Managed Futures: Staying the Course

Short-term Drawdowns, Long-term Focus

June 2012*

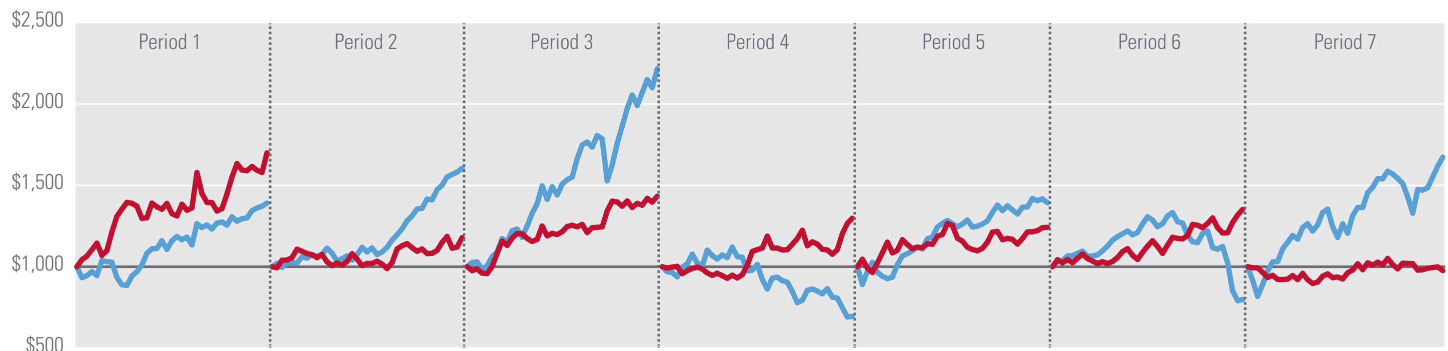
The Question: For each period, which line do you choose?

The Details: Each line represents an investment. The time frame examined is January 1990 through March 2012, divided into seven equal periods (slightly over three years per period).

The Result: The investment represented by the blue line outperforms four of the seven periods (periods two, three, five and seven go to blue and periods one, four and six go to red). Thus most would likely select the blue line investment as the better of the two options.

FIGURE 1.

WHICH LINE DO YOU CHOOSE?



The referenced indices are shown for general market comparisons and are not meant to represent any particular Fund. There is no guarantee that any investment product will achieve its objectives, generate profits or avoid losses. PAST PERFORMANCE IS NOT INDICATIVE OF FUTURE RESULTS. 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. Date range based on common period of data availability for shown indices. US stocks (blue line) represented by S&P 500 Total Return Index; managed futures (red line) represented by Altegris 40 Index® (started July 2000; data available back to 1990). Time frame: January 1990–March 2012. Source: Altegris.

**Originally published May 2011.*

KEY POINT

We believe it is important that investors consider an allocation to managed futures *before* the next crisis, not *after,* to best capture its potential benefits.

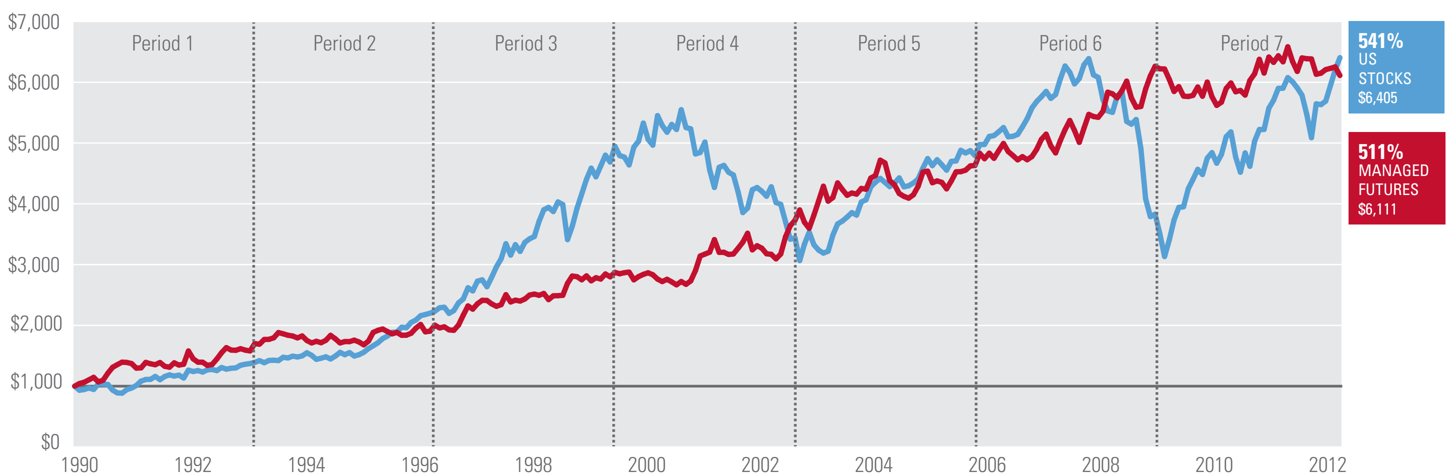
What is discovered through the line choice example is a common mistake of basing investment decisions on short-term, recent performance. Although the blue line (US stocks) beats the red line (managed futures) in four of seven instances, it is the red line that is the better option, in our opinion, from a long-term historical return perspective. Combining each individual line from the line choice example reveals that managed futures historically had similar total return performance to US stocks at the end of multiple bull markets, without following the same deep drawdown patterns over the past 20 years (FIGURE 2).

The short-term performance of an investment, good or bad, can have a powerful impact on an investor. For example the 12 months preceding the "tech wreck", which started in September 2000, saw US stocks gain over 16% while managed futures lost -5%. Investors with a short-term focus likely did not consider allocation to managed futures at that time, but basing their investment decisions on the previous 12-month return comparison (and a US stock bull market that encapsulated the previous decade) turned out to be detrimental to those who were invested too heavily in equities and were not prepared for the adverse market conditions that riddled the markets in the following years. Disregarding managed futures due to its recent relative underperformance, or due to the strong recent performance of US stocks at the time, would have led to a decade of missed opportunities, in which managed futures thrived through the volatile stock market swings. Since the onset of the "tech wreck" in September 2000, US stocks are up 15% while managed futures are up over 124%. Of course, past performance is not indicative of future results.

Since the end of the "credit crisis", which ended in February 2009, US stocks are up 104% while managed futures are down 2%. Many may wonder why they should consider managed futures when stocks have been so strong over the past couple of years. We believe it is important that investors consider an allocation to managed futures *before* the next crisis, not *after*, to best capture its potential benefits.

FIGURE 2.

MANAGED FUTURES VS. US STOCKS HISTORICAL PERFORMANCE | January 1990–March 2012



The total return of an investment is only one measure of performance. Performance should never be the sole consideration when making an investment decision. The referenced indices are shown for general market comparisons and are not meant to represent any particular Fund. There is no guarantee that any investment product will achieve its objectives, generate profits or avoid losses. PAST PERFORMANCE IS NOT INDICATIVE OF FUTURE RESULTS. 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. Date range based on common period of data availability for shown indices. US stocks represented by S&P 500 Total Return Index; managed futures represented by Altegris 40 Index® (started July 2000; data available back to 1990). Source: Altegris.

Managed Futures During Crisis

KEY POINT

Investor demand for managed futures has increased significantly in recent years, as the potential diversification benefits of the asset class were highlighted during the credit crisis.

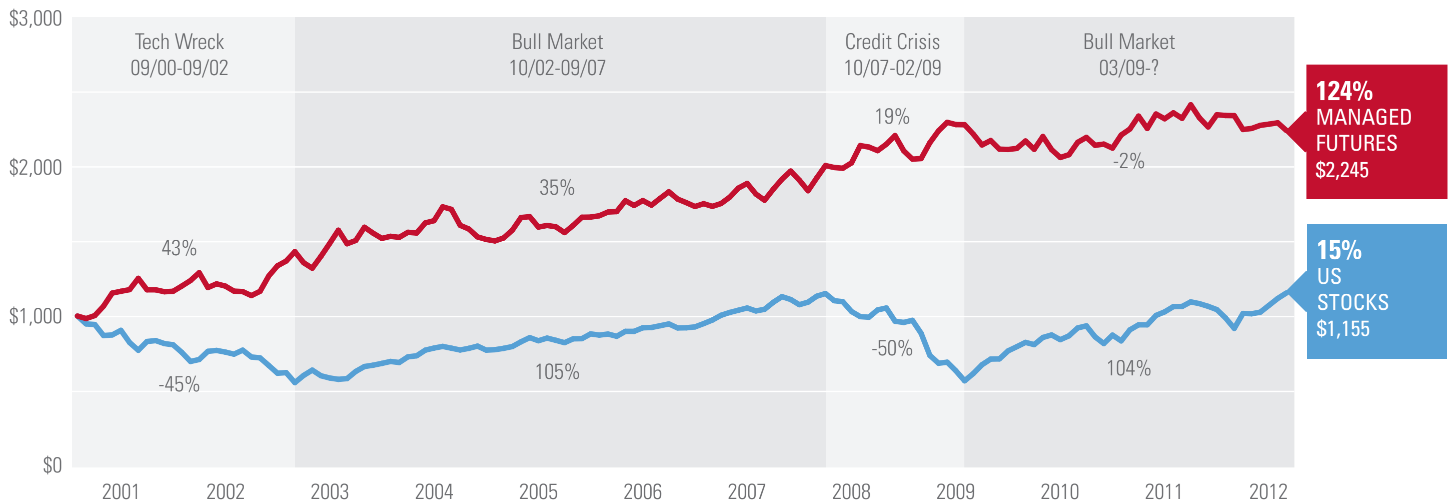
Managed futures have historically exhibited very low correlation to traditional investments, generating strong absolute returns across market cycles. Investors have long recognized these diversification benefits, but until recently, the asset class has largely been unavailable to the broader investment community. With innovations in the mutual fund industry now making the potential benefits of managed futures more accessible, investors previously unfamiliar with the asset class are now able to more easily access the strategy.

Investor demand for managed futures has increased significantly in recent years, as the potential diversification benefits of the asset class were highlighted during the credit crisis. From October 2007 to February 2009, managed futures generated double-digit returns while the stock market, as represented by the S&P 500 Total Return Index, lost approximately half of its value. As illustrated below (FIGURE 3), this dynamic was not unique to the recent crisis, but also was exhibited during the tech wreck in the early 2000s.

FIGURE 3.

MANAGED FUTURES PERFORMANCE DURING CRISIS PERIODS: VALUE OF AN INITIAL $1,000 INVESTMENT

September 2000–March 2012



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The Impact of Short-term Drawdowns

KEY POINT

Like other asset classes, managed futures too are subject to drawdowns, a phrase used to describe the percentage of value lost from the highest (peak) to lowest (trough) point.

While the potential benefits of managed futures have been well established, investors should remember that these benefits typically accrue over the long-term. This is because managed futures are not immune from their own volatility. Like other asset classes, managed futures too are subject to drawdowns, a phrase used to describe the percentage of value lost from the highest (peak) to lowest (trough) point. To illustrate this concept, US stocks (as measured by the S&P 500 Total Return Index) experienced a drawdown of -51% that lasted from the end of October 2007–February 2009 (16 months) during the credit crisis. Managed futures experience drawdowns because markets do not move in a straight line, nor do trends persist indefinitely. As a primarily trend following strategy, managed futures will often suffer losses during choppy markets, sharp market corrections and/or trend reversals. The good news is that trend following systems are reactive, and are designed to determine when to continue with an existing trend, or to reverse positions and follow a new trend in the opposite direction.

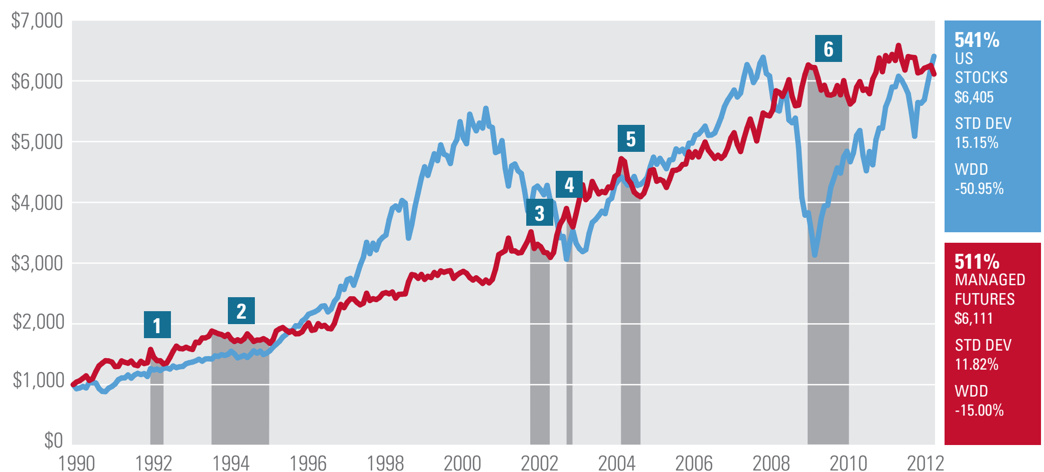
It is important to be patient during these inflection points or periods of choppy, trendless markets, and understand that the potential benefits of managed futures are typically realized over longer periods of time. Investors should be prepared for the inevitable, and hopefully short-term, downdrafts. Premature redemption during periods of short-term volatility would crystallize losses and cause an investor to miss out on the longer term diversification benefits that historically have been available. Unfortunately, behavioral finance has proven academically that investors are subject to "myopic loss aversion," a phrase used to describe the tendency of investors to be more sensitive to losses than to gains, especially in the short-term. Focusing on the negative effects of recent losses often results in investors buying high and selling low, which is the exact opposite approach that results in positive portfolio returns.

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. The Altegris 40 Index represents the dollar-weighted average performance of those 40 programs.

FIGURE 4.

VALUE OF AN INITIAL $1,000 INVESTMENT IN MANAGED FUTURES | January 1990–March 2012



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KEY POINT

The potential benefits of managed futures are typically realized over longer periods of time.

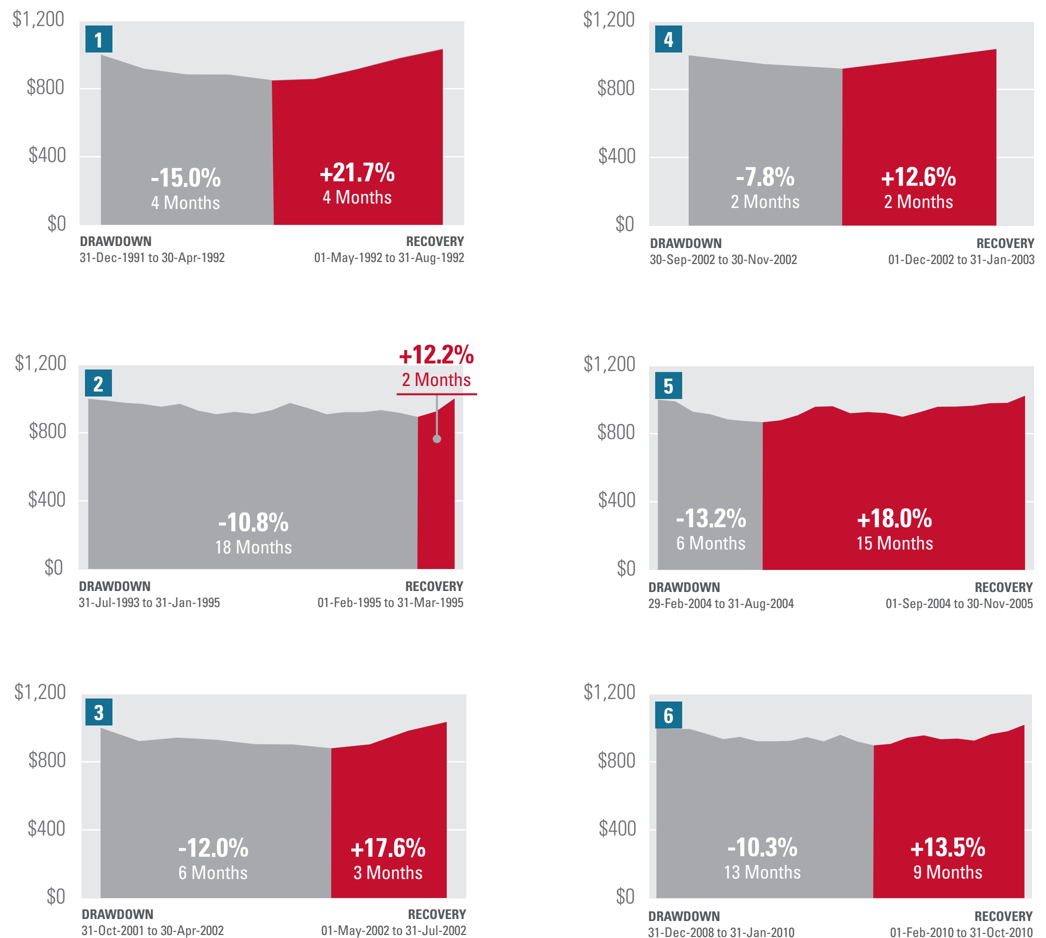
Highlighted on the previous page are the six largest drawdowns experienced by the Altegris 40 Index since January 1990 (FIGURE 4). While those following the index's performance ultimately observed these short-term downturns, they were often sharp enough to make even the most studious question whether returns would turn back to the positive.

These negative periods have historically been short-lived, and managed futures have often exhibited some of their strongest performance following their largest drawdowns. Of course, past performance is not indicative of future results. The charts below (FIGURE 5) isolate the six largest drawdowns highlighted in the previous chart. As you can see, over the long-term the index ultimately delivered strong subsequent performance, though there were certainly negative downturns along its return path.

FIGURE 5.

TOP SIX HISTORICAL DRAWDOWNS AND RECOVERY PERIODS OF MANAGED FUTURES

Since January 1990



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KEY POINT

Short-term drawdowns and recoveries actually are historically common in managed futures.

These short-term drawdowns and recoveries actually are historically common in managed futures. The chart below compares the calendar year performance of the Altegris 40 Index to the maximum drawdown that occurred during the same year for the past 20 calendar years (FIGURE 6). What is surprising is that even during years when managed futures produced double-digit returns, the path taken to achieve these strong results often included intra-year drawdowns in the high single-digits.

FIGURE 6.

CALENDAR YEAR RETURNS OF MANAGED FUTURES AND THE LARGEST MONTHLY DRAWDOWN DURING THAT YEAR

January 1992–December 2011

YEAR	WORST DRAWDOWN	ANNUAL PERFORMANCE
2011	-6.9%	-3.2%
2010	-3.5%	11.3%
2009	-8.0%	-8.0%
2008	-7.1%	15.5%
2007	-6.7%	7.2%
2006	-5.4%	6.7%
2005	-6.4%	4.5%
2004	-13.2%	2.6%
2003	-5.7%	16.0%
2002	-7.8%	15.2%
2001	-7.8%	5.4%
2000	-6.9%	10.6%
1999	-4.4%	0.9%
1998	-4.0%	12.6%
1997	-4.8%	10.2%
1996	-6.0%	16.0%
1995	-5.3%	13.2%
1994	-6.8%	-5.5%
1993	-4.7%	14.7%
1992	-15.0%	0.9%

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Staying the Course

KEY POINT

Despite these frequent drawdowns, an allocation to a broadly-diversified investment in managed futures for the full 12-month rolling period ultimately resulted in an average return of 8.6%.

In order to enjoy the compelling long-term potential benefits of managed futures, investors should be prepared for possible short-term drawdowns. Over any given 12-month window, managed futures investors have historically had to weather a drawdown of -6.8% on average. Despite these frequent drawdowns, an allocation to a broadly-diversified investment in managed futures for the full 12-month rolling period ultimately resulted in an average return of 8.6%.

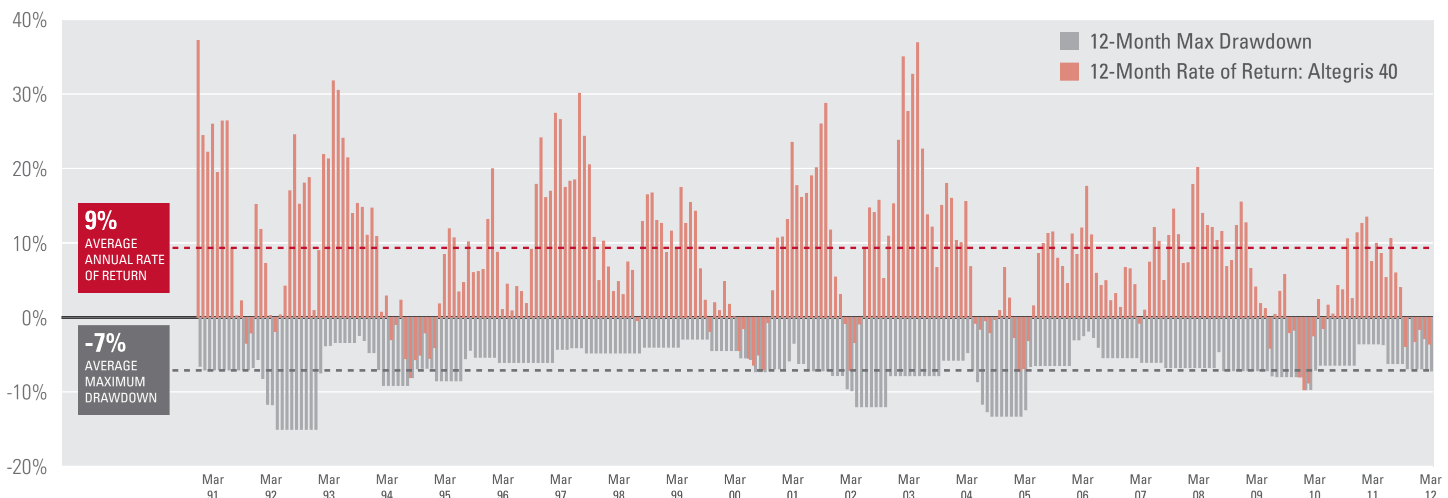
The chart below illustrates this point in greater detail by comparing the rolling 12-month return of Altegris 40 Index to its maximum drawdown during the same period (FIGURE 7). Choosing one period as an example, the Altegris 40 Index experienced a 6-month peak-to-trough drawdown of -12.0% from the end of October 2001–April 2002. However, if an investor held the broadly-diversified managed futures investment for the full 12-month period (from October 2001–September 2002) losses would have been recouped as the Altegris 40 Index posted a positive return of 15.7%. Of course, this is a hypothetical example and there is no guarantee that any investment product will achieve its objective, generate profits or avoid losses.

Conclusion

We hope the preceding analysis provides evidence that drawdowns are not out of the ordinary. In fact, short-term drawdowns are normal, even during years that ultimately turn out to be profitable for the strategy. This is one of the reasons we believe that managed futures are a potential source of diversification for traditional portfolios as long-term investors have historically been rewarded with attractive absolute returns with less volatility and lower drawdowns than the stock market. The key to potentially realizing these long-term benefits is not to lose focus during periods of short-term losses, which can be expected.

FIGURE 7.

COMPARISON OF MANAGED FUTURES ROLLING 12-MONTH RETURNS VS. DRAWDOWN PERIOD | January 1990–March 2012



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INDEX HISTORICAL PERFORMANCE

As of 31 March 2012

	10-Year			
	Ann ROR	Std Dev	WDD	Total Return
Altegris 40 Index	6.79%	10.51%	-13.24%	92.83%
S&P 500 Total Return Index	4.11%	15.92%	-50.95%	49.65%

	5-Year			
	Ann ROR	Std Dev	WDD	Total Return
Altegris 40 Index	4.79%	9.64%	-10.27%	26.33%
S&P 500 Total Return Index	2.01%	18.92%	-50.95%	10.46%

	3-Year			
	Ann ROR	Std Dev	WDD	Total Return
Altegris 40 Index	0.36%	8.96%	-7.18%	1.07%
S&P 500 Total Return Index	23.41%	16.00%	-16.26%	87.97%

	1-Year			
	Ann ROR	Std Dev	WDD	Total Return
Altegris 40 Index	-3.56%	8.34%	-7.18%	-3.56%
S&P 500 Total Return Index	8.53%	16.08%	-16.26%	8.53%

	Historical Correlation			
	20-year	10-year	5-year	3-year
Altegris 40 Index– S&P 500 Total Return Index	-0.12	-0.10	-0.08	0.14

PAST PERFORMANCE IS NOT INDICATIVE OF FUTURE RESULTS. Correlation is a statistical measure of how two securities move in relation to each other. Standard deviation is a statistical measure of how consistent returns are over time; a lower standard deviation indicates historically less volatility. US stocks represented by S&P 500 Total Return Index; managed futures represented by Altegris 40 Index® (started in July 2000; data is available back to 1990). The referenced indices are shown 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. There is no guarantee any investment will achieve its objective, generate profits or avoid losses.

INDEX DEFINITIONS AND RISKS

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 programs. The Index started in July 2000; data is available back to 1990.

Characteristics: 40 top AUM managed futures programs, monthly, as reported to Altegris.

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.

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.

Characteristics: 500 US stocks, weighted towards large capitalizations.

Risks: stock market risk—stock prices may decline.

GLOSSARY

Correlation. A statistical measure of how two securities move in relation to each other. Correlation is mathematically expressed by the correlation coefficient, which ranges between -1 and +1. Perfect positive correlation (a correlation co-efficient of +1) implies that as one security moves, either up or down, the other security will move in lockstep, in the same direction. Alternatively, perfect negative correlation means that if one security moves in either direction, the security that is perfectly negatively correlated will move by an equal amount in the opposite direction. If the correlation is 0, the movements of the securities are said to have no correlation; they are completely random.

Drawdown. A drawdown is any losing period during an investment time frame. It is calculated by taking the peak to valley loss relative to the peak for a stated time period. The figure is expressed as a percentage.

Standard deviation. Standard deviation is a statistical measure of how consistent returns are over time; a lower standard deviation indicates historically less volatility.

VAMI. Value added monthly index. A graph that shows the compounded growth of a $1,000 investment on a monthly basis.

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

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Important Considerations

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. 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.

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. 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.

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Altegris has one core mission—to find the best alternative investments for our clients. Altegris offers what we believe are straightforward and efficient solutions for financial professionals and individual investors seeking to improve portfolio diversification with historically low correlated investments.

With one of the leading Research and Investment Groups focused solely on alternative investments, Altegris follows a disciplined process for identifying, evaluating, selecting, and monitoring investment talent across the spectrum of hedge funds, managed futures funds, and other alternative investments.

Veteran experts in the art and science of alternatives, Altegris guides 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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Printed June 2012
405635_060112

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