SWAN GLOBAL INVESTMENTS

Issue #16 - Q1, 2015

The Good, the Bad, and the Ugly

Quarterly Update of the Swan Defined Risk Strategy

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From the Desk of Randy Swan

The Good

The DRS returned 0.43% and 0.82% for Premier and Institutional respectively in the first quarter, versus 0.95% for the S&P 500. The performance is in line with our expectations of performance in a flat market.

Our market neutral income trades, commonly referred to as Basket II and III, have moved up to the good from the bad. Quite frankly, the income trades have been in the dog house for the last year or so. It is important to note that 2014 was not a great year but also not a negative year.

The income trades returned approximately 2% in the first quarter, which is slightly higher than what we would expect on average for a particular quarter. Of course, an average is just that. We profited on almost all of our income trades despite the low volatility. A range bound market like the one seen in the first quarter is much more conducive to profit for our market neutral income trades.

As I have discussed many times, the most unpredictable portion of the DRS's return stream is our income trades because the timing of winning and losing trades are not regular, even though we expect to win on about 3 of every 4 trades. In other words, winning and losing trades often come in clustered bunches. For example, we had 13 consecutive winning trades in 2012 for Basket II and a slightly lower amount for Basket III. But we probably had 4 losing trades in a row in 2011 during the last half of the year. For obvious reasons, we would prefer to earn our average income every year but that is not possible. We take what we can get, when we can get it.

It is important to note that we have averaged over 5% per year since July 1997 from our income trades (based upon our oldest DRS account). The question though that we are often asked is: Can Swan maintain its historic average return from its income trades? Yes, we believe we can for the following 4 reasons:

1. Risk premia
2. Active trading and/or risk management
3. Improvement in technology that allow us to monitor when conditions are more favorable to engage in additional income trades
4. Same strategy throughout many types of market environments

Risk premia is a concept that we mentioned in the last GB&U. This subject has been extensively researched and documented. Simply, risk premia is the concept that there is a premium for taking on risk. In other words, it is the premium that sellers require in return for their acceptance of risk. There is a fundamental imbalance in the markets that indicate that implied volatility, on average, is less than actual volatility (the difference equating to the risk premia). All indications are that the risk premia exists and will continue to exist.

Swan also places a high value on its active trading or risk management as it relates to the income trades. In fact, we would place a higher value on the active management rather than the risk premia.

Unlike many of our competitors, we use active trading and/or risk management in our income trades. In other words, our income trades are based upon the proper actuarial analysis and underwriting (similar to an insurance company underwriting) prior to designing, testing, and implementation of a trade. We are able to ascertain, on average, what our expected return should be given the various inputs, how and when to make adjustments to maximize our profits and/or minimize losses before the original trade is executed. Our goal is to implement pre-determined adjustments to not only change the probability of profit but also expected returns. This is similar to the concept of what is called isolation system design in aerospace engineering whereby redundancies are put in place to lower the probabilities of a failure towards zero.

Swan believes that our ability to generate income in most market environments is crucial to our long-term outperformance of the markets. Without income trades, we would still argue the DRS is better on a risk-adjusted basis and maybe an absolute basis over a full market cycle but our goal is to return the highest possible return given the risk parameters, namely to not lose more than single digits in a year. The DRS was designed to shift large losses during market declines and accept small unrelated risk in various isolated spots on the market price continuum/ spectrum. Please review our targeted or expected return band for an analysis that shows our consistent returns since inception and how income should add value at all places upon the band.

Our rules are time-tested in that they involve the systematic rules of similar positions on a regular monthly basis. We have almost 20 years of experience in executing similar trades. Although we have not always managed the trades in the exact same manner, they are consistent enough to have a high level of confidence. We also believe we have made improvements over that time period to provide more stable consistent returns.

We also have a lot more resources and more technology currently than we have ever had. In fact, we now have three full-time traders at Swan. This not only allows us to execute more trades on more assets but also complete much more research to fine tune our trading strategies. We are also in the process of hiring a full time programmer to build out an expert trading and backtesting system for additional research. It is important to note that the DRS was created in a vacuum without any real back system. Swan is also researching ways of better measuring the risk premia to be more aware of when the risk premia has shrunk or vanished.

Although the two prior income years have been lower than normal, we are emphatically optimistic because nothing has fundamentally changed in our strategy. While it is true that we have successfully scaled up operations from $100 million in 2011 to over $2 billion in 2015, nothing has changed in the markets nor how we manage the trades.

We have systemically sold short-term premium either as strangles (selling out of the money puts and calls) and/or various spread orders, without missing a month, for almost 18 years. If anything, we have worked diligently to fine tune, make minor adjustments and improve over that time period. I believe that our income trades are more efficient, systematic, and more rules based than ever.

To reiterate points made in prior GB&Us, the lack of profit is usually a result of two conditions that occur simultaneously; low volatility and abnormal market moves over a short period of time. This is not to say that you cannot lose on a trade unless both conditions exist but it makes it difficult for the market to systematically beat us over longer periods of time since we make adjustments to our trades. We can take this year as an example. The volatility is low but we have still managed to profit this year. If the volatility were to rise rapidly this year because

a bear market began, we would expect to lose on several trades but that increased volatility should ultimately benefit us due to higher premium on future trades and increased valuation on put protection. Taken together, these four reasons explain why Swan believes in the continued success of the income trades.

Similar Market Conditions + Same Strategy = High Probability of Success

Another good is the successful launch of several new DRS products. To reiterate, Swan views the DRS as an engine that can be applied to almost any asset provided there is sufficient liquidity in the underlying asset (ETF) and in the options on that asset. Liquidity is necessary since we want efficient trades where the spreads are small. It is our belief that the DRS can deliver risk/return results in these other products that are consistent with our flagship DRS S&P 500 products. To date, Swan now has track records on 9 other underlying assets.

Our goal is simply to provide investors more DRS choices so they can build better portfolios. Our thesis is that the benefits are threefold: (1) additional DRS choices should equate to a more diversified portfolio, (2) investors can allocate more toward assets with a higher expected or targeted return, and (3) optimization potential.

Beyond having other DRS assets, another good is the consistency of returns applying our DRS strategy to various other assets. Our thesis has been that we can target similar returns to our flagship DRS S&P 500. So far, for all new assets, returns are consistent and as expected.

The Bad

The bad was slight underperformance of the equal-weighted Select Sectors SPDRs. The underperformance has continued another quarter but as discussed in the last issue is not surprising since the market has been trending for the last 6 years.

The equal weight strategy underperformed the cap weight strategy by .40% this past quarter.

Another bad; the slight decline in volatility that has occurred this year. This has caused a greater than normal decay in our put protection and assuming this lower than normal volatility continues we should expect lower than normal income opportunities. Of course, our realized income trades mentioned in the Good section is designed to offset the unrealized losses and so far this year, has done so. The silver lining is that the decline in puts has not been realized and can still be reversed if volatility rises either through an increase in fear or an outright bear market.

We anticipate a rise in volatility throughout the end of the year based upon mean reversion. The bottom line is that we believe that this bull market is long in the tooth by historical standards and is due for a large correction, if not an outright bear market. For good reason however (see page 5), we make no prediction of this happening.

The Ugly

The outlook is bleak for investors in a traditional 60/40 portfolio.

Swan's philosophy is that it is difficult, if not impossible, to use market-timing and/or stock selection to outperform a benchmark over a full market cycle. Furthermore, asset allocation or modern portfolio theory alone is not sufficient to protect against market risk. Market risk by definition is non-diversifiable.

The DRS was created to solve these inherent limitations. Our goal was to seek to provide absolute and risk-adjusted returns where the risk could be quantified and controlled on an annual basis with a high level of confidence. This direct approach to managing risk is more reliable and efficient to traditional methods of portfolio management. We believe allocating 40% of a portfolio to fixed income with very little upside and lots of downside risk is an inefficient use of capital.

Quite simply, the DRS was designed to outperform both the broad market (i.e., S&P 500) as well as a traditional 60% equity/40% bond balanced portfolio over an entire investment cycle. In fact, the DRS was specifically designed to replace a traditional 60/40 balanced portfolio. Morningstar actually agreed with this description in their 2013 write-up on Swan. We have recently completed a research project that shows how the DRS adds value to almost any balanced portfolio by increasing returns and reducing risk at almost all levels of allocation. In other words, our belief is that the DRS adds value to any portfolio and the larger the DRS allocation, the better the results. Please contact Swan if you are

interested in reading this report (or the aforementioned Morninstar write-up on Swan).

The DRS has vastly exceeded its goal since inception, outperforming the Russell Balanced by 337 basis points per year with lower volatility (the Russell Balanced, as represented by RBLEX, equates to 60% equity, 40% fixed income and cash instruments). It is important to note that the DRS has also outperformed the S&P 500 since inception and we expect that outperformance to increase during the next bear market in equities.

Current Dilemma

Many believe that the strong performance of the 60/40 portfolio recently versus previous periods has been largely attributed to the decades-long bond bull market. Many are concerned that going forward bond returns might be muted in a best-case scenario and disastrous if rates rise substantially. Prior to the beginning of the current 30-year bond bull market, returns were substantially lower for a 60/40 portfolio. It is logical to assume that with rates currently lower than either of the interest rate environments listed below, the future returns will be lower.

	60/40	S&P 500	10 Year Treasuries
1948-1981	8.13%	11.00%	2.86%
1982-2014	10.89%	11.68%	8.41%

Source: Ben Carlson, "The Real Risk to a 60/40 Portfolio"

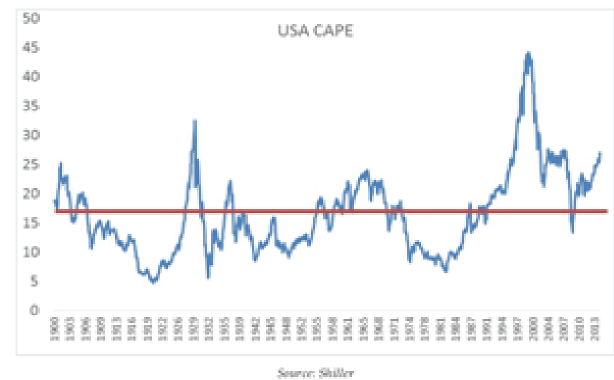
The million or maybe billion dollar question is 'What are the risk/return expectations going forward for a 60/40 portfolio?' Although Swan does not engage in prognostication, we have always believed it is beneficial to invest in a strategy that accounts for all types of market environments. "Irrational exuberance" was the environment late last century when the DRS was designed and created. Today we would argue that the governments around the world have orchestrated the biggest bubble in history via massive monetary and fiscal stimulus. We would also argue that at some point the bubble will eventually burst. Regardless of whether or not you agree with this assessment, bonds face significant headwinds in this low-interest rate environment.

So how might a balanced portfolio perform over the next ten years, based on the current interest rate environment?

Rob Arnott's Research Affiliates recently conducted a study going back to 1871 on a 60/40 portfolio, showing an average historical return of approximately 7.6% compared to an expected return of 7.1% based upon their dividend yield and earnings growth model. In other words, the 60/40 portfolio did slightly better than their model predicted. However, going forward, their model forecasts only a 4% return per year for the next ten year period (Source: Research Affiliates).

Investment manager and author Mebane Faber in his recent book "Global Asset Allocation: A Survey of the World's Top Asset Allocation Strategies", took a simple yet logical approach to forecasting the likely returns of a 60/40 portfolio. His projection was based on the theory that long-term future returns for stocks are highly dependent on starting valuations, as measured by the CAPE Shiller PE ratio (ten-year cyclically adjusted price-to-earnings ratio). The current CAPE Shiller PE reading as of December 2014 was 27, which is about 60% higher than the long-term average of about 16.5. At the current levels over 25, future median ten-year returns in the past have been about 3.5% since 1900.

Figure 13 – Ten-Year Cyclically Adjusted Price-to-Earnings Ratio (CAPE), 1881-2014



Source: Shiller

Source: Shiller

Source: Mebane Faber, "Global Asset Allocation: A Survey of the World's Top Asset Allocation Strategies"

Future bond returns are forecasted via a much simpler method: the predicted future bond return is simply the starting yield as if held to maturity. Near the end of December and the publishing of Faber's book, the ten-year nominal return for U.S. government bonds sat around 2.25% (2.05%, as of April 30th, 2015 according to ycharts.com historical US Treasury data).

Thus, per Faber's estimations, investors are presented with the following opportunity set of annual returns for stocks and bonds over the next ten years, assuming 2.25% inflation going forward:

- U.S. Stocks: 3.50% nominal, 1% real
- U.S. Bonds: 2.25% nominal, 0% real
- Cash/ T-bills: 0.00% nominal, -2% real

The final result is an expected return of 2-3% nominal return for a 60/40 investor, or about a 0-1% real return, adjusted for inflation.

Again, Swan does not build its investment philosophy around market forecasts. Although data may seem to point to a certain outcome at times, predicting what will happen and basing decisions on these predictions will lead, in the majority of cases, to poor and inconsistent returns and generally disappointing investment decisions. This sampling of article headlines over the last few years shows just how difficult it can be to predict the markets:

- Barron's, Nov. 2009: "*The Easy Money's Been Made*"
- Morningstar, Dec. 2010: "*The Easy Money Has Been Made*"
- MarketWatch, Nov. 2011: "*The easy money has already been made*"
- The Street, May 2012: "*The Easy Money Has Been Made*"
- Morningstar, Dec. 2013: "*The Easy Money Has Been Made*"
- Barron's, Oct. 2014: "*The Easy Money Has Been Made*"
- Harry Dent, Sept. 2011: "Dow Could Crash to 3,000 in 2013"
- Charles Nenner, Mar. 2013: "Dow Dropping to 5000 Starting This Year"
- Chris Martenson, April 2013: "S&P 500 May Fall More Than 40% By Fall"
- Charles Hugh Smith, Dec. 2013: "The Case for a Crash: And for Staying in Cash Until 2015"
- Harry Dent, Mar. 2014: "Get Ready for the Dow at 6,000 by 2016"
- Leon Cooperman, Aug. 2007: "Why I'm a Bull (and stocks are on track for solid gains)"

This is why we believe the DRS, with its consistent, non-predictive approach, can provide better peace of mind for investors than a strategy that depends on accurate forecasting. That said, returns for a 60/40 portfolio look bleak for the next ten years. We believe the DRS should be a smoother and better ride than any traditional balanced fund or 60/40 robo-advisor portfolio.

Swan adds more staff to further build out team

Marc Odo, CFA®, CAIA®, CIPM®, CFP®

Marc has joined the firm as Director of Investment Solutions. He is responsible for helping clients and prospects gain a detailed understanding of Swan's Defined Risk Strategy and how it can best fit into an overall investment strategy. His responsibilities also include producing some of Swan's thought leadership content.

Prior to joining Swan, Odo was Director of Research for 11 years at Zephyr Associates, a leading provider of investment analysis software. He was responsible for developing next generation risk analytics. Previously he was a portfolio manager with Accessor Capital Management and part of the investment analytics team at Pacific Portfolio Consulting, an RIA catering to high net worth individuals and ERISA plans. In both positions, Odo was the resident Zephyr expert. He graduated from the University of Washington in 1996.

Marc is well known and a highly regarded expert in investment analysis, particularly in terms of risk management, so he is an ideal fit for Swan. He will be a valuable asset to Swan in our upcoming increase in product offerings and corresponding expansion of service and sales and marketing efforts.

Chris Hausman, CMT®

Chris started his career as an investment banking analyst before transitioning to the trading pits of Chicago. In 1996, Chris became a market maker for Wolverine Trading, LLC where he worked on the floor of the Chicago Mercantile Exchange trading options on the S&P 500 futures index and on the Pacific Stock Exchange, trading options on Microsoft. In April 1999 as Senior Trader, Chris joined an options broker-dealer (STC, LLC) founded and managed by Anthony Saliba. During that same period, he also served as lead instructor for the International Trading Institute Ltd., teaching option strategies and risk management techniques to market makers and traders from around the world. In January 2002, Chris joined CAZ Investments in Houston, TX, where he held the position of Senior Vice President. He re-joined Mr. Saliba in a new venture, Saliba Portfolio Management, as Senior Portfolio Manager and Chief Portfolio Strategist in January 2004 and ultimately became the Director of Trading Operations in January 2011. Chris is a member of the Market Technicians Association and is a Chartered Market Technician and is a graduate of the University of Pennsylvania's Wharton School of Business with a Bachelor of Science Degree in Finance. He brings a wealth of options experience and knowledge to Swan's trading team.

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Disclosures: Performance results are presented in U.S. dollars, net of management fees, and include reinvestment of dividends and capital gains. Fees may vary based on account size, custodial relationship and other factors. No current or prospective client should assume future performance of any specific investment strategy will be profitable or equal to past performance. All investment strategies have the potential for profit or loss. Changes in investment strategies, contributions or withdrawals may cause client portfolio performance results to differ from the composite. Different types of investments involve different degrees of risk; we make no assurance that a specific investment will be suitable or profitable for a client's portfolio. Historical performance results for market indices and categories do not reflect the deduction of transaction fees, custodial charges, or management fees, the incurrence of which would have the effect of diminishing historical performance. Economic factors, market conditions, and investment strategies will affect the performance of any portfolio and there are no assurance that it will match or outperform any particular benchmark.

Swan Global Investments, LLC ("Swan") is an independent Investment Advisory headquartered in Durango, Colo. registered with the U.S. Securities and Exchange Commission under the Investment Advisers Act or 1940. Being an SEC-registered advisor implies no special qualification or training. Swan Global Investments, LLC, Swan Capital Management, LLC, Swan Global Management, LLC and Swan Wealth Management, LLC are affiliated entities. Further information may be obtained by contacting the company directly at 970-382-8901 or www.swanglobalinvestments.com. Swan offers and manages its Defined Risk Strategy to individuals, institutions and other advisory firms. There are three Defined Risk Strategy composites offered: 1) The Defined Risk Strategy Composite which includes all accounts. 2) The Defined Risk Strategy IRA Composite which includes IRA assets under management. 3) The Defined Risk Strategy Select Composite which includes all non-qualified accounts. Additional information regarding Swan's policies and procedures for calculating and reporting performance returns is available upon request. Swan claims compliance with the Global Investment Performance Standards (GIPS) and has prepared and presented this report in compliance with GIPS standard. Swan investment performance has been independently verified from its inception on July 1, 1997 through December 31, 2013. A copy of the verification report is available upon request by calling 970.382.8901 or emailing operations@swanglobalinvestments.com. Verification assesses whether (1) the firm has complied with all the composite construction requirements of the GIPS standards on a firm-wide basis and (2) the firm's policies and procedures are designed to calculate performance in compliance with GIPS standards. Verification does not ensure the accuracy of any specific composite presentation.

The Defined Risk Strategy Select Composite demonstrates the performance of all non-qualified assets managed by Swan Global Investments, LLC since inception. It includes discretionary individual accounts whose account holders seek the upside potential of owing stock, and the desire to eliminate most of the risk associated with owning stock. The composite relies on LEAPS and other options to manage this risk. Individual account own S&P 500 exchange-traged funds, LEAPS associated with the ETFs, as well as option strategies based on other widely traded indices. The Defined Risk Strategy Select Composite includes all non-qualified discretionary accounts which are solely invested in the Defined Risk Strategy. The Defined Risk Strategy was designed to protect investors from substantial market declines, provide income in flat or choppy markets, and to benefit from market appreciation. Stock and options are the primary components of the strategy. The performance benchmark used for the Defined Risk Strategy is the S&P 500 Index comprised of 500 large-capitalization stocks, and which does not charge fees. One cannot invest directly in an index. 019-SGI-050715

Annualized Returns as of March 31, 2015

	One Year	Three Year	Five Year	Ten Year	Since Inception
Swan DRS Select Net-of-Fees	5.64%	7.75%	6.11%	8.47%	9.06%
S&P 500 TR	12.73%	16.11%	14.47%	8.01%	6.85%