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THE WALL STREET TRANSCRIPT

Connecting Market Leaders with Investors

A Long-Term, Cost-Effective Strategy to Hedging a Portfolio

RANDY SWAN, CPA, is the Founder, CEO and Lead Portfolio Manager of Swan Global Investments, and the creator of the proprietary Defined Risk Strategy. In 1997, recognizing the limitations of modern portfolio theory and the difficulty of market timing and picking stocks, Mr. Swan developed the DRS to help investors gain a more consistent, smoother and beneficial, long-term investment experience by seeking capital appreciation over time while always seeking protection from large losses. As President of Swan Global Investments and Chief Portfolio Manager of the Defined Risk Strategy, Mr. Swan oversees and manages the strategy across numerous product portfolios and asset classes such as large-cap stocks, emerging market stocks, foreign developed stocks, small-cap stocks, long-term bonds, gold and more. Before founding Swan Global Investments, Mr. Swan was a Senior Manager for KPMG's Financial Services Group, primarily working with risk managers and insurance companies. His experience at KPMG helped him in designing the DRS, as he was able to see firsthand how insurance companies and risk managers focused on defining risk. With the DRS, Mr. Swan began to use options as an investment vehicle to manage and hedge risk. The strategy uses equities and options to define a particular risk/reward structure in portfolio management, thus seeking to mitigate large risks in portfolios and markets. Mr. Swan is a 1990 graduate of the University of Texas with a master's degree in professional accounting.

SECTOR — GENERAL INVESTING

TWST: Why don't you start from the beginning? Tell me how this idea came to you and how you executed it and what the results have been.

Mr. Swan: Sure, thank you. About 20 years ago I started my career as a CPA. I worked at KPMG in Houston in the Financial Services Group, mostly with insurance companies. While at KPMG I got to see firsthand how insurance companies manage the liability side of their balance sheet. Insurance companies get to structure their risk in precise ways with the deductibles they set, the assets they have available to cover retention levels, the reinsurance to off-load risk, etc. Now I was an avid investor since a young teenager and loved everything about investing. I thought someone really needs to have an investment strategy that takes some of these insurance concepts of risk management into account.

At that time we were in the midst of the irrational exuberance phase of the 1990s bull market. Personally, I felt there was a fundamental flaw in the whole modern portfolio theory approach. With asset allocation you try to combine different assets in a portfolio and hope they are going to be noncorrelated when bad events happen. I argued that type of approach is a case of hope triumphing over experience.

I believe that when you're able to pair options with underlying positions in equities or other assets, you are much better prepared for ill events. You have a much higher likelihood of structuring the kind of risk/return trade-off you want out of your investments. My thesis was simple: If you combine something like the S&P 500 with options on the S&P 500, you can precisely define your risk/reward profile. This will ultimately lead to outperforming the S&P 500 on an absolute and risk-adjusted basis over a full market cycle. By "full market cycle" I mean a market that includes both a bull and bear market.

Asset allocation is part of the solution, but it's not the entire solution. One of the long-standing tenets of modern portfolio theory is that market risk cannot be diversified away. And yet market risk is the biggest risk an investor faces. Of course, we've seen this manifest itself twice over the last 15 to 20 years. We've experienced two very large bear markets, and we were able to test and prove our theory in practice. Our experience through the 2000 to 2002 02 dot-com crash and the 2007 to 2009 financial crisis validated our strategy.

Since the last bear market we've launched three additional mutual funds in addition to our flagship large-cap/S&P 500 fund. These new funds apply the same hedged equity strategy to different underlying assets. Today the Defined Risk Strategy is available in large cap, small cap, foreign developed and emerging markets. Our strategic vision of the firm is to improve the building blocks people use to build their portfolios by applying the Defined Risk Strategy to the various asset classes they utilize. Ultimately, you will get a better portfolio if you build it with better tools.

Let's face it, the traditional 60/40 portfolio is in a lot of trouble. The 40% in fixed income is not yielding very much today, and looking ahead there is a lot of interest rate risk baked into bonds. Meanwhile, we have equity markets near all-time highs, and this bull market is the second-longest in U.S. history. Something has to give sooner or later. While most people remember 2007 to 2009 as a nightmarish confluence of events, from our perspective it actually validated what we created at Swan. The catastrophic losses in many investment strategies opened a lot of people's minds to what we are saying and doing. Prior to 2007 to 2009, most advisers would not use managers that use options.

So what is the Defined Risk Strategy? If I could sum it up in a short motto, it would be, "Always invested, always hedged." We take an underlying ETF position in an asset like the S&P 500, emerging markets, foreign developed or small cap. We like the low-cost, tax-efficient nature of ETFs. We don't try to pick winning stocks or time the market — that's not our game, and we believe it's difficult to be consistent doing that. Thus, we are always invested.

But we also have the "always-hedged" element. The value our firm provides is to come up with a cost-effective way to hedge the portfolio as well as generate income by selling short-term options. We use our options expertise to both hedge the portfolio and generate income to cover the carrying cost of the hedge. That's it in a nutshell.

Highlights

Randy Swan discusses his firm's Defined Risk Strategy, or DRS. Mr. Swan believes modern portfolio theory is limited. The DRS involves paring options with underlying positions in equities or other assets. Mr. Swan says it all comes down to building a better portfolio with better tools. He says the motto of the Defined Risk Strategy is "always invested, always hedged." He says the value his firm provides is coming up with a cost-effective way to hedge the portfolio as well as generate income by selling short-term options.

TWST: Why do you focus on the S&P 500 as your benchmark? Why did you choose that particular one?

Mr. Swan: Well, for better or worse, the S&P 500 is the main index everyone in the world looks at. When someone says "the market," they are generally referring to the S&P 500. The second reason is because we are dealing with options, we need liquidity in those options. The SPX options that track the S&P 500 and are traded in the Chicago Board Options Exchange are the most liquid options market in the world. Liquidity is always good when you're trading.

It's also true that SPX options are considered 1256 contracts, which carry some tax advantages to them. Sixty percent of the gains you might generate trading SPX options are taxed at a long-term capital gain rate, regardless of the holding period, and only 40% of the gains are treated as short-term gains. So it's the tax benefits, the liquidity and the broad acceptance of the S&P 500 that explains our use of the S&P as the main benchmark.

TWST: And you said you have started some new funds; do they also use S&P 500?

Mr. Swan: No, the new funds use other underlying benchmarks. We have an emerging markets fund that's based on EEM, we have a small-cap fund that's based on IWM, and we have a foreign developed that's based on EFA. Those are the tickers for the underlying ETFs we use, the most common ETF investment vehicles for their corresponding asset classes. By utilizing those ETFs, we are able to implement our firm's strategic vision of hedging different assets. We also have Separately Managed Accounts — SMAs — where we have applied the DRS to Treasuries, gold and real estate.

There's been a lot of independent research in the industry and in academia about hedged strategies. The concept is based on the idea that if you can minimize the risk in a strategy, over time benefits accrue because you don't have as much variance drain afflicting performance. We've put those theories and research into practice. We've taken what the OIC — the Options Industry Council — has researched and expanded our strategy beyond the S&P 500 to multiple assets. It really gives our advisers and our clients the ability to access almost any asset class in a more risk-managed way.

TWST: And so history has shown, if I'm reading this correctly, that you limit the downside risk substantially, but maybe don't capture all of the upside. But do you capture some of the upside?

Mr. Swan: Yes, that's a fair assessment. Historically speaking, we've gotten about 60% of the upside, and we have had a negative downside-capture ratio, which means on average on an annual basis we've actually made money during the down years. Now that's not a guarantee obviously, but what we are trying to achieve is simple. Mathematically, if you lose 50% of your investment, you have to make 100% to get back to even. Not 50%, but 100%. Alternatively, if you lose 5%, which is about what our worst loss year has ever been, it only takes about a 5.25% return to be made whole. So protecting on the downside is much more important than catching all of the upside.

In fact, statistics and studies have shown that if you don't have any of the downside, you only need about 30% of the upside to actually match a buy-and-hold position. So if you look at that differential, it's always the trade-off between the upside participation and downside avoidance that determines how it will perform over time. That's just from a purely mathematical basis.

Once you start dealing with investor psychology and how their emotions come into play, it makes the importance of avoiding losses all the more valuable. Everyone knows that investors are often their own worst enemy — panicking and selling at market lows or waiting too long and missing rallies. If you have a strategy that can protect people and minimize losses, they are much more likely to stay the course during a bear market like we saw in 2007 to 2009.

TWST: And you mentioned investor emotion, and I'm sure that your clients are grateful when there is downside, but do they get anxious or inquisitive when the market is going up and you're not capturing as much as the overall market upturn?

Mr. Swan: Well, that's difficult to answer when you have tens of thousands of investors, but yes, a percentage of our investors aren't happy with missing some of an up market. With this bull market entering its eighth year, the second longest on record, it becomes difficult for us and the financial advisers we work with to keep clients focused. We do have clients turn away, and we do see some redemptions, but it all goes back to the education of your clients. If they know initially that they're supposed to underperform on the upside, but they also know that minimizing losses will help them outperform over a full market cycle, then I think that gives them some level of confidence.

It's a problem that anyone using the S&P 500 as a benchmark is facing. The last few years, any allocation away from the S&P 500 was going to hurt your relative performance. International, commodities, bonds, balanced portfolios, contrarian strategies — all have "underperformed" the S&P 500. If you're comparing our strategy to more of a diversified portfolio or maybe a simple 60/40 mix, then the dynamics change somewhat.

So I go back to my thesis that modern portfolio theory is limited. It's part of the solution, but it's not the entire solution. Say, for example, the S&P 500 goes up 20% in one year, and we only make 12% or 13%. You might say, "That's kind of bad that you trail the market so much." But if you were to look at the bigger, broader picture; if you look at a balanced portfolio, bonds probably didn't go up 20% either. You'd maybe get 1% or 2% out of bonds in that kind of environment, and the two would average each other out.

Let's flip it. In 2008, the S&P 500 was down 37%, and 60/40 mix was down 22%. We lost 4.5% in 2008, net of fees. So it always comes down to education. It's about not letting the twin forces of fear and greed overwhelm an investor's decision-making process. Since we never know when the bull market party is going to end, and no one else does either, we believe it's better to gladly underperform during those times in order to have protection in place to avoid catastrophic losses.

TWST: OK. And so, as you know, there's widespread speculation that the Fed will raise rates before the end of the year, but that doesn't really affect your strategy.

Mr. Swan: Well, it wouldn't directly affect our strategy in the sense that if they do raise rates and the market sells off substantially, we've got that protection in place. I would argue that if rates do start rising, which they will at some point, that's going to be bad for a traditional portfolio because equities should go down, and bonds should go down in value. And so relative to those assets, we should do better than those assets.

As I mentioned earlier, our motto is, "Always invested, always hedged." We don't believe in market timing, we don't believe in stock selection, and we believe that modern portfolio theory is only a partial solution and can't truly protect against market risk. If market risk by definition can't be diversified away, we believe it must be hedged away. So how we manage risk is much more direct. The traditional approach combines different assets that you hope are going to be noncorrelated when you need them to be.

TWST: So are there others out there who have adopted this theory and strategy that you have developed?

Mr. Swan: That's a good question. There are definitely a lot of players out there in the option space. As a matter of fact, Morningstar recently created a new category specifically for option-based strategies. What I would say differentiates Swan is that we have been doing this longer than most anyone else. A lot of these option strategies have not been battle-tested through a bear market. We've been through two. Just as important, we have a different approach. We've come up with a long-term, cost-effective way to hedge a portfolio that doesn't have some of the pitfalls that you would have if hedging on a short-term basis.

Allow me to go through an example of what we do differently. So as stated previously, we don't think you can predict or time the market. Therefore we're always invested, and we're always hedged, but we do so in a cost-effective manner. We hedge 100% of the portfolio, and we hedge with long-dated options. That means that we will typically buy a two-year put option, but we only hold it for about one year. Near the end of the calendar year we then trade that one-year option for another, newer two-year option.

By "rolling" the hedge every year, we accomplish three things. First we reduce the impact of the put option's time-decay cost by selling it halfway through its lifecycle. Options are decaying assets and lose value the closer they get to expiration. However, they don't lose value at a constant, linear rate. As you get closer to expiration they decay at an exponential rate. So by holding an option during the cheaper, earlier parts of that lifecycle of that option, it's a cheaper way to maintain the hedge.

The second benefit of longer-dated options is that it allows us to effectively keep that protection in place throughout a crisis. To give you an example, assume you're hedging on a 90-day basis, using shorter-term put options, like many of our competitors do. Suppose the market sells off big during the quarter. At the end of that quarter you may have made money on that put option because the market dropped, let's say, 15%. But now what? The kind of bear markets we are trying to protect against last years, not 90 days. Now your portfolio is no longer protected.

What is it going to cost you now to hedge your portfolio after the market has sold off by 15%? Everyone is panicking and trying to buy put options, and guess what? You're going to pay through the nose now that the risk level is much higher in the market. The option market is going to demand a much higher price to insure that portfolio. Because we already have our long-term insurance in place, we never have to hedge under duress. Everyone else is trying to buy hurricane insurance when the winds are whipping at 90 mph, but we are all set.

Third, and perhaps most importantly, we can actually profit from a bear market. After the market experiences a major selloff, our long-term put option is worth a lot — "deep in the money" in options-speak. We will sell that option at a profit, re-hedge the portfolio at current

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market levels, and reinvest our proceeds in the market ETFs, which of course are trading at a steep discount in a bear market. Sell high, buy low. We get to choose when we want to re-hedge, and we have transference of that volatility pickup of that increased risk in the market in the current option that we're selling. That allows us to save additional hedging cost, so that's really one of the ways that differentiates us.

Now when you get into the second component of our strategy, which is our option income component, that's where I think some competitors do something more similar to us. The idea there is that we, as well as others, are trying to profit from the gap between implied volatility and realized volatility in the short term. But when it comes to our main focus, the concept of hedging away market risk, we don't know of any competitors that do it the way we do it. And no one has a whole family of hedged investments across different asset classes like we do.

investing. That's happening for a lot of reasons, but the big one is that a lot of studies have shown that low-cost ETFs do well relative to most active managers. But it's also true that there's kind of a self-fulfilling prophecy when it comes to passive investing. People are putting more money in cap-weighted passive products because they've performed better than active managers, but that just drives the prices of the stocks in an index like the S&P 500 higher.

Moreover, we are in a market environment that's hard to predict what's going to happen next. I mean, if you had a tactical asset allocation model right now or some kind of a top-down macro play, the monetary conditions are unlike anything we've ever seen before. The Federal Reserve and the other central banks around the world have created trillions of dollars in liquidity, and it's had all sorts of unintended consequences. We have negative yields — paying someone else to

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This is what we do. This is pretty much all we do as a firm. We apply our strategy across multiple assets, and that gives us a level of expertise that comes with being strictly defined and narrowly focused. We have one strategy across many asset classes. This is different than the grab bag of strategies you might see at a firm that has 20 or 40 different funds, where all they do is try to sell whatever is hot right now. So that's the differentiator for us versus other people.

TWST: Right, so you don't really have to spend a lot of time thinking about from your investment perspective, for instance, the current presidential campaign in the United States. Your strategy minimizes surprises?

Mr. Swan: It takes the guesswork out of it, right. It doesn't change our strategy one bit what could happen in the election. I remember going through 2000 when there was the recount and how that went on for it seemed like a month or so. Yet all that turmoil and uncertainty really didn't factor into our equation of how we're going to do what we do.

I go back to the irrational exuberance speech by Greenspan in December 1996. Greenspan said this market is irrational, we've got a bubble on our hands, but of course we all know the market didn't top out until 3.5 years later. I think that kind of shows you that it's really difficult to call the tops and bottoms of markets over time. Certainly someone can have a good call at one point, and some people have made entire careers around the one time they were right. But over 10, 20 years or longer, it's really hard to do that consistently.So we've chosen to take the guesswork out of stock selection or market timing and always maintain market exposure via low-cost, tax-efficient ETFs. Years can go by between bear markets, so we want to make sure we capture some upside when markets are good. Our value add as a firm is to hedge and protect in a cost-effective manner and supplement returns by generating additional income via the premium collection component of our strategy. That's really what we bring to the table and what our firm is built upon.

I'm sure you're aware of the trend toward low-cost passive borrow your money. It's absurd. It's hard to know if your stock selection or tactical allocation model will really work anymore under this environment. It's almost like we're in "The Twilight Zone," although using that cultural reference kind of dates me.

TWST: So it seems to me that maybe it's easier for you to sleep at night than for some of your competitors?

Mr. Swan: Absolutely. And actually I had a client come up to me once and say, "You know what Swan stands for? Sleeps Well At Night." I use that line occasionally, but absolutely, I sleep better at night knowing my investments are hedged. It takes a lot of the pressure away. It sure does.

And it helps the financial adviser have a better conversation with the client. Rather than hiring me to pick stocks or time the market, we perform a holistic, portfolio-level risk management role. We've come up with a more cost-effective hedge, and I think it's a better conversation. Quite frankly, I think it gives us a level of sustainability in this marketplace. You know we are being frank and honest with what we do. People can choose or not to invest with us, but they understand exactly what we're going to do.

We have what we call a targeted or expected return band that shows what we expect our performance to be within various market conditions, and in 19 years we've been in or above where we expected be every year but one. We have a model that says if you have a 20% selloff in the market, we expect to be within a very predictable range. We've run those tests over all our different assets, and 96% of the time we are within or better than where we should be.

So that it goes back to the repeatability, scalability of our strategy. Whether the market is down 50% or if it is in the eighth year of a bull market, we are doing the same thing. It's a constant, you know what we do. We have a table showing all of our rolling 10-year averages compared to the S&P 500, and we beat the market on a rolling 10-year average going back 18 years to our inception, 94% of the time. That's not based on market timing or getting a single call right; it's about consistently applying our strategy throughout all market environments. At the end of the day, it's based on a strategy that you stick to regardless of what happens in the market, regardless of the elections, regardless of Federal Reserve policy. We think ultimately what we do is more defendable.

TWST: Very interesting. Is there anything else that you would like to add that we have not talked about?

Mr. Swan: I guess the last thing is, "What kind of opportunities exist going forward for the average investor?" Our strategy is compelling because, as I mentioned previously, the 60/40 portfolio is dead. It didn't really work well in previous bear markets. And I think it is really hard to make a compelling case that equities are going to generate anything more than 2% to 4% per year on a nominal basis given where valuations are today. But more importantly, today we are in this low-yield, high-risk environment. You know you want something that's going to protect you, but bonds at low or even negative yields can't do that like they once did.

So we would argue the more likely scenario is the end game plays out in terms of the interest rate cycle. There's some big correction looming out there; bubbles always burst. But regardless, we still think that we can deliver the kind of equity-like returns over the long haul even if we don't have kind of a long-term secular bull market. So that's I guess the last thing I would just add.

TWST: So you don't think that future interest rate hikes are baked into the market?

Mr. Swan: You know what, no. I guess I don't. I think the reason why is that people know they're going to go up at some point, but people have been forced into accepting this is the market environment we are in, like it or not. I don't think people have said, "Interest rates have bottomed out and are soon going to start going up. Therefore I'm going to start moving money in or out of equities or bonds." Instead I think everyone has been forced to play this new game where everyone is fuzzy on the ground rules.

I think that would be excruciating for me from a risk management perspective, to sit there and say I don't know when this is going to end, I don't know how exactly it is going to end, but it's going to probably end, and my investment success depends upon making that call. That sounds awful, and I'm glad I'm not in that position. As I've established, our strategy's success isn't going to be built on any predictive ability, and that gives us a leg up on the competition. And I just think that's the key at this point, waiting for that day to occur and how it's going to unfold.

TWST: Thank you. (JM)

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