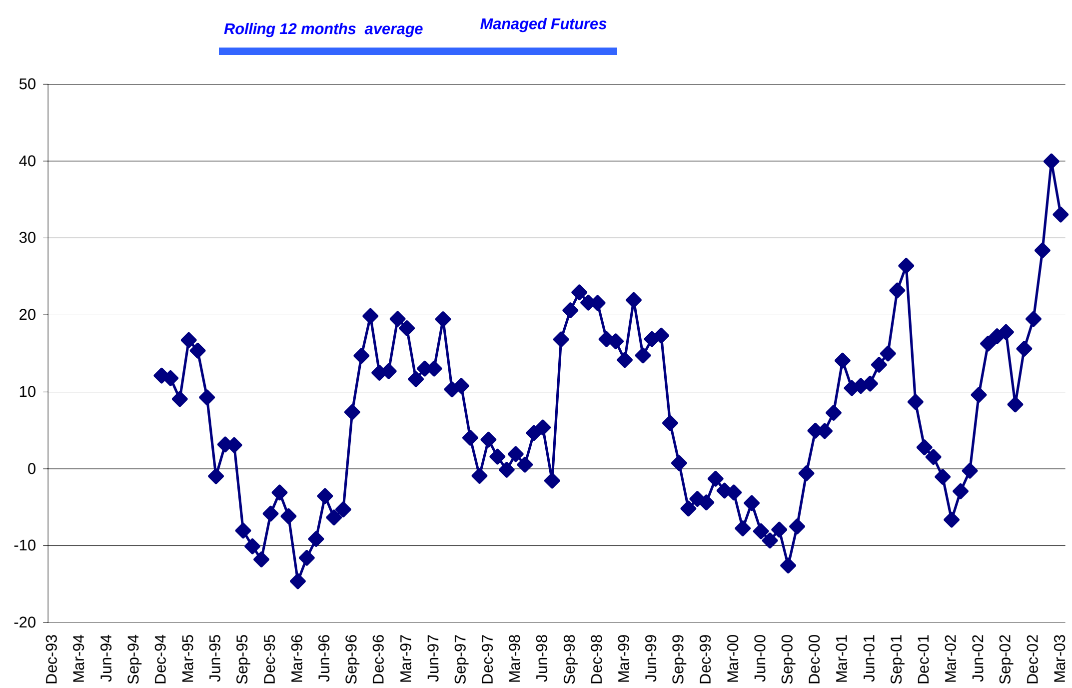
Sopa Piranha* Market Commentary April 21, 2003 A Trading Decade

Special Commentary: This quarter's special market commentary is focused on commodity and macro investing. In our February monthly commentary we noted that we had cut back on CTA's as an investment. We believe the group is at a high water mark and that it will be 6-12 months before it is time to reenter or increase those holdings. To a lesser extent, the same applies to the pure macro. We focus on these strategies primarily because we believe the decade of the 2000's is the decade of the CTA and macro. These will be the best performing strategies. They will also be among the most volatile and difficult to evaluate.



The chart of the CSFB managed futures index above clearly shows that the CTA's are experiencing their highest 12-month rolling returns since the index began. The group peaked at a 40% annualized rate of return in February before turning sharply down in March (and it looks like April as well). This 40% annual rate of return is not unprecedented. It also happened in the late 80's and through much of the 70's.

* Publication of Wolf Advisors – Any reproduction is prohibited

In the last eight years however, CTA's as a group produced poor statistics. Returns were low and risk was high. The managers in the group were highly correlated and generally dependent upon trend persistence. The group's risks were dominated by interest rate futures, energy, and currencies (including gold). Below are the statistics for the managed futures index within the CSFB.

	CSFB CTA INDEX BY ITSELF			
	Average Monthly return	0.55%		
	Annualized Monthly Return	6.82%		
	Standard Deviation	3.56%		
	Annualized St Dev	12.32%		
	Sharpe @ 5.%	0.15		
	Risk free rate	5.0%		
	Sharpe @ 4%	0.23		
	Sharpe @ 2%	0.39		
	Maximum Monthly Return	9.95%		
	Minimum Monthly Return	-9.35%		
	Positive Months	55%		
	Negative Months	45%		
	Correlation with S&P	(0.27)		
	Best 12 Months Period	38.64%		
	Worst 12 Months Period	-15.42%		
Best	3/1/02	to	2/28/03	
Worst	4/1/95	to	3/31/96	
	Sum of Negative months	-115.57%		

You might ask why put something into the portfolio at all when the pool shows a poor rate of return and high absolute volatility. The standard answer in all the research is that the group is negatively correlated and reduces risk so much that other assets can be kicked up in risk. A better answer is that the CTA's make money in all the worst data points and provide significant draw down protection. The best way to see this is to look at the largest loss months (March 94, August 98, September 2001) in all other strategies and to visually compare them to returns for CTA's. Even on a daily basis the Carr/Barclays index shows an impressive 38% negative correlation to the S and P. It is hard to find a good hedge that is profitable and CTAs make one of the best hedges for that reason. The CSFB with and without CTA's is shown below. The large drop in standard deviation is visible.

CSFB with CTAs	CSFB w/o CTAs
0.79%	0.78%
9.96%	9.75%
2.53%	2.33%
8.76%	8.08%
0.57	0.59
5.0%	5.00%
0.68	0.71
0.91	0.96
8.34%	7.85%
-8.35%	-6.95%
68%	68%
32%	32%
0.50	0.47
34.95%	33.48%
-8.14%	-6.71%

With this background, the purpose of this special commentary is to make the case that the huge jump in CTA returns lately is an early signal of what will happen in the balance of this decade. CTA returns are going to rise while most other categories of the index are going to fall. The overall CSFB index is about 40% equities. We assert that returns to equities, especially sector funds, are going to be lower in the 2000's than in the 90's. Sector funds in the 90's were the highest returning category and benefited from a bull market. We won't use up space supporting this since most of you will agree.

Arbitrage is about 35% of the overall index. We expect lower average libor rates. These will put some drag on arbitrage returns absent credit improvement. Between equities and arbitrage, 75% of the index should show lower rates of return.

If the above is true, the CTA contribution will become much more important. The 7% historic return might look pretty good. With some excellent CTA manager selection, a 15% return can be achieved. The same applies to the pure global macro but we are using the CTA index for our statistics because the macro index has a short list of managers. We believe the data is skewed. Lets turn to the case for better returns ahead in CTA/macro.

Why is it a CTA and traders decade?

1. **High grade fixed income is starting from a low point and rates will go higher through the decade.** We believe CTAs and macros can do a better job of shorting high grade interest rate markets globally. Traders and trend followers are trying to predict the direction of rates, not sit on a positive yield curve with leverage. Relative to many funds that benefited from years of riding the yield curve, we believe the CTA group has the best long term record when it comes to bond shorts or a volatile yield curve. Note this is a huge factor in deciding which CTA to choose. Some are highly dependent upon short term interest rate futures.
2. **Macros are on top of the factors that make interest rates move.** Many macros have strong economic research teams that have an early read on movements in interest rates. Many have information advantages on movements in currency. We expect more up and down action in both.
3. **Equity values are starting the decade from a high and going down.** Macros and CTAs have a much better record when it comes to shorting stocks. Even the execution through index futures can be more effective. For those that think the bear market is over, we would argue that equity markets are more likely to go through several ups and downs than an up period like the 90's.
4. **There has been a breakdown of historic correlation patterns.** This is showing up at many levels. See our comments below on equity hedge. Macros have strong and deep research teams that can analyze this problem. CTAs also have deep technical research and are less dependent upon these correlation relationships. Instability in these correlations spells potential profit for both macro and CTA.
5. **The coming decade will present more opportunities in currencies.** Specifically most hedge funds are investments in dollar assets and macros in particular are sensitive to their dollar exposures. The dollar is expensive and most economists agree that the dollar needs to go down. Macros and CTAs will be less exposed to dollar flight and will be on the trends that emerge early. If the dollar proves to be highly volatile as we expect, this presents opportunities for CTA/macro and huge challenges for those funds not experienced in currencies.
6. **Nearly all commodities are traded in dollars.** Commodity outputs are in dollars. Nearly all inputs are in local currencies. These inputs are a larger percentage of global output than they have ever been. If the dollar does depreciate significantly in this decade, there will be an impact on commodities. Cuts in production can occur as input costs rise above output prices. This may not result in any large rise in inflation, but it does mean the possibility of making huge money in commodity trends.
7. **The number of systems and amount of money now trading commodities dominates the underlying markets.** An enormous OTC market has developed that is off exchange and is not subject to the position limits imposed on speculators. If and when all these speculators

get into the same trade, the possibilities for speculative bubbles can make the NASDAQ look like a small time bet. Retail did enter the speculative bubbles in the commodities in the 70's. If any of these develop we should assume that on-line trading in the breakfast pit (OJ, Pork Bellies, and Coffee) will become a fad.

8. **The CFTC's most recent proposal for regulating pool operators exempts those investing less than 50% in futures.** Regulation may be declining and this proposal should be watched carefully. They seem to be a bit out of sync with the SEC. I have images of mass speculation in zinc with half the trading off the exchange and half the "on exchange" portion unregulated.

Our conclusion is that over the balance of the decade, there will be many opportunities in currencies, bonds, commodities, and several up and down periods in equities. Many people believe that this decade will be more like the 70's than the 90's and this seems right. It is hard to imagine an inflation decade when the world is focused on deflation. But we do think there will be many opportunities to make money from price spikes. We think the market dynamics have changed and these price spikes will be extreme. We think that our macros and CTAs will be well positioned to take advantage. Over the next 12 months, we will put a large effort into freshening our understanding of the intimate details of the CTA/macro group as we increase the number and type of managers.

How are the macros and CTA's different now and what should one look for? We should add a disclaimer and state that the world of trading is not the same as the 70's. CTAs bear little resemblance to the CTA systems players of those days. Financial futures really did not get off the ground until 1982. Options markets did not exist. Macros in those days were equity managers. The CTA like macro emerged in the mid to late 80's. Any comparison at the manager level is a waste of time.

Above we stated that CTAs and macros would be volatile and difficult to evaluate. Here are some of the key factors we are considering.

1. **The number of potential markets to trade has quadrupled**. Most CTA's are now highly diversified and have specific limits on individual markets and groups of markets. The funds you choose should have individual market limits. It is important to work with CTAs that are trading at least 25 different markets. This does not mean 25 different interest rate contracts. My research suggests that anything less will result in poor risk adjusted results. Commodities in particular are far more volatile than financials and diversification is needed. So a fund that trades only oil and gas or only financials is less desirable in the long run.
2. **Macros have much stronger risk control methods to deal with position concentration** and this accomplishes the same objective as

hard limits. We look for people with strong experience in risk control or firms with a long history of strong risk control. Most macros have concentrated position risk and can do enormous damage if proper stop loss systems are not in place. A case can be made that great macros make money because they don't ever lose a lot of money and this supports the idea that excellence in risk control systems is key.

3. **Options markets have added a complex dimension to markets in the last two decades.** Most macros are better at options than most equity funds. Commodity options are particularly difficult and particularly volatile. Macros can make excellent money with their combined expertise in options and commodities. On the CTA side options are more often use by the discretionary CTA. Opportunities will be excellent.
4. **Signal generation is no longer a simple moving average, breakout or pattern.** Most top CTAs have highly complex combinations of systems and have stayed well ahead of changes in trading technology. This is creating some smoothing of volatility. The best managers are using multiple systems with a method for moving between systems based on what is working. My preference is for systems that move their time horizon. We prefer a good combination of mean reversion and trend following.
5. **CTAs nearly all use volatility to risk adjust position size**. This is a change that occurred long ago but was not present in the 70's. So if commodities get extremely volatile, CTAs can handle this. I also like those who measure relative volatility and not just absolute volatility. This should be done over different time periods as a predictive risk tool.
6. **Trend followers are no longer only dependent on long term trends**. Trends can be much shorter and still result in strong profits for CTAs and macros.
7. **Profit targets and rising stops have changed the risk profile of the CTA world**. The days of "let your profits run" have been replaced by "use rising stops and keep more clients". CTAs suffer from large reversals at the end of a trend. As the position makes large quantities of money, it grows as a percent of assets. Many CTA's now use position adjusting and rising stops to deal with the much hated reversal. Personally I am old school and think these methods do nothing more than cut my profits when I need them most. For those fund of funds using leverage, the answer is clear that profit targets and rising stops must be implemented.
8. **Use at least 5 CTA's and 3 macros spread across styles**. We have done managed accounts with less but in all cases we wished we had more. So even if only 5% of the assets are in the area, 8 managers are needed.
9. **The big money is in commodities**. CTAs should have good concentrations of commodity trading and should either be small or use OTC trading to increase capacity. If our analysis is correct about the coming decade, your CTAs need to be in heavy quantities of commodities to keep up with the averages. This last 40% ror ending in February was

impacted to a large degree by financial futures, especially Eurodollars. So don't assume the winners in the past will be the winners in the future. Many funds are now really financial funds and this is a big change from the 70's when financial futures did not exist.

When do we enter or add? CTA systems are reporting a high level of reversals right now, the fourth highest in the last ten years according to one study. Reversals tend to last a few months and are bad for most CTA's. Second, the 12 month rolling return has turned negative and is a relatively reliable predictors of interim highs. Third, 9 of the top 10 performing funds in our database in Q1 were CTA's. This is also a reliable predictor of the short term high. This says wait.

There are a number of timing methods that work well on entry. One simple method that is relatively reliable is to add to CTA's when they reach half their largest historical draw down. I do have a friend that has been doing this for 25 years successfully. A more complex method is to add using the rolling 12-month rate of return based on an algorithm. What ever you do, it is clear that adding to CTAs is best done when everyone hates the strategy. It is merely a sign of a lull in trends.

The exit is far more complex because the largest returns tend to come at the end of the period. This tendency is changing somewhat as more and more funds impose rolling stops to dampen their volatility. Those interested in the details can call. The things to remember are that a cluster of reversals are bad, don't add when the rolling rates of return are headed sharply down- add when rolling rates of return lose downside momentum, and when every CTA is hitting big it is probably the end of a short-term trend.

The mix can be summarized as follows. It would have a mix of pattern recognition, breakout and economic systems. It would mix trend following and mean reversion. It would cover short, intermediate, and long-term signal generation. It would have components of value and momentum. It would have relatively high concentrations of commodity trading but would cover all markets including individual stock trading. And last, it would contain some element of discretionary trading in the macro piece. Macros are faster on their feet (or should be) than any other category. They will take risk to zero and will reverse risk when needed providing diversification.

As we do more work on the area in the coming months, we will update our reports. We will keep you updated on our timing and managers in our monthly reports.

Current Hedge Fund Industry Events: There is a mass exodus from equity hedge primarily in the US and Europe. The percentage of managers meeting investment targets is extremely low and if emerging markets are removed, it is under 5%. The exodus is so pervasive; it suggests a low point in the strategy. There are many defections of senior equity managers at large hedge funds as well. Please see our comments below on equity hedge.

Last, we have analyzed the financial statements of this year's high profile blow up of a billion dollar equity hedge fund. (We were not in this fund). Clues are always easier to see after the fact but we did count over a dozen clues in the last three year's financial statements. Some of the most common clues were present such as: a change in the manager's deferral election, a change in the accounting policy as it relates to marking securities, a change in the board, assets held in custody by the manager, assets marked at cost on the balance sheet, assets marked at cost that were rising as a percent of the total nav, and there was more. Evaluating these situations is excellent training regardless of how many times you have seen this. One should never stop looking at these.

Good luck in your investing…
Mari Kooi
Wolf International Advisors
April 21, 2003