Futures Evolution: The Road to Here and Looking Ahead

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TOPICS COVERED

EVOAX 2020 performance, manager allocation, market environment, outlook

READ TIME

10 minutes

Since the Fund's inception in 2011, the overarching goal of the Altegris Futures Evolution Strategy Fund (EVO) has been to provide investors with access to what we believe are the leading investment managers in both managed futures and active fixed income. Since then, we have strived to maintain upper quartile performance in the managed futures category while staying consistent with our manager selections and allocations. Until this year, the combination of the slower trading systems managed by Winton Capital with the faster reacting models of ISAM have generally provided the Fund with the right combinations of futures market exposures relative to peers. Simultaneously, DoubleLine has carefully managed the fixed income collateral risks and opportunities to meet our goal of 150–200 basis points of excess return over a risk-free benchmark.

This year's underperformance is very disappointing and not consistent with EVO's historical portfolio return objectives and diversification benefits. First — the good news. The faster reacting and ultra-diversified models traded by ISAM have resulted in a

Diversification does not ensure profit or protect against loss in a positive or declining market. There is no guarantee that any investment will achieve its objectives, generate profits, or avoid losses.

positive contribution to EVO in 2020. ISAM is near the top of a list of trend following peers represented by the SG Trend Index.[1] More disappointing is DoubleLine, who have been able to recover from the unprecedented volatility experienced by fixed income markets in late March as the pandemic took hold, but are approximately flat year to date. By far and away the greatest contributor to EVO's underperformance has been the very difficult year experienced by Winton Capital and the Diversified Macro Strategy (DMS) that EVO has exposure to.

Altegris (and its predecessor) has entrusted investor capital to Winton and their DMS strategy for over 20 years. This is Winton's worst ever drawdown when adjusted for target volatility. Most of Winton's losses in 2020 have come from their suite of non-trend models inside DMS, including systems dedicated to carry factors, market seasonality, equity valuations and other fundamentally derived models. These same models have been largely responsible for Winton's outperformance on a risk-adjusted basis over the past 10 years as they progressively implemented these diversifying strategies to supplement their core trend approach in DMS. The challenge for Altegris is to determine if Winton's models are permanently impaired. The short answer is that we don't believe so. The drawdown is within statistical parameters based on their volatility profile, and we have seen Winton recover from past drawdowns to reestablish their pedigree as one of the "best" in the peer group. However, we also believe that some adjustments to the Fund's allocations are warranted in order to optimize for our understanding of the current environment.

We are implementing these changes in part to adjust to a "new normal" of shorter and sharper periods of volatility. Additionally, the changes are in light of the current 0% interest rate environment, which is expected to persist for a prolonged period. Overall, we believe that the Fund will be in a better position to capture trends and trend reversal more quickly, and to generate 150–200 basis points from the collateral.

1. The SG Trend Index, which is equal-weighted and reconstituted annually, calculates the net daily rate of return for a group of 10 trend following CTAs selected from the largest managers open to new investment.

MANAGED FUTURES ALLOCATIONS

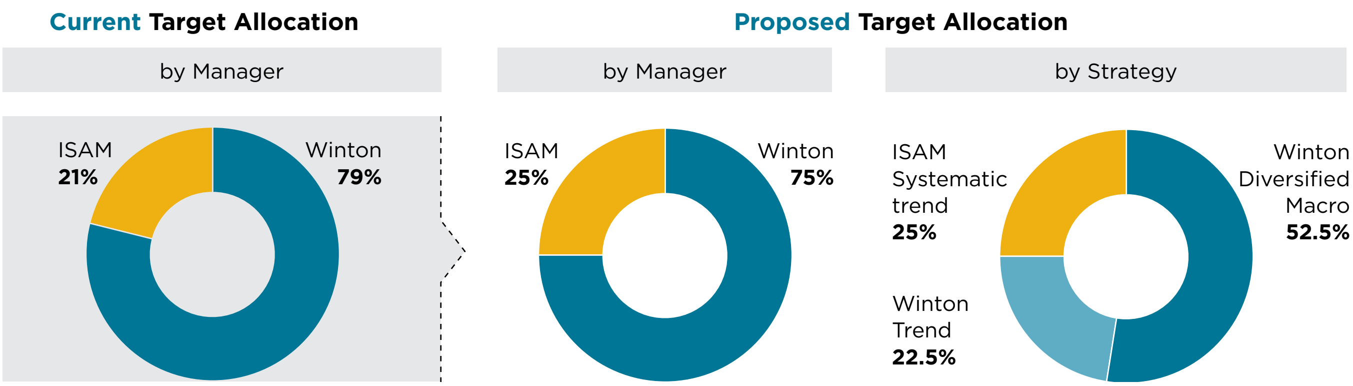
Firstly the allocation between Winton and ISAM will be changed. ISAM will receive a 25% allocation, versus the current 21%.

We believe that ISAM's faster trend program and the greater focus on commodities and less-traded markets may benefit the Fund and may continue to offer a diversification benefit from the majority Winton exposure. The allocation to Winton will thus change from 79% to 75%, but remains a majority of the Fund's managed futures exposure. This is a reflection of our conviction in Winton's continued ability to discern and capitalize on trends despite the two recent very challenging quarters.

However, we are also making changes within the Winton allocation. More specifically, 30% of the 75% Winton allocation (or in other words, 22.5% of the Fund's allocation) will be to a new strategy, the Winton Trend Strategy.

FIGURE 1

CURRENT AND PROPOSED TARGET ALLOCATIONS



Winton Trend Strategy

The Winton Trend strategy is a program launched in 2018 that focuses solely on trend following and trades 80 of the most liquid futures markets across all four asset classes. The average trend speed in Winton Trend is a little over a month, with ranges from 2 weeks to 3 months. For context, Winton Diversified Macro strategy (DMS) has a range of ~5 weeks to upwards of 4 months, with an average trend time of slightly over 2 months. Additionally, the target volatility of Winton Trend is 10–12%, which is consistent with EVO.

Generally speaking, recent history has shown that capital market appreciation has been punctuated by short and sharp periods of higher volatility. Several quantitative analyses that we have conducted have suggested that this new allocation may be additive to EVO specifically during selloffs, such as this year's correction in March and the correction in Q4 2018 where markets turned rapidly and where Winton Trend was able to react more quickly.

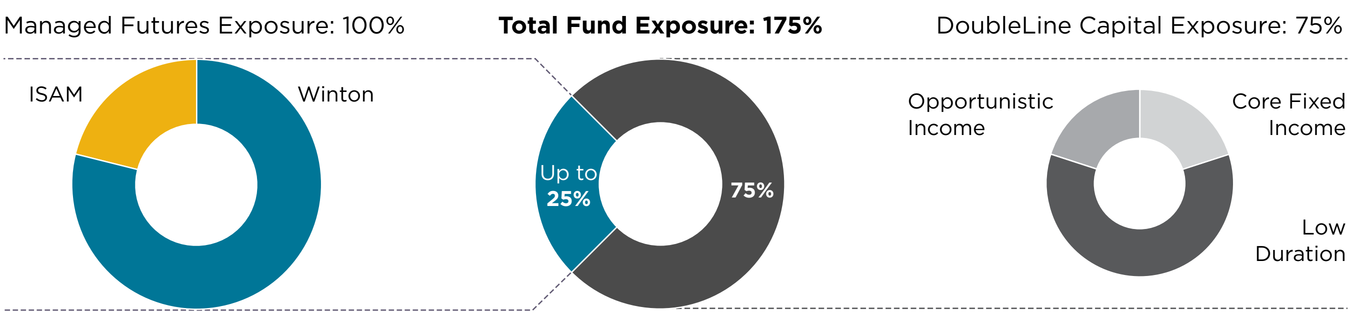
Importantly, not only is this change potentially better suited for today's environment, but it also maintains the Fund's expected volatility versus a baseline increase in allocation to ISAM only. We believe that this is a prudent and potentially accretive change that will increase the Fund's exposure to trend and will increase the velocity of the Fund's aggregate trend following systems. The change will be effective September 30th, 2020.

DOUBLELINE ALLOCATION

We are also looking to implement allocation changes to active fixed income component of EVO, managed by DoubleLine. Recall that assets not used for managed futures margin are actively managed in fixed income strategies subadvised by DoubleLine. These constitute approximately 75% of the fund's assets. The diagrams below outline the Fund's structure for both DoubleLine and managed futures.

FIGURE 2

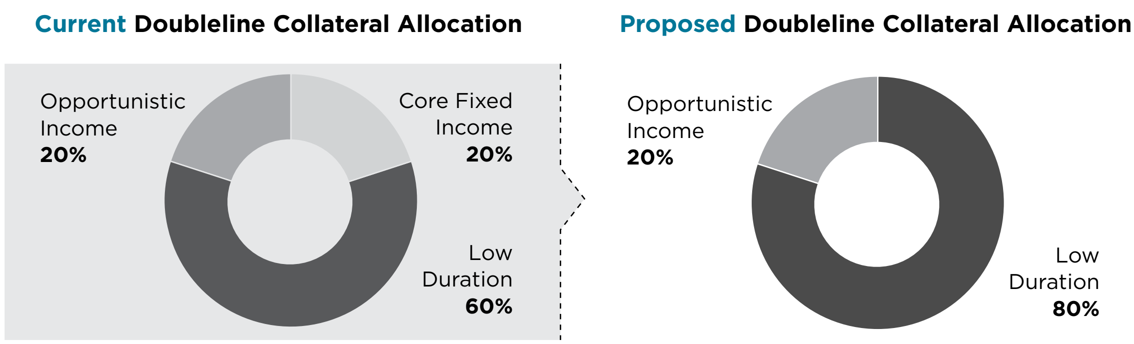
CURRENT COLLATERAL ALLOCATIONS



Currently, the collateral allocations are 60/20/20% to Low Duration, Opportunistic, and Core strategies, respectively. Going forward, the new allocation at September 30th will be 80% to Low Duration and 20% to Opportunistic. On a go-forward basis, the new potential allocation ranges may vary from 70–100% for Low Duration, and 0–30% in Opportunistic and will result in the removal of the Core strategy.

FIGURE 3

CURRENT AND PROPOSED DOUBLELINE ALLOCATIONS



It is our view, after a review of the fixed income environment and various manager perspectives, that a challenged outlook and limited upside may exist for long exposure to interest rate duration. Research and commentary from both **DoubleLine** and asset allocation leader **Bridgewater** for example, have not only highlighted the multi-year expectation for 0% short term US interest rates, but also comment on the broad consensus that medium term interest rates (in the 2–5 year range) may also continue to be quite low. Simultaneously however, there is a reticence on behalf of the US Federal Reserve to move policy rates negative, effectively creating an interest rate floor at 0%.

This scenario and outlook is causing one of the lowest and flattest yield curves in history. Given the 2-year US interest rate stands at 14 basis points at the time of this writing at September-end 2020, the prospect of benefiting from duration exposure of 2–5 years is realistically constrained, and yet is also one of the characteristics of the Core strategy's positioning.

Conversely, Low Duration focuses on finding high-yielding yet attractive fixed income opportunities that have shorter maturity, and on generating alpha from improvement of underlying *credit* fundamentals on a security by security basis. Additionally, the Opportunistic strategy is a benchmark-agnostic, absolute return strategy that seeks compelling fundamental investments across the entire fixed income space with fewer investment guidelines than Core, and thus has more investment flexibility.

With these changes, we believe that the proposed allocation to DoubleLine will be better equipped to continue generating the target of 150–200 basis points per annum versus the previous 60/20/20 allocation.

THE ROAD AHEAD

Our conviction and long-term confidence in Winton and ISAM has not changed; we remain convicted specifically in Winton's continuing ability to discern and capitalize on trends, while also adapting to two quarters of extraordinary conditions and disappointing performance. Our changes are more of a reflection of two broader market factors: the first being how market conditions have changed (and more acutely this year) both in terms of volatility sharpness, length, and trend speed. As a result, we wish to move trend exposure faster than Winton themselves are doing so while also reducing exposure to Winton's non-trend models. The second factor is an expectation of a much lengthier 0% interest rate environment.

Our focus and diligence on this Fund have not wavered and we are as purposeful as ever. We anticipate these changes to be a reflection of this focus, but as always we welcome to hear your **thoughts**.
Thank you for your support.

Sincerely,

Matt Osborne
Altegris CIO and Fund Portfolio Manager

Matt Osborne

Matt oversees Altegris' investment research, product structuring, and portfolio strategy teams. With more than 30 years of finance, international business, and investment industry experience, Matt is responsible for investment product development and is co-portfolio manager of several award-winning alternative funds. As a senior member of the Altegris Investment Committee, Matt is responsible for the qualification, approval, and ongoing review of all alternative strategies and managers on the Altegris Platform. Matt previously worked at Man Group.

PLEASE REVIEW THE FOLLOWING RISK DISCLOSURES AND IMPORTANT CONSIDERATIONS

Please carefully consider the investment objectives, risks, charges and expenses of the Altegris Futures Evolution Strategy Fund. This and other important information is contained in the Fund's Prospectus and the Summary Prospectus, which can be obtained by calling (888) 524-9441. Read the prospectus carefully before investing.

Funds are distributed by Northern Lights Distributors, LLC. Altegris Advisors and Northern Lights Distributors, LLC are not affiliated.

MUTUAL FUNDS INVOLVE RISK INCLUDING POSSIBLE LOSS OF PRINCIPAL.

The value of fixed income securities, including preferred stock, will typically fall when interest rates rise. Additionally, fixed income securities are subject to credit risk, which refers to an issuer's ability to make interest and principal payments when due, and risk of default. Asset or mortgage-backed securities are subject to prepayment risk. Below investment grade and lower quality high yield or junk bonds present heightened credit risk, liquidity risk, and potential for default. Investing in defaulted or distressed securities is considered speculative. REITs are subject to market, sector and interest rate risk.

Investing in commodity futures markets subjects the Fund to volatility as commodity futures prices are influenced by unfavorable weather, geologic and environmental factors, regulatory changes and restrictions. Trading on foreign exchanges and foreign investments including exposure to foreign currencies, involve risks not typically associated with U.S. investments, including fluctuations in foreign currency values, adverse social and economic developments, less liquidity, greater volatility, less developed or inefficient trading markets, political instability and differing auditing and legal standards. These risks are magnified in emerging markets.

The use of derivatives such as futures, swaps, structured notes, and options contracts expose the Fund to additional risks such as leverage risk, tracking risk and counterparty default risk that it may not be subject to if it invested directly in the underlying securities. Although futures contracts are generally liquid, under certain market conditions there may not always be a liquid secondary market. Option positions held may expire worthless and cause a loss. Managed futures programs accessed by the Fund may be traded with additional notional funding. The use of leverage can increase share price volatility and magnify gains or losses, as well as cause the Fund to incur additional expenses.

The Fund may engage in short selling and short position derivative activities which are considered speculative and involve significant financial risk. Short positions profit from a decline in price so the Fund may incur a loss on a short position if the price increases. The potential for loss in shorting is unlimited. Shorting may also result in higher transaction costs which reduce return.

Investing in commodities through a controlled foreign corporation Subsidiary involves taxation and regulatory risk. Where applicable, income received from commodities-related investments will be passed through to the Fund as ordinary income, which may be taxed at less favorable rates than capital gains. Changes in applicable foreign and domestic laws could result in the inability of the Fund and/or Subsidiary to operate.

Underlying Pools in which the Subsidiary invests will pay management fees, commissions, operating expenses and performance-based fees to each manager it retains. As a result, the cost of investing in the Fund may be higher than a mutual fund that invests directly in securities. There is no guarantee that any of the trading strategies used by the managers retained will be successful. The adviser's judgments about the investment expertise of each manager accessed may prove to be inaccurate and may not produce the desired results.

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ABOUT ALTEGRIS

Altegris is a pioneer in providing access to alternative sources of income and growth. With one of the leading research and investment teams 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, real estate, global macro, long/short equity, and event-driven, among others.

For additional information, please visit www.altegris.com.

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