# 06/11/2021: Be Like Don… [A Case Study of Conditional Edge Stacking]

Today we're going to walk through an example of the conditional edge stacking we talked about in yesterday's piece (link here). We'll start with the macro, go through the quantitative, then end with the micro and how we bought a piece of a Mexican *compounding machine* trading at *inconceivalbe* prices...

But, first… let's turn to one of the sharpest conditional edge stackers I've ever read about—a man who goes by the name Don Johnson (that's him on the right).

There's an old *Atlantic* profile of him that begins:

> *Don Johnson won nearly $6 million playing blackjack in one night, single-handedly decimating the monthly revenue of Atlantic City's Tropicana casino. Not long before that, he'd taken the Borgata for $5 million and Caesars for $4 million…*

When you hear about someone making millions at blackjack, you automatically think "card counting" — the spotter, the big player, doing a smash and grab on the casinos, that kind of thing.

But what is so fascinating about Don Johnson's multi-million dollar scores is, he didn't count cards.

The edge he found was actually much more subtle and brilliant than that. He won the game before he ever sat down at the tables... Here is the money excerpt (emphasis by me):

> *Johnson is very good at gambling, mainly because <u>he's less willing to gamble than most</u>. He does not just walk into a casino and start playing, which is what roughly 99 percent of customers do. This is, in his words, tantamount to "blindly throwing away money." The rules of the game are set to give the house a significant advantage. That doesn't mean you can't win playing by the standard house rules; people do win on occasion. But <u>the vast majority of players lose, and the longer they play, the more they lose.</u>*
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> *<u>Sophisticated gamblers won't play by the standard rules. They negotiate.</u> Because the casino values high rollers more than the average customer, it is willing to lessen its edge for them. It does this primarily by offering discounts, or "loss rebates." When a casino offers a discount of, say, 10 percent, that means if the player loses $100,000 at the blackjack table, he has to pay*

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> *only $90,000. Beyond the usual high-roller perks, the casino might also sweeten the deal by staking the player a significant amount up front, offering thousands of dollars in free chips, just to get the ball rolling. But even in that scenario, Johnson won't play. By his reckoning, a few thousand in free chips plus a standard 10 percent discount just means that the casino is going to end up with slightly less of the player's money after a few hours of play. The player still loses.*
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> *But two years ago, Johnson says, <u>the casinos started getting desperate</u>. With their table-game revenues tanking and the number of whales diminishing, casino marketers began to compete more aggressively for the big spenders. After all, one high roller who has a bad night can determine whether a casino's table games finish a month in the red or in the black. Inside the casinos, this heightened the natural tension between the marketers, who are always pushing to sweeten the discounts, and the gaming managers, who want to maximize the house's statistical edge. But month after month of declining revenues strengthened the marketers' position. By late 2010, the discounts at some of the strapped Atlantic City casinos began creeping upward, as high as 20 percent.*
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> *"The casinos started accepting more risk, looking for a possible larger return," says Posner, the gaming-industry expert. "They tended to start swinging for the fences."*
>
> *Johnson noticed...*
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> *<u>When casinos started getting desperate, Johnson was perfectly poised to take advantage of them</u>. He had the money to wager big, he had the skill to win, and he did not have enough of a reputation for the casinos to be wary of him. He was also, as the Trop's Tony Rodio puts it, "a cheap date." He wasn't interested in the high-end perks; he was interested in maximizing his odds of winning.* ***<u>For Johnson, the game began before he ever set foot in the casino.</u>***

Did you catch that? Here's the breakdown:

- The odds on most casino games are unbeatable, as most everyone knows. (How else could they pay that $500,000 electric bill every month.)
- "Whales," i.e., players willing to drop huge sums, are a casino's most profitable patrons by far — and the casino will bend over backward to keep these whales happy. But only if they reliably lose.
- When times get tough and revenues drop, casinos offer special deals to high rollers to try and pull them in. In doing this, they're saying, "We will shave down our statistical edge against you, if you agree to come and play."

It's estimated that the house has a 2% advantage over the typical blackjack player.

That 2% edge is like a biased coinflip — big enough for the house to win all the money over time.

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With a 100% correct theoretical gameplay strategy — not counting cards, just playing every hand in mathematically optimal fashion — it's estimated that the house edge is whittled down to 0.5%.

Now you are getting very close to 50/50 odds… but that 0.5% is still enough for the house to make good.

Johnson figured out how to drive the house edge even lower. He got it down to (by his estimate) just one-quarter of one percent through complex negotiations.

That's super close to dead even — but still not quite enough. And then came the coup de grâce. With some negotiated loss discounts on top of that — agreements for the casino to reimburse a certain amount if Johnson lost — he actually flipped the overall edge in his favor without the casino realizing it.

House management got played by a math shark:

> *So how did all these casinos end up giving Johnson what he himself describes as a "huge edge"? "I just think somebody missed the math when they did the numbers on it," he told an interviewer.*
>
> *Johnson did not miss the math. For example, at the Trop, he was willing to play with a 20 percent discount after his losses hit $500,000, but only if the casino structured the rules of the game to shave away some of the house advantage. Johnson could calculate exactly how much of an advantage he would gain with each small adjustment in the rules of play. He won't say what all the adjustments were in the final e-mailed agreement with the Trop… But when Johnson and the Trop finally agreed, he had whittled the house edge down to one-fourth of 1 percent, by his figuring. In effect, he was playing a 50-50 game against the house, and with the discount, he was risking only 80 cents of every dollar he played."*

From a trading perspective, what Don Johnson did is absolutely fantastic:

- He waited patiently for a huge edge to develop (refusing to play on anything but his own terms).
- He used observation, psychology, and math to exploit one of the most significant strategic blunders in casino history (giving big loss rebates to an unknown high roller that wiped out the minimized house edge).
- He protected his capital and ensured the risk would be minimal, even if he lost.
- When he saw that he was ahead, he chose to pyramid — press his bets — and absolutely crushed the tables to the point where they simply wouldn't let him play anymore.

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Johnson is a conditional edge stacking master… The guy printed millions playing a game designed to be unbeatable over the long pull — unless you're the house, of course. And he did so by only playing when the conditions were stacked in his favor. He leveraged his patience and skill to essentially become the house.

This is precisely what Soros' early partner Jim Rogers was talking about when he said:

> *The way of the successful investor is normally to do nothing — not until you see money lying there, somewhere over in the corner, and all that is left for you to do is go over and pick it up.*

But for discretionary traders and investors, the math is never so clear cut... The edge is not as quantifiably certain… So to remedy this, we need to put as *many* conditional edges in our favor as possible.

Doing so is at the crux of what made the Chandler Brothers — The Greatest Investors You've Never Heard Of. Like Johnson, they only played when the conditions were ripe to do so, as Richards points out:

> *The market gives you the opportunity to arbitrage what the emotional investor will pay or sell at versus the fundamental value of a company, but you've got to pull the trigger promptly without hesitating… We've disciplined ourselves mentally and prepared ourselves in terms of information, as well as relationships with brokers, to do that.*

This brings us to our number of investments in Mexico, which we began buying last year.
Why Mexico and why these particular investments? The answer is we were given conditional edges that were firmly stacked in our favor. And given these odds, it'd been irresponsible not to buy.

Let's run through what we call a *Macro Spiral*, where we'll start at 30,000ft and drill down to the ass of a gnat level to give a quick overview of how this is done. I'll just hit the key points to keep this from getting too long.

- First, capital concentration and relative valuations were well above historical averages and due for a cyclical, if not secular reversal. All that was needed was a catalyst, which came via COVID and the subsequent US policy response. This meant a changing US dollar regime, which I outlined last year in *Soros' Currency Framework*.

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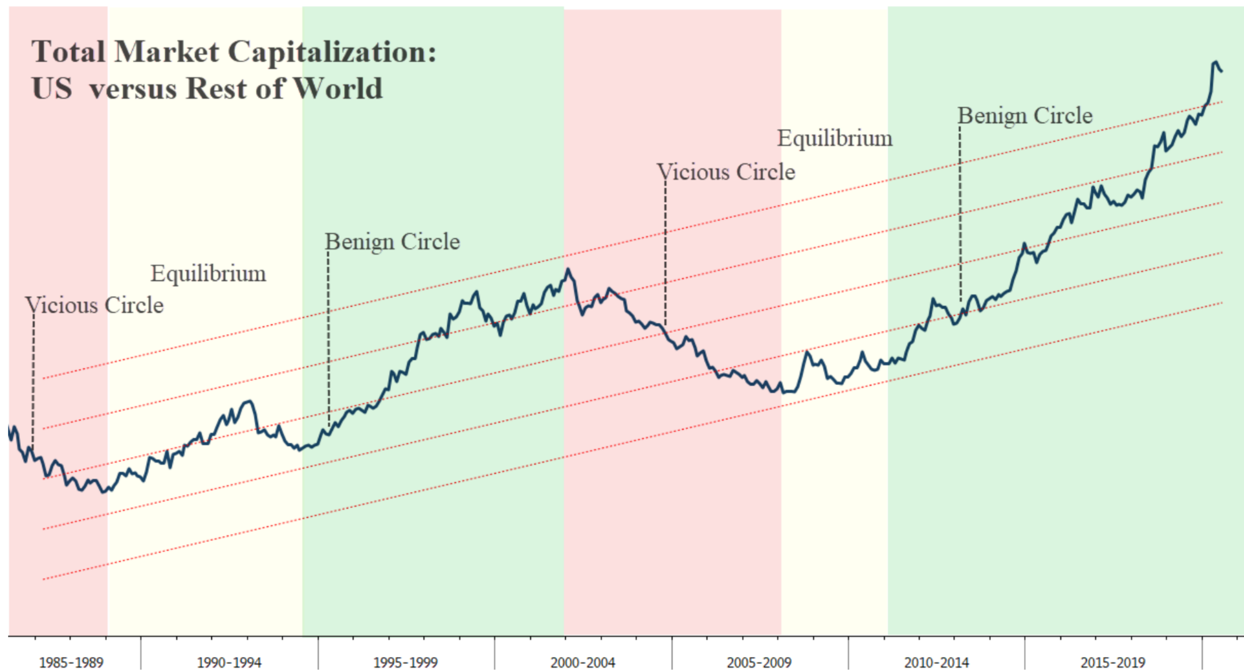
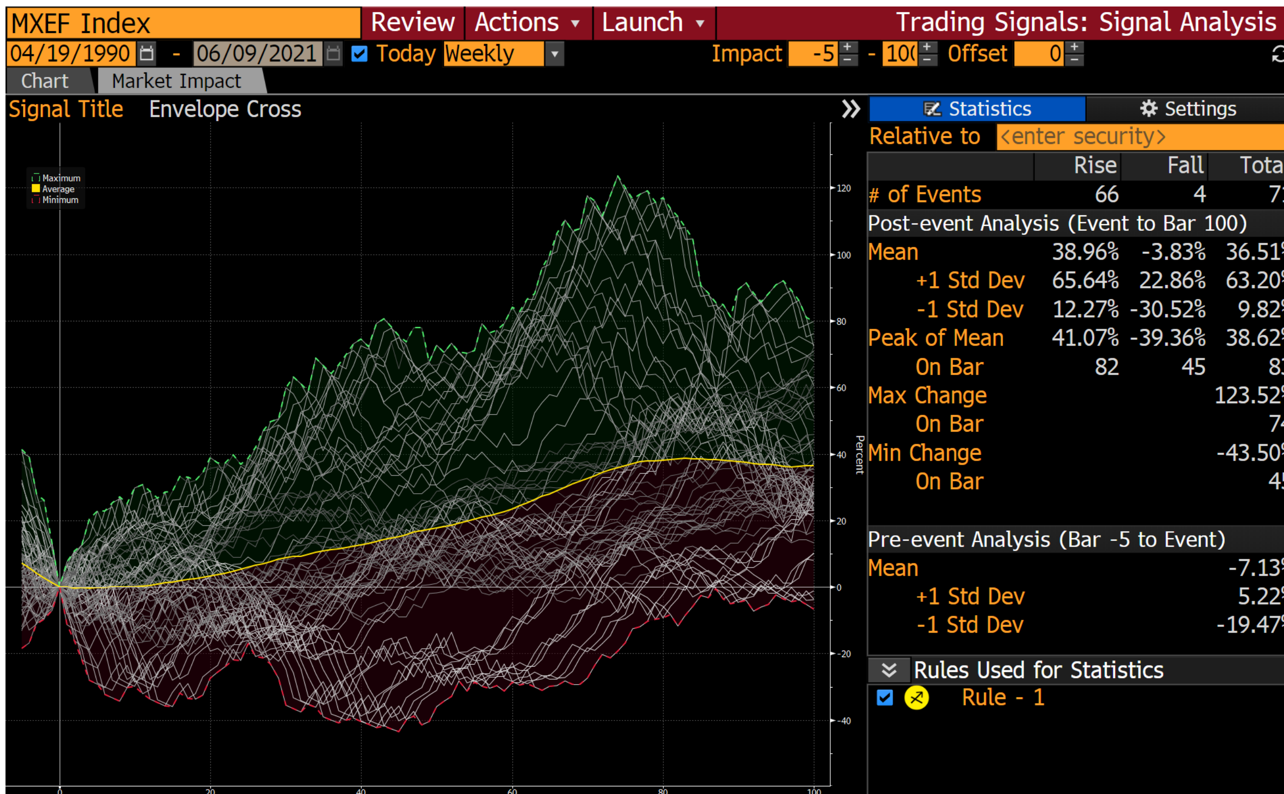



- A US dollar bear trend meant that EMs warranted a look since the two have a high inverse correlation. This was bolstered by the fact that emerging markets [historically outperform in the 2-years] following a global financial crisis (chart shows the 2-year returns of MSCI EM following a two standard-deviation move below its 200-week moving average. Returns are incredibly favorable).

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- Issue: most EMs have piss poor demographics. Every EM save two, Mexico and South Africa, will see their populations decline over the next 80 years. Demographics are a slow burn kind of thing, but they impact growth at the margins. Given the opportunity, you want them working *for* you, not *against* you.

- South African politics are *complicated* while Mexico's are less so. The latter has geopolitical tailwinds from our deglobalizing into competing spheres of influence. The US-Mexico border already makes for the world's busiest manufacturing, energy, and financial transfer border in the world. A growing number of multinationals are moving their operations there from Asia. We outlined all this in our report *Slowablization and Near-Sourcing.*

- An 8-year bear market compounded by Trump's political threats had driven investor sentiment and positioning in the country to multi-decade lows. Mexico versus EM average price-to-sales, price-to-book, and forward PE spreads were more than 2stdev below their long-term averages. The country was (and still is) ripe for some massive mean reversion.

- We ran several screens rating stocks by relative momentum, historical growth, balance sheet quality, and shareholder friendliness (i.e., leave out serial diluters). This gave us a list from which to further drill down and do the fundamental work.

- We've added a number of Mexico-based names to our book using this process, FRAGUA being just one example.

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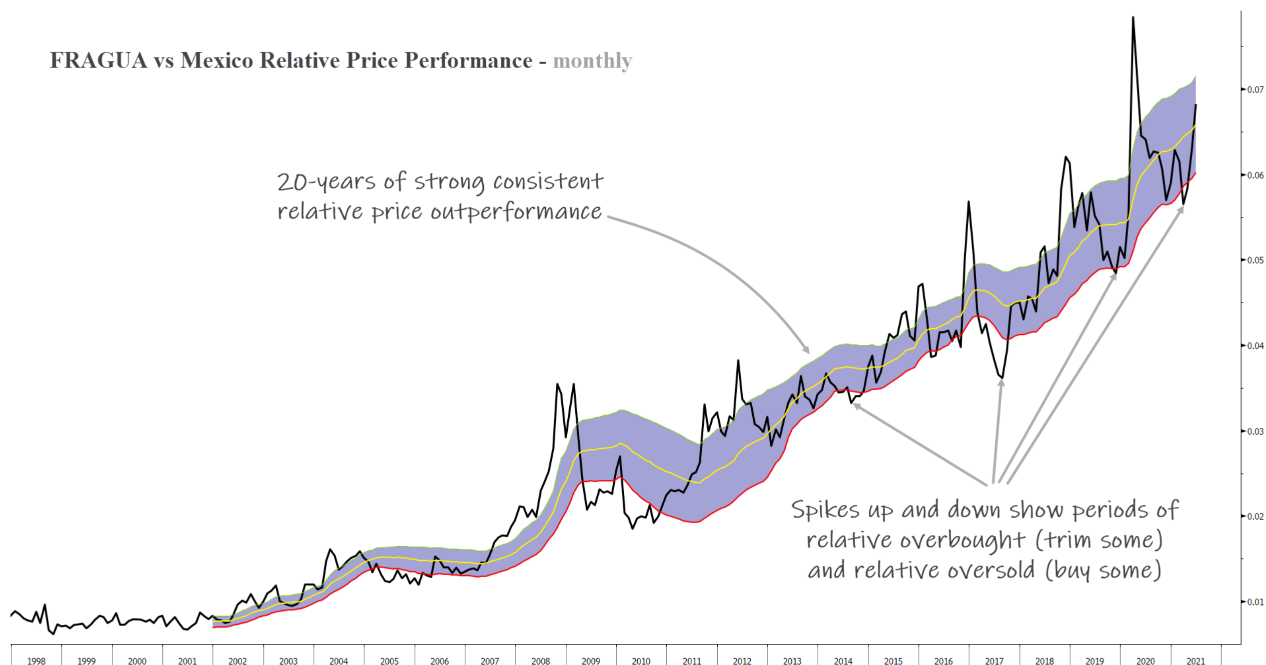
- FRAGUA showed 20-years of strong outperformance against the Mexican market with zero signs of stopping. We were also able to buy near a relative short-term oversold level that had acted as a positive turning point for relative performance over the last two decades.




- And finally, through Brandon's digging into the nitty-gritty of its financials, we discovered a company that's:
    - Dominant in its market (has twice the locations as its next closest competitor)
    - Been compounding revenues at 12% and EPS 18% annually over the last 10 years+
    - CAPEX growth spend hides its true profit potential, and once FRAGUA switches from growth to maintenance mode, it'll generate more income in a single year than it has in its entire history
    - Family-owned and operated, and they've accomplished this growth without taking any outside capital or issuing a single additional share.
    - And yet, despite all of the above, the company **traded at just 0.3x NTM sales and 12x NTM earnings** (efficient market, my arse…)

Here's the original report.

In this FRAGUA investment, we stacked macro tailwinds (reversal of long-time core to periphery flows, a bull to bear USD regime, and a secularly changing geopolitical landscape). With quantitative tailwinds (tendency towards positive EM outperformance following a global shock, Mexico vs. EM relative valuation metrics, strong relative single stock vs. home market outperformance, etc.). And finally, the extremely asymmetric micro (history of compounding, a proven defensible moat, disguised earning power, illiquid and under the radar name, etc…)

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Doing this isn't incredibly hard. It just takes a process where you know what to look for and when to look for it.

We're not that smart (I was recycled through kindergarten twice because I kept eating the crayons…). The great thing is you *don't* have to be a genius to win at this game. You just need a tested process that works. The right tools to implement it. And the mental maturity to diligently execute on it.

Stacking numerous conditional edges in your favor allows you to get some things wrong and still win.

It's this that distinguishes between the degenerate gambler or WSB HODL'ers from the cold, calculating player — the Don Johnsons — who remain unfazed by the natural P&L swings. Because in the big picture, they know they're playing a game of probabilities. And by stacking conditional edges and ruthlessly executing on their process, they'll come out ahead over time because the odds dictate so.

Thanks for reading!

Your Macro Operator,

Alex

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