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Only three things to gamblin'

As I write this month’s musing, we have suffered a mind focusing drawdown in our funds so it is with that in mind I tackle the very important question.

What does one do following a negative period in investing, or in life for that matter?

My best guess… re-examine everything you know, including your assumptions. Reflect on whether you have positioned yourself correctly and are merely experiencing the “slings and arrows of outrageous fortune”, whether your strategy was incorrect to begin with, or whether something has changed and thus action is required.

With regards to investing in options, probabilistic instruments which have a wager (premium) and a pay-off (return), one need look no further than the simple ideas of late two-time champion world poker player Puggy Pearson who offers us this set of rules to follow (Wagner, n.d.).

"Only three things to gamblin'," Puggy once said, "knowing the 60/40 end of a proposition, money management and knowing yourself." Well, those rules apply to option investors too.

Here are Pearson's rules:

1. ***Knowing the 60/40 end of a proposition***
   Understanding the odds of drawing a winning hand is essential to poker. The 60/40 bets are those that offer the best chance of winning given all the options available. If you only play hands that have these odds or better, the statistics are on your side.

   As option investors, we should strive to put the odds in our favour.

   Bottom up it means finding the best 60/40 opportunities: this takes time and research.

   Top down it means investing counterintuitively throughout the volatility cycle, i.e. investing more when volatility is low.

2. ***Money Management***
   Managing money is an ongoing process. The first tenet is to minimise losses on each opportunity. Unfortunately, option investors have to ante up to play, as in poker.

   Once you have a good opportunity, it is time to decide how much money to commit to the opportunity.

   Basically, when the best opportunities present themselves, it is usually wise to make a significant commitment. For good (but not great) opportunities, committing smaller amounts makes sense as the potential reward is lower.

In option portfolios, reference to the Kelly criterion will give you an excellent guide as to how much to invest in any one opportunity.

3. ***Knowing Yourself***
   The last rule, knowing yourself, means doing everything you can to stick to your discipline. Following your discipline is essential for success as an options investor.

We believe we follow these three rules, that our investment philosophy and process puts us at the right end of a 60/40 proposition. Our investment process helps us size correctly and our profit taking rules ensures our discipline.

So why then do drawdowns, sometime outsize, occur?

When you position for volatility and you experience a multi decade low in volatility, you will take mark to market losses.

When one’s philosophy is to invest more as the level of volatility declines and it declines further, the drawdowns become greater.

The longer the bear market in volatility continues, the more convinced the short sellers of volatility become, the greater their eagerness for selling volatility at lower and lower levels.

The price of volatility is itself convex. This is a two edged sword; it is convex downwards as well, i.e. the lower volatility becomes, the greater potential loss per 1% move downward.

It is important to bear one simple truth in mind….

THE LOWER THE VOLATILITY, THE GREATER THE EXPECTED RETURN FOR LONG VOLATILITY INVESTORS.

This is the time when “know thyself” becomes very important, as well as “know the market” I suppose.

The discipline to wait for a sea change is still there and hopefully remains there for our investors. The temptation to faint at one minute before dawn is real!

I would surmise that the market for volatility has not reached a permanently low plateau but just happens to be an extraordinarily long bear market.

If anyone knew what the butterfly’s wing was which will lead to market volatility, we would have already driven up the price of it.

The fact that volatility will return is inevitable, the timing unfortunately is not.

Preparation plus opportunity equals luck.

References

Wagner, H. (n.d.). Financial Wisdom From Three Wise Men. Retrieved from Investopedia: http://www.investopedia.com/articles/06/threewisemen.asp#ixzz4v20gYrmj