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The Swan Defined Risk Strategy (DRS):

A Full Market Cycle Strategy

by Randy Swan

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INTRODUCTION

The following is a brief discussion of the Swan Defined Risk Strategy (DRS) as a full market cycle strategy as compared to a long-only strategy by Swan Global Investments founder and president, Randy Swan. A full market cycle is defined as a market cycle that includes both a bull and a bear market.

DRS PHILOSOPHY AND GOALS

The DRS philosophy is grounded upon the belief that market timing and stock selection investment strategies cannot provide superior returns over the long-term and that asset allocation is limited in its ability to protect capital from catastrophic risk. The DRS emerged out of a desire to find an investment approach that could allow someone to benefit from an investment in the equities market while reducing the risks inherent in equities investing.

This philosophy or belief was stated at the inception of the DRS in 1997:

> "The great claim of asset allocation is that risk can be reduced by diversifying over several broad asset classes (i.e., stocks, bonds, cash and real estate) without a similar reduction in return. This risk reduction is, however, strictly theoretical (typically based upon relationships that existed over a particular period). There is no guarantee that these same relationships will continue in the future. This is the crux of where asset allocation or modern portfolio theory breaks down. Risk is not defined; instead it is merely expressed in historical standards."
>
> - Randy Swan, founder and CEO of Swan Global Investments, 1997

The inherent weakness of asset allocation to protect against market risk was exposed in 2008 when a broad-based equities market meltdown took place and well-diversified investment portfolios were subject to ruinous declines in value in a relatively short period of time. The value of the defined risk approach became apparent in this scenario.

The DRS was designed to avoid the inherent difficulties of selecting individual stocks for investment, timing the overall market, and the vulnerabilities inherent in passive asset allocation investment strategies. Specifically, the DRS was designed to protect against systemic or market risk. Even well-diversified portfolios can be hurt when all the components decline at the same time. The goal of the DRS is not to outperform the broad market indices on the upside but rather to seek outperformance over an entire investment cycle, which includes periods of widespread equity market declines. In actual trading, which began in mid-1997, the DRS has been able to accomplish the primary goal of allowing investors to participate in bullish equity market gains while seeking to protect capital from the market's inherent potential to decline. (No representations about future performance are being made in this observation.)

While we cannot claim that the Swan DRS will

outperform the market in any particular time frame, it was designed to provide significant downside protection. Protecting against downside risk can be one of the best ways to outperform the market over a longer time frame. In order to provide significant downside protection, the DRS tends to underperform the broader market on the upside (excluding the option income trades). Historically, when considering annual returns, the DRS has captured about 63% of the upside when including the option income on a year to year basis and none of the downside (the strategy was positive on average over all negative market years since DRS inception).

The importance of protecting assets against downside risk and the effect of that protection on long-term returns was stated by John Nyaradi:

> "If you don't lose money during downturns, you only have to capture roughly 30 percent of the upside move of a bull market to beat buy and hold."
>
> -John Nyaradi (Super Sectors: How to Outsmart the Market Using Sector Rotation and ETF)

A recent study by Crestmont Research validates Nyaradi's 30% claim, actually finding that only 26% of the upside move is needed and this study is consistent with our experience and analysis of the DRS historical outperformance over a period of 18+years.

Investors should not focus solely on the upside performance of an asset or asset class but rather on a return of that asset over an entire market cycle. It is irrelevant what a strategy returns if you lose most of those gains in the next bear market.

PROPER INVESTMENT MANAGER AND ADVISOR GOALS

A prudent investment manager has a fiduciary responsibility to protect capital and provide for the possibility of long-term gains. A good prudent manager should manage to outperform over the long-term and should facilitate client education to ensure they understand and fully comprehend the manager's investment goal. Judging and taking action on the short-term is folly, we believe, as it is often based on emotional responses to market moves. Such investment actions often lead to disastrous consequences (i.e., quitting on a good long-term strategy or buying at the high and selling at the low).

If that perspective is valid, then the DRS is at least suitable and at best ideal for a core investment allocation. It is designed to provide substantial, always-on, downside risk protection. Of course, where the DRS fits into an investor's portfolio is up to the advisor, consultant, or individual investor.

We believe the DRS can serve very well as the core investment for a broad range of investors because the Swan DRS has demonstrated the ability in the past, with actual capital, to match the long-term rate of returns for stocks with substantially less risk than most other investment strategies, as benchmarked against the S&P 500 index.

We place an emphasis on protecting capital against market risk because we do not believe that it is unreasonable to suggest that the current market environment is uncharted territory. The potential for another calamitous year such as 2008, or worse, is always a realistic possibility. This consideration makes the risk-protecting DRS even more valuable given the dynamics and uncertainties of the current economic environment.

We usually ask investors: "There is market risk out there—what are you doing about it?" Most people insure their property, health, and life. Why not your portfolio?

Investors who seek higher upside capture ratios than the DRS has provided, historically, should perhaps invest in other assets but must also acknowledge and accept the higher risk inherent in those investments.

We manage the DRS in a similar fashion to what we believe advisors should be doing; protecting the core equity as we do with a hedge while allowing a small portion of the portfolio to generate additional returns with option strategies.

The goal of a good advisor is to find good managers and allocate in the right proportion considering the client's goals and objectives as well as the client's tolerance for risk. Assets that have the potential for high returns with low risk and low correlation should be the ultimate goal of every advisor and client.

WILL THE TRUE COST OF HEDGING PLEASE STAND UP?

Despite the fact that we expect the DRS to underperform the market in most years when the market rallies, we believe that the DRS can offer competitive returns versus the market over an entire investment cycle. As stated in the Fourth Quarter 2012 edition of "The Good, the Bad and the Ugly" (GB&U) newsletter, the long-term cost of the hedge protection has been relatively low over the implementation period since inception in mid-1997. The performance of just the DRS underlying equity and hedge alone has nearly matched the return performance of the S&P 500 with substantially lower risk, much lower standard deviation and lower beta. The addition of option income has only improved the relative performance of the DRS versus the S&P 500.

The Fourth Quarter 2012 GB&U discusses and analyzes the upside capture ratio from a historical perspective. We have been able to capture on an annual basis, as a general guideline, about 50% of the first 10% of the underlying market's upside gains, 75% of the second 10%, and almost 100% of the remaining gains. Of course, that guideline is a rough approximation but it has been historically accurate as an average.

There are other risks that may cause a given DRS investor to underperform. For example:

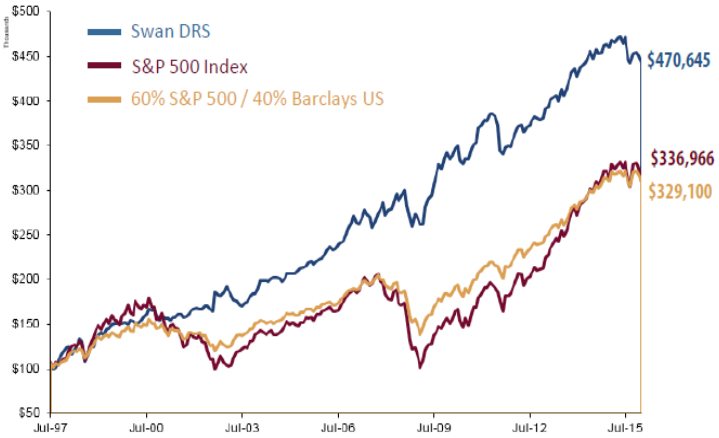
1. A re-hedge event shortly after adopting the DRS
2. Changes in volatility
3. Inability to achieve the option income goals over a short-period of time

WHAT BENCHMARK RETURNS SHOULD THE DRS BE COMPARED TO?

We are comfortable comparing ourselves to the S&P 500 provided that longer investment time horizons are used (ones that include bear markets).

We are also comfortable comparing the DRS to a diversified portfolio of stocks and bonds, cash, etc.

Growth of $100,000 (July 1, 1997 to May 31, 2016)



Risk / Return (July 1, 1997 to May 31, 2016)

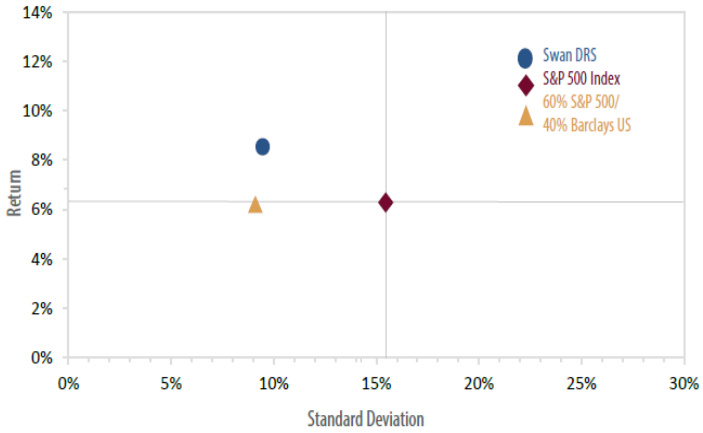


Chart 1 (See footnotes and disclosures below for sources and definitions)

A long-term annualized rate of return of 7% on capital investments in a diversified portfolio has been used in the past as the assumed rate of return for pension plans. However, that 7% is not as reasonable in the current environment due to the low interest rate regime, and the low returns from "safe" investments in U.S. Treasury securities. In other words, because of prior years of high inflation, bonds have provided a great tailwind over the past 30+ years, but the secular bear market for interest rates has caused that tail wind to dissipate.

Regardless of what an appropriate rate of return should be, the DRS performance of 8.5% annualized since inception in July 1997 (as of May 31, 2016) compares very favorably to a diversified portfolio, outperforming a traditional 60/40 portfolio and the S&P 500 over that time period. The DRS has not compared as favorably to the S&P 500 over the past several years but, once again, is it fair to compare only to positive years in the S&P 500?

The question then becomes: Which portfolio would you rather have, a portfolio that returns 7% in which true risk cannot be quantified, or a portfolio in which you are better able to quantify the risk (albeit not with 100% certainty)?

Let's assume that the DRS historically returned only 7% per year as opposed to its 8.5% historic average (as of 5/31/2016 using the Swan Defined Risk Select Composite, net of fees). Based upon various measures of performance such as beta, standard deviation and absolute levels of risk, Swan believes that the DRS is the superior investment because the risk, which is effectively limited, can more easily be measured and estimated. The DRS is even more valuable if you accept the assertion that the tailwind provided by the bond market returns in its recent bull market is potentially lessened or gone.

APPRECIATION OF THE GOALS OF THE DRS

Clients of the DRS sometimes question the portfolio's under-performance during market advances but those clients often fail to appreciate the risk-reducing objective of the strategy or its potential through a full market cycle.

It would be easier not to have dual goals of protecting wealth and providing for the opportunity for growth and income but it is a worthy goal nonetheless. As previously mentioned, the DRS was designed to outperform on an absolute and risk-adjusted basis over an entire market cycle, not just a bull market. We believe it would be difficult for anyone to match our performance without using the risk management techniques we employ. Stock selection and market timing have proven ineffective in dealing with systemic risk over the long term precisely because they don't adequately address systemic risks. The DRS focuses on risk management to deliver historically better returns than its benchmark. The math of upside/downside capture ratios is what distinguishes the DRS and is the key to outperforming the markets. Focusing on the downside capture ratio by using proper risk management techniques gives an investor the best chance of reaching the holy grail of investing, namely beating the market.

The proof of the pudding is in the eating—various performance rankings which place Swan at or near the top of most long-term performance categories provide a strong testimony to the value of our approach. The high rankings consider longer-term holding periods, over a "full market cycle" where our risk management has the opportunity to prove itself with excellent results:

- Morningstar rating: 5-Stars—Swan Defined Risk Strategy (Select)—Dec 2014
- Pensions & Investments #1 Market Neutral Manager 5 years—Dec 2012
- Pensions & Investments #3 Market Neutral Manager 1 year—Dec 2012

The Swan DRS proves its value by providing the potential for consistent long-term returns and the confidence and peace of knowing that if a large market decline occurs then the DRS should provide significant downside protection. Any out-performance is icing on the cake. Historically speaking, there has been a lot of icing for Swan investors willing to be patient investors.

Another benefit Swan provides is that the DRS does not rely upon timing the market successfully for entry and exit, nor does it need rising markets to reach its long-term objectives. Investors are often conflicted about entering the markets during certain times of the investment cycle.

The DRS has proven it does not need a secular bull market to reach its objectives. All it requires is investors with full market cycle patience and an intolerance for large capital losses.

FOOTNOTES

Important Disclosures:

Swan Global Investments, LLC is a SEC registered investment advisor providing asset management services utilizing the proprietary Swan Defined Risk Strategy, allowing our clients to grow wealth while protecting capital. Note that being an SEC registered Investment Adviser does not denote any special qualification or training. Swan offers and manages the proprietary Defined Risk Strategy ("DRS") through multiple product offerings for its clients including individuals, institutions and other investment advisor firms. Information is this communication is aggregated from Swan affiliated companies. Swan Global Investments, LLC, Swan Capital Management, LLC, Swan Global Management, LLC and Swan Wealth Management, LLC are affiliated entities. More information about Swan and Swan's DRS can be found at www.swanglobalinvestments.com or by contacting Swan at sales@swanglobalinvestments.com, Swan Global Investments, LLC, 277 East 3rd Ave, Durango, CO 81301. (970) 382-8901

Any historical numbers, awards and recognitions presented are based on the performance of a (GIPS®) composite, Swan's DRS Select Composite, of managed accounts which include all discretionary accounts invested in since inception, July 1997. Swan claims compliance with the Global Investment Performance Standards (GIPS®). The verification and performance reports are available upon request. This composite is a combination of accounts utilizing margin and accounts not utilizing margin. Further information may be obtained by contacting the company directly at 970-382-8901 or www.swanglobalinvestments.com.

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The S&P 500 Index represents the top 500 publicly traded companies in the U.S. S&P is a registered trademark of the McGraw-Hill Companies, Inc. Indexes are unmanaged and have no fees or expenses. An investment cannot be made directly in an index. Accordingly, comparing results shown to those of such indexes may be of limited use. Swan makes no representation regarding the accuracy or propriety of the information received from any other third party. Overall Morningstar Rating TM Market Neutral Category as of 12/31/2014. Source Morningstar, Inc. Pension and Investments Ratings – offered by Pensions & Investments; owned by Crain Communications Inc. http://www.pionline.com/. ***-SGI-061616

ABOUT SWAN GLOBAL INVESTMENTS

Randy Swan started Swan Global Investments in 1997 looking to supply investment management services that were not available to most investors. Early in his financial career, Randy saw that options provided an opportunity to minimize investment risk.

His innovative solution was the proprietary Swan Defined Risk Strategy, which has provided market leading, risk-adjusted return opportunities through a combination of techniques that seek to hedge the market and generate market-neutral income.

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