Managed Futures and Macro

Q3 2011 Market Commentary

Overview

The market seemed devoid of any good news during the third quarter of 2011. Worse still, it seems as if investors don't expect any good news to be on the horizon. These statements are sentiment-based; and it is sentiment about the global economy that sunk markets nearly in tandem throughout the third quarter of 2011.

While the S&P 500 rallied for the first half of the year, many investors developed amnesia, leaving the lessons from the past in the dust. As the proverbial saying goes, history tends to repeat itself. Having a well-hedged, diversified portfolio is the best way to ensure past losses are not repeated as well.

Therefore, one of the only bright spots this quarter came if you were a well-diversified investor with an allocation to managed futures strategies.

> ...the only good news for the quarter came if you were a well-diversified investor with an allocation on managed futures strategies.

An allocation to managed futures, including trend following, short-term systematic and global macro managers, not only outperformed the market, but also returned positively for the quarter.

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As represented by the Altegris 40 Index®, managed futures returns were up, 3.27% during a tumultuous quarter. By comparison, equities (as represented by the S&P 500 Total Return Index) were down -13.87% in their worst quarter since 2008, while bonds (as represented by the Barclays Aggregate Bond Index) were up 3.83% (FIGURE 1).

Figure 1.

MANAGED FUTURES AND GLOBAL MACRO PERFORMANCE VERSUS INDICES

Quarterly, Annual and 10-Year Returns through September 30th, 2011

	Quarterly Returns 2011			Yearly Returns				10-Year Returns October 2001-September 2011			
	Q1 Return	Q2 Return	Q3 Return	2011 YTD Return	2010 Return	2009 Return	2008 Return	Total Return	Ann ROR	Std Dev	Max DD
Altegris 40 Index®	-1.23%	*-2.52%*	*3.27%*	*-0.56%*	11.33%	-7.98%	15.47%	89.33%	6.59%	10.90%	-13.24%
Barclay Global Macro	-0.29%	*-1.28%*	*-0.25%*	*-1.81%*	6.74%	7.49%	-0.65%	97.45%	7.04%	5.23%	-6.42%
HFRI Fund Weighted Composite Index	1.70%	*-0.92%*	*-6.16%*	*-5.44%*	10.25%	19.98%	-19.03%	86.95%	6.46%	6.47%	-21.42%
S&P 500 Total Return Index	5.92%	0.10%	-13.87%	-8.68%	15.06%	26.46%	-37.00%	32.01%	2.82%	15.75%	-50.95%
Barclays US Aggregate Composite Bond Index	0.43%	2.30%	3.83%	6.67%	6.56%	5.93%	5.24%	73.57%	5.67%	3.79%	-3.82%
MSCI EAFE Index (Net)	3.36%	1.56%	-19.01%	-14.98%	7.75%	31.78%	-43.38%	63.34%	5.03%	18.46%	-56.68%
NAREIT Composite Index	6.98%	2.87%	-14.51%	-5.92%	27.55%	27.79%	-37.84%	127.74%	8.58%	24.24%	-68.17%
GSCI Total Return Index	11.57%	-7.95%	-12.96%	-10.61%	9.02%	13.67%	-46.49%	38.99%	3.35%	25.14%	-67.65%

** Estimates as of October 19, 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.*

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Overview: Macroeconomic Events Dominate

Last quarter we mentioned that if another crisis were ahead, managed futures could generate crisis alpha, potentially outperforming long-only asset classes during times of duress as it did in 2008. Likewise, if the economy and the markets in general found their footing, the asset class was equally well positioned to capitalize on strong trends. During Q2, which direction markets were headed was uncertain and sustained trends were few and far between. The tide turned in Q3. Optimism exited, and "risk on" trades such as long stock indices and long energy reverted, while "risk off" rallies in sovereign debt (yields trending lower) gained strength.

While the quarter as a whole was rife with economic pessimism and market turbulence, each month had its own set of related issues. In July came the great debt ceiling debate in the United States, as politicians on both sides of the aisle demonstrated an impressive ability to disagree. Political wrangling has always been a staple of American politics; however, the lack of agreement did not sit well among investors concerned with an ever-weakening economy saddled with anemic growth numbers. A sustainable debt ceiling plan via political compromise appeared nearly impossible.

On the other side of the globe, Europe's sovereign debt crisis broadened with yields on PIIGS[1] sovereign debt spiking. The European Union (EU) and International Monetary Fund (IMF) agreed to a 109 billion euro bail out of Greece only to be followed by a Moody's downgrade from Ca to Caa1 due to a lack of conviction in Greece's ability to apply even more austerity measures. Despite being pumped with capital from its neighbors for a second time, Greece still appeared highly vulnerable. Further, concern about Greek contagion increased as Moody's downgraded both Ireland and Portugal to junk (Ba1 and Ba2, respectively). Lingering concerns over Europe's core countries' (Germany, France, etc.) ability to support their peripheral brethren, and the potential for negative impact on their banks also became headline news. Yields on core Europe sovereign debt remained at record lows nonetheless.

The S&P's downgrade of U.S. debt on August 5th coupled with low consumer confidence figures and lowered GDP estimates put investors solidly in the "risk off" camp for August. Investors deleveraged across the board as global interest rate yields fell, equity markets collapsed, and precious metals rallied. The S&P 500 TR Return Index lost 5.43%, its fourth straight losing month in a row, while the VIX, a measure of investor fear, reached a two-and-a-half year high.

[1] **PIIGS.** Portugal, Italy, Ireland, Greece and Spain

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Eurozone debt issues continued to dominate the global investment landscape throughout the quarter.

While the U.S. debt crisis was a catalyst for August, eurozone debt issues continued to dominate the global investment landscape throughout the quarter. Clearly the U.S. political system has discord, but the negotiations surrounding eurozone debt concerns are far stickier. The euro is one currency, but each country has its own political system and its own motivations. The perceived lack of unification and disparate positioning among European policy makers led to volatile price action throughout August as well as the quarter as a whole. In August, specifically, European financial stocks faced heavy selling pressure, and governments reacted by banning short sales of financial stocks in France, Spain, Belgium and Italy, extending to futures in the FTSE/Mib, CAC 40, Eurostoxx 50 and Ibex 35.

Government intervention continued in September when the Swiss National Bank adopted a target rate of 1.20 Swiss francs (CHF) against the euro. The CHF declined nearly 11% as a result, leading to more volatile price action in the currency markets.

On September 21st, the Fed's "twist" policy action was revealed with the aim of reducing long-term interest rates in order to simulate spending. Specifically, the Fed announced their intent to replace $400 billion of its $2.87 trillion balance sheet in short-term treasuries with the same amount of long term treasuries. The Fed also announced their intent to reinvest maturing mortgage backed securities into the mortgage market. The U.S. stock market reacted with resounding disproval; the S&P 500 fell nearly 3% on the trading day.

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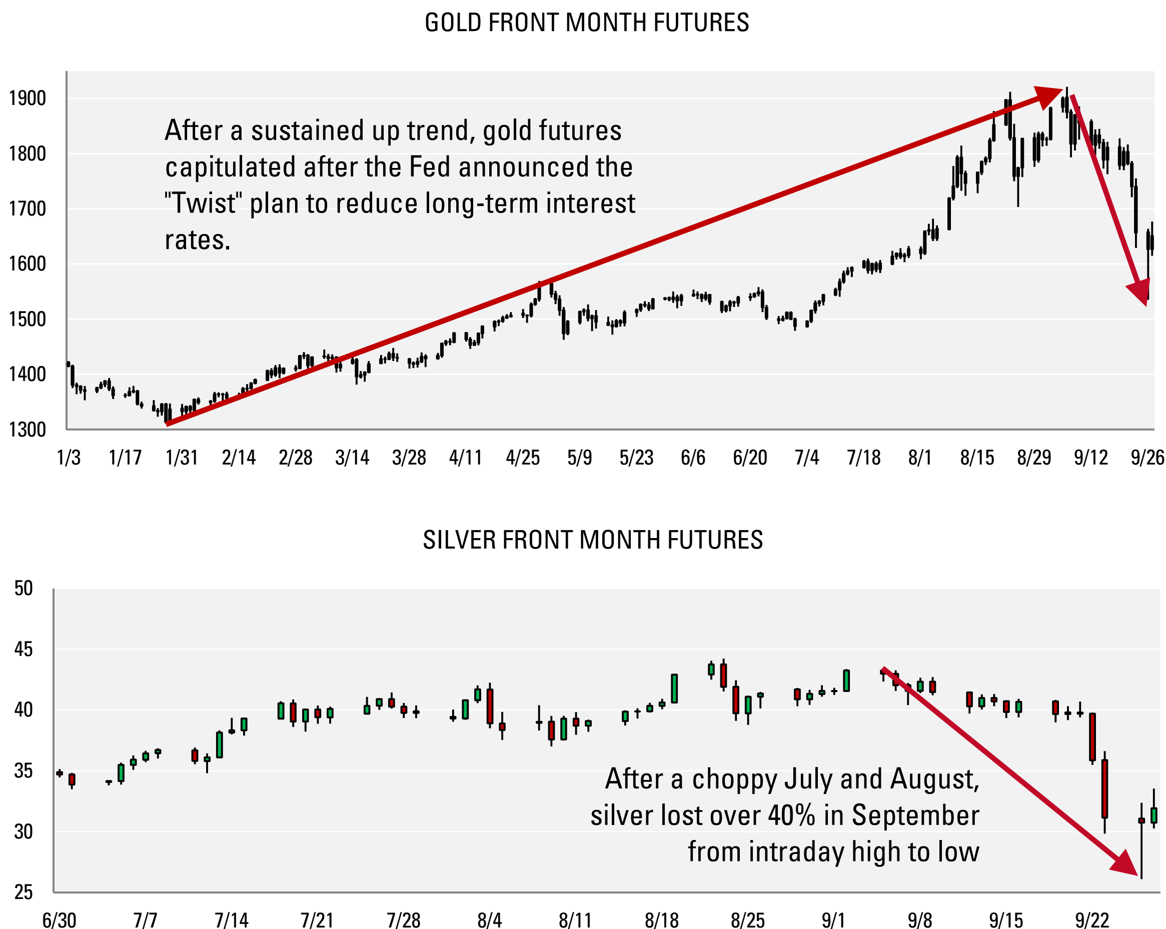
Perhaps most interesting was the reaction of the precious metals futures markets. The Fed's statement on slowing economic growth accelerated fears of deflation rather than inflation. This, coupled with the fact that a possible speculative bubble was building in precious metals, led to a large sell-off. Gold futures were down over 20% from their peak of $1,921 an ounce (intraday high) on September 6th, to nearly $1,500 an ounce (intraday low) on September 26th. Silver futures were also down from their peak of $43.41 (intraday high) in early September to around $26.10 (intraday low) per ounce by month end, a decline of nearly 40% from peak to trough (FIGURE 2).

Figure 2.

GOLD AND SILVER FRONT MONTH FUTURES

Through September 2011



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While markets gyrated and precious metals sank, the U.S. interest rate market continued its entrenched trend of narrowing yields and rising prices. Yields on 30-year bonds dropped nearly 40 basis points from the 20th to the 22nd of September while yields on 10-year notes reached 1.72%, their lowest levels on record.

In a quarter marred by lack of clarity in both the U.S. and Europe, managed futures managers' performance for the third quarter of 2011 was strong across the board. Short-term systematic managers as a group regained their footing, and trend following managers capitalized on falling equity markets, rallies in precious metals during July and August, and the sustained compression on sovereign debt yields in core Europe and the U.S.

In a quarter marred by lack of clarity in both the U.S. and Europe, managed futures managers' performance for the third quarter of 2011 was strong across the board.

Macro managers found the quarter to be fertile ground, as volatility across currencies, stock indices, fixed income/rates and commodity markets were profitable for many managers.

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Strategy Summary

Specialized: Short-Term Systematic

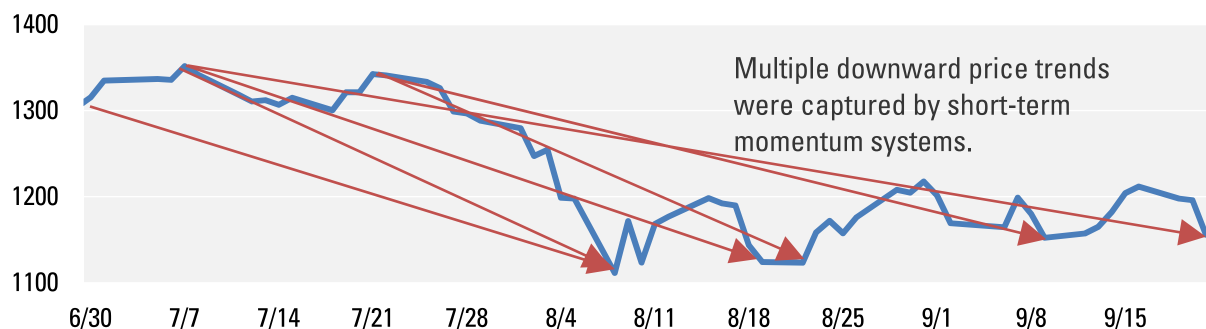
Short-term systematic managers are a specialized and diverse subset of managed futures managers, representing roughly 9% of the Altegris 40 Index during the second quarter of 2011.

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 over 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.

Unfortunately, for this subset of managers, they have shared one strong commonality: muted performance over the last three years. The Barclay Alternative Short-Term Traders Index was down -4.04% in 2009, up 0.33% in 2010, and was down nearly -3.5% through the second quarter of 2011. Certainly not every manager experienced the same return profile as the index; in fact, several core short-term systematic managers that we follow performed well in 2009 and 2010. 2011 has been a different story, as nearly all managers that we follow in this space suffered poor performance. As we discussed in our Q2 letter, market prices have been so heavily influenced by non-market participants and global government intervention that the behavioral tendencies which many of the short-term systematic models are designed to detect simply did not work.

For some managers, it looked as if short-term systematic models may have finally caught up to the markets in the third quarter, with two main themes driving performance: reduced exposure to the volatile currency markets and increased exposure to momentum based stock indices. Short-term systematic managers can and will often follow trends as well. As one would expect, these trends are simply shorter-term in nature (FIGURE 3).

Figure 3.
E-MINI S&P500 FUTURES
July 2011-September 2011



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Unfortunately, the volatility in global stock indices created a mine field for mean reversion trading. Mean reversion 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. Success in such trading strategies can depend greatly on the timing of a system as well as a system's risk management parameters. The S&P 500's meltdown during early August proved to be difficult for several short-term managers because the price action was sharp and protracted.

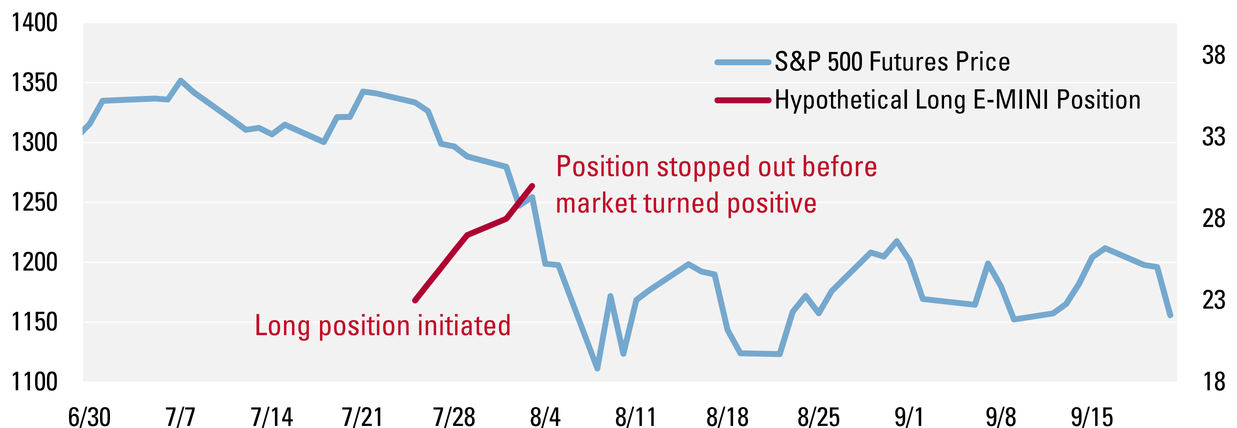
The following graph of front month E-MINI S&P 500[2] futures shows how the price moved nearly 5% on August 4th, followed by a modestly down day on August 5th, and then fell again over 7% on August 8th. Despite some positive days in between, the trend was decidedly downward (FIGURE 4).

[2] Managers often trade the E-MINI S&P 500 futures contract as part of their stock index exposure due to its smaller notional size (it is 1/5th the size of S&P 500 futures) as well as the fact that it can be traded electronically.

For a manager that began building their mean reversion positioning as the market declined in late July, the continued decent of the market triggered a significant loss. For example, if a manager's systems were to enter a trade on July 26th by going long 20 contracts that system would likely add to the position each day the market declined under the assumption that the market would revert and turn positive after several trading days. However, the S&P did not revert (turn positive) until mid-August, twenty trading days after this hypothetical trade was initiated. Most short term systems likely stopped out of this position long before markets reverted, locking in losses.

While mean reversion trading was difficult in August in particular, Q3 was profitable overall for short-term systematic managers. The Barclay Alternative Short-term Traders Index was up in July, August and September, ending the quarter up 1.39%.

Figure 4.
E-MINI S&P500 FUTURES
July 2011-September 2011



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Specialized: Global Macro

Global macro trading can be categorized into two primary categories: discretionary global macro and foreign exchange (FX) trading. Discretionary global macro traders account for 3.9% and foreign exchange managers account for 7.1% of the Altegris 40 Index.

Discretionary global macro managers take a top-down approach to investing in stock index, currency, fixed income and commodity futures markets. Managers typically utilize fundamental data such as supply and demand, GDP statistics, unemployment rates, the yield curve shape, etc. rather than rely on the price at which a certain contract is trading. Unlike their trend following peers, discretionary global macro managers aim to predict price movements driven by underlying macro conditions, rather than react to price movements by following a trend. Of all strategies under the managed futures umbrella, discretionary global macro tends to be the most flexible and opportunistic. Managers know that somewhere in the world there is an opportunity to make money. This "go anywhere" mandate allows managers to keenly spot market anomalies, mispriced assets and other significant shifts in economic patterns. This nimble trading style allows them to shift positioning and exposure to the best opportunities on a timely basis, making discretionary global macro an ideal strategy for the current market environment.

In a quarter where, every day, a new headline drove market sentiment, a manager with a deep understanding of the political landscape and central banking policy, as well as a strong risk discipline, effectively traded sentiment driven price action throughout Q3 2011. In general, most managers played the risk off theme artfully, with positions in long US and core Europe fixed income throughout the quarter, long gold in July and August, as well as short stock index positions in both the U.S. and in Europe.

Like discretionary global macro managers, FX macro managers generally utilize a fundamental approach to trade global currency markets. The concept behind such strategies is that proper analysis of global growth, inflation, central banking policy, and other fundamental factors can help predict currency values across markets.

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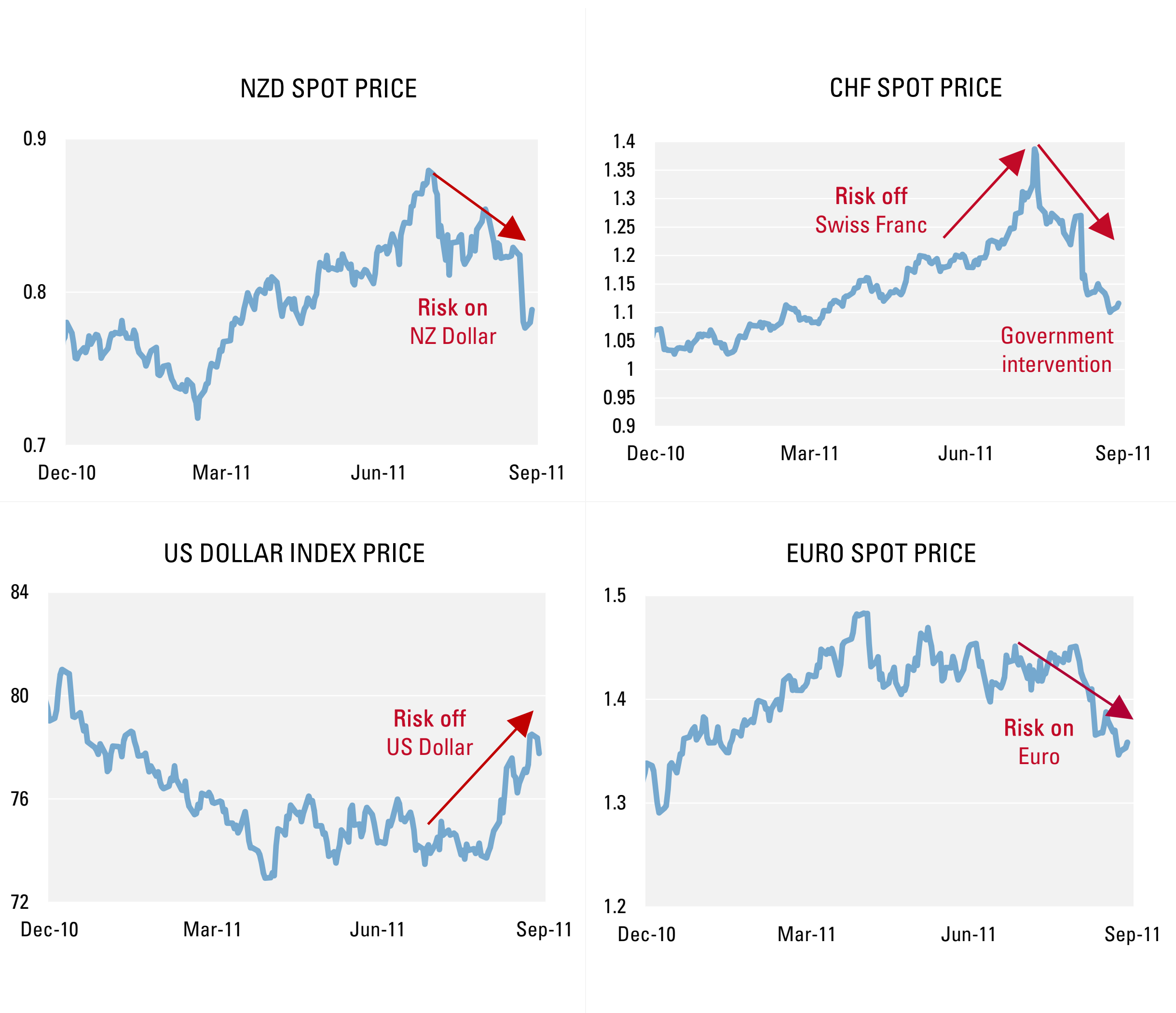
Over the quarter, profits were derived from trading risk on and risk off themes. Risk off trades were clearly more pervasive. Short euro trades were profitable as confidence sank over sovereign debt concerns while risk on trades in the commodity currencies were profitable in July as both the Australian dollar and New Zealand dollar reached new highs (FIGURE 5). However, these currencies quickly reversed course, weakening throughout August and September as the risk off trade permeated markets.

Figure 5.

CURRENCY CHARTS

January 2011-September 2011



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Trading was not entirely black and white throughout the month. The Swiss National Bank's attempt to stem Swiss franc currency appreciation caught several managers by surprise, leading to losses in long Swiss franc positions in August. Japan also intervened in the currency markets in early August (for the third time in 2011) as safe haven currencies gained strength post the U.S. ratings downgrade. Despite pockets of intervention, FX macro managers navigated the currency markets as expected, generating positive returns in July, mixed returns in August, and strongly positive returns in September.

In general, most managers we follow found the quarter ripe with opportunity as currency markets vacillated along with investor sentiment. Such imbalances between currencies globally tend to create significant opportunity for FX macro managers, and with the exception of government intervention, we expect opportunities to be equally rewarding in the coming months.

Trend Following

The most difficult trading markets for trend following managed futures are typically periods in which price action is sideways and unpredictable.

During these periods, managed futures managers may underperform traditional markets and systems attempt to search for patterns and price trends. We've experienced such markets for the past year as markets ebbed and flowed in reaction to a variety of news-related items — some advocating that the economy is rebounding, and others indicating that the worst is yet to come. From the commodity euphoria of year-end 2010, to the Arab Spring, to Japan's devastating earthquake/tsunami, to the U.S. weak recovery to Europe's omnipresent debt troubles, 2011 markets were dominated by macroeconomic events and relatively short-lived trends.

During the first quarter of 2011, trend following managers were largely positioned "risk on" with long positions in several commodity futures, the commodity currencies (the Australian dollar, New Zealand dollar, Canadian dollar, etc.), and stock index futures while short interest rate futures (yields trending higher). Last quarter we witnessed most medium- to long-term trend following managers maintain their long exposure to stock indices while switching their positioning in interest rates to long (yields trending lower) positions. The yin and yang of positioning during Q2 provided some balance. When equity markets rallied and yields rose, trend followers were able to generate net profits. And if equity markets and yields declined, managers could still be profitable. This changed in Q3.

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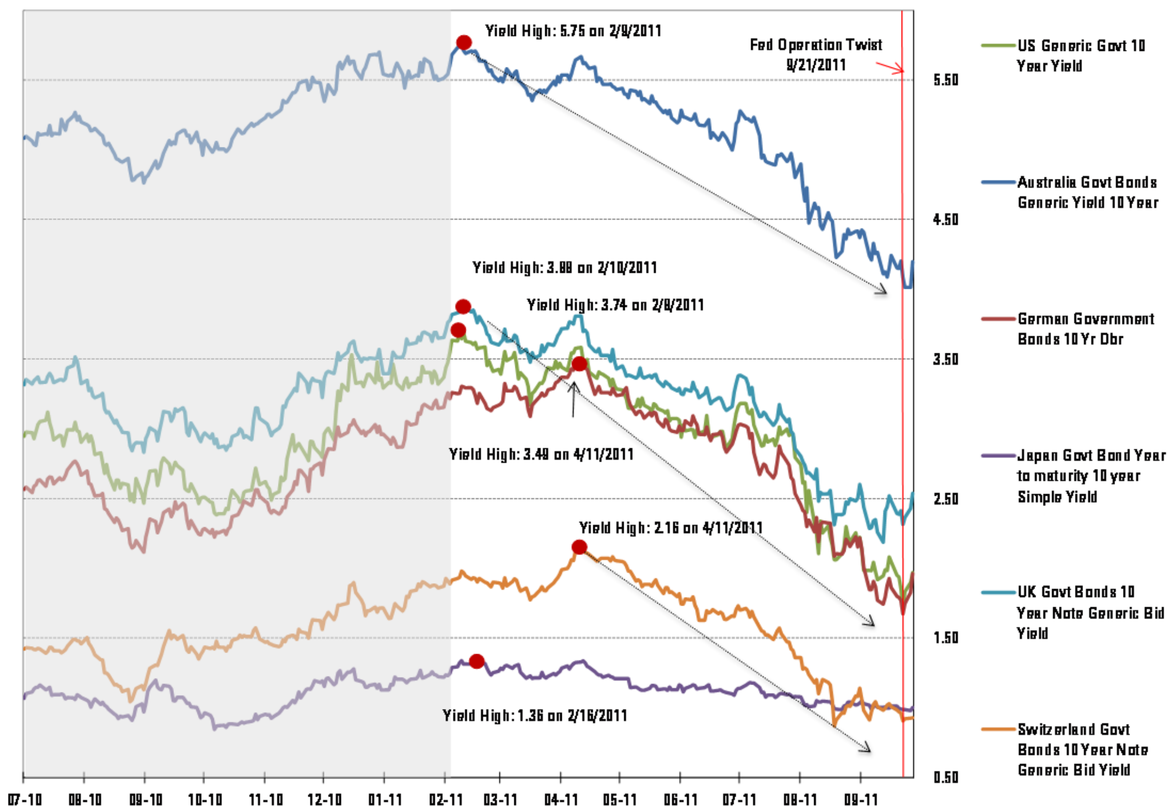
For the third quarter, most profits were derived from the long interest rates (yields trending lower) side of the trade. In fact, looking at the graph below, it's clear just how strong these trends in fixed income became over the course of the third quarter across developed market interest rates (FIGURE 6).

Figure 6.

10-YEAR GOVERNMENT BOND YIELD COMPARISON: DEVELOPED COUNTRIES

July 2010-September 2011



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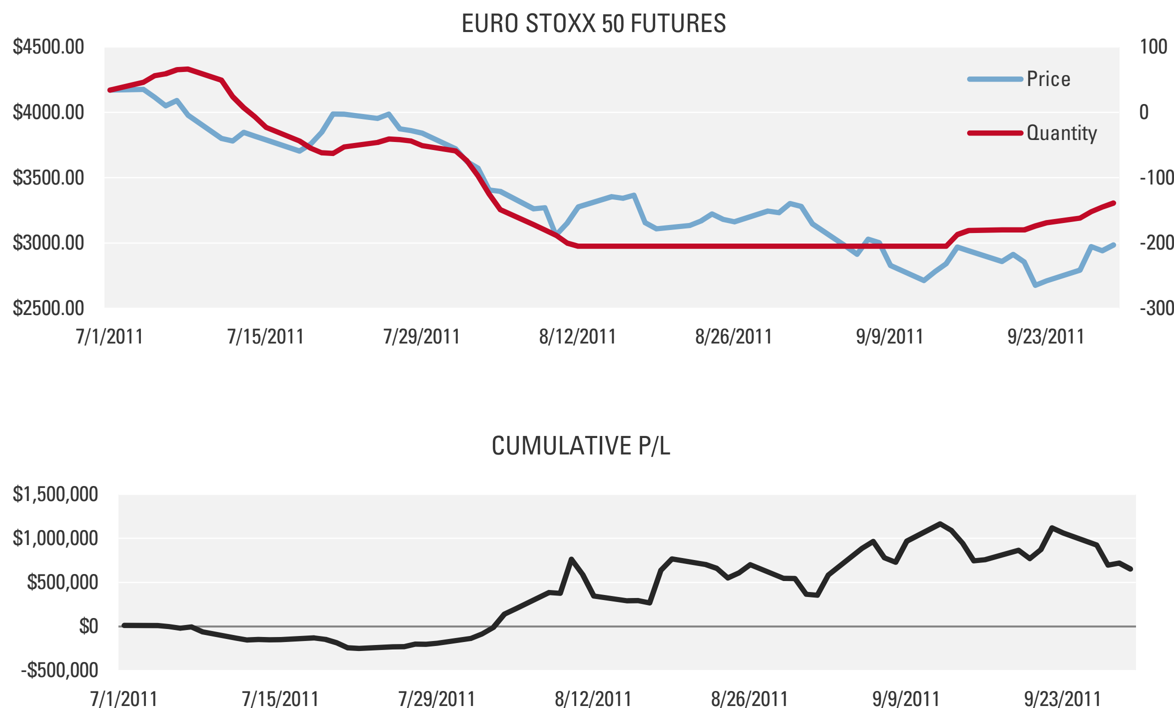
With poor economic news permeating the third quarter, stock indices collapsed. While it generally takes trend following systems several months to reverse positioning, managers reduced their stock index exposure to multiple global stock indices significantly during Q3, with several managers positioned slightly short, particularly in European stock indices. The reduced exposure to stock indices insulated trend following managers from much of the losses experienced by traditional asset classes over the quarter. At the same time, if managers had reversed course completely and built sizeable short stock index positions, performance would have been far more volatile during the last days of September as equity markets rallied on optimistic news out of the eurozone.

The following chart demonstrates how a hypothetical trend following manager was positioned in Euro Stoxx 50 Futures over the course of the quarter (FIGURE 7). You can see how, as the price of the contract (blue line) trended down, the manager's systems followed the trend by gradually reducing positions (orange line). As European stock indices rallied in late September, the manager reduced the short position in lock step. From a performance standpoint, the transition from long Euro Stoxx 50 Futures to short proved profitable over the duration of the quarter, despite a few bumps along the way.

Figure 7.

HYPOTHETICAL TREND FOLLOWING MANAGER POSITION: EURO STOXX 50 FUTURES

July 2011-September 2011 For illustrative purposes only



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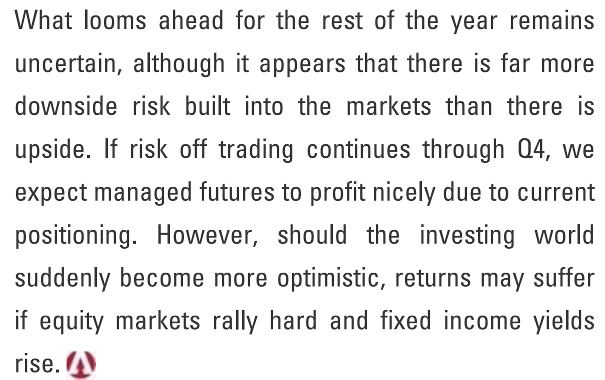
Despite the difficult trading environment for the year overall, trend following managers have, nonetheless, proven their resilience, finding solidified trends in core Europe and U.S. sovereign debt (long interest rates) and, until September, precious metals.

Conclusion

While Q3 performance demonstrated that managed futures can generate crisis alpha, we are not out of the woods. The economic picture is no clearer today than it was three months ago. The dizzying headline risk that has dominated 2011 looks to continue; and, we could possibly be on the precipice of a global economic crisis, led by Europe and exacerbated by economic weakness in the U.S.



What looms ahead for the rest of the year remains uncertain, although it appears that there is far more downside risk built into the markets than there is upside. If risk off trading continues through Q4, we expect managed futures to profit nicely due to current positioning. However, should the investing world suddenly become more optimistic, returns may suffer if equity markets rally hard and fixed income yields rise.

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INDEX DEFINITIONS

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. The Index started in July 2000; data is available back to 1990.
Barclay Alternative Short-Term Traders Index	The AlternativeEdge Short-Term Traders Index is designed to track the daily performance of a portfolio of short term CTAs.
BarclayGlobal Macro Index	The Barclay Global Macro Index track the performance of ~175 global macro programs, by ending monthly values, net of fees, as reported to Barclay Hedge.
Barclays US Aggregate Bond Index	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.
CAC 40 Index	The CAC 40 Index is a benchmark French stock market index. The index represents a capitalization-weighted measure of the 40 most significant values among the 100 highest market caps on the Paris Bourse (now Euronext Paris).
E-Mini S& 500 Futures Index	E-Mini S&P is a stock market index futures contract traded on the Chicago Mercantile Exchange's Globex electronic trading platform. The notional value of one contract is US$50 times the value of the S&P 500 stock index.
Eurostoxx 50 Index	The EURO STOXX 50 Index, Europe's leading Blue-chip index for the Eurozone, provides a Blue-chip representation of supersector leaders in the Eurozone. The index covers 50 stocks from 12 Eurozone countries: Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal and Spain.
FTSE/Mib Index	The FTSE MIB is the benchmark stock market index for the Borsa Italiana, the Italian national stock exchange. The index consists of the 40 most-traded stock classes on the exchange.
HFRI Fund Weighted Composite Index	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.
Ibex 35 Index	The IBEX 35 is the benchmark stock market index of the Bolsa de Madrid, Spain's principal stock exchange. It is a market capitalization weighted index comprising the 35 most liquid Spanish stocks traded in the Madrid Stock Exchange General Index.

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MSCI EAFE Index (Net)	The MSCI EAFE Index (Europe, Australasia, Far East) is a free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the US & Canada. The MSCI EAFE Index consists of the following 22 developed market country indices: Australia, Austria, Belgium, Denmark, Finland, France, Germany, Greece, Hong Kong, Ireland, Israel, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, and the United Kingdom.
NAREIT Composite Index	The NAREIT(R) 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 GSCI Total Return Index	The S&P GSCI Total Return Index measures a fully collateralized commodity futures investment and currently includes 24 commodity nearby futures contracts.
S&P 500 Total Return Index	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-CBOE Volatility Index	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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With one of the leading Research and Investment groups focused solely on alternatives, Altegris follows a disciplined process for identifying, evaluating, selecting and monitoring investment talent across a spectrum of alternative strategies including managed futures, global macro, long/short equity, event-driven and others.

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 $2.88 billion in client assets, and provides clearing services to $780 million in institutional client assets.

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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 in protecting themselves, investing for the future and planning for retirement, and also offers mortgage insurance to help consumers achieve homeownership while assisting lenders manage risk and capital.

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ALTEGRIS ADVISORS
888.524.9441
www.altegrisadvisors.com

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