Magnitude Matters

Managing Expectations for the DRS during Drawdowns

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In this, the second of three blog posts, we discuss the different variables that will impact the DRS's performance during a downturn. There are three primary variables that we use to differentiate the downturns. They are:

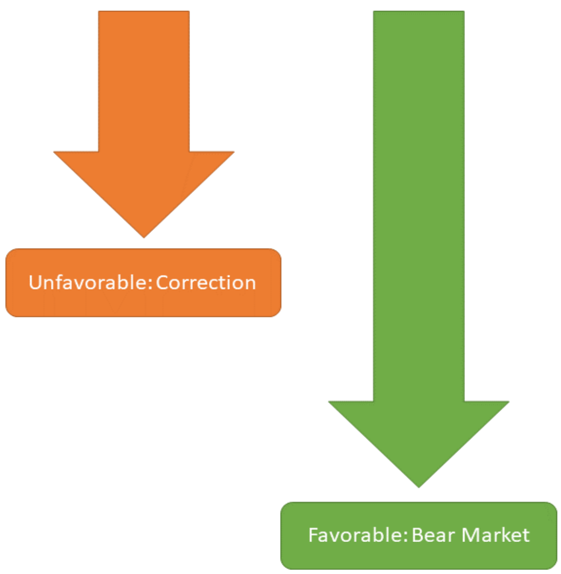
1. The speed of the sell-off,
2. The magnitude of the sell-off, and
3. The duration of the sell-off

In a previous blog post we discussed the speed of the sell-off. This post discusses the magnitude of the self-off.

Swan has always maintained that the Defined Risk Strategy was built to [protect against bear markets, not corrections]. Bear markets are commonly defined as sell-offs of 20% or more and take months if not years from which to recover. Alternatively, corrections are sell-offs of 10% to 19%, might last a few weeks or at most a couple months. Bear markets are life-changing whereas corrections are quickly forgotten.

Magnitude of the Sell-Off

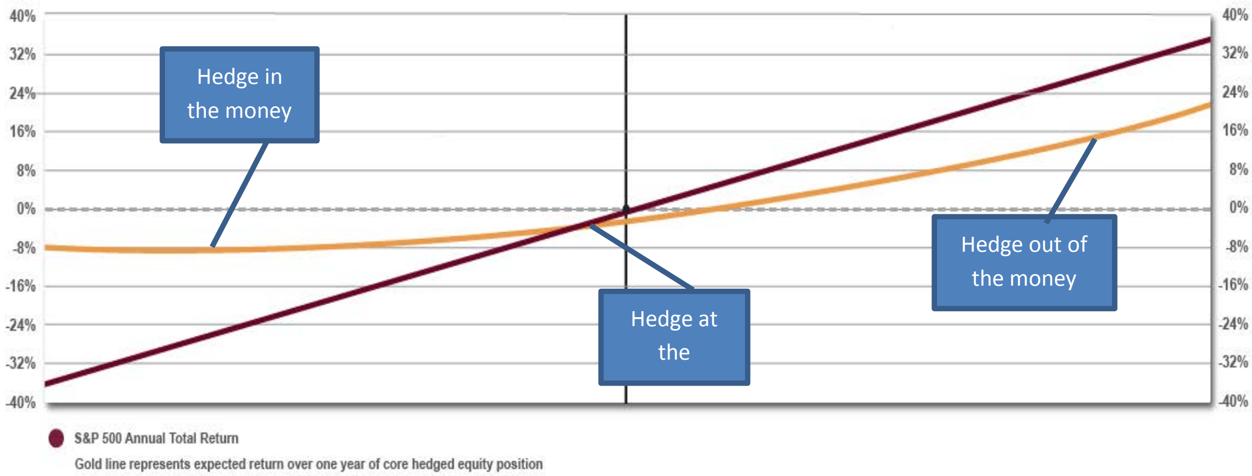
The magnitude of a market downturn primarily impacts the value of the hedging component of the DRS. The more the market moves down, the more valuable the hedges become. Furthermore, the value of the put options accelerates as they go deep-in-the-money. The larger the magnitude of the sell-off, the better the performance of the DRS's hedge.



Source: Swan Global Investments; hypothetical representation

Magnitude and the Value of the Hedge

This relationship is displayed in the graph below. If the hedge is out-of-the-money, the DRS will likely move more in-line with the market. This is true for both upwards and downwards moves at this point in the curve. If the hedge is at- or near-the-money, it will be partially sensitive to market moves. However, if the hedge is deep in-the-money, losses in the market are offset dollar-for-dollar by increases in the value of the hedge.



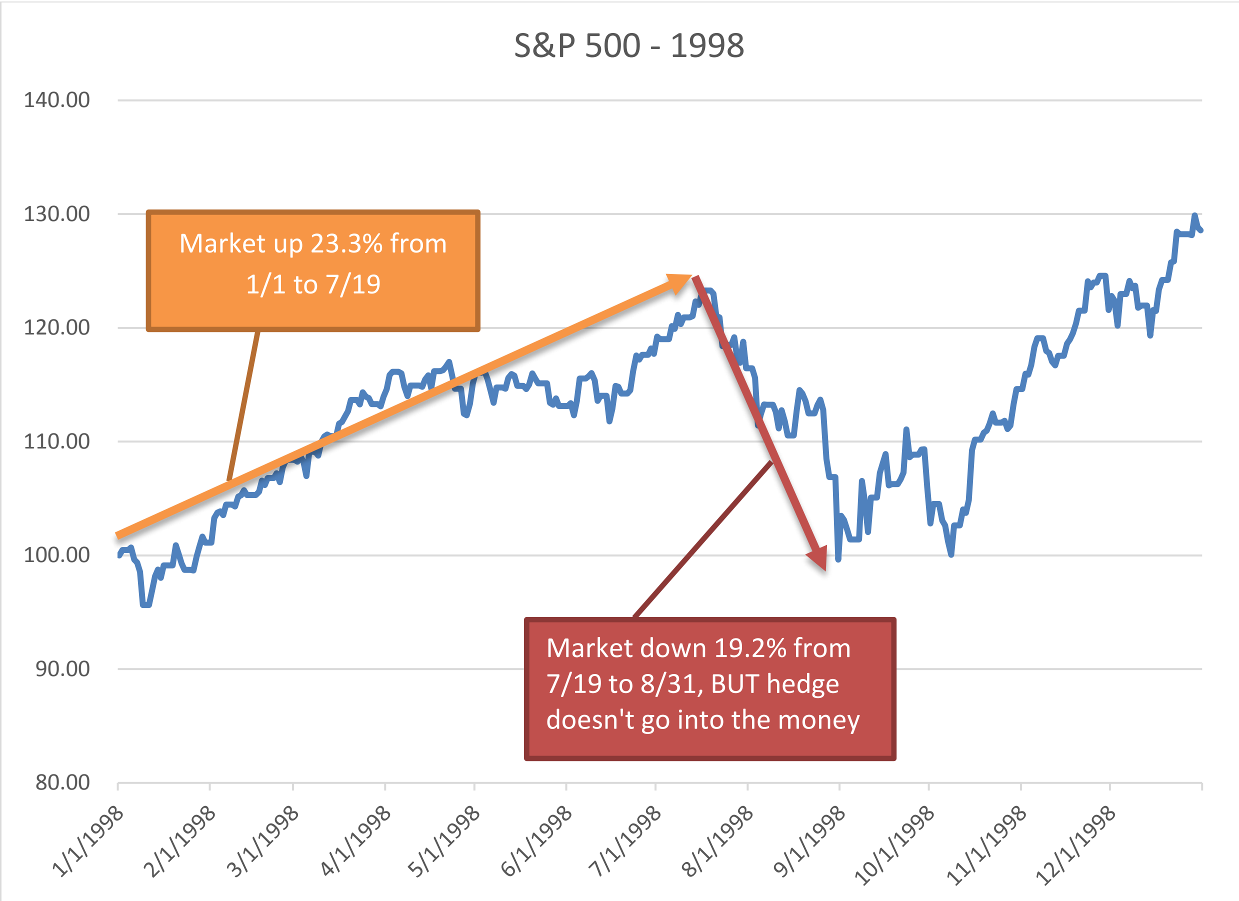
Source: Swan Global Investments; hypothetical representation

Unfavorable Scenario: August 1998, LTCM.

During the summer of 1998 the Russian default triggered a crisis at the hedge fund Long Term Capital Management. The market had been up 23.3% up until that point. During the crisis, the peak-to-trough losses were 19.2% on the S&P 500. While certainly a major correction, the LTCM crisis technically just missed the 20% breakpoint to be called a true bear market. In addition, the market also quickly recovered to new highs.

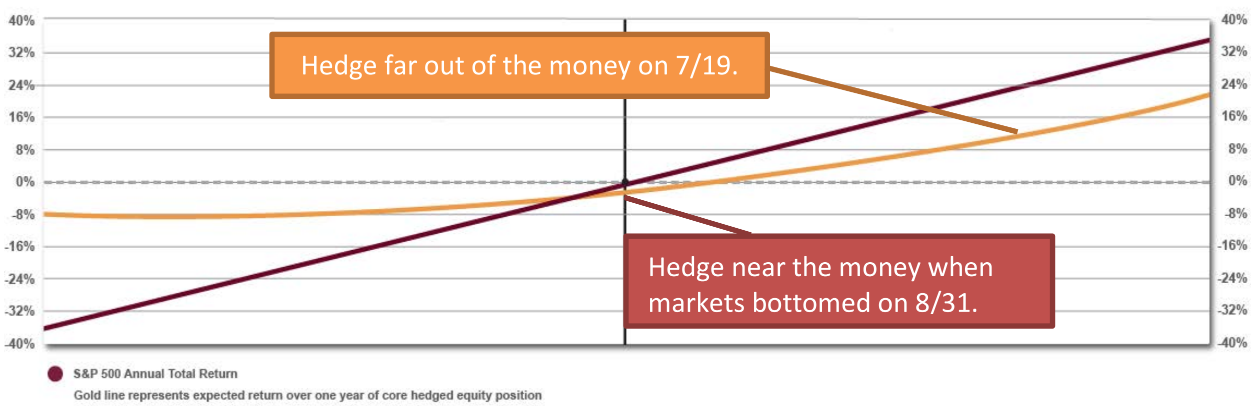
The bigger impact on the DRS, however, was due to the fact that the hedge did not go in-the-money. Essentially, the LTCM crisis had erased all of 1998's gains up until that point; by the time the market bottomed out, the market was more or less where it started the year. On the way down, the hedge did not offer a lot of protection since it was so far out-of-the-money. The hedge was near-the-money when the market bottomed, and its value would have accelerated had the market continued to drop. Instead, the market reversed itself and all of the losses associated with LTCM had been recovered by November 23rd, 1998.[1]

[1] Notes to August 1998: during the LTCM crisis, the harvesting of option premium trades also suffered. In this highly volatile environment, markets whipsawed up and down, a difficult scenario for market-neutral trades.



Source: Morningstar Direct, Bloomberg

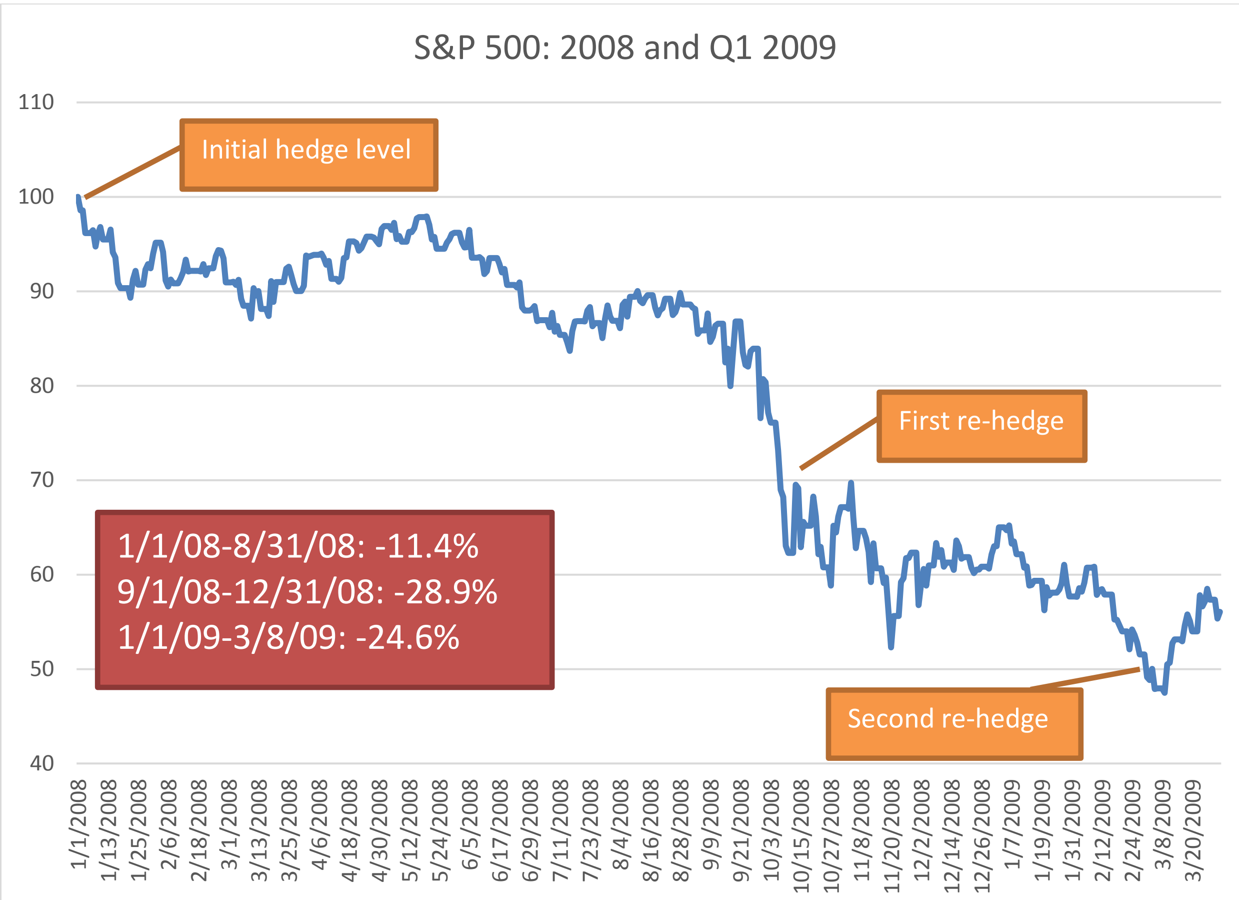
Returning to our most useful charts, we can see where the DRS was prior to and after the LTCM Crisis



Source: Swan Global Investments; hypothetical representation

Favorable Scenario: Financial Crisis, Sept 08-Feb 09.

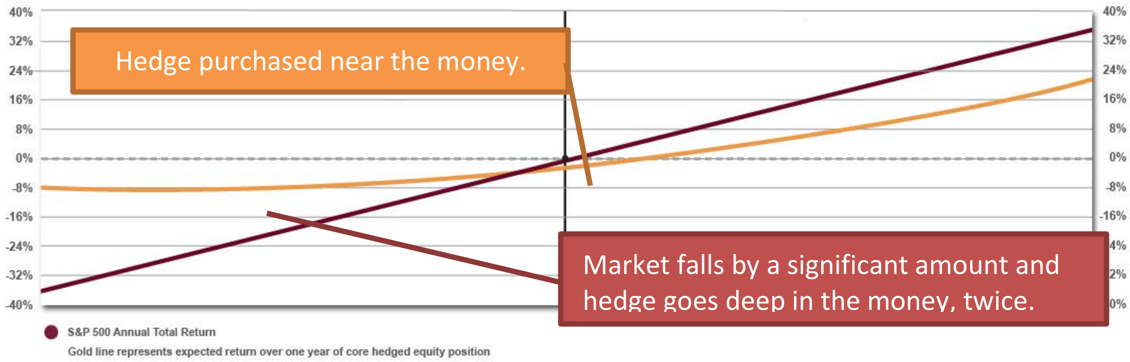
Although markets had been trending downward throughout 2008, they plummeted in the last four months of the year. The S&P 500 was at 1,468 at the start of 2008 but fell to 1,193 after Lehman failed on September 15th. The S&P 500 ended 2008 at 903 but didn't bottom until March 9th, 2009 at 677. The magnitude of the sell-off in the markets was so great we were able to execute not one but two rehedges. Twice, our put options went quite deep in-the-money and really proved their value to the portfolio. The DRS was able to sell those put options at a healthy profit and re-invest in the market as the market was trading at a low point[2].



Source: Morningstar Direct, Bloomberg

Below we see the Global Financial Crisis play out on the target return band. This process occurred twice during the crisis, setting up the DRS to perform quite well when markets rebounded in 2009.

[2] Note to Global Financial Crisis: In addition, our option premium trades were able to generate sizable returns.



Source: Swan Global Investments; hypothetical representation

In the third and final blog post in this series we discuss the final factor, the duration of the drawdown.

About the Author:

Marc Odo, CFA®, CAIA®, CIPM®, CFP®, Client Portfolio Manager, is responsible for helping clients and prospects gain a detailed understanding of Swan's Defined Risk Strategy, including how it fits into an overall investment strategy. Formerly, Marc was the Director of Research for 11 years at Zephyr Associates.

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