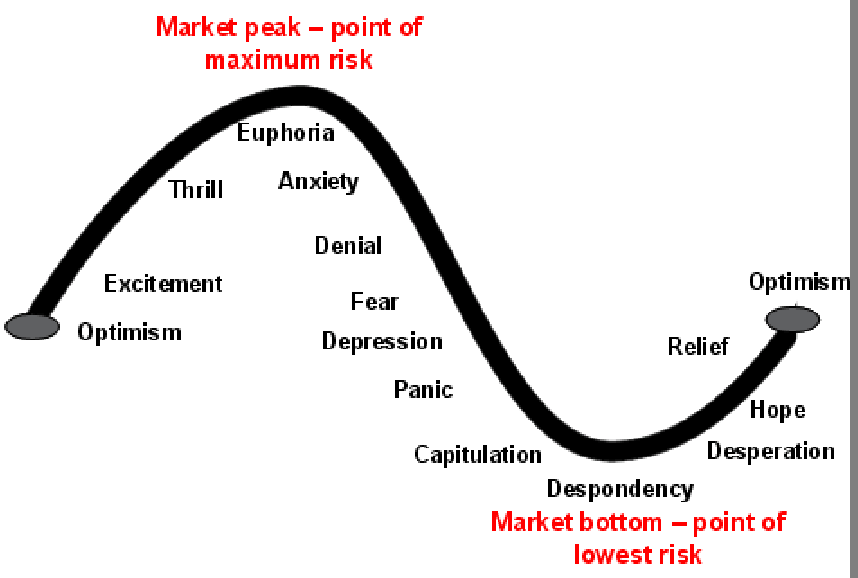
# The Search for Absolute Returns

**Mumbai**

**August 2013**

# The Need for Absolute Returns: The Perils of Volatility

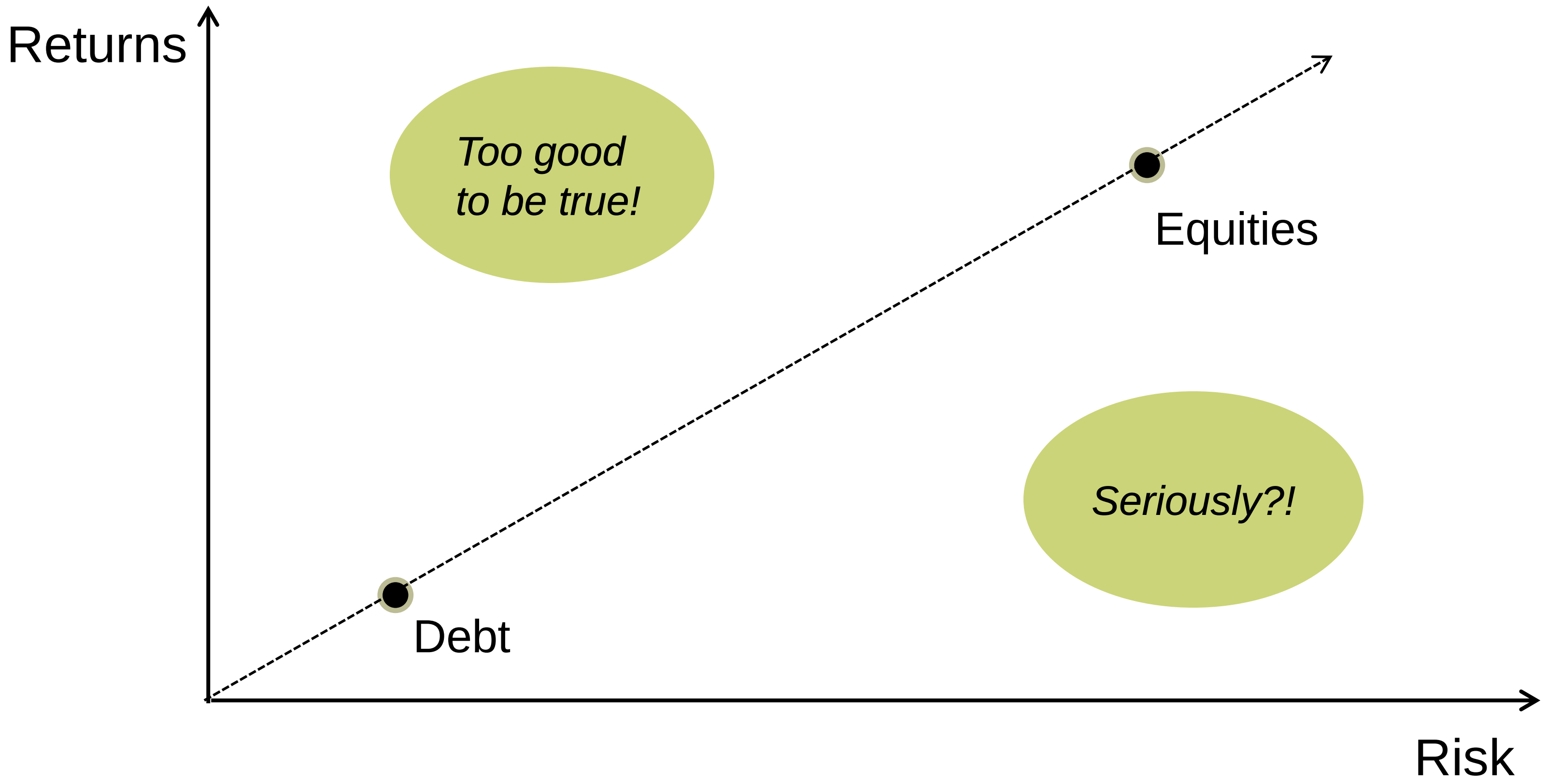



# The Economists and the 100 Rupee Note

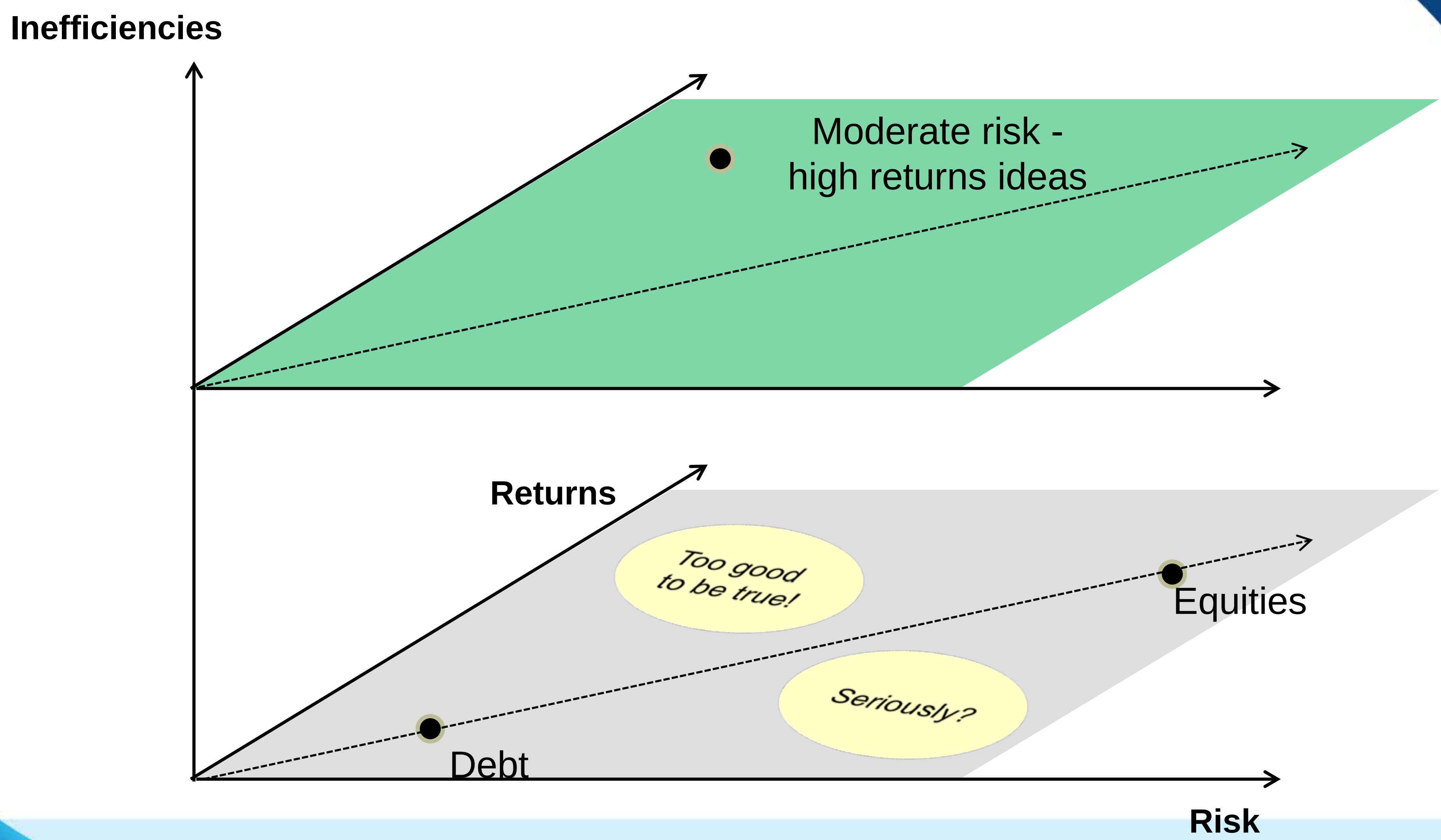
*Don’t bother to pick it up. If it were real, somebody would have taken it already.*

# The Conventional Paradigm of Risks and Returns

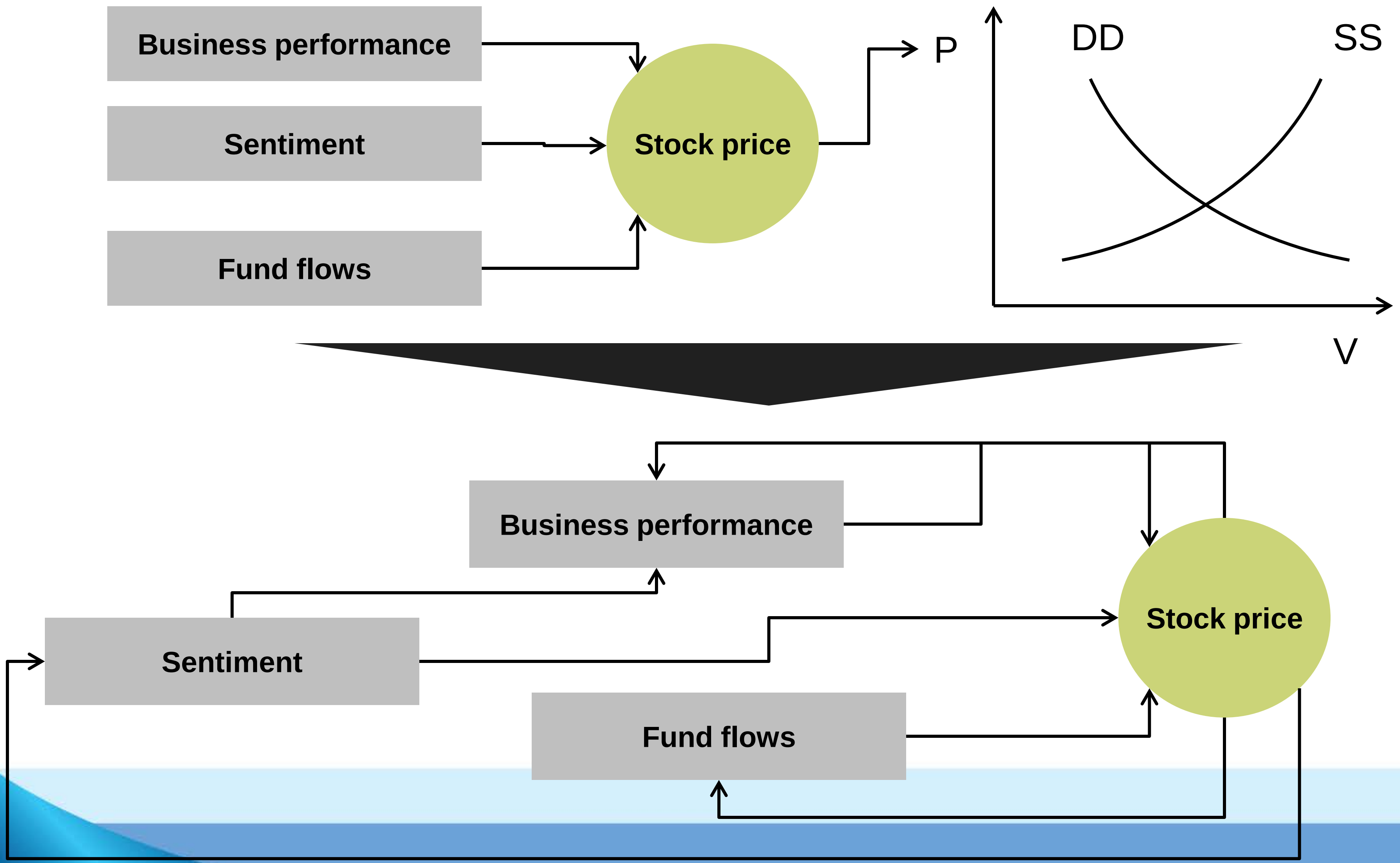
**Capital Asset Pricing Model: The 'Accepted' Wisdom on Risks and Returns**



# The Free Lunches
# (Or At Least Very Cheap Ones!)

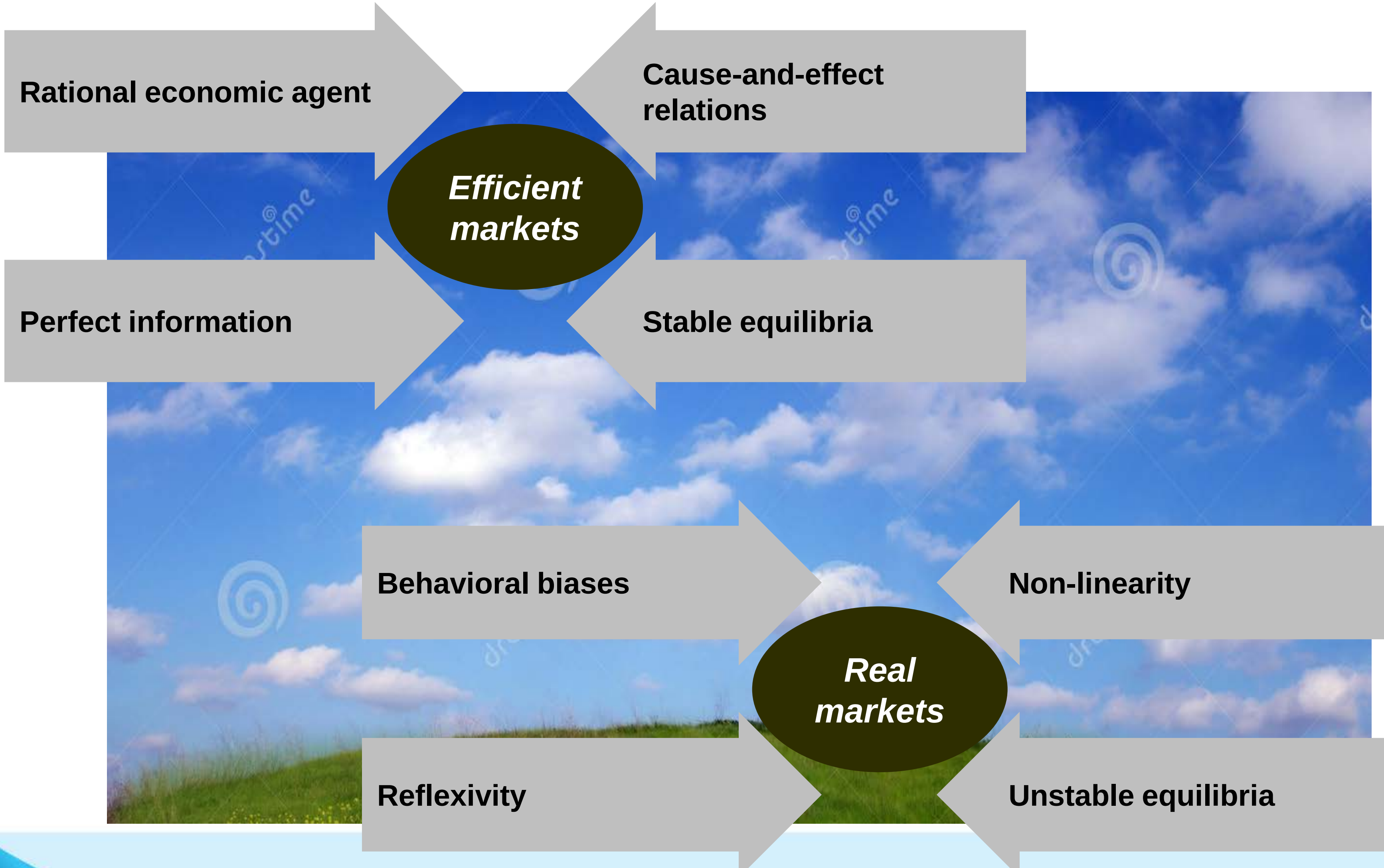


## Cause and Effect Vs. Reflexivity



KARVY CAPITAL

# Summary: From Efficient Markets to Real Markets



## Nature of the Signal

**Assume that you have a biased coin and are betting with an opponent**
**The bias of the coin is such that it is heads 60% of the times (instead of 50%)**

**For every correct bet, you win Rs. 1**
**For every wrong bet, you lose Rs. 1**

**You follow the strategy of betting only heads all the time.**

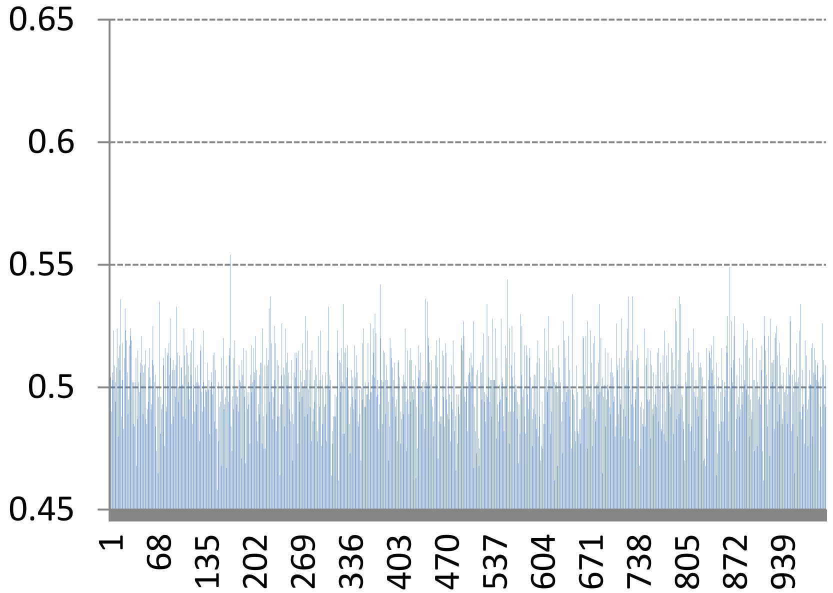
**You play the bet 1000 times.**

**What is your expectation of the final payoff?**

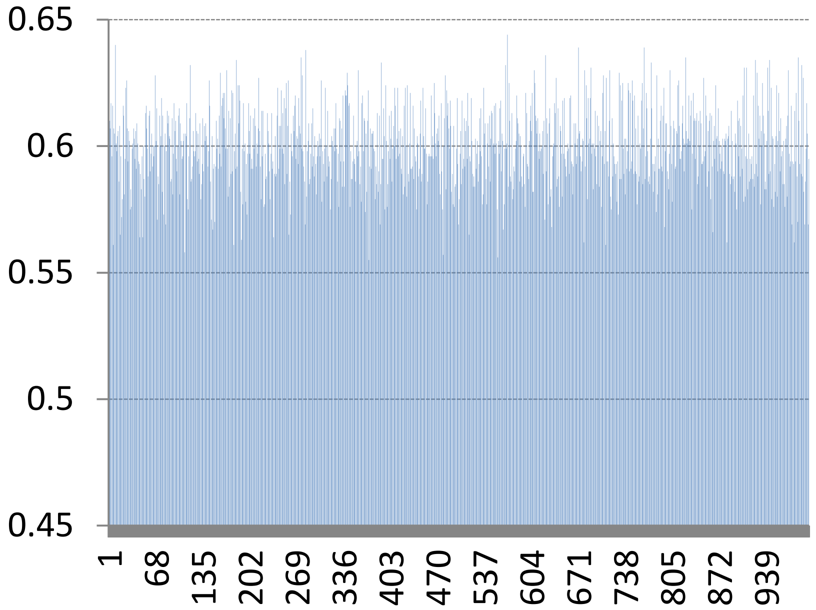
**If 1000 people played the above bet (each 1000 times), what is their expectation of the final payoff?**

# The Edge Based on Signal

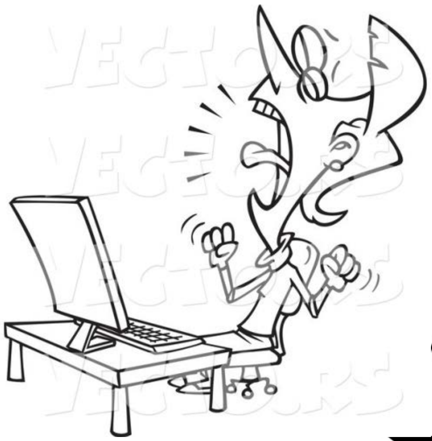
**Noise with no signal**



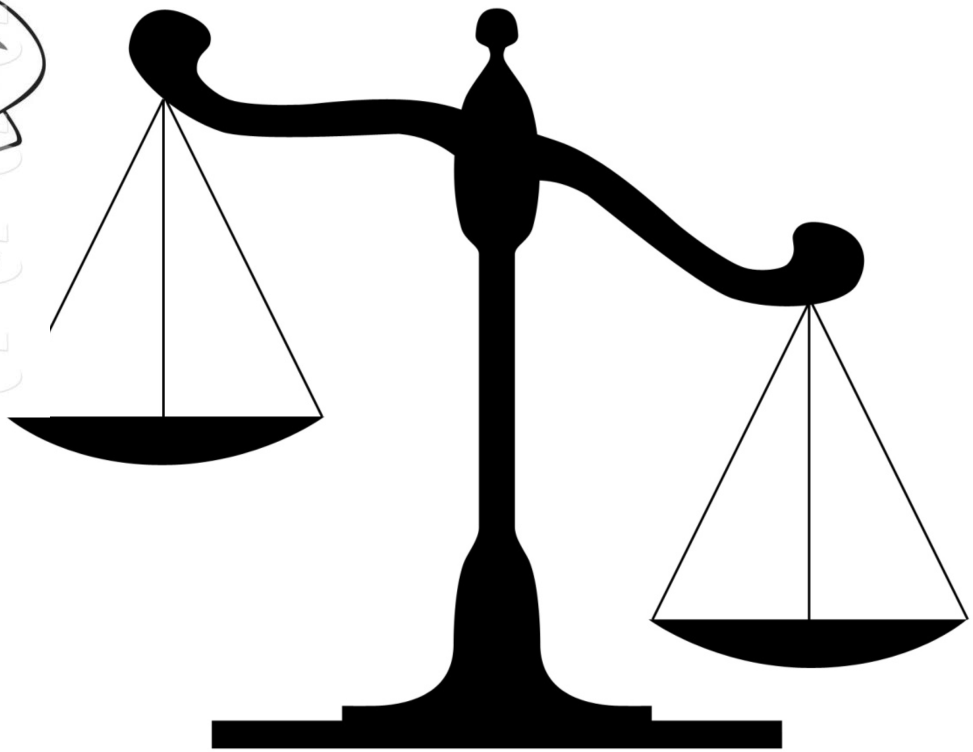

**Noise with some signal**

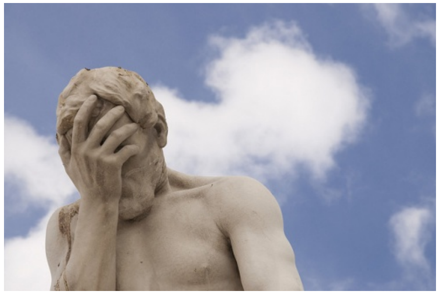


# 1. The Source: Regret Avoidance



Opportunity lost





Regret

# 2. Effect: Momentum in Falling Stocks (The Signal)

**Hypothesis: Securities falling in value will have a tendency to continue falling**

**Test: In the available data set, find out the prevalence of this behavior**

- **at various time horizons**
- **at various look-back periods for definition of "falling"**

**Parameters of interest**

1. **Content of information of the dataset**
2. **Nature of information – trending or mean reverting**
3. **Presence of momentum as measured by recurrence of 'runs'**

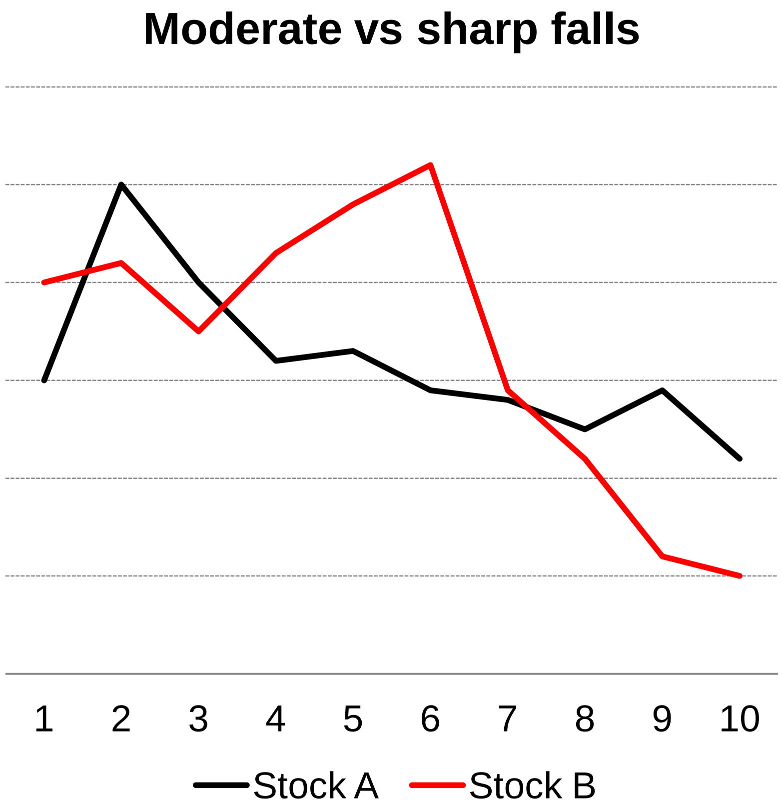
**Candidate data sets**

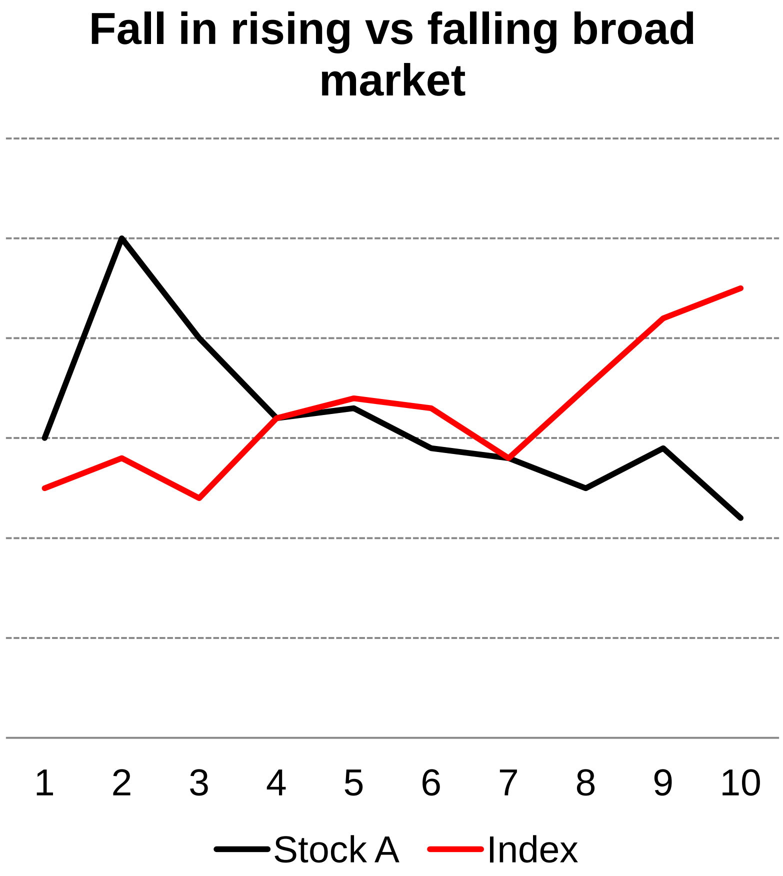
1. **Index data**
2. **Sector data**
3. **Stock data**

**Period of analysis**

1. **Last 3 years**
2. **Last 10 years**

# 3. But Not All Falling Stocks and Not in All Regimes (Refinement of Signal)



# Multiple Strategies Reduce Volatility

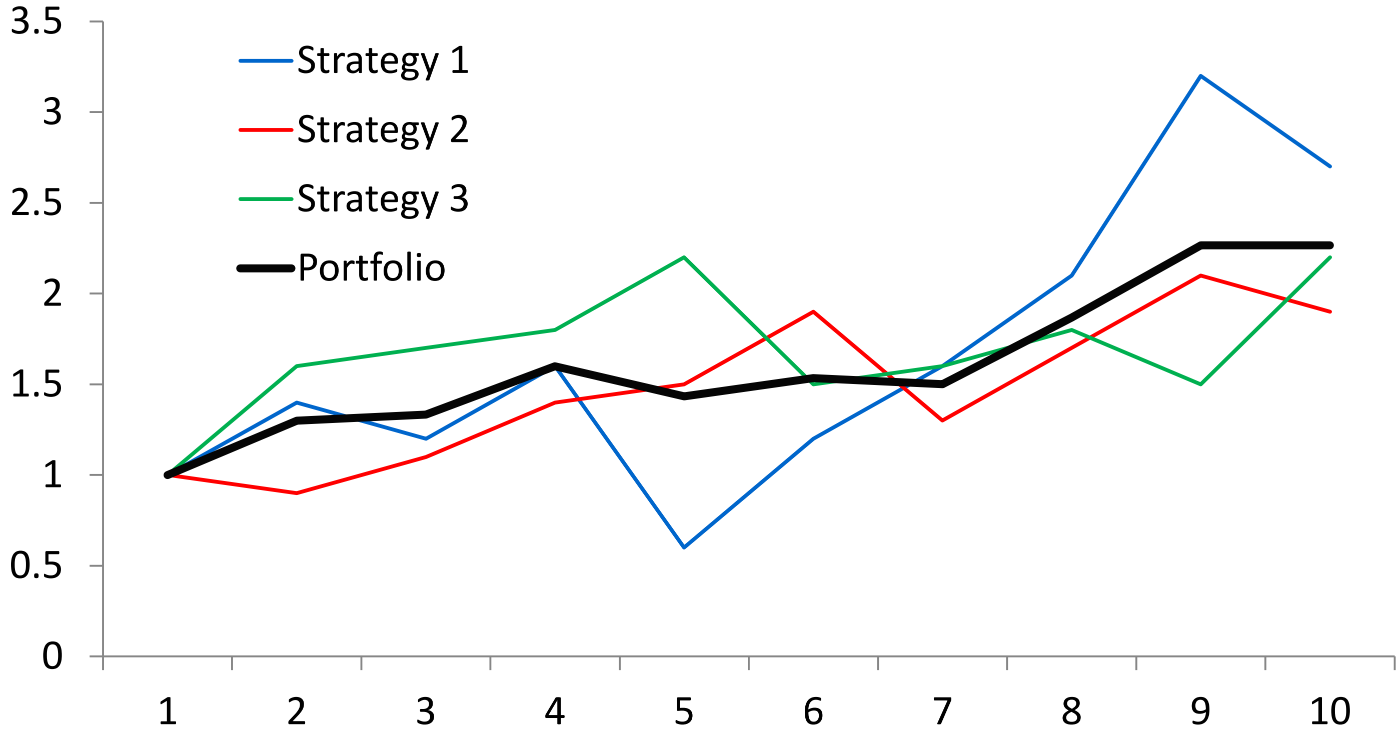



**Illustration of the stability of portfolio of strategies**

# Summary

- **Volatility is corrosive for long term wealth building – due to human biases**

- **Markets are inefficient – at least in pockets**

- **These inefficiencies can be exploited to generate absolute returns**

- **Doing so requires a rigorous and new approach**

*“It is not a case of choosing those faces that, to the best of one’s judgment, are really the prettiest, nor even those that average opinion genuinely thinks the prettiest. We have reached the third degree where we devote our intelligences to anticipating what average opinion expects the average opinion to be. And there are some, I believe, who practice the fourth, fifth and higher degrees.”*

- John Maynard Keynes

(General Theory of Employment, Interest and Money)

# Thank You!