Managed Futures and Macro

Q4 2011 Market Commentary

January 2012

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Overview

The fourth quarter of 2011 echoed the very familiar themes of global economic uncertainty and unresolved European debt issues which have played out throughout much of the year. Western economies continued to struggle with policy decisions that may or may not be enough to make a difference. The U.S. continues to receive mixed signals on the economy as positive data points such as improved unemployment have been offset by prolonged negativity in the housing market.

European leaders are attempting to stabilize their sovereign debt crisis with no easy solution to balance austerity and the need for economic growth.

Because of the looming uncertainty and unresolved economic issues, fundamentals such as supply and demand for commodities or earnings announcements for equities have had little, if any, impact on market behavior as the resolution of many global issues seems remote.

As represented by the Altegris 40 Index,® managed futures returns were down an estimated -2.66% during a volatile quarter. By comparison, equities (as represented by the S&P 500 Total Return Index) were up 11.82%, while bonds (as represented by the Barclays Aggregate Bond Index) were up 1.12% [FIGURE 1].

FIGURE 1.

MANAGED FUTURES PERFORMANCE VERSUS INDICES

Quarterly, Annual and 10-Year Returns through December 31, 2011

	Quarterly Returns 2011					Yearly Returns			10-Year Returns January 2002-December 2011			
	Q1 Return	Q2 Return	Q3 Return	Q4 Return	2011 YTD Return	2010 Return	2009 Return	2008 Return	Total Return	Ann ROR	Std Dev	Max DD
Altegris 40 Index®	-1.23%	-2.50%	3.32%	*-2.66%*	***-3.14%***	11.33%	-7.98%	15.47%	87.71%	6.50%	10.59%	-13.24%
Barclay Global Macro Index	-0.30%	-1.28%	-2.34%	*0.46%*	*-3.44%*	6.74%	7.49%	-0.65%	88.20%	6.53%	5.27%	-6.42%
HFRI Fund Weighted Composite Index	1.70%	-0.92%	-6.74%	*1.26%*	*-4.83%*	10.25%	19.98%	-19.03%	77.66%	5.92%	6.52%	-21.42%
S&P 500 Total Return Index	5.92%	0.10%	-13.87%	11.82%	2.11%	15.06%	26.46%	-37.00%	33.35%	2.92%	15.93%	-50.95%
Barclay US Aggregate Composite Bond Index	0.43%	2.30%	3.83%	1.12%	7.86%	6.56%	5.93%	5.24%	75.45%	5.78%	3.70%	-3.82%
MSCI EAFE Index (Net)	3.36%	1.56%	-19.01%	3.33%	-12.14%	7.75%	31.78%	-43.38%	57.78%	4.67%	18.73%	-56.68%
NAREIT Composite Index	6.98%	2.87%	-14.51%	14.06%	7.31%	27.55%	27.79%	-37.84%	146.87%	9.46%	24.54%	-68.17%
GSCI Total Return Index	11.57%	-7.95%	-11.69%	8.96%	-1.18%	9.02%	13.67%	-46.49%	73.29%	5.65%	25.18%	-67.65%

** Estimates as of January 11, 2012 . PAST PERFORMANCE IS NOT NECESSARILY INDICATIVE OF FUTURE RESULTS. There is no guarantee that any investment product or strategy will achieve its objectives, generate profits or avoid losses. SOURCE: Altegris.*

Unresolved Economic Issues

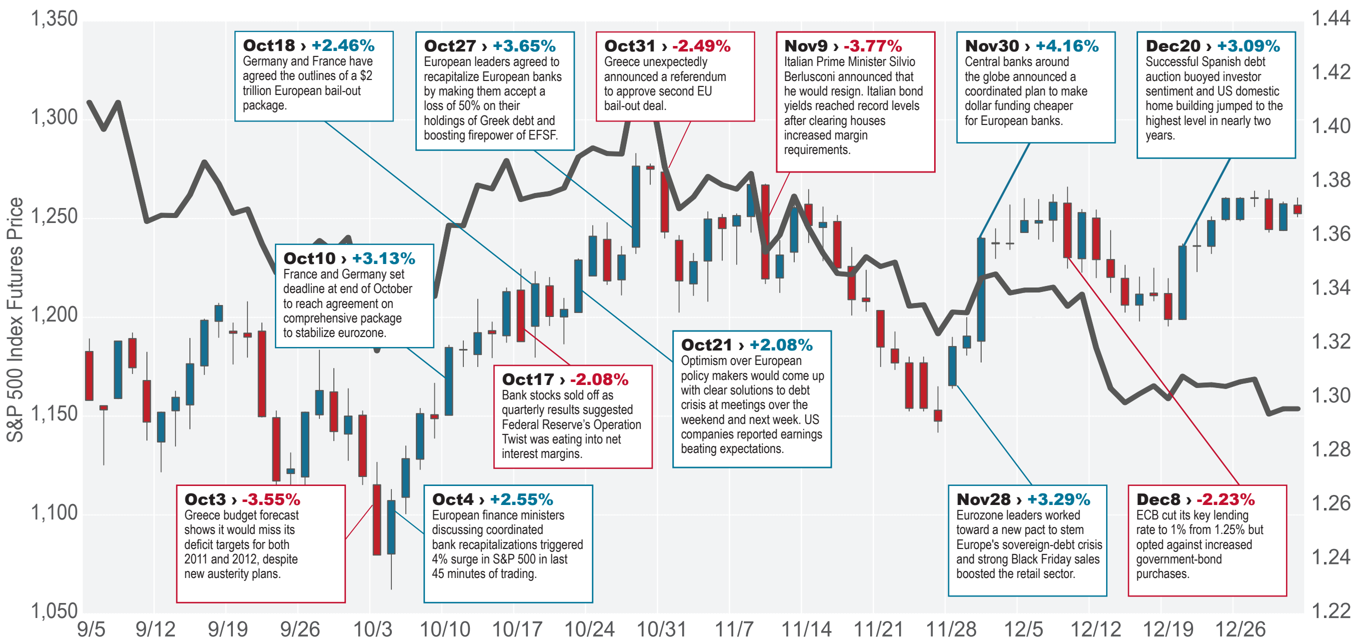
While Europe's debt crisis began over two years ago, its influence over the markets has steadily risen. Markets gyrated in tandem over the course of the fourth quarter based on frequently conflicting headlines from Europe. In fact, over the course of the fourth quarter, S&P 500 futures experienced 33 days of 1% moves (positive or negative) and 14 days of 2% (positive or negative) moves due primarily to what seemed like daily announcements regarding new progress (or temporary setbacks) in solving Europe's debt problems. At this time last year, there were only eight days in which S&P futures moved up or down 1% and zero days in which it moved 2%. The magnitude of these volatile days in the market, as well as how closely the U.S. stock market followed the euro, is delineated in the graph below of S&P 500 futures [FIGURE 2].

> Markets moved in tandem to the upside one day and then reversed direction the next, making it difficult for even the most seasoned and nimble managers to garner profits.

While stock market volatility has been particularly notable in recent months, other asset classes were similarly affected. Currency, commodity, and even U.S. fixed income futures markets experienced sustained volatility as well as high correlation over the fourth quarter. The unresolved economic issues have created a "risk on" to "risk off" trading environment that kept switching back and forth throughout the quarter. Markets moved in tandem to the upside one day and then reversed direction the next, making it difficult for even the most seasoned and nimble managers to garner profits.

FIGURE 2.

S&P 500 INDEX FUTURES DRIVEN BY MAJOR NEWS EVENTS IN Q4 2011



SOURCE: Altegris.

Evidence of this can be seen in the chart below, which shows that the rolling 3-year correlation between the S&P 500 Index and an equal-weighted portfolio of seven different markets (the MSCI EAFE Index, the MSCI Emerging Markets Index, gold, copper, 10-year US Treasury debt, the euro, and the GSCI Total Return Index) has reached unprecedented levels. [FIGURE 3].

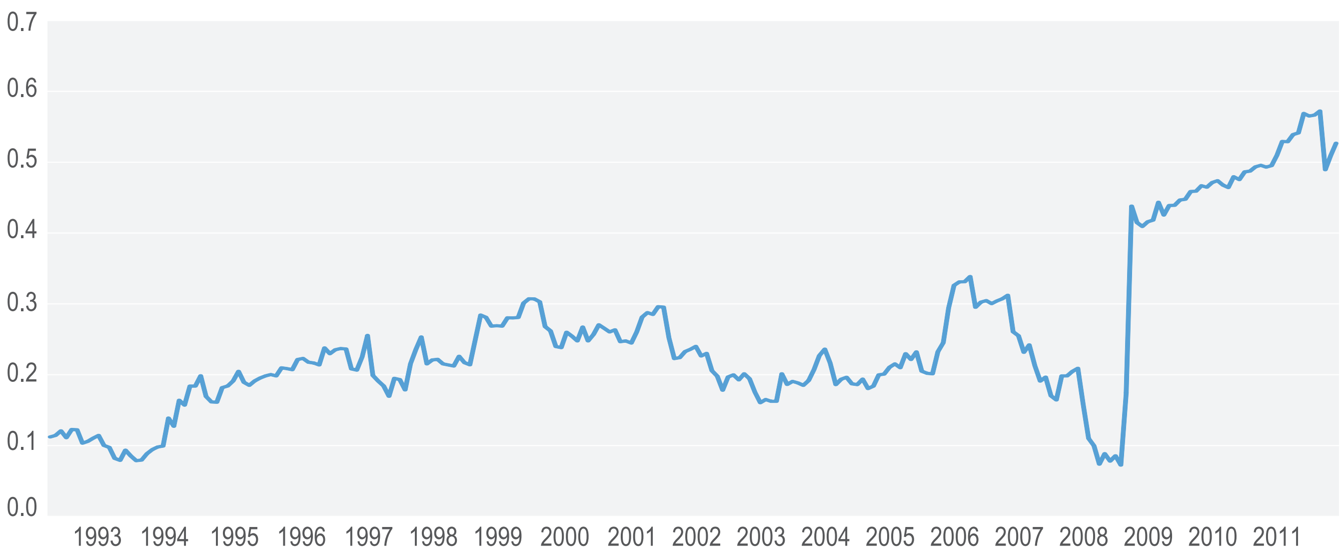
Q4 2011: High Correlation, Continued Uncertainty

Looking back at the quarter on a month by month basis, eurozone policy decisions continued to dominate the markets. If you recall, managed futures managers were positioned firmly in the risk off camp with long positions in fixed income (yields trending lower) and short positions in commodities and commodity currencies. On October 4th, markets surged after European finance ministers discussed coordinating bank recapitalizations. This led to a sustained risk rally through the end of the month as eurozone leaders took additional steps to stabilize the euro. The S&P 500 TR Index rose over 10%, while the Altegris 40 was down -3.96%, the second worst month for managed futures in the past five years. Most notably, trend following managed futures managers positioned risk off experienced a difficult month as the vast majority of their positioning (long USD, long yen, short the euro, short stock indices) was counter to the risk on rally. While largely negative on the month, macro-oriented managers fared better than their trend following peers as many were able to more nimbly respond to the rapid switch from a risk off to a risk on environment.

FIGURE 3.

S&P 500 VERSUS ASSET CLASSES: 3-YEAR CORRELATION

1993–2011



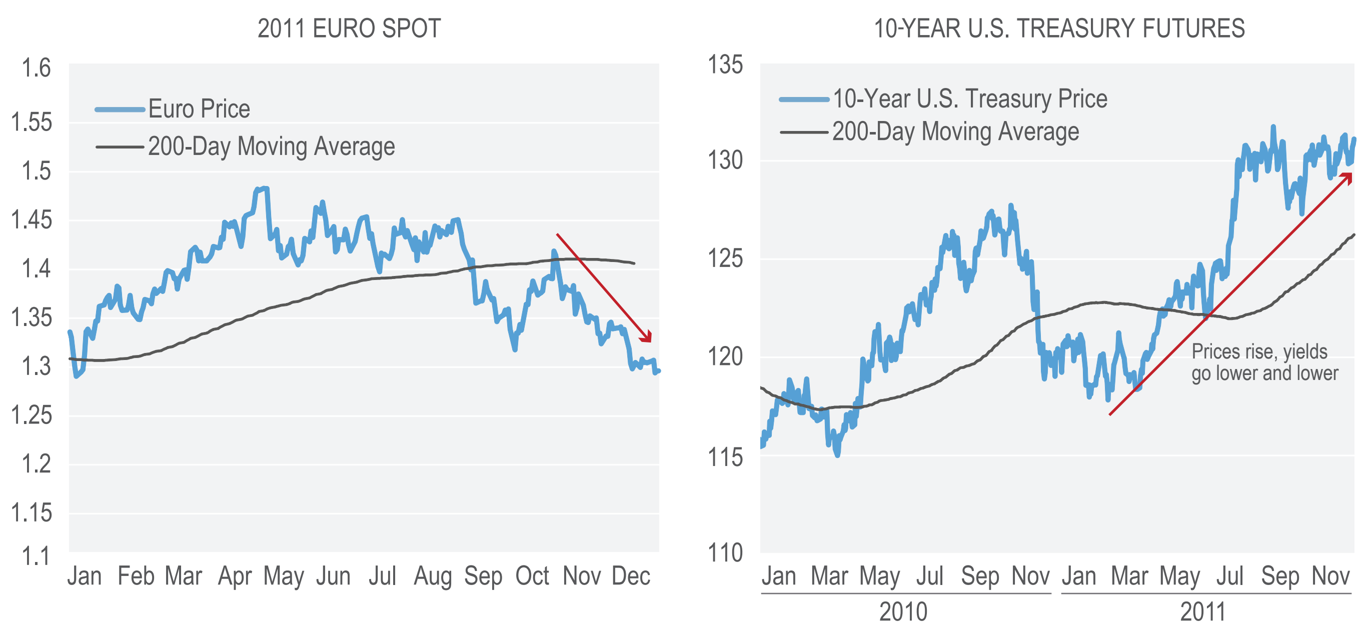
SOURCE: Altegris.

The risk rally abated in early November as pessimism over Europe crept backed into the picture. Italy's Prime Minister, Silvio Berlusconi, announced that he would resign and Italian bond yields reached record levels. Markets tumbled for the most part on increased fear that Europe's woes could extend to core countries like Germany and France. Managers with risk off positioning again profited from short positions in high yielding currencies and commodities and long positions in fixed income. In fact, it looked to be a very profitable November until month end. Two pieces of positive economic news emerged in the last week of the month: strong Black Friday sales figures in the U.S. as well as the announcement from six global Central banks regarding a coordinated plan to increase global liquidity. Markets reversed sharply, with S&P 500 futures up over 3% on November 28th and over 4% on November 30th. With a return to the risk on environment, trend following managers saw much of their monthly gains dissipate in just a few days. The Altegris 40 was up a modest 0.30% for November while S&P 500 TR Index declined -0.22%.

The first half of December was again influenced by renewed eurozone fears as the euro dropped below the key level of $1.30/USD, a 12% decline from its May 2011 high. Meanwhile, 10-year Treasury yields continued their descent, falling to a 10-week low as the long fixed income trade continued to be profitable for trend following managed futures managers. Charts for both the euro and U.S. 10-Year Treasury futures are pictured below [FIGURE 4].

FIGURE 4.

EURO AND US 10-YEAR TREASURY FUTURES



SOURCE: Altegris.

However, the risk on/risk off pendulum swung mightily again on December 20th after a successful Spanish debt auction, encouraging economic news from Germany, and positive U.S. housing data. Global stock index, commodity currency (Australian, Canadian and New Zealand) and commodity futures surged. For December, the Altegris 40 was up an estimated 1.05% while the S&P 500 TR Index was up 1.02%.

While European leaders continue to grasp for answers to their debt problems, the difficult choice between austerity and growth leaves no easy solution to this issue. There has been some positive economic data out of the U.S., with unemployment falling to 8.6% coupled with rising consumer expectations, but mixed data on the housing front tempers hope. Nonetheless, as Europe struggles with its sovereign debt crisis, policy decisions yielding both positive and negative sentiment may only reinforce the high correlation between markets. Regardless of the outcome, the market awaits resolution.

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The following detailed review of markets and managed futures strategy performance for Q4 2011 should help shed some light on how trend following, short-term systematic, global macro discretionary and global macro foreign exchange managers performed throughout the market turbulence.

Strategy Summary

Trend Following

In last quarter's market commentary, we highlighted the strong performance of trend following strategies amid the broader market turmoil and growing economic uncertainty in Q3. As the European debt crisis intensified and financial markets braced for a global economic slowdown, trend following managers profited handsomely from long positions in developed market fixed income (i.e. positioned for interest rates to fall) in early Q3 and short equity and commodity markets later in the quarter. Because of the strong risk off sentiment and downward price persistence in Q3, trend followers entered the quarter with positions in all four major asset classes (fixed income, equities, commodities, and currencies) that would benefit from the sustained economic and financial market weakness that was prevalent throughout the previous quarter. Trend following managers were therefore positioned for a continued risk off environment, which they expressed through long developed market fixed income, short equities, short commodities, and long the U.S. dollar against most foreign currencies.

While the previous quarter's trends persisted over the first several days of Q4, prices made an abrupt and powerful reversal during the first week of October and set the tone for a challenging quarter. On October 4th, news out of the eurozone indicating a voluntary haircut on Greek debt and a $1 trillion commitment to backstop European debt issuance provided the market with a temporary psychological relief and triggered powerful risk on rallies across global financial markets. The result was a nearly instantaneous reversal of the prevailing price trends over the past several months: equities and commodities rallied, developed market interest rates spiked, and the U.S. dollar fell against nearly all currencies as markets priced in a lower probability of a eurozone-led global economic slowdown. Against this backdrop, trend following managers gave back most of their profits from the previous quarter due to the sharp and sustained market reversals in October.

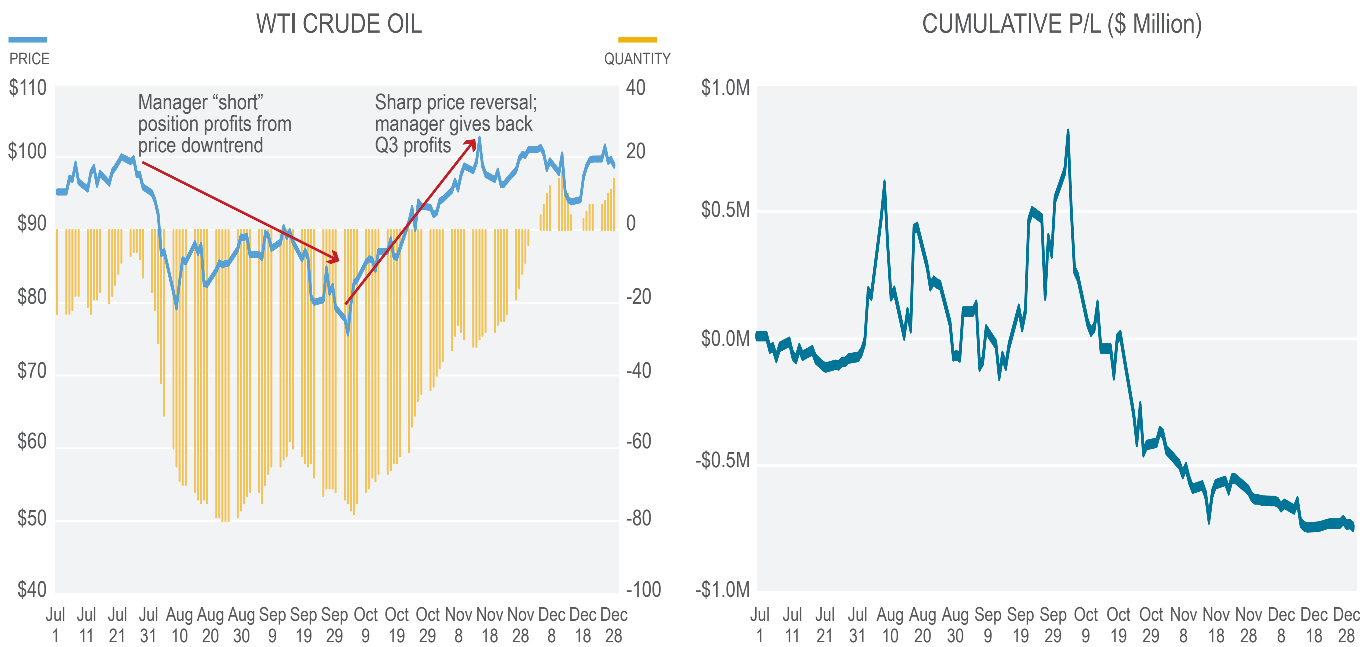
The remainder of Q4 presented similar challenges, with a continued "push and pull" between conflicting economic data that indicated modest growth one week and contraction the next, unrelenting news flow and rumors emanating from Europe, and worries about slowing (but strong) growth from China. A key theme during the quarter was the constant re-adjustment of prices to the impact (or potential impact) of government intervention. As the market's attention focused on the unresolved situation in Europe, most financial market prices flitted back-and-forth on a weekly basis but largely remained in a holding pattern for the final two months of the year. In both November and December, risk off market behavior in the first half of the month resulted in strong performance among trend followers (primarily driven by gains in the fixed income and currency sectors), but positive news in the back half of the month gave way to price reversals that reversed earlier gains.

To provide further context for the challenging market environment during Q4, the following chart demonstrates how a hypothetical trend following manager was positioned in the WTI Crude Oil futures contract over the course of the quarter [FIGURE 5]. After making profits late in Q3 from downward price momentum in crude oil futures, the manager maintained its short position into early Q4. The abrupt move from risk off to risk on in early October led to rallies in crude oil (blue line, left chart) and resultant losses (teal line, right chart), and the manager's systems followed the upward trend by shifting its positioning from short to long by early December (yellow lines, left chart). Price choppiness in crude oil over the final two months of the quarter resulted in additional losses and underscored the difficulties for trend following strategies during Q4. This price pattern was similar for many markets during the quarter (and the year as a whole), with periods of solid profitability offset by sharp reversals and choppy price action.

FIGURE 5.

HYPOTHETICAL POSITIONING OF A TREND FOLLOWING MANAGER IN THE WTI CRUDE OIL FUTURES CONTRACT

For Illustrative purposes only.



SOURCE: Altegris.

In many ways, Q4 was a microcosm of the very challenging market environment in 2011; throughout the year, trend following managers have endured both "noisy" markets and sharp trend reversals which have historically been the two most difficult environments for the strategy. As highlighted in the "Overview" section, the persistently high correlation across asset classes and frequent switching between risk on and risk off regimes has largely neutralized the benefits of holding a highly diversified portfolio of positions across asset classes, as markets have behaved very similarly but few (outside of the fixed income sector) have exhibited sustained price trends throughout the year. Despite these challenges, we believe that trend following managers have produced uncorrelated (albeit slightly negative) returns in 2011 and will continue to provide a strong diversification benefit to traditional portfolios in the months and years to come.

Specialized: Short-Term Systematic

Short-term systematic managers are a specialized and diverse subset of managed futures managers, representing approximately 9% of the Altegris 40 Index.

The exact nature of the strategies employed by short-term systematic managers can vary greatly from manager to manager, often resulting in vastly different performance from one program to another. As such, it can be difficult to make broad generalizations regarding the performance of short-term systematic managers as a whole. The fourth quarter was a prime example of this fact, as some managers generated exceptionally strong results, while others struggled to double digit losses.

Despite their differences, short-term systematic managers do share some common traits. First, as the name suggests, their models are designed to capitalize on shorter term price movements than those of longer-term trend followers, typically holding trades for days to weeks (or even intra-day) rather than weeks to months. Secondly, short-term systematic managers generally perform best during periods of sustained and/or rising volatility.

Given the heightened level of volatility experienced throughout the fourth quarter, it would be fair to ask why short-term systematic managers didn't perform better as a whole. To be fair, some managers did produce outstanding performance during Q4, particularly those managers with greater focus on stock indices and interest rates. The price action in the S&P 500 was particularly profitable for some of these managers, as the frequent back and forth price action provided opportunities for both mean-reversion and short-term momentum strategies.

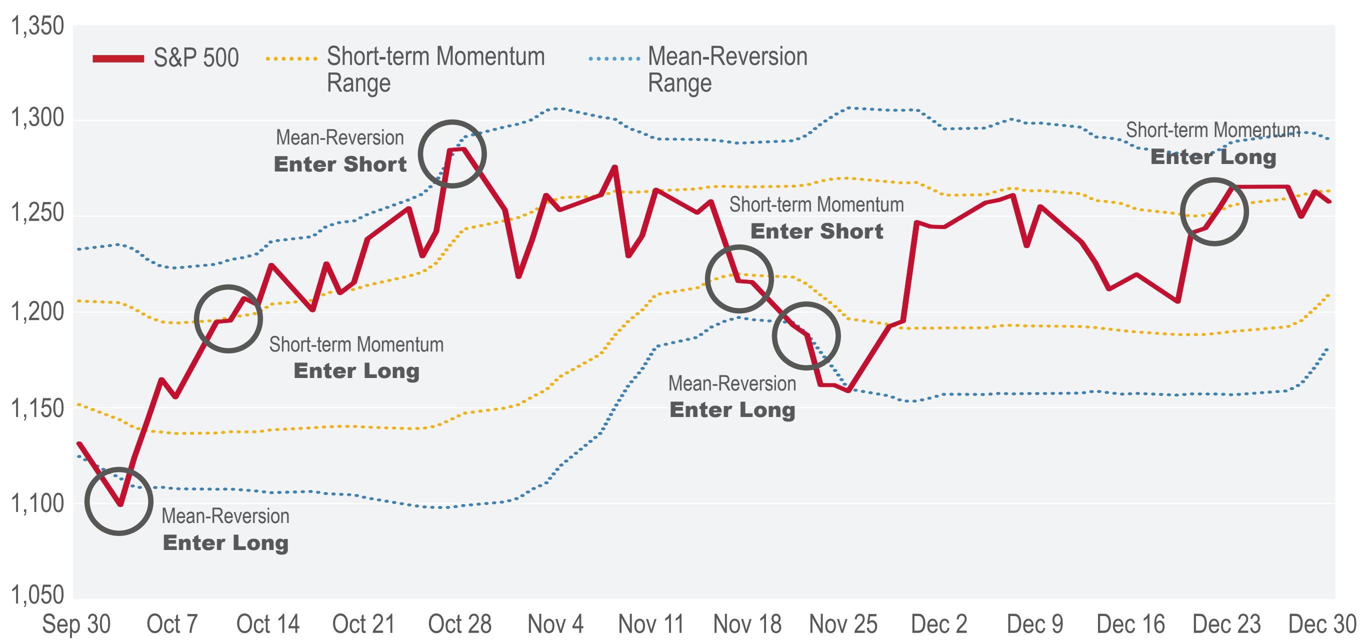
Short-term momentum and mean-reversion strategies are really two sides of the same coin. Momentum strategies attempt to profit from the continuation of a price move following a breakout from an established range (yellow trading bands below), while mean-reversion strategies attempt to profit from a return to "normal" after prices have moved too far beyond an established range (blue trading bands below). The following hypothetical chart illustrates how some managers employing mean reversion and/or short-term momentum strategies were able to profit so handsomely from the S&P 500 during Q4 [FIGURE 6].

Why then did the fourth quarter prove so difficult for other short-term systematic strategies? The answer lies in another common trait of short-term systematic managers: their models are generally believed to work by capitalizing on the knee jerk behavioral tendencies of market participants. When government intervention prevents markets from behaving as they otherwise would, it can wreak havoc on trading models designed to profit from the behavioral tendencies that manifest themselves during a normally functioning market. This has been particularly true in the FX markets, as governments and central banks around the globe have directly intervened to support or depreciate their currencies, resulting in large losses for some short-term systematic managers.

Overall, the Alternative Edge Short-Term Traders Index finished the quarter down an estimated -1.79%, although this relatively modest number obscures the broad range of performance exhibited by many of the managers we track.

FIGURE 6.

HYPOTHETICALLY, MANAGERS EMPLOYING MEAN REVERSION AND/OR SHORT-TERM MOMENTUM STRATEGIES PROFITED HANDSOMELY FROM THE S&P 500 DURING Q4 | For Illustrative purposes only



SOURCE: Altegris.

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 approximately 4% and foreign exchange managers account for approximately 7% of the Altegris 40 Index.

Instead of reacting to price movements like their trend following and short-term systematic peers, discretionary global macro managers analyze fundamental economic data (such as supply and demand, GDP statistics, unemployment rates, etc.) in order to identify imbalances and hopefully predict price changes in the future. These managers tend to be the most flexible and opportunistic of all the managed futures sub-strategies, allowing them to nimbly shift positioning and exposures ahead of their systematic peers who must first see prices change before they change their positioning.

While their reasons for holding the positions are completely different than those of trend followers, discretionary global macro managers have generally been holding many of the same risk off positions as their trend following peers. Short equities, long interest rates, and long gold remain favorite trades of many discretionary global macro managers who fear that any misstep in Europe could trump whatever meager signs of U.S. growth are to be believed. As with trend followers, these risk off positions generally resulted in losses for discretionary global macro managers during Q4. On the bright side, these losses were typically more modest for discretionary macro managers, who were able to nimbly cut exposures as prices moved against them, helping to mitigate further losses.

Like discretionary global macro managers, FX macro managers typically utilize fundamental economic data in order to trade global currency markets. However, FX macro managers often incorporate additional currency specific factors, such as interest rate differentials, into their trading models. Despite these nuances, the end result was similar for FX macro managers during Q4, with most managers struggling to produce positive results.

FX macro managers are probably the most impacted by the ongoing government and central bank interventions into the currency markets. The fundamental factors utilized by these managers in order to determine which currencies are under/overvalued relative to one another have frequently been trumped by large scale interventions by governments and central banks. While currency market intervention is certainly nothing new, the magnitude of the eurozone crisis has resulted in currency manipulation beyond the scope of what FX macro managers have typically had to cope with. Despite these near term difficulties, governments cannot intervene indefinitely. Ultimately, imbalances between currencies will need to be resolved, likely creating significant opportunities for FX macro managers in the process.

Conclusion

Markets were greatly affected by the ongoing European debt crisis during the fourth quarter. While the global economic picture remains cloudy, European policy makers will most likely make harder decisions in the near term to avoid potential sovereign defaults. For managed futures, the key variable will rest in whether the markets will take a more conclusive view, either positively or negatively, and have a more persistent directional move that managers can take advantage of. A clearer picture could also lead to fundamentals being relevant and the reduction in market correlation, both of which should fuel a more favorable investment environment.

Ironically, positive U.S. economic data continued to come out in the latter part of December. However, all eyes remain on Europe, hoping for a resolution of their issues. While one obviously cannot predict if we will continue to muddle along or have a more definitive outcome in the near future, it remains prudent in our view to hold a diversified portfolio containing managed futures should the European outcome become materially unfavorable.

INDEX DESCRIPTIONS

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.

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

Alternative Edge Short-Term Traders Index—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.

Barclays Capital U.S. Aggregate Index—The Barclays Capital U.S. Aggregate Index covers the U.S. Investment grade fixed rate bond market representing taxable U.S. dollar securities.

Barclay Global 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.

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.

S&P GSCI Total Return Index—The S&P GSCI Total Return Index measures a fully collateralized commodity futures investment. Currently the S&P GSCI includes 24 commodity nearby futures contracts.

S&P 500 Total Return Index—This index is the total return version of S&P 500 index. The S&P 500 index is unmanaged and is generally representative of certain portions of the U.S. equity markets. For the S&P 500 Total Return Index, dividends are reinvested on a daily basis and the base date for the index is January 4, 1988. All regular cash dividends are assumed reinvested in the S&P 500 index on the ex-date. Special cash dividends trigger a price adjustment in the price return index.

MSCI EAFE Index—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 U.S. & 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.

MSCI Emerging Markets Index—The MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets. The MSCI Emerging Markets Index consists of the following 21 emerging market country indices: Brazil, Chile, China, Colombia, Czech Republic, Egypt, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Morocco, Peru, Philippines, Poland, Russia, South Africa, Taiwan, Thailand, and Turkey.

NAREIT Composite Total Return Index—The NAREIT® Composite Total Return Index includes both price and income returns of all publicly traded REITs (equity, mortgage, and hybrid).

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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.

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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.

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