What Return Are You Targeting?

Setting Expectations with an Appropriate Benchmark

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One of the more frequent questions we receive at Swan Global Investments is,

"What is the appropriate benchmark for the Defined Risk Strategy?"

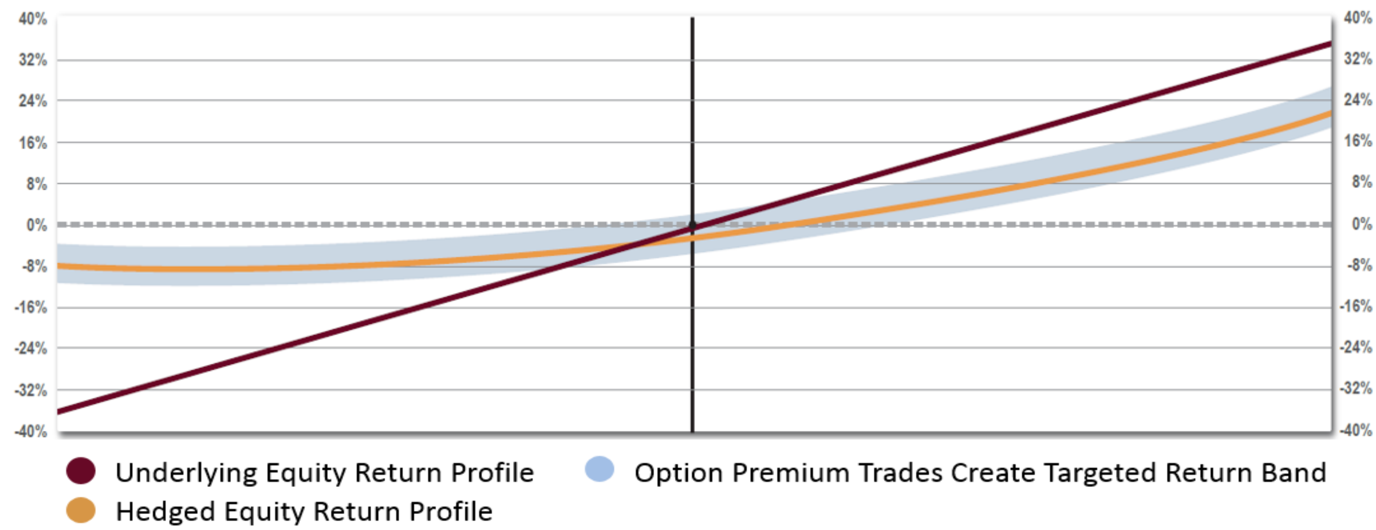
It's a legitimate question. The Defined Risk Strategy (DRS) is a unique solution and standard off-the-shelf indices aren't ideal benchmarks. It is important to remember our goal is to outperform both the S&P 500 and a balanced equity/bond portfolio over a full market cycle, which by definition includes both a bull and bear market. However, a full market cycle can take quite a long time to unfold. Just witness our current bull market, now in its ninth year.

So, how should the DRS's performance be evaluated over shorter periods of time?

Setting an Appropriate Target

We believe that our **Target Return Band** is a very appropriate prism through which our performance can be viewed. The three main elements of the Defined Risk Strategy are represented in the Target Return Band:

1. A long, buy-and-hold position in ETFs, typically representing 85%-90% of the portfolio (burgundy line)
2. Long-dated put options used to hedge market risk (gold line)
3. Short-term, market-neutral premium collection trades to generate cash flow (blue range)



Source: Swan Global Investments. NOTE – this chart is for illustration purposes, not a guarantee of future performance. The charts and graphs contained herein should not serve as the sole determining factor for making investment decisions.

The main idea is that at any given return level of the S&P 500, the DRS's return should fall either within or above the blue range. If our returns fall within this targeted return band in the shorter-term (one year), we believe we will be on track to beat both the market and a balanced equity/bond portfolio over a full market cycle.

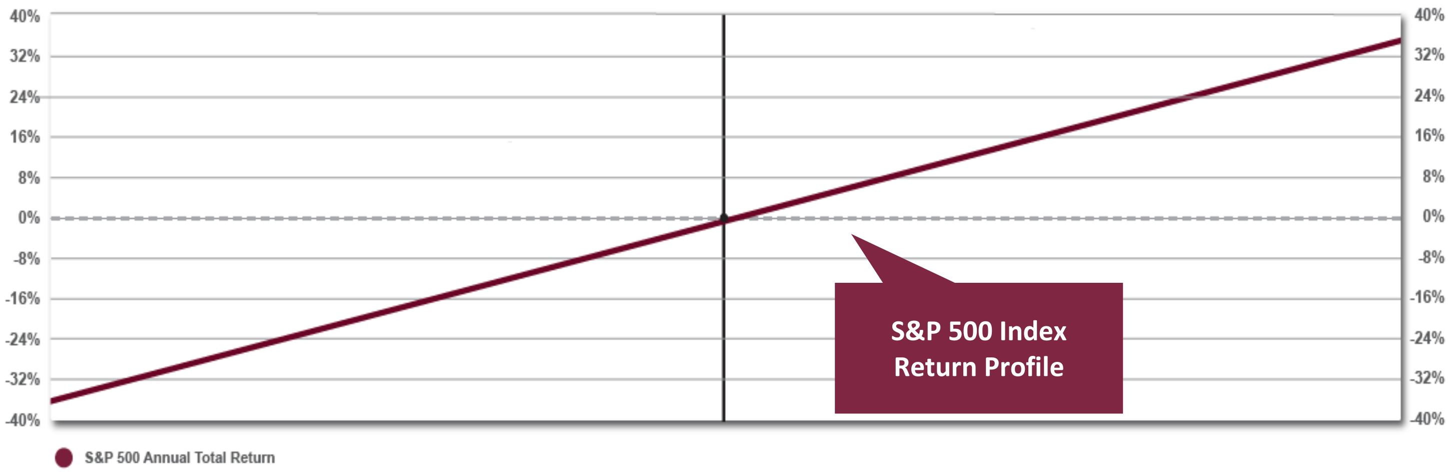
Let's breakdown this benchmark further.

Targeting Returns

First, we start with the burgundy colored line. This diagonal-like line represents the return profile of the S&P 500.

This element is simple and straight-forward: It represents a long position in passively-managed ETFs. An investment in a S&P 500-based mutual fund or ETF seeks returns that correspond substantially to the returns of the S&P 500 index[1].

[1] It should be noted that the large cap Defined Risk Strategy uses an equal-weighted sector approach to its long positions, rather than the capitalization-weighted methodology of the S&P 500. This can lead to some dispersion in performance.



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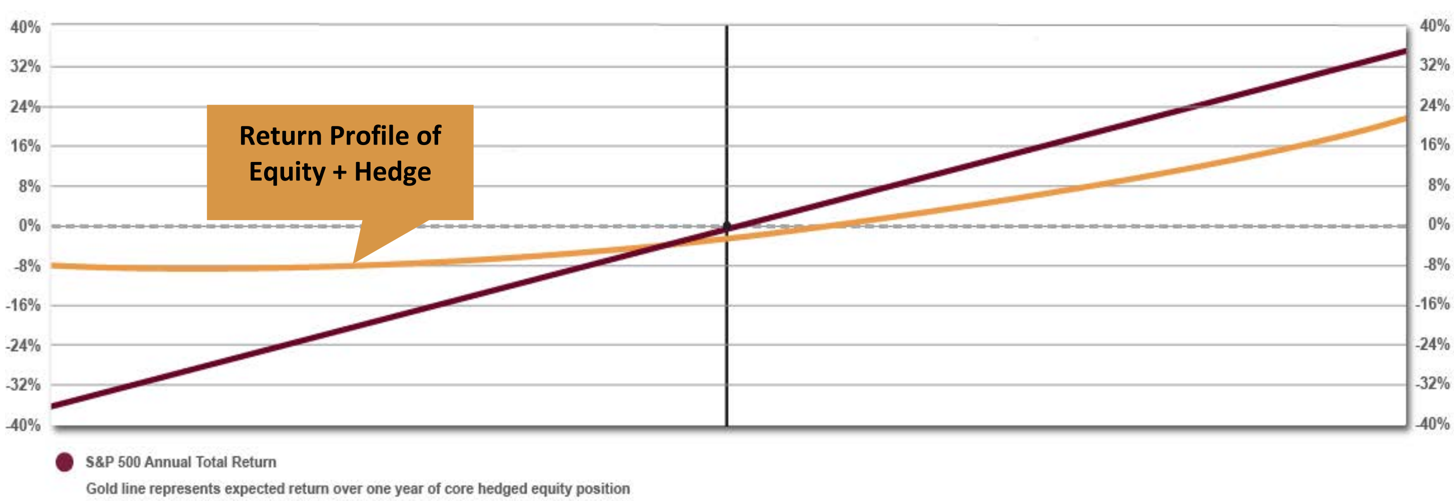
Hedging to Improve Return Targets

The problem with this kind of passive, buy-and-hold approach is that it has unlimited downside risk. The market can sell off by 20%, 30%, 40% or more and has done so many times through history. Such losses can be catastrophic and require years for a portfolio to recover.

To protect against these types of major losses, the second component of the DRS is to overlay the ETF positions with put options to hedge against downside risk.

The return profile of this combined equity-and-hedge position is seen in the gold line below.



Source: Swan Global Investments. NOTE – this chart is for illustration purposes, not a guarantee of future performance. The charts and graphs contained herein should not serve as the sole determining factor for making investment decisions.

The gold line lags the S&P 500 in up markets but is still upward sloping, so the DRS's potential upside capture is not capped.

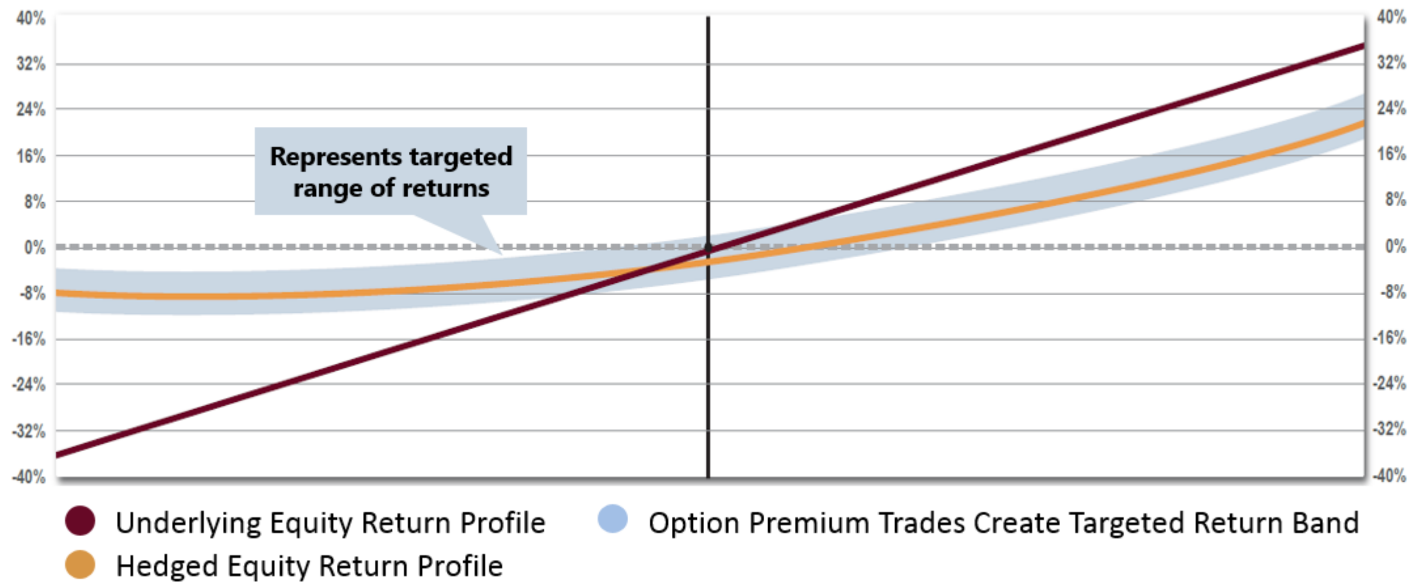
In down markets, however, the value of the hedge is readily evident. As the S&P 500 drops, the hedged equity positions flatten out. At a certain point, the slope of the curve is flat or 0, meaning that the hedged equity position is insulated from further losses in the market. The value of downside protection is clear and is explored in-depth in previous blog posts on avoiding large losses and the importance of distribution of returns.

That said, in a flat or up market the hedge does act as a drag on performance.

Targeted Returns for Cash Flow

The third element to the Defined Risk Strategy is the short-term, market-neutral premium collection trades. These are meant to be an additional source of return that is not dependent on the overall direction of the market.

The impact is seen by overlaying the premium collection trades on top of the hedged equity position and is represented by the blue band below:



Source: Swan Global Investments. NOTE – this chart is for illustration purposes, not a guarantee of future performance. The charts and graphs contained herein should not serve as the sole determining factor for making investment decisions.

While the premium collection trades add a bit of uncertainty to the equation, more often than not, these trades have been a net positive to performance and have boosted the DRS's returns above what would have been expected by just the hedged equity component alone.

The upper range of the blue band represents the average annual return generated by the income component throughout the history of the DRS.

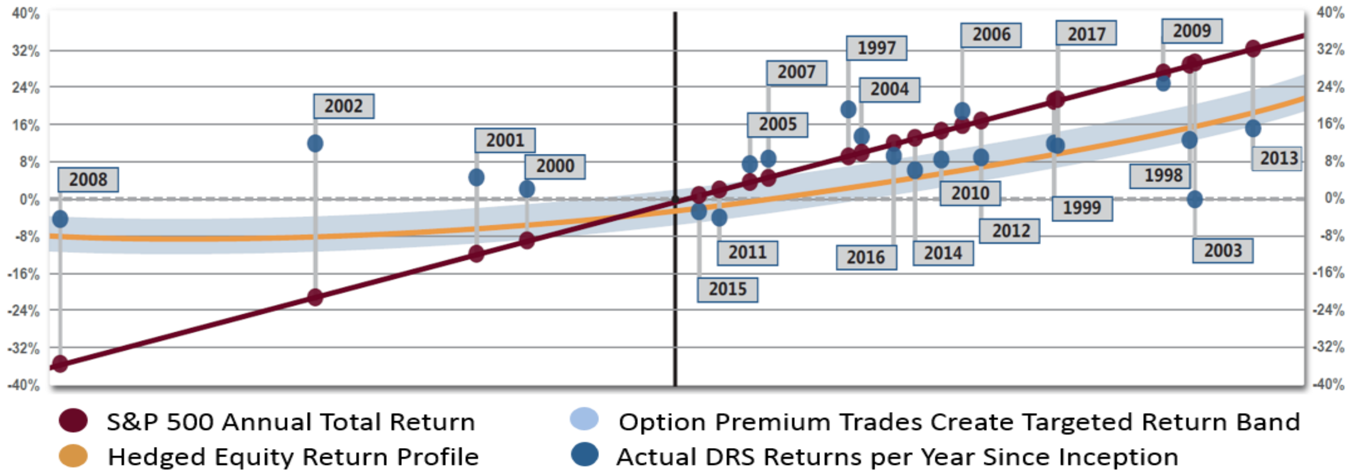
However, there have been times when the income trades have been detrimental to the DRS's performance. The lower range of the blue band is defined by the worst single-year return of the income trades.

By using the average income return to define the upside and the historical worst return to define the downside, the blue band is a more conservative way of anticipating the DRS's overall returns.

The Target Return Band as a Short-Term Benchmark

We believe the targeted return band is the most appropriate shorter-term benchmark for the Defined Risk Strategy.

In any given year, it is our goal that returns of the DRS will be within or above the blue shaded area. In 20 of the 21 years, they have been.



Source: Swan Global Investments. The S&P 500 Index is an unmanaged index and cannot be invested into directly. DRS returns are from the Select Composite, net of all fees. NOTE – this chart is for illustration purposes, not a guarantee of future performance. The charts and graphs contained herein should not serve as the sole determining factor for making investment decisions.

The one year where the DRS's returns fell outside its expected return range was 2003. That year Swan stepped outside its normal investment philosophy and came into the year with the portfolio over-hedged, which exposed it to the risks of taking a directional bet on the market.

- The primary lesson of 2003 was that the DRS shouldn't take a directional view of the market and should stick to its core investment philosophy of avoiding market timing and stock selection.
- The secondary lesson of 2003 was that it is much more important to avoid major losses than to capture all of the upside. The DRS's strong performance through the bear market of 2000-02 more than compensated for the lag in 2003's up market.

Targeted Returns Across Asset Classes

The Target Return Band drives our thinking when it comes to applying the DRS to other asset classes as well.

The DRS has almost two decades of live, verified results utilizing U.S. large cap stocks.

In recent years, Swan has been applying the DRS to other asset classes like U.S. small cap, foreign developed, emerging markets, gold, and long-term Treasuries. In all of these cases, the Target Return Band has been very accurate in judging the actual or simulated results of applying the DRS to other asset classes.

Investing in a Myopic Marketplace

It is our opinion that too much emphasis has been placed upon "beating the market".

The short-termism or preoccupation with comparing performance against the S&P 500 on a yearly, quarterly, monthly, and/or daily basis mirrors the myopic focus that many company analysts have on individual companies beating their quarterly earnings estimates. The inherent risk in such an approach is that one may start to lose the forest for the trees.

At Swan, our objective is to outperform over the full market cycle, rather than to 'beat the market' in any short-term period. We believe achieving returns within the targeted return band year after year can lead to long-term success.

Investors generally have goals that require years or even decades to accomplish. With such longer-term horizons, we believe the goals of an investor should mirror the goal of the DRS: to produce stable, consistent results. Over our 20-year history, that is exactly what we have strived to achieve.

To learn more about Swan's DRS investment approach, past performance, or how it may fit into a portfolio, please contact Swan at 970–382-8901.

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 Notes and Disclosures:

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The Swan Defined Risk Strategy Select Composite demonstrates the performance of non-qualified assets managed by Swan Global Investments, LLC since inception. It includes discretionary individual accounts whose account holders seek the upside potential of owning stock, and the desire to eliminate most of the risk associated with owning stock. The Composite relies on LEAPS and other options to manage this risk. Individual accounts own S&P 500 exchange traded funds and LEAPS associated with the exchange traded funds as well as multiple other option spreads that represent other indices that are widely traded. The Defined Risk Strategy was designed to protect investors from substantial market declines, provide income in flat or choppy markets, and to benefit from market appreciation. Stock and options are the primary components of the strategy.

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