What I've Learned From 5 Years of Stock and Options Trading

<p> For 2013, I traded my way to a return of 47%. In fact, if I had simply quit in May of 2013, I would have crossed into 2014 closer to an 85% return. No, I didn’t do this with penny stocks, bitcoin or anything else marginally stupid to put more than a few % of your money into. </p>

<p>‘The market’, let’s use the SPY ticker, (an S&P 500 tracking ETF for those who aren’t familiar), had a total return of 32% all by itself so maybe my year wasn’t all that great. My estimation of my 2013 trading year is that it was both real skill and a lot of dumb luck all at the same time. In fact, that’s the summary conclusion of what I’ve learned from 5 years of stock and options trading: it’s a lot of skill tossed into a blender of dumb luck.</p>

<p>

Writing about the stock market is hard for two big reasons. You either sound:

<ul>

<li>Bitter: <em>“It’s impossible to beat the market, so why try?”</em>.</li>

<li>Or Naive: <em>“Let’s assume company abc’s growth rate of 40% continues for the next xyz years. This means abc earnings per share would be xyz and at today’s PE that means the stock price would be 300% higher than where it is today. It’s so clear and logical, how could I lose money on this bet?”</em>.</li></ul></p>

<p><strong>For the Bitter</strong><br>

Yes, the majority of people cannot beat the market. That’s not something you need an economist, a trader or even your 401k preaching mom to tell you: it’s simple logic. Pretend allocation was equally weighted, and imagine the market as a set of numbers and your portfolio as a set of numbers. The market’s return would be the average of it’s set of numbers, and your portfolio’s return would be the average of your set of numbers. If you wanted your average to be <em>higher than</em> the market’s average, would it make sense to just copy the market’s set of numbers? A lot of well meaning people do just that. The market is so heavily correlated, that even a portfolio of 5 to 20 stocks might just end up being a mini representation of the market. To continue the ‘set of numbers analogy’: the market is made up of market participants, and this means that most people’s ‘set of numbers’ is merely a subset of the market’s ‘set of numbers'. It’s not likely that a lot of people are going to be beating the average unless there were a few really low numbers pulling the average way down below the median.</p>

<p>So how do people get around this problem of number subset and correlation? Most people who have a high return year traded high beta stocks and/or used leverage (beta is a measure of how much stronger or weaker a single stock moves in relation to how much the overall market moved. A high beta stock might move 5% when the market moves 2%). This effectively differentiates your set of numbers from the market’s set of numbers. </p>

<p>Important caveat: leverage and beta will accelerate your losses, and even people with winning years certainly have losing positions and losing trades. Regardless of beta or leverage, every time you lose a % of money, it takes a higher % gain just to get back to break even. Beta and leverage have a way of amplifying this effect and messing with your psyche. </p>

<p> <strong>Now for the Naïve… </strong><br>

If I had a nickel for every one of those stupid articles about a specific stock… As if anyone really knows.

<ul>

<li>The ‘hot stock of the season’ article: <em>CompanyABC has been on a tear this year up over 60%. We see more upside as its grown its revenue by an average of 40% over the past 5 years, and should grow at a similar pace for the next 5 years.</em></li>

<li>The ‘story stock’ article: <em> Technology ABC invented by Mr Personality CEO will replace everything in the future: cars, clothes, energy, you name it. As soon as the price comes down and the mass-market version comes out you’ll see that these huge growth projections were actually conservative! </em>.</li>

<li>The ‘resurrection’ article: <em> Stock ABC was once high flyer, has been beaten down for a long time, and I think it’s due for a come back because it simply can’t go any lower. Also, a low P/E is automatically a good thing because I'm a value investor like [insert famous investor]. </em>.</li></p>

<li>The 'Discounted Cash Flow' article. A DCF might make sense in real estate where you have contractual cash flow that changes year to year based on lease agreements. You could run different DCFs on different market leasing scenarios, lease lengths and $/sqft rents. However, with stocks it's my personal opinion that DCFs usually just arrive at the answer the analyst wanted when they picked their assumptions.</li>

</ul>

<p><strong>Supply and Demand</strong> <br>

If only it were as simple as reading <a href='http://www.SeekingAlpha.com'>SeekingAlpha</a> cover to cover! It's just not though. That's because what determines the value of something is simple supply and demand:

<li> stock prices don’t follow the Gordan Dividend Growth model</li>

<li> stock prices don't follow what the accountant values the business as </li>

<li> stock prices don't bounce or crash at certain magical maximum or minimum P/E values</li>

<strong>Stocks really only seem to follow one rule: if more people want to buy shares than people that want to sell, then the price goes up. It's a popularity contest as shallow as high school. That’s it. </strong>. Amazon doesn't need to churn out a 'dividend stream valued at perpetuity' like they tell you in a college finance class. Amazon doesn't really ever need to turn a profit as long as they have cash to run day to day. As long as more people want in on 'the Amazon brand' than people who want out, the stock will go up. As long as the stock goes up and the employees can enrich themselves on stock options, they won't care about turning a profit either. If the stock goes up, the investors won't care about dividends or eventual profits. However, this all depends on people being obsessed enough with your brand that they simply want in on your stock no matter the metrics. See the collapse of Apple stock for the aftermath.</p>

<p><strong>Technical Analysis and Supply and Demand </strong><br>

Technical analysis seems to work because the squiggly lines that people develop technical analysis from follow typical human reactions to supply and demand in a liquid auction market. 'Oversold' indicators, 'Price Consolidation before breaking out of a range', these are all likely a part of how humans navigate any liquid auction environment. The more liquidity a market gets, the more it's able to 'explore price levels' in an orderly fashion. An instrument that makes wild moves, like bitcoin or a penny stock has to travel farther up and down the price ladder to find enough buyers or sellers to satisfy supply. A simple triangle pattern like this one will help demonstrate: </p>

<p><img src='/static/triangle.jpg' /></p>

<p>Every time the price heads for the top of the triangle, that's buyers buying up supply from people who are willing to sell. The price keeps going up just like an auction. Eventually, at the top of the triangle, for whatever reason, sellers have decided to step in much more forcefully and offer more supply at that price. The buying pressure cools off as the price heads downward, but not before similar buyers to the earlier buyers decide that the price has reached a level they'd like to buy at. The auction repeats, and the bouncing between the top of the triangle and the bottom of the triangle represents the forces of the buyers and sellers inching closer and closer ready to do battle. Eventually, the top of the triangle just can't hold any longer and the buyers overrun the sellers. The buyers don't forcefully overtake the sellers until they've tested the battle line a few times. Does the intrinsic value really change on any given day without any stock driving news? No. However, I would argue that the intra-day movements aren't random either. They follow supply and demand just like the stock does over the long term.

<p><strong>Wait, so how did you return 47% this year again?</strong><br>

This year I finally feel like I learned 'the game'. It really is a silly little game. It has nothing to do with the companies themselves. The stock market exists to reward some awesome entrepreneurs who need to unload assets on all the peons who clamor to own a piece of great brands. As soon as the IPO happens that stock ticker just becomes another table at the casino, completely divorced from the actual health of the company. The stock market is musical chairs. Get the high beta high leverage story stocks while you can, and then don’t fall down too hard when the music stops. When NFLX opened up nearly 20+% on a single day in January 2013 I knew it was time to buy. That's beta and momentum. I remember thinking, <em>"Of course NFLX isn't actually worth this much based on business cash flow sense. The more subscribers they get the more the content owners charge NFLX for it." </em> But that’s not what the stock market is. The trade turned out great as the stock kept on chugging up and up and up before I sold within a month.</p>

<p> <strong>Enter Tesla Motors</strong><br>

TSLA. Here was my luck in 2013: I found the right sector: Automotive, in the right buzz area: Tech, and with the right 'Cult Stock CEO: Elon Musk'… all just before the story took off. Was it dumb luck or skill? The skill part was that I was indeed targeting Auto makers as I kept seeing Ford setting record sales, and I could sense that for all of the tech boom in cell phones and computers, cars just hadn't done much yet. I fell hard for the TSLA story well before it really took off in the media. I also could sense that people were looking for their Steve Jobsian replacement, and Musk had already taken another company into outer space (literally, it's called SpaceX). The timing and audacity of concentrating a portfolio into TSLA was sheer dumb luck. I also tried to profit off of a housing market recovery with some residential REITs (it did not turn out well!). In summary, I got in TSLA at $35, rode it to $100 and sold at $80. I got in again at $140, sold at $175.

</p>

<p><strong>With Options, You're Wrong Even When You're Right</strong> <br>

The summary conclusion of what I've learned about options is that you are pretty much wrong even when you're right. I'll try and explain this without using delta and other Greeks that option traders use. I did make some money on leap options for the up move in TSLA, but my attempt at 'shorting' TSLA via put options should illustrate my main point. I shorted TSLA at $155 using put options. I was 'right' on the direction being 'down'. The stock dropped down to $120, before I closed my position at 125. However, did I make any real money doing this? Not really, <em>while being right</em>. I had the right to sell TSLA at the $125 strike price. So as the stock fell closer to and eventually below this price, I had the direction right, and one would think my put options would have appreciated significantly. However, depending on how you look at it, my timing and magnitude were off. To really profit, I would have needed to own a higher strike price put option (ie predicting a different magnitude of movement), or I would have needed to own shorter duration options (ie better predicted the timing of the movement). Picking the direction of a stock is hard enough. Picking the direction, the timing and the magnitude? Forget it, you're going to lose in the long run. </p>

<p><strong>So What’s a Man to Do With His Money Then? </strong><br>

If you have the stomach for it, trying your luck at the high beta and/or high leverage side of things can yield some success. The main problem there is then avoiding enough disaster that it doesn't wash out your success. It's a lot like that phrase in commodity trading: "its easy to make money; the hard part is keeping it. From my readings about successful people in the trading and investing world, there's really only two ways to do it: <ol>

<li>Manage other people's money, call yourself a value investor, justify everything you do with well reasoned DCFs, but basically over time fail to beat the market and live off of management fees. Examples: Wealth Management</li>

<li>Don't actually make your fortune from the stock market that we think of today, but somehow end up associated with the trade. Examples: Warren Buffet (Yes, he has <em>grown</em> wealth in the stock market by compounding some fantastic but hardly logarithmic numbers in investments like Coke. However, he made his initial logarithmically growing fortune from what would today be called Private Equity – investing in private companies). Another common example is George Soros (his wealth was mostly made from running a global macro hedge fund that tended to specialize in futures/commodities and currency).

</ol></p>

<p>My true answer is to simply do something else. The stock market exists so that entrepreneurs have a place to divest their awesome creations. After they divest though, it's basically a casino. <em>Amazing</em> wealth can be compounded from mere wealth. However, compounding $20,000 at 10% or 20% won't be nearly as impressive as you think. You can’t live off of 20% of $20,000. In the long run, you're much better off focusing on creating value in some other venue. I don't regret the years I've spent dancing with the stock market. I've learned all sorts of interesting math, psychology, and self-discipline. The push to develop trading plans has a way of forcing you to do different things. In 2009 I developed a trading plan by writing an extensive VBA program (probably a 1000+ lines of codes) that worked with Yahoo historical data. It was an excellent, trial by fire, way to learn about arrays, loops, static typing and other programming concepts. More recently, I developed a futures trading plan that required a lot of psychological discipline to execute live. I learned a lot about myself that I might never have learned.</p>

<p> Whether it's programming, market psychology, technical analysis, or DCF financial modeling, all of these investment styles take skill. However, they must always go through the blender of dumb luck. In theory, if you have a good trading plan, you can ride out the storms with discipline and have your good days of dumb luck outweigh your bad days of dumb luck. In practice, I'm not so sure. That's what I've learned from 5 years of stock and options trading. </p>

<p>Disclaimer: I am not a registered investment advisor and these are my opinions for entertainment purposes only. They are not financial recommendations for your specific situation. </p>