Its a Jungle Out There

Is investing a zero or constant sum game? In derivative markets, FX, commodities, the game is trivially constant sum. In equities there is some debate.

Some claim that ownership of equity is a claim on future cash flows and is therefore not a zero sum game. The value of equity is therefore sensitive to growth rates and discount rates extending far into an uncertain future.

The sensitivity of valuations to this uncertain future is too high so that valuations are too uncertain to be of much value. If the valuations were as stable as some proponents of equity investing purport, their models would not be able to explain the volatility in equity prices.

As far as I am concerned, investing is very close to a constant sum game. The pie is growing but at rate close to GDP growth in order of magnitude. It does not come close to the volatility observed in the markets. This volatility must therefore represent the winners and losers around the long term trend growth rate. This trend growth rate is so small relative to the volatility that one may as well regard the game as a constant sum game. So, where there are winners, there are losers, and its all a mighty big game.

Fundamentals are only of value in their impact on investors expectations and behavior.

A minority non-control investor in a public company can talk all day about their claim on assets and cash flow and still be no more closer to being an owner or operator of the business.

A minority non control investor in a private company beyond receiving dividends owns little more than a concept of charity.

Investment can sometimes seem like just one big casino, and for many it is. For the house and the card counters, the size of the markets makes it fertile hunting ground indeed. One overriding principle in all games of strategy, even where chance plays a hand, is that you always play the players, not the cards. Games of pure chance are for mugs, and the house. The house always wins.

Its a jungle out there and the majority of the players are sheep. There are professional traditional investors who may be more sophisticated, although many of them believe that fundamentals drive prices and analyse companies to that end. The more sophisticated investor realizes that fundamentals drive prices through mass psychology and thus take a more trading oriented approach, reacting to the reactions of others.

At the top of the food chain are the lions, wolves, hyenas and cheetahs. They realize that fundamentals are meaningless beyond the impact it has on the sheep, the cattle, the intermediate predators, the scavengers and the top of the food chain, themselves.

Their job is to figure out how all the other herds, packs and prides behave. Their objective is to pick out the weaklings from the herd. Occasionally there will be the opportunity to take down an entire herd, or better, a pack or even better, another pride. The sharp investor or trader is not only aware of fundamentals but who owns the stock, who trades the stock, what are their instincts and trading habits, how do they react to good news and bad, how quickly they act and who runs and who fights. Market impact is all that counts, so one has to know all the players and their firepower and thus marginal impact.

There are examples of successful retail punters. Sheep are after all not extinct. There are enough sheep to feed the wolves and still propagate the species.

Hyenas prey on the weak, foxes prey on the stupid, cheetahs on the slow. Each predator has qualities and strategies suited to their prey.

Betting on a deal closing or breaking. If you know the water is poisoned, all you have to do is take lots of antidote and wait by the water. Eventually there are lots of carcasses that are energetically free to devour.

Front running volatility. Watching structured products issuance in the retail investment market gives clues as to chronic demand supply imbalances in the vol market. A professional vol trader may look at vol surfaces and technicals to trade. The predator watches the root source of demand and supply and trades ahead of even the professional vol trader.

Knowing who is in play, what do they need, what are their instincts, what they will likely do next, what is their impact, is ultimately more important than knowing companies. The only time knowing companies is important is when you have control, or if not control then significant influence, or if you have the staying power to match the maturities in the fixed term securities issued by the company. If you have neither, knowing the company may be intellectually satisfying, but of little value otherwise.

In a constant sum game the number and nature of the players is very important. You can’t have more wolves than sheep. When convertible arbitrage suffered in 2005 it was preceded by a period when over 90% of new issuance went to hedge funds and only the scraps fell to non-arbitrageurs. When equity quant strategies hit a speed bump in 2007 they had all crowded into a small cap value overweight position. When trades get crowded, the traders get burnt. Not enouigh sheep. Diversifying among managers doesn’t help in zero sum games. You only pick up the transaction costs. When a strategy gets crowded there are only two things to do, get out of the strategy, or concentrate your bet to one manager who will be top dog. You can recognize this manager, he is the contrarian in a crowded strategy. The contrarian in an uncrowded strategy is a difficult bet. You just don’t know.

Favour environments where there are lots of sheep and a few wolves. Just make sure you are betting on the wolf, or are yourself one. If you are unsure, you are the sheep. Its a theorem. Part time investors are excellent prey.

Strategies are cyclical, even absolute return ones. The cyclicality arises often from the balance of sheep to wolves. As the wolves gorge they deplete the sheep and end up crowding each other out. Some sheep learn and become wolves. At the height of the feeding frenzy the wolves are eating each other. Get out of the way. But cycles are precisely that. The sheep never learn, they only need time to regenerate. There is always another generation of sheep for the slaughter.