

Diversifying Your Diversifiers: Part 1, Sporadic Asymmetry

This is one part of a three part series on how we think about and utilize options to create strategies designed to help an overall portfolio navigate today's markets. A basket of options is worth more than an option on a basket. That's a crucial concept to our business. We wanted to explore two topics related to that concept (Part 1 and Part 2) and a third related to how we view risk management as a tool for higher return (Part 3).

Options/Derivatives seem to be financial dirty words, but used correctly they can change the landscape of a portfolio for the better. We've written about how options provide the ability to hedge away risk and define uncertainty, but this series digs deeper into how we utilize options for specific objectives.

Part 1: Asymmetry - More specifically, sporadic asymmetry - This applies to our Defined Risk Strategy

Part 2: The Differentials in Implied Volatility- This applies to our Collared Income Strategy

Part 3: Managing Risk for Higher Returns- This applies to our Drawdown- Managed Equity Strategy

*Side note - we are writing about these concepts because we are in the minority when it comes to looking at things this way. More importantly, we actually carry out these concepts in our portfolios and day to day operations. Much of what's said in these posts represents high level ideas we've spent entirely too much time thinking and building on.

Repeat after me - a basket of options is worth more to us than an option on a basket.

Part 1: Sporadic Asymmetry

Sounds fancy - we may trademark that. It's really pretty simple though. A basket of options - keep that concept in mind.

A basket is a number of individual bets that are independent of each other and each providing potential for asymmetric returns. Let's simplify:

We need to start with this concept: "independent from each other". We want separate bets on the table, each having little to do with the bet on either side of it. It's hard to do when owning stocks because a stock is a stock, and over time, each stock's relationship to the next may not be sporadic. The stock market is an ocean full of individual stocks that tend to move along with the tide over time. Meaning, the return of each is not independent of the other.

Welp, that's not what we want. How can we get exposure to stocks where returns will truly be sporadic/uncorrelated? Answer: shorten your time frame.

Correlation of returns is an important concept. It just means how closely the return of one thing is to the next. Stock correlations tend to grow as time horizons are lengthened. But, if you shorten the time frame, correlations are all over the board...sporadic.

Take a look at a simplified illustration of this point below using S&P 500 as a whole. As time expands, the probability of a positive outcome becomes more and more certain. But, with the time horizon shortened to a day, it's a flip of a coin:

S&P 500: 1926 - 2015		
Time Frame	Positive	Negative
Daily	54%	46%
Quarterly	68%	32%
One Year	74%	26%
5 Years	86%	14%
10 Years	94%	6%
20 Years	100%	0%

Source: Returns 2.0

The S&P 500 is an ocean of 500 individual stocks. If outcomes over shortened time frames for the ocean are a flip of coin, imagine what's going on with each individual company's returns! Short time frames provide a great chance for sporadic returns. Now to asymmetry...

Asymmetry simply means one side is bigger than the next. When it comes to owning call options, or being long the contract, your upside is unlimited while your downside is a known quantity.

*Reminder - A Call option gives you the right to buy a security at a certain price. Stock ABC trades at \$100. You buy a call option with a strike price of \$105. If ABC goes to \$200, you can buy it at \$105, that's great news. If ABC goes out of business, your loss is limited to the cost of the option.

Your potential loss is limited to the amount you paid for the option, nothing more (defining uncertainty). But your gain could be multiples of what you have at risk. That's the asymmetric payoff potential of options.

An individual stock's potential upside is dramatically larger than the market's as a whole. In other words, a typical move in a single stock over a day, week, or month has a much wider band around potential outcomes than the market as a whole. That can be great when you own options on those moves. We know what we can lose, and the potential for gains much larger than what's at risk is exciting. Repeat after me: A basket of, is greater than a basket on!

A basket of options provides sporadic asymmetry that an option on a basket doesn't. This matters to both provide potential return and lowering potential risk.

That said, we do have the ability to own index call exposures within the portfolio. When it comes to sporadic asymmetry, owning multiple individual (call option) positions in a portfolio opens the best opportunity to an uncorrelated return profile (unlimited upside, defined downside, etc).

However...

When you own a decaying asset by way of a call option, some of these characteristics can diminish in a market with little to no leadership. In that case, we want to have the ability to own the index where we can capture market upside even if there are major performance discrepancies under the hood of the index.

One notable fact of owning index exposure vs and individual call: **LEVERAGE, LEVERAGE, LEVERAGE**. We get massive notional market exposure via index calls, again with unlimited upside and defined downside (call premium deployed).

To sum it up, when we have a market where there is leadership (we'd dare to say some momentum), we will own more individual call options to expose our shareholders to a more sporadic profile. When leadership is missing, we can own S&P 500 to get market exposure paired along with a few of our top conviction/ high leverage, idiosyncratic individual call positions (and ALWAYS our puts) throughout the defined risk portfolio. While individual options are near and dear to our strategy, we need to stay flexible in adjusting to conditions.

Return & Risk

The inherent leverage in options gives us asymmetric upside on each individual bet. To move the needle and generate return, our position size can be minimal. Minimal position sizing means you can avoid concentration risk. Thanks to the combination of leverage and small position sizing, if one or two bets do well, it can eliminate the risk in most, and sometimes ALL, other bets. Having sporadic/uncorrelated returns in the mix makes this work.

Think about it, the odds for a stock moving up are typically in your favor. If you can access that probability equipped with leverage and sporadic asymmetry - you position yourself to deliver returns at the strategy level that offer lower volatility and drawdown.

But wait, what happens when correlations go to 1 and poop hits the fan?

That's a great question to ask, and something we've thought a lot about. Unfortunately, shortening the time frame to help control correlations works...until it doesn't. Big market drops happen more often than we'd like to admit. It's during those left tail events that correlations across the board increase and that's not good, as it hurts our ability to access sporadic moves in our stocks.

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Our preference is as little drawdown as possible and for that reason...

We always blend our individual bets in call options with an overall and actively managed market hedge. It helps chop down a known risk amount and further reduces the chance of drawdown. In addition, we wrap the combination of call options and a market hedge up with boring investment grade bonds, designed to spit off reliable income with short maturities to reduce interest rate risk.

We just covered three things there quickly:

Call Options

Market Hedge

Bonds

Let's put this together

The concepts above and the three items listed are components of our firm's flagship Defined Risk strategy. What makes it work? You guessed it, the sporadic asymmetry concept. Defined Risk was conceived from the idea of sporadic asymmetry.

Let's take \$100 and break down what this looks like in the real world:

\$94 (ish) into boring bonds providing stability and potential for income.

\$5 (ish) into 10 to 20 call options (individual companies providing sporadic asymmetry or index calls).

\$1 (ish) into an actively (and when we say active - we mean active) managed market hedge providing the potential to offset drawdown and create value as prices drop.

Summary

Sporadic asymmetry is what allows this strategy to give us the potential to generate returns with lower correlation to other asset classes and minimal exposure to drawdown risk.

This was created to be a bond replacement and help reduce potential drag on portfolios, but the power of a basket of options has provided a return stream that's hard to define as strictly a bond replacement.

Again, repeat after me, a basket of options is greater than an option on a basket.

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The S&P 500, or Standard & Poor's 500 Index, is a market-capitalization-weighted index of the 500 largest U.S. publicly-traded companies. A call option gives the owner the right to buy the underlying security at the specified price within a specific time period. The strike price is the price at which a put or call option can be exercised. Drawdown is defined as the peak-to-trough decline for an investment during a specific period. Correlation is a statistic measuring the degree to which two securities move in relation to each other.

Investing involves risk; Principal loss is possible. The Funds are non-diversified, meaning they may concentrate their assets in fewer individual holdings than diversified funds. Therefore, the Funds are more exposed to individual stock volatility than diversified funds. The Funds may invest in options, the Funds risk losing all or part of the cash paid (premium) for purchasing put and call options. The Funds' use of call and put options can lead to losses because of adverse movements in the price or value of the underlying security, which may be magnified by certain features of the options. The Funds' use of options may reduce the ability to profit from increases in the value of the underlying securities. Derivatives, such as the options in which the Funds invest, can be volatile and involve various types and degrees of risks. Derivatives may entail investment exposures that are greater than their cost would suggest, meaning that a small investment in a derivative could have a substantial impact on the performance of the Funds. The Funds could experience a loss if its derivatives do not perform as anticipated, the derivatives are not correlated with the performance of their underlying security, or if the Funds are unable to purchase or liquidate a position because of an illiquid secondary market.

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