Market Brief – 90/10

"Hey, Sisyphus, when you've got a minute I'd like to discuss this progress report with you."

We all know the story of Sisyphus, right? He was known as the most cunning knave on earth. And through his trickery, he was able to fool the Gods and extend his life. Eventually though, the Gods wised up and Sisyphus was hauled down to Hades as punishment for his crimes. He was assigned an eternity of hard labor. The labor consisted of rolling a large boulder to the top of a hill — only every time he summited by the greatest of toil and exertion, the boulder would roll back down and he was forced to begin again.

Inevitably, as traders and investors we will often find ourselves feeling a lot like poor Sisyphus. We will toil, analyze, research and exert ourselves in search of asymmetric opportunities… and we'll build up profit over a period of time (push our bolder to the top) only to watch the market swiftly take it all back (down to the bottom our boulder goes).

These periods are about as fun as pissing on spark plugs.

The Macro Ops portfolio is currently doing one of these two steps forward two steps back shuffles — I call it profit/loss purgatory. So far this year, we have been up 9% on paper to back near breakeven and then up to new equity highs only to fall back down to where we started (this isn't so bad when compared to the killing fields that are taking place in the hedge fund industry at the moment).

Are we doing something wrong? Has our methodology degraded… is it time to search for a new strategy?

Nope. And definitely not.

The reasons why lead us to discuss two important truths about trading and investing.

1. Investing returns follow a natural power-law distribution.
2. Humans are not neurologically wired to instinctively embrace this power-law distribution of returns.

Pareto and Profits

Vilfredo Pareto was an Italian economist born in the mid-19th century and who made an interesting discovery about land ownership in Italy. While surveying his Italian city he found that 80% of the land was owned by 20% of the population.

After further inquiry, he found that this 80/20 distribution was prevalent in other cities. And in fact this 80/20 rule didn't seem to just apply to land ownership, but also income distribution, and revenue origination streams.

Pareto had discovered a natural occurring power law. A power law, as known in mathematics, is just a relationship between two quantities such that one is proportional to the fixed power of the other. Power laws seem to be embedded in the very fabric of the universe; applying to the sizes of solar flares, the populations of cities, and the intensities of earthquakes to name just a few. The 80/20 rule, now known as Pareto's law is often used as a guiding principle in business and productivity decisions.

Trading and investing profits tend to adhere to this power law too. Actually, they seem to follow an even more extreme distribution of 90/10. Meaning, amongst great traders and investors, 90% of their profits tend to come from 10% or less of their trades. Let's look at the following from Ken Grant in his book *Trading Risk*:

> *"Some years ago in my observation of P/L patterns, I noticed the following interesting trend: For virtually every account I encountered, the overwhelming majority of profitability was concentrated in a handful of trades. Once this pattern became clear to me, I decided to test the hypothesis across a large sample of portfolio managers for whom transactions-level data was available. Specifically, I took each transaction in every account and ranked them in descending order by profitability. I then went to the top of the list of trades and started adding the profits for each transaction until the total was equal to the overall profitability of the account.*
>
> *"What I found reinforced this hypothesis in surprisingly unambiguous terms. For nearly every account in our sample, the top 10% of all transactions ranked by profitability accounted for 100% or more of the P/L for the account. In many cases, the 100% threshold was crossed at 5% or lower. Moreover, this pattern repeated itself consistently across trading styles, asset classes, instrument classes, and market conditions. This is an important concept that has far-reaching implications for portfolio management, many of which I will attempt to address here.*
>
> *"To begin with, if we accept the notion that the entire profitability of your account will be captured in, say, the top 10% of your trades, then it follows by definition that the other 90% are a break-even proposition. Think about this for a moment: Literally 9 out of every 10 of your trades are likely to aggregate to produce profits of exactly zero. It almost makes you want to pack up your charts and go home, doesn't it? Indeed, the main danger in being aware of this concept is the tendency to misinterpret its implications. For this reason, we want to be very*

careful about how we use the information in driving the portfolio management process and all of its components.

"Most people's first reaction when they see their "90/10" score is to assume that it is a problem that wants correcting. This is simply not so; and if they respond by trading less, concentrating their portfolio exclusively on what they feel to be their best ideas, they are likely to be disappointed by the results. The 90/10 rule is hard to overcome, and so I think the better way of looking at it is that you need the 90 to get the 10. To best understand this, let's use a baseball analogy (why not, everyone else does). Think of the situation faced by a .300 hitter in baseball, who, even though he knows he's going to be unsuccessful 70% of the time cannot simply decline to step up to the plate on the 7 out of 10 occasions where (statistically speaking) he isn't likely to get a hit. Truth is, the 7 outs he makes in 10 at-bats are a necessary condition of his .300 batting average, and he can no more expect to be more successful by limiting his at-bats than you can expect to be successful in your trading by reducing your number of transactions. True, just as the batter may know that he does better against certain teams and pitchers and in certain parks than others, so will you as a portfolio manager have some insights into the conditions that are most conducive to maximum profitability – across individual names, market cycles, and other factors. However, in both cases, the individual in question cannot expect to gain any benefit through a lack of participation.

"Therefore, the principal lesson you should derive from 90/10 may well be that the lower 90% of your transactions, which are likely to sum up to zero P/L, are a critical component of your success. If properly analyzed, these trades can provide insights into the controllable elements of your portfolio management activities that can be enormously valuable to your bottom line. However, if you fight against this tide, you are likely to fall into a large group of market participants who have very useful skill sets but who inevitably become their own worst enemies."

Our (Macro Ops Portfolio's) historical return distribution follows this 90/10 rule too. So this means that the majority of our annual profits will come from just a handful of trades throughout the year. Conversely, I know, that most of our trades/investments that we enter (on average 90% of them) will effectively just cancel one another out. We will have a lot of small losers and some small winners… and then we'll have 2-3 massive winners that generally make up over 90% of our bottom line.

This is a fundamental fact of successful trading and investing. Buffett, Soros, Druckenmiller, and Dalio all live by this same law of distribution. If you study their returns, the 90/10 rule is prevalent amongst all of the greats. One of the reasons why they're "great" is because they have learned to actively embrace this truth and build their strategies in a way that exploits this power law to its full effect.

The fight against the natural distribution of returns is one of the largest failure points among traders and investors… it's why 90% of traders fail to beat the market and only 10% succeed (ironic, right?).

Over-optimization, trying to improve one's win rate is a common trap and a loser's game. Like Grant said "*you need the 90 to get the 10.*"

So why are these periods of enduring the 90% of profit-chop so painful?

Because we just aren't wired right for markets.

Lizard Brains and Loser's Games

Dreyfus built a fund with an outstanding record, bringing the sensibilities of a superb bridge player – which he is – to the market. For many years, Dreyfus had had an emotional rapport with a particular psychiatrist, and finally he decided that the psychiatrist should have an office at the Dreyfus Fund, just to see whether the managers were functioning at peak efficiency.

A portfolio manager of my acquaintance was called in one day. All prepared, he loosened his tie, took off his jacket, and lay down on the couch, The psychiatrist sat in his psychiatrist's chair, and the portfolio manager waited for the probing question.

"Polaroid," said the psychiatrist.

"Polaroid," repeated the portfolio manager.

"It's awfully high here, don't you think?" suggested the psychiatrist.

The portfolio manager mulled over the possible unconscious implications of this.

"I have a lot of Polaroid, personally," said the psychiatrist. "It's come up awfully fast. Should I hold it?"

The portfolio manager sat up. "It's going to work out just fine."

The psychiatrist slid into a more relaxed position. "I worry about Polaroid," he confessed.

> *"Let's examine this," said the portfolio manager, "and see why you're so worried. I think I can be of some help…"*

The above is from the book, *The Money Game* written by George Goodman under the pseudonym Adam Smith. I like the story, not just because it makes me laugh but because it's a good example of the strange power markets often possess over investors mental state.

We are emotional and often irrational creatures. We need to accept this. Our lizard brain often hijacks the rational section of our brain (the prefrontal cortex).

The prefrontal cortex is where abstract cognition happens, this is the part of the brain where we're most like Spock from Star Trek — logical and analytical in thought. Our lizard brain — the section of our brain that came first in our evolution — is the powerful, emotional, impulsive, and often hysterical part of our brain that tends to gut-punch the prefrontal cortex and take over our decision making process.

The dichotomy of this structure leads to an interesting and often tenuous relationship between the two parts. You see… the lizard brain and Spock brain don't usually agree with one another. They are often at odds and it's a constant struggle between the two on who leads in our decision making process… and the winner of this struggle is often dependent on the activity in which the actor is engaged.

And it just so happens that trading tends to be one of these activities that send our lizard brains into full on abusive captor mode.

I have been mentoring a relative of mine who has wanted to improve his trading. Now this relative, we'll call him Joe, is a very smart and extremely successful businessman. Joe, in nearly every aspect of his life, epitomizes rationality and prudence. This has allowed him to thrive in business for over 30 years.

But, there is one area where Joe completely loses touch with reality and goes bat-shit bonkers… and that is when he's engaged in the markets.

Joe has lost a lot of money in the markets over the years. When he came to me asking for help at the end of last year I started teaching him about risk control and trade management — the foundation of successful trading.

He took these lessons and started doing really well. I got him on the dumpster diving trade (buying oversold commodity stocks) in February and he made 20% in a month. This quick success was the worst thing that could have happened. Joe is now up 90% since the start of the year (and this is on a sizable line).

You're probably thinking "Ummm… 90% sounds friggin great Alex what the hell are you talking about, worst thing?"

Here's the thing; once Joe got that easy 20%, his lizard brain went fully radioactive. The thrill of winning was too much. He ended up getting the other 70% by throwing the risk and trade management rules that I taught him out the window. He's now leveraged up to the eyeballs… thinks he's the love child of Soros and Livermore… and is now swinging for the fences at every single pitch that comes his way.

Now, every time I talk to Joe I spend the whole conversation trying to talk him off the gambler's ledge that he doesn't even think he's standing on. If he doesn't get control of his lizard brain soon… he will blow up. I have seen this movie too many times… hell, I've been the lead actor in this story before (I'll write someday about how I lost $127,369 in just a few short months while in my 20s.)

Arrogance. Greed. Fear. Hope. Dissatisfaction. These are all emotions born from our lizard brains that affect our decision making process. This is why we find it so hard to embrace the 90/10 rule of return distributions. We want to win <u>every</u> time. We take losses personally. Our hopes and fears and greed affects our analysis and deludes us into thinking we are special — this human foible is what Vegas is built on.

But you cannot beat 90/10. Over the long haul, probability always wins out and even somebody who's been very lucky will experience the flipside of that luck. This is why we need to completely accept 90/10 and utilize a robust strategy that maximizes the benefit we reap from this fundamental truth.

To again quote Adam Smith (Goodman),

> *"Irregular Rule: If you don't know who you are, this is an expensive place to find out." It can be a very expensive place indeed. So much of becoming a master trader is about knowing yourself; quirks, fears, delusions and all. That way you can better step outside yourself and know when manaicle lizard brain is driving the bus or steady Spock is at the wheel."*

The Obstacle Is The Way

> *Our actions may be impeded, but there can be no impeding our intentions or dispositions. Because we can accommodate and adapt. The mind adapts and converts to its own purposes the obstacle to our acting. The impediment to action advances action. What stands in the way becomes the way.*
>
> ~ Marcus Aurelius

I have long been a fan of Stoicism. Stoicism is one of the four original schools of philosophy from ancient Greece. The other three being; Plato's Academy, Epicurus' Garden, and Aristotle's Lyceum.

Stoicism can be boiled down to four main truths (via Stoicism Today):

> **Value** – the only thing that is truly good is an excellent mental state, identified with virtue and reason. This is the only thing that can guarantee our happiness. External things such as money, success, fame and the like can never bring us happiness. Although there is nothing wrong with these things and they do hold value and may well form part of a good life, often the pursuit of these things actually damages the only thing that can bring us happiness: an excellent, rational mental state.
>
> **Emotions** – our emotions are the project of our judgements, of thinking that something good or bad is happening or is about to happen. Many of our

negative emotions are based on mistaken judgements, but because they are due to our judgements it means they are within our control. Change the judgements and you change the emotions. Despite the popular image, the Stoic does not repress or deny his emotions; instead he simply doesn't have them in the first place. This isn't as cold as it might at first sound: we ought to overcome harmful, negative emotions that are based on mistaken judgments while embracing correct positive emotions, replacing anger with joy.

Nature – the Stoics suggest we ought to live in harmony with Nature. Part of what they mean by this is that we ought to acknowledge that we're but small parts of a larger, organic whole, shaped by larger processes that are ultimately out of our control. There is nothing to be gained from trying to resist these larger processes except anger, frustration, and disappointment. While there are many things in the world that we can change, there are many others we cannot and we need to understand this and accept it.

Control – in the light of what we have seen, there are some things we have control over (our judgements, our own mental state) and some things that we do not (external processes and objects). Much of our unhappiness is caused by confusing these two categories: thinking we have control over something that ultimately we do not. Happily the one thing we do have control over is the only thing that can guarantee a good, happy life.

A successful trader needs to embody these truths, if not in all aspects of life, then at least in his engagement with the markets.

We can't control external outcomes of markets. But we can control our internal processes and how we interact with these markets.

We can't resist the 90/10 rule and thrive in the markets. But we can accept this fact and build a strategy that fully exploits this distribution.

We can't pick the periods that we'll make these profits. The market will always do what the market wants to do and it never owes us anything. But we can remain disciplined during periods of drawdown so we don't lose more than we should.

Really, what makes a great trader great is that they are really good at losing. They lose often but never a lot. They win few but a lot when they do.

So let's not resist these periods of profit/loss purgatory. We need to embrace the suck (as they say in the Marine Corps). These are great opportunities to test our mettle and see how robust our strategy is. How emotionless and coldly calculating we can be.

Instead of fighting the markets and trying to pull profits that just aren't there. We should instead be asking ourselves these three questions during times of dissonance (via Peter Brandt).

1. <u>Has my trading plan/guidelines/rules been out of synch with the markets</u>?
    - If so, in what ways? Has the drawdown uncovered some basic flaws of the plan? [*Note: Basic flaws in trading plan are masked during profitable periods – they show their hand during drawdown periods*.]
    - What modifications could I make to address foundational flaws of the trading plan, **<u>not</u>** to optimize the plan against the recent time period, but to improve upon the plan. *[By the way, I am* ***not*** *a believer in the optimization of indicators.]*
2. <u>Has the basic behavior of the markets changed</u>?
    - If so, might the change in market behavior be permanent?
    - If permanent, what might be the reasons?
    - If permanent, what are the implications for the trading plan?
3. <u>Has my trading execution been out of synch with the plan</u>? (*Note: this applies more to discretionary traders than to systematic traders*.)
    - If so, in what ways has my execution been out of synch with my trading plan?
    - Have there been any particular patterns in the breach of the trading plan?
    - What changes are needed to bring execution back into line with the plan?

Like the Stoics, let's acknowledge our inherent tendency towards the irrational that arises from our lizard brain and consciously make an effort to analyze and act through our prefrontal cortex. Let's become Spock-like. Know that our profits and losses adhere to Pareto's law and build our trading strategy around this truth. By becoming really good at losing we'll become great at winning.

Turn the focus from immediate outcomes to creating and refining a disciplined process. Embrace the drawdowns… use them as training grounds and chances to evolve our craft. Like Albert Camus said, "The struggle itself is enough to fill a man's heart. One must imagine Sisyphus happy."

Now onto markets!

The foggy veil is beginning to lift…

Dissonance is slowly dissipating in the markets for the first time in a couple months.

The macro picture is still muddled to be sure, but I feel like we're hitting a turning point. And like sailors who've been drifting blindly through the fog I feel our ship is now piercing the edge of the cloud and the horizon is just over yonder…

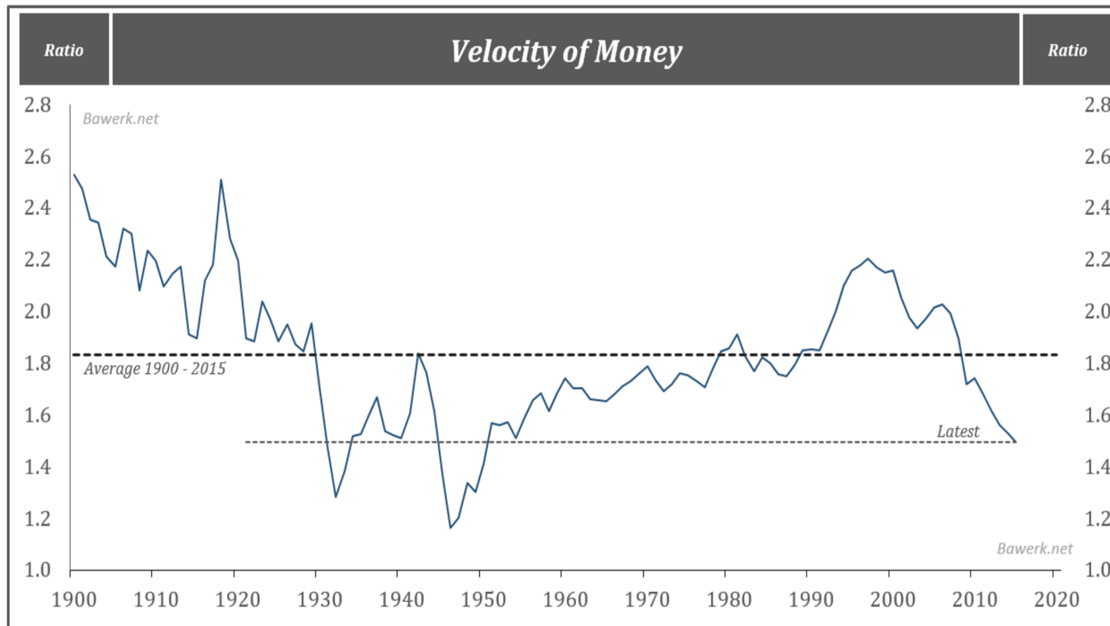
This is what I think we'll see.

I have increasing confidence that our original highest probability scenario is still in play. That is, that we are in a turning business cycle, the dollar will soon finish its correction and resume its bull run, and the market is in a cyclical bear market — having peaked last year.

The whipsawing we have seen in the equity indexes is typical of large cyclical turning points. I believe this volatile chop has been more pronounced in this cycle versus past cycles because of changing player profiles. Primarily, the increasing amount of money that is going to the short side. The hedge fund space has grown too large (we are at the beginnings of what will probably be a brutal washout now). This, along with more retail investors going short means that on a relative basis we have more and more players getting short the market.

This high short interest has acted like jet fuel on typical bear market rallies (which already tend to rip). Combine this with lower volume and extremely short-term momentum chasing HFTs and you have a recipe for a neck breaking schizophrenic seesaw market — expect more of this as the bear market progresses.

Here are some charts to note on the US.

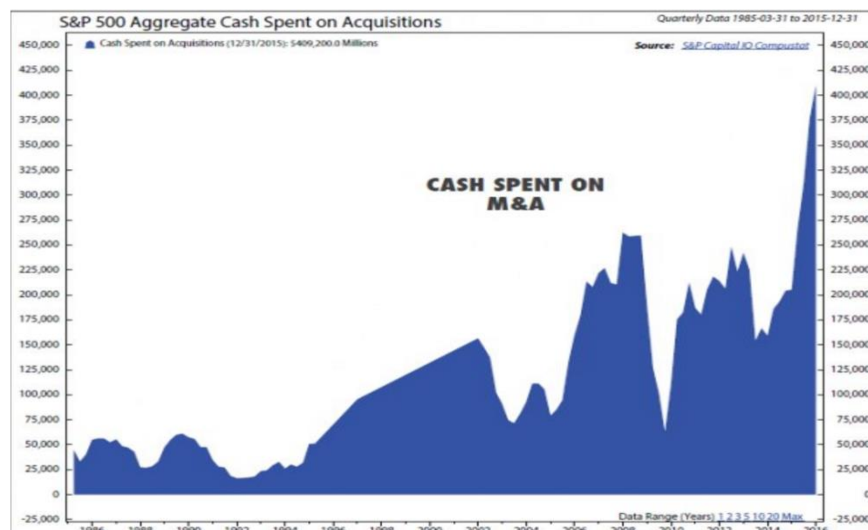


Source: National Bureau of Economic Research, Federal Reserve, Bawerk.net

The velocity of money has slowed to its lowest pace since the early 1930s. Velocity of money is a derived number, it's not a real thing. It's an attempt to measure the rate at which money is exchanged, from one transaction to another over a given period of time. Increasing velocity generally means that money is being spent and travelling quickly through the economy. Slowing velocity on the other hand means that money is being hoarded and not used to purchase goods and services.

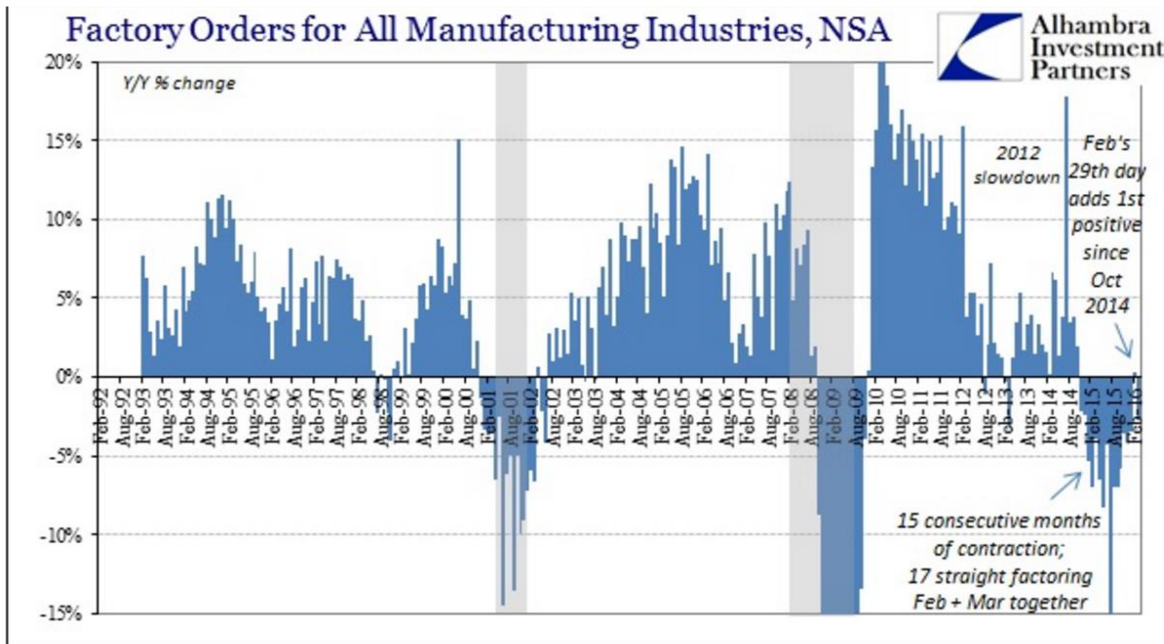
It is no surprise that we are nearing Great Depression lows in velocity. This is a natural byproduct of being in a secular deleveraging. I would expect that we go lower than 1932 as we are deleveraging from a higher debt level this go around.

The yield curve continues to flatten. Above you can see the spread between deuces and dimes. When the spread falls below 1% there is a high-probability of a recession (when we're at zirp). I expect that we'll likely fall into recession at the end of this year or beginning of next — recessions always follow bear markets, not the other way around.



Cash spent on M&A has reached record levels — another characteristic that is also typical of market tops. When future consumption has all been pull forward and

there are little to no compelling reasons to invest towards organic growth, companies go out and overpay for a rival. And everybody tends to fare worse for it down the road in decreased efficiency.



For the US, factory orders have now been in contraction for 15+ months. The last time things were this bad was 08'-09' and 00'-02.

And finally, speaking at the Sohn conference this past week Druckenmiller (one of, if not *the* greatest trader to play the game) said the following:

> *The myopic policy makers have no endgame. They stumble from one short-term fiscal or monetary stimulus to the next, despite overwhelming evidence that they only produce an ephemeral 'sugar high' and grow unproductive debt that impedes long-term growth…The chickens are now coming home to roost…. Sell equities and buy gold.*

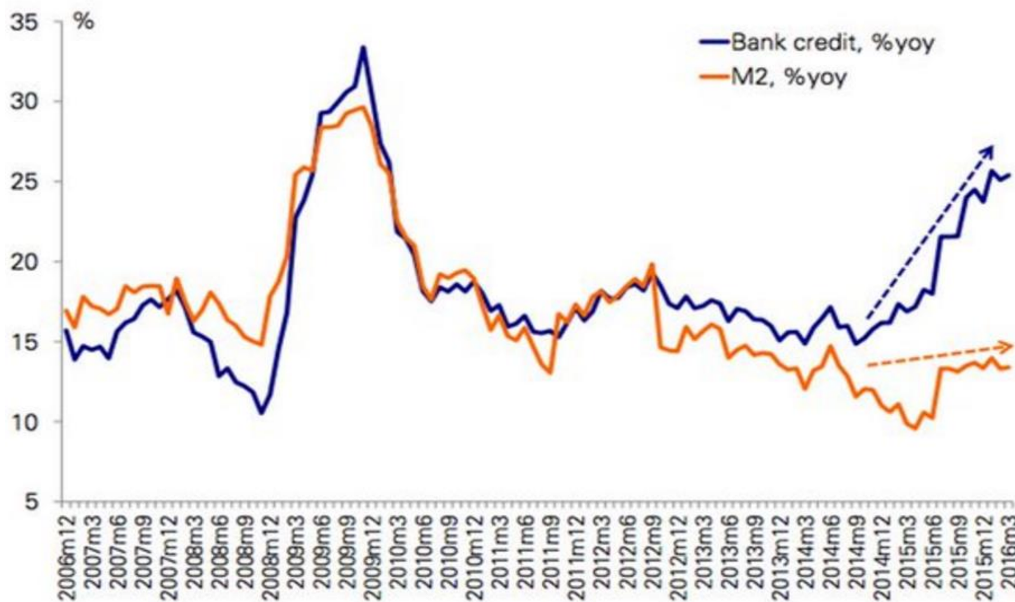
I agree with Druck and expect there to be some fantastic trades lining up soon. Maybe not this week or next, but soon. We will remain vigilant and keep you posted.

Real quick, just cause I have to… China.

China, still the biggest wild card in the macrosphere seems to be losing its mojo. As we talked about last week, China has been hitting the credit button like a nicotine craving lab-rat… but the effects are starting to wear thin. Here's this from Deutche:

Bank credit growth has picked up from 15% yoy in late 2014 to 25.4% by March 2016. M2 growth moved up since mid 2015 after policy easing happened, but only to 13.5% by March. The gap has widened from 7.8% in June 2015 to 12% in March 2016.

Figure 1: Bank credit and M2 growth



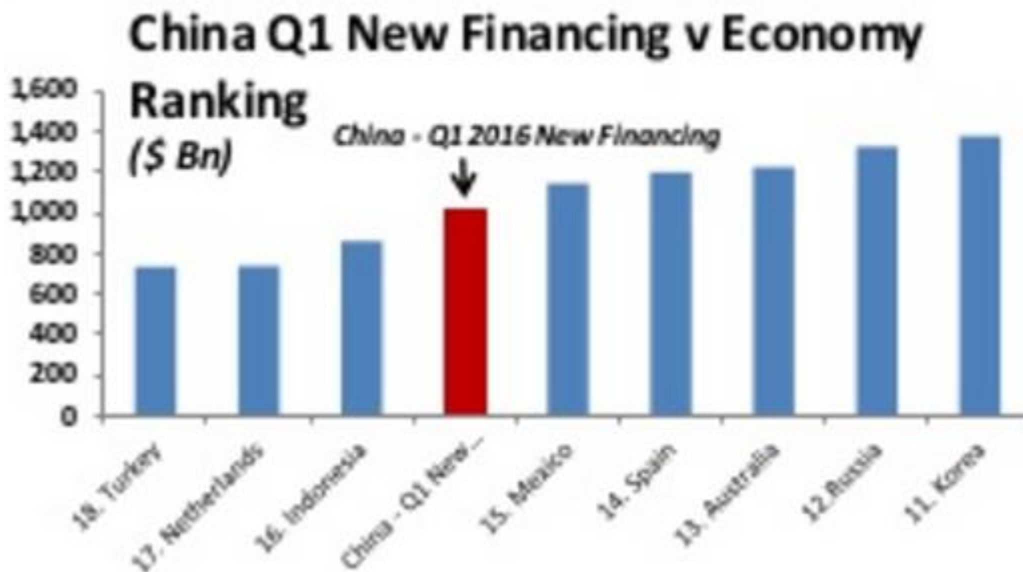
Source: Deutsche Bank, PBoC

Why is China's bank credit growing so much faster than M2? Well china has milked its real economy out of every bit of credit demand growth it had. Now there is simply little promising investments to be made. Not to be deterred, instead of putting the credit to work in the real economy they are speculating with it in the bloated financial economy – great idea right!?

The Palindrome, George Soros, came out this week and said China's financial system "eerily resembles what happened during the financial crisis in the US in 2007-08." You mean putting financial leverage on top of leverage on top of more LEVERAGE is a bad idea George? Well I'll be darned…

Here are just some mind-numbing charts to show you how bizarre the situation has gotten.

China has started the first quarter off with its highest rate of new financing… ever!



If the credit that China has created in just the last four months were an economy, it would be larger than Indonesia and Turkey and nearly the size of Mexico and Australia.

And like I said, with all real investment opportunities gone… this credit has gone to slot machine style speculation. Tier 1 property prices have increased over 40% in just the last year alone.

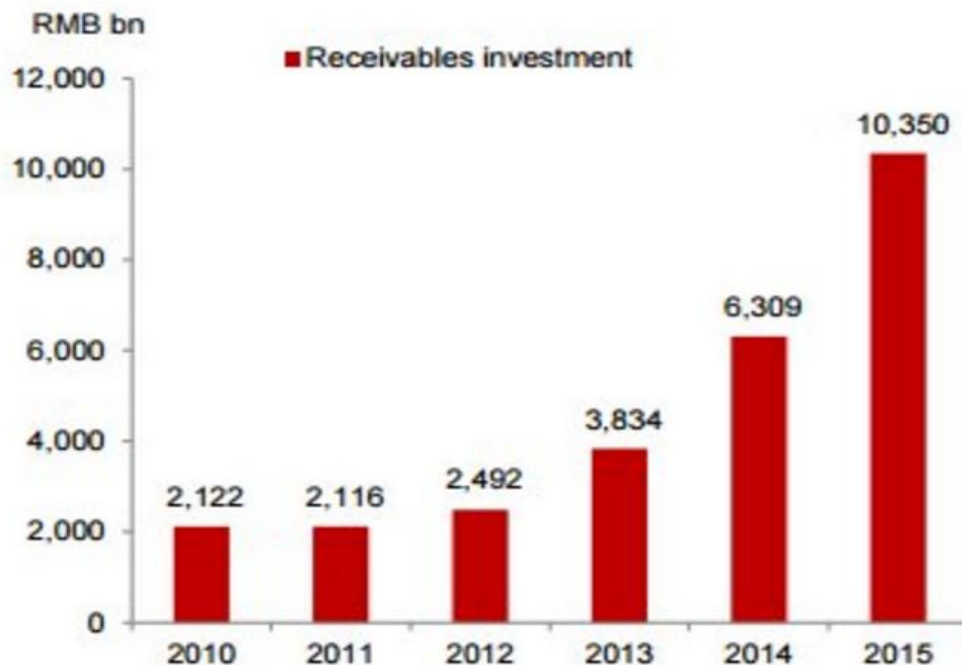
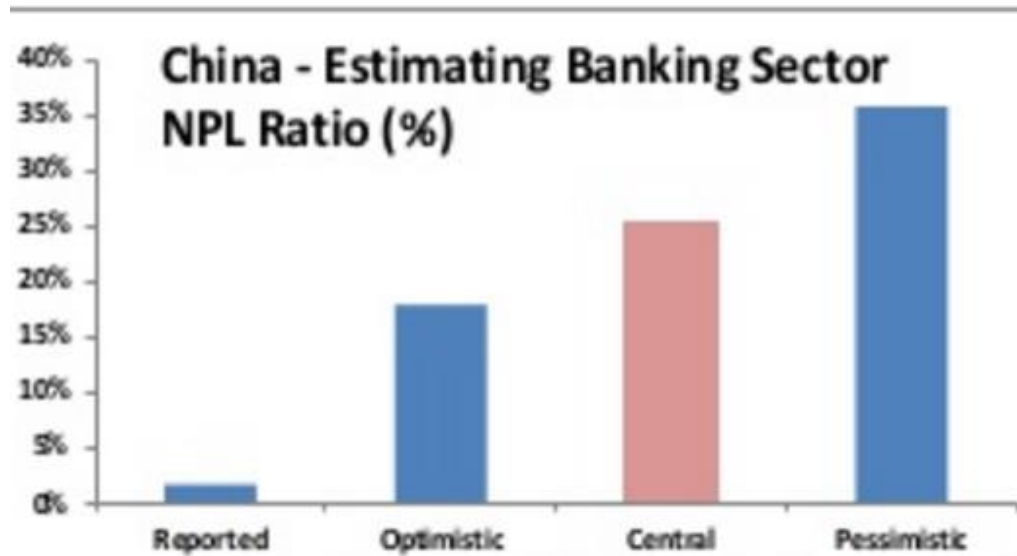


Fig. 1: "Receivables investment" of 26 listed banks

Note: The data is collected from balance sheets of 26 either A- or H-share listed banks. Source: WIND and Nomura Global Economics.

Meanwhile, receivables continue to skyrocket for A and H share listed Chinese banks.



Finally, this credit is being thrown after bad. The middle of the road case has China's NPLs (non-performing loans) at over 25% in its banking sector. We would lean to the more pessimistic scenario here and say current NPLs are likely in the 35-40% range. That is bonkers. Banking crises historically occur with much lower NPL ratios… this should be fun to watch.

Portfolio Update

It was Spring Cleaning in our Tactical Portfolio this week. We removed a number of our positions, taking profits as the market continued to gyrate back and forth. During times like these it pays to be conservative.

Macro Ops Hub
Target. Deploy. Profit.

Macro Ops Tactical Portfolio

NAV $999,053.97

Asset Class	Position	Size	Cost Basis	Risk Point	Open Risk	Target 1	Notional
Commodity	Bean Meal (ZM)	3	281.50	273.4	$2,430.00	296.5	$171,420
Commodity	Platinum (PL)	2	996.50	967.3	$5,840.00	1059	$200,500
Commodity	Gold (GC)	2	1295.80	1267.00	$5,760.00	1381	$259,380
Forex	GBTC	205	72.00	59.85	$2,490.75	124.00	$14,699

Metrics

Exposure Breakdown	
Equity	$0.00
Commodity	$14,030.00
Fixed Income	$0.00
Forex	$2,490.75

Commodity
Forex
84.9%

Total Open Risk
$16,520.75
1.65%

*Updated 5/8

The Income Portfolio continued to gain this week from our short calls position.

Macro Ops Income Portfolio

NAV $1,021,850.60

Asset Class	Position	Size	Cost Basis	Max Profit
Option	SPX June 16 1960 Put	-10	10.80	$10,800
Option	SPX June 16 2155 Call	-10	14.80	$14,800
Option	SPX June 16 1520 Put	10	1.00	Hedge

Scenario Analysis/Stress Tests

Worst Case	Worst Drawdown
SPX Down 10%	-$58,000
SPX Down 20%	-$252,861

The Strategic Portfolio is still in cash as we wait for more clarity in markets.

Macro Ops Strategic Portfolio

NAV $966,487.94

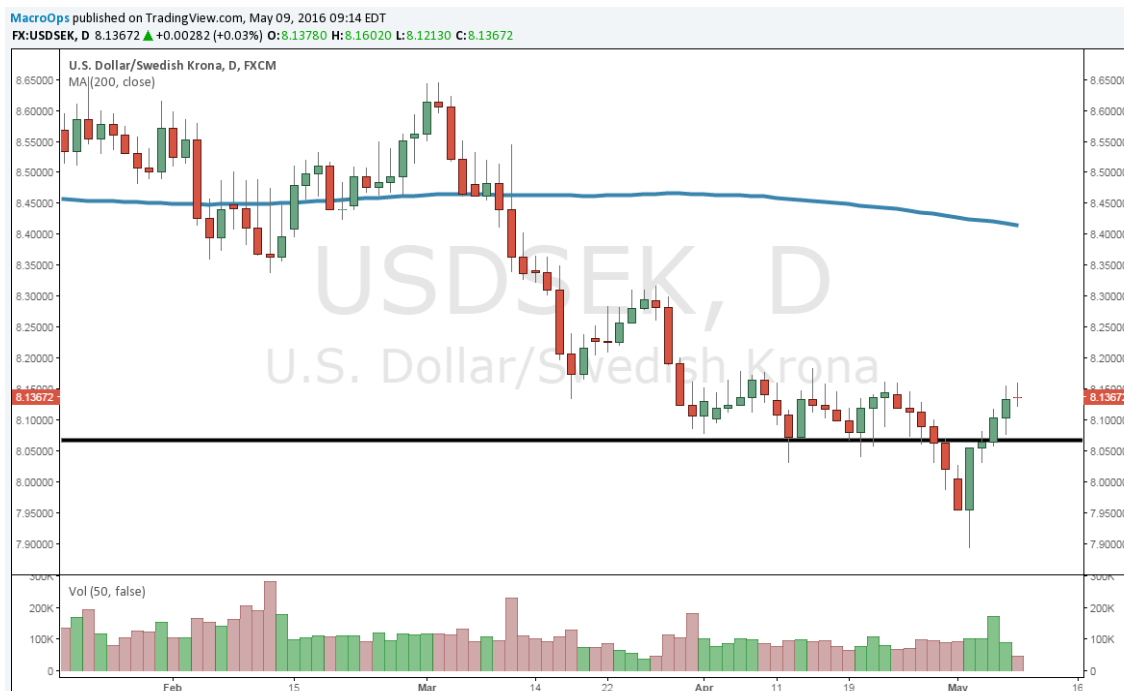
Asset Class	Position	Size	Cost Basis	Risk Point	Open Risk	Target 1	Beta (1yr)	Notional

Trade Update

It's fakeout galore in the markets right now! Not fun for traders. But as we discussed, we need to stick to our process and keep taking the trade setups that meet our criteria. You need the 90 to get the 10. It's the only way to work through periods like this.

All the trading below occurred in the tactical account.

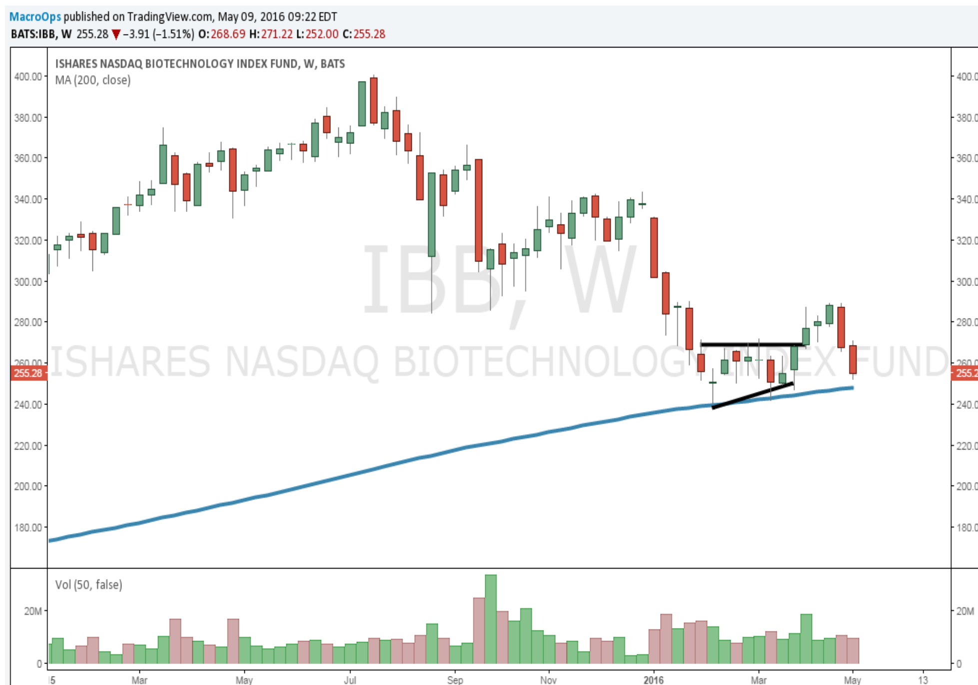
USDSEK & Euro



We took a position in a breakdown of USDSEK last week, but as you can see above, it rebounded hard and stopped us out. In retrospect, this was a good trade and we would have taken it again. Dollar weakness was holding fundamentally and this pattern had a very strong, end-of-week close below a support line over a year long. Unfortunately this was a false breakout, but this is exactly why we keep our risk control tight.

The strong completion in USDSEK encouraged us to take another short dollar position, this time going long Euro futures. This wasn't a weekly close, but was still strong enough to take. Unfortunately this breakout was also false and it stopped us out.

IBB



We didn't take a position in IBB, but this is just another example of the type of false breakouts we're seeing in markets.

<u>Soybean Meal</u>

We're still holding soybean meal which has had a massive run. We already took half profits which was a good play because now we're comfortable holding the second half of the position for the long term. If meal consolidates here, we'll wait for a breakout to the upside to add to our position.

Platinum and Gold

Platinum is currently holding as the dollar strengthens. We're willing to give it a little more room because we already took half profits.

We had to cut Gold today as it fell beneath its current support level.

GBTC

You can see above that BTCUSD has stalled at a horizontal resistance level, which is also why our trade in the Bitcoin ETF GBTC has also stalled. We will continue to hold it and wait for a resolution.

For portfolio details and trade logs you can see it all here in the hub.

Comm Center Highlights

President Trump?

As Trump continues to sweep up in these elections, it's coming time to discuss what a Trump presidency will mean for markets.

On one hand, if you believe what Trump says, you can expect a protectionist trade war. A wall between US and Mexico, greatly reduced trade with China… it's all a part of his plan. This would be detrimental to US multinationals. Global trade is a good thing, unless you're one of the workers whose job is being lost, which is exactly who Trump is catering to. This could be a large risk to markets.

On the other hand, guys like Jeff Gundlach believe the US will "get a Reagan response" with Trump. The US has room to turn up spending and take on more public debt. This is what Trump may do to reinvigorate the economy. Billions worth of spending on infrastructure and military could create a number of new jobs.

As Tyler explained, as long as inflation is low, the government should have no problem spending. In the short term there is only upside as officials think about their own careers. The only time they'll be forced to care about debt is when inflation gets out of control. Because once that happens, the Fed will be forced to hike, which will increase debt servicing payments to unsustainable levels. But until then, it's all good! Spend away!

As far as timing goes for this debt fueled run-up, it's uncertain. If Trump wins the presidency, he may be able to put these spending programs together quickly. If not, they may come together after the S&P already has a significant correction and the debt spending will ignite the new bull trend.

Edge

Tyler and Jamie had an interesting discussion regarding what type of edge in markets is best.

In conclusion, it's likely better to have a smaller edge that is more robust and will last through various environments. Why? Because compounding is extremely important. You want to keep making gains and letting them grow. You also don't want a strategy over-optimized to one environment (which is usually how you get the extra edge) that craps out when the environment changes. You do not want to lose all your past gains.

An example of a large edge, non-robust strategy would be buying equity breakouts in 99'. This would work for a short period of time and make a ton of cash, but it would not last into future markets. A strategy that has a smaller edge, but is more robust would be something like standard trend following or value investing.

To put it another way, you want a strategy with low expectancy that lasts a long time over a strategy with high expectancy that lasts a short period of time.

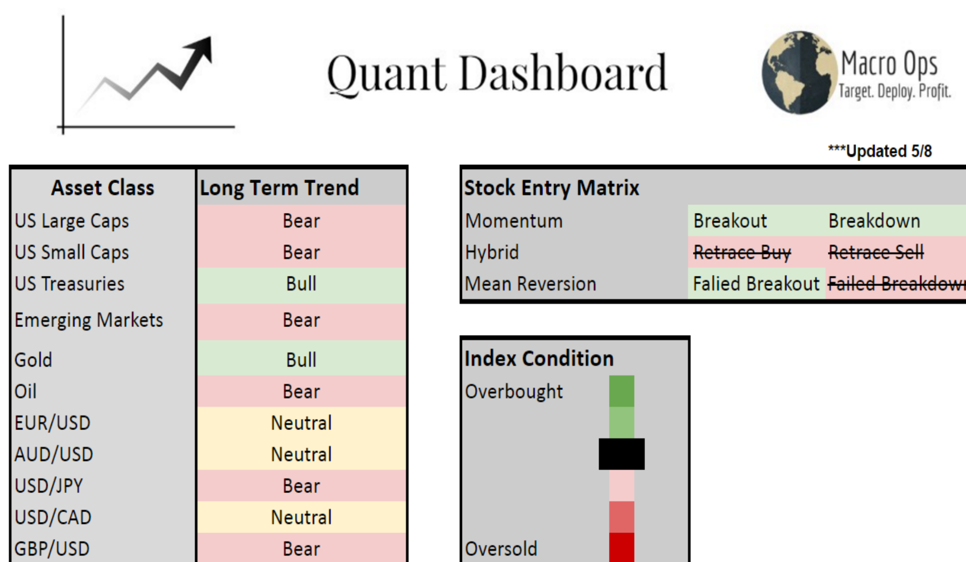
Expectancy = (Probability of Win x Average Win) – (Probability of Loss x Average Loss)

As always, markets are mostly a game of survival. Survive and you win. Robustness is more important than edge.

Hub Spotlight

You can check out the updated IMINT here. And the updated HIT List can be found here.

The quant dashboard had a few updates this week.



Asset Class	Long Term Trend
US Large Caps	Bear
US Small Caps	Bear
US Treasuries	Bull
Emerging Markets	Bear
Gold	Bull
Oil	Bear
EUR/USD	Neutral
AUD/USD	Neutral
USD/JPY	Bear
USD/CAD	Neutral
GBP/USD	Bear

Stock Entry Matrix		
Momentum	Breakout	Breakdown
Hybrid	~~Retrace Buy~~	~~Retrace Sell~~
Mean Reversion	Falied Breakout	~~Failed Breakdown~~

Index Condition
Overbought
Oversold

US large caps had a trend change from neutral to bear. When markets are caught in a range and things get choppy, the trend calculation tends to flip a lot. A change is not an immediate sell or buy signal in this environment. Until the markets start trending again the trend designations should be taken to build context, not create entries or exits.

Also the index condition has moved down to a neutral reading as the S&P has come off the high of the range and has begun consolidating sideways. This makes it easier to play both sides of the market now that we no longer have relentless one-way momentum.

You will also notice that "Breakdown" has opened in the stock entry matrix. With the general indices moving sideways to down, breakdown plays become viable once again.

-See you in the hub!

Alex