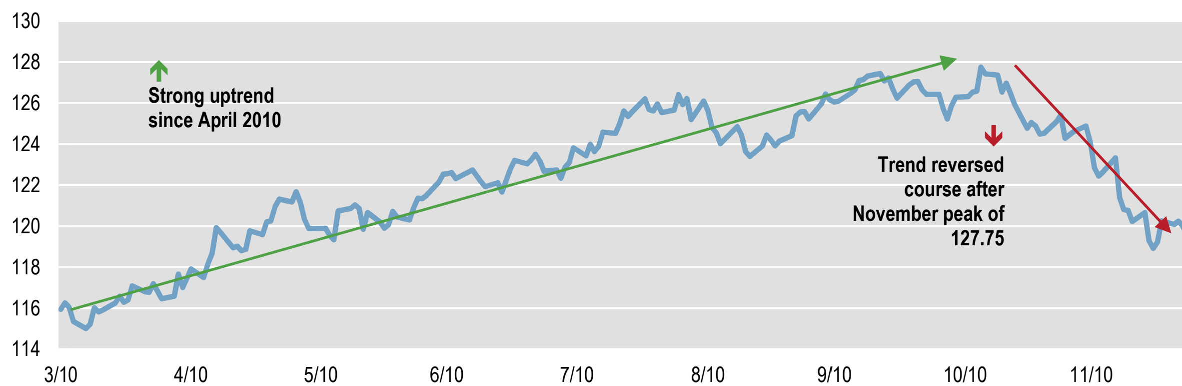
Most trend following systems initially identified this trend several years ago, profiting nicely while reducing and adding exposure to the AUD based on various trend signals. Given the persistence of AUD price appreciation, it is possible that upside in the currency is limited at this point. On the other hand, should commodity prices continue their ascent, the AUD could continue to rise alongside commodities as it's done for quite some time. The good news is that many trend following systems have models that can detect trend reversals. Some systems are quicker than others to identify reversion signals. As a result, one manager may be significantly long the AUD while another is gradually reducing position sizing. We noticed the same phenomenon at the end of Q3 2010 in the interest rate markets. Many trend following programs that we follow were in the process of reducing long interest rate exposure after several months of declining yields. As exemplified in the graph below, 10-year treasury futures (front month) peaked in early November, and subsequently declined nearly every day until year-end (Figure 7).

Systems that reduced exposure to interest rate markets early were less affected by the reversal, while systems that were late to reduce positions suffered losses. Overall, trend followers performed well over the quarter and accrued strong profits in October and December. Programs with high exposure to commodity futures were especially successful.

Figure 7.

10-YEAR TREASURY FUTURES

Front Month Contracts: Q2 2010-Q4 2010



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Conclusion

Following a terrific year for managed futures in 2008 (+15.47%), 2009 was the asset class's second losing year in the past twenty (-7.98%). At the onset of 2010, we published the report, *Managed Futures: Is the Trend Your Friend* at a nadir for the asset class; a time when unpredictable macro influences dominated the investment landscape and futures markets exhibited significant sideways price action and tight trading ranges. As we advised, short-term swings are often ephemeral and perseverance can be rewarded over time. The difficulties of 2009 were indeed short lived. Managed futures rebounded in 2010 ending the year up just under 12%. Nearly one year after writing the report, the macro environment is still unpredictable, but there appears to be more persistence in futures' price movement.

For 2011, the potential for inflation is far stronger, deflationary forces are weaker, and fundamental (supply and demand) influences in the commodity markets are pushing futures markets to new highs.

While the intent of QE2 was to keep long-term interest rates low, the result of increasing inflationary pressures will likely be that rates continue to rise as expectations of economic improvement dominate the markets. Fueled by emerging market demand, commodity prices should also continue to rally, as should stock indices. The impact on both trend following and specialty managers will vary based on nuances within each manager's program. In general, we expect that trend following managed futures programs should capitalize if reflationary trends continue to persist. Although, given North versus South Korea, never-ending European bank woes, unemployment, et cetera, anything can change. In fact, while strong trends in markets should continue into 2011 (notably commodity futures), sharp reversals are likely as both increased fear over Chinese inflation as well as deflationary influences periodically surface.

For 2011, the potential for inflation is far stronger, deflationary forces are weaker, and fundamental (supply and demand) influences in the commodity markets are pushing futures markets to new highs.

In general, the wind is at managed futures' back, and from a historical perspective, the asset class has performed well throughout multiple market cycles. While past performance does not guarantee future results, over the last five years, managed futures as represented by the Altegris 40 Index has returned approximately 6.26% on an annualized basis, with a worst drawdown of -10.27%. This compares to annualized returns of 2.29% for the equity market as represented by the S&P 500 Total Return Index and a worst drawdown of -50.95%. Over a 10-year period, the benefits of managed futures are even more evident. Managed futures returned 7.42% on an annualized basis with a worst drawdown of -13.24%. The equity market returned 1.41% over the same time period, with a worst drawdown of -50.95%.

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Given the current market backdrop as well as managed futures returns from a historical context, we are optimistic about managed futures returns for 2011 (Figure 8).

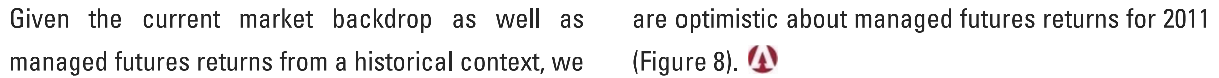

Figure 8.

RATE OF RETURN OVER 11 YEARS

January 2000–December 2010

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010*
POSITIVE RETURNS				EAFE 38.59%	NAREIT 30.40%	GSCI 25.56%					NAREIT 27.55%
				NAREIT 38.47%	EAFE 20.24%	EAFE 13.56%	NAREIT 34.02%	GSCI 32.68%		EAFE 31.78%	S&P 500 15.05%
	GSCI 49.77%			S&P 500 28.69%	GSCI 17.27%	HFRI 9.27%	EAFE 28.12%	EAFE 11.18%		NAREIT 27.79%	Altegris 40 11.49%
	NAREIT 25.88%	NAREIT 15.50%	GSCI 32.08%	GSCI 20.72%	S&P 500 10.87%	NAREIT 8.52%	S&P 500 15.79%	HFRI 9.95%		S&P 500 26.45%	HFRI 10.43%
	BC Agg 11.63%	BC Agg 8.42%	Altegris 40 15.22%	HFRI 19.55%	HFRI 9.05%	S&P 500 4.89%	HFRI 12.89%	Altegris 40 7.18%		HFRI 20.01%	GSCI 9.02%
	Altegris 40 10.63%	Altegris 40 5.39%	BC Agg 10.27%	Altegris 40 15.99%	BC Agg 4.34%	Altegris 40 4.51%	Altegris 40 6.70%	BC Agg 6.96%	Altegris 40 15.47%	GSCI 13.67%	EAFE 7.74%
	HFRI 4.98%	HFRI 4.62%	NAREIT 5.22%	BC Agg 4.11%	Altegris 40 2.57%	BC Agg 2.43%	BC Agg 4.33%	S&P 500 5.50%	BC Agg 5.24%	BC Agg 5.93%	BC Agg 6.56%
NEGATIVE RETURNS	S&P 500 -9.09%	S&P 500 -11.88%	HFRI -1.44%				GSCI -15.10%	NAREIT -17.83%	HFRI -19.03%	Altegris 40 -7.98%	
	EAFE -14.16%	EAFE -21.45%	EAFE -15.94%						S&P 500 -36.99%		
		GSCI -31.94%	S&P 500 -22.10%						NAREIT -37.84%		
									EAFE -43.39%		
									GSCI -46.49%		

** Estimates as of January 7, 2011. 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. See next page for Index Description of each asset class. SOURCE: Altegris.*

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INDEX DEFINITIONS

Altegris 40	The Altegris 40 Index tracks the performance of the 40 leading managed futures programs, by ending monthly equity (assets) for the previous month, as tracked by Altegris Advisors. The Altegris 40 index represents the dollar-weighted average performance of those 40 programs.
GSCI	The GSCI Total Return Index measures a fully collateralized commodity futures investment. Currently, the GSCI includes 24 commodity nearby futures contracts.
EAFE	The MSCE EAFE Index is a capitalization-weighted index widely accepted as a benchmark of non-US stocks compiled by Morgan Stanley. It represents an aggregate of 21 individual country indices that collectively represent many of the major markets of the world.
S&P 500	The S&P 500 Total Return Index is the total return version of S&P 500 index. The S&P 500 index is unmanaged and is generally representative of certain portions of the U.S. equity markets. For the S&P 500 Total Return Index, dividends are reinvested on a daily basis and the base date for the index is January 4, 1988. All regular cash dividends are assumed reinvested in the S&P 500 index on the ex-date. Special cash dividends trigger a price adjustment in the price return index.
REITs	The NAREIT Composite Total Return Index includes both price and income returns of all publicly traded REITs (Equity, Mortgage, and Hybrid). The index began on December 31, 1971 with a base value of 100.
BC Agg	The Barclays Capital U.S. Aggregate Index represents securities that are SEC-registered, taxable, and dollar denominated. The index covers the US investment grade fixed rate bond market, with index components for government and corporate securities, mortgage pass-through securities, and asset-backed securities. These major sectors are subdivided into more specific indices that are calculated and reported on a regular basis. These specific indices include the Government/Credit Index, Government Index, Treasury Index, Agency Index, and Credit Index.
HFRI	The HFRI Fund Weighted Composite Index is an equal-weighted return of all funds in the HFR Monthly Indices, excluding HFRI Fund of Funds Index.

NOTES

1 *Based on the top 40 CTA program assets as reported to Altegris Advisors or to the Altegris managed futures database.*

2 *The Wall Street Journal, China Cracks Down on Shanghai Lending, December 16, 2010.*

3 *Value Added Monthly Index based on a $1000 initial value.*

4 *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.*

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

6 *CME Group press release dated December 2, 2010.*

7 *Bank of America Merrill Lynch Hedge Fund Monitor, December 20, 2010.*

8 *Fifteen (15) commodity futures markets, five (5) metals futures markets, ten (10) currency futures (spot) markets, four (4) energy futures markets, eleven (11) equity index futures markets, and eight (8) fixed income futures markets.*

9 *Front month gold future contracts.*

10 *Reuters CRB Commodity Index.*

11 *Multiplied by 2 for scale.*

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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.

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