The Zen Strategist

June 2017

Investing While Sitting Still

Eric Winig

Doubling Down on Triple-Leveraged Calls

Doubling Down on Triple-Leveraged Calls

Zen Master Unmon said: "The world is vast and wide. Why do you put on your robes at the sound of a bell?"

"The past obviousness of anything you never knew is a delusion. Many things seem clear only once they have been taught to you, once all the prejudices, confusion and competing theories have been omitted."—Emanuel Derman

Why do we do the things we do? And how do we know the things we know? As with many "obvious" questions, in both cases the seeming simplicity betrays a bottomless well of possibilities.

In fact, most of our decisions are made *not* from some sort of rational analysis of "facts," but are rather driven largely, if not exclusively, by the environment in which we happen to find ourselves, and more succinctly, by the opinions of others[1]. Thus, the reason most people are poor investors is that they are forever doing what is popular (and thus crowded and expensive) instead of seeking out truly alternative investments in which few are willing to traffic.

Further, things that *seem* obvious after the fact (e.g. 1999 and 2007 were classic bubbles, or Apple would someday rule the world) were, contrary to popular perception, not always so clear-cut. I recall business school classmates day-trading their tuition money in the late 90s—and scoffing at my "old-fashioned" concerns—and more or less constant eye-rolling from acquaintances and colleagues[2] when I questioned the foundations of the housing market. I also recall a Credit Suisse research report on Apple from a 1998 B-school presentation titled "Apple: Ya Gotta Believe," when the stock was selling for a split-adjusted price of about $1 a share. (Of course, five years later it was still available for that dollar…)

After all, in 1999 everyone "knew" the Internet was going to change the world[3], and in 2007 no less an oracle than Ben Bernanke confidently told us that, as housing prices had *never* fallen on a national scale, worries about what was essentially a coalition of local markets were just plain silly. And Apple? Come on! The idea that Apple would come to dominate the (non-existent) smartphone industry in little more than a decade was as silly as, well, the idea that Barack Obama and Donald Trump would win consecutive Presidential elections.

Most people, of course, remember things differently. One acquaintance, for example—who had consistently scoffed at my housing concerns throughout the 06-07 bubble—later told me the downturn had been obvious because "the economy is cyclical," and the number of people who have "always" owned Apple stock seems similar to the inflated numbers who claim to have been at some epochal sporting event.

---

[1] For those of you wondering whether this represents circular logic (i.e., where did others get *their* opinions), the answer is no. Think about it…

[2] Not all…but more than you might think.

[3] Spoiler alert: it did, but many Internet stocks still went to zero.

I, of course, am no different. My forecasting record is painfully flawed, perhaps most notably after the 08 crash when I truly believed central banks would *not* be able to put Humpty back together again, that stocks would stay depressed and interest rates spike, and investors should hunker down in precious metals and other physical "stuff." Ouch.

But this is also a great example of something obvious to me *now*—my understanding of quantitative easing was badly flawed—but that seemed, as Wallace Shawn might say, *inconceivable* to me then.

As investors, therefore, we need to ask not just what will seem obvious to *us* in the future, but also to other investors. This opens opportunities, but be warned! Being a true contrarian is *hard*. It requires not only an openness of mind, but a willingness to look like a fool…often for long stretches of time[4]. It means not being able to participate in cocktail party banter about "hot stocks," but rather being forced—as discussed below—to mumble something about this strange, esoteric trade that sounds, um, kind of crazy.

It means that when the bell rings and everyone else puts on their robes, you sit still and read your book. Or take a quiet stroll in the garden. Or strip off your clothes and cavort about singing "*Hallelujah*!" Or, in the ultimate act of uniqueness…you also put on your robes. But only for today.

DUST Revisited

Over the past several months I have made the case for selling long-dated calls on an ETF that provides triple the inverse daily return of an index of gold stocks. Potential things to think about, therefore, include the following:

1) The price of gold
2) The price of gold stocks
3) The strike price of the option
4) The implied volatility of the option
5) Interest rates
6) Fed policy
7) Policies of other central banks
8) The return patterns of inverse ETFs
9) The return patterns of triple-leveraged ETFs
10) How do I explain this at parties??

Whew! Well, no wonder people are skeptical. In fact, even when I explain this trade to people well-versed in such areas I often get a raised eyebrow…or a question such as "So…I want gold stocks to go…up?"

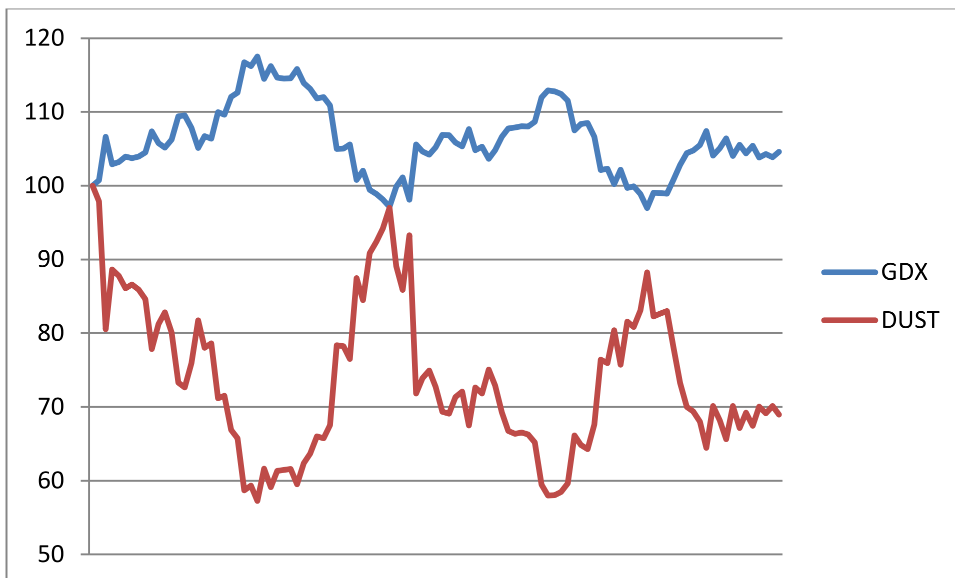
[4] And sometimes forever. The herd is not always wrong.

The good news is, even as this trade has worked quite well over the past few months, for those willing to *really* look different it remains, in my opinion, among the fattest pitches available today. And one that will seem, dare I say it, *obvious* in retrospect.

Let's dig in.

The idea behind selling calls on triple-leveraged ETFs is actually quite simple. When you increase the volatility on an underlying asset, the price of the resulting security will, over time, inexorably trend down. This is not conjecture or my best guess…it is math[5].

To illustrate, let's look at the returns of DUST versus the GDX gold stock index since the beginning of the year. Remember, DUST provides 3X the inverse return of the index.



OK, so after some ups and downs GDX is up just under 5% for the year. But DUST is not down 15%...it's fallen more than 30%! As noted in prior letters, this is because of the decay caused by the increased volatility. For example, if GDX goes up 10% one day and down 10% the next (or vice versa), the index will show a 1% loss, but triple-leveraged ETFs (long *and* short) will be down 9%.

Thus, the day-to-day volatility of any stock—but particularly something highly volatile like GDX—is, when magnified on a daily basis, a powerful downside force over time. This is particularly so when the underlying asset is range-bound, as GDX has been for the past several months.

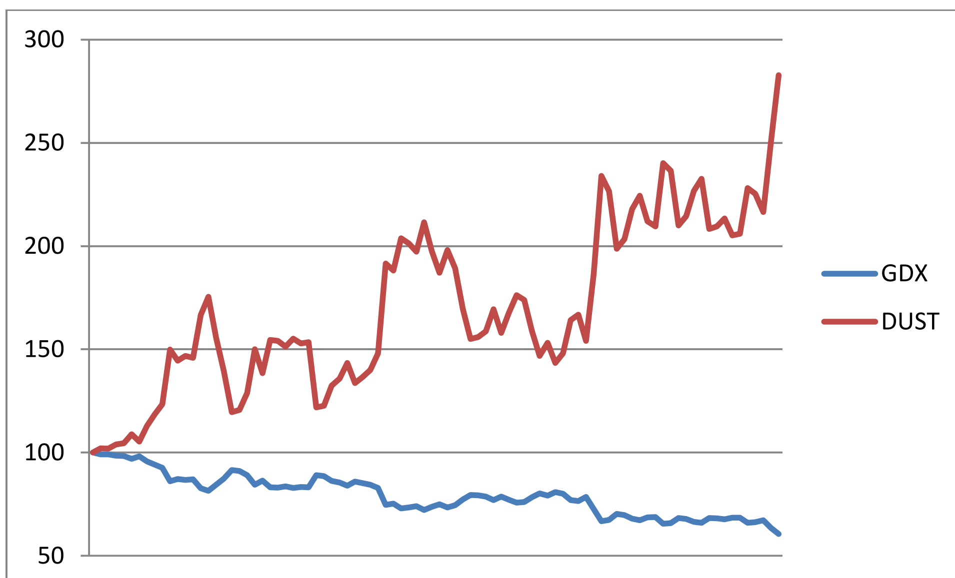
Consider that GDX closed at $22.81 on March 31, virtually the same price as on June 9 ($22.83). DUST, meanwhile, closed at $31.06 on March 31…and $28.43 on June 9. Going back another month, GDX closed at $22.84 on February 27, and DUST at $33.38. In other words, while GDX has been dead money

[5] It is true that 3X ETFs can spike for long periods of time when the underlying asset moves relentlessly higher, as have those that track US equity indices over the past few years. However, the math is different for *inverse* ETFs, as while prices can *in theory* continue to move higher more or less indefinitely, they cannot go below zero.

for more than three months, day-to-day volatility during that period caused DUST to decline by 15%. The price of the DUST calls I recommended selling, meanwhile, has dropped from $2.80 (and $3.80 when I re-recommended them last month) to about $1.25.

It is difficult to overstate the significance of this. When you are selling long-dated calls on triple-leveraged options, there are, in industry parlance, many ways to win…and only one to lose. In order for the options I recommended two months ago (January 18 calls with a $90 strike price) to go into the money, gold stocks would not only need to fall dramatically, but do so in an almost straight line.

In fact, we have a recent example of just how extreme this would need to be. This chart shows GDX and DUST returns starting August 10, 2016—when GDX peaked at $31.30—through December 15, when it bottomed at $18.99.



As you can see, while GDX went down roughly 40% in just over four months, DUST *still* fell short of tripling. Yes, it came close, but consider that an equivalent decline from current levels would take GDX below $12 a share, *lower than its all-time panic low of early 2016*—which was itself 25% below the late-2008 low—after which the index nearly doubled over the next three months.

Which brings me to another point. While these trades are often attractive, this one is doubly so given the horrible bear market suffered by gold stocks since 2012…and even over the past year. Thus, turning around the prior analysis, GDX has fallen by about 25% since July, but the price of DUST—after some violent swings—is about the same today as it was then.

Further, given the generally expensive state of risk assets[6], a seemingly daily increase in geopolitical tensions, and the likelihood central banks will continue their recent trend of responding to any and all market hiccups with cheap(er) money, it would seem the path of least resistance for gold stocks is up.

But, once more with feeling…*gold stocks don't have to go up for this trade to work…they merely have to avoid an historic collapse*. Given the potential returns involved—not to mention that such a collapse would, as mentioned, need to take GDX below its *all-time trough*—that's a pretty low bar.

There are no free lunches in finance (or anywhere else…) but this is about as close as it gets. And I find it even more compelling given the lack of attractive alternatives (more on which below).

A few caveats. As noted in prior issues, you need an account where you can sell naked options, and you should build in extra capital to avoid margin calls when (not if) the trade goes against you. And I strongly recommend against checking this trade on a daily basis. As shown above, DUST has had two rallies of more than 50% this year…but it's still down 30%!

Put simply, if you have already put this trade on, I would recommend holding and/or adding to it, and if you have not…there's still time to do so.

Markets Enter (Exit?) the Manic Phase

"The waiting…is the hardest part"—Tom Petty and the Heartbreakers, *The Waiting*

"Welcome to the jungle…we got fun and games. We got everything you want…honey we know the names"—Guns N Roses, *Welcome to the Jungle*

On Friday, June 2, investors eagerly awaited the US monthly nonfarm payrolls report. Expectations were high, as the ADP report issued a few days earlier had been strongly positive, and most observers expected confirmation of the strengthening trend cited by Federal Reserve officials in their most recent meeting, when they called weak Q1 economic data "transitory."

I should note that I view the attention paid to this report as absurd, given its extreme lagging nature—think how long it takes for a firm to actually hire a new worker once it makes a decision to do so—as well as its large margin of error and the amount of pure guesswork involved, e.g. the "birth/death" adjustment that purports to quantify the net number of small businesses created or destroyed in a given month (see below). That said, perception is reality in markets (and elsewhere…) and thus the reaction to the report is worth parsing.

Historical birth / death adjustments (in '000s)	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	Latest recovery 2010 - 2016
Net jobs added	3,283	1,695	(1,838)	(270)	183	2,014	2,658	2,007	1,147	(3,569)	(5,070)	1,066	2,087	2,149	2,311	3,015	2,744	2,157	**15,529**
of which: through birth / death adj.	30	39	196	289	695	836	866	964	1,130	904	882	510	490	535	624	733	781	841	**4,514**
% of jobs added through birth/death adj.	0.9%	2.3%	n.m.	n.m.	379.8%	41.5%	32.6%	48.0%	98.5%	n.m.	n.m.	47.8%	23.5%	24.9%	27.0%	24.3%	28.5%	39.0%	**29.1%**

Source: BLS, Morningside Hill

[6] As Investment Management Associates' CIO Vitaliy Katsenelson put it in his most recent quarterly letter, "the average stock is overvalued somewhere between tremendously and enormously."

As it happens, the report was a disaster, with the number of new jobs not only falling well below the Wall Street "consensus" estimate, but failing to match even the lowest estimate. Average hourly earnings, which have been another part of the bullish narrative, also failed to meet expectations, and while the unemployment rate did fall, this was only due to the fact that an enormous number of people "opted out" of the jobs market entirely.

So what did stocks do? They rallied, of course! But even more interesting was the commentary of market observers. Here, for example, were the top stories on Yahoo Finance in the middle of the day:

Stocks Add to Gains After Rate Hike Chances Remain High After Disappointing Jobs Report

Why Facebook, Amazon and Netflix Could Soar At Least Another 40%, Says Analyst

Why We Might Not See Another Nasty Recession Until 2024

For those of you who missed the late 90s tech bubble, or even the 08 financial crisis, this is classic stuff. A little more poking around, meanwhile, found this clip-and-save headline from mid-May: "'What could derail the markets? Probably nothing,' expert says." Even noted bear Jeremy Grantham—who famously let assets at his firm GMO implode in the late 90s rather than participate in the bubble—now believes valuations have moved to a more or less "permanently high plateau[7]."

In fact, while it has become fashionable to claim this is not a bubble because no one is excited about stocks…the environment reminds me more of the late-2007 phenomenon referred to as the "fully invested bears." I recall attending a Bank Credit Analyst conference during that time, at which just about every fund manager I talked to would wax eloquent about all the dangers facing markets…then say they were basically all-in on stocks because they couldn't afford to miss any further upside.

Today, the narrative (incredibly, in my view) seems to be that since things aren't quite as crazy as they were in the late 90s or 2007-08, it's clear sailing for markets[8]. This was summed up in a remarkable recent piece titled "Why the end of a bull market can be a nightmare for bears[9]," in which a parade of Wall Street figures cited the strong gains at the end of prior bubbles (sorry…bull markets) as reasons to never, ever, sell.

It also included this helpful chart, showing the types of returns investors who bail out of these markets are purportedly leaving on the table:

[7] Irving Fisher's infamous 1929 statement that basically top-ticked the market.

[8] Or as short-seller Jim Chanos recently quipped: "I am buying stocks here, because once they went higher…for a year."

[9] Available here, and definitely worth a read: https://finance.yahoo.com/news/ends-bull-markets-nightmares-bears-131151195.html

Table 3:Historical S&P500 total returns preceding market peaks

	Returns			% of cycle return		
Peak	24 months	12 months	6 months	24 months	12 months	6 months
Mar-37	129%	33%	19%	58%	12%	7%
May-46	72%	33%	15%	46%	19%	8%
Aug-56	74%	20%	15%	24%	5%	3%
Dec-61	32%	32%	11%	34%	34%	11%
Feb-66	30%	11%	11%	34%	12%	12%
Nov-68	44%	18%	12%	82%	35%	23%
Jan-73	39%	19%	14%	52%	25%	17%
Nov-80	65%	39%	29%	44%	25%	18%
Aug-87	93%	40%	20%	46%	18%	8%
Jul-90	45%	15%	10%	65%	21%	14%
Mar-00	42%	22%	20%	11%	5%	4%
Oct-07	36%	18%	9%	38%	18%	9%
Average	58%	25%	16%	44%	19%	11%
Median	45%	21%	14%	45%	19%	10%
Min	30%	11%	9%	11%	5%	3%
Max	129%	40%	29%	82%	35%	23%

Source: BofAML US Equity & Quant Strategy, Bloomberg, S&P

This, of course, is ridiculous…unless BofA will also tell investors when to sell? As I recall, Wall Street remained almost uniformly bullish through most of the 2000-02 and 2008-09 declines[10].

I also remember hearing this exact same reasoning during my brief stint at Merrill Lynch in late 1999, when brokers were advised to use so-called "mountain charts"—which show equity returns since 1926—to convince investors that, as the saying goes, "it's not tim*ing* the market…it's *time in* the market," which is coincidentally quite useful for the business of selling stocks.

Then, as now, gains were increasingly concentrated in big tech stocks with protective "moats" and high barriers to entry; I remember hearing two West Coast acquaintances argue about who had done better in Intel; they finally realized one had bought it three splits ago…and the other only two.

Here, by the way, is Intel's pre- and post-bubble performance[11], which pretty much makes a mockery of the idea that you "can't afford" to miss the end of a bubble.

[10] Sorry – this is a little unfair. Wall Street is *always* uniformly bullish.
[11] I could, of course, show the same chart for any number of tech stocks such as Cisco, Oracle, Microsoft, etc.

Update

I wrote the above the week of June 5, and obviously things have changed a bit since, with tech stocks beginning to show some cracks. Whether this is the "beginning of the end," a shot across the bow, or simply yet another buying opportunity is of course yet to be determined…but it sure feels ominous to me (shocking, I know…).

As discussed in prior issues, we avoid shorting stocks on a tactical basis at the Zen Strategist, but I reiterate last month's recommendation to buy call options on the UVXY double-leveraged volatility index. However, given the change in market dynamics, I think buying closer-term options now makes more sense.

Recommendation: Buy UVXY $20 call options expiring in September 2017.

As of June 14 these are selling for about $1.30. And as suggested last month, one alternative to this "straight" trade is to simultaneously sell the $30 call, which trades for about 80 cents, to either keep costs down or leverage the trade to take advantage of the $20 to $30 range**.**

It is also worth noting that this trade serves as a hedge against the DUST trade outlined above, as a 2008-style collapse in markets could indeed take down gold stocks with it. In such a scenario, UVXY calls would provide very good protection.

Conclusion

This strikes me as a very dangerous time in markets. It is also, not surprisingly, a difficult time to go against the crowd, as witnessed by the steady stream of negative feedback I received on last month's recommendation to buy volatility. (One Seeking Alpha commenter said it was the "worst call" he had ever seen on the site.)

When tech stocks can only go up, and volatility only go down[12]…well, let's just say it doesn't sound like a market bottom.

Be careful out there…and here's to doing less!

Eric Winig
zen.strategist.letter@gmail.com

To subscribe or provide feedback, please click below:

https://goo.gl/forms/wpOhCtdl4kXpfm1p1

Disclaimer: Information contained herein is obtained from sources believed to be reliable, but its accuracy cannot be guaranteed. It is not designed to meet your personal financial situation – I am not an investment advisor nor do I give personalized investment advice. The opinions expressed herein are mine and subject to change without notice. Information or opinions may become outdated and there is no obligation to provide updates. Investments recommended in my publication should be made only after consulting with your investment advisor and only after reviewing the prospectus or financial statements of the company or fund in question. You shouldn't make any financial decision based solely on what you read here.

[12] I highly recommend reading the WSJ's recent puff piece on volatility sellers and how easily they make money as an example of how lopsided sentiment has become: https://www.wsj.com/articles/you-dont-know-vix-wall-streets-fear-gauge-is-now-a-multibillion-dollar-market-1497281745