Managed Futures

Q2 2011 Market Commentary

Overview

While Q1 2011 was an event-driven quarter, Q2 2011 was dominated by continued economic weakness that simply would not dissipate. Markets look to be in a transition period, waiting for some economic certainty before heading in one direction or another.

As represented by the Altegris 40 Index®, managed futures returns were down -2.42% over a volatile quarter for trend following, short-term systematic and discretionary managers alike. By comparison, equities (as represented by the S&P 500 Total Return Index) were up 0.10%, while bonds (as represented by the Barclays Aggregate Bond Index) were up 2.30% (FIGURE 1).

Figure 1.
MANAGED FUTURES PERFORMANCE VERSUS INDICES
Quarterly, Annual and 10-Year Returns through 30 June 2011

	Quarterly Returns 2011		Yearly Returns				10-Year Returns July 2001-June 2011			
	Q1 Return	Q2 Return	2011 YTD Return	2010 Return	2009 Return	2008 Return	Total Return	Ann ROR	Std Dev	Max DD
Altegris 40 Index®	-1.23%	*-2.42%*	*-3.62%*	11.33%	-7.98%	15.47%	95.24%	6.92%	10.90%	-13.24%
HFRI Fund Weighted Composite Index	*1.71%*	*-0.94%*	*0.76%*	10.25%	19.98%	-19.03%	91.17%	6.69%	6.35%	-21.42%
S&P 500 Total Return Index	5.92%	0.10%	6.02%	15.06%	26.46%	-37.00%	30.77%	2.72%	15.82%	-50.95%
Barclays US Aggregate Composite Bond Index	0.43%	2.30%	2.74%	6.56%	5.93%	5.24%	74.89%	5.75%	3.81%	-3.82%
MSCI EAFE Index (Net)	3.36%	1.56%	4.98%	7.75%	31.78%	-43.38%	73.44%	5.66%	18.27%	-56.68%
NAREIT Composite Index	6.98%	2.50%	9.65%	27.55%	27.79%	-37.84%	158.88%	9.98%	23.98%	-68.17%
GSCI Total Return Index	11.57%	-7.71%	2.96%	9.02%	13.67%	-46.49%	44.25%	3.73%	25.06%	-67.65%

Source: Altegris as of July 12, 2011. Estimates are shown in italics. 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.

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Overview: A Transitionary Market

We have all heard the saying "time heals all wounds." This was certainly the case after the Internet bubble burst; eventually the economy recovered and markets soared. Despite the pain inflicted by Lehman and the near collapse of our financial system in 2008, optimists believed that we would soon turn our economy around and continue to thrive. Mid-way through 2011, the U.S. is still in a bind despite modestly improved economic data. The job market has not recovered as much as we'd like, the housing market continues to sputter, and the U.S. budget is at distressing levels. Adding salt to the wound are Europe's sovereign debt woes, coupled with Chinese inflation and elevated global commodity prices. The economy may simply need more time to heal, or maybe the economy is not recovering at all. Or, perhaps we are merely at a mid-cycle lull with more normalized growth on the horizon? The problem is that no one knows. This uncertainty created an unbalanced second quarter of 2011 which was full of significant commodity reversals, the resumption of declines in U.S. treasury yields, and steep currency price moves.

If another crisis is ahead, managed futures is an asset class we believe should be considered as a source of diversification for investment portfolios. Managed futures has the potential to generate crisis alpha that could outperform long only asset classes during times of duress, such as it did in 2008. Likewise, if the economy and the markets in general find their footing, the asset class is equally well positioned to capitalize on strong trends. This is because managed futures as an asset class has proven its ability over time to react to market changes, although the past performance of any asset class is not necessarily an indicator of its future performance. Unfortunately, whether we are indeed heading for another crisis or recovery remains in question. This current period of uncertainty has delivered sporadic pockets of volatility, significant price reversals, and all without sustained directional price movement.

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Overview: What a Difference a Month Makes

The quarter started off on a relatively sanguine note. Markets shrugged off the event-driven melee of Q1 (Japanese earthquake as well as the Middle Eastern crises) and began April on a positive footing. Managed futures managers that were positioned "long" the economy since late 2010 (long riskier assets such as stock indices, commodities, and high yielding currencies) generally exhibited positive performance. Precious metals, energies, and stock indices rallied, while the U.S. dollar fell to its weakest level against the euro since August 2008. Managed futures, as represented by the Altegris 40 Index®, were up 3.90% in April largely driven by trend following managers in currency/FX positions.

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In reality, April represented the calm before the storm. Investors paying very close attention to manager's positions may have noticed that trend following managers began to modify their U.S. interest rate exposure throughout April as systems gradually shifted from short positions in fixed income (yields trending higher) to long positions in fixed income (yields trending lower). This change in positioning was a complete reversal from the long economy trade of short fixed income, which was established at the end of 2010. Managers' systems experienced strong enough signals based on price action in the U.S. interest rate market during 2011 to shift their interest rate positioning almost completely by April month end.

Shifting interest rate exposure proved fruitful. In fact, the long fixed income trade was the only profitable trend upon which to capitalize during May.

Aside from interest rate trading, May was an incredibly difficult month for managed futures managers across the board due to poor economic data out of the U.S., accelerating inflation in China, and the resumption of Greece's sovereign debt woes. Concerns regarding Greece's potential default and its implications on the Eurozone provided ample weakness for the euro and sent investors to the U.S. dollar in a flight to safety. The rapid rise of the U.S. dollar not only helped garner losses for currency/FX positions, it provided the catalyst for a dramatic reversal in commodity futures. The "risk off" trade began as investors sold commodities in size. The result was a significant down month for commodities futures, with the GSCI Total Return Index dropping -6.89% after eight months of prior gains. Silver, energy and agricultural commodities in particular experienced sharp and pronounced declines. With the one exception being long fixed income, as a group, managed futures managers were positioned "risk on." As a result, long commodities and commodity currencies (Aussie dollar, Canadian dollar, etc.) trades were whipsawed, leading to a negative -3.64% return in May.

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In June, the Greek tragedy continued and global markets gyrated as the plot thickened. The country's rejection of Papandreou's (Greece's PM) austerity measures fell flat, leading to more riots as well as an official downgrade from the S&P to CCC with a negative outlook. A bailout package from the European Union (EU)/International Monetary Fund (IMF) loomed, while the EU was also left to ponder contagion concerns within the PIIGS [1] nations. Eventually the austerity measures were passed, but all is still not well for Greece and the EU. Additionally, oil futures declined markedly towards month end as the U.S. and other International Energy Agency (IEA) members collectively released 60 million barrels of oil reserves. Bonds rallied while stock indices experienced a volatile and difficult month, down nearly 3%.

Managed futures managers' performance for the second quarter of 2011 was disappointing overall, but varied depending on each manager's core strategy. Short-term systematic managers as a group continued their struggles in 2011. Discretionary commodity managers who utilize spread trades were successful over the quarter, while those who were directionally long suffered losses along with their trend following peers.

Trend following managers overall experienced a difficult Q2. Very few trends were present, and the potential for getting whipsawed was abundant. This is because, by definition, trend following systems are reactive, responding to sustained trends in the prices of futures contracts. Thus far in 2011, there have been very few sustainable trends for systems to even recognize much less build positions in.

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As we discussed in our previous market commentary, these periods of transition can be frustrating for investors. The following detailed review of markets and managed futures strategy performance for Q2 2011 should help shed some light on recent returns

Strategy Summary

Specialized: Short-Term Systematic

Short-term systematic managers are a specialized and diverse subset of managed futures managers, representing roughly 11% of the Altegris 40 Index® during the second quarter of 2011.

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.

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While each short-term systematic manager is unique, most investors utilize short-term systematic mangers in their portfolio for the same reason: their diversification benefits. Over the course of 2011, short-term systematic managers have, unfortunately, suffered losses alongside a host of other managed futures managers. In fact, the correlation between the Barclay Alternative Short-Term Traders Index and the Altegris 40 Index® was very close to 1 for Q2 2011, while just one year ago correlations were near negative. [2]

While significant short-term changes in correlations are not anomalistic, the question remains: why have short-term systematic managers experienced such a challenging 2011? Several managers have told us that market prices have been so heavily influenced by non-market participants (e.g. government intervention a la QE1, QE2, etc.) that the behavioral tendencies which many of the short-term systematic models are designed to detect are falling short. A good example of this was the impact of the U.S. and other IEA members' announcement on June 23rd to release 60 million barrels of oil reserves.

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Crude futures rallied from the end of February through the end of April as positive economic news dominated the marketplace. As markets reversed in May, crude prices declined naturally on concerns of lower economic growth. We say naturally because investors sold their crude positions when it became clear economic growth was slowing in the U.S. with GDP increasing only 1.9% compared to 3.1% from the previous quarter. What was unnatural was the announcement from the Obama administration regarding the release of U.S. strategic oil reserves. The news sent crude to even lower levels; levels that were unlikely to occur in the current traditional supply and demand scenario.

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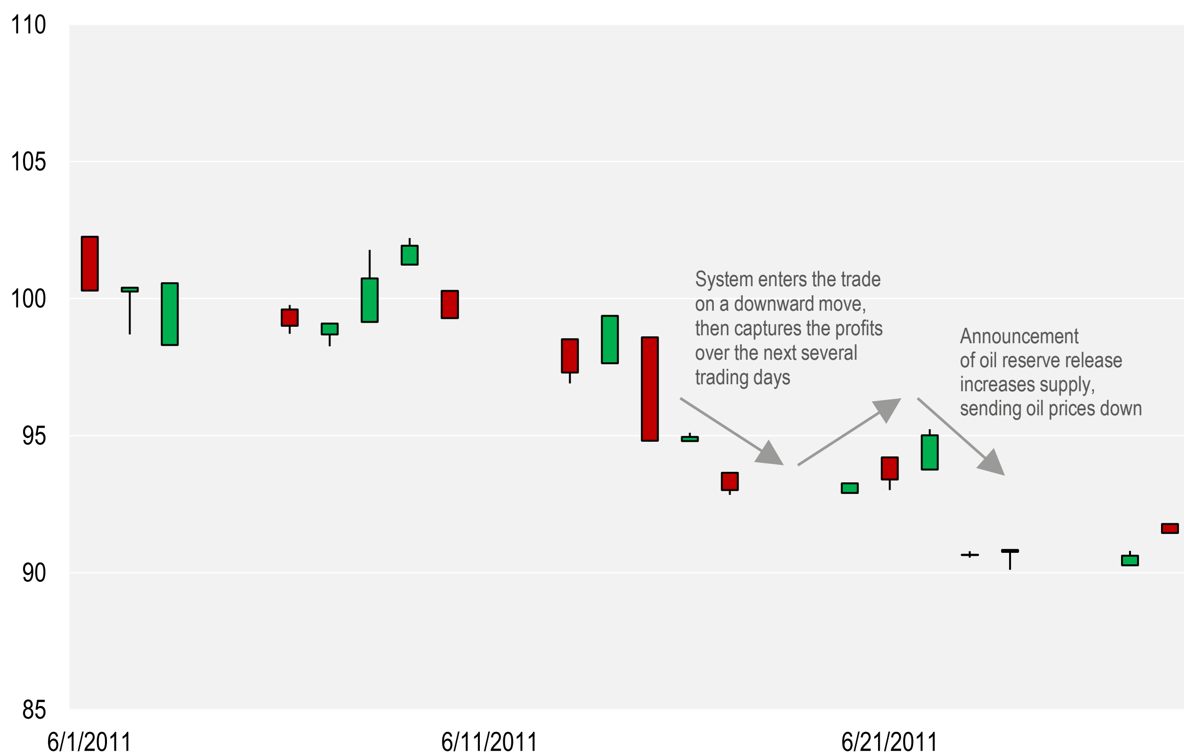
This announcement was particularly impactful for some short-term systematic managers as the unnatural decline in prices resulted in false breakouts. Specifically, reviewing crude prices throughout late June, one can certainly see a downward trend occurring, with a few up days interspersed among the down days. On June 20th, a small breakout in crude occurred, leading to a short-term upwards trend from the 20th to the 22nd. Managers positioned to capitalize upon this breakout reaped a day or two of profit. Those who held onto the position were quickly stopped out as crude futures lost 4.6% from the 22nd to the 23rd of the month (FIGURE 2).

Figure 2.
CRUDE OIL: FRONT MONTH FUTURES
June 2011



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Most managers we've spoken to find a trading environment riddled with government intervention difficult for their systems. However, with the end of QE2 in sight, managers are cautiously optimistic that a more normalized trading environment may be on the horizon. On the other hand, should Bernanke keep the door open wide enough for additional stimulus measures, managers may begin (or continue to) adapt how their systems react to price data. As we wait for some clarity in the markets, returns for short-term managed futures may continue to be volatile.

Specialized: Discretionary Commodity Trading

Discretionary commodity trading managers are a very specialized group of managed futures managers, representing only 3% of the Altegris 40 Index® during the second quarter of 2011. While this subset of managers is small in size, how these managers trade the markets on a discretionary basis provides an informed corollary to the systematic nature of both short-term systematic and trend following managers.

Much like the first quarter, Q2 2011 was positive for discretionary commodity trading managers who did not take on directional risk. Managers that employ spread trades (both calendar and inter-market spread trades), fared well in comparison, thanks in part to the fact that the hedged nature of their positions left them less exposed to directional market volatility.

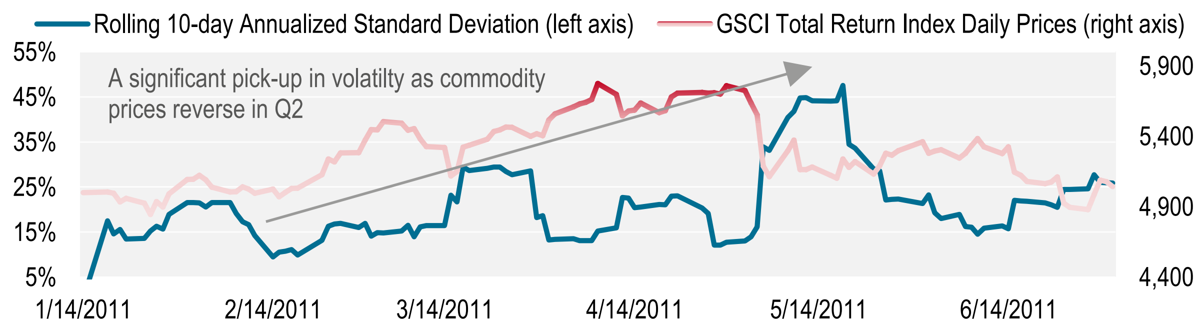
Much like the first quarter, Q2 2011 was positive for discretionary commodity trading managers who did not take on directional risk.

Long positions in interest rate futures were the only directional trade that was profitable as the economic outlook reverted to more a gloomier picture. It is fairly simple to see how the whipsaw action in other markets made it difficult for traders who were directionally positioned. Markets, notably commodity futures, moved sharply from one direction to another throughout May and June (FIGURE 3).

Figure 3.

SHORT TERM VOLATILITY INCREASE IN THE GSCI TOTAL RETURN INDEX

January 2011-June 2011



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Despite these erratic pockets of commodity price volatility, for the quarter, discretionary commodity managers were up 0.99% as represented by the Barclay Discretionary Traders Index.

Trend Following

Trend following managers have been positioned long the economy for several quarters. Over the course of Q2 2011, the only continuous trend was in interest rates. Therefore, the crux of this section focuses on the lack of sustained trends in the market, as well as the large price reversals experienced across several of the long economy/ risk on trades.

Chief among the volatile contracts was silver. The precious metal was in a sustained uptrend from the end of January through late April, rallying from $26.93 on January 27th to $48.44 an ounce on April 28th; an increase of nearly 80%. From April 28th to quarter end, silver plummeted 30% to just around $33.71 an ounce with very choppy price action (FIGURE 4). Most investors attribute this sharp selloff to the COMEX's [3] announcement on May 4th that initial margin requirements for both hedgers and speculators would be increased by 84% across two days: May 5th and May 9th. [4]

Figure 4.
SILVER FRONT MONTH FUTURES
January 2011-June 2011

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Another good example is the EUR/USD cross (FIGURE 5). Much like silver, the EUR/USD experienced a strong upward trend from January through the end of April, with the euro rallying hard against the greenback to a near 15-month high. Easy U.S. monetary policy led investors to the more risky asset, the euro, despite signs that Greece's debt troubles were far from solved. Fast forward to June 1st and investors abandoned their riskier euro in favor of the U.S. dollar as the prospects for Greece defaulting on its debt seemed all too real.

Just as with silver, the contract peaked on May 4th at 1.48 euros/USD only to lose nearly 5% by May 25th and then bounce around as positive and negative news from Greece sent the euro and U.S. dollar in either direction.

Figure 5.

EURO/US DOLLAR CROSS RATE

January 2011-June 2011

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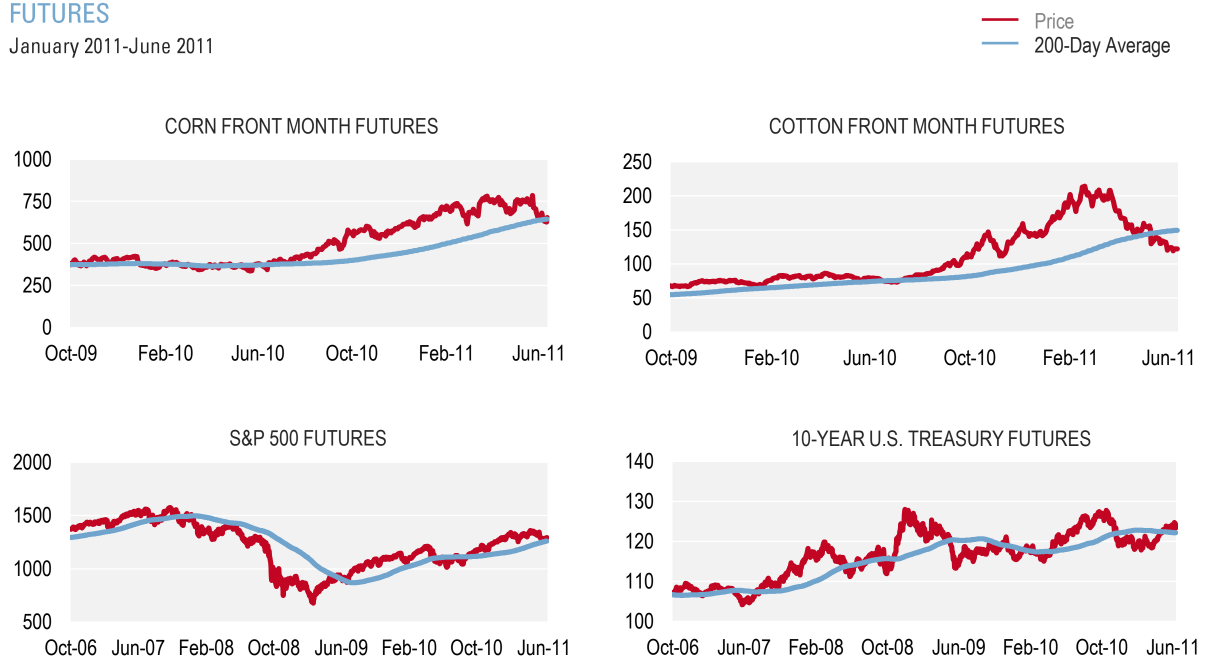
The question remains, are the long economy or "risk on" trends persistent enough to keep trend followers long commodities, long stock indices, and long higher yielding currencies, or have we experienced enough downside pressure for trend following systems to modify their exposures?

The best way to answer this question is to look at the persistence of longer-term price trends (or the lack thereof) by analyzing the most widely used trend-following indicator: the 200-day moving average.[5] Moving averages generally provide a good indication of price "trendiness." Rising 200-day moving averages (a positive slope) generally represent a strong uptrend while falling 200-day moving averages (a negative slope) generally represent a strong downtrend.

Many futures contracts have traded above their 200-day moving averages for several quarters, but have recently begun trading at or below these levels. Breaking through 200-day moving averages is generally a signal that a downtrend has already begun. Equally interesting, the slope of the moving average line across many major futures contracts is still positive, indicating that a long-term uptrend is still present (based on 200 previous days of prices). Essentially, multi-quarter long uptrends are getting tested and, based on current contract prices; it looks as if a downtrend may be ahead. Corn and cotton futures are two good examples of this fact. Corn has just broken through its 200-day moving average while cotton is well below this threshold. At the same time, S&P futures, as well as U.S. treasury futures are both sitting just above their 200-day moving average (FIGURE 6).

Figure 6.
FUTURES
January 2011-June 2011



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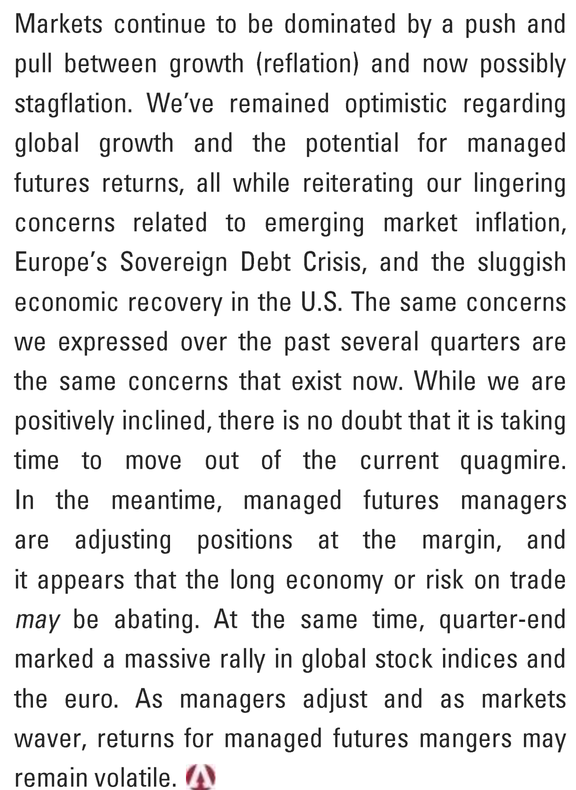
As a result, we are seeing some long economy/risk on trades lose steam in certain trend following manager's positions. However, because of these conflicting indicators (contracts breaking through the 200-day moving average, albeit with a positively sloped moving average curve), the way in which trend following managers have changed their positioned has varied widely. Depending on whether a trend following managers' systems are primarily long-term, whether they "turn quickly" by reacting to short-term trends, or whether the systems possibly have non-trend components, we are seeing quite disparate positioning among trend following managers as we reach a transitionary point in the economy and in markets as a whole. Longer-term trend followers, for instance, still maintain well-sized long positions in corn, for example. Managers with non-trend components appear to have less corn positions on, or are even short corn. At the same time, several managers' stock index exposure has declined markedly, while for others it has increased.

The good news is that correlation among risky assets appears to be dropping over the short-term. Trend following managed futures managers are reacting depending on the nuances of their systems, but it is important to remember that we do not want systems to be too reactive. For example, had managers significantly reduced exposure to stock index futures over the course of the quarter, they would have suffered significant losses as global stock indices rallied at quarter end.



Conclusion

Markets continue to be dominated by a push and pull between growth (reflation) and now possibly stagflation. We've remained optimistic regarding global growth and the potential for managed futures returns, all while reiterating our lingering concerns related to emerging market inflation, Europe's Sovereign Debt Crisis, and the sluggish economic recovery in the U.S. The same concerns we expressed over the past several quarters are the same concerns that exist now. While we are positively inclined, there is no doubt that it is taking time to move out of the current quagmire. In the meantime, managed futures managers are adjusting positions at the margin, and it appears that the long economy or risk on trade *may* be abating. At the same time, quarter-end marked a massive rally in global stock indices and the euro. As managers adjust and as markets waver, returns for managed futures mangers may remain volatile.

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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.
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.

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NOTES

1 *Portugal, Italy, Ireland, Greece and Spain.*

2 *Please note that several managers in the Altegris 40 Index® are also included in the Barclays Alternative Edge Short-Term Traders Index.*

3 *Commodity Exchange Inc, a designated contract market for the CME.*

4 *http://goldandsilverblog.com/how-the-comex-crashed-the-silver-market-0235/.*

5 *For the purposes of this analysis, we used a simple moving average calculation as opposed to exponential.*

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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.

The Altegris Companies,* currently have approximately $2.55 billion in client assets, and provide clearing services to $800 million in institutional client assets.

* *The Altegris Companies are wholly owned subsidiaries of Genworth Financial, Inc., and include: (1) Altegris Advisors, LLC, an SEC registered investment adviser; (2) Altegris Investments, Inc., an SEC-registered broker-dealer and FINRA member; (3) Altegris Portfolio Management, Inc. (dba Altegris Funds), a CFTC-registered commodity pool operator, NFA member and California registered investment adviser; and (4) Altegris Clearing Solutions, LLC, a CFTC-registered futures introducing broker and commodity trading advisor and NFA member. The Altegris Companies and their affiliates have a financial interest in the products they sponsor, advise and/or recommend, as applicable. Depending on the investment, the Altegris Companies and their affiliates and employees may receive sales commissions, a portion of management or incentive fees, investment advisory fees, 12b-1 fees or similar payment for distribution, a portion of commodity futures trading commissions, margin interest and other futures-related charges, fee revenue, and/or advisory consulting fees.*

Genworth Financial, Inc. (NYSE:GNW) is a leading Fortune 500 insurance holding company with more than $100 billion in assets and employs approximately 6,500 people. Genworth has leadership positions in offerings that assist consumers protect themselves, invest for the future and plan for retirement, and also offers mortgage insurance to help consumers achieve homeownership while assisting lenders manage risk and capital.

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IMPORTANT RISKS AND DISCLOSURES

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.

There are substantial risks and conflicts of interests associated with Managed Futures and commodities accounts, and you should only invest risk capital. The success of an investment is dependent upon the ability of a commodity trading advisor (CTA) to identify profitable investment opportunities and successfully trade. The identification of attractive trading opportunities is difficult, requires skill, and involves a significant degree of uncertainty. CTAs have total trading authority, and the use of a single CTA could mean a lack of diversification and higher risk. The high degree of leverage often obtainable in commodity trading can work against you as well as for you, and can lead to large losses as well as gains. Returns generated from a CTA's trading, if any, may not adequately compensate you for the business and financial risks you assume. CTAs may trade highly illiquid markets, or on foreign markets, and may not be able to close or offset positions immediately upon request. You may have market exposure even after the CTA has a request for closure or liquidation. You can lose all or a substantial amount of your investment. Managed Futures and commodities accounts may be subject to substantial charges for management and advisory fees. It may be necessary for accounts that are subject to these charges to make substantial trading profits in order to avoid depletion or exhaustion of their assets. The disclosure document contains a complete description of each fee to be charged to your account by a CTA. If you use notional funding, you may lose more than your initial cash investment. If you purchase a commodity option you may sustain a total loss of the premium and of all transaction costs. If you purchase or sell a commodity future or sell a commodity option you may sustain a total loss of the initial margin funds and any additional funds that you deposit with your broker to establish or maintain your position. If the market moves against your position, you may be called upon by your broker to deposit a substantial amount of additional margin funds, on short notice, in order to maintain your position. If you do not provide the requested funds within the prescribed time, your position may be liquidated at a loss, and you will be liable for any resulting deficit in your account. This brief statement cannot disclose all the risks and other significant aspects of the commodity markets, and you should carefully study the disclosure document before you trade, including the description of the principal risk factors of an investment. PAST RESULTS ARE NOT NECESSARILY INDICATIVE OF FUTURE RESULTS.

This commentary was prepared by Altegris Advisors. Altegris Advisors LLC is an SEC-registered investment adviser that advises alternative strategy mutual funds that may pursue investment returns through a combination of managed futures, fixed income and/or other investment strategies

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