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Times of Stress Create Opportunities

Volatility and extreme market moves create good risk/reward opportunities for those who are patient and disciplined. This is not the time to freeze up or become indecisive. There are plenty of opportunities to execute options strategies in this market precisely because of some of the extreme moves that we are witnessing.

Volumes in index options and futures markets have been heavy over that last several weeks. During times of stress many portfolio managers use these products to hedge, speculate, or transfer risk. The price of insurance has clearly risen as evidenced by the rise of the VIX (currently hovering around 35-40).

There is increased demand for hedging to smooth out returns. Many investors cannot afford to stay invested if the market drops significantly from here. However, some investors also need or want to stay long equities and are buying defensive puts on the S&P500. This makes sense, but buying protection directly with puts or put spreads at these elevated prices may be suboptimal.

We believe that without a disciplined process for adjusting these hedges, the odds of success are greatly diminished. Insurance in any form needs to be combined with a disciplined process for monetizing and adjusting to new market conditions over time.

Currently, we see opportunity in skew (the difference between implied vols of upside calls and downside puts). Skew has been priced high for quite some time largely due to massive amounts of call selling (by investors in search of yield enhancement) that has pushed down call option implieds relative to puts. We may now be witnessing upward pressure on put option implieds due to an increase of put buyers in search of downside protection. The 25 delta calls are trading at volatility levels far cheaper than ATM options and also far cheaper than 25 delta puts.

Buying calls and delta hedging them every day with the underlying futures can provide a superior way to achieve downside protection. It also has the added benefit of making you long convexity in either direction. For example, the May 10% out of the money call is trading at around 19 vol. That call may seem expensive, but it is far cheaper than the similarly out of the money put (around 35 vol). It is possible to delta hedge the calls to take advantage of the daily volatility. If the market falls further, the short futures can payoff more than the loss on the calls.

When fear rises and markets become more volatile, it is critical to avoid a panicky response or to freeze in your tracks. We continuously search for the optimal way in which to trade a given option strategy. Lots of dislocations occur during times like these. Lake Hill's Engine and our team's experience gives us the ability to quickly identify the most exceptional market opportunities and optimize to many option-based investment strategies

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

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