October 2016 Investment Newsletter

On Love, Investing and Blowups

1. A breezy discourse on love and investing

What do humans really care about? For most of us, it is about love and money — spending time with loved ones and using money as a means to achieve that. (For some, it's about money and love, in that order, and it's love — of themselves.)

Given the various upheavals we have endured throughout the year, perhaps we can take a breather and afford a breezy discourse on the similarities between relationships and investing, whilst we wade into a historically volatile month.

Because money is so important to us, we approach investing the way we approach love. If we have been investing for some time we might be able to separate the two: we can be cold and emotionless on the trading floor, with numbers constantly flashing and profit/loss massively fluctuating, as we allow waves and waves of information to wash over us. Yet away from the world of financial markets, the heart is a stormy sea of emotions. For what it's worth, here are some similarities between relationships and investing:

Holding on to a losing position

In relationships, people like to cling on to past relationships, hoping for that someone to come back. In finance, humans like to sit tight on a losing position. Why is that so? It's not about economic loss, it's about emotional loss as well. People never like to admit they are wrong; once you bail out, you have to admit that you are wrong. We want to hope and to pine for some divine intervention; we want to feel vindicated: "I have still made a good choice, and it will come back." Research has shown that individual investors are 50% more likely to sell a winning stock than a loser. Also, many investors who are losing money may automatically assume that their position is bound to recover (because many of us still believe in fairy tale endings).

The enormous emotional investment also works against cutting losses, especially for those with a long-term/ value angle. Because they put so much time and effort into studying each stock, they are much more likely to fall in love with it. Even when it becomes obvious that they must have missed something in their analysis or that something has fundamentally changed, many such investors stubbornly hold onto a bad stock—because they become too emotionally invested.

I once held onto a losing position for 3 years, hoping and pining for the tide to turn. She never did. I refused to face the fundamentals. But when I finally gathered the courage to examine the situation seriously, all illusions peeled away. Unlike fairy tales, in real life Bathsheba never got together with Gabriel Oak; Estella never loved Pip.

"There is no safe investment. To love at all is to be vulnerable. Love anything, and your heart will certainly be wrung and possibly be broken." - C.S. Lewis

1. (continued)

In finance, accepting a loss is easier when we think of it as a swap rather than a sale — we replace the losing position with a new position that has the potential to do well. That tends to make taking action easier, since we are not forced to admit that our original judgment was a complete failure.

This is the same in relationships. Once someone leaves there is a hole in our hearts and after a brief respite we should replace it with someone. If we don't the wound will continue to fester, until such a time where we become so used to the pain that we accept it as a part of our lives.

Failure to avoid blowups

Relationship-wise, blowups here refer to angry arguments, and I am not referring to blowup dolls. Blowups almost always end a relationship, especially at the beginning of one. We really need to keep our cool at all times. I have seen countless examples of my friends who ended budding relationships over innocuous tiffs that escalated quickly.

In investing, investors want to see a manager employing a consistent strategy resulting in consistent expected returns (and that does not equate to not having losses). Particularly in the early stages of investing, if you were to take excessive risks and things blow up, you may find it psychologically hard to recover from such a loss and your investors will view it dimly too. Therefore the idea is to play it safer until some sort of trust and track record is established. Even if you are convinced your strategy is the best for the longer term, depending on your investor base you still need to manage the short term fluctuations.

In the next section, let's discuss a popular strategy to manage blowups and how to make the best of it.

2. Managing Blowups — Volatility and the VIX Index

The VIX Index, a measure of volatility, continues to trade at historically low levels. Since the VIX Index is zero bound, you would think there is only one way to go and that is up. However, there isn't really an instrument that perfectly mirrors the VIX Index.

One of the popularly traded products to effect a VIX position is the iPath S&P 500 VIX Short-Term Futures ETN (VXX). Ideally VXX would track the VIX Index. However since there are no investments available that directly track the VIX it tracks the next best choice: VIX futures. The VXX thus tracks the current value of an index (S&P VIX Short-Term Futures) that manages a hypothetical portfolio of the two nearest to expiration VIX futures contracts.

Unfortunately, it has sometimes been called 'worst investment in the world'. It can be useful for tactical trading, where the holding period is over a few seconds to a few days. Beyond that timeframe it is a challenging product to use. The VXX has also been reverse spilt 4 times since its launch. (For example, suppose the VXX is trading at $10 and you hold 100 shares. A 1-for-4 reverse split will change the price of VXX to $40 while you hold 25 shares.) Why do they do it? The reason is because they wanted to give investors the optical illusion that VXX is doing alright when it has actually been subject to heavy losses over time. Here are some of the problems associated with it:

Problem # 1 with VXX: horrible negative carry

Most days both sets of VIX futures that VXX tracks drift lower relative to the VIX — dragging down VXX's value at the average rate of 5% per month (65% per year). This drag is called roll or contango loss. In fact, the VXX has average a 50% annual loss since its inception in January 2009.

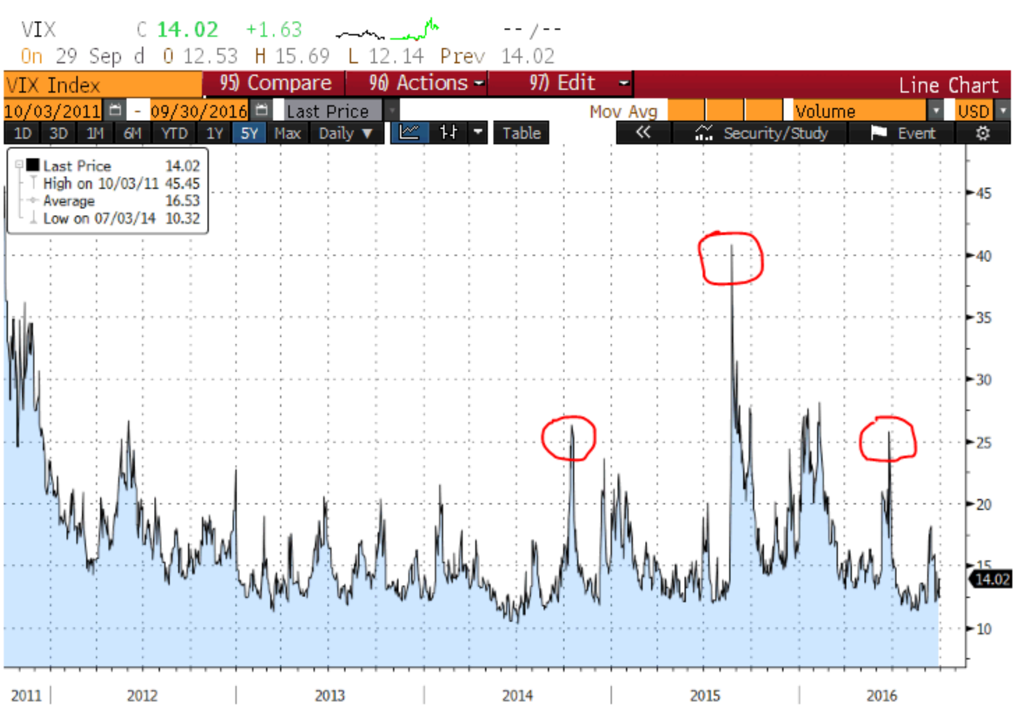

Chart 1: Fresh perspective of VIX. VIX is a truly range-bound beast. When it is down you know it is just a matter of time before it goes up, and when it is up there you know it will come back down eventually.

2. (continued)

Problem # 2 with VXX: not as sensitive as VIX

Another problem is that the combination of VIX futures that VXX tracks does not follow the VIX index particularly well. On average it moves only 55% as much as the VIX index. That is to say, if the VIX Index gains +20%, the profit to an investor who is long the VXX will only see +11% gain. Therefore, even if you are right, the return is not as profitable as you would have expected.

Problem # 3 with VXX: an erratic contrarian investment

Most people invest in VXX as a contrarian investment to hedge their long equity positions, expecting VXX to go up when the equities market goes down. Historically the VXX has average percentage moves of -2.94 times the S&P 500, but 16% of the time VXX has moved in the same direction as the S&P 500. There will thus be times where you will experience losses in both your long equity positions and long VXX position, when both the S&P 500 and the VIX turn down together.

Therefore, with heavy negative carry, poor tracking to the VIX and erratic tracking with the S&P 500, owning VXX is not something that works out for most investors. One needs good timing to make the most of this product.

So what do we do with this information? How about taking the other side of the trade then. There is a similar but inverse ETF/ETN such as the Velocity Shares Daily Inverse VIX Short Term ETN, (XIV), which allows investors to benefit from this negative roll. XIV is up around 40% per annum over the past five years. The VIX Index is truly a range-bound creature — when it is low there is always the chance of it spiking up. When it is sky-high, it will eventually come back down. Therefore, when VIX spikes up a trade idea is to buy XIV, waiting for VIX to settle back down while collecting the juicy carry.

Another opportunity to buy the XIV is when VIX index is low relative to the first futures. The roll effect will be the greatest. The effect to 'pull down' future prices will be stronger and thus the carry will be greater when we long the XIV.

In conclusion, as we enter October, put on your seatbelts and enjoy the ride, if it comes to that. Keep calm, try not to blow up and opportunities should present themselves.

Sources:
- Bloomberg

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