

A lethal brew

Discount rate:

The discount rate refers to the interest rate used in discounted cash flow (DCF) analysis to determine the present value of future cash flows.

- Investopedia

If the discount rate is zero, the present value of future cash flows is infinity. By definition, when approaching zero, we get values of "approaching infinity".

I mention this because I had a realisation that the discount rate has rendered all other valuation criteria meaningless and irrelevant.

The S&P 500 could double from here and redouble and it now makes sense using DCF analysis. Scary but understandable.

The second realisation I had is if 'discount rate' trumps 'pandemic', which I called in January 2020 the "Mother of all Black Swans", pretty much nothing will derail the equity market except an increasing discount rate.

So what could trigger higher interest rates?

Only significant and persistent inflation, which is trending exponentially higher.

But central banks insist inflation is transitory and mean reverting. It is a huge call with massive consequences. If they are right... Happy days. If they are wrong... I will relabel the rise in discount rate "the Mother of all Black Swans".

Why?

Firstly, a discount rate going from zero to 1% means a DCF valuation going from infinity down to a 100 price earnings, a massive fall.

A discount rate going from 1% to 2% is a DCF valuation falling 50%.

A discount rate going from 1% to 4% is a DCF valuation falling a 75%. etc

The biggest falls occurring as we move away from zero.

Secondly, your bond "diversifiers" will be part of the problem, not part of the solution.

Traditional portfolios are constructed in mix of 60% equities and 40% bonds. Risk parity portfolios are similar, except they lever up the bond leg. They are supposed to be diversifiers i.e. if one zigs the other zags and for the longest time that has been true.

If the price of both go down together which WILL happen if interest rates rise, the investment losses will accumulate rather than cancel each other out. Bonds in a diversifying/protection portfolio will add to the problem.

All supposed diversifiers like private equity, venture capital, property, forestry... you name it, will surely tend to fall together because their valuation is based on the same thing... the discount rate.

Investors are likely to overreact in such a situation. Add to that, they all hold the same 5-10 mega cap stocks thanks to passive investing.

A potentially lethal portfolio brew.

So persistent trending inflation would cause the central banks to blink and reverse course and raise interest rates.

The Fed are using an eight year average inflation rate which buys them time. So even if current inflation is 10% the eight year average will be a lot lower, but they could be seen shifting in their seats! Other central banks might well blink first, causing interest rates to rise in other countries first thus causing currency volatility amongst other things.

But there is a time when they will blink if they are wrong on the transitory nature of inflation and *that* is the black swan that must be protected against if viable to do so.

Fortunately, market data going back 30 years gives a very low probability of interest rates rising and equity markets falling. This means options that cover that possibility are well priced.

On another note. . . .

I listened to a well-known, well-respected financial podcast where they interviewed a long volatility hedge fund manager.

The basic view by both the interviewers and the long volatility hedge fund manager was that if you hold options over time i.e. long volatility, you will lose money over time. Therefore, you must have carry assets to mitigate these losses.

Fundamentally incorrect. . .

A portfolio of options bought at the right price in the correct size and correlation mix WILL make positive returns over time.

What confuses seemingly everybody is the amount of time during an investment cycle that the said asset spend carrying either positively or negatively.

If the asset carries positively 90% of the time, investors, professional or not, tend to like it.

If the asset carries negatively 90% of the time, investors tend not to like it.

It is simply behavioural bias. It tells you NOTHING about the quality of the investment.

Let us take an example using certain pay-offs like a roulette wheel.

The positively carrying investment pays £1 a spin and loses £50 if the number 17 comes up.

The negatively carrying investment loses £1 a spin but gains £50 if the number 17 comes up.

Which is the real gamble and which is the real investment?

It depends on the odds of a single number coming up which in this case we know i.e. 37 to one.

Over time in this example, the negatively carrying investment will massively outperform the positively carrying investment i.e. by £13 every 37 spins.

If the entry price is moved to £2, the situation changes totally. What was once the investment now becomes the gamble and vice versa.

At £2 per spin, the positively carrying investment will accrue wealth over time and the negatively carrying investment will go to zero over time.

It depends on entry price ...

Now add bets so that every number is bet on. Now regardless of what comes up, the portfolio will make or lose a certain amount depending on the entry price only.

If you pay £1 per spin and you bet on all 37 numbers, you will make £50 per spin less your cost ... you will make £13 per spin.

If you receive £1 per spin and bet on every number you will make £37 pounds in premium and pay out £50 for a net loss of £13.

This is loosely why we have a portfolio of options which are multi-asset class (think every number).

Options are similar yet different. They are similar in that they are percentage bets with corresponding pay-offs. The only real difference is that the pay-off is based off unknown risk (uncertainty) in options, whereas roulette is based off known risk.

My point is this ... a portfolio of options bought at the correct price (low implied volatility) in the correct size and correlation, can have a POSITIVE EXPECTED RETURN over time.

How an asset carries, positive or negatively tells you VERY LITTLE about the quality of the investment.

A negatively carrying portfolio does NOT NEED a mandatory carry to offset the premium decay over time.

This flawed understanding invariably leads to unsuitable carry asset additions with negative convexity being added, which will unwittingly offset any potential gains when they occur.

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