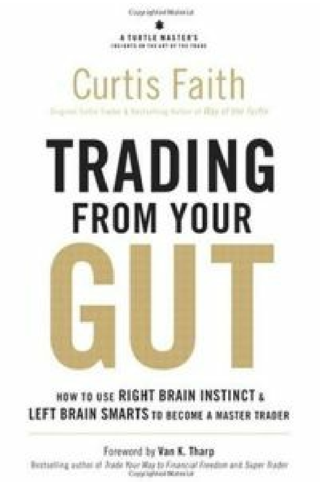


# Book Trading from Your Gut

## How to Use Right Brain Instinct & Left Brain Smarts to Become a Master Trader

Curtis Faith
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## Recommendation

Internet search engines seem able to deliver every possible answer for every imaginable question in an instant. But no software program can replicate or replace human intuition, the greatest gift any securities trader can wield. Inexplicable investment instincts arise from feelings that right-brain thoughts inspire. Dismissing these instinctive feelings may seem rational to traders with a lopsided preference for left-brain thinking. For a more balanced approach, apply rational, left-brain tests to right-brain ideas, says investor Curtis Faith, author of *Way of the Turtle*. He offers compelling evidence and personal testimony about the overlooked power of intuitive thinking in securities trading. *BooksInShort* recommends this book to traders who want to make better use of their intuition.

## Take-Aways

- The human brain’s left side and right side have different cognitive strengths.
- Humans analyze facts with the calculating left brain and envision possibilities with the creative right brain.
- Smart traders bring a balance of left-brain and right-brain thinking to their investment decisions.
- Investment experience increases the left-brain’s capacity to evaluate right-brain ideas.
- Traders use intuition to recognize price patterns and decipher market psychology.
- Trading on intuition is different from and preferable to trading on emotion.
- “Master traders” learn to block such cognitive biases as aversion to loss.
- Buyers and sellers in the stock market are always equal in number (every trade has a buyer and a seller), but their relative sense of anxiety varies and affects the market.
- “Swing” traders monitor changes in the anxiety levels of buyers and sellers in the market. Buyers are rarely as tense in a positive cycle as sellers are in a negative cycle.
- Some advances in trading technology are extensions of reasonable left-brain thinking.

## Summary

### Left-Brain and Right-Brain Investing

Understanding the differences between the two hemispheres of the human brain is the first step toward using the whole brain to make investment decisions. The left hemisphere is the rational, analytical side that respects rules and recognizes limits. The right hemisphere is more inductive, better at identifying patterns and imagining possibilities.

> “Whole brain trading involves both hemispheres and is a balancing act between the brain's two primary types of cognitive function: logical reasoning, and intuitive feelings and impressions.”

Two distinct categories of securities traders represent the type of thinking that happens in each hemisphere of the brain. “Discretionary traders” tend toward right-brain thinking. They follow no specific formula for buying or selling because they regard investing as an art. “System traders” treat investing like a science, basing their decisions to buy or sell on preset rules. Both tactics have drawbacks. Acting on investment ideas without analyzing them is reckless. Trading exclusively “from the gut,” or on instinct alone, also can produce lackluster returns. Many traders pay more attention to facts than their feelings; however, they could achieve better returns by putting more trust in right-brain thinking and by using intuition to generate more ideas for left-brain evaluation. This is the "middle way" of trading.

> "There is a big difference between trading emotionally and trading from your gut."

Investors who embrace "whole brain trading" excel by making decisions based on a balance of intellect and intuition, of left-brain and right-brain thinking. The left side is best at understanding why certain trades worked in the past, and the right side is best at anticipating what might do well in the future. Right-brain thinking is crucial in the securities trading business because originality matters so much. Obvious trading opportunities become less profitable as more traders seize them. The best traders watch what most other traders do and intuit alternative approaches. Such pattern recognition is a form of intuition that often improves over time. In the technical analysis of stock prices, a trader with decades of chart-watching experience can identify a significant price pattern called a double-top formation much faster than a young college graduate who has seen only textbook, idealized versions of this pattern. Compared to novices, experienced traders have greater left-brain capacity to evaluate whatever catches the right brain's attention.

## Blocking Cognitive Biases

Emotion compares poorly with intuition as a measuring stick for investing. Using intuitive feelings to make investment decisions is different from investing on the basis of exuberance, envy or fear. The best traders make decisions free of the sway of emotion because they have learned to block certain cognitive biases that are common to human nature. For example, trying to avoid losses seems rational. But this conservative style of investing can be overly emotional and ultimately unprofitable. "Loss aversion" is one of the burdensome biases many traders bring to their investment decisions. The best traders block this bias by seeing each trading loss as a cost of doing business. They tend to accumulate many small losses and a few exceptionally large profits.

> "Trading styles generally fall on a continuum between the purely intuitive discretionary trader and the purely rule-oriented system trader."

Behavioral finance studies reveal several other cognitive predispositions that interfere with optimal investing, including "outcome bias" (judging investment decisions by their results) and "confirmation bias" (ignoring contradictory evidence). "Master traders" learn to keep such biases from coloring their investment decisions. They develop immunity to confirmation bias – the urge to ignore evidence that contradicts their investment theories – because they spend more time determining if they are wrong than trying to prove they are right. They resist developing outcome bias against an investment idea solely because it produced a loss or only a small return. Inexperienced investors often surrender to the emotional urge to change their whole trading strategy when one trade sours. But some trades flop due to unforeseeable developments and the tactic used may be worth repeating under different circumstances.

## Filtering Information

Predicting the future based on fresh, new facts – the newer the better – is a common form of left-brain thinking among investors. Many traders pay too much attention to the daily cacophony of media reports on firms, industries, markets and the economy. Trading based strictly on the nonstop flow of news is a left-brain approach with poor prospects. Experts call this behavior "recency bias," a tendency to respond to new information and to disregard history. This bias leads to erroneous valuation because the last price paid for an asset may not reflect its true value. To succeed, investors must filter out the "noise" in the news. Master traders disregard most news reports and market shifts as irrelevant to their strategies. An overload of information can erode the ability to filter and focus.

## Monitoring Market Tendencies

Classifying market conditions, like recognizing pricing patterns, is a form of right-brain cognition. Master traders routinely assess the market to determine if the time is right for an investment or divestment, or if trading at another time would be better. They never succumb to the "mental inertia" that discourages regular re-evaluation of their assumptions about the market's character. They adjust their trading tactics, or simply stop trading, as market conditions dictate. Master traders see much more in market price fluctuations than novices do, not just the mathematical changes over time but the mood swings behind them. Some investors wrongly believe the fallacy that stock prices vary depending on the number of buyers and sellers in the market. In reality, of course, the number of buyers and the number of sellers in the stock market are always equal, that is, one to one. What changes is the trader's relative sense of urgency.

> "The right brain excels at reading patterns and interpreting their meaning in the context of a larger picture."

In a rapidly falling stock market, for example, many sellers will feel more desperate than buyers. This is one of several types of predictable market behavior that present opportunities for profitable trading. Another tendency of the market is overreaction in one direction or the other. Powerful price trends often persist. Each price trend in the market will reverse course and move in the opposite direction, but strong trends usually recede gradually, not suddenly. That is why many traders invest "long," or for appreciation, in a rising stock market; sell stocks short in a falling market; and take both long and short positions in a stable market. The market also shows predictable tendencies when the price of a stock hits a resistance level (above which traders resist buying it) or a support level (below which traders resist selling). Understanding such market tendencies provides profitable investment opportunities for smart traders.

## Anticipating Market Swings

Changes in market psychology drive changes in stock prices. That's why master traders consider how most other traders will react if a market index plunges below a support level (seller anxiety) or soars above a resistance level (buyer anxiety). In his book *How to Trade in Stocks*, a superior investment speculator named Jesse Livermore advised against struggling to find "a good reason" to purchase or divest a stock. He considered this practice pointless because no one can perfectly predict the future direction of a stock price, let alone the whole market. Livermore depended principally on market psychology to guide his investing decisions. This is a reliable approach to investing because so many investors participate in "herd" mentality, repetitiously responding in the same way to the same stimuli with the rest of the crowd.

> "The left brain is good at building and understanding models for how the world of trading works, and the right brain is good at generating ideas and recognizing opportunities."

In nature, the parallels to human pack behavior include the coordinated movements of fish swimming in schools and birds flying in flocks. Like birds and fish in formation, markets exhibit what scientists call "emergent behavior," or group responses arising from group members' individual interactions. Trading on the basis of emergent market behavior can pay off because such behavior is predictably repetitive.

### The Practice of "Swing Trading"

Understanding market conditions and how they could change is easier and more useful than attempting to predict the direction and magnitude of future market moves. When master traders analyze the market, they think less about current conditions than about how the investing public would respond "if something significant changes" in the market. Swing trading is one way to profit from stocks' price pendulums. Many investors may find this form of short-term investing more appealing than day trading, which involves more transactions and may demand full-time attention. A swing trade may last days or weeks; a day trade, only a few minutes or hours. Swing trading is a better alternative for investors who have additional interests unrelated to investing.

> "Whenever the market does not act right – that is reason enough for you to change your opinion and change it immediately."

Swing traders use historical price-chart analysis to try to identify the beginning of transition periods when most of the anxiety in the stock market swings from buyers to sellers, or from sellers to buyers. Investors who trade ahead of these transitions can profit from the swings in the cycle if the movements are dramatic enough. When seller anxiety is receding and buyer anxiety is growing, for example, the market is likely go up as investors hurry to buy stocks before prices rise, a signal to swing traders to take long positions and try to profit from price appreciation.

> "Most of the time, the markets are not doing anything that merits our attention."[ 38] "Simplicity and speed are signs of the master trader."

Some day traders extol their heavy transaction volume as a virtue. But large volume may not mean large profits. Swing traders can earn substantial returns by making fewer – but bigger and better – trades. Successful swing traders know that this investment style works only when market conditions are right and a compelling "trigger" or "exit" event occurs. Most days, wise swing traders avoid initiating trades. They operate like surfers who ride only the biggest waves, not every wave. Swing trading hones intuition because traders must rely on right-brain thinking to anticipate changes in buyer and seller anxiety. Anticipation of a transition to buyer or seller anxiety is instinctual, not intellectual, since evidence of a pending change is usually incomplete.

### Swing Trading in Flat Markets

When the stock market is stuck in a range, making no big moves up or down, traders may turn to "rebound swing trading," which is reliably rewarding because stock prices usually will move for days in a single direction, up or down, after crossing a level of support or resistance.

> "Master traders are always ready to change their opinions and perspectives."

The price history of a stock will reveal its normal tendencies after touching resistance or support. For instance, if a stock usually rebounds for several days after falling to a support level of $20, a smart trader may execute a market order to buy it at $20 and to sell if the price drops to $19. Because the maximum loss from exiting this trade is $1 per share, the trader should anticipate a potential profit of several dollars, based on how high the stock price rebounds. Investors should make sure that their potential profit is several times greater than the maximum loss in any swing trade.

> "So if you find yourself relying on your logic and analysis in your trading, I encourage you to consider the possibility that you are selling yourself short."

Unforeseen shifts in market sentiment easily can kill the profit potential of swing trading, so correctly anticipating investors' mood is an invaluable right-brain skill. Traders can do a simple exercise to train their right brains to assess market sentiment. To decide how to trade a stock, a trader should make one of three choices within 15 seconds: Buy the stock if its price rises above the previous day's high, sell if the price drops beneath the previous day's low, or don't act. If a trader fails to choose within 15 seconds, the no-action option is the default choice. Limiting the time to choose forces traders to rely more on right-brain instinct than left-brain analysis.

### Technology and Brainpower

Information technology has transformed the investment business, enhancing both left-brain and right-brain thinking among traders. Advances in trading software, for example, include features such as a "backtesting" function that enables traders to learn easily how current investment ideas would have performed under past conditions. This test is an extension of left-brain thinking. While this practice may complement the right-brain process of conceiving ideas worthy of review, backtesting programs lack human sensitivity to the emotional anxiety of buyers and sellers as stocks prices approach support and resistance levels. Technology has other limitations that human intuition refuses to recognize. Programming a computer to mimic the human skill of visually detecting important price patterns is not feasible. In trading and in other endeavors, human intuition remains far too complex to reduce to software.

## About the Author

**Curtis Faith** is the author of *Way of the Turtle*, based on his successful experience as a member of a legendary Chicago securities trading group called the Turtles. In his early 20s, he earned more than $30 million as a member of this group.

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