SWAN GLOBAL INVESTMENTS

The Case for the DRS as a Total Portfolio Solution

Where the Defined Risk Strategy Fits

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When Randy Swan first developed the Defined Risk Strategy (DRS) in 1997, it was designed to be a total portfolio solution. Randy started investing at an early age and tried many of the strategies available: buy-and-hold, market-timing, stock-picking, traditional diversification, etc. Those strategies did not prevent him from feeling the pain of the 1987 "Black Monday" crash or the 1990-1991 recession. It wasn't until he started working with insurance companies while at KPMG that he struck upon the ideas that would one day become the DRS.

A Strategy Built for Different Market Environments

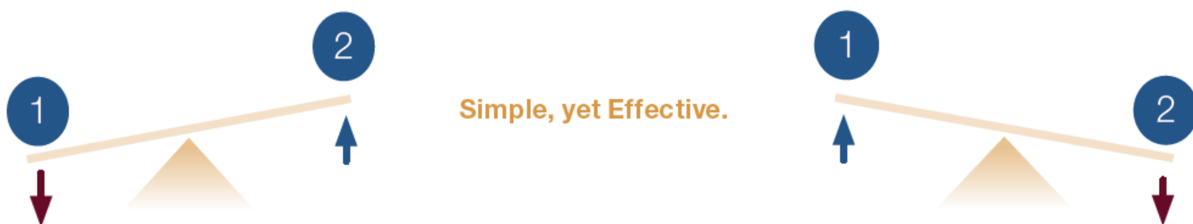
A successful money manager might be in business for decades. Alternatively, successful insurance companies have been around for centuries. Ultimately, an insurance company bears the risk of policy claims, and its balance sheet must be strong enough to withstand those claims when they come in. A successful insurance company must invest their assets well, be very cognizant of the probabilities of unfavorable outcomes, and generate sufficient revenue in order to stay in business. Suffice to say, a hit of 30% or more to its balance sheet could be catastrophic.

Many of those insurance principles are seen in the DRS:

- Exposure to the equity markets is maintained via low-cost ETFs, without any attempt to outsmart the market via stock selection or market timing.
- Downside risk is mitigated via the holdings in long-term put options.
- Revenue is generated from the premium collection trades.

Swan's Investment Process Adheres to our Core Beliefs

These three primary building blocks are complementary and seek to provide a source of returns in just about any market environment. After all, the market can do one of three things: it can go up, it can go down, or it can stay flat. The first component, equity, does well when markets go up. In the second component, the hedge gains value if the markets go down. With the third component, if the markets stay flat and range bound in a short time horizon, the premium collection trades tend to do well.



It can be said with a high degree of certainty that in no environment will all three components positively contribute to performance. However, in any given environment, at least one, if not two, of the three components may be contributing positively to the DRS.

This, of course, is by design and is a manifestation of a truly diversified strategy.

To dampen overall portfolio volatility, the individual components need to have a low or negative correlation. Historically speaking, the hedge component has been negatively correlated to both the equity position and the income trades, and the income trades have had a low correlation to the equity stake.

Time Tested Strategy

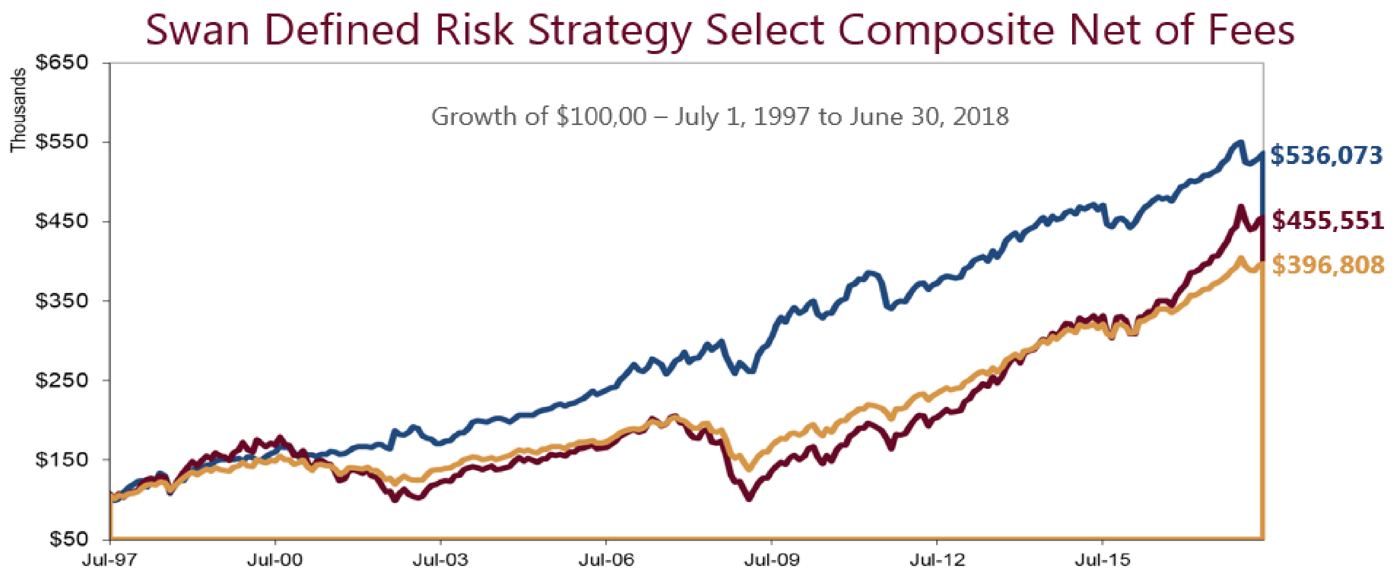
Over the course of its 20-year history, the DRS has seen many different market environments and events, including:

- The Long-Term Capital Management bust and Russian default in 1998
- The “irrational exuberance” of the dot-com bubble
- The subsequent bursting of the dot-com bubble and the long bear market of 2000-02
- The September 11th terrorist attacks
- The 2008 market collapse, the most severe bear market since the Great Depression
- The second-longest bull market in U.S. history, starting in March 2009
- The “flash crash” of May 2010
- The debt downgrade of August 2011
- A 32.4% gain in the S&P 500 in 2013

Throughout a two-decade period that encompassed many peaks and valleys, the 100% Swan DRS Select Composite outperformed both the S&P 500 and a 60% equity/40% bond portfolio. Even though the current bull market is in its eighth year and is the second-longest bull market in U.S. history, the downside protection the DRS generated through the bear markets of 2000-02 and 2007-09 have compensated for its underperformance relative to the S&P 500 during the last several years.

Only the most optimistic and foolish investors would argue that bear markets have been banished forever.

When the next bear market does arrive, the DRS will be prepared.



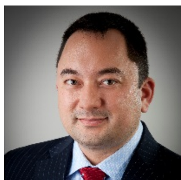
Net Annualized Performance (June 30, 2018)

	Swan DRS Select Composite	S&P 500 Index	60% S&P 500 Index / 40% Barclays US Agg
YTD	-1.98%	2.65%	1.00%
3 Year	4.88%	11.93%	7.88%
5 Year	6.00%	13.42%	8.97%
10 Year	6.40%	10.17%	7.84%
Inception (7/97)	8.32%	7.49%	6.78%

Source: Swan Global Investments and Morningstar; the Barclays U.S. Aggregate Bond Index and the S&P 500 Index are unmanaged indices, and cannot be invested into directly. Past performance is no guarantee of future results. Swan DRS results are from the Select Composite, net of fees, as of 6/30/2018. Structures mentioned may not be available within your Broker/Dealer.

All that said, we realize that most investors are unable or unwilling to invest 100% of their money with the DRS. The DRS can still perform a constructive role within a portfolio either as a core equity solution, as a distribution vehicle, or as a capital preservation vehicle.

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.

Important Disclosures

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