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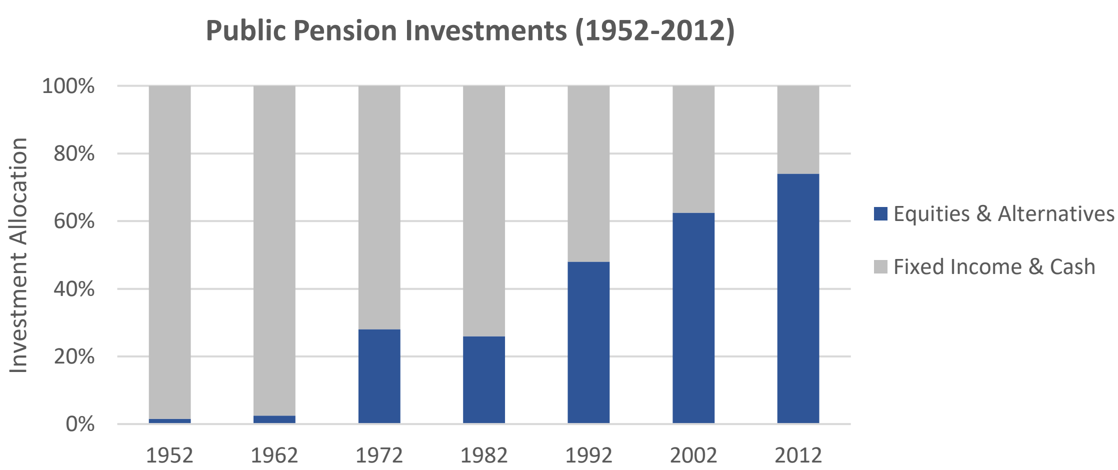
If It's a Bull Market, What's to Worry About?

"It is not given to human beings…to foresee or to predict to any large extent the unfolding course of events" - Winston Churchill

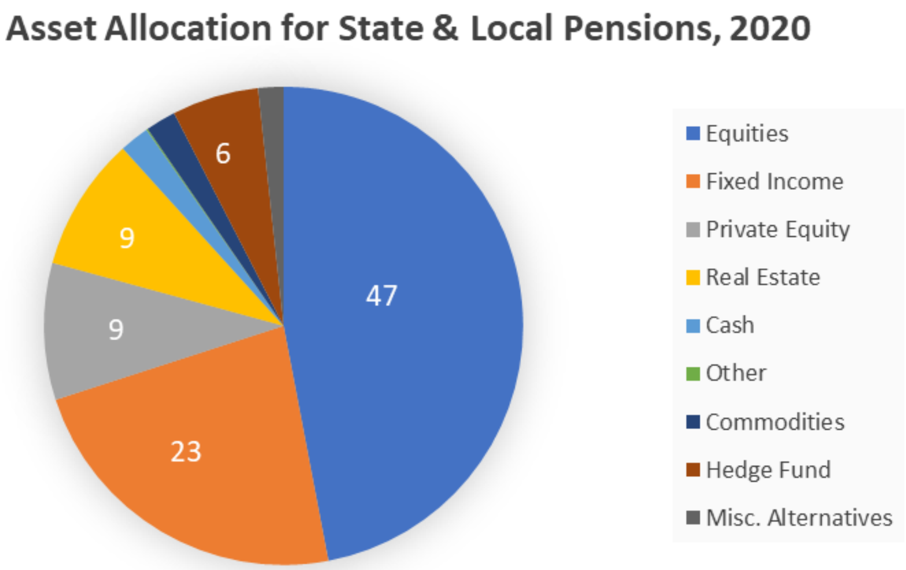
We often look at history to help us predict the future. The influenza pandemic of 1918 was followed by the roaring 1920s which was followed by the Great Depression. Many pundits are thinking we may be entering the roaring 2020s. We are experiencing larger than life government stimulus combined with a pent-up demand for everything that was missed for the last 12 months of the COIVD-19 pandemic: dining, travel, concerts, sports, and weddings. That is a lot of discretionary spending heaped atop an already robust economy. Given this backdrop of government stimulus and potential volatility, in this letter we consider how government might be influenced by stock market performance, and we look at a very significant structural change in the options market.

In a previous letter, we discussed how the rise of the retail investor is changing the stock market and in particular the options market as volumes in single stock options rise to new highs. However, there is another influence that requires more examination: The interweaving of politics and the stock market. Just as "the average Joe" cares about gasoline prices and what the President is doing about it, more and more regular folks are exposed to the ups and downs of the equity market than ever before. We are not talking about public policy, shareholder ESG initiatives, or distribution of wealth. We are highlighting the fact that so many people's economic future is tied to the stock market as compared with prior eras.

Public pension portfolio allocations have changed dramatically over the last several decades. Until about 30 years ago, these pensions generally were benchmarked to Treasuries, but as Treasury yields declined, return targets forced pensions into equities (including private equity, hedge funds, real estate, and other alternatives). Allocation to equities of all kinds is now greater than 75%. When equities decline, public plan pensioners are still entitled to their defined benefits, but the state and local budgets will have to make up for the shortfall. In other words, if equities go down, all taxpayers are on the hook.



Sources: U.S. Board of Governors of the Federal Reserve System, *Financial Accounts of the United States, 1952 to 2012*; Pew Charitable Trusts Analysis of State Financial Reports



Source: Public Plans Database

Not only have equity exposures increased over the years, but The Federal Reserve, Congress, and multiple administrations now have experience using an arsenal of tools to combat sagging equity prices. This is no longer just Donald Trump being fixated on the stock market. It is now an imbedded part of our entire national governance and pension infrastructure.

This may seem to be a convincing argument for the bulls. However, history is riddled with example after example of governments debasing their coinage (Romans), attempting to monetize their debt via stock (French and British), and printing money (countless European, African, and South American countries) to escape their problems. Every attempt results in a painful repricing of markets. When it happens, many taxpayers will be at risk.

The problem is that it can take a long time for these events to unfold. Predicting the market is fraught with uncertainty. We are not "perma-bears" at Lake Hill, since history has also shown that markets can go "supernova" and go much higher from here. Anything can happen.

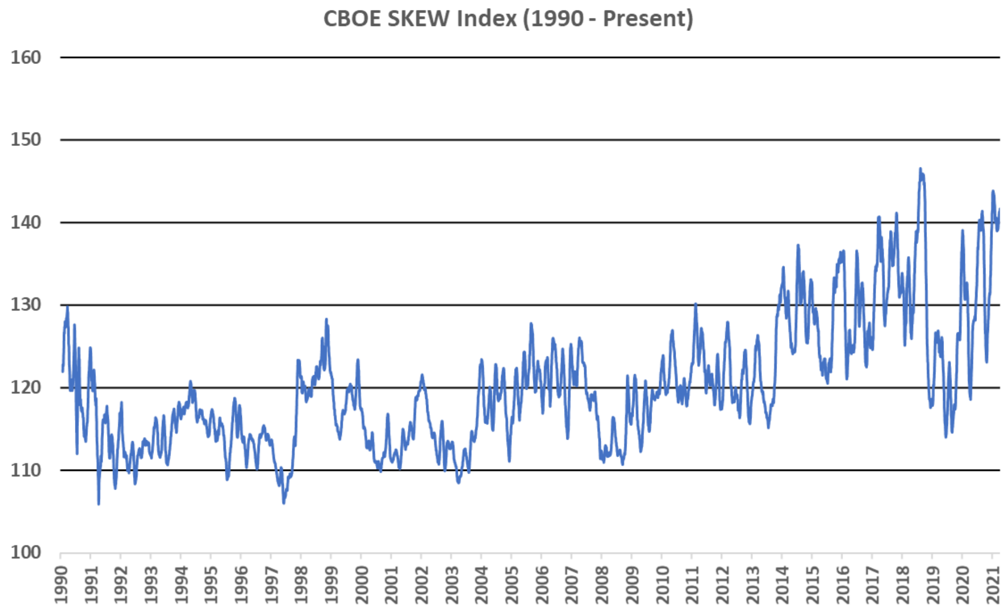
It is difficult to predict the direction of the stock market or the level of volatility in the future. We do not have a crystal ball. Counterintuitively, even if we could predict the level of volatility with certainty, trading options around such a fixed and certain volatility does not lead to a fixed and certain profit. See a previous letter in which we discuss that issue: Lake Hill Group: The Edge in Discipline and Time.

We care much more about skew than the direction of the equity markets.

We think there are certain actors that are systematically selling calls at any price. It is a simple way to generate yield and easy for folks to understand. It seems like a straightforward way of generating income in a world of low yields. This systematic call selling along with other factors has created an extreme and structural opportunity in skew.

The CBOE SKEW index is one measure of downside implied volatility vs upside implied volatility in the S&P500 Index options market. A SKEW index value of 100 indicates that both upside and downside implied volatilities are equal. As far back as the late 1980's, an index level of 120 indicated extreme market stress. The SKEW Index reached 120 during the Asian Crisis, the collapse of the tech bubble, and the Global Financial Crisis. It rarely ever exceeded 130 even at the heights of those market panics.

Where is the SKEW Index hovering today? It is around 140. Over the last 5 years, the SKEW Index has been above 130 for 50% of the time. Over the 25 years prior to that, it was above 130 only 5% of the time.



Source: CBOE

It is likely that this repricing is structural and caused by a combination of new financial products (such as VIX-linked ETNs), risk transfer activity moving from bank balance sheets to listed markets, government intervention, and other factors at play in our go-go markets.

But this shift is so extraordinary and structural that even with current VIX levels back below 20, it indicates both a potential serious warning and a serious opportunity. Our analysis indicates that currently most of the steepness in SKEW is attributable to the extreme offering of calls, not panic buying of puts. It is suppressed upside volatility on steroids.

How can one profit from this? The simplest and highest potential "alpha" is to buy inexpensive out-of-the-money (OTM) options and hedge them. This can lead to great risk/reward profit. The difficulty with such a trade is that these OTM options always have a low probability of a payoff – irrespective of price – so you must be prepared to buy them repeatedly until the expected payoff occurs. This takes time -- often more time than most investors can endure.

Another approach is not to maximize alpha but rather buy the cheap calls while selling other less cheap calls. This will deliver a higher probability of a positive returns in a shorter period of time. Both trades can make sense at the same time depending on one's objectives.

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Ultimately, whether your objective is to create short term income, add downside protection, pursue absolute return, or a combined portfolio of all three, the opportunities today are real, structural, and persistent. When the odds are “normal”, you must be prepared to wait until you “win”. With SKEW levels as they are today, we believe the odds are extraordinarily good. So now is the time to apply a disciplined, risk managed, capital preserving strategy in pursuit of those extraordinary odds.

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.

References to the CBOE SKEW Index (SKEW) are based on published results and, although obtained from sources believed to be accurate, have not been independently verified. The skewness of a rate of return indicates returns around 0. Negative skewness entails The CBOE Index™ (SKEW) estimates the skewness of S&P 500® returns at the end of a 30-day horizon. Similar to VIX® the price of the S&P 500 tail risk is calculated from the prices of S&P 500 out-of-the-money options. SKEW typically ranges from 100 to 150.

The opinions expressed herein are subjective opinions regarding financial markets and may be based on sources believed to be accurate, but which have not been independently verified. In addition, there is no guarantee that these opinions are correct, or that they will correctly assess the future direction of the financial markets. This communication is for informational purposes only and its accuracy cannot be guaranteed.