36 South Views

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What bookmakers know…

I wish John L. Kelly had won the Nobel Prize for economics instead of Markowitz. At least then we would not have the burden of the delusions we carry around now.

Markowitz implicitly assumed:

- We live our lives in discrete steps. Arithmetically, one period at a time.
- Outcomes are approximated by the normal distribution.
- Volatility tells us all we need to know about risk.
- Return and "known" risk is all we need to know to evaluate an asset and a portfolio.

Kelly, on the other hand, thought like a bookmaker:

- That life was a one long horse race and the horses were all the possible outcomes that could happen…in this case your assets.
- You HAVE to invest ALL your capital in this horserace.
- The real important thing is the finish line and which outcome/horse finishes past the post. (Your terminal wealth at retirement) i.e. you accumulate wealth geometrically.
- Risk is known and unknown and is best evaluated by looking at your edge over the odds.

What Kelly and the bookmakers know?

- Nothing is certain.
- Try and cover the most unlikely scenarios when the price versus the odds are in your favour.
- Never risk total ruin. Live to be in an unassailable position (a Dutch book) by the end if possible.

In the "portfolio" horse race, property, bonds, credit and equities are 10 furlongs ahead. They have been doped by the Central Bank Cartel and look, for all money, to be doozies to win the race first, second third and fourth.

Precious metals, a previous 10-time winner, looks old and tired.

Crypto, a relatively unknown yearling, is up there and has potential but has yet to be tested against such a robust field.

Uncertainty, a sometime outsider, has been weighted down with lead in his saddlebags by the very same Central Bank Cartel and is 20 furlongs adrift at the back of the field.

The bookmakers have shortened the odds on property, credit, equity and bonds to the point that you have to invest a lot just to make a little. Cash is in the middle of the field, it generally always get a placing unless the running is extremely good (inflation) in which case it ends up at the back of the field.

At the same time, it is such an improbable event that either cash or uncertainty come in, that no-one is taking these bets therefore the odds have lengthened way past the point where their true odds lie.

It is a long race. Years in fact. But where we sit here now, the sun is shining, the going is good, the favourites are winning and punters are almost exclusively invested in them.

The clever bookmakers cover the long odds when the odds are too long and whilst their investment is low probability and negative carry, it is cheap insurance as the odds are too generous.

These bookmakers are not going to make as much as the young bulls who scoff at the old bookmakers investing in highly improbably horses!!! But as time goes on, the clever bookmakers have a "book" where there is not one horse/outcome which can come in which will lead to either ruin or substantial loss.

Round and round they go. Storm clouds begin to gather.

No worries the optimists say, the Central Bank Cartel shoots a dart of adrenaline into the top three horses every time they start to flag…What could possibly go wrong?

It starts raining…with lightning and thunder.

The shooter for the Central Bank Cartel adds too much stimulatory adrenalin into his dart when he QE's the front horses.

Credit has a minor heart attack and stumbles blocking the way for the front runners who also start to flag under the overstimulation and ensuing confusion caused by lightning.

Uncertainty and cash, unfazed by recent developments, find the lightning stimulating and the going underfoot favourable. They catch up and then sail past the front runners.

The complacent bookmakers and punters scramble for cover, looking to sell their "dead certs" at any price and look to place some bets on uncertainty and cash.

But the odds have shortened. Cash and uncertainty are now priced way too expensively as everybody tries to reconfigure their book. They face total ruin if they don't.

The favourites are now cheap and cash and uncertainty, now 10 furlongs ahead, are expensive.

The wise bookmakers know this and adjust their book selling out cash and uncertainty and buying the favourites in size whilst on offer at such great prices.

The race continues and things settle down to "normal". Most of the traditional bookmakers and investors are now sitting with large bets on cash and uncertainty.

Wise bookmakers find their realignments have paid off in spades and they now have much more capital at work plus the ability to buy into cash and uncertainty as the odds lengthen again way over what is prudent.

The traditional bookmakers and investors find their capital diminished. And now the race is almost done.

The only way to get their capital back is to lever up, borrow money and go all into the favourites again!

Storm clouds gather as they start their final lap…

Disclosure