Managed Futures

Q1 2011 Market Commentary

Overview

Q1 2011 was a disappointing quarter for managed futures as event-driven markets led to unfavorable trading conditions. As represented by the Altegris 40 Index[SM], managed futures returned -1.5%, driven largely by trend following as well as short-term systematic managers. By comparison, equities (as represented by the S&P 500 Total Return Index) were up 5.9%, while bonds (as represented by the Barclays Aggregate Bond Index) were up a marginal 0.4% (Figure 1).

Figure 1.
MANAGED FUTURES PERFORMANCE VERSUS INDICES
Quarterly, Annual and 10-Year Returns through March 2011

	Quarterly Returns 2011	Annual Returns			10-Year Returns April 2001–March 2011			
	Q1 Return	2010 Return	2009 Return	2008 Return	Total Return	Ann ROR	Std Dev	Max DD
Altegris 40 Index	*-1.50%*	11.33%	-7.98%	15.47%	*85.25%*	*6.36%*	*10.95%*	-13.24%
HFRI Fund Weighted Composite Index	*1.44%*	*10.26%*	19.98%	-19.03%	*99.15%*	*7.13%*	*6.32%*	-21.42%
S&P 500 Total Return Index	5.92%	15.06%	26.46%	-37.00%	38.28%	3.29%	15.98%	-50.95%
Barclays US Aggregate Composite Bond Index	0.43%	6.56%	5.93%	5.24%	71.92%	5.57%	3.79%	-3.82%
MSCI EAFE Index (Net)	3.36%	7.75%	31.78%	-43.38%	68.99%	5.39%	18.36%	-56.68%
NAREIT Composite Index	6.98%	27.55%	27.79%	-37.84%	181.32%	10.90%	23.97%	-68.17%
GSCI Total Return Index	11.57%	9.02%	13.67%	-46.49%	48.44%	4.03%	25.05%	-67.65%

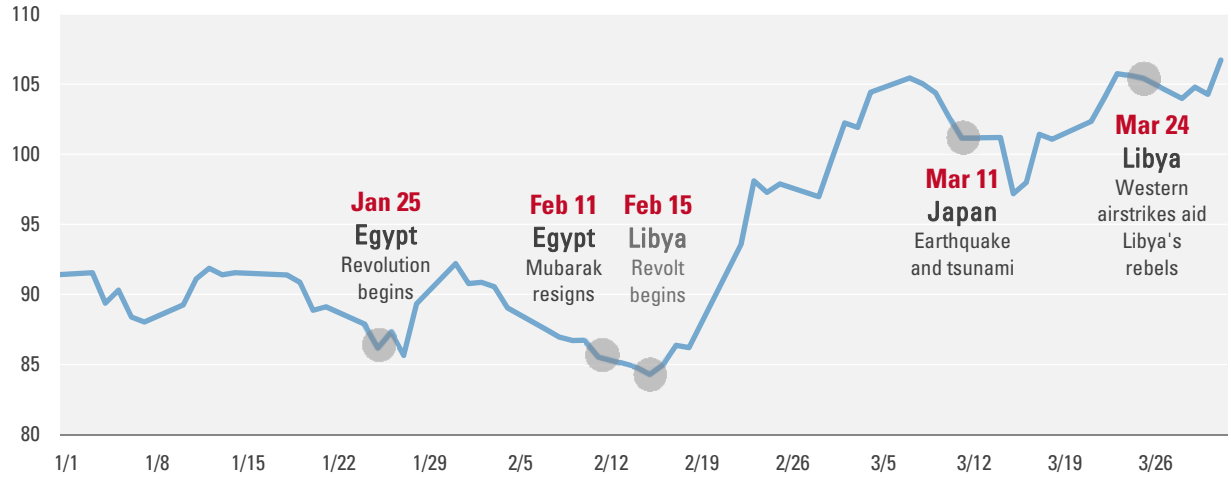
** Estimates as of April 12, 2011. PAST PERFORMANCE IS NOT NECESSARILY INDICATIVE OF FUTURE RESULTS. There is no guarantee that any investment product with achieve its objectives, generate profits or avoid losses. SOURCE: Altegris.*

Event-Driven Markets

During the fourth quarter of 2010, the US Federal Reserve injected its version of financial adrenaline (aka Quantitative Easing Round 2, or "QE2") into the economy. Aided by burgeoning emerging market demand, QE2 led to global asset price inflation, causing stock indices, commodities, and higher-yielding commodity currencies to rally through year-end 2010. While geopolitical concerns along with resolute deflationary pressures were certainly present, overall, the markets were trending towards a reflationary environment. As a result, the vast majority of managed futures managers entered 2011 positioned "long" the global economy.

With the start of the New Year came the beginning of a series of exogenous events. While many certainly celebrated the democratization of the largest country in the Middle East, Egypt's quest for democracy in late January sent shockwaves across multiple futures markets. The price of oil, the region's most lucrative export, vacillated as tensions spiked and then abated once Egypt's dictator finally relented. Moments of excitement were soon met with concern as the prospect of revolution spread to a country with a far more stubborn dictator: Libya's Gaddafi. As Libya's revolt turned into civil war, oil futures' closed at $106 a barrel in March (a 17% rise on the quarter) as supply concerns impacted industries and consumers across the globe (Figure 2).

Figure 2.
EVENT-DRIVEN PRICE ACTION: CRUDE OIL FRONT MONTH FUTURES
January 2011–March 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: Bloomberg and Altegris.

The spike in oil only exacerbated the potential for even further asset price inflation; a positive for trend following managers positioned long energy. The impact is significant. This is because oil is used to make goods. Oil is used to farm goods. Oil is used to get goods from one place to another. Oil is used to get people from one place to another, and with gas priced at over $4 a gallon in the US, the increased price of oil has hit the proverbial pocketbook with a thud.

Adding to the event-driven quarter was Japan's 9.0 earthquake on March 11th, which devastated Sendai, Japan and other neighboring towns north of Tokyo. With it came a massive tsunami and the possibility of a nuclear meltdown. The Nikkei collapsed and other stock indices followed along with commodities (notably precious metals). In the coming days, bonds rallied, and the dollar fell to its lowest level against the yen in sixteen years, sending many managed futures managers near their worst single-day drawdown in recent memory.

While the quarter was clearly rife with short-term events, there is not yet cause for alarm. Several weeks of geopolitical news coupled with natural disasters does not necessarily mean that global financial markets are headed for trouble. Although lingering concerns regarding the global debt crisis have yet to subside and exogenous events risk remains unpredictable, the structural soundness of the current economic recovery appears to be on relatively stable footing...for now.

Impact on Managed Futures

In light of the current event-driven market environment, managed futures managers' performance for the first quarter of 2011 varied depending on each manager's core strategy. A handful of short-term systematic managers weathered the quarter well, capitalizing on bursts of short-term momentum across several markets, while most found the environment decidedly less favorable. Discretionary commodity managers were a mixed bag; managers who reigned in risk post the Q4 2010 rally outperformed their peers with higher commodity market exposure.

While a hallmark of managed futures has always been the asset class's historically low correlation to traditional markets, it is important to remember that low correlation does not equal negative correlation, especially in the short-term.

Lastly, trend following managers overall experienced a difficult Q1. By definition, trend following managers typically follow medium- to longer-term trends. In very short-term windows, such as days or weeks, managed futures may be highly correlated with traditional markets. When trends reverse, trend following programs will likely suffer short-term losses alongside their traditional market peers just as they have this past quarter. The good news is that trend following systems are reactive, and designed to determine when to continue with an existing trend, or follow a new trend in another direction. It is important to be patient during these potential inflection points, and understand that low correlation is created over long periods of time. While a hallmark of managed futures has always been the asset class's historically low correlation to traditional markets, it is important to remember that low correlation does not equal negative correlation, especially in the short-term.

Strategy Summary

Specialized: Short-Term Systematic

Short-term systematic managers are a specialized and diverse subset of managed futures managers, representing roughly 15% of the Altegris 40 Index during the first quarter of 2011. These managers attempt to capitalize on short-term price movements using a number of technical models including, but not limited to mean reversion, moving oscillators, volatility breakout, pattern recognition, channel breakout, and countertrend.

While there are a variety of models that short-term systematic managers employ, all managers in this category generally trade in shorter time windows than their longer-term oriented trend following peers. Some managers may trade intraday while others may hold positions across several weeks. Given the eclectic nature of short-term systematic managers, the dispersion of returns from manager to manager varies widely depending on the subtleties of their respective systems and time frames utilized.

REPRESENTATIVE SHORT-TERM SYSTEMATIC MODELS

Mean Reversion. These systems are based on the premise that the price of a futures contract will eventually move back towards the historical average price of that contract. This strategy seeks to profit when a price reverses and moves back towards its recent historical average.[1]

Countertrend Systems. Actively looks for a reversal in a current trend in the context of a short-term time frame. Contrarians tend to buy or sell before the trend actually reverses–a contrarian will buy or sell if the market is still trending in the opposite direction because most other market participants are selling in anticipation that the trend will reverse sooner than later.[2]

Moving Oscillator. Also called "momentum indicator" or "rate of change indicator." These systems seek to measure the speed, or strength of a price movement, which is believed to be indicative of the strength of a trend (and a good measure for the likelihood for a continuation of that trend). These models typically work by comparing the most recent price to either a moving average of historical prices, or the most recent prices.[3]

Volatility Breakout Models. These models are a type of trend following breakout system, which, in the context of a short-term system, will focus on a trend of a few to several days. These systems are based on the premise that if the price of a futures contract moves by a certain percentage or amount from the previous price (an amount that is considered to be statistically significant), then it is indicative of an emerging trend and the price of the contract is likely to continue to in the same direction.[4]

Channel Breakout. These models are a type of trend following price break-out system, which, in the context of a short-term system, will focus on a trend of a few to several days. These models establish an upper and lower band for a price of a futures contract based on a historical moving average of that contract's high and low prices. If the price of a futures contract moves to a new high or low outside of the band, then it is indicative of an emerging trend and the price of the contract is likely to continue to move in the same direction.[5]

Pattern Recognition. These models seek to identify a repetitive series of price movements in historical prices (a pattern) in order to develop a probabilistic forecast for a future movement in the market.[6]

True to their nature, short-term systematic manager returns across Q1 varied significantly. Some managers found Q1 to be modestly profitable, while most found the quarter's price action to be unfavorable.

Front month copper futures are a perfect example of a contract that was both ripe for opportunity and disappointment during Q1 for short-term systematic managers. Copper futures are a liquid market in which a large amount of managed futures managers trade. Copper is also at the nexus of the global reflation argument, and as such, its volatility resulted from a trifecta of influences: fundamental supply and demand shifts, macroeconomic influences, as well as event risk associated with Japan and the Middle East.

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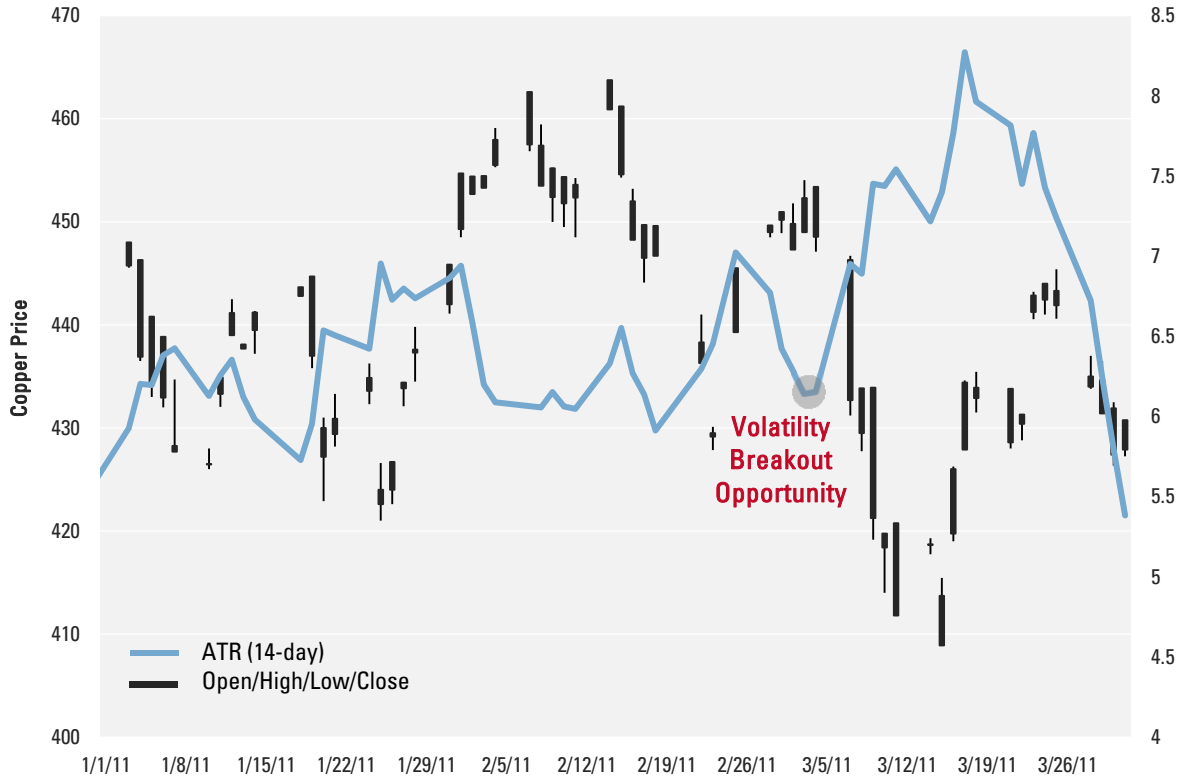
After reaching a closing high of $463.75 (US dollars/lb) on February 14th, the contract tumbled over 7% over the following nine days as declining imports from China coupled with large exchange stores of copper led investors to perceive the metal to be overpriced. As a result, copper imports fell to their lowest level since November 2008 after months of economic recovery driven price gains.[7]

While the contract's price rose later in February, it declined -50bps on March 14th, with an additional decline of -1.18% on March 15th as earthquake aftershocks were felt not only on the ground in Japan, but in the markets as well. The unstable metal then rose 1.46% on March 16th, and then rose another 3.49% on March 17th as investor unease subsided. By quarter end, the contract had recovered much of its previous losses.

Clearly, the daily price action in copper futures was quite volatile. Taking this analysis a step further, it is important to review exactly what volatility means. In fact, there are many ways to measure volatility. The VIX Index is used as a frequent proxy for equity market volatility. Standard deviation is also a frequently used method for measuring volatility; however, standard deviation only accounts for changes in daily closing prices and not intraday moves. In our opinion, one of the best measures of short-term volatility comes in the form of Average True Range (or ATR) which takes into account intraday data.[8] While the VIX Index is a fantastic measure of implied volatility (or how much a position is going to move in the future) for the equity market, ATR measures actual daily volatility of any type of trading instrument. ATR is therefore particularly helpful when looking at futures market volatility over a short period of time.[9]

Viewing front month copper futures, one can see how volatility, as measured by ATR, was fairly constant until mid-February (Figure 3). From that point on, the contract's volatility spiked then declined several times through quarter end due to events in the Middle East as well as the Japanese earthquake. Volatility breakout models were profitable for several managers during this volatile quarter as systems detected the persistence of a short-term trend in early March, entered the trade on its downward move, and then captured profits over the next few trading days.

Figure 3.
FRONT MONTH COPPER ATR (14-DAY)
January 2011–March 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: Bloomberg and Altegris.

While the quarter's volatility presented several breakout opportunities, mean reversion or countertrend trading was very difficult for short-term systematic managers' programs. For instance, several managers mean-reversion models generated signals to "double down" on copper futures contracts over the quarter, buying more contracts as the price of copper futures declined. However, it took over thirty-three trading days before the trade reverted, and only a handful of managers held onto the position long enough to be profitable. Most managers systems signaled to sell copper after a few days as significant losses accumulated. When the contract recovered, these managers were not positioned to capitalize on upside opportunity.

Copper's price action is a microcosm of the overall futures landscape during Q1. The result was significantly varied returns among short-term systematic managers depending on the nuances of their models. As a group, short-term systematic managers returned -2.25% for the quarter as represented by the AlternativeEdge Short-Term Traders Index.[10]

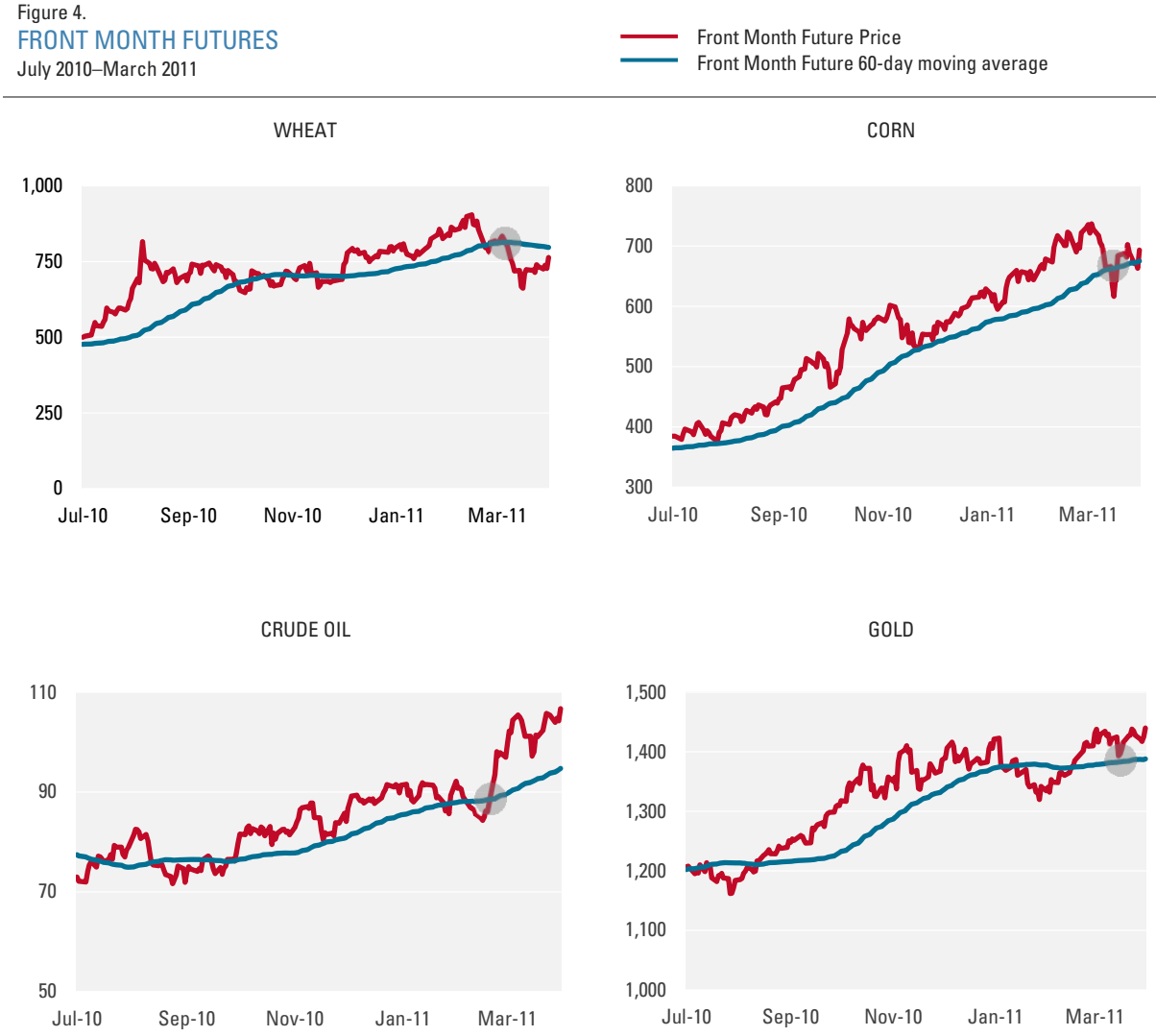
Specialized: Discretionary Commodity Trading

Q1 2011 was a mixed bag for discretionary commodity managers. Driven largely by event risk, directional commodity traders watched their positions get whipsawed on a frequent basis as volatile markets limited profit potential. On the other hand, managers who reigned in risk or structured spread trades were more profitable overall. For the quarter, discretionary commodity managers were up 0.85% as represented by the Barclay Discretionary Traders Index.

While the quarter was volatile, prospects for Q2 appear to be more sanguine for commodity futures, beginning with positive fundamental news out of the US Department of Agriculture's (USDA). The USDA quarterly report released on March 31st, 2011[11] signaled for tighter than expected crop supplies. As an example, the USDA reported that corn bushels were down 15% from March 1, 2010 to March 1, 2011 as the result of freezing winter weather in Mexico.[12] Additional concerns over upcoming spring weather, from unwelcome wet weather in the Plains states to dry weather in the Southeast, have also affected corn supply. As markets digested the USDA report's news sighting supply constraints for the crop, front month corn futures jumped over 4% on March 31st.

With supplies tightening globally and demand for commodities rising out of emerging markets, the natural consequence is an increase in commodity prices. In fact, several commodity futures markets crossed their 60-day moving average towards quarter end, a bullish sign that discretionary traders should capitalize upon in the coming months (Figure 4).

Figure 4.
FRONT MONTH FUTURES
July 2010–March 2011



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By quarter end there was certainly a sense in the markets that the earthquake induced commodity reversal of 2010 was temporary. The posture of commodity markets again appears to be bullish due to increased signs of economic recovery alongside tight supplies and increasing demand. Technical indicators of upward momentum coupled with the experienced decision making of discretionary commodity traders should lead to a profitable second quarter; however, as we have seen recently, markets are highly susceptible to large swings.

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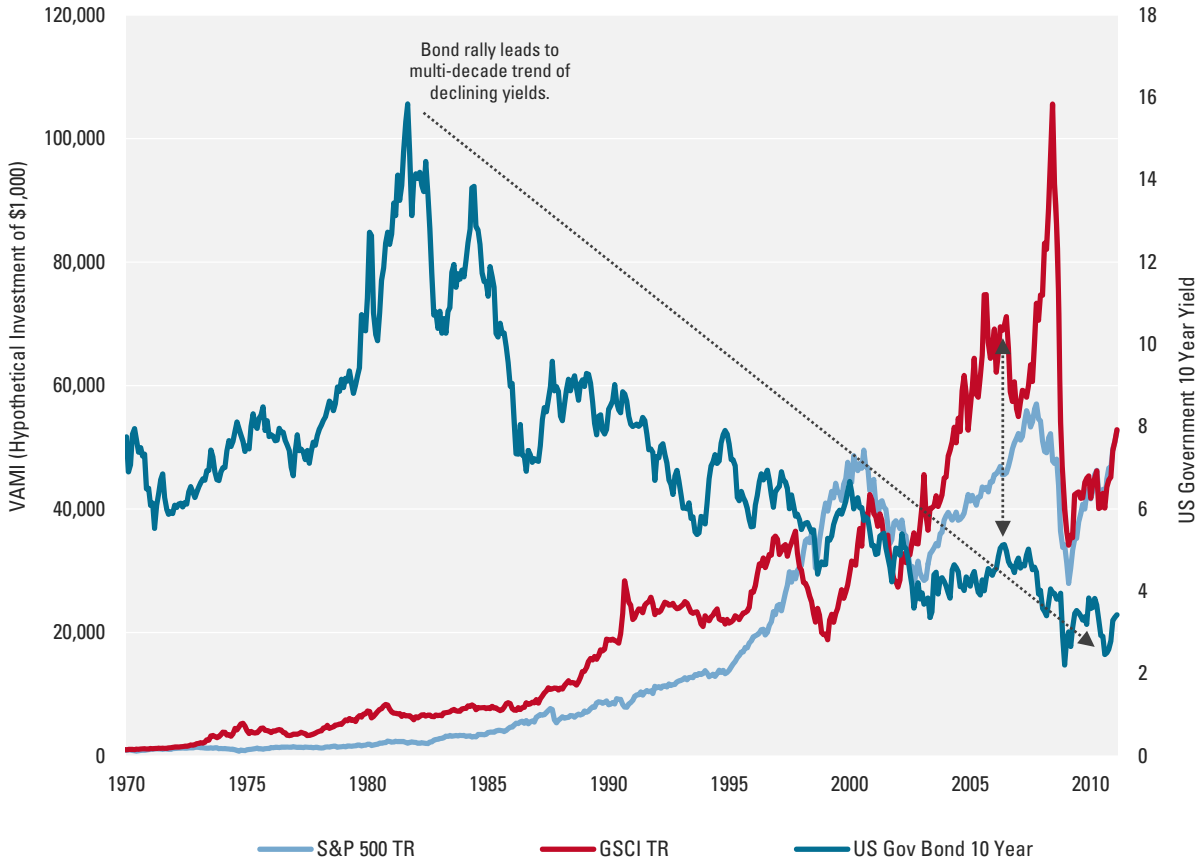
Trend Following

In our *Managed Futures Q4 2010 Market Commentary*, we discussed how trend following managers were well positioned for global growth. Specifically we stated that the potential for inflation was far stronger, deflationary forces were weaker, and fundamental (supply and demand) influences in the commodity markets were pushing futures markets to new highs. As a result, trend following managers were generally long commodity and stock index futures towards the end of 2010. We also discussed how while trends should continue into 2011, sharp reversals were likely, and this was indeed the case in Q1 2011. The recent crises in the Middle East as well as Japan caused significant movement in futures markets' prices, and as expected, trend following managers' performance was volatile.

However, it would be naïve to think that recent volatility was simply a by-product of exogenous global events. Rather, recent volatility was also because the direction of current trends is one-way only: long the global economy. The implications are particularly salient now because if the trends were to reverse course significantly, trend following managers may not have the same exposure to uncorrelated trends as they have in the past.

This is because over the last 30 years, the US government bond market presented a persistent long-term trend for managed futures managers. Accommodative US Federal Reserve policy pushed yields to lower and lower levels through the years in order to incite spending and hence economic growth. Consequently, bond yields declined over the long-term (Figure 5), providing significant profit opportunities since the early 1980s.

Figure 5.
VAMI [S&P 500 TR & GSCI TR] VERSUS US 10-YEAR GOVERNMENT BOND YIELD
January 1970–March 2011



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Perhaps more importantly, following this US government bond trend has provided a "natural hedge" within trend following portfolios. Due to the continued downtrend in yields, trend following managers were long government bonds. Profits garnered from US government bond futures often offset losses from other less enduring trends. For example, given the historically inverse relationship between US government bonds and the stock market, if the stock market were to decline, trend following managers would likely lose money on long stock index trades. However, in a flight to quality, US government bond futures typically rally, providing gains to compensate for equity related losses. As global growth continues and inflation risks grow, many trend following managers are reacting by accumulating short positions in sovereign fixed income contracts. Since trend following managers have now significantly decreased exposure or are short longer-dated fixed income contracts, this natural hedge may no longer be present in trend following portfolios.

The lack of a natural hedge does not imply that trend following profit opportunities are less abundant; rather, it could mean that lower portfolio diversification translates to less downside protection intrinsic to trend following portfolios. One possible result of this scenario is that trend following managers systems reign in risk, reducing their exposure and attempting to make portfolios less susceptible to extreme market swings.

> Managers whose systems reduced risk the most fared much better over the quarter than managers who maintained higher levels of margin to equity exposure.

Risk reduction is a more recent phenomenon we have witnessed in several trend following portfolios, and managers whose systems reduced risk the most fared much better over the quarter than managers who maintained higher levels of margin to equity exposure. Nonetheless, this was a difficult period for most trend following managers with marquee manager returns varying from up 8% percent to down over 14% for the quarter.

Conclusion

Markets were clearly dominated by exogenous shocks in Q1 2011. While there is always event risk, there are less transient risks present as well, particularly in regards to global debt levels. Nonetheless, we believe that global growth will likely continue despite these hiccups. A possible scenario is that the long economy trade abates and becomes more of a "trend growth" or normalized growth trade.

As emerging market economies transition from significant GDP increases to a more a stable economic growth pattern, commodity prices may continue to increase, but perhaps to a lesser extent. Likewise, as the effects of QE2 subside, the US recovery may shift to a more natural economic growth phase that is free of loaded stimulus measures. Overall, we are optimistic on both the economy and the potential for managed futures to outperform; however, given the macro landscape coupled with the potential for further geopolitical as well as sovereign debt risks, managed futures returns may be volatile.

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.
Alternative Edge Short-Term Traders	The Alternative Edge Short-Term Traders Index is designed to track the daily performance of a portfolio of CTAs and global macro managers executing diversified trading strategies with a less than 10-day average holding period.
Barclay Discretionary	The Barclay Discretionary Traders Index is an equal weighted composite of managed programs whose approach is at least 65% discretionary or judgmental. In 2011 there are 150 discretionary programs included in the index.
Barclays US Aggregate	The Barclays Capital US 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.
GSCI	The GSCI Total Return Index measures a fully collateralized commodity futures investment. Currently, the GSCI includes 24 commodity nearby futures contracts.
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.
MCSI EAFE	The MSCI 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.
NAREIT	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.
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 US 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.
VIX	VIX is the ticker symbol for the Chicago Board Options Exchange (CBOE) Volatility Index, which shows the market's expectation of 30-day volatility. It is constructed using the implied volatilities of a wide range of S&P 500 index options. This volatility is meant to be forward looking and is calculated from both calls and puts. The VIX is a widely used measure of market risk and is often referred to as the "investor fear gauge". There are three variations of volatility indexes: the VIX tracks the S&P 500, the VXN tracks the Nasdaq 100 and the VXD tracks the Dow Jones Industrial Average.

NOTES

1 *http://www.investopedia.com/terms/m/meanreversion.asp; http://www.iasg.com/education/definitions-formulas*
2 *http://www.cmegroup.com/education/modules/managed-futures/equinox/files/diversifying_mfs.pdf; http://www.investopedia.com/articles/forex/08/directional-trading-strategies.asp*
3 *http://daytrading.about.com/od/indicators/a/Momentum.htm; http://www.trade10.com/momentum_indicators.htm; http://www.investopedia.com/terms/s/stochasticoscillator.asp*
4 *http://www.traderslog.com/volatility-breakout-systems*
5 *http://www.trading-systems.pro/wp-content/uploads/44_45_46_47_48_e_tra10_jaekle.pdf; http://www.investopedia.com/terms/d/donchianchannels.asp; http://blog.nobletrading.com/2010/04/donchian-channel-trend-indicator.html*
6 *http://www.opalesque.com/OFI1154/Founders_does_pattern_recognition_A_pioneer154.html; http://www.iasg.com/education/definitions-formulas*
7 *"Copper Enters the No-Fly Zone," March 24, 2011, WSJ Online*
8 *As defined by Welles Wilder, 1978 with definitions provided by Investopedia.com*
9 *ATR Calculation: The first step in the calculation of ATR is determining a data stream's True Range. True Range is calculated by taking a data steam's largest value on a daily basis for:*
- *Recent period's high less the most recent period's low,*
- *Absolute value of the most recent period's high less the previous close,*
- *Absolute value of the most recent period's low less the previous close*

The next step is to smooth the data utilizing an exponential moving average of 14 days (or more) to come up with a handy statistic for short-term volatility.
10 *The Alternative Edge Short-Term Traders Index is designed to track the daily performance of a portfolio of CTAs and global macro managers executing diversified trading strategies with a less than 10-day average holding period.*
11 *"Agriculture Futures Surge on Crop Reports," WSJ, March 31, 2011*
12 *Released March 31, 2011, by the National Agricultural Statistics Service (NASS), Agricultural Statistics Board, United States Department of Agriculture (USDA)*

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 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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Hedge funds, commodity pools and other alternative investments involve a high degree of risk and can be illiquid due to restrictions on transfer and lack of a secondary trading market. They can be highly leveraged, speculative and volatile, and an investor could lose all or a substantial amount of an investment. Alternative investments may lack transparency as to share price, valuation and portfolio holdings. Complex tax structures often result in delayed tax reporting. Compared to mutual funds, hedge funds and commodity pools are subject to less regulation and often charge higher fees. Alternative investment managers typically exercise broad investment discretion and may apply similar strategies across multiple investment vehicles, resulting in less diversification. Trading may occur outside the United States which may pose greater risks than trading on U.S. exchanges and in U.S. markets. PAST RESULTS ARE NOT NECESSARILY INDICATIVE OF FUTURE RESULTS.

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