ALTEGRIS ACADEMY
RESEARCH SERIES

Managed Futures: Staying the Course

Short-term Drawdowns, Long-term Focus

May 2011

"An investment in knowledge always pays the best interest."

~Benjamin Franklin

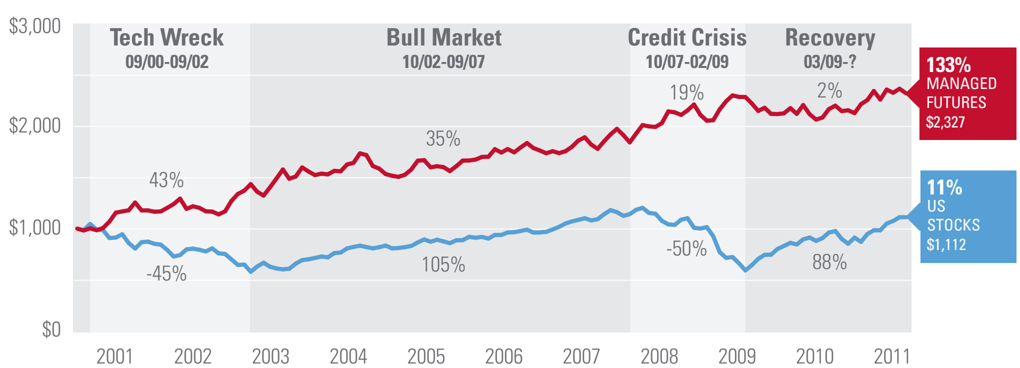
The Long-Term Benefits of Managed Futures

Managed futures have historically exhibited very low correlation to traditional investments, generating strong absolute returns across market cycles. Investors have long recognized these diversification benefits, but until recently, the asset class has largely been unavailable to the broader investment community. With innovations in the mutual fund industry now making the potential benefits of managed futures more accessible, investors previously unfamiliar with the asset class are now able to more easily access the strategy.

Investor demand for managed futures has increased significantly in recent years, as the potential diversification benefits of the asset class were highlighted during the credit crisis. From October 2007 to February 2009, managed futures generated double-digit returns while the stock market, as represented by the S&P 500 Total Return Index, lost approximately half of its value. As illustrated below (FIGURE 1), this dynamic was not unique to the recent crisis, but also was exhibited during the tech wreck in the early 2000s.

FIGURE 1.

MANAGED FUTURES PERFORMANCE DURING CRISIS PERIODS:
VALUE OF AN INITIAL $1,000 INVESTMENT July 2000–March 2011



PAST PERFORMANCE IS NOT INDICATIVE OF FUTURE RESULTS. US stocks represented by S&P 500 Total Return Index; managed futures represented by Altegris 40 Index, which was started in July 2000. The referenced indices are shown for general market comparisons and are not meant to represent any particular investment. Source: Altegris.

The Impact of Short-Term Drawdowns

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KEY POINT

Like other asset classes, managed futures too are subject to drawdowns, a phrase used to describe the percentage of value lost from the highest (peak) to lowest (trough) point.

While the potential benefits of managed futures have been well established, investors should be aware that these benefits typically accrue over the long-term. This is because managed futures are not immune from their own volatility. Like other asset classes, managed futures too are subject to drawdowns, a phrase used to describe the percentage of value lost from the highest (peak) to lowest (trough) point. To illustrate this concept, US stocks (as measured by the S&P 500 Total Return Index) experienced a drawdown of -50% during the credit crisis that lasted from October 2007–February 2009 (16 months). Managed futures experience drawdowns because markets do not move in a straight line, nor do trends persist indefinitely. As a primarily trend following strategy, managed futures will often suffer short-term losses during sharp corrections and/or trend reversals. The good news is that trend following systems are reactive, and are designed to determine when to continue with an existing trend, or to reverse positions and follow a new trend in the opposite direction.

It is important to be patient during these inflection points, and understand that the potential benefits of managed futures are typically realized over longer periods of time. Investors should be prepared for the inevitable short-term downdrafts. Premature redemption during periods of short-term volatility would crystallize losses and cause an investor to miss out on the longer term diversification benefits that historically have been available. Unfortunately, behavioral finance has proven academically that investors are subject to “myopic loss aversion,” a phrase used to describe the tendency of investors to be more sensitive to losses than to gains, especially in the short-term. Focusing on the negative effects of recent losses often results in investors buying high and selling low, which is the exact opposite approach that results in positive portfolio returns.

ALTEGRIS 40 INDEX℠

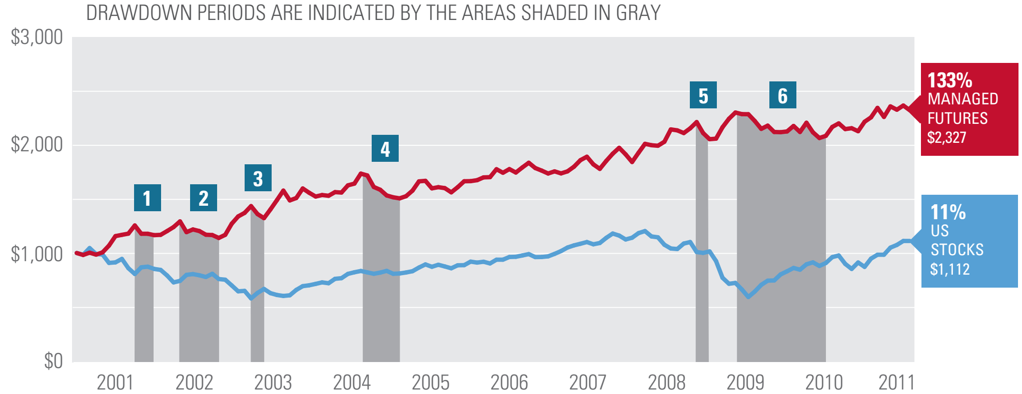
The Altegris 40 Index tracks the performance of the 40 leading managed futures programs, by ending monthly equity (assets) for the previous month, as tracked by Altegris. The Altegris 40 Index represents the dollar-weighted average performance of those 40 programs.

FIGURE 2.

PERFORMANCE COMPARISON: MANAGED FUTURES VS. US STOCKS

Value of an Initial US $1,000 Investment: Altegris 40 Index vs. S&P 500 Total Return Index

July 2000–March 2011



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KEY POINT

The potential benefits of managed futures are typically realized over longer periods of time.

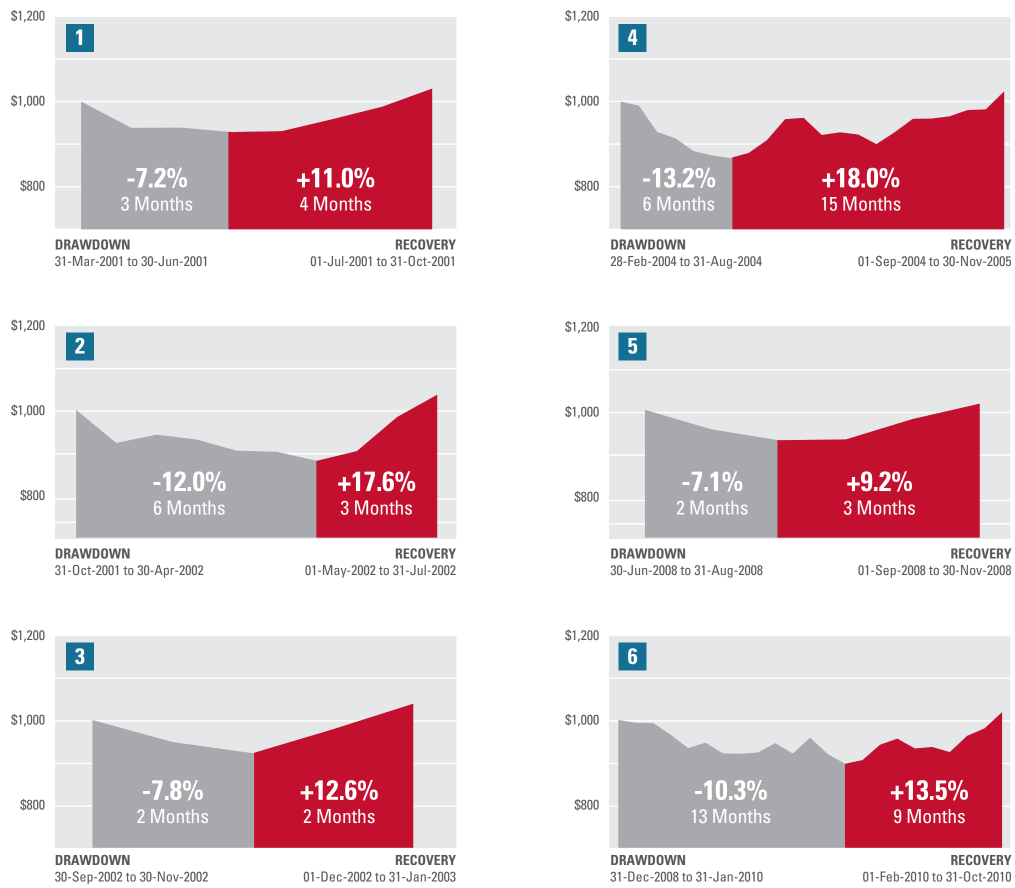
Highlighted on the previous page are the six largest drawdowns experienced by the Altegris 40 Index since its inception in July 2000 (Figure 2). While long-term investors were ultimately rewarded with strong absolute returns, these short-term losses were often sharp enough to make even the most rational investors question their allocations.

These losses have historically been short-lived, and managed futures have often exhibited some of their strongest performance following their largest drawdowns. Of course, past performance is not indicative of future results. The charts below (FIGURE 3) isolate the six largest drawdowns highlighted in the previous chart. As you can see, investors who maintained their allocations were ultimately rewarded with strong subsequent performance, while investors who redeemed due to short-term volatility may have missed out on some of the subsequent rallies for the strategy.

FIGURE 3.

TOP SIX HISTORICAL DRAWDOWNS AND RECOVERY PERIODS OF MANAGED FUTURES

Since July 2000.



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altegris

KEY POINT

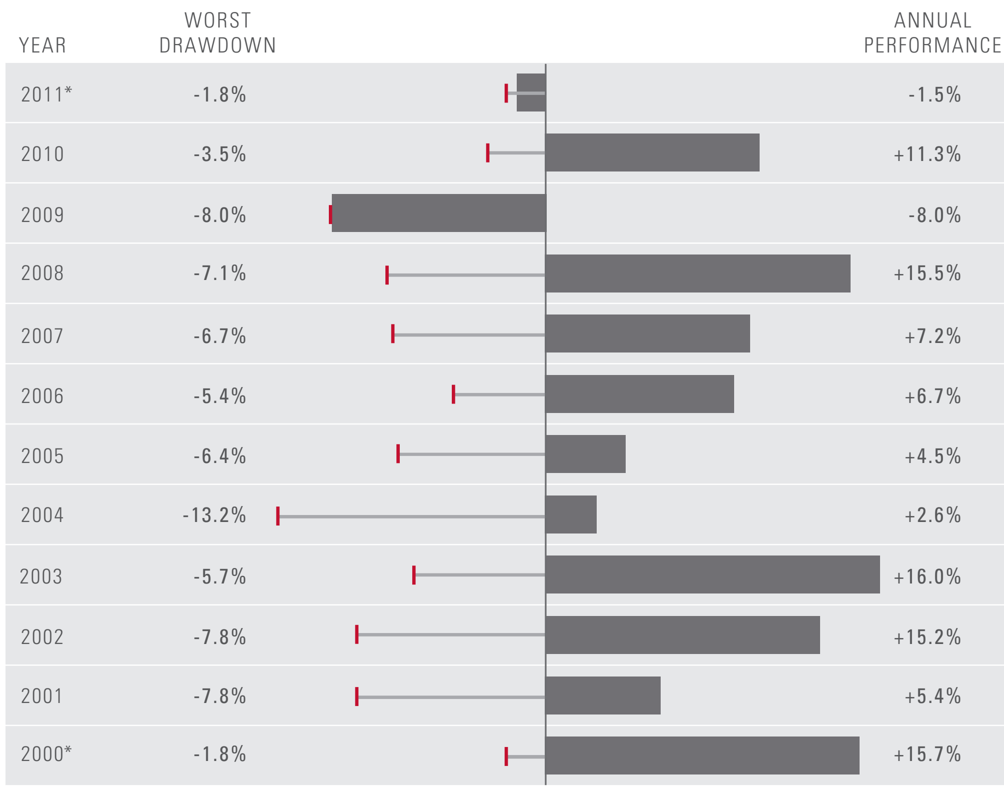
Short-term drawdowns and recoveries actually are historically common in managed futures.

These short-term drawdowns and recoveries actually are historically common in managed futures. The chart below compares the calendar year performance of the Altegris 40 Index to the maximum drawdown that occurred during the same year (FIGURE 4). What is surprising is that even during years when managed futures produced double-digit returns, the path taken to achieve these strong results often included intra-year drawdowns in the high single-digits.

FIGURE 4.

ANNUAL PERFORMANCE OF MANAGED FUTURES AND THE LARGEST MONTHLY DRAWDOWN DURING THAT YEAR

July 2000–March 2011



** Represent partial years.*

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Staying the Course

In order to enjoy the compelling long-term potential benefits of managed futures, investors should be aware of the frequency and magnitude of possible short-term drawdowns. Over any given 12-month window, managed futures investors have historically had to weather a short-term drawdown greater than 7% on average. Despite these frequent drawdowns, investors who were able to maintain broadly-diversified investments in managed futures for the full 12-month rolling period were ultimately rewarded with an average return of more than 8%.

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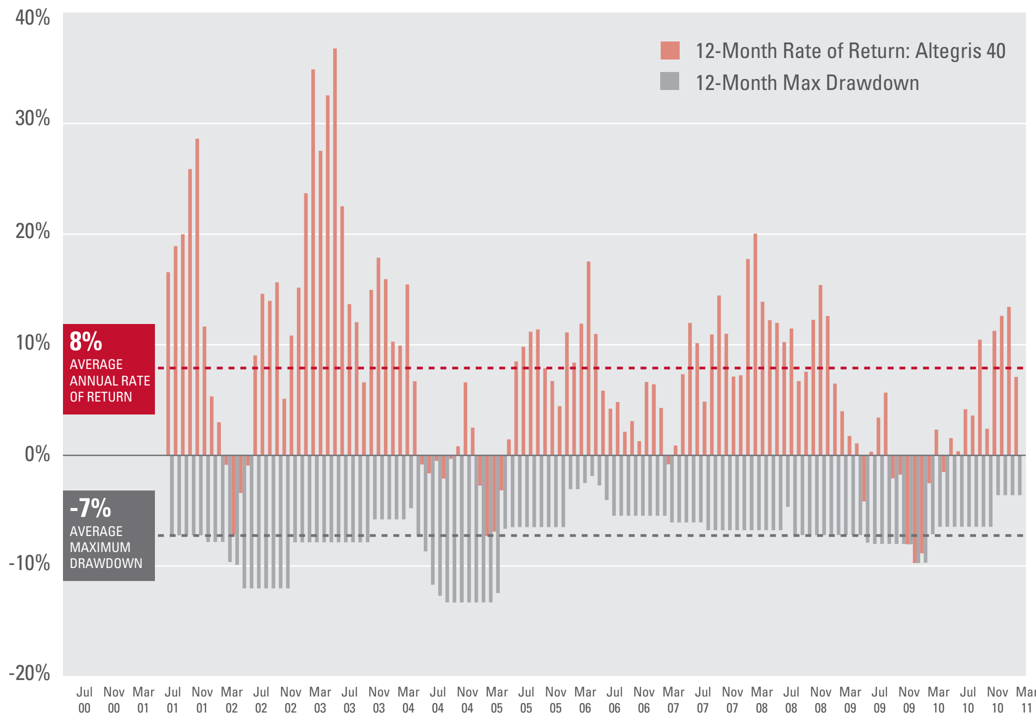
Despite these frequent drawdowns, investors who were able to maintain broadly-diversified investments in managed futures for the full 12-month rolling period were ultimately rewarded with an average return of more than 8%.

The chart below illustrates this point in greater detail by comparing the rolling 12-month return of Altegris 40 Index to its maximum drawdown during the same period (FIGURE 5). Choosing one period as an example, the Altegris 40 Index experienced a 6-month peak-to-trough drawdown of -12.0% from October 2001–April 2002. However, if an investor held the broadly-diversified managed futures investment for the full 12-month period (from October 2001–September 2002) losses would have been recouped as the Altegris 40 Index posted a positive return of 15.7%.Of course, there is no guarantee that any investment product will achieve its objective, generate profits or avoid losses.

FIGURE 5.

COMPARISON OF MANAGED FUTURES ROLLING 12-MONTH RETURNS VS. DRAWDOWN PERIOD

July 2000–March 2011



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Conclusion

We hope the preceding analysis provides comfort to investors that short-term drawdowns are not out of the ordinary. In fact, short-term drawdowns are normal, even during years that ultimately turn out to be profitable for the strategy. This is one of the reasons we believe that managed futures are a potential source of diversification for traditional portfolios as long-term investors have historically been rewarded with attractive absolute returns. The key to realizing these long-term benefits is not to lose focus during periods of short-term volatility, which can be expected.

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 by 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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Risk Disclosure

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.

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

A fund's Offering Memorandum or a manager's Disclosure Document 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.

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Investors should carefully consider the investment objectives, risks, charges and expenses of the Altegris Managed Futures Strategy Fund. This and other important information about the Fund is contained in the Prospectus, which can be obtained by calling 877.772.5838. The Prospectus should be read carefully before investing. The Altegris Managed Futures Strategy Fund is distributed by Northern Lights Distributors, LLC member FINRA. Altegris Advisors, Rodney Square Management, and Northern Lights Distributors are not affiliated.

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