

Managed Futures

Is The Trend Your Friend?

August 2011

▶ KEY POINT

Managed futures have shown their ability to thrive in up and down markets.

In their 2010 Alternative Investment Survey of U.S. Institutions and Financial Advisors, Morningstar discovered that 66% of financial advisors believe that alternatives will become as or more important than traditional investments over the next five years. Even more interesting, advisors awarded top ranks to managed futures strategies as offering the greatest growth potential through 2015 amongst alternative strategies.

The appeal of managed futures is that they have shown their ability to thrive in up and down markets. Of course, we all know that past performance is no guarantee of future results. Managed futures managers also have the ability go long and short in all four asset classes (stocks, bonds, currencies and commodities) across 150 global markets — creating an immense opportunity for investment.

The overwhelming majority of managed futures managers (~75%) are known as trend followers. Trend followers seek to capture the majority of a market trend, up or down, for profits in all major asset classes. Many trend followers use proprietary and fully automated technical trading systems based on a highly objective, disciplined set of rules predefined by the fund management. So unlike traditional money managers, managed futures managers do not predict where the market is going, rather they wait for prices to trend and then react. The remaining managed futures managers are specialized traders. Their strategies include, but are not limited to, short-term, discretionary, sector-specific, and counter-trend trading.

** Originally published in February 2010.*

KEY POINT

During a time of extreme volatility for equity markets, traditional asset classes suffered their steepest declines in decades, while managed futures delivered positive returns of more than 15%.

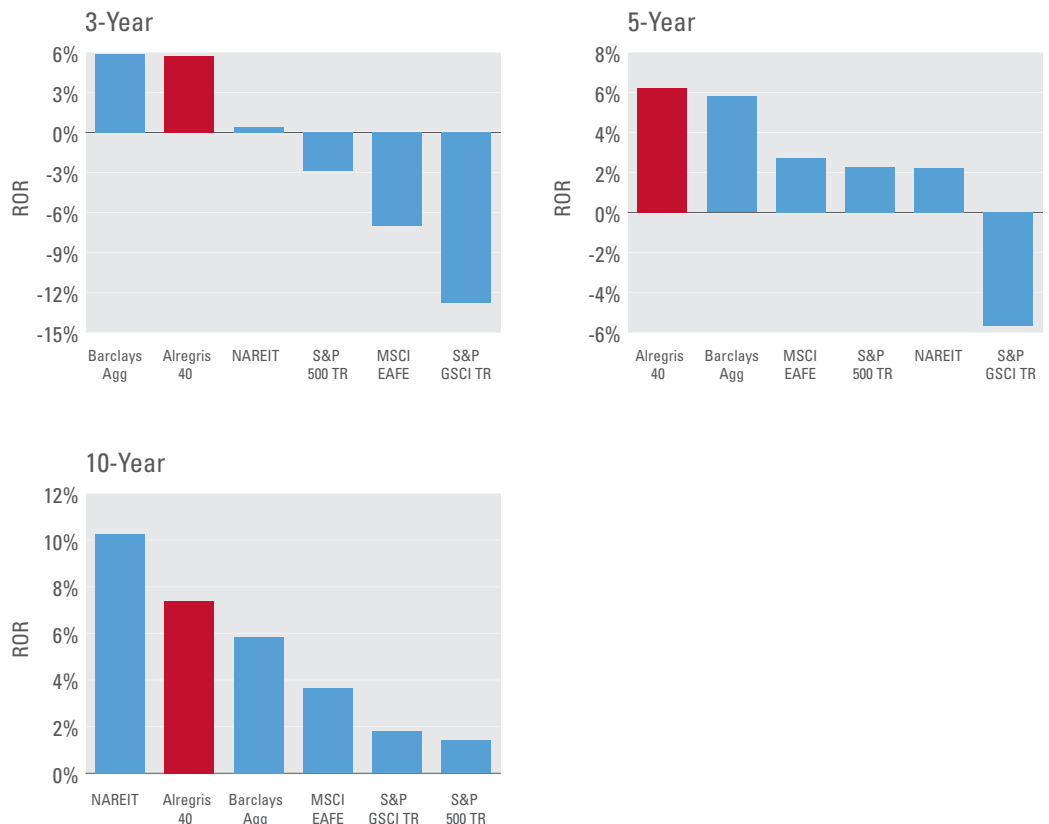
Looking Forward by Looking Back

Managed futures professionals often talk about 2008 (the “Credit Crisis”) when identifying the potential benefits of the asset class—a time when the trend was truly managed futures’ friend. Whether it was equities, interest rates or the commodities markets, most managers were able to capitalize on seemingly smooth long-term trends over the year, in the midst of the global economic crisis. During a time of extreme volatility for equity markets, traditional asset classes suffered their steepest declines in decades, while managed futures delivered positive returns of more than 15%.

In contrast, sideways price action across several markets wreaked havoc on both short- and long-term trend followers in 2009. Managed futures rebounded in 2010 ending the year up just under 12%. Looking forward, it is important to remember that the last few years represent only three calendar years over a significant history for an asset class that has profited over the long-term, through various market cycles.

Perhaps more compelling, on an annualized basis managed futures ranked among the top three best-performing asset classes over the 10-year time frame ending in 2010, as well as the past three and five-year periods (FIGURE 1). Of course, past performance of any asset class or index is not necessarily indicative of its future performance.

FIGURE 1.
TOP THREE ANNUALIZED RATE OF RETURN OVER MULTIPLE TIME PERIODS
3-, 5-, 10-Year trailing as of December 2010



Source: Altegris

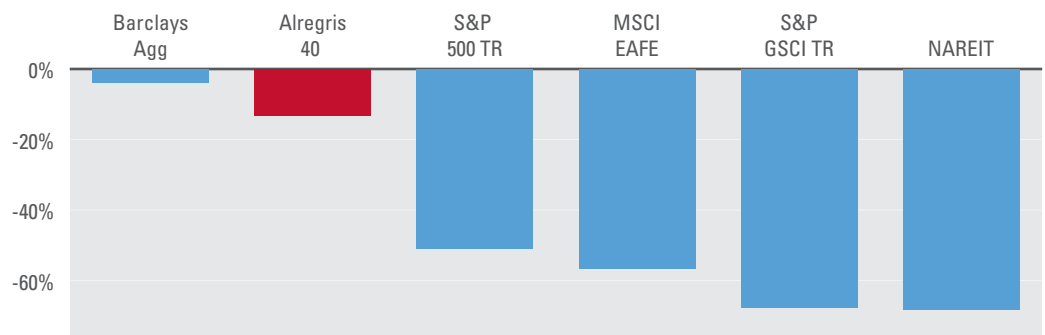
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through several periods of significant drawdowns (peak to valley rate of return). From 2001–2010, the worst drawdown maxed out at nearly -51% for equities (FIGURE 3). If you invested in the equity market in October 2007, by February 2009 you had lost more than half of your total capital through the credit crisis.

In contrast, the worst drawdown for managed futures over the same time period was -13% during the seven months from February 2004 to August 2004. Bonds were the only asset class that had a relatively low drawdown of -4%. However, on a total return basis, managed futures outperformed bonds over the same time period, with annualized returns of 7.4% over the last 10 years.

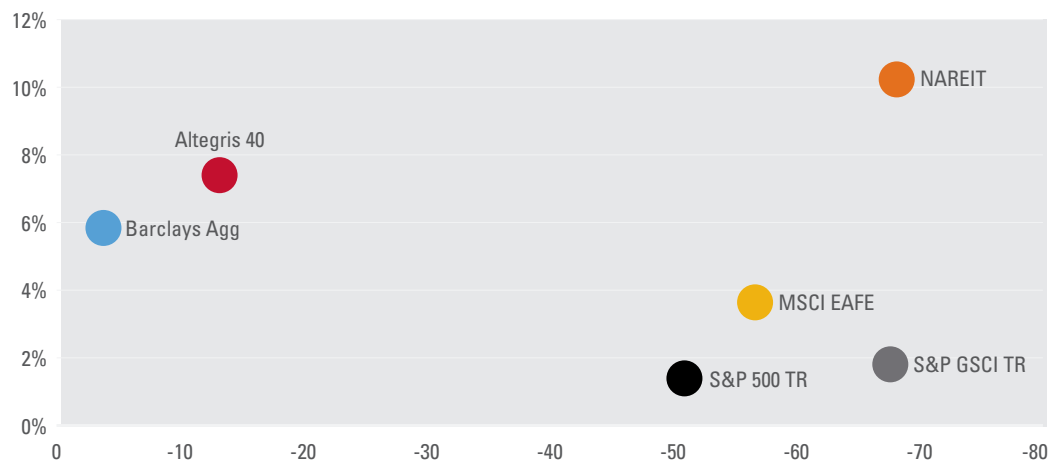
Taking into account the returns and the corresponding level of risk, we believe managed futures can represent a better risk-adjusted return than long-only, emerging market equities, real estate securities, and commodities for those investors for which managed futures may be a suitable option (FIGURE 4).

FIGURE 3.
WORST DRAWDOWN | 10-Year six major asset classes



Source: Altegris

FIGURE 4.
10-YEAR DRAWDOWN/RETURN COMPARISON | Six major asset classes 2001–2010



Source: Altegris

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No Asset Class is an Island

It is important to understand the potential role of managed futures in an investment portfolio, particularly the historical correlation with other asset classes. Most investors have a broad asset allocation, with a heavy weighting of stocks and bonds whether directly or through mutual funds that invest in such. In addition to stocks and bonds, research, most notably that of Dr. John Lintner, has demonstrated that it is desirable to invest in multiple asset classes, particularly ones with little correlation to existing investments, in order to attain a well diversified portfolio.[†] Our data suggests in 2008 when U.S. equities declined nearly -37%, investors whose portfolios included allocations to managed futures, in addition to equities, in many instances weathered the storm far better than those who did not, given the fact that managed futures rose by more than 15%.^{*}

Similarly, the performance of managed futures has demonstrated a lack of historical correlation with investments in emerging markets, real estate, commodities and even bonds. Over the course of the past decade, managed futures have consistently demonstrated low or even negative historical correlations to each of the major asset classes. With all five of these major asset classes combined in an equally-weighted portfolio, managed futures averaged near zero historical correlations to the portfolio over the past 3-, 5-, and 10-year time frames (FIGURE 5).^{**}

Portfolio Impact

Historically, these near zero correlations have resulted in an improved risk-adjusted return profile for the average investor that remained in the managed futures asset class for at least five years. For example, a traditional portfolio with 50% allocated to equities

†"The combined portfolios of stocks (or stocks and bonds) after including judicious investments in leveraged managed futures accounts show substantially less risk at every possible level of expected return than portfolios of stock (or stocks and bonds) alone." -Dr. John Lintner, "The Potential Role of Managed Futures Accounts in Portfolios of Stocks and Bonds", 1983.

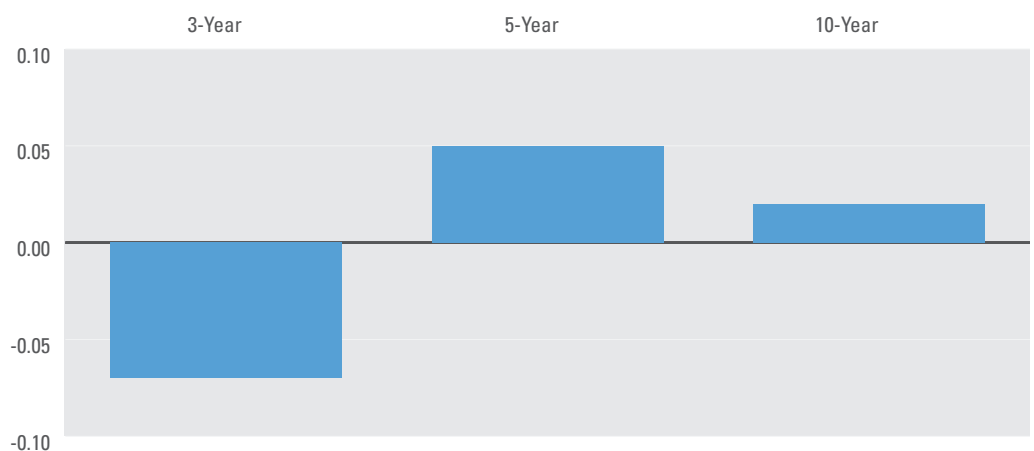
**Source: Altegris*

***Correlations are subject to change and may vary over time.*

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FIGURE 5.

MANAGED FUTURES CORRELATION TO MAJOR ASSET CLASSES | Correlation to equally weighted portfolio of five major asset classes over multiple time frames



Source: Altegris

and 50% allocated to bonds provided annualized historical returns of 4.8% with a worst drawdown of -25.2% (January 2006 through December 2010). For the investor who included an allocation to managed futures over the same five-year period (33% equities, 33% bonds, and 33% managed futures), the statistics improved dramatically. Annualized returns increased by nearly 1% to 5.7% while the worst drawdown decreased by nearly half to -13.4% (FIGURE 6). Of course, when comparing performance of asset classes represented by indices, past performance of any asset class or index is not necessarily indicative of its future performance.

Short-Term Pain, Long-Term Gain?

At Altegris, we believe perseverance is rewarded over time. Clearly, it is important to look at performance on a longer time frame rather than purely short-term swings. A smooth trending environment like 2008 may or may not return again.

Likewise, a choppy, unfavorable market is equally unpredictable. Most investors are seeking appreciation over a long time frame, through various market cycles.


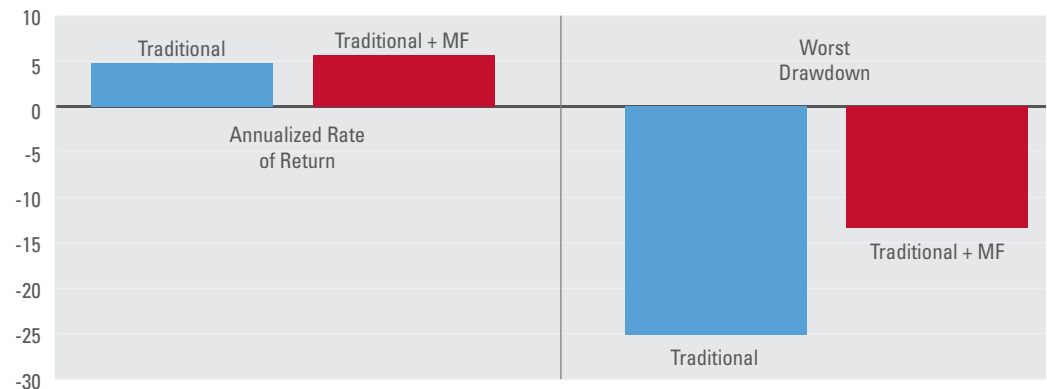
Over the long-term, managed futures have proven their resilience and diversification benefits for many investors. As a result, we believe that managed futures can be a critical asset for the portfolios of sophisticated and suitable investors. 

FIGURE 6.

ADDING MANAGED FUTURES | Adding managed futures to a traditional asset class over 10 years



Source: Altegris

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APPENDIX 1. PERFORMANCE STATISTICS

SIX MAJOR ASSET CLASSES COMPARING 3-, 5-, AND 10-YEAR TIME FRAMES

As of 31 December 2010

	3-Year			
	Ann ROR	Std Dev	Max DD	Total Return
Altegris 40	5.76%	9.76%	-10.27%	18.29%
S&P 500 Total Return	-2.86%	21.85%	-48.46%	-8.34%
Barclays Capital U.S. Aggregate	5.91%	4.16%	-3.82%	18.80%
MSCI EAFE — Net	-7.02%	26.24%	-54.18%	-19.62%
NAREIT Composite Total Return	0.44%	37.03%	-60.76%	1.32%
S&P GSCI Total Return	-12.80%	31.50%	-67.65%	-33.69%
	5-Year			
	Ann ROR	Std Dev	Max DD	Total Return
Altegris 40	6.23%	9.54%	-10.27%	35.28%
S&P 500 Total Return	2.29%	17.68%	-50.95%	11.97%
Barclays Capital U.S. Aggregate	5.80%	3.62%	-3.82%	32.58%
MSCI EAFE — Net	2.74%	21.37%	-56.68%	14.49%
NAREIT Composite Total Return	2.22%	30.62%	-68.17%	11.58%
S&P GSCI Total Return	-5.67%	27.49%	-67.65%	-25.31%
	10-Year			
	Ann ROR	Std Dev	Max DD	Total Return
Altegris 40	7.40%	11.02%	-13.24%	104.26%
S&P 500 Total Return	1.41%	16.31%	-50.95%	15.02%
Barclays Capital U.S. Aggregate	5.84%	3.79%	-3.82%	76.36%
MSCI EAFE — Net	3.64%	18.55%	-56.68%	43.05%
NAREIT Composite Total Return	10.27%	23.83%	-68.17%	165.72%
S&P GSCI Total Return	1.79%	25.00%	-67.65%	19.35%

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Source: Altegris

APPENDIX 2. CORRELATION STATISTICS

SIX MAJOR ASSET CLASSES COMPARING 3-, 5-, AND 10-YEAR TIME FRAMES

As of 31 December 2010

3-Year Correlation January 2008–December 2010	Altegris 40	S&P 500 TR	Barclays Agg	MSCI EAFE	NAREIT	GSCI Total
S&P 500 Total Return	-0.14		0.21	0.93	0.84	0.61
Barclays Capital U.S. Aggregate	0.06	0.21		0.30	0.26	-0.03
MSCI EAFE — Net	-0.02	0.93	0.30		0.78	0.65
NAREIT Composite Total Return	-0.21	0.84	0.26	0.78		0.41
S&P GSCI Total Return	0.07	0.61	-0.03	0.65	0.41	
5-Year Correlation January 2006–December 2010	Altegris 40	S&P 500 TR	Barclays Agg	MSCI EAFE	NAREIT	GSCI Total
S&P 500 Total Return	-0.01		0.15	0.92	0.82	0.52
Barclays Capital U.S. Aggregate	-0.06	0.15		0.23	0.21	-0.04
MSCI EAFE — Net	0.10	0.92	0.23		0.74	0.60
NAREIT Composite Total Return	-0.11	0.82	0.21	0.74		0.32
S&P GSCI Total Return	0.12	0.52	-0.04	0.60	0.32	
10-Year Correlation January 2001–December 2010	Altegris 40	S&P 500 TR	Barclays Agg	MSCI EAFE	NAREIT	GSCI Total
S&P 500 Total Return	-0.17		-0.08	0.89	0.67	0.29
Barclays Capital U.S. Aggregate	0.20	-0.08		0.02	0.14	-0.03
MSCI EAFE — Net	-0.04	0.89	0.02		0.65	0.42
NAREIT Composite Total Return	-0.03	0.67	0.14	0.65		0.21
S&P GSCI Total Return	0.18	0.29	-0.03	0.42	0.21	

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Source: Altegris

GLOSSARY

Alpha — Alpha measures the non-systematic return, that which cannot be attributed to the market. It reflects the difference between a fund's actual return and its expected return, given its level of systematic (or market) risk (as measured by beta). A positive alpha indicates that the fund has performed better than its beta would predict. Alpha is widely viewed as a measure of the value added or lost by a fund manager.

Beta — A measure of the relationship of a fund's movement relative to a benchmark, such as a market index. Beta is the correlation (a measure of the statistical relationship between fund and benchmark) multiplied by the magnitude of relative volatility of the fund to the benchmark. A fund with a beta of 1.2 relative to a benchmark, for example, is expected to move 12% when the benchmark moves 10%. When the fund is comprised of the same instruments as the benchmark, beta can be thought of as a measure of relative volatility. A low beta does not necessarily indicate that the fund has low volatility; rather, it may indicate that the fund's returns are not related to the movement of the market benchmark.

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.

Leverage — When investors borrow funds to increase the amount that they have invested in a particular position, they use leverage. Investors use leverage when they believe that the return from the position will exceed the cost of the borrowed funds. Sometimes, managers use leverage to take on new positions without having to liquidate other positions prematurely. Leverage can effectively increase the potential for higher capital gain returns on investment capital, but can also increase the risk of greater capital loss.

Long — A position that will profit from an increase in the security's price.

Short — A position that will profit from a decrease in the security's price.

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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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.

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.

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.

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 US & Canada. The MSCI EAFE Index consists of the following 22 developed market country indices: Australia, Austria, Belgium, Denmark, Finland, France, Germany, Greece, Hong Kong, Ireland, Israel, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, and the United Kingdom.*

NAREIT Composite 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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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.

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Investors should carefully consider the investment objectives, risks, charges and expenses of the Fund or Funds described herein. This and other important information about a Fund is contained in a Fund's Prospectus, which can be obtained by calling (877) 772-5838. The Prospectus should be read carefully before investing. Funds are distributed by Northern Lights Distributors, LLC member FINRA. Altegris Advisors, J.P. Morgan Investment Management and Northern Lights Distributors are not affiliated.

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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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