

Market Commentary



Year in Review 2008

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INC

2008: A YEAR UNLIKELY TO BE FORGOTTEN

Throughout history there are years that are defined by such monumental events that the mere mention of the year conjures up graphic pictures of its impact on our societal evolution. Scholars will devote lifetimes studying the vast pools of evidentiary matter pertaining to these years so that they can feel comfortable that we are now better prepared to predict what is possible in our future. I suggest that 2008 is such a year; we should accept that we can learn from the missteps that led to this economic disaster, but there will always be events that pervade our thoughts and test our resolve as investors in the markets. This has happened in the past, is happening now, and certainly will happen again in the future.

The year 2008 may be regarded as one of the most calamitous and volatile years in the history of the financial markets. Global equity markets fell more than 50 percent from 2007 peaks amidst a sharp deterioration in economic conditions worldwide. The pathology of the global crisis is complex and not easily traced to a specific date or event. However, 2008 was a year when perception finally met reality. It was a year when the cumulative excesses of the past, fueled by inexpensive and abundant credit, burst so violently that it will likely provoke transformational change in the way society spends, invests and governs itself for years to come. This cataclysmic market environment proved so difficult for many investment managers, even those held above all others and believed to be the ones who had finally discovered how to identify and remove risk from the investment equation, that it will stand as the most relevant and tangible example of the inability of all investors and investment managers to predict the future. This reality has always been at the core of the JWH Investment Philosophy.

While this year was filled with record-breaking negative results in almost every area of the investment universe and many experienced the painful realization that sometimes when things seem too good to be true, they actually are not true, JWH achieved record positive results for its clients. JWH GlobalAnalytics®, JWH Diversified Plus, International Foreign Exchange Program and JWH World Commodity Portfolio all posted record performance numbers in 2008, ranging from +40 to +91 percent.

These returns were achieved utilizing an investment philosophy that has been employed by JWH for over a quarter century through the application of a long-term, disciplined and systematic trend-following approach to investing in the world markets.

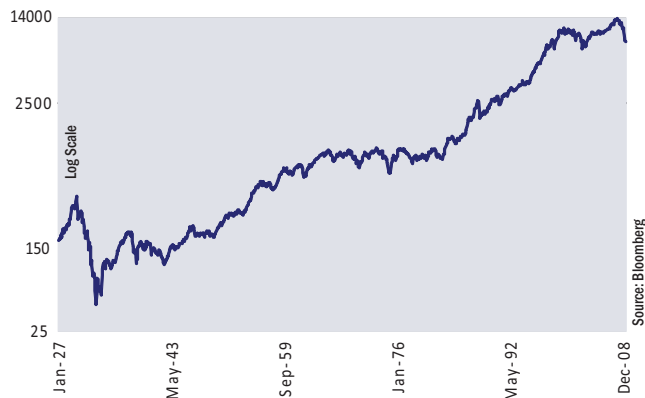
The path of markets is unpredictable

Throughout history, there has always been an industry dedicated to providing traders with investment tools that deliver an “edge” through early information dissemination and advanced market analysis. In the past, these tools have been available to “Investment Managers,” whose training and occupation has been the oversight and stewardship of client investment capital. The maturation of the internet has provided the ultimate advancement in data availability and communication evolution, and these advancements have leveled the investment playing field by bringing these tools to all who dare to enter the world of investment management. The problem is that the availability of a tool does not mean that all who have access to that tool are trained in its safe operation and should therefore take the risk of using it to achieve a set goal. Trading in the markets to achieve a goal of wealth appreciation is no exception. While these tools, delivered to anyone with a computer and internet access, do not appear dangerous they support a notion that investors who have these tools and abundant market information are more than qualified to manage their own portfolios. 2008 has shown that a lack of professional training, dedication and experience in investment and risk management can cause disastrous results. No one can consistently predict the future and no level of increased information flow or ease of electronic trading can provide an investor with the understanding of the underlying risks that can arise in a crisis period. It is the actions taken in a crisis period that define our success, and that is also the time when most investors will not be able to adhere to a sound investment approach, regardless of their good intentions.

At the start of the year, the average forecast for the S&P 500 by the top ten investment banks in the U.S., as quoted by the Wall Street Journal, called for a gain of 13 percent. As it turned out, the S&P 500 had one of the worst years since the Great

Depression, losing more than 35 percent.

Dow Jones Industrial Average (1/31/27 - 12/31/08)



In its August statement, the Federal Reserve Board (the Fed) highlighted the upside risk to inflation. If investors had responded to this guidance in a seemingly logical manner by purchasing the inflation-protected securities of the U.S. government (“TIP’s”), they would have suffered through one of the worst declines in the relatively short history of the inflation-linked market when just two months later the market swiftly began to price in the risk of deflation rather than inflation. 2008 provided many other relevant examples of the continual inability of any person or group to accurately forecast events or predict the future. Even agencies tasked with the oversight and control of a market, and with access to the most accurate and timely information, were unsuccessful. A financial headline dated August 16th, 2008 announced that the Organization of Petroleum Exporting Countries (“OPEC”) was forced to slash its export predictions for the fifth consecutive month. Similarly, the International Energy Agency made seven revisions to its energy outlook in 2008.

Market forecasting is a technique utilized by many investors and organizations well armed with data to support their proclaimed expertise in predicting the future. 2008 clearly identifies that there are significant risks associated with such a belief, and the consequences can be catastrophic when that belief meets with market reality.

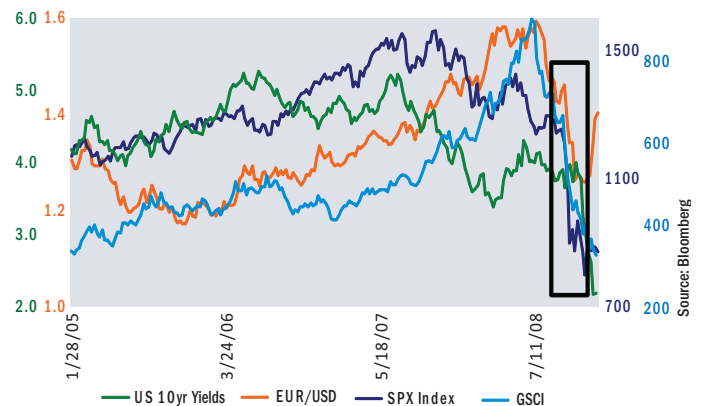
Since the inception of JWH, our Investment Philosophy has been based on the premise that market prices, rather than market fundamentals, are the key aggregator of information necessary to make investment decisions, and that market prices, which may at first appear to be random, actually move through time in complex, but discernible ways. JWH believes that market behav-

ior is based upon the investors’ expectations, which may at times adjust slowly through time to manifest themselves in long-term price trends, and that there is an inherent return opportunity in participating in those price trends identified by JWH’s analytical models.

The value of true diversification

Looking backwards, one can conveniently assemble a basket of assets in a certain proportion that will appear diversified and generate solid risk-adjusted returns. But that process fails to take into account things that will certainly impact the markets that have yet to occur. Unforeseen events and our reactions to those crisis points can have a devastating and long-lasting impact on our investing goals. 2008 reminded us that, during periods of crisis and stress in the financial markets, correlations within and across many market sectors can often approach one rendering a poorly diversified portfolio completely exposed to the heart of the crisis.

EUR/USD, U.S. 10yr Yields, GSCI & SPX Index (1/28/05 - 12/31/08)



The scorecard for 2008 reads as follows: U.S. Large Cap Stocks (S&P 500) down 37 percent, U.S. Small Cap Stocks (Russell 2000) down 34 percent, International Stocks (MSCI EAFE) down 41 percent, Emerging Markets (MSCI-EM) down 49 percent, Commodities (Dow Jones Index) down 37 percent. At the same time, bonds (Barclays/Lehman Aggregate Index) returned just 7 percent during this extraordinary period of risk aversion while the Fed continued lowering rates in historic steps. Even hedge funds that purport to generate returns that are independent of market beta lost an average of 18.8 percent as measured by the Credit Suisse/Tremont Hedge Fund Index in 2008.

JWH believes that true diversification is achieved by constructing a portfolio that is broadly diversified across markets and market sectors and that, when combined, is historically non-correlated to traditional equity and fixed-income portfolios as well as other alternative investments. Composition of the portfolio is only one aspect of the diversification equation; it's ineffective without a strict investment discipline and a non-directional bias where there is a willingness to take short positions in all markets, even those that have shown a tendency in the past to rise over time.

Investing discipline and a long-term perspective

It was John Maynard Keynes, the influential British economist, who first said: "Markets can stay irrational longer than you can stay solvent". JWH believes this to be a profoundly true statement and has found through our trading experience and ongoing research efforts that trends can and often do last longer and go further than most market participants think. Our belief in this simple maxim has served clients well over the years, and it has never been more evident than in 2008. This year holds many examples that illustrate this point, but none as clearly defined as an examination of trading in the crude oil market.

Crude Oil
(1/2/07 - 12/31/08)



The crude oil market entered 2008 trading in the vicinity of \$80 per barrel after increasing over 70 percent in 2007. It would have been a logical question for a trader to ask: "Why should I take more risk in a market that has come so far? How much further can this market go?" The answer turned out to be just short of \$150 per barrel or nearly another 90 percent further by the middle of the summer. Coinciding with the ever rising price of crude oil were all kinds of theories and commentary on why the high price was rational and justified, including the idea that the world had reached "peak oil" and that future amounts of oil

extracted from the earth would only decline while demand for oil would continue to grow as a result of rising standards of living all over the world. Forecasts began to appear from many well-respected market "experts" that we would see crude oil prices crest \$200 per barrel by year's end. Ultimately, the price of crude oil began to fall, and it took a systematic and disciplined approach to trade against conventional wisdom and to stay long with the trend until it expired around the \$150 level and then enter into a short position profiting from the ensuing decline. By year-end, crude oil had fallen more than 70 percent from its summer peak, making 2008's crude oil journey one of the most profitable trades in JWH history.

Defining risk management

The history of the financial markets is littered with examples of price bubbles and irrational investor behavior; but few instances have been more widespread and impactful than was experienced in 2008. In recent years the seemingly unfettered access to credit by anyone who would pain themselves long enough to fill out an application and the creative financing options fueled by lucrative incentives helped to create an environment unimpeded by regulation or prudence that was ripe for bubble formation. The price of many asset classes rose to historic levels, bringing with them a dramatic increase in underlying risks. This year, we have seen a bursting of many bubbles and a realization of the heightened and unanticipated risks in the price of corporate equities, real estate, emerging markets, credit products and commodities.

At the same time that these price appreciation phenomena were occurring, it was assumed that the ability to assess risk was improving as there was certainly more sophisticated ways to quantify it and more capital – financial and intellectual – devoted to monitoring it. One of the important lessons that 2008 taught us is that, no matter how much science and technology advances; there is no substitute for good judgment and ethics. JWH has long been considered among the more volatile members in its peer group, but we believe there is a major distinction to be made between the standard deviation of investment returns and the true risk of losing capital.

Unfortunately, 2008 provided too many examples of investments that had some history or profile of low volatility that ultimately wound up worthless. Investors are learning a very painful lesson

that there is no “free lunch”. Despite volatility that is above the industry mean, JWH investment programs (during their worst periods) have year-over-year performance draw downs that are just a fraction of those of the stock, credit, real estate and commodity markets.

JWH risks a small percentage of capital on each trade with the intention of participating in and profiting from a long-term price trend. We know exactly how much we are willing to risk on each and every trade we execute. If the market moves against our newly established position, we will liquidate that trade at our predetermined risk level, incurring a small loss, but with no emotional ties to that position. We know that every trade will not be profitable, and we also know that we cannot predict which trades will turn into those favorable long-term trends. This fundamental belief is the foundation of our views on risk management and why we adhere to this strict discipline, thereby removing market fundamentals and emotional missteps from our decision-making process.

Another core tenet of investing at JWH is the management of risk through portfolio construction. JWH portfolios are constructed utilizing only the world’s most liquid markets traded on a regulated futures exchange or interbank market. This ensures that we are able to value our portfolios in real-time, and our clients are never subject to questionable pricing of illiquid investments. This also allows us to provide attractive liquidity terms to our investors, ensuring that they have sufficient access to their invested assets and without subjecting them to redemption gates and other impediments to their investment capital. Risk Management is a critical component of the JWH Investment Philosophy, and we strive to reduce our client’s overall investment risk by addressing the many components of risk management. We manage market risk on individual trades by imposing strict stop-loss levels, counterparty risk by trading on regulated exchanges or deep interbank markets, liquidity risk through careful market selection, and overall investment risk by providing investment liquidity and transparency to our investors. Managing risk is not as simple as a single calculation measure.

In conclusion

2008 was a dismal year on many fronts. It was a year of wide spread loss and substantial wealth reduction, a year of continual market turmoil with historic directional shifts in all sectors

of the world’s markets, a year of continual realization that no matter how much we want to believe that we have made all the right decisions as investors and that our assets are being stewarded by those with only our best interests in mind, we are ultimately responsible for our own futures.

We at John W. Henry & Company, Inc. have dedicated ourselves to our clients through a disciplined and systematic approach to investing in the futures and foreign exchange markets for over 25 years. We have done so through a process of education and support of our clients, and our industry, to ensure that all who invest with us understand the benefits and the risks associated with these investments. We have had periods of underperformance, as all investments do, when it has been difficult for some to understand why we stay committed to our core philosophy, and many called for change simply for the sake of change. It is our long-term experience and understanding coupled with the results of our ongoing research efforts that have proven that those are exactly the times that you need to stay focused and not allow emotion to overtake discipline. We have seen the development of an ever-increasing array of complicated financial instruments over these past years and the marketing of those products (with the complication itself being touted as a benefit and proof that the manager is one to be desired). 2008 has shown that it is not the product complication but the experience and discipline of a manager, whether discretionary or systematic, through all periods, including the unforeseen crisis periods that should be an integral component of all investment measures. We have always been transparent in our beliefs and in the application of our investment philosophy. We are grateful to our clients for remaining with us through our difficult periods so that we could provide them the support and financial rewards that we have achieved in their time of need.

We thank you for your continued support and wish you the very best in the uncertain future ahead.

Kenneth S. Webster



President and Chief Operating Officer

Past performance is not indicative of future results.