

“I will prepare and some day my chance will come” – Abraham Lincoln

Banking crises, financial panics and stock market swoons have existed throughout history and will certainly happen in the future. While the reasons for market panics are varied, the results are similar. Be it a natural disaster, act of terror, corporate scandal, unintended consequence of monetary or fiscal policy or some other unforeseen cause, panics and extreme market moves happen and investors must prepare for them.

Many studies have shown stock market returns to have “fat tails”, meaning the odds of extreme moves are much higher than indicated by a normal distribution. A histogram of returns of a broad-based equity index such as the S&P 500 provides insight into the probability of large moves.

An insurance company will use historical probabilities as well as any other relevant data to construct actuarial tables. Index options can be used to hedge a portfolio just as the insurance market is used to manage risk. Lake Hill is an active participant in the index options market and looks at all relevant data to gauge the cost of insuring and re-insuring its investment portfolio.

The newest iteration of portfolio insurance comes in the form of “tail-risk funds” that create hedging solutions by buying out-of-the-money options. This strategy has gained popularity in response to the extreme market volatility related to the financial crisis. Demand for tail risk hedging remains high as policy makers and central bankers have yet to create a workable solution to mounting debt problems in the face of higher interest rates and slower economic growth.

A strategy often marketed in various forms is to simply buy an appropriate amount of near term out-of-the-money puts on the S&P 500 and roll this position monthly. This strategy removes any human timing element, is simple and seems to provide protection should the market collapse. Does it work?

Figure 1 illustrates the cumulative simple returns over the past 14-years of implementing such a simple strategy. The backtested model returns are gross of fees but account for execution costs and slippage.

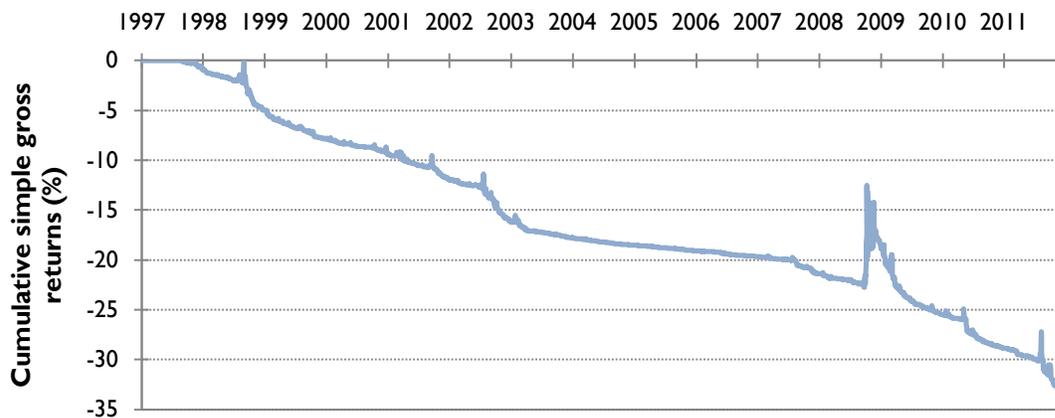


Figure 1: Performance of buying 1-mo 15% out-of-the-money SPX put options and rolling each month.

This backtest indicates that systematically buying out-of-the-money puts not only generates pernicious losses but also provides false comfort to those who believe they are hedged. To be successful, a portfolio manager must have extraordinary ability to consistently predict the timing of extreme market moves, buy puts just prior to a collapse and then sell them afterwards at just the right time.

Lake Hill manages tail risk differently. Trading tail risk products is challenging and requires expertise to do so without the costs exemplified by the above backtest. Incorporating tail risk hedging is a core component of Lake Hill's investment program.

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