# Managed Futures:
## Fear Not Volatility

February 2012

**Fear, as defined by Merriam-Webster dictionary, is an unpleasant often strong emotion caused by anticipation or awareness of danger. Uncertainty in the markets and increased volatility[1] seem to bring fear to the forefront of many investors' minds, with many anticipating poor portfolio performance due to past experiences during similar market conditions. Volatility in the markets will always exist to some degree, so we contend it is important for portfolios to incorporate investments that are not only able to withstand volatility, but also perhaps profit from it.**

## Volatility Measure: The VIX

A common measure of expected market volatility is the Chicago Board Options Exchange Volatility Index, commonly known as the "VIX." The VIX measures implied near-term volatility of S&P 500 index option prices. Basically, it represents the market's *expectation* of stock market volatility over the next 30-day period, measured on an annual basis. A VIX of 25 indicates an expected annualized change of 25%, or, a 1.88% market move up or down over the next 30-day period. The higher the VIX the higher expected near-term volatility in the markets, and vice-versa, the lower the VIX the lower near-term expected volatility in the markets. A high VIX, however, does

*1. Volatility is a measurement of the change in price over a given time period. Typically higher volatility is associated with an elevated level of risk.*

## KEY POINT

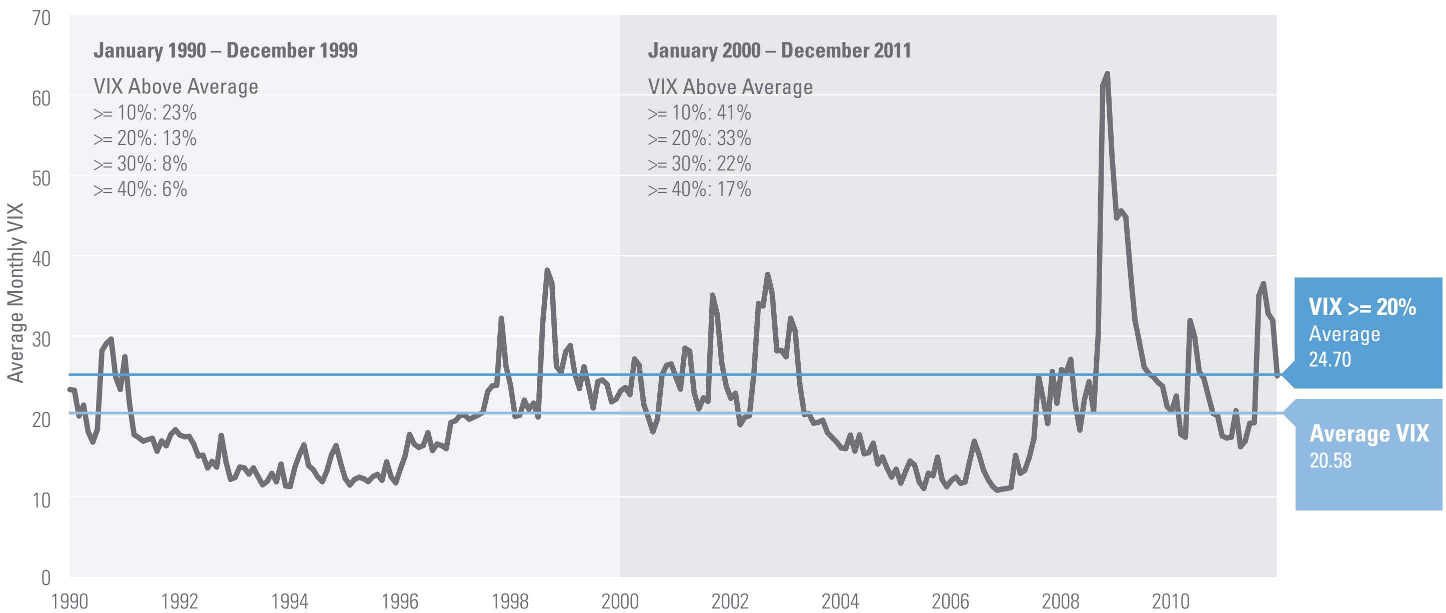
A high VIX does not necessarily mean that the prices of stocks or equities will go down.

not necessarily mean that the prices of stocks or equities will go down as it is not a fear index; instead it means volatility in the near term is expected to be higher, which could be price movement *either* up or down. Figure 1 shows the average monthly VIX since 1990.

Looking at the past two decades, from 1990 through 2011, the average historical monthly VIX was 21. However, if you compare the last ten years versus the 1990s, it's clear that expected volatility has increased dramatically. The monthly VIX was at least 20% above its historical average during the 1990s only 13% of the time. In comparison, during the 2000s the monthly VIX was at least 20% above its historical average 33% of the time, more than double the number of times of the previous decade. The more frequent occurrences of elevated monthly VIX levels during the 2000s does not necessarily mean that stocks or equities were expected to go down, only that there was an increase in expected volatility. In 2001 when US stocks lost nearly -12%, the average monthly VIX for the year was 26. The average monthly VIX during 2009 was 32, but US stocks did not drop in value that year, in fact, US stocks returned over 26% during 2009.

FIGURE 1.

AVERAGE MONTHLY VIX | January 1990 – December 2011




*PAST PERFORMANCE IS NOT NECESSARILY INDICATIVE OF FUTURE RESULTS. These values represent an index. 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. Index: Chicago Board Options Exchange Volatility Index (VIX Index). Source: Bloomberg, Altegris.*

Another indication of elevated expected volatility is a comparison of the number of months the VIX has historically been above its long-term average.[2] Significant difference in expected volatility between the two decades demonstrates a rise in volatility expectations.

During the 1990s, 16 months had a VIX level that exceeded the index's average by at least 20%. Since 2000 has been a different story: monthly values have been 20% or more than the average 48 times. Further, after January 2000 it only took until October 2002 for the VIX to accrue the same number of months (16) with values at the same above average threshold. That is, it took less than three years for the frequency of elevated volatility expectations to equate to the entire decade of the '90s.

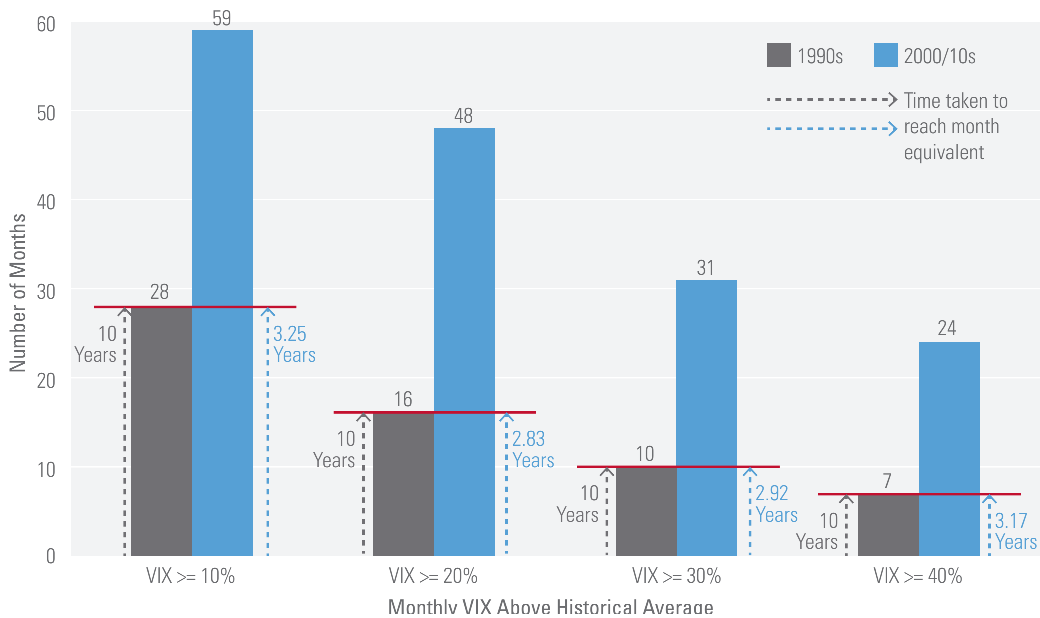
It of course is unknown whether future decades will resemble either of those of the past 20 years. However, the VIX may be a useful tool of measure to understand how certain investments may react to varying levels of expected volatility surrounding future markets.

**KEY POINT**

The VIX may be a useful tool of measure to understand how certain investments may react to varying levels of expected volatility surrounding future markets.

FIGURE 2.

NUMBER OF MONTHS VIX AT ELEVATED LEVELS | January 1990 – December 2011

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*2. VIX long-term average calculated from the period January 1990 to December 2011.*

## VIX Levels

Volatility in the markets will always exist to some degree, at some times greater than others. We believe it is important for portfolios to incorporate investments that are able to not only withstand, but potentially profit, in times of increased market volatility. While investing in the equity markets during periods of high volatility has been historically difficult, managed futures may be one such investment that has the potential to thrive. Although clearly, there is no guarantee that any investment will achieve profits or avoid losses.

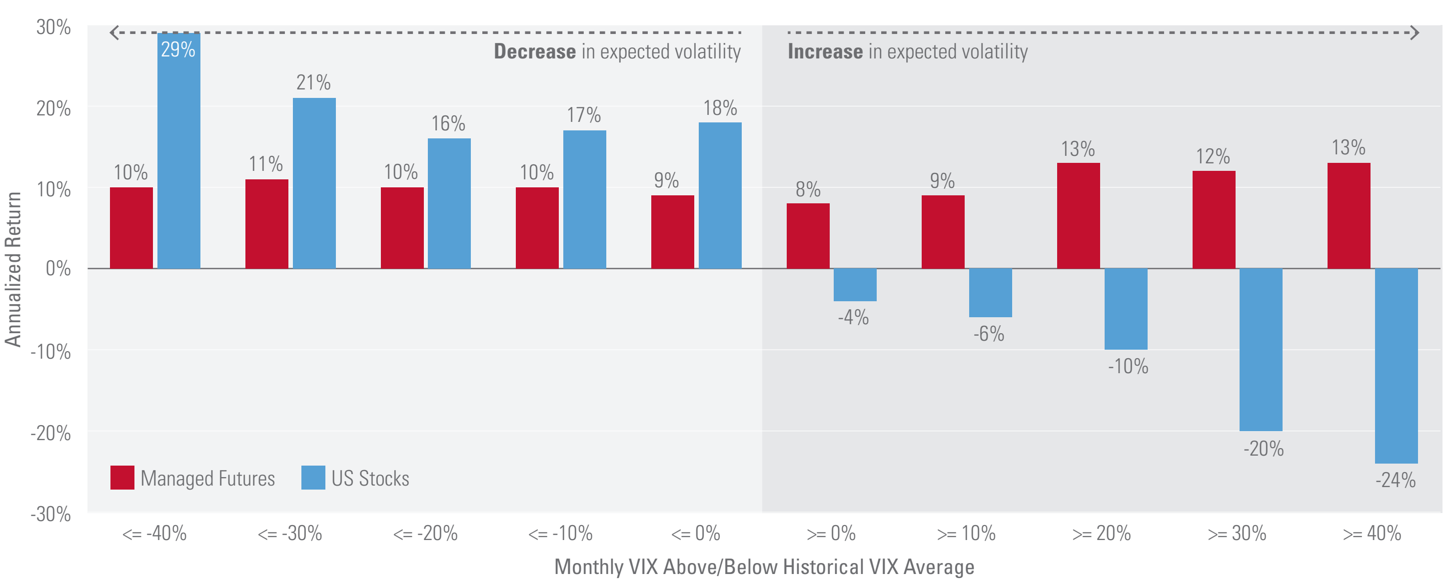
In the past, as the VIX has moved above its historical average, the average annualized return of US stocks progressively worsened (FIGURE 3). US stocks experienced an annual historical loss near -4% during months when the VIX was greater than its historical average. Even more striking, US stocks experienced an annualized historical return near -24% during those months when the monthly VIX was 40% or greater than its historical average. When the VIX has been below its historical average, indicating lower expected near-term volatility, US stocks historically delivered positive returns. On average, performance actually incrementally improved the lower the value of the VIX. Of course, these results may not repeat themselves in the future.

Managed futures' behavior during volatile markets has been a completely different story. In fact, on average, managed futures have achieved positive returns even when the VIX has been at significantly elevated levels (FIGURE 3). During months when the VIX was 40% or greater above

FIGURE 3.

ANNUALIZED RETURNS OF MANAGED FUTURES AND US STOCKS ABOVE / BELOW HISTORICAL MONTHLY AVERAGE VIX

January 1990 – December 2011




*The annualized return of an investment is only one measure of performance. Performance should never be the sole consideration when making an investment decision. There is no guarantee that any investment will achieve its objectives, generate profits or avoid losses. PAST PERFORMANCE IS NOT NECESSARILY INDICATIVE OF FUTURE RESULTS. An investor cannot invest directly in an index. Moreover, indices do not reflect commission or fees that may be charged to an investment product based on the index, which may materially affect the performance data presented. INDICES: US Stocks: S&P 500 Total Return Index; Managed Futures: Altegris 40 Index® (started July 2000; data available back to 1990); VIX Index. Source: Bloomberg, Altegris.*

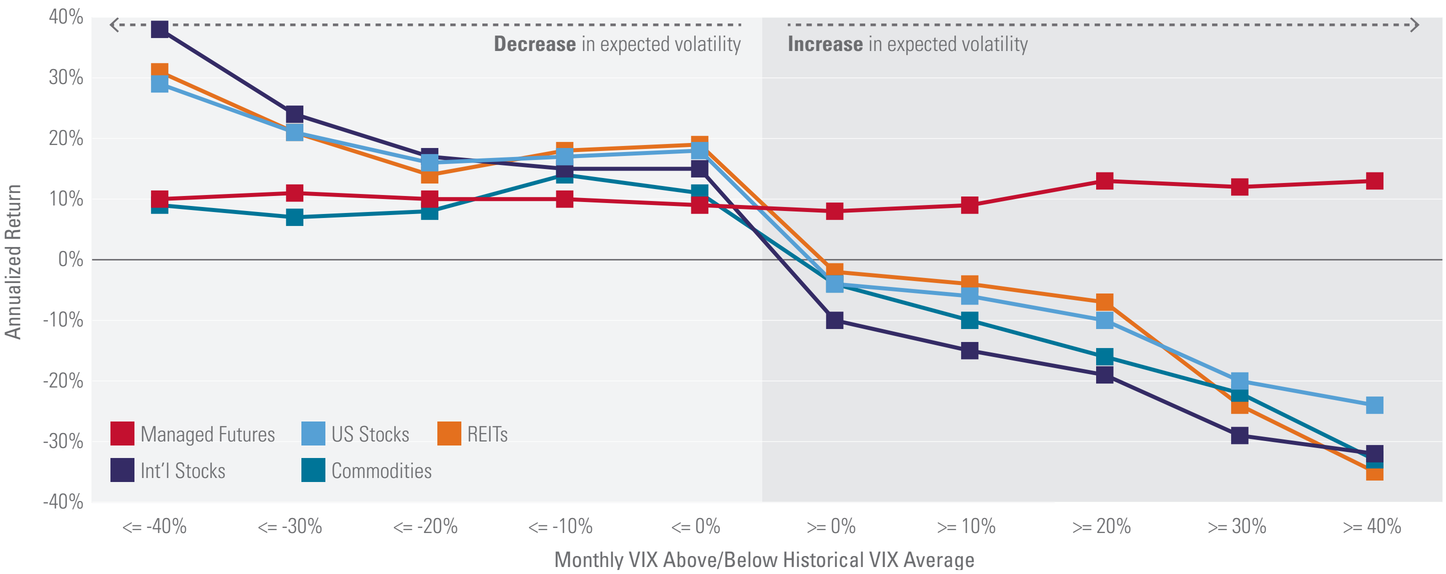
its historical average managed futures realized an annualized historical return of 13%. This represents a difference of nearly 37% on an annualized basis compared to US stocks during such periods. Even as the VIX was below its historical average, indicating lower expected volatility, managed futures still delivered historically consistent positive returns. Of course, past performance is not indicative of future results.

Many investors allocate portions of their portfolios to asset classes besides US stocks, perhaps to investments such as international stocks, commodities or real estate investment trusts (REITs). A closer look at these investments when the VIX was higher than average may help put into perspective previously unknown characteristics about these investments in times of expected increased volatility surrounding the markets (FIGURE 4).

A strikingly similar story to that of US stocks emerges, with performance gradually worsening during months the monthly VIX was incrementally higher than its historical average. However, managed futures has been the exception to this tale. The ability of managed futures to perform historically well in various market environments, regardless of expected volatility, depicts the typically flexible nature of managed futures; managed futures managers have the ability to react to changes by taking long or short positions across multiple asset classes in various global markets. Of course, there is no guarantee any investment will achieve its objectives, generate profits, or avoid losses.

FIGURE 4.

ANNUALIZED RETURNS OF MULTIPLE INVESTMENT CHOICES AT VARIOUS VIX LEVELS | January 1990 – December 2011

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## VIX Shifts

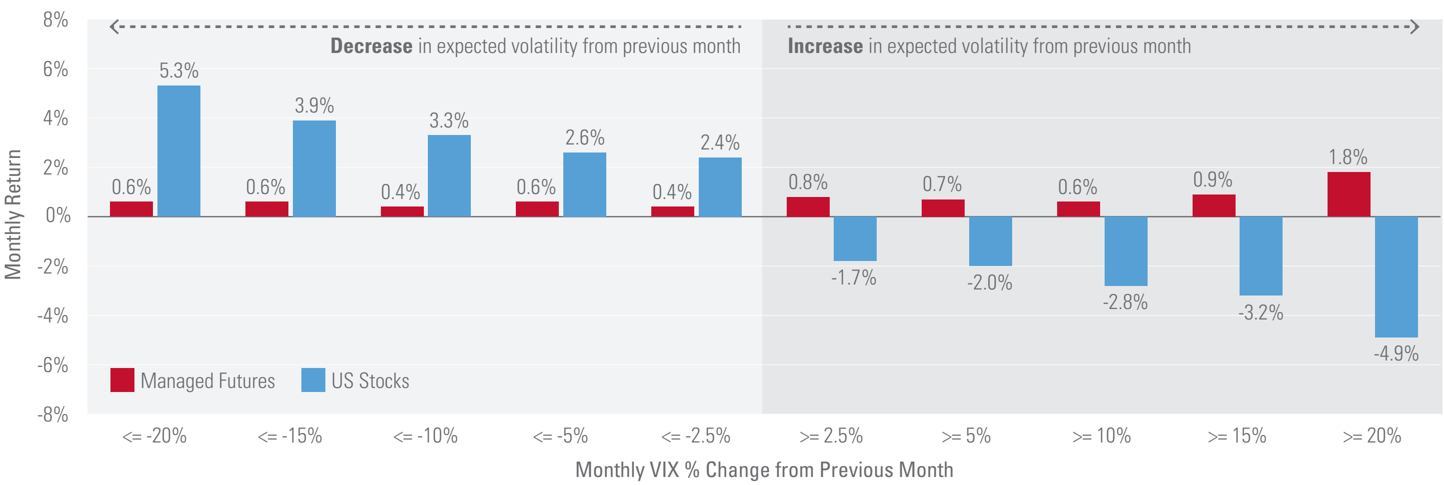
The ability of an investment to be nimble may be another important aspect in a portfolio, especially with short term expected volatility shifts. A change in the VIX from 12 to 13.2, a 10% increase, will have the same weight in this analysis as a change from 30 to 33, a 10% increase from the previous month as well. In other words, this analysis ignores the absolute level of the VIX, but instead looks at its upward or downward movement. By looking at the monthly percentage change of the VIX, it may give additional insight to how investments perform when short-term expected volatility change surrounds the market.

Historically, US stocks' monthly returns have progressively worsened as the percentage change of the VIX from the previous month increased (FIGURE 5). During those months when the VIX increased by 20% or more from the previous month, US stocks experienced historical returns near -5% per month on average. This may be a significant statistic as changes in the VIX from the previous month have occurred with greater regularity and magnitude over the past three years. Whether this trend will continue or not is not known, but having an investment that may be able to perform when the VIX shifts could be beneficial. Of course, these results may not repeat themselves in the future.

Managed futures experienced historical returns of nearly 2% per month, almost a 7% historical monthly advantage over US stocks, when the percentage change of the VIX from the previous

FIGURE 5.

MONTHLY RETURNS OF VIX PERCENTAGE CHANGE FROM PREVIOUS MONTH | January 1990 – December 2011

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**Note:** Monthly returns are used in this analysis to get a better idea of how expected volatility shifts in the markets may affect short term performance of an investment, since long-sustained consecutive monthly percentage increases or decreases of the VIX rarely occur. In fact, three consecutive months is the longest streak when a 5% increase occurred in the monthly VIX over the previous month, while the longest streak of consecutive 5% monthly decreases is four months.

month increased by 20% or more (FIGURE 5). Not only have managed futures performed historically well when the percentage of the VIX has increased from the previous month, but consistently returned historical positive monthly performance when the percentage change of the VIX decreased from the previous month. Of course, past performance is not indicative of future results.

A comparison of other investments should also be examined to find if other traditional investments perform well during short-term fluctuations in the market (FIGURE 6).

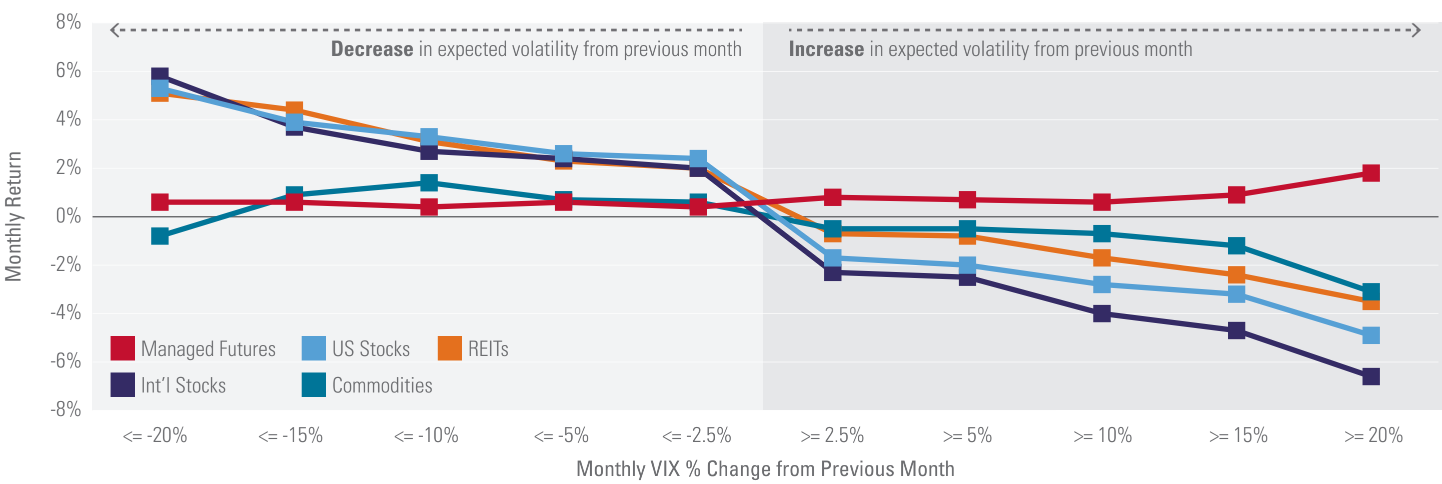
International stocks, commodities and REITs follow a similar path to that of US stocks, as the historical monthly returns worsen as the percentage change of the VIX from the previous month increases. The consistent historical monthly returns managed futures have shown during short-term shifts in volatility may be an important investment to include in a portfolio.

## Conclusion

Market volatility to some degree is inevitable. The VIX measures the near-term expected volatility of the markets and may be a good indicator as to the expectation of how certain investments may perform in various market volatility environments. Many investors may fear the word volatility when it comes to investments, but at Altegris, we believe this should not be the case. Managed futures have historically performed well whether expected volatility is high or merely shifting. The ability of managed futures to perform despite market volatility may be beneficial to those seeking an alternative to counter market uncertainty.

FIGURE 6.

MONTHLY RETURNS OF VIX PERCENTAGE CHANGE FROM PREVIOUS MONTH OF VARIOUS INVESTMENTS | January 1990 – December 2011

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## INDEX DEFINITIONS

*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.*

**Commodities.** The S&P GSCI Total Return Index measures a fully collateralized commodity futures investment and currently includes 24 commodity nearby futures contracts.

**Int'l Stocks.** 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.

**Managed Futures.** The Altegris 40 Index® tracks the performance of the 40 leading managed futures programs, by ending monthly equity (assets) for the previous month, as reported to Altegris by the over 500 managed futures programs that report performance to Altegris' proprietary database. The Altegris 40 index represents the dollar-weighted average performance of those 40 constituent programs. The Index started in July 2000; data is available back to 1990.

**REITs.** The FTSE 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.

**US Stocks.** 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 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.

**VIX.** Chicago Board Options Exchange Volatility Index, commonly known as the VIX, measures implied near-term volatility of S&P 500 index option prices.

## INDEX DESCRIPTIONS

| | Representative Index | Characteristics | Key Risks |
|---|---|---|---|
| **US Stocks** | S&P 500 Total Return (TR) Index | 500 US stocks<br>Weighted towards large capitalizations | **Stock market risk.** Stock prices may decline. |
| **International Stocks** | MSCI EAFE Index | 1,000+ stocks from 20+ developed markets in Europe and the Pacific Rim | **Stock market risk.** Stock prices may decline.<br>**Country / regional risk.** World events may adversely affect values.<br>**Currency risk.** Unfavorable exchange rates may occur. |
| **Managed Futures** | Altegris 40 Index® | 40 top AUM managed futures programs, monthly, as reported to Altegris | **Market risk.** Prices may decline.<br>**Leverage risk.** Volatility and risk of loss may magnify with use of leverage.<br>**Country / regional risk.** World events may adversely affect values. |
| **REITs** | FTSE NAREIT Composite Total Return Index | Publicly traded US real estate investment trusts (REITs) | **Stock market risk.** Stock prices may decline.<br>**Industry risk.** Adverse real estate may cause declines.<br>**Interest rate risk.** Prices may decline if rates rise. |
| **Commodities** | S&P GSCI Total Return Index | 24 principal physical commodities that are the subject of active, liquid futures markets | **Market risk.** Prices may decline.<br>**Derivative risk.** May be subject to higher volatility.<br>**Leverage risk.** Volatility and risk of loss may magnify with use of leverage. |

## Important Risk Disclosure

*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.*

## About Altegris

Altegris searches the world to find what we believe are the best alternative investments. Our suite of private funds, actively managed mutual funds and managed accounts provides an efficient solution for financial professionals and individuals seeking to improve portfolio diversification.

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 $3.36 billion in client assets, and provides clearing services to $774 million in institutional client assets.*

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