OPALESQUE
FUTURES STRATEGIES
Making Money with Managed Futures & CTAs

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How to Analyze and Supervise a Managed Futures Investment: The P(A|B) Method

Welcome to *Opalesque Futures Strategies*

The emphasis in this publication is the *strategies* aspect of the investment. The goal is to provide professional asset managers a framework for analyzing and managing uncorrelated investments on a going forward basis.

We have also created a companion educational web site to assist professional asset managers in understanding managed futures and making appropriate decisions. Visit www.UncorrelatedInvestments.com for access to articles, white papers and educational videos from top industry participants.

While there are credible methods of managed futures evaluation put into operation by several well known brokerage / portfolio management practitioners, this newsletter will introduce the P(A|B) Method of managed futures performance evaluation.

In this issue we will utilize the P(A|B) Method as an overlay to understand the subsector of managed futures investing known as volatility investing. First we consider the beta market environment exposure of the investment, with an eye to setting performance expectations in a variety of market environments. In the case of a volatility-based investment, the system highlights specific performance measures to consider and discusses hidden risk of leverage usage relative to deviation and returns performance.

With a basic understanding of how the system works in place, consider the related interview of LJM Partners, a short volatility investment. After this, visit the exclusive web site for OFS members to see in-depth video interviews with the manager as well as various performance analytics relative to the investment. Consider LJM alongside their other CTAs with similar beta performance driver exposure and interact with the author of the P(A|B) Method during specific live chat opportunities.

After we reveal insight into managed futures volatility investing, we move to the Untold Story, which provides unique insight into the US debt crisis, MF Global and other issues seldom discussed in the mainstream.

Opalesque *Futures Strategies* is about providing investors a framework for investment decisions; a template that provides structure for confidence.

In This Issue

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In this issue, we are also unveiling a new **educational website Uncorrelated-Investments.com with significant free resources** that will help you to understand and better invest in Managed Futures and CTAs. You will have to confirm your **Qualified Investor** status to access the **Research Archive** and the comprehensive **Needs Analysis**.

If you have comments or questions, feel free to e-mail melin@opalesque.com

Mark H. Melin
Editor, *Opalesque Futures Strategies*

QEP Risk Disclaimer:

This newsletter is confidential, available only to subscribers who have previously acknowledged their qualified eligible participant status. There is significant risk of loss in managed futures. Past performance is not indicative of future results. See full risk disclosure at the end of this document. This newsletter significantly represents the opinions of the author and may not have considered all risk factors.

Opalesque Futures Strategies offers unique insights about:

- **Making Money with Managed Futures and CTAs**
- **Detailed Analysis of Managed Futures Programs and CTAs**
- **"Under the Hood": Analysis how specific Formulas and Algorithms operate**
- **Analysis of CTA Performance with Recommendations and Due Diligence**
- **For Qualified Eligible Participants or Accredited Investors only**
- **Analysis of Market Environments, Opportunities & vital updates on Investor Protection**
- **Research & Intelligence on Portfolio Management, Tactics, Strategies for Uncorrelated Investing**

Opalesque Futures Strategies is designed to include industry voices and information from a number of different perspectives and sources. Information must be factual, not promotional in nature and ideally address deep industry issues and reveal insight into how strategies operate, all delivered from a balanced perspective, addressing risk in frank terms.

For general information and education about Managed Futures & CTAs please refer to our sister publication Opalesque Futures Intelligence.

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Managed Futures Key Performance Benchmarks

Index Spotlight: Barclay BTop 50

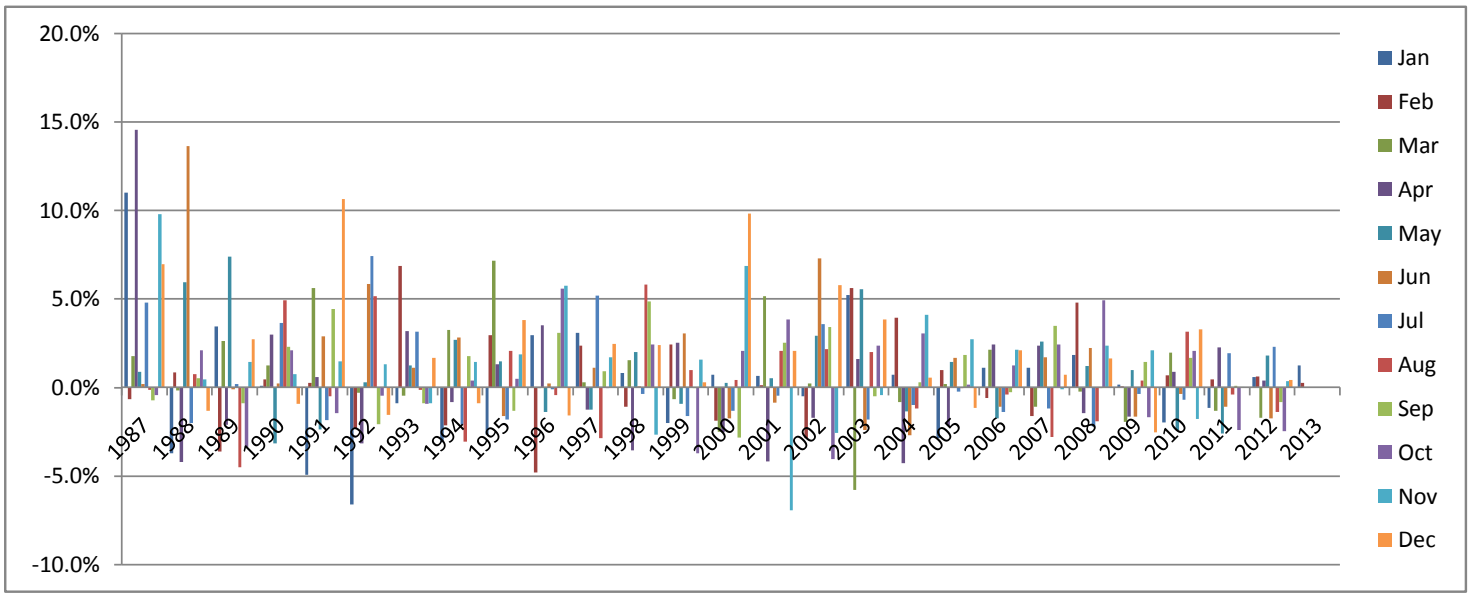
What is interesting about this index: It has very low study bias due to the fact that it consists of the top 50 industry CTAs based on Assets Under Management. The index utilizes an equal weighting formula and CTA participants are NFA members and have their ***past performance audited by the National Futures Association multiple times****. It would be considered a statistical rarity for a member of this index to suddenly cease reporting. Survivorship bias is rarely the case, as AUM disintegration would typically result in the CTA being dropped from the index before they would drop off, which is one reason the index is investible. While it is one of several "large cap" managed futures indices that typically display more conservative, it is perhaps more reliable performance when compared to broad-based indices. While the index is heavily weighted towards trend following, the investible nature of the index makes it an interesting proxy for overall managed futures performance. (Performance Source: BarclayHedge)*

Compounded Annual Return:	Worst Drawdown / Worst 12 Month Period:	Average Losing Month:	Monthly Standard Deviation:
+9.51%	-13.31 / -12.72%	1.77%	3.07%

Leveraged Returns Indicator©	Leveraged Volatility Indicator©	January Returns Performance	Cyclical Market Environment©
1.24	66.15	+1.24%	Negative

The Leveraged Returns Indicator, the Leveraged Volatility Indicator and Cyclical Market Environment Indicator are all explained in detail at www.UncorrelatedInvestments.com

The Leveraged Returns Indicator is a measure of the level of leverage used to achieve performance; The Leveraged Volatility Index Measures the level of leverage relative to volatility with a weighting towards downside deviation as a more negative factor than upside deviation; the Cyclical Market Environment measures the climate for the predominate market environment .



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	Jan	Feb	Mar	Apr	May	Jum	Jul	Aug	Sep	Oct	Nov	Dec
1987	11.0%	-0.7%	1.8%	14.5%	0.9%	0.2%	4.8%	-0.1%	-0.8%	-0.5%	9.8%	7.0%
1988	-3.7%	0.8%	-0.2%	-4.2%	5.9%	13.6%	-2.0%	0.8%	0.5%	2.1%	0.5%	-1.3%
1989	3.4%	-3.6%	2.6%	-2.1%	7.4%	-0.1%	0.2%	-4.5%	-0.9%	-3.4%	1.4%	2.7%
1990	0.1%	0.4%	1.2%	3.0%	-3.2%	0.2%	3.6%	4.9%	2.3%	2.1%	0.7%	-0.9%
1991	-4.9%	0.2%	5.6%	0.6%	-2.4%	2.9%	-1.9%	-0.5%	4.4%	-1.5%	1.5%	10.6%
1992	-6.6%	-2.3%	-0.3%	-3.2%	0.3%	5.8%	7.4%	5.2%	-2.1%	-0.5%	1.3%	-1.6%
1993	-0.9%	6.9%	-0.5%	3.2%	1.3%	1.1%	3.1%	-0.2%	-0.9%	-0.9%	-0.9%	1.7%
1994	-3.1%	-2.2%	3.3%	-0.8%	2.7%	2.8%	-2.1%	-3.1%	1.8%	0.4%	1.4%	-0.9%
1995	-2.7%	2.9%	7.2%	1.3%	1.5%	-1.6%	-1.8%	2.1%	-1.3%	0.5%	1.9%	3.8%
1996	2.9%	-4.8%	-0.0%	3.5%	-1.4%	0.2%	-0.1%	-0.4%	3.1%	5.6%	5.7%	-1.6%
1997	3.1%	2.4%	0.3%	-1.3%	-1.3%	1.1%	5.2%	-2.9%	0.9%	-0.0%	1.7%	2.5%
1998	0.8%	-1.1%	1.5%	-3.6%	2.0%	0.1%	-0.4%	5.8%	4.9%	2.4%	-2.7%	2.4%
1999	-2.0%	2.4%	-0.7%	2.5%	-0.9%	3.1%	-1.6%	1.0%	-0.0%	-3.7%	1.6%	0.3%
2000	0.7%	-1.9%	-2.5%	-2.6%	0.2%	-1.7%	-1.3%	0.4%	-2.8%	2.1%	6.9%	9.8%
2001	0.6%	0.1%	5.2%	-4.2%	0.5%	-0.9%	-0.5%	2.1%	2.5%	3.8%	-7.0%	2.1%
2002	-0.5%	-2.9%	0.2%	-1.7%	2.9%	7.3%	3.6%	2.2%	3.4%	-4.1%	-2.6%	5.8%
2003	5.2%	5.6%	-5.8%	1.6%	5.5%	-2.4%	-1.8%	2.0%	-0.5%	2.4%	-0.4%	3.8%
2004	0.7%	3.9%	-0.8%	-4.3%	-1.4%	-2.7%	-1.0%	-1.2%	0.3%	3.1%	4.1%	0.6%
2005	-2.9%	1.0%	0.2%	-2.2%	1.4%	1.7%	-0.2%	-0.0%	1.8%	0.2%	2.7%	-1.2%
2006	1.1%	-0.6%	2.1%	2.4%	-1.7%	-1.1%	-1.4%	-0.4%	-0.3%	1.2%	2.1%	2.1%
2007	1.1%	-1.6%	-1.1%	2.4%	2.6%	1.7%	-1.2%	-2.8%	3.5%	2.4%	-0.1%	0.7%
2008	1.8%	4.8%	-0.2%	-1.5%	1.2%	2.2%	-2.2%	-1.9%	-0.0%	4.9%	2.4%	1.6%
2009	0.2%	0.0%	-2.0%	-1.6%	1.0%	-1.7%	-0.4%	0.4%	1.4%	-1.7%	2.1%	-2.5%
2010	-2.0%	0.7%	2.0%	0.9%	-2.4%	-0.4%	-0.7%	3.1%	1.7%	2.1%	-1.8%	3.3%
2011	-1.2%	0.5%	-1.3%	2.3%	-2.6%	-1.1%	1.9%	-0.4%	0.1%	-2.4%	0.0%	0.0%
2012	0.6%	0.6%	-1.7%	0.4%	1.8%	-1.7%	2.3%	-1.4%	-0.8%	-2.5%	0.4%	0.4%
2013	1.2%	0.3%										

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The P(A|B) Method to Analyze and Supervise a Managed Futures Investment

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This article introduces you to the P(A|B) Method of managed futures **investment evaluation** and **ongoing risk management.** The P(A|B) Method has heretofore been a private method for managed futures evaluation. The P(A| B) Method takes its name from Baye's Theorem, which is an algebraic formula to assist probability factoring.

This system walks professional asset managers through a **series of queries based on the risk exposure** of each managed futures program. At its core managed futures is a derivatives-based investment and as such often has unique sets of performance measures relative to time horizon, related product structure and contract type.

The P(A|B) Method starts by considering the beta performance factors in the investment, then moves into alpha considerations. For the sake of brevity, this article only touches on key points.

Step One: Understanding System Analytical Structure

P(A|B) Method Educational Overview

The P(A|B) Method considers risk factors at the start of the process, applying a top down approach. It examines managed futures investments in different category slices, prioritizing based on factors that influence performance. For instance, the system's first priority are beta performance drivers impacting the investment. In this respect, the system is similar to the analysis structure a hedge fund investor might view a private equity IPO. In the aftermath of the Facebook IPO occurred, for instance, many private equity managers accurately noted that the "**market environment for IPOs has changed**." Market environments tend to be viewed as **cyclical**, and the attitude among those seeking to bring IPOs to market would return after market forces played their statistically validated game of asset rotation favoritism.

In the case of this example, P(A|B) Method will **examine the volatility managed futures investment category**. This article only reveals top level considerations and does not provide detailed analysis, which is available in a separate report.

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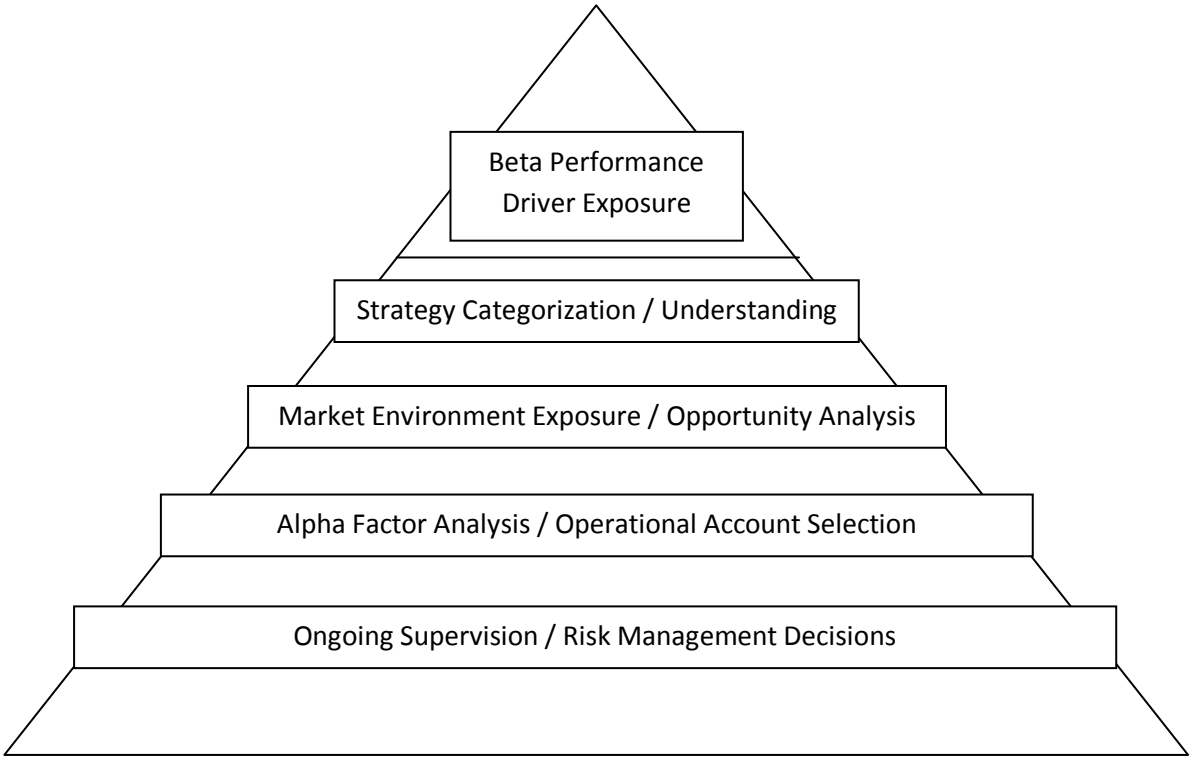
The P(A|B) Method 6

The P(AlB) Method Educational Hierarchy:



Step Two: Understand Strategy Categorization

(This article has 2773 more words. To view the balance of the content, please register on our sister web site UncorrelatedInvestments.com. Click here to register and access the full article.)

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Volatility Investing Reveals Interesting Issues at AlphaMetrix Educational Event

Unfamiliar to even many sophisticated asset managers, volatility investing provides unique opportunities for risk management and market understanding.

Volatility investing involves trading programs based on market price volatility. The **primary volatility market is based on the stock market, but variations of volatility investing methods are used in commodity markets** as well. In light of an approaching debt crisis and always unpredictable world events, volatility-based investment techniques, both long and short, are worthy of detailed investigation.

A recent educational opportunity sponsored by AlphaMetrix and the CBOE Futures Exchange revealed interesting issues as it relates to the debt crisis and volatility investment techniques. In addition to stock and commodity option contracts, one of the primary methods of volatility trading occurs with the VIX, the CBOE's popular measure of implied volatility in the equity market.

Did Volatility Skews on December 21, 2012 Reveal a Market Imbalance?

"Just before the conclusion of the fiscal cliff debate, **the time horizon spread in the VIX options exhibited unusual expectations**," noted Christopher Cole, managing partner at Artemis Capital Management and one of the panelists. "We could **buy the front month VIX options and sell the back month with a positive carry**." This is unusual because such a long volatility position typically involves the purchase of premium, but in this unusual relative value situation the trading manager collected premium and had long volatility exposure.
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What is The Appropriate Process For Selecting a Managed Futures Investment?

By Mark Melin

Investing in a managed futures investment program can be significantly different from traditional hedge fund / alternative investing. To some, the required education process can be a foreboding task because the variables are new. Depending on the evaluation and ongoing risk management system, both **the complexity of a program and its risk management features can be a variable output**.

In this article professional asset managers are introduced to a systematic method of managed futures investment analysis and ongoing supervision.

Quantifiable issues professional asset managers may wish to include are margin usage, leverage exposure to downside deviation, time horizon correlation, volatility exposure relative to beta market environment risk and the always sometimes business operations exposure. For those new to managed futures, this all might represent new variables.
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Interview with Short Volatility Trader LJM Partners

Today's interview is with Scott Sykora and Arjuna Ariathurai of LJM Partners, one of several well known short volatility investments. LJM has been an innovator in the short volatility space and has exhibited thought leadership in a number of academic research projects. A thoughtful piece was recently authored by their Chief Investment Officer, Anish Parvatenini. (Full Disclosure: The author of this article worked with Anish on a Barclay CTA Graveyard Database study when he was at University of Chicago.) In today's interview we have Scott and LJM's Chief Risk Officer, Arjuna Ariathurai.

Mark Melin: Why don't you start identifying your program by defining it at a **high level based on the market environment performance factors?**

J. Scott Sykora: We offer a set of investment products that are all basically variations on a common theme. We only **sell (short) options and S&P futures**, and what we are able to bring to market are products that offer clearly differentiated risk return profiles, each targeting differing rates of return, and each that have **extensive public track records**. So the suite of products offers investors a clear choice in terms of investing to their personal portfolio requirements.

These products also tend to provide great ability to diversify traditional portfolios, and by traditional I say portfolios that invest in the traditional asset classes of equities and fixed income. So a big component of our products in addition to their return stream is the ability to add diversification to a broadly diversified portfolio.

Because of these performance qualities, we are getting a lot of attention in recent years, because whereas many investment asset classes have unperformed or outright failed, our set of products have been able to demonstrate very consistent and persistent performance now over a 15-year timeline.

So to speak roughly about when they perform well and when they do not, again, these are short volatility investment strategies.

Beta Market Environment Analysis

The hallmark is that they are profitable -- consistent and profitable in most market conditions, and by most I think that **when equity markets are moving mostly sideways, our products are very profitable**.

If **equity markets are rallying**, such as when **volatility is falling somewhat slowly**, we are most **likely profitable**.

If markets are selling off slowly; we call that **market erosion**, there is a very **good chance that we are profitable.**

So that begs the question, what is the **stress point for these strategies?** And the answer to that is **when markets demonstrate a big increase in volatility and it typically corresponds to market sell off**, that is the **singular stress point for these strategies**. So either when markets are trashing about, maybe not moving that much overall, roughly sideways, but with a lot of increase in volatility, or a single precipitous market sell off, where volatility escalates quickly, those are the stress points for the strategy.

Mark Melin: I would like to start drilling down a little bit if you do not mind. You talk about the **stress point of the strategy being enhanced volatility over a short span of time**. Let us talk about potential **risk management tools** that you have to work with that help **mitigate exposure to short volatility implosion**, because that is really the key point you want to manage.

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This could include items such as portfolio sizing, rolling contracts to the forward month, options or futures contract hedges to name a few.

Arjuna Ariathurai (Chief Risk Officer): Hopefully I will qualify to give you some answers to your inquiry. Actually when it comes to risk management, we have evolved obviously from our earlier roots, but we tend to take a look at the **combination of volatility and of underlying moves**.

So the performance of the products, the funds themselves are really **tied to change**. If there is a **lack of change, or if the change is controlled, we are able to manage our risk at a very efficient or cheap level and that impacts our return stream**. The **more change there is over shorter periods of time**, both in volatility and in underlying movement, the **greater the associated hedging costs** to affect risk reduction cost which of course impact our performance.

So what our main focuses are with regards to risk management is this: a combination of proactive risk management (i.e. hedging traded integral to the strategy) and then reactive risk management in response to market behavior. With our **more aggressive funds, we tend to be more reactive than proactive**.

The concept to the idea there is we are looking to reduce hedging investments as much as we can while still maintaining a reasonable risk profile. In our most conservative strategy, we tend to **spend more of our available capital on managing risk or proactively managing risk**.

So we work on risk reducing trades in advance of market movements based off of macro scenario analysis.

Mark Melin: Drill down on that concept a little bit, as best you can, and I know you cannot give away your secret sauce, but can we talk about some of the **different types of strategies** you might be employing and the **market environments in which they might work** out? Particularly, are you **hedging with futures or options?** Are you **trading different timeframes?** Are you **rolling certain months based on volatility disparities** between the strike prices?

Arjuna Ariathurai: I will give it to you in a very simple way. We trade **options against options** incorporating extensions to the classic Black–Scholes models. We build off of a return target and we take that return and we execute trades in a systematic fashion to generate theta, or the decay value for the option. And the real risk comes in how much volatility exposure or vega we have in order to generate the desired theta decay collection on a daily basis.

Secondarily, we have a sort of relationship between the underlying movement, and it is actually encapsulated in gamma as opposed to delta, and I will get to that in a second.

Mark Melin: That is interesting!

Arjuna Ariathurai: Yes. What we do is we **run our deltas as a latent hedge against the volatility skew in the market**. So **volatility spikes tend to occur in downward movements in the underlying S&P**. So we will **stay latently short delta** which provides time to respond and that time offers a level of risk reduction in the cases where there is significant movement. We do not settle this risk mitigation immediately. We tend to keep ourselves in a hedge or at least a mitigated position for the first several percentages of movement. The more gamma we are carrying, the **more short gamma we carry**, the **faster the protection of the proactive hedging dissipates**.

Mark Melin: I know exactly where you are going.

Arjuna Ariathurai: So that is a really critical measure as well. The corollary then is if we experience a scenario where the **underlying does not move, but volatility increases**, i.e. we were to **engender immediate vega losses** only, we would look at that as an opportunity to sell additional contracts rather than a scenario requiring risk mitigation.

So we will be looking at ways to **take advantage of the spike and volatility**. So you can see kind of our general methodology is to look at when are vols going to spike, because when they do, that can be beneficial for us.

Mark Melin: Right, after the **spike** the **market environment can be productive** given a **reversion back to the mean**.

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Arjuna Ariathurai: Right. And we want to just sort of mitigate through that vol spike. So if things are in a controlled manner, even at low vol regimes, we will perform well because our hedging cost are low and because everything is moving in a controlled manner. But we do to some extent have to be prepared to take short-term pain for medium and long-term gain.

Mark Melin: That is a concept the United States needs to learn in regards to their fiscal deficit.

Arjuna Ariathurai: That is true. So how do we manage that? We will run merely three months, no more than 90 days of maturity, so our entire portfolio will turn over in those three months.

Mark Melin: Well, the **45-day window** is kind of the **sweet spot of delta / theta time decay opportunity.**

Arjuna Ariathurai: Yes, to a certain extent. So we look at the **second month as sort of our short vol or our systematic volatility placement**. We used the third month as the **back month for vega hedging**, so we might do spreads in the back months to hedge. We will manage our gamma in the front month.

Mark Melin: What is your favorite book on Option Volatility? Are you a Natenberg fan?

Arjuna Ariathurai: Actually I am a Natenberg fan.

Mark Melin: I am a huge Natenberg fan. His book was amazing!

Arjuna Ariathurai: I am a textbook guy too, so Hull is really the book that I have used the most. I think Hull's book provides a really great overview. It gives you a great overview of all the different types of markets, but it does a great job of explaining models, and from our perspective here, – the macro risk overlay is actually the behavioral overlay.

So we do not just try and trade straight volatility, we are really looking at market behavior. So the combination -- there are three things we are looking at. We are looking at our current portfolio and forecast the response under different vol regimes that exist and may develop in the future. We look at the macro conditions but are not attempting to predict direction, but really model the response to several possible market scenarios.

Mark Melin: Scenario management, that is the top CTAs. **It isn't about predicting anything as it is portfolio management, position sizing, appropriate hedging**.

Arjuna Ariathurai: Yes. And of course the third perspective is the **specifics of the market we trade**. We are looking at the **volatility surface over those three months**, even beyond that, and we will look at the **relative values**; where things are trading, **how puts are related to calls**, how short days are related to longer days. If there are, I guess for lack of a better term, juicer pieces on the surface, we will attack those. If there are places where we just do not see a lot of value, we will stay away from them.

So that is incremental, we do not try to make **large scale bets**. We are not taking entire positions off only to find three days later that we have to put them back on again, because we were a little bit too hasty in our actions. We are incremental in the sense of, we will take some more off, we are never being perfectly optimized, but who will? But we find that, that **dollar cost averaging** on the system side where we are entering everyday and collecting a little bit of theta and keeping that collection at low and manageable levels, that tends to work best for us.

Mark Melin: Well, that is kind of fascinating. So everyday you are working the theta. A lot of times you look at the S&P option strategy, particularly in our retail direct account, and they will set that trade and sort of forget it for about 40ish days.

Arjuna Ariathurai: Right. In your example they are market a forecast - they are trading to the forecast that the market is not going to 1,200 or the market is not going to 1,600.

Mark Melin: Exactly, that is a simplistic method.

Arjuna Ariathurai: Yes, we are different in that important aspect.

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Mark Melin: I can see that.

Arjuna Ariathurai: So obviously for options, the rate of decay changes over time, especially for out of the money options. What we are looking for is, in our portfolio what is contributing to theta? What is taking away from theta?

We ask the questions: If we are long an option, why are we long an option? Is it effective in its risk management? If they are not, then are we going to roll into a long cntract that is. That is kind of where we tend to look at things. If the market is not giving us great return, we are not going to try and go for big returns. We are going to trade within what the market is going to give us, and we think that, that model works very well. I mean, honestly, there always have been, and certainly at least in the foreseeable future, seem to be more option buyers than sellers.

Mark Melin: That is always the case.

Arjuna Ariathurai: The sellers are providing liquidity in a demand market and are able to extract premium from that, as long as we are able to keep our cost of hedging down in a responsible manner. We believe we can consistently generate returns, and that profile has worked well for LJM for 14 years now.

Mark Melin: Well, let me address a couple of other issues. First, I want to talk about that white paper that Anish put out, and then second, I would like to get into the direct account options versus a fund account option and talk a little about your target lines.

J. Scott Sykora: Okay. Now, we have invested in research for over six years now and it has totaled several million dollars. It has been very interesting to look at those investments in hindsight. Our focus and views for R&D have developed over time. Our investments today are more focused on the development side than pure research.

In one example, we invested the better part of a year-and-a-half and close to a million dollars supporting a senior guy in the industry, who built a system for us that we trademarked under the name of the LJM STORM System. STORM was an acronym (System for Trade Optimization and Risk Management) , but also a metaphor of course.

The point of the system was that it was a statistical and mathematical representation of historic S&P behavior. It was a very involved system that was built on a two components Student-T distribution, with fat tails on the left side. The system also incorporated GARCH(1,1) or GARCH(2,2) volatility clustering. It was a very, very ambitious effort that was intended to the the foundation for our risk modeling and trading operations.

We then tried to integrate that platform with best of breed, off-the-shelf software from Prime Analytics, their product called ProOpticus. They integrated some of the outputs of our LJM STORM System in their volatility modeling package as well, and that was another six to nine months effort.

Along the way we then realized that one of the most important factors of all is that it really is not possible to in any way predict the future, despite the best efforts of volatility clustering, where that yesterday's event gives you an edge on forecasting today's event, we realized that volatility is inherently unpredictable, these are random events, and so we began to move in a new direction. We ultimately pulled the plug on ongoing development for the LJM STORM System.

Mark Melin: Scott, think about this for a minute. Volatility by its nature is not predictable otherwise it would not be volatile. It is like a trend. What I like doing with short volatility guys or volatility investment is comparing them with trend following.

In trend following there is a specific methodology of looking at momentum in the market to determine based on probabilities how things are going to continue in the market or price persistence. But volatility, if people knew that -- a couple of issues, look at the debt crisis. People knew about it so we were able to soften it up. For a while there was a big, keep it a secret, do not talk about it, it hurts market sentiment, but the fact is when you start to put things on the table and people see the risks, you can mitigate some of the volatility. There are no guarantees though.

J. Scott Sykora: Well, you are right, if volatility was forecastable, then the markets would not panic and it would not be volatility; the whole event would be traded forward so that the ripple would dissipate in the pond.

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So I agree. The question was whether or not volatility clustering would allow you to have a little bit of an edge statistically over a very lengthy period of time. But when you look at events which have really happened, like Flash Crash, a risky event which was a mechanical breakdown in the execution side of the industry, it turns out this event was totally unforecastable.

Mark Melin: Okay, wait, Flash Crash was in part an electronic eye issue. They can see all those orders coming in. The electronic eye pulls the bids and offers.

J. Scott Sykora: Right. And it could have been a cascading of trades and various things like that. It occurred with an absence of cross-exchange firewalls, but there are so many ways the risk can play out. You have geopolitical events, you prominent failures of FCMs including fraud. We are clearly not trying to make any claims about predicting the future, we do not try to predict vol regimes, all that we are looking at is what is the market offering us today.

We try to maximize our performance based on what the market provides for us. And so then we have decisions to make, do we need to adjust the targeted rates of return for the LJM products based on what the vol regime is offering us.

So we have adjusted our thinking over time. We used to target consistent and uniform performance across various vol regimes; we have now evolved to the point where we will amend our targeted rates of return based on the vol regime.

So the best case study was this fourth quarter just ending. Volatility was surprisingly low given global uncertainty, including a US election, stimulus generated by the Fed, Eurozone instability and most recently the fiscal cliff. So we made a discretionary decision to temper our targeted rates of return, which softened some of the returns we would have received otherwise. But if markets had reacted with increased volatility, we had a ton of dry powder available to sell into that volatility. So we do apply a discretionary overlay to our systematic trading. That is one of the hallmarks of our approach.

Mark Melin: Talk about the dry powder in your returns. What are your targeted returns and what is your risk profile? Also, I want to talk a little about margin equity. Let us talk about leverage usage and how you manage that, particularly during a vol spike?
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The Underground Battle for The US Criminal Justice System

By Mark Melin

There is a **battle that is taking place behind the scenes**, mostly **unknown outside a small group of insiders**. It is a **fight for control of the US judicial system in regards to financial crimes**.

It's really a long running battle, **hard to tell the start date**. I tend to think it is 1998, the year CFTC Chairwoman Brooksley Born was humiliated out of office by a gang of thugs. Her offense? She requested transparency into improper derivative structures that ultimately imploded in 2008 and continue to underlie the economic structure across the Westernized world.

The fight for criminal justice has many causalities. This includes former CFTC Chairman William Rainer. (Full disclosure: The author worked with the former Mr. Rainer in the past.) In my opinion Mr. Rainer was a principled man who tried to stand up for common sense derivative regulation in the Enron illegalities, but was **"chewed up," a causality of the underground justice war**. It's interesting in this long-running war, the causalities tend to be people who have upheld the rule of law, fought for basic common sense derivatives management principals. Seems like those supporting the criminal ways seldom get chewed up, but rather lauded once they leave office. This could be considered reverse deterrence.

A recent Frontline PBS documentary, produced by the hard-hitting journalist Martin Smith, clearly documented the facts: In 2008 the damage to the financial system, causing $12.8 Trillion in damage by one estimate, involved criminal behavior. Much of this **criminal behavior was not investigated**, the documentary points out. For instance, the documentary notes that a mortgage company fraud investigator with key knowledge regarding criminal knowledge, was not even questioned.
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Lack of Prosecutions in 2008 Led to MF Global Criminality

By Mark Melin

The Frontline documentary, *The Untouchables*, was legendary on several counts.

But perhaps most historic was the establishment of fact that a policy existed to ignore criminality related to a small cadre of powerful Wall Street bankers. Ignoring this "criminal problem" has several costs and was followed by an even more spectacular crime: MF Global.

Here is the most significant fallout if MF Global criminal activity is not punished: It will **lead to even more brazen crime** because the concept of deterrence will vanish. While DOJ's Mr. Breuer cites concern for market stability in prosecution of protected elite, by not enforcing the law the DOJ is in fact the cause of financial instability and a significant risk to the loss of confidence in the US financial system.

People on the inside the derivatives industry, such as Jon Corzine, might have learned the clear message of 2008. **Evidence** suggests fraud was committed by bankers at the "C level" that led to the US financial meltdown yet no punishment of relative significance occurred.

Regulatory history might be written that the clear message of 2008 was the lack of criminal punishment lead to additional criminality. And the problems with derivatives criminality have been known and identified.

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Why Was Lanny Breuer Allowed To Remain at DOJ?

This is a serious question, since it's been two days since his "voluntary" resignation as director of the criminal division was announced. Speculation is Mr. Breuer an exit agreement is in place, with one stipulation: he is allowed to **unwind the most damaging government policy in DOJ history, the Too Big to Jail and playing favorites with financial criminal prosecution. While Mr. Breuer being allowed to order tough investigations into Wall Street crime before exiting his position might sound odd (or hopeful)**, stranger things have happened.

While Mr. Breuer being allowed to order tough investigations into Wall Street crime before exiting his position might sound

It is Mr. Breuer who was so brilliantly called to task in the Frontline / PBS documentary "The Untouchables." In the documentary Mr. Breuer admitted to Frontline producer Martin Smith that DOJ applies a different standard of justice to an elite list of Wall Street criminals. The transcript is too unbelievable to consider coming from an officer of justice:

MARTIN SMITH: *You gave a speech before the New York Bar Association. And in that speech, you made a reference to losing sleep at night, worrying about what a lawsuit might result in at a large financial institution.*

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LANNY BREUER: *Right.*

MARTIN SMITH: *Is that really the job of a prosecutor, to worry about anything other than simply pursuing justice?*

LANNY BREUER: *Well, I think I am pursuing justice. And I think the entire responsibility of the department is to pursue justice. But in any given case, I think I and prosecutors around the country, being responsible, should speak to regulators, should speak to experts, because if I bring a case against institution A, and as a result of bringing that case, there's some huge economic effect — if it creates a ripple effect so that suddenly, counterparties and other financial institutions or other companies that had nothing to do with this are affected badly — it's a factor we need to know and understand.*

Speculation is the argument Mr. Breuer had given to to remain at DOJ until MF Global crimes are investigated is that essentially many more were involved in providing criminal cover to a select list of Wall Street executives.
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Disclosure: Underground Justice Club

There is a small group that has been working behind the scenes to reign in criminality on Wall Street. Many of us are also greatly concerned about the debt crisis. Speaking out on these issues has been punishing to anyone involved, so many of the names of participants are generally protected but known by certain insiders. The fight for justice, initially outlined in the book *The Payout* just scratches the surface. A minority on Wall Street is working to cover up criminal activity. This is evident in MF Global, but that's part of the back story likely never to be told. The criminal activity must end, and the real risk in improper derivatives structures understood. The real mathematical risks in the debt crisis – and the absurd leverage used by certain Too Big to Fail / Jail banks – should be known.

The fact the US government is likely going to be on the hook for UNLIMITED LIABILITY must be known. That's right. A derivatives contract, by definition, carries with it the risk of unlimited loss. These unregulated derivatives will implode and destroy the economy again. It's just a matter of when and who pays for the risk on the trade. The traders at some of the TBTF banks have created a derivative structure that saddles the US tax payer with unlimited liability, while they pocket a small but lucrative percentage of notional transactional value. In other words, the "interesting" derivatives products sold in 2008 are going to be nothing compared to the derivatives crash ahead. The OTC derivatives these banks have on the books are a high probability for another implosion. The real risk disclosure is that because 2008 was not prosecuted additional derivatives scams and criminality ensued. MF Global is not only an example of a complete breakdown of the rule of law, but a man who thumbed his nose at the law, his industry and counterparties. This story, the real inside story, must be told. Volatility can sometimes be prevented by identifying it beforehand. It's only volatile when it's a surprise.

Over the past 15 years, unregulated derivatives have been at the center of recent economic crisis. More troubling, they are at the center of the next great crash. A crash that we can hopefully avert… if the real issues are allowed to be discussed in public, that is.

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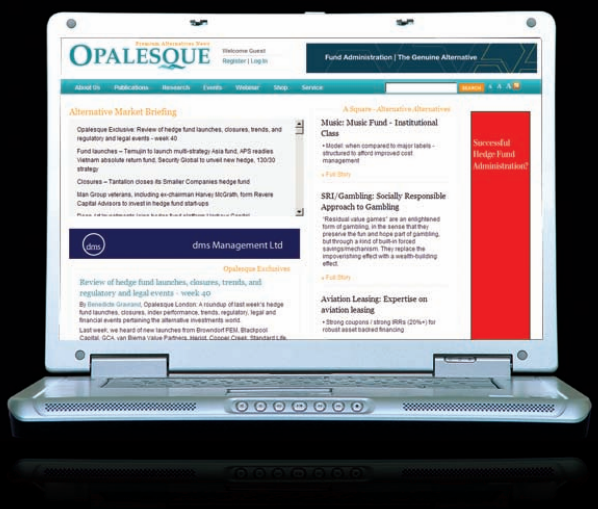

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