“VUCA, VUCA, VUCA” – THE ENVIRONMENT OF VOLATILITY, UNCERTAINTY, COMPLEXITY AND AMBIGUITY

VUCA is the acronym developed by the United States Army War College to describe the new environment we will face in the 21st century — volatile, uncertain, complex, and ambiguous. VUCA aptly describes the market environment JWH and the managed futures industry faced in 2004, and the environment we may continue to see in 2005. This type of environment can be very good for our divergent style of trading, but there are still risks because there can be periods of trendless behavior, as well as quick reversals caused by market uncertainty. JWH’s skill is navigating the problems of VUCA and exploiting opportunities by following price trends through our long term systematic methodology and maintaining the discipline of exiting market risk when appropriate.

For the first half of the year, the overall environment was unfavorable for trend-following, even with some selected markets having strong directional moves. The key trends found during this period were not in the markets where we had the highest allocations. We generally maintain stable market exposures through time. Large market exposures in currencies, bonds, and equities were not able to capitalize on the overall trendless environment. However, the second half of the year, especially the fourth quarter, was marked by a strong dollar decline, a good rally in global bonds, and an unprecedented peak in oil, which culminated in a turnaround in performance for JWH programs. This improved environment provided solid year-end gains in many of our programs.

Performance in 2004 was led by the programs with high energy content, Global Financial and Energy Portfolio 31.1 percent, Global Diversified Portfolio 27.7 percent and our GlobalAnalytics® Family of Programs at 12.1 percent. We were able to exploit the rising oil price trend for almost the entire year in spite of its high volatility. The currency programs showed the poorest performance in spite of a strong comeback in the fourth quarter. The gains in the fourth quarter could not fully offset the losses accumulated earlier in the year except for the Dollar Program which gained just under 8 percent for the year and had concentrated exposure in the large European currency moves. Our flagship Strategic Allocation Program gained 13.6 percent for the year based in large part on strong energy gains.

December followed the seasonal pattern of declining volume and liquidity as we moved closer to Christmas and the end of the year. This may have been a period of potential false signals, with large market moves unassociated with new information and relatively quick reversals in price on limited trading. However, we have generally found that if strong trends are in place going into December, they will often continue for the entire month. Accordingly, market trends in December generally added to performance, especially in the currency programs, but volatile conditions in the energy markets dampened returns in our diversified programs. Interest rate markets were mixed, with limited new information entering the market because of the year-end holiday slowdown. December represented a trendless period for commodity markets, which showed their usual low trading volume behavior.

The Year in Review – Drawdowns and Comebacks

The four themes of volatility, uncertainty, complexity and ambiguity played through 2004 as both positive and negative contributors to JWH’s performance. Higher volatility was a major factor in many markets. Although not high by historical standards, spikes in volatility were apparent through large price moves coupled with strong reversals. This was a big contributor to losses in the Japanese markets.

Uncertainty was present in many markets; for a significant portion of the year, there was a lack of clarity on the growth prospects of the major economies. This contributed to the trendless financial market environment. The US pres-
idential election, which looked to be close, also contributed to trendless market behavior. The dollar decline did not take hold until after polls started to show a potential Bush re-election.

Complexity persisted between markets because we saw the interesting combination of the Fed raising rates on the front-end of the curve, while the long-end sustained a strong rally. This is seemingly in conflict with conventional wisdom.

Finally, ambiguity surrounded the markets. The impact on market prices from economic policy moves in China and the actions of some central banks were often unclear to investors. Ambiguity was even present with the big dollar sell-off in the fourth quarter. While many agreed that a dollar decline was expected, the potential size of the move was cloudy because the links between fundamentals and price seemed muddled.

**A Mixed Year in Currencies Ended on a High Note**

The difficult times with trading currencies in the first half of the year seem like ancient history now. The programs faced significant drawdowns through the first eight months of the year, caused by a combination of low amplitude or no trends in major markets, such as the euro, or unusually high amplitude over a short time scale, as in the case of the yen. The dollar showed strength in the first half of the year and only commenced its depreciation in the fall. The primary catalyst for the specific move in the fall was unclear. The fundamentals for a decline were in place for the entire year. Perhaps political-policy issues were the driver. With another four years of a Bush presidency, there is an expected continuation of budget and current account deficits coupled with a laissez-faire policy toward the dollar. This negative expectation is believed to have spurred the continued selling of dollars; consequently significant profits were generated from the dollar decline in the fourth quarter.

**Global Bond Markets did not Follow the Expected Script**

Interest rates followed three distinct periods during the year. After a strong rally for the first three months, the market saw a sell-off in the spring in response to expected rate increases by the Fed based on perceived higher inflation and growth. The markets were bracing for a 1994-type Fed tightening market environment, which never materialized. In front of the gradual Fed easing, markets rallied as the rising price of oil reduced growth expectations. It was surprising to see such a strong bond rally, given the total of five Fed rate increases, totaling 125 bps and leading to a Fed Funds rate of 2.25 percent. The reaction of the bond market has been a decline in 10-year interest rates from a high in June of 4.89 percent before the first Fed increase to a low of 4 percent in the middle of October near the peak in oil prices. Interestingly, the US bond market actually ended within 20 basis points of where it started the year.

The more profitable bond story was in the bund market, which saw a seven-point move since the summer driven...
on the low growth forecasts for European economies, especially Germany. What truly sustained this rally was the persistence of the European Central Bank’s (ECB) low inflation policy which showed no change in its base rate for the entire year. Ignoring growth issues, the ECB made clear statements to the world that price stability is its number one priority. Japanese bonds followed a similar behavior to US rates. As the economic news suggested a decline in growth, rates fell; however, the volatility in this market was significantly greater than in other bond markets, leading to a more difficult trading environment.

Stock Indices Showed Limited Trends

Global equities were range-bound for most of the year until the price of oil peaked in the middle of October. Since this peak, stocks around the world have moved higher as if a significant weight has been removed from the market. These equity gains have been less pronounced in Europe, which has slower expected growth, and in Japan, which also has been fighting structural issues that have curtailed growth expectations. Because of this tight price range, the equity sector was unable to contribute to program performance.

Metals Markets Showed Mixed Performance

The gold market showed a 20% gain within the year on the back of the dollar decline, but it has continued to be a market with mixed liquidity and subject to significant reversals relative to currency markets. Hence, gold did not provide as much profit as would historically be expected, given the size of the upward move in price.

Base metal price changes were highly correlated with overall economic growth, especially in China. However, the markets were punctuated with two strong reversals, the first in April after the increase in reserve requirements for Chinese banks, and the second associated with higher Chinese interest rates. These exogenous shocks to the Chinese banking system contributed to the limited gains in base metals markets in spite of the overall increase in prices.

Agricultural Markets Driven by Growing Conditions

Corn was a strong performance contributor to the diversified programs, as the market declined by 30% based on a strong harvest and the fact that China was a net exporter of corn. A similar price decline was present in the soybean markets, which saw declines of over 40% from the highs at the beginning of the year. Wheat marched to the same drummer, but faced greater volatility than the other grain markets.
The price moves in the soft markets were more modest and mixed in their contribution to the portfolio. Sugar showed a strong upward trend that lasted a significant portion of the year. Coffee, after poor harvests in Vietnam and lower inventory than originally expected in Brazil, produced a strong run-up in the fall. Cocoa experienced a wild ride of price swings throughout the year, and this dampened performance.

**VUCA - Volatility, Uncertainty, Complexity and Ambiguity**

**Volatility** - because change today is not gradual and predictable, but discontinuous and surprising. The unpredictable surprises that create trends are the driver of our strategy. We are focused on market divergences. Surprises in fundamentals cause markets to immediately react, but the continuation of surprises cause prices to adjust systematically and can allow for trend-following to be effective from both the long and short side of the market.

**Uncertainty** - because even as we cope with information overload, we cannot be sure we have interpreted correctly, nor do we have the luxury of time. The information gained through economic announcements is often conflicting and confusing, so the best policy may be to follow the market action embedded in price; in other words, the price trend. An uncertain environment needs disciplined and systematic decision-making.

**Complexity** - because every event and every variable are embedded in a web of interconnecting factors. Who can say what the relationship between an employment announcement and bond prices will be? Who can say what the reaction of the market will be to a change in geopolitical risk? Consequently, it may be more effective to follow price reactions than attempting to discern what the specific information or events are telling us.

Relationships between price and fundamentals will change, so following just price may be more effective.

**Ambiguity** - because change often brings paradox as in the phrase “think globally, act locally” Ambiguity represents the “fog” of market behavior. There is a lack of clarity of how markets interpret information or what the behavioral response will be to changing market conditions. You cannot often trust the status quo of market behavior; hence there is a need to be disciplined and systematic in your response to market events. Disciplined stop-loss management can help eliminate the ambiguity of the downside.

**Beginning the Year with the Best Non-Investment Investment Books of 2004**

We believe there are strong reasons to be a trend-follower, but conventional thinkers in “efficient markets” finance are often the most difficult to sway. As stated by Keynes, “Practical men, who believe themselves to be quite exempt from any intellectual influence, are usually the slaves of some defunct economist.” Looking beyond standard finance can provide a richness of information and alternative frameworks that can help to make anyone a better investor.

An investment philosophy is not always about the numbers; we can be fooled into believing in an investment style due to short-term performance. Philosophy has to be driven by principles and by simple stories that can make sense in a wide variety of framework situations. Two thought-provoking books that have made me a better market observer are: *The Wisdom of Crowds: Why the Many Are Smarter than the Few and How Collective Wisdom Shapes Business, Economies, Societies, and Nations* by James Surowiecki and *The Paradox of Choice: Why More Is Less* by Barry Schwartz.

Our streak of individualism is pervasive in the United States, and our desire to be thought of as an investment
manager who can see the market differently from the entire crowd may be even stronger. However, there is value in following what others do, especially when chasing the money flows that drive price. The idea of following the crowd has been beaten out of many managers through repeated folklore in many mob psychology stories, and markets bubbles like, tulipmania. In The Wisdom of Crowds, the author turns many of the arguments against following the crowd on their head and suggests there is value with following group behavior. Expertise may be overrated, and there is value when you take the average of many diverse views. If the market is just an aggregation of all market views, looking to the behavior of prices may serve as the best proxy of where the future market will be heading. Markets have all of the criteria that are needed to have effective group decisions. The participants are independent, decentralized and diverse. Given those conditions, you can get a good estimate of price, and that is better than using your own judgment. This belief in following the crowd is related to our focus on signal extracting through our trend-following models.

We are often asked, “Why don’t you use more information that is available in the market?” The Paradox of Choice addresses some of the reasons for our rationale for simplification. Research has found that, when given more choice, people often have a harder time making decisions and are no happier than if their alternatives were limited. Instead of being a “maximizer” who is always trying to find the best forecast or the best answer to the direction of price, there may be significant value in being a “satisfier”, someone who chooses an answer that is good enough. Using price data to find trends may make us effective satisfiers, especially in a volatile complex world. Could there be a better answer than always following the trend? Perhaps, but the objective is not to find the best answer all of the time because the process may be too difficult. The answer may be to find a style that is effective in many market circumstances that will stand the test of time, and is durable enough to be effective across a wide variety of markets.

I recommend these two works, not because they will provide secrets for making money, but because they will broaden your sense of what is possible. There is value in following the behavior of others. Marching to a different beat can be rewarding, but it can also be extremely risky when you do not have control of the environment. It's equally important to simplify processes. Too many alternatives will actually make it more difficult to take any action, and inaction can be a costly decision.

In 2005, we will continue to follow the crowd as expressed in price trends, and we will focus on what is most important, the risk in price movement. We will seek to filter out the noise, market rumor, and fundamental announcements and apply our disciplined systematic approach as we have for nearly 25 years.

Mark S. Rzepczynski, Ph.D.
President and Chief Investment Officer

Past performance is not necessarily indicative of future results.

1The bold descriptions of VUCA have been taken from Be, Know, Do: Leadership the Army Way: Adapted From the Official Army Leadership Manual; Leader to Leader Institute 2004.

2The classic book by Charles Mackay, Memoirs of Extraordinary Popular Delusions and the Madness of Crowds, provides the basis for many of the speculative stories concerning crowds; and financial mob behavior yet Peter Garber provides an interesting refutation of many the arguments for manias in Famous First Bubbles: The Fundamentals of Early Manias.

3There is a strong history for following a strategy of being a satisfier. Nobel Prize winner Herbert Simon developed the concept of bounded rationality to address the issue of making decisions in a complex world. We may not need to be utility maximizers who try and measure all of the alternatives and probabilities. In fact, it may be too difficult to solve the maximization problem and understand all of the alternatives. It may be better for us to simplify the problem solving processes. This is part of our reasoning behind describing our strategy as fast and frugal decision-making.