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Wirecard and the Cockroach Theory

In finance, there is never just one «bug». The practical relevance for investors today is that reversion to the mean is an iron market rule. Bad news, when all seems well, is often a harbinger of more to come.

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Deutsche Version

Europe might have just had its Enron Moment. With Enron in 2001, it was short sellers that thought there was something wrong. In the case of Wirecard it was probably a mix of things, including one British financial newspaper being quite critical of some of Wirecard's accounting practices for more than a year.

There is a proverb or saying that states that there is no fire without smoke. If you see smoke, there is a fire somewhere.

In finance, this there-is-no-fire-without-smoke idea goes by the name of *Cockroach Theory,* which states that there is never just one bug. The Cockroach Theory is loosely related to a variation of *Murphy's Law,* namely *Lubarsky's Law of Cybernetic Entomology* that states: There is always one more bug.

The concept was most likely originated and applied to finance by Warren Buffett, and it has been popularised by Dennis Gartman, an American newsletter writer, over the past decade or two. The Cockroach Theory loosely relates to mean reversion, or the idea that success begets failure.

The sighting of a cockroach is like an early indicator of a trend reversal, i.e., an early indication that the ensuing trend is reverting to its long-term mean. Mean reversion is an iron rule in finance:

«Reversion to the mean is the iron rule of the financial markets.» [1]

—John C. Bogle (1929-2019), Founder of the Vanguard Group

Cockroach Theory is also loosely related to Hyman Minsky's idea of stability being unstable and begetting instability. The state of the world is not one that is seeking equilibrium, as it is often assumed in business-school-economics, but rather the opposite: disequilibrium in form of instability, chaos, and destruction.

Rather than rational agents forcing prices to converge to fair value and equilibrium, there are – positive or negative – feedback loops at work that move prices away from equilibrium. The economist Hyman Minsky reminded us:

«Each state nurtures forces that lead to its own destruction.» [2]

—Hyman Minsky (1919-1996), American economist

It is the idea that trees do not grow to the sky. The sighting of the first bug is anecdotal evidence that the tree growth might be in the process of ending.

Sometimes a security is sold off sharply for exceptionally good reasons. However, it is well known that markets overreact. If a 50% fall is fundamentally justified, a 80-90% fall is not entirely unheard of. This represents an opportunity for an investor who has insight into the value and short-term discount. However, Warren Buffett calls buying a business with terrible long-term prospects and a low price the «cigar butt» approach and recommends against it.

«A cigar butt found on the street that has only one puff left in it may not offer much of a smoke, but the «bargain purchase» will make that puff all profit.» [3]

—Warren Buffett (b. 1930), American investor and businessman

Buffett argues that picking up the cigar butt for that one last puff is a «bargain-purchase» folly.

«[T]he original ‹bargain› price probably will not turn out to be such a steal after all. In a difficult business, no sooner is one problem solved than another surfaces - never is there just one cockroach in the kitchen.» [4]

—Warren Buffet

The «serious investor» sides with Mr. Buffett and avoids the occasional last puff. The cockroach idea is indeed a good way of thinking of a strong fall in a stock, sector, or whole economy. From a Cockroach Theory perspective, the fall might indeed – economically speaking – not be a bargain but the market, quite wisely, anticipating further cockroaches. Mr. Buffett's advice in this regard is powerful:

«It's far better to buy a company at a fair price than a fair company at a wonderful price.» [5]

—Warren Buffett

When discussing his own mistakes, Wall Street legend Byron Wien lists «underestimating the seriousness of a problem» as one of them. In relation to emerging growth stocks, he quotes Dennis Sherva, a financial analyst who won the prestigious All-American Research Team 1st place award by Institutional Investor Magazine six times between 1979 and 1987:

«The first bad quarter is rarely the last.» [6]

—Dennis Sherva (b. 1942), American financial analyst

The practical relevance for investors today is that reversion to the mean is an iron rule of financial markets. Bad news, when all seems well, is often a harbinger of more to come.

This was true for Enron and Wirecard but is applicable more broadly. Bad news is often clustered. There is never just one bug.

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Alexander M. Ineichen is the founder of Ineichen Research and Management AG, and has been a CAIA Association member since 2003. He started his financial career in origination of risk management products at Swiss Bank Corporation in 1988. From 1991 to 2005, he had various research functions within UBS Investment Bank in Zurich and London related to equity derivatives, indices, capital flows, and alternative investments. Mr. Ineichen has written extensively on investment topics. He is the author of the two popular UBS research publications, «In Search of Alpha-Investing in Hedge Funds» (October 2000) and «The Search for Alpha Continues-Do Fund of Hedge Funds Add Value?» (September 2001), as well as two books, Absolute Returns-The Risk and Opportunities of Hedge Fund Investing (Wiley Finance, 2002) and Asymmetric Returns-The Future of Active Asset Management (Wiley Finance, 2006). He is also the author of AIMA's «Roadmap to Hedge Funds» that has been published in 2008 and updated in 2012. Mr. Ineichen holds the Chartered Financial Analyst (CFA) and the FRM designations.

[1] Speech given at the University of Missouri, 22 October 2002.

[2] Minsky, Hyman P. (1975) "John Maynard Keynes," New York: Columbia University Press, p. 168.

[3] Berkshire Hathaway, 1989 letter to shareholders, 2 March 1990.

[4] Ibid. What herein is called “cockroach theory” is also a strongly emphasised trading rule by Dennis Gartman who often quoted Claudius speaking to his wife Gertrude in Act 4, scene 5 of Hamlet: “When sorrows come, they come not as single spies but in battalions.”

[5] Ibid. Charlie Munger’s *Poor Charlie’s Almanack* lists “Munger’s Three Great Lessons of Investing: 1. ‘A great business at a fair price is superior to a fair business at a great price.’ 2. ‘A great business at a fair price is superior to a fair business at a great price.’ 3. ‘A great business at a fair price is superior to a fair business at a great price.’ From Poor Charlie’s Almanack: The Wit and Wisdom of Charles T. Munger,” edited by Peter D. Kaufman, Expanded Third Edition, 2008, Virginia Beach: The Donning Company Publishers, p. 69.

[6] From “If Freud were a portfolio manager,” by Bryon Wien, in “Classics – An Investor’s Anthology,” Edited by Charles D. Ellis with James R. Vertin, Homewood: Business One Irwin, 1989, p. 755. Originally published by Morgan Stanley, 7 July 1986.