Lake Hill

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Don't Mess with El Paso

What can Texas' electric grid tell us about the financial markets? A lot.

1930, 1940, 1951, 1978, 1983, 1989, 2011, 2021…every so often, there is a cold snap in Texas. It is rare, but it can wreak havoc for those that are not prepared. After the February 2011 cold snap that knocked out 100% of El Paso Electric's generating capacity, The City of El Paso decided they had enough. They invested $4.5 million in protection to winterize their electric grid. These improvements cost less than $7 per resident (about the cost of a 10-piece McNuggets Meal) and allowed the electric grid in El Paso to avoid blackouts that affected the rest of Texas last month. The rest of Texas runs on its own separate grid called ERCOT. Although experts recommended that ERCOT take similar actions in 2011, nothing was done. The Governor of Texas recently asked the entire leadership of ERCOT to resign and asked the state legislature to enact reforms.

The financial markets are remarkably similar. History tells us that every so often there is a market disruption. Some will have the foresight to prepare, while others will be caught flat footed.

Lake Hill's *Dynamic Hedge* strategy is for those investors who want to be prepared, but it is not necessarily for those readying themselves for a total apocalypse. While *Dynamic Hedge* aims to protect against painful market declines, it also resets the protection each day. This is important because over the course of most market corrections, there are multiple down days (not necessarily all in a row), and the benefit of resetting the protection level daily can really add up. Although there is no such thing as free protection, Lake Hill's technology aims to protect in a cost-effective manner. Every day, the Lake Hill "Engine" searches for the best combination of options and futures which provide a certain amount of portfolio protection against a downside shock. This allows the portfolio to minimize costs while maximizing a predetermined amount of protection.

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How is *Dynamic Hedge* different from a Tail Hedge? Very.

Buying 10% out-of-the-money puts is expensive because those options rarely pay off, and when they do pay out, the protection must then be rolled (reset), which is likely to be very expensive at that point in time. Although tail protection sounds very straightforward, the actual implementation can be quite complex. There are so many variables that may not go your way, which makes a potentially very expensive endeavor fraught with uncertainty. *Dynamic Hedge* on the other hand consists of a much larger number of options and futures positions (from 30 to 90 at a time) that collectively provide a pre-determined level of estimated portfolio protection every day. That collection of options and futures hedges is re-optimized every day as the market moves (and the protection level is reset) and new opportunities arise. One goal of *Dynamic Hedge* is to have a positive expected carry while providing a constantly resetting level of protection.

Hasn't the market changed? Yes and no.

Indeed, the market structure is changing, but the fundamentals have not. Investors still seek to transfer risk, and they are turning to the S&P 500 Index option market more and more. Long gone are the days of big banks that dominate the risk transfer marketplace with ISDA-based OTC options and swaps. Now there is a whole world of exchange-traded products that have weekly expirations or are linked to indices such as the VIX. The democratization of the risk transfer marketplace has allowed for more market participants, which has increased efficiency, but there are still unknowns. The *Dynamic Hedge* strategy attempts to find the best opportunities for protection each day, which can vary over time. Purchasing a put may be the most effective hedge one day, but at other times selling calls and buying futures may be the best strategy. Buying at-the-money-puts and selling further out-of-the-money puts may also be a good opportunity. As skew changes, the best opportunity changes. The key is to be dynamic and adapt every day to seize the best opportunities the market presents.

The City of El Paso understood that "rare events" that seem to happen over and over are not rare at all. A thoughtful way of mitigating the downside without market-timing allowed them to thrive during the inevitable storm.

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

Important information regarding the information provided herein:

HYPOTHETICAL PERFORMANCE RESULTS HAVE MANY INHERENT LIMITATIONS, SOME OF WHICH ARE DESCRIBED BELOW. NO REPRESENTATION IS BEING MADE THAT ANY ACCOUNT WILL OR IS LIKELY TO ACHIEVE PROFITS OR LOSSES SIMILAR TO THOSE SHOWN. IN FACT, THERE ARE FREQUENTLY SHARP DIFFERENCES BETWEEN HYPOTHETICAL PERFORMANCE RESULTS AND THE ACTUAL RESULTS SUBSEQUENTLY ACHIEVED BY ANY PARTICULAR TRADING PROGRAM. ONE OF THE LIMITATIONS OF HYPOTHETICAL PERFORMANCE RESULTS IS THAT THEY ARE GENERALLY PREPARED WITH THE BENEFIT OF HINDSIGHT. IN ADDITION, HYPOTHETICAL TRADING DOES NOT INVOLVE FINANCIAL RISK, AND NO HYPOTHETICAL TRADING RECORD CAN COMPLETELY ACCOUNT FOR THE IMPACT OF FINANCIAL RISK IN ACTUAL TRADING. FOR EXAMPLE, THE ABILITY TO WITHSTAND LOSSES OR ADHERE TO A PARTICULAR TRADING PROGRAM IN SPITE OF TRADING LOSSES ARE MATERIAL POINTS WHICH CAN ALSO ADVERSELY AFFECT ACTUAL TRADING RESULTS. THERE ARE NUMEROUS OTHER FACTORS RELATED TO THE MARKETS IN GENERAL OR TO THE IMPLEMENTATION OF ANY SPECIFIC TRADING PROGRAM WHICH CANNOT BE FULLY ACCOUNTED FOR IN THE PREPARATION OF HYPOTHETICAL PERFORMANCE RESULTS AND ALL OF WHICH CAN ADVERSELY AFFECT ACTUAL TRADING RESULTS.

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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