Lake Hill CAPITAL MANAGEMENT
lakehillgroup.com 150 East 58th Street 25th Floor New York, NY 10155 212-792-6672

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"We are drowning in information, while starving for wisdom. The world henceforth will be run by synthesizers, people able to put together the right information at the right time, think critically about it, and make important choices wisely."
— E. O. Wilson

Investors frequently ask, "What is happening in the world today that makes a strategy compelling?" We like to frame this in a slightly different way: "Why is a particular fund a good *business* and why *now*?" Our answer is multi-faceted:

The rapid changes in financial markets, coupled with low yields and high macroeconomic uncertainty, are driving investors in a search for real returns. Investors can easily access an array of exchange-traded products, and the firms specializing in providing liquidity for these products have a compelling business model.

Alpha

Volatile and uncertain markets are here to stay and the result is a "bull market in fear." Historically, alternatives managers have found it difficult to generate alpha in these types of environments. While rates are low, some investors are responding by increasing leverage or reaching further out on the risk curve.

It is hard to justify hedge fund fees for lackluster performance or for simply levering a basic strategy. Therefore, investors are looking for new sources of sustainable alpha. One unique revenue source comes from firms providing liquidity to investors searching for this elusive alpha.

New Market Participants

An investor with a specific trade idea in commodities, mortgages, volatility, etc., can place a bet, potentially lever it, and earn a return (or a loss). The rapid growth of hedge funds, pursuing any possible combination of strategies, has lead to an evolution of the term "hedge fund" into a catch-all phrase. While there may be no limit to what constitutes a hedge fund, there is in fact a limited amount of alpha in the universe.

Coincident with the rise of hedge funds is an explosion of exchange-traded products (ETPs). There are ETPs for very specific investments, ranging from country exposures to dynamic trading strategies. There are dozens of ETPs in the volatility space that have amassed billions of dollars under management. With such a wide assortment of ETPs accessible at the click of a button, investors are trading themselves more than ever. In addition to the underlying products, options on these ETPs are trading at an increasing rate to hedge risk or lever returns.

There is value in businesses that offer pickaxes and blue jeans to those searching for gold. Being able to provide, absorb, and distribute "risk" efficiently to the growing number of new participants in the options space can be a source of alpha when everyone is busy buying and selling.

Technology

As with many businesses, technology is a highly competitive arms race. Sophisticated infrastructure and constant upgrades are required to run a modern options trading business. Electronic trading has made execution easy but that does not equate to easy profits. There are a multitude of views, opinions and reasons to trade. The ease provided by electronic markets and real-time information can be an ill-advised inducement to over-trade.

"High-frequency" traders are dominating worldwide markets and increasingly populating the options space. Some are traditional market-makers who provide liquidity, while others may actually add to an investor's overall cost of trading. Without detailed knowledge of the microstructure of these markets, investors may end up incurring fees and costs, which can materially impact performance.

Exclusivity

The recent decrease in liquidity provided by traditional Wall Street firms has blown the doors open for others to participate in the space. However, few firms are able to successfully inventory listed options portfolios and do so in a disciplined, systematic manner. Some firms that have had success are no longer open to outside investors.

Summary

Investors are using index options to hedge against the wall of uncertainty on the macro front. Liquidity providers can absorb inventory in these products in a transparent and systematic way. There is a persistent edge associated with managing the risks of buying and selling options at the right price. However, knowing where the edge lies is only a small part of the equation. The hard part is having the experience, technology, and most of all, the discipline required to transform it into a successful business.