Macro Hive: Trading Hacks – The One-Two Punch

(Thorsten Wegener, 26 May 2022)

'May you live in interesting times.' Often quoted as the Chinese Curse, its origin is dubious. One theory suggests it just might have originated not in China but with the Chamberlains of 'peace in our time' fame. Regardless, interesting times doubtless also hold the opportunity to profit from the ever-repeating patterns we tend to observe while trading financial assets. And one of those opportunities to make a fast buck, I call the 'one-two punch'.

The one-two punch is no elaborate fundamentally researched investment strategy. Nor does it rely on excessive number crunching or even in-depth macro analysis of global markets. However, it almost always works to generate good short-term gains with a reasonable risk-reward ratio. The only problem is it gives you the gut-wrenching feeling that you are doing something really, really wrong while setting it up, sure to lose your shirt, entering a trade so counterintuitive to every fibre of your positive, well-meaning soul.

So, What Is a 'One Two Punch?'

The thesis is simple. If a well-held stock gaps down after some horrific news event (perhaps disappointing earnings, subscriber numbers, guidance, or governance misjudgements), you do not accumulate into weakness. You short the bugger into the closing of the event day and close your position one day after the horror event.

To be on the safe side, the downside gap should be at least three standard deviations. The higher it is, the better your chances. If, for example, the daily trading range as indicated by implied or historical volatility is +/-3% and the earnings call after closing is, let us call it a rather subdued dive of -15%, the next trading day should give you the confidence to open a short position into the closing on day one and close it out per closing on day two.

The more brutal the initial punch is, the better. My personal favourites start with a -20% drop. They are rare. But when they occur, you want to drop those excel spread sheets and pay attention.

There are now two 'most likely' outcomes. On day two, the short candidate will close below the closing of day one. And it will do this to a far smaller magnitude than the initial hit it had to suffer. It is by no means a knockout combination, but it clearly has the potential to get our disappointing fighter on the ropes. What comes after that is anybody's guess. But by then, we have already left the arena to focus our attention on our day job and pick up those spread sheets again.

Why Does It Work?

There is a well-defined group of everybody's darlings in the average portfolio. That is especially so after a long bull run. Such markets are driven by favoured sector accumulation in a herd. And that mentality makes many investors feel impervious to the dangers every financial asset holds.

Management could not do wrong in the honeymoon phase. Market participants chose to ignore signs of nonsensical business plans, gross indecency or corporate insiders selling the bejesus out of their own company shares. And eventually, there is no way anymore to rationalize a grim reality away. As always, when that day comes, the stampede presents you with volatility – the kind mostly frowned on.

And once the lions have circled the herd, the fast, strong gazelles stage a breakout. That leaves the fatter, slower, and more self-delusional members of the herd behind. In our analogy, these laggards are the big pension funds, insurance money and retail customers, who are still contemplating what just happened.

Their rigorous investment process requires a thorough analysis of the sudden new informational paradigm. Additionally, finding a brave man or woman to make the call to stop the bleeding without group consent is often hard. So, while on day one after the event (punch one), meetings are convened, analysts shouted at, and senior managers dragged of the golf course, the setup is laid for punch two.

In my experience, the executors of the inevitable exit receive the order to 'get out' but lose no more money in the process. The 'two punch' is therefore somewhat weaker and more controlled. But it hurts nonetheless.

Jumping back to our gazelle analogy, the remaining herd finally decides to make a run after the edges of the herd have already been nibbled away. Fast action would have surely saved some baby gazelles but at least the decision has been made under consensual duress.

After this stage, the one-two punch is over, and we have taken our investment of the table. Now, the once-favourite watering hole will not be revisited soon. And that is another opportunity in the making.

Some Cold, Hard Examples – Past and Present

The first time I had to explain this rather crude thought process was almost exactly 20 years ago to one of my junior market makers. It is one of those experiences you do not find in a trading syllabus. And the only way to lose the retail mindset is to learn it the hard way.

Some years earlier, my firm had IPO'ed a star of the 'New Economy'. That star was able to brag with a stock market performance north of 1000%. And, as always when things finally get a bit boring, I was kindly asked (forced) to issue a wide range of warrants, mostly calls, some puts on the company in question. Uptake of these potentially supercharged instruments was phenomenal, and we made good money as we provided continuous market making.
In the context of the book we were managing, these warrants were still one of the smaller positions. And I allocated it to one of my juniors on the desk with the strict order to keep it 'delta neutral' – normal moves within our three standard deviation framework should not screw us too hard if things went south. (If you are interested in the details of the terror short gamma can invoke on a trader, check out my other Macro Hive articles.)

The junior did this amicably until punch one came flying in after a Sunday presser about 'irregularities' and an 'updated' guidance. After an opening auction, which appeared to take hours, the onetime darling gapped in with roughly -40%. The whole business case had been blown apart, and the formerly very media affine Two Brothers Management Team could not be reached by telephone.

My young market maker had only ever experienced BTFD markets. So naturally, he asked me whether we should load up on our now very long position (negative gamma makes you long when stocks fall, short when they rise) to recoup some of our losses in the inevitable ‘dead cat rebound’.

Here is a secret for you: dead cats do not bounce. They go ‘flop’, and that is it.

So, as described above, we did what we had to do. We sold our long exposure into punch one and shorted some more. This is the psychological part that really hurts. You do not want to do it, but all empirical evidence tells you that you must do it. You have just been beaten up. All fibres of your body want to go long and cash in on the pending counterreaction you can clearly see on the screen at this moment. After all, the clever shorties are now buying back, giving the false impression what you just witnessed was a fluke. It was not.

Well, we made some losses back cashing in on day two. And our prop desk eventually took a very profitable strategic short position. The company in question did not make it.

This was just one of the first of many high-volatility events to follow. And as we seem to have some anecdotal evidence that in our ‘interesting times’ the frequency of these events is picking up, I want to remind you that the one-two punch tactical setup works only 90% of the time. But if it fails, your upside risk is manageable – remember the dead cat flop.

Were it a sure-fire thing, I would not have told you. So, keep your position size reasonable when you see an opportunity. And do not forget: as profitable as this setup is, it hurts to put the positions on. Maybe that is the reason the market has not arbitraged it away yet.

Date	Price	% Change
NFLX		
19.04.22	348.6	
20.04.22	226.2	-43.26%
21.04.22	218.2	-3.59%
FB		
02.02.22	323.0	
03.02.22	237.8	-30.64%
04.02.22	237.1	-0.28%
TGT		
17.05.22	215.3	
18.05.22	161.6	-28.68%
19.05.22	153.4	-5.19%
PYPL		
01.02.22	157.8	
02.02.22	132.6	-17.42%
03.02.22	124.3	-6.44%
WMT		
16.05.22	148.2	
17.05.22	131.4	-12.08%
18.05.22	122.4	-7.03%
TWTR		
26.10.21	61.4	
27.10.21	54.8	-11.40%
28.10.21	54.3	-0.95%
GS		
14.01.22	378.7	
18.01.22	352.3	-7.22%
19.01.22	345.3	-2.02%
ORCL		
16.12.21	102.4	
17.12.21	95.9	-6.61%
20.12.21	91.0	-5.29%
CISCO		
18.05.22	48.4	
19.05.22	41.7	-14.77%
20.05.22	42.9	2.88%