

POTOMAC PORTFOLIOS LLC

CADC Presentation

November 29, 2011

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Managed Futures

“Changing landscapes in managed futures are offering new directions for portfolio diversification.”

---Thomas Lott, President, Potomac Portfolios LLC

- Macro Landscape
 - Topping Patterns
 - Converging Correlations
 - Recent Trends in Managed Futures
- Asset Allocation
 - New Directions in Portfolio Diversification
 - Beta, Alpha, Various Combinations

All Sectors (2011)

SPX / Bonds / Managed Futures / Hedge Funds
Mixed Market Conditions



CBOE SPX Volatility Index (VIX) (2008-2011)

Weighted Average of Implied Volatilities
Market Volatility - Stocks



Deutsche Bank 3Mo Implied FX Volatility (2007-2011)

Underlying Basket: 9 Major Currency Pairs

Market Volatility - Currencies



Currency Carry Trade (2005-2011)

High Yield: AUD/NOK/NZD Low Yield: JPY/USD/GBP

Currency Trend



Bloomberg Financial Conditions Index (2010-2011)

Money Market/Bond Market/Equity Market vs. Inflation Expectations

Approaching Negative -1.50 Standard Deviations < Pre-Lehman



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Bloomberg Financial Conditions Index (2010-2011)

Money Market/Bond Market/Equity Market vs. Inflation Expectations

Approaching Negative -1.50 Standard Deviations < Pre-Lehman

Figure 1

	---- Weights ----	
	BFCIUS	BFCIUS+
Money Market		
Ted Spread	11.1%	6.7%
Commerical Paper/T-Bill Spread	11.1%	6.7%
Libor-OIS Spread	11.1%	6.7%
	33.3%	20.0%
Bond Market		
Baa Corporate/Treasury Spread	6.7%	4.0%
Muni/Treasury Spread	6.7%	4.0%
Swaps/Treasury Spread	6.7%	4.0%
High Yield/Treasury Spread	6.7%	4.0%
Agency/Treasury Spread	6.7%	4.0%
	33.3%	20.0%
Equity Market		
S&P 500 Share Prices	16.7%	10.0%
VIX Index	16.7%	10.0%
	33.3%	20.0%
Asset Bubbles		
Nasdaq/S&P 500 Ratio		10.0%
S&P Homebuilders/S&P 500 Ratio		10.0%
		20.0%
Equilibrium Yield Gap		
5-Yr. Treasury Yield less Nom. GDP Growth		10.0%
Real Baa Corporate Yield less Average		10.0%
		20.0%
Total	100%	100%

Source: Bloomberg

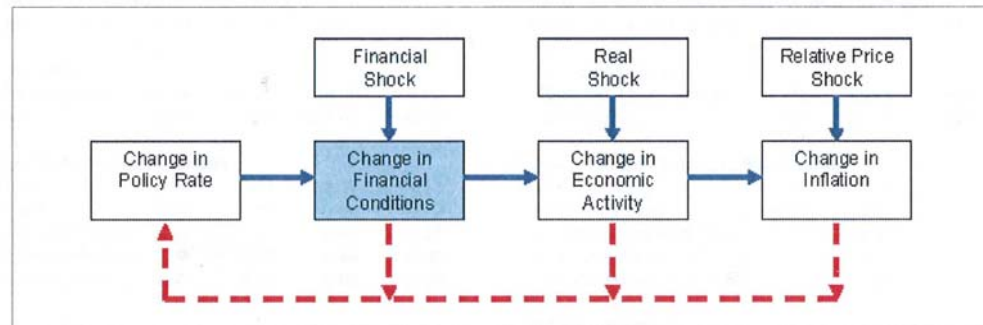
Bloomberg Financial Conditions Index (2010-2011)

Money Market/Bond Market/Equity Market vs. Inflation Expectations
Approaching Negative -1.50 Standard Deviations < Pre-Lehman

MICHAEL R. ROSENBERG

Inside This Issue:

Introducing Bloomberg's Euro-Area Financial Conditions Index

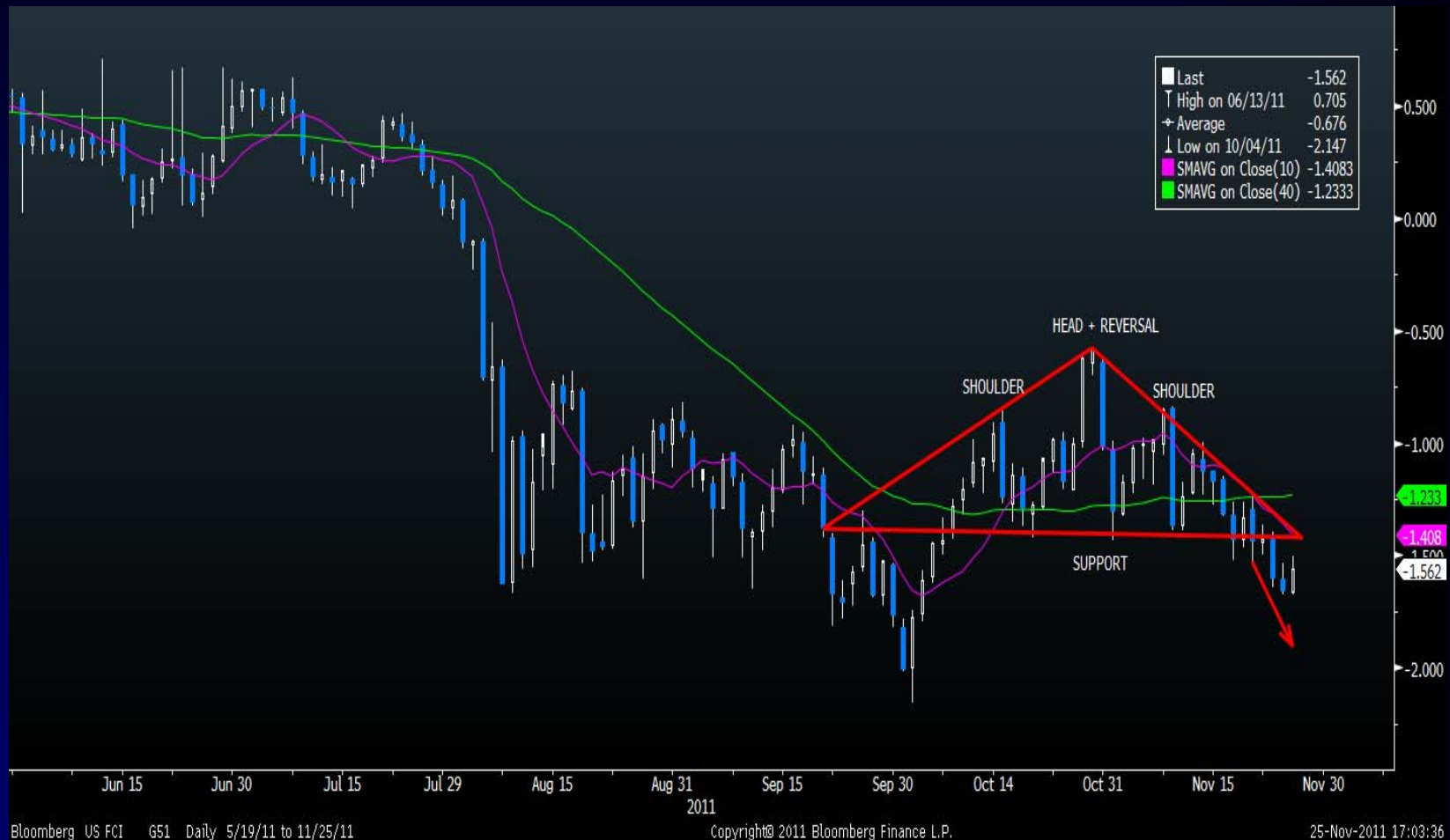


"Monetary policy works in the first instance by affecting **financial conditions**, including the levels of interest rates and asset prices. Changes in **financial conditions** in turn influence a variety of decisions by households and firms, including choices about how much to consume, to produce, and to invest."
Federal Reserve Chairman Ben S. Bernanke, March 2, 2007

Bloomberg Financial Conditions Index (2010-2011)

Money Market/Bond Market/Equity Market vs. Inflation Expectations

Approaching Negative -1.50 Standard Deviations < Pre-Lehman



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Money Market/Bond Market/Equity Market vs. Inflation Expectations

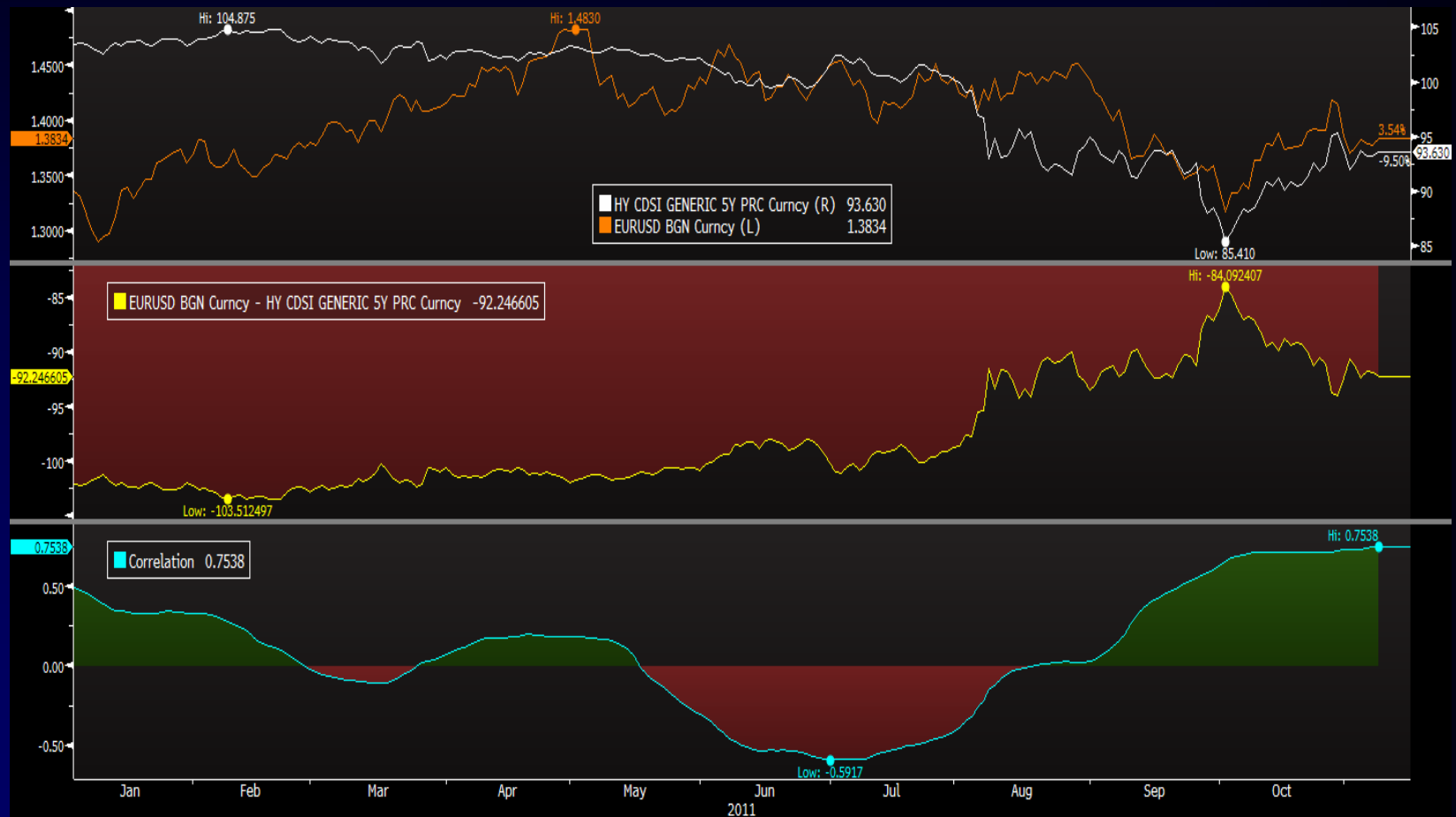
Approaching Negative -1.50 Standard Deviations < Pre-Lehman



EUR/USD vs. US High Yield Debt (2010-2011)

100 US Non-Investment Grade Entities

Rising US/Euro Correlation

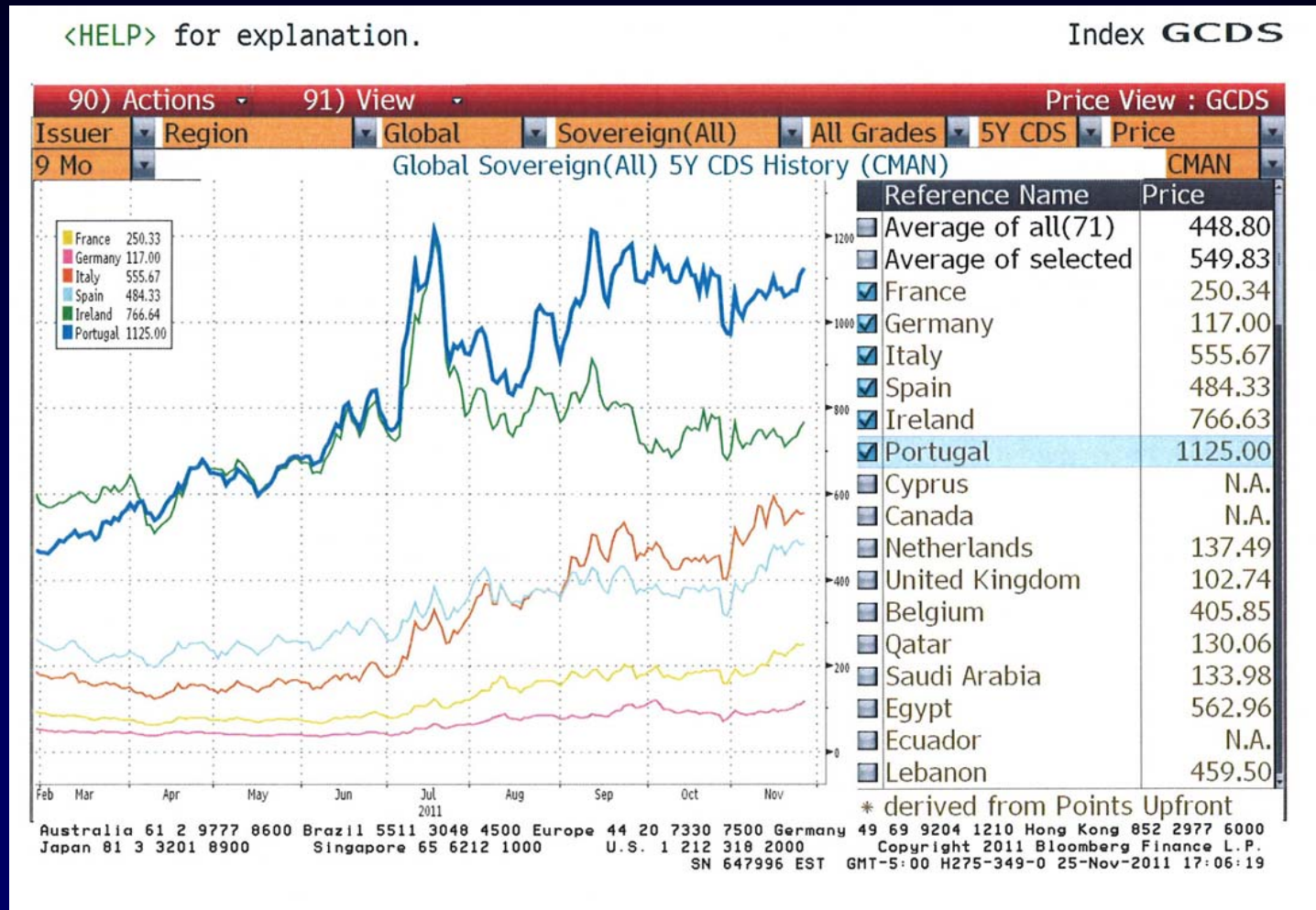


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CDS Pricing- European Countries (2011)

Top-to-Bottom: Portugal / Ireland / Italy / Spain / France / Germany
Correlations Increasing



CDS Pricing- 25 Investment Grade Banks (2011)

Markit iTraxx Europe Senior Financial Index

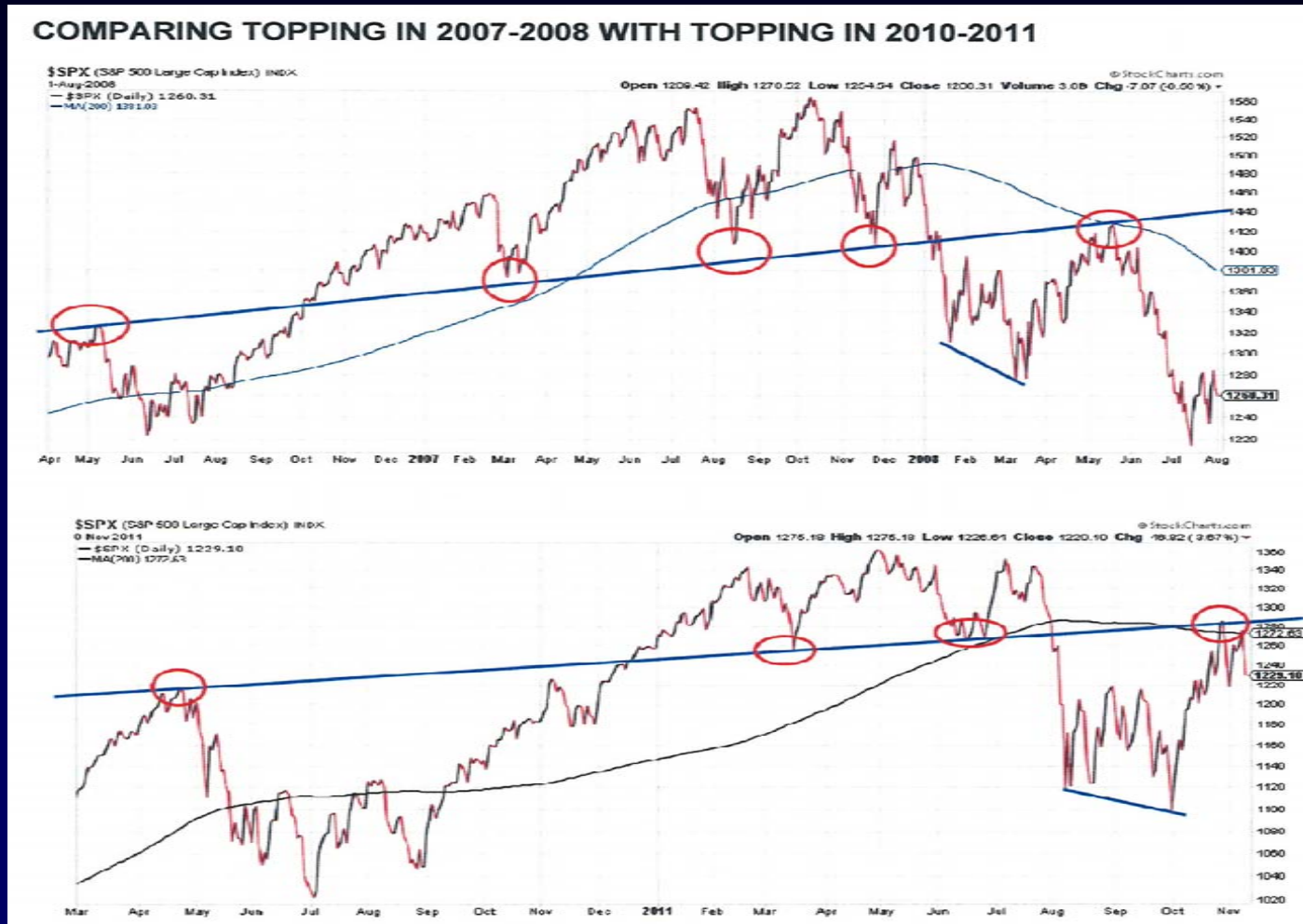
Hitting New Highs



Comparative Topping

SPX in 2007/2008 vs. SPX in 2010/2011

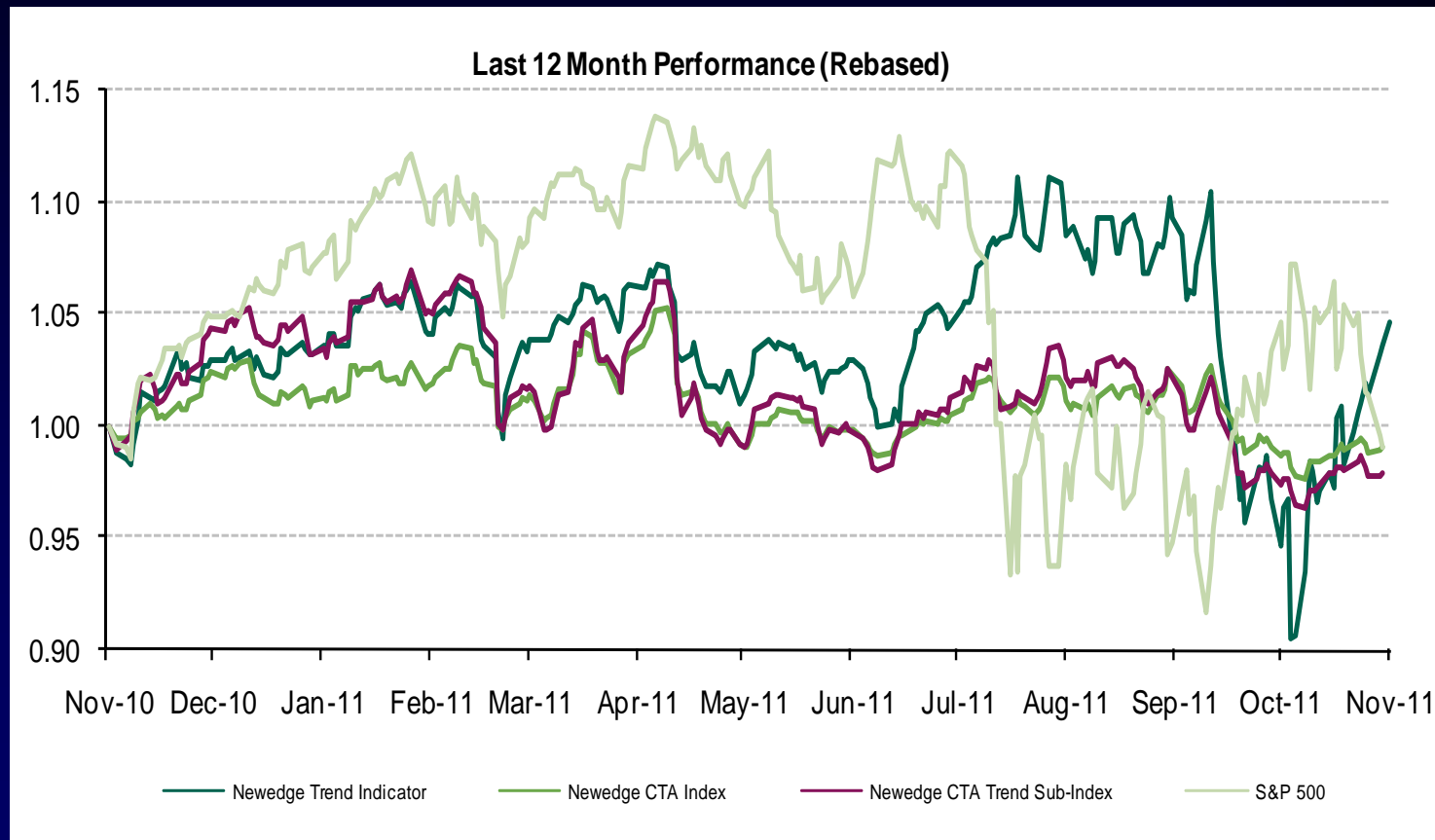
Similar Patterns



Industry Performance (Daily: Trailing 12-Months)

NewEdge Indices vs. SP500

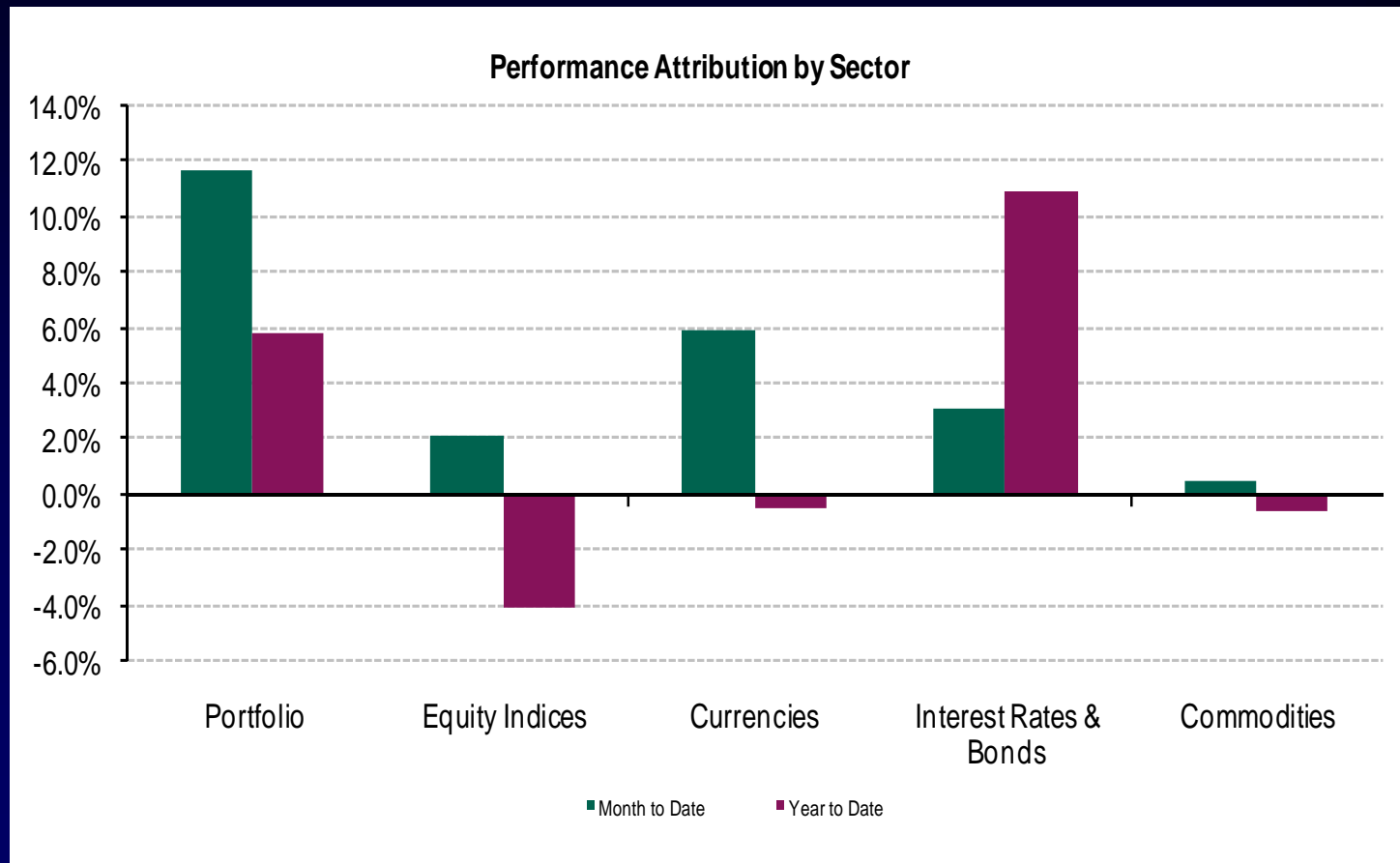
Trends Resume as Equities are Challenged



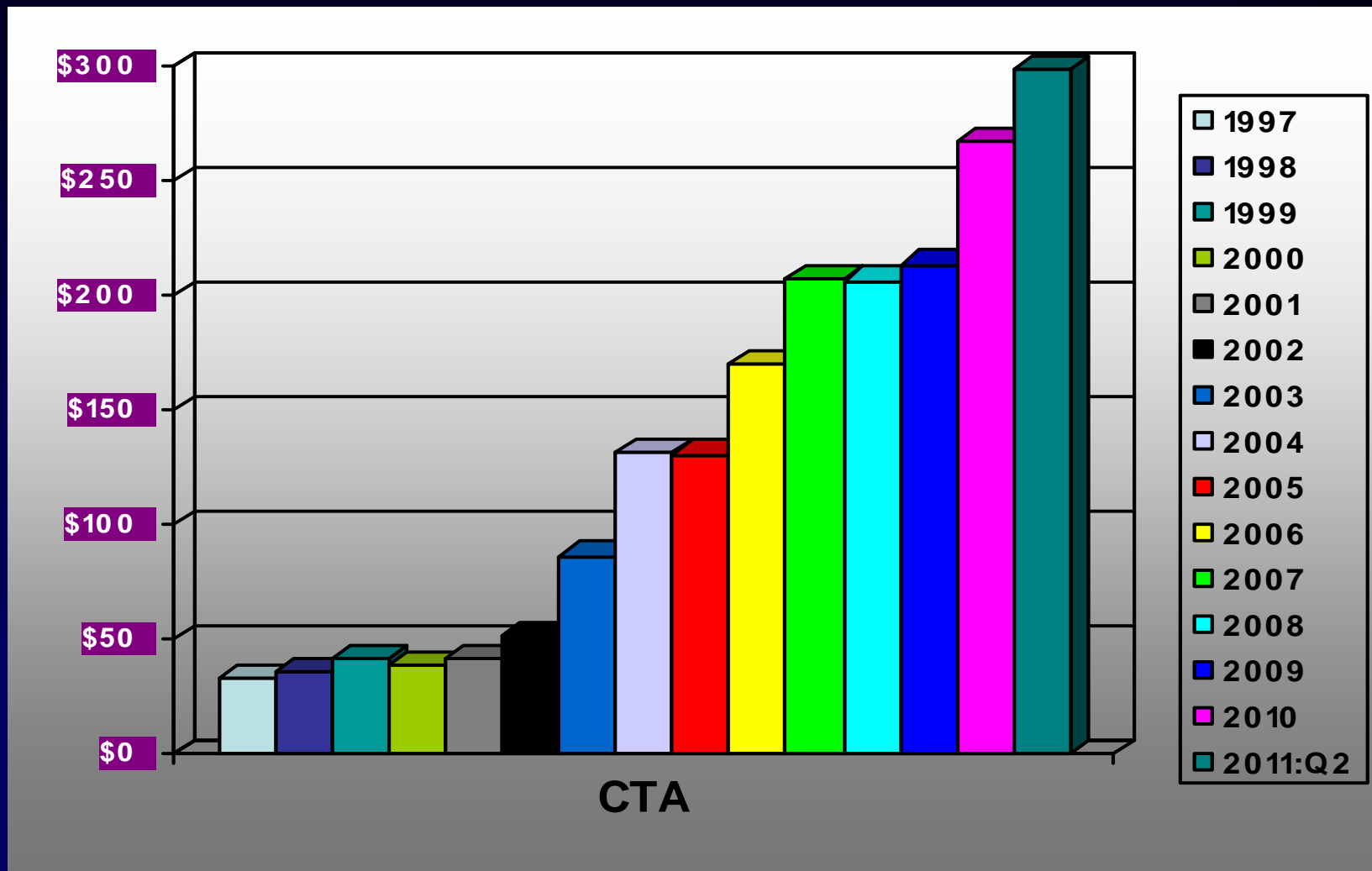
Industry Performance (MTD/YTD 2011)

New Edge Trend Indicator

All Sectors Profitable Month-to-Date



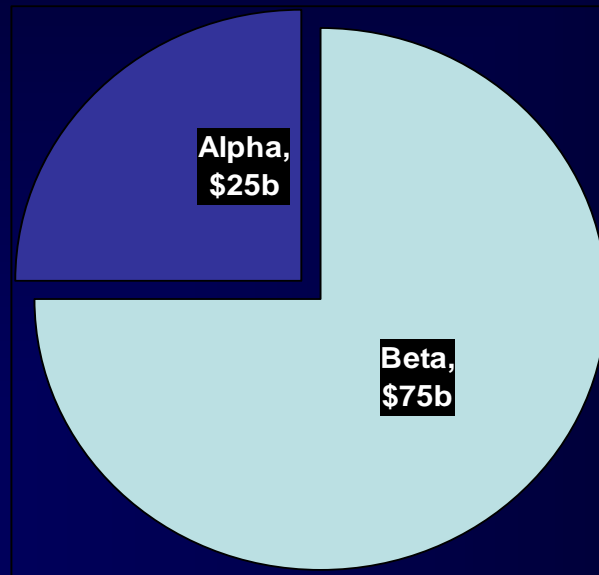
Funds Under Management - CTA Managed Futures (\$ billions)



Market Segmentation: CTA Pre-2000

Alpha vs. Beta Trading Strategies

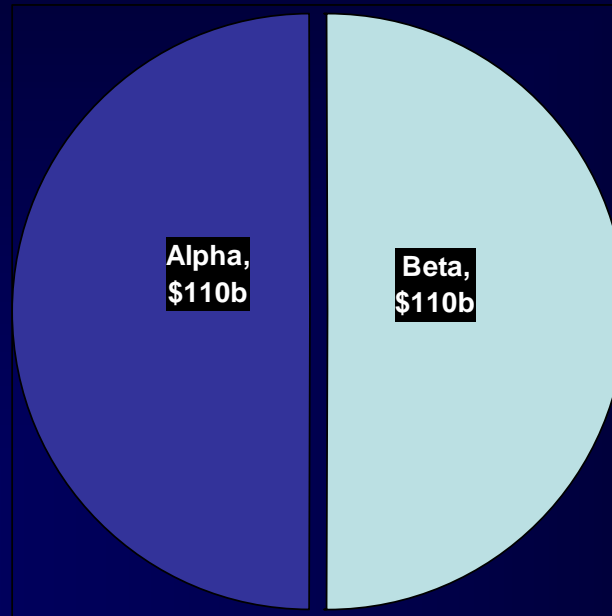
Alpha (25%) vs. Beta (75%)
\$50 - \$100 Billion



Market Segmentation: 2010

Alpha vs. Beta Trading Strategies

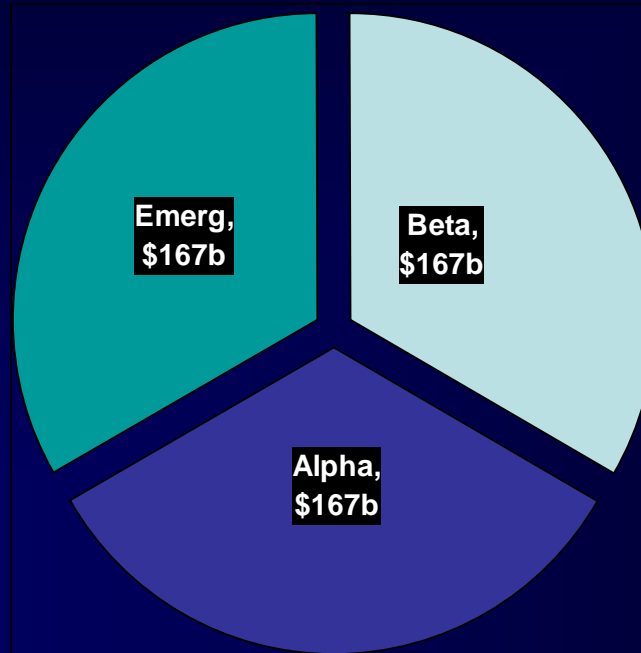
Alpha (50%) vs. Beta (50%)
\$220 Billion



Market Segmentation: 2015-2020

Alpha vs. Beta vs. Emerging Strategies

Alpha (1/3) vs. Beta (1/3)
vs. Emerging (1/3)
\$500 Billion



Portfolio Construction - Beta (Jan 2005 – Dec 2010)

Correlation Matrix (pair wise = 64%)

%	BETA 1	BETA 2	BETA 3	BETA 4	BETA 5	BETA 6	BETA 7	BETA 8	BETA 9	BETA 10
BETA 1	100	59	52	58	52	57	38	49	52	62
BETA 2	59	100	74	77	75	87	65	76	71	78
BETA 3	52	74	100	58	55	80	69	63	69	58
BETA 4	58	77	58	100	72	72	54	69	61	58
BETA 5	52	75	55	72	100	77	55	74	66	59
BETA 6	57	87	80	72	77	100	60	74	69	65
BETA 7	38	65	69	54	55	60	100	57	64	63
BETA 8	49	76	63	69	74	74	57	100	73	67
BETA 9	52	71	69	61	66	69	64	73	100	69
BETA 10	62	78	58	58	59	65	63	67	69	100
AVG	42	74	64	64	65	71	58	67	66	64

Beta portfolios can be volatile (Jan 2005 - Dec 2010)

Aggregating trend following strategies



Alpha correlations are low (Jan 2005 - Dec 2010)

Correlation Matrix (pair wise = 10%)

%	ALFA 1	ALFA 2	ALFA 3	ALFA 4	ALFA 5	ALFA 6	ALFA 7	ALFA 8	ALFA 9	ALFA 10
ALFA 1	100	(1)	16	(27)	(11)	(11)	(9)	11	16	34
ALFA 2	16	100	9	(4)	30	27	7	8	-	(26)
ALFA 3	(27)	9	100	(11)	14	2	8	(10)	(4)	7
ALFA 4	(11)	(4)	(11)	100	20	36	11	56	4	(23)
ALFA 5	(11)	30	14	20	100	48	48	36	58	11
ALFA 6	(9)	27	2	36	48	100	21	6	25	9
ALFA 7	11	7	8	11	48	21	100	28	30	4
ALFA 8	16	8	(10)	56	36	6	28	100	55	(5)
ALFA 9	34	-	(4)	4	58	25	30	55	100	2
ALFA 10	(2)	(26)	7	(23)	11	9	4	(5)	2	100
AVG	2	5	5	25	-2	18	-10	-8	3	-7

Alpha portfolios can be less volatile (Jan 2005 - Dec 2010)

Aggregating Alpha Strategies



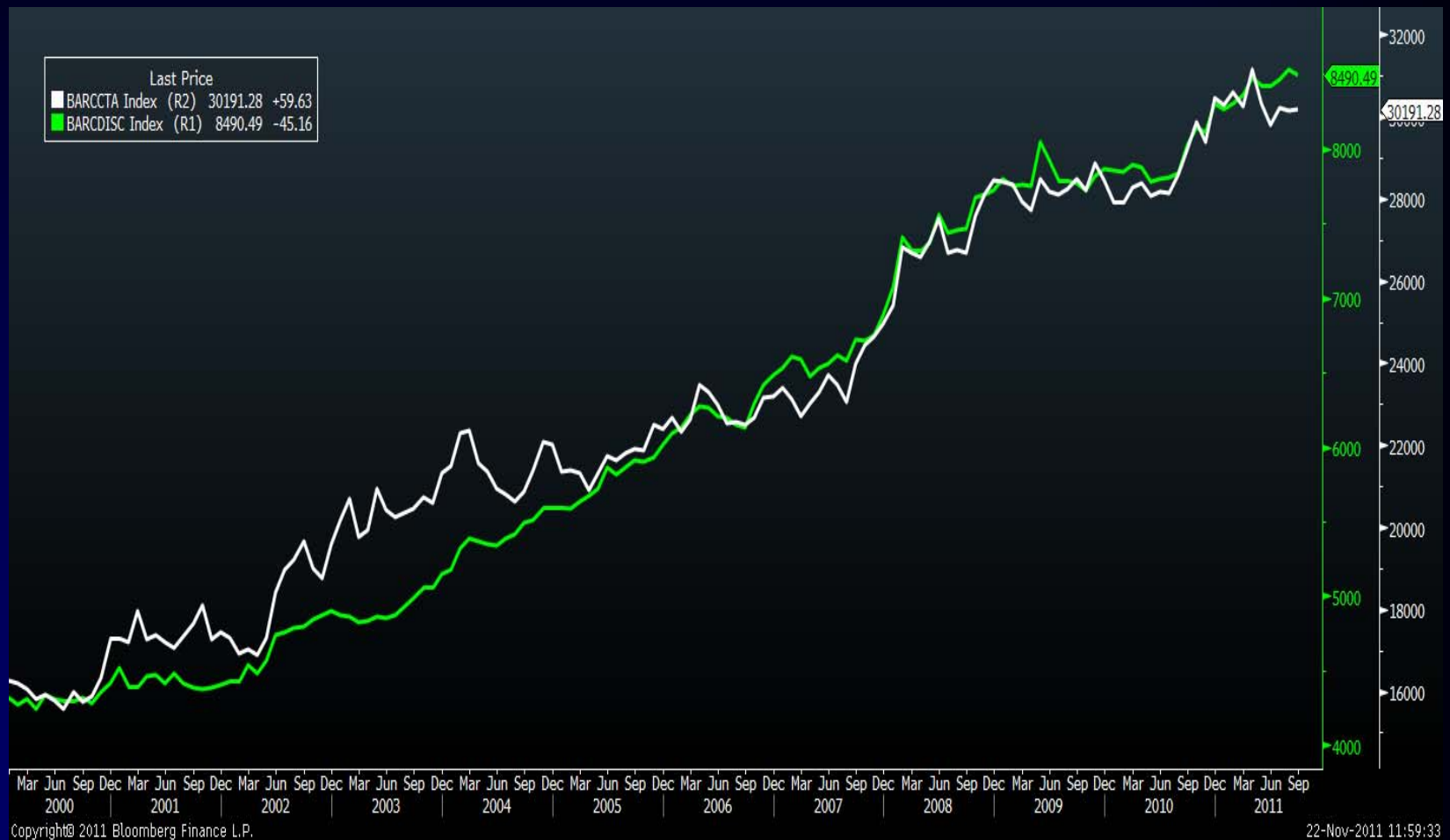
Alpha portfolios can be less volatile (Jan 2005 - Dec 2010)

Aggregating Alpha Strategies



Alpha portfolios can be less volatile (Jan 2000 - Sep 2011)

Barclay Indices: CTA vs. Discretionary Only



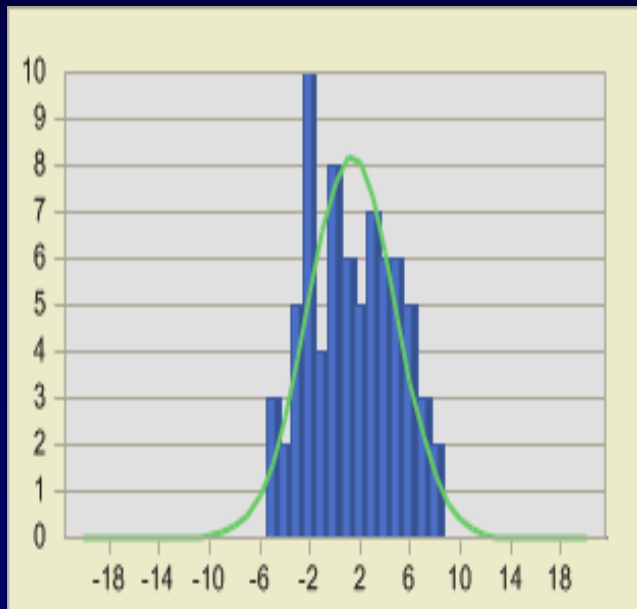
Portfolio Construction - Analytics

Monthly Distribution of Portfolio Returns

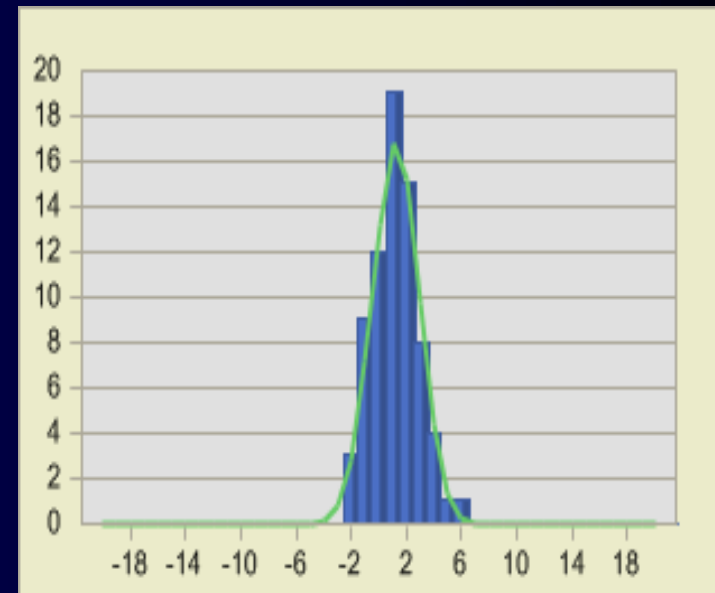
Without Cash Efficiency

Jan 2005 - Dec 2010

Beta: Trend Following

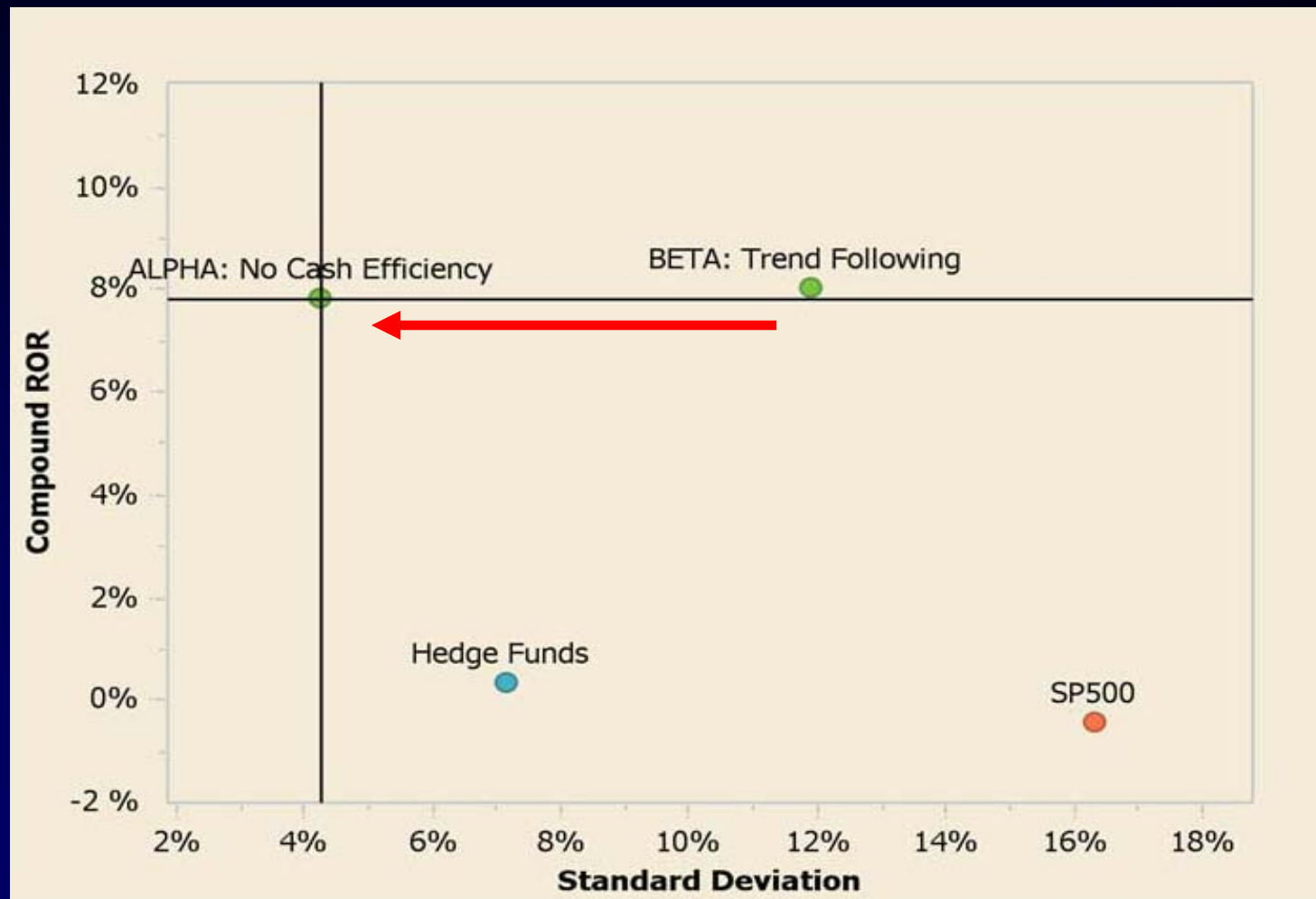


Alpha: Potomac's Approach



Implications for Portfolio Construction

Alpha vs. Beta vs. Benchmarks (Jan 2005 - Dec 2010)



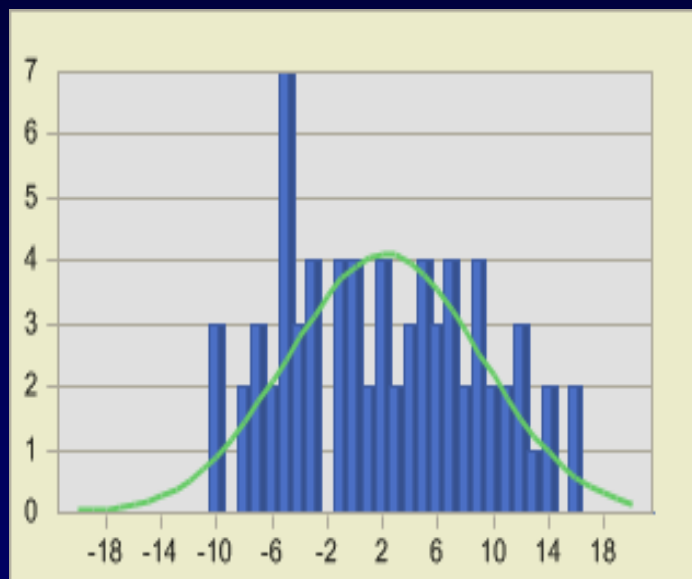
Portfolio Construction - Analytics

Monthly Distribution of Portfolio Returns

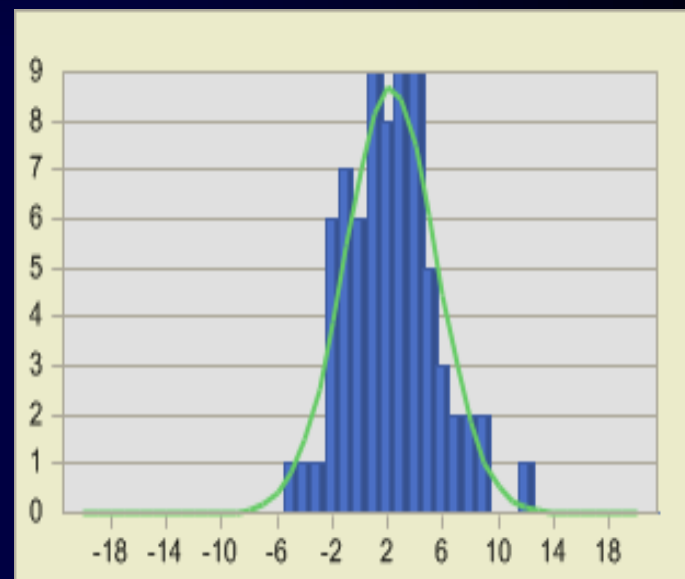
Adding Cash Efficiency

Jan 2005 - Dec 2010

Beta: Trend Following

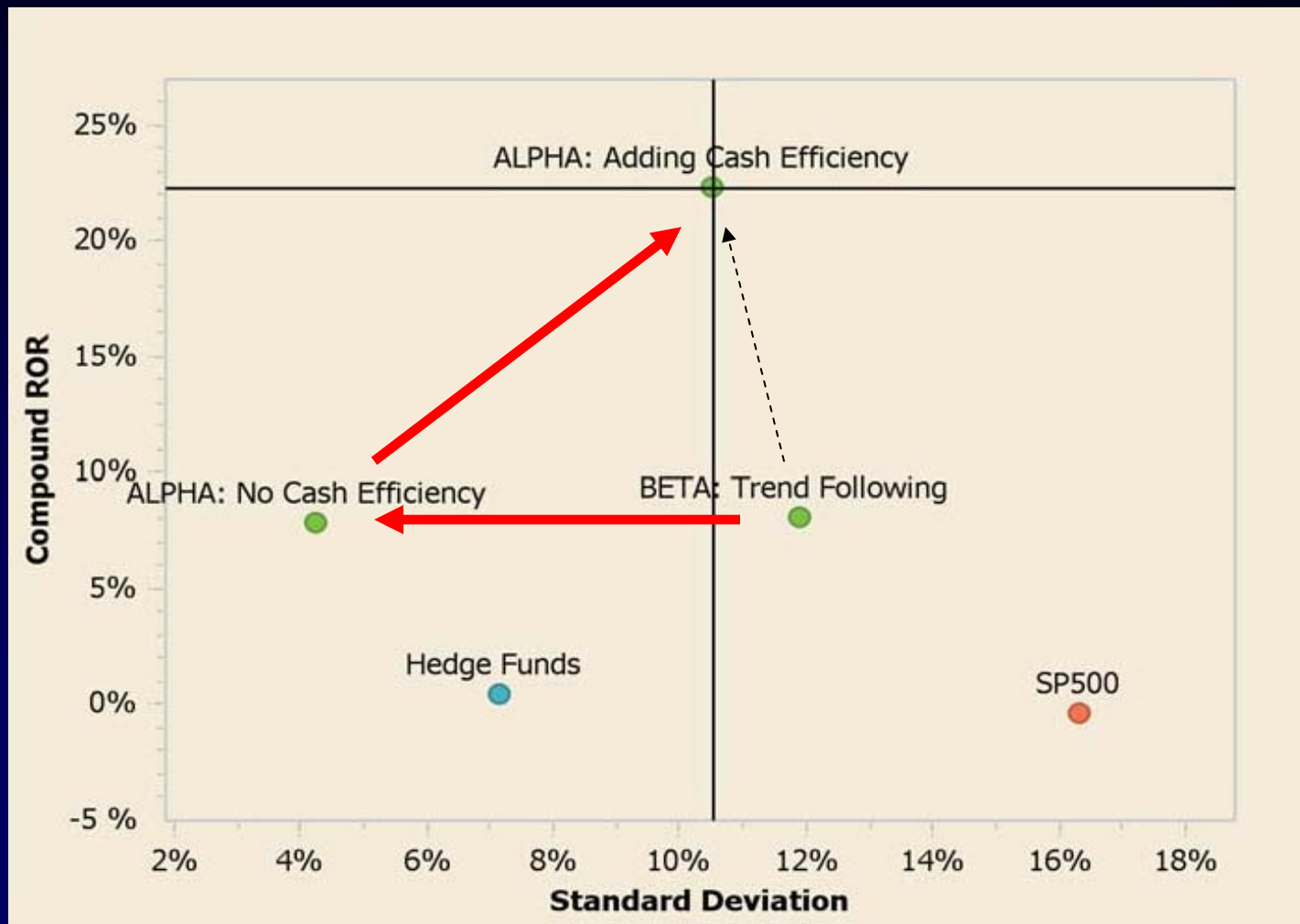


Alpha: Potomac's Approach



Implications for Portfolio Construction

Alpha vs. Beta vs. Benchmarks (Jan 2005 - Dec 2010)



Implications for Portfolio Construction

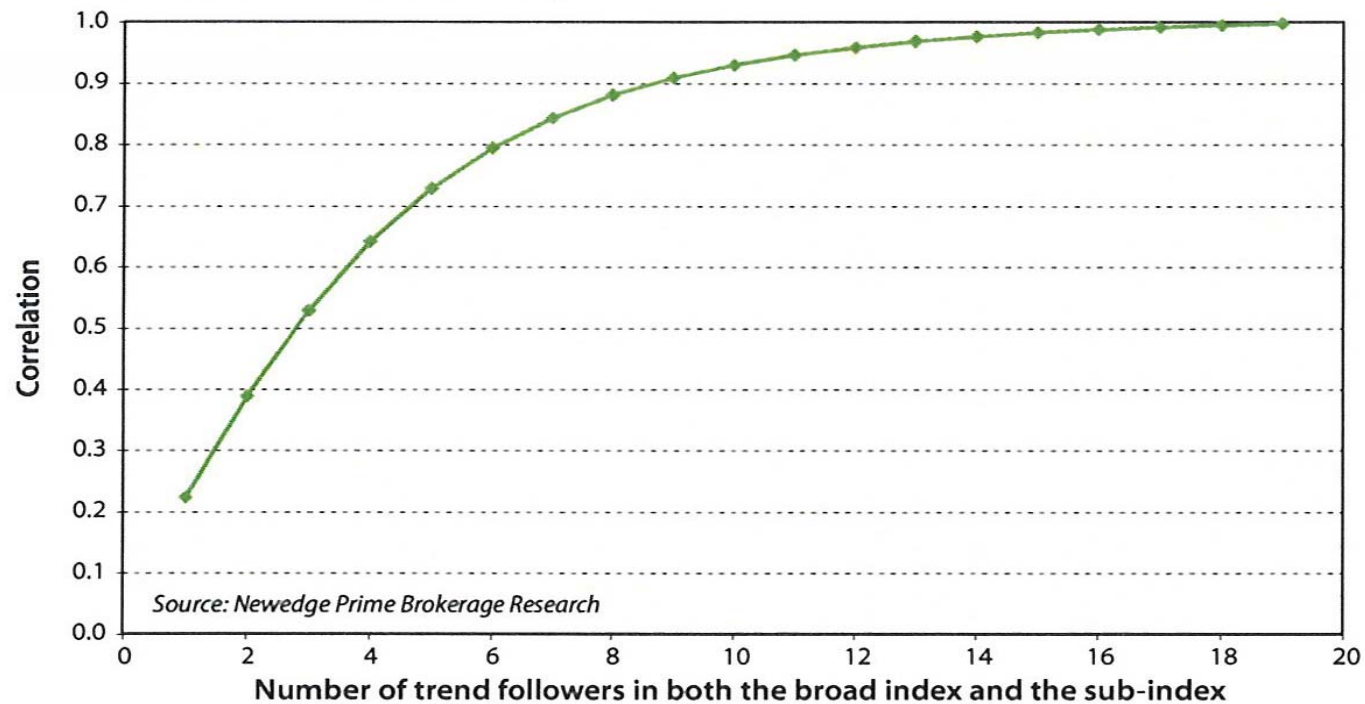
Mixing Beta and Alpha

NewEdge USA Research

Exhibit 4

Correlation between returns on a sub-index of correlated returns and a broader index

(Correlation among "trend followers" = 0.60, all other correlations = 0.0, total number of CTAs = 20)



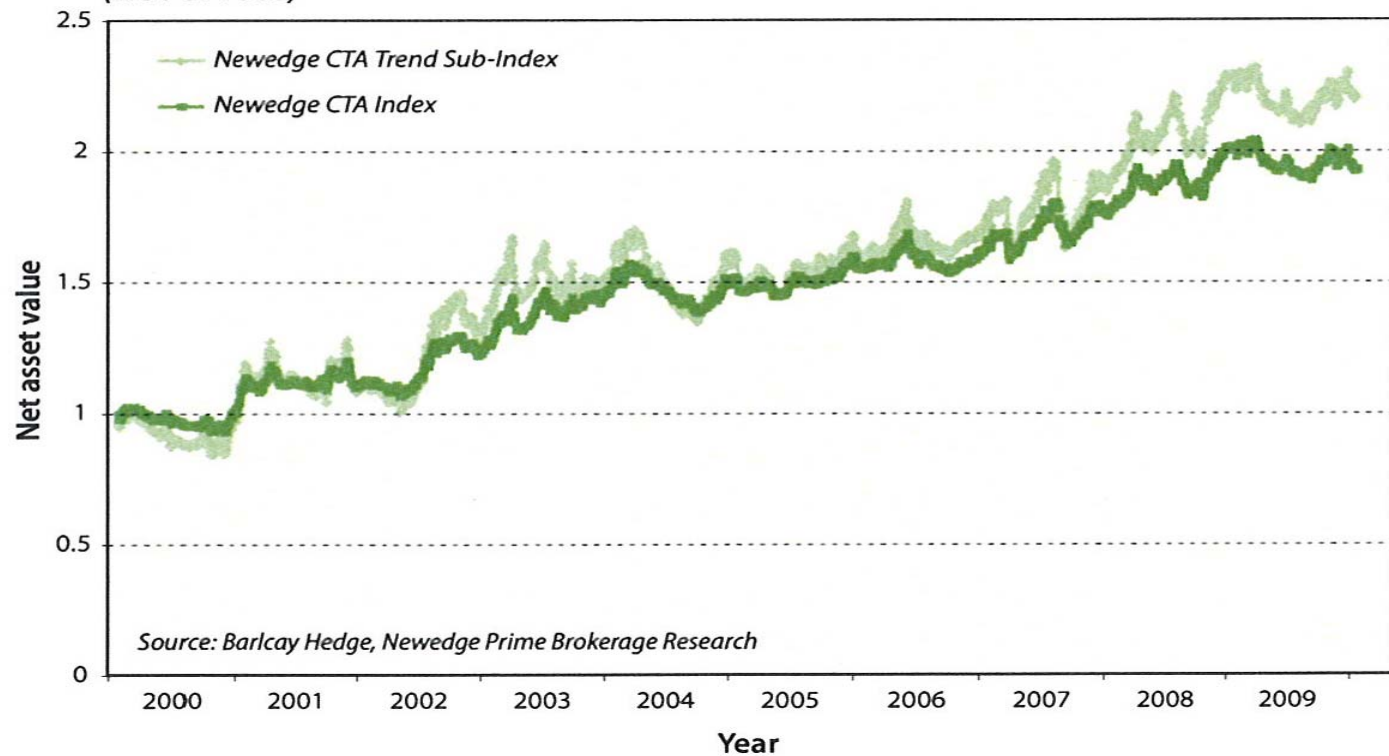
Implications for Portfolio Construction

Mixing Beta and Alpha

NewEdge USA Research

Exhibit 6

*Net asset values for Newedge CTA Index and
Newedge CTA Trend Sub-Index
(net of fees)*



Summing Up

“Changing landscapes in managed futures are offering new directions for portfolio diversification.”

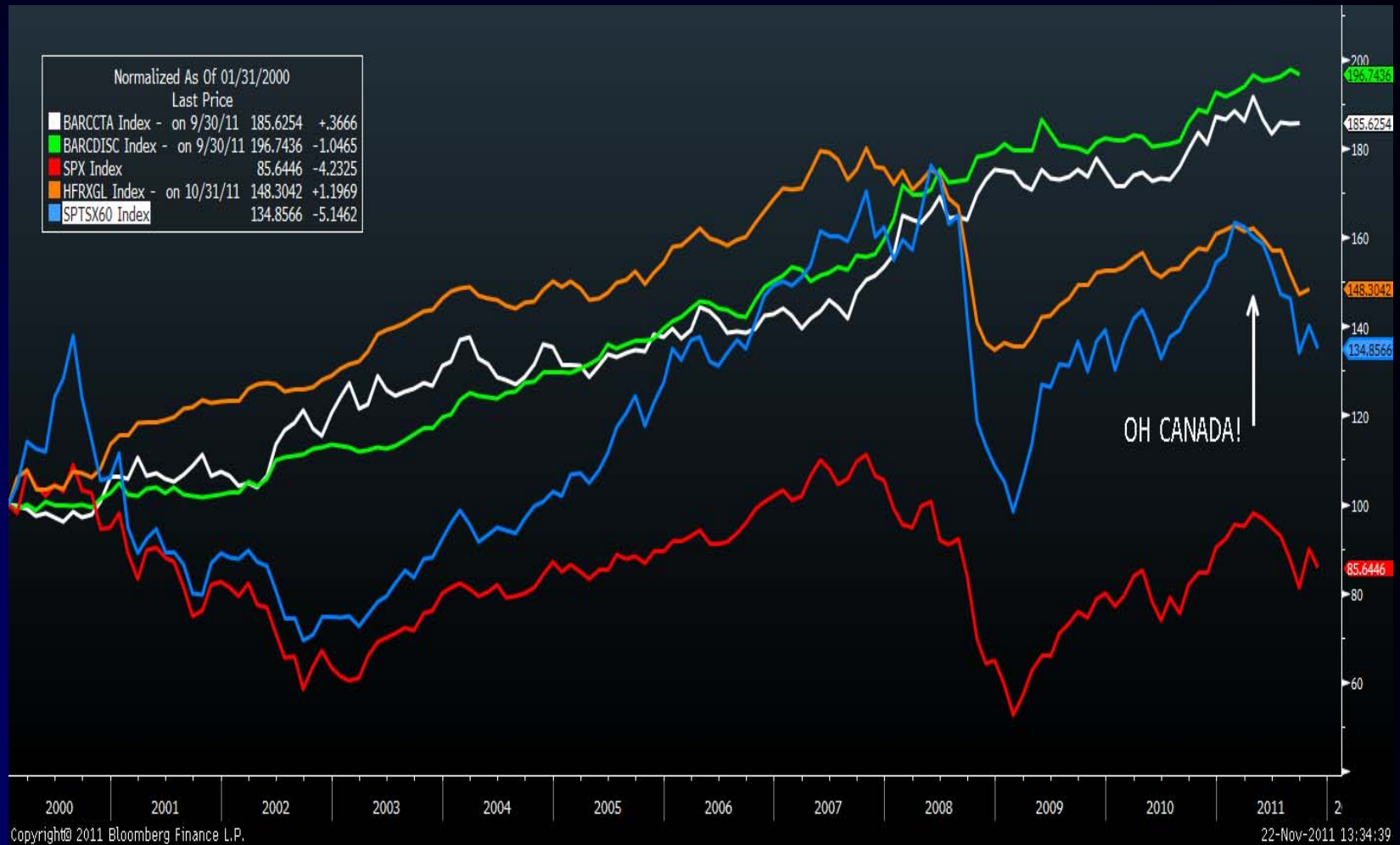
---Thomas Lott, President, Potomac Portfolios LLC

“The fortunes of trend followers and the industry tend to rise and fall together, although with one significant difference. While the two paths follow one another closely, the total index path exhibits much lower volatility than that exhibited by the trend following path. The lower volatility stems from the presence of low correlation returns, and the result is a higher return/risk ratio for the industry than for the trend followers by themselves.”

---NewEdge USA (Alternative Edge Research)

Summing Up (2000 – 2011)

SP500 / Managed Futures / Hedge Funds + Canada! (SPTSX)
Role & Choices in Managed Futures



For Further Information

- **Potomac Portfolios, LLC**

Thomas Lott, President
Potomac Portfolios, LLC
5185 MacArthur Blvd, N.W.
Suite 220
Washington, DC 20016
Tel: 202-237-8878 x25
Email: Info@PotomacPortfolios.Com
Web: www.PotomacPortfolios.Com

- **AlphaMetrix Client Relations**

AlphaMetrix Client Relations
181 West Madison
34th Floor
Chicago, IL 60602
Tel: 312-267-8400
Email: Client.Relations@AlphaMetrix.Com
Web: www.AlphaMetrix.Com