Speed Matters

Managing Expectations for the DRS during Drawdowns

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In the midst of a bull market, investors tend to forget that markets can and do sell off. The longer markets go up, the more surprised investors are when markets eventually go down. Swan Global Investments believes that it is essential to understand and accept that market downturns are a natural part of investing.

No two sell-offs are exactly the same. Over the last twenty years we've seen the two largest bear markets since World War II as well as numerous shorter, smaller corrections. While each is a unique event, there are three primary variables that we use to differentiate the downturns.

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

Differences in these variables will determine how the DRS will perform, so understanding these elements and how they affect the strategy's performance is essential for managing expectations during the sell-off.

While there might be additional "X-factors" that would help or hinder the DRS during a sell-off, the speed, magnitude, and duration of a downturn will be the primary drivers of the DRS's performance. This post will look at how speed of a sell off impacts the DRS's performance and explain favorable and unfavorable scenarios in the strategy's history.

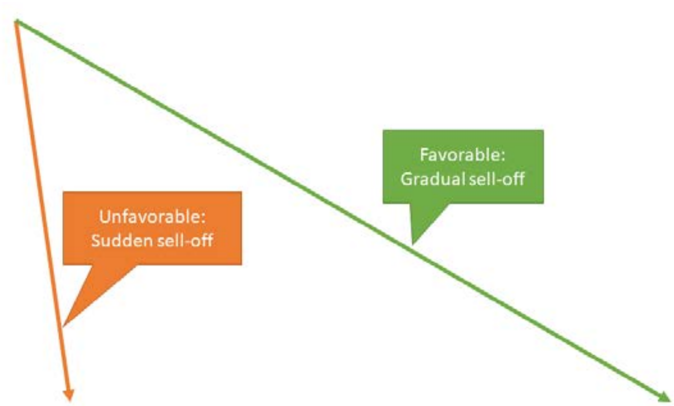
Speed of the Sell-Off

One of the primary drivers of performance during downturns is the speed of the sell-off. Markets selling off by 10% in a single trading session is an entirely different scenario from markets gradually selling off 10% over the span of a month or two. The DRS typically performs better during gradual sell-offs rather than instantaneous drops in the market.

Speed and Short-Term Put Options

The impact of the speed of a downturn is primarily borne by the harvesting of option premium trades. The equity portion and the hedge portion of the portfolios are little impacted by how quickly the markets sell off. If markets do sell-off quickly and Swan is forced to close out the short put positions, it might be done under unfavorable pricing. Alternatively, if markets are slowly "bleeding out" it gives Swan the time to make orderly exits from the short positions.

Moreover, the whole process of writing short-term options is based upon their rapid time decay as they get closer to expiration. In a gradual market sell-off the short options are losing value over time anyway.



Source: Swan Global Investments; hypothetical representation

In both cases, the elevated volatility levels that tend to follow a market sell-off usually make future premium collection trades more profitable. This is discussed further when we talk about the duration of the sell-off. But during the initial point when markets tip-over, a gradual sell-off is preferable to a sudden crash.

Favorable Scenario: Gradual Sell Off

In early 2016, markets gradually sold off over the first six weeks of the year as investors worried about a slowing global economy. Markets bottomed on February 11th after losing 10.27%. In this case, it took over five weeks to officially become a correction. During that stretch there wasn't a single day where the market lost more than 2.5%. In this environment, the DRS performed quite well, and was down roughly a third as much as the index[1].

Unfavorable Scenario: Rapid Sell Off

In late August 2015 markets sold off very violently. In the span of just one week, markets entered correction territory, losing over 10%. August 18th and 19th were modest loss days, but over the next four trading days markets dropped like a stone. The nadir of the sell-off was Monday, August 24th when the Dow dropped 1,000 points and the S&P 500 almost 100 points at opening. Although the markets recovered nearly half of their initial losses by midday on August 24th, Swan's strict adherence to their risk-control rules forced the DRS to close out the short option position at a sizeable loss.

Despite this, the hedge component did well during this period in August. They started the correction slightly out-of-the-money, but the hedge did perform its intended role as the markets sold off. Moreover, in subsequent months the DRS was able to "claw back" some of its initial losses. This phenomenon is explored in the duration section.

The chart below provides a visual comparison of the early 2016 correction to the August 2015 sell-off.

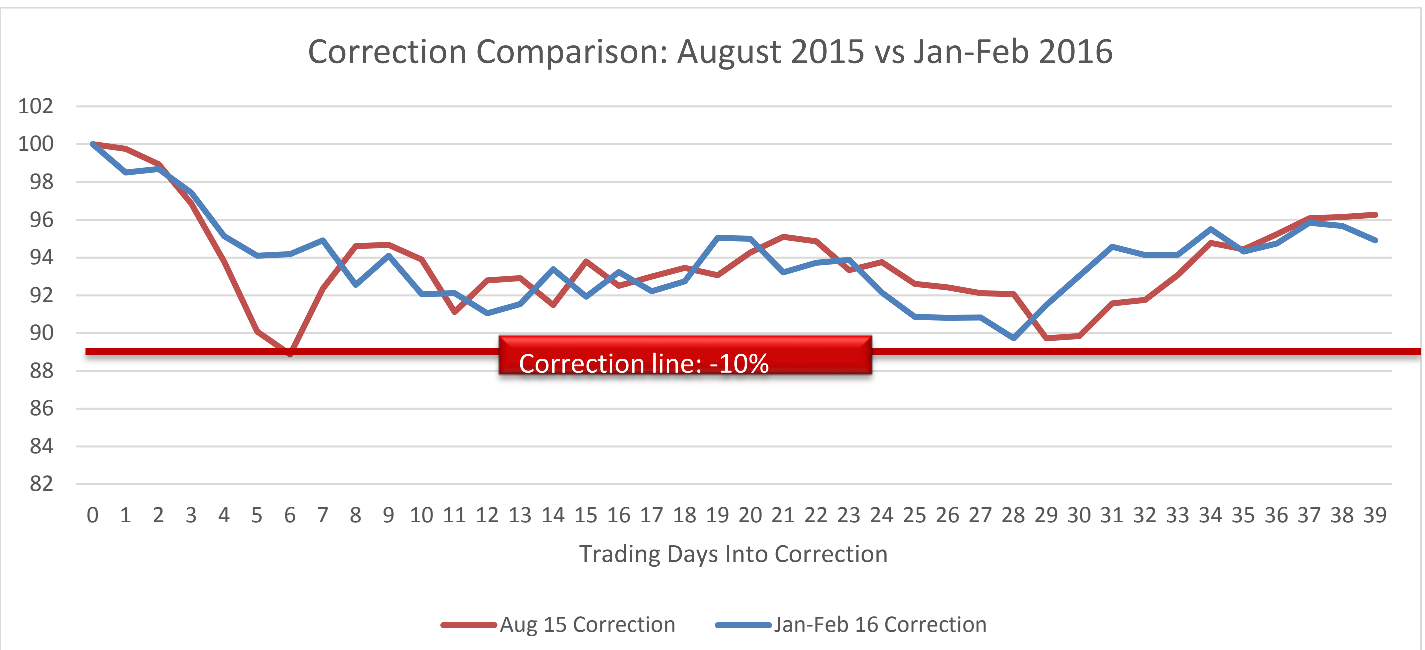


Chart 5. Source: Morningstar Direct, Bloomberg

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[1] Notes to early 2016: The DRS also benefitted from the fact that it had just re-hedged the portfolio at the end of 2015, so its hedges went in-the-money as soon as the markets opened up down in 2016.

Managing Expectations during a Downturn

Many are on edge during market sell-offs and may sometimes have misguided expectations about their investments. Proper expectations are one of the most important elements of an investment strategy and plan because it helps investors keep their cool during heated market movements and help them avoid getting out too early.

Swan's Defined Risk Strategy was designed so that elements of it could protect and potentially even profit during market downturns. If markets never sold off, there would be no reason to hold the Defined Risk Strategy (DRS).

At the beginning of a market sell off, the DRS will likely participate in more of the initial downward move. But this characteristic doesn't necessarily apply to the performance of the DRS over an entire cycle. An investor might look at a week when the S&P 500 is down 5% and the DRS is down 4% and incorrectly assume that if the market goes down 50% that the DRS will lose 40%. The initial hit is usually the worst while follow up losses are less.

The DRS is constructed so that if the market does keep moving down, the DRS's performance tends to level off. It catches less and less of a downturn the longer and further the market falls.

In a subsequent post, we discuss the second factor, the magnitude of the sell-off.

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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