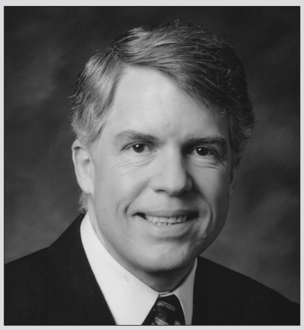
REPRINTED FROM SEPTEMBER 19, 2011

THE WALL STREET TRANSCRIPT
Connecting Market Leaders with Investors

Lowering Volatility Through Managed Futures



ALAN SNYDER is the Founder and Managing Partner of Shinnecock Partners L.P. — the general partner of its investment limited partnerships — and Managing Director of Shinnecock Group. Mr. Snyder was the Founder, CEO, President and Chairman of the board of Answer Financial Inc. and the Insurance Answer Center, LLC; CEO of Aurora National Life Insurance; President and COO of First Executive Corporation; and Executive Vice President and Member of the board of directors at Dean Witter Financial Services Group Inc., a predecessor firm to Morgan Stanley. Mr. Snyder is a graduate of Georgetown University and Harvard Business School, where he was a Baker Scholar.

SECTOR — GENERAL INVESTING

TWST: Please give us a history of Shinnecock and tell us why you started the company.

Mr. Snyder: I started Shinnecock Partners after a 14-year career at Dean Witter Financial Services, which later merged with Morgan Stanley. At the time, I had been one of a dozen EVPs. My job there was managing many of the product areas, marketing, and the weird and wonderful, including working with the Discover Card startup team.

The impetus to start Shinnecock came from the realization that most investment managers seemed too casual about risk and were frequently only fee focused. It became obvious that this shoemaker had to make his own shoes. Not having enough dollars of my own, several friends were invited to join. The goal was to create a mult-strategy fund of funds that could be an investment for all seasons.

This first fund included a healthy allocation to managed futures. The belief in futures stemmed from having been brainwashed when young and impressionable while getting an MBA at Harvard Business School. Harvard was one of the earliest converts to the belief that futures can lower volatility and enhance returns in a diversified investment portfolio. After years of seeing these effects actually work in our fund, we decided 18 years ago to establish a managed futures fund of funds as a standalone effort.

In January of this year, we came out of our marketing exile. We recognized that more assets should mean even more attractive returns — selfish no doubt, but with real skin in the game, as significant investors in our own funds, highly motivating. That's the history.

TWST: What are the two funds you have at this time?

Mr. Snyder: We have our original multistrategy fund of funds and several variations of our futures fund of funds. The original multistrategy fund is internally nicknamed "the turtle fund," because its objective is to grind out a return through thick and thin times. The futures fund has modestly more aggressive objectives, yet it too seeks to minimize volatility. There are two variations on the base futures fund: one pays a commission to sellers, the other is an insurance fund for privately placed variable annuities or variable universal life.

TWST: As a fund of funds, this means that you hire managers who do the individual position selections, right?

Mr. Snyder: Yes, but let's back up for a moment. There are three hurdles that any investor looking at us or any other fund is going to have to clear. First, does the fund have material investor safeguards? Second, do they have a scalable and credible organization? And third, do they have a time-tested investment process? We would argue that, if the answer to all of those questions is yes, the fund has gone a long way toward delivering a durable long-term investment record for an investor.

Our investment process involves three steps. First, we try to identify the best managers and firms in which to make our investment on behalf of our investors. And your question is right, our submanagers make their investments based on the monies they have, including what we have invested with them. Second, we craft a portfolio of these different manager allocations. Lastly, we must manage this portfolio through time. As some managers do well, we must be careful about overweighting and vice versa. Clearly some managers may require replacing if either they falter or a superior manager emerges.

TWST: Do you have any overarching principles in your investment management?

Mr. Snyder: For sure. We have 10. One, protect capital. Two, be flexible. Three, seek steady gains to compound returns and facilitate entry and exit timing. Four, generate returns over time and varying events. Five, employ super diversification. Six, be wary of highly leveraged strategies. Seven, run from guaranteed hedges. Eight, understand that mean reversion is normative but balance risk against secular shifts. Nine, market mispricings, imperfections and opportunistic anomalies disappear over time. Tactical strategies may be transitory. Ten, don't short change the due diligence process.

Highlights

Alan Snyder discusses the investment strategy at Shinnecock Partners, and he lays out some of the firm's guiding principles. The firm invests in managed futures, and Mr. Snyder says they lower volatility in a diversified investment portfolio, while providing a higher degree of liquidity. Mr. Snyder says the firm believes in superdiversification, and the firm diversifies by strategy, by managers and by average trade duration.

TWST: How does superdiversification work with managed futures and in your approach?

Mr. Snyder: We believe in superdiversification. In the futures portfolio, that means looking at diversification by manager — the human risk — asset class and strategy. Further, we look at average trade duration, sector, the trading instrument and individual position — the degree of concentration that a submanager may have. There's still more. Liquidity and then the big one: correlation between different managers, indices and strategies. That's a mouthful, but that's what we look to for balance.

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For example, by asset class, our submanagers trade in approximately 95 liquid futures markets. They span the gamut from different agricultural products, precious metals and others — tangible commodities — all the way through currencies and financial futures. In our case, and being the risk-averse chickens that we are, we want to be sure that we're balanced between tangible commodities — which makes us a little bit unusual — currencies and financial futures. Typically, the very biggest single-manager funds that are in the multibillions have a tendency to become concentrated in financial futures.

Another example differentiating us would be diversification by strategy, with a balance between trend followers versus fundamental managers. For fundamental managers, think of macro- and micro-economic research — e.g., to decide there's going to be grain shortages or corn shortages because of ethanol, etc. — instead of only technical or quantitative analysis of price movements. Under the fundamental rubric, we would divide that further between discretionary managers, using human judgment, versus systematic, using algorithmic trading based on macro- or micro-economic factors.

Then the third strategy is, for want of a more technical term, "all other," which would include pattern recognition, countertrend, momentum, etc.

A fourth differentiating category is average trade duration. Regulated futures contracts are taxed 60% long term, 40% short term, regardless of holding period, for taxable investors. This tax structure opens up a deliciously additional way of diversifying, which is by the average holding period or trade duration of a particular manager. This means that there may be managers that hold a position for a period of time from as short as seconds up to two days, from two days to three months, and from three months to a year, then longer than a year and as long as three years. Such bucketing is no doubt obvious given that there are short-term, intermediate-term and long-term disruptions. Of course, such patterns are available in other asset classes. However, they do not have the favorable tax structure. For equities, holding periods of less than a year would result in short-term capital gains, generally taxed at ordinary rates.

TWST: Is managed futures still a good place to be, considering the volatility, the E.U. situation and the U.S. tax situation?

Mr. Snyder: Statistics, I believe, provide a resounding yes over long time periods as well as relatively short. Over the last 20 years — from July 31, 1991, to July 31, 2011 — the CISDM index of managed futures managers was 40% less volatile than the S&P 500, and interestingly enough, 39% less volatile than passive futures as measured by the DJ-UBS index. Over the last five years, managed futures were 51% less volatile than the S&P 500 and 57% less volatile than passive futures, and had a maximum drawdown from peak to valley of 5% versus a hair-raising 52% for the S&P 500 and almost 55% for passive futures.

Over the last 20 years, managed futures has had very low correlation to the S&P 500, approximately 0.03; and over the last five years, 0.01. One might conclude that, for practical consideration over those time periods, there was no meaningful correlation. Therefore, managed futures are real diversification.

Returns may whet your whistle more. Over the last 20 years, the compound annual growth rate of managed futures has been 44% higher than the S&P 500 and 251% higher than the passive futures index. Over the last five years, it's even more dramatic. It's 4,000% better than the S&P 500, 10% versus 0.2% and a negative 2.4% for passive.

Is past prologue? Nobody knows for sure, but it's not just the absolute rate of returns that counts. It's the pattern of returns, which modern portfolio theory highlights. We have found that over any reasonably long time period adding managed futures to a diversified portfolio does lower the risk and increase the return.

TWST: What are the most important factors that you're looking out for right now and how does the futures market look?

Mr. Snyder: Well, we don't believe in making directional bets. People more famous than I have said the markets will go up and down. We agree with that. We would say that over a future period of time, managed futures will continue to bring very useful diversification to any portfolio, and an investor should have an allocation to this category. Depending on the expert, the total portfolio and the investor's objective, a range of 10% up to a high of 25% is worth considering.

TWST: How do you invest in the futures without losing your shirt?

Mr. Snyder: We would suggest a diversified portfolio across all those different categories described earlier. We passionately believe that a fund of funds vehicle for most people, including most institutional investors, is the best way to go. The reason for this is fascinating. What's the volatility between the best futures manager in a given year and the worst? For the last nine years, the range of performance between the best manager in a year and the worst is 350%. A particular manager could be down as much as 50% in a year, and in that year the most aggressive manager might be up 300%. Of course, these are unfiltered results. Being selective helps, but most investors don't feel comfortable with high volatility, particularly on the downside. By creating a portfolio of managers that interlace, compelling results can be garnered. Picking highs and lows to invest has not been a long-term successful strategy. High volatility, even with high returns, creates enormous entrance and exit risks. In short, lowering volatility with attractive returns means investor peace of mind.

One other thing that's not intrinsically obvious about managed futures may be very timely to your question. The markets in general have been really terrifyingly volatile since 2008, including July and August of this year. Generally, managed futures have acted like a giant shock absorber to a portfolio. Looking back during periods of severe stock market declines, when we're ready to jump out the window, managed futures have performed: the May flash crash of 2010, the last decade for stocks from January 2000 through 2010, the housing bubble crisis in 2007 to 2009, the tech bubble of September 2000 and September 2002, and so on. With no guarantees that past is prologue, managed futures have been historically a very attractive component to include in a diversified portfolio.

TWST: What's the best advice you would give to investors right now?

Mr. Snyder: Given our risk aversion, we would suggest having a well-crafted portfolio widely diversified, including a reasonable allocation to an experienced managed futures practitioner. Make sure that our careful investor chooses a practitioner with material investor safeguards, a scalable and credible organization, and a time-tested investment process — and with no prejudice, a fund-of-funds structure.

TWST: What are some of the things that make managed futures particularly attractive?

Mr. Snyder: One of the things that I think adds spice to the broth and makes managed futures especially attractive is that it is a liquid market. In the crunch of 2008, there were a number of hedge funds which were not particularly liquid. That means if an investor wanted to get his money out, these funds wouldn't give it back because liquidity had dried up. With the regulated futures markets, you have an exchange as the counterparty with liquidity. While the prices may not always warm the heart of our investor depending on what position taken, the futures markets are liquid. Thus, if there is a change of heart or an emergency need, our investor can generally get their money back.

Lastly, there is another thing that's unusual about this category. The Commodity Futures Trading Commission and their self-regulatory arm, the National Futures Association, are serious regulators. They periodically examine all registered managed futures managers. That's different than a typical hedge fund. Most hedge funds, unless they are an investment advisor, don't have this additional safety value.

TWST: Do you like what you do?

Mr. Snyder: I love it. It's like a giant puzzle factory. It's hard, but where else can you find a business that drives you to connect all the macroeconomic dots and makes you think about what's happening everywhere and the ramifications of any actions? The classic example from chaos theory is, if a butterfly flaps its wings somewhere, it will have an impact somewhere else in the world. In our case, it's a multilayered onion in that we are trying to manage against all of those criteria that we laid out earlier on almost a second derivative level, i.e., our fund level. The onion must be peeled layer by layer. Pick the best managers in the context of a cohesive portfolio, then adjust as required going forward through time.

An individual might say, "I can do anything you can do." Fair enough, but holy smokes, there's a lot of work here. One example highlights the work. Every month, we verify each sub-manager's assets under management, AUM, with data sourced independently of the money manager. We separate the change in AUM between that due to performance and that due to investor additions and withdrawals. If a manager is undergoing super growth, can the organization handle that high growth? They have to hire traders, make more trade reconciliations and have enough idea generation to support all of those new assets that are pouring in. The flip side of the coin is if the assets are declining sharply, are they organizationally reaching a breakeven point or worse or, are people leaving and there is a brain drain? That's one risk. Another risk might be if they are divesting the most liquid and high-quality positions, is the portfolio as balanced as their strategy calls for and/or is what's left toxic waste?

TWST: You recently received an honor from *World Finance* magazine. Please tell us about that.

Mr. Snyder: *World Finance* magazine in London sent out a questionnaire to their 40,000 readers asking which hedge funds and other fund vehicles were noteworthy. Then, they tabulated the information for a panel of experts to evaluate. A few weeks later, they called us and said they had awarded us the "Best Managed Futures CTA Fund" in North America for 2011. It is really an honor for us, especially since we aren't exactly well known — that is until this article appears.

TWST: Thank you. (LMR)

ALAN SNYDER
Founder & Managing Partner
Shinnecock Partners L.P.
10990 Wilshire Blvd.
Suite 1150
Los Angeles, CA 90024
(424) 248-1800
(424) 248-1829 — FAX
www.shinnecock.com
e-mail: info@shinnecock.com

© 2011 The Wall Street Transcript, 48 West 37th Street, NYC 10018
Tel: (212) 952-7400 • Fax: (212) 668-9842 • Website: www.twst.com