36 South Views

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Rolling the dice

When examining the world of options, it helps to consider other fields in which probability plays a vital role. Let us take the casino as a metaphor.

For my money, *gambling* is when the odds are against you and you are relying on luck, i.e. you have a negative expected return in the long run. *Investing* is when you place bets where the odds are in your favour and you do NOT rely on luck.

Many investors seem to view options investing as a gamble. They often focus on two things:

1. Where will volatility be in three months' time?
2. They don't do negative carry strategies.

My response?

1. Forecasting actual future volatility is nearly impossible.
2. Negative carry tells you nothing about the quality of the proposition.

Let's look at forecasting volatility first.

Future volatility is essentially unknowable. There. I said it.

Volatility occurs when an asset price moves from price A to price B based on some new information, fact or perception which galvanises action.

If we knew what this information was, the asset price would have already moved unless it happened to be inside information. The fact that it hasn't moved means ALL (legal) information regarding that asset is reflected in the price as it stands today.

That is why the odds on a single bet on a roulette wheel, say the number 17, do not vary, i.e. 37 to 1.

There is no information which we can glean which could change the odds of the number 17 coming up next.

Financial assets are slightly different. We DO believe that we have information which changes the likelihood of asset price changes.

If this wasn't the case, option prices would be fixed at a single price/volatility just like on a roulette table.

Curiously enough, in the financial casino, when 17 comes up three times in a row, e.g. high volatility, we believe that 17 will come up more often going forward and are willing to buy options which reflect this, i.e. buying high priced options at high volatility.

When, in the financial casino, the number 17 has not occurred for an extremely long time, we believe it is now inherently unlikely and are willing to sell options at very cheap prices.

This is the equivalent of the croupier being allowed to set the odds on a roulette table based on what he/she THINKS, not the long run odds. She might shorten the odds (low pay-out relative to bet) on numbers that have recently come up and lengthen odds on numbers that haven't been observed for a long time (low price relative to pay-out).

Casinos would all go bankrupt!

Yet the 100 trillion dollar options market works on exactly this principle.

When volatility is low, investors are not inclined to buy options, in fact they are more likely to be sellers. 2017 was a prime example of this. February was the inevitable result.

When volatility is high and the odds dictate they should be sellers of this mispriced bet, they are buyers.

Volatility is now nearing decade lows in most asset classes. Where are the buyers? Predictably absent…

Therein lies the beauty of a long volatility strategy. There is no competition for what we do because, although the odds are firmly in our favour if we are given enough time to be right, this is a counterintuitive proposition and not undertaken by many.

There is, in fact, an added benefit: that option investing returns generally occur when traditional assets are going down in price, making an investment in cheap long dated volatility a valuable diversifier/tail hedge in ANY portfolio.

Now let's look at negative carry.

If, in the casino, you observed a croupier offering odds of 500 to 1 on a single number and they offer you the next 1000 spins at those odds, would you not jump at the opportunity?

Placing a bet in a normal casino is essentially negative carry, you place 1 dollar down on number 17 every spin in the expectation of some pay-out.

If the probability is 37-1 (UK roulette wheels), this means it will come up on average once every 37 times.

If you were offered 37-1 or a pay-out of 37 for every one placed, over 100 spins you would be about square. In reality they offer you 35-1 so you lose about two dollars every 37 spins on average.

If you were in this strange casino where the croupier could vary the odds and you were offered 5-1 or five dollars paid-out for every dollar outlaid you would lose 32 dollars every 37 spins on average.

If you were offered 100 -1 or 100 dollars paid-out for every dollar spent you would make 63 dollars every 37 spins on average.

What's the point? The point is this: in ALL cases these betting strategies were negative carry. In one instance is was neutral expected return (37-1), in one instance it was negative expected return (5-1) and in one instance it was positive expected return (100-1)

The fact that it is a negative carry strategy tells you NOTHING about the quality of the strategy!

In the financial casino, when volatility is low you can find options which are negative carry but positive expected return given enough time. This is because of their reduced price due to a low expectation of future volatility.

I will give you another example a bit closer to home. Literally.

Buying a house as an investment is a negative carry strategy if you take out a mortgage.

The premium you outlay is your deposit and your monthly interest payment.

If, like in 2009, you observe that you can buy a house which has fallen 50% in value at a monthly repayment which is extremely low due to near zero interest rates fixed for 20 years (cheap option) – do you rush out and buy? Not most investors.

It is a negative carry strategy, but with massive optionality and positive expected return given enough time to be right (fixed mortgage).

I digress. For investors to write off negative carry strategies is to preclude profitable opportunities to add diversifiers to their portfolio which can reduce their portfolio risk and provide a positive expected return in the very times they need it.

> *He said, "If you're gonna play the game, boy*
>
> *You gotta learn to play it right"*
>
> The Gambler by Kenny Rogers

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