THREE REASONS FOR MANAGED FUTURES AND MACRO...NOW

July 2014

Money managers and asset allocators who specialize in the esoteric strategies known as managed futures and global macro have had a tough time. Amidst the investment wreckage of 2008, these strategies were among the few bright shining lights, providing uncorrelated positive returns as traditional assets cratered. Investors and advisers were attracted to the unique benefits of absolute returns in any market environment, increasingly packaged in accessible "liquid alternative" format, and the assets predictably followed.

What happened next? Investors have subsequently faced the worst period of underperformance that these strategies have ever reported. Flow data indicates that an increasing number of investors have grown impatient. Some see these strategies as a form of disaster insurance for portfolios, and, as the risk of renewed crisis is perceived to be low, they are choosing other more directional diversifiers. Others are rebalancing portfolios back to long-only equities as the bull market seemingly defies gravity and either grinds higher, or just simply soars.

It's tempting to use that investor psychology as one of our three reasons for a prediction of better days ahead for managed futures and global macro. After all, isn't poor relative performance and declining investor popularity a contrary indicator? Perhaps, but not necessarily within a timeframe that we can predict with enough accuracy to impact our wealth building objectives.

Predicting mean reversion in return streams simply because it feels like it should be time is not a reliable portfolio strategy. There is a certain appeal to "buying low," but remember that these are global skill-based investment strategies that trade long and short, not individual securities with inherent value characteristics.

So why are we saying that the time might be right to review your allocations to these strategies?

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Matt Osborne has more than 25 years of international business and financial market experience. As the Executive Vice President and Managing Director of Altegris Advisors, and a Director of Altegris Funds, Matt is responsible for Strategic Initiatives. He is also a co-portfolio manager of the company's mutual funds. Matt is a member of the Altegris Investment Committee, responsible for qualification, approval and ongoing review of all investment strategies and managers on the Altegris platform.

BEFORE I ADDRESS OUR REAL THREE REASONS, LET'S REVIEW WHERE WE ARE AND HOW WE GOT HERE.

The performance drawdowns have not been overly drastic in terms of depth: -16% for managed futures, a category dominated by systematic trend following strategies, and -8% for the broader macro index that includes some of the great names of the hedge fund elite; but the duration of the losing period has been agonizing for many investors.[1,2,3]

April 2011 was the most recent performance high for both categories, followed by a low in September 2013. Three consecutive calendar years of losses from 2011-2013 are material blemishes on these category indices, and while individual manager track records of course vary, few have escaped with reputations and records unscathed. *(For perspective, investors in the NASDAQ Composite are still waiting for new highs since March 2000, a drawdown that was -80% deep and is currently over 14 years long—but that's another story).*

SO WHAT HAPPENED TO MANAGED FUTURES AND GLOBAL MACRO STRATEGIES?

We believe that the overriding factor has been coordinated global central bank intervention. Unprecedented monetary policy has been the lead weapon to reverse the course of the Global Financial Crisis. Let's for a moment agree that if the definition of success of these policies is the avoidance of another Great Depression or even worse, a complete breakdown of the financial system as we know it, then central banks have saved the planet—for now. We don't have room here for a full discussion of the long-term future impact and implementation of exit strategies.

However, the impact of the central bank put option on world financial markets has been pronounced since the financial crisis. Whether it is the predominantly systematic trend driven approach of managed futures or the fundamental market forecasts of global macro specialists, these managers typically thrive in periods of expanding volatility and low correlations between markets. They want prices to trend with persistence and are generally agnostic whether that trend is up or down. They also prefer clear-cut differentiation between the economic policies of individual countries in order to create relative value trading opportunities across fixed income and equity securities, as well as currencies. Unfortunately, the overwhelming flood of quantitative easing in its various forms has had the opposite effect. Volatility across markets has been steadily contracting since the highs of 2008 and correlations between markets were unusually elevated leading to the phenomenon known as "risk-on/risk-off."

The only significant and sustainable trend that has not been curtailed is the rise in global equity prices. Of course, the central bankers are pleased with that outcome as it is the most visible asset price indicator of their "success." Meanwhile, currency and commodity market volatility have been at all-time lows, and bond markets remain tightly controlled. Yes, there have been opportunities—notably, (i) the fall of Europe that didn't actually occur *(saved by Mario Draghi at the ECB)* but created a risk environment that was notoriously difficult to trade; and (ii) Japanese yen weakness in late 2012/early 2013 that was certainly easier to trade for most managers. But if you missed the yen trade and have been cautious on equities, you have faced substantial headwinds from trendless and choppy commodity markets, low volatility currencies trading in tight ranges, and bond yields that reversed sharply against trend in mid-2013. Again, a central bank was the cause with Bernanke's taper talk responsible for some serious negative performance in that period. In a nutshell, the few winning trades have typically been more than offset by a diverse set of losing trades. At a conference in May of 2014, macro legend Paul Tudor Jones was quoted as saying, "Macro trading has probably been as difficult as I have ever seen it in my career." And to top it all off, Zero Interest Rate Policy has effectively eliminated the positive carry on collateral balances that has materially benefited these strategies over the years. Three years of 3% annual collateral gains would make a huge dent in those cumulative drawdown totals I referred to earlier.

WHAT CAN CHANGE, AND WHY NOW? LET'S LOOK AT THREE REASONS.

1: TAPERING WILL BECOME TIGHTENING. The Fed is likely to finish QE tapering in October. In our opinion, a tightening cycle will follow. Most pundits view mid-2015 as the date most likely for US short rates to begin rising. The recent employment data causes Altegris to lean toward an earlier timeframe and perhaps a more aggressive tightening. We also favor upside surprises on inflation data. The key point, though, is that global central bank policy will no longer be coordinated. The US Fed will be looking forward, while the BOJ and ECB

__1__ Drawdown measures the peak to valley loss relative to the peak for a stated time period. __2__ Managed futures represented by the Altegris 40 Index; macro represented by the HFRI Macro (Total) Index. Time period based from the end of the financial crisis in February 2009. Past performance is not indicative of future results. Source: Altegris, HFR. __3__ Trend following is a core managed futures strategy that generally seeks to profit from the continuation of medium- to long-term directional price moves in a market. For example, being positioned long after market prices have moved higher for a period of time or positioned short after prices have moved lower for a period of time.

are still fighting deflation. We think this dislocation creates many opportunities for market movement and expanding volatility, specifically in currency markets. Currencies have historically trended based on the absolute change or relative rate of change in global interest rate differentials, and there may finally be some differentiation between the world's three major currency blocks.

2: THE TECHNICALS LOOK BETTER. There are technical drivers that we think underpin the opportunity sets for managed futures and global macro managers:

Market volatility. We believe that expanding volatility is better than contracting volatility for these managers. See *Figure 1* for a view of current levels versus the long run average and the financial crisis highs.

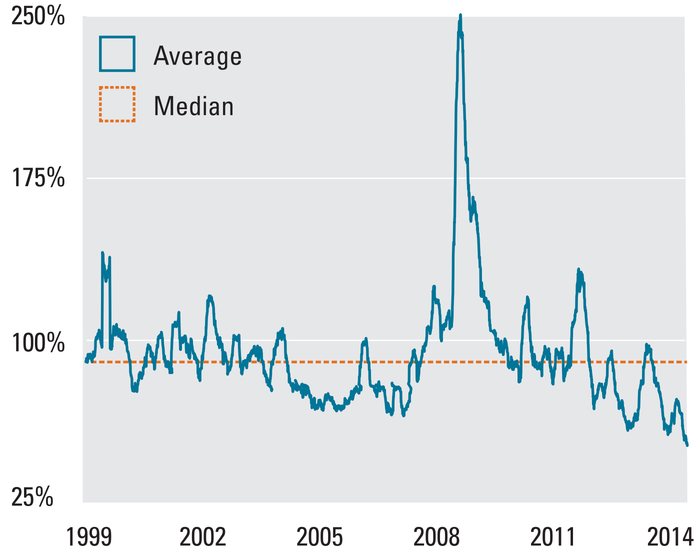
Here, we believe that there is a mean reversion characteristic worth paying attention to. The Fed appears to agree, and in the June minutes some Fed officials expressed concern about low volatility in equity, currency and fixed income markets, and associated investor complacency. In our view, global market volatility is more likely to rise from these low levels than fall to sustainable new lows.

Trendiness. See *Figure 2* for a long-term view of how the trending strength across markets appear to correlate with managed futures returns. Again, we believe this factor has mean reversion characteristics and there is a discernible movement towards an increase in market trendiness from very low levels.

FIGURE 1.

VOLATILITY AT ALL-TIME LOWS

50-day Moving Average | July 1999–June 2014

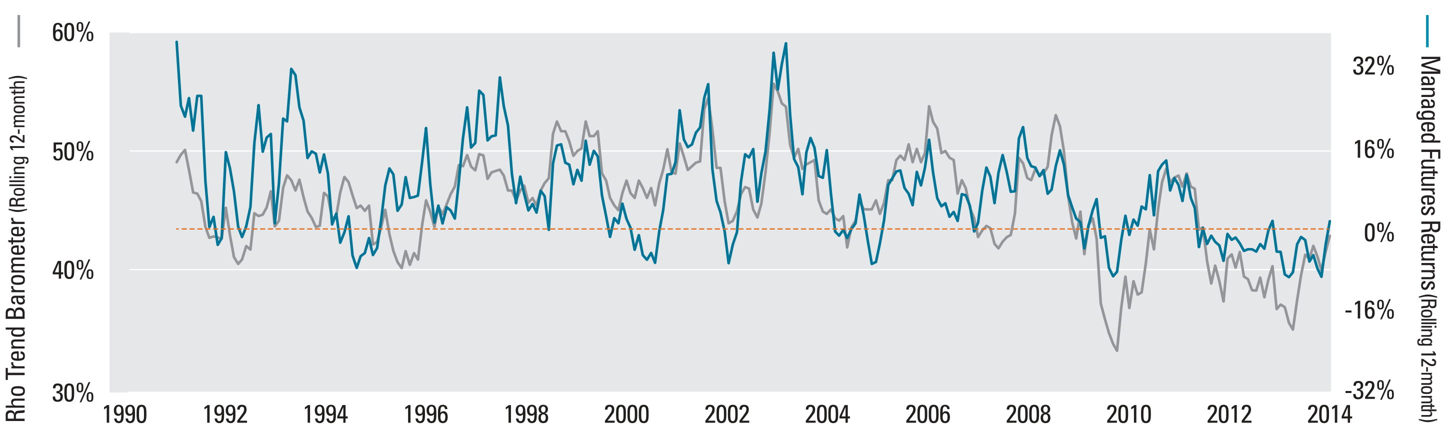


Average 50-day moving average is the average volatility, measured by standard deviation, of 14 markets; median represents the median value of the average 50-day moving average. Standard deviation is a statistical measure of how consistent returns are over time; a lower standard deviation indicates historically less volatility. Past performance is not indicative of future results. Date range based on previous 15-year period. Source: Altegris, Bloomberg.

FIGURE 2.

TRENDING STRENGTH OF MARKETS

January 1990–June 2014



Past performance is not indicative of future results. There is no guarantee that any investment will achieve its objectives, generate profits or avoid losses. Rho Trend Barometer measures the percentage of markets with medium to strong trends; orange line depicts the Rho Trend Barometer value that has historically equated to a zero percent rolling 12-month return for managed futures. Source: Altegris, Rho Asset Management. Please see www.rhoam.ch for more information about Rho Asset Management. Date range based on data availability. Returns are represented by a benchmark index for general market comparisons and are not meant to represent any particular fund. 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. Managed futures represented by the Altegris 40 Index (started July 2000, data is available back to 1990).

Cross market correlations. The third technical factor is perhaps the most significant. See *Figure 3* for a measure of cross market correlations. The 2009-2012 period was dominated by very high inter-market correlations that resulted in the dreaded risk-on/risk-off market action. Essentially, all of the world's markets were characterized as either risk-on or off and groups of markets would seemingly always travel in lockstep on any given day, week or quarter.

Figure 3 reveals that we have returned to pre-crisis levels of cross market correlations among global markets and there are definitive signs of idiosyncratic trending across market sectors.

After all, it is the diversity of opportunity set for managed futures and global macro managers that has been a significant factor underlying their return streams over the decades. A return to a more normal state of inter-market correlation bodes exceptionally well for an increase in tradeable opportunity sets.

FIGURE 3.

CROSS MARKET CORRELATIONS DECLINING

Average Absolute Between-Market Correlation | March 1993–June 2014

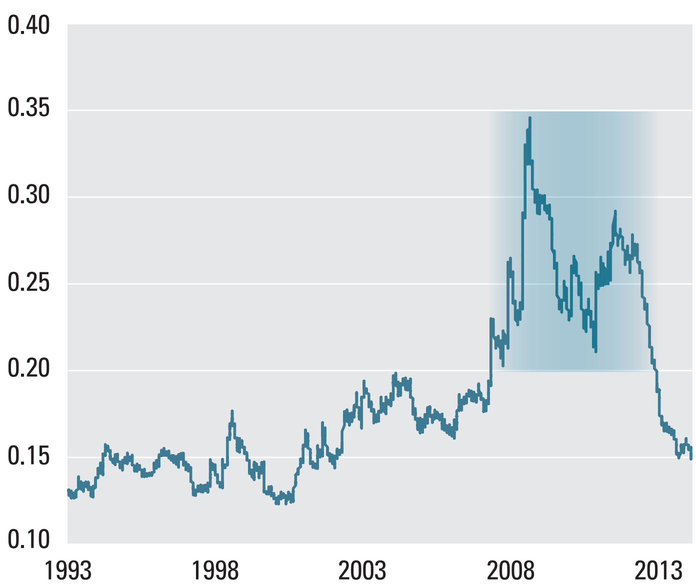


Chart above depicts the rolling average absolute correlation between a constant set of 52 futures markets since 1992. Correlation is a statistical measure of how two securities move in relation to each other. Past performance is not indicative of future results. Date range based on data availability. Source: ISAM.

3: COMMODITIES ABOUT TO BECOME SIGNIFICANT AGAIN? For the past few years commodity prices appeared to be detached from underlying realities as sentiment replaced fundamentals and valuations often didn't matter. True demand was depressed by a slowing Chinese economy. The risk-on/risk-off environment created unusually high correlations with stocks, and many specialized commodity managers went out of business while banks rationalized their trading operations.

Recent dynamics, however, appear more encouraging. Fundamentals have become significant again. Managers can again spend time analyzing crop yields, weather, stockpiles versus consumption, geopolitical risk in oil producing nations, and various other genuine supply/demand factors, and again have a reasonable expectation that those changing fundamentals might be reflected by market prices.

The ability to participate in commodity trends, both long and short, is a unique strength of most managed futures and global macro strategies. We believe that genuine trading opportunities in commodities will again feature prominently in manager attribution and this development will only be assisted by upside surprises in the inflation data.

FINAL THOUGHTS

If you are an investor or adviser and have stayed away from managed futures and macro strategies, now may be a great time to consider an initial foray. After all, you have the welcome psychological advantage of buying low.

If you are an existing investor and have become frustrated, you are clearly not alone. We strongly recommend that you fight the current consensus, stay patient and stay invested. In fact, consider whether your portfolio has enough exposure to these strategies. Each investor's allocation will depend on their objectives and existing portfolio makeup, but in our view, even a 10% allocation can potentially have a meaningful impact.

We aren't calling for a crisis, which is sometimes a catalyst for massive outperformance in these strategies. But we are looking for the beginning of a Fed tightening cycle along with supportive technical factors and expanding opportunity sets in commodities to be the sparks that may ignite a fire under the status quo of investor complacency.

RISKS AND IMPORTANT CONSIDERATIONS

It is important to note that all investments are subject to risks that affect their performance in different market cycles. Equity securities are subject to the risk of decline due to adverse company or industry news or general economic decline. Commodities are affected by adverse weather, geologic and environmental factors and heightened regulatory oversight. Bonds are subject to risk of default, credit risk, and interest rate risk; when interest rates rise, bond prices fall.

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 profit¬able investment opportunities and successfully trade, which is difficult, requires skill, and involves a significant degree of uncertainty. CTAs may trade highly illiquid markets, or on foreign markets, and the high degree of leverage often obtainable in commodity trading can lead to large losses as well as gains. Returns generated from a CTA's trading, if any, may not adequately compensate for the business and financial risks assumed. Managed futures and commodities accounts may be subject to substantial charges for management and advisory fees. Past results are not indicative of future results. Mutual funds involve risk including possible loss of principal. An investment in an alternatives strategy mutual fund should only be made after careful study of the prospectus, including the description of the objectives, principal risks, charges, and expenses of the fund.

The analysis herein is based on numerous assumptions and past market conditions. Different benchmarks, market conditions and other assumptions could result in materially different outcomes. The reference to the statements or opinions of persons or firms not affiliated with Altegris is intended for informational purposes only and does not constitute investment research, and should not be viewed as investment advice. The inclusion of such does not constitute endorsement, sponsorship by, or affiliation with Altegris with respect to any persons or firms named.

ALTEGRIS ADVISORS

Altegris Advisors LLC is a CFTC-registered commodity pool operator, commodity trading advisor, NFA member, and SEC-registered investment adviser that advises alternative strategy mutual funds that may pursue investment returns through a combination of managed futures, global macro, long/short equity, long/short fixed income and/or other investment strategies.

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The Altegris group of affiliated companies is wholly-owned and controlled by (i) private equity funds managed by Aquiline Capital Partners LLC and its affiliates ("Aquiline"), and by Genstar Capital Management, LLC and its affiliates ("Genstar"), and (ii) certain senior management of Altegris and other affiliates. Established in 2005, Aquiline focuses its investments exclusively in the financial services industry. Established in 1988, Genstar focuses its investment efforts across a variety of industries and sectors, including financial services. The Altegris companies include Altegris Investments, Altegris Advisors, Altegris Funds, and Altegris Clearing Solutions.

INDEX DESCRIPTIONS AND RISKS

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.

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. 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.

KEY RISKS: Market risk—prices may decline; leverage risk—volatility and risk of loss may magnify with use of leverage; country/regional risk—world events may adversely affect values.

Global Macro. The HFRI Macro (Total) Index tracks managers which trade a broad range of strategies in which the investment process is predicated on movements in underlying economic variables and the impact these have on equity, fixed income, hard currency and commodity markets. Managers employ a variety of techniques, both discretionary and systematic analysis, combinations of top down and bottom up theses, quantitative and fundamental approaches and long and short term holding periods. The HFRI Macro (Total) Index is a fund weighted index and reflects the monthly returns, net of all fees, of funds that have at least $50 million under management or been actively trading for at least twelve months.

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GLOSSARY

Long. Buying an asset/security that gives partial ownership to the buyer of the position. Long positions profit from an increase in price.

Short. Selling an asset/security that may have been borrowed from a third party with the intention of buying back at a later date. Short positions profit from a decline in price. If a short position increases in price, the potential loss of an uncovered short is unlimited.

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