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May 12 2020

**The Crisis Playbook**

At Lake Hill we have a 3-ring binder labeled "The Crisis Playbook". This book was meticulously updated throughout the years. Early versions contained phone numbers of all our brokers, driving directions to our backup office, and training protocols so that every employee would know how to get to our disaster recovery site and operate seamlessly if necessary. Later editions contained instructions on how to access the servers in our data center. Fortunately, this 3-ring binder has become smaller and smaller over the years largely as a result of the technology and process enhancements that we have made. After extensive testing of our cloud based services, we decided to move our primary infrastructure entirely to the cloud. This has made a huge difference. Parts of the Crisis Playbook have been rendered obsolete because we took the necessary steps to keep our technology at the forefront. Our employees log into their computers, just as they would over the weekend at home or on vacation, except now they do it on the weekdays as well. We did not miss a beat as a result of the shelter in place order.

Has the Crisis changed the options market? Not really for Lake Hill. We stick to the most liquid parts of the options market, listed index options, to avoid the liquidity squeeze that invariably grip the more exotic parts of the derivatives market. Societe Generale Research recently reported that "Volumes are focused on plain vanilla volatility products, whereas liquidity for more exotic variants remains very limited."[1] While supply and demand for trading risk today has no good historical analogy, the simple fact is that Investors today are uncertain of the future as they also were in 2008, 2001, 1998, 1993, 1987, 1982, and 1973, but for different reasons each time. The one constant is that many Investors turn to the options market even more when uncertainty is high.

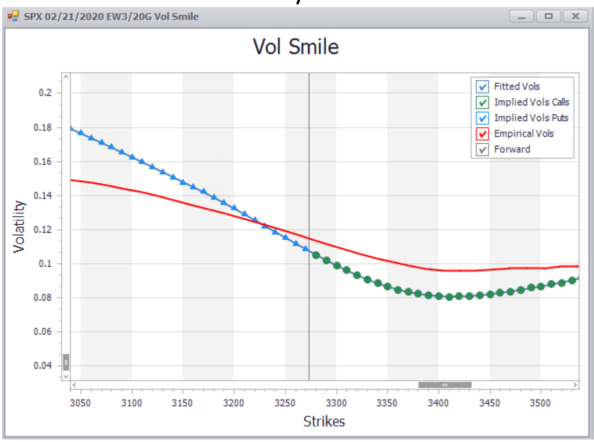
At Lake Hill we are not directional investors. Predicting prices of individual stocks is not our area of expertise. We leave that to other qualified professionals. We care about the odds, the probabilities, and think of option prices as expressions of the probability of an event happening or not. We greatly improve our chances of understanding the odds inherently expressed in options prices if we stick to stock indices rather than individual stocks. An Index eliminates most of the idiosyncratic unknowns inherent to any single component stock. While it's true that we don't know where the market will be 1 year from now, we do gather and analyze lots of information from the options markets to determine how rationally options buyers and sellers are pricing risk today and if is there an edge such that we can expect to take a profit tomorrow. To do this efficiently, we have fined tuned our machines for the past 15 years to grind out, day by day, the analysis of thousands of option prices expressing probabilities of index price movement that we hope will come into fruition tomorrow.

Stay nimble, have the latest tech, stick to deep and liquid markets, and constantly survey the playing field. That's the real Crisis Playbook.

Below are three snapshots of the implied volatilities in the S&P500 Index option market taken in various moments in time this year with some insight into how Lake Hill's positioning changed as the probabilities changed:

*Blue line: put option prices. Green line: call option prices. Red line: Lake Hill's "Engine" pricing.*

January 2020

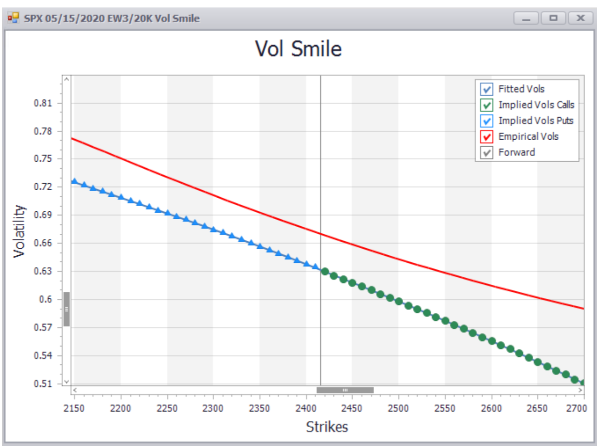



A fairly typical volatility smile profile.

Calls are identified as inexpensive, so buy calls and sell (short) futures to hedge downside risk.

As equity markets drop, the calls become worthless but the short futures positioning are profitable.

March 2020

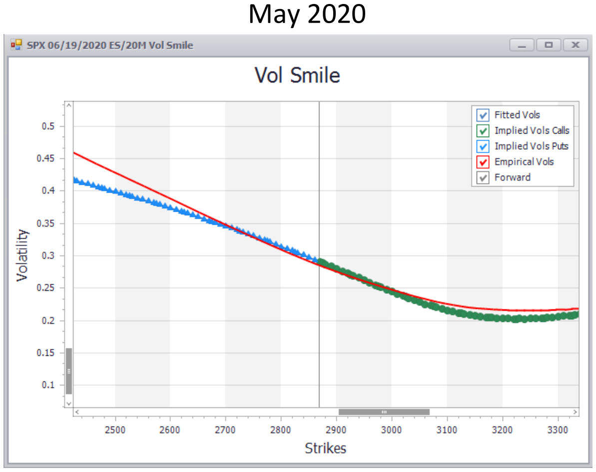



Expected in times of crisis, the smile flattens as market participants are uncertain of market direction

The Engine identifies both calls and puts to be inexpensive, with a bias on calls.

As markets rally, purchased puts become worthless but long calls are profitable.

May 2020




The smile returns to a more typical shape.

At the money options are slightly expensive while out of the money puts identified as inexpensive.

As markets stabilize, purchased tail puts become worthless but sold at the money options on average are profitable.



[1] Societe Generale (van Slooten, Bokobza, et. al.), Hedge Fund Watch (extended version). Special focus – How Hedge Funds Have Been Riding the Volatility Storm, May 7, 2020

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Futures, options and derivatives products inherently involve substantial leverage and also greatly increase the risk of loss.