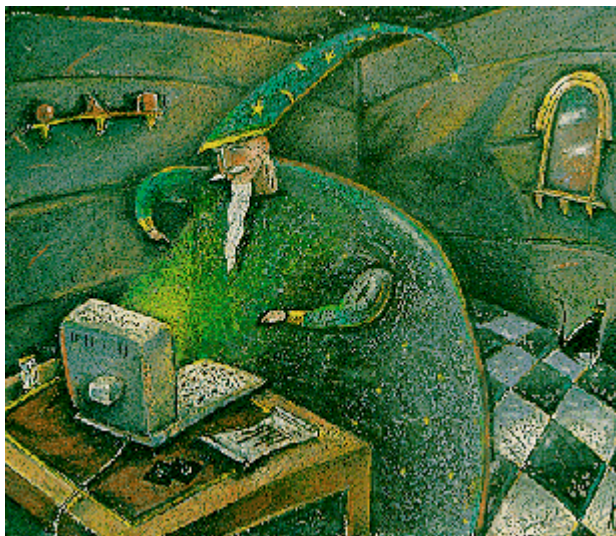


Wizards: minds over markets

by Van K. Tharp



Jack Schwager, commodity trader and confessed system skeptic, has been a familiar name in commodity trading for a number of years. His 1984 book, A Complete Guide to the Futures Market, laid out most tested techniques along with other methodologies.

His latest book, The Market Wizards: Interviews with Top Traders (Simon & Schuster, New York) might be considered a companion to his technical tools book. Wizards brings home some of the more important, and often, overlooked elements of successful trading—not magical systems, but the beliefs that have made the most successful traders what they are today. Appropriately, trading psychologist Van K. Tharp interviewed Schwager while he was in the process of writing Wizards. What follows is a distillation of their six-hour discussion and follow-up questions.— Ed.

You've completed The Market Wizards. You've spent a lot of time talking with different top traders and you've had a chance to think about their responses. At this point, what do you think it takes to be a top trader?

The following are not in any particular order, just the order that I think of them. To begin, confidence in your ability to consistently win as a trader over the long run is absolutely essential. Admittedly, this is a bit of a Catch 22 proposition: in order to be a winning trader, you need to have confidence; but in order to have confidence, you need to be a winning trader. That aspect, however, does not diminish the importance of confidence. The one absolute common denominator among all the traders I interviewed was a confidence in their continued ability to win over the long run. Everything else stemmed from this confidence.

Another critical factor is discipline. While this may sound like a cliché, it is probably the single most mentioned word that cropped up when the top traders tried to explain what made them so successful.

The top traders tend to be very independent. With few exceptions, they restrict their trading decisions to their own opinions (or systems). The importance of not being swayed by the crowd was a frequently mentioned point. While this may not be very surprising, many of the traders I interviewed also stressed

the importance of not being influenced even by other superior traders. This has to do with the importance of sticking with our own approach, because that is the only thing you can have confidence in. As one trader said, "if my only reason for being in a trade is because Bruce recommended it, I am not going to have the confidence to stay with that position if it starts going against me."

Superior success at trading often involves extraordinary hard work. Many traders have devoted their lives to reaching their success level. The amount of reading and analysis some of them do is staggering. For example, one trader follows and intricately analyzes economies and political events in virtually every country with a meaningfully traded currency. Another trader follows the world economy, the world currency markets, the world stock markets, futures markets and individual stocks in various countries. The same trader has also studied the history of these various markets often going back into the 19th century. Another trader has explored virtually every technical methodology under the sun and their interrelationships in stocks, options and futures. Being a great trader is hard work. There are no shortcuts.

I can think of a couple of exceptions and if there are a few exception then I tend to think that element is not an essential characteristic. The people I'm thinking about tend to be traders who only trade a few times each year in each market. These traders are generally right about these moves and make outstanding rates of returns. On the average, they probably only spend a couple of hours a day on market-related activity All of those people did a lot of research and study to get where they were, but now trading, itself, is not that difficult. A second comment is that even the people who constantly put in long hours don't really consider what they do to be hard work. They do it because they love it.

Very frequently, the traders I interviewed mentioned their love for analysis, the markets and trading. They associated trading and analysis with game-like qualities. Some of the statements that came up included "(the market) is a big three-dimensional puzzle....Market analysis is like a tremendous multidimensional chessboard...(Picking a winning stock) is like a giant treasure hunt." One trader, when asked about his success, responded, "I feel my success comes from my love of the markets. There is no question that this is what I am supposed to do with my life."

I believe every person I interviewed had an overwhelming desire and persistence to succeed as a trader. In a number of cases, they wiped out more than once, but something inside of them told them to just keep at it, because eventually they would succeed. This may just be one of those factors you either have or don't have. Although winning trading may be teachable, extraordinary successful trading may not be, and this may be an example of why.

I call that commitment. Many people just do not have the commitment to be successful as traders. What else do they have in common?

The top traders have game plan or methodology, they don't just shoot from the hip. The existence of an effective methodology makes their high confidence level possible, which as I stated before, is a key ingredient to success.

Another frequent theme was the emphasis on the idea that losing is part of the game. If you can't accept losses or take them easily, you can't be an efficient trader. Most readers might think this means only taking your losses quickly so that small losses do not turn into account-destroying losses. While this is true, accepting that losses are part of the game also means that the fear of losing does not prevent a trader from putting on a potentially profitable position, or cause a trader to get out of a position that is good too quickly. A loss that follows the game plan is not a bad trade, it is part of the game plan. This ties in with the confidence element mentioned before. Since superior traders are extremely confident they will win, it

is easy for them to accept losses as part of the process.

Patience is another critical element. A number of traders stressed the importance of waiting for the right trade to come along. A phrase that Jim Rogers used sticks in my mind, "I just wait until there is money lying in the corner and all I have to do is go over there and pick it up. I do nothing in the meantime."

What do those traders have in common, in terms of their personalities, their psychology (i.e., self-analysis), their risk control and money management, and their trading styles?

I realize something that strikes me a bit odd. Many of the traders I interviewed could be described as quiet, introverted and soft-spoken. This is surprising when you consider that the popular image of a large, successful trader is probably more closely associated with such adjectives as flamboyant and loud. Despite their enormous financial success, the traders I interviewed did not come across as overwhelmed by their own self importance. In fact, many of them were downright modest. And I mean modest in a real sense rather than in a controlled way. For example, one trader with a remarkable win/loss ratio would say such things as, "It will be obvious when the market bottoms." He seemed to have no concept that what was obvious to him was by no means obvious to the rest of the world.

As far as risk control, in most cases it was of paramount importance, with the traders following very rigid rules or guidelines. However, surprisingly, in some cases, risk control, as we normally think of it, was not readily evident. By this, I mean the trader would often take a position he felt was correct and hold it even if the market moved substantially against him. In fact, he might even add to the position in such cases. Obviously, this style of trading takes enormous confidence, accuracy and skill, not to mention courage.

How do such traders avoid catastrophic losses? I think the answer consists of two elements: diversification and extraordinary accuracy on the trades they really believe in.

In regards to trading styles, I saw no consistent patterns. Trading styles ranged from cerebral to wired.

Finally, I would note that the top traders tended to be strong-willed and inner directed.

I noticed that the traders you interviewed had little in common in terms of methodology. Some were fundamentalists, others were technicians and others were both. Some were mechanical and others were intuitive. What conclusions can you draw from that?

That's a good point and one that I emphasized myself in the book's final wrap-up chapter. The contrast, in fact, was striking. For example, one trader commented, "I haven't met a rich technician. Excluding, of course, technicians who sell their technical services and make a lot of money." At the other extreme, were comments such as, "I've never met a rich technician. I love that (comment)! That is such an arrogant, nonsensical response. I used fundamentals for nine years and got rich as a technician." Also, as you imply, some traders were 100% system followers, while others never made a single system-generated trade, in some cases, even expressing the sentiment that systems were for suckers.

Given these direct contradictions, it is obvious that as great as the individuals I interviewed were as traders, some of them were obviously wrong in their beliefs about the efficacy of different trading methods. The success of the technicians disproves the claims of the adamant fundamentalists and vice versa; the success of the system traders invalidates the skepticism of some of the pure intuitive traders. The point is that the type of method is unimportant. What is important is that the method fit the belief system and style of the individual trader. Otherwise, the trader will not be able to achieve the high degree of confidence that is apparently one of the essential elements exhibited by top traders.

I used to call one of my tasks of top trading Market Analysis. Now, I think it has little to do with market analysis. The task involves developing a low-risk idea, and you can develop low-risk ideas with a number of different methodologies. What else do they have in common?

Another lesson is psychology and discipline are apparently much more critical than the type of method or approach employed. I believe these observations also help explain why such a small percentage of people make money trading purchased systems. Even if one restricts the universe of systems to those that are profitable, most system buyers will still lose money trading these systems. Why? First, since they did not develop the system, and in the case of a black box system will not even have any idea how the system works, they're not likely to have any depth of confidence in the system. Thus, when the system goes through a losing streak as all systems inevitably will, they will be prone to abandon the system often just before it begins to make money again. Also the odds are slim that any purchased system will closely match a given trader's intrinsic style.

If you could narrow it down to any one element, what would come closest to being the Holy Grail secret of trading success? Consider all aspects of trading here, not just methodology.

The Holy Grail is not a specific method, because the method is completely different for different top traders. The Holy Grail is a state of knowing that you have a method that gives you an edge and sticking to it. I know everyone reading this is going to say, "Yes, sure, but tell me a specific method that will give me the edge." There's the rub. If it were that easy, we'd all be millionaires. All I can tell by inference from the traders I interviewed is that when you find it, you'll know. I say by inference because I have personally never arrived at that point of complete confidence. That's why I've only managed to be a profitable trader over the years, not a super trader. In other words, knowing the nature of the Holy Grail still doesn't guarantee you can find it.

Although you are by no means a super trader, you are still way above average. What do you think is important about trading? Is there anything we haven't mentioned that you think is important to your success?

Well, I recognize that trading is the only way I will be able to achieve financial independence. Secondly, trading has been my career. I have made a lot of good recommendations, but I will never consider myself successful until I make at least what I consider a small fortune. It is not for the money actually, I just want the sense of doing well.

There was a point last year to where I had done quite well and then had a terrible period of trading. I had noticed a Salvation Army guy at the local train station and I decided that if I got back to my prior peak, I would give him a small percent of every thousand dollars I made. I loved doing that. It was just this great feeling. Anytime I went by I would put in a \$10 or \$20 bill. He thought that was a lot of money, but it wasn't. It was just doing something nice and it was a concrete connection with my doing well in trading. I felt real positive about that.

Did your trading change as a result of doing that?

My account went straight up. Virtually every week I put money in the guy's can. Which means I was making money every week, I mean virtually every week, which is pretty incredible. Actually, when I made that mental commitment, I started doing it and then I recouped everything I lost and I actually started making new highs in my account equity.

I've heard similar stories from people. It seems that giving like that changes your mental state and

makes you much more receptive to making money. Incidentally, that may help you resolve the dilemma of how you can be confident before you are a winning trader. What else do you think is important in order to be successful as a trader?

Well, you have to be able to cut your losses. If you don't sooner or later you will go back to zero. You can't be loyal to a position. In my early years I was a terrible, terrible trader. I was probably as bad a trader as you could be. I probably started off like a cripple trying to run a marathon. I have learned from experience. I have absolutely no loyalty to market position and I think that is good, that is one of the things that I do right.

I think you have to be flexible enough not only to get out, but actually reverse your position and that is something I do that is important.

One of the things that top traders do is to really put their foot on the accelerator when they have these really good trades. One trader told me, "Hey, I have two big trades a year, but those two big trades do it, and I get returns over 100% a year." When all the market indicators really line up, they heavily commit to a position and make a very large return.

You have to be organized. A lot of specifics like stops, exiting the market correctly, etc., all come under the general frame of being organized.

You have to be focused to follow a set pattern of looking at markets. I think that if you are emotionally troubled by other things, that confuses trading. If you don't focus, it blurs the position.

Something I learned a long time ago is to never trade against your basic feeling. So what I used to do, for example, I would be right in the long-term market and be so intent on a correction that I actually would get out of my long-term position and try to trade the correction. Never go against your basic feeling!

What do you think contrasts you from the average trader who just plunges into the market and loses a lot of money?

That is pretty easy. For extended periods, although I was financially comfortable, I didn't have money I felt I could trade with so I didn't trade. For me, that is like a system because I know not to trade with money I can't really afford to lose. I am really good about taking very, very small initial risks. Once you have the market's money, then you can take more risk.

I always pride myself on being flexible. I can be bullish one day and bearish the next. I think that is real good.

I can look at charts and have some potential leverage, not to a degree that I am ever very, very confident, but enough so that I should win over the long run.

On the fundamental side, I sometimes am very good about picking a major move situation. Yet, in my case, the weakness is always coming away with a much smaller portion of the pot than I should have. At least I feel good about being able to identify the major move in those cases.

I have no problem buying a market when it is falling if I feel that it is basically a real bull market. I have to have some confidence to be able to go into a falling market and buy it or to go into a rising market and sell it. I won't just do it through a free fall. It must be under the right circumstances, a market that I believe could have a major trend in the opposite direction.

I don't do anything reckless. I am very, very conservative, so I will trade one, two, three contracts. I will

never put on 20, 25 contracts at a time. I never put on any really major positions, so I don't take big risks.

When I am methodical, I have made money. I had my specific rules, I was keeping a trader's diary, so I guess anything I do which is organized and systematic is beneficial. I do an element planning and I find that I do best when I plan systematically.

Here is one thing I do and it's worked for me. I am a perfectionist in what I do. I find it easier just to do something the way I can, even if it means doing a lot of work, than trying to find something halfway. I try to do things the right way, not take the short cut.

What did you learn about trading that you didn't know prior to doing *The Market Wizards*?

Each person reading this book will come away with different insights that are personally relevant. What may be unimportant to one reader may be absolutely critical to another. But not to dodge the question, some of the personal insights I experienced:

- Discipline is much more than a cliché.
- Patience waiting for the right trade is absolutely critical.
- To achieve exceptional performance, it is occasionally necessary to step on the accelerator. In other words, those trades you really believe in, you play more aggressively. Of course, the tricky thing is doing this while still maintaining risk control. Obviously, you need both a high degree of confidence and accuracy to pull this off.

I discovered that a number of the extraordinarily successful traders failed a number of times and sometimes for an extended period before they finally put it all together.

If you were starting again, but know what you know now about trading, how would that change you?

This isn't like the question, "How would you live your life differently if you were 18 again?" That is a hypothetical question. In the case of trading, unless you are out of the game (i.e., broke), you can start again. In fact, in a way, you start again every day.

Has your trading changed as a result of your insights from *The Market Wizards*? If not, what do you think you need to do to produce the spectacular results that you'd like? What would you need to give up to become a top trader yourself? Are you willing to do it?

As I have only recently finished the book, it is far too early to say. Ironically, the period since I began working on the book has been my worst trading phase in recent years. Although there were, no doubt, other factors involved to some extent, I believe the strain of simultaneously working at a full-time job and doing this book had a detrimental impact on my trading. This may be a rationalization, but I think it is true.

How has my trading changed? Well, for one thing, the reinforcement of the discipline message has gotten me to become more methodical. I have just resumed keeping a trading diary, an exercise I knew from past experience was very valuable, but one that I had let lapse for many years. I have also started routinely reviewing multi-year charts every week, instead of haphazardly as I did before.

Another change is that I am now more conscious of the need to wait for the right trading opportunity and not feel you have to make a trade every day. Oddly enough, even though I consider myself a long-term trader, the desire to trade frequently has been a problem. Thinking of your own works and writings, I

guess this might be a good example of what you call "conflict."

For example, I find that for myself, unplanned trades made at the spur of the moment during market hours are almost invariably losers. I am trying to keep myself from doing those trades. It is not as easy as it sounds because the lower risk (i.e., relatively close stop points) often associated with such trades makes them very alluring. The problem is their success rate is dismal. I believe that the reinforcement of the message of patience that I received in doing the book will eventually help me eliminate this personal flaw.

As to what I need to do to become a super trader, I don't think I know the answer. In fact, I am not even sure there is necessarily an answer. On a basic level, I don't agree with the premise of the question. It implies that any individual can achieve spectacular performance if he or she does the right things and avoids basic mistakes. This may be true to achieve profitable trading, but there is a vast difference between profitable trading and super trading. Excellence in trading like excellence in any other field is a blend of hard work (which is achievable) and talent (which you either have or don't have). I don't believe that most traders have the capability to become super traders.

Marathon running I believe provides a very appropriate analogy. Virtually anyone can run a marathon if they are willing to work hard enough at it. Even handicapped people can and have achieved this feat, which is an impossibility for the healthy but untrained individual. However, no matter how hard you train there will be some natural limit that you will not be able to exceed. Probably only a small percentage of the population has the physical makeup that would make a 2:10 marathon even a possibility. Of course, such a select individual would still have to do a remarkable amount of hard work to achieve that time. However, the rest of us can never achieve a 2:10 marathon no matter how hard we train. The limit of what is achievable will vary from individual to individual.

But for the sake of answering your question, assuming I had the capability, what would I need to give up to become a super trader? Judging by the history of most of the traders I interviewed, I would probably need to give up my job and devote myself full time to trading and trading-related analysis. (Although I am very fortunate in that my job is related to trading — research director at a major brokerage firm — a great deal of my time is devoted to tasks that have nothing to do with trading, such as writing or editing all the reports turned out by my department, answering phone inquiries, and so on. If I were single, perhaps I might consider this alternative. But with a wife and three small children, I wouldn't even dream of taking this action, which I would consider gambling with their financial security and well being. Obviously, in my life, other things take priority over the goal of becoming a top trader. By the way, I don't mean to imply that by devoting myself full time to trading I would necessarily become a super trader. I am only answering your question as to what I think I would have to give up to achieve this goal and am unwilling to do.

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