APTUS CAPITAL ADVISORS

Diversifying Your Diversifiers: Part 3, Managing Risk for Higher Returns

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 a financial dirty word, 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.

Part 3: Managing Risk for Higher Returns

Look, we could make this complicated, but we're just going to shoot you straight – we believe future returns for bonds look pitiful. As in, expect a goose egg for real return. No, we can't guarantee that, but we'd argue your bonds' future is not bright. What has happened...probably won't happen again, and that matters for the lifeblood of investors.

For the last few decades, bonds have ridden the wave of interest rates dropping, significantly. Rates dropping means bond prices go up. If we issue a 10 year bond paying 5% interest and then all of a sudden the going interest rate for 10 year bonds drops to 3%...that 5% paper we issued just got more attractive, prices go up. See how that works.

To summarize what bonds have done...they've crushed it. In some time frames over the last 20 years, the boring conservative bond portion of portfolios has outperformed their risky counterparts, stocks! They've done more than just provide stability and income, they've injected growth of capital as well.

Why are we talking about bonds? Because there's massive amounts of wealth invested in bonds. That wealth needs to generate return and has been able to rely on bonds for stability, income, and return in the past. Now, hopefully they provide stability, but income and return is highly questionable. Remember where rates are?

Return and the risk associated with it is what matters to investors. Can they generate enough return to maintain or improve the quality of life, retirement, or whatever the objective? And, just as important, can they handle the risk associated with those returns? How you get from point A to point B matters. Here's the problem:

Potential return is greater in stocks than bonds, but so is the risk. Bonds are a pony, saddled up with a lead line. Stocks are a wild stallion you're trying to ride bareback. The stallion can get you there faster, but you better hold on.

In today's market investors need stocks for the math to work out.

Now, the foundation is laid, let's look at how managing risk can allow for higher return.

We're going to say this next sentence in more words below, but this is all you need to remember. To own more stocks and keep risk in a place investors won't bail at the wrong time, you have to chop off their left tail.

The two ways managing risk can lead to higher returns:

- Initial Asset Allocation
- Opportunistic Capital

Before we get into those points, let's cover what we mean by chopping off stocks' left tail.

Left Tail Chop - Avoiding Drawdown

Think back to Stats 101 and the normal distribution curve or a probability bell curve. Here's what that looks like for a visual:

In a perfectly normal distribution, you will have a whole lot of data points cluster around the center of the curve (the mean) and other data points scattered to the left and to the right where the curve gets closer and closer to the horizontal axis - those are the tails. There's a left and a right tail. In terms of stock returns, the right tail is where great returns show up, and the left tail is the ugly stuff, major drawdowns.

> Drawdown risk is the peak to trough decline in a portfolio's value. $1,000,000 turning into $500,000 is a 50% drawdown. Volatility can't be avoided, but panic-inducing drawdowns can be by effectively chopping the tail!

For stocks, the curve is not perfectly normal. Stocks have a fat left tail. Meaning, the disastrous returns happen more than the good stuff. Owning more stocks exposes you to a great chance of experiencing the agony of left tail events.

Chopping the left tail means owning vehicles to hedge away that risk - yes, options are those vehicles. Ok, back to the two ways managing risk can lead to higher returns.

Initial Allocation

This topic here is the secret sauce to our portfolios. Don't tell anybody.

If we properly minimize our exposure to the left tail of stocks, it provides the ability to own more of the asset class with potential return (stocks), and less of the asset class that looks like poop (bonds). More importantly, we can do so without exposing the portfolio to outsized drawdown risk.

* Side note - volatility is part of investing, and we can deal with that. It's the drawdown that keeps us up. Nothing blows up a plan quicker than drawdown.

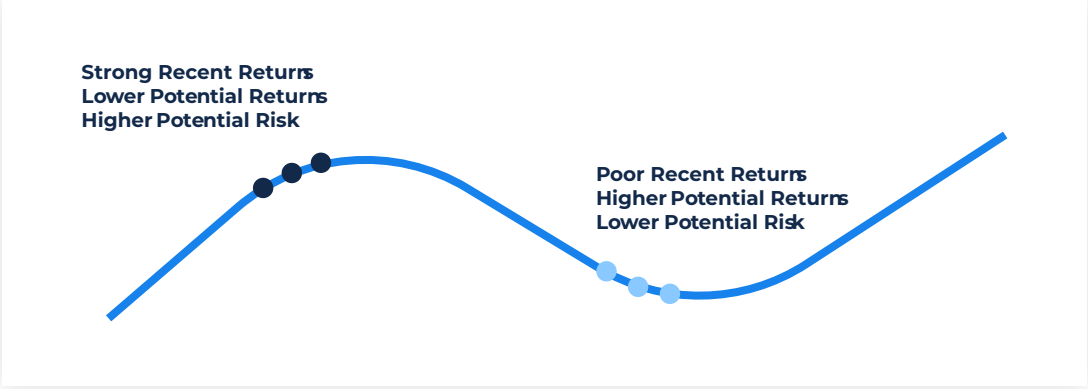
We can't stress this part enough - the increase of potential return to a portfolio by owning more stocks than bonds is amplified by the market we're in. We'd argue, future returns have never looked so bad for bonds.

We are able leverage our ability to hedge away drawdown risk to build in more potential return in our asset allocation decisions. Using risk for higher return.

Opportunistic Capital

We covered how we build in more potential return on the front end, but can we alter potential return during market turmoil?

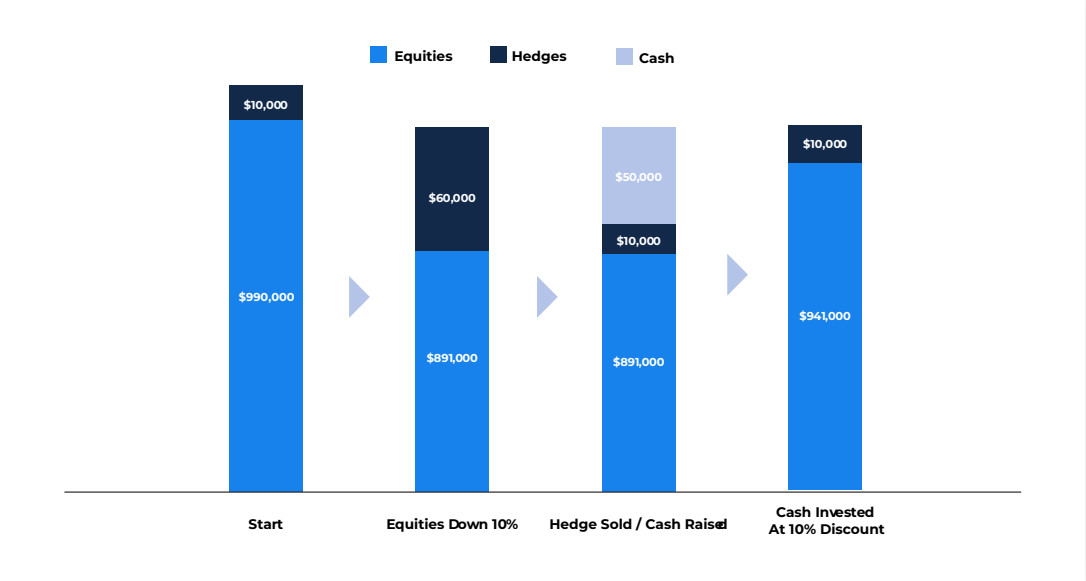
Let's use deductive reasoning. That's a fancy way of saying common sense. High valuations lead to lower returns associated with higher risks (a bad combo) and low valuation leads to higher returns associated with lower risks (a good combo).



"Investors should pray for a market crash because it will allow them to buy at lower prices. When the opportunity to put capital to work is great!"

Yeah yeah, we hear you...but do investors really want a market crash? Maybe the 35 year old stashing away money monthly. Definitely not the 60 year old in or nearing retirement.

Minimizing exposure to drawdown is a great first reason to deploy risk management, but an even more compelling reason is to create capital when the opportunity to deploy is at its greatest. Think about why you are able to minimize drawdown. It's because what started as a small hedge grows in value as markets drop. Converting this value to cash provides an opportunity to **buy at lower prices** when future potential returns improve. More shares at lower prices, a good combo helping with upside capture when markets recover.



Source: Aptus Hypothetical Illustration

The above example is shown for informational purposes only and should not be interpreted as actual historical performance of Aptus Capital Advisors, LLC. Results are hypothetical and do not reflect trading in actual accounts. The actual results of individual clients will differ due to many factors, including individual investments and fees, individual client restrictions, and the timing of investments and cash flows. Clients should not rely solely on this or any other performance illustrations when making investment decisions.

This allows advisors and clients to eliminate the need for attempting to time the market, and gives them the chance to create capital when it's needed most.

While others are in a panic during market drawdown, you are altering potential return by opportunistically looking for areas to deploy freshly created capital. The second way you can use risk management as a tool for higher potential return.

Putting this together

The concepts above are the components of our firm's Drawdown-Managed equity strategy. It's a strategy we position as the core of equity exposure in our model portfolios. We blend 50 hand-selected stocks from our compounder framework with market hedges designed for chopping left tails.

Our version of a left tail chop includes both market hedges and exposure to long volatility. We want hedges in place for prolonged market sell offs and long volatility exposure for the quick and nasty drops. Just as in our Defined Risk strategy, our hedges are actively managed.

Naturally, we expect our Drawdown-Managed strategy to trail during rip-roaring markets. But what we sacrifice in short term upside, we believe we make up for it by what our risk management allows us to do at the asset allocation level along with potential to create cash when opportunities look better.

An investor should carefully consider the investment objectives, risks, charges and expenses of ADME, as applicable, before investing. The prospectus for ADME contains this and other important information and is available free of charge by calling toll-free at 1-800-617-0004 or writing ACA at 265 Young Street, Fairhope, AL 36532. The prospectus should be read carefully before investing.

Drawdown is defined as the peak-to-trough decline for an investment during a specific period.

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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