Lake Hill

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Social Order

"Pain is inevitable. Suffering is optional" - Dalai Lama

Markets are in upheaval. The social order of things seems to be changing. The government is intervening like never before. Parts of society are rapidly adapting to new technologies while others are not. Some stocks are booming while others are collapsing. We believe that the elephant in the room is the massive fiscal and monetary initiatives of governments and central banks globally. There is a lot of academic and commercial debate as to the soundness, efficacy, and influence of these policies. We don't know what will happen, but we are certain that markets are on a new risk trajectory. Those who are not prepared will be left behind.

Traditional methods of hedging market risk or adding a bit of yield may not work going forward.

We all see the same events unfolding. Day traders are trouncing the professionals. Oil markets have gone negative. Interest rates are effectively pinned at zero with real rates even lower. The VIX Index is jumping up and down. Margin debt is at very high levels. The risk of an extreme market move in any direction is heightened so naturally the pundits are providing all sorts of explanations.

At Lake Hill we are less concerned with explanations and more concerned with something a bit different. Namely, how can one now effectively hedge and profit at the same time?

We assume that traditional forms of diversification may no longer work. Allocating to private-equity, commodities, hedge-funds, sector ETF's, fixed-income and other asset classes can generate returns and diversify a portfolio, but it may not hedge the downside.

The simplest and most direct method of hedging downside risk is to invest in S&P500 Index puts, delta-hedged S&P500 Index calls, or some other combination of index futures and options. The challenge is: While it is easy to buy a put with a click of a mouse, how do you know which put(s) to buy? When should you sell them or roll them? Why select a single strike price and maturity? There are over 20,000 unique listed index option contracts trading every day and an infinite number of potential combinations to choose from, all with different costs and payoffs.

The same holds true for those seeking to enhance their yield using options.

As we have said many times in this forum, as with any endeavor in life, if you choose to use options, you must have a disciplined process. Any process of buying or selling options must incorporate an estimate of expected value and an understanding of how the odds play out over time.

Below are are several graphs showing recent changes in the S&P500 Index option implied volatility curve (or "smile").

Figure 1. March Expiration SPX Vol Smile (as of January 5, 2021): OTM calls (green line) are slightly cheap and OTM puts (blue line) are slightly expensive vs. our fair value estimate (red line)

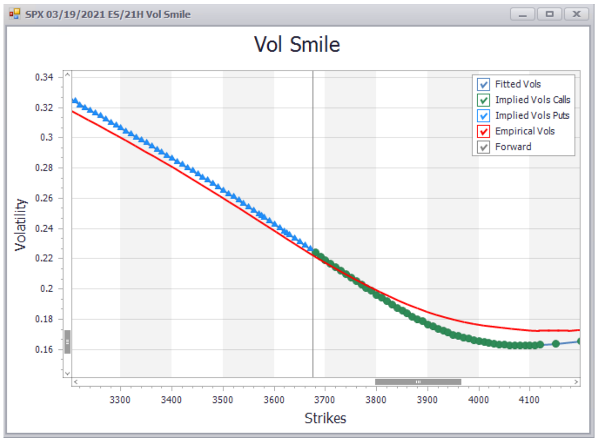


Figure 2. March Expiration SPX Vol Smile (as of January 29, 2021): OTM calls (green) have become even cheaper vs. fair value (red)

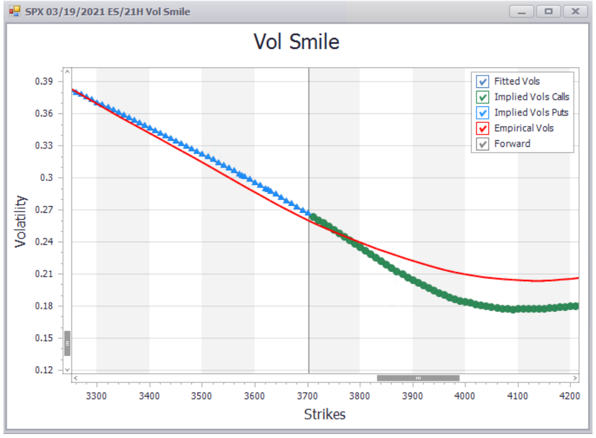
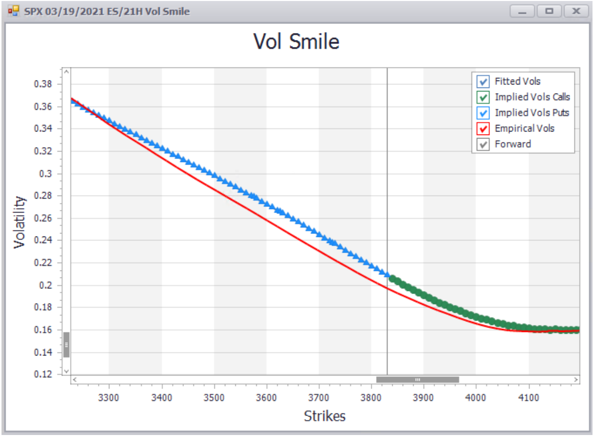


Figure 3. March Expiration SPX Vol Smile (as of February 2, 2021): OTM calls (green) reverse course and become expensive vs. fair value (red). Puts (blue) continue to be expensive vs. fair value.



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At the end of January, our models indicated that calls were significantly undervalued versus our estimate of fair value. As a result:

> Our Downside Mitigation strategies were overweight long calls;
> Our Absolute Return strategies were overweight long calls; and
> Our Income Generation strategies were overweight long calls

How could it be that three very different strategies with similar positions generate completely different results? As Eric Clapton said, "it's in the way that you use it". It is because the calls are combined with other options and futures leading to very different portfolio outcomes. For example:

> You can buy calls and short futures to simulate a synthetic long put position for Downside Mitigation.
>
> You can buy calls, and also sell puts, and sell futures to create a delta-neutral combo for Absolute Return.
>
> You can buy calls and sell other more expensive calls for Income Generation.

Our differing strategies are long and short both puts and calls, and futures. What really matters is choosing the right strikes, quantities and combinations coupled with an ever-changing hedge. Markets are moving due to heighted risk. We believe it's important to be prepared.

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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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