Essential Elements for an All Weather Portfolio

March 2011

KEY POINT

Alternative investing provides a unique edge in comparison with traditional long-only investing.

Given the high degree of uncertainty in today's global economy and financial markets, astute investors the world over are asking the question, "Are there investments I should be considering that can work in almost any market conditions? Do I have to be 100% correct on major economic forces such as inflation vs. deflation, or are there (to the extent possible) investments that can be considered all weather?"

Alternative investing provides a unique edge in comparison with traditional long-only investing. There are certain attributes which are associated with specific alternative investments that are designed to potentially perform in a wide range of market conditions. These attributes are expressed in three specific strategies which we believe are essential for an all weather portfolio.

The Investor Challenge

According to Modern Portfolio Theory (MPT), "markets are efficient" and "investors are rational." But past crisis periods, including the recent Credit Crisis, demonstrated that theory alone was insufficient to protect investors on the downside.

Modern Portfolio Theory assumes a normal distribution of returns from the market, yet we have learned that periods of volatile or extreme returns have occurred with greater frequency than a normal distribution would predict. These "fat tails" of abnormal events are not accounted for by MPT. Additionally, MPT relies solely on historical inputs. While history is important, it does not predict the future.

During times of duress, as experienced during the Credit Crisis, traditional asset classes often become more highly correlated with one another compared to their historical relationships. As a result, many investors may be "falsely" diversified because they have relied on past correlations when building their portfolios. When the Credit Crisis hit, most traditional asset classes fell in unison because they shared a common characteristic of reliance on credit availability.

For your convenience, a glossary is included at the end of this document.

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All Weather Alternatives

KEY POINT

Alternative investment managers may offer unique management skills and flexibility that have a potential alpha-generating advantage.

The desire to allocate to strategies that have the potential to perform well in a wide range of market conditions leads many investors to alternative investments. There are two components to a portfolio's performance: 1) beta, or general market returns and 2) alpha, excess return (positive or negative) compared to the market, often referred to as manager skill. As investors deploy capital into low-fee, passive ETFs/Index funds to gain beta exposure, many turn to alternatives seeking alpha and to complement other portfolio holdings. Alternative investment managers may offer unique management skills and flexibility that have a potential alpha-generating advantage.

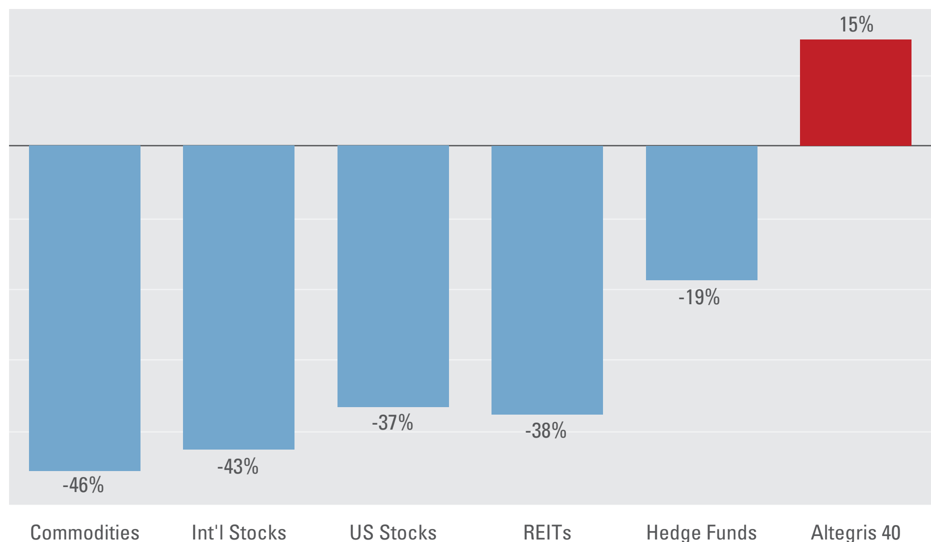
How have alternatives performed in crisis periods? When equity markets fell nearly 40% during the year 2008, the universe of hedge funds (as measured by the HFRI Hedge Fund Index) fell roughly half the distance of overall equities, providing a degree of capital preservation for the asset class as a whole. Strategies which incorporated hedging techniques demonstrated a greater potential for managing risk.

Other alternative asset classes also provided a counterbalance to this decline. During the same crisis period, managed futures (as measured by the Altegris 40 Index℠)† demonstrated the potential benefits of non-correlated diversification, increasing by over 15% during 2008 [FIGURE 1].

FIGURE 1.

TOTAL RETURNS BY ASSET CLASS DURING 2008 CREDIT CRISIS

January 2008–December 2008



Source: Altegris. Index Descriptions: Commodities: GSCI Total Commodity Index; Int'l Stocks: MSCI EAFE (Total) Index; US Stocks: S&P 500 Total Return Index; REITS: NAREIT Index; Hedge Funds: HFRI Fund Weighted (Total) Index; Altegris 40: Altegris 40 Index

† 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.

PAST RESULTS ARE NOT NECESSARILY INDICATIVE OF FUTURE RESULTS. There is no guarantee that any investment product will achieve its objectives, generate profits or avoid losses. See Important Risk Disclosures at the end of this document. All data as of 12/10 unless otherwise noted.

KEY POINT

These essential, all weather attributes express the potential core benefits of investing in certain alternative investments.

- Risk-Adjusted Returns
- Opportunistic
- Low Correlation

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- Liquidity

All Weather Attributes

Certain alternatives are designed to do well in a wide range of market conditions. We consider the following to be the essential, all weather attributes that express the core potential benefits of investing in certain alternative investments:

- **Risk-Adjusted Returns**
- **Opportunistic**
- **Low Correlation**

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- **Liquidity**

We believe three alternative investment strategies stand out for offering these attributes, providing the potential for a portfolio that invests in them to perform well in a wide range of market conditions:

- **Long/Short Equity**
- **Global Macro**
- **Managed Futures**

Each strategy offers characteristics that, when combined, and depending upon the manager and the type of investment, can provide the potential for a more all weather portfolio that performs across a wide range of market conditions. The inclusion of strategies with these core attributes can diversify a portfolio and potentially help make it better positioned to meet an investor's investment objectives.

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1. Long/Short Equity:

KEY POINT

Long/short equity managers seek to design their portfolios to capture the upside in the equity markets while providing downside protection during crises.

Long/short equity is often considered the core of hedge fund investing, representing more than half all industry assets.† Examining the characteristics of long/short equity, this strategy is designed to provide attractive risk adjusted returns and is opportunistic in its approach. As equity traders, most long/short equity managers maintain a liquid portfolio compared to many other alternative strategies. Most managers tend to be long-biased, but can be market neutral.

There are many different types of long/short managers. Long/short managers can be broad based or may focus on one geographical area or sector, such as technology, energy, healthcare, consumer, or financials. Secondly, the methodology used to trade stocks can vary significantly; though these managers typically achieve their results primarily through bottom-up fundamental analysis, some managers are quantitatively driven. A third and important factor which differentiates managers is the use of leverage in the portfolio, which can range widely across funds.

Performance

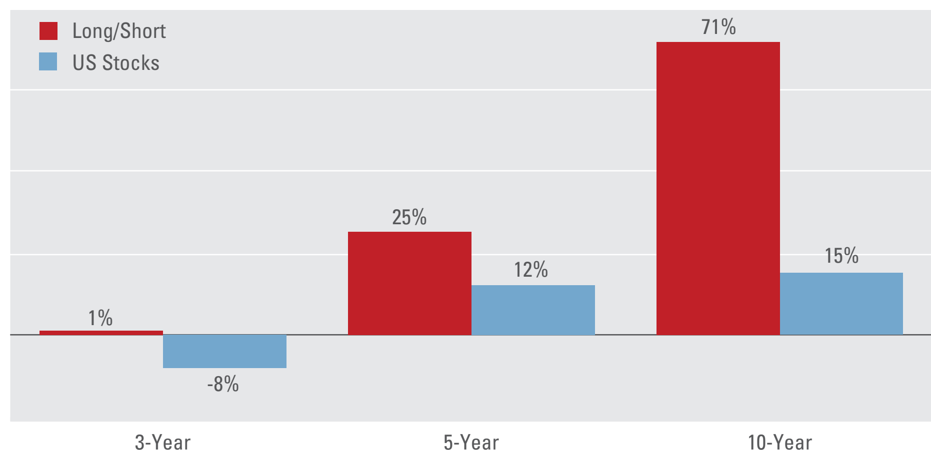
Long/short equity managers seek to design their portfolios to capture the upside in the equity markets while providing downside protection during crises. This is quite evident by the asset class' returns compared to long-only US stocks returns over trailing periods [FIGURE 2]. Long/short managers have often successfully captured gains on the upside, as well as provided some protection on the downside.

These returns have been achieved with nearly half the volatility of the US equity markets, as demonstrated by a standard deviation of long/short equity (as measured by the HFRI Equity Hedge Index) of 8% versus that of US stocks (S&P 500 TR Index) of 16% over the past 10 years [FIGURE 3]. Given the general long-bias positioning of long/short equity managers, correlation with US equities is higher than that of some other alternative strategies [FIGURE 4].

FIGURE 2.

TOTAL RETURNS: LONG/SHORT EQUITY VS. US STOCKS

HFRI Equity Hedge Index vs. S&P 500 Total Return Index | 3-Year, 5-Year and 10-Year Through December 2010



Source: Altegris

† *Source: HFRI, 2009 Annual Report.*

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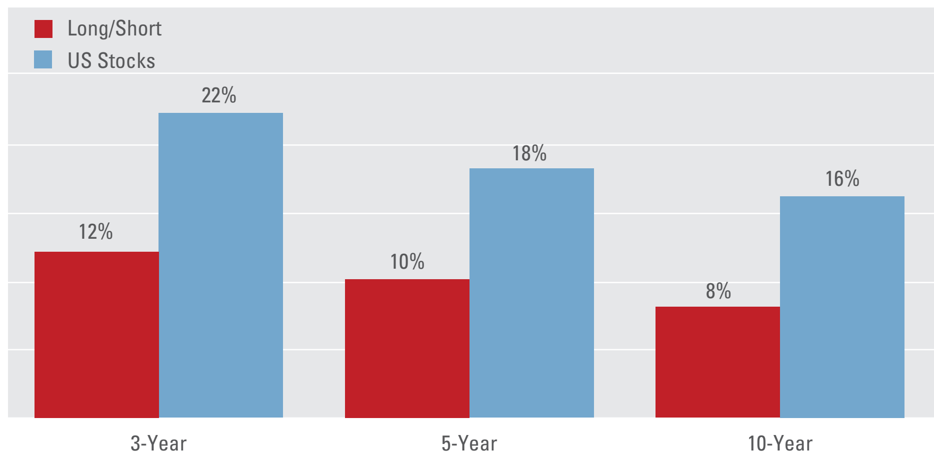
KEY POINT

After the significant rebound in stocks, the time for a simple "beta bet" may be over.

FIGURE 3.

STANDARD DEVIATION: LONG/SHORT EQUITY VS. US STOCKS

HFRI Equity Hedge Index vs. S&P 500 Total Return Index | 3-Year, 5-Year and 10-Year, Annualized
Through December 2010



Source: Altegris

FIGURE 4.

CORRELATION: LONG/SHORT EQUITY VS. US STOCKS

HFRI Equity Hedge Index vs. S&P 500 Total Return Index | Credit Crisis October 2007-February 2009 | 10-Year
Through December 2010

Source: Altegris

Stock Selection is Key

Looking at US equities, a stock picking strategy may be an important component to achieving desired returns. After the significant rebound in stocks, the time for a simple "beta bet" may be over.

This underscores the important role of a long/short strategy in designing an all weather portfolio—one which is designed to potentially perform well in a wide range of market conditions. As such, we believe long/short equity remains one of the three core strategies when considering an all weather portfolio.

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2. Global Macro:

KEY POINT

Global macro strategies, as a whole, are highly opportunistic and demonstrate historically low correlation to equities and strong risk adjusted returns.

Global macro may also demonstrate a mix of the essential all weather characteristics. Global macro strategies, as a whole, are highly opportunistic and demonstrate historically low correlation to equities and strong risk adjusted returns. In addition, these managers often trade in some of the most highly liquid instruments in today's financial markets.

Global macro is possibly one of the most important discretionary strategies for the sophisticated investor, particularly given the current environment of economic uncertainty and fiscal imbalance. These managers are highly discretionary with decisions typically being driven by comprehensive, fundamental analysis.

Global macro managers trade some of the world's largest, most liquid markets, including currencies, interest rates, bonds, and equities (primarily in the form of indices). Global macro funds typically include deep research teams who can evaluate the many macro-economic developments in the world and then design their investment strategies accordingly.

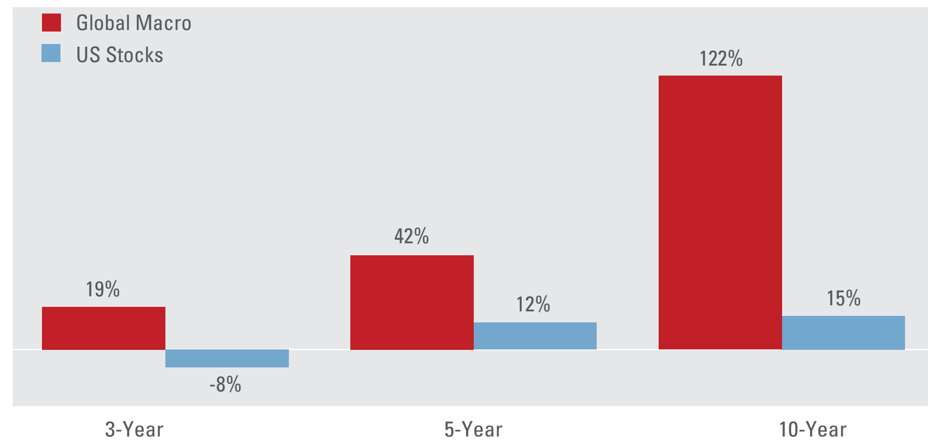
Performance with Lower Volatility

Over the long term, global macro has historically outperformed equities. Over the past 10 years, the global macro index provided a total return of 122% compared with that of US stocks of 15% [FIGURE 5]. At the same time, these returns came with volatility that was roughly one third that of US equities: the returns of global macro as an asset class had a 5% standard deviation compared with that of US stocks of 16% [FIGURE 6]. Furthermore, global macro managers have had an almost zero correlation with the US equity market, as seen in the correlation during the Credit Crisis of -0.05 and over ten years 0.20 when compared with US equities [FIGURE 7].

FIGURE 5.

TOTAL RETURNS: GLOBAL MACRO VS. US STOCKS

HFRI Macro (Total) Index vs. S&P 500 Total Return Index | 3-Year, 5-Year and 10-Year Through December 2010



Source: Altegris

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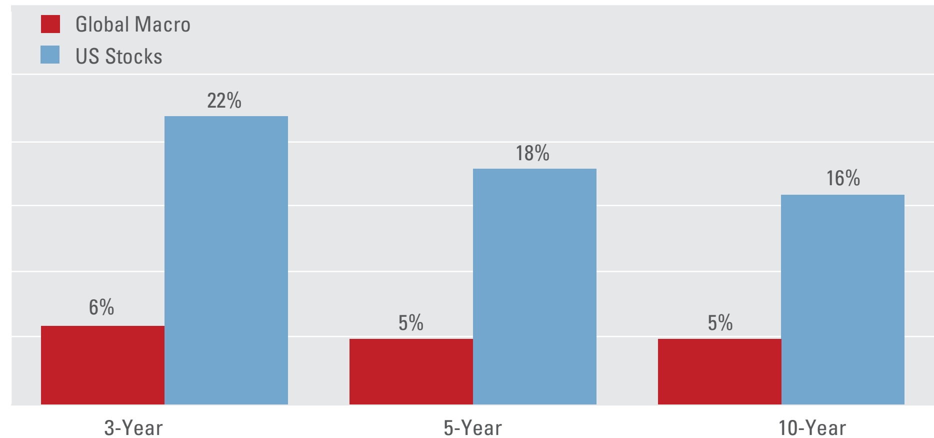
KEY POINT

The discretionary nature of global macro gives it a unique role in the design of a potentially all weather portfolio of alternative investments.

FIGURE 6.

STANDARD DEVIATION: GLOBAL MACRO VS. US STOCKS

HFRI Macro (Total) Index vs. S&P 500 Total Return Index | 3-Year, 5-Year and 10-Year, Annualized Through December 2010



Source: Altegris

FIGURE 7.

CORRELATION: GLOBAL MACRO VS. US STOCKS

HFRI Macro (Total) Index vs. S&P 500 Total Return Index | Credit Crisis October 2007-February 2009 | 10-Year Through December 2010

Source: Altegris

Capitalize on Change

The rapidly changing environment of government indebtedness, both in the US and abroad, presents enormous potential opportunity for global macro managers. Uncertainty regarding future interest rates, whether in a deflationary or inflationary environment, creates unique potential trading opportunities. Global macro managers are typically skilled in trading across the yield curve in government debt markets.

Global macro funds deploy highly focused, dedicated teams with a deep understanding of economic fundamentals. They seek to identify macro inefficiencies and imbalances across global markets and then structure investment opportunities around these factors. We believe the discretionary nature of global macro gives it a unique role in the design of a potentially all weather portfolio of alternative investments.

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3. Managed Futures:

KEY POINT

In our view managed futures can contribute to the primary attributes for an all weather portfolio, including strong risk adjusted returns and opportunistic market exposure.

Managed futures represents the third core strategy in alternative investing. This strategy has provided investors with historically low correlation to traditional asset classes on a consistent basis over many years. In our view managed futures can contribute to the primary attributes for an all weather portfolio, including strong risk adjusted returns and opportunistic market exposure. Managed futures strategies trade in the highly liquid futures markets, which often provide a high level of transparency. This strategy may offer a core component in achieving an all weather portfolio design.

Most managed futures managers are primarily trend followers who utilize systematic, computer-driven decision models rather than a discretionary approach. The managed futures asset class includes managers who may trade long or short across all four major asset classes: stocks, bonds, currencies, and commodities. Most futures contracts are exchange traded rather than traded over the counter, resulting in more highly liquid markets as compared to OTC markets. In addition to providing liquidity, this factor can also serve to reduce counterparty risk.

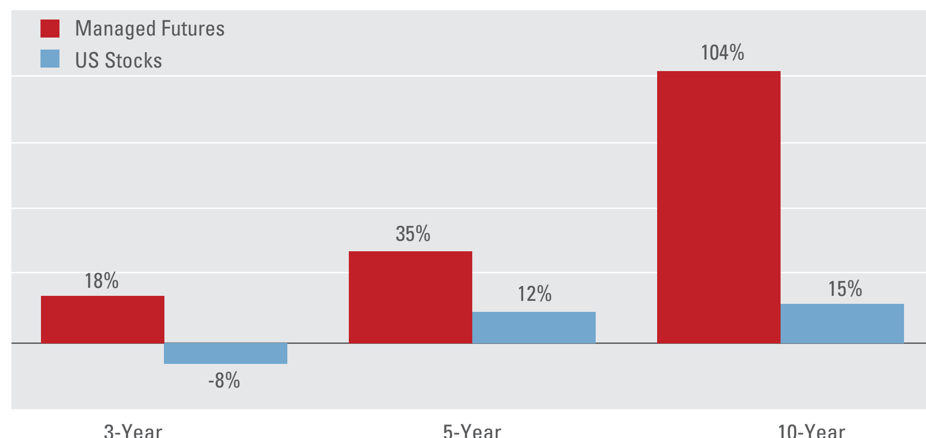
Performance

Over the past 10 years managed futures have outperformed US equities, with managed futures as an asset class delivering returns of up 104% while US stocks were up 15% overall [FIGURE 8]. Although past performance is not a predictor of future returns, managed futures managers have successfully captured gains on the upside, while protecting investors in crises such as the Tech Wreck†, in which managed futures gained 43% while stocks lost -45%. During the period October 2007 to February 2009, managed futures gained 19% while stocks were down -50%.

FIGURE 8.

TOTAL RETURNS: MANAGED FUTURES VS. US STOCKS

Altegris 40 Index vs. S&P 500 Total Return Index | 3-Year, 5-Year and 10-Year Through December 2010



Source: Altegris

† *Date range: September 2000–September 2002.*

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KEY POINT

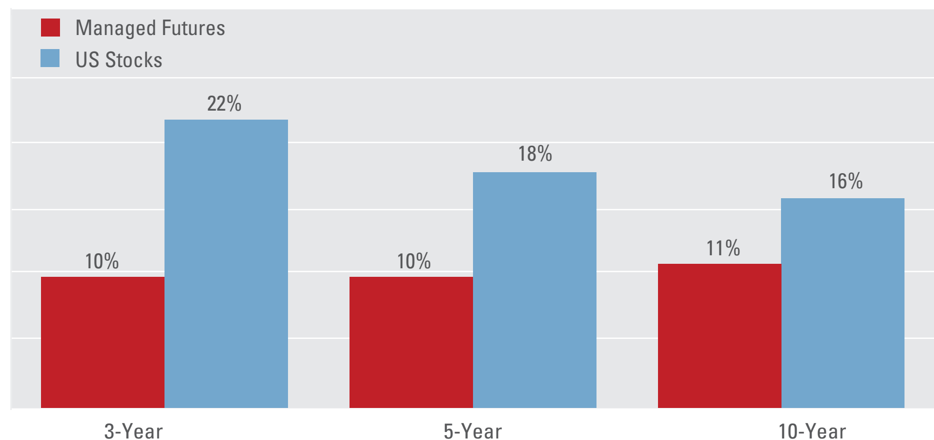
The managed futures strategy has provided investors with historically low correlation to traditional asset classes.

This performance of managed futures as an asset class has historically been achieved with lower volatility of returns as compared to US equities. In fact, over the past three years, the annualized standard deviation of managed futures has been less than half of US equities [FIGURE 9].

FIGURE 9.

STANDARD DEVIATION: MANAGED FUTURES VS. US STOCKS

Altegris 40 Index vs. S&P 500 Total Return Index | 3-Year, 5-Year and 10-Year, Annualized
Through December 2010



Source: Altegris

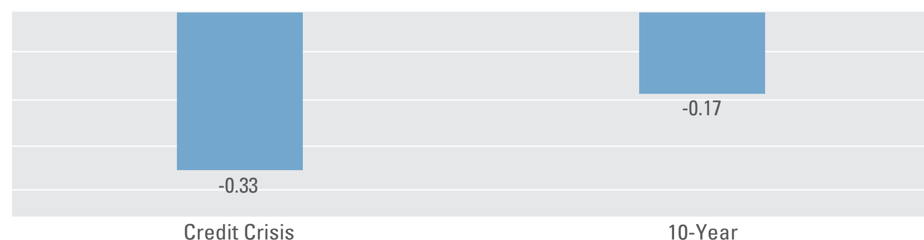
Low Historical Correlation

Over the past ten years, managed futures as an asset class has had an almost zero correlation with the US equities market. In fact, the correlation of managed futures over the past ten years was negative -0.17 with the US stock market. Importantly, during the Credit Crisis managed futures demonstrated an even greater negative correlation of -0.33 with US equities [FIGURE 10]. As equities fell during the Credit Crisis, managed futures delivered positive returns.

FIGURE 10.

CORRELATION: MANAGED FUTURES VS. US STOCKS

Altegris 40 Index vs. S&P 500 Total Return Index | Credit Crisis October 2007-February 2009 | 10-Year
Through December 2010



Source: Altegris

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All Weather Portfolio

In conclusion, we believe it is important to construct your portfolio to possess characteristics that have the potential to perform over all types of market conditions. The essential attributes for what we call the all weather portfolio include:

- Risk-Adjusted Returns
- Opportunistic
- Low Correlation

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- Liquidity

In our view, these attributes may be achieved through suitable investments which draw upon the three core strategies of alternative investing:

- Long/Short Equity
- Global Macro
- Managed Futures

These are what we consider to be core alternative strategies, designed to work across a wide range of market conditions, forming the basis of an effective all weather portfolio [FIGURE 11].

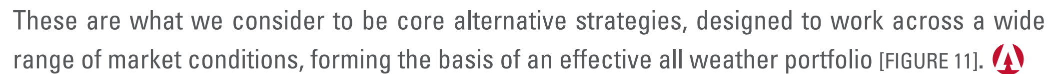

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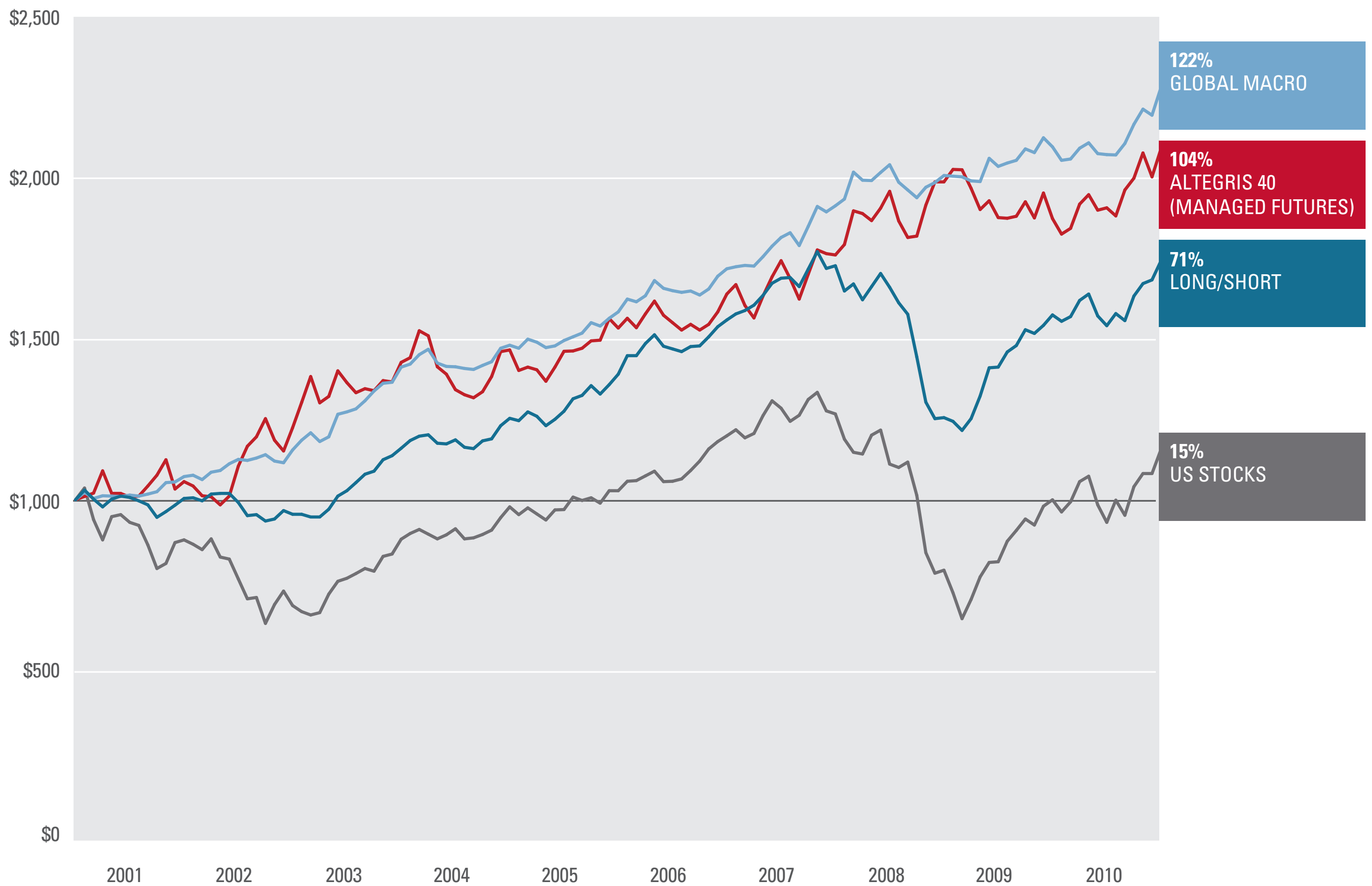
FIGURE 11.

VALUE OF AN INITIAL $1,000 INVESTMENT

HFRI Macro (Total) Index, Altegris 40 Index, HFRI Equity Hedge Index vs. S&P 500 Total Return Index

Through December 2010



Source: Altegris

GLOSSARY

Alpha - Alpha measures the non-systematic return, that which cannot be attributed to the market. It shows the difference between a fund's actual return and its expected return, given its level of systematic (or market) risk (as measured by beta). A positive alpha indicates that the fund has performed better than its beta would predict. Alpha is widely viewed as a measure of the value added or lost by a fund manager.

Altegris 40 Index - The Altegris 40 Index tracks the performance of the 40 leading managed futures programs as reported to managedfutures.com each month. Each month MF.com ranks its' database to find the top 40 Composite CTA Programs based on ending monthly equity for the previous month. MF.com then calculates the dollar-weighted average performance of those 40 programs for the monthly Altegris 40 Index performance. Although the Altegris 40 tracks only 10% of the CTAs who report their performance, their combined equity represents approximately 50% of the equity of the entire managed futures industry.

Beta - A measure of the relationship of a fund's movement relative to a benchmark, such as a market index. Beta is the correlation (a measure of the statistical relationship between fund and benchmark) multiplied by the magnitude of relative volatility of the fund to the benchmark. A fund with a beta of 1.2 relative to a benchmark, for example, is expected to move 12% when the benchmark moves 10%. When the fund is comprised of the same instruments as the benchmark, beta can be thought of as a measure of relative volatility. A low beta does not necessarily indicate that the fund has low volatility, rather, it may indicate that the fund's returns are not related to the movement of the market benchmark.

Correlation - A statistical measure of the degree to which the movements of two variables are related. For example, a hedge fund's returns may have positive or negative correlation with the market.

Counterparty Risk - The risk to each party of a contract that the counterparty will not live up to its contractual obligations. Counterparty risk as a risk to both parties and should be considered when evaluating a contract.

Discretionary Trading - Discretionary trading rely on intuition to decide when to enter or exit a market. While other trading methods emphasize the reading of signals based on formulae or patterns, discretionary trading involves using subjective experiences. They are the polar opposite of Systematic Trading.

Fat Tail - A fat tail is a property of some probability distributions (alternatively referred to as heavy-tailed distributions) exhibiting extremely large kurtosis particularly relative to the ubiquitous normal which itself is an example of an exceptionally thin tail distribution. A high kurtosis portrays a chart with fat tails and a low, even distribution, whereas a low kurtosis portrays a chart with skinny tails and a distribution concentrated toward the mean.

Fundamental Analysis - A method of evaluating a security that entails attempting to measure its intrinsic value by examining related economic, financial and other qualitative and quantitative factors. Fundamental analysts attempt to study everything that can affect the security's value, including macroeconomic factors (like the overall economy and industry conditions) and company-specific factors (like financial condition and management).

HFRI Equity Hedge Index - Equity Hedge investing consists of a core holding of long equities hedged at all times with short sales of stocks and/or stock index options. Some managers maintain a substantial portion of assets within a hedged structure and commonly employ leverage. Where short sales are used, hedged assets may be comprised of an equal dollar value of long and short stock positions. Other variations use short sales unrelated to long holdings and/or puts on the S&P 500 index and put spreads. Conservative funds mitigate market risk by maintaining market exposure from zero to 100 percent. Aggressive funds may magnify market risk by exceeding 100 percent exposure and, in some instances, maintain a short exposure. In addition to equities, some funds may have limited assets invested in other types of securities.

Leverage - When investors borrow funds to increase the amount that they have invested in a particular position, they use leverage. Investors use leverage when they believe that the return from the position will exceed the cost of the borrowed funds. Sometimes, managers use leverage to enable them to take on new positions without having to liquidate other positions prematurely. Leverage can effectively increase the potential for higher capital gain returns on investment capital, but can also increase the risk of greater capital loss.

Liquidity - The ability to exit positions on demand. Many hedge funds may not want to or may not be able to exit positions on demand. Redemptions are normally limited to once a week, once a month, or even longer periods.

S&P 500 Total Return Index - This 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.

Standard Deviation - A measure of the dispersion of a set of data from its mean. The more spread apart the data, the higher the deviation. Standard deviation is applied to the annual rate of return of an investment to measure the investment's volatility. Standard deviation is also known as historical volatility and is used by investors as a gauge for the amount of expected volatility.

Systematic Trading - Systematic trading utilizes computer models, mainly based on technical analysis of market data or fundamental economic data, to identify and make trades, with limited manager intervention. They are the polar opposite of Discretionary Trading.

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.

Important Risk Disclosure

Alternative investment products, including hedge funds and managed futures, are not for everyone and entail risks that differ from more traditional investments. When considering alternative investments you should consider the fact that some products use leverage and other speculative investment practices that may increase the risk of investment loss, can be illiquid, are not required to provide periodic pricing or valuation information to investors, may involve complex tax structures and delays in distributing important tax information, are not subject to the same regulatory requirements as mutual funds, often charge high fees including incentive fees, and in many cases have underlying investments that are not transparent and are known only to the investment manager. With respect to alternative investments in general, you should be aware that:

- *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*

An investment's offering materials describes the various risks and conflicts of interest relating to an investment and to its operations. You should read those documents carefully to determine whether an investment is suitable for you in light of, among other things, your financial situation, need for liquidity, tax situation, and other investments. You should only commit risk capital to alternative investments. You should obtain investment and tax advice from your advisors before deciding to invest. The material and any views expressed herein are provided for information purposes only and should not be construed in any way as an inducement to make any investment.

About Altegris

Altegris has one core mission—to find the best alternative investments for our clients. Altegris offers what we believe are straightforward and efficient solutions for financial professionals and individual 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, selecting, 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 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 Companies, wholly owned subsidiaries of Genworth Financial, Inc., include Altegris Investments, Altegris Advisors, Altegris Funds, and Altegris Clearing Solutions. Altegris currently has approximately $2.2 billion in client assets, and provides clearing services to $800 million in institutional client assets.*

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Genworth Financial, Inc. (NYSE:GNW) is a leading Fortune 500 global financial security company. Genworth has more than $100 billion in assets and employs approximately 6,000 people with a presence in more than 25 countries. Its products and services help meet the investment, protection, retirement and lifestyle needs of more than 15 million customers.

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