The Zen Strategist

Issue 2, March 2017

Investing While Sitting Still

One of my favorite Zen koans asks simply:

When you can do nothing, what can you do?

Perhaps the main paradox of Zen is that the more one pursues enlightenment, the further away it gets, like chasing a phantom in a dream. After all, if one seeks to extinguish desire…is that not still a desire?

Or as the great Zen philosopher[1] Alan Watts so eloquently expounded:

Although Westerners speak of "conquering space," they have a radical prejudice and a positive blind spot with respect to the importance of nothingness. They balk at it as people used to balk at thinking of the world as round. To them, nothingness is the awful-awful, the end, the demise which, we most fervently hope, is not to be the ultimate destiny of man and the universe. Yet this is due to a freaky lapse in our logic which affects our theology, our science, our philosophy, and our most vivid emotions. No one seems to have realized that you can't have something without nothing. How can you know "is" without understanding "isn't"? Try to imagine a solid without any space through and around it. Try to imagine space without any solid, including yourself, within it.

How, you may be thinking, can this *possibly* relate to investing?

Put simply, one cannot be a successful investor without first understanding what *not* to do. Inaction, as it were, creates the opportunity for *positive* action.

Meet the New Boss…

So what should investors be "not doing" today? Ah, now we're getting somewhere!

In my opinion, perhaps the most pernicious investment vehicles out there today—by which I mean they seem designed almost solely to separate investors from their money—are the rapidly-growing crop of "niche" ETFs. While not frauds in the vein of Madoff and Enron (more on which below), at best such offerings charge fees for exposure investors could easily acquire themselves, and at worst seem nothing more than poorly-conceived marketing schemes. In fact, some of the latest offerings—the recently-launched "Whiskey and Spirits" ETF, with the cheeky ticker WSKY, jumps to mind—seem to openly mock buyers with their ridiculousness.

But by far the worst are the increasingly-fashionable leveraged ETFs—offering leveraged exposure to the overall market, high-beta sectors such as biotechs and gold stocks, and even the volatility…of volatility.

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[1] Although Watts would dispute this characterization. As he put it in the intro to *The Way of* Zen: "I cannot represent myself as a Zenist, or even a Buddhist, for this seems to me like trying to wrap up and label the sky."

Let’s dive in.

First, it is worth mentioning that *of course* such offerings have no place in a Zen Strategist portfolio, and some may wonder why even bother to discuss them here. Well, two reasons. First, my guess is most people don’t realize just how dangerous these vehicles are, and second, their problematic nature actually opens the door to what can, in the right situations, be extraordinarily attractive opportunities.

In other words, once we know what *not* to do…

But first, the problems.

Leveraged ETFs are relatively simple to understand, offering 2X or 3X the *daily* return of a specified index. The “daily” part is important, as one of the more common mistakes investors make is to believe these vehicles will provide double or triple the index return over *any* time period. Emphatically not true.

In fact, leveraged ETFs, given enough time, all go in one direction—down. This is due to the nature of volatility. Consider the following example.

Janet Yellen gives a hawkish speech, thus worrying investors about interest rate hikes and causing gold stocks to crater, falling 10% in a day (for illustrative purposes, assume the GDX gold stock index falls from 100 to 90). The next day, Yellen “walks back” her comments, causing markets to reverse their moves, with the GDX rallying 10% (from 90 to 99). So the gold stock investor is down, but not by much, while someone short gold stocks is up the same 1%.

Now consider the popular—and wonderfully named—leveraged gold stock ETFs from a firm called Direxion, which offer 3X daily exposure to GDX. The long ETF (NUGT) went down a whopping 30% the first day (from 100 to 70), then rallied 30% the next day to…91. As you can see, despite the index having barely budged, the leverage factor has been ruinous to the long gold investor.

But wait, it gets worse. The owner of the short ETF (DUST, perhaps my favorite ETF name) was dancing in the streets after day 1, with his fund soaring from 100 to 130. But after day 2, the fund not only retraced that gain, but fell all the way to…91!

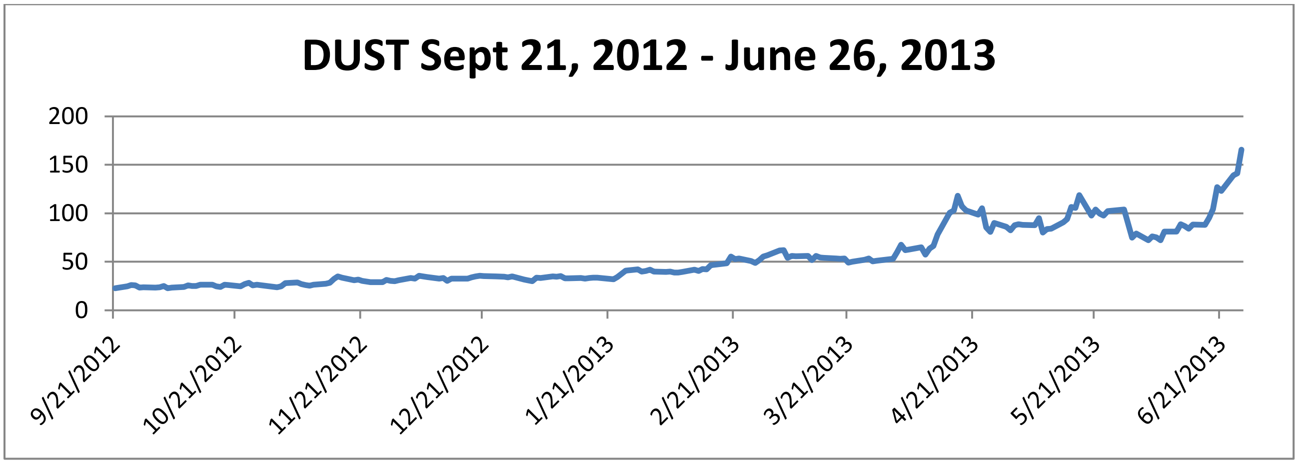
(This is reminiscent of the old Wall Street saying about bulls making money, and bears making money, but pigs getting slaughtered.)

Basically this is a math issue. Indeed, leveraged ETFs turn one of the most useful ideas in finance—that the easiest way to boost long-term returns is to lessen volatility—on its head.

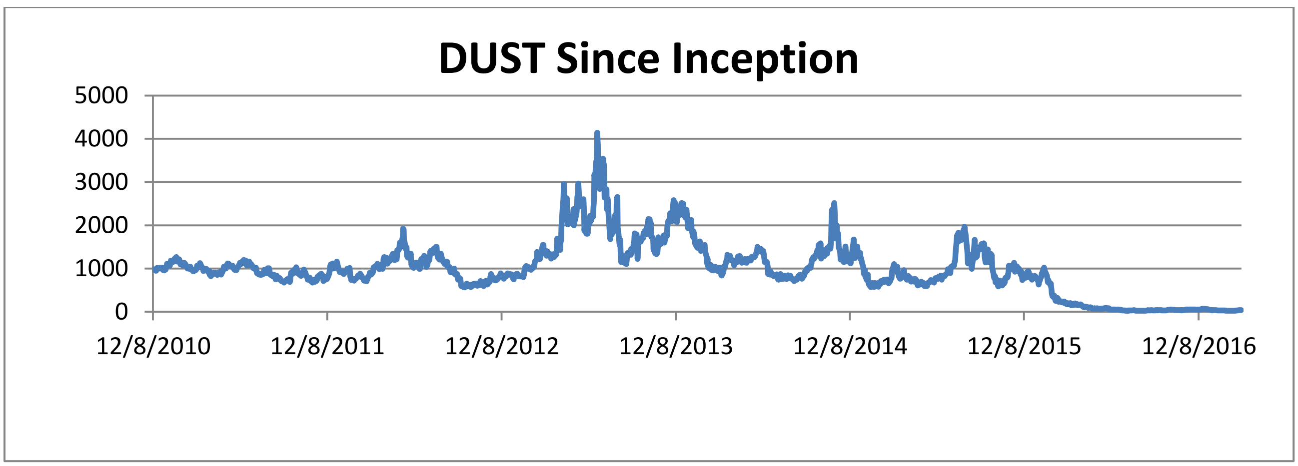
So why does *anyone* own these things? Well, for the chance to make a quick buck, of course! And it is true that during periods of trending markets the leverage factor works in your favor. In the prior example, if gold stocks fell an additional 10% on day 2, the DUST investor would be up an astounding 69%, compared to about a 19% gain for someone short the index.

Let’s take a look at those potential gains. (And yes, obviously I am cherry-picking the data to make a point—it is extremely unlikely anyone, anywhere, actually achieved these returns…)

From Sept. 21, 2012 to June 26, 2013, as gold stocks cratered *by nearly 60%*, DUST soared from about $20 a share to over $160, for an astonishing 633% gain…in nine months! (As one of my ex-colleagues used to quip when he made a short-term gain: Do you realize what that is annualized??)



Clearly, then, this is the appeal of leveraged ETFs. However, about that cherry-picking……

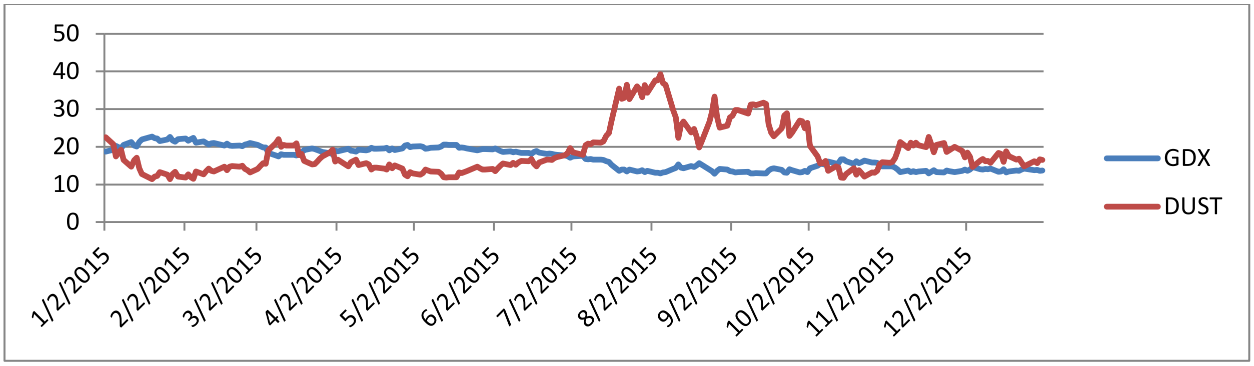


Indeed, pretty much all leveraged ETF charts look like this, at least on the right. To borrow from Tolstoy, all standard ETFs are alike; each leveraged ETF goes to zero in its own way.

The reason for the different values, by the way, is that the stock has since reverse-split twice, so one share today is the equivalent of 25 shares back in the halcyon 2012-13 period. Or said another way, had you bought 25 shares at the $160 peak (about $4000), you would today have one share worth…$40.

One more example, which makes the point that, my cherry-picking notwithstanding, these investments can be losers *even if you knew the market direction ahead of time.*

Consider 2015, when the GDX fell 27% for the year. Must have been a great year for DUST, right? Umm…not so much.



OK, hopefully by now we all agree these are vehicles to be avoided. But can we somehow turn this to our advantage?

The obvious question is…why not just sell these short? This is indeed a valid strategy—and can, done correctly, fit the Zen Strategist framework—but you need to pick your spots. Take a look at the first DUST chart to remind yourself of the dangers therein.

Another alternative, again in the right situation, is to either buy long-term puts or sell long-term calls. Generally call-selling is the more attractive (ahem) option, due to the high premiums on both. In other words, the high volatility on the ETF drives up option prices, which hurts in the case of *buying* puts, but helps if you are *selling* calls. This would be a wash, except…in contrast to typical option trades when more time is more valuable in both directions, with leveraged ETFs *this is only true for puts*. Remember the 2015 DUST chart, as well as the "since inception" chart.

My preference for these trades is always to choose the longest maturity and highest call price to minimize risk. For example, right now the January 2018 $90 call (the right to buy the stock at $90, expiring Jan. 19 of next year) is selling for about $8. With the stock at $40, this means you need it to rise less than $50 (or 125%) for the option to expire worthless. And of course it could rise by $57 and you would still make money…but not much.

Further, you need to have enough capital—and fortitude!—to withstand any *short-term* spikes. Margin rules are somewhat complicated, but the amount of required capital increases, sometimes dramatically, as the stock approaches the strike price. Currently it will "cost" you about $400 in capital[2] for each call sold (for proceeds of $800), so the potential profit from this trade is roughly 100%. Not bad for a nine-month investment!

However, from a Zen Strategist perspective, the time is not yet right…but seems close. Gold stocks have been falling lately—due mainly to worry about rising interest rates—which has pushed DUST from $25 to $40 in less than a month. For context, it topped out in mid-December at $68 a share. GDX, meanwhile, is at about $21, below its December level of $25 and September peak of $28, but well above

[2] Margin rules vary by firm, and you should always check with your broker before placing a trade.

its early 2016 trough of under $13. And with the potential that a Fed hiking cycle (and/or strengthening economy) could torpedo the price of gold and gold stocks, there is a bit too much risk here for my taste.

This, it is worth noting, is not unusual for the Zen Strategist method, which I sometimes liken to the poker game Texas hold ’em. For those not familiar with it (although I think *all* investors should play poker…) hold ’em is a game where each player gets two cards, then makes the best possible hand using those along with the five “community” cards on the table, which are dealt 3 (flop) 1 (turn) 1 (river).

The hardest part about hold ’em is the patience required. While televised poker makes it seem as if every hand has multiple players involved and an exciting showdown at the end, in reality the game is a long slog of waiting for good cards, then playing them to the hilt[3]. Or in baseball terms, letting a lot of “good” pitches go by…waiting for the *fat* pitch.

Stay tuned!

The Shocking Denouement

Continuing in the vein of what not to do, let’s look at an example from a “sophisticated” investor.

December 9, 2008. (The reason I remember the date will soon become obvious.)

Two colleagues and I are pitching a prospective client with a net worth in the high eight-figure range (i.e. tens of millions of dollars). Somewhat surprisingly, more than half this amount is not only invested with one manager, but a manager of whom none of us have ever heard.

(A bit of background, and the reason I said “somewhat”. One of the things that never ceased to amaze me at my old job was the utter crap filling prospective client portfolios. From “structured products”—generally vehicles designed mainly to create fees for the issuing investment bank—to “in-house” funds—ibid—to funds with high loads and fees…the list goes on. Those interested in a witty and frighteningly accurate take on this phenomenon should run, not walk [well, given that this is a Zen letter…perhaps a rapid stroll] to read Fred Schwed’s timeless classic *Where Are the Customers’ Yachts?)*

Anyway, back to the story. Given that we were unfamiliar with the manager, we had prior to the meeting convened a call with one of the few individuals in our firm who had, and what he told us was not encouraging. To begin with, he had reached out to the firm several times for information and been rebuffed. While not unheard of, this was definitely unusual, since, as one of the largest advisory firms in the world, the vast majority of managers were clamoring for access to our clients. To not allow us to do “due diligence”—providing audited returns, allowing us to do onsite visits, or even just explaining the investment strategy in detail—effectively precluded us from recommending the fund. And, of course, it made us suspicious.

[3] Although this is not *always* the case—google “Doyle Brunson” for the classic counterexample.

Split-Strike Strategy

A split-strike strategy is actually quite simple, designed to provide returns similar to the market but with less risk, paid for through sacrificing some upside and/or the cost of insurance.

The investor buys a basket of stocks—usually about 25 or 30—that tracks the index, along with out-of-the-money puts on the same stocks, funded by selling out-of-the money calls on the basket. The strike prices will vary depending on option "skew"—essentially the price difference between puts and calls at different strike prices based on current implied volatility.

You can also do this with an index ETF (e.g. SPY), but most practitioners prefer using individual stocks to arbitrage price differentials and thereby boost returns.

Potential returns vary depending on market conditions, but are typically in the low-to-middle single digits annually. The strategy also does not preclude losses if the market falls, especially if, as generally happens during such periods, put options become more expensive.

Further reasons for worry were that the fund's auditor was a small local shop, and that the manager's approach—a so-called "split-strike" strategy (see box)—was not one that could realistically provide the claimed returns of about 12% a year, not to mention its extremely low volatility and virtually no losing months.

So to recap, an individual deep within the top .01%, and with consequent access to just about any money manager he wished, had more than half his money invested with a secretive fund that used a small local accountant, and claimed to have provided impossibly consistent 12%+ returns running a strategy that, in the best of times, would be expected to generate less than half that.

Now, typically such a story would throw up huge red flags for fraud. And this was certainly part of our internal discussion. But the manager in question also ran a large broker-dealer, giving him extremely valuable data on fund flows. Our conclusion was therefore that he was illegally front-running his brokerage clients (e.g., when he saw a large buy order on a stock he would buy it for his fund before the order pushed up the price). But it didn't really matter. Either way, we wanted nothing to do with his fund.

This is where things get really interesting. We of course raised these concerns during our meeting with the investor. He, along with his New York lawyer—replete with immaculate pinstripe suit and pocket square—sought to allay our fears with "proof" that things were on the up-and-up.

The manager, they told us, was in fact very forthcoming with information about the fund. Every month, for example, they received a slip of paper listing the prior month's trades. Further, the investor had several relatives who had been invested in the fund longer than he—with even higher percentages of their assets in the fund—and everything was fine with them. They had even withdrawn money with no problems, although not for a while (returns, after all, were too good!).

Finally, the lawyer could not resist telling us his story, which I quote for posterity:

"I was his biggest skeptic, but he won me over. I trust him completely. In fact, he may be our most transparent manager."

The manager, as you may have guessed, was Bernie Madoff, and *two days later* he was arrested for running the biggest Ponzi scheme in history.

Now, at first blush it may not be obvious how this fund fails the Zen Strategist test. After all, the returns shown by Madoff were exactly what the long-term investor should be seeking: good, but not *too* good—which partly explains why he got away with it for so long—along with low volatility and investments in blue-chip stocks.

To see the problem, remember our SIT method:

Safety: (apparently) outstanding. Very low volatility, and almost no down months.

Investment edge: (apparently) excellent. Returns better than the S&P 500, and extremely low volatility.

Transparency: A-ha! Poor, as noted, and a *huge* red flag.

As mentioned last month, the SIT method guarantees nothing (this is investing, after all), but it does act as a solid defense against schemes such as Madoff's.

Some of you may be thinking, well, this goes without saying, but to repeat: this was an individual with an eight-figure net worth and all the consequent advantages. And please go read his lawyer's quote one more time…

The Lure of Easy Money…It's Got a Very Strong Appeal

One final story.

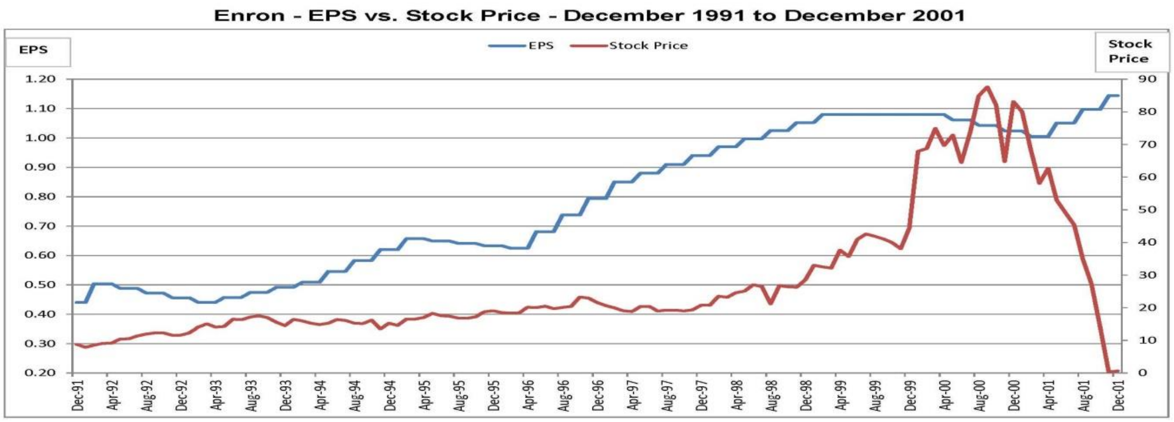
Way back in my investing career, during a (very brief) stint as a broker in the late 1990s, there was a company that captivated all manner of investors. There were lots of things to avoid then, of course, but this one stands out not only with regard to transparency, but to its widespread appeal.

Not an internet or telecom firm (no sock puppets here!) it was instead an energy company that had, most people agreed, revolutionized the industry with its modern approach to trading and energy distribution. The brash CEO was lionized for his take-no-prisoners attitude, once winning plaudits for calling an analyst an "asshole" during a conference call. (The analyst had dared to question the CEO's assertion that the balance sheet and cash flow statement were not "ready" in time for the call.)

Most of my colleagues were gaga over the stock, which had soared from around $20 a share in late 1998 to over $70 in early 2000. And yet, amidst all the cheering, a small minority (including the "asshole") openly worried about a, well, seemingly important issue—the company flat out refused to tell people how they made money. In Wall Street parlance, it was a "black box."

You probably realize I'm talking about Enron, and if not (or even if so!) I would urge you to read Bethany McLean's classic recap: *The Smartest Guys in the Room*.

The below chart is one of my all-time favorites, particularly since the EPS (earnings per share) number was the most common retort to anyone questioning the company's fundamentals.



But the best part of the story—and what makes it germane to the current discussion—is a conversation I had with one of my former colleagues a few years later, after the company was exposed as a fraud.

"How," he said, respect oozing from his eyes, "did you *know* about Enron?"

Well…of course I didn't! All I "knew" was that there were several thousand public companies in the US alone, so why should I buy one where I didn't know—and the company refused to tell me—how they made money?

Again, it seems so simple, but you can't act until you know what *not* to do.

Or as Watts summed up the challenge to what he called his "most important philosophical discovery":

The remaining question is how to get one's feelings, those easy victims of habit, to recognize that it takes nothing to start something.

Thanks for reading, and here's to doing less!

Eric Winig

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