Looking Under the Hood: “Passive” Managed Futures Mutual Funds

June 2012*

Introduction

Over the past few years, investors have been increasingly allocating to managed futures mutual funds.¹ Due in part to this increasing popularity, in 2011 Morningstar launched a managed futures mutual fund category, which, in aggregate, represents $7.8 billion in assets under management. One of the primary reasons for the recent inflows into managed futures is the potential diversification benefits they can provide due to their historically low correlations with traditional market indices such as the S&P 500 Index and the Barclays Aggregate Bond Index. This has been especially true in times of turmoil, such as 2008, when managed futures managers were not only able to avoid the large losses that investors in traditional asset classes such as equities and corporate bonds suffered, but were actually able to capitalize on the volatility and generate strong profits. Of course, past performance is not necessarily indicative of future results.

There are currently three primary types of managed futures mutual funds: two options utilize actively managed strategies, either through an open architecture structure or proprietary management, while the third utilizes so called “passively” managed strategies. Many investors have opted to forgo active management, perhaps due to a lack of knowledge of what “passive,” as it relates to managed futures, really means. The most prominent of these “passive” strategies are those designed to track the Diversified Trends Indicator (DTI). In fact, of the $7.8 billion in assets managed by managed futures mutual funds, approximately one third of these assets fall into this category.² Given that such a large percentage of managed futures mutual fund assets are managed in this way, it’s worth examining the DTI in more detail.

Managed Futures Mutual Funds

- “Passive” management
- Active proprietary management
- Active open-architecture management

¹ Source: Morningstar 2010 Alternative Investment Survey.
² Source: Morningstar.com, Altegris.
* Originally published August 2011.
The methodology employed by the DTI was developed by Alpha Financial Technologies, a Dallas-based firm owned by Victor Sperandeo (also known as “Trader Vic”). The methodology was licensed to Standard & Poor’s, which subsequently launched the S&P Diversified Trends Indicator in January of 2004, and the first mutual fund employing this strategy with investor money was launched in 2007. While the DTI is often described as a passive managed futures index, its construction methodology is actually more complex, with individual positions varying from long to short depending upon whether or not their prices are above or below their seven-month moving average. We believe the dynamic nature of this approach has much more in common with a simplistic active trading strategy than with traditional indices, such as the S&P 500.

Can There Be a Truly Passive Managed Futures Index?

Index funds for traditional asset classes, like stocks and bonds, can simply buy and hold the underlying securities of their representative indices. In contrast, the dynamic nature of managed futures does not easily lend itself to this type of passive indexing. As the name implies, managed futures are by definition “managed.” Managers can actively change positions from long to short at any given time depending upon market conditions. Managed futures’ managers can invest in futures contracts tied to any number of sectors, and exposures can change frequently both in size and direction (long vs. short) depending upon the market environment and the exact trading strategy employed. How, then, does one develop a passive index around such a dynamic strategy?

Most managed futures index providers have developed passive indices that track the performance of active managers. Two such indices are the Altegris 40 Index and the Barclay BTOP50 Index. The Altegris 40 Index tracks the performance of the forty largest managed futures programs that report to Altegris, weighted by assets under management. The Barclay BTOP50 Index is similar in approach, but is designed to track at least half of the investable assets of the Barclay CTA universe, and is equally-weighted. The Altegris 40 Index’s asset-weighted approach emphasizes how a typical investment in managed futures has performed over time, while the Barclay BTOP50 Index’s equal-weighted approach emphasizes how the typical managed futures manager has performed over time (see page 6 for full index definitions). While both of these methodologies have their nuances, they are in many ways similar to the straightforward construction methodology employed by indices such as the S&P 500 Index, which is more or less comprised of the 500 largest publicly traded US companies weighted by market capitalization.

The construction methodology employed by the DTI is much more complex in comparison, and we believe is more akin to a simplistic trading strategy than a passive index. For example, the DTI determines whether to hold a particular position long or short based upon a “moving average crossover.” Specifically, the moving average crossover strategy employed by the DTI dictates that a position be held long if its price is trading above its seven-month moving average. Conversely, the DTI will hold a short position if its price is trading below its seven-month moving average.

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. The referenced indices are shown for general market comparisons and are not meant to represent any particular Fund. See page 6 for Index/Indicator Descriptions, Definitions, and Risks. See Important Risk Disclosures at the end of this document. Source: Altegris.
A moving average crossover is actually one example of a model that an active managed futures manager might use when employing a trend following strategy. In fact, many active managed futures managers refer to individual components of their strategies, such as a moving average crossover, as “indicators.” This is a very important distinction, and one that the DTI’s own name seems to acknowledge: it is called the Diversified Trends Indicator, not the Diversified Trends Index. The DTI’s own name implies that it is more of a single trading strategy than a passive index.

Evaluating the DTI as a Managed Futures Strategy

Now let’s compare the DTI’s strategy to the strategies employed by typical managed futures managers. First, we will compare the performance of the DTI to the performance of widely known managed futures indices, and then, we will explore the possible reasons behind the significant deviations in performance (FIGURE 1).

As noted, both the Altegris 40 Index and the Barclay BTOP50 Index are well-known managed futures indices that track the performance of active managed futures programs. To that end, the performance of either index should be fairly representative of what a typical investor in managed futures would have experienced had he passively invested in a broadly diversified portfolio of active managed futures programs.

Using performance as the first point of comparison, it’s clear from the chart below that the DTI has significantly underperformed the broader universe of managed futures programs over time when measured against the Altegris 40 Index and Barclay BTOP50 Index.

FIGURE 1.
INDEX/INDICATOR PERFORMANCE: ALTEGRIS 40 VS. BARCLAY BTOP50 VS. S&P DTI
Value of an Initial $1,000 Investment | July 2000-March 2012

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From July 2000 through March 2012, the DTI has underperformed the Altegris 40 Index by -73% and the Barclay BTOP50 Index by -50%. While the DTI has exhibited less overall volatility, as measured by standard deviation, than either the Altegris 40 Index or the Barclay BTOP50 Index, it has done so with larger losses of capital. The DTI has experienced a maximum peak-to-trough drawdown of -19.8%, compared to just -13.2% for the Altegris 40 Index and -10.9% for the Barclay BTOP50 Index (FIGURE 2). Of course, past performance is no guarantee of future results.

Why the Performance Disparity?

If we look under the hood of the strategy employed by the DTI, it is easy to understand why it has historically underperformed the broad managed futures universe over time. The DTI’s usage of just one trading indicator (a seven-month moving average crossover) to determine whether to hold a position long or short stands in stark contrast to typical managed futures managers who often utilize multiple indicators, various time frames and even multiple strategies.

Individual indicators tend to work well in some market environments, while performing poorly in others. By using multiple indicators, active managed futures managers are able to design trading strategies that can be much more robust than those based upon a single indicator. The idea is similar to the concept of diversification applied to traditional portfolios: just as equity investors may improve risk adjusted performance by investing in a diversified portfolio of stocks, managed futures managers may improve their risk adjusted returns by employing multiple trading models designed to perform across a wider range of market environments. For example, several managers in the Altegris 40 Index utilize hundreds of indicators in their trading strategy. While not all managed futures managers utilize as many models, most use far more than the single indicator employed by the DTI.

7 **Sharpe Ratio.** A measure of risk-adjusted performance. It subtracts the risk free rate from the net return rate and divides the result by the standard deviation of the return.
Additionally, many managers improve their risk-adjusted returns by diversifying away from trend-centric strategies and employing uncorrelated strategies such as pattern recognition, mean reversion, and many others. In fact, identifying new strategies and perfecting existing ones is so important that many managers employ large teams of analysts dedicated to researching trading strategies that work not only on a standalone basis, but also within the context of their overall portfolio. For example, Winton Capital Management, another of the largest managers in the Altegris 40 Index, employs over 100 researchers to fine tune their models. Not all managed futures managers have teams this large, but most have analysts dedicated to continual research and development. In contrast, the DTI utilizes just a single indicator and, in our view, lacks the potential benefits of ongoing research. The DTI is also less diversified than many managed futures programs on a sector basis. For example, the DTI does not trade equity indices or short-term interest rates, completely eliminating opportunity sets that have historically provided potentially profitable trading opportunities (from both the long and short side) for many active managers.

Conclusion

Managed futures, by definition, are “managed.” Managed futures managers employ active trading strategies designed to perform across a wide variety of market environments. In our opinion, the nuances of individual managers and their dynamic trading strategies make it very difficult to design a truly passive index that is representative of the managed futures asset class. Firms like Altegris and Barclay Hedge have addressed this problem by developing indices that passively track the performance of active managers. These indices can be a source of valuable information which can be used to benchmark individual managed futures strategies.

Evaluated against these benchmarks, it’s clear that a single indicator, as employed by the DTI, is not representative of the managed futures industry as a whole. The DTI has historically performed worse than the “typical” managed futures manager, as reflected by the true managed futures indices previously mentioned, which is not surprising given its single indicator approach and lack of a research and development component. While the “typical” managed futures program has performed better than the DTI, we believe it’s possible to further improve performance through intelligent manager selection and portfolio construction. While proper due diligence requires significant time and expertise, we believe it is possible to construct multi-manager portfolios that not only outperform the DTI, but also the Altegris 40 Index and Barclay BTOP50 Index over time.
INDEX DEFINITIONS, 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. The referenced indices are shown for general market comparisons and are not meant to represent any particular investment.

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 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.

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.

Barclay BTOP50 Index. The BTOP50 Index seeks to replicate the overall composition of the managed futures industry with regard to trading style and overall market exposure. The BTOP50 employs a top-down approach in selecting its constituents. The largest investable trading advisor programs, as measured by assets under management, are selected for inclusion in the BTOP50. In each calendar year the selected trading advisors represent, in aggregate, no less than 50% of the investable assets of the Barclay CTA Universe. To be included in the BTOP50, the following criteria must be met: 1) Program must be open for investment. 2) Manager must be willing to provide us daily returns, 3) Program must have at least two years of trading activity. 4) Program’s advisor must have at least three years of operating history.

Characteristics: Tracks at least 50% of investable assets of the Barclay CTA universe, equally-weighted.

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.

S&P Diversified Trends Indicator. The S&P DTI is a composite of 24 highly liquid futures grouped into 14 sectors, evenly weighted between financial and physical commodities.

Characteristics: Composite of 24 liquid futures evenly weighted between financial and physical commodities.

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.

INDEX/INDICATOR HISTORICAL PERFORMANCE

As of 31 March 2012

<table>
<thead>
<tr>
<th>10-Year</th>
<th>5-Year</th>
<th>3-Year</th>
<th>1-Year</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Ann ROR</td>
<td>Std Dev</td>
<td>WDD</td>
</tr>
<tr>
<td>Altegris 40 Index</td>
<td>6.79%</td>
<td>10.51%</td>
<td>-13.24%</td>
</tr>
<tr>
<td>Barclay BTOP50 Index</td>
<td>5.75%</td>
<td>7.93%</td>
<td>-10.92%</td>
</tr>
<tr>
<td>S&amp;P DTI</td>
<td>3.44%</td>
<td>8.30%</td>
<td>-19.75%</td>
</tr>
</tbody>
</table>

PAST PERFORMANCE IS NOT INDICATIVE OF FUTURE RESULTS. Standard deviation (Std Dev) is a statistical measure of how consistent returns are over time; a lower standard deviation indicates historically less volatility. Drawdown (WDD) measures the peak to valley loss relative to the peak for a stated time period. 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. Source: Altegris.
IMPORTANT RISK DISCLOSURES

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.

Mutual funds involve risk including possible loss of principal. An investment in a managed futures 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.

Altegris Advisors

Altegris Advisors, LLC is an SEC-registered investment adviser that advises alternative strategy mutual funds that may pursue investment returns through a combination of managed futures, equities, fixed income and/or other investment strategies.
About Altegris

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.

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 $3.27 billion in client assets, and provides clearing services to $327 million in institutional client assets.*

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