OPTION OVERLAY UPDATE - JULY 2016

Option Overlay Portfolio	YTD 2016^	2015	2014	2013	2012
Put Income - Overlay from the sale of puts	*-2.27*	*-9.17*	0.56	5.92	7.94
Index Spread - Overlay of index credit spreads	*2.21*	*-3.80*			
Iron Condor Income - Overlay of equity credit spreads	*-8.56*	*0.11*	-1.91*	*Inception date of 2/1/2014	
Index					
S&P 500	3.84%	2.70%	13.69%	32.39%	16.0%

^January through June. **Please see important notes on back**. *Denotes partial year, with note reference. Results are net of fees and brokerage commissions. Composite results are the aggregate total net gains divided by the total collateral across the entire portfolio of accounts. The above results reflect only realized gains on the aggregate composite of all overlay accounts and do not include gains or losses from the underlying collateral in the accounts. **Past performance is not indicative or a guarantee of future results.**

The option overlay products are intended to be additive in return to other investments held in an account. Selling puts in **Put Income** generally adds cash, slowly-but-surely, to an account, however realized gains come in a very erratic fashion. Completed transaction-trails on a security can last many months. **Index Spread** is more of a one-and-done periodic trade. Some months, no action; some months a trade or two. By the time the trade is over (normally a week or two) you know the outcome. It is more of an instant gratification strategy. **Iron Condor** is a group of credit spread trades of short-to-medium-duration. The strategy usually works well in a sideways market, but performs poorly in volatile, choppy markets.

Put Income

Selling put options on equities to generate cash-flow is an income strategy based on equity prices. A short put, below the strike price, carries the same risk as a long stock position. Historically, the cash-flow from Put Income has been positive from year-to-year. However, realized gains and losses are very inconsistent. Generally speaking, in flat to rising equity markets, gains are realized . In falling markets, losses are realized. Just like any other equity based investment, this is a long-term strategy and may not produce capital gains over the short-term.

The first four months of 2016 were difficult for put income. Mainly because of energy position rollouts, gains were elusive. In May, the recovering stock market allowed us to take gains of $2.1 million across all accounts, or 44 basis points, which is right in the sweet spot of our target. The two main problem children for the month were Ensco (which only a few clients hold) and American Airlines, while the biggest gainers were Coach (some of you thought we would never see the day) and Qualcomm. In June, large gains and large losses mostly offset each other which left us with a miniscule gain, but essentially a flat month, 0% in realized gains. The big gains booked were Freeport-McMoran for $1.2 million and Baker Hughes for $1.0 million. However, those were offset when Mosiac was exercised and Gilead Pharma was rolled out, causing losses of $2.1 and $1.5 million respectively.

The recent strong stock market has helped all Put Income accounts significantly because many of the recently strong sectors are the ones we have the most exposure to. But so far in 2016, Put Income has been a tale of two client groups:

<u>Longer-term clients</u> (more than one year) - Our long-term clients still have high embedded exposure to some in-the-money puts on mostly commodity type of stocks, such as Alcoa, Ensco, Freeport-McMoran, Mosiac, and Whiting Petroleum. In the last 30 days (as of 7/25) this group has realized very large capital gains, booked from puts that were rolled earlier for losses. As a group, these clients now have positive realized gains for the year, however their cash flow has slowed to between 1 and 2%. The slower new cash-flow is due to the fact that this client group has high "notional exposure" already, so we haven't added as many new names to their accounts this year. The longer-term clients have been put shares several times this year from positions on stocks like Ensco, HP, Micron Tech, and Gilead. This group's "short options value" on their TD Ameritrade account screen has improved significantly to about -24% of their account values, which is down from the -40% level 4 months ago.

<u>Shorter-term clients</u> - Clients that started within the last 12 months don't have the above-mentioned legacy positions, so we have been able to add positions year in a variety of stocks. Newer clients have very few in-the-money positions. This group has added cash-flow in the 4%+ annualized range, right on target. The new clients have higher cash-flow, have not been put a single stock in 2016, <u>but</u> have lower realized gains. This group's "short options value" on their TD Ameritrade's account screen is peanuts, like 2 to 3% of their account value.

As the longer-term clients are worked out of their in-the-money legacy positions (such as the large gains taken in the last 30 days), their accounts will start to look more like the shorter-term clients, higher cash-flow paired with lower short option liability.

<u>All clients</u> - One significant change in the last 9 months for all clients is the quality of the stocks on the list we use to sell puts on. The new tool we use focuses 100% on the *downside risk* a stock has vs. the upside potential that most research focuses on. It has been a very good change with tangible results.

Index Spread

Credit spreads are the simultaneous sale of an out-of-the-money option, paired with a purchase (for insurance purposes) of farther out-of-the-money option. They are entered into for a finite period of time. Spreads are entered only if the probability of success (as calculated by thinkpipes) is over 95%. A maximum of 20% of an account is at risk on any given trade, and this is more of a trading strategy than a long-term premium collection strategy.

May and June were very good for this strategy with gains booked of 1.67% net of fees. The strategy has been quiet for 26 days now, waiting for a good trade entry point. Usually it is best to be

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patient and wait in the weeds for a good opportunity, rather than putting a trade on at a poorer time. Clients in the Index Spread strategy receive emails on every trade so we won't delve into the recent trade details, but overall (year-to-date) the strategy is batting 1000 and working well.

Iron Condor

Iron Condors are the simultaneous sale of a put and a call credit spread on the same security. A put "wing" and a call "wing". A trade is successful if the security closes in between the short put and the call strike prices. Returns are highly volatile.

In the first six months of 2016, Iron Condor had a terrible January, a weak April, an OK February and March, and fantastic May and June. May showed gains of +5.73% and June was +2.86%. The almost 9% of gains in the last two months helped fill the big-ole-hole dug by the market whipsaw in January. As of this writing, July looks like it may be a small loss, but a lot can change in a week so we'll wait and see. Currently there are eleven condor structures on six different securities. As we mention often on the monthly calls, a condor position has maximum profitability in a flattish market. The reason July has been tough is because in the last 30 days the Nasdaq 100 is up 11%, the S&P 500 and the Dow Jones Industrials are up 8%, and the small-cap ETF (IWM) has gained 6%.

One thing we all know is that markets don't go straight up for long, so perhaps the often-seen August doldrums will allow for late summer gains.

We believe option overlays that profit from the inevitable time-value degradation in option premium are solid long-term strategies to add cash-flow and capital gains to an account. Unfortunately, because equity prices are temperamental, the road is not always smooth. Patience is key, which interestingly is the same attribute necessary for success in <u>any</u> investment strategy.

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