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What the Open Book Carries

The Machine States, Paper II · Under Carry and Cover

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A machine that only wins, and is down

Paper I of this series defined the states of a trading book against its Chartered Capital. A book is Under Carry while its equity stands below that capital, and it enters Cover at the moment its equity reaches it. This paper concerns the ground between the two.

The question arises in its plainest form early in the life of a book. A machine may bank position after position without a single loss and still show an equity below the capital it was given. I do not regard that as a paradox. It is a consequence of four features of a design that banks its winners, and each of them is deliberate.

Why a banking machine floats below its balance

The first is selection. A machine that banks a winner at a short distance removes it from the book. What remains open is the part that has not yet banked, and a population from which the winners are continuously withdrawn will show a negative average however sound it is.

The second is the cost of entry. Every new position pays its spread and commission before the market has moved, and so begins its life offside by a known amount. The third is the manner of filling. Where a position is built in parts, with later parts entered only at better prices, the book reaches its full size exactly when it is most offside.

The fourth is the difference in clocks. A machine that trades several horizons at once banks its short-horizon positions in hours and its long-horizon positions in days or weeks, while the long horizons carry the wider stops and the larger money. The harvest arrives from one part of the book while the carry sits in another.

Beneath all four lies an asymmetry. The most an open book can show in profit is the sum of the distances to its banks, because a position that reaches its bank leaves. The most it can show in loss is the sum of the distances to its stops. The floating figure of such a machine is bounded closely above and widely below, and it should be read with that in mind.

Five measures of the carry

Measure	Definition
Carry	Balance less equity: what the open book is costing the balance now.
Cover Distance	Chartered Capital less equity. At zero the book is in Cover.
Cover Ratio	The Retained Harvest as a share of the floating loss.
Net Cover Ratio	The same, with the cost of entry set aside.
Recovery Debt	The floating loss expressed in days of banking at the rate observed.

The measures of carry. Each is read from the account and its ledger; none requires a forecast.

The net measure exists because the carry has two parts of different character. The cost of entry is a toll paid to the venue and no decision of the machine can recover it. The remainder is the market, and it is the part that resolution can return. A book should be judged on the part it governs.

Recovery Debt is expressed in days so that a proportion can be felt. It divides today's carry by yesterday's rate of banking, both of which move, and it sets no date for anything.

Two clocks in one book

The measures become informative when they are taken by horizon. In the books I have studied the pattern at the beginning is consistent: the short horizons bank most of their positions within hours and supply nearly all of the early harvest, while the long horizons bank rarely in the first days and hold most of the carry. A long-horizon position that has been open for a day has not failed. It has not yet had the time its horizon expects.

To set the carry of the long horizons against the harvest of the short, and to call the difference a loss, is to compare two clocks. The honest reading keeps them on separate lines: the short horizons judged on their rate of banking against their rate of loss, the long horizons on their age against the time their horizon ordinarily takes.

The route to Cover

Two routes lead to the Cover Point, and they are not rivals. The short horizons may go on banking until the Retained Harvest exceeds the carry. Or the long horizons may begin to arrive, and a long-horizon bank is several times the size of a short one. If the long horizons bank with anything like the regularity of the short, the book does not merely reach Cover but holds it with a margin the short horizons alone cannot supply. That is a conditional statement about a design, and the market alone decides whether the condition is met.

The Case

The following case is an illustration built from operating data. The figures have been altered and it reports no account's results.

A book chartered at 100 units has, in its first days, banked every position it has closed. Its Retained Harvest is 0.40 and its floating loss 0.60, so its equity is 99.80 and its Cover Distance 0.20. The Cover Ratio is 67 per cent. Of the floating loss 0.08 is the cost of entry, and the Net Cover Ratio is therefore 77 per cent. The short horizons have supplied three quarters of the harvest; the long horizons hold five sixths of the carry, in positions that are younger than the time their horizon ordinarily takes to resolve.

The same book has 9 units at risk at its stops. The carry is the visible part of what the open book could cost and the risk at the stops is the whole of it. A book Under Carry has, by definition, the least behind it, and a single loss would be paid from a harvest of 0.40.

How the measures can mislead

The Cover Ratio is unstable in a young book: one long-horizon bank or one loss moves it by tens of points. It also flatters a book whose carry is small only because few positions are open. It should be read beside the count of losses against banks and beside the risk at the stops, and never alone.

What would falsify this reading

The account given here would be wrong if the long horizons, given their ordinary time, failed to bank at a rate that pays for their losses; the carry would then be a loss in waiting and the comparison of clocks an excuse. It would be wrong if the cost of entry proved to be a growing share of the carry, since the part the machine cannot govern would then dominate. And it would be wrong if books of this design did not, in the ordinary course, pass from Under Carry to Cover. Each can be checked against the ledger of a book as it ages.

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