Assante WEALTH MANAGEMENT

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Chris provides financial planning, investment planning and full implementation services to about 100 families.

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Donald Trump and a Loaded Coin

Lessons From A Loaded Coin

How easy is it to lose money betting with a loaded coin, when you know the probability is 60% heads? Apparently easier than you think.

An October 2016 study published in Social Science Research Network[1] played a very simple game, using primarily finance and economics students as well as some young professionals at finance firms.

Players were given $25 of real money to bet on the toss of a loaded coin. Players were aware that the coin was loaded to turn up heads 60% of the time. (It was a computer simulation so the coin could be loaded accurately).

The players had to decide how much to bet on heads or tails, and could play for 30 minutes, giving them time to make about 300 bets. The authors limited the total winnings of any player to $250, to keep the experiment from becoming very expensive, since a player could theoretically win about $3 million in 30 minutes.

The strategy for a game like this has been known since the 1950's, when John Kelly at Bell Labs worked out the optimal amount to bet. Turns out with a 60% probability of winning, you should bet 20% of your pot on every flip[2].

So how did the players do? Only 21% of players maxed out their winnings at $250. Two thirds (65%) of players ended up with less than they started with. Of those 2/3, almost half (28%) went bust.

In other words, 65% of educated, financially literate people, tossing a coin they knew was loaded in their favor, managed to lose money, half of whom lost it all! Ask yourself how that can possibly happen, when you know the probability of the toss?

1 Haghani and Dewey, SSRN, October 2016, SSRM.com

2 The Kelly Criterion = double the probability, minus 1 = % of total pot to bet. So if the probability of winning is 70% you would bet 40% of your pool each time. As it turns out, the game isn't very sensitive to size of the bet. Simulations were done with bets at a constant 10% and 15% of the pot, and the results didn't vary much. The point of the Kelly Criterion is the higher the probability of winning, the greater percentage of your pot you should bet.

Turns out they made a number of errors that are quite common to us as investors: betting on tails after a string of heads, betting too much capital on a single flip, haphazardly varying the amount of the bet, and surprisingly, just giving up.

Betting on tails in a loaded game is a classic investment error; the parallel is selling out of a perfectly good portfolio because you think 'next year will be worse'. Varying the bet is equally dumb: you bet big, maybe after a couple of tails, because you think 'Its gotta be heads this time', only to learn that 3 tails in a row is much more likely than you thought[3].

One fellow, a financial journalist, got the opening bet right at $5 on heads, but did not increase it as he started out winning, or reduce it proportionally when he encountered a string of tails. He then overreached with a large bet and lost, cutting his stake to $2; became dispirited at the embarrassment of almost going bust, and quit the game. (Oh sweet schadenfreude, the thought of a financial journalist going bust!)

Perspective of Years

Over the 90 years since 1926, the equity market goes up more than 7 years out of 10.[4] The market is a heavily loaded coin, and it is loaded in your favor. Does it always come up heads? Of course not. Can it have a run of 5 years of zero return? Yes, of course, but it's a low probability: 87% of 5-year periods will be positive[5]. The point is, over time, it's hard to lose.

3 The probability of three tails in a row with a 40% loaded coin is 6% of 3-toss strings; since you have time for 300 tosses in this game, or 297 3-toss strings, you should expect 3 tails in a row 19 times.

4 Nick Murray. Simple Wealth, p71

5 Ibid

The game helps us reframe investing into a longer term perspective, as a series of annual outcomes. This perspective helps you withdraw from and dismiss the cacophony of useless daily noise. It lets you see more clearly how the longer you're in the game, the greater your probability of accumulating significant gains.

Pessimists Get Hammered Again

Readers may remember that 2016 started out with a rough patch: January began with the 'worst 5 days since 2008', which became the 'worst 12 days since 1929', and then 'the worst 2 weeks of any year ever'.

Of course, financial media screamed of imminent disaster. Andrew Roberts, chief of Europe research at UBS, a bank, made headlines around the world with his statement January 11, 2016 that investors should 'Sell everything and buy only high quality government bonds'.[6]

Turns out a lot of people did just that. As at the end of May, US investors had redeemed a net $52 billion from US equity funds and ETFs. And since the Brexit vote followed in June, I'm quite sure the net redemptions have continued. At least $10 billion went to 'low volatility' funds – funds designed to have little decline, but also little upside. Low vol funds have had net inflows for 11 straight months to May 2016 and have doubled in assets in just 6 months.[7]

How did that work out? The S&P500 ended 2015 at 2044. As Armageddon supposedly approached it fell a bit over 10% to its low on February 11, 2016, whereupon it began its recovery and today sits around 2100. A misguided soul who sold shortly after the UBS advice to 'sell everything', say on January 20th, has locked in a 9% loss. And if he is waiting for the signal to buy back in, he has missed not only the complete recovery to 2044, but another 2% or so to today's 2100.

6 UK Telegraph, January 12, 2016

7 N Murray, August 2016 p3

So he's down 11% from where he would be if he had done absolutely nothing.

Speaking of buy signal, it might not be emanating from UBS: the bank announced a restructuring of its wealth management division in April 2016 along with layoffs of 'hundreds' of people. The fate of Andrew Roberts is not known. To me, anyway.

Looking forward, here's a fact that tortoises might be interested in: the S&P500 has been trading in a range around 2100 for almost 2 years since February 2015. Nick Murray, longtime industry commentator and advisor, reports that there have been 24 instances in the 85 years since 1929 where the market ran more than 300 days without making a new high. But, 250 days after breaking out of such a trading range, the market was positive over 90% of the time, and the average increase was 15%.

I have no idea what the future holds. But I did notice, the week after Trump won, the Dow Jones (a narrow gauge of the US market) hit a new high. Maybe, with the election finally behind us, and nothing really the matter with the US economy, just maybe the train is pulling out of the station.

Early View on Trump*

The surprise US election results have everyone asking "What now? As of the Wednesday after, the North American equity markets are both up about a little less than 1%. Bond markets are not so happy: the 10-year US Treasury yield has jumped almost a full point, cutting the price almost 10% in about a week, as the bond market contemplates Trump's ideas for economic stimulus and potential for resurgence of inflation. (bond prices fall as rates rise)

The good news is that we have a clear winner with a clear mandate to "Make America Great Again." Similar to the British vote to exit the Euro, Trump's election symbolizes the public's frustration and determination to try something completely different, come what may. America's middle class and blue collar Rust Belt are willing to run that risk, because political mainstream thinking isn't working for them.

The progression of the post-Lehman crisis sequence (from financial to economic to social to political) took an important step November 8. The Washington consensus (what we're doing) and its establishment purveyors (who's doing it) have been jettisoned.

Voters have trashed the political establishment: self-dealing politicians, uncontrolled immigration, sophistry-driven environmentalism, and leftist-liberal media. Trump makes Rob Ford look polite, but his popularity taps the same vein.

Clinton's left-leaning centrist position was too closely associated with traditional politics to be considered anything other than more of the same. This opened the door for Mr. Trump, who became the political embodiment of this desire for something completely different. Fortunately for the economy, change has emerged from the right under the Republican banner and not in a more deeply socialistic, economically destructive form along the lines of what Bernie Sanders had in mind. The "U.S. Brexit" appears to have a retained a pro-business element that may not be all bad for the US.

* borrowing heavily from comments by Eric Bushell, CIO of Signature Investment Advisors

In coming to this point, Trump has bred fear into race, gender, geopolitical and economic relations. The divisive campaign has alienated liberals and globalists, but it is premature to judge the outcome of President Trump's administration. Some patience and observation is advisable. It is not likely that a Republican Congress will tear up the trade agreements that have been the foundation of global prosperity in the last 30 years.

I recall being apprehensive when Ronald Reagan was elected President; what could a B-movie actor know about running the United States? And yet Reagan turned out to be a great president. I have no hope that Trump will be a great president – but a Republican Congress may well be able to move the country forward, while keeping Trump on a short leash.

So, steady as she goes. No changes recommended. I still prefer equities, especially US and Canadian equities, to bonds. The cross-currents may be sharp, as the Trump administration evolves policy, so it will be important to not overreact to short-term events.

Excellent Outlook for US

Earnings Recession Over

The US Census Bureau reported that US household median income gained over 5% in 2015 – the largest annual increase since the data survey began in 1967. The gains reflected recent years of strong employment growth, with 2.4 million net new full-time jobs created in the US in 2015.

The largest gains were in the lowest fifth of income earners, thereby reducing the supposedly dreaded income inequality, improving the US poverty rate more than a full percentage point, moving 3.5 million people above the poverty line[1] .

As well, women made greater income gains than men, reducing the gender pay gap.

Of course these gems are not widely reported; they are good news. The US economy, shaken by the financial crisis, continues to gain momentum.

Corporate earnings in the US and Canada have faced a headwind in 2015 as oil prices were hammered from over $100 in June 2014 to about $26 in February 2016. The Canadian industry's experience was a little worse, courtesy of our self-inflicted wounds from stonewalling new pipeline construction.

Lack of pipelines to get Canadian oil to markets has kept oil prices significantly lower for Canadian producers, put Canadians out of work, contributed to the railcar disaster at Lac Megantic, and damaged the formerly robust Alberta economy, all regrettable results of US-funded special-interest lobbying[2].

1 N Murray, October 2016, p1

2 See Vivian Krause for excellent detail on US special interest funding of Canadian environmental groups. The notion that stopping new pipelines will somehow reduce carbon emissions and slow global warming is pure fantasy. Canada could close its entire oil and gas industry, and there would not be one less barrel of gasoline burned, because other producers would happily supply all the oil the world wanted.

In the US, losses from oil and gas companies knocked about 20% off the total earnings of the S&P500 by Q1 of 2016, from about $125 to $100. With oil now back around $50, much of the industry is profitable again. As the losses begin to fall out of the data in Q1 2017, only four short months away, corporate earnings in the US will begin to show year/year growth again soon.

Earnings are the main underpinning to markets. With S&P500 12 month forward consensus forecast earnings at $129, and the S&P at around 2100, the P/E (price/earnings) ratio is 16. Since the average forward earnings ratio over the last 25 years is … hold your breath… 16, the market valuation is thus exactly average.

(Note: media reports of 'overvalued' markets are based on current P/E, not forward P/E. Current valuations include the losses discussed above, which inflates the ratio, making the market appear overpriced. But the market, being brighter than a financial journalist, looks through the earnings trough to see the recovery.)

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