Our Convictions Tested
2011 Year End Review

If anything 2011 provided a market environment that strenuously tested our convictions on both the long and short sides. The year saw the market traverse three phases. The first five months of the year (Phase 1) saw a sustained market rally despite plenty of headline risk including the Arab Spring revolutions and the devastating Japanese earthquake/tsunami. During the middle two months of the year (Phase 2), the market traded sideways as the storm clouds gathered over Europe (Greece default risk) and US political wrangling put the debt ceiling debate in stark focus for the markets. The market finally capitulated during August in the wake of a US credit rating downgrade and as fears of contagion across Europe dominated investors' psyche. The capitulation in August set off very high volatility and a roller-coaster ride that we may still be riding today (Phase 3).

Looking back, our strategies outperformed their benchmark by a wide margin throughout Phases 1 and 2 (see Table 1).

Table 1: Net Returns (July 2011)

	July 2011	YTD
Composite	to 7/31/11	to 7/31/11
AlphaClone Select Long/Short	**-2.0%**	**7.7%**
S&P 500 (w/dividends)	-2.0%	3.9%
Momentum Select Long/Short	**-1.6%**	**5.2%**
Russell 2000 (w/dividends)	-3.3%	2.70%
International Long/Short	**3.5%**	**8.4%**
BNY Composite ADR	-0.9%	-0.3%
Value Masters Long	**2.7%**	**4.4%**
S&P 500 (w/dividends)	-2.0%	3.9%
Activist Masters Long	**-4.1%**	**8.0%**
S&P 500 (w/dividends)	-2.0%	3.9%
ETF Ideas	**1.1%**	**4.4%**
MSCI World Index (w/dividends)	-1.3%	3.9%
Gold (GLD)	8.4%	14.10%

The sharp market correction in August finally pulled the S&P500 below its 200 moving average although a strong late month rally meant the S&P500 was only down 5.4% for the month (it was down as much as 14% during the month). Never the less, the index did close below its average at the end of the month and thus our dynamic hedge mechanism was triggered on

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August 30th. By the end of the month, our strategies all of which were running long only up to that point had given up their gains for the year but most were still ahead of their benchmarks (see Table 2). The best performing strategy for the month was our ETF Ideas strategy which with a high allocation to gold and gold miners helped cushion the strategy as investors sought refuge in the precious metal.

Table 2 Net Returns (Aug 2011)

	August 2011	YTD
Composite	'to 8/31/11	'to 8/31/11
AlphaClone Select Long/Short	**-9.2%**	**-2.2%**
S&P 500 (w/dividends)	-5.4%	-1.8%
Momentum Select Long/Short	**-9.6%**	**-5.0%**
Russell 2000 (w/dividends)	-8.6%	-6.4%
International Long/Short	**-12.5%**	**-5.1%**
BNY Composite ADR	-9.1%	-9.3%
Value Masters Long	**-5.3%**	**-1.1%**
S&P 500 (w/dividends)	-5.4%	-1.8%
Activist Masters Long	**-5.9%**	**1.6%**
S&P 500 (w/dividends)	-5.4%	-1.8%
ETF Ideas	**-0.5%**	**3.8%**
MSCI World Index (w/dividends)	-8.2%	-5.1%
Gold (GLD)	12.3%	28.1%

September saw the S&P500 lose another 7% and by the end of the month the index (with dividends) was down nearly 9% on the year while the Russell 2000 and BNY ADR Composite indexes were down a painful 14.6% and 19.9% respectively. The fact we entered the month hedged on our dynamically hedged strategies paid dividends as each saw significantly lower losses for the month than their respective benchmarks (see Table 3).

Table 3 Net Returns (Sept 2011)

	Sept 2011	YTD
Composite	to 9/30/11	'to 9/30/11
AlphaClone Select Long/Short	**-3.70%**	**-5.80%**
S&P 500 (w/dividends)	-7.00%	-8.70%
Momentum Select Long/Short	**-4.80%**	**-9.50%**
Russell 2000 (w/dividends)	-8.6%	-14.60%
International Long/Short	**-1.70%**	**-6.70%**
BNY Composite ADR	-10.10%	-19.90%
Value Masters Long	**-10.30%**	**-11.30%**
S&P 500 (w/dividends)	-7.00%	-8.70%
Activist Masters Long	**-9.30%**	**-7.90%**
S&P 500 (w/dividends)	-7.00%	-8.70%
ETF Ideas	**-12.70%**	**-9.40%**
MSCI World Index (w/dividends)	-6.50%	-10.20%
Gold (GLD)	-11.30%	13.90%

In many ways October played THE pivotal role for the year overall. During the month the S&P500 hit its yearly low (down 12.6% on the year) but instead of further capitulation world markets came roaring back. The S&P500 finished the month up nearly 11% for the month while the Russell 2000 returned a spectacular 18.2% for the month. By any measure, October's rally was impressive. Driven again largely by (this time) positive headlines out of Europe markets virtually erased their losses for the year. The month was also critical for our strategies in that those that were hedged largely missed the month's rally while those that were long only benefited in spades. Our Activist Masters strategy returned 16% for the month pushing its year to date performance to 7% by the end of the month. In contrast our AlphaClone Select strategy, being hedged, returned 1.2% for the month. (see Table 4)

Table 4 Net Returns (Oct 2011)

	Oct 2011	YTD
Composite	'to 10/30/11	'to 10/30/11
AlphaClone Select Long/Short	**1.2%**	**-4.7%**
S&P 500 (w/dividends)	10.9%	1.3%
Momentum Select Long/Short	**0.4%**	**-9.2%**
Russell 2000 (w/dividends)	18.2%	-1.3%
International Long/Short	**0.1%**	**-6.5%**
BNY Composite ADR	8.5%	-7.5%
Value Masters Long	**13.5%**	**0.7%**
S&P 500 (w/dividends)	10.9%	1.3%
Activist Masters Long	**16.1%**	**7.0%**
S&P 500 (w/dividends)	10.9%	1.3%
ETF Ideas	**10.8%**	**0.4%**
MSCI World Index (w/dividends)	13.7%	-0.2%

Comparing our hedged strategies with a long only index at the end of October is an opportunity to remind ourselves of the job our dynamic hedge is meant to perform – a) protect against large multi-month drawdowns (>25%) and b) reduce volatility during times when equities are highly correlated and the market doesn't care about relative stock values. By that measure, our dynamic hedge worked flawlessly and in line with historical backtests – a loss in the month prior to entering the hedge followed by much lower overall volatility and good downside protection in subsequent months.

In context then, the missed rally in October was simply the price paid for lower volatility (half as volatile as the overall market during hedged months) and downside protection (it could have been much worse) in an extremely jittery macro environment. It bears reminding that our dynamic hedge is still in effect today and while we may see an exit at the end of this month, no rational analysis would put us out of the woods yet.

In the final analysis, our hedged strategies ended the year on par with the DJ Credit Suisse Core Equity Long/Short index (see Table 5). On the long only side, our Activist Masters strategy returned 7.4% for the year while our Value Masters strategy was down 2.7% on the year. A December correction in gold prices pushed our ETF Ideas strategy down 6.6% for the month to end the year down 7%.

After a year that threw everything but the kitchen sink at us, based on our performance, I am more confident in our approach than I have ever been. While the conventional wisdom is that "tail risk" is lower in 2012, it has certainly not disappeared and we remain susceptible to "air pockets". Whatever the markets will bring in the new year, may yours be healthy and fulfilling.

Table 5 Net Returns (Dec 2011)

	Inception	Dec 2011 to 12/31/11	YTD to 12/31/11	Since Inception Total Return%	Since Inception Ann Vol %
AlphaClone Select L/S Composite**	**01/01/11**	**-0.9%**	**-6.8%**	**-6.8%**	**12.9%**
S&P 500 (w/dividends)		1.2%	2.3%	2.3%	16.0%
DJ Credit Suisse Core Equity Long/Short Index		-2.3%	-7.4%	-7.4%	10.0%
Momentum Select L/S Composite**	**01/01/11**	**-0.5%**	**-7.6%**	**-7.6%**	**14.6%**
Russell 2000 (w/dividends)		0.7%	-4.2%	-4.2%	23.3%
DJ Credit Suisse Core Equity Long/Short Index		-2.3%	-7.4%	-7.4%	10.0%
International L/S Composite**	**11/01/10**	**-2.2%**	**-9.1%**	**-6.6%**	**16.9%**
BNY Composite ADR		2.2%	-8.1%	-6.6%	19.0%
Value Masters Long Composite	**09/01/10**	**2.7%**	**-2.7%**	**19.9%**	**21.2%**
S&P 500 (w/dividends)		1.2%	2.3%	23.4%	**16.5%**
Activist Masters Long Composite	**09/01/10**	**0.7%**	**7.4%**	**28.4%**	**20.3%**
S&P 500 (w/dividends)		1.2%	2.3%	23.4%	16.5%
ETF Ideas Long Composite	**11/01/10**	**-6.6%**	**-7.0%**	**-2.2%**	**19.5%**
MSCI World Index (w/dividends)		-0.2%	-2.8%	2.1%	19.7%
DJ Credit Suisse Core Global Macro Index		0.0%	-10.5%	-8.1%	8.5%

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AlphaClone, LLC. Index comparison returns are shown with dividends reinvested were available. ** Indicates strategy is risk managed.

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