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Bank runs in the time of COVID

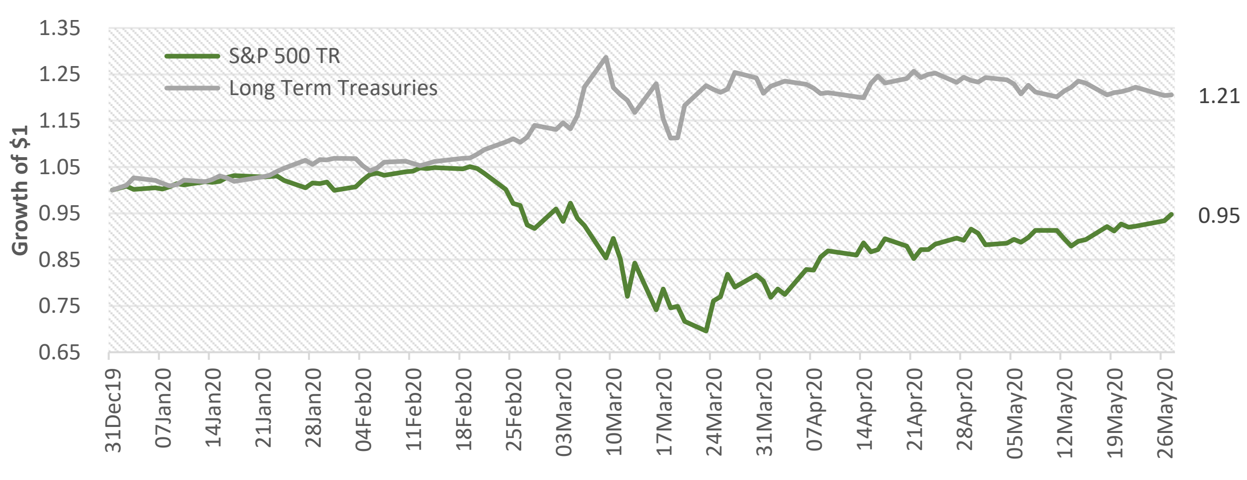
In the old days, banks often had grand atriums in order to project a sense of opulence and wealth, but the design was also intended to stall or prevent runs on the bank. Panic can quickly bring about the rapid death of any bank. Once one customer hears of a banks questionable standing, their immediate reaction is to withdraw money. A second customer will do the same. Once enough customers line up, the queue wraps around the block. That's when the real panic sets in and brings down an otherwise healthy bank.

There are some analogies to the current COVID pandemic. Flattening-the-curve via social distancing, masks, and other measures were meant to slow down the "bank-run" on hospital ICU wards. It helped prevent the health care industry from being overwhelmed. Doctors still don't quite understand the virus, and our frontline workers are risking their lives for those of others, but even though the human toll is utterly tragic, it is merely a blip in a historical context.

The Black Plague caused over 50 million deaths in Europe alone, nearly half the population. Left untreated it has a case fatality ratio of 30-100%.[1] Even with modern medicine, the death rate is 11%.

During WWII, 50 million Americans registered for the draft, 10 million entered service, and half a million perished. That is a death rate of about 1% of those of draft eligible and 4% of those drafted into combat.

The US government has shouldered more than a bazooka to stem a possible "bank run" due to COVID. The Fed has brought overnight rates to zero, bought trillions of long term securities, relaunched the money market mutual fund liquidity facility, expanded repo operations, lowered rates it charges banks for loans, relaxed regulatory constraints, initiated direct lending to major corporates, expanded loans to mid and small businesses, supported asset backed securities, directly loaned to states and municipalities, and cut rates on international swap lines for other central banks[2] and more.



[1] https://www.who.int/health-topics/plague

[2] https://www.brookings.edu/research/fed-response-to-covid19/

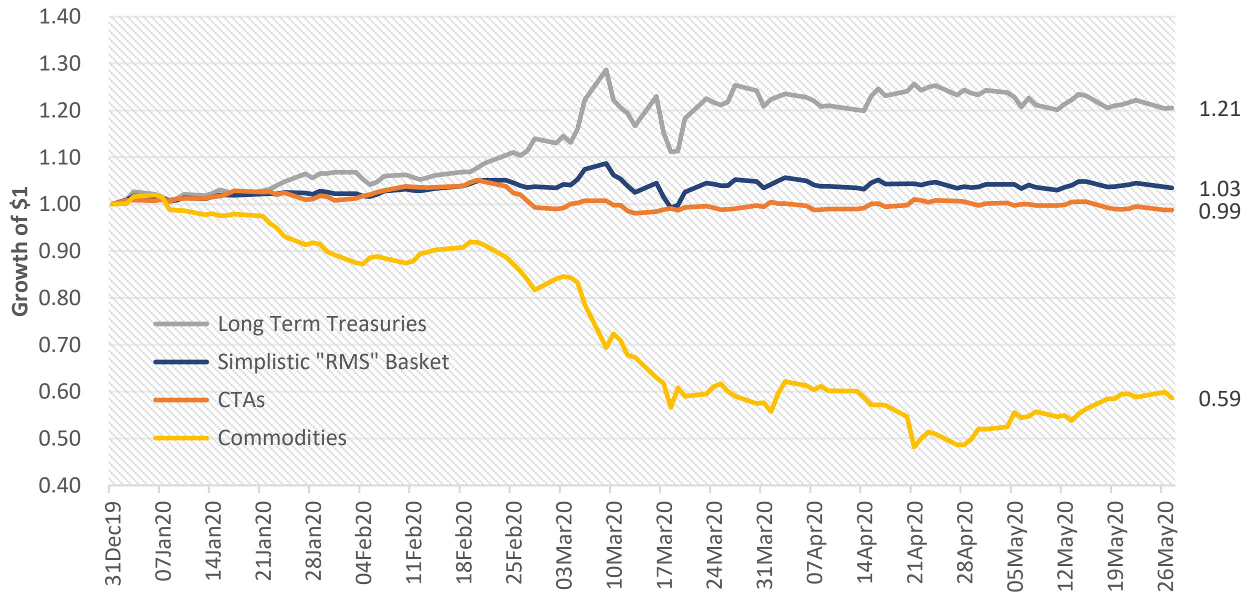
The primary impact of these actions were seen in the fixed income market. During February and through the first half of March there was a flight to quality as a type of "bank run" occurred. Investors rushed to the bank to cash their Treasuries. Only after additional Fed actions did the market calm down. Long term treasuries continued to hold gains as long term rates declined from levels seen at the beginning of the year.

What happens next?

What will the Fed do if and when a "real" crisis occurs? We are not minimizing the magnitude of COVID, but if what we have witnessed is the Fed's crisis playbook, what happens when a nuke goes off in a major city? Or if a war starts? Or a meteor hits? Will inflation kick-in? Will equities tank or rally? Will cash be worthless? We believe the risk of a major event and its economic impact is far higher than COVID, but if this is the Fed's major crisis playbook, then we should proactively implement our own playbook in advance.

What to do?

Diversification can help, but it only goes so far. Diversification may reduce variability, but it may not be the best way to directly protect the downside. Certain strategies can work in the short term. In-fact, owning options worked in March, but many who profited in March gave it all back in April. As we wrote in our January letter (before the market turmoil), there are several tools investors can use to create Risk Mitigation Strategies, or RMS, that both help protect wealth or generate extra wealth at the same time. We believe the most direct way to preserve and grow wealth is to add options and futures to the mix. These are basically insurance products, and insurance can be great to buy or sell if done correctly.



Data through May 31. The Simplistic "RMS" Basket is 45% CTA, 45% Long Term Treasury, and 10% Commodity. CTAs is the SG CTA Index, Long Term Treasuries is 10+ maturities, commodities is the GSCI TR.

Options and futures on the S&P500 can be the most direct way of hedging or adding yield for those interested in preserving and growing wealth. The problem is, it's too easy to trade. It's too easy to click on a screen or follow pundits ever-changing recommendations. The key to success is to have a very disciplined but dynamic process that delivers results over time. Interestingly, programs that collect premium and programs that pay out premium both can profit at the same time. At Lake Hill, we combine tremendous analytical capability with rigorous portfolio risk management discipline and highly automated processes to deliver dynamic strategies that are re-optimized at least daily within defined risk parameters. We continuously evaluate tens of thousands of option and futures trading opportunities as we seek to re-optimize our portfolios in an ever-changing market. Lake Hill Dynamic Hedge is an equity replacement strategy that exemplifies our disciplined but dynamic approach.

Both risks and opportunities are greater today than they have been in a while. Knowing that your bank has a beautiful grand atrium or that the Fed might be there to bail you out is not the way to prepare for the next crisis.

Past Performance is not indicative of future performance. Data is subject to revision without notice.

Important information regarding the information provided herein:

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FOR CUSTOMERS TRADING OPTIONS, THESE FUTURES AND FOREX CHARTS ARE PRESENTED FOR INFORMATIONAL PURPOSES ONLY. THEY ARE INTENDED TO SHOW HOW INVESTING IN OPTIONS CAN DEPEND ON THE UNDERLYING FUTURES PRICES; SPECIFICALLY, WHETHER OR NOT AN OPTION PURCHASER IS BUYING AN IN-THE-MONEY, AT-THEMONEY, OR OUT-OF-THE-MONEY OPTION. FURTHERMORE, THE PURCHASER WILL BE ABLE TO DETERMINE WHETHER OR NOT TO EXERCISE HIS RIGHT ON AN OPTION DEPENDING ON HOW THE OPTION'S STRIKE PRICE COMPARES TO THE UNDERLYING FUTURE'S PRICE. THE FUTURES CHARTS ARE NOT INTENDED TO IMPLY THAT OPTION PRICES MOVE IN TANDEM WITH FUTURES PRICES. IN FACT, OPTION PRICES MAY ONLY MOVE A FRACTION OF THE PRICE MOVE IN THE UNDERLYING FUTURES. IN SOME CASES, THE OPTION MAY NOT MOVE AT ALL OR EVEN MOVE IN THE OPPOSITE DIRECTION OF THE UNDERLYING FUTURES CONTRACT.

Futures, options and derivatives products inherently involve substantial leverage and also greatly increase the risk of loss. There is no additional portfolio leverage applied to generate the returns.

Risk Factors: Hedge funds and Managed Accounts have certain inherent risks associated with them, including but not limited to the following:

(i) the funds and managed accounts are speculative and involve varying degrees of risk, including substantial degrees of risk in some cases; (ii) the funds and managed accounts may be leveraged and may engage in other speculative investment practices that may increase the risk of investment loss; (iii) the funds' and managed accounts performance may be volatile; (iv) an investor could lose all or a substantial amount of his or her investment; (v) the investment managers have total trading authority over the funds, the funds are dependent upon the services of the investment managers, and the use of a single advisor could mean lack of diversification and, consequently, higher risk; (vi) the funds may have varying liquidity provisions and limitations and there is no secondary market for investors' interests in any of the funds and none is expected to develop; (vii) there are restrictions on transferring interests in the funds; (viii) the funds' fees and expenses may offset the funds' trading and investment profits; (ix) the funds may not be required to provide periodic pricing or valuation information to investors with respect to individual investments; (x) the funds are not subject to the same regulatory requirements as mutual funds; and (xi) the funds are subject to conflicts of interest.

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