Chapter 15

How to Stop Losing Money

How to Stop Losing Money on the Right View

In the global macro community it's fairly common to express a general view on commodities, or even a specific one, by positioning via a highly correlated instrument. Let's say you are bullish on oil, for example, you might get long one of the traditional commodity currencies such as the Canadian Dollar (CAD), Mexican Peso (MXN), or Russian Ruble (RUB). Looking at the charts in Figure 15.1, it would seem that really any of these would make an excellent proxy.

These are the kinds of charts that salespeople and analysts like to include when making trade suggestions for good reason. By appealing to our inherent desire to simplify what is a rather complex world with a nice, neat, coherent story, in which A leads to B and B leads to C, they get us to take action. Unfortunately, neither the world, nor our investment mandates work so linearly, and that creates some real problems. It is what often leads to us getting our view right while simultaneously experiencing losses.

AlphaBrain: How a Group of Iconoclasts Are Using Cognitive Science to Advance the Business of Alpha Generation, First Edition. Stephen Duneier.

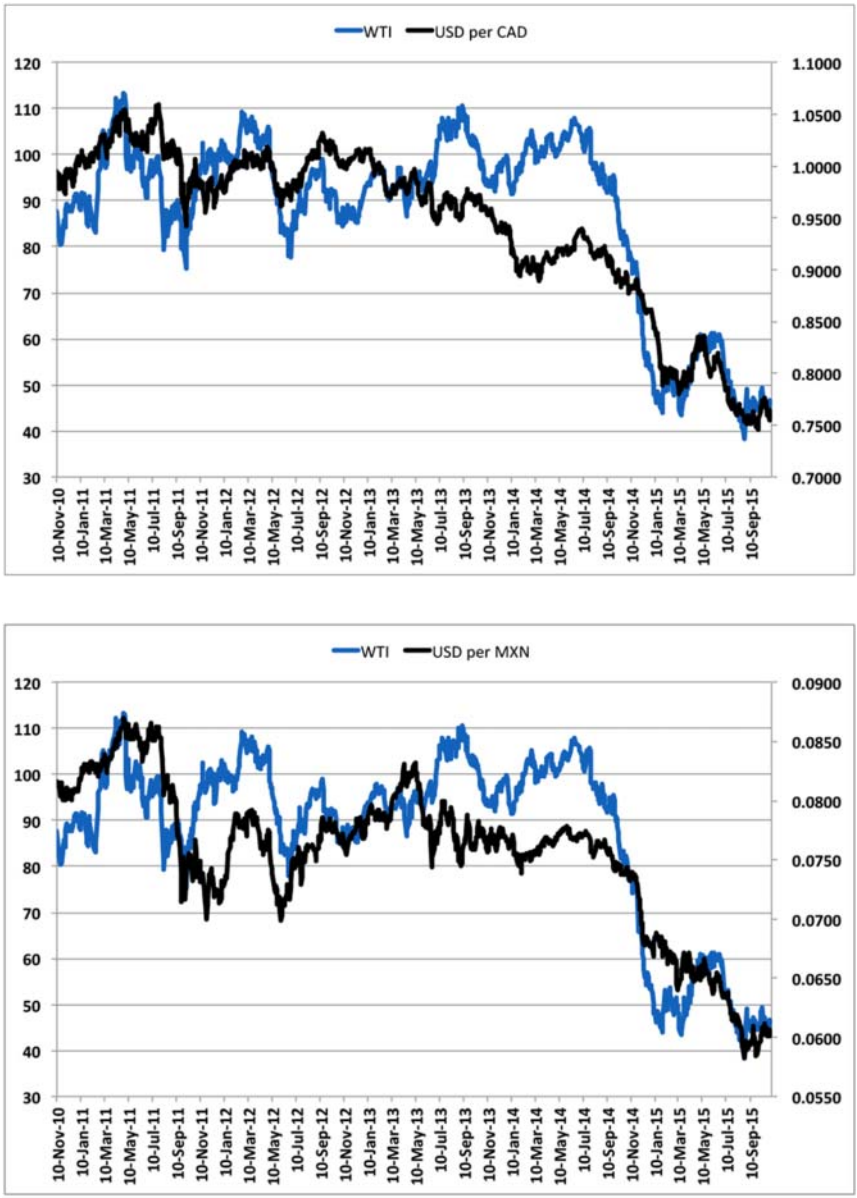

Figure 15.1 Commodity currency charts
SOURCE: Bija Advisors.

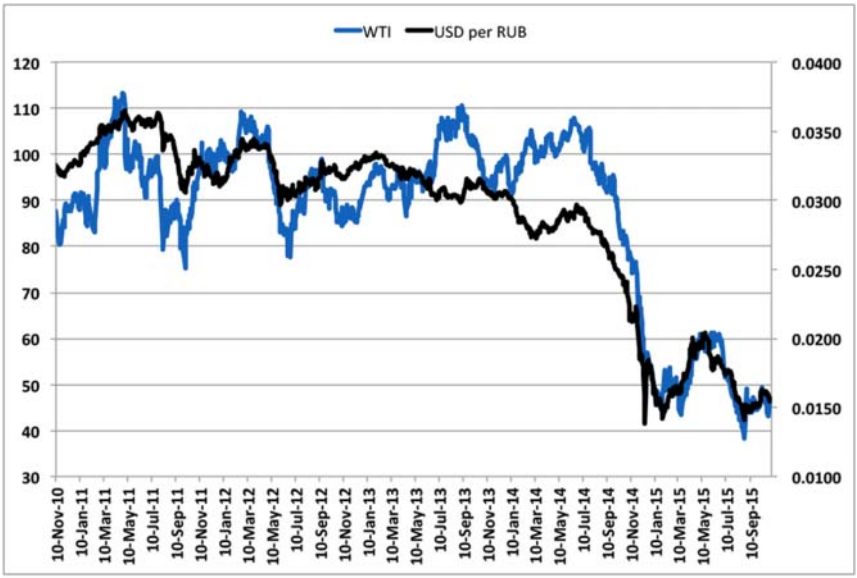

Figure 15.1 (*Continued*)

There are a couple of key issues we are dealing with here. First, you have to not only get your view on oil right, but you also have to do so both in the long run and the short. Second, the commodity currency must also be highly correlated not just in the long run but in the short run as well. That last aspect is made all the more significant when markets become more volatile as they have been recently.

Before I detail how difficult a task this is, and particularly just how much more difficult you have made it for yourself by using what is essentially a derivative instrument, let's take a look at a classic study from cognitive psychology published by Kahneman and Tversky in 1983 that can provide some perspective. It's called The Linda Problem.

Linda is 31 years old, single, outspoken, and very bright. She majored in philosophy. As a student, she was deeply concerned with issues of discrimination and social injustice, and also participated in antinuclear demonstrations.

Rank the following from most to least likely to be true:

A. Linda is a teacher in elementary school.
B. Linda works in a bookstore and takes yoga classes.
C. Linda is active in the feminist movement.
D. Linda is a psychiatric social worker.
E. Linda is a member of the League of Women Voters.
F. Linda is a bank teller.
G. Linda is an insurance salesperson.
H. Linda is a bank teller and is active in the feminist movement.

Eighty-five percent of respondents ranked H as more likely than F which is statistically impossible. At best, they could be equally likely, but that would mean that every single female bank teller is active in the feminist movement.

What Kahneman and Tversky were attempting to exhibit is an inherent flaw in our judgment called Representative Conjunction Fallacy. It combines the representative heuristic (a fancy term for mental shortcut), wherein we note some key characteristic of someone or something, and elevate its importance well beyond its statistical significance. In Linda's case, most of us see the feminist label as highly representative of who she is, whereas the bank teller label is far less certain. Therefore, it's easier to see her as a feminist who happens to be a bank teller than simply being a bank teller.

It's a very similar leap that we make when we develop a bullish view on oil. Let's consider a few possible (and fictitious) reasons for our optimism on oil. Perhaps OPEC has made some comments reflecting their displeasure with the current low price level, consumption numbers have unexpectedly increased recently, or a pipeline project has been shutdown for fear that war is growing in one of the major oil production countries. (Note: This list is fictitious, created purely for the purpose of a hypothetical analysis.) These are all excellent reasons to tilt the odds in favor of higher rather than lower oil prices.

Given this information, rank the following from most to least likely to occur:

A. Oil goes up.
B. Oil and commodity currencies go up.
C. Commodity currencies go up.

When you imagine oil going higher it's difficult to imagine that Russia's economy and its currency not benefiting as well. Intuitively it makes sense, and when combined with the charts in Figure 15.1, it only serves to solidify that intuition. Still, let's dig a bit into the data just to confirm what we feel in our gut.

On a quarterly basis over a recent five-year period WTI crude oil has a 0.78 correlation to the Russian currency against the Dollar (RUB/USD) confirming what appeared obvious in the chart. So you might put on a short USD/long RUB position in anticipation of higher oil prices. Maybe we diversify a bit, going long CAD and MXN as well. In that moment, when we have a clear view and thoughtfully establish a position to express it, it's difficult to imagine how many different ways our P&L can diverge from the path of that vision. It seems almost unfathomable that oil could trade 20% stronger six months from now, yet we somehow lost money not just on these three positions, but on "hedges" that were established along the way. Unfortunately it happens all the time.

Very few investors have the investment time horizon and tolerance for pain they believe they do, and therein lies the real issue. You see, although the correlation between WTI and RUB is 0.78 on a quarterly basis, it is 0.65 on a monthly, 0.46 on a weekly and a mere 0.29 on a daily basis. Its R-Squared is 0.60 on a quarterly basis, but daily it's a minuscule 0.09.

Over the same five years WTI has gone up just 50% of the time on a daily, weekly, monthly, and quarterly horizon, but let's assume your timing is impeccable and you nail oil perfectly. Even when oil went up, RUB strengthened just 60% of the time, and yes, that includes quarterly snapshots. So, if we pretend that the data in Figure 15.1 represents roughly 1200 balls in a jar, with each of them painted one of four colors representing WTI up/RUB up, WTI up/RUB down, WTI down/RUB up, and WTI down/RUB down, the probability of you drawing one that represents your perfect scenario is just 30%.

Perhaps you're thinking, "that's not bad." Fair enough. Now consider that so far we have only been concerned with the matching of direction. How *far* they diverge when going in opposite directions is also significant, both to your P&L and your emotions, especially when markets become more volatile. Let's say they suddenly diverge by

5%, 10%, or even 20% in a given week, which they have done several times. All these positions that are "highly correlated" suddenly don't feel that way. So you improvise. With commodity currencies down 15% and a big event on the horizon for oil, perhaps you buy some short-term oil puts to protect against things getting even worse for your portfolio. After all, if oil rallies your currency positions are likely to reverse more than making up for the loss of premium. Then, oil rallies, you take a deep sigh of relief, write off the premium, and look forward to better days ahead. The option expires and the currencies sink again. Finally, exhausted from the markets not making sense, you call it quits and stop out of all the related positions. That's when the currencies play catch up and in the end, as Figure 15.1 appear to show, it all winds up exactly as you had anticipated, only without the profits to show for it.

Consider one more data point for this highly correlated pair. On a quarterly basis, the beta of RUB to WTI is 0.56. When WTI goes up, the beta is 0.44, and when WTI goes down, it is 0.87, or roughly two times greater, making it a tricky play for relative value enthusiasts.

It's difficult when you're focusing on one driver, like oil in this case, to recognize that there are other significant factors to consider at the same time. For instance, while Mexico is a major player in the oil industry, roughly 80% of its economy is tied to the United States. So, if you were instead focused on the US economy and predicting a sizable decline in economic activity, you might short MXN as a high beta play on that view, while ignoring other factors like oil. Yes, cognitive science has a name for that too called availability bias.

The reason I bring this up is that many long/short equity managers are struggling for this exact reason. Correlations that continue to hold up over a quarterly or annual basis are either breaking down in the short run, or even when reflecting the same short-term correlations, because of the spike in volatility, those low correlations have become much more painful, often too painful to ride out. *That* is how you can get your view right while losing money. The best defense is a more proactive, evidence-based approach to position structuring, portfolio construction, and risk management.

I Knew It!

I unwound a trade called JPY1. As I described it to my clients:

> With US & Japanese policy and economic expectations at opposite extremes, this trade is a way to express a different opinion. If our view is correct, either US expectations will be dampened or Japan's picture seen as improving relative to expectations, either of which has the potential to break technical support around 116.00. If it gets through, there is little between it and 100. We are looking to play that break and compound the returns through the development of a long vega position with downside skew, all of which is currently trading near the long-term lows. A combination of spot, skew, and implied vols all moving in favor of this trade provides great potential for leveraging the underlying idea. It's this combination of inputs at relatively attractive levels that makes the position particularly compelling. If all factors come together in an optimistic fashion, this trade has the potential for a 10-to-1 return. That potential, along with numerous other very attractive outcomes (based on a far more mundane repricing of implied vols, skew, and/or spot), is what drew our attention.

So far, it hadn't hit any reassessment triggers and everything was going according to plan. Volatility, skew, and spot were all moving in the right direction and all for the reasons I had laid out in the trade write-up. For the unwind this was my thinking:

> I decided to err on the conservative side. Having had an opportunity to add to the position at 120 as planned. Everything had very rapidly moved in all components (risk reversal, volatility, and spot FX) and with the key 116 level having broken faster than expected. After only 25 days in the trade risking 150bp, the return is now 145bp. Will look to re-enter on a pullback.

Clients sent emails congratulating and thanking me for the idea.

In the minutes that followed the unwind and hitting send on the email, spot ticked higher, leading one subscriber to remark on my "uncanny timing." I, however, wasn't so sure and it showed in my response. "Only time will tell." I'll admit, it was a relief to see it go higher, for I had gone against my plan and taken profit early. I wanted to be vindicated for that decision. I wanted to be right.

Between coaching sessions, my eyes would glance over at the Bloomberg monitors. As the close approached, spot began the next leg of its descent and didn't look back. Regret kicked in. "I knew it!" shouted my inner voice. Not only had spot continued to move toward my initial target, but so too did implied volatility and skew. Rather than being up 145 bps on the trade I'd be showing a 228 bps profit, and every reason for entering the trade remained intact. "I knew it!"

Truth is, I didn't *know* it. If I did I'd still be in the trade. Yes, I believed the odds were in favor of doing this trade when I initiated it. At that moment, particularly when I doubled up after the BoJ policy decision, I received plenty of push back. It was a clear case of WYSIATI (What You See Is All There Is), which, at that time, were negative rates for Japan.

Well, it's a similar phenomenon that occurs now, only in this case it's called hindsight bias. It's difficult to see how the past 24 hours could have played out any other way, especially given my original write-up. It's all right there. Clearly, I *knew* this would happen. However, what's also there is my postmortem, the explanation for why I unwound it when I did.

Simply by writing that postmortem, I have helped myself overcome the regret I would likely feel in this moment. Thanks to an understanding of how our brains work I really did know that if things played out as they have that I would be experiencing regret in this moment. That postmortem was really a note to Steve of the future, letting him know that he *didn't* know this would happen. The reason that's so important is that it allows me to move on. It reminds me that this is but one trade of many that are available. Yes, I missed out on 83 bps, but this isn't the only trade out there. Literally billions of opportunities exist to make the next 83 basis points. I can either expend the limited mental effort I have

available to me laser focused on the one that got away, or I can search for more bait, put it on my line, and drop it back in the water.

Want to know how money is made and lost in this business? It's right here, in these moments. You either prepare for them ahead of time or suffer their consequences.

Stop-Loss Trade Entry

On June 12, 2015, I wrote the following:

> I remain bullish 30 year US Treasuries, but am of the opinion that they should be treated as a trading instrument until one to two months after the Fed raises rates, or it becomes apparent it is off the table. Use the taper tantrum period, when we saw rates ebb and flow around Fed meeting dates, but with an upward trend bias, as your guide.

Ideas like this are easier said than done. When stocks are rallying, we often hear people say, "If the S&P goes down to (insert level here), I will get very long." Then, when it gets to that level, the plan goes right out the window. Why? Because something will have happened to push it down to that level, something clearly negative for stocks. That's the part we rarely consider when devising the plan. The same lack of foresight also tends to occur when we reach our take-profit levels (what I call a *reassessment trigger*).

Here is an actual response from a very experienced portfolio manager I coached a few years back when I inquired about his lack of action when a trade hit his predefined take-profit.

> Portfolio manager: "1336 reassesment trigger is here, but given weakness in Asia, sovereign spreads in Europe, political uncertainty in Europe, monetary policy paralysis in US (as it currently looks), I'm not really inclined to take trade off, more tempted to add to position on break, looking for 1300 initially. I'll update sheet if needed when in office (going to see a show)."

> Me: "No opinion re: the 1336 level being right or wrong, but I will say its unlikely you would have hit your reassessment trigger on a bearish S&P trade without some bearish news getting you there."

What I'm trying to explain to the portfolio manager is when you were nonemotional, not impacted by your P&L and confirmations around you, you planned this level for a reason. Listing the facts that got us to this point is only explaining the move to here. This is what you were looking for, for the reasons you were expecting. You didn't expect the S&P to fall to this level for no reason. Why change your plan because you were right?

He ended up unwinding at 1367, his new stop-loss reassessment trigger. Still think this job is all about having the right view?

Easy Money

> *Make the hard trade, not the easy trade.*
>
> *– Paul Tudor Jones*

I have a confession to make. I like the easy trades, the obvious stuff. My trades are structured to provide a wide range of profitability and an extended period of time to be right. It's very rare for me to ride a move all the way to the very end. Instead, I prefer to play the meaty part, and then move on. Many times, after presenting a new trade to colleagues in an investment committee meeting, I've heard, "Well that's not rocket science," in response. That's when I know I'm on to something. It's always baffled me why so many professional investors constantly try to thread the needle, both on the way in and on the way out. You see, my ego isn't tied up in being perceived as the smartest guy in the room. It's more concerned with the returns generated. I don't get attached to trades regardless of how compelling they might be. It's the investment process that is paramount to me.

Case in point, when USD/JPY reached the original targets identified in the trade called JPY1 back at the end of January 2016 (101.20 spot, −2.5 risk reversal, as shown in Figure 15.2), quite a few asked what

Figure 15.2 USD/JPY spot
SOURCE: Bija Advisors.

I thought about the currency pair. The simple answer was not much. Opportunity exists at the extremes, not in the middle. All the factors that made it a compelling trade at the end of January had been resolved. Spot was at the top of the range. By June, when the question was being asked, it was in the middle. When the trade was established risk reversals (skew) had been very low relative to the norm, especially given where spot was trading. By June, they were back up. Implied vols had been trading near the lows at trade initiation, but not in June. It was the combination of heavily skewed expectations based on what I believed to be a flawed analysis of the macro picture, particularly as it related to the United States versus Japan, along with market prices that underweighted the possibility that the prevailing view could be wrong, which created

the opportunity. In other words, the fact that so few thought USD/JPY lower was even a remote possibility was reflected in the price. The trade was attractive given that I believed a big move lower in USD/JPY was a high probability. None of what made it attractive to me back then was in play when everyone was inquiring about my opinion in June.

Here's the thing about big contrarian calls like this one, people tend to become attached to them. For many, it's difficult to walk away, to stop talking and thinking about it, because it is the narrative to which they become attached. Narratives can morph if they aren't prescripted, making it difficult to know when they end. However, if you treat it as simply another expression of a view, one with gradually diminishing risk/reward attractiveness, with specific and finite expectations, it is easy to leave it behind when they are triggered.

Positive Expectancy

For quite some time I was very vocal about my oil view. I believed it would take a tremendous spike in demand for it to stay above $50 for any length of time, and given how every country in the world had been struggling to stimulate demand of any kind for years, I just didn't see that happening anytime soon. Some read that and draw the conclusion that I thought oil was going down. That's how our brains work. We tend to think in terms of binary outcomes. Yes or no. Black or white. Up or down. Spike or collapse. We spend far more time talking about the extremes all while muddling through gray "maybes" right in the middle.

One of my clients shared my oil view but for weeks was having trouble putting on a trade to express it. In considering different possibilities, he would inevitably begin with a put on oil and then explore different ways to offset, or at least reduce, the cost. He kept coming to the conclusion that implied volatility was too high.

For nonoption traders, volatility is the key determinant of options pricing. Essentially, implied volatility is the market expectation of how much the market will move or the uncertainty. Realized volatility is how much it actually did move. What the client is saying here is that the market is pricing oil to move too much to be able to buy an option

on oil falling. An option is buying for a set price (or selling) the right, not the obligation, to buy or sell something (in this case oil) at a set price in the future.

For example, oil is at 60, you can buy the option giving you the right to sell oil at 50 for a price (based on the implied volatility). If oil is below 50, you can sell at 50 and hold that short or cover it at the current market rate. Your profit is 50 minus the current price of oil. Also minus the cost you paid for that option. If oil is above 50, you lose what you paid. You cannot lose more. When buying options this means your worst-case outcome is known going in. If you sell an option, you are paid upfront and someone has the right, in this case to sell you oil at 50 dollars, regardless of the current price.

If this approach sounds rational, it's because that's how we are programmed to think about markets and positioning. I mean, when was the last time you heard an analyst come to your office or a talking head on TV say, "I think Company XYZ will just sit right here." Maybe once, because they'd never be invited back. Consider a probability distribution (Figure 15.3). You'd be hard pressed to find one that isn't heavily weighted toward the center, anticipating no change. Yet, because of the way information is presented to us and because most investment instruments require movement in order to generate returns, our first instinct is to position for a directional shift. Even in the case where the trader's view was that oil would not go higher, the first thought was to position for it to go lower. They are not synonymous. It was a mistake, but not the only one.

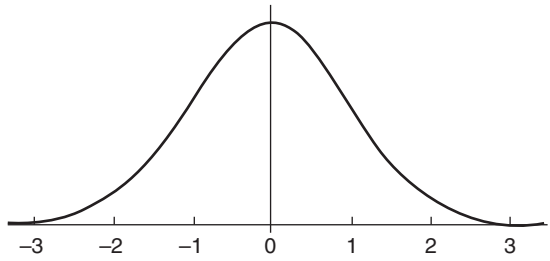

Figure 15.3 Probability distribution

Given that the trader believed that implied vols were too high, spot was trading at $50, and the trader thought it unlikely that it could stay above there for very long, the best expression of the trader's view would involve selling volatility and betting that it wouldn't go much above $50 for any length of time. The simplest expression of that would be the sale of a European digital call. To review, a European digital call option is an exotic, but relatively simple, option. It involves a fixed payout of 100% of notional if the price is above the strike on the day of expiration. The seller would receive a proportion of the notional amount up front as a premium. If spot finishes below the strike, they keep that premium and the option expires worthless. Typically, the premium is roughly equivalent to the delta of a plain vanilla option with the same strike. If the seller were to sell a European digital call option struck at $50, it would likely be priced around 50% of payout, reflecting the 50/50 odds of it being above versus below $50 at expiration. However, selling that wouldn't take advantage of what he believed to be high implied vols. To do that, he could either look to sell a 35-delta strike or a simple call spread, say, selling a $50 call versus buying a $55 call. Both trades have predefined, limited downside, and both are short volatility and profit if spot doesn't rise above $50 for an extended period of time. There's one problem with both of them though, they don't adhere to the misguided, yet generally accepted principle regarding risk/reward, similar to that proposed by Paul Tudor Jones.

My client immediately rejected the idea to sell the 35 delta equivalent European digital call (struck at 55). Why? Well, it would mean risking 65% in the hope of making just 35%, and who in their right mind would do that? Not many investors, but why not? Knowing the payoff is only part of the equation. If the payoff was all that mattered we should just have Powerball tickets in the portfolio. In order to judge whether it's a good investment we need to know the investor's expectations. In other words, the probabilities he or she assigns to the different outcomes. In this case, the investor believed there was just a 25% chance that oil would rise above $55 and an even lower probability it would remain there until expiration. The expected return on the trade is therefore $(0.75 \times 35) + (0.25 \times -65) = +10$. Given the investor's expectations, that's a trade that should be done.

Three Key Reasons Investors Should Use Options but Rarely Do

I began trading options early in my career, and they have been an integral part of my DNA ever since. Whether as a market maker, prop trader, portfolio manager or CIO, I have always expressed every view through options, with a particular penchant for exotics. When it comes down to it, I believe there are three separate and distinct reasons to intelligently employ options. First, they are an excellent tool for helping us to overcome cognitive biases, including inertia and emotional attachment, by forcing a level of discipline we can rarely attain on our own. Second, they enable investors to express a view while protecting against the black swan event. Finally, they offer a way to isolate very specific expectations, both individually and in combination, creating a leveraged means by which to capitalize on or protect against them. If you do it right, you can combine all three benefits in one beautifully crafted position. Let's explore all three in some detail, with specific examples.

1. A Tool for Avoiding Cognitive Bias

Recently, one of my coaching clients was grappling with whether he should unwind a long equity position after it had experienced a far bigger drop than anticipated. Like many portfolio managers, he doesn't typically employ hard stops but rather gathers information as a trade progresses and depends on his experience to dictate when to exit. It's a very common approach, but one that leaves you vulnerable to a number of powerful, and potentially debilitating, cognitive biases. In this case, he was concerned that he'd be selling at the lows, effectively getting out when he should be doubling up. He feared the potential for regret.

Over the coming weeks he continued to take a beating on the position. Every step of the way, the potential opportunity cost weighed on his psyche far more than the accumulation of real losses. Each call ended with him acknowledging that the right decision was to unwind the position and to move on to finding more predictable opportunities, only to begin the next session with, "I should have listened to you."

Two weeks in to the trade a narrative developed concerning the company's earnings announcement which were due to be announced in one week. My solution was to convert the long into a call position representing the same number of shares using options that would expire in two months. I didn't make the suggestion because implied vols were cheap, but because it was the only way to help him overcome his inertia bias. In essence, I was weening him off the position. The rationale went like this: if the stock continued to collapse, the loss for the strategy would be finite, so the bleeding would end and he could move on to opportunities that presented better odds of success going forward. If the stock jumped back up on the back of the earnings announcement he could capitalize on it thereby resolving his fear of potential regret. If the announcement turned out to be a non-event, he could sell out the options before decay became an issue. (In effect, the pending time decay would serve as the "unbalanced force" needed to break the inertia.) As it happened the stock continued to plummet, and although the option was quickly worthless, it saved him millions in P&L, putting the emotional trauma to rest and allowing him to move on to better opportunities.

Postscript: A month later, largely as a matter of luck, a positive announcement came out that pushed the stock back up to where he'd first swapped into the options, allowing him to recoup half his premium. I say *largely* because this potentiality was a factor in choosing the two-month expiration rather than a shorter horizon.

2. Black Swan Protection

No matter how much research we do, how many possible scenarios we explore, we simply cannot anticipate every possibility, nor can we fathom just how ferocious a move can be ahead of time. By positioning with options, we can express almost any view while limiting the maximum possible downside to a predefined limit. By employing exotic options, you could go so far as to sell volatility in a currency and still limit your loss to the same amount whether it winds up moving 5% or 150%. In fact, Nassim Taleb concluded from the research that went into his book, *The Black Swan*, that you should build a portfolio exclusively betting on black swan events. Taleb concluded that black swan events were

underpriced and you should buy options that express them. Instead, I take his lesson as never sell black swan options, but relying on buying them is not part of my process. You can't predict black swans so never be short them.

As an example, in July 2012, corn had exploded on the back of the 50-year drought. I saw this as an opportunity to express my bearish view on commodities. To simply go short corn at a time when it was in uncharted territory was too risky for my taste. Instead, I went short via put options. By fixing my risk to the premium paid, while allowing me to position for what I believed was a very likely event, I could effectively ride the train without getting run over (i.e., without exposing my portfolio to great risk). As someone who has traded emerging markets for more than 20 years, this approach has served me well during more than a few crises.

There is a huge benefit to this strategy, particularly in this situation, which often goes unnoticed. You see, if I had simply gone short and spot jumped, it is likely that I, like so many others, would have been spooked by the move. In response, I would have been "disciplined" enough to stop out quickly. When it started to come back off, I'd likely have been tempted to reenter, only to be taken out again with another "disciplined" tight stop. By the time it made its big move lower, yes, I probably could have participated, but I'd first have to make up for all the previous little losses before showing a profit. Just as importantly, by using options, I avoided the emotional trauma along the way which allowed me to participate in other opportunities as they presented themselves in the meantime.

3. Expressing Views with Pinpoint Accuracy for Maximum Leverage

Purchasing and selling plain vanilla puts and calls to express a directional view in the underlying is one way to use options, but it isn't where their true power exists. Options are merely an instrument for expressing a view. The simpler your view, the fewer the benefits options offer, and vice versa. Let's say, for instance, you believe EUR/USD is headed lower, but you haven't developed any specific expectations for how much lower, how long it will take for the move to begin, how rapidly it will happen,

what will happen to implied volatility if it does, what role interest rates will play, what alternative outcomes might look like, or what the odds of the different scenarios playing out might be. In this case you have a fairly undeveloped view which can be expressed with any number of unsophisticated instruments. However, if you have taken the extra time and effort to fully develop your expectations, options can be a phenomenal tool to help you maximize your return on that investment of time and effort.

Let's take the example of USD/SAR (US dollar versus Saudi Arabian riyal) from back in June 2015. At the time, I put out SAR1, a trade I structured to express my view on the currency pair. I wasn't alone when I got involved, but the structure I chose was very different from those selected by most other market participants. USD/SAR is a pegged currency which explains why it typically trades at a very low implied volatility of roughly 1.0%. Anytime tensions flair up in the region or oil takes a beating, market participants who don't normally play in the currency take notice of the low vol and see it as a "cheap punt," just in case they were to let the peg go. These are the moments guys like me live for, when the uninitiated come to play in our sandbox.

Having seen this happen numerous times over the last 20 years or so I began setting my expectations. First, I was looking to capitalize on what I call the "meaty" part of the trade while ignoring the aspect that would likely become the focus of blogs and research reports catering to the speculators. In other words, I wasn't looking to benefit from the peg breaking, but rather from a modest repricing of that potential event. At the same time, if I could position in such a way that I could also benefit if it didn't break – and even if it broke in the opposite direction of the expectations – then I could put far more capital behind the idea. This last aspect is where my structure differed. Most were playing for the expectation that the Saudi authorities would be forced to let the Riyal devalue. What made the bet particularly appealing was that the implied vols were so low. So, even if the probability of the peg breaking was low, the potential payoff from an explosive move made the position interesting for them. Understanding this point is important, for it lies at the heart of the difference between how I chose to position and how most others did.

If you are betting on an event that has little chance of occurring, you will wisely risk a relatively small amount on the position. Since you are betting a small amount, the only way the trade is worth having is if the potential payoff relative to that bet is very large. Therefore, traders were looking for options that were heavily biased directionally, so they could cheapen the premium as much as possible, thereby creating a highly leveraged position. In order for it to pay off commensurately they needed an explosive move in spot, forwards and/or implied vols. A combination of all three would provide the mother lode. Understandably, most opted for the low delta USD call/SAR put.

Instead of betting a small amount in the hopes of an explosive, low probability event, I sought out a structure where I would be willing to apply a significant amount of capital, but with a high probability of benefitting from a modest repricing of risk and even in the absence of that, at least recouping my premium. I chose to purchase a one-year at-the-money forward straddle. The reason is that the forwards had already increased in price, but the implied vols were still near their lows. That is what made the USD puts an essential part of the trade.

By purchasing the combination of calls and puts, if nothing happened, i.e. the peg remained in place, the carry earned on the USD put was so great, it actually paid for the full straddle premium. Since I was primarily interested in benefiting from an increase in implied volatility (vega), it didn't really matter whether I owned calls or puts. Finally, it was helpful to know that in a previous episode when the Saudi authorities were pressured to devalue, they actually surprised all the speculators by first revaluing, before finally allowing it to devalue. If that were to happen again, it would have proven to be of huge benefit to me, while everyone else would have suffered. By structuring to benefit from the three most likely outcomes, while losing in only the most extremely unlikely event, I could invest a significant amount of capital in the idea. As a result, I only needed a mild repricing to benefit greatly, which is what happened.

In effect, I had combined all three of these reasons to use options into one simple yet elegant solution. The result was a 540 basis point return to the portfolio after just four days in the trade, while avoiding any sleepless nights.