

Searching for an Edge

Published on: 15 March, 2019 | Author: Investment Team

In 1969, Buffett announced he was closing down his fund – the Buffett Partnership. This was after a stellar track record of 30% annualised over a 13-year period since the fund was started. Some of his clients asked him to suggest other managers they could give their money to. One name that was thrown at Buffett as a possible replacement was Edward Thorp.

Edward Thorp is a name that is likely to be unknown to most people. He started off his career as a maths professor and wrote a book about blackjack where he explained how to count cards. Of course, not everyone believed his claim that counting cards could remove the casino advantage and create an edge for the player. He was taunted with the stereotypical line levelled at academics, “if you’re so smart, why aren’t you rich?”. He swiftly proceeded to the casinos in Las Vegas and made a lot of money using his card counting strategy.

Without going into too much detail, Thorp’s strategy at its core was simple and its lessons can be translated to investing. Card counters understand that sometimes the deck is stacked against them and at other times, they have a slight edge. The strategy was to bet as little as possible when the casino had the edge and make larger bets when the odds shifted in his favour. At the same time, he avoided very large bets because given enough time, these are likely to end in ruin.

His big edge eventually disappeared. His book on card counting became wildly popular which improved the odds of other gamblers. The casinos wised-up to the fact that his methods worked and so they changed the rules. This is the nature of any successful investing edge. Given enough time, the action of other players who have discovered the edge will eventually erode it.

After his stint at the casinos, Thorp started a fund which was in the effect the first quantitative hedge fund. It went on to be very successful, generating returns of 20% over 29 years. Other successful hedge funds like Citadel, Elliott and D.E Shaw used similar strategies to Thorp. As more scientists and engineers jumped ship into finance, the edge enjoyed by hedge funds began to wither away. It is not surprising that hedge funds in aggregate have had a poor run of performance. A crowded market with an army of intelligent analysts erodes any edge that previously existed. Add to this expensive management fees and clients are likely to see only mediocre returns.

While we don’t have supercomputers or an army of PhDs at Tacit Investment Management, we apply Thorp’s principles to managing risk and reward. In investing, one is not penalised for inaction so when the odds are not in our favour, we sit on our hands while we continue to search for value. When we find opportunities, we make high conviction investments.

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