36 South Views

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Learning to love what you fear

Most asset managers look for assets that go up in price, which is understandable.

However, this captures just over half (assuming positive drift) of the total movement of that asset over time, the remaining balance being the movement in price downwards.

It's like scouring the hills for gold, not realizing that there is an abundance of gold in the depths of the oceans. However, no one looks there. Instead, one complains bitterly about any time spent in the ocean and not in the hills.

The downward movement, from a compounding point of view, is problematic as you lose not only what you have gained, but also time, which is an important factor in compounding returns.

Most investors assume that this downward movement is unavoidable. They therefore live with it, seeking upside beta and upside alpha instead, which are generally provided by "industry experts" in the form of proclaimed timing skills, or by monetizing a subtle form of added risk into return, i.e. correlation, illiquidity, or volatility, just to name a few.

What is the solution then?

Adding assets that provide performance when traditional assets go down in price is a fool's errand. If one has both types of assets, then you have cancelled out the performance of one with the other.

However, having both types of assets could work…

If one could "freeze" the returns of the "long" asset while it is going down and let the returns of the "short" asset run when the market is going down, that would work.

Alternatively, when the asset is going up, one would ideally have the "short" asset returns frozen and the "long asset" returns free to run.

This has a corollary in mathematics and physics called the Parrondo's paradox.

This way, it is possible to keep on compounding returns or at least not go backwards in BOTH up and down markets.

The key to understanding how to design this superior compounding machine is in the term "ratchet".

The definition of ratchet on Wikipedia is as follows: "a situation or process that is perceived to be changing in a series of irreversible steps".

Options are the ratchets of finance. They allow unlimited returns in one direction but limited loss (of premium) in the other direction.

Let's look at a portfolio of long assets and an attached put option. This lets the return run to the upside and "freezes" the losses to the downside.

In order to be truly effective, we need one more ratchet, and that is on the returns of the put option when it is performing i.e., in down markets.

So when the market goes up, there is a ratchet in place, i.e. losses are limited to the put option premium paid, and when the market goes down, the option itself is ratcheted so it gets to keep the bulk of the returns it has made.

You now have this machine.

In a bull market, “long” asset returns may run unfettered, while “short” assets can only lose the premium paid. In a bear market, “short” asset returns run unfettered, hopefully negating the losses of the long assets. When the market turns bullish again, the second “profit stop” ratchet freezes the returns of the short asset, i.e. put options at or near their highs, and the long assets can start compounding again from where they left off, resulting in considerable gains as they do not have to return to their high water mark to begin the compounding process in earnest. Precious compounding time is also saved.

This can be further improved by rebalancing the relative sizes of the short and long assets once the put premium is monetized.

In this way, downside moves, instead of detracting from compounded returns, assist them.

Learning to love what you fear is counterintuitive… maybe that’s why they call it a paradox?

Disclosure

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