

The Results Are In

As previously mentioned in my last two articles, the primary motivation for developing and implementing the Strategy over the past 9½ years is to prevent or minimize the risk of losing investment capital. It is no secret that I am not a perma bull, someone that is always bullish on the stock market, even though I believe that the stock market provides the best long-term opportunities versus other traditional investments such as bonds, cash and real estate. In fact, I have been very bearish over the past 10 years due to the valuations of virtually all assets classes, the debt level of individuals, businesses and governments and the demographics in our society.

In essence, the goal of the strategy was to participate in the upside of the stock markets while protecting the investment capital. Quite frankly this was a lofty goal but one worth pursuing due to the perceived risks.

The following article is a brief discussion of the how the Strategy has performed compared to the relevant benchmarks, other competition and an analysis of future performance under various market scenarios.

The results are in. The Strategy has outperformed the S&P 500 by a wide margin over the implementation period with substantially less risk (as defined by the standard deviation and the guaranteed sales price). In fact, the Strategy has kept pace with an investor with perfect timing. The Strategy has also outperformed recent competition that offer similar but deficient option writing and hedging strategies.

Historical Performance

The following is a comparison of the S&P 500 performance versus the Strategy¹.

Growth of \$ 10,000

Year	S&P 500				Strategy (SPDRs + Puts/Calls)				Relative Performance % - Cum.
	Return	Value	Annualized Return	Standard Deviation	Return	Value	Annualized Return	Standard Deviation	
1997	9.98%	10,998	20.96%	0.00%	17.68%	11,768	38.50%	0.00%	7.70%
1998	27.43%	14,015	25.23%	8.72%	19.92%	14,113	25.82%	1.12%	0.98%
1999	20.99%	16,957	23.52%	7.20%	21.92%	17,206	24.24%	1.73%	2.49%
2000	-9.58%	15,332	12.99%	14.04%	3.72%	17,845	17.99%	7.14%	25.13%
2001	-11.32%	13,596	7.07%	15.69%	5.70%	18,862	15.14%	7.56%	52.65%
2002	-22.01%	10,603	1.07%	18.06%	9.80%	20,710	14.15%	7.06%	101.07%
2003	27.89%	13,561	4.80%	18.92%	7.10%	22,181	13.04%	6.87%	86.20%
2004	10.84%	15,031	5.58%	17.77%	13.32%	25,135	13.08%	6.43%	101.05%
2005	5.26%	15,821	5.55%	16.76%	6.01%	26,645	12.22%	6.39%	108.24%
2006	15.47%	18,269	6.55%	16.12%	19.05%	31,722	12.92%	6.45%	134.53%

The Strategy has outperformed its benchmark by 135% over the implementation period. Implementing the Strategy has outperformed the market with much less risk as defined by the standard deviation and guaranteed sales price (outperformed on an absolute and risk adjusted basis).

¹ Please note that all expenses (management fees, margin interest (if any), etc.) have been removed from the performance figures. In addition, these figures are an average for all accounts under management that have primarily implemented the Strategy or a variation thereof and have more than ½ a year of performance figures. The performance figures would be increased if non-strategy performance figures were excluded. Please note that 9½ year period ended December 31, 2006 encompasses the entire period that the Strategy has been implemented.

Strategy Relative Performance versus Investor with Perfect Timing

In order to achieve the previously mentioned goal of capital preservation, the Strategy must protect previously earned gains while allowing an investor to profit from a market rebound after a substantial market decline. In other words, the Strategy wants to profit from bull markets and protect the portfolio in bear markets. The following example should illustrate whether or not the Strategy's goal has been realized.

Example

Investor WPT (with perfect timing) buys the S&P 500 on July 1, 1997 at 900. Investor WPT sells the S&P 500 @ 1469 in December 1999 for a 70% profit (including dividends) with an ending balance of \$17,000. Investor WPT invests the cash @ 4% during 2000 – 2002 with an ending balance \$19,000. Investor WPT buys the S&P 500 in December 2002 @ 880. Investor WPT sells the S&P 500 @ 1,418 in December of 2006 for a 68% profit with an ending balance of \$32,000. Investor WPT would have gains totaling 220% over the past 9½ years.²

The Strategy's gain over the past 9½ years has been 222%. In other words, the Strategy has outperformed an investor with perfect timing by 2% over the past 9½ years. As a result, the Strategy's objective has been met as evidenced by the previous example.

Imitation or Good Timing?

Before implementing my Strategy I wrote a book in 1997 titled "Unlimited Potential / Limited Risk Strategies" that outlined my conclusions about why my Strategy was superior to a buy and hold strategy and discussed the difficulty of timing and stock selection and discussed the primary flaw with asset allocation (risk is not defined; instead it is merely express in historical standards). The book also outlined the basics of the Strategy and provided back testing. Of course nothing beats actual experience which has since been provided. However, it is often said that imitation is often the highest form of flattery and I am flattered that two research reports have been written since my initial book was written in 1997.

It is important to note that I am not suggesting that my strategy has been imitated or copied. The strategies that are used by me were neither invented nor created by myself. However, I feel vindicated that a more basic form of my Strategy has received such positive coverage. Of course it took a 50% decline in the S&P 500 for these research reports to be written.

Since 2004 several new buywrite investment products (option writing against the underlying security) have been launched since the publication of the Ibbotson case study in summer 2004. Callan Associates provided an additional historical evaluation of the CBOE BuyWrite Index Strategy in October of 2006. Both reports have similar conclusions, namely that writing options against the underlying security significantly reduces the risk of investing in the stock market. It is important to note that the buywrite

² For simplicity, the example assumes that an Investor WPT uses the year end values for the high and the low. For example, the December 31, 1999 price is used instead of the March 2000 price and December 2002 price is used instead of the March 2003 price.

index did not provide superior returns but rather superior risk adjusted returns.³ In fact, the actual experience has been less than stellar based upon JLA annualized return of 6.86%. Of course 20 months is not a long enough time period to properly evaluate a strategy. However, what value does a buywrite strategy (that provides no real downside protection) provide if it cannot keep up with the market in a bull market other than to lower the standard deviation.

The primary reason why my Strategy has outperformed on an absolute and risk-adjusted basis is that these buywrite strategies have not implemented the Strategy entirely but rather left off a key component, namely purchasing downside protection via long-term Puts. The central question has always been can you provide the downside protection at a cost that does not hamper your long-term returns. Based upon the above-mentioned results, I believe the answer to be yes even though the Strategy will often under-perform during bull markets.

It is important to note that only time period the research reports includes is from the late '80s. The longest bear market was 2½ years. So it could be argued that the buywrite strategy's performance is overstated since the period that was tested was atypical (i.e. only two bear markets in 25 years, three if you count 1987). I believe that the results of the buywrite will not be as positive under normal market conditions.

Implications for Portfolio Management

One of the conclusions reached in my book was that an investor would be able to allocate more of their portfolio towards stocks via the Strategy if the risk of holding stocks was reduced significantly. In other words, allocating more of the portfolio towards an asset class with a higher expected return should yield a higher return for the portfolio without subjecting the portfolio to greater risk. In fact, interest rate risk would be eliminated assuming the amount allocated towards the Strategy is taken from fixed income investments portion of the portfolio. In addition, the risk is actually quantified as opposed to being stated in historical terms.

Expectations on Future Performance

It is important to discuss the expectations on future performance of the Strategy under three different assumptions for the stock market over the next 10 years.

Bull Markets

Although I do not believe the market can sustain the advances over the past 25 years due to the above-mentioned reasons, it is important to address the expected performance under a bull market. Major market advances are typically the most difficult for the Strategy to outperform due to the nature of hedging.

The markets advance over the implementation period has not hindered the performance of the Strategy. The Strategy outperformed the S&P 500 from 1997 – 1999 (see historical performance chart) and underperformed from 2003 – 2006 (see historical

³ Nuveen Equity Premium Advantage Fund, one of the funds that have adopted the buywrite strategy, NYSE: JLA, has an annualized total return since inception in May 2005 of 6.86% after expenses (based upon share price) through 12/31/06.

performance chart) for a net underperformance of approximately 12% on a total return of 138%. In other words, the Strategy captures approximately 91% of the upside in the two bull markets over the implementation period. I believe capturing 91% of upside would justify adopting the Strategy given the risk/rewards characteristics of the Strategy.

Flat Markets

Although there have not been any extended periods of price stability during the implementation period, my expectation is that the Strategy should perform similar to a fixed income investment due to the option writing strategies. It is difficult to quantify how the Strategy would perform since the markets have not experienced several years that were +/- 5%. However, a 5% annualized return seems reasonable given the option writing components of the Strategy.

Bear Markets

This is where the Strategy really outperforms. During the previous bear market from 2000 – 2002 the Strategy earned an average return of 6.4% versus an average loss of 14.3% per year. The Strategy's success relative to its benchmark and other competition is entirely based upon its bear market performance.

As mentioned in previous articles, one of main advantages of investing in the Strategy is the ability to profit from a market rebound instead of regaining previously lost capital. The Strategy allows an investor to use the proceeds from the portfolio insurance to buy additional shares at a lower price after the fact.

In summary, I am more confident of the Strategy's future success based upon the historical performance. In fact, it is difficult to foresee of a market scenario that would lessen the Strategy's performance versus its benchmarks and competition assuming the last 25 years performance will not be repeated.

The only relevant question is, is there investment risk and what are you doing about it?

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“Prophesy as much as you like, but always hedge.”

Oliver Wendell Homes, 1861