OPALESQUE
# FUTURES INTELLIGENCE

ISSUE 48 • March 18 2013

## In This Issue





## A Conversation With a Congressional Staffer and A Debt Crisis Time Bomb

I had a **conversation with a Capital Hill staffer** Tuesday.

"Your legislation has been **headlined as 'de-ruglatory' certain OTC derivatives**," I said, pausing to listen to his argument that the legislation was misinterpreted. Truth be told, I only read one article on the topic, not in depth study. It was the first time I had spoken to the articulate youngster, and he had the advantage on this particular derivatives legislation. However, it didn't take long for the **conversation to jump the shark** when he attempted to tell me a **certain TBTF bank deeply involved in the MF Global incident was actually interested in the brokerage accounts of farmers**. Stunned, it was here I decided to switch topic.

"As long as we are talking about OTC SWAPs legislation," I remember saying, "are you aware of '***the problems***' that underlie Europe?"

Silence.

I pivoted to the real inside story. "What do you know about **debt crisis financial modeling** relative to the **unregulated derivatives** supporting

Europe and much of the Western world?"

**What mattered** was the **hot button,** the previously unmentionable industry whisper. We talked about the **OTC derivatives time bomb** that involves a government bailout when the mathematical event occurs.

The staffer's response was initially pensive, but he quickly hit the target. "Yes, I know. It's big. **Trillions and trillions of dollars in liability. Big.**"

There was a pause of surprise. This was a startling admission, much like the shock industry participants had when Eric Holder **admitted the DOJ is afraid to prosecute certain TBTF banks and/or their executives**.

"There is **no way all the OTC derivative obligations can be covered**," the staffer admitted, which is essentially to say the large banks and their Too Big To Fail / Jail guarantee was likely to swamp the US government at a time when it could least afford such a financial drain.

"So you're aware of **modeling in a debt crisis**?" I questioned, only to hear silence. "**Debt crisis modeling isn't pretty**… at all. The **OTC derivatives implode** in a debt crisis."

### Why Isn't This "Bull Market" Believable? Sequester, Debt Crisis and Triggering the TBTF Guarantee

As the **equity markets continue to plow higher** with interest rates (and yield curve buyers) **artificially supported**, to call this **market move a bubble is almost trite. Debt crisis modeling** has several variables and potential outcomes. The worst of all scenarios is that the **markets continue to climb artificially higher, driven by stimulus and artificial market manipulation**… until they crash harder than ever before. This scenario has everyone fat and happy like the go-go 80s and 90s, ignorant of "the boom **problem**," the coded term used to discuss the unmentionable **leveraged debt crisis crash**. The modeling is very different from any previous crash, including the great depression. This is what society should avoid.

This is what political leaders were discussing when Barack Obama went around the backs of party leaders to have dinner with Senate Republicans. Speculation is the **conversation centered on more than the sequester** and avoiding the debt crisis, but might have included **discussion of bi-partisan support** for tackling the Too Big to Fail / Jail problem. Let's face it, the control the banks have over the **Department of Justice** is historic in nature, but not generally reported. It is unknown if the Obama administration connected the dots between the sequester, debt crisis and the **Too Big to Fail guarantee that could destabilize society in a debt crisis**.

Speaking of connecting the dots, in this issue of Opalesque Futures Intelligence we write on the potential for the **rule of law to be in tact** in the United States… at least in the case **of MF Global, as criminal charges are expected in the near future.**

It's fascinating when dots are connected, and that's why a new white paper from Campbell & Company is so interesting. To some knowledgeable asset managers, **managed futures has been considered a play in part on interest rates** due to the potential to invest margin deposits. Some questioning of CTA performance in a rising interest rate environment is answered in this white paper.

Speaking of questioning, take a look at what industry original Jerry Parker says about managed futures and other hot button industry issues in the article that starts by questioning the name managed futures and ultimately lands into the role a CTA should play in diversification and brokerage fees.

If you have any questions, feel free to reach out.

Best Regards,
**Mark H. Melin**
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# CTA Campbell & Company Releases Critical Interest Rate Study

*By Mark Melin*

Campbell & Company, a specialist in systematic trading strategies, touched on a **hot button issue** recently when it released its white paper "Prospects for CTAs in a Rising Rate Environment."

Among institutional investors one of the managed futures investing concerns has been the **relative impact of interest rates on CTA performance**. Although never widely discussed, the owner of the managed futures segregated account can benefit from interest income derived off the margin deposit. Due to this funding structure, CTAs have multiple returns streams. The primary performance driver is their trading strategy, but under certain circumstances CTAs also generated returns from the collateralized margin deposit that could be invested in interest bearing products such as short term US Treasuries. This **additional returns driver, available only on investments that utilize a margin deposit**, was always whispered to be part of the "secret sauce" of why managed futures performance has been traditionally strong. Thus, a managed futures investment was always viewed in part as a play on interest rates. In regards to returns from investments in Treasury Products, when rates were high and moving lower, the CTA might have benefited from two returns sources: the interest income from the treasury products and the price appreciation from the bonds.

Problem is CTAs who benefited from interest income and bond prices might encounter difficulty in a rising rate environment, is thinking among some. However, this myth might not be entirely accurate.

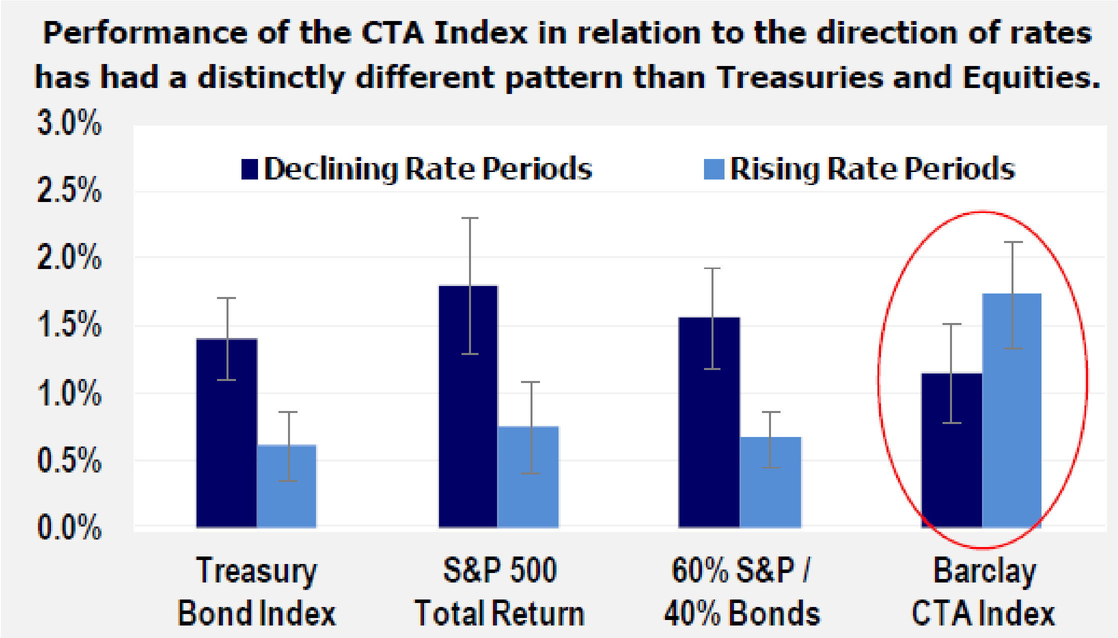
What is not being considered is the CTA can actually benefit from rising rates in the form higher interest income. While the value of a short term bond may declinein price as interest rates rise, these bonds are typically held to maturity by a cash management firm, thus negative price swings in performance bonds are negligible on the CTA's performance.

Enter the study by Campbell & Company, which takes a statistical look at CTA performance during periods of rising interest rates. With interest rates at all time lows and much analysis focusing on the potential for a rising rate environment when the Fed finally stops manipulating the yield curve, the question becomes salient to investors.

## Statistical Study of Managed Futures during Rising Rate Environments

The study considered the Barclay CTA index, where performance data of the diversified index back to 1980 and study bias issues with the index are reasonably close to issues with equity indexes. The Campbell study showed that in fact performed well during periods of rising rates, outperforming equity investments. Trends come and go, and on a statistical basis the trendless market environment has been rather long in the tooth.

## EXHIBIT 5 – Average Monthly Return since 1980




Source: PerTrac; data from Jan-80 to Nov-12. 60/40 portfolio assumes monthly rebalancing. Each error bar extends one standard error on either side of the mean return.

**Is All Interest Income Calculated in Reported Returns?**

What the study did not address is that depending on the account type and investor sophistication, the investor might not be credited with interest earned off collateralized margin deposits. For instance, much of the general Barclay CTA index is comprised of CTAs who might have operated in a distribution channel where the brokerage firm, not the CTA, accrued the interest income from the margin deposit. This thus such interest earned ("float") may not be included in the CTA's performance calculation. In a direct segregated account opened in the name of the investor, and not the CTA, the institution might typically accrue 60% or 80% of the interest income, depending on the negotiation and services being provided by the brokerage firm. In a retail account such interest is typically accrued to the brokerage firm. The point is, under many circumstances, the CTA might not even be capturing interest income. The Barclay CTA index is generally considered to include a significant number of CTAs using in retail distribution channels through FCMs, and thus the CTA likely did not accrue interest income and could not report this as a component of their performance capsule.

Performance reported by a CTA to major CTA databases is typically reviewed by the National Futures Association (NFA) during their audit of the CTA. In a direct segregated account the goal to ensure that reported performance is an accurate reflection of the actual investor experience, inclusive of all fees, expenses. Further, performance reporting between databases is typically monitored by the brokerage industry and reviewed by investors.

*To download the CTA report in detail, click on this link to visit www.uncorrelatedinvestments.com (requires free registration).*

# Prospects for CTAs in a Rising Interest Rate Environment

### The following is an excerpt of the Campbell & Company Study

## EXECUTIVE SUMMARY

• Since 1972, the S&P 500 Index, US Treasuries and traditional 60/40 portfolios have each underperformed (on average) in Rising Rate periods relative to Declining Rate periods (as defined by changes to the Fed Funds target rate). Performance of the CTA industry in relation to the direction of interest rates has exhibited a distinctly different pattern.

• A quantitative evaluation of CTA performance in relation to the direction of rates suggests that the strategy has not historically been rate regime-dependent. This is based on an analysis of the Barclay CTA Index (since inception in 1980) and a proprietary trend following benchmark (since 1972). Results were independent of trading time horizon.

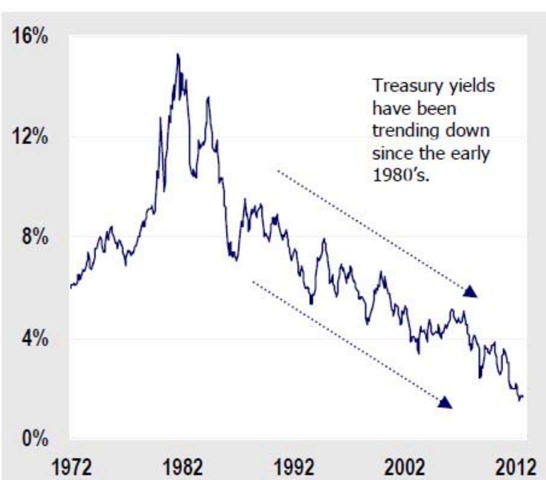
• The multi-dimensional approach to portfolio diversification employed by many CTAs may lessen the effect, positive or negative, of any single risk factor (including the monetary policy environment) on performance.

• A decomposition of CTA performance into its underlying sources of return -- the spot price change, the roll yield and the return on cash -- can provide additional insight.

## INTRODUCTION

The last sustained rise in interest rates, as defined by the direction of the Fed Funds rate, ended in 1982. Since then, with the exception of just a few years in each of the last three decades, the US Federal Reserve has proffered an easy money policy, gradually guiding interest rates down from the Volker-era stratosphere.

**EXHIBIT 1: 10-Year Treasury Yield**




Source: PerTrac; average monthly yield from Jan-72 to Nov-12.

During this period, the alternative investment industry evolved dramatically from its nascent stages in the 1970s, when it consisted of a handful of funds managing a relatively small pool of assets. Consequently, the majority of active hedge funds and CTAs have spent their entire existence operating in a bull market for fixed income, and have yet to experience a secular uptrend in rates. This lack of experience and corresponding lack of performance data can make it somewhat challenging for investors to set appropriate expectations for such an environment.

Many pundits began predicting an imminent turning point in interest rates several years ago, as the Fed Funds target rate sat dormant at 0%-0.25% and yields on long-dated government securities seemingly bottomed out. Since then, however, deterioration in the Eurozone, an uncertain climate in the Middle East, and fiscal concerns in the US have caused rates to decline even further; as we now know, one of the best trades in 2011 was simply to be long Treasuries.

# CTA CAMPBELL & COMPANY



As of this writing (December 2012), Treasury yields remain near their historical lows. The purpose of this paper is not to predict when interest rates will begin to trend upwards, how high they will go, or what the catalyst will be for such a change. This paper will instead evaluate the possible implications to the CTA industry of a shift to a rising interest rate environment in the US.

*To download the CTA report in detail, click on this link t0 visit www.uncorrelatedinvestments.com (requires free registration).*

# CFTC Expected to Unveil New Thinking on HFT

*By Mark Melin*

A commissioner at the Commodity Futures Trading Commission is expected to unveil a new method of defining High Frequency Trading, an elusive task for US regulators to date.

CFTC Commissioner Bart Chilton is expected to detail the proposal in March 19 speech to commercial hedgers in San Francisco. The proposal is expected to define HFT participants based on their relative market impact only during periods of volatile or otherwise market damaging market behavior. Market participants identified as engaging in HFT who were also responsible for a high percentage of a negative market move could face fines or other regulatory actions, according to sources who have seen the presentation.

Defining HFT has always been a problem, particularly with regards to differentiation with market marketing activities – the linchpin in a successful and liquid market. It is unknown how such a definition could differentiate between legitimate hedging interests and HFT based on volume in a negative market move, among other early questions.

**Key Concern**

One inner fear among knowledgeable market observers is the flash crash. Even the most sophisticated of managed futures algorithms would not likely benefit in a flash crash type volatility due to the time horizon variable (assuming trades were not invalidated). Managed futures rarely utilize HFT tactics, a strategy more commonly associated with proprietary trading operations.

The concern with HFT relative to a flash crash is that HFT could significantly increase negative market momentum. A key point to consider is the triggering of cascading stop orders, which generates a certain volatility profile that can be detected by the "electronic eye" of computer-based market making systems. While it wasn't widely reported, such electronic volatility detection systems were said to pull market bids and offers during the flash crash of May 6, 2010, exacerbating if not the key contributor to the event. Certain elements within the managed futures industry have been mapping crash potential scenarios relative to the US debt crisis. Among the worst case situations is a flash crash fundamentally sparked by a lack of confidence in US debt instruments.

The cause or motivating factor of future market crashes is unknowable, yet the goal to create stable market environment endures. While the exact details of Commissioner Chilton's proposal are at this point unknown, focus appears to apply around the apparent concept of deterrence (fines and penalties for violators) along with a definition of the activity based on when the time period that matters most, during times of volatility or market crisis.

If ultimately adopted, the proposal would push the CFTC to the forefront among US regulatory agencies to accomplish the task of defining HFT to a certain degree.

*Would you like to know the difference between HFT and managed futures strategies? The author is available to chat Tuesday and Thursday from 4-5 PM CST. Click here to visit www.uncorrelatedinvestments.com (requires free registration).*

# "Original Turtle" Jerry Parker Questions Managed Futures Name and Current Industry Direction, Fees

*By Mark Melin*

"Managed futures is a name that doesn't provide education to investors," noted Jerry Parker of trend follower Chesapeake Capital, speaking to a private audience of investors in New York City on March 6.

Speaking out on a hot topic, Mr. Parker addressed a core issue in that the name "managed futures" does not adequately provide clarity to the investment nor provide clues as to how performance is generated.

"I'm amazed at how appreciative people are when we don't try to mystify the investment," he said in a post speech interview. "CTAs should explain to investors in a fashion that explains exactly what they should expect."

In the case of trend following, Chesapeake should experience positive market environments during periods when market trends, or "price persistence," is a present market environment. "When the markets we trade experience trends, we tend to make money; when the investment is not trending we will not make money," he said, noting that 2012 was the trend follower's worst year, down 17.81% , the worst performance in a 30 year history.

Long term trend followers such as Chesapeake, which have average hold periods north of one year, buy and sell commodities and financial futures in 100 markets. Investors in such long term programs might expect volatility to occur during periods of non-directional market environments. "Volatility in a positive trade (upside deviation) is entirely tolerated in this system," noted Mr. Parker. CTAs with a long hold period often have a wide berth on the downside, particularly once a trade becomes profitable investors might expect the CTA to let the trade run. "Once a trade becomes profitable, we let the (upside) volatility run."

"It's become popular in the industry to take small losses on a trade," he said. "That's the wrong approach." Mr. Parker noted the difficulty, "the hard work," is in remaining in a volatile but profitable trade.

A debate has raged in the managed futures industry regarding the ineffectiveness of the Sharpe Ratio to measure investment risk in managed futures. The statistical measure should treat upside volatility to a different degree than downside volatility. "We've been in very profitable trades that are highly volatile to the upside, he said.

Typically long term trend followers such as Chesapeake Capital can be expected to have a large win size with win percentage not as a statistically significant variable for consideration. "When you have a non normal distribution with profitable outlier trades that dominate the portfolio, applying normal statistical measurements on top of that is probably incorrect," he said.

What has always stood out about the CTA's strategy is their use of single stock futures to replicate trend following in the equities. "It's works for our current clients to have segregated accounts at an FCM to not open an equity account. On the long side we trade 100 single-stock futures.

*Mr. Parker had frank thoughts on brokerage fees and industry issues. To view this and additional performance details regarding Chesapeake, log in to the web site.*

# MF Global Criminal Investigation Likely Headed Into Final Stages

*By Mark Melin*

The MF Global investigation is expected to be entering its final stages after two and a half years of on again, off again activity.

There will be several paths the investigation could take, the most likely of which starts at the CFTC. The derivatives regulator could make a recommendation to criminally indict certain MF Global executives, including Jon Corzine, the former US Senator and Governor of New Jersey and onetime president of Goldman Sachs.

If a recommendation for criminal charges is made by the CFTC, it could ultimately move to the Department of Justice for review with a likely stop at the Obama White House before approval. This is the primary path being watched, but other scenarios with different probability factors exist.

Under this scenario there will be three initial key points to watch at the CFTC and three key points to watch at the DOJ and in the Obama administration.

The first transition point is likely to be the resignation of CFTC Commissioner Jill Sommers, who is currently commissioner in charge of the MF Global investigation. Commissioner Sommers was scheduled to resign at the end of March.

In her oversight capacity, Commissioner Sommers is expected to be replaced by senior CFTC Commissioner Bart Chilton.

Ms. Sommers MF Global experience likely involved frustration. Placed in a politically hot situation, she had the unenviable task of operating in the middle of a difficult mine field that included limited information flow and documented stand down orders grinding the investigation to a halt at times.

Speculation is once Commissioner Chilton takes the administrative reigns, investigation events could become fast moving. However, it should be noted Commissioner Chilton's role, like that of Commissioner Sommers, is not as the investigator, but rather manager of the administrative process.

### Initial Process Inside the CFTC

If the regulatory agency follows protocol, initial decisions regarding recommendation for criminal charges against MF Global executives will be made independently by the CFTC's New York field investigators.

The field office case description and recommendations will ultimately arrive at the desk of CFTC Director of the Division of Enforcement David Meister. A former Skadden, Arps attorney with the firm's white collar crime group, Mr. Meister previously served as Assistant US States Attorney for the Southern District of New York. It is unknown if Mr. Meister is friendly with Skadden, Arps bankruptcy attorney, Kenneth Ziman, who played a role in the MF Global bankruptcy process.

Mr. Meister will be key towards determining if criminal charges are filed against MF Global executives. It is unknown who, if anyone, Mr. Meister will consult on the decision, but consultation with the CFTC Commissioner in charge of the MF Global investigation is possible.

If Mr. Meister recommends criminal charges, the issue is likely to go before CFTC Commissioners for a vote on the topic. If CFTC commissioners approve recommendations for criminal action, a case referral to the Department of Justice is likely.

These are the initial points to consider when watching the initial benchmarks in the MF Global investigation, as a number of variables can change based on the scope and clarity of Mr. Meister's recommendation.

*For additional reporting on the MF Global criminal incident, click on this link to visit [www.uncorrelatedinvestments.com](www.uncorrelatedinvestments.com) (requires free registration).*

# NFA Board Holds Off Lifetime Ban On Jon Corzine… For Now

*By Mark Melin*

In a meeting on February 21, the National Futures Association Board of Directors did not immediately act on a motion to ban former MF Global CEO Jon Corzine for life, but left open the possibility for the self regulator take action after ongoing investigations by government agencies are complete.

"Once the appropriate agencies have completed their investigations, NFA has the authority to bring disciplinary action against Mr. Corzine for violations of any NFA rules that occurred while he was a member," according to a statement from the NFA. "The sanctions for disciplinary actions could include a lifetime ban and significant monetary fines."

While published reports noted Mr. Corzine was no longer a member of the NFA, materially he was a member during the time criminal activity occurred at MF Global.

"The Board notes that Mr. Corzine is not currently a member of NFA. The Board is aware of publicly available information that raises issues concerning Mr. Corzine's fitness for NFA membership," the statement said, likely alluding to the fact that information in the public domain that points to criminal activity. "If Mr. Corzine applies for membership in the future, he will not be granted membership unless NFA, after completing its fitness investigation, resolves those issues to its satisfaction."

Going into the meeting, popular support indicated potential for board members to approve the measure. The measure was brought by Commodity Customer Collation co-founders and newly elected NFA Board members James Koutoulas and John Roe, who were fulfilling a campaign pledge to bring the issue to a vote.

At the time of the meeting speculation indicated the NFA board had mixed feelings about the proposal. The point of the proposal was to bring accountability to criminal actions that appeared to be eluding investigation. While damage done to the commodity markets has been significant, the validity of the MF Global investigation had always been questioned by knowledgeable industry participants. This suspicion is due, in part, to sources close to the investigation being quoted in several news stories diminishing prospects of an investigation, saying the "case was cold" before the primary suspects, MF Global executives, had been questioned and while clear indications of criminality existed in the public realm. Arguments that weighted against the motion likely included jurisdictional issues with other regulatory agencies and interference with ongoing investigatory efforts, analysis first reported the day of the meeting.

# Pinnacle Awards Coming in June

The Pinnacle Awards Event, now in its 2nd year, is unique because of the award category types. Typically award winners have demonstrated superior risk management and diversification methods.

The awards competition highlights the unprecedented growth of the industry and transformation gripping the industry. "The main change that I've seen over the past several years is the growing acceptance of Managed Futures as a viable and accepted alternative investment category among the ranks of the largest and most sophisticated investors," noted conference founder Sol Waksman. "As a result of this 'institutionalization,' managers have become more focused on risk management and moderate returns. To use a sports analogy, someone who can hit singles and doubles consistently is valued more than a home run hitter who strikes out often."

Presented by CME Group and BarclayHedge, Ltd, the purpose of the Pinnacle Awards is to recognize and honor excellence within the CTA community. It is the only awards event that is focused entirely on Managed Futures. This year's event, scheduled for June 19 in Chicago, has been expanded to include a Meet the Nominees networking event earlier in the day. Admission to both events is by invitation only. Investors that are interested in attending can contact Sol Waksman (swaksman@barclayhedge.com) and request a complimentary registration.

This newsletter is designed to include a wide variety of industry voices and information. To participate, send your news, events and viewpoints to melin@opalesque.com. To be considered for inclusion information must be factual, and ideally address deep industry issues and reveal insight into how strategies operate, all delivered from a balanced perspective that addresses risk frank terms.

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The user acknowledges and agrees to all of below:
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OPALESQUE
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