36 South Views

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Farmers dilemma

You are a farmer in Tanzania or maybe Kenya in a verdant valley system, consisting of four valleys. In each valley, you farm corn, wheat, barley and fresh vegetables.

Your whole family wealth is tied up in the operation and you are good at making decent returns every year, except for when a random migration of animals come through one or more of these four valleys. Nobody knows when or why they migrate but, when they do, they devastate the crops as they pass.

Some farmers "hedge" their crops by laying traps in the valleys where they can catch some animals and sell them for meat, thus offsetting the losses which simultaneously occur when the animals devastate their crops. This would be a great hedge if the traps were free, but they are not - hence the farmers have a dilemma.

What is a fair price for a trap which will improve my compound annual wealth, taking both the crops and sale of meat vs trap cost (when it happens) into account?

And do I buy soft iron traps which are cheap but rust away in three months or stainless-steel traps which last 5 years but are much more expensive?

Traps are bought and sold at the local general store. The price of traps varies with the farmers perception as to how likely the animals are to migrate. Very little chance? Prices of all traps are low. Animals on the move in the valleys? Price of traps are high.

It is counterintuitive, but when the animals have not migrated for the longest time, traps are the cheapest. Farmers get hedging fatigue and begin to believe the animals are gone for good. Some stop buying traps, others sell their traps back to general store at rock bottom prices.

The cheap farmer buys three-month traps at rock bottom prices but, as time progresses without a migration, he quickly tires of this strategy as it just seems like money down the drain.

The wise farmer knows that he must buy stainless steel traps when the price is unnaturally low and absorb the cost from his thriving harvest.

As time goes by, he is unperturbed by the slow degradation in his traps. He is ambivalent which valley they come through as he has them all covered.

Return-wise, he underperforms his farmer buddies who are unhedged and is often the butt of jokes when they all get together for a BBQ.

The traps may get even cheaper and cheaper, he is not deterred and even buys more stainless-steel traps.

Fast forward two years.

The animals show up in force, devastating the crops and ruining the unhedged farmers, who are now panicking.

The wise farmer catches animals in all of his traps in all the valleys yielding a healthy profit which offsets most of the losses on his crops.

He then notices that all the other farmers are in a panic and buying traps at 10 times what he bought them for two years previously for so he lifts them up and sells them back to the general store at a healthy profit even though they only have three years' life left in them. He finishes the year virtually unscathed.

The unwise farmers fall into two camps of belief. One camp has bought expensive traps in the belief that animals will migrate annually, the other camp believe it was a one off and it will never be that bad again and so they borrow more money and replant their crops shunning the use of traps yet again.

Fast forward two years.

The unwise farmers have lost a lot of money buying expensive traps. They have borrowed money to plant more crops. Their net wealth has gone down … a lot…

They still tease the wise farmer at BBQs, calling him a lucky so and so.

The wise farmer is debt free. His wealth is now increasing again substantially. He waits for price of traps to come down so he can reinstitute his hedge.

Fast forward three years.

Animals come again, this time in only two of the valleys but with the same effect.

Rinse repeat.

This time the unwise farmers cannot roll over their loans and they "lose the ranch".

The wise farmer picks up the farms at rock bottom prices and the unhedged farmers end up working for him as farm managers or trap layers.

They would like to tease him at BBQs but now they can't because they work for him.

Over years of positively compounding by minimising his losses wisely using judicious buying and selling of traps, the wise farmer ends up owning the whole valley.

Moral of the story?

The four valleys represent four asset classes where your wealth could reside.

The animals are unexpected events which cause your investments to go down.

Traps are option/hedges which kick in when your traditional investments fail.

Implied volatility is the price you pay for these options and the durability of the metal used to make these traps is the duration of those hedges.

Long dated options are akin to stainless steel traps, three-month options akin to soft iron traps.

If you are reading this, you are a probably a wise farmer/portfolio manager. Hat tip…

The animals will come again .

P.S. I abhor the thought of trapping animals for whatever reason.

Disclosure

All of the calculations, figures and charts presented in this document are entirely hypothetical, simplistic, unrealistic and have been made retrospectively, with the benefit of hindsight. We are in no way suggesting that it is possible to mitigate or avoid losses altogether. The idea is simply to illustrate the concept that losses can have a greater effect than gains on CAGR over the long term. Nothing in this document should be taken as investment advice, or an invitation to invest in any particular strategy or product.

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