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The Rise of Long/Short Equity

Amid equity market uncertainty, a more flexible investment approach can prove essential to investors.

With the broader equity markets being punctuated in recent years by increased volatility, high levels of correlation and disappointing long-term performance, many investors have been searching for new opportunities for their portfolios that might allow them to better limit the downside yet still enjoy the return potential of the upside. That the category of liquid alternative investment in a mutual fund format has expanded dramatically at the same time has only increased investors’ menu of options.

Against this backdrop, Altegris believes that liquid long/short equity will increasingly serve not only as a component of an alternative investment portfolio, but also as a part of an investor’s core equity holdings that may lower volatility and correlations while increasing the potential risk-adjusted returns of portfolios.

Long/short equity has long been considered the quintessential hedge fund strategy, and has historically attracted the most assets within the alternative investment universe (See Figure 1).

“The ability to short is a rare and difficult skill, and is one that experienced alternative investment managers have honed over many years.”
STOCK PICKING AND MARKET EXPOSURE MANAGEMENT

The strategy seeks to profit through effective stock selection and market exposure management. Managers have the ability to buy (go long) securities they expect to increase in price and sell (go short) borrowed securities they expect to depreciate. They also control the portfolio’s net exposure by adjusting the mix of long and short holdings to reflect their market outlook. Managers’ ability to profit from both rising and falling prices of individual equities, as well as their ability to adjust their aggregate market exposure, determines their success.

Stock selection is typically a fundamental, research-driven process, in which the ability to pick stocks is a core element in generating alpha. The best long/short managers implement direct alpha shorts as a means of seeking profits—with significant shorting of this kind leading to a natural hedge for a portfolio. It’s important to note that the ability to short is a rare and difficult skill, and is one that experienced alternative investment managers have honed over many years of pursuing a long/short strategy. Managers who have only recently moved over from the long-only world, however, have often not yet mastered this skill—and, as a result, investors should be careful of mutual fund providers who place a long/short equity label on funds that might have little short exposure or portfolio managers with a limited background in the challenging shorting process.

Managing a portfolio with a focus on market exposure consists of the ability to adjust long/short exposure and the holding period of investments. Higher net long exposures generally correspond to periods of increased bullishness, while lower net exposures generally indicate a more bearish outlook or cautious positioning. We believe that this ability to adapt exposures with both long and short positions provides an edge over traditional long-only portfolios, where a manager is limited to relying on long-only stock-picking abilities and market beta. As illustrated in Figure 2, a long/short portfolio can be adjusted to hedge against swings in the market, whereas a portfolio that is 100% net long (high beta) is vulnerable to such swings.

FIGURE 1.
HEDGE FUND STRATEGY ALLOCATIONS BY % OF ASSETS UNDER MANAGEMENT | As of March 31, 2012

Long/short equity leads the way in % of AUM among alternative investment strategies.

Source: Hedge Fund Research Q1 Industry Report
Total may not equal 100% due to rounding.
A long/short portfolio with low market exposure can be less susceptible to market swings than one that is 100% net long.

For illustrative purposes only.

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, covering the short position at a higher price may result in a loss. Long: buying an asset/security that gives partial ownership to the buyer of the position. Long positions profit from an increase in price. There is no guarantee that any investment product will achieve its objectives, generate profits or avoid losses. The success of an investment is dependent upon the ability of a long/short equity manager 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. See the glossary on page 18 for term definitions. Source: Altegris
Allocating to long/short equity can offer investors important potential benefits.

> A Measure of Downside Protection
The best long/short equity managers have displayed the ability to deliver returns across a broad array of market environments, including the potential to profit, or at least mitigate losses, during bear markets.

> Lower Volatility
The ability of long/short equity managers to manage market exposure and adjust according to varying conditions demonstrates the potential of this strategy to profit in equity markets with return streams that may exhibit low volatility.

> Broad Investment Mandate
An array of sub-strategies can fall under the long/short equity umbrella, in addition to market exposure management, including a market neutral approach (balancing the long and short sides of a portfolio to hedge out market risk); pairs trading (matching long and short positions one pair at a time); and an activist stance (working directly with a company’s management to make changes to improve its share price). Managers may specialize in particular regions, industries or sectors where they have the most expertise, or they may take a more generalist approach, allocating capital where they see the best opportunities. Investment styles can also vary broadly, including fundamental value, growth, quantitative approaches, or any combination thereof. This array of approaches gives managers the opportunity to potentially profit from both positive and negative developments in multiple markets simultaneously, allowing them flexibility.
As demand grows for non-correlated returns, investors enjoy unprecedented access to a strategy with the potential to deliver them.

One of the principal legacies of the financial crisis that began in 2008 has been an increased focus on liquid, non-correlated assets as investors seek to better manage risk in their portfolios—without sacrificing performance. As a consequence, increasing numbers of financial advisors and their clients are turning to liquid alternative investments to help meet this challenge.

At Altegris, we define liquid alternative investments as mutual funds that are available to a wide range of investors, and which provide access to best of breed alternative investment managers who can go long or short various markets. While alternative investments have historically been the exclusive province of institutional and high-net-worth investors, liquid alternatives enable a broader range of investors who are willing to assume the various risks to take advantage of their strengths—including reduced portfolio volatility and lower correlations, as well as strong potential risk-adjusted returns—while also benefiting from the hallmarks of mutual funds, including a high degree of liquidity, low investment minimums, more flexible investor pre-qualifications and efficient 1099 tax reporting.

**GROWING DEMAND AND SUPPLY**

At a time of rising investor demand, alternative investment managers are also becoming increasingly open to offering their strategies via more liquid vehicles as they seek to diversify and expand their businesses. Liquid alternatives offer managers another avenue for asset growth at a point when competition has never been fiercer—estimates peg the number of alternative investment managers operating globally at more than 5,000.

“At a time of rising investor demand, alternative investment managers are also becoming increasingly open to offering their strategies via more liquid vehicles as they seek to diversify and expand their businesses.”

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1 Altegris defines “best of breed” as managers which, in our opinion, have demonstrated success in terms of sustained investment edge, effective risk management processes and established operational infrastructure.
The fact that long/short equity managers trade in fairly liquid markets—publicly traded stocks from around the world that are primarily centrally cleared—and can successfully pursue their investment strategies with reasonable levels of leverage, has helped spur a proliferation of mutual funds in the space. Indeed, the strategy is well aligned with the primary features of mutual fund investing—a high degree of transparency, the ability to quickly invest and redeem (thus aiding in actively rebalancing portfolios), and regulatory and board oversight. As a result, long/short equity mutual funds have enjoyed substantial growth, with more than $3.4 billion in asset flows in 2011, and total assets nearly doubling since 2008 (See Figure 3).

However, in spite of the growth of long/short equity mutual funds, few of these offerings, in our view, provide investors with access to “real” long/short managers: stock-pickers with the proven ability to generate strong risk-adjusted returns on both long and short positions, as well as deep experience in adjusting their exposures in up and down markets.

**FIGURE 3.**  
**LONG/SHORT EQUITY MUTUAL FUND ASSETS | $ Billion**

Liquid long/short funds have attracted a steady stream of assets in recent years.

*Source: Morningstar Monthly Fund Flows Report Assets consist of Mutual Funds in the Long/Short Equity Category, as well as the Market Neutral Category of Morningstar.*
AN ‘ALTERNATIVE’ TO LONG-ONLY

Looking ahead, asset flows into liquid long/short equity offerings could increase substantially as more advisors view long/short equity as a potential replacement for—or more dynamic supplemental allocation to—long-only equities in a traditional portfolio. Indeed, an investment in the strategy can potentially provide strong risk-return benefits to a portfolio compared over time to a traditional long-only equity strategy (See Figure 4).

In addition, long/short equity can potentially help “smooth” the return path of an investor’s portfolio, as the strategy has historically tended to avoid the extreme lows of the broader equity market over the long-term.

This is illustrated by the performance of a hypothetical $1,000 investment in long/short equity vs. the same investment in a long-only strategy during some of the recent bull and bear markets (See Figure 5).

Particularly in light of the markets’ dramatic swings in recent years, the ability on a historical basis to both cushion a portfolio on the downside and nimbly take advantage of profit opportunities on the upside makes long/short equity the ideal strategy for investors to consider in lieu of or as a counterbalance to a traditional long-only approach.

FIGURE 4.

PERFORMANCE TABLE | January 1990–August 2012

Long/short equity features compelling risk-reward characteristics when compared to long-only equity.

<table>
<thead>
<tr>
<th></th>
<th>Annual Rate of Return</th>
<th>Annual Standard Deviation</th>
<th>Worst Drawdown</th>
<th>Sharpe Ratio</th>
<th>Long/Short Equity</th>
<th>Long-only Equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Long/Short Equity</td>
<td>12.66%</td>
<td>9.27%</td>
<td>-30.57%</td>
<td>1.10</td>
<td>1.00</td>
<td>0.73</td>
</tr>
<tr>
<td>Long-only Equity</td>
<td>8.58%</td>
<td>15.10%</td>
<td>-50.95%</td>
<td>0.40</td>
<td>0.73</td>
<td>1.00</td>
</tr>
</tbody>
</table>

Source: PerTrac, Altegris

Past performance is not indicative of future results. The referenced indexes are shown for general market comparisons and are not meant to represent any particular fund. An investor cannot invest directly in an index. Moreover, indexes do not reflect commissions or fees that may be charged to an investment product based on an index, which may materially affect the performance data presented. There is no guarantee an investment will achieve its objective, generate profits or avoid losses. Long/Short Equity represented by HFRI Equity Hedge (Total) Index, Long-only Equity represented by S&P 500 TR Index.

Standard deviation is a statistical measure of how consistent returns are over time; a lower standard deviation indicates historically less volatility. Drawdown measures the peak to valley loss relative to the peak for a stated time period. Sharpe Ratio measures return in excess of the risk-free rate, per unit of risk, as measured by standard deviation. Date range based on common period of data availability for shown indices. Performance should never be the sole consideration when making an investment decision. Correlation is a statistical measure of how returns of two strategies move together over time; a correlation of 1 indicates the two returns move perfectly together, 0 indicates movements are random, and -1 indicates opposite movements. Correlations will by nature vary over time. See page 12 for correlations and other performance return measures over various time frames. See page 19 for additional index definitions, descriptions, and risks.
FIGURE 5.
GROWTH OF $1,000 DURING BULL MARKETS & CRISIS PERIODS | January 1990–August 2012

Long/short equity has historically exhibited a stronger total return than long-only equity over their indices’ common time period.

Source: Altegris

PAST PERFORMANCE IS NOT NECESSARILY 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. Long/Short Equity represented by HFRI Equity Hedge (Total) Index; Long-only Equity represented by S&P 500 TR Index. Percentages reflect cumulative return over time period covered. Total return is only one measure of performance. Performance should never be the sole consideration when making an investment decision. There is no guarantee that any investment will achieve its objectives, generate profits, or avoid losses. The referenced indices are shown for general market comparisons and are not meant to represent any particular fund. See page 12 for performance returns over various time frames. See pages 19 for additional index definitions, descriptions, and risks.
Designing the Optimal Exposure to Long/Short Equity

Elite-level stock selection, skilled shorting, and low market exposure and leverage are among the key attributes investors seek when allocating to the strategy.

In spite of the growth of liquid long/short equity mutual funds, investors continue to face constraints. For example, the majority of long/short equity mutual funds are single-manager, proprietary strategies, with a significant long bias (e.g., a minimal short component), as many of the managers involved come from the long-only world and do not have extensive alternative investment experience.

Others are directional in nature, attempting to go long indices in rallying markets and flat in declining markets, thus foregoing the considerable potential benefits of stock selection altogether. At the same time, the majority of “pedigreed” long/short equity managers are offered only through private placements. These are “pure” long/short strategies, in that their goal is to create profits from both long and short positions, while maintaining lower volatility than traditional equity indices.

“We believe an optimal portfolio is one that has been designed to hold low-to-moderate market exposure, with an emphasis on managers’ stock selection skills rather than market direction.”
In designing liquid exposure to long/short equity, we believe that **investors should prioritize certain criteria:**

- **Elite Managers**
  The underlying managers within a long/short equity mutual fund should be pre- eminent compared to their direct peers. That is, the managers should be of such quality that experienced alternatives investors would consider allocating to them on a stand-alone, private placement basis—and who would, as a result, typically command higher fees than traditional mutual fund managers due to their historical ability to generate superior risk-adjusted returns net of fees.

- **Investment Flexibility**
  Investment flexibility is a key feature of a strong long/short equity mutual fund. The underlying managers in a fund should not only be able to generate returns on both long and short trades, but also to actively manage their market exposure through different cycles. In this way, they have several options for adding value—as opposed to a long-only manager, who can essentially only adjust one variable of buying or not buying. In addition, the optimal fund should encompass a variety of investment styles and sectors—the managers in this scenario would have flexibility within their strategies to pursue more opportunities and thus would possess greater risk-adjusted return potential than managers confined to strict benchmark-oriented mandates.

- **Limited Market Exposure**
  We believe an optimal portfolio is one that has been designed to hold low-to-moderate market exposure, with an emphasis on managers’ stock selection skills rather than market direction. Among the growing universe of long/short equity funds are a number of long-only managers with minimal experience running short portfolios. We prefer underlying managers in a fund that have extensive track records of delivering strong risk-adjusted performance not only by going long, but also by mastering the difficult act of managing shorts. Of course, it is important to note that past performance is no guarantee of future results.

- **Moderate Leverage**
  The optimal long/short portfolio should feature a moderate and tightly managed level of gross leverage as well as net leverage. In a real-life illustration of the importance of this point, in 2007, a number of large, highly leveraged quantitative (“quant”) hedge funds carrying similar positions attempted to reduce their exposures to the market at the same time. These funds were further hurt by their relatively high gross exposures (See Figure 6 for an example of how gross exposure can affect returns). We believe the best long/short equity managers can and should successfully manage both their gross and net exposures through robust risk management.

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**FIGURE 6. PORTFOLIO NET AND GROSS EXPOSURE EXAMPLE**

Funds with similar net zero exposures may have very different gross exposures, which will impact returns.

<table>
<thead>
<tr>
<th>Fund A</th>
<th>Low Gross Exposure</th>
<th>Fund B</th>
<th>High Gross Exposure</th>
</tr>
</thead>
<tbody>
<tr>
<td>Exposure</td>
<td>Leverage</td>
<td>-3% Return</td>
<td>Exposure</td>
</tr>
<tr>
<td>Gross Long</td>
<td>100%</td>
<td>1x</td>
<td>-3%</td>
</tr>
<tr>
<td>Gross Short</td>
<td>100%</td>
<td>1x</td>
<td>-3%</td>
</tr>
<tr>
<td>Total Gross</td>
<td>Gross Long + Gross Short</td>
<td>200%</td>
<td>2x</td>
</tr>
<tr>
<td>Total Net</td>
<td>Gross Long – Gross Short</td>
<td>0%</td>
<td>—</td>
</tr>
</tbody>
</table>

*Source: For illustrative purposes only. Does not represent any actual funds.*
PERFORMANCE IN UP AND DOWN MARKETS

The ultimate goal is a diversified exposure to long/short equity that possesses the potential to deliver strong risk-adjusted returns in a variety of markets, as well as the capability of generating low volatility of returns when compared to traditional long-only equity funds. As illustrated in Figure 7, a long/short equity index demonstrates the potential of the strategy to handle a variety of markets to deliver favorable long-term risk-return characteristics.

In absolute terms, a long/short equity strategy would be likely to perform best in a rising equity market due to its natural long equity bias. However, on a relative basis, this type of strategy would likely underperform the S&P 500 TR Index in a high beta market rally due to a lower net exposure than a long-only strategy. In flat to negative markets, however, we would expect a long/short equity strategy to outperform the S&P 500 TR Index due to the ability to potentially generate alpha on the short side as well as the long side. Thus, over the longer term, we would expect an “optimal” long/short equity strategy to produce equity-like returns with stronger risk-adjusted performance than traditional equity indices.

It is important to acknowledge that, as with all investments, there would be some risks involved in investing in a liquid long/short equity strategy in a mutual fund format. There is idiosyncratic risk—stock selection is key to the long/short equity strategy, and each underlying manager would potentially see their long investments decreasing in value and their short borrowed securities increasing in value (perhaps even at the same time). Shorting carries its own set of risks—if, for example, a short position increases in price, the manager must cover that position at a higher price, which would result in a loss.

From a broader standpoint, historically even some of the best hedge fund managers have periodically attempted to take advantage of equity rallies and found themselves with long beta positions. The core value of long/short equity, in our view, is stock selection, with a goal of making money on both long and short positions, in addition to benefits provided from net exposure management. However, if a manager becomes too enamored with market rallies, that manager’s strategy could assume some of the same characteristics as a long-only approach.

“The core value of long/short equity is stock selection, with a goal of making money on both long and short positions, in addition to benefits provided from net exposure management.”
### Annual Rate of Return

<table>
<thead>
<tr>
<th></th>
<th>20-Year</th>
<th>10-Year</th>
<th>5-Year</th>
<th>3-Year</th>
<th>1-Year</th>
</tr>
</thead>
<tbody>
<tr>
<td>Long/Short Equity</td>
<td>11.39%</td>
<td>5.44%</td>
<td>-0.12%</td>
<td>3.64%</td>
<td>-0.91%</td>
</tr>
<tr>
<td>Long-only Equity</td>
<td>8.43%</td>
<td>6.50%</td>
<td>1.27%</td>
<td>13.62%</td>
<td>17.99%</td>
</tr>
</tbody>
</table>

### Annual Standard Deviation

<table>
<thead>
<tr>
<th></th>
<th>20-Year</th>
<th>10-Year</th>
<th>5-Year</th>
<th>3-Year</th>
<th>1-Year</th>
</tr>
</thead>
<tbody>
<tr>
<td>Long/Short Equity</td>
<td>9.29%</td>
<td>8.79%</td>
<td>10.95%</td>
<td>8.96%</td>
<td>10.68%</td>
</tr>
<tr>
<td>Long-only Equity</td>
<td>15.08%</td>
<td>15.57%</td>
<td>19.01%</td>
<td>15.41%</td>
<td>15.91%</td>
</tr>
</tbody>
</table>

### Worst Drawdown

<table>
<thead>
<tr>
<th></th>
<th>20-Year</th>
<th>10-Year</th>
<th>5-Year</th>
<th>3-Year</th>
<th>1-Year</th>
</tr>
</thead>
<tbody>
<tr>
<td>Long/Short Equity</td>
<td>-30.57%</td>
<td>-30.57%</td>
<td>-30.57%</td>
<td>-13.18%</td>
<td>-6.04%</td>
</tr>
<tr>
<td>Long-only Equity</td>
<td>-50.95%</td>
<td>-50.95%</td>
<td>-50.95%</td>
<td>-16.26%</td>
<td>-7.03%</td>
</tr>
</tbody>
</table>

### Correlation

<table>
<thead>
<tr>
<th></th>
<th>20-Year</th>
<th>10-Year</th>
<th>5-Year</th>
<th>3-Year</th>
<th>1-Year</th>
</tr>
</thead>
<tbody>
<tr>
<td>Long/Short Equity—Long-only Equity</td>
<td>0.75</td>
<td>0.83</td>
<td>0.88</td>
<td>0.92</td>
<td>0.95</td>
</tr>
</tbody>
</table>

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Standard deviation is a statistical measure of how consistent returns are over time; a lower standard deviation indicates historically less volatility. Drawdown measures the peak to valley loss relative to the peak for a stated time period. Correlation is a statistical measure of how returns of two strategies move together over time; a correlation of 1 indicates the two returns move perfectly together, 0 indicates movements are random, and -1 indicates opposite movements.
Partnering with ‘The Real Deal’

While investing in long/short equity can produce a number of benefits, simply allocating to it is not enough—the strategy is only as strong as the managers pursuing it.

At Altegris, we hold the view that investors have a better opportunity to realize the full potential benefits of liquid alternatives only when they work with “the real deal”: top-flight, experienced alternative investment managers with a robust infrastructure behind them, and the ability on a historical basis to deliver alpha. Figure 8 illustrates the greater dispersion of long/short equity manager performance as compared to long-only equity managers. This highlights the fact that, unlike traditional investments measured against benchmarks, alternative investments are driven by manager skill—whether good or bad—and thus manager selection is particularly important.

This disparity means, in our opinion, that manager selection should rely upon those with expertise in alternatives, blending top-down viewpoints with bottom-up analysis to identify the most compelling strategies based on market opportunities and the best of breed managers within each strategy. A detailed assessment and multi-layered due diligence process for each manager is also essential before an investment is approved. Because access to some managers may be limited due to capacity constraints or confined to institutional investors, securing a point of access also must be considered. The manager selection process becomes even more complex within the constructs of building a portfolio with multiple alternative investment managers.

“An advisor should be able to provide an entrée to managers who are often capacity constrained or have historically provided limited access to non-institutional investors.”
Long/short equity has seen a far greater historical dispersion in manager performance than long-only equity.

<table>
<thead>
<tr>
<th>Year</th>
<th>Large Cap Value Mutual Funds</th>
<th></th>
<th></th>
<th>Long/Short Equity Hedge Funds</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Top 25%</td>
<td>Bottom 25%</td>
<td>Difference</td>
<td>Top 25%</td>
<td>Bottom 25%</td>
<td>Difference</td>
</tr>
<tr>
<td>2000</td>
<td>23.19%</td>
<td>-0.09%</td>
<td>23.28%</td>
<td>56.33%</td>
<td>-16.54%</td>
<td>72.87%</td>
</tr>
<tr>
<td>2001</td>
<td>8.18%</td>
<td>-11.40%</td>
<td>19.58%</td>
<td>41.61%</td>
<td>-14.23%</td>
<td>55.84%</td>
</tr>
<tr>
<td>2002</td>
<td>-0.66%</td>
<td>-23.60%</td>
<td>22.94%</td>
<td>24.53%</td>
<td>-19.66%</td>
<td>44.19%</td>
</tr>
<tr>
<td>2003</td>
<td>36.62%</td>
<td>1.60%</td>
<td>35.03%</td>
<td>71.47%</td>
<td>0.15%</td>
<td>71.33%</td>
</tr>
<tr>
<td>2004</td>
<td>18.68%</td>
<td>0.75%</td>
<td>17.93%</td>
<td>29.99%</td>
<td>-0.03%</td>
<td>30.02%</td>
</tr>
<tr>
<td>2005</td>
<td>11.57%</td>
<td>0.23%</td>
<td>11.34%</td>
<td>38.90%</td>
<td>0.12%</td>
<td>38.78%</td>
</tr>
<tr>
<td>2006</td>
<td>22.03%</td>
<td>1.19%</td>
<td>20.84%</td>
<td>37.47%</td>
<td>0.09%</td>
<td>37.38%</td>
</tr>
<tr>
<td>2007</td>
<td>8.80%</td>
<td>-3.84%</td>
<td>12.63%</td>
<td>43.18%</td>
<td>-0.81%</td>
<td>43.99%</td>
</tr>
<tr>
<td>2008</td>
<td>-2.72%</td>
<td>-43.43%</td>
<td>40.70%</td>
<td>4.34%</td>
<td>-53.74%</td>
<td>58.07%</td>
</tr>
<tr>
<td>2009</td>
<td>35.03%</td>
<td>1.49%</td>
<td>33.54%</td>
<td>80.98%</td>
<td>-1.34%</td>
<td>82.32%</td>
</tr>
<tr>
<td>2010</td>
<td>17.96%</td>
<td>0.99%</td>
<td>16.97%</td>
<td>31.83%</td>
<td>-1.28%</td>
<td>33.10%</td>
</tr>
<tr>
<td>2011</td>
<td>6.28%</td>
<td>-7.25%</td>
<td>13.53%</td>
<td>9.16%</td>
<td>-25.85%</td>
<td>35.01%</td>
</tr>
<tr>
<td>2012 YTD</td>
<td>13.25%</td>
<td>0.75%</td>
<td>12.51%</td>
<td>16.96%</td>
<td>-7.60%</td>
<td>24.56%</td>
</tr>
</tbody>
</table>

Source: HFR; Morningstar; Altegris

PAST PERFORMANCE IS NOT NECESSARILLY INDICATIVE OF FUTURE RESULTS. There is no guarantee any investment will achieve its objectives, generate profits, or avoid losses. Long/Short Equity universe includes 3,792 funds derived from HFR Equity Hedge (Total); Large Cap Value universe includes 1,197 funds derived from Morningstar Category Large Cap Value. Top 25% Average represents the average return of the highest returning funds by calendar year by defined universe; Bottom 25% Average represents the average return of the lowest returning funds by calendar year by defined universe. Rounding may affect “Difference” calculation.
Utilizing advanced return and risk techniques to actively manage and rebalance the portfolio is also important. In addition, one should have the resources to perform an ongoing evaluation of each manager in the portfolio—including constant investment review and risk monitoring.

This blend of alternatives background, investment skills and analytical resources is rare among investment advisors, and is a key rationale for partnering with a firm such as Altegris.

GETTING WHAT YOU PAY FOR

Mutual fund investors have historically been fee-sensitive, as they are more accustomed to buying low-cost, index-based products. From the fund provider side, this more constrained compensation structure has in recent years helped spur a “brain drain” as many of the best in-house managers left to start or work for hedge funds. This, in turn, has played a role in a number of alternative mutual funds being launched without “real” alternative managers running their portfolios, in our view.

Altegris believes that true talent is worth paying for—from a mutual fund investor’s standpoint, potentially higher fees are appropriate in exchange for access to some of the best investment talent in the world: an elite group of “real” managers within the alternative investment universe with a history of consistently generating strong risk-adjusted returns in both up and down markets, supported by an institutional-quality operational infrastructure.

Whether in private placement or mutual fund format, the best managers can be more expensive for investors to engage directly—if they are open to new investors at all. Regardless of the vehicle, these managers are in a position to be able to command higher fees—and if they can deliver consistently strong risk-adjusted net returns, these fees represent a wise investment, in our view.
Long/short equity: Opportunism in the best sense of the word.

As investors confront an economic climate characterized by turbulence and uncertainty, they are justifiably placing an ever-greater emphasis on investment strategies that can potentially lessen the downside while also possessing the agility to opportunistically profit in both rising and falling markets.

Against this backdrop, we believe that:

› By allocating to long/short equity, investors can potentially achieve long-term capital appreciation with moderate correlation to major market indices, with less volatility than those indices.

› In seeking exposure to long/short equity in a liquid format, investors can benefit from some of the historical strengths of mutual funds—ease of allocating and rebalancing, low investment minimums, more flexible pre-qualifications for suitable investors and efficient tax reporting.

› Partnering with best of breed long/short equity managers, and doing so in a liquid mutual fund structure with robust portfolio oversight, can position investors to overcome a variety of short-term market challenges on the way to achieving their long-term investment goals.
For more information and perspectives on alternatives, please visit altegrisacademy.com or contact your alternatives consultant at Altegris Investments (800) 828-5225.
**GLOSSARY**

**Alpha:** measures the non-systematic return which cannot be attributed to the market. It shows 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 volatility that reflects the tendency of a security’s returns and how it responds to swings in the markets. A beta of 1 indicates that the security’s price will move with the market. A beta of less than 1 means that the security will be less volatile than the market. A beta of greater than 1 indicates that the security’s price will be more volatile than the market.

**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.

**Exposure:** the proportion of money invested in a particular type of security and/or market sector or industry. Usually expressed as a percentage of total portfolio holdings.

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

**Sector:** group of businesses that share similar characteristics or a related product of service (e.g., energy, consumer, financials, technology).

**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, covering the short position at a higher price may result in a loss.

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

**Style:** the primary strategy or philosophy used by an investor or money manager to select individual securities.

**VAMI:** value added monthly index. A graph that shows the compounded growth of a $1,000 investment on a monthly basis.
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. The referenced indices are shown for general market comparisons and are not meant to represent any particular investment.

**Long/Short Equity.** The HFRI Equity Hedge (Total) Index tracks funds that maintain positions both long and short in primarily equity derivative securities. Equity hedge managers would typically maintain at least 50% exposure, and may in some cases be entirely invested in, equities—both long and short. HFRI Equity Hedge (Total) is a fund weighted index and reflects 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.

**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.

INDEX DESCRIPTIONS AND RISKS

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RISKS AND IMPORTANT CONSIDERATIONS

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, macro, equity long short, fixed income and/or other investment strategies.

MUTUAL FUNDS INVOLVE RISK INCLUDING POSSIBLE LOSS OF PRINCIPAL.

As with all mutual funds, there is the risk that you could lose money through your investment in the Fund. No Fund is intended to be a complete investment program. Many factors affect a fund’s net asset value and performance and there can be no assurance that any fund will achieve its investment objectives.

Alternative investment mutual funds are subject to certain risks including, but not limited to, non-diversification risk, which means that a fund may invest in fewer securities at any one time than a diversified fund and the fund’s performance may be more sensitive to any single economic, business, political or regulatory occurrence. Factors such as domestic and foreign economic growth and market conditions, interest rate levels and political events affect the securities and derivatives markets. When the value of the fund’s investments goes down, your investment in a fund decreases in value and you could lose money.

An investment in derivatives, such as futures and options contracts, involves additional risks that a fund would not be subject to if it invested directly in the securities and commodities underlying those derivatives. The fund may experience losses that exceed losses experienced by funds that do not use futures contracts and options. Long options positions may expire worthless. Although futures contracts are generally liquid instruments, under certain market conditions there may not always be a liquid secondary market. Trading restrictions or limitations may be imposed by an exchange, and government regulations may restrict trading in futures contracts and options. Over-the-counter transactions are subject to little, if any, regulation and may be subject to the risk of counterparty default.

Foreign investing involves risks not typically associated with US investments, including adverse fluctuations in foreign currency values, adverse political, social and economic developments, less liquidity, greater volatility, less developed or less efficient trading markets, political instability and differing auditing and legal standards. These risks are magnified in emerging markets.

Alternative investment mutual funds that engage in short selling and short position derivative activities involve significant financial risk. Positions in shorted securities and derivatives are speculative and more risky than “long” positions (purchases) because the cost of the replacement security or derivative is unknown. Therefore, the potential loss on an uncovered short is unlimited, whereas the potential loss on long positions is limited to the original purchase price. You should be aware that any strategy that includes selling securities short could suffer significant losses. Shorting will also result in higher transaction costs (such as interest and dividends), which reduces a fund’s return, and may result in higher taxes. The use of leverage by a fund, such as borrowing money to purchase securities or the use of options, will cause the Fund to incur additional expenses and magnify the fund’s gains or loss.

The investment expertise of the portfolio manager and the manager’s judgments about the attractiveness, value and potential appreciation or depreciation of a particular security in which the fund invests may prove to be inaccurate and may not produce the desired results.

If used in connection with the sale or promotion of an investment company product, this material must be preceded or accompanied by a prospectus for the respective product.
Veteran experts in the art and science of alternatives, Altegris guides investors through the complex and often opaque universe of alternative investing.

Altegris searches the world to find what we believe are the best alternative investments. Our suite of private funds, actively managed mutual funds and managed accounts provides an efficient solution for financial professionals and individuals seeking to improve portfolio diversification. With one of the leading research and investment groups focused solely on alternatives, Altegris follows a disciplined process for identifying, evaluating, selecting and monitoring investment talent across a spectrum of alternative strategies including managed futures, global macro, long/short equity, event-driven and others.

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 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. As of June 30, 2013, Altegris had over $3 billion in client assets, and provided clearing services to $752 million in institutional client assets.