



SUPPLEMENTAL RISK DISCLOSURE INFORMATION

Alternative Investments
Integrity. Knowledge. Experience.

When considering alternative investments, such as hedge funds and managed futures, you should consider various risks including the fact that some hedge fund and managed futures products use leverage and other speculative investment practices that may increase the risk of investment loss, can be illiquid, are not required to provide periodic pricing or valuation information to investors, may involve complex tax structures and delays in distributing important tax information, are not subject to the same regulatory requirements as mutual funds, often charge high fees, and in many cases the underlying investments are not transparent and are known only to the investment manager.

With respect to alternative investments, such as hedge funds and managed futures, in general, you should be aware that:

- Returns from some alternative investments, including hedge funds and managed futures, can be volatile
- You may lose all or portion of your investment
- With respect to single manager products the manager has total trading authority. The use of a single manager could mean a lack of diversification and higher risk
- Many alternative investments that include hedge funds and managed futures are subject to substantial expenses that must be offset by trading profits and other income. A portion of those fees is paid to Altegris
- Trading may take place on foreign exchanges that may not offer the same regulatory protection as US exchanges

With respect to an investment in a hedge fund or managed futures fund, you should be aware that:

- There is often a lack of transparency as to the fund's underlying investments
- With respect to hedge fund of funds, the fund's manager has complete discretion to invest in various sub-funds without disclosure thereof to you or to us. Because of this lack of transparency, there is no way for you to monitor the specific investments made by the hedge fund or to know whether the sub-fund investments are consistent with the hedge fund's historic investment philosophy or risk levels
- A hedge fund of funds invests in other funds and fees are charged at both the fund and sub-fund level. Thus the overall fees you will pay will be higher than you would pay by investing directly in the sub-funds. In addition, each sub-fund charges an incentive fee on new profits regardless of whether the overall operations of the fund are profitable
- There is no secondary market for fund interests. Transfers of interests are subject to limitations. The fund's manager may deny a request to transfer if it determines that the transfer may result in adverse legal or tax consequences for the fund

A hedge fund's Offering Memorandum or a money manager's Disclosure Document describes the various risks and conflicts of interest relating to an investment and to its operations. You should read those documents carefully to determine whether an investment is suitable for you in light of, among other things, your financial situation, need for liquidity, tax situation, and other investments.

Keep in mind that the past performance of any investment is not necessarily indicative of future results. You should only commit risk capital to any Investment Product. Alternative investment products, including hedge funds and managed futures, are not for everyone and entail risks that are different from more traditional investments. You should obtain investment and tax advice from your advisers before deciding to invest.

Lost in America? Asset Allocation and the Old Brain

From the Desk of Jon Sundt
October 2006

"Setting a goal is not the main thing. It is deciding how you will go about achieving it and staying with that plan."

-- NFL Legend Tom Landry

One of my favorite comedies is "Lost In America" starring Albert Brooks. In this mid-80s film, Brooks and his wife (a yuppie couple in their 30s) decide to quit their jobs, sell everything and RV across America.

The trouble starts when they end up in Las Vegas one night and, on a whim, decide to hit the casino. Everything seems fine for a while, but when Brooks gets tired and goes to bed early, the trouble begins. He wakes up to the news that his wife has gambled away their life savings... "You lost our nest-egg?" he asks in disbelief.

The comedy takes off from there, and the couple soon realizes that even the free-and-easy lifestyle they have adopted requires planning. Brooks and his wife didn't have a sound game plan, or if they did, they certainly didn't stick to it. As a result, from the moment that they bellied up to the tables at Vegas, they were in trouble. They had nothing to fall back on to combat the emotion of the moment. They were vulnerable to making big mistakes.

Although I don't like to compare investing with gambling, the casino analogy is a good one for making this point: in both investing and gambling, you can make and lose a lot of money—and to win you need a game plan.

This plan needs to be created prior to investing in the markets, prior to looking at track records and executing stock transactions...prior to getting 'sucked in' to the moment.

It sounds both easy and rational to have a sound game plan in investing. An asset allocation framework is a good start. Most investors understand the basic concepts of asset allocation, but when it comes to following the plan, many investors find it difficult.

Let me try to help you understand why this is.

OLD AND NEW BRAINS

As humans, we make decisions using our brain. But the brain is divided into different areas, which are responsible for different functions. Since this isn't a biology class, I'll make it simple and call these areas the 'Old Brain' and the 'New Brain'. Both our Old and New Brains are essential for our existence, but each behaves very differently.

The New Brain is built to handle advanced cognitive processing. It includes the pre-frontal cortex, which is the part of our brain above the eyes that helps us calculate and strategically plan for the long term. This is the rational, logical part of the brain that would ideally be relied upon to make complex decisions.

This should, on the surface, be great news for us as we make our investment decisions and create an asset allocation. We have the most advanced New Brain on the planet, capable of absorbing volumes of information, performing advanced 'what-if' risk analyses, and making rational judgments and comparisons. So where is the problem?

The problem is what is in the way of our New Brain: the Old Brain. The Old Brain is a small area of our brain that sits directly on the top of our spine, and is completely concerned with our survival. This part of the brain is extremely good at reacting quickly to perceived physical danger. Feeding off of serotonin and adrenaline, this is the part of your brain that moves you away from a hot stove before you even have time to think about what is happening. It is the part of the brain that can use backward-looking pattern recognition to quickly recognize the shape of, say, a snake, and signal you to move away. And it is the part of the brain that drives you to reproduce and pass on your genes to the next generation. Are you starting to get the picture?

Unfortunately, the Old Brain stinks at making the type of rational, analytical, thought-out decisions that are best suited to choosing how to invest your money. It's not that the Old Brain is stupid; it is in fact amazingly adept



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at fight-or-flight responses and other emotionally charged responses. Thousands of years ago, these characteristics were critical to our survival, but today, especially if we are talking about financial survival, they can cripple us. The Old Brain is concerned only with your immediate physical survival...eating, drinking, reproducing, and steering you clear of danger. It deals with the emotion of the moment, not with rationalization of what will be the consequences in the far-off future. You cannot make good long-term plans as an investor when your Old Brain controls you.

So why all this talk about the Old Brain and investing?

Despite knowing how poor our Old Brain is at making investment decisions, we have to work incredibly hard not to fall into the trap of being influenced by it. The Old Brain is a powerful player in our decision-making and, as a result, we are basically hard-wired to make poor investment choices. How many times do we buy a stock too late in its cycle (at the high) and sell at the low?

How many times have you hired a money manager after a run up and fired him after a sell off only to see him perform well over time? Why are we so concerned with the last 12 months performance of a track record? Why did many of us commit too much money to a certain sector during the Internet bubble simply because prices were flying high? Or bought Gold only after it ran up over \$500 per ounce? Or made an investment without thinking it through that turned out to be a real loser? The list goes on.

If it makes you feel any better, now you know—you can blame it on your Old Brain.

KEEPING THE NEW BRAIN INVOLVED

So if we have the impediment of an Old Brain that tends to 'short-circuit' our more rational, thoughtful New Brain, what then? How do we help our New Brain? The answer starts with planning. We need to have a scripted, rational approach ready to go before we even consider our first decision.

Let's think again about the film 'Lost in America' that I mentioned at the outset of this newsletter. Brooks and his wife didn't have their plan fully thought-out before walking in to the casino. Maybe a good plan would have been to keep driving right through Vegas. Or if they really wanted to visit the casino, maybe a good plan would have been to restrict themselves to the small-money games, or better yet, to limit the total amount of money they were going to gamble with. In any event, having a plan in place that they

could fall back on and use to guide their Old Brain emotional responses may have helped them make more sensible decisions.

Investing works the same way. An intelligent investor needs a sound investment philosophy and a plan to execute that philosophy. This plan needs to be created prior to going into the markets, prior to looking at track records and executing stock transactions, prior to getting immersed in the emotion of the moment. Once your money is invested in the markets, the Old Brain holds tremendous influence. If you can wait until after you invest to form your plan, it can be very difficult to combat the Old Brain.

Now, I am not suggesting you need to revisit every decision you have made, or every investment, and question whether this was a case of you letting your Old Brain have its way. What I am suggesting is that it may be useful for all of us

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to systematically take a step back and examine whether we have a good framework in place for approaching our investments. The key to this is to step away from the noise from time to time—to temporarily give up your seat at the 'table' and force yourself to take a thoughtful, rational, forward-looking view of your portfolio. The goal is to use your New Brain to create a long-term plan that may help save you from your Old Brain's emotional prompting—to ensure that our important investment decisions do not default to the Old Brain.

ASSET ALLOCATION: INVESTMENT'S VERSION OF A GAME PLAN

In investment-speak this rational, long-term view of your portfolio starts (but of course does not end) with what we call an asset allocation. Your personal asset allocation is simply a model of where and to what extent your investment dollars should ideally be placed. I believe this is especially important for high net worth, sophisticated investors like you, given today's complex market environment. Never before have you had so many investment choices, and never before have your investment choices been so interrelated. Twenty years ago, we might have been looking exclusively at US Stocks and Bonds. Our newsletters, thoughts and debates were once centered only on the US markets. Large Cap, Small Cap, Growth, Value, Sectors, Government vs. Corporate bonds...that was about it. Planning doesn't take long if you have only two buckets to put your money in.

But today, especially if you decide for good reasons to step

outside the Long US Stock and Bond mentality, your investment choices are many and complex. Many of our clients are actively seeking choices that are as close to zero correlation to the US markets as possible. Others are looking at Asia, Europe, Emerging Markets or other geographic zones of investment. Still others are looking to invest in commodities and natural resources, hedge funds, foreign exchange, foreign bonds...and the list goes on. What quickly becomes clear is that the more choices we have, the more necessary an asset allocation plan is.

THE PRIMARY DRIVER

Just how important is asset allocation? As discussed, I believe it is a critical element to help keep the Old Brain in check. It gives an investor a beacon by which to chart his or her course. And it provides an important counterpoint to possibly irrational, emotional and instinctual Old Brain responses.

But beyond just having an asset allocation, we need to worry about how it is composed...how to get the allocation right. This is not easy as author David Swensen, author of *Pioneering Portfolio Management* and CIO of Yale's Endowment has stated, "Construction of a financial-asset portfolio involves full measures of science and art."

Just how important is the composition of your asset allocation? I believe it is fundamental to your success in investing. As support, using data on balanced mutual funds and pension funds, a study published in the *Financial Analysts Journal* found that about 90% of the variability of returns of a typical fund across time is explained by asset allocation policy. (Source: Ibbotson, Roger G. and Paul D. Kaplan, "Does Asset Allocation Policy Explain 40 Percent, 90 Percent, or 100 Percent of Performance?" *Financial Analysts Journal*, January/February 2000.) Where you put the assets (i.e. in what categories) is really the primary driver of returns, not the individual investments within those categories.

GETTING IT RIGHT

If asset allocation is important, how can we figure out what the optimal asset allocation is...does 'optimal' even exist? The best place to start is to agree on a few asset allocation principles.

Last May we hosted our third annual Strategic Investment Conference in La Jolla. About 150 high net worth investors and representatives from family offices and institutions converged on La Jolla for 3 days of debate, prognostication

and market analysis. We had as our panel of featured speakers Art Laffer (Reagan's economic advisor and inventor of the Laffer Curve), Richard Russell, Author John Mauldin, Bank Credit Analyst head Martin Barnes and Louis Gave of GaveKal out of Hong Kong. Collectively these are some of the top thinkers in the business.

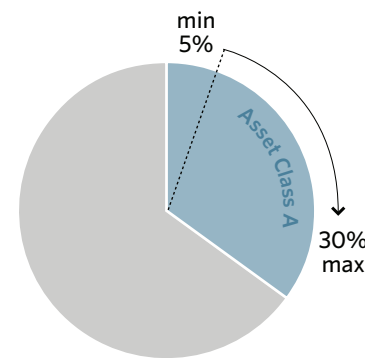
When I asked the panel basic questions about the dollar, or about the US markets, it was hard to find agreement on the outlook. The point is, of course, not that these experts don't know what they are talking about, because they do. They each have their own viewpoints, supported by their own data. The point is only that, in the end, they do not agree. And, as in the old Dire Straits song, "two men say they're Jesus; one of them must be wrong."

This disagreement amongst even some of the best minds in the industry makes a good argument in support of diversification. As the hallmark of sound investing and asset allocation,

diversification attempts to lower overall risk by not making heavy bets in any one piece of your asset allocation pie. According again to investment guru David Swensen, when you allocate assets, you should pick at least five distinct classes, with each accounting for at least 5-10% of assets...but no more than 25-30%. The reasons for Swensen's recommendation make good logical sense—less than 5% in one asset class and it will have no real impact on your portfolio, and more than 25-30% and you can be overweighed—an 'eggs-in-too-few-baskets' situation.

RUNNING CIRCLES AROUND YOUR PORTFOLIO

Again, this all sounds logical. But our La Jolla conference put into perspective just how focused we, as investors, can become on the individual investments, at the expense of a true understanding of our overall portfolio. When I asked the crowd—some of the most affluent, sophisticated investors around—to take a piece of paper and draw a circle, divided up to represent their current asset class allocation, it became clear it was no simple task. While many could tell you about their favorite stock, or their best investment, their total allocation (probably the most important aspect of their investment plan) took a lot of time and hard think-



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David F. Swensen, Author of *Pioneering Portfolio Management* and CIO of Yale's Endowment



ing to nail down. If you have the time, I'd challenge you to do the same right now.

Let's suppose you complete this task, and you have a pretty good understanding of where you are right now in terms of which classes you have allocated to, and how much. What then? How do you tell if you have the 'right' allocation? Where should you be?

CHOICES, CHOICES AND MORE CHOICES

The idea with respect to what is the 'right' allocation has changed over the years, and of course varies from person to person. When I started in this business in 1986, I remember a typical asset allocation recommendation provided by a typical large brokerage firm might have been a simple mix of US Stocks and US Bonds. Then what happened? The market decline of 1987. Many investors who had allocated in this manner found that their bond portfolio didn't save them from the decline. Post-1987 the typical asset allocation may have evolved to include some Foreign Equity in the mix, to attempt to move away from the reliance on US Stocks that had earlier hurt us so bad. But the Tech Wreck of 2000 showed that even portfolios that include significant amounts of Foreign Equity could be vulnerable. So as you we now know, the solution is not just diversifying your portfolio with

different types of investments or across different sectors. Diversifying amongst different sectors didn't necessarily save us in 1987 or in 2000. Instead, the key is adding non-correlated assets into the mix assets that you believe will not move together, even in times of stress.

THE BOTTOM LINE

In the end, all this talk of Old Brain and New Brain comes down to a simple concept: before you even think of where to invest, you need to have your game plan in place. And your game plan—your asset allocation—should be structured to allow your portfolio to respond to any of the scenarios that may arise. Regardless of which expert ends up being right, choosing the right asset allocation before you begin choosing investments will help you keep focused on the end game and help you nurture your nest egg.

WHAT'S NEXT?

In coming newsletters, I'll be describing specific ideas concerning the construction of your asset allocation, and how to intelligently diversify using non-correlated assets. In the meantime, please feel free to call me with any questions or to discuss your own portfolio...I'd be happy to speak with you.

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Altegris is headquartered in La Jolla, California, and specializes in finding unique alternative investments to help high net worth and institutional investors diversify their portfolios. Altegris' clients currently represent a trading level of over U.S. \$2 billion in hedge fund and managed futures investments. You can access other Altegris Newsletters on the web at www.altegris.com.

Alternative investment products, including hedge funds and managed futures, involve a high degree of risk, often engage in leveraging and other speculative investment practices that may increase the risk of investment loss, can be highly illiquid, are not required to provide periodic pricing or valuation information to investors, may involve complex tax structures and delays in distributing important tax information, are not subject to the same regulatory requirements as mutual funds, often charge high fees which may offset any trading profits, and in many cases the underlying investments are not transparent and are known only to the investment manager. Alternative investment performance can be volatile. An investor could lose all or a substantial amount of his or her investment. Often, alternative investment fund and account managers have total trading authority over their funds or accounts; the use of a single advisor applying generally similar trading programs could mean lack of diversification and, consequently, higher risk. There is often no secondary market for an investor's interest in alternative investments, and none is expected to develop. There may be restrictions on transferring interests in any alternative investment. Alternative investment products often execute a substantial portion of their trades on non-U.S. exchanges. Investing in foreign markets may entail risks that differ from those associated with investments in U.S. markets. Additionally, alternative investments often entail commodity trading, which involves substantial risk of loss. PAST RESULTS ARE NOT NECESSARILY INDICATIVE OF FUTURE RESULTS.

Altegris, a member of NASD and the NFA, offers various alternative investments, including hedge funds, futures funds and managed commodity and futures accounts, that may operate in commodities markets and foreign markets, among others. Altegris and/or its officers/partners may have a financial interest in such alternative investments.

