Edward O. Thorp

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by Jeffrey Saut

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I was talking to my friend, and 60-year stock market veteran, Jim Rivenes (Raymond James) last week and somehow, we got on the subject about Edward Thorp an individual Jim use to have as a client. It reminded me of a report I wrote in 2005. I like this report.

The ultimate dream of market mavens is discovering a method that predicts the price movement of the major common stocks such as the 30 Dow Jones Industrials. Obviously, such a system could not make the perfect prediction, could not be 100% right all the time. But there have been prediction methods exploiting price discrepancies that gave investors an edge of perhaps 20-25% or more a year.

For instance, back in the 1960s, Edward O. Thorp, onetime university professor and mathematical whiz, discovered a hedging system for all kinds of convertible securities and their related common stocks that produced an average yearly gain of 25% for five years. According to 25iq:

"Edward O Thorp is the author of Beat the Dealer, which was the first book to prove mathematically that blackjack could be beaten by card counting, and Beat the Market, which showed how warrant option markets could be priced and beaten. He also was the co-inventor of the first wearable computer along with Claude Shannon. Thorp also pioneered the use of quantitative investment techniques in the financial markets (Option Arbitrage, Warrant Modeling, Convertible Arbitrage, Index Arbitrage and Statistical Arbitrage)."

But guess what? When he tried to interest wealthy investors in his scientific system for stock market profits, he ran into either rampant skepticism and/or an attitude that they would rather do it themselves. As written in the book: "One oil baron with an income of more than $1 million a year . . . was not excited when he learned that we were making 25% a year in the market. Suspecting the reason, one of us questioned him closely and learned he expected to earn 50% on his assets in the coming year. All his funds were committed to his oil business and he was hungrily seeking more cash. It was more profitable for him to invest his money himself.

One of our millionaire friends saw his equity in the market shrink from $1 million to $400,000 during the 1966 crash. He then invested $20,000 with us. After he got a glimmer of the method from the trade slips, he commented that it was a 'sure thing'. He accepted our estimate that it would most probably take about four or five years to expand his $400,000 to $1 million again.

This was too slow for him. In his heart he believed that this market which had so quickly sliced his $1 million to $400,000 would just as quickly give it back again. He was not the owner now of a mere $400,000, but rather of $1 million that was whimsically imprisoned and that must soon be returned to him. To get his $1 million back he would have to invest his money himself, presumably by the same amazing methods that had recently been so costly.

We knew that he wondered how our abstract 'system' could produce better profits than his investments. The investments which dealt him such rapid, enormous losses were recommended by close friends on the inside of companies. Those tipsters assured him that they too had lost temporarily. But they were investing even more now that prices had fallen to such bargain levels. When prices rebounded soon, all losses would be wiped out, the originally expected profits would be realized, and the extra investments made at bargain prices would yield a fortune. Yes, he would rather do it himself."

Beat The Market, by Edward O. Thorp & Sheen T. Kassouf

Now don't get excited and start searching for the Edward O. Thorp Fund, because there isn't one. He has since left the business after beating the market and averaging 19.5% per year from 1969 through June 1998 versus 9.8% for the D-J Industrial Average. Why? Well, initially, Thorp was way ahead of everybody else and was the ultimate in trying to get rid 2 of risk. But he admitted upon retiring, "The ideas have spread, so that the lowest-cost producers are those that can operate the most profitably. They are the large private partnerships that can hold down expenses because they do their own clearing and trading." "So," Jeff, "What's your point?"

Well, we wanted to emphasize there are so many big pools of money reacting to the same information in a flash around the world that everything trades like a pork-belly contract. The program players, low-cost producers, the triple-witchers, the Chicago option-futures crowd, the institutions, et al have taken over the markets, making it more difficult for you and me to beat the market. Yet the main point we want to emphasize is to beware of the attitude that losses are temporary and the belief the market will quickly give those losses back. When you find yourself thinking that way, either your market method is wrong, and/or your emotions have taken over. That is when you are most vulnerable to even more mistakes and losses, trying desperately to get “your” money back! You must realize it is no longer yours. The market has it. And, you must regain your discipline and reexamine your market method that was so costly to you.

Having been there, we speak from experience. Our greatest losses, and our worst market frustrations, have been synonymous with the feelings that the market owed us our loss, and just as quickly as it took it, it would give it back. You must deal with reality. Realize all the sophisticated competition you face and strive for a disciplined approach that works for you. When you are down, try for risk-adverse “singles.” Don’t try and hit home runs or do anything exciting or brashly brilliant, because usually when you do, you end up losing even more. Sooner or later those singles will add up to sizeable gains. And then you can become more venturesome, knowing that your slow, disciplined approach will produce profits.

This is what we try to do at Capital Wealth Planning (CWP). We buy large-cap blue chip stocks with dividends and then strategically sell short-term out-of-the-money call options in an attempt to get index like returns with about two thirds of the stock market volatility while generating a 5% to 7% income distribution to our clients. Historically, CWP gets ~90% of the upside in the stock market with only 60/70% of the down side. For investors of my generation that are seeking reasonable returns, with diminished volatility and an income stream, CWP’s investment strategy is a great investment model.

As for the stock market, last Monday we wrote “Yes, the stock market is short-term overbought and there was a trader’s ‘sell signal’ on July 11 when, ‘Lowry’s Short-Term Index completed a drop of six or more points from its most recent high.’ Yet the Advance-Decline Line continues to make new all-time highs and our models are aligned to the upside. And, while our internal energy model is marginally lower from its recent energy peak there is still plenty of energy to carry stocks higher.” And with that, the S&P 500 (SPX/2976.61) peaked last Monday (7-15-19) at ~3017 and slid into Friday’s close of 2976.61. It was almost a forgone conclusion when the SPX broke below the 3000-support level the short-term trading target became 2960. Our work suggests stocks are still in a strong position to rally into year end. Further, the Russell 1000 Value Index has strengthened, Financials are acting much better with the slight steepening of the yield curve, Industrials continue to look good, and tech remains in a strong position. Last week on CNBC when asked about the Tech (particularly the FANGs) we said, “We do not understand the valuation metrices of the FANGs so we leave that to our friend Tom O’Halloran who is the best large-cap growth stock portfolio manager we know and who manages the Lord Abbett Growth Leaders Fund (LGLAX/$30.72). We have owned Tom’s fund for years.

The call for this week: Our firm, Capital Wealth Planning’s CEO (Kevin Simpson) and I are doing a system wide conference call on August 1, 2019 at 4:15 p.m. You can register for the call here (The call). As for us, last week was a non-linear upside consolidation with no real trend. To that point, we issued this Trading Flash on 7-15-19 (last Monday), “Despite today’s Dow 116-point decline this looks like merely an upside consolidation; and, a bullish one! Prices tagging new highs with NO real trend, is highly bullish.” While short-term traders can attempt to trade these “wiggles,” investors should not over-interpret such trading moves. This morning we are leaving for Berlin to see some portfolio managers and then speak at Steve Forbes’ Cruise for Investors. We will be gone for ten days. The Fed is now in a blackout period ahead of its July 30-31 FOMC meeting. So, it’s up to Team Trump and BoJ Chief Kuroda, who speaks today at the IMF in DC, to provide the verbal “horsepower” to rally stocks. As we write at 6:10 a.m. the preopening S&P 500 futures are better by some 8-points.

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