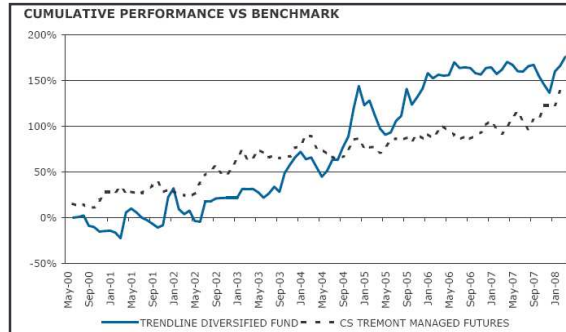


Back to our Roots (Redux)

We recently advised our investors & anyone else who would listen that we had “returned to our roots” – that both returns & volatility would increase.

The graph alongside is evidence of how uncharacteristic the low volatility/ low return 2006/2007 period was, and also the early signs of a return to the profitability in 2008.

To be more specific, it is increased volatility of individual positions that we will tolerate. In contrast, total portfolio volatility will be constrained in two ways: firstly by the continuous refinement of our risk budgeting process, and secondly by the on-going broadening of our investment universe. The former has been & will remain the main focus of our research; the latter has been assisted by increasing liquidity in the Safex agricultural contracts, ETF's brought to market by investment banks, and the ongoing liberalisation of currency controls by the Minister of Finance. We now trade bonds, commodities, currencies & equities in the Trendline Diversified Fund.



2008 Q1 Returns

- Trendline Diversified Fund: 16.6%
- CS Tremont Managed Futures Index: 11.0%
- HFRI Fund Weighted Composite Index: (2.0%)

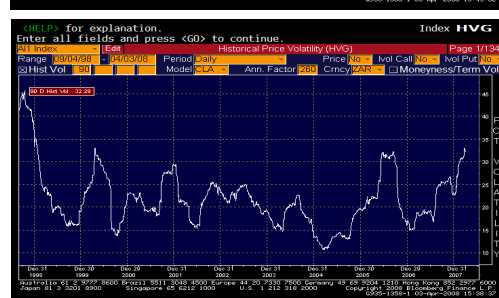
How do we place Trendlines' & the Managed Futures' returns in the context of the current difficult environment that most hedge funds have been experiencing, both locally & internationally?

In January 2008 many markets broke decisively out of their former price channels & volatility bands. In a speed which would have Nassim Taleb rubbing his hands with glee, the “short volatility” strategies incurred one of the infrequent large losses which any junior risk manager at a bank prop. trading desk would instinctively recognise as inherent to the strategy.

Conversely, the long volatility strategies such as macro managers, systematic managers & CTA's had one of the less frequent highly profitable periods (see Trendline and also Managed Futures Index 2008 Q1 returns above). These portfolios are able to benefit from market volatility, rather being hostage to it.

Convergent or Divergent?

Will this recent volatility persist, increase, or will it revert to its' mean? Will BS (Before Sub-prime) relationships still be valid? For a look in the rear view mirror, the VIX and the 90 day historical volatilities of the MSCI World Equity and Near ALSI future are shown at right.



However, because looking forward is more subjective, it is appropriate to have a prism or framework through which to view this future.

An alternative to the long volatility/ short volatility categorisation is one which categorises trading philosophies (& thus trading strategies) by their view on the stability of financial markets & market prices (Rzepczynski, 2003).

A convergent trading philosophy assumes that there are stable price relationships that can be statistically measured & exploited when prices that are out of line move back to their mean or theoretical value.

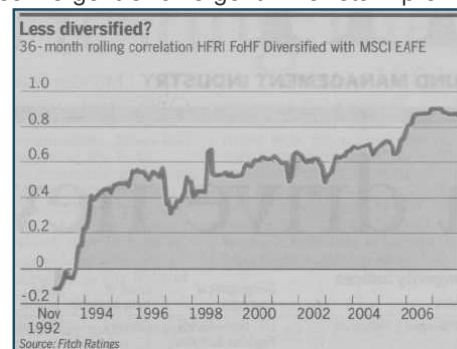
Conversely, a divergent approach assumes that prices are only stable in the very long run. There can be significant divergences from believed or perceived theoretical or statistical relationships that can be profitably exploited through following trends in the price adjustment process.

Clearly the world is not entirely random, so convergent strategies will be profitable when appropriately employed. The problem arises when believed stable relationships break down. Non-recurring events may not follow traditional behaviour. A new equilibrium price may exist, but it is not easily knowable; it takes time to gather data and verify the new equilibrium. Uncertainty in the effect of disruptive shocks means markets cannot adjust immediately, and the slower adjustment in prices plays to the strength of trend-followers, who believe the world to be a place of constant change & disruptive divergencies.

Red or Black ...

All trading strategies may be categorised as either convergent or divergent. The return profile of convergent traders will typically be a tight distribution with a negative skew associated with divergent events, such as Q1 2008. Divergent traders will have higher volatility, but a positive skew associated with profits from extreme trends and stop losses that cut risks.

However, as visible in the graph at right, FoHF correlation with equities is increasing, indicating a bias towards equity-related strategies which are either unhedged, or long of illiquid positions like emerging markets or small cap. shares.



Loading the dice on multiple convergent strategies works well in a low volatility environment, and is manager diversification, but it is neither strategy diversification nor risk management ("Unfortunately, the majority of hedge funds in South Africa still fall into just two categories, equity market neutral (28%) & equity long/short (48%)" Whose Money is it Anyway?" Rusconi 2008). Not one of those prop desk risk managers at any bank would allow their whole trading team to be short of at-the-money options without insisting on being long of at least some out-the-money option strikes for disaster insurance.

or Red and Black?

Diversification would argue that there is a need for both types of trading styles. Market competition dictates that FoHF managers tilt this diversification in an attempt to increase return or reduce risk, depending on the current & expected degree of market stability.

In the current environment of uncertainty, where regulators are grappling with the sub-prime fall-out, where markets are frequently unable to price assets, and where no-one seems to know the value of anything at times, it is worth revisiting George Soros' concept of reflexivity: "There is a two-way, reflexive interaction between the real state of affairs, and the participants' biased views and misconceptions. Instead of random deviations, reflexivity may give rise to initially self-reinforcing but eventually self-defeating boom-bust sequences or bubbles."

In an uncertain world, identifying and following trends may be the only reasonable investment approach.