Why Convexity Matters

A few months ago, I explored the idea of **optionality** as one of the key benefits of saving. A related and equally powerful concept in business and investing is **convexity.**

In the context of investing, convexity means seeking opportunities where the **potential upside** far exceeds the potential downside.

Jeff Bezos once said, *"Given a 10% chance of a 100-times payoff, you should take that bet every time."* This captures the essence of convexity: situations where the potential reward vastly exceeds the possible loss.

Convexity in Life and Investing

In life, convexity means structuring your choices to **maximise big wins** while limiting your exposure to losses. In investing, it's about aiming for asymmetric payoffs, where **losses are small or capped**, but the gains can be substantial.

Mathematically, convexity refers to a non-linear relationship in which gains accelerate faster than losses.

Examples of Convex Payoffs

1) Startup investing: A $10,000 investment in a startup might result in a total loss if it fails, but if the startup succeeds, the payoff could be $1 million.
2) Options trading: Buying a call option on a tech stock might cost $1,500, but if the stock surges, the gain could be $50,000.
3) High-growth sectors: Investing in innovative sectors like technology often provides asymmetric returns. Much of the wealth created over the past few decades has come from these types of bets.
4) Real estate flips: Buying a fixer-upper for $100,000 with $20,000 down payment, renovating it, and selling it for $200,000 yields a high return on initial capital.
5) Bitcoin: A $1,000 investment in Bitcoin a decade ago would be worth around $550,000 today, a classic example of convexity in action.
6) Education and skills: Investing time and money in learning high-demand skills (e.g., data science, finance, communication) has limited downside but can unlock exponential career and income opportunities.

Conclusion

Optionality often leads to convexity. By keeping your options open, you position yourself for **asymmetric outcomes** where the potential reward outweighs the risk.

In both investing and life, the goal is to avoid getting stuck in linear, low-return situations. Instead, seek opportunities where **small inputs can lead to outsized results.**

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If you have any questions, Ian and our team would love to hear from you on global@seedinvestments.co.za.

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