PRICE**VALUE**PARTNERS

Balls

"People who insist on telling their dreams are among the terrors of the breakfast table."

- Max Beerbohm.

Readers may enjoy our recent State of the Markets podcast with Professor of Economics at the Université d'Angers, Guido Hülsmann, recorded at the end of September 2019

Well, since you ask, it was a dream last week about a casino, and a roulette table. Your correspondent bided his time, placed his chips on the number 3.. and won. This being a dream, we then all went off to celebrate by splurging our winnings on a cheese sandwich. Just the one. Perhaps Beerbohm was on to something.

So far, this correspondent has come across two cracking 'true life' books about roulette. The first was *The Newtonian Casino* by Thomas A. Bass, which tells the story of a bunch of physics graduate hippies from the University of California at Santa Cruz during the late 1970s and early 1980s who take on the roulette wheels of Las Vegas. As most readers will probably appreciate, a classic 'newbie' tactic at the tables is to bet on one of the 50:50 outcomes (black or red, odd or even), and then 'double up' on that bet every time it goes awry. This is, of course, a one way ticket to the poorhouse – absent having an infinite float, you go quickly bankrupt, and all you ever stand to make is your money back to begin with. Nor did these escapees from *The Big Bang Theory* commit the comparable newbie error of making a note of all the previous spins and then placing bets accordingly. Assuming the wheel is honest, the past has no influence on the outcome of future spins.

What these guys did, however, was brilliant. Using the principles of Newtonian physics, they marched into the casino armed with rudimentary computers and timing devices strapped onto their chests and embedded in the soles of their shoes (this was all legal at the time, namely at the dawning of the personal computer). They set out to prove that if they could calculate the rate of decay of the spin of the wheel versus the rate of decay of the spin of the ball (which were spun in opposite directions), they could determine roughly which part of the roulette wheel the ball would end up in. They then slathered their chips over that portion of the table.

Did the theory work ? Suffice to say baseball bats ended up being deployed and laws getting changed.

The other, comparably classic, tale was *Thirteen Against the Bank* by Norman Leigh (a hat tip to the trader Chris Clarke is due here), which tells the story of a group of adventurers during the late 1960s who go down to the Casino Municipale in Nice with the express aim of beating the bank. Rather than deploy technology they used a system (the 'Reverse Labouchere' method, for the technically minded). A total of 13 players covered all of the even-money bets at all the tables simultaneously, with a view to maximising their take whenever a seemingly unlikely run of odds came about. In essence, they doubled down ***each time they won***, meaning that after a relatively short run in their favour, their compounded returns became astronomical. This required a) a sizeable float for the avoidance of an early bath, and b) rigorous risk management and position sizing. Did it work ? Suffice to say baseball bats ended up being deployed, and 13 roulette players getting deported.

The relevance of these stories, especially the latter ? *Thirteen Against the Bank* is essentially a story about systematic trend-following, which – along with a hefty allocation to the monetary metals, gold and silver – forms the cornerstone of our portfolio diversification and portfolio protection strategy. You can find an excellent introduction to the approach here.

Most fund managers attempt to predict the future (or, technically speaking, in the case of the CTA sector, ***futures***). Perhaps uniquely in asset management, trend-following managers do not. Rather, they simply let the price do the talking, and place their bets accordingly. The shorthand version: wait for strong price trends to develop – whether to the long side or the short is somewhat academic – cut your losses quickly, and let your winners run. All of this is done, typically, according to preset systematic limits, so that there is no discretionary input required on the part of the programme's manager. And this is also done across multiple markets, whether in equity index futures, or interest rate futures, or currencies, or hard commodities like copper and zinc, or soft commodities like soyabeans and cocoa..

Since most fund managers typically limit their field of activities to equities and bonds, systematic trend-following funds offer significant diversification benefits within a genuinely balanced portfolio. Since most conventional fund managers are typically restricted to 'long-only' positions in stocks and bonds, during bear markets for both, they get hosed. But trend-following managers have no such limitations. Indeed, during the worst year for financial markets in living memory (2008), trend-following funds made out like bandits – in large part because they simply followed the prevailing markets down, and made money from those shorts.

Trader Chris Clarke recently conducted an exercise to try and identify the best-performing funds in the world. His criteria were straightforward: to qualify for the shortlist, funds had to have been in operation for at least 20 years (most fund managers retire or get fired before then); funds also had to have generated, on average, 20% annualised returns over that same period.

Eleven funds made the final cut. Of those eleven funds, six were trend-followers. The results are shown in the table below. Note that Berkshire Hathaway, technically a holding company as opposed to a fund, only just squeaks onto the list, in last place:

Funds with a 20 year track record that have generated 20% annualised average returns

Fund	Class / Share / Programme	Manager	Inception	CAGR %
Eckhardt	Standard Programme	William Eckhardt	Jan-87	23.81%
EMC Capital Management	The Classic Programme	Liz Cheval	Jan-85	23.20%
Hawksbill Capital Management	Global Diversified	Jerry Parker	Nov-88	22.24%
Blenheim GL Markets LP		William Kooyker	Dec-86	22.06%
Tudor Investment Corp	BVI Global Fund	Paul Tudor Jones	Oct-86	21.76%
MJ Walsh	Standard Programme	Mark Walsh	Sep-85	21.33%
JW Henry & Co	Financials & Metals Programme	John Henry	Oct-84	21.10%
Moore Capital	Global Inv Fund, Ltd	Louis Bacon	Dec-89	20.64%
Abraham Trading Company	Diversified Programme	Salem Abraham	Jan-88	20.33%
Gamut Investments		Bruce Kovner	Jun-86	20.31%
Berkshire Hathaway	Per share book value	Warren Buffett	1965	20.30%

(Source: Lawrence Clarke Investment Management)

Trend-following funds are not without their demerits. Many investors are uncomfortable with the inevitable drawdowns that come with the strategy. (They should take a look at their equity portfolios in the same light.) After an 11-year bull run in the US equity market, many trend-followers have recently lagged the S&P 500 index. But to be fair, so has just about every other equity market in the world. To us, a key attraction of trend-following funds is that they are genuinely uncorrelated to the stock and bond markets of the world. This is entirely intuitive, given that at any time they may be either long or short those markets, or entirely uninvested in them, or invested either to the long or short side in markets that have no correlation with stocks or bonds.

But other key attributes of trend-following funds include:

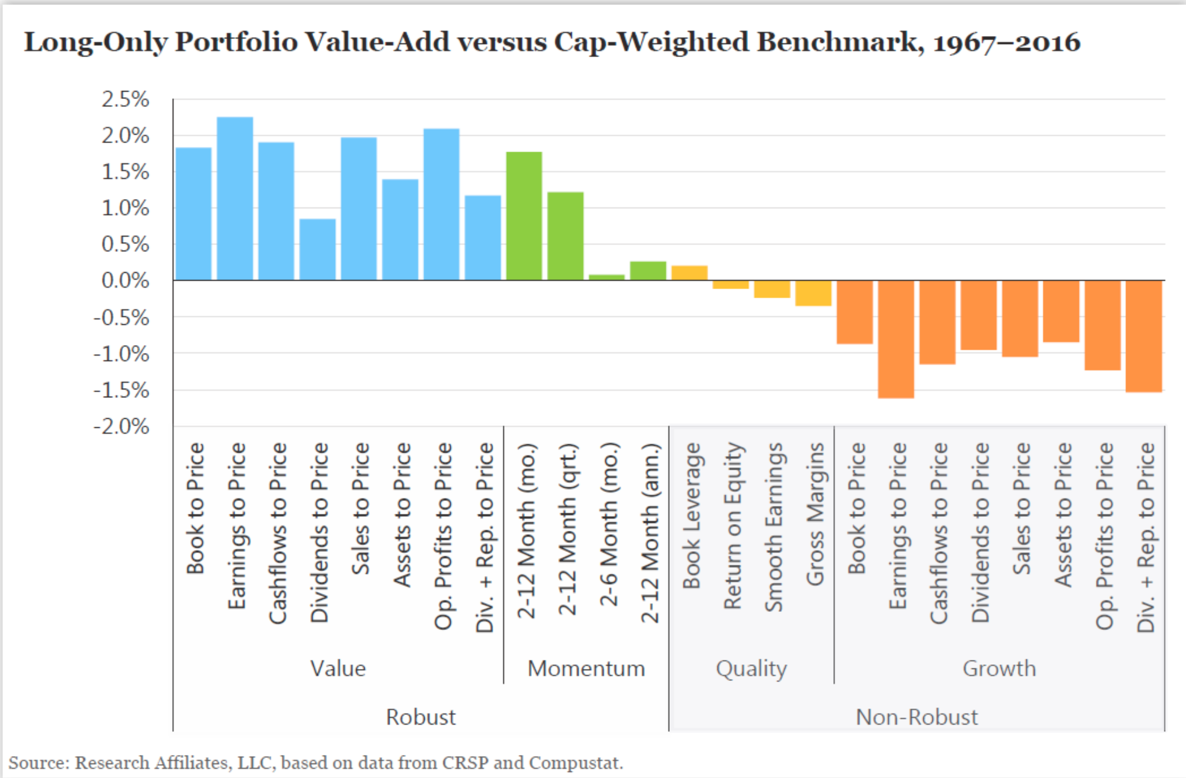
* High historic returns

* A particular ability to generate strong gains in difficult markets (e.g. 2008)

* Genuine diversification versus traditional asset classes

* No 'discretionary' manager risk (i.e. making disastrous market calls).

In our view the financial markets are ***not*** strictly akin to a casino, in that two strategies at least have shown a sustained ability to outperform over the long run. One of them is value, which we practise in our equity selection. The other is momentum, to which we gain exposure via our trend-following managers. (See Research Affiliates' research piece, How not to get fired with smart beta investing, from which the following chart is taken, showing the performance of different equity investing styles in the US over a 50 year period.) The Research Affiliates research strongly suggests that if past is prelude, 'quality' and 'growth' investing detract rather than add to index returns.



"You think the odds look right, that they are in your favour ?" writes Ian Fleming in *From Russia With Love*:

> This is a billiard table. An easy, flat, green billiard table. And you have hit your white ball and it is travelling easily and quietly towards the red. The pocket is alongside. Fatally, inevitably, you are going to hit the red and the red is going into that pocket. It is the law of the billiard table, the law of the billiard room.
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> But outside the orbit of these things, a jet pilot has fainted and his plane is diving straight at that billiard room, or a gas main is about to explode, or lightning is about to strike.
>
> And the building collapses on top of you and on top of the billiard table. Then what has happened to that white ball that could not miss the red ball, and to the red ball that could not miss the pocket ? The white ball could not miss according to the laws of the billiard table. But the laws of the billiard table are not the only laws in this particular game.

We diversify our client portfolios as best we can, across globally unconstrained value stocks, systematic trend-following funds, and real assets at fair prices. This is because although we have quite strong views about the future, we cannot entirely predict it. This degree of diversification acts, in a way, as a form of insurance against our own overconfidence – at a time when global economic, geopolitical and market valuation trends all look distinctly challenging. If your manager thinks he or she can foresee the future, we have a one word response. Balls.

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Tim Price is co-manager of the VT Price Value Portfolio and author of 'Investing through the Looking Glass: a rational guide to irrational financial markets'. You can access a full archive of these weekly investment commentaries here. You can access the archive of our regular 'State of the Markets' podcasts, with Paul Rodriguez of ThinkTrading.com, here.

Price Value Partners manage investment portfolios for private clients. We also manage the VT Price Value Portfolio, an unconstrained global fund investing in Benjamin Graham-style value stocks and specialist managed funds.