When RCM originally was devising the Mosiac fund they researched many models over a range of indicators and time scales. They then broke this universe into non-trend and more trend-like models in an effort to create a fund that would be relatively independent of trend models and thus be complimentary (and marketable). That was the genesis of the Mosaic fund, which makes up the bulk of the fund’s assets today. Up until 2006 the Alpha system was more of a traditional trend-following system. It wasn’t until August of 2006 that RCM adopted the current set of models that drive the strategy today. Given that the firm had research on several models that had moderate correlations for trend following as a part of the development of the Mosiac program, these models subsequently became the basis for the Alpha fund. Many of the same concepts are used across the funds but given the higher correlation of the Alpha funds models to trend-following, there is no direct overlap between models in Mosaic and models in Alpha. Other than some tweaks made in 2009 where RCM “refined the protocol”, the strategy has largely been unchanged for many years.

Models

The seven primary models that make up the Alpha fund today are really different variations of the same trend reversion model. In its most basic sense, the trend reversion model is designed to look for corrections in trends and to put on a position in anticipation of a resumption of the original trend. In researching the strategy RCM had many variations of this model, most of which were relatively highly correlated to each other and thus had less benefit to including in the same program. The seven models identified today are the result of filtering through the various iterations and removing idiosyncratic issues.

Trend reversion is unique in that it will not participate in a gradual trending market the way a trend-following model would, nor does it put on a position in anticipation of the exhaustion of a trend the way a counter-trend strategy would. It will participate in a portion of a trend should a trend break down as long as the patterns of that breakdown signal that it will ultimately resume. As a result, the trend revision strategy participates only in a portion of a trend and will have only modest correlation over time. The strategy is expected to have a .5 correlation to trend-following (TF measured by monthly Barclays or NewEdge CTA performance) over the long term but may be have low as 0 or as high as .8 correlation to trend-following in the short and intermediate term (less than two years). The holding period “sweet spot” for the strategy tends to be in the 3-40 day period, which again has the effect of lowering the correlations to trend-followers.

Trade Allocation

To enter a trade, the models will look for deviations of a trend, and based on their proprietary signals, enter into a trade when the signals indicate that this trend will ultimately resume. Each model has different signals over different time frames and based on different metrics (shapes of the trend, etc/) that will often lead to scaling into the same trade (with a trade defined as a position in a market). Signals will create an “entry region” whereby a position is taken. Trades will close when ether 1) the position leaves the predetermined region, either as a profitable trade or a loss, or 2) the position doesn’t leave the region over a defined period of time, thus signaling a lack of resumption of the trend. There are no explicit stops based on losses, per se, but rather expectations that will be met, not met or not met in a specific time period. Often models will be adding to positions in the face of losses as opposed to reducing exposure.

Each of the models has a particular weight within the system that was determined from the outset based on the constraints and objectives of the fund. Each day each model may generate a trade signal and each of the signals will be weighted and aggregated. The max aggregate signal that can be created will fall between -1 to +1, creating the maximum strength of a signal. The models are often times offsetting each other and a historically high strength number would be a .3. Position size is then a function of the strength factor times the account aum (or trading level) and divided by the volatility of the market being traded. The maximum margin to equity constraint set at the portfolio level is 25% and the average margin to equity is around 8%. All models apply the same to all markets, although some models have historically performed better in some markets vs others. The full listing of the 35 markets is listed in the markets section later in the report.

Trade Execution

Need to discuss

Research:

Revolution continually works on improving models and adding time scales. They are currently in the process of rolling out intra-day trading models. These models are being tested in the Mosaic program currently and are expected to be active in the Alpha program starting June/July 2012. The intra-day models are meant to address the following issues: mitigate negative skew, provide additional protection on the downside (when markets are trending down), improve year-over-year consistency.

Manager’s Edge

Markets:

Agriculturals

Soybeans, Wheat, Soybean, Oil, Coffee, Cotton, Sugar, Live Cattle, Feeder Cattle, Lean Hogs

Energies

Crude Oil, Heating Oil, RBOB Gas

Stock Indices

S&P, CAC, DAX, FTSE, Nikkei, Hang Seng, SFE SPI 200

Non-US Interest Rates

SFE 3-Year Bond, Long Gilt, BOBL, Bund, Schatz

Currencies

Australian Dollar, British Pound, Canadian Dollar, Swiss Franc, Mexican Peso, Japanese Yen

US Interest Rates

10-Year Notes, 2-Year Notes

Metals

Gold, Copper

The ideal market environment tends to be one of frequently interrupted trends, or said another way, more choppy markets. The fund will not participate in strongly trending markets and is most susceptible to large losses in strongly reversing markets, particularly if the models indicate that the trend was expected to continue. As such, large shocks and market panic, which is often times the best market for trend-followers, are very challenging for the strategy. In an effort to reduce losses, RCM has portfolio level checks, in addition to position sizing level tools (volatility adjusting position sizing), which are designed to mitigate losses. The primary tool is a signal that is generated based on shorter term correlations across markets. The risk tool is binary in that if correlations reach a particular level (considered high but not given) the system will de-lever the portfolio by 55%. Once correlations drop below a level, trading level will resume to the 100% level. The increase in exposure can happen no sooner than three trading days.