Lake Hill

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April 13 2020 **Wimbledon Aced It**

I am pretty sure that no child has ever said "I want to work in the insurance industry". But insurance has become very interesting recently. As shelter in place policies keep drivers off the road, insurers are mailing rebate checks to policy holders due to the dramatic reduction in auto accident claims. On the other hand, many interrupted businesses expect to be in litigation with their insurance providers soon. Since the outbreak of SARS in 2003 and other pandemics, business insurance policies generally have excluded pandemics. However, Wimbledon is one of the few reported businesses that consistently purchased pandemic insurance over the years. For 17 years they paid $2m per year and are now set to receive a payout of $141m[1]. Many others would surely have given up after maybe 10 years of paying premiums without any claims. Writing a check year after year and receiving nothing in return could be frustrating – or it could be an enabler. Wimbledon chose to manage their business differently over the last 17 years. Knowing that they could survive a catastrophe like a pandemic enabled Wimbledon to invest more capital into their core business. Over the last decade alone they have built a new Broadcast Center and installed a roof on Centre Court in part because they had downside protection to weather a storm. What could you do if you knew your downside was protected?

The options market is very similar to insurance. Instead of an insurance company writing bespoke policies, participants in the listed equity options market can buy or sell standardized contracts. Although there are no listed options on "pandemic" risk, most financial risks ultimately end up being hedged with the most liquid and heavily traded contracts on the S&P 500. Purchasing put options on the S&P 500 would have been equivalent of purchasing widespread pandemic insurance. With the added benefit of covering a lot of other business risks such as recession or war.

Protecting downside risk allows businesses and investors alike to feel more comfortable increasing their overall levels of risk. Imagine if a restaurant chain could expand at a higher rate if it knew it would be protected in the case of an economic contraction? What if a plane manufacturer could continue producing planes through a pandemic, keeping their employees and supply chain partners working.

For investors - it is no different. The key objective for many long-term investors is to maximize upside potential while limiting downside. This can be done most effectively with options. But not all drawdowns are the same, and option managers may exit profitable positions too early or too late. Tail hedging strategies that kick in only during large drawdowns tend to lose it all when markets recover. Properly structured drawdown mitigation strategies must actively engage in the market on a daily basis, rebalancing as the options markets change in order to maintain risk levels. This is discussed in greater length in this article.

Most "tail hedging" strategies purchase protection in exchange for the future promise of payment. This requires a premium payment to the insurance provider (the option seller). Lake Hill's tail-risk strategies do that too, but we are not necessarily constrained to always pay for insurance. Sometimes our tail-risk strategies will identify certain options that are overvalued and sell those options while purchasing less expensive options to provide protection. Our tail-risk strategies could also short the market directly if all

[1] https://www.bostonglobe.com/2020/04/08/sports/pandemic-insurance-package-will-allow-wimbledon-recoup-141-million-per-report/

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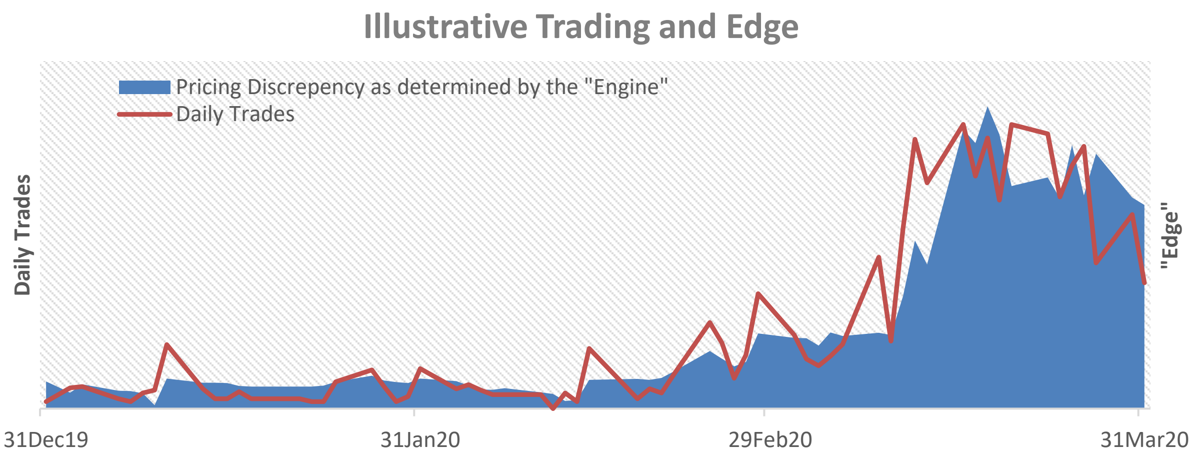
options are identified as expensive. The key benefit of our approach is that it can both dramatically reduce the cost of insurance over time while holding onto gains when they occur. This is very different than just buying puts.

In extremely turbulent times, such as this past month of March, supply and demand imbalances can cause a significant amount of mispricings that change from day to day. Lake Hill's proprietary Engine identified a significant spike in "Edge" in March and increased trading activity accordingly. The overall portfolio benefits by entering into new trades and locking in gains from options that are fairly valued or overvalued. We discussed the linkage between "Edge" and VIX in this past letter, in the figure below you can also see the linkage with Daily Trades.



Given that the strategies hold 1 and 2 month options, at least half the portfolio is turned over in a given month due to maturing positions. In the relatively stable month of January the illustrative portfolio in the figure above turned over 23% of previous week positions. During the month of March, illustrative turnover soared as a result of enormous opportunities:

Week 1 : 80%
Week 2: 85%
Week 3: 85%
Week 4: 27%

The experience of March 2020 shows us is the value of a dynamic approach to options investing where you continuously evaluate the risk/reward propositions across the thousands of options being quoted and traded every day. New opportunities arise as previous ones run their course. Trying to do this all manually or sticking with a rigidly defined system such as always buying the same out of the money put will likely lead to subpar returns because option positions will most likely be exited too early or too late.

March 2020 is an extreme example of how a highly automated, dynamic approach to option investing benefits you, but the "Edge" is there in all market conditions to varying degrees. Lake Hill's Engine is built to find that "Edge" and re-optimize a portfolio within defined risk parameters every day.

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

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Futures, options and derivatives products inherently involve substantial leverage and also greatly increase the risk of loss.