

Exploring your Investment Options in the 21st Century

Are you tired of watching your portfolio decline in value with each statement?

Are you tired of listening to your broker or money manager tell you to “stay the course” or that “stocks always outperform other investments over the long-haul?”

Are you tired of hearing that you only have three options... buy, sell or hold?

If the answer to these questions is yes, then you should consider adding a word to your investing vocabulary, “**hedge**”.

Everyone should know by now that investing is war. Therefore, you must use the latest technology to ensure success.

If you, like most investors, have watched your investment capital evaporate over the past 3 years, then you have not explored your investment “**Options**”.

This article is intended to provide a different perspective about portfolio management. There are new weapons to use in the investing war. It is not too late to protect your capital and provide double-digit return opportunities in the future even though the markets have plummeted over the past 3 years. Regardless of whether or not the bear market is over, there is a better way to invest your money.

On June 30, 1997, the S&P 500, viewed by many as a proxy for the US market, was trading at 885 and it peaked on March 24, 2000, at 1527. This translates into a gain of 72% (excluding dividends) if you had perfect timing and sold at the all-time high. Would you believe me if I were to tell you that you could have accomplished the same results without selling at the top? Probably not, but that is exactly what you could have accomplished if you explored your options more thoroughly.

Defined Risk Strategies

The following outlines the risk and return profile of an S&P 500 investment portfolio (defined risk strategy, “DRS”) that used index options to hedge its downside risk. A Portfolio that outperformed the S&P 500 over the past 5 ½ years by over 85% with less than half the risk of the S&P 500 (risk defined by standard deviation),

1. A Portfolio that had a guaranteed sales price of between 900 and 1600 during the 5 ½ year period (900 currently) that effectively eliminated any downside risk and locked in the previously earned profits from the prior bull market,
2. A Portfolio that increased the S&P 500 shares by 60% with no new investment as of 12/31/02),
3. A Portfolio that has the ability to profit from any future market rebound instead of merely recovering your previously lost capital.

Please note that these results were not based on stock selection, market timing or asset allocation. In other words, there was no market bias (either bullish or bearish) over the 5 ½ year period. The strategy has been implemented assuming that the market returns about 10% per year and that any attempt to time, stock pick or allocate is futile.

Most of us have been taught through experience that if it sounds too good to be true, then it usually is. This is true in most cases and certainly has been my experience.

However, an even more accurate statement would be to say that no one can predict the future. The bottom line is that you do not know what is going to happen in the stock market over the next few days, years or even decades. In fact, Alan Greenspan (Mr. Irrational Exuberance) does not know. Didn't he make that statement in 1996 when the Dow Jones Industrial Average was considerably below its current level? Doesn't that imply that the market is overvalued according to, arguably, the most powerful person (un-elected) in the world? Of course there are those who believe that the market is undervalued.

There are Perma Bulls and Perma Bears and those in between each with their own case. Even if you can trust the information released from publicly traded companies about their numbers and investment professionals for their research, the fact remains... there is investment risk. What are you doing about it?

Most investment professionals manage the "risk" by adhering to a particular investment strategy. This is the basis for compensating them.

Let's review the advice most likely given by most investment professionals. It goes something like this:

I (We) employ one or a combination of the following: (1) stock selection (2) market timing and (3) asset allocation to provide superior performance to that of the general market (risk and return). This is why you pay me X. You are relying on my ability to pick stocks, time the markets or allocate assets to achieve superior performance. However, past performance is no guarantee of future performance and your investment is at risk.

The fundamental flaw with each of these strategies is that someone is required to do something that has never been done before over an extended time period. This exerts an extreme amount of pressure on the strategy employed by the investment professional given that most investors have an extended time period left here on earth. Of course, you still have to pay for their advice regardless of how valuable that advice actually is to you.

Alternatively, indexing seemed like a great strategy until the NASDAQ 100 lost 75% of its value over the past 3 years.

Discussing the merits of stock selection and market timing is not justified since most mutual fund managers don't outperform the markets. That leaves asset allocation as the sole defender of the faith. Faith is the proper word since you are relying on something

that may or may not occur.

Asset allocation is necessary since everyone is required to choose between investment asset classes (typically stocks, bonds, cash and real estate). However, asset allocation relies on historic assumptions that cannot be guaranteed to continue. In other words, the risk reduction is strictly theoretical (typically based upon relationships that existed over a period of time with no guarantee that these 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. As a result, asset allocation is limited and must be used in conjunction with other risk reduction techniques.

The fundamental problem with asset allocation is that one is trying to reduce risk by an abstract amount rather than eliminating risk by a definable amount. In other words, investment professionals have accepted the premise that you cannot eliminate risk. While it may be true from a theoretical standpoint that all risk cannot be eliminated, a lot more risk can be eliminated that most are willing to admit.

Most investment professionals are fighting the war (investing) with outdated weapons (allocation solely between assets). For example, “this is your model portfolio given your tolerance for risk.” This practice is outdated since new weapons are available to fight the war. I would hate to have a doctor who was 15 years behind the available technology.

New weapons of the Investing War

The new weapons of war are options and exchange-traded funds (“ETFs”). Combining Standard and Poor Depository receipts (“SPDRs”) with put options and covered calls on the S&P 500 is an example of how to lower or eliminate risk while providing respectable returns.

Most investment professionals have failed to incorporate the new weapons of war because: the money was too easy during the last bull market, lack of knowledge on the part of many investment professionals and difficulty in explaining hedging to clients. In all fairness, some investment professionals have offered these services (albeit at exorbitant costs) but the public is ultimately responsible for historically focusing on returns. It is simply supply and demand.

The most intellectually honest approach to portfolio management is to seek the highest returns with as little risk as possible. Do not accept the premise that risk is unavoidable. It is like expecting to make mistakes instead of striving for perfection but settling on excellence.

Let’s compare results over the past five years, since it contained both rising and falling markets.

Growth of \$ 10,000

Year	S&P 500				Defined-Risk Strategy				Rel. Perf. % Cum.
	Return	Value	Annualized Return	Std Deviation	Return	Value	Annualized Return	Std 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%	17.36%	13,811	24.02%	0.16%	-2.04%
1999	20.99%	16,957	23.52%	7.20%	18.39%	16,351	21.74%	0.43%	-6.06%
2000	-9.58%	15,332	12.99%	14.04%	0.54%	16,440	15.26%	7.49%	11.08%
2001	-11.32%	13,596	7.07%	15.69%	1.02%	16,608	11.93%	8.35%	30.11%
2002	-13.13%	11,812	3.39%	16.26%	2.66%	17,049	11.26%	8.23%	52.38%

Please note that 1997 and 2002 represent ½ year and the S&P 500 figures assume an investment in SPDRs on 7/3/97 at 89.375. A discussion of the mechanics of the hedging strategies used and the implementation thereof is not practical. However, the basics of using put options and the writing of calls against your portfolio is widely accepted in the profession as a safe and conservative method of reducing risk.

The hedged portfolio has outperformed the S&P 500 with less risk. How can that be? By implementing sound hedging strategies into your portfolio management techniques. The most important aspect of the results is not the relative return performance but rather that risk can only be defined historically for asset allocation; whereas, it was defined prospectively for the defined-risk portfolio. In other words, the risk of the portfolio that used asset allocation solely was not definable and open-ended.

The fact is, unless you are willing to employ these strategies over your lifetime, you are doomed to the same fate as those investment professionals who rely on stock picking, market timing and asset allocation. The above-mentioned results are meaningless unless the strategy is implemented over bull and bear markets.

The real question: Is there a better mousetrap is available to investors. The answer is 'YES', due to the recent proliferation of investment products that are available to all investors. The individual investor can finally employ risk reduction techniques to overcome the pitfalls of traditional investment strategies.

The defined-risk strategies are appropriate for all types of investors, whether you are an aggressive or conservative investor. The strategies offer an alternative to those seeking to make consistent returns that can equal or exceed the stock market return without the risk. The strategy allows its investors to profit from the market's general upward move without the risk typically associated with investing in common stocks.

Key Considerations of Defined-Risk Strategies

(1) Upside participation in the equity markets

The portfolio performance is linked on the upside to the performance of indexes such as the S&P 500, DOW or NASDAQ.

(2) Defined risk upon initiation of investment

Your downside risk is capped and can be eliminated over a one-year period. This is not a claim of an 80% prior success rate that provides no assurance of future success, but rather a definable risk that is determined before investing.

(3) No predictive ability required to be successful

These strategies do not rely on stock selection, market timing or asset allocation to be successful.

(4) Ability to profit from a market decline

After investing you will not only NOT CARE about a market correction, but also welcome it. Again, you will welcome a market crash. You will be able to profit, not recover, from a rebound after a correction because your investment after the market decline (initial cost and earned profits) will approximate your investment before the market decline. You can profit in two ways: (1) adjust your hedge to the existing market level that allows an investor to profit from a subsequent market rebound and (2) use the excess proceeds from the sale of your hedge to obtain additional shares. In essence, you have the ability of hindsight to buy shares at the current market levels even though you originally purchased shares at a higher level.

(5) Protect future unrealized gains

After initial investment, adjusting your hedge can lock in future unrealized gains. In other words, investors do not need to worry about protecting unrealized gains and thus avoiding having to sell thereby creating realized gains and missing potential future stock price increases.

Don't be angry that your investment professional didn't implement a similar strategy over the past 2½ years, instead be angry that it wasn't implemented 5 years ago. The strategy works well in both bull and bear markets.

Swan Consulting, Inc. is a registered investment advisor in Durango, CO whose primary objective is to provide a superior return on an absolute and a risk-adjusted basis to the stock market. For investment information about setting up a managed account with a minimum of \$250,000 email us at swanconsulting@qwest.net.