ABR
Dynamic Funds, LLC

Getting Smart About Volatility

Preparing for and Talking Clients Through Turbulent Markets

March 2016

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Summary

Mike Tyson might as well have been talking about the markets and financial planning when he said; "Everyone has a plan until they get punched in the mouth."

Iron Mike was talking about his ferocious left hook, but for investors, the hit is volatility and a sudden downturn in the market. It's a blow that can leave them weak in the knees, dazed & confused, and scared. It's not the time to make important decisions about their portfolios and it is not the time for you to begin a conversation on how to safeguard their assets in turbulent times.

The time to talk with your clients about volatility is before it hits and the keys to a productive conversation are your basic understanding of volatility and a specific plan for dealing with volatility before, during, and after the next crisis.

To help your clients survive market volatility, you need to understand volatility and have a simple and easy-to-understand plan for discussing it with them. Most importantly, you need to understand how to manage volatility as an asset class. By making volatility an integral part of your clients' portfolios, you can help them prepare for, and better withstand, turbulent markets.

This guide will first explain volatility and the difference between "real" versus "temporary" volatility and then offer three simple steps to help advisors navigate the life cycle of a market crisis:

Step 1: Preparing clients for significant market volatility when times are good and a crisis in the markets is the furthest thing from clients' minds;

Step 2: Talking clients through a volatile period when they "get hit" and want to make rash, subjective decisions that aren't part of the plan;

Step 3: Conducting a *post-mortem* with a client when the dust is settling after a crisis in order to show them the value of sticking to the plan.

Understanding Equity Volatility: Implied vs. Realized Volatility

For stocks, volatility is a measure of the range of prices within a certain period of time. There are two main types of volatility measures: historical, or *realized volatility,* and future, or *implied volatility*.

Realized Volatility (Historical)

Realized volatility is simple to examine; it is an actual result of how much a stock price moved over time. It's easy to look back and see how the broad markets and individual securities have behaved in the past and to compare which swung more violently and which held steadier in turbulent markets.

Implied Volatility (Future)

Implied, or future, volatility is a little harder to explain to clients. Implied volatility is a measure of expected future stock price movement based on the prices of options (both calls & puts) on the underlying stock/index/ETF. The implied volatility is the "premium over parity" built into the option price. If an implied volatility is high, that means the expected future price movements of a stock are greater. This could happen before an earnings report, before an interest rate announcement by the Federal Reserve, or during a geopolitical crisis. Implied volatility can be related to historical volatility. Stocks that generally move around a lot tend to have a higher implied volatility than those that are steady (think tech stocks vs. utility stocks).

Measuring Volatility: CBOE Volatility Index (VIX)

The VIX is the most commonly used measure of overall stock market volatility. It is a calculation of implied volatility (expected price movement) over the next 30 days of call & put options on the S&P 500. The VIX was invented in 1993 by Professor Robert Whaley for the CBOE, with futures contracts on the VIX launching in 2004. Also called the "Fear Index", the VIX has had a long-term average of about 20, with lows around 10 (2007, 2014) and highs around 80 (2008, 2009). Since volatility is mean-reverting, the VIX generally trades sideways.

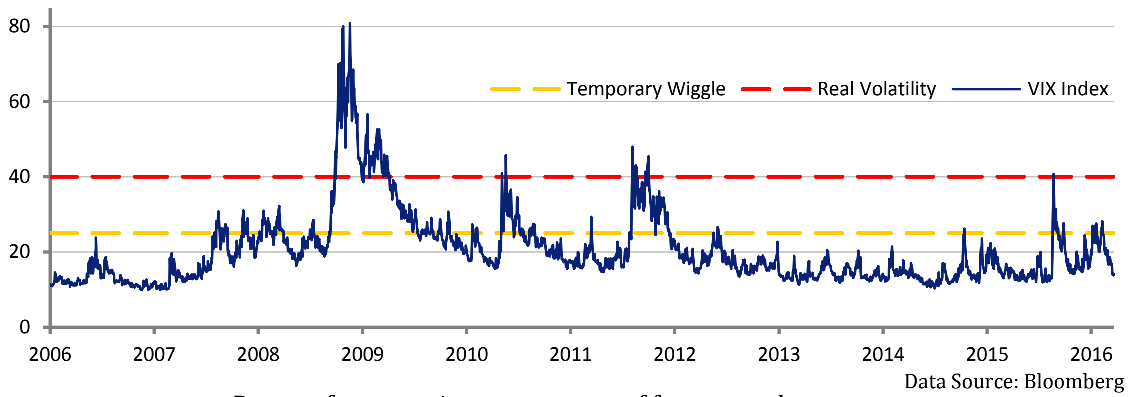
"Real" Volatility vs. Temporary Wiggle/Head Fake

When the markets are in a relatively calm, bull market, the VIX has historically been below 15. If the market drops a few percent in a short period of time (less than a week), the VIX can pop to 20-25 or higher. Sometimes there will be a follow-through to the downside (August 2015), and sometimes the market will rally back (January 2016).

When a follow-through occurs, the VIX generally moves to 40 or higher. This can be called "real volatility". Clients and advisors become concerned, portfolio values decline quickly, TV pundits talk about the end of the bull markets, and the Fear Index gets significant press.

When the market turns around and rallies from the "temporary wiggle", advisors and the media talk of "buying the dips", investors generally remain calm, and the VIX drops back to its happy place. However, clients may think that there was a lot of realized volatility even though the VIX says otherwise. Many advisors call these scenarios "head fakes" in the market. This is a great opportunity for advisors to reach out to their clients to discuss portfolio management using volatility as an asset class.

VIX Index from 2006 to 2016: Real Volatility vs. Temporary Wiggle

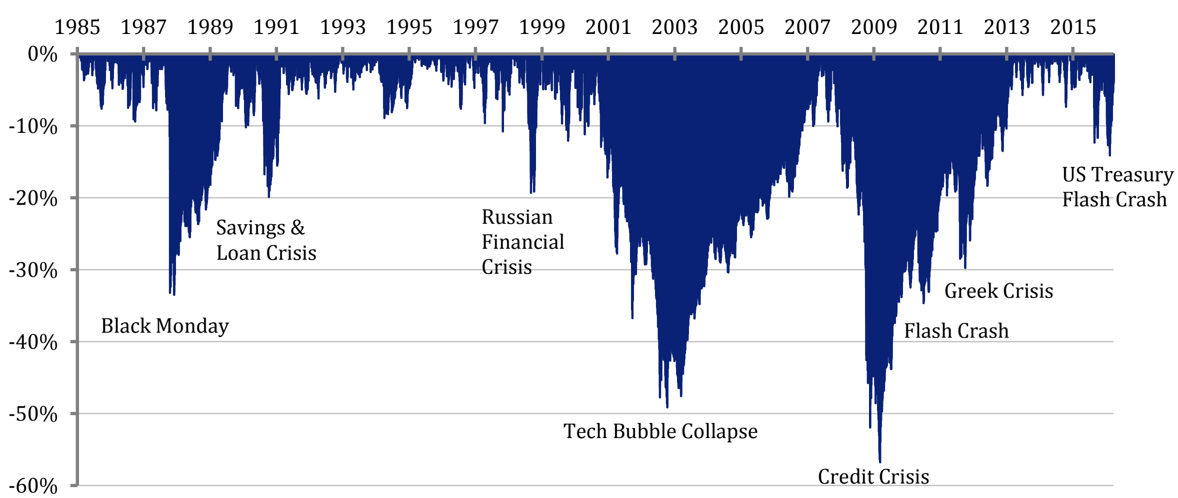


Past performance in no guarantee of future results

Navigating the Life Cycle of a Crisis

A real crisis occurs much more often than investors think. Probability statistics show that a major crisis should almost never happen, but in reality, they tend to happen once a decade or more. In the last 30 years alone, there was the Crash of 1987, the Russian Financial Crisis, the post-9/11 drop, the Credit Crisis, and the Greek Crisis.

S&P 500 Drawdowns from 1985 to 2015



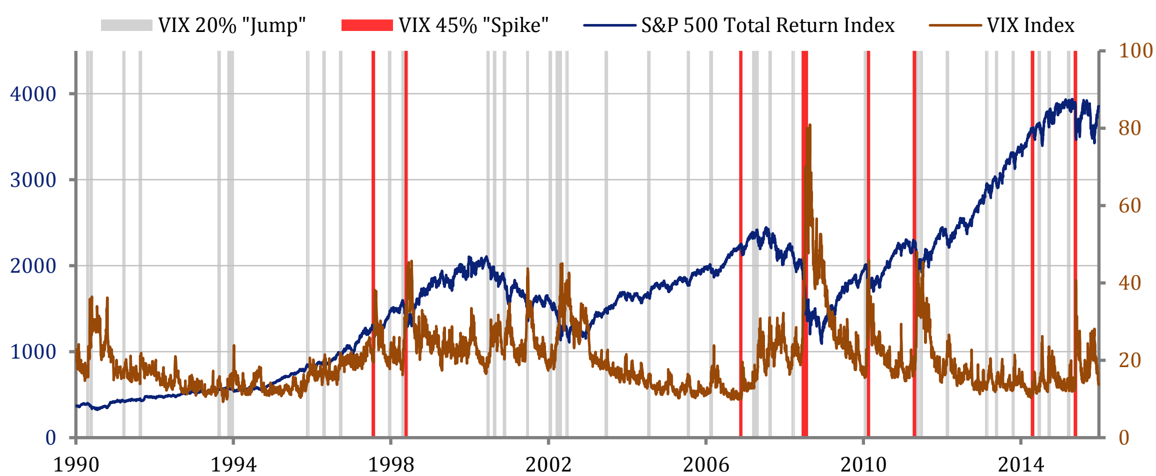
Past performance is no guarantee of future results

After a crisis, there are many systems and rules put in place for either preventing or managing futures crises. Following the Black Monday Crash of 1987, exchanges introduced “trading curbs” (known as circuit breakers), to temporarily halt entire markets during crashes. These did not help in 2008/2009, as the markets fell over 55% in 3 months. They also certainly didn’t help during the Flash Crash in 2010, when the markets lost over a trillion dollars and 9% in minutes. In response to that crisis, regulators instituted new circuit breakers for individual stocks and ETFs. These additional measures did not help on August 24, 2015 in the Flash Crash II, when the market dropped around 8% for a short period of time before rallying back.

Crises happen every few years, more than most investors may think. So planning and preparing for them is vital. However, it is not as simple as just buying volatility or selling equities as the VIX begins to rise.

The following chart shows a grey bar every time the VIX "jumps" 20% from one month to the next without developing into a true crisis, and it shows a red bar when that initial "jump" followed through into a 45% "spike", indicating a possible true crisis. To illustrate the importance of discerning between a "jump" and a "spike", consider a simple hypothetical investor who liquidated his equity holdings at each grey bar to prepare for trouble. This investor would have missed out on an average S&P 500 rally of 4.4% over the two months following each grey bar as the market quickly recovered without a crisis. A systematic volatility solution can help investors distinguish between a "jump" and a "spike".

Market Turbulence vs. True Crises



Past Performance is no guarantee of future results

Data Source: Bloomberg

Step 1: Preparing Clients when Times are Good

In bull markets, like the one experienced from 2010-2015, clients are focused on returns, generally wondering why they need advisors when they could just buy ETFs that replicate the S&P 500 and achieve superior returns without fees. Everyone thinks that they are smart and sophisticated enough to know how to properly set up a portfolio. Individuals become stock pickers, construction workers talk about biotech stocks, and clients begin to question the merit of having an advisor when they can now choose new-fangled things called robo-advisors. This is the most important time for advisors to work with clients to construct a long-term portfolio that strives to protect principal, provide income, and still has an opportunity to appreciate in value.

60/40 May be Problematic

Historically, these portfolios have been "60/40" portfolios. Roughly 60% of a client's portfolio rests in some sort of equity blend (growth, dividend, domestic, international) while the other 40% is in fixed income to provide a steady stream of interest payments. The reasoning behind this construction lies in the historical "protection" that bonds offer in a crisis. Generally, bonds have provided a safety net when the equity markets are in crisis.

Recently, the "60/40" portfolio has come into question. As equities and fixed income have significantly appreciated in a low interest rate/bull market environment, valuations have become frothy. If both equities and fixed income have appreciated at the same time, it stands to reason that they can both depreciate at the same time. It is possible that the safety net has a huge hole.

Volatility as an Asset Class

There are several ways to use volatility assets in order to complement equities in a crisis. We believe the most important factor in determining how and when to buy volatility assets in a portfolio is having a plan. If volatility is not handled systematically, it can end up costly and possibly do more harm than good. Whether an advisor is recommending the purchase of puts or the purchase of volatility through VIX futures or some other exchange-traded product, a systematic plan can help avoid panic, and the often poor decisions that can be driven by panic.

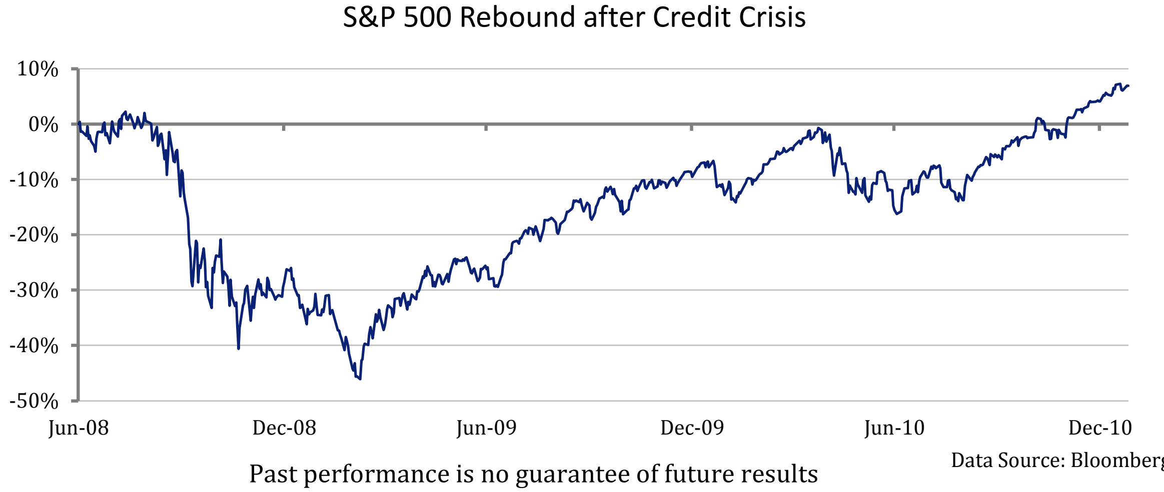
Talk with clients and discuss pain points. "If the market is down 10-15%, how painful would it be? How about if it is down 25-50%?" Walk clients through these scenarios and then discuss ways to help manage that volatility in a crisis. We believe 10% of a client's portfolio should be committed to volatility as an asset class in some manner. Once the advisor and client have developed a plan, make sure it is clearly communicated to the client so the advisor can use the plan as a reference point when the crisis occurs. Trying to time markets in a crisis is a losing game.

Advisors need to be systematic. Without a systematic approach, it is possible that some of the same advisors and clients who were timing stock buys when the market first started dropping in early 2008 were also the ones liquidating their holdings on the lows in early 2009. If that happened, they may have missed the stock market rally from 2009-2010.

Step 2: Talking Clients through a Crisis

Usually, market participants don't know that they are in a crisis until it is already upon them. Now they have been "hit" and the plan goes out the window. Trying to manage portfolio risk at this time without a systematic plan can be costly and ineffective. The cost of volatility assets may have already skyrocketed at this point. If advisors have properly educated and prepared clients, they can walk through the situation and prepare to play offense instead of defense.

Clients call advisors in a crisis and want to do *something*, and this may be the best time to do *nothing*. If an advisor has prepared by owning volatility as an asset class for their clients, the talk can move to going on the offensive for a small part of the portfolio, rather than trying to figure out how to protect what is left in the portfolio. However, no one really knows when a crisis is over. Is the market at a bottom when it is down 20%? Down 50%? In 2009, there were real fears that the banking system as we know it was going to collapse. If Lehman Brothers could go bankrupt, no one was safe. Few people at that point were worried about missing out on a bull market; most people were worried about the future of the economy. However, if advisors and their clients were consistent and did not try to time the markets, portfolios would rebound. By late 2010, stocks were back at pre-2009 highs.



Past performance is no guarantee of future results

When the clients call the advisors in a crisis and want to know, “What should we be doing?”, it is important for the advisor to be able to say, “Remember when we added volatility as an asset class to your portfolio? We prepared for this. Let’s see if there are any opportunities to take advantage of the increase in volatility.” Most people would rather play offense than defense, and now advisors can help their clients do just that. A simple strategy of buying some depressed blue-chip stocks can show the value of a good advisor.

Step 3: Conducting a Crisis *Post-Mortem* to Show Your Value to Clients

When in the depths of a crisis, it feels like things will never get better, that this time it is, in fact, different. The financial markets have permanently changed, stocks will never be a good investment again, etc. The reality is that things have always improved at some point. Eventually, things do get better, sometimes quite quickly, like after the Credit Crisis in 2008-2009.

As the markets calm down and the VIX returns below its long-term average of 20, it’s time for advisors to go over what happened with clients. This is usually a period of raging bull markets, like those seen in 2003-2007, or 2010-2014, and clients want to move on to the next great idea. Maybe that idea involves forgetting that another crisis will come and removing volatility as an asset class from a portfolio in order to more aggressively chase the bull market. However, advisors should caution against this approach and look at thoughtful research that shows the long-term compounding benefit of including a 10% systematic volatility allocation at all times.

Conclusion

Mike Tyson went on to win 50 fights, 44 by knock out. He lost six. Everyone gets hit, but when you make getting hit part of your plan, you are far more likely to survive and win. You can prepare your clients for the hits they are bound to take by treating volatility as an asset class and implementing a systematic plan to maintain exposure levels to stay the course in a crisis.

ABR Dynamic Funds family strives to provide systematic investment options to help advisors and their customers address their volatility concerns.

Disclosures

There are risks involved with investing in mutual funds, including the possible loss of principal. **Investing is subject to risk**; investment return and principal value will fluctuate, and upon redemption, shares may be worth more or less than the amount originally invested. The ABR Dynamic Funds (the Funds) may be **non-diversified**, and fluctuations in individual holdings will have a greater impact on the Funds' performance. The Funds may also invest in **derivative instruments**, and a small investment could have a large potential impact on the performance of the Funds.

Investment strategies used to help protect a portfolio from volatility also include unique risks that investors should consider when evaluating how to manage volatility in a portfolio. Moreover, the types of strategies used to manage volatility may not be appropriate depending on an investor's specific financial circumstances and risk tolerance.

Volatility assets entail their own unique risks that investors should consider when evaluating a volatility strategy. Volatility-based futures, options, and other derivatives can become illiquid, volatile, and difficult to value; are subject to possible counter-party default; and can be imperfectly correlated to the underlying asset or index. Due to leverage, the loss on a long futures contract could greatly exceed the initial investment. The loss on a short sale theoretically is unlimited since the appreciation of the shorted asset also theoretically is unlimited. Thus a small investment in derivatives could have a large potential impact on the performance of a portfolio. Exchange-traded funds (ETFs) and other pooled vehicles investing in volatility derivatives are subject to the same risks as their underlying volatility assets. Additionally, an ETF may trade at a premium or discount to the net asset value of its portfolio holdings. Further, a volatility strategy may at times call for high portfolio turnover rates, which increases brokerage costs. High turnover also may generate net short-term capital gains. Volatility assets and strategies, therefore, may not be suitable for some investors due to their financial circumstances and risk tolerance. A volatility strategy should not be viewed as a complete investment program.

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