

The Problem with Macro Investing Today

FQ Perspective



MAX DARNELL
Managing Partner and
Chief Investment Officer



JEPPE LADEKARL
Partner, Investments



DORI LEVANONI
Partner, Investments

It has been an environment that would have seemed perfect for macro. Macro phenomena dominated investment returns throughout the credit crisis and its aftermath; thus opportunities for macro investing seemed, at least on the surface, to be plentiful. While there's been some success in macro investing over this period, there has been less success than one might expect, and more recently, mostly disappointment. It is not that macro managers have been suffering - unless you categorize CTAs as macro, in which case they have suffered a great deal - it is that they have generally, with few exceptions, been failing to generate (much) return as a group. We believe we can shed some light on the difficulties, and despite the pessimistic title, also provide a view as to how these troubles can be addressed, and when/how/where they may ultimately come to an end - for end they will.

Our own experience, we think, sheds some light on what the trouble has been for many macro managers and what to expect from macro as you look forward. Our thesis is that those asset classes most influenced by central bank decisions or government responses to the credit crisis, and the resulting economic turmoil, should have been the ones most difficult to trade for profit by those managers whose decisions are driven by economic and fundamental drivers of return. We see bonds and equities as having been impacted the most, while currencies, commodities, and arguably the most macro of tradable macro risks, volatility, has been impacted the least.

Our own performance runs consistent with this thesis. To begin with, trading sovereign debt for profit based on fundamentals has been tough as central banks have been an overly dominating influence on the interest rate markets at both the short and long end of the curve. Economic and fundamental drivers have been of little importance during this period for selecting between the debts

of various sovereigns. Investment success or failure has been driven by the ability to forecast the behavior of central banks, government officials and politicians. For fundamentally driven macro managers, in general, we would expect this to have been a problem. Bonds are, after currency, often times the most actively traded instruments by macro managers.

Looking forward, then, we're optimistic that the efficacy of trading sovereign debt futures will improve as central banks incrementally reduce their direct influence on the long end of the yield curve as the need for direct intervention in asset markets through quantitative easing continues to dissipate. We say "incrementally" because fully retiring unconventional monetary policy instruments across the globe will take some time.¹ The good news is, we believe, that macro managers should begin to see improvement in this aspect of their performance as fixed income as an asset class normalizes through time.

The trading of equity indexes is a different

Past performance is no guarantee of future results. Potential for profit is accompanied by possibility of loss.

¹Today, a more activist approach to central banking appears to have been successful in response to the credit crisis (never mind that the excessive liquidity that central banks were throwing at the markets were certainly a meaningful part of the reason why the credit crisis occurred in the first place!), and now this activist approach to central banking may lead to excessive confidence. We worry that central banks will act from this position of excessive confidence and overuse the tools at their disposal. Should this occur, trading sovereign fixed income instruments for fundamental, economically rational reasons may again suffer from the hand of intervention more frequently than we might like. We'll see.

matter, and here we are not so optimistic about the near-term future. This is an area of investment activity that has also been tough as government and non-governmental organization (NGO) policy decisions, most notably decisions to backstop faltering European countries, banks, and “strategic industries” such as parts of the auto industry in the US, have unduly rewarded investments into markets with deteriorating fundamentals.² Looking forward, we are concerned about the challenges we face in trading equity indexes on a fundamental basis if governments continue to increase their appetite for regulatory and legislative interventions. There are certainly plenty of excuses to go down the interventionist route: significant imbalances related to government and private debt, pension and healthcare overhangs, and possibly increasing geopolitical risk. There’s a risk of that happening, at least, and we are concerned about that.

Beyond fixed income and equity futures, the reflection of macro phenomena in market prices has not only been more normal, but, in fact, at times better than normal – consistent with the assumption that this would have seemed to have been a period with rich opportunities for macro. As we move further away from asset classes with direct policy impact and into currencies, commodities or more esoteric asset classes such as volatility, we find that returns in these asset classes were most certainly influenced by the actions of central banks, governments and NGOs, but only indirectly. That notion is important because it signifies that the economic impact of these actions moved asset prices. That, in turn, means that fundamental, economically-based investment strategies were able to work in these markets. Again, using our own experience as admittedly limited evidence, this has, in fact, been a particularly good period for us in generating alpha in all three of these asset classes.

There’s a limit to how much risk can be taken in commodities and in volatility trading across the industry, so as trading in fixed income futures comes back on track, this leaves currency to carry an outsized weight in generating macro returns.

We think investors should be comfortable with this. We see currency as the quintessential macro asset, reflecting nearly all major macro phenomena and serving as a virtual weather vane for macro events. Because it is the most liquid market, and because currency trades on a nearly continuous basis, investors are able to react quickly, in size, and at low cost, when positioning in anticipation of, or in response to, macro phenomena. In this market environment specifically, we have seen fundamental macro phenomena play out in a manner consistent with established relationships in currency, while the same phenomena have had a much more muted impact on equity and fixed income markets due to the influence of governments and central banks mentioned above. Currency is therefore, at least for us,³ a great place to focus outsized macro efforts right now.

Fundamental Supply/Demand Dynamics

Currency trading is not a homogeneous activity. Just as traders of futures contracts shouldn’t be viewed as all being the same (commodity trading advisors, discretionary macro traders, systematic macro managers, managers who use futures for rebalancing or for porting alpha are all clearly understood to be quite different from each other), neither should currency traders. There are those who rely upon trend, there are those who are beta grazing, e.g. playing the carry trade, there are discretionary macro traders who express many of their macro views through currency, and there are those who focus systematically on the fundamental and economic dynamics of the currency markets.

The latter category is where we happen to reside. It is worth a moment to explain what it means to focus on fundamental and economic dynamics. Simply put, in any free market, prices are set where supply intersects with demand. What is supplied is what investors find available to them in the market – a large set of assets that carry various characteristics. While defining and measuring these characteristics is in most cases

²While actions such as the formation of the European Financial Stability Fund (EFSF) did not specifically or directly target asset prices, it did directly turn on its head the role that fundamentals play in setting asset prices. Through the provision of financial backing and financial resources to states that were in trouble, the EFSF caused investors to be rewarded for holding poor, rather than high, quality assets. Conversely, the debt ceiling debate in the US, at least temporarily, had the opposite effect.

³Counter to our own experience, most other currency managers have been having a difficult time of late. For the most part the explanation is simple: carry and trend have not been working well over an extended period of time, and most currency management today is heavily dependent upon these two sources of return. That’s important to understand, as it would be incorrect to draw a sweeping conclusion about the efficacy of currency management based upon these two sources of difficulty no matter how prevalent. The fact that neither of these sources of return relate to, nor depend upon, underlying fundamentals of the currency markets, makes such a blanket perception particularly suspect.



challenging, differences in investors' views as to the nature and magnitude of these characteristics only occur because the approaches to estimating, forecasting, and measuring those characteristics vary. Were investors to use the same methods and inputs, they would all share a common view as to what characteristics are available to them in the marketplace. In other words, what is supplied would be universally agreed upon.

That does not mean that they would agree upon the market price at which assets should trade. Agreeing on the attributes is not the same thing as agreeing upon the price at which those attributes should trade. "Intrinsic value" derives from the essence of the thing itself, and is strictly independent of anything else such as the usefulness of the thing to others. Intrinsic value is independent of demand, and therefore speaks not of the market clearing price. Where investors are expected to have substantive differences is on the value to themselves that they place on these characteristics. Investors and their investment objectives are highly heterogeneous. They differ by the duration of their objectives, their risk tolerance, their sensitivity to inflation, their need for current income relative to long-term capital appreciation, their preferences for liquidity, and so on. Two investors can agree on what the asset characteristics are, but at the same time, they are likely to disagree on how valuable those characteristics are in the pursuit of their own, differentiated objectives. Their demand differs.⁴

To ensure the interplay of supply and demand is clear, let's use equities as an example. The characteristics that determine the intrinsic value of an equity would include the stock's dividend yield, its book value, the firm's prospects for growth, its debt burden, the quality of the management team, and so forth. These are the characteristics that are supplied, i.e. available to be acquired by investors. Demand for these characteristics clearly varies across time. Consider how scarce yield has been in the low interest rate environment of late, and how that has caused heightened investor demand for dividend-yielding stocks, and therefore the

price of dividend-yielding stock, to rise on a relative basis. That's a shift in demand. Similarly, consider how investors' demand for stocks overall diminishes during times of significant market stress (think 2008), causing prices to fall far more than the change in underlying fundamentals could possibly explain (as Robert Shiller argued in 1981). A change in risk appetite during such times translates into a drop in demand.

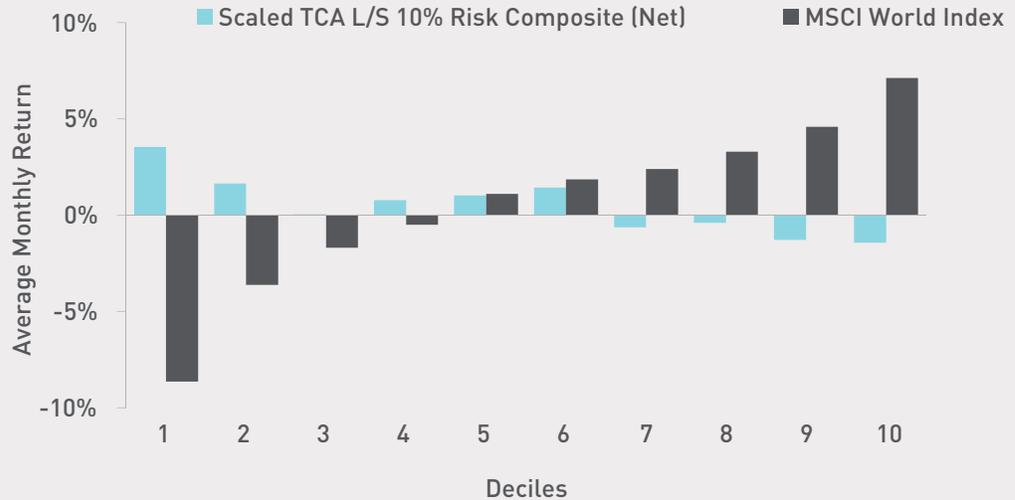
Currencies work the same way. What is supplied are the fundamental attributes of each currency. Demand for currencies derives from those who trade currency as a pass-through asset when transacting internationally in financial assets, goods, and services. Demand also derives from central banks (market participants not motivated by profit), hedgers, and traders who are seeking to profit from currencies. What we do is evaluate changes in the characteristics of what is supplied and, at the same time, determine what motivates changes in the demand for each of these market participants so that we may estimate likely variations in demand. When investors react with frustration that exchange rates can vary significantly away from their fair value, we say, "Of course they do. Variations in demand explain why they do!"

Icing on the Cake

Focusing on the interplay between the supply and demand for the fundamental attributes of currencies is, we believe, the key to why we have had success where others have failed, when it comes to our macro currency investing over the past years. In particular, demand helps explain why currencies may drift away from fundamental fair value during periods where investor risk appetite is high, allowing misvaluations to grow more exaggerated. When risk appetite shrinks, i.e., when various sources of demand withdraw – sometimes very quickly – misvaluations are quickly mended. Specifically, we don't often see demand increase for currencies that are already expensive in relation to their intrinsic value, in times of crisis. This has allowed us to produce a somewhat unique and uncorrelated return

⁴It is telling that the impact demand has on the setting of prices for financial assets was never mentioned in either Robert Shiller's seminal 1981 paper (which addressed the fact that equity prices vary much more than can be explained by underlying fundamentals), nor was demand addressed in other articles responding to this paper. The implication that Shiller drew was that markets were not efficient, and that market participants were not making fully rational decisions. To this day we see far less work being done to examine the variation in demand across time, and across market participants, and how the demand for financial assets influences market prices. This is ironic given that the financial markets rate amongst the most free markets in existence. See: Shiller, Robert J., "Do Stock Prices Move Too Much To Be Justified by Subsequent Changes in Dividends?", nber.org.

FIGURE 01 - DECILE RETURNS OF MSCI WORLD TOTAL RETURN INDEX VS SCALED TCA L/S 10% RISK VALUE-ADDED (NOVEMBER 2006 - MAY 2014)



Sources: First Quadrant, L.P., MSCI

stream with, as icing on the cake, a tendency to have its best performance during times when risk assets are down. The chart above shows the performance of the FQ Macro FX program scaled to a 10% risk level⁵ and MSCI World, sorted in deciles of MSCI World performance from November 2006 to April 2014. It clearly shows the tendency to gain most when the equity index is down.

It is worth keeping in mind that our fundamentally created long volatility bias is

very different from naively created long volatility strategies, such as, for example, just being short the currency carry trade at all times (the currency carry trade is highly correlated to equity markets) or flight to safety plays such as just being persistently long the US Dollar or long the USD and CHF against AUD and NZD. What differentiates these three examples of naive long volatility strategies referenced in Table 01 from our Macro FX strategy is less how they perform during crisis; they all add value on average based

⁵The scaled performance was derived by scaling the live performance of the Tactical Currency Allocation Long/Short USD (2% Risk Value-added) to 10% to reflect returns at a typical alternative risk level. All scaled returns are supplemental to the composite. Please see Scaled TCA Returns Disclosures and Tactical Currency Allocation Long/Short USD – Valued –Added Composite Information and Additional Disclosures: Tactical Currency Allocation Long/Short USD – 2% Risk Value-Added found at this end of this paper for further details regarding the live performance used.

TABLE 01 - AVERAGE MONTHLY RETURNS OF DEFENSIVE CURRENCY STRATEGIES WHEN MSCI WORLD IS UP OR DOWN (NOVEMBER 2006 - MAY 2014)

	Scaled TCA L/S 10% Risk (net)	Risk Off Portfolio 1	Risk Off Portfolio 2	Short Carry
MSCI World TR positive	-0.21	-1.47	-1.44	-1.17
MSCI World TR negative	1.59	1.78	1.43	2.13
Average Monthly Return	0.50	-0.12	-0.25	0.20

Risk Off Portfolio 1: Long USD and CHF against short AUD and NZD in equal proportion.

Risk Off Portfolio 2: Long USD against an equally weighted portfolio of other develop market currencies (AUD, CAD, EMU, JPY, NOK, NZD, SGD, SEK, CHF and GBP)

Short Carry: Short the three highest cash yielding currencies and equally long the lowest three currencies in the developed market universe traded in the TCA 10 pct strategy (AUD, CAD, EMU, JPY, NOK, NZD, SGD, SEK, CHF, GBP and USD)



on our back test - though not every time as they are all examples of proxy hedging strategies. Instead, what's more relevant is how much drag they have on the portfolio in normal times.

All three sample strategies would have been negatively correlated with exposures typically found in most long only portfolios (most of us are negatively exposed to tail events not only directly through our equity exposure, but also indirectly through correlated risk exposures elsewhere in the portfolios, so any strategy with a long volatility characteristic will typically be highly diversifying), and all three strategies would have made money during crisis episodes. However, the three naïve strategies would have lost most and in two of the cases all (and more) in periods between crisis.

Timing of the shifts in demand for the fundamental characteristic does matter, and it is what, we believe, has allowed our macro currency investment approach to deliver not only as a standalone investment vehicle, but also when it comes to increasing the return, reducing the risk and reshaping the return distribution of both traditional and alternative portfolios. And it has done so using one of the most liquid sets of financial assets in the world: developed market currencies.

Summary

The recent challenges that macro managers have faced in generating strong returns during a period that, on the surface, would have seemed ideal for macro trading can be explained by the outsized influence of central banks, governments, and non-governmental organizations on the financial markets. This runs consistent with our own experience, as trading in those assets that have been only indirectly impacted by the actions of these entities has, in fact, been profitable for us. We believe that the environment for macro investing is generally improving, and for currency, in particular, it is not only the past but also the future that seems especially promising.

From our experience, it makes sense that currency – which we view as the cornerstone of macro and the quintessential macro asset –

has been working very well over this period; we trade based upon fundamentals rather than upon anomalies or beta grazing. It is well worth noting that an approach to currency that focuses on fundamentals tends to provide rare and desirable characteristics that, we contend, make currency one of the best marginal contributions to a plan's overall risk and return profile.



Scaled TCA Return Disclosures All scaled returns are considered simulations and are supplemental information to the live composite. (Creation Date: November 2013) Unlike an actual performance record, simulated results do not represent actual trading. Also, since the trades have not actually been executed, the results may have under or over compensated for the impact, if any, of certain market factors, such as lack of liquidity. Simulated trading programs in general are also subject to the fact that they are designed with the benefit of hindsight. No representation is being made that any account will or is likely to achieve profits or losses similar to those shown. Performance returns for periods of less than one year are for the period reported. Scaled TCA performance presented differs from live performance experienced using the strategy for the following reasons: • The scaled performance streams were derived by scaling the live performance of the Tactical Currency Allocation Long/Short USD (2% Risk Value Added) Composite to the risk level as indicated on the presentation. • With exception to scaled value-added performance presented, the scaled total return performance includes a stated cash index return to reflect a fully funded total return strategy, whereas the live composite is a value added strategy and not a total return strategy. Please refer to the Tactical Currency Allocation Long/Short USD (2% Risk Value Added) Composite and disclosures for further information on live performance used in the scaled return simulations. **Investment Management Fees:** Gross Presentation - Performance results, which are presented are gross of investment management fees, but after all trading commissions. The FQ investment management fee schedule for this strategy, which is negotiable, is risk level dependent. Two fee options are available to investors: 1) the flat fee option or 2) the base + incentive fee option. Flat Fee Option: Portfolios carry a base fee equaling .125% per 1.00% of targeted risk. Assuming a 0.37% advisory fee based upon a \$200 million portfolio size with a 3% targeted risk and no increase in the asset value over a five year period, the compounded total return of a portfolio would be reduced by 0.37%, 1.12% and 1.86% for the one-, three- and five-year periods, respectively. Base + Incentive Fee Option, Portfolios carry a base fee equaling 0.05% per 1.00% of targeted risk. Additionally, the fee schedule calls for all portfolios to be structured with a 20% incentive fee. Assuming a 0.15% advisory fee based upon a \$200 million portfolio size with a 3% targeted risk and no increase in the asset value over a five year period, the compounded total return of a portfolio would be reduced by 0.15%, 0.45%, and 0.75% for the one-, three-, and five- year periods, respectively. Assuming a similar \$200 million portfolio size with an annual excess return of 1.00%, the incentive fee would further reduce the annual excess return of a portfolio by 0.20%, 0.61% and 1.04% for the one, three and five year periods, respectively. Of course, the impact of an incentive-based fee on the total return of a portfolio will vary depending upon the performance of the portfolio relative to its benchmark. Net Presentation - Performance results which are presented net of investment management fees are calculated off of the Base + Incentive fee option, i.e. 0.05% per 1.00% of targeted risk and 20% incentive fee. All performance results presented include trading costs. **Market Impact on Returns:** Certain material market or economic conditions can impact the returns of an investment strategy. We have provided below what we believe to be a fair, yet subjective, assessment of those outliers that have significantly and positively impacted the strategy's performance. From August 2008 to January 2009 AUD, EUR, JPY and GBP all experienced pricing moves from more than 15% to nearly 40% against the Dollar. As our model was favorably positioned, we were able to take advantage of these significant pricing moves. The strong decline in EUR and early increase in USD in 2010 favored our short EUR and Long USD positions significantly.

Tactical Currency Allocation Long/Short USD - 2% Risk - Value Added Composite	Value-Added Gross ¹	Value-Added Net ¹	Composite 3-Year Standard Deviation Gross [Annualized]	Benchmark 3-Year Standard Deviation [Annualized]	Number of Portfolios ⁴	Composite Dispersion [%]	Total Composite Assets ^{5,6} (Millions USD)	% of Firm Assets ⁴	Total Firm Assets ⁴ (Millions USD)	Total TCA Strategy Assets ^{1,4,6} (Millions USD)	Total Firm AUM (Including Notional Values) ^{1,4,5} (Millions USD)
2006 (Nov-Dec)	+0.5%	+0.4%	-	-	<5	-	2,250	-	14,404	11,958	26,301
2007	+0.1%	-0.1%	-	-	<5	-	2,250	-	14,594	12,921	31,025
2008	+4.0%	+3.9%	-	-	<5	-	2,250	-	9,508	6,884	20,043
2009	+0.9%	+0.7%	2.1%	-	<5	-	2,250	-	7,867	5,810	17,342
2010	-0.4%	-0.5%	2.1%	-	<5	-	2,250	-	8,558	7,203	18,713
2011	+0.8%	+0.6%	2.1%	-	<5	-	2,250	-	7,967	6,591	16,725
2012	+1.6%	+1.5%	2.3%	-	<5	-	2,250	-	7,891	7,972	17,104
2013	+1.2%	+1.0%	2.2%	-	<5	-	1,250	-	9,702	7,274	17,284
2014 (Jan - May) ²	+1.5%	+1.5%	2.1%	-	<5	-	1,250	-	11,780	7,234	18,908

See additional disclosures for important information concerning this composite and the effect of fees. ¹Supplemental Information. ²All Performance and AUM data is preliminary. ³Includes market values for fully funded portfolios and the notional values for margin funded portfolios, all actively managed by First Quadrant. ⁴At End of Period Reported. ⁵Includes market values for fully funded portfolios and the notional values for margin funded portfolios, including both active and passive components, all managed by First Quadrant and non-discretionary portfolios managed by joint venture partners using First Quadrant, L.P. investment signals. First Quadrant is defined in this context as the combination of all discretionary portfolios of First Quadrant, L.P. and its joint venture partners, but only wherein FQ has full investment discretion over the portfolios. ⁶Effective December 31, 2012, reflects all actively managed TCA strategy assets, inclusive of currency managed on a constrained, customized, or long-only basis. Prior to December 31, 2012, this figure was restricted to include only assets managed under the standard TCA Long/Short strategy. Includes other TCA composite assets based in foreign currencies for all periods presented.

Tactical Currency Allocation Long/Short USD - (2% Risk - Value Added) Past performance is no guarantee of future results. Potential for profit is accompanied by possibility of loss. **GENERAL DISCLOSURES:** First Quadrant, L.P. claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS standards. First Quadrant, L.P. has been independently verified for the period 1995-2013. The verification reports are available upon request. Verification assesses whether (1) the firm has complied with all the composite construction requirements of the GIPS standards on a firm-wide basis and (2) the firm's policies and procedures are designed to calculate and present performance in compliance with the GIPS standards. Verification does not ensure the accuracy of any specific composite presentation. First Quadrant, L.P. ("FQ" or the "Firm") is defined as the combination of all discretionary portfolios of First Quadrant, L.P. and its joint venture partners, but only wherein FQ has full investment discretion over the portfolios. First Quadrant L.P. is a registered investment adviser and is an affiliate of Affiliated Managers Group, Inc. A complete list and description of the Firm's composites is available upon request. **COMPOSITE DETAILS: Composite Description:** (Creation Date: May 2012) The portfolios of the Tactical Currency Allocation Long/Short USD - (2% Risk - Value Added) ("TCA L/S - 2%") Composite are unique in that their mandates provide latitude to invest in the strategy with symmetric active investment ranges. Symmetric active investment ranges mean that FQ is allowed to overweight an asset relative to a benchmark by the same amount as FQ is allowed to underweight the same asset. This strategy uses currency futures or forwards, which are based on the movement of the underlying currency. The performance returns exclude the returns on the cash. The TCA L/S - 2% strategy is a value-added strategy, and therefore no composite benchmark is included. Although all portfolios within the composite are managed using the same investment strategy, they may have varying constraints as to how they are managed. The composite returns are shown on a value-added-only basis, since the individual portfolio objectives are designed to generate gains without regard to a specific benchmark. The composite and its historical returns reflect only stand alone mandates which have a USD base currency. **Portfolio Criteria:** There is no minimum balance requirement for a portfolio to be included in a composite. Portfolios included in the composite may utilize leverage at FQ's discretion. **Calculation Methodology:** Valuations and returns are computed and stated in U.S. dollars. Monthly portfolio returns are time-weighted rates of return using the daily valuation method. Annual portfolio returns are calculated by linking the monthly returns. The dispersion of a composite is calculated using the asset-weighted standard deviation formula. Only portfolios managed for the full calendar year are included in the dispersion calculation. Where a composite contains five or fewer portfolios, a measure of dispersion is not statistically representative and is therefore not shown. The three-year annualized standard deviation measures the variability of the composite and the benchmark returns (if applicable) over the preceding 36-month period. The standard deviation is not presented for periods in which 36 months of historical composite returns are not available. Policies for valuing portfolios, calculating performance, and preparing compliant presentations are available upon request. **Composite Assets:** Composite Assets reflect the notional amount of assets managed to the composite's strategy. FQ believes that the notional amount is the most representative and meaningful figure that expresses our breadth of management in this particular strategy. **Derivatives:** The underlying investment process composing this composite uses derivative instruments to achieve desired returns. Derivatives are financial instruments whose value is derived from another security, an index or a currency. Futures contracts are derivatives that specify a purchase or sale of an asset at a specified price on a specified date in the future. Forward contracts are derivatives that allow the purchase or sale of currency in the future at a currently agreed-upon rate of exchange. There is a risk that a derivative may not perform as expected, thereby causing a loss or amplifying a gain or loss for a portfolio. With some derivatives there is also the risk that the counterparty may fail to honor its contract terms causing a loss for a portfolio. **Cash Allocations:** Certain managed portfolios may contain more than one product. These products are presented in separate composites. Cash in these portfolios is allocated to each product based upon the actual cash balances maintained in separate cash balances for each product. **Investment Management Fees:** Performance results presented net of investment management fees are based upon actual portfolio investment management fees charged to each portfolio within the composite. These net of fee results also reflect the effect of any negotiated fee arrangements, which are different than FQ's fee schedule. All performance results presented include trading costs. The FQ investment management fee schedule for this strategy, which is negotiable, is risk level dependent. 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