36 South Views

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All roads lead to Rome

The Kelly Criterion, well known especially among gamblers as a way to assess whether or not to place a bet (or in financial management terms, whether to put a position in a portfolio) and most importantly how to size that bet or position is, to my mind, phenomenally undervalued as a financial tool.

It is simplicity incarnate: you input only two pieces of information: the probability of winning and the odds you are given, or expected pay-out. E.g. a 125% pay out for winning a coin toss game should be played with only 10% of your bankroll.

The formula gives you in return two important pieces of information:

- The optimal bet size to maximise your long term portfolio.
- A reasonably accurate idea of where you will end up at a point in the future if you play this game repeatedly with that bet size or any other (suboptimal) bet size.

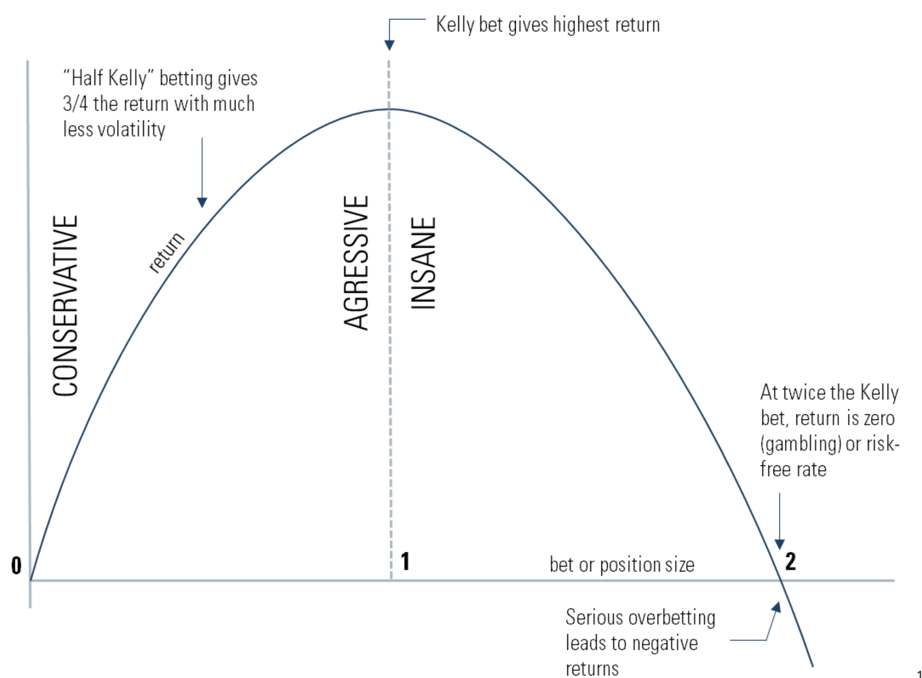
Why am I even discussing this? I believe that investors are massively over-investing in highly correlated assets which will lead to wealth destruction one way or another and this is easily predicted by the Kelly Criterion.

Today's gestalt, given interest rates at near 0%, encourages all investors to invest nearly 100% of their wealth, sometimes even more with leverage, in effectively one bet, i.e. bonds, property and equities.

And the odds of that bet remaining successful are getting smaller and smaller.

The Kelly Criterion could now assess the odds of losing a significant percentage of one's "bankroll" or portfolio (perhaps even going bankrupt) are approaching 100%. See below diagram:

Aggressive vs. Insane Risk taking



[1]

[1] Poundstone, W. (2005) Fortune's Formula, New York, New York: Hill and Wang; p. 232 (We have recreated this.)

That is the problem: the goal of portfolio management is to protect a portfolio for some point in the future.

Wait you say…..We diversify, we don't just have one bet.

I beg to differ…

As we near the end of this super-cycle bull market, equities are super-correlated with each other, ditto bonds and property.

Why?

They are now all bound together by one huge driver, low interest rates. Equities and property are now just proxy bonds. Their prices could ALL go down together if and when interest rates rise.

Ole Peters in a YouTube video called "Time for a Change: Introducing irreversible time in economics" absolutely nails this concept.

Give 1,000,000 people 60 fair coin tosses (50/50) with a pay-out that is in their favour, i.e. 50% return if you win, 40% loss if you lose. They have to bet 100% of their money each time.

What is the chance they will end up with more money than they started with?

Almost everyone agrees that MOST people will end up with more money than they started with.

Wrong! The average wealth does climb but the averages do not tell us anything about dispersion of those returns.

Most people get poorer! In fact, after 60 tosses, a third of people will lose all their money while one investor has close to 100 million dollars. Buffet, Gates … Ring a bell?

Why? The size of the bet! Everybody was running suboptimal bet size by risking either NONE OR ALL of their entire bankroll on every coin toss, both massively increasing their risk.

The parallel is clear to see in the financial markets, everybody's bet size is too big… or too small.

This is occurring on a global scale driven by low interest rates.

Those who are betting nothing can't bet because they have no discretionary income or capital. As the nominal amount of money increases and financial assets reprice, they are left behind. They are disgruntled and unhappy at the perceived "unfairness" of what is happening today.

Those who do have access to debt, discretionary income or capital are finding themselves betting "the ranch" i.e. everybody is forced to increase their "bet size" in order to increase yield.

It is a recipe for disaster – whether the markets go up, down or do nothing:

1) Asset prices fall precipitously

Everybody is caught with the same problems at the same time, having forgone proper diversification, e.g. investing in low cost ETFs.

2) Asset prices rise precipitously

Inequality rises as less than 10% of the population will benefit (largely the baby boomers) potentially leading to some sort of revolutionary reset. That is, unless central banks step in and raise interest rates to ward it off – leading to asset prices falling.

In both cases, most of the population will watch their assets head to zero irrespective of whether the market goes up or down.

Only those few lucky (or clever?) investors that took out some non-traditional diversification or some sort of tail risk insurance will survive in any meaningful way.

The point is, only these few investors will be in a position to thrive, no matter what happens to asset prices.

Why?

Everybody had the wrong bet size and was playing the same game.

As Ole Peters points out, if GDP rises because asset prices rise, this doesn't necessarily mean things are going well. For example, if a billionaire makes an extra billion but 20,000 teachers become jobless, try telling the teachers that the economy, as judged by GDP, is OK!

What if volatility stays low?

If volatility stays low, this inequality marches on, disguised by complacency leading to asset prices rising precipitously (and, as above, likely some sort of uprising). It just takes longer.

Volatility will eventually expose this over/under-betting one way or another and punish it.

That is why we believe the Kohinoor and related strategies, which have a two tailed pay-off on extreme market moves up or down accompanied by volatility may be a valid antidote for what is about to happen.

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